HOUSING DEVELOPMENT AND HOUSING FINANCE IN BRITAIN

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Forwards

The International Real Estate Advisory Network Limited (IntREAN) exists to promote a clearer understanding of the benefits which flow from the establishment of a secure and transparently enforceable system of land rights. The principal benefit is economic. As such, all developing and emerging economies that wish to participate in the global economy and have a modern market economy have to engage with the issue of how to harness for its own economy's benefit the one asset which every country by definition has – namely, land.

There is a notable gap in the literature on land rights in that there are very few clear statements of the law and practice relating to how land rights are organised in developed countries and how economic benefit is derived. This paper seeks to fill that gap by setting out the position so far as Britain is concerned.

IntREAN believes that a sustainable system of land rights (a transparent and reliable system enforceable through an independent judiciary) is an unavoidable and crucial bedrock for any country seeking to establish itself as a modern global market economy. Such a system can be established systematically, and the benefits go far beyond the narrow confines of a "land right", which basically involves the recordation of parcels of land and interests in them in a form that is secure. Several crucial and important benefits will flow from the creation of a secure system of land rights.

First is constitutional benefit. Given that an inherent requirement of the notion of establishing individual land rights is that such rights should be protected by a transparent and reliable system of law, the establishment of an independent judiciary – free from political and administrative interference - will be paramount. This in turn will demonstrate the benefit of living under the rule of law.

The second is economic benefit. Development of land rights is often solely thought of in terms of real estate markets. Such a view is short-sighted and ignores the crucial role that land rights play in all successful developed market economies – all of which have active real estate markets. In order to exist in useable form, what is required is the creation of a system of regulations and law which recognize it as an asset which can be deployed for the benefit of individuals and companies alike. Once established, an interest in land can be used to create a capital sum (by sale or by the use of it as security for a loan) or develop an income stream (by letting).

Thirdly, people become empowered, which in turn brings immense social benefit. The individual attains a real stake in his country, and visibly and directly benefits from reform which has devolved responsibility to the individual. The critical significance of this to the maturing of a country should not be underestimated.

Fourthly, the development of a reliable and independently enforceable system of land rights can help solve practical problems when they occur. Compare what happened after the Tsunami in South-east Asia and Hurricane Katrina in New Orleans. The former by and large relied on traditional custom based unrecorded systems of land rights. The latter had a recorded land rights system. Two years after the catastrophic events, New Orleans is back in business, federal aid having been directed to those entitled having been identified in large measure by title records. In contrast, in parts of South-East Asia, funds provided for aid lie unspent because identification of recipients based on occupation of land devastated by the tsunami cannot be confirmed.

Many fundamental and practical benefits flow from the creation of an independent and recorded system of land rights, which will lead to the creation of a viable market in real estate which in turn brings essential economic benefits. This in turn will contribute significantly to the country in question being able to participate on an equal basis in the global economy.

This paper sets out how the land rights system works in Britain and illustrates the benefit of having a flexible system

Bob Hall
Chairman,
International Real Estate Advisory Network Ltd

As a director of two companies involved in the development of land in Britain and abroad, I am glad to support this paper. It fills a gap by providing a clear, brief and informative account of the law and practice in Britain with respect to what a land right is, how it is identified and protected and then the issue of the financial benefits which can be derived from a securely established land rights system.

We are currently experiencing difficulties in a wide variety of markets as a result of the sub-prime lending issues in the USA – which have resulted in value write-downs by financial institutions and others that a year ago would have been unthinkable. However, in reacting to this global crisis, we should not kill the goose that laid the golden egg. The use of an interest in land as an asset which has value and can accordingly be used to realize capital (by sale or use of land as security) or income (by letting) is as valid as it was a year ago. The asset value of land remains as strong as it has been over the last two or three centuries. It is just the use of that asset value that needs to be more carefully managed.

I commend this paper as a guide to the reality of using land as an asset and how the value it creates can help the wider economy.

Alderman and Sheriff Michael Bear
City of London

February 2008

Introduction

There is an acceptance in many transitional and developing countries that functioning housing markets can make a significant contribution to economic growth and improved standards of living. Those countries naturally look at experience in other countries, and there are many international and national agencies and commercial organisations willing to provide access to such experience.

The British housing market is, by any standards, effective, and has valuable lessons for transitional and developing countries. The British model can best be described as a free market operating within a legal framework governing land ownership, planning, building standards and mortgages, and sound prudential regulation of financial institutions. In the British model there are few special arrangements for housing. This model is attractive to other countries; it is implemented primarily by removing obstacles rather than creating new institutions, and requires minimal public funding.

However, the model is not well understood or documented, largely because it is an informal model that has evolved and which does not have specialist institutions to champion it.

This publication aims to provide a succinct, but comprehensive, description of the British model, written specifically for an international audience. It concentrates on the market for owner-occupied housing, covering other forms of tenure only to provide the necessary context. It has not involved original research but rather draws on existing material, putting it in an international context so that it can be easily understood by someone familiar with housing markets but with no knowledge of the British market.

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Mark Boleat
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The meaning of "Britain"

This paper is about the "British" housing market. However, Britain is not a single administrative unit. Great Britain comprises England (population 50.8 million), Scotland (5.1 million) and Wales (3.0 million). The United Kingdom includes Northern Ireland (1.7 million). Scotland has its own legal system relevant to housing, although in practice it has the same housing finance system. This paper uses the term Britain, and most of it applies to Great Britain as a whole. Where there are differences within Britain the paper refers to the situation in England and Wales. Where possible differences in Scotland are noted. While this might sound complex, in practice the British "system" is sufficiently flexible to accommodate a different system of land tenure and some other legal differences in Scotland.

1. Executive summary

Overview
Britain has an effective and efficient housing market. This has resulted not from any formal government plan, but rather has evolved over time in response to changing needs and circumstances. Underlying the development of the market are some basic principles: clear property rights, the rule of law, a network of qualified property professionals, the widespread availability of good quality data, and a financial system that allows banks freedom to operate within a sound prudential framework.

The government provides no housing directly, and does not prescribe where or what housing should be built, how the house purchase process should be conducted or the terms and conditions of mortgage loans. Housing development and housing finance operate within a framework that is a mixture of statutory regulation, self-regulation and custom and practice. This framework has facilitated a market that is both flexible and competitive. There is no dominant group able to manage the market for its own benefit.

Planning framework
Britain has a top down planning system. The government sets out the basic framework, and local plans must be within that framework. The planning system ensures that housing is not significantly adversely impacted by commercial or industrial development.

All new developments, including housing, require planning permission from the relevant local authority. Local authorities are required by central government to ensure that land is available for development and that they have an overall plan for their areas. Over half of new housing is now built on sites that were previously developed, and an increasing proportion of new developments are of apartments rather than single family houses. The planning system has failed to produce an adequate supply of land. This has contributed to house prices increasing more rapidly than prices generally and land prices much more rapidly.

A significant feature of the planning system is that the government effectively "captures" some of the value created by the granting of planning permission. Developers are required to provide social housing within new developments and also to make other contributions to infrastructure and community facilities.

Building standards and controls
Local authorities administer the Building Regulations, which ensure that all building work meets acceptable standards. The system is generally accepted and vigorously enforced.

A private sector insurance scheme ensures that buyers of new homes are protected both during the course of construction and for the first 10 years after completion. This protection extends to subsequent purchasers.

House building
New housing for sale is built by private developers, generally large scale developments built on a speculative basis. The acquisition and management of land banks is a key part of the development process. The large house builders hold substantial land banks, which they manage so as to achieve a reasonably steady flow of new housing.

There has been extensive consolidation in the house building industry such that the largest ten companies account for over half of all production. These companies operate through local operating companies that compete with regional and local builders.

House building is financed by a mixture of internally generated funds and bank borrowing.

New houses are sold though a combination of marketing by the developer and use of estate agents. In large developments a show house is completed at an early stage. Developers offer incentives to buyers, the most important of which is purchase of an existing home.

Land tenure and registration
Property rights in Britain are well established. Single family homes are generally owned on a freehold basis, and apartments on a long leasehold basis. Land ownership and charges against property are registered on government run registers. The government guarantees title to registered land.

The proportion of houses that are owner-occupied has increased rapidly from 30% in 1950 to 50% in 1970 to 70% today.

The house purchase process
There is a dynamic market in existing properties, which account for most of the houses made available for sale. On average people move several times during their lives, typically starting with a small property then moving into something more expensive as they can afford to before perhaps moving into smaller accommodation later on in life.

Houses are sold through estate agents. Marketing is increasingly through the Internet, but local offices also play a key part. There are about 11,000 estate agency offices in Britain. Some are in large chains, the largest having over 1,000 offices, some are part of networks and some are local or regional businesses.

Agents normally work on a sole agency basis, charging a fee of 1.5 – 2% of the selling price. Most agents now belong to an ombudsman scheme. Generally however, estate agency is more lightly regulated than in other countries.

A recent innovation in the house purchase process is the requirement on sellers to make available to buyers a "Home Information Pack" containing information about the property, much of which previously had to be obtained by the purchaser.

The costs of housing transactions are comparatively low in international terms.

Valuations and survey
Valuers play an important role in giving assurance on property values to buyers, sellers and lenders. However, the steady rise in house prices has protected developers, home owners and lenders from the consequences of faulty valuations and bad investment decisions.

Properties are valued on the comparative prices approach. There is a great deal of publicly available information about house prices, which makes this an effective approach. Increasingly, automated valuation models are used either as the first stage in the process, or as the only stage particularly for houses which are standard in most respects.

Home buyers can commission a full survey or a simpler Homebuyer's Report, although many rely on the valuation prepared for the mortgage lender.

There is self-regulation of valuations and surveys through the professional body, the Royal Institution of Chartered Surveyors.

Regulation of mortgage lending
The giving of advice and provision of information on mortgage lending has, since 2004, been regulated by the Financial Services Authority (FSA). Those who give advice or make loans must be authorised, hold an appropriate qualification and comply with detailed rules of conduct. These are mainly concerned with the provision of information in standard form.

The Law of Property Act 1925 contains the major legal provision on mortgages, and deals in particular with the ability of the lender to realise its security in the event of the borrower defaulting. These provisions have now been supplemented by FSA rules. Lenders must have a court order to take possession of and sell a property of a borrower who defaults. A court order will be given if the court is satisfied that the borrower is in default and is unlikely to be in a position to repay the mortgage.

Mortgage products and lending
Most houses are bought with the help of long term mortgage loans from banks or building societies. Mortgage loans are a mainstream financial product; there is no special housing finance circuit. Loans can be for up to 100% of the value of the property. Most loans are at a variable rate of interest or a rate fixed for a short period, generally two years. Mortgage loan rates range from 50 to 200 basis points over the cost of funds.

Lending criteria cover the property (for which a valuation is required), the percentage advance (loans for over 85-90% of value attract a higher lending charge), the ability to repay of the borrower (3.5 times income or 2.5 times joint income in the case of two borrowers are typical) and credit checks.

Mortgage lenders and funding
The major lenders are the retail banks and specialist building societies – savings banks whose lending is largely mortgage loans. Over the past 20 years most of the large building societies have converted into banks and some have merged with existing banks.

Over half of mortgage business is obtained through intermediaries.

About 60% of outstanding mortgage debt is funded by retail deposits. Wholesale funding, in particular residential mortgage backed securities and covered bonds, have increasingly been used to raise funds in the last 20 years. This has been entirely a market development; there is no legislative provision for either mortgage backed securities or covered bonds.

Prudential supervision of mortgage lending
Mortgage loans offer exceptional security, which is recognised in the international capital adequacy standards published by the Basel Committee of Banking Supervisors.

Residential mortgage loans that are no more than 80% of the value of the property qualify for a 35% capital weighting under the new Basel 2 capital adequacy arrangements which are being applied in Britain. The introduction of Basel 2 will lead to a significant reduction in capital requirements for most British mortgage lenders.

Relevance to emerging markets
The British experience offers some useful lessons for emerging markets –

- The rule of law, a sound economy and a stable society are essential requirements for the development of a housing market.
- Clear ownership or occupancy rights are necessary if people are to be encouraged to invest in their own housing or to engage in housing development.
- Land and utilities must be available for new housing development, and housing must not be adversely impacted by other form of development.

- The quality of construction must be regulated.
- There must be high quality valuation and surveying standards.
- Mortgage lending will develop of its own accord if the conditions are right. Mortgage lending is largely a banking function that should be performed by banks and be regulated by the banking supervisor. Large scale, safe, mortgage lending is essential both to enable people to buy homes and to bring down the cost of mortgage loans to a reasonable spread over the cost of funds.
- Mortgage lending can help develop the breadth and depth of financial markets.
- Governments should concentrate on removing obstacles to housing development and mortgage lending such as unreasonable restrictions on land use, the inability of banks to realise the mortgage security, inefficient land registry systems, unreasonable restrictions by the banking regulator, legislation or regulation which attempts to control the terms of mortgage loans and directed lending.
- Mortgage insurance can play a useful “pump priming” role to help achieve the critical mass that housing finance needs.
- Mortgage securitisation is not a substitute for an efficient primary mortgage market, but can be a useful means of raising funds from the capital markets. Securitisation can develop entirely for market reasons; government legislation and sponsorship is not essential.

2. Planning framework

The importance and function of planning
The value of housing depends to a large extent on the environment in which it is located. A house in an attractive area and with nice views will be more valued than an identical house in a heavily industrial area. New developments must also take account of natural risks, such as flooding, and the availability of essential services such as transport and schools.

Planning policy therefore needs to zone land for specific uses – such as agricultural, industrial and residential, provide a framework within which individual developments are permitted and prevent unauthorised development.

Inherent conflicts
In most countries there are widely opposing views about what developments should and should not be allowed, at national, regional and individual site level. These conflicts arise from –

- A divergence between internal and external costs and benefits. The developer of a site will benefit from the development. However, the development may well impose a cost on the occupiers of neighbouring properties who will have to suffer the consequences of building work and quite possibly a long term deterioration of their environment.
- The owner will want to secure the maximum value from his land, even if that imposes a direct financial cost on others – for example the need to provide additional transport or school facilities. The community costs are frequently borne by the same authority that considers applications for planning permission.
- There are a number of pressure groups that have no direct interest in a site but have a view on all developments or all developments in a particular area or of a particular type. Most pressure groups are in favour of conserving what is there – that is they are against development.
- The costs of new development are immediate, obvious and specific. For example occupiers of neighbouring properties will face some nuisance caused by building work and will probably finish up in a slightly worse environment. The benefits are longer term and widely diffused – for example more homes or more jobs.

Generally the weight of argument is against development, both on the part of those directly and adversely affected and those that represent them, that is local politicians. This is linked to misconceptions about the extent of existing development. Research carried out for the Barker Review, described subsequently, showed that 54% of people think that around half or more of England is developed whereas the actual proportion is at most 13.5%.

Planning decisions are all about choices in which some people will be aggrieved; there is seldom a “win win” situation.

It is necessary to recognise the effect that obtaining planning permission can have on a piece of land. In the south east of England, agricultural land is worth £12,000 a hectare (a standard unit of land area equal to 10,000 square metres), land for office development is worth £1.7 million a hectare and land for residential development is worth £3.2 million a hectare. These differences lead the government to seek to capture part of the value of planning permission, generally by imposing requirements on developers to build or pay for necessary community facilities including transport, schools and housing.

The planning framework in England and Wales
In England and Wales the legal framework through which planning is delivered is the Town and Country Planning Act (TCPA) 1990, as recently modified by the Planning and

Compulsory Purchase Act 2004. Both are based on the first comprehensive planning legislation that was introduced in 1947. The TCPA 1990 is plan-led system of land use regulation. The approach is a top down one of guidance and plans at national, regional and local level against which planning applications are assessed. Any development of land requires planning permission. Planning applications are normally determined by local planning authorities. Under the plan-led system, decisions on planning applications are made in accordance with the development plan unless there are material considerations sufficient to overrule the plan. A developer should therefore have a reasonable degree of certainty as to whether a particular planning application is likely to be approved.

Central government retains extensive powers. The relevant minister can direct planning policy at both the national and regional level, and determine a very small number of high profile planning applications through use of 'call-in' powers. There are strong policies protecting the countryside and containing urban areas.

At the top of the hierarchy in England and Wales is Communities and Local Government, a (frequently renamed) government department that sets out the broad policy and framework. Regional Assemblies are responsible for preparing regional spatial strategies and regional housing strategies. These Assemblies require a little explanation. One of them, the Greater London Authority, is elected, although the power largely resides with a directly elected mayor. The other eight English regional assemblies are not directly elected. About two-thirds of assembly members are appointees from the local authorities in the region, and the remaining one third are appointees from other regional interest groups. They have no power and a very low public profile. Their only significant function is to prepare regional and spatial strategies.

Local planning authorities are responsible for local development plans and for dealing with applications for planning permission. The local authority structure in the UK is complex. In Scotland, Wales, Northern Ireland and parts of England unitary authorities have the full range of local authority powers. In the rest of England there is a two tier arrangement – county councils and district councils. The district councils are the planning authorities.

All regional plans and local development plans have to be in a prescribed format and must be approved by Communities and Local Government. Local planning authorities must consult the relevant regional assembly in drawing up their local development plans and also on planning applications that have a significant regional impact.

The effectiveness of the planning framework

The planning framework described above has been successful in some respects. That development that has taken place is generally well designed and located; most areas give the impression of being well planned. The exceptions date back largely to the 1950s and 1960s when there was an undue emphasis on quantity rather than quality.

The planning system and housing policy have been particularly effective in recent years in producing developments that combine both owner-occupied housing and low income housing. This has been achieved through requiring developers, in exchange for obtaining planning permission, to build a certain proportion of housing in the development for lower income groups, generally rental housing which is sold at an artificially low price to "registered social landlords", not-for-profit organisations that manage rented housing for low income groups. This has helped reverse the previous policy where very large estates were built to be occupied entirely on a rental basis by low income households.

But in other respects the planning system has failed, and is generally accepted to have failed. The planning system has been weighted against development. There has generally been no incentive for a local authority to grant planning permission.

Insufficient land has been made available for residential development and the rate of new house building has been insufficient to meet demand. In relation to other countries the rate of construction in relation to the existing stock has been very low. This has led to house prices increasing much faster that the general level of prices, and land prices increasing very rapidly. Between 1993 and 2005 retail prices increased by 37% while house prices more than doubled and land prices nearly quadrupled. This has benefited existing owners of land and housing, but at the same time made it more difficult for people to become owner-occupiers for the first time. The government and the market have partly responded to this by requiring greater densities. As a result, an increasing proportion of new housing is in the form of apartments rather than single family units.

A related problem has been the increasing cost of obtaining planning permission, largely as a result of lengthy delays often involving formal appeals. The system is also bureaucratic with thousands of pages of regulations and guidance. There are no fewer than 200 statutory instruments (regulations) all of which have the force of law. One large housing developer recently reported that it takes 14 months to obtain planning permission for major developments compared with 12 weeks 25 years ago.

There are similar arguments in respect of commercial developments. The general view is that the anti-development bias is an obstacle to economic growth as businesses are deterred from expanding or modernising. Planning difficulties are also cited as one factor deterring inward investment. The problem is well illustrated by the planning process for the approval of a new terminal at Heathrow Airport. The process began in 1993 and was concluded more than seven years later, in 2001.

Recognising the problems, the government commissioned a leading economist, Kate Barker, to consider how planning policies and procedures could better deliver economic growth and prosperity. Her report, *Barker Review of Land Use Planning* (2006), comprehensively reviews the planning system and makes a number of recommendations which are now in the process of being implemented.

Planning for housing – current policy

The government has said that it wants the number of new houses built to increase from the current level of about 170,000 a year to 240,000 a year by 2016. The Barker Report has influenced *Planning Policy Statement 3 (PPS 3): Housing*, issued by Communities and Local Government in 2006. This describes the government's strategic policy objectives as –

> "The Government's key housing policy goal is to ensure that everyone has the opportunity of living in a decent home, which they can afford, in a community where they want to live. To achieve this, the Government is seeking:
>
> - To achieve a wide choice of high quality homes, both affordable and market housing, to address the requirements of the community.
> - To widen opportunities for home ownership and ensure high quality housing for those who cannot afford market housing, in particular those who are vulnerable or in need.
> - To improve affordability across the housing market, including by increasing the supply of housing.
> - To create sustainable, inclusive, mixed communities in all areas, both urban and rural."

The document continues –

> "These housing policy objectives provide the context for planning for housing through development plans and planning decisions. The specific outcomes that the planning system should deliver are:
>
> - High quality housing that is well-designed and built to a high standard.

- A mix of housing, both market and affordable, particularly in terms of tenure and price, to support a wide variety of households in all areas, both urban and rural.
- A sufficient quantity of housing taking into account need and demand and seeking to improve choice.
- Housing developments in suitable locations, which offer a good range of community facilities and with good access to jobs, key services and infrastructure.
- A flexible, responsive supply of land – managed in a way that makes efficient and effective use of land, including re-use of previously-developed land, where appropriate."

