centreforcities

The credit crunch and implications for the UK housing market

Catherine Glossop, May 2008

Slow down across the housing market

Growing macro-economic uncertainty and tensions in money markets are now being felt across the UK housing market. House prices fell by 1.5% in the first quarter of this year compared with the last quarter of 2007, according to the average of Nationwide and Halifax house price indices. This means house prices are now falling in real terms on an annual basis, with further falls expected over 2008. Increasing divergence between regions

It is difficult to talk about the 'housing market', with wide variations in both sales rates and prices between regions and cities. Although the North/South affordability gap has been closing, there remains considerable regional divergence in terms of house prices. Investors in London and the South East have accumulated more equity in their property and households in the North are at higher risk of repossession. As the market in the South continues to out perform the North, we may witness increasing divergence in housing market performance.

Housing is not becoming more affordable

The cool-down in the housing market will not necessarily improve affordability. Although falling prices could make home ownership more affordable, UK house prices have almost tripled over the last 10 years. House prices would need to fall substantially to become 'affordable' relative to average household earnings. The credit crunch is particularly hitting first time buyers, with lenders applying tighter criteria, demanding larger deposits or taking mortgage products off the market.

Existing homeowners will face considerably higher repayments as mortgages come up for renegotiation. The number of repossessions is up by 20% compared with the previous year and the Council of Mortgage Lenders predicts a further 50% rise for 2008.

Slow down in private rental supply

The up shot of this is that there will be an increased demand for renting, but the pressure is just as acute on buy to let landlords. With downward pressure on income yields, increased costs of borrowing and a decline in sales, the flow of rented stock coming onto the market is likely to slow down in the short term. The downturn will particularly hit small buy to let landlords, who have seen increased borrowing margins over the last year.

The Centre for Cities and the Smith Institute are currently looking at ways in which the private rented sector can better meet housing demand, against an uncertain economic backdrop and continuing affordability pressure. A monograph on the 'Future of the Private Rented Sector' will be published in June 08. For more information on the Centre's housing research, contact Catherine Glossop on 0207 803 4308.

The impact of buy to let on the housing cycle overall, however, will not necessarily be severe. Housing transactions have high costs, which deter strategies of rapid entry and exit, while selling in a falling market will jeopardise long term gains. The majority of larger landlords, who will have accumulated a more significant 'equity cushion', still expect to expand their portfolio and take advantage of low interest rates, but with greater emphasis on stock selection. This expansion of portfolios, however, is likely to also include overseas investment.

Good news for property type, bad news for housing management

There is likely to be reduced levels of investment in new build flats and an increase in empty units as the nature of demand changes, reflecting oversupply in some locations (such as in Nottingham, Leeds and Manchester city centres). In this respect the market adjustment is positive. Developers will need to refocus their attention on parts of the market where demand still exists and we should expect to see a shift in investment patterns towards a more diverse range of property types, including family sized housing.

While this may be good news for the future type of property coming onto the market, however, this may be bad news for housing management. As investors concentrate their efforts on maximising profit margins, they may look to reduce costs by managing portfolios themselves on a part-time basis. This will have adverse consequences for the provision of better quality rental accommodation. Investors will need to realise that in the long run, this will benefit neither the sector nor their profit margins.

House building targets under threat

The reduced turnover in new build sales has already resulted in lower building activity. Last year housing supply grew at a rate of only 172,000 units and completion rates are expected to drop considerably this year - falling far short of the Government's 240,000 new homes per year target. Developers' are facing rising building costs – not just in terms of construction, materials and labour, but also increasing infrastructure costs (such as through the proposed Community Infrastructure Levy) in addition to growing regulatory pressure (including 2016 zero carbon targets).

If house price growth slows further, it may only match the projected increase in costs. Investors will be less able to forward-fund large-scale housing developments and developers may choose to land-bank, reducing the amount of brownfield sites coming forward. This could also result in the postponement of large physical regeneration schemes, where the release of land for development is typically staggered to fund ensuing development stages. Projects could be left incomplete, with unsightly gap sights further knocking economic confidence.

Reduced affordable housing provision

Affordable housing provision is closely tied to the private market, with approximately 70% of affordable housing completions now delivered through Section 106. We may see increased renegotiations of both planning permission and Section 106 agreements on the grounds that they are now commercially unviable. RSLs' building programmes could be squeezed by tighter public spending, in addition to the reduction in private credit availability. The number of banks actively lending to Housing Associations (HAs) has declined, making it difficult to syndicate deals. The impact on HAs however will not necessarily be severe. HAs tend to take a longer term view relative to private developers who are more likely to sell immediately on completion. HAs hold onto development for the long term and may be able to take advantage of these lower costs.

