Inquiry into the Economics of the UK Housing Market

Written Evidence from the New Economics Foundation

Thursday 17th December 2015

The New Economics Foundation (NEF) is a UK think tank promoting social, economic and environmental justice. Our aim is to transform the economy so that it works for people and the planet. NEF is fully independent of any political party.

Summary

Housing policy in the UK has been characterised by interventions to boost mortgage finance in the hope of enabling those on lower incomes access home ownership and stimulate the private sector to build more homes. These interventions have worsened the situation by boosting house prices and have made little difference to the rate of home building as yet.

For over two decades there has been a dramatic decoupling of house prices from average earnings. Average house prices are now almost 9 times incomes and as much as 20 times in more desirable areas such as the South East. Effective interventions into the dysfunctional market need to respond to the demand-led drivers of increasing house prices. These are:

- Financial deregulation and innovation have lifted the constraints on purchasing power from mortgage debt, allowing price rises to race ahead of median wage increases
- Households with moderate incomes have to compete with speculative buyers, including overseas investors and buy-to-let landlords, who bid up prices
- The promise of capital gains from home ownership in the face of stagnating wages, weak pensions and welfare provision has reinforced demand for ownership amongst the general population – to the extent that ordinary households continue to borrow many times their annual earnings in order to get a foot on the housing ladder
- Demand has been boosted by government subsidies like Help to Buy (see section 1.a, which further inflate prices by boosting debt-based purchasing power)

This has created growing economic inequality, distorted the efficient allocation of capital and threatens financial instability. The overall effect of state-led interventions so far has been to shift the debt burden away from banks, who have been encouraged to lend more cautiously, whilst the state itself takes on more financial liability in the form of home ownership subsidies and equity.

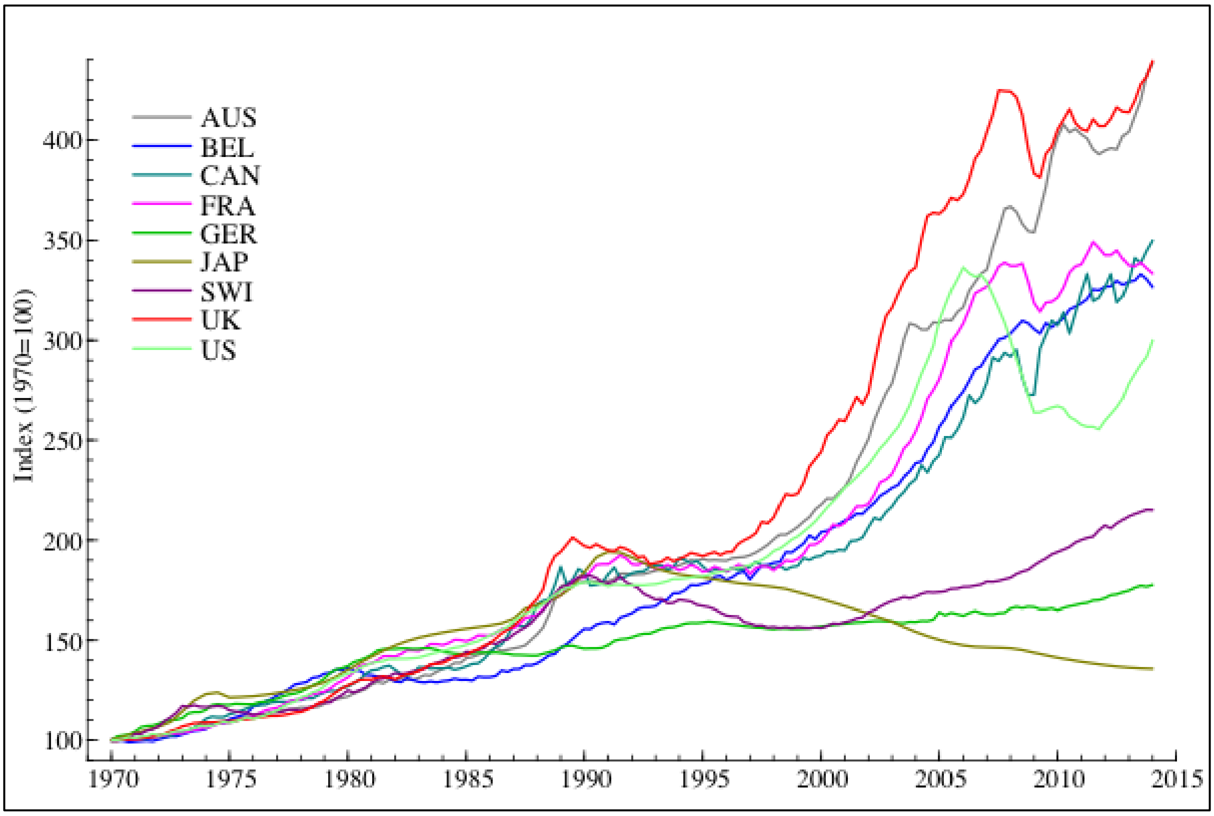
Nevertheless, the threat of mortgage default still has implications for financial stability, since real-estate assets are the largest component in the balance sheet of banks and levels of household debt to income remain very high. The solution to the current problem is for government to target the causes of the housing crisis, not subsidise prospective buyers to cope with its symptoms, which merely exacerbates the problem.

economics as if people and the planet mattered

1. Private Ownership: What measures can be taken to increase the supply of reasonably priced housing in the UK?

1.1 The UK has experienced some of the highest increases in house prices of any advanced economy over the past two decades (figure 1). Given the diversity in changes to house prices across countries, it is clear that any claims about the causes of house price increases being 'global' or 'secular' (for example historically low interest rates) need to be challenged. Rather we propose there are specific dynamics at work in the UK (and some other advanced economies) that have led to the current housing crisis.

Figure 1: House price index for nine advanced economies since 1970 (1970=100)



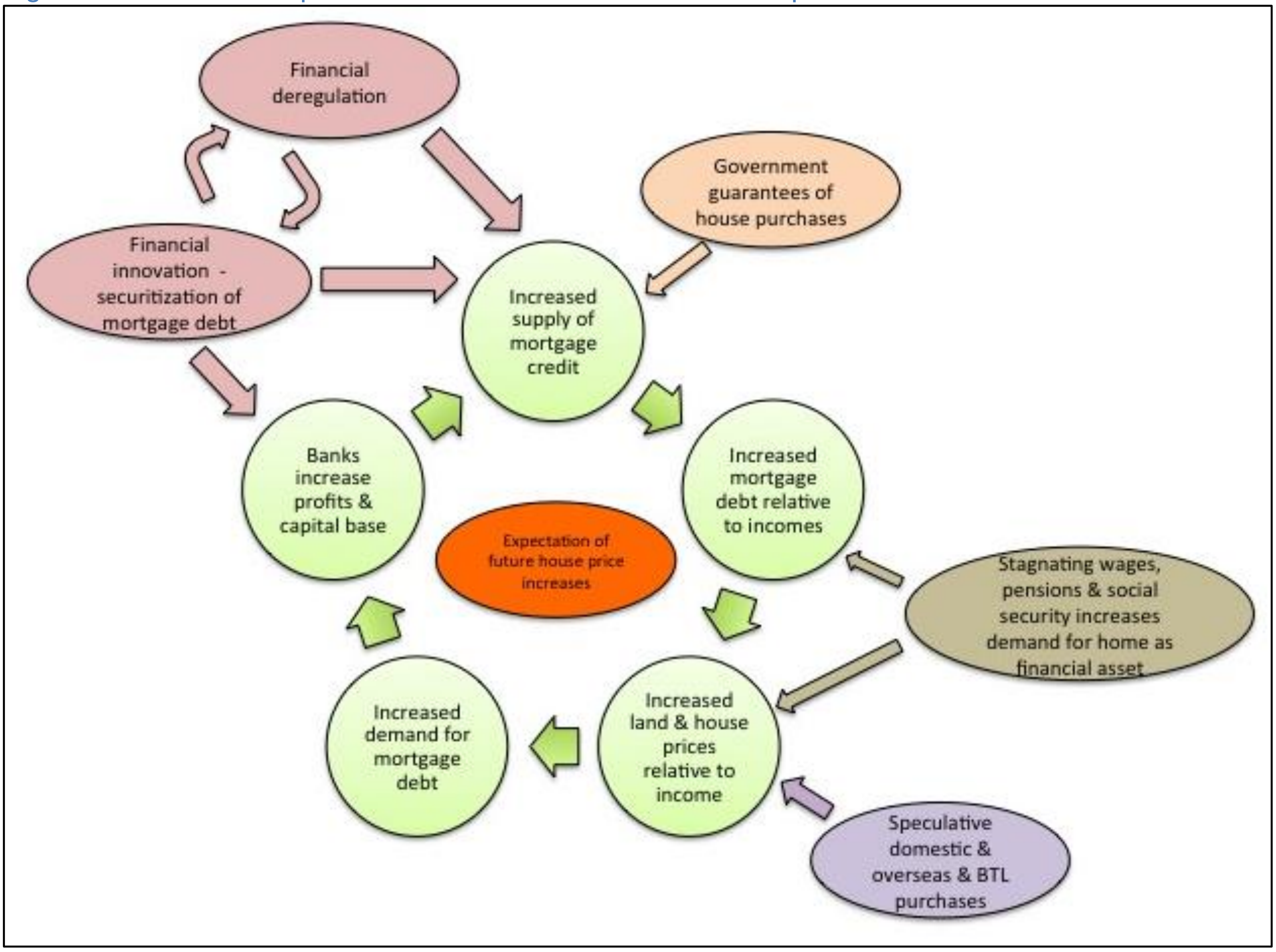
Source: Bank of International Settlements, Residential Property Price statistics, http://www.bis.org/statistics/pp.htm

