COUNCILS AND THE HOUSING CRISIS

The potential impacts and knock-on effects
of the credit crunch on councils and their housing role

Local Government Association

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Foreword

The boom in house prices over the past ten years has fuelled an unprecedented demand for social housing, with 1.6 million households now on the waiting list in England, representing an estimated 4 million people, or 1 person in 13.

The unexpected severity of the global credit crunch and the real possibility of a housing crash has prompted serious concerns that demand for social housing will exceed all expectations and could reach 2 million households by 2010, or one in ten people.

Councils are already struggling to cope and are calling for a review of existing government policy to give local government greater freedom to invest in house-building.

This report briefly outlines the challenges posed by the credit crunch by examining the nature of previous recessions and the impact on the housing market. It also identifies the risks and issues that will be presented to local government over the coming months as mortgage lenders continue to tighten their lending criteria, house prices drop and what happens if repossessions start to gain pace.

The report also examines the effect on new build of affordable property, as developers recognise the slowdown in demand for new developments, which in turn, will restrict the number of new affordable homes being built. It also looks at the difficulty housing associations and other Registered Social Landlords could have when seeking out new lines

of credit or borrowing facilities as they, just like individual homeowners or potential homeowners, see increasing restrictions placed on the amount they can borrow.

When the credit crunch began last August, many policy-makers believed that the disruption to financial markets was likely to be short-lived and have only a small effect on the housing market and the wider economy.

Now it is becoming clear that the credit crunch is likely to last longer, hit economic growth more deeply and spread more widely than previously believed.

The housing market is already showing signs of being seriously affected. House prices have recorded their first year-on-year fall for 12 years and new mortgage approvals have fallen to their lowest level since records began in 1990. Persimmon, Britain's biggest house builder, has shelved the building of new homes until the mortgage market improves. And substantial house price falls are now being predicted, leading to large numbers of people facing the prospect of negative equity and repossessions.

Cash-strapped banks have been bailed out to the tune of £50 billion, prompting Mervyn King, the Governor of the Bank of England, to warn them to learn from their mistakes and not to return to the "hubris and excessive lending" seen in the run up to the credit squeeze. The days of 100 per cent lending and risk-taking may be over, but consumers have yet to see the £50 billion filter down to mean lower borrowing rates for potential homeowners.

Summary

The impacts of a housing crash are in short:

- lower consumer confidence
- precautionary saving
- curtailed ability to borrow
- finance for property development harder to source
- lenders face losses
- weaker economic environment
- higher unemployment
- slowdown in the economy
- increase in bankruptcies and individual voluntary agreements and mortgage repossessions
- increased demand on rental property
- lack of confidence in long-term investments
- negative equity
- potential reduction in private sector house building and land value

Potential impacts for local government :

- Debt – a number of individuals could end up in debt, and therefore fail to pay council tax. People in debt may also seek advice, as directed by the FSA

- Labour market – there could be an increase in those turning to benefits as they can't find work

- Housing – individuals found homeless could be in need of social housing

- Equity – many retired people will rely on the equity of the house as provision for care/care homes. If this decreases, this may place more demand on social care services. This may also impact take up of benefits, and state pension provision

- Housing stock – the number of homes built by the private sector may fall, thus affecting house building targets and putting pressure on social housing provision. There could also be a drop in land value, potentially allowing housing associations to acquire land more cheaply.

Question

This paper is designed to discuss some of the issues that could arise for local authorities should there be a housing crash.