These statements in practice say little more than the obvious. The more specific requirements can be summarised as follows –

- Provision must be made for a supply of housing to meet demand based on a wide range of relevant information. Regional plans should enable local authorities to plan for housing over a period of at least 15 years. Regional plans should identify broad strategic locations for housing developments.
- Local authorities should identify sufficient deliverable sites to deliver housing for the next five years. "Deliverable" is defined as meaning available now, suitable and achievable. In addition, local authorities should identify a further supply of specific "developable" sites for years 6 – 10 and if possible for years 11 – 15.
- Where a local authority cannot demonstrate that it complies with the five year requirement then it is required to consider all applications for new housing development favourably. In effect local authorities are forced to ensure an adequate supply of land, otherwise they risk losing control over developments.
- Local planning authorities must set an overall target for the amount of affordable housing to be provided. In practice, this housing is now provided as part of planning agreements. In exchange for permission to build a specified number of homes for the private market the developer also has to provide some "affordable homes". These can be under one of a number of home ownership schemes for those on low incomes or rented housing managed by a social housing landlord. In this way the local authority effectively "captures" part of the value created by giving planning permission. It is expected that affordable housing will be required where any site is larger than 15 units. The presumption is that affordable housing will be provided on the site of the development so as to help achieve the objective of a mix of types of housing and of tenures.
- Extensive consultation arrangements with local communities are required.
- In considering planning applications design quality is important, covering matters such as transport, community facilities and the effect on the neighbourhood.

The importance of spatial frameworks

Britain has had a national mapping agency since 1791 and although not providing truly national map coverage at a common scale (of 1:10,560) until 1840 onwards, it now boasts one of the most sophisticated national geo-reference frameworks in the developed world. Following a comprehensive digitisation program in 2001, the Ordnance Survey established a seamless digital national framework called OS MasterMap®, which is a series of geo-referenced layers the foremost component of which is the Topographic layer. Data from OS MasterMap® offers definitive, consistent and maintained referencing to more than 440 million individually referenced man-made and natural landscape features in Britain and undertakes 5,000 changes to it every day. Although the Topographic layer is not a cadastre, it is the definitive and authoritative delineation of all physical features on the land, down to individual buildings and properties.

Having some form of geographical reference framework is vital for a fully functioning land administration sector. Not only for the creation of a cadastre, but when integrated as part of a Geographical Information System (GIS) it can be used as a land management and control tool to assist not only land property registration, but also the management of other taxes levied on properties, such as rent and rates but also the management of other processes including;

- Construction permitting and licensing
- Contract enforcement
- Business registration - Land acquisition and development
- Environmental Planning and Zoning

Likewise an integrated map base can assist in regulatory areas such as reducing the multiple allocation of land, encroachment on non-permitted development areas (road corridors, utilities, etc) and validation of independent land surveys. Although Britain's heritage has been steeped in a culture of surveying and mapping, a rich asset that our housing market has inherited, this might not always be the case in developing countries. The point to note is that with today's modern surveying techniques, national spatial frameworks can be created in a fraction of time than it has taken the Ordnance Survey to create MasterMap® and the data once generated can support many uses across the housing market and other areas of government.

It is important for emerging economies who have a negligible or poor legacy in spatial data frameworks to consider a few overriding principles for their development. Lessons to be learned from Britain's national mapping experience include the following;

- Data should be collected once and used many times. The inherent versatility of spatial data is that it has more than one use and multiple beneficiaries. Across governments particularly, it is at the very heart of providing improved public services and enhanced governance and improved agricultural and land management efficiency. This means the justification for developing a national mapping framework should not be based on improving the property market alone.

- Recognising this dual nature of mapping data, means that data should be captured at the highest resolution and largest scale possible. The demand and application with the most exacting level of detail requirements should be the one that dictates the overall design.

- To facilitate cross-government and multi-agency use, as well as interoperability with international databases, it is imperative to use recognised spatial data standards. This would also form part of the spatial data policy design.

3. Building standards and controls

Building regulations
The Building Regulations are designed to ensure that all construction work is safe. They also provide for energy conservation and access to and use of buildings. In England and Wales the current Building Regulations are made in powers given under the Building Act 1984.

The Regulations set out the type of work to which they apply, the notification procedures that must be followed and the requirements that must be met. These requirements cover 14 areas: structure, fire safety, site preparation and resistance to contaminants and moisture, toxic substances, resistance to the passage of sound, ventilation, hygiene, drainage and waste disposal, combustion appliances and fuel storage systems, protection from falling, collision and impact, conservation of fuel and power, access to and use of buildings, glazing and electrical safety.

With the exception of the installation of some specific items and services, a builder must use the relevant local authority's Building Control Service or an "Approved Inspector" so as to ensure compliance with the Regulations. Building inspectors are readily available and therefore work is not held up by the Regulations. The inspectors are qualified and experienced professionals and command the necessary confidence and authority. Local authorities have power to issue enforcement notices and where necessary to prosecute for breach of the Regulations.

The Building Regulations are readily accepted and rigorously enforced. They are effectively administered and are not seen as a bureaucratic obstacle to development, but rather as an essential safeguard. They are considered to have been very successful in ensuring that building work is done in such a way as not to pose a risk either to the occupants or to other people.

New home warranties
Neither a purchaser nor a mortgage lender nor even a surveyor can be expected to identify hidden faults in new houses. If a house has been standing for 30 years then it is a reasonable assumption that if there were any faults in the construction then they would have come to light. This is not the case with a newly built house.

If a new house does turn out to be faulty then in law the buyer would have a remedy against whoever sold the house, in practice the developer. However, builders can go out of business leaving the home owner with the problem, and also pursuing a legal case is likely to be prohibitively expensive for most people. Related to this is the position of second and subsequent purchasers who have no contractual relationship with the builder and therefore are unable to take legal action against it even if it can be shown that the builder was negligent.

Where a person purchases a house before it is started ("off plan") or during the course of construction, he faces a different risk, that is that the builder will go out of business and will not complete the house.

Recognising the need for consumer protection in this area, builders took the initiative to ensure that new houses were covered by an effective warranty scheme. This was achieved through the National House Building Council, which had originally been established in 1936. The Council has set standards that have to be met over and above the Building Regulations, provides for the inspection of properties during the course of construction and provides a

warranty against major structural defects. In the 1960s mortgage lenders made lending on a new house conditional on an NHBC warranty.

To participate in the NHBC scheme a builder must demonstrate reasonable financial security, together with an acceptable level of technical competence, comply with the NHBC rules and agree to build in accordance with NHBC standards.

NHBC is an independent, non-profit distributing company limited by guarantee, with no shareholders. It is governed by a Council with representatives from organisations or groups that have an interest in raising standards in UK house building. They include mortgage lenders, solicitors, consumer groups, architects, surveyors and house builders. A 14 person board is responsible for overseeing NHBC's strategy and financial resources, particularly the business planning and budgeting process.

The NHBC is a UK regulated insurance company. Builders pay a composite fee for each home, consisting of a charge for inspection (and similar risk management services such as technical vetting of plans) and a separate insurance premium. The fee is based partly on previous claims experience so that there is an incentive on builders to comply with the standards.

NHBC's Buildmark insurance policy provides the following cover to purchasers of new homes –

- Before completion, if, due to insolvency or fraud, the builder does not start building or converting a home or fails to finish it, it will reimburse money paid to the builder for the home where the money cannot be recovered from him. If the property is not finished, the NHBC can arrange for it to be finished in accordance with its standards.
- During the first two years after purchase the builder must put right any defect or damage within a reasonable time scale. If the builder fails to rectify the problems, NHBC will usually offer a free resolution service and can also help arrange the remedial work needed to put things right if the builder fails to do so. If the builder is insolvent, then NHBC will discharge his obligations.
- In years 3 – 10 cover is provided against major structural defects through an insurance policy. The cover is not confined to the initial purchaser but also extends to second and subsequent purchasers.

There are approximately 20,500 house builders and developers on NHBC's Register. Around 80% of new homes built in the UK each year are registered with NHBC and around 1.7 million homeowners are currently covered by Buildmark policies. In the year to 30 March 2007, NHBC received premium income of £68.7 million and paid out claims of £36 million. Its gross insurance reserves at the end of the year were £1,455 million.

There are now several competitors to the NHBC in the field of warranties for new homes, including the Zurich insurance and financial services group.

4. House building

House builders
Almost all new houses in Britain are built by private sector developers operating independently of each other and each trying to maximize its profits. Most are built speculatively – that is they are designed and building is commenced before they are marketed. This is a specialist business, and to a large extent a local or regional one as a comprehensive understanding of local land and housing markets is essential for success.

Most private housing developers are not also engaged in commercial development as other than the physical construction the activities are very different. However, a small number of developers specialise in comprehensive redevelopment, embracing housing, office, retail and occasionally industrial units.

The skills involved in the building of houses are different in nature from the skills involved in identifying and purchasing land and securing planning permission. Generally, the development and the building functions are combined in a single business, although functionally the activities are separated. However, some businesses concentrate more heavily on the development aspect while others concentrate more on the building aspect, a point developed in more detail subsequently.

The business is inherently risky given the long time frame. While a new house is generally built in less than a year, the process of land assembly, planning a development and obtaining planning permission may take many years. The risk derives from macroeconomic considerations, with demand being sensitive both to interest rates and trends in real incomes at the national level, and also local issues. Costs can also be unpredictable, particularly on brownfield sites.

These factors combine to make house building a fairly fragmented industry. There are a small number of companies that operate nationally, but even these are effectively divided into a number of regional units where the key decisions on land purchase and construction are made. There are many companies that operate only at regional or local level, relying on their expertise in the local market for competitive advantage. In many local markets the largest house builder may well be a relatively small business in national terms.

The following table lists the largest house builders, each of which is a publicly quoted company, listed on the London Stock Exchange.

House builder	Annual production Units, 2006	Market capitalisation December 2007 £bn
Taylor Wimpey	24,000	2.19
Persimmon	17,000	2.40
Barratt Developments	17,000	1.57
Berkeley	3,000	1.63
Bellway	8,000	0.97
Bovis Homes	3,000	0.76
Redrow	5,000	0.52

The largest three developers now account for about one third of all new private houses for sale. There has been a significant rationalisation of the house building industry in recent years, largely because of the need to drive down costs and to acquire land. Currently, the ten largest builders incorporate 44 businesses that were separate companies ten years ago. The largest company, Taylor Wimpey, was formed by a merger of two companies, Taylor Woodrow and Wimpey, in 2007. The company operates through six brands in the UK, these

brands largely being previously independent companies that have been acquired by the Group. Illustrating the point made earlier, its largest brand, Taylor Woodrow, has 26 regional businesses and three satellite companies in the UK. The company also has operating companies in other countries – Spain, Gibraltar, the USA and Canada.

Land assembly

In some countries the provision of land for development is not an issue. If a developer wants land for any form of development then it can be relatively easily obtained for a reasonable price.

This is not the position in the UK. The planning framework, described in Chapter 2, should ensure that there is sufficient land available for development. However, most proposed housing developments meet strong opposition from local communities who object on grounds of their view being ruined, environmental concerns, increased congestion, greater pressure on schools and health facilities and the nuisance while development takes place. These objections often come from people who say that they accept the need for new housing – but not in their particular area. This has spawned the expression – “nimby” – “not in my back yard”.

This complicates and increases the cost of the development process and restricts the supply of new housing. The planning system should prevent this happening. However, in practice there are always decisions that are at the margin and even developments that come fully within national and local plans are likely to encounter opposition. Developers have to try to identify sites where “nimbyism” does not exist or where they feel that they can overcome it. Because the supply of land that can de developed is so limited there is fierce competition for that land that does become available.

There are three types of land that developers can acquire –

- Greenfield sites, that is land that has not previously been developed. This is the easiest land to develop as there are none of the uncertainties inherent in brownfield land. However, the supply of greenfield land zoned for housing is limited, and there is a prevailing view, generally offered with no substantiation, that there is plenty of brownfield land available which should be developed while the “countryside should be left alone”.
- Brownfield sites, that is land which previously has been developed. There is a wide range of such sites, varying from land previously used for housing which in practice may be little different from greenfield sites in terms of ease of development, to old industrial sites with contaminated land and where the requirement is for a mixed use development. Generally, brownfield sites are more difficult and costly to develop. In recent years brownfield sites have included former hospitals, military accommodation, industrial sites and docks. The local authority may well play a role in initiating the development and may be a development partner.
- Infill sites, that is small sites generally in areas of residential housing. Such sites include back gardens, corner plots and also sites where a large house is demolished and replaced by a number of apartments. Infill sites are very much smaller than either greenfield or brownfield sites. This part of the market is dominated by small local developers.

The government has a target that 60% of new houses should be built on brownfield land. Over the last few years the proportion has been as high as 75%, having increased from 55% 10 years ago.

Land can be acquired with varying degrees of planning permission and on various terms.

Greenfield sites may be acquired with no planning permission at all or with outline planning permission only, that is an agreement in principle that the land can be used for housing development. It may be acquired outright or an option to purchase may be used. An option gives the developer the right to acquire the property at a given price for a given period. The price may be dependent on outline planning permission being obtained. A brownfield site is likely to be acquired only if there is outline planning permission.

Once there is detailed planning permission for a site it has a higher value, and there is a trade in such sites. Some developers are regular sellers of land ready for development while others, particularly smaller developers, are purchasers of such land.

The position is complex. It is not simply a case of buying a piece of land and building a house or houses, the whole process being completed in a year. While some house builders do work in this way it is a small part of the market.

The large developers have substantial "land banks" with land at varying stages of the process. "Strategic land" does not have planning permission. Only a little more than half of such land actually gets planning permission and is built on. The next category is land with outline planning permission. Finally, there is land with detailed planning permission, ready for construction to begin.

The land banks are massive in relation to the annual volume of construction. This has led to criticism that builders that builders cause house prices to rise by refusing to build on land that they own. The reality is more complex as the analysis is this section has shown. The position can usefully be illustrated by information in the 2007 Annual Report of Barratt Developments. The company, which is the third largest house builder, is currently building about 17,000 units a year. Its land bank comprised –

- 109,700 plots with a total book value of £3,297 million. Over £1 billion had been spent on acquiring land in the previous year.
- 23,000 of these plots were subject to contract, that is Barratts had an option to purchase.
- 72% of the plots had detailed or outline planning permission.
- Of plots scheduled for development in 2007/08, 99% had detailed planning permission, and of plots scheduled for development in 2008/09 91% had detailed planning permission.

For the large developers the average site has between 30 and 45 units, although this average masks a wide dispersion, with some sites having over 1,000 units. In a typical year, the very largest developers may be working on 450 to 500 sites, while a builder such as Redrow, completing around 5,000 units a year, is likely to be working on around 120 sites.

Over time a particular developer's appetite for land at the various stages of the process may vary, or the landbank may become unbalanced, for example because it fails to get planning permission for some of its sites and does not have enough land ready for development, or it may feel overexposed in a particular market. Also, another developer may value a particular site more highly than the developer who owns the site. This means that there is a lively trade in land between developers. Some of this trade is driven by financial considerations. A publicly listed developer that has had a bad year may need to sell some sites to produce an acceptable profit even though in doing so it may be sacrificing a greater profit if it developed the land. It can also work the other way. A developer who has had a very good year may sell sites that have fallen in value so as to smooth its profit figures.

Developers also need to spread their risks. A developer may have assembled and obtained outline planning permission for a very large site. However, it does not want to have an

undue concentration of risk or to be exposed to adverse local market conditions. It may therefore sell two thirds of the site, developing the remaining third itself. It may balance this transaction by buying land ready for development on a large site from another developer.

Determining the price to pay for a piece of land is the major skill for a developer. In essence the calculation is a simple one –

Total value of house sales when development is completed in some years' time –
Less cost of holding land
Less planning costs, including contribution to social housing and community facilities
Less construction costs
Less marketing costs
Less share of overheads
Less profit to obtain required return on capital
Equals price to be paid for land.

Broadly speaking, construction costs account for a little over half of the final selling price, land for 20%, overheads for 5%, direct selling costs for 3% and the profit margin for 18%. This can be illustrated for the simplest of transactions, that is the purchase of a single plot ready for development –

Value of house to be sold	£250,000
Less cost of planning permission etc	0
Less cost of holding land	£5,000
Less construction costs	£135,000
Less marketing costs	£5,000
Less share of overheads	£10,000
Less required profit	£45,000
Equals price to be paid for land	£50,000

Identifying the value of a property or properties which can be built on a site is the major skill of a developer. The longer the time frame the more difficult it is to make the calculation. In the case of a large site that may take up to ten years to develop, the developer has to assess what the local market will be like when the properties are completed.

The major risks to the developer are the value of the houses to be sold, which is influenced by market conditions, and to a much lesser extent construction costs. If the market moves against the developer such that a sale cannot be achieved at the desired price then the developer has to balance the higher interest costs and marketing costs against the price at which the property can be sold. For the acquisition of land without detailed planning permission the risk in respect of the value of the properties and the cost of holding land rises.

The developer is unlikely to begin the construction process until it is satisfied that it will obtain its desired profit. Sites with detailed planning permission may not be developed for come years, although in some cases a site may be built out or sold so as to minimize losses.

Financing new house building

The time lag between land acquisition and sale of a house is likely to be between two and six years, and the time lag between the start of physical construction and sale probably averages about nine months. House builders therefore need to fund a significant amount of work in progress. This can be costly and there is always the risk of being unable to extend bank facilities if the market turns down and sales reduce. Developers seek to minimise their need to borrow by –

- Purchasing land through options rather than straight cash purchases.

- Not beginning the costly construction stage of a project unless market conditions are right.
- Speeding up the construction process as far as possible.
- Selling at as early a stage of the construction process as possible, including before construction even begins.
- Phasing construction on big projects.

A developer will also seek to minimise construction costs. There are significant economies of scale in large scale developments compared with building single units or a small number of units. Use of prefabricated components can both reduce costs and speed up construction.

Developers fund their activities through a mixture of internally generated funds and bank loans secured on their developments. Developers generally have not had difficulty in obtaining the finance they need. This is partly because they have had a good track record, partly because they can offer some security in the form of land with planning permission, and partly because for most of the last 30 years market conditions have been benign with a strong demand for housing and restricted land supply resulting in rising land values. Large developers typically use bank finance secured on the whole of their assets, while smaller developers are more likely to use bank loans secured on specific sites.

Provision of utilities
New housing requires the provision of basic services such as gas, water, waste disposal and electricity. It is generally also necessary to provide services to the development as a whole such as roads and street lighting. Depending on the size of the development there may also be a need for community facilities such as schools and health centres. These services are provided on commercial terms by a mixture of private and public agencies. They are paid for by the developer either directly, for example in respect of connections to the main water, gas and electricity supplies, or indirectly through a condition in the provision of planning permission. The suppliers of the utilities have a legal duty to supply the necessary services. This is generally done in a timely and efficient way.

Volume of house building
The demand for housing is very sensitive to economic conditions, and house builders face strong competition for their product from sales of existing houses. Builders respond to changes in demand by changing selling prices and to a lesser extent by speeding up or slowing down construction. In practice the rate of new house building by the private sector has been remarkably stable because of planning constraints, as a result of which most of the pressure is taken on prices. Between 1990 and 2006 the number of private housing completions in Great Britain varied in a narrow range from 140,000 to 170,000. In addition, housing associations have completed around 20,000 units a year for rent.

Rising land prices have combined with government requirements for higher densities to lead to a significant increase in the building of apartments as opposed to single family homes. Apartments as a proportion of total completions increased from just 15% in 1997 to nearly 70%. Correspondingly the number of units per hectare has increased from 25 in the early 1990s to 40.

It is generally accepted that this rate of house building is too low given demographic changes and the need to replace houses that have reached the end of their natural lives. Annual housing completions have run at under 1% of the total stock, well below the proportion of other industrialised countries. However, given an open market it is reasonable to assume that builders have reacted to market conditions as they have seen them and that the volume of new houses built has been sufficient to meet demand. Difficulties in obtaining land that

can be developed have probably played a significant part in constraining supply, reflected in a rapid rise in house prices in relation to earnings.

Selling new houses

Developers need to sell their product at the earliest possibly stage, both for cash flow and profit reasons. With an interest rate of 7%, each month a property is unsold reduces the profit margin, typically 20%, by 0.6 percentage points.

Marketing is therefore a key aspect of development and is fully integrated into the planning of a particular project. Developers use a mixture of their own staff and local estate agents. The smaller the development the more likely it is that local estate agents will be used. On a large scale development the developer will generally undertake marketing in-house, although possibly with some support from estate agents.

A show house is a key element of a marketing campaign. This will typically be a real house in the development in a strategically sited location. Where a “real” show house is not feasible, for example in an apartment block, a show house, in whole or in part, may be created in say a hotel. Marketing may begin at a very early stage in a project, even before construction begins, with the aim of identifying potential buyers with whom regular communication can be maintained. Websites are now a key part of any marketing campaign, dedicated sites being established for particular projects. People can register an interest in a development through the site and can be kept informed of progress, invited to events and be subject to direct marketing.

New houses account for fewer than 15% of the houses sold each year and therefore face competition from sales of existing houses. Prices have to be set accordingly. New houses will generally attract a premium over existing houses. Among the selling points offered by developers are –

- Latest equipment, particularly in bathrooms, kitchens and technology infrastructure.
- High standards of construction, backed by a warranty.
- Ready to move in, often including full decoration and choice from a range of curtains and carpets.
- No prospect of the sale falling through, as can easily happen with existing houses where a seller may change his mind or be unable to proceed with a transaction because his own sale has fallen through.
- Assistance with arranging loan finance if this is required.
- Legal formalities being handled by the developer.
- The ability to sell an existing home to the developer – often the most attractive incentive.
- Sales incentives (particularly when demand is sluggish) such as free carpets and curtains or other optional extras.