1.2 The debate on solving the affordability problem in the UK has been focussed on supply side reforms. Whilst we agree there are supply side issues, there is an urgent need to tackle the demand side drivers of house price inflation which are currently receiving much less policy attention. These are:

- Financial deregulation and innovation lifting the constraints on purchasing power
- Increased willingness of households to take on mortgage debt at levels many times higher than in the past, as other sources of financial security have declined
- The promise of capital gains enticing new buyers into the market, in particular in the south-east of the UK, and the ripple effect of growing inequality

These demand side dynamics interact and reinforce each in a 'doom loop' that leads to ever higher but ultimately unsustainable house prices, as illustrated in figure 2. We now explore each of these dynamics in more depth.

Figure 2: Feedback loop between financial sector and house prices



<u>Financial deregulation and innovation have lifted the constraints on purchasing power in the UK housing market, exacerbating the affordability crisis and increasing the risk of economic crises.</u>

1.3 The funding available to back people's desire for home ownership is not limited by the amount of money already in circulation. A significant (and still increasing) proportion of the money used to buy houses is created through bank lending.[1] This is particularly the case for buy-to-let landlords and first time buyers. Given the current house price to income ratio in the UK of 9:1, purchasing power in the housing market is to a large extent determined by households' willingness and ability to access mortgage credit.

1.4 Since the mid-1990s, UK banks have significantly increased their lending to domestic and commercial real estate relative to total lending, incomes and GDP growth (see figure 6 below). The spur for this increase in mortgage lending relative to incomes has been financial deregulation, liberalisation of the mortgage market and financial innovation, including the increasing use of securitization to sell on mortgage debt to non-bank investors whilst also accessing international wholesale markets for additional funding.

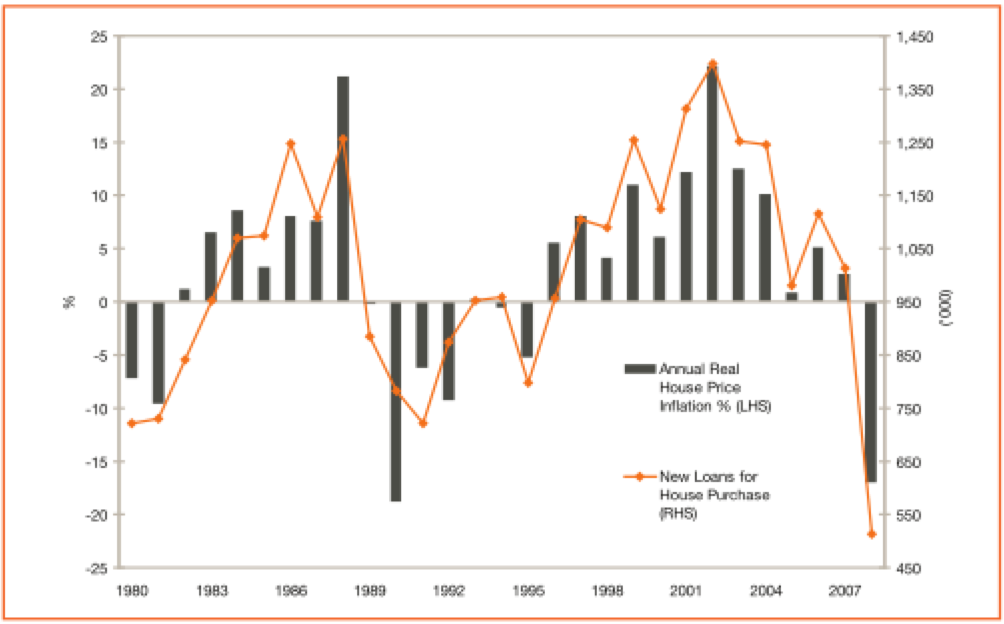
1.5 The feedback loop between the banking sector and house prices lies at the heart of any discussion of the economics of the UK housing market. The central loop (in green in Figure 2) is simple – if banks expand their supply of mortgage loans at a rate beyond general incomes and the creation of new homes, this will inevitably lead to increases in

[1] Banks create 97% of the money supply via their lending activity - see Mcleay, M., Radia, A. and Thomas, R. (2014), 'Money creation in the modern economy', Bank of England Quarterly Bulletin, Vol. 54, No. 1.

house prices. As house prices rise, households are forced to take our larger mortgage loans to get on the housing ladder, boosting banks' profits and capital. This enables them to make even more loans and further bids up prices relative to incomes. The process continues until there is an economic shock and incomes can no longer keep up with repayments, leading eventually to mortgage defaults, house price falls, bank lending contracting, recession and, potentially, a financial crisis. This relationship therefore matters not only for affordability but also for financial stability.

1.6 Whilst there are of course a number of causes of house price growth, it is clear that in the UK mortgage credit is a major contributor. Figure 3 shows the close correlation between the rate of new loans for house purchase and the rate of house price growth. An IMF study of 36 advanced and emerging economies (including the UK) found that a 10 percentage point growth in mortgage credit as a percentage of GDP was associated with a 16 percentage points higher growth of real house prices.[2]

Figure 3: House price inflation and mortgage lending[3]



Source: HPI data from Nationwide; lending data from CML

1.7 It is possible that UK policy makers have neglected the financial sector driver of house price inflation because of a widespread misunderstanding of the nature of the monetary system and the role of banking lending in determining purchasing power, particularly in the housing market. A 2014 survey of MPs found that 71% of MPs thought that only the government was able to create money, for example. Only 1 in 10 MPs accurately understood that banks create new money every time they make a loan, or that money is destroyed whenever individuals or businesses repay loans.[4]

We consider what might be done to address this problem under question 1.c on the Mortgage Market Review (MMR).