Method

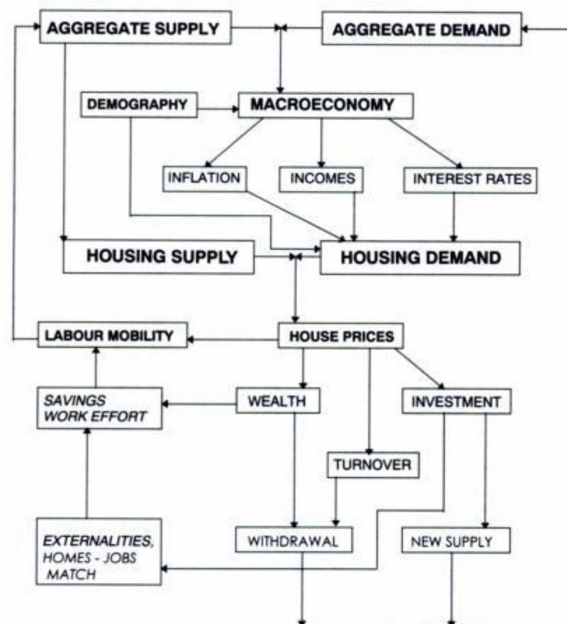
A number of sources were covered including academic papers, JRF papers, and advice web pages for home owners and buyers.

Introduction

The JRF[1] (2007) comment that "In the past, local authorities' assessments of housing markets rarely went beyond rather formulaic exercises calculating the 'backlog' of demand and future trends in the need for housing outside private provision. More sophisticated appraisals are now necessary"

The research question above has two complexities, firstly the complexity of the housing market and all those factors linked into the system. Secondly the affects of a housing crash are unlikely to be universal but vary across the county and vary dependent on geography (sub regional, district and neighbourhood levels).

A summary of the housing market system is found in Williams and Holman's (1997) book:



Before analysing the implications of a housing crash it is important to understand[2]:

- The housing market is multi-layered – different factors influence demand at sub-regional, district and neighbourhood levels.
- Patterns of investment vary increasingly from one area to the next, due to different arrangements for stock-transfer and arm's-length-management.
- 'Spill-over effects' from one tenure to another, e.g. affordability pressures in owner-occupation can have an impact on the demand for social or private rented housing.
- Housing needs and housing aspirations are different things and need to be recognised accordingly.

A housing market crash will affect different people in different ways, and will therefore have different implications for local government. The JRF in its paper[3] "Understanding and responding to housing market change" (May 2007) classifies households into 9 groups:

- Students – investment in purpose-build accommodation and renting.

- Recent graduates – quality of place factors, not housing, will be a concern for retaining recent graduates.

- New urbanists – not economic reasons, but wishing to be close to the "buzz" of the city.

- Long-distance movers – often retired, semi-retired or home workers, less concerned about the quality of the properties but more about transport links.

- International economic in-migrants – not well understood, but can be single men, often clubbing together to form households.

- Established minority ethnic communities – emerging generation produces high rates of household formation and therefore pressure on already densely populated areas.

- Family builders – priority is placed on relative affordability, and the quality of local schools is likely to be a strong influence. They will often move to small market towns or suburbs.

- Empty nesters - groups moving for the benefits of owning property to fund retirement or children through higher education etc.

- The asset- and income-poor – this group are most vulnerable to market fragility, have least opportunity to seek other options and are most likely to be pushed into more concentrated areas if affordability problems elsewhere bring new pressures on areas where prices have previously been low.

The current housing market context

According to the Royal Institute of Chartered Surveyors[4] accessibility and affordability are both worsening.

An accessibility index (calculated by looking at the up-front costs of purchasing a home as compared to combined take-home pay), developed by RICS has found that the cost of becoming a home purchaser in Great Britain has worsened by 351% since the most accessible point in 1996, after hitting a high of over 500% in 2005.

They comment that "a first-time buyer couple, both on lower quartile earnings (totalling £26,595 after taxes), will now have to save up to the equivalent of 104% of joint take-home pay, to build up the £27,729 needed for up front buying costs on a typical home including the deposit, fees and stamp duty. This equates to a substantial rise from the low point of 23% required in 1996." However, it is important to note that the current first time buyer cohort may have access to family wealth, which may not always be the case.

The RICS attribute the worsening in accessibility to rising costs of buying a home, stamp duty and slight reductions in loan-to-value ratios that lenders have been offering first time buyers.