In short, the developer is offering to take all the hassle out of a housing transaction, by providing a “ready to move in” state-of-the-art house with all the transaction details taken care of and the sale of an existing house as well.

Houses will be sold at varying stages of the construction process, prices being adjusted continually to maximise the return to the developer. Initially, prices may be pitched a little on the low side to develop some momentum and to give the impression that there is a strong demand. If demand increases then prices will be raised.

Apartments present particular challenges. A full scale show house is not possible, and building an apartment block cannot be phased. A developer will limit its exposure to single

apartment blocks for this reason. A show unit, perhaps featuring a kitchen and living room, will be built nearby. An attempt will be made to sell units “off plan”.

A significant development in the last few years has been the “buy to let” market. Private investors, including individuals, buy new units to let out, in the hope of making a capital appreciation when the property is eventually sold. Most buy to let activity is in respect of apartments, and provides developers with the opportunity to sell a number of units in a single transaction either off plan or at an early stage of the construction process.

5. Land tenure and registration

The importance of security of tenure
In many countries security of tenure is taken for granted. This is true in Britain. Home owners know that the property they live in is theirs and can only be taken away from them if they fail to keep up mortgage repayments or, in exceptional cases, if the land is needed for essential development – in which case they will be suitably compensated. Owners are also free to do what they like – within reason - with their homes, including extending, modifying, selling or letting them. Renters also have security of tenure for the period of their lease.

Such security does not exist in many emerging markets. As a result lenders may be reluctant to lend and people may be reluctant to buy, or where they "own" a house to invest in it.

Security of tenure has long been enshrined in British law, although not necessarily in an easily understandable way. "An Englishman's home is his castle" is a common expression that neatly summarises the position.

Ownership and renting
The key difference between owning and renting is that the owner benefits from any increase in the value of a property and suffers the consequences of a fall in the value. Home ownership is therefore an investment as well as a means of occupying housing. This has been particularly important in Britain as housing has proved to be a very good investment, house prices having risen substantially faster than prices generally. The reasons for this are complex but include constraints on the supply on new housing, covered elsewhere in this paper, and the favourable tax treatment of housing, in particular exemption from capital gains tax and preferential treatment in respect of inheritance tax. The proportion of homes in Britain that are owner-occupied has risen rapidly from 30% in 1950, to 50% in 1970 to 70% today. This trend is explained more fully in Appendix 3.

Forms of ownership tenure
Single family homes are almost always owned on a freehold basis through which the owner owns the land as well as the building. Under what is technically called "fee simple", ownership continues as long as the owner has heirs and is as near as one can get to absolute ownership.

Apartments are generally owned on a leasehold basis, that is the owner owns a right to occupy or to sub-let the apartment until a given date, but the land and the structure of the building is owned by a different person, the freeholder, to whom a rent has to be paid. New leases have typically been for 99 year periods. As the lease become shorter over time so the investment aspect diminishes and the property becomes more comparable with a rental unit.

Commonhold is an alternative to the conventional method of owning apartments and other interdependent properties under a lease. The legal basis for commonhold is given by the Commonhold and Leasehold Reform Act 2002. Commonhold combines freehold ownership of a unit in a development with membership of a commonhold association. The association (and consequently the unit holders) owns and is responsible for the management and upkeep of the common parts of the development.

Land Registration in England and Wales
Britain has systems of land registration that provide for the registration of title which then has a state guarantee.

The Land Registry is responsible for registering title to land and recording dealings (for example, sales and mortgages) with registered land in England and Wales. In 1925 there were several separate pieces of legislation which provided a framework that lasted for nearly 80 years. The legal framework for land registration has recently been modified through the Land Registration Act 2002. Besides bringing the legislation up to date generally, it also provides a framework for the development of electronic conveyancing.

In order to register land that was not previously registered historic title deeds going back 15 years are required. Registration of title is compulsory on a change of ownership. As a result, the vast majority of land in now registered. The register describes -

- The land - a geographical description of the land with reference to a plan and a legal description of the property. If the property is leasehold then details of the lease will be included. Any covenants for the benefit of the land, such as a right of way over adjoining land, are also included.
- The owner of the land and his address.
- Third party charges registered against the land such as mortgages and restrictive covenants.

The massive task of computerising almost 18 million titles was completed in 2002 such that all registered titles are now fully computerised. The register is open to public inspection; anyone paying the required fee can obtain details of the register entries for a particular property.

The Land Registry is funded by fees. The basic fee scale for registering a transfer of ownership runs from £40 for properties up to £50,000 to £700 for properties over £1 million. Most properties attract a fee of £100 - £220.

Land Registration in Scotland
Scotland has always had a separate system of land registration. The Register of Sasines was established in 1617 to record deeds relating to rights in property. However, this has now been superseded by the Land Register on which properties are now registered on creation or sale. This operates in a similar way to the Land Registry in England and Wales.

6. The house purchase process

The supply of houses for sale
There are three principal sources of houses that are made available for sale –

- New houses – as described in Chapter 4.
- The sale of existing houses where the sellers are not also buyers, for example on death or where someone emigrates or moves to rented accommodation.
- The sale of existing houses where the sellers are also buyers.

The third category is far by the largest. Unlike in some other countries where people buy a first house relatively late in life and occupy it for a long period of time, in Britain people tend to buy earlier in their lives and move more frequently, often to a better house in the same area. Turnover of the housing stock in Britain is about twice the European Union average. 89% of British houses have had more than one owner compared with 78% of houses in the USA, 66% in France and only 13% in Japan.

In 2006 1,126,000 loans for house purchase, totalling £158 billion, were made. 85% of loans were on existing rather than new houses and over 60% were to existing home owners moving house rather than to first time buyers.

Estate agents
In most countries estate agents play a major role in the housing market, by bringing buyers and sellers together. The nature of their role varies significantly, dependent largely on the ways that the market has evolved over the years.

In England and Wales, with the exception of some new houses which are sold directly by the developers, those selling houses usually do so through estate agents. The agent markets the house and conducts the sale negotiations on behalf of the seller. Various marketing techniques are used. Many agents take advertisements in local newspapers. Increasingly website marketing is used, and the Internet is now the first port of call for prospective house buyers. A number of websites have been established on which estate agents and developers advertise their properties for sale. Potential buyers can search by area, price and type of house. Having identified a particular house the potential buyer then contacts the agent. The largest such site is Rightmove (www.rightmove.co.uk), which is used by almost all the largest estate agents and developers. However, much marketing is still done through local offices. A prospective buyer will, after obtaining what information he can from the Internet, typically visits or telephones agents in the area where he is seeking to buy, explains what roughly he is looking for, and the agent then provides details of properties on its books.

Estate agency is therefore a local business needing a local presence on the ground. There are about 11,000 estate agency offices in Britain. The following table lists the largest agencies as at January 2007.

Agency	Number of offices
Countrywide	1,176
Connells	496
Lending Solutions	420
Halifax Estate Agency	329
Spicehaart	231
Arun Estates	123
Savills	73
Kinleigh Folkhard & Hayward	67
Hamptons International	65
Humberts	61

Source: *Estate Agency News.*

Countrywide is by far the largest agency with around 10% of the total number of offices. It has been built up through a series of acquisitions and mergers, and currently operates through 53 separate estate agency subsidiaries. It also provides conveyancing, property management and insurance services. The Group was a listed company until May 2007 when it was acquired by a private equity group.

Halifax, the fourth largest agency, is a subsidiary of HBOS, the largest mortgage lender. In the late 1980s a number of mortgage lenders built up or acquired estate agency chains. However, the very different cultures of banking institutions and estate agencies proved difficult to manage, particularly when there was a severe downturn in the housing market. As a result most mortgage lenders sold their estate agencies, generally at a substantial loss. In addition to the Halifax, Connells, the second largest agency, is owned by a building society, the Skipton, the business having been acquired and developed after this downturn.

Many of the smaller agencies belong to affinity groups which give them access to central marketing and other support. The largest affinity group, Movewithus, has members with over 1,000 offices.

The agent charges a commission to the seller, payable when a buyer is found. A typical agency fee is 1.5% - 2% of the selling price, but the range is from 1% to 2.5%. A sole agency contract, under which the seller contracts with a single agent and has to pay the fee to the agent even if the seller subsequently finds a buyer himself, is used in about 75% of cases. In a joint agency contract, used in about 20% of cases, commission is shared between the agents whoever makes the sale. The multiple listing system, common in the USA and other countries, has begun to be used recently but accounts for under 5% of transactions. Under this system a property is listed with a number of agents and whoever makes the sale gets the commission. (Multiple listing is used in Scotland, where the role of estate agents is performed by Solicitors' Property Centres.)

The estate agency business lends itself to malpractice. The seller often will not have a good idea of what the selling price should be, although the availability of details of recent sales on the internet has helped sellers in this respect. An agent may be tempted to pitch the sales price low so as to secure a quick sale without needing to do much work. 2% of £300,000 (£6,000) is not very different from 2% of £270,000 (£5,400). In the case of a vulnerable seller, for example someone selling on the death of a spouse, it is not unknown for the agent to pitch the selling price at a very low level and sell to an accomplice. Agents may also favour buyers willing to buy financial services from them, and not disclose that there are other buyers willing to pay higher prices.

The scope for malpractice means that there is a need for some regulation. In Britain this is provided through a combination of laws and codes of practice. The subject has been controversial, with there being frequent demands for "tougher" regulation, which the government generally resists.

Regulation of estate agents in Britain is modest compared with other countries. There is no requirement to be licensed, no training or competency requirements and little effective enforcement of what rules there are. The Estate Agents Act 1979 provides for a negative licensing regime; that is anyone is free to provide estate agency services but if this is done in a way that breaks the rules then the person can be banned. The Act lays down duties that agents owe to clients (such as passing on of offers, handling money and giving details of charges) and to third parties (such as disclosure of personal interests). The Office of Fair Trading (OFT) has power to issue warning or prohibition notices against those persons they consider unfit to carry on estate agency.

The Estate Agents (Provision of Information) Regulations 1991 impose a requirement on estate agents to use specified language to explain certain statutory terms when used in agency contracts. The intention is to ensure that the terms are explained in a consistent manner and that consumers fully understand their meaning.

The Property Misdescriptions Act 1991 seeks to prevent agents making incorrect statements about the properties they are selling.

Recognising that the legislation provided insufficient protection to the public, the industry itself has sought to supplement this through voluntary codes of practice and an Ombudsman scheme. There are two principal trade bodies. The Royal Institution of Chartered Surveyors (RICS) is the professional body for surveyors, some of whom also operate as estate agents. About 5,000 chartered surveyors work in residential property. The National Association of Estate Agents (NAEA) is a specialist trade body for estate agents. It has about 10,000 individual members.

Both the RICS and the NAEA have codes of practice. However, it is estimated that only 20 – 25% of estate agents belong to one or other of the organisations.

There is a voluntary Ombudsman for Estate Agents (OEA) Scheme, started in 1980. In order to be a member of the scheme an estate agent must –

- Follow the OEA Code of Practice. This sets out the framework within which member agents must operate and the standards of service they must provide for both buyers and sellers.
- Belong to an estate agency professional association or be recommended for membership by two current member agents or suitable professional referees.
- Have professional indemnity insurance.
- Have an in-house complaints system with written procedures; inform customers how to refer any unresolved dispute to the Ombudsman; and co-operate with any investigation by the Ombudsman.
- Agree to pay compensation, in full and final settlement of a complaint, if this is awarded by the Ombudsman and is accepted by the complainant. The maximum award is £25,000.

The main points in the OEA Code of Practice are –

- An estate agent must always work in the best interests of the client, but must also always treat fairly all those involved in the proposed sale or purchase. Any personal or business interest in the property must be disclosed to the client.
- No sellers or buyers must be disadvantaged because they are unfamiliar with any aspect of the home buying and selling process.
- The recommended asking price must not misrepresent the value of the property but reflect current market conditions.
- Terms of business must be in writing.
- All fees and charges must be explained.
- The draft Sales and Particulars describing the property must be sent to the seller to check their accuracy.
- If the agent holds the keys, staff from the agency must accompany those who are viewing and anyone else requiring access on behalf of the buyer - unless the seller gives authorisation to the contrary.
- The agent must follow the seller's instructions on how viewings should be conducted and record and pass on to the seller any feedback from viewings.
- All offers received must be recorded and a written copy passed to both the seller and the buyer. When an offer has been accepted 'subject to contract', the agent must ask the seller if marketing should continue or if the property should be withdrawn from the

market. If marketing is to continue, the agent must advise the prospective buyer in writing.
- When an offer is accepted, the agent must find out and inform the seller how the buyer will fund the purchase - including whether the buyer must sell a property, obtain a mortgage, or is a cash buyer.
- The agent has no responsibility for the mortgage lending process or the conveyancing process but will help where possible - by monitoring progress, keeping in touch with both buyer and seller and their solicitors, and reporting information likely to help the transaction.

The code of practice has been approved by the OFT, indicating that it has official recognition.

The Ombudsman does monitor compliance through consumer surveys but does not have the resources to engage in regular inspections of businesses. The Ombudsman Scheme has gradually become more and more accepted in the marketplace. Currently, 60% of agents in the UK are covered by the scheme.

The Consumers, Estate Agents and Consumer Redress Act 2007 widens the circumstances in which the OFT can issue prohibition and warning notices, requires estate agents to keep certain records, makes provision for all agents to belong to an ombudsman scheme and gives the OFT and Trading Standards Officers greater power to inspect. Broadly speaking, this involves a modest strengthening of the existing regime. However, there are concerns that the legislation will be ineffective as there are no additional resources for enforcement.

Home information packs

A recent addition to the regulatory framework is a requirement on those selling houses to provide a "Home Information Pack" containing prescribed legal and other information about the property, under the provisions of the Housing Act 2004. This has been a controversial issue that took ten years from the initial proposals to implementation. The government argued that the introduction of the pack would speed up the house purchase process by requiring the seller to provide information upfront which otherwise would have to be obtained subsequently by the buyer. This would prevent the practice of one of the parties seeking to withdraw from the transaction between an agreement in principle and a legally binding contract. Most controversially, the intention was to require the pack to include a house condition report. Critics argued that the concept was treating a problem that did not exist, would slow up the putting of houses on the market and that a house condition report prepared by the seller would not be trusted by either the buyer or the lender. Eventually the government decided to drop the requirement for a house condition report and instead emphasised the importance of Energy Performance Certificates, an EU requirement. The introduction of the requirements was delayed. They were finally implemented at the end of 2007.

The pack must contain-

- Evidence of title, generally official copies of the individual register and an official copy of the title plan.
- The sale statement, which should provide some basic information about the property, including:
  - The address of the property being sold.
  - Whether the property is freehold, leasehold or commonhold.
  - Whether the property is registered or unregistered.
  - Whether or not the property is being sold with vacant possession.
- Standard searches –
  - The local land charges register relating to the property being sold.

    - Other records held by the local authority on matters of interest to buyers, such as planning decisions and road building proposals.
    - The provision of drainage and water services to the property.
- An Energy Performance Certificate, which indicates how energy efficient a home is.
- Additional information for leasehold and commonhold properties.

In addition there are some optional documents –

- A Home Condition Report, comprising information about the physical condition of a property, which sellers, buyers and lenders will be able to rely on legally as an accurate report.
- A summary of the legal content of the pack.
- Home use and home contents forms, which let sellers give buyers information on a range of matters relating to the property. These include information on boundaries, notices, services, sharing with neighbours, planning permissions and other matters of interest to potential buyers.
- Non-standard searches covering matters such as rights of way, ground stability and actual or potential environmental hazards such as flooding and contaminated land.

The purchase process

A previous section explained the process from the seller's side, and mentioned that the first port of call for a prospective buyer is local estate agents, although increasingly supplemented by the Internet.

Buyers are typically not represented in the early stages of the purchase process. The key decisions are whether to make an offer and if so at what level. Potential buyers will be influenced by what they can afford, what they perceive the house is worth in relation to other houses they have looked at and perceived competition from other potential buyers. In reaching a view a buyer will compare properties on the market and may well use an online valuation tool.

Most buyers do not commission a structural survey or even a valuation of a property before making an offer, and take no professional advice on how much to offer.

If the seller accepts an offer from the purchaser it is qualified by the words "subject to contract", which means that either side can withdraw. The property is usually taken off the market, although if a higher offer is subsequently received there is nothing stopping the seller from accepting this. The purchaser will seek to complete the various formalities as quickly as possible so as to avoid the risk of losing the property. Around a quarter of all transactions fail between acceptance of an offer and exchange of contracts. The main reasons are chain problems (the buyer's sale has fallen through or the seller's purchase has fallen through), the seller receiving and accepting a higher offer (a practice known as "gazumping"), the buyer demanding a reduction in price (known as "gazundering"), the buyer deciding to buy a different house, or one of the parties simply changing their minds about the transaction.

(In Scotland there is a different process. Potential buyers submit sealed bids for the property each of which counts as a binding offer. Buyers therefore have to satisfy themselves about the value and structure of the property and the title before making a bid, whereas in England and Wales only the person whose offer is accepted does this, after the offer has been accepted. These different systems result from custom and practice rather than legal differences.)

The buyer will at this stage, or if not before, ensure that he has the offer of a loan necessary to complete the purchase. He will also need to employ a solicitor or licensed conveyancer to undertake the legal formalities. Many buyers will not previously have needed a solicitor and

so have to find one. The lender may recommend one, the estate agent (even though acting for the seller) may recommend one or the buyer will select one that advertises locally or on the Internet.

At this stage the purchaser may choose to commission a report on the structure of the property, as described in Chapter 7.

The buyer's solicitor will ensure that the legal documentation is in order, relying to some extent on the information in the Home Information Pack if one has been provided, and when everything is in order will "exchange contracts" with the seller. At this stage the transaction becomes irrevocable. Completion, when the buyer formally takes possession of the property, will be later, generally one month although more quickly if both buyer and seller agree.

Both seller and buyer have to meet various costs. The seller has to pay the fee to the estate agent (1.5 – 2% of the value of the property) and the cost of the Home Information Pack (typically £300). The buyer has to meet the following costs –

- Solicitor's fee, typically £500 - £1,300.
- Land Registry charge, typically £100 - £220.
- Stamp duty, a government tax. This is levied on the value of the property. Houses worth less than £125,000 are exempt, the rate is 1% for properties between £125,000 and £250,000, 3% for properties between £250,000 and £500,000 and 4% for properties above £500,000.
- A valuation fee, typically £180 - £320.
- Search fees, typically £150 - £300, although where a Home Information Pack is provided these costs are now met by the seller.
- A mortgage application fee, typically £50 - £400.

While these costs may seem substantial in absolute terms they are relatively modest in relation to the value of the property and significantly less than the comparable charges in most other countries. The relatively low level of charges has facilitated rapid turnover in the market.

7. Valuations and surveys

The importance of valuations and surveys
Reliable estimates of the value of houses are essential for an effective housing market. Sellers want to ensure that they are getting the best price for their properties, buyers want to pay the lowest possible price and lenders want to ensure that the value of their security is reliable. The government also has an interest in ensuring that valuations are accurate, as it levies stamp duty on the reported sale price. Accurate valuations give all parties confidence to operate in the housing market.

Surveys are important in a different way. Individual properties, particularly older ones, may have significant faults which will require dealing with in the foreseeable future, and almost all houses have a number of minor issues that ideally require attention. These issues can be identified only by a structural survey of the property. A lender can take a broad view about the properties it mortgages. It does not particularly matter if one in a hundred properties it has lent on has structural problems which mean that it is worth considerably less than a valuation would suggest. This is predominantly a problem for the owner, and even if he defaults with a loss, the lender can absorb this. By contrast, an individual cannot afford to be that one in a hundred cases. Many borrowers therefore commission surveys, both to give assurance that there are no major structural faults and to provide a list of more minor issues that need to be dealt with. The buyer may use the survey to seek to negotiate a lower price, particularly if it reveals faults not previously disclosed by the seller.

Valuations – basic models
There are three basic approaches to valuing property –

- The comparative prices approach; that is using data on the price of comparable properties, both currently and over time.
- The rental value or income capitalisation approach, basing value on the current value of future rental income.
- The depreciated replacement cost approach, the cost of rebuilding the property.

The first approach is possible only where there is a large number of transactions and a functioning market. The second approach is appropriate where the market is predominantly of rented property, and the third approach is most suitable where there is no market for either rental or owned properties. In countries where there is a functioning market for owner-occupied properties then the comparative prices approach is appropriate. This is the approach that has been used in Britain for many years.

International valuation standards
There is an international standard for valuations promulgated by the International Valuation Standards Committee (IVSC), a voluntary body which works with international agencies and others including valuation societies throughout the world to harmonize and promote agreement and understanding of valuation standards.

The IVSC has developed an internationally accepted definition of market value –

> "Market Value is the estimate of the most likely price or Market Value for which a property should exchange on the date of valuation between a willing buyer and a willing seller in arms' length transactions after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion."