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[2] International Monetary Fund [IMF] (2011) Global Financial Stability Report: Durable Financial Stability, Getting There from Here Washington DC: IMF
[3] Dolphin, T. and Griffith, M. (2011), Forever blowing bubbles? Housing's role in the UK economy. IPPR
[4] Positive Money Dods Monitoring Poll of MPs (2014) http://positivemoney.org/wp-content/uploads/2014/08/Positive-Money-Dods-Monitoring-Poll-of-MPs.pdf

The willingness of ordinary households to take on ever larger mortgage debt has increased for a number of reasons.

1.8 Successive governments have reduced the value of state pensions, and encouraged citizens to assume responsibility for their own costs of care in old age. In this context, it is inevitable that people seek their own asset 'cushions' – their own 'insurance' against the risk of unemployment, ill-health or an insufficient pension. What's more the experience of rent hikes and insecurity in the private rented sector (PRS), and a depleted and oversubscribed social rented sector means that for families in particular, home ownership is the only tenure option that offers sufficient stability.[5] These factors, combined with widespread expectation that house prices will continue to rise, has made home ownership a critical financial ambition for many.

1.9 Government schemes to boost purchasing power among aspiring home owners – for example via the various Help-to-Buy equity schemes – has further put upward pressure on prices. Put simply, if everybody is standing on tiptoes, nobody gets a better view. We cover this in more detail in question 1.a.

Promise of capital gains enticing new buyers into the market and the ripple effect of growing inequality

1.10 As shown in figure 4, economic inequality has risen rapidly in the UK over the past three decades, tracking the inflation of house prices. The falling overall wage share and redistribution of incomes away from lower- to high- income households, has meant that in the UK economy, more money is flowing to those with lower marginal propensity to consume (the owners of assets) and less to people with low incomes who have a higher MPC (whose spending on basic needs like food and energy bills takes up a larger chunk of income). Therefore the cycle of house prices inflation and inequality can lead to a decrease in the overall consumption rate of a country.[6]

1.11 One of the feedback loops in this trend[7] is increasing socio-economic sorting into neighbourhoods, or 'ghettoisation', and an increased polarisation of house prices between areas. [8] More attractive neighbourhoods take on the property of luxury goods as people are willing to pay excessively high prices to access them. Inequality levels are in turn exacerbated by the capital appreciation of home owners in these increasingly affluent areas.

1.12 The promise of capital gains has enticed new buyers into these areas – most noticeably buy-to-let landlords and overseas investors, the latter usually able to buy outright and gain from speculation. Estate agency Knight Frank estimated that overseas buyers spent £2.2 billion on new-build central London property in 2012 accounting for 73% of all transactions.**[9]** We discuss this driver of house price inflation in more detail in questions 1.b and 1.c.

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5 YouGov polling for Shelter in 2011 found that nearly half of families with children in rented accommodation worry about unaffordable rent increases, and more than a third worry about their contract being ended before they are ready to move. Shelter (2012). A better deal Towards more stable private renting http://england.shelter.org.uk/__data/assets/pdf_file/0009/587178/A_better_deal_report.pdf

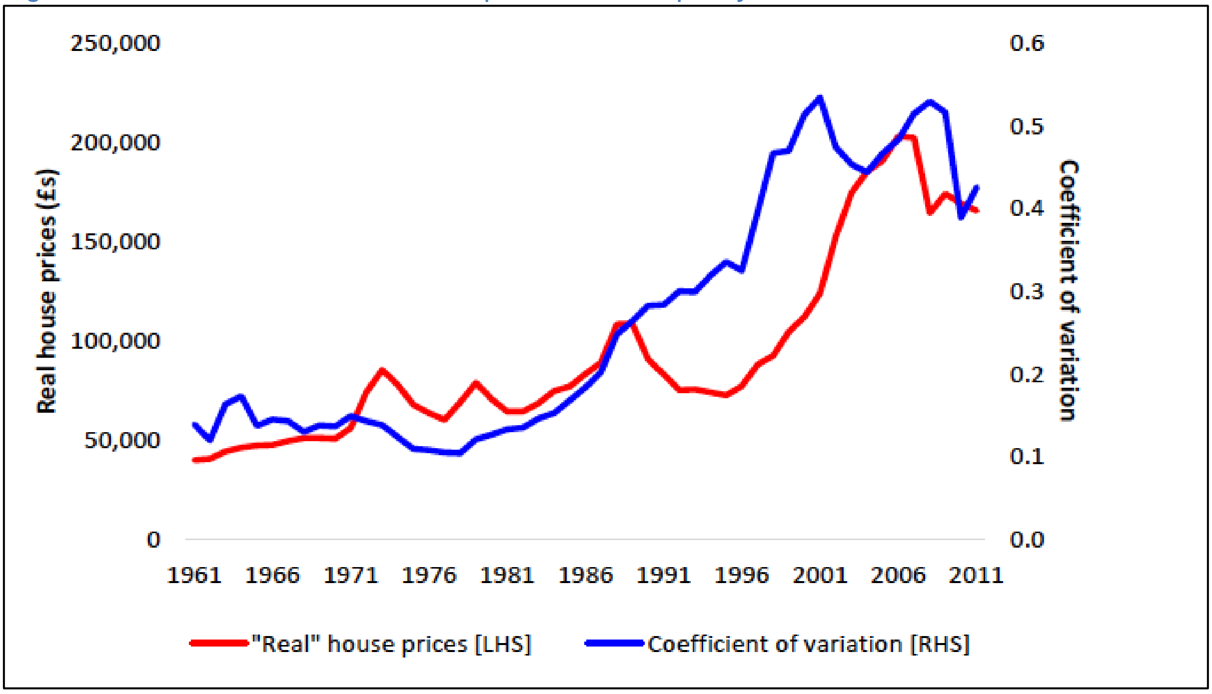
6 Kumhof, M. and Ranciere, R. (2010) Inequality, Leverage and Crises. IMF Working Paper WP/10/268. Retrieved fromhttps://www.imf.org/external/pubs/ft/wp/2010/wp10268.pdf

7 NEF (2014). Inequality and financialisation: a dangerous mix. Available online at http://www.neweconomics.org/publications/entry/inequality-and-financialisation

8 Lupton, R., & Power, A. (2004). 'What we know about neighbourhood change: a literature review.' CASE Report, 27. Centre for the Analysis of Social Exclusion, London School of Economics and Political Science, London, UK. Increasing income polarisation has resulted in increasing socio-economic sorting into neighbourhoods.

9 Knight Frank (2013) International investors spent £2.2 billion on central London new-build property in 2012. http://www.knightfrank.co.uk/news/international-investors-spent-%C2%A32.2-billion-on-central-london-new-build-property-in-2012-01526.aspx

Figure 4: Correlation between house prices and inequality[10]



Source: Nationwide average house price deflated using HMRC Treasury GDP deflators. Inequality: Institute of Fiscal Studies. (2013). Living Standards, Poverty and Inequality in the UK.

1.13 Finally, the UK domestic construction sector further fuels, rather than mitigates, rising house prices. It is dominated by a small number of very large private developers driven by short-term profits over and above the provision of affordable housing according to need. These companies utilise the well-known 'residual land value' model which means land value will always be derived from current house prices. This process is why we see land value prices rise far faster than house prices.

1.14 Taking these factors into account, we are unlikely to see any stabilisation of prices and therefore any increase in effective supply whilst demand remains at such inflated levels. Any new supply, unless it is on a vast scale, is likely to disappear into the 'black hole' of demand, without making a serious dent in the backlog of housing *need*.

1.15 A policy landscape to address this would need to include the following:

- Limiting property speculation by making clear that the government is committed to stopping house prices from rising further – through fiscal (e.g. capital gains taxes) and monetary/macroprudential measures
- Addressing the structural problems with the banking system that exacerbate house price inflation
- Improving conditions and security of tenure in the PRS
- Investment in jobs and infrastructure outside of London and other places of high demand, to rebalance the economy and spatial demand
- Ensuring secure and attractive pensions and alternative saving/investment options so that people are not so dependent on housing wealth to pay for retirement/old age care
- Increase non-market housing stock both by increasing social housing provision and supporting the expansion of alternative models of ownership

[10] NEF (2014). Inequality and House prices in the UK. Working Paper, p.19, available online at http://www.neweconomics.org/blog/entry/working-paper-is-inequality-exacerbating-our-housing-crisis

We provide detail to these recommendations under the specific questions outlined.

a) Government schemes: How effective have Government schemes (such as Help to Buy, shared ownership and the right to acquire) been in improving the affordability of housing? Have these schemes exacerbated any lack of low cost housing? What will be the impact of the cessation of these schemes?