The article also highlights problems with affordability (calculated by looking at mortgage interest payments compared to combined take-home pay). They state "a couple on lower quartile income now has to spend 40.3% (down slightly from 40.8% in Q3 2007) of their combined take-home pay to service their mortgage, 8% below the all time high of 47.8% in Q1 1990." Whilst there appears to be a slight improvement, attributable to stable interest rates in Q4 and rising earnings, the trend is still generally of worsening affordability. This is particularly the case in London and the South East. The RICS comment that in London, the South East and the South West a couple would have to save 100% of their combined take-home pay to be able to afford a property, and in London a first-time buyer household would be likely to spend 51% of their after-tax income on mortgage payments compared to 29% in the North East.

In addition to worsening affordability and accessibility, the RICS comment that repossession levels are also likely to rise estimating that "123 houses will be repossessed per day in 2008." [5]

The 1990s housing crash

A recent paper by the GLA[6] considers the differences between the current economic climate and that of the early 1990s and the 1970s. They comment that "Historically, sudden drops in house prices have only occurred in an environment of rapidly rising

unemployment and/or interest rates, as for example in the early 1990s. Current employment forecasts for London and the UK do not suggest rapidly rising unemployment, and an interest rate trigger is absent. A house price crash therefore seems less likely than in the early 1990s."

The following table from this GLA paper summarises the changing economic picture:

	Growth of House Prices	Unemployment	Interest Rates	Inflation	Expectations
Early 1970's crash	Between 1971-1973 there was an almost 40% rise in average house prices	Fairly low at around 2% prior to the crash.	Grew from 7 to 12% in the early 1970s	Inflation grew rapidly along with unemployment, creating a period of stagflation	
Early 1990's crash	Between 1990 and 1995 house prices fell by around 10% on average.	Unemployment grew from around 6% in the late 1980s to around 10-12% in the early 1990s with London fairing worse than the UK.	Around 17%	Between 7 and 8% in the early 1990s	
Situation now	Rapid growth over late 1990s and early 2000s. Particularly higher levels of growth in London.	Unemployment in UK is currently at its lowest level since 1975.	Around 5-6%. Long term interest rates likely to remain low	Expecting a year of slightly above target inflation at around 2.5-3% but still relatively low in comparison to previous periods.	RICS house price balance dropped to its lowest level since November 1992 - 49% more Chartered Surveyors reporting a fall than a rise in house prices.

The GLA comment that the policy impacts were as follows: "In response to the 1992 crash, housing market packages were introduced to capitalise on the housing market recession. A select group of housing associations were given 100 days to spend £557 million of government grants plus £400 million of private cash on 180,000 empty homes, which had already been built."

Statistics on mortgage and landlord possessions[7] indicate that properties taken into possession hit 75,540 in 1991 and remained high (68,540 in 1992 and 58, 540 in 1993), before dropping to 29,990 in 1999; totalling 489,320 in the 1990s.

Housing crash implications

Big picture

The FSA financial outlook for 2008[8] provides an overview of what could happen to both industry and individuals should there be a drop in residential and/or commercial property prices.

The FSA reports that housing assets constitute about 45% of personal wealth in the UK, which means a sharp fall in house prices could have a number of knock-on effects. For the individual, household spending could be vulnerable to changes in house prices. A fall may lead to a drop in consumer confidence, reduced spending and an increase in precautionary saving. If happening quickly, all three impacts could lead to increased unemployment and a slow down in the economy.

In the short-term there could also be an impact on individuals' ability to borrow against the value of their homes. Lenders would be likely to reduce the percentage of the value that they are prepared to lend in order to mitigate this risk. A combination of reduced spending, slower economic growth and a weaker labour market could increase the numbers of individuals facing financial hardship and falling into debt. This is particularly problematic if individuals cannot consolidate debts through further borrowing against their property. This could result in personal bankruptcies or individual voluntary arrangements (IVAs) and increased mortgage repossessions.

The affects above (pressure on house prices, tighter credit conditions, lower consumer confidence and high levels of personal debt) could lead to a decline in both demand and supply of mortgages, thus affecting the mortgage intermediary industry.