The IVSC *International Valuation Application 2 – Valuation for lending purposes* (2007) is the current applicable standard. The standard requires a valuation report to –

- Comment on current activity and trends in the relevant market.

- Comment on historic, current and anticipated future demand for the category of property in the locality.
- Comment on the potential and likely demand for alternative uses.
- Comment on both the current marketability of the property and, if requested, the likelihood of its sustainability.
- Comment on any impact of foreseeable events (at the date of valuation) on the value of the security.
- State the valuation approach adopted, and a statement as to the degree on which the valuation reflects market-based evidence.

Valuations in practice in Britain
Valuation standards are set by the surveying profession. The Royal Institution of Chartered Surveyors (RICS) is the professional body for property professionals. Its Practice Statements (2003) complement the International Valuation Standards. Their application is mandatory for RICS members. The standards are laid down in a publication known as the "Red Book" – formally the *RICS Appraisal and Valuation Standards* (2007).

Lenders generally require a formal valuation by a qualified valuer of any property which they are to mortgage. The borrower pays for this valuation, typically, £200 - £300, and receives a copy of the report. All valuations are done on the comparative prices approach.

Britain has had a very active owner-occupied housing market for many years and there is a wealth of data on house prices. All sale prices in England and Wales have to be recorded at the Land Registry, and this information is publicly available. There are also a number of house price indices produced by the government and mortgage lenders. These provide disaggregated data by region and by type of dwelling. Measuring changes is house prices is difficult because each house is different, and average prices can be affected by the mix of properties being sold and changes in quality over time as well as actual price changes. A great deal of work has been done to make the indices as reliable as possible.

It is a simple matter to multiply the most recent recorded sale price of a house by the change in the relevant index since then to provide a rough estimate of current value. Such a calculation takes no account of any improvements or extensions to the property or its state of repair generally or of the inherent deficiencies in house price indices, but it sufficient to give a broad brush estimate. There are a number of websites that enable this to be done instantly.

Such a calculation may well be the first stage of valuing a property.

A "gold standard" valuation involves an internal and external examination of the property and is particularly appropriate for unusual properties and properties that have been the subject of significant improvements.

For more standard properties a more cursory "drive by valuation" may be appropriate, simply to validate that the property actually exists and that there is nothing in the external appearance to suggest that the value should vary significantly from that suggested by data analysis. As the name suggests there is no internal inspection. The valuer may literally drive past and have a quick look, or there may be a cursory examination of the exterior.

A recent trend is to use automatic valuation models, basically a sophisticated version of using available data to determine market value. Potential home buyers can access versions of these models online. For example, Hometrack (www.hometrack.co.uk), a property information company, has an online valuation system called Realtime. Hometrack claims that it is used by over 70% of mortgage lenders and that it is used to perform over 10% of

property valuations. Its database contains over 22 million units of property data including all transactions registered at the Land Registry since 2000.

While the quality of valuations is generally high, it is worth noting that valuing is easier in a rising property market. When valuations have been unrealistically high then rising house prices mean that any adverse consequences are limited. If prices fall the consequences of faulty valuations more readily become apparent. In themselves falling house prices are likely to lead to an increase in defaults on loans and it is only at that stage that the valuation is really significant. When house prices fell in Britain in the late 1980s it soon became apparent that some valuations had been unsatisfactory. This led to litigation between lenders and borrowers and between lenders and valuers.

Professional valuations are of greater significance in respect of new developments. Banks rely on professional valuations in deciding whether to lend to a developer in respect of particular development, how much to lend and what other security to take. Again, in a rising market, a problem caused by a faulty valuation is unlikely to come to light. In a falling market any problems will quickly become apparent as the developer may default leaving the bank with a substantial bad debt. This happened in the late 1980s.

Surveys

Most buyers rely on the lender's valuation and their own knowledge of the market to satisfy themselves about the house that they are buying. However, the general advice is that they should protect themselves by commissioning a survey.

There are two principal types of survey.

A Homebuyer Survey and Valuation (HSV), also known as a Homebuyer's Report, is a survey done to a standard format set out by RICS. It is most suitable for conventional properties built within the last 150 years, which are in reasonable condition. It does not detail every aspect of the property, and only focuses on urgent matters needing attention. The survey includes reports on –

- The general condition of the property.
- Any major faults in accessible parts of the building that may affect the value.
- Any urgent problems that need inspecting by a specialist.
- Results of tests for damp in the walls.
- Damage to timbers.
- The condition of any damp-proofing, insulation and drainage.
- The estimated cost of rebuilding the property after a fire, for building insurance purposes.
- The value of the property on the open market.

A Building Survey is a more comprehensive inspection of a property. It examines all accessible parts of the property and includes details of -

- Major and minor defects and what they could mean.
- The possible cost of repairs.
- Results of damp testing on walls.
- Damage to timbers – including woodworm and rot.
- The condition of damp-proofing, insulation and drainage.
- Technical information on the construction of the property and the materials used.
- The location.
- Recommendations for any further special inspections.

A Building Survey does not include a valuation.

8. Regulation of mortgage lending

Mortgage law
A mortgage is the giving of land as security for repayment of a loan. The borrower therefore gives the mortgage and is the “mortgagor”; the lender receives the mortgage and is the “mortgagee”. In practice however, the term mortgage is frequently used as shorthand for “mortgage loan”, and thus it is the lenders who are said to “give mortgages”. When a property is mortgaged the borrower retains full title to the land. Under common law a mortgage borrower has the right to redeem the mortgage at any time.

A mortgage lender registers his charge over the land at the Land Registry. Until the charge is registered it is not legal.

The lender is a secured creditor. In the event of a borrower becoming bankrupt the mortgagee has first claim on the property, and if the borrower defaults on the loan again the lender has a first claim on the property.

Regulation of mortgage lenders and intermediaries
Most mortgage loans are arranged by intermediaries, such as insurance brokers and estate agents. Until recently mortgage intermediaries were not regulated. As mortgage products became more complicated in the 1990s, and as other financial intermediaries were increasingly subject to regulation, so the demand for regulation of mortgage intermediaries grew.

The Council of Mortgage Lenders, the trade body for the mortgage lending industry, established a voluntary mortgage code for lenders and intermediaries in 1997. In practice this became compulsory as all but a handful of mortgage lenders subscribed to it, and they required intermediaries also to abide by it as a condition of doing business with them. A Mortgage Code Compliance Board, largely independent of the industry, was established to maintain a register of mortgage lenders and intermediaries and to monitor compliance with the code. The Code covered a wide range of aspects of lender and intermediary relationships with consumers.

The government decided that mortgage lending should come within the province of the Financial Services Authority as a regulated activity under the Financial Services and Markets Act 2000. After lengthy consultation Mortgage Conduct of Business (MCOB) Rules (now renamed *Mortgages and Home Finance: Conduct of Business Sourcebook,* but still known as MCOB) were applied from October 2004, superseding the CML Code. They are long and complex, running to 337 pages. They cover mortgage lenders, advisers, arrangers and administrators.

MCOB adopts a “cradle to grave” approach throughout the relationship between customers, intermediaries and lenders. In summary -

- It sets out a "financial promotions" regime on advertising.
- Lenders and intermediaries must give customers a copy of a “key facts about our mortgage services” document which sets out the level of service which the firm proposes to offer, the range of products it can sell/recommend and (if an intermediary) whether it is independent or an appointed representative of an authorised firm.
- Lenders and intermediaries must give customers a copy of a "key facts illustration" (KFI) before they apply for a particular home finance transaction. The KFI sets out information relating to a specific product in a consistent format. This is intended to enable customers to shop around, compare different products, and make informed choices.

- Lenders are under a duty to lend responsibly. They must give proper consideration to a prospective customer's ability to repay the amount being applied for.
- Information must continue to be given to customers, in prescribed format, at offer stage, and throughout the life of the loan.
- Customers who fall into arrears must be given prescribed information, including an official FSA leaflet.
- There are rule on how lenders must deal with arrears and possessions cases.

The FSA rules also require all those who give advice on mortgage contracts to have an appropriate professional qualification.

The imposition of these requirements has been costly. A cost benefit analysis identified one-off costs of £136 million and ongoing costs of £68 million a year.

Dealing with mortgage arrears
How a mortgage lender is able to realise its security is a key part of any country's housing finance system. In Britain the legal framework allows lenders to take possession of and sell the property of a borrower who defaults, but subject to obtaining a court order so as to give some protection to the borrower. The MCOB Rules now supplement the legal position and in effect codify what was common practice.

While in theory a mortgagee can exercise its right to take possession at any time, in practice this is done only if the borrower is in default of his mortgage agreement, and all other actions have been pursued and exhausted. As a last resort, the lender will seek a court order for possession. The court will refuse possession only if it is satisfied that in a reasonable time the borrower will be able to remedy any breach of the mortgage terms. The order may be suspended provided that the borrower meets certain conditions. If the borrower fails to comply then the lender can apply to the Court for a warrant of possession, which will normally be granted. The courts give outright possession orders in about 40% of cases, suspended possession orders in about 53% of cases, about 6% of cases are adjourned and only about 1% of cases are dismissed. This does not mean that the courts are biased towards the lenders; rather that everyone understands the rules and that a possession order is sought only if all other avenues are exhausted and there is no prospect of the borrower being able to repay the loan.

Where a lender takes possession it is under a duty to keep the property in reasonable repair. If it is to be let, which is unusual, the lender must obtain the best possible rent and account to the borrower for it.

There is a statutory power of sale under the Law of Property Act 1925. Lenders have a statutory duty to obtain the best price that may reasonably be obtainable. To secure this the lender will take steps to ensure that the property is in a good state of repair and seek to sell it using estate agents in the normal way. Where a mortgage lender exercises this power then the proceeds are held on trust and must be used to pay in this order –

- Any superior mortgages, although in practice there are unlikely to be any.
- The sale expenses.
- The principal, interests and costs of the lender's mortgage.
- Any other loans secured on the property.
- The borrower, who is entitled to any surplus after all the costs have been met and the mortgage paid off. In practice however, there is seldom any surplus; where there is then the borrower is likely to take the initiative to sell the property.

These general legal provisions have now been supplemented by the MCOB Rules which require mortgage lenders -

- To have a written policy/procedures for dealing 'fairly' with borrowers in arrears. This must be made available to borrowers so they can check whether they have been treated fairly.
- To give borrowers a 'reasonable' time to repay the mortgage arrears.
- Where a borrower is two months in arrears to send the borrower a list of missed payments, the total sum of outstanding arrears, arrears charges incurred, the likely charges if arrears persist, the consequences including possession and a statement of the lender's willingness to discuss the borrower's case with money advisers.
- The lender must not put any pressure on the borrower via excessive phone calls or make contact with the borrower in unsocial hours.
- The lender will still be responsible for complying with the FSA rules even where it outsources arrears and possessions work to a third party.
- Any recovery action for a shortfall following the sale of a property in possession must start within six years.

A straightforward possession and sale is likely to take between eight and 12 months. The cost of possession proceedings is typically in the £270 - £1,500 range, and the cost of selling a property in possession is likely to be between £1,400 and £3,000. However, often cases are not straightforward and the property may well be in a poor state of repair. When house prices are falling or stagnant a possession and sale may well be very costly for the lender.

9. Mortgage products and lending

While housing finance as an activity is regulated by the Financial Services Authority, any organisation is free to provide loans for house purchase on any terms it wishes. There are no statutory restrictions on the amounts that can be lent, either in absolute terms, in relation to the value of the property or in relation to the income of the borrower. There are also no restrictions on the type of mortgage, in particular how the rate of interest is determined and can be changed. Lenders are free to offer any type of mortgage loan from one at a fixed rate of interest for 25 years to one with a rate that can be changed at any time by the lender in any way it wishes. The only restriction is that in effect a lender cannot prevent a borrower with a loan at a variable rate of interest from redeeming that loan at any time. This is a powerful mechanism, limiting the extent to which existing borrowers can be forced to pay a rate significantly out of line with market rates.

Mortgage products

A key feature of the housing finance arrangements in any country is whether mortgage loans are at a fixed or variable rate of interest. At first sight a fixed rate loan is more attractive to borrowers as there is no possibility of repayments increasing. However, if interest rates fall borrowers expect to be able to redeem long term fixed rate loans so as to be able to take advantage of lower market rates. Broadly speaking, borrowers want the best of all worlds – protection against rising interest rates while being able to benefit from falling rates.

There are currently two principal types of mortgage loan in respect of the way interest rates are determined. The traditional British mortgage instrument is the variable rate loan. In theory the rate can be varied at any time by the lender. In practice the rate moves broadly in line with money market rates, typically about 200 basis points above the three month money market rate. To attract new business, lenders generally offer a discount for the first few years of a year. The main instrument for new loans is a fixed rate for two years. At the end of the fixed period another fixed rate is offered or the loan reverts to the standard variable rate.

There are endless variations on these two basic instruments, many of which are no more than marketing gimmicks. The variations include –

- A variable rate loan but with a capped rate for the first few years.
- Loans with rates fixed for periods other than two years – currently even up to 25 years. Lenders must protect themselves from the consequences of borrowers redeeming long term fixed rate loans when interest rates fall. This is done by limiting the ability of the borrower to prepay early, levying a charge to cover the cost of early repayment to the lender, charging an arrangement fee or charging a higher rate of interest.
- Tracker loans, the rates on which move exactly in line with money market rates.
- “Offset mortgages”, the combination of a mortgage account and a current or savings account. This can be tax-efficient as instead of interest being paid on savings which would be taxed, the interest reduces mortgage payments which have to be paid out of income after it has been taxed.
- Facilities to make overpayments or underpayments or take a “payment holiday”.

In 2006 66% of new loans were fixed rate (but most fixed only for two years), 12% were discounted variable rate and 19% were trackers. The fixed rate proportion varied substantially over the previous 10 years, from 19% to the peak of 66%. In international terms Britain is at one end of the spectrum in respect of the proportion of loans at either variable or short term fixed rates.

A borrower can take advantage of the system by taking up any special offer, refinancing as necessary and never paying the standard variable rate, invariably the highest rate in the marketplace. There is a huge market for remortgages, which helps ensure that lenders cannot charge their existing borrowers unreasonably high rates. In recent years remortgages have accounted for between a third and a half of all lending. Conversely, the lenders benefit from consumer inertia as a significant proportion of their borrowers are on the standard variable rate.

Competitive forces do result in a fairly narrow spread of rates. The following table shows the rates offered by the largest lender, Halifax, to new borrowers seeking a loan for no more than 90% of the value of the property as at 21 October 2007 (at the time the Bank of England rate was 5.75%).

Product	Term	Interest rate	Early repayment charge	Product fee
Standard variable rate		7.75%		
Fixed rate	11 – 25 years	6.39%	10 years	£699
	5 – 10 years	5.99%	5 years	£699
	4 years	6.34%	4 years	£699
	3 years	6.44%	3 years	£699
	2 years	6.54%	2 years	£699
	1 year	6.64%	1 year	£699
2 year fixed rate	2 years	6.39%	2 years	£999
		6.69%	2 years	£499
		6.89%	2 years	None
		5.29%	2 years	3%
		5.59%	2 years	2%
		5.99%	2 years	1%
		6.09%	2 years	0.5%
Tracker rate	2 years	5.75% + 0.14%	2 years	£999
	2 years	5.75% + 0.24%	2 years	£499
	2 years	5.75% + 0.64%	None	£499
	2 years	5.75% + 0.64%	2 years	None
	2 years	5.75% - 0.51%	2 years	2%

The table shows that the standard variable rate (SVR) was 200 basis points above the Bank of England rate. The cheapest rate, a two year fixed rate at 5.29%, required a 3% product fee, effectively equating to a 6.75% rate, whereas the highest rates carried the lowest fees or repayment charges. Broadly speaking, the cost to the borrower of the various products was very similar. With three exceptions, the effective interest rate (calculated on a standardised basis, known as the annual percentage rate (APR), so as to be reasonably comparable), varied from just 7.6% to 8.1%. Two small exceptions were for long term fixed rate loans, where the APR was 6.7% for loans of 10 – 25 years and 6.8% for loans of 5 -10 years, reflecting market interest rates. The more important exception is the standard variable rate loan which is substantially more expensive than any other loan. In effect those borrowers, generally through inertia, paying the standard variable rate are cross-subsidising other borrowers. Miles (2004) calculated that the margin on an SVR loan was 141 basis points compared with 38 points for a discounted variable rate loan, 36 points for a two year fixed rate loan and 83 points for a 10 year fixed rate loan.

Lending criteria

Lending criteria are fairly straightforward. The key variable is the income of the borrower. The maximum loan is typically 3.5 times income. Where there are joint borrowers 2.5 times

joint income is typical. Lenders will want to satisfy themselves about the security of the income. MCOB requires them to satisfy themselves that the borrower can afford to repay the loan, whether purely from income or from a combination of income and other sources. Some lenders have now moved to an overall affordability assessment, looking at income, other debts and household bills. Where a borrower is self-employed then a lender will want clear evidence of actual earnings over a reasonable period of time.

A lender will normally undertake a credit reference check. If a borrower has defaulted on any type of loan this will be taken into account and may make it difficult for the person to obtain a loan on the usual terms. Lenders share information on borrowers through credit reference bureaux. These record publicly available information such as any court judgments for debts, electoral roll information and bankruptcies. Also, it is now a condition of most borrowing that relevant information on repayment patterns is recorded with the bureaux. Records are therefore available to a lender on other loans and whether repayments are on schedule. Mortgage lenders also share information on possessions, both by court order and voluntarily.

Almost all properties are acceptable as security. If the property is new an NHBC certificate or equivalent will be required. For a leasehold property the lender will require a minimum lease period, perhaps 20 years, after the loan has been paid off.

Exceptionally, a lender may require a survey where there are doubts about the structure of the property or if it is of a very unusual design.

In Britain high percentage loans have always been readily available. This reflects the historic position when rented housing was not available so people had to buy a first home at a young age when they had not had an opportunity to accumulate substantial savings. Even though this is no longer the position, because private rented housing is readily available, a loan of 90% of the value of a property is fairly standard. Where a loan is for more than 90% of the value of the property then lenders typically charge a higher interest rate, typically 40 basis points more, as high percentage loans carry a greater risk. This is generally known as "higher lending charge". Until the early 1990s it was more common for lenders to require such borrowers to pay for a mortgage indemnity guarantee policy which covered the lender against the consequences of the borrower defaulting and there being a loss. These arrangements were severely tested when house prices fell in the late 1980s, resulting in huge losses for the insurers, followed by litigation between insurers and lenders. Insurers sought to develop new arrangements to protect themselves. Lenders have found it more economical to take the arrangements in-house, using the higher lending charge to compensate for the higher risk and in some cases purchasing insurance to protect themselves from catastrophic risk.

A market has developed for those who cannot obtain a mortgage loan on the usual terms, typically because of previous credit record. This "sub-prime" market has grown rapidly over the last few years, accompanied by increasing concern about the dangers of "reckless lending". Following the difficulties in the sub-prime market in the US, this part of the market declined sharply in the middle of 2007. It is important to note the differences between the US and UK markets in respect of "sub-prime". In the UK the expression refers to loans to people with an adverse credit history; this part of the market has been no more than 5 - 6% of the total. In The US the expression includes high loan to value and loan to income loans, and at its peak was around 25% of the total market. In the UK the expression "non-conforming" is also used – to refer to buy-to-let, self certified and income release mortgage loans.

Insurance

Insurance plays an important part in the housing and housing finance markets, protecting both borrower and lender.

The protection given to buyers of new houses through the National House Building Council warranty has already been noted. The insurance premium in this case is paid by the house builder, but both the borrower and the mortgage lender benefit by it.

Lenders naturally require that properties they mortgage are insured against structural damage – known as "buildings insurance". This is a condition of the mortgage loan, and the lender is named as an additional party on the insurance policy. It is up to the borrower to decide whether to insure the contents of the property against accidental damage or theft, but in many cases borrowers take out a combined "buildings and contents" policy. The situation is slightly different for leasehold properties such as blocks of apartments, where responsibility for arranging the buildings insurance lies with the owner (freeholder), although this may be actually arranged through an agent acting for the owner. Usually, the cost of the insurance will then be apportioned between the various leaseholders and payable by them.

Many borrowers take out life insurance policies which pay off the mortgage loan in the event of their death. For many years a popular mortgage product was an "endowment mortgage", which combined an interest only loan with a life insurance savings policy which would both pay off the mortgage in the event of the death of the borrower but also build up a capital sum to pay off the mortgage on maturity. These products were attractive because they were tax efficient (the premiums were tax deductible until 1984) and the value of the investments increased when share and other asset prices rose. However, when share prices declined, many borrowers found that their endowment policies were not sufficient to pay off their loans. Borrowers claimed that they had not understood that the investment vehicle was linked to the equity markets and that its value could go down as well as up. They therefore challenged lenders and intermediaries, who were in many cases judged to have "mis-sold" the endowment policies because they had not explained the nature of the potential investment risk. Where borrowers complained, the Financial Services Authority required insurance companies and intermediaries to review their cases and pay compensation if appropriate.

Endowment policies are still sold as a means of paying off loans, but this is much less common, and borrowers generally purchase other types of investments to build up a fund with which to repay the capital element of the loan. They therefore have to take a separate decision whether to purchase life insurance.