1.16 We have focussed our response on the Government's Help to Buy Scheme. This has not been effective in improving the availability of affordable housing. In fact is has further increased house prices, by as much as £8250 for the average house.[11]

1.17 The Government has responded by altering the scheme, as announced in the Autumn Statement, by raising the limit on who can participate. Now households with incomes of less than £80,000 outside, and £90,000 inside London are eligible, as they are largely the only households who can afford entry level house prices even when sharing ownership. These are not the low to middle income prospective buyers the Government initially set out to help when it launched the scheme.

1.18 It is irresponsible to encourage households to take on mortgage debt many times their annual earnings. The increased debt burden of younger groups has less pay off in terms of long term financial security or wealth accumulation,[12] and poses risks to financial and economic stability.

1.19 A large proportion of mortgage holders face higher costs today than in the 1990s when interest rates were far higher. A 2012 study for the Resolution Foundation found that one-in-five mortgagors – or 2.4 million households –spend more than one-quarter of their gross income on repayments, up from around one-in-ten in the late 1990s when the base rate was 7 per cent.[13]

1.20 Given that four-fifths of mortgages are currently subject to variable interest rates, a very significant number of households could be in difficulty if interest rates were to move from their historically low levels. The Bank of England has held mortgage rates at 0.5% for six years now, a record low, with unintended consequences for other aspects of the economy. It is likely that one of the main reasons for not raising rates is fears about the ability of vulnerable households to survive any kind of increase.

1.21 The threat of mortgage default has important implications for financial stability, since assets whose value is tied to residential real estate are a very large component in the portfolio of financial institutions. Numerous studies have found that rising asset-market credit and asset prices are strongly correlated to financial crises and the recessions following asset market busts last longer than other types of financial crisis.[14]

1.22 Although it is true that UK banks now hold much more capital in relation to their assets than in the run up to the crisis, this is just one measure of financial resilience and not necessarily the most useful. Research by NEF has shown that the UK has the least resilient financial sector in the G7 from a systemic perspective because it has 1) a larger

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11 Shelter. (2015) Research: How much help is Help to Buy? https://england.shelter.org.uk/professional_resources/policy_and_research/policy_library/policy_library_folder/research_how_much_help_is_help_to_buy

12 Rostom, M. (2015) A lifecycle story of housing in blighty. Bank Underground. http://bankunderground.co.uk/2015/09/18/a-lifecycle-story-of-housing-debt-in-blighty/

13 Resolution Foundation (2012). Whittaker, M. (2012). On borrowed time? Dealing with household debt in an era of stagnant incomes

14 Bezemer, D.J. and Zhang, L. (2014), 'From Boom to Bust in the Credit Cycle: The Role of Mortgage Credit', Research Institute SOM Working Paper series, Groningen: University of Groningen, Faculty of Economics and Business.; Mian, A. and Sufi, A. (2008), 'The consequences of mortgage credit expansion: Evidence from the 2007 mortgage default crisis', NBER Working Paper Series, Vol. 13936, No. 13936.; Jordà, Ò., Schularick, M. and Taylor, A.M. (2014), 'The great mortgaging: housing finance, crises, and business cycles', NBER Working Paper Series, No. 2050.

financial system relative to GDP 2) a more interconnected financial system, as measured by intra-financial and international lending assets; 3) the most complex financial system as measured by very high levels of securitized assets, a high proportion of which are mortgage backed securities (see figure 5) ; 4) a higher proportion of mortgage assets as proportion of total assets; and 5) a higher level of household debt to income than other countries.[15] All of these factors mean that the UK is highly vulnerable to economic, financial and house price shocks at a systemic level, even if individual banks are better capitalised.

1.23 The Office of Budget Responsibility have reported that lending to households continues to pick up 'mainly as rising house prices lead to more secured mortgage lending, which makes up the majority of household debt.'[16] Given UK household debt to GDP is already one of the highest in the world, new government proposals to guarantee mortgage purchases would appear to undermine the UK's financial resilience.[17] Mark Carney recently told the Treasury Select Committee that rising household debt was a potential cause for concern[18] – and the IMF has also sounded the alarm on this issue in its recent review of the UK economy.[19]

1.24 What's more, the increasingly complex nature of the Government schemes mean many of the households involved are not fully aware of the debt burden they have taken on. A YouGov poll in 2014 found that only 3 in 10 first time buyers actually understood how Help to Buy worked.[20]

1.25 These funds for homeownership subsidies are being introduced while other subsidies for people struggling to access housing on lower incomes are being cut. Government efforts should be redirected into stabilising the PRS and increasing social and other forms of non-market based housing to ease demand pressures that are pushing up house prices.

b) Taxation: are there tax measures that would improve housing supply and affordability?

1.26 Buy-to-let mortgage lending had increased by more than 40% since the 2008 banking crisis, while owner-occupied lending had increased by 2% over the same period. The Bank of England has warned that this demand, and the upward pressure it puts on prices, poses serious risks for overall financial stability.[21]

1.27 The growth of buy-to-let borrowing is not surprising given the returns on offer. One analysis showed that buy-to-let investors could have seen a compound annual return of 16.2% since 1996.[22] This profitability is based not only on capital gains, but historically low interest rates, a captive market of households that cannot get into social housing or onto the housing ladder, and a highly advantageous regulatory and fiscal framework.

1.28 The unearned profits made on the ownership of property need to be more effectively taxed to make land a less attractive speculative investment. Some steps have been taken by the last and current government to address this issue, in particular for second homes,

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[15] NEF (2015). Financial System Resilience Index. Available online at: http://www.neweconomics.org/publications/entry/financial-system-resilience-index
16 OBR (2015) http://cdn.budgetresponsibility.independent.gov.uk/July-2015-EFO-234224.pdf p38
17 Mckinsey. Debt and (not much) deleveraging. 2015. Available online at:: http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging
18 Bank of England (2015) http://www.bankofengland.co.uk/publications/Documents/other/treasurycommittee/other/carneytsc.pdf
[19] This is Money (2015) http://www.thisismoney.co.uk/money/news/article-3356117/IMF-s-Christine-Lagarde-warns-negative-impact-referendum-uncertainty-strong-UK-economy.html
20 Independent (2014) http://www.independent.co.uk/property/first-time-buyers-dont-understand-help-to-buy-9577743.html
21 Bank of England (2015) http://www.bankofengland.co.uk/publications/Pages/news/2015/022.aspx
[22] Wriglesworth (2015) Buy-to-let reaches 18 years and comes of age. http://www.wriglesworth.com/news/25-wriglesworth-news/314-buy-to-let-reaches-18-years-and-comes-of-age?Itemid=107

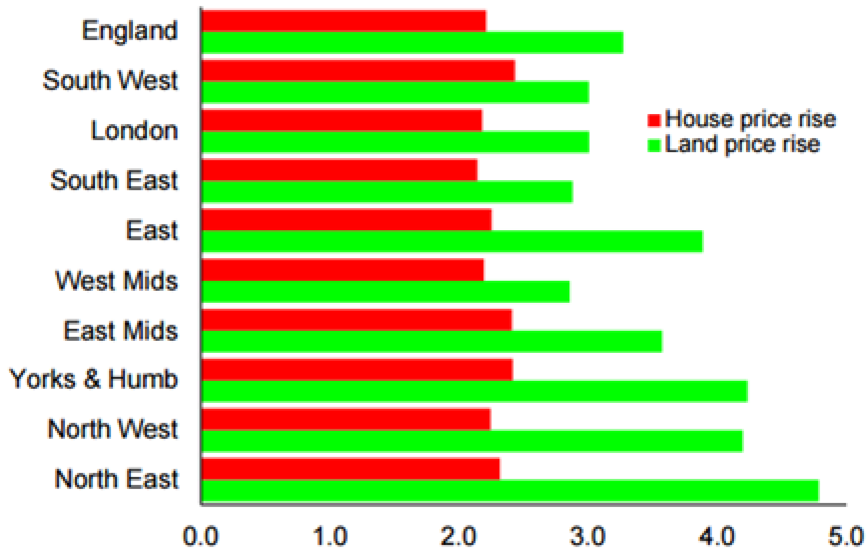
but much more could and should be done. Since government investment, via tax-payer money, in the south east is one of the main sources of such windfall gains there is a moral as well economic duty upon the state to address this issue and prevent further increases in inequality.