What will happen in the future?

Amidst the gloom, it is important to recognise that what happens next is unlikely to be a simple repeat of what happened during the 1990s downturn in the housing market. Overall economic prospects are better - although unemployment has started to rise, underlying economic fundamentals remain relatively strong and employment is still running at record levels. In order for house prices to significantly drop, there would need to be a surge of property coming onto the market. Market activity is currently low and falling, with the number of transactions predicted to drop by a further 25% this year. Most importantly, opportunities from new and unmet housing demand, supported by demographic projections of increasing household formation and high rates of in-migration, point to a continuing demand-supply imbalance. As output continues to fall notwithstanding rising demand – the downward pressure on house prices is more likely to reflect cyclical volatility than a long term trend.

The greatest uncertainty, however, relates to the wider economy. The impact on the housing market will depend on how protracted the economic downturn is and how stable employment rates remain. An important lesson from 1989-1993 was that a housing market bust can both exacerbate and feed off wider economic decline. Recent economic growth has been strongly supported by both unsecured credit and housing wealth effects. Unfortunately, the converse is also true in recession. The prospect of further interest rate cuts may help to stabilise the market, but the likelihood of rate reductions are constrained by rising inflation against a backdrop of rising global energy and food prices, and a falling pound. The impact of any base rate cut will depend on the extent to which mortgage lenders pass this reduction onto consumers – so far, many lenders have failed to cut their fixed rate deals. Compared to the 1990s, mortgagors getting into difficulty have less of a safety net because of changes to income support for mortgage interest and under-provision of mortgage payment protection insurance.

Recommendations for the public and private sector

The market downturn and macro economic uncertainty reflect the interdependencies between housing markets and wider economic trends. This is no less true at the local level, than it is nationally or globally. Cities will need to think through the relationship between their economies and local housing systems to ensure that the delivery of new supply reinforces competitiveness. Different cities will need to respond in different ways, depending on local housing market conditions and underlying economic fundamentals. The onus, however, will be on all cities to make better use of their strategic planning tools to shape local markets and deliver a housing growth plan that will better align supply with demand.

Tensions in the credit market will result in a continued increase in the demand for renting. Cities will need to shift their attention to expanding and improving the private rented sector, which provides a fundamental bridge for those unable to access social housing and unable (or unwilling) to enter home ownership. Increasing the supply of flexible housing is a necessary condition for sustained economic growth - supporting labour mobility, bringing greater market stability and helping to meet the affordable housing needs of different groups.

The Homes and Communities Agency will need to give urgent thought to the kind of additional support cities need. Many already face substantial barriers to housing delivery. Local Authorities with skills and capacity issues may need particular support if they are to attract the right type of investment - and work better with what is already there - in a fragile market. Enhanced partnership working with the private sector will be crucial. Attracting private investment in affordable housing, for example, can be a viable way of helping developers to spread financial risk. In an environment where landowners are more reluctant to sell, the Homes and Communities Agency will also need to look at more forthcoming ways in which public land can be brought forward.

From the perspective of the private sector, the market adjustment should force investors to make more careful stock selection. Housing supply will need to become more diverse and developers will need to offer higher quality products, in terms of both design and quality of place, if sales rates are to be maintained. Investors should take advantage of falling property prices, but if the private rental market is to remain strong, the quality of management cannot be compromised and buy to let landlords will need to take a longer-term investment approach.

With macro economic conditions weakening the capacity of small landlords, Whitehall's attention will need to shift towards measures that will attract institutional investment, if market conditions are to stabilise and supply targets are to be met. Institutional investors operate a different business model from the small buy to let landlord, with longer-term strategies and an emphasis on stable long term income returns, rather than capital growth. They are better placed to help address the management and quality issues facing the private rented sector, and will be less deterred by macro economic uncertainty. There are several policy levers available, including:

- Fiscal incentives - such as modifications to stamp duty and VAT. Institutional investors are penalised in terms of both higher levels of stamp duty than individual investors, due to larger lot sizes, and their inability to reclaim VAT on repairs; and

- Planning incentives – such as the creation of a new planning use class for residential property or reduced Section 106 requirements for property remaining in the rental market for a sustained period of time.

May 2008

Enterprise House
59 - 65 Upper Ground
London SE1 9PQ

t **020 7803 4300**
www.centreforcities.org

© Centre for Cities 2008

Centre for Cities is a registered charity (No 1119841) and a company limited by guarantee registered in England (No 6215397)