Mortgage payment protection insurance meets mortgage costs if the borrower loses his income through accident, sickness or unemployment. The monthly premium is typically £5 per £100 of mortgage repayments. However, coverage is limited and there are many exclusions. There have been concerns about mis-selling. Only about 20% of borrowers have such insurance.

The government provides some assistance to borrowers through the income support scheme. A borrower who loses his income may be eligible for state support to meet mortgage interest payments. The terms used to be quite generous, but eligibility requirements have been significantly tightened. Payments are not now made until nine months after a borrower loses his income and are limited to interest on the first £100,000 of a mortgage loan. Also, the payments are calculated according to the typical interest rate being charged by lenders. This means that if rates go up, the state support payments may take some time to catch up with the increase, leaving the borrower with a shortfall.

For many years mortgage indemnity insurance played a significant role in the mortgage market. Where borrowers had a high percentage advance, over 80% of value, then they paid the premium for an indemnity policy which protected the lender in the event of a property being taken into possession and sold a loss. As has already been explained this product fell into disuse following substantial losses in the early 1990s.

10. Mortgage lenders and funding

Britain has a huge mortgage market. Loans outstanding at the end of 2006 were over £1,000 billion. In comparative terms, Britain has one of the largest mortgage markets in relation to the size of its economy. Outstanding mortgage loans are roughly equivalent to GDP. Of the major industrial countries the USA and Denmark have high mortgage/GDP ratios of around 100%, while at the other end of the spectrum France and Italy have ratios of under 30%.

Mortgage lenders

Well over 90% of all mortgage loans in Britain are made by retail banks, and mortgage lending is regarded as a mainstream mortgage lending activity rather than a specialist activity to be conducted by specialist institutions. The retail banks can be divided into four broad categories –

- The building societies – mutual institutions that are required by law to concentrate on taking retail deposits and making mortgage loans.
- Retail banks that previously were building societies. They have generally diversified their sources of funding and to a limited extent extended their areas of lending.
- Retail banks that have absorbed or merged with former building societies.
- Retail banks that have developed with their own mortgage business and have not acquired former building societies.

The following table shows the major mortgage lenders and their status using the categorisation above.

Mortgage lender	Type of business	Loans Outstanding End-2006 £bn	Market Share %
HBOS	Bank, formed by merger of Bank of Scotland (bank) and Halifax, formerly the largest building society	220.0	20.4
Abbey National	Bank, former building society, acquired by Spanish bank, Santander	101.7	9.4
Lloyds TSB	Bank, including acquisition of Cheltenham & Gloucester, former building society	95.3	8.8
Nationwide	Building society	89.6	8.3
Northern Rock	Bank, former building society	77.3	7.2
Royal Bank of Scotland	Bank	67.4	6.2
Barclays	Bank, including acquisition of Woolwich, former building society	61.6	5.7
HSBC	Bank	39.1	3.6
Alliance & Leicester	Bank, former building society	38.0	3.5
Bradford & Bingley	Bank, former building society	31.1	2.9
Bristol & West	Former building society, subsidiary of Bank of Ireland	23.0	2.1
Britannia	Building society	21.5	2.0
Portman	Building society, acquired by Nationwide in 2007	16.1	1.5
Yorkshire	Building society	13.5	1.3
GE Money Home Lending	Specialised lender, wholly owned subsidiary of General Electric	11.7	1.1
GMAC-RFC	Specialised lender, subsidiary of Residential Capital Corporation	11.3	1.0
Standard Life Bank	Subsidiary of Standard Life insurance company	10.4	1.0

Source: *Housing Finance Review.*

The table would have looked very different 20 years ago, when it would have been dominated by building societies. Of the largest ten building societies in 1987, only two (the Nationwide and the Britannia) retain their building society status.

While the lenders obtain some of their business directly, a significant proportion, probably 50 – 60%, is obtained through mortgage brokers to whom a commission is paid. These intermediaries include estate agents and insurance brokers. Intermediaries have an interest in the volume of transactions, which helps to explain why there is a substantial market in remortgages. Borrowers are able to obtain a lower rate of interest and the intermediary earns commission each time a new loan is taken out. However, the borrower may well incur significant fees in the process, both in redeeming the existing loan and taking out the new one.

Servicing mortgage loans
Mortgage lenders typically service loans that they originate. With the development of securitisation, a separate mortgage servicing function has developed. This has typically been used by new lenders that fund themselves entirely on the wholesale markets and which have sought to avoid any "back office" functions. The largest company in this market is Homeloan Management Ltd (www.hml.co.uk), a wholly owned subsidiary of the Skipton Building Society. The company currently acts for 40 mortgage lenders and manages over £50 billion of mortgage assets.

Funding mortgage loans
Mortgage loans in Britain can be funded in any way the lender chooses, from retail deposits through to unsecured wholesale funding, covered bonds and securitisation. There is no legislation governing any of the specific forms of funding. Some lenders rely wholly on retail deposits, others wholly on securitisation. The large lenders generally use all types of funding although with retail deposits predominating.

It is not possible to give precise figures for how mortgage loans are funded as the large banks do not hypothecate all of their funding to particular categories of loan. In very round terms the outstanding stock of mortgage loans is funded as follows –

Retail deposits	60%
Mortgage backed securities	20%
Covered bonds	5%
Other wholesale funding	15%

The various forms of funding are now examined in more detail.

Retail deposits
Appendix 3 briefly describes the development of the housing finance market in Britain. Until the mid-1980s building societies dominated the mortgage market. They operated as specialist savings banks, raising all of their funds from individual investors and making all of their loans to home buyers. Under their specific legislation they were restricted to these activities. Increasingly, they dominated the retail savings market as well as the mortgage market.

The traditional building society account was the passbook, with transactions being made over the counter and manually entered into a passbook. Most of their funding was technically in the form of shares, conferring ownership rights on the holders, but in practice identical to deposits. Individual investors generally want immediate access to their savings and shares were withdrawable on demand. At first sight it might seem dangerous to fund long term mortgage loans with deposits withdrawable on demand. However, the variable rate mortgage made this a very safe form of financial intermediation. If the general level of

interest rates rose then building societies increased their deposit rates so as to prevent an outflow, and increased their mortgage rates so as to be able to pay for the increased cost of deposits. Conversely, when rates fell both deposit and mortgage rates were reduced.

The concept was readily accepted in the marketplace. This was partly because, with official sanction, the building societies collectively set savings and mortgage rates through their trade association in a system specifically exempted from legislation prohibiting price fixing. The arrangement was used to dampen increases in the mortgage rate, thereby protecting captive borrowers although resulting in a shortage of mortgage loans.

The variable rate mortgage and retail funding worked well in the 1950s and 1960s when interest rates were relatively low and stable. However, from the late 1960s interest rates became more volatile and so the system came under pressure. Building societies had typically given three months' notice of changes in mortgage rates, but they gradually reduced this to one month and then to no notice so as to minimise the impact of rising deposit costs on their financial position.

In the 1980s the banks and building societies moved into direct competition and the cartel broke down. Societies began to offer different types of retail accounts including –

- Term accounts where a differential was paid above the base rate for accounts held for one, two or three years.
- Fixed rate accounts.
- Notice accounts, with a higher rate of interest being paid for accounts which could be withdrawn only after a period of notice, typically one, three or six months.
- Postal accounts – operated only through the post so as to minimise handling costs.
- Accounts with a minimum balance.
- Accounts with current account facilities.
- Tax favoured accounts, in particular Tax Exempt Special Savings Accounts (TESSAs) from 1991 to 1999 and Individual Savings Accounts (ISAs) from 1999, through which £3,000 can be saved a year with the interest being tax free.

More recently accounts operated only through the Internet have been offered. These typically offer higher rates of interest because they are cheaper to operate.

With the exception of ISAs, for which total balances are currently around £200 billion, there are no other significant tax favoured deposit accounts. Interest is subject to tax at the investor's marginal tax rate. Interest is normally paid net of the basic rate of tax with investors liable to the higher rate of 40% paying additional tax through their tax return. Those investors whose incomes are below the income tax threshold can elect to receive their interest gross.

However, the basic feature of retail funding remains – the funds are generally held at short or no notice and are generally at variable rates of interest. It follows that when retail deposits are used to fund mortgage loans then the loans must be at a variable rate of interest or fixed for only a short period.

Experience shows that large scale use of retail funding offers significant benefits to a housing finance system –

- In practice the funds are very stable, much more so than wholesale funds.
- The average cost of holding retail funds is lower than the cost of wholesale funds, although this is partially offset by the higher cost of administering many small accounts.
- An efficient "savings bank" structure with branch networks can attract funds that might not otherwise be saved.

- Retail financial institutions help deepen and widen the financial system, encouraging more people to manage their money efficiently.

The following table shows retail deposits outstanding in 2000 and 2006, illustrating also the substantial increase in deposits between the two years.

Personal sector liquid assets

	2000 £bn	%	2006 £bn	%
Deposits with banks	415	63	713	66
Deposits with building societies	109	16	188	17
Deposits with National Savings and Investments	63	10	78	7
Other	74	11	96	9
Total	661	100	1,075	100

Source: Bank of England and National Savings.

The table shows the dominance of the banks, followed by the building societies. Unlike in many other countries there is no structure of savings banks, the building societies largely performing this role. The relative importance of retail funding to building societies can be illustrated by the following key statistics at the end of 2006 –

Retail deposits	£188 billion
Other deposits and loans	£83 billion
Mortgage assets	£228 billion
Total assets	£294 billion
Number of branches	2,103

However, the use of other forms of funding by building societies has increased markedly; in the last ten years 30% of the increase in total funds held by building societies has come from the wholesale markets.

Residential mortgage backed securities

Residential mortgage backed securities (RMBS) now account for about 20% of the funding of the outstanding stock of UK mortgages; this percentage has increased rapidly in recently years, but will decline sharply in the immediate future because of the credit crunch in the summer of 2007. Unlike in other countries there has been no British legislation on securitisation nor have any quasi-government agencies, such as the American Freddie Mac and Fannie Mae, been established. Securitisation has been entirely a market development.

There have been two waves of securitisation in Britain. The first was in the mid-1980s and reflected a mismatch between the ability of institutions to originate mortgage loans and to hold them. As financial markets generally became more competitive in the 1980s, so the mortgage rate moved from being something determined by building society management to a market related rate, averaging around 150 basis points above money market rates. The transformation from an uncompetitive market to one where market forces played the dominant role had a major effect on the way mortgage business was undertaken. Power shifted from the suppliers of what had previously been the scarce commodity, mortgage loans, towards the suppliers of what was now the scarce commodity, borrowers. This immediately put considerable power into the hands of intermediaries such as insurance brokers and estate agents. Conversely, with the mortgage rate bearing a normal relationship to money market rates of interest, so the opportunity to use wholesale funds to fund an entire mortgage book was open.

It was no surprise that the combination of these forces led to the development of the secondary market. It enabled intermediaries to exploit their power by introducing mortgage business to newly formed companies which in turn could exploit the capital markets. This development coincided with the bull market in equities, which distorted the normal savings market, making wholesale funds more attractive than retail funds.

The secondary market was predominantly developed by new institutions such as the Mortgage Corporation, National Home Loans and the Household Mortgage Corporation, supported by investment banks using their experience of the US market. Building societies played no significant part in the market, but building society data on the mortgage market was used extensively by the rating agencies to rate issues.

The first issue of mortgage backed securities was made in 1987; by the end of 1990 there had been 50 issues raising a little under £9 billion, and accounting for around 6% of net mortgage funding in that period. These issues all had a similar structure, largely driven by the rating agencies and insurers –

- Loans had to meet certain criteria in respect of percentage advance, income multiple etc.
- The loans were sold to a special purpose vehicle (SPV) established by the originator. The SPV would contract back with the originator to service the loans for a fee, typically 0.25% of outstanding balances.
- Credit enhancement was provided either by pool insurance or by issuing senior/junior categories of securities.
- The mortgage backed securities issued by the SPV were at a fixed rate over the three month interbank rate, the margin generally being 20 – 70 basis points.
- Interest and principal repayments from the loans was passed through to the holders of the securities.

No secondary market in the securities subsequently developed; they were bought by investing institutions and held to maturity.

This phase of securitisation came to an end in the early 1990s when a combination of an economic downturn and rise in interest rates led to falls in house prices and substantial bad debts. The spread on mortgage backed securities widened such that this ceased to be a viable method of funding. One of the largest of the new lenders, National Home Loans, had to be rescued by the Bank of England.

The second wave of securitisation began in the late 1990s. This time it was led by the major lenders – Halifax (now part of HBOS), Abbey National, Northern Rock, Bradford & Bingley and Britannia. The motivation was twofold – diversification of sources of funding and efficient management of capital. Some specialist lenders also developed, reliant largely on securitisation for their funding.

Moody's Investors Service has published statistics showing the volume of securitisation in the UK and other countries. In 2006 Moody's calculated that structured finance issues in Europe, the Middle East and Africa totalled £371 billion, of which mortgage issues accounted for half - £185 billion. The UK accounted for over half of this total with issues of £95 billion, a 71% increase over the figure in the previous year. The largest originator of mortgage backed securities since 2000 has been Northern Rock, though its issuer Granite, with a market share of 31%, followed by Abbey (Holmes) with 23%, and HBOS (Permanent) with 22%.

The big lenders use what is known as a Master Trust system. The structure of these is complicated, but the effect is to turn mortgage backed securities into securities that look like medium term notes with an enhanced yield. The key features include –

- A huge size – over £3 billion for an issue, allowing multiple series to be issued. The arrangement is open ended so new loans can be put into the pool to maintain or increase its size. All of the loans in the pool support all the securities rather than a

specific tranche of loans supporting a particular issue. This structure allows for substantial economies of scale.

- A tiered structure based on the security of the notes. A standard structure in the early part of 2007 involved A notes (typically a little under 90% of the pool with an AAA rating), B notes (5% of the pool with an AA rating), C notes (5% of the pool with a BBB rating) and an equity element of about 1% of the pool. The lender takes the first loss through the equity element then losses are taken through the C, B and finally the A series. Prior to the credit crunch in August 2007, the A notes were typically at 10 basis points over LIBOR and C notes at 34 basis points.
- A return linked to money market rates.
- Repayment on the due date, typically between one and four years.
- The securities are generally issued in Dollars and Euros, swaps being used to convert the proceeds into sterling.

Other, smaller, lenders have used the more traditional "pass through" securities where the principal and interest payments on a pool of loans are passed directly to the holders of the securities. These securities are less attractive to investors particularly because of the uncertain repayment profile.

UK issues can be subdivided into "prime" and "non-conforming". Prime consists of standard good quality loans to individuals. Non-conforming includes buy to let mortgages (30% of the total in 2006), higher percentage loans, loans where borrowers have self-certified income and loans to borrowers who do not meet normal credit tests.

Even though the size of the RMBS market in 2007 was much larger than that in the late 1990s there is still only a limited secondary market in the securities. The securities are generally purchased and held to maturity. No substantial "market maker" has developed and there is no government support for the market. This is in contrast to the position in the USA where the "government sponsored enterprises", Freddie Mac, Fannie Mae and Ginnie Mae, have in effect turned mortgage backed securities into government backed securities and there is a thriving secondary market in the securities.

The sub-prime crisis in the US in the summer of 2007 had an immediate impact in the UK market even though the underlying conditions were more favourable. The largest issuer of RMBS, Northern Rock, found itself in a particularly vulnerable position. It had expanded rapidly since 1999, and was almost wholly reliant on wholesale funding. In August 2007 it faced a liquidity crisis, although it remained solvent and had a strong capital position and good quality mortgage book. When the Bank of England announced that it was providing liquidity to the Bank this had the seemingly perverse effect of causing a run, with depositors, fearful that they would lose their savings, queuing in the streets to take their money out. Eventually the Government was forced to announce that it would guarantee all the deposits in Northern Rock. The Northern Rock experience is examined in more detail in the annex to this chapter.

The full repercussions of this affair in particular and the credit crunch generally have yet to be felt. In the short term specialist lenders reliant on the wholesale markets are unable to do business. New issues of mortgage backed securities have halted, and it may well be some time before the non-conforming sector in particular recovers. Some other banks that were nearest in funding structure to Northern Rock have been subject to market rumours but none has been in any difficulty.

In comparative terms the big banks and building societies that use all available funding channels are well placed, as are the specialist building societies that rely on traditional retail funding.

Covered bonds
Covered bonds are widely used in a number of countries, in particular Germany and Denmark, for financing mortgage loans. The basic principle is that a pool of mortgages on the mortgage lender's balance sheet is ring fenced and bonds are then issued secured on that pool as well as being liabilities of the lender. In the event of the lender being unable to meet its obligations then the holders of the bonds have first call on the mortgages in the pool. Covered bonds are viewed as high quality debt and accordingly have high credit ratings.

Where covered bonds are used there is normally a specific law governing their use. The EU has established criteria for covered bonds that meet strict quality criteria through the Directive on collective investments in transferable securities (known as the UCITS directive). Bonds that comply with the UCITS directive benefit from higher prudential investment limits and preferential credit risk weighting.

In the UK there is no legal provision for ring fencing a pool of assets in this way and there is no legislation on covered bonds.

Covered bonds were first issued in Britain in 2003, and subsequently have increasingly been used to raise funds. The two largest mortgage lenders, HBOS and Abbey, are the main issuers of the bonds. Covered bonds totalling about £40 billion have been issued so far. They have mimicked the typical covered bond structure. A pool of mortgages is transferred to a special purpose vehicle so they are technically off the balance sheet of the lender. The lender guarantees the bonds. Bond holders have recourse both to the mortgages if the bank cannot meet its obligations and to the bank if the mortgage pool performs badly. Covered bonds therefore are a cross between a straightforward bond and a mortgage backed security. Indeed, HBOS uses its Master Trust arrangement for covered bonds as well as RMBS.

Bonds have been issued for periods of 3, 5 and 7 years, and all have been variable rate linked to LIBOR. Most have raised funds in Euros the proceeds then being swapped into sterling.

Like RMBS there is no secondary market in covered bonds.

The British Government is planning to introduce legislation that will bring covered bonds within the framework of the UCITS directive. The legislation will not require any significant change to current practices in respect of covered bonds in the UK, but will make them more attractive as a source of funding through widening the investor base and reducing capital requirements.

Other wholesale funding
In addition to RMBS and covered bonds, mortgage lenders also obtain some of their funds on the normal wholesale markets. They raise funds through certificates of deposit, time deposits, commercial bonds and interbank loans. Most of the funding is at variable rate. Where necessary interest rate swaps are used to match the profile of mortgage loans.

Annex

The Northern Rock affair

This paper is being written at the beginning of 2008 when the events at Northern Rock were a major issue, calling into question aspects of mortgage funding and banking supervision. The developments at Northern Rock need explaining in the context of this paper.

Northern Rock Building Society was formed on 1 July 1965 as a result of the merger of Northern Counties Permanent Building Society (established in 1850) and the Rock Building Society (established in 1865). It then merged with a number of small local building societies such that it was an amalgamation of 53 societies. It was a traditional building society, the 10th largest in the country, based in Newcastle with a heavy concentration of business in the north east of England, although with branches throughout the country.

On 1 October 1997 Northern Rock converted from a building society to a public limited company, listed on the London Stock Exchange and authorised under the Banking Act 1987. In this respect it followed the same pattern as most of the other large building societies. Some converted societies (Halifax, Abbey National and Woolwich) became part of the larger banking groups and some (Cheltenham & Gloucester and Bristol & West) became part of banking groups as soon as they converted. The Northern Rock, together with the Bradford & Bingley and the Alliance & Leicester, remained as separate corporate bodies, although there were regular rumours of takeovers by larger banking groups.

July 2007 – no signs of trouble
From 1999 the Northern Rock adopted a business strategy of rapid growth based on raising large amounts of funds from the wholesale markets, mainly through securitisation. It rapidly moved up the league table of mortgage lenders by size such that by the end of 2006 it was the fifth largest lender with loans outstanding of £77.3 billion. It had trebled its share of new lending, from 6% to 19%, in just eight years. Since 2000 it had been the largest UK issuer of mortgage backed securities with a market share of 30%. It had also made extensive use of other forms of wholesale funding, much of it on a short term basis. In July 2007 the bank announced its half year results which included –

- Record half year gross lending of £19.3 billion - an increase of 30.5%, with record net lending of £10.7 billion - an increase of 47.3%.
- Share of UK gross mortgage lending of 9.7% and net mortgage lending of 18.9%.
- Total underlying assets of £113.0 billion - an increase of 28.3% from June 2006.
- Residential mortgage arrears of about half the industry average.

The Chief Executive concluded that “the medium term outlook for the Company is very positive”.

The Interim Statement included the following on the capital position –

> “On 29 June 2007, we received notification of approval by the FSA of our Basle II waiver application. Our regulatory capital requirements, comprising both Pillar I and Pillar II, are therefore calculated under Basle II with effect from that date.
>
> We have adopted the Retail Internal Ratings Based (IRB) approach for our residential and personal unsecured loans, the Foundation IRB approach for our treasury portfolios and the Standardised approach for commercial loans and operational risk.
>
> The implementation of Basle II results in our Pillar I risk weighted assets at 30 June 2007 falling from around £33.9 billion under Basle I to £18.9 billion under Basle II, a reduction of some 44%. The risk weighting for our residential mortgages reduces to mid-teens %, treasury assets to around half of Basle I

> requirements, also around mid teens %, reflecting the low risk nature of these portfolios and personal unsecured loans to slightly below Basle I requirements."