1.29 Stamp duty creates a lumpy pricing distribution as home-owners are able to adjust prices up or down depending on where the tax kicks in. Although the recent change has reduced stamp duty payable on the majority of house purchases, any downward move in stamp duty merely makes space for prices to rise further, meaning that the overall impact of affordability is likely to be non-existent. With the promise of rental returns in the PRS is so strong that the tax is unlikely to deter new buy-to-let uptakes.

1.30 We therefore suggest that a *removal* rather than reduction of mortgage interest relief is required, as well as increasing council tax on empty and second homes. Council tax bands must also be updated – they have not been reviewed since 1991.

1.31 Figure 5 shows the growth of land prices ahead of property. The long term view of a reappraisal of council tax banding should be to stabilise house prices through capturing the value of land.

Figure 5: regional house and land prices



Source: ONS House Price Index, March 2014: Annual Tables 20 to 39, Table 25 Housing market: mix-adjusted house prices, by new/other dwellings, type of buyer and region, United Kingdom, from 1993; DCLG, Live tables, Table 563: average valuations of residential building land with outline planning permission (final version) (discontinued)

c) Mortgages: Has the introduction of the Mortgage Market Review (MMR) changes in April 2014 restricted lending in particular to first time buyers? Should further changes be made to the rules?

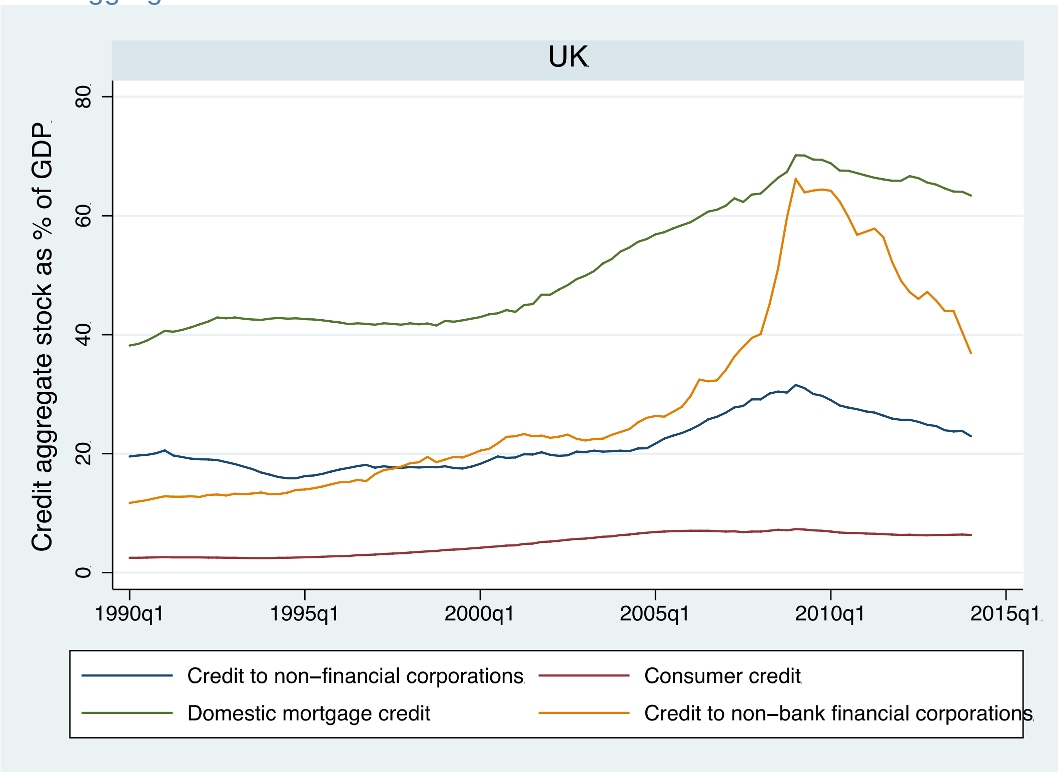
1.32 The control of mortgage credit is the main mechanism that the state can use to intervene in the housing market. We welcome many aspects of the MMR as more effectively constraining risky lending but concerned that these effects will be cancelled out by the contradictory Government schemes – not least Help to Buy - that are pushing up house prices.

1.33 The overall effect of these state-led mechanisms is to shift the debt burden away from banks, who have been encouraged to lend more cautiously, whilst the state itself takes on more financial liability in the form of home equity loans. The alternative option, that is a fall in subsidies for home ownership that might have led to a fall in house prices, does not seem to have been considered.

1.34 As remarked on by the Council for Mortgage Lenders (CML) "whatever the effects of the MMR, they seem to have been relatively modest" - since the introduction of the new rules, gross advances in mortgage lending have increased by 9 per cent each year.[23]

1.35 Figure 6 shows that UK domestic mortgage lending (green line) has expanded from 40% of GDP in 1990 to over 60% now, while lending to non-financial firms has stayed between 20% and 30% of GDP. The UK also saw a huge rise in lending to other non-bank financial corporations (yellow line) in the lead up to the financial crisis but this has contracted considerably since the crisis.

Figure 6: Disaggregated nominal credit stocks as % of GDP in the UK



Sources: National central bank data, NEF calculations

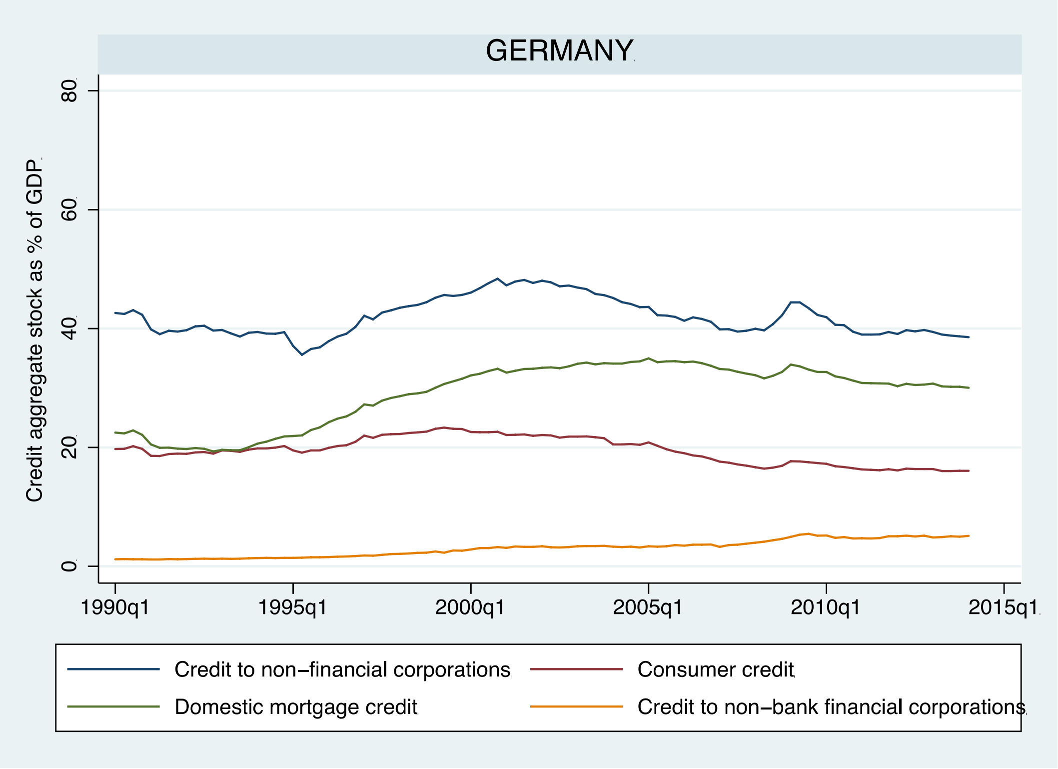
1.36 Although the general pattern in advanced economies in recent decades has been a shift towards mortgage lending, there are exceptions to the rule. Figure 7 shows the equivalent breakdown of credit stocks for Germany where bank lending to non-financial businesses is significantly higher than mortgage lending at 40% of GDP. It is worth considering the reasons for this divergence to illustrate the challenge facing the UK housing market.