The FSA warn that a lack of confidence in long-term investments and pensions (following mis-selling cases of both personal pensions and mortgage endowments) at a time of rapidly rising house prices has caused some individuals to forego investment in a pension in favour of relying on the increase in equity in their homes for their long-term financial provision, therefore storing up a potential problem should equity drop.

In addition to impacts on individuals, a drop in property prices will have wider impacts. A fall in commercial property could mean that finance for property developments or securitisation deals become increasingly difficult to obtain. For financial firms with a large reliance on this type of lending there could be a significant impact on profits. As values in property decrease and the economic outlook deteriorates equity markets could come under pressure, impacting upon the life-insurance industry and other financial service sectors. A fall in investor confidence could also result in commercial property-backed investment funds being forced to sell properties to maintain liquidity. The FSA warn that further restrictions on withdrawals by consumers could lead to a further drop in confidence and slow down of the economy.

An article in Housing Market[9] (August 2007) comments that if house prices fall sharply then a rush by weak buy-to-let investors to cut losses could hasten the decline in UK house prices during 2008. It also makes the point that a credit crunch can suppress bonuses and

thus lead to a depression of London house prices and send a negative ripple through the whole UK housing market.

Individuals

Dorling and Cornford[10] looked at how house price falls in 1993 affected different groups of homebuyers by examining the distribution of negative equity between different categories of borrowers in Britain by the third quarter of 1993. The major findings are:

- negative equity was disproportionately held by borrowers with properties in the South East (although there are very significant micro-spatial variations).

- only in the northern regions of Britain were people with mortgage advances of more than 90% of purchase price unlikely to have negative equity.

- negative equity was disproportionately held by those who purchased their property between 1988 and 1991.

- negative equity is disproportionately held by those on lower incomes.

- negative equity is disproportionately held by younger borrowers. In every region it is borrowers who were under 25 at the time of purchase who held the largest proportions of negative equity in 1993.

- Negative equity is disproportionately held by those who purchased properties at the lower end of the market (in every region it was 1988-91 borrowers whose property was purchased for less than £40 000 who were most likely to have negative equity).

- Negative equity was disproportionately held by borrowers whose occupations at the time of purchase were in clerical or manual work. Some of the implications of these findings are discussed.

House building

A recent paper by the GLA[11] comments that if there is a drop in house prices, homes in the planning pipeline may slow down and this could affect whether housing targets (i.e. the GB target of 3 million new homes by 2020) are met. They expect in the short term that new starts levels in 2008 will be lower than 2007, although homes currently under construction will complete.

Developers' sales expectations have declined recently. "For virtually the whole of the past decade house price growth substantially exceeded growth in building costs. In contrast, if house price growth slows, it may only match the rate of increase in build costs over the next five years. The tightening in supply of new build homes will be exacerbated if input costs (including labour, plant and materials) begin to increase more rapidly than in the past (for example, if imported materials become more expensive on the back of a falling pound)." This could in turn affect land values.

The 1990s house crash led to both a decrease in private sector house building and land value. The number of permanent private enterprise completed dwellings fell from a peak in 1988 of 176, 018 to 116,634 in 1993 before increasing again[12]. The land price index (where 1985=100) fell from 216 in 1990 to 169 in 1993, before increasing again[13].

Local government

The JRF comment that there is a limit to how local government can influence the housing market. Formerly the council was "landlord, investor, allocater, manager, rent setter and in many cases developer".

- Debt – a number of individuals could end up in debt, and therefore fail to pay council tax. People in debt may also seek advice, as directed by the FSA.

- Labour market – there could be an increase in those turning to benefits as they can't find work.

- Housing – individuals found homeless could be in need of social housing.

- Equity – many retired people will rely on the equity of the house as provision for care/care homes. If this decreases, this may place more demand on social care services. This may also impact take up of benefits, and state pension provision.

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LGA Heads of Housing Survey

An LGA Heads of Housing Survey found that 80 per cent of councils reported an increase in demand for social housing in the last two years, with 66 per cent blaming the high level of house prices. Nearly half (47 per cent) said their current allocations policy is not coping with the increase.

Lack of housing stock was named as the biggest challenge.

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