At the end of June capital resources were equal to over 18% of risk weighted assets, more than double the regulatory requirement. The company anticipated a capital surplus and was planning share buybacks.

The funding model
The interim statement showed the extent to which the company relied on wholesale funding. In the first half of 2007 the net increase in its funding was –

£1.7 billion from retail deposits.
£2.5 billion from non-retail deposits.
£10.7 billion from residential mortgage backed securities.
£2.2 billion from covered bonds.

Just 10% of its net funding was from the retail markets, and by June 2007 retail funds accounted for 23.7% of total fund balances.

While other mortgage lenders had moved in a similar direction none had moved so far or so fast as Northern Rock.

The credit crunch
Just two weeks after Northern Rock issued its impressive half year results, on 9 August 2007 the credit crunch occurred, its origins being in the sub-prime crisis in the USA. This had a knock-on effect around the world. The cost of wholesale funds on the interbank market in particular rose sharply and demand for residential mortgage backed securities and covered bonds dried up almost overnight. The Northern Rock was under liquidity pressure as short term capital market instruments matured and it had nowhere to go to raise further funds. Unlike other banks it had not secured lines of credit which it could access.

On 14 August it was apparent both the Northern Rock itself and to the Financial Services Authority was the Bank was facing a crisis. It explored various funding and sale options, and the authorities monitored the position closely. By mid-September it was clear that Bank of England support was needed. On 14 September Northern Rock issued a trading update, which included the following –

> "Global investor appetite in the medium and long term markets, for either senior unsecured or asset backed securities, is currently greatly reduced. Whilst we expect conditions will improve over the medium term, potential volumes and pricing levels for the remainder of 2007 are likely to remain less favourable than those which have been achieved during the last two years. While Northern Rock has continued to raise new funds, these have been mainly in the short term wholesale debt markets and the amounts raised have not allowed Northern Rock to refinance maturing liabilities as well as to write new business at previous levels. In view of the difficulties Northern Rock has had in accessing longer term funding and the mortgage securitisation markets, the Company has been using its cash and other liquid reserves to support the funding of its business. Northern Rock expects current market conditions to continue for some time.
>
> In light of the above, Northern Rock has concluded that it is important to ensure that additional standby liquidity arrangements are available. Accordingly, Northern Rock has agreed with the Bank of England that it can raise such amounts of liquidity as may be necessary by either borrowing on a secured basis from the Bank of England or entering into repurchase facilities with the Bank of England. Such repurchase facilities would include securities that have prime residential mortgage assets as underlying collateral. The collateral that can be used under this "Repo" facility is similar in nature to the collateral currently utilised by many Eurozone banks with the ECB. This additional source of funding will enable Northern Rock to adapt its business model in line with the developing market conditions."

The Treasury issued a supporting statement –

> "The Chancellor of the Exchequer has today authorised the Bank of England to provide a liquidity support facility to Northern Rock against appropriate collateral and at an interest rate premium. This liquidity facility will be available to help Northern Rock to fund its operations during the current period of turbulence in financial markets while Northern Rock works to secure an orderly resolution to its current liquidity problems.
>
> The decision to authorise was made by the Chancellor on the basis of recommendations by the Governor of the Bank of England and the Chairman of the Financial Services Authority in accordance with the framework set out in the published Memorandum of Understanding between the Bank, FSA and HM Treasury.
>
> The FSA judges that Northern Rock is solvent, exceeds its regulatory capital requirement and has a good quality loan book. The decision to provide a liquidity support facility to Northern Rock reflects the difficulties that it has had in accessing longer term funding and the mortgage securitisation market, on which Northern Rock is particularly reliant.
>
> In its role as lender of last resort, the Bank of England stands ready to make available facilities in comparable circumstances, where institutions face short-term liquidity difficulties."

The expectation was that this would be sufficient to deal with the problem. Providing liquidity to the market is one of the principal functions of a central bank; this was not the first time that a bank had needed to use such a facility.

The crisis

In a somewhat perverse way the announcement of 14 September and more particularly the leaking of it on television news the night before, that the Bank of England was providing liquidity to Northern Rock, precipitated a crisis. Notwithstanding the Chancellor of the Exchequer appearing on TV to emphasise that the Northern Rock was "safe", retail investors took fright and began queuing outside branches to get their money back. The issue became a major news story. The queues and interviews with worried investors proved to be excellent TV, and the story quickly fed on itself.

On 17 September the Chancellor issued a second statement, that he would put in place "arrangements that would guarantee all the existing deposits in Northern Rock during the current instability in the financial markets".

This naturally had the desired effect of removing the queues, although both retail and wholesale investors continued to take money out of the Bank.

However, the government had committed itself to guaranteeing all deposits in a major bank, which had significant implications for all banks and the financial markets generally.

Implications for deposit protection

The UK has traditionally had modest arrangements for deposit protection, wishing to avoid the moral hazard problem. Under the deposit protection scheme compensation was limited to the first £2,000 plus 90% of the deposit between £2,000 and £35,000. This was clearly unsustainable as the government had committed itself to 100% protection of all deposits in the Northern Rock. As an interim measure, on 1 October 2007, it was announced that 100% protection of deposits would apply up to £35,000. The government has subsequently issued a consultation document on longer term reforms to the deposit protection system.

Future of the Northern Rock

At the time of writing (early January 2008) Northern Rock is continuing to operate with a UK government guarantee of all its deposits. It has lost a substantial proportion of both wholesale and retail deposits, and has loans from the Bank of England in excess of £25 billion. The intention is that the Bank will be taken over by another financial institution. However, the terms of the sale will be difficult and complex, particularly with respect to the unwinding of the Treasury guarantee and the repayment of Bank of England loans.

Currently, there are two prospective purchasers, a consortium led by the Virgin Group and Olivant, a vehicle established by a former chief executive of Abbey National. It is not clear that either group will be able to complete the acquisition on terms that satisfy both the government and the shareholders of Northern Rock, which are now dominated by hedge funds. The nationalisation of the bank, followed by a progressive sale of assets and run down of its business, is an alternative option that is being increasingly mentioned by commentators. This is not attractive for the government as it would mean substantial job losses in the Newcastle area.

Implications of the Northern Rock affair for banking and mortgage market regulation
The affair has already had, and will continue to have, significant implications for banking regulation. Already deposit protection has been made more generous, and the government is consulting on new arrangements.

Much of the focus of banking regulation recently has been on capital adequacy, in particular the implementation of the Basel 2 arrangements. The Northern Rock was, and still is, well capitalised. The problems have been entirely on the funding side. The Financial Services Authority duly issued a consultation paper on liquidity regulation in December 2007.

There are wider concerns, not just in the UK, about the transparency of some complex financial instruments although this is not a factor in respect of Northern Rock. The issues raised by recent events have been usefully summarised in the most recent Bank of England *Financial Stability Review.*

Key lessons from recent events

Area of weakness	Specific issues raised
Liquidity Management	• Underinsurance against closures of key funding markets. • Inadequate recognition of contingent liquidity obligations to off balance sheet entities. • Scenarios used in the stress testing of funding insufficiently severe.
Valuation of complex structured products	• High dependency on models in valuation. • Extent of investors' reliance on a narrow ratings metric. • Insufficient clarity in the composition and construction of instruments.
Opacity of structured credit Exposures	• Inadequate disclosure of exposures and losses. • Lack of transparency in off balance sheet exposures.
Crisis management Arrangements	• Insolvency arrangements for banks. • Deposit insurance regime. • Improvements in tripartite arrangements. • Underdeveloped practical arrangements for managing stress at an international institution.

Source: Bank of England *Financial Stability Review*, 25 October 2007.

What about the implications for the British housing finance model as described in this report? The Northern Rock affair has dented confidence in banking regulation and mortgage funding in the UK. On the lending side there is nothing in the Northern Rock's business that has indicated a problem. It did not concentrate on the sub-prime market and there is no evidence of significant bad debts in its mortgage portfolio. However, given the significant proportion of its lending that is relatively new and the early signs of a downturn in the housing market, it is reasonable to expect that arrears and losses will increase significantly from the latest reported position of being well below the industry average.

Northern Rock was brought down by its over-reliance on wholesale funds and its failure to have adequate arrangements in place to cope with a tightening of liquidity. It was atypical in respect of its funding, no other major lender having anywhere near the same dependence on wholesale funds.

The run on the Northern Rock did not lead to a run on any other bank, and no other major mortgage lender is in difficulty. The two banks most similar to the Northern Rock, building societies that converted to banks and remained independent, the Bradford & Bingley and the Alliance & Leicester, both continue to operate normally.

The Northern Rock had departed significantly from the traditional British model which involved significant use of retail funds. Its demise reflects its particular circumstances and its relevance is to banking regulation in general rather than to mortgage finance in particular.

11. Prudential supervision of mortgage lending

The security offered by residential mortgage loans
Loans to home buyers secured on residential property are considerably safer than other forms of bank lending. There are four principal reasons for this -

- Unlike many commercial loans the income earned to repay the loan does not derive from the investment financed by the loan. Loans are repaid out of income earned by borrowers and borrowers prioritise mortgage loan repayments because failure to do so might mean them losing their home.
- If borrowers lose their income then other means may be available to repay the loan, including income from other family members, savings, and income from renting out part of the property.
- If borrowers are unable to repay their loans the lender may well still not lose any money because it can take possession of the property with vacant possession and sell it. The lender is likely to be able to recover the loan from the proceeds because the security is readily marketable (unlike the security for many commercial loans), the loan will probably have been for no more than 90% of the value of the property, the chances are that house prices will have risen since the loan was taken out and insurance may cover any loss that the lender may make.
- Insurance provides additional protection to the lender. Lenders require the property itself to be insured. Many borrowers take out life insurance policies which will pay off the mortgage loan if the borrower dies while the mortgage is outstanding. Many borrowers also take out payment protection insurance which will help meet their mortgage repayments if they experience a loss of income because of illness or unemployment. Some borrowers can also benefit from social security payments to meet mortgage payments if they lose their income.

Empirical evidence confirms that residential mortgage lending is safer than other forms of bank lending. This is demonstrated by the loss experience and also by the willingness of lenders to make residential mortgage loans at a narrow spread over the cost of funds. In developed economies this is typically around two percentage points. In emerging markets the spread is more typically 12 – 15 percentage points. The exceptional security offered by residential mortgage loans is recognised in the international standards for capital requirements.

However not all mortgage lending is "safe"; there are many examples of specialist mortgage lenders running into severe financial difficulty through bad debts. In respect of individual mortgage loans the following factors are all relevant to the security from the point of view of the lender –

- Loan to value (LTV) ratio. Empirical evidence shows that this is a particularly significant factor in determining the likelihood of mortgage defaults and resultant losses. Broadly speaking, a loan with an LTV of 75-80% has a four times greater expected loss than one with an LTV of between 60-65%, and a loan with a LTV of 95-98% has an expected loss 3.4 times higher than a loan with an LTV of 75-80%.
- Loan to income ratio. Other things being equal, the higher the loan to income ratio, the greater the risk of default. A regulator may wish to see a maximum loan to income ratio and may look at the average loan to income ratio for a bank in comparison with other banks. However, this does assume that the income figure is meaningful, which does not always apply in emerging markets.
- Credit history of the borrower.
- Insider lender, in particular lending to purchasers of properties the construction of which the bank has financed or which the bank itself owns, for example having taken them into possession.
- Any guarantors, for example a relative or an employer.

- Mortgage insurance.

At the aggregate level the spread of risk is important. When there is a downturn in the market different parts of the market can be impacted in different, generally unpredictable, ways. The lender can reduce the risk to it by ensuring that it has reasonable spread of lending by geography, type of house (in particular apartments), value of house and type of borrower.

Interest rate risk

The soundness of residential mortgage loans depends also on any interest rate risk that the lender takes. In theory, a bank can take no interest rate risk by making fixed rate loans funded by fixed rate liabilities of the same maturity. For example, 25 year loans would be funded by 25 year bonds, five year loans by five year bonds or deposits, etc, or interest rate swaps could be used to have the same effect. Alternatively, the lender can make variable rate loans funded by variable rate deposits, that is the rate of interest on loans can be increased at any time in line with the increase in the cost of deposits. In some systems, the lender has discretion as to when, and by how much, to change interest rates with the market providing the necessary protection to borrowers. In other systems, interest rates must be tied to some cost of funds index.

In practice, however, a lender cannot entirely eliminate interest rate risk whichever system it uses. Fixed rate loans present a risk when interest rates fall. If the borrower has the right to redeem the loan at any time without penalty or with a repayment charge that does not reflect the loss that the lender could incur then the lender carries a substantial risk. Even if the borrower cannot redeem there is an increased default risk if interest rates fall as borrowers may refuse to continue paying what they see as an above market interest rate. This particular risk is reduced the more stable the general level of interest rates. The lender can reduce the risk by limiting the period for which a loan is fixed. For example, a loan can be for a fixed rate for five years, the borrower then having the option of rolling over the loan into another fixed rate loan or a variable rate loan. However, the lender may suffer the risk if interest rates rise rapidly over the period of the fixed rate. Alternatively, the lender can charge a higher rate of interest (the cost to a lender of protecting against premature redemption of a 25 year fixed rate loan in Britain currently is 100 basis points).

With variable rate loans the risk of default is increased if interest rates rise rapidly, as borrowers may be unable or unwilling to meet the higher repayments. To a limited extent, lenders can mitigate the effects of higher interest rates by extending the loan term. Again, in a stable economy with relatively stable interest rates this risk is reduced.

Generally, long term lending of any form is risky in an economy where interest rates are unstable. Short of government guarantees (for example compensating lenders when borrowers prepay long term loans in response to an interest rate fall) there is no means of isolating totally lending institutions from interest rate risks in respect of long term residential mortgage lending. Beyond the obvious points (such as not allowing long term loans to be made without long term liabilities to back them), banks and regulators must look to the stability of interest rates generally. In an unstable environment, particularly one characterised by a high rate of inflation and correspondingly high interest rates, banks (and their supervisors) may decide that it is simply imprudent to make any loan with a long maturity. In these circumstances to the extent that banks finance house purchase at all they do so through a succession of short term loans, although the borrower can never be certain that the next loan will be forthcoming.

The development of capital requirements
Prudential supervision of mortgage lending in Britain has evolved over time in response to market developments. Until the 1980's building societies were the only significant mortgage lenders, and generally mortgage lending was regarded as so safe that little attention was given to it.

Specific capital requirements were initially introduced in 1959 – a single 2.5% ratio; this was reduced to 2% in 1964. In 1968 a sliding scale was introduced based on size of assets, starting at 2.5% of assets, reducing to 1.25% of assets. In practice, societies held reserves well above the minimum requirement, the average being around 4% in the mid-1980s.

The Building Societies Act 1986 provided for a specific authorisation regime for building societies. The new regulator, the Building Societies Commission, for the first time published a comprehensive framework for the assessment of capital adequacy. This took account of the various points made at the beginning of this chapter. However, the capital requirement for residential mortgage loans remained low – 1% for "mature mortgages" and 2% for "core business". Higher capital requirements were imposed for other assets including loans to developers and non-mortgage lending. In addition to the overall capital requirement resulting from application of the formula, an additional margin of 0.5% was required. Building societies responded by significantly increasing capital held.

In 1991 the requirements were refined further – allowance being made for the period since the loan had been made, the loan to value ratio and other specific mortgage characteristics.

In 1987 work began on developing international standards for banking supervision. In July 1988 the Group of 10 Committee on Banking Regulations and Supervisory Practices (known as the Basel Committee) published *International Convergence of Capital Measurement and Capital Standards*, now known as Basel 1. This proposed a risk weighted system for assets and off-balance sheet items and a standard ratio of capital to risk weighted assets of 8%. However, residential mortgage loans qualified for a 50% risk weighting, so the required capital ratio was 4%. The relevant section of the report is set out below –

> "Loans fully secured by mortgage on occupied residential property have a very low record of loss in most countries. The framework will recognise this by assigning a 50% weight to loans fully secured by mortgage on residential property which is rented or is (or is intended to be) occupied by the borrower. In applying the 50% weight, the supervisory authorities will satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria. This may mean, for example, that in some member countries the 50% weight will only apply to first mortgages, creating a first charge on the property; and that in other member countries it will only be applied where strict, legally-based, valuation rules ensure a substantial margin of additional security over the amount of the loan. The 50% weight will specifically not be applied to loans to companies engaged in speculative residential building or property development. Other collateral will not be regarded as justifying the reduction of the weightings that would otherwise apply."

In applying Basel 1 to building societies, the Commission duly adopted the 50% risk weighting for "traditional and seasoned advances", with a 60% weighting for loans with one or more additional risk factors and 75% for loans seriously in arrears. However, the Commission also took account of a range of other factors in assessing whether the nature of the business of a particular building society should warrant a higher capital requirement. This approach was taken forward by the Financial Services Authority when it took over responsibility for the supervision of building societies in 2001.

This brief summary has shown how specific capital requirements for mortgage lenders have been integrated into the framework for banks. It has also shown the increasing complexity of the capital requirements from a starting point of a fixed 2.5% ratio of capital to assets to a more complex risk weighted system backed up by an assessment of the particular risks posed by the business of a particular building society.

Basel 2

From the beginning of 2007 what is known as Basel 2 is being implemented in the European Union through the Capital Requirements Directive. It is being implemented in many other countries as well. Basel 2 is far more detailed than Basel 1 and has been the subject of considerable debate.

In addition to capital requirements for credit, operational and market risk, Basel 2 also sets out requirements for internal capital adequacy assessment and supervisory review and public disclosure of risk and capital information. The basic requirement for a ratio of risk weighted assets to capital of 8% remains. The special nature of residential mortgage lending continues to be recognised, with the basic risk weighting reduced to 35% - equivalent to a ratio of 2.8%. Residential mortgage loans are the only category of assets for which the risk weight is being reduced. The relevant sections of the Basel 2 report are set out below -

> "72. Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met.
>
> 73. National supervisory authorities should evaluate whether the risk weights in paragraph 72 are considered to be too low based on the default experience for these types of exposures in their jurisdictions. Supervisors, therefore, may require banks to increase these risk weights as appropriate.
>
> 78. In the case of qualifying residential mortgage loans, when such loans are past due for more than 90 days they will be risk weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50% at national discretion."

Lenders can choose between a number of measurement approaches. The simple "standardised" approach provides for the 35% risk weighting for mortgage exposures of 80% or less of the property's value with a marginal risk weight of 75% for the excess proportion, although this can be reduced if the lender purchases credit risk insurance. This approach is expected to be adopted by the smaller lenders.

Larger lenders will generally opt for the Retail Internal Ratings Based (IRB) Approach. This involves using their own data in respect of default information. The quality of that information and procedures and systems generally have to meet high and consistent standards. The general view is that adoption of IRB approach should reduce the weighting to under 20% - equivalent to a capital ratio of 1.6%. This will give lenders adopting this approach a competitive advantage over others, and over time will encourage even small lenders to move to the IRB approach.

Basel 2 also requires capital to be held in respect of operational risk. Broadly speaking the requirement is for capital of 12 – 15% of positive gross annual income.

Finally Basel 2 requires lenders to publish information on their risk exposures, assessment processes and capital adequacy.

Basel 2 is expected to have a significant effect on mortgage products and pricing in Britain and other countries. Margins are likely to narrow on "prime" loans reflecting lower capital requirements, and widen on sub-prime loans. Lower capital requirements will reduce the incentive to securitise as a means of managing capital, but at the same time make mortgage backed securities more attractive to hold.

The impact of Basel 2 is analysed in a report by Brian Jagger (2007) for the Council of Mortgage Lenders. The conclusions of that report are set out below –

> "Basel 2 is a major regulatory change for mortgage lenders. It is complex and expensive to implement. Mortgage lenders adopting the advanced approaches have potential competitive advantages from lower capital requirements and the use of more advanced risk measurement and management capabilities.
>
> Reductions in the credit risk capital requirements for mortgages are expected to average over 60% for lenders adopting IRB compared with around 25% for those on standardised. The reductions allowable under IRB are limited in the first few years due to capital floors set under transitional arrangements. The majority of lenders surveyed for this report expect capital changes to translate to price changes, with margins narrowing on prime and buy-to-let lending and widening for self certified and sub-prime.
>
> Lenders adopting IRB models for regulatory capital are expected to use the models within the business, such as for supporting portfolio acquisition strategies, determining internal capital allocation, in credit approval decisions, portfolio risk management, arrears management and provisioning. The information from ratings models may help lenders to refine their customer segmentation and target customer acquisition and retention more closely, with appropriate products and pricing. Over time, lenders with less sophisticated risk measurement capabilities and using the less risk sensitive standardised approach to regulatory capital may suffer adverse selection.
>
> However, much of the change anticipated represents a continuation of trends already evident in the market. The impact of Basel 2 is, therefore, expected to be evolutionary rather than revolutionary."

12. Relevance of the British experience to emerging markets

It is dangerous to seek to transfer practices in respect of housing and housing finance from one country to another. As this paper, in particular Appendix 3, has demonstrated, the British housing development and finance systems have developed over a period of many years, in response to particular circumstances. However, every country's experience with housing has lessons for other countries – on how things might be done and how they should not be done.