1.37 Little attention has been paid by financial regulators and policy makers (including in the MMR) as to the structural causes of this pattern of increased mortgage lending. Deregulation and liberalisation of the banking sector in in the UK in the 1980s and 1990s led to a wave of mergers and acquisitions and the eventual domination of the sector by a small number of very large shareholder owned banks. These banks have converged on a business model with a strong preference for lending against assets – in particular property or land - which they can claim in case of default. In contrast, in Germany two thirds of bank deposits are controlled by either cooperative or public savings banks - 'stakeholder banks' that focus on business lending. Lending activities are de-risked

[23] Mortgage Strategy (2014) Cover story – MMR: One year, many changes
https://www.mortgagestrategy.co.uk/cover-story-mmr-one-year-many-changes/

through establishing strong relationships with businesses, rather than asset-based collateral, as in the UK.[24]

Figure 7: Disaggregated nominal credit stocks as % of GDP in Germany



Sources: National central bank data, NEF calculations

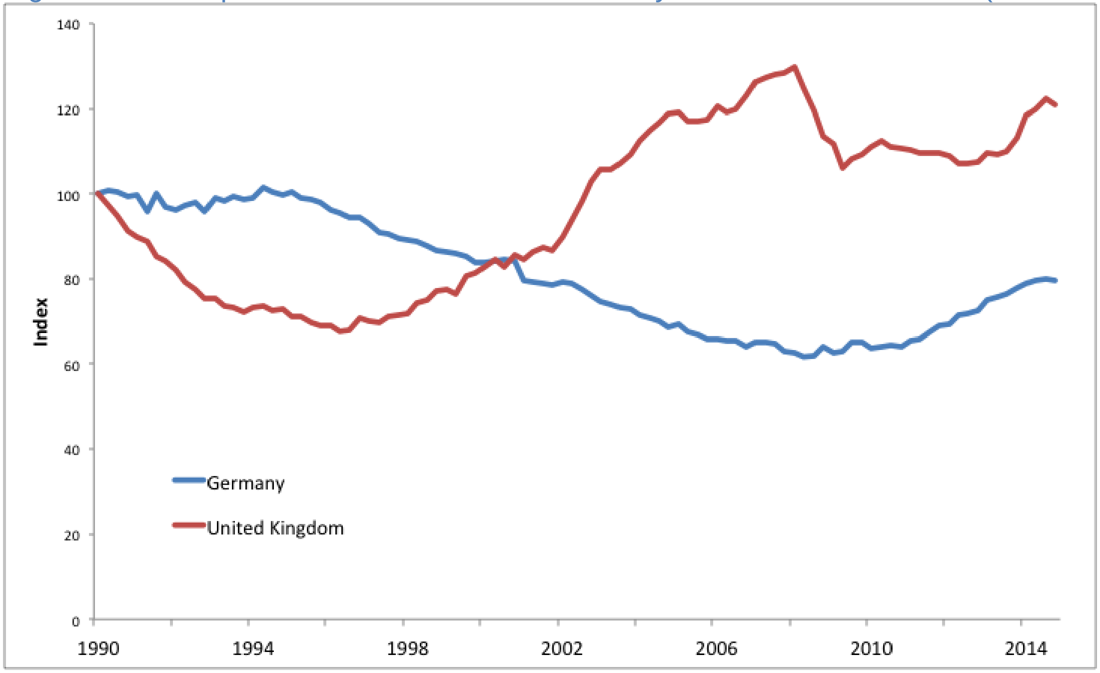
1.38 In addition, Germany has a different land economy to the UK with a relatively elastic supply of land and a diverse construction industry - including private and cooperative developers and a strong self-build industry. Only two thirds of Germans own their own homes with the majority enjoying a well-regulated PRS offering much better quality and security than the UK. The result is average house prices have changed little in Germany over the last few decades. In fact, as shown in figure 8, the house price to income ratio actually dropped in Germany during the 2000s, in contrast to an unsustainable expansion in the UK.

1.39 It is therefore crucial that the structural problems with the banking system that exacerbate house price inflation are addressed. More impactful interventions into the mortgage market would therefor include ensuring that 'risk-weighted' capital requirements no longer amplify incentives towards mortgage lending. Together with macroprudential policy and credit guidance, the government and Bank of England should mandate a refocus of the banks and the wider economy on productive investment, including the building of homes. Breaking up one of our part-nationalised mega-banks in to a network of regional banks owned by local stakeholders and focussed on SME business relationship lending is one option for achieving this.[25]

[24] NEF (2013) Stakeholder banks. Available online: http://www.neweconomics.org/publications/entry/stakeholder-banks

[25] NEF. Reforming RBS. 2015. http://b.3cdn.net/nefoundation/141039750996d1298f_5km6y1sip.pdf

Figure 8: House price to income ratios for Germany and the UK since 1990 (Index, 1990=100)



1.40 Other policy solutions to mitigate against the financial risks of house price bubbles, could be implemented through changes in the distribution of mortgage credit. Changing the mortgage system to one where terms between borrower and credit issuer are fixed for longer periods could be a significant policy improvement. Currently in the UK, lenders aim to improve their ROI by using fixed term mortgages for only a short period, between 1 and 10 years, and many of these periods could be interest-only periods. This can lead to "short-termism" in borrowers, always looking to refinance or trade up houses near the end of these periods.

1.41 Alternatively, removing interest only periods, and shifting to 25-30 year fixed interest and payment mortgages would allow a period of long term stability for the borrower, and also orientate expectations towards staying in a home for a long period.

1.42 These changes can be made gradually, slowly phasing out riskier mortgage products, which would allow for a slow-down in the market, rather than just a sudden drop. This is not a silver-bullet, but shifting expectations around what the home represents, and a slow-down in the market, could be achieved through the mortgage credit mechanism.

d) Planning: Are any further changes to the planning system necessary to increase the availability of low cost housing?

1.43 The responsiveness of supply to higher levels of demand is low in the UK by international standards[26] because the business model of UK builders, who rely heavily on land-banking and low output as a strategy for maintaining profit margins and managing risk. This strategy of drip feeding supply is possible because of the lack of diversity and competition in the building sector, a result of many decades of mergers and acquisitions. The scale of the land banks held by the market leaders, and lack of transparency around land holdings, makes it difficult for smaller builders to enter the market.