This chapter pulls together the British experience and identifies areas of relevance to emerging markets. First however, it is useful to rehearse why housing and housing finance is so important to economic development.

The importance of housing and housing finance to economic development
Appendix 4 briefly analyses housing development and finance in emerging markets drawing heavily on relevant World Bank papers. The key points are –

- In the poorest economies most people live in an informal economic structure, occupying properties for which they have no ownership rights and having no contact with formal financial institutions.
- Urban land markets are frequently dysfunctional, partly as a result of land being owned by government and inappropriate controls on the use and development of land.
- Where formal housing finance loans are available they are likely to be at a substantial spread over the cost of funds – up to 15 percentage points in the least developed countries compared with under two percentage points in the UK.
- Banking systems are not well developed.
- Bank lending is constrained by poor collateral, inadequate information about the credit-worthiness of potential borrowers and inability to enforce contracts.
- People are frequently constrained from investing in housing as they do not have security of tenure.
- Housing investment often occurs on an incremental basis as resources are available, with little opportunity to borrow on reasonable terms to allow significant investment.

Investment in housing contributes directly to an improvement in living conditions. Housing investment has a favourable effect on economic development, particularly as it is less import intensive than forms of expenditure.

The development of housing finance contributes directly to lower housing costs. Monthly repayments on a five year loan at a ten percentage point spread over the cost of funds are more than three times higher than repayments on a 25 year loan at a two percentage point spread. Housing finance also helps strengthen and deepen the financial system, which in turn is likely to have a beneficial effect on economic development.

There is a general acceptance that investment in housing and an effective housing finance system not only improve living standards but also contribute in a positive way to economic development.

The British model
This section briefly summarises the British "model" for housing development and finance. It is a model that has not been planned or legislated for, but rather has evolved over a period of years in response to changing needs.

Housing is built and financed by private sector institutions operating within a legal framework that allows them to innovate and compete. The rule of law is paramount. Compared with

many other countries Britain has lightly regulated housing and housing finance markets, but the legal provisions are understood, accepted and enforced. Limited regulation effectively enforced is preferable to a complex legal framework which may look good on paper but which is largely ignored in practice.

Within this very broad framework the key features of housing and housing finance in Britain can be summarised as follows –

- A legal framework for the ownership and transfer of land in which occupiers have security of tenure and clear legal rights and obligations.
- An efficient system for registering ownership of land with a government agency, which gives a government guarantee on the validity of title.
- Spatial planning policy that helps ensure that the value of residential housing is not adversely affected by other development.
- Building standards that are generally accepted and rigorously enforced.
- Protection for buyers of new houses through private sector insurance arrangements, effectively enforced by the lenders.
- Large scale development of new housing by private developers. Houses are generally built speculatively, that is serious marketing does not begin until after construction has started.
- A transparent system by which developers are "taxed" on the increase in the value of land as a result of granting planning permission, part of the proceeds being used to fund housing for low income people, essential infrastructure and community facilities.
- Comparatively low costs for buying and selling houses, which contribute to an active market in the resale on existing houses.
- A national network of skilled property professionals who facilitate the effective functioning of the market.
- Mortgage law which gives clear rights and obligations to both parties.
- Regulation of mortgage lending to ensure that borrowers are aware of the nature of their contracts.
- Legislation and regulation that allows lenders to take possession of and sell the properties of borrowers who default on their loans. However, there is protection for a borrower in that a court order for possession must be obtained, and the court will not give an order unless it is satisfied that the borrower will not be able to repay the loan.
- Financing house purchase is a mainstream banking function and does not operate on a special circuit.
- Sound prudential regulation of bank lending.
- Lenders are free to make loans and fund these loans in any way they like within the framework of prudential regulation and market disciplines.
- Sound underwriting criteria, based around the value of property, the percentage advance, and the income and credit record of the borrower.
- Loans largely at variable rates or at rates fixed for short periods, generally two years.
- Mortgage loans largely financed out of retail deposits. In recent years increased use has been made of residential mortgage backed securities, covered bonds and other forms of wholesale funding.
- 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 50 – 200 basis points.

However, the impression should not be given that the British system is perfect. To give a complete picture it is necessary to note where there have been problems.

For 50 years rent controls and legislation on security of tenure made it uneconomic to provide private rented accommodation. This forced people into owner-occupation too early

in their lives and contributed to the rise in house prices. This situation has now been changed and there is a thriving private rental market.

Discrimination against private renting was reinforced by very favourable tax treatment of owner-occupied housing until the late 1980s. As in many other countries housing is exempt from capital gains tax, and there is also favourable treatment in respect of inheritance tax. Interest on loans for house purchase also qualified for tax relief at the borrower's highest marginal tax rate. There was therefore a strong artificial incentive to invest in owner-occupied housing, which further boosted house and land prices. This favourable tax treatment was reduced progressively in the 1980s and 1990s through the ending of mortgage tax relief, although preferential treatment in respect of capital taxes remains. At the same time, discrimination against the private rented sector was ended. These changes, while very necessary, caused market turbulence, particularly as they combined with a downturn in the housing market as a result of economic factors.

As the chapter on planning observed, the operation of the planning system has been heavily weighted against development. As a result insufficient land has been available for house building, which has contributed to a rapid rise in house prices in relation to earnings. It is now difficult for first time buyers to get into the housing market without committing an excessive proportion of their income to mortgage repayments. Many young first time buyers receive financial help from their parents, leaving those without access to such help in an even less favourable position.

While Britain has an excellent network of property professionals, it is fair to say that rising property values have meant that poor quality valuations have been of little consequence. When house prices have fallen, as in the early 1990s, the quality of some valuations was shown to be questionable. The estate agency business is effective in facilitating the sale of houses, but the scope for malpractice has not been adequately minimised by regulatory action.

In practice, lending criteria have turned out to be satisfactory because rising property values have compensated for imprudent lending. The experience of the early 1990s and perhaps also the experience that might emerge over the next year or two shows that in a bid to get business lenders have sometimes been unduly liberal in their lending standards.

Lessons for emerging markets

The lessons for emerging markets from the British experience naturally follow on from the analysis above.

The rule of law, a sound economy and a stable society are taken for granted in Britain and in many other countries. If they do not exist then the task of encouraging investment in housing is difficult.

Clear ownership or occupancy rights are essential if people are to be encouraged to invest in their own housing or to engage in housing development. This requires a legal framework in which contracts are enforceable and an efficient and effective system for recording ownership of property. The Land Registry in England and Wales, similar agencies in other countries and international agencies are able to help emerging markets put the necessary systems in place. However, full scale title registration will not help the poorest people who are unable to access formal finance. They simply need security of tenure, which will encourage them to invest in their housing largely through doing work themselves. This point was well illustrated in an article "A flourishing slum" in *The Economist* on 19 December 2007. The article was about Dharavi, a huge area of informal housing in Mumbai. It noted that -

> [Dharavi] "has become safer for two main reasons. One is that in 1976 the state government gave the slum-dwellers limited rights over their hutments. They were recognised as "identified encroachers", a status guaranteeing compensation in the event that the government bulldozed their shanties. In return, the government began collecting peppercorn rents—currently around 100 rupees [about £1.50] a month for each hutment—on the encroached land. It also started supplying Dharavi with mains water and power, which the gangsters hitherto had stolen from the city and sold in the slum. This step put the slumlords out of business, and started a modest property boom. Today, tiny hutments in Dharavi are sold, without title, for 500,000 rupees [about £6,500].

The availability of land for new housing development is not a problem in some emerging markets; rather the problems are unpermitted development which can adversely affect the value of houses, space and other standards which are unrealistically high given the means of the inhabitants and the lack of availability of essential utilities. Britain's utilities are not ideal – much of the infrastructure is very old and needs modernising. However, it is taken for granted that the necessary infrastructure and utilities will be provided for new developments in a timely and efficient manner, the developer meeting the costs either directly or through planning agreements.

In many developing countries there is no large scale housing development. Even where a large site is available the developer has to build units individually as the potential purchasers are able to pay for the work. This is inefficient because economies of scale, which potentially are massive, cannot be achieved, and it is also undesirable for those people who do buy because they will be living in the middle of a building site for many years. Ideally, builders should be able to develop a site as a single operation. For this to happen they need access to bank funding to finance work in progress, and potential buyers need to be able to obtain long term house purchase loans.

Purchasers of new housing need some assurance that their houses are structurally sound and free from major defects. This can be achieved in various ways including regulation of building standards. However, if the resources to do this effectively are lacking there is a risk that such controls simply become a bureaucratic obstacle offering scope for corruption rather than protection for the public. In such circumstances it might be better to allow developers to develop their own arrangements, backed up by insurance.

Perhaps more importantly, in developing countries buyers frequently have to pay a large initial deposit and are at risk if the developer fails to complete the house. An insurance arrangement like that offered by the National House Building Council provides valuable protection to buyers of new houses, and should be an essential part of the consumer protection framework in any country.

A strong surveying profession and expertise in valuing make a significant contribution to the efficient functioning of a housing market. These cannot be created overnight, and data needs to be built up on which valuations can be based. The Royal Institution of Chartered Surveyors in Britain has members throughout the world and is always ready to help develop the profession and appropriate standards in emerging markets. The government must take responsibility for ensuring that a database of information on property transactions and values is built up and is readily accessible. Ideally it should not undertake this activity itself but rather should ensure that it is done by an appropriate private sector body or perhaps an agency such as the central bank.

Mortgage lending will develop of its own accord if the conditions are right. There is no need for the government to create a "National Housing Bank", or to pass laws specific to mortgage lending or to create a "Mortgage Regulatory Authority". These may well create obstacles to

mortgage lending rather than encourage it. Mortgage lending is a banking function that should be regulated by the banking supervisor. Retails banks should generally be mortgage lenders. There is room for specialist non-bank lenders, funded on the capital markets, but they should be subject to compatible regulation by the banking regulator.

Large scale, safe, mortgage lending is essential both to enable people to buy homes and to bring down the cost of mortgage loans to a reasonable spread over the cost of funds. The 50 – 200 basis point spread that exists in the UK and many other industrialised countries will not be achieved in emerging markets for many years to come. However, substantially reducing the spread, which in some countries is over 15 percentage points - ten times that in the UK, will make a far greater contribution to increasing investment in housing than anything that a government initiative could achieve.

Interest rate spreads

	Banking business generally %	Mortgage business %
OECD countries	4	2
Middle income countries	7	5
Sub-Saharan Africa	13	10 - 12

The implications of these spreads are illustrated by comparing the annual payments on repayment mortgages for varying terms with spreads of two and ten percentage points.

The impact of high spreads on mortgage rates

	UK Market	Developing Country
Cost of funds	5%	5%
Mortgage rate	7%	15%
Repayments on £30,000 loan		
Interest only	£2,100	£4,500
25 year repayment	£2,534	£4,640
10 year repayment	£3,981	£5,976
5 year repayment	£5,723	£8,950

A borrower with an income of £10,000 would be committing 25% of income to repayments on a 25 year loan at 7%, but a prohibitive 46% with an interest rate of 15%. If a 10 year loan is the maximum term available then repayments increase to 60% of income. The table illustrates the importance both of reducing spreads and lengthening repayment periods.

Minimising bad debts and economies of scale are crucial in reducing spreads. Mortgage lending needs to be on a large scale if the fullest possible benefits are to be obtained. Whether wholesale or retail sources of funds should be attracted is essentially a tactical decision. There are naturally concerns about the principle of funding long term mortgage loans with short term retails deposits. However, the British experience shows that this can be done successfully and safely, by using the variable rate mortgage or by fixing rates for two or three years at a time. These instruments have the effect of compensating for a maturity mismatch while at the same time tapping retail deposits which are likely to be more stable than wholesale funds. It is not feasible to require lenders, by legislative or regulatory means, to make long term loans at fixed rates of interest.

Emerging markets need to increase the depth and breadth of financial markets as an objective in its own right, and at the same time remove any obstacles to banks financing house purchase. It may be thought that if banks are lending to finance house purchase then those funds cannot be used to finance essential industrial investment. This is a short sighted view. Strengthening the financial system and an expansion of mortgage lending go together. Even very poor people will invest in their own housing. They are more likely to open a bank account and to become more a part of the formal economy if the bank can help them fund house purchase. More generally, the banks are more constrained by a shortage of suitable lending opportunities than they are by a shortage of funds.

There is a strong correlation between economic development and the size of the mortgage market. This is not to suggest that mortgage lending is a driver of economic development, but rather that the two go together and that house purchase lending should not be seen as competing with industrial investment in a zero sum game.

In the USA, the mortgage debt/GDP ratio is about 90%, in Western Europe it averages 45%, in Central Europe 7% while in developing countries it is just 2%. However, it should be noted that countries in a similar stage of development have widely differing mortgage debt/GDP ratios. An EMF study (2004) showed that in Western Europe the residential mortgage debt/GDP ratio ranged from 13% in Italy to 100% in the Netherlands, with an average of 45%.

Removing obstacles

Governments in emerging markets should concentrate on removing obstacles to mortgage lending. Such obstacles include –

- The inability of lenders to realise the mortgage security in the event of the borrower failing to make the necessary repayments. This inability may result from laws which misguidedly give excessive protection to the borrower, or an inability to use a satisfactory law effectively either because of the time that it takes (ten years is common in some countries) or the courts interpreting the law in a way that defeats its purpose. A mortgage loan should be the cheapest finance available to individuals because of the security it offers to the lender. If that security is reduced or removed then the loan is in effect unsecured and must carry a corresponding interest rate.
- Related to the previous point, the apparently minor point of delays in registering transfers of ownership and registration of mortgage charges. This puts the lender at risk between the time when it advances the money and the time when it has security. The likely response of a bank is not to lend the money until it has the security, which may mean that it will not lend at all or that the bank or another institution has to provide expensive bridging finance. Efficient land registry procedures do not necessarily require substantial investment; often competent management is all that is needed.
- Unreasonable restrictions by the banking regulator, such as unrealistically low limits on the amount of lending on the security of property. If mortgage lending is in practice safer than other forms of lending, and this can be demonstrated by default rates, then the banking regulator should give a preferential risk weighting to residential mortgage loans in line with the international standards set by the Basel Committee. "Basel 2" allows a 35% risk weighting for mortgage loans that meet certain standards. However, this is probably inappropriate for emerging markets, as indeed is the whole of Basel 2. The 50% risk weighting provided for in Basel 1 is more appropriate but only where mortgage lending can be demonstrated to be less risky than other forms of lending.
- Legislation or regulation which attempts to control the terms of mortgage loans, for example whether loans should be at a fixed or variable rate, or the imposition of lending criteria. These will inhibit the development of the market. Market forces

combined with prudential regulation provide the necessary safeguards to borrowers. However, where loans are at a variable rate or a rate fixed for a short period then it is essential to ensure that the borrower is fully aware of the nature of the loan and the fact that repayments may increase.

- Directed lending, for example a requirement to make loans to certain sections of the community or on certain types of property that would not otherwise qualify for a loan. In the early stages of development of a mortgage market it is proper that lenders concentrate initially on "safe" lending. As they gain experience and as the volume of their lending increases so their unit costs fall and they are better placed to extend their lending to wider sections of the community. Pushing the banks to liberalise their lending criteria prematurely will increase their costs and be counter-productive.

Does the British experience suggest that there are positive steps that governments might take to develop mortgage lending? The simple answer is no, but that does not mean that that is the position in emerging markets.

In addition to ensuring that there is an adequate legal and prudential framework this section has already made the point that government has a role in ensuring that a database of information about house prices in particular is built up.

Is securitisation the answer?

Emerging markets naturally look at means of increasing the provision of housing finance. If loans that have already been made can be removed from the balance sheet of the lender then the scope for new lending is increased. There are three basic ways in which this can be done –

- The sale of a package of loans to an institution that wishes to hold long term mortgage loans in its portfolio, for example an insurance company or a pension fund which has long term liabilities. In such a case the lender will probably continue to service the loans. Some allowance for this activity must be taken in calculating the capital required by the lender.
- Selling bonds backed by a portfolio of loans which remain on the balance sheet of the lending institution. In the event of the lender defaulting then the loans act as security for the holders of the bonds. The advantage to the purchaser of the bonds is that they are able to obtain a higher rate of interest than on say government securities, but they do not have the hassle of administering mortgage loans.
- Securitisation – that is selling securities backed by a pool of mortgages which then are no longer on the balance sheet of the lending institution.

Securitisation is to many people an exciting concept and some see it as a route to obtaining more money for house purchase loans. It has been energetically promoted by its proponents, and a number of emerging markets have announced ambitious plans to develop secondary market activity. However, securitisation is often over-sold. The issue of mortgage bonds or securitisation is merely a means of obtaining finance. They do not create new finance in themselves and there are considerable costs incurred in raising money in this way.

Chiquier, Hassler and Lea (2004) provide an excellent analysis of mortgage securities in emerging markets. They conclude that, despite numerous attempts, there have only been limited successes in introducing mortgage securities in emerging markets on a significant scale.

Two main reasons are given for the relative lack of success. The first is that the infrastructure requirements for mortgage security issuances are demanding, time consuming and costly. Secondly, it is highly unlikely that mortgage securities can be successfully issued in countries with weak and underdeveloped primary mortgage markets: "There must be a

modicum of standardisation in mortgage instruments, documents and underwriting, reasonable standards of servicing on the part of lenders and issuers and professional standards of property appraisal."

The paper notes that government involvement is not a guarantee of success but that there must be an underlying market need for capital market funding and investor demand for mortgage securities.

The paper lists three prerequisites before investors will be interested in mortgage related securities –

- They must offer attractive risk adjusted returns. Mortgage securities will be seen as an alternative to government bonds which provide a benchmark yield.
- Investors must have a capacity for mortgage related securities.
- Investors must be able to invest in mortgage related securities, that is they must have the necessary legislative and regulatory authority and the regulatory treatment must be appropriate.

The paper also details the legal requirements: an adequate legal, tax and accounting framework for both investors and borrowers, facilities for lien registration, the ability to enforce liens, the ability to transfer or assign security interest and protection of investors against the bankruptcy of the originator or the servicer.

In addition there are three primary market prerequisites as well: standardisation of documents and underwriting practices, high quality servicing and collection and professional standards of property appraisal.

Perhaps the key message from the paper is that mortgage securities are not a substitute for an effective primary market nor are they a means for emerging economies to take a short cut in developing an effective housing finance system. This does not mean that securitisation has no place in emerging markets. The authors conclude: "Mortgage securities are the vehicle to tap the capital markets for funds for housing and can improve the accessibility and affordability of housing and allow lenders to better manage the complex risks of housing finance. In markets with demonstrable need and appropriate instruments and institutions, mortgage securities can make a real contribution to housing finance. We believe the use of such instruments will grow over time as housing demand increases, as lenders become more capital and liquidity constrained and as investors become more familiar with their risks." In particular the authors see mortgage securities as a means of sharing the interest rate risk between borrowers and institutional investors who are better able to manage such risks.

Is this UK experience relevant to emerging markets? The fact that securitisation has developed purely as a market development is evidence that government support is not essential. The availability of good quality information on the mortgage and housing markets and comprehensive insurance arrangements did play an essential part in developing the market. In an emerging market where these do not exist some government pump priming, particularly through mortgage insurance, may have a useful role to play in widening funding sources through securitisation, but only if the essential building block of a sound primary market exists.

The UK experience also suggests that covered bonds may well be a better option than mortgage backed securities. They are simpler in concept, do not require a significant legal infrastructure, and offer better security to investors who have a claim against the issuer as well as the bonds. Because the lender remains at risk they also encourage sound lending and mortgage administration. Covered bonds may be a particularly attractive investment for pension funds and insurance companies to hold.

Appendix 1 Summary of relevant legislation

Copies of all British acts of Parliament and Regulations can be found at www.opsi.gov.uk.

Town and Country Planning Act 1993 consolidates and amends previous legislation on town and country planning.

Planning Policy Statement 3 (2006) Housing sets out the national planning policy framework for delivering the Government's housing objectives.
http://www.communities.gov.uk/publications/planningandbuilding/pps3housing

Building Act 1984 provides for Building Regulations to be made.

Law of Property Act 1925 provides the basic framework for land ownership and transfer in England and Wales.

Commonhold and Leasehold Reform Act 2003 provides for the commonhold system of ownership of apartments and makes changes to the law on leasehold tenure.

Land Registration Act 2002 creates a framework in which it will be possible to transfer and create interests in registered land by electronic means and makes minor changes to ownership rights.

Estate Agents Act 1979 regulates the conduct of estate agents in the course of estate agency work concerned with buying and selling property. The Act gives the Office of Fair Trading the power to issue warning or prohibition notices against persons it considers to be unfit to carry on estate agency work. The Act lays down the duties that agents owe to their clients.

Property Misdescriptions Act 1991 makes it an offence to falsely describe or make misleading statements in relation to land. This includes descriptions of the address and location of a property, room sizes, easements and maintenance charges.

Consumers, Estate Agents and Consumer Redress Act 2007 requires estate agents to belong to an ombudsman scheme, and to make and keep adequate records of their dealing with a client for six years, and gives the Office of Fair Trading greater powers over estate agents.