1.44 As a growing percentage of the cost of residential development has been taken up by land prices, and prices have become more volatile, UK builders have become more risk

[26] Organisation for Economic Cooperation and Development [OECD] (2011) 'Housing and the Economy: Policies for Renovation', chapter from Economic Policy Reforms 2011, Going for Growth Paris: OECD

averse in their development strategies, limiting production as a way maintain prices and profit margins. The high up-front costs and the length of time it can take to assemble a site, secure planning, design and build large housing schemes expose developers to the risk that the housing market will turn before the homes are sold. Developers are therefore under structural pressure to constrain overall housing production for fear of reducing sales values.[27]

1.45 A substantial affordable house building program is required and it is not clear this will happen without significant government intervention. The government's plan to push developers to increase capacity and build more at lower margin where there is tight supply of raw materials and skilled labour seems optimistic. The only previous period in the twentieth century when there was a significant increase in home building was the post-war period, largely driven by public sector home building.

1.46 Loosening requirements for S106 and eroding building standards will likely drive up the price of land and result in a decades-long legacy of low quality housing and poor wellbeing.[28] The UK is already building the smallest homes in Europe[29] an indication that planning controls are relatively lax in terms of ensuring housing quality. The UK economy is also the most regionally unbalanced in Europe,[30] contributing to an inefficient use of current housing stock, imbalances in spatial demand for housing and driving up demand in London and the south east.

1.47 Indeed, the financial viability test already gives developers significant power to dictate standards: research by the Town and Country Planning Association has found a 'tangible sense of powerlessness' among local authorities when it comes to maintaining minimum standards of housing quality.[31]

1.48 It is possible to control land prices through the planning system. This already happens; land that is zoned for commercial use has a different value say than land zoned for agriculture or housing. Long term planning agreements that keep land tied up in suitable tenures such as subsidised rented housing will ensure that land prices remain depressed vs zoning for private housing, as the return an investor can reasonably expect to earn would be lower. This is common practise in many other advanced economies.

1.49 This approach could also be useful in leveraging in institutional investors to the PRS and social housing sector. If an investor is given a maximum amount earnable on a parcel of land, then that return, in itself, dictates the capital value of the land. If this was combined with a system that could recycle "excess earnings" back into the project to subsidise rented housing, this would be an effective land value capture scheme in which the benefits of gentrification and infrastructure investment are used to subsidise a larger proportion of rented housing within the development.

1.50 NEF have been developing a model "NEF Flex" or "Flexirent"[32] which without recourse to the public purse facilitates institutional investment into the PRS, providing both full market rent and subsidised rent units. This requires a novel type of planning permission which

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[27] Lloyd, T. 2009. Don't bet the house on it. Compass. http://www.compassonline.org.uk/wp-content/uploads/2013/05/Compass-Housing-web.pdf

[28] NEF (2014) APPG report Wellbeing in four policy areas (p.24 Chapter on building high wellbeing places) http://b.3cdn.net/nefoundation/ccdf9782b6d8700f7c_lcm6i2ed7.pdf

29 http://www.independent.co.uk/news/uk/home-news/rabbit-hutch-britain-growing-health-concerns-as-uk-sets-record-for-smallest-properties-in-europe-9544450.html

30 NEF (2013) Why we need a new macroeconomic strategy. pp16–17 http://b.3cdn.net/nefoundation/66609d0bb3c446660a_z6m6b6zxt.pdf

31 Ellis, H. & Henderson, K. (2013). Planning out Poverty: The reinvention of social town planning. London: TCPA.

[32] Home Group launches 'nil grant' flexi rent white paper (2015) http://www.socialhousing.co.uk/home-group-launches-nil-grant-flexi-rent-white-paper/7012621.article and https://www.homegroup.org.uk/Media/News/Home-Group-news/Home-Group-launches-Flexible-Rent-White-Paper

would require the property to be held as rental units for the lifetime of the project. Large scale construction of such units, as would be possible using the novel financing structure, would depress the price of the private rental sector, with some commensurate knock on effect on the price of buy-to-let properties and again on private sale properties, but not to the extent of causing damaging falls in property prices. NEF is currently working with Home Group to pilot this scheme and are in advanced talks with a number of local authorities. The Flex scheme units would have a contract length of 5 years and would be managed by a social landlord.

2. Privately Rented Accommodation: What measures can be taken to increase the supply of low cost private rental properties in the UK?

2.1 Before turning to the specific questions posed by the commission, we wish to emphasise that rising prices in the PRS ought not to be taken as a signal of the increasing popularity of private renting. Regular polls show it is the least popular tenure, not only due to the high rents, but also the insecurity of tenure, problems with disrepair and lack of freedom to do simple things like decorate. Boosting the supply of this kind of privately rented accommodation is not a solution. Rising rents must be understood as a result of the shrinking supply of social housing and a housing 'ladder' moving increasingly out of reach.

a) Will the reduction of tax relief available to private landlords announced by the Chancellor of the Exchequer in the 2015 Budget increase the cost of privately rented accommodation?

2.2 The main drivers of high and unaffordable rents in some parts of the country in recent years have not been high mortgage costs for landlords, which have been historically low. Rather, they have been driven by the prohibitively high cost of home ownership and lack of social housing, which has forced more households to compete for private lets.

2.3 As noted, the extremely high levels of profitability in the buy-to-let sector is boosting demand for houses and adding to the upward pressure on house prices. A removal, rather than reduction of mortgage interest relief would help take away some of the advantages that buy-to-let landlords have over first time buyers in the housing market.

2.4 Landlords can cover their operating costs and make a revenue return on their investment, quite apart from longer-term capital gains. Rents provide almost a 40 per cent margin over the costs of a 100 per cent interest-only mortgage.[33]

b) Will the current trend of a decline in home ownership and an increase in private renting continue?

2.5 If steps are not taken to address the root causes of house price inflation, and increase the supply of social housing then it is very likely that the trend toward private renting will increase. In the meantime, there is much that could be done to improve the security, quality and affordability in the PRS.

c) What are the advantages and disadvantages of restricting rent increases in the private sector?

2.6 The UK private renting system is almost unique among developed countries in offering short-term contracts with no restrictions on rent increases.[34]

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[33] Using average private rent and house price data for two-bed dwellings in 2013. Wilcox and Perry (2013). UK Housing Review: Briefing Paper, pp.14–15

[34] Shelter (2012) A better deal Towards more stable private renting, p.29

2.7 Rent rise restrictions could address the ballooning housing benefit bill as well as alleviating problems of instability (the uncertainty associated with rent hikes is disruptive to schooling, employment, and community building), and overcrowding.[35] It is also the case that increases in homelessness from the PRS have been most dramatic in areas of rapid rent rises: London for example has seen a 316% per cent increase in homes lost due to AST terminations in the three years to 2012/13, and a 60% increase in rough-sleeping in the two years to 2012/13.[36]

The practicalities and feasibility of introducing rent regulation

2.8 Research for Shelter by the University of Cambridge's Centre for Housing and Planning Research suggests that rent regulation of this kind could be introduced without risk of serious unintended consequences.[37]

2.9 One concern is that it could lead to buy-to-let landlords, who have invested for capital appreciation rather than income, leaving the market if they perceive home values will fall as a result. Whilst this is a risk, in the longer term the UK needs to move away from such speculative forms of property purchase. Counter-balancing this effect, rent regulation might make the PRS more attractive to institutional investors, such as pension funds, looking for long term secure but potentially lower returns and not seeking speculative capital gains.

2.10 Rent controls would need to go hand in hand with increased security of tenure and other measures to protect tenants. This could include increased notice periods and a tenants 'first right of refusal'.

2.11 An additional option, particularly if there are concerns about a flight of landlords, would be the creation of a Public Clearing House for homes which would provide a powerful new lever for acquiring homes for affordable housing. This might also prevent sharp falls in house prices by creating a minimum market price that the government would buy a property for.[38]

3. Social housing: Are any measures needed to increase the supply of social housing?

3.1 Secure tenancy and sub market rents provided through social housing can act as a platform for low income households, a potential source of government revenue and way of collectivising 'scarcity rents'.

3.2 The private sector has never supplied houses on the scale that is required. In 2013 the number of households waiting for social housing[39] stood at around 1.7 million, representing a 65% increase since 1997.[40] In the long term building social housing would be much more cost effective than subsidising private rents.

[35] Data from the English Housing Survey suggests that the growth of overcrowded households – as measured by the Bedroom Standard - has been particularly dramatic in the PRS where the number of overcrowded households increased by over 240% between 1995/6 and 2012/3 (Annex Table 9, EHS headline report 2012 – 2013)

[36] Fitzpatrick, Pawson, Bramley, Wilcox and Watts. (2013). The homelessness monitor: England 2013. Crisis, p. 12

37 CCHPR (2015). The effects of rent controls on supply and markets http://england.shelter.org.uk/__data/assets/pdf_file/0009/1166958/Rent_controls_impact_on_PRS_-_CCHPR_report.pdf

[38] Lloyd, T. 2009. Don't bet the house on it. Compass. http://www.compassonline.org.uk/wp-content/uploads/2013/05/Compass-Housing-web.pdf

39 The waiting lists, however, may no longer be a reliable indicator of need, since the Localism Act 2011 gave local authorities more powers to set their criteria for accessing social housing and waiting lists. There is evidence that some local authorities have cut waiting lists overnight by excluding many vulnerable people.

[40] DCLG Live Table 600

3.3 There are a number of ways that investment could be stimulated to rebuild the public housing stock, such as enabling local councils to borrow to invest in house building as they do in many other EU countries. Government should also commit to a large scale investment program in social housing, particularly given historically very low interest rates on UK gilts at the present time. Accounting rules on government debt need to be reviewed to support such activity - government built homes should be viewed as assets rather than simply adding to the public deficit.

3.4 Another option would be for the Bank of England working with the Treasury to use quantitative easing to buy assets that will support home building. NEF has described this as 'Strategic QE' and argued that it could fund the construction of new social homes, easing supply and creating jobs. QE so far has involved the creation of £375bn worth of central bank money, all of which has been used to purchase government bonds in financial markets. A £10bn investment in housing would deliver around 60, 000 new homes, for each house creating 1.5 direct jobs and another 3 jobs in the supply chain.[41]

a) What will be the impact of the Right to Buy for housing association tenants?

3.5 The subsidies come at the expense of genuinely affordable homes. Right-to-Buy will decrease the stock of sub-market rent, social and affordable homes, which will be replaced with subsidised Starter Homes for the few who can afford to buy.

3.6 Right-to-Buy is reducing council stock much faster than it can be replaced: between 2012 and 2014, council homes were being sold at more than five times the rate of replacement.[42] Costs which local authorities will ultimately be forced to pay, by means of forced disposal of remaining high value social rented properties, further reducing the ratio of affordable and social rented properties within market.

3.7 If Right-to-Buy of any kind is to stay, a commitment must be made by the government that each home sold will be replaced by one with the same tenure, in same place and at same price.

3.8 Overall, social landlords estimate they are likely to lose around 10% of existing stock under the Right-to-Buy extension with the Chartered Institute of Housing forecasting 1.45 million tenants are eligible with 145,000 likely to buy over the first 5 years.[43]

3.9 Chartered Institute of Public Finance and Accountancy (CIPFA) chief executive Rob Whiteman said: "Extending Right to Buy, without proper consultation with the public bodies which will foot the bill for it [local authorities], is effectively stripping local communities of their most valuable assets in order to subsidise discounted sales elsewhere […] It is unfortunate that the secretary of state's proposals have been formulated without any obvious negotiation between the two sectors. We believe it could well drive a wedge between housing associations and local authorities at a time when they should be working more closely together."[44]

3.10 Concern expressed by Communities and Local Government MPs[45] regarding local authorities footing the bill for Right To Buy, relates to the fact housing associations are heavily financialised, with potential costs of exiting or renegotiating loans and hedging

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[41] NEF. Strategic quantitative easing: Stimulating investment to rebalance the economy. 2014. http://b.3cdn.net/nefoundation/e79789e1e31f261e95_ypm6b49z7.pdf

[42] Lyons Housing Review 2014 http://www.yourbritain.org.uk/uploads/editor/files/The_Lyons_Housing_Review_2.pdf p.146)

[43] Inside Housing. 'RTB Extension Could See 145k association homes sold' 2 September 2015. http://m.insidehousing.co.uk/rtb-extension-could-see-145k-association-homes-sold/7011579.article

[44] http://www.publicfinance.co.uk/news/2015/10/cipfa-extension-right-buy-likely-deepen-housing-crisis

[45] Inside Housing. *'MPs 'Uneasy' Over Housing Associations Derivative Exposure'.* March 2015 http://www.insidehousing.co.uk/mps-uneasy-over-housing-associations-derivatives-exposure/7008943.article

positions in the wake of Right to Buy breaching loan covenants substantial. Costs currently unaccounted for in social housing providers annual accounts.

3.11 In the case of some commonly used loan products such as Lender Option, Borrower Option (LOBO loans)[46] the cost of exiting the loans can be greater than 90% of the loan value. New accounting standard FRS102 will force housing associations to account for the full cost of off-balance-sheet derivatives positions in their end of year accounts from March 2016.[47]

3.12 There is a significant potential cost being imposed on local authorities through Right to Buy that is currently un-costed by regulatory authorities, and may result in the forced sale of significantly more local authority land and property, than Treasury or the Homes and Community Agency currently acknowledge, in order to offset exit penalties on loans imposed by bank lenders.

b) What will be the impact of the proposed changes to social housing rents announced by the Chancellor of the Exchequer in the 2015 budget? Are any additional or alternate changes to social housing rents needed?

3.13 Lowering social rents is in theory a good thing for social tenants, but the manner in which it was done will likely be damaging to housing associations. The announcement came less than 18 months after a ten year promise to increase social rents by RPI+1% - on the basis of which housing associations and councils were borrowing money and planning housing supply. As a result, this will likely negatively impact on Housing Associations' credit ratings and borrowing ability.

3.14 The vast majority of the 2011-2015 Affordable Homes Programme has been used to build *affordable* rent rather than social rent. Now the 2015-18 AHP will be dominated by affordable *ownership*. Support for "affordable ownership" will come at the cost of cannibalising affordable/social rent.[48]

3.15 Reclassification of Housing Associations as public bodies by the ONS has added £60bn to the UK public sector net debt (PSND), and this could further increase to £135bn in 2016, as the potential costs of swaps and derivatives are revealed by recent FRS102 accounting changes. The Office of Budgetary Responsibility (OBR) found that the social rent reduction would further add to PSND, as the rent reduction reduces public sector income and outweigh housing benefit and other savings.[49]

3.16 The affordable rents strategy should be replaced with a tightening of the requirement under Section 106 for affordable housing from private developers, bringing rules on council borrowing in line with other European.

This submission draws - with permission - on research from Beth Stratford (forthcoming) *Post Growth Economics and the Housing Market.* PhD thesis, University of Roehampton; Joel Benjamin, research assistant with the Goldsmiths University Political Economy Research Centre (PERC) and James Wood, PhD candidate at King's College London and visiting PhD fellow at Copenhagen Business School, Department of Business and Politics.

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46 Inside Housing. '*LOBOs Explained*.' 2009 http://www.insidehousing.co.uk/lobos-explained/6502500.article

47 Inside Housing. '*Associations Race to Renegotiate Lending Terms'*. August 2015 http://www.insidehousing.co.uk/associations-race-to-renegotiate-lending-terms/7011320.article

48 https://redbrickblog.wordpress.com/2015/12/02/its-not-just-social-rented-housing-thats-at-risk-so-is-new-housing-at-affordable-rents/ and http://www.insidehousing.co.uk/moment-in-the-sun/7013066.blog

49 Goldmsiths Press Briefing – Housing Association Right-to-Buy Increases UK Public Debt and May Trigger Losses from Off-Balance-Sheet Derivatives.