Housing Act 2004 introduces two new licensing regimes for private rented properties and provides for sellers or estate agents to produce a home information pack before marketing any residential property for sale.

Financial Services and Markets Act 2000 provides for a single financial regulator (the Financial Services Authority) for almost all financial services in Britain. Schedule 2 to the Act prescribes the areas that FSA regulation may cover.

Mortgages and home finance: conduct of business sourcebook provides for the regulation of mortgage advice.
http://fsahandbook.info/FSA/html/handbook/MCOB.

Building Societies Act 1986 provides for the constitution and powers of building societies.

Basel 2 sets out international standards for capital adequacy for banks.
http://www.bis.org/publ/bcbs107.htm

Appendix 2 The major institutions

Land Registry (www.landregistry.gov.uk)
HM Land Registry is responsible for registration of title in England and Wales. In Scotland the same service is provided by the Registers of Scotland.

Government departments
In England and Wales housing policy is the responsibility of Communities and Local Government (CLG) (www.communities.gov.uk). Over the last few years there have been a number of changes in the structure of government. In practice, housing, planning and local government have been combined in a single department and the changes have been more in name than in structure. However, CLG is not responsible for any housing production. Its role is largely to provide the framework in which the housing market operates including planning legislation and policy, financing and regulating social renting housing and building regulations.

In Scotland the same functions are provided by the Housing Division of the Scottish Executive.

The Treasury (www.hm-treasury.gov.uk) has in recent years played an active role in housing policy, in particular by commissioning major studies on the supply of land and on mortgage finance.

Local government
Local authorities are responsible for planning at the local level, but within the framework set by national legislation. They also enforce the building regulations. Some local authorities are still significant landlords.

The trade association for local government in England is the Local Government Association (www.lga.gov.uk).

Home Builders Federation (www.hbf.co.uk).
The Home Builders Federation is the principal trade organisation for private sector house builders. Its member firms account for approximately 80% of all new homes built in England and Wales.

National House Building Council (www.nhbc.co.uk)
The National House Building Council is a private sector body, structured as an insurance company, largely owned by the house builders, but influenced by the government. It sets standards for construction, inspects houses in the course of construction, and provides a 10 year guarantee for buyers of new houses.

Housing market professionals
Surveyors are commissioned to value properties, and in some cases to undertake surveys, by some purchasers and all lenders. Estate agents, who may also be professional surveyors, are commissioned by vendors to sell properties. Solicitors and licensed conveyancers are commissioned to undertake the legal work to transfer properties. The various types of institution have their own representative, professional and regulatory bodies. The Royal Institution of Chartered Surveyors (RICS) (www.rics.org) is the representative body for surveyors and valuers, the National Association of Estate Agents (www.naea.co.uk) is the main representative body for estate agents, solicitors are represented by the Law Society (www.lawsociety.org.uk) and supervised by the Solicitors Regulation Authority (www.sra.org.uk), and licensed conveyancers are supervised by the Council of Licensed Conveyancers (www.theclc.gov.uk).

The Ombudsman for Estate Agents (www.oea.co.uk) provides a free complaints service for estate agency services.

Financial Services Authority (www.fsa.gov.uk)
The Financial Services Authority (FSA), which regulates almost all financial services in the UK, is responsible for the prudential regulation of mortgage lenders and deposit takers and also for the conduct of business of mortgage lenders and intermediaries.

The Office of Fair Trading (www.oft.gov.uk)
The Office of Fair Trading (OFT) has a modest regulatory role in respect of estate agents and a more general consumer protection role.

Council of Mortgage Lenders (www.cml.org.uk)
The principal mortgage lenders are the main retail banks and the building societies (specialist savings banks). Since 1990 most of the major building societies have either been acquired by banks or have transformed themselves into banks. The Council of Mortgage Lenders (CML) is the representative body for mortgage lenders.

Building Societies Association (www.bsa.org.uk)
The Building Societies Association (BSA) is the trade body for the UK's remaining 59 building societies – mutually owned savings and mortgage lending institutions. Building societies account for around 20% of mortgage lending in Britain.

Appendix 3 Housing and housing finance – historical evolution

The housing finance system in any country is largely a consequence of a series of decisions taken over many years. The effect of these decisions may well be unpredicted and unintended. An understanding of the history of housing and housing finance in Britain is therefore essential in order to understand the system in operation today.

The influence of the housing market
The nature of the housing market is one of many factors influencing the housing finance system. In the early part of the 20th Century about 90% of all housing in Britain was owned by private landlords. In 1915 rent control was introduced as a war-time measure. It remained in force until the 1980s. Tenants also had security of tenure for life. The inevitable consequence was the ending of new investment in rented housing and a steady running down of the stock.

Beginning in the 1920s, successive governments encouraged the development of large housing estates by local authorities, allocated to local residents on the basis of need. Much of this housing was unattractive, as well as being unavailable to large sections of the community.

There was therefore an artificial demand for owner occupation. By 1938 the proportion of privately rented units had fallen from 90% to 58%, 32% of units were owner-occupied and 10% were rented from local authorities. The trend continued after the Second World War.

Housing stock, Great Britain, by tenure

Year	Owner-occupied %	Public rented %	Private rented and other %
1910	10	-	90
1938	32	10	58
1950	29	18	53
1961	42	26	32
1971	51	31	19
1981	58	31	11
1992	66	24	10
2000	69	21	10
2005	70	19	11

The Conservative Government, elected in 1979, implemented a huge programme of selling public sector dwellings to sitting tenants and reduced new house building by local authorities. Between 1980 and 2005 1,770,000 public sector houses were sold. Public sector housing completions, which peaked at 172,000 in 1970, have not exceeded 1,000 a year since1995. Rents controls and security of tenure were also progressively eased, and from the early 1990s local authorities were encouraged to transfer their remaining stock to social landlords, mainly housing associations established for the purpose. The factors explain the sharp increase in owner-occupation between 1981 and 1992 in particular, and also the reversal of the decline of private renting.

These trends had a significant influence on the nature of the housing finance market. From the 1950s in particular the only tenure open to most new households was owner-occupation, many households going straight from living in their parents' home to living in their own home. They did so at a comparatively young age – typically mid-20s - and had not had the time to accumulate a significant deposit. They therefore needed high percentage advances,

typically 90-95% of purchase price. This combined with the rapid increase in owner-occupation to result in a huge demand for long term loans to finance house purchase.

The emergence of a true private rented sector has been a significant development. This development is somewhat masked in the table as the “old private rented” sector has continued to decline. People now have a choice as to whether to buy or rent rather than being pushed into owner-occupation at a young age. The proportion of households in the 20-24 age group who are owner-occupiers peaked at 41% in 1988; it has since fallen steadily to 20% in 2004. Over the same period the proportion in the private rented sector increased from 30% to 51%. The same trends can be seen in the 25-29 and 30-34 age groups.

Building societies
Building societies have been central to the housing finance market in Britain. To understand their role, again it is necessary to go back a little in history.

Building societies date back to the late 18th century. As their name suggests they were originally small groups of people who got together to pool their human and financial resources to build themselves homes. When all the members had been housed the building society wound up. In the 19th century building societies gradually evolved into permanent retail financial institutions. They found that the process of providing each of their members with homes could be speeded up if money was borrowed from other people who did not want a home. Interest had to be paid on these deposits and accordingly interest had to be charged on loans.

The first legislation specifically on building societies was in 1836, and in 1874 there was comprehensive legislation governing societies which largely remained intact until 1986. Broadly speaking, that legislation provided that societies had a mutual constitution, being owned by their investors and borrowers, and that their lending had to be secured against property.

Originally, building societies operated in small local areas. As the mobility of the population generally increased so building societies had to expand geographically by opening branch offices. There has been a continuing process of building societies merging and smaller ones going out of business completely. The numbers of societies fell from over 2,000 in 1900 to no more than 100 by the early 1990s. The number is now 59. Societies range from large societies operating with hundreds of branches throughout the country to small societies operating from a single office.

Building societies have their own distinct legal form. That is, societies are not companies, and they are subject to no legislation in relation to their corporate structure other than the Building Societies Act which lays down their constitution and how they are to be governed. That Act also sets out their powers of building societies. Until 2001, when the FSA became the regulator, building societies had their own regulator, the Building Societies Commission, and before that the Chief Registrar of Friendly Societies. However, not too much should be made of the unique legal characteristics of building societies. Much of the legislation is similar to companies legislation, and prior to building societies being absorbed into the bank regulation structure, the regulatory system was similar to that for banks.

Traditionally, building societies raised all of their funds through the retail markets, their most common product being what was called the passbook or ordinary share account which allowed total flexibility for receipts and withdrawals. Beginning in the mid-1970s building societies began to diversify the range of their savings accounts, differentiating between customers according to the frequency with which they used their accounts, the notice period on the account and the amount invested. Now, only a small fraction of deposits are held in the old fashioned passbook accounts.

Since the early 1980s building societies have also had access to the wholesale markets and they have raised a significant proportion of their funds from bank deposits, syndicated loans, Eurobonds and other capital market sources.

Since the 1874 legislation building societies were empowered to lend only with the security of a first mortgage. In practice, their lending was confined even more closely to loans to individual owner-occupiers.

By the mid-1980s the building society industry had grown to a huge size while retaining its basic characteristics. Building societies remained as mutual institutions owned by their investors and borrowers, raising retail savings and making loans for house purchase. They accounted for 70% of mortgage lending and 50% of personal deposits.

It should be noted that unlike in many other countries, Britain has never had a strong network of regional savings banks, the building societies in effect performing this role.

A key feature of the operation of building societies needs to be noted here. Traditionally, their standard mortgage instrument has been the variable rate loan. Societies had the power to change the rate of interest on existing loans. Originally, three months notice was required, but this period was gradually reduced to no notice. This instrument was a necessary counterpart to the short term nature of building society liabilities – retail deposits. The variable rate mortgage enabled societies to withstand more volatile interest rates in the 1970s and 1980s, as they could react quickly to a rise in market interest rates by increased rates on both sides of their balance sheet. However, rapid rises in mortgage rates were uncomfortable for many borrowers and also thrust societies into the political spotlight.

The special status of building societies increasingly became incompatible with developments in financial markets. In 1979 and 1980 the banks were freed from the balance sheet constraints under which they had operated. Until that time, for large financial institutions with huge branch networks, they had only a very modest share of the retail savings market and were virtually inactive in the mortgage market. They naturally took steps to rectify this position and posed a severe competitive threat to building societies. The banks were able to offer a wider range of related products including consumer loans and overdraft facilities, whereas building societies were confined to mortgage loans. The societies themselves increasingly wanted to diversify, making use of their huge customer base and their popular image with the public.

In the early 1980s the Government decided that there should be new building society legislation. This duly appeared in the form of the Building Societies Act 1986. This retained the basic mutual characteristic of building societies but gave them a range of additional powers in the property and financial areas. These powers have subsequently been further widened by secondary legislation under the 1986 Act.

Broadly speaking, building societies are now free to offer the full range of retail financial and housing related products although they still concentrate on their core businesses of savings and mortgage loans.

The 1986 Act gave building societies the option to convert to public limited company status where they would be subject to normal Companies Act provisions and to regulation as banks. Conversion was attractive to shareholders who stood to make substantial windfall gains. The second largest building society, the Abbey National, converted in 1989; it continued operating as an independent financial institution concentrating on housing finance although with substantial diversification on the funding side of its balance sheet, until it was acquired by a Spanish bank, Santander, in 2005. In the next five years no building societies converted but in 1994-96 most of the major ones converted, either to operate as independent retail banks or as part of a package in which they were immediately acquired by existing banks.

The growth of bank lending for house purchase
Until the early 1980s the major commercial banks had had no significant role in providing mortgage loans, and also were not generally regarded as a home for long term savings. As they were freed from balance sheet constraints so they saw these two markets as ones they should be in given their large customer base, substantial branch networks and expertise in financial markets. Each of the banks began mortgage lending, generally on similar terms to the building societies. Since the 1990s some of the banks have acquired former building societies. Each of the large commercial banks in Britain (HSBC, Lloyds TSB, Royal Bank of Scotland, HBOS and Barclays) are now among the ten largest mortgage lenders.

Appendix 4

Housing development and finance in emerging economies

There has, over the last few years, been a significant increase in the understanding of the way that housing markets operate in emerging markets, the policy instruments that can be used to improve housing conditions and the relationship between housing market developments and economic growth. This section attempts to do no more that summarise that understanding, drawing on a number of World Bank publications (in particular Buckley & Kalarickal (2006) and World Bank (2006) and (2008)).

Urban land markets

In the poorest countries most economic activity is informal. People live in housing they have built themselves on land which they have no entitlement to occupy. They work in the informal economy.

A significant trend in housing markets has been the huge increase in urbanisation, largely on an unplanned and uncontrolled basis. Urban land markets are probably the major constraint to improving housing conditions. Much land is owned by the government or other public sector institutions and what rules there are for development may well be inappropriate given the incomes of the local people. In particular, space standards may be well-meaning, but the poor are not helped by housing development which is beyond their means.

Land ownership and land title systems have been the subject of considerable debate. In many emerging markets much land is occupied informally and what registration systems exist are often ineffective and inefficient. It is accepted that a formal housing finance system requires proper ownership rights and registration of title. However, formal housing finance is unaffordable for most people in the poorest countries. For them security of tenure is important rather than formal legal title to their land.

The academic literature has recently been reviewed by Buckley and Kalarickal (2006). Their conclusions are summarised below –

> "Perhaps the main argument of much of the early research – and particularly the economics research – on developing country housing markets was that it was distortions of markets, oftentimes well-intended, that created many of the shelter-related problems faced by the poor. As a result, this literature argued that with such a long-lived, spatially-specific, socially-freighted good, it was important to clarify whether the public or private sector had a comparative advantage in carrying out specific functions. The public sector, according to this view, was unlikely to be a good producer, owner, or financer of housing. Nor would it be an effective designer of subdivisions or development of land.
>
> The research reviewed here indicates that in recent years empirical evidence has accumulated largely, but not completely, in support of these views. Indeed, some of the earlier, most strongly-held conjectures about the efficacy of various public policies, such as rent control and the importance of secure titles, have been, if not refuted, at least substantially revised. This is not to say that the shelter problems faced by low-income families in poor countries can be completely addressed by simply adopting more market-oriented housing and land market policies. Rather…… it is to emphasize: first, that many interventions do indeed exacerbate rather than improve the shelter situation of the poor……….. and second, that improved policies, by themselves, without additional resources, can often improve their situation.
>
> Finally, and unfortunately, the research has also shown that there is no mysterious, straightforward capitalist panacea that can address all of the shelter problems faced by low-income families in developing countries. Circumstances vary widely and policy must be designed to exploit local conditions. Just providing titles, for instance, will not magically transform the housing situation of the poor, although in the right circumstances, it can be very important. Instead of just providing titles we have a much stronger sense that there is a need to incorporate the views of the poor on how to effectively address their concerns.

Buckley and Kalarickel analyse the link between housing and development –

> "A major underlying theme of shelter policy should be to recognize that, while shelter provision is important for improving the livelihoods of the poor, it is also an important sector in its own right. Improving shelter conditions has undeniably desirable welfare effects. But when housing and land account for such a significant share of investment, wealth, and (in functioning systems) finance, improvement of shelter conditions can also be a key feature of the investment climate. It follows that when managed effectively, shelter policy can be an important source of financial stability and economic resiliency, as well as a major component of the social development agenda. Perhaps equally importantly, when shelter policy is not managed effectively, the housing sector can contribute to financial instability and increased inequality."

Housing finance

Housing finance and housing development are closely related in that one facilitates the other, but housing finance is important in its own right as a component of the financial infrastructure of the country. In African countries on average 20% of the population have a relationship with a formal financial institution. However, as many as 80% have a relationship with an informal financial institution. Formal financial institutions find it difficult to deliver services to rural areas in particular, and are not well suited to providing services to people who have no formal employment or income and have difficulty in even proving their identity. This applies not just to lending to households but also to lending to businesses, the absence of credit information being a particular problem. Informal mechanisms meet market needs but are far from efficient and can been risky.

The more that an economy can be monetized the greater the impact on economic growth as surplus funds can be put to productive use. Housing finance can contribute to a deepening and widening of financial markets.

Bardhan and Edelstein (2007) develop this argument –

> "The development of the housing sector is widely recognized as an integral part of economic development. In addition to the large share that the housing sector occupies in the economy, its importance also arises from the positive externalities and spillover effects, and its impact on the social and political climate, issues of particular importance in developing countries. In most countries, and increasingly so in emerging economies, housing represents a large proportion of a household's expenditure and takes up a substantial part of lifetime income. Usually, it is the largest asset owned by households. The backward and forward linkages to land markets, durable goods manufacturing and development of labor markets with depth and mobility further underscore the significance of this sector, particularly in the process of economic transition.
>
> It is also widely understood that the provision of housing services depends upon a well-functioning housing finance system. Indeed, without a properly functioning housing finance system that operates in an allocationally and operationally efficient manner, the "real" housing market would be sub-optimal. Moreover, similarly to the housing markets, the housing finance system has beneficial spillover effects on the entire financial system with far-reaching consequences for economic development. Increasing emphasis is therefore being placed in developing and transitioning countries on the reform of real estate finance and mortgage markets."

They also identify the main policy issues that arise from successful reform of housing finance –

- The social value creation of homeownership, such as social stability, functioning neighbourhoods, development of civil society, abatement of crime and general enhancement of welfare.
- Property is largely non-tradeable so expenditure on real estate supports more jobs than other expenditure.
- A mortgage market is important for the process of capital accumulation in a developing economy, and is critical to enhancing the depth and reach of financial markets.
- Real estate markets are essential for the development of integrated economic markets in general.
- The purchase of an entry level home serves as a stepping stone for upward social and economic mobility.

"Illustrative of the limited availability of term finance is the lack of housing finance in most African economies. While the stock of housing finance in Namibia and South Africa comes to 18-20 percent of GDP, the figures for other countries for which data is available are no more than 2 percent (Senegal, Rwanda, Mali) or no more than 1 per cent (Uganda, Ghana and Tanzania). This is not only small in relation to GDP, but even as a percentage of total private credit. In addition to the general confidence factors that have worked against the growth of term finance, many specific factors impede expansion of mortgage credit, including lack of effective title and collateral registration systems. Attempts by many African governments to address the dearth of housing finance over the years with government-owned housing finance intermediaries resulted in skewed allocations of subsidy to a small number of well-connected borrowers. As with other state-owned DFIs, many of these institutions eventually became insolvent and had to be bailed out as in Cote d'Ivoire, Tanzania, Rwanda, Niger and elsewhere."

Source: World Bank, *Making Finance Work for Africa,* World Bank (2006).

So far however, housing finance is still fairly primitive, particularly in the poorest countries. Formal mortgage loans in most of Africa are equivalent to just 1% of GDP rather than nearer 100% in the UK. Governments have in the past sought to promote housing finance by creating "housing banks", but these have operated in an uncommercial way and have generally been a failure.

Buckley and Kalarickal help to explain why housing finance has not developed –

"Perhaps the clearest lesson of the past 20 years is that housing finance does not work in unstable or inflationary environments. Of the housing finance projects rated unsatisfactory, almost 30 percent took place in inflationary environments. Nor can housing finance be expected to be productive in a highly regulated or distorted housing market. In such an environment, greater access to finance is likely to contribute to asset price bubbles rather than expansion of the housing stock. Finally, housing finance tolerant of high levels of delinquency and default inevitably leads to failure. Rarely, if ever, has a public institution returned to sustainable lending from a prior position of having tolerated high levels of delinquency."

However, there is substantial investment in housing in emerging markets and like all investments it is financed. That finance comes from a mixture of sources –

- The poorest people use a combination of sweat equity and incremental building. They do the building themselves, often with the help of friends and relatives, buying material as they can afford to from current income. While primitive homes can be built quickly in this way, more substantial homes may take ten or more years to build.
- Remittances from abroad. These are massive – a multiple of foreign aid. Much money goes directly to the poorest people who use it to finance their day-to-day living but perhaps also to finance some investment in housing.
- Short term loans, particularly to finance major items of expenditure such as a roof. These loans may come from an informal money lender or from a semi-formal micro finance institution (MFIs). MFIs are increasingly recognised as playing a major part in providing financial services to poorer people, particularly for business rather than housing purposes. Such loans are likely to carry very high rates of interest – much higher than those of formal housing loans from banks.
- A limited amount of formal lending by banks, generally to middle and higher income groups. Such lending may not formally be secured by mortgages, particularly where the mortgage security is of little value. Other forms of security may be sought. A "salary loan" is commonly used, the lender receiving repayments by direct deduction from wages.

Whatever combination of finance is used, the result is expensive and partial, and for many households completely out of reach.

What needs to be done to promote housing finance?
The World Bank report on finance in Africa (2006) suggests two priorities relevant to the financial structure as a whole. The first is to strengthen land registries and credit reference agencies and streamline court procedures. This set of measures would increase the security of bank lending and therefore bring down the price. The second priority is independent supervision of banks. Such supervision should not be too intrusive or give substantial discretion for the regulator. Bank supervisors are in short supply and in most countries are simply not equipped to provide anything other than broadbrush supervision. Discretion always runs the risk of opening up possibilities for corruption. Simple basic requirements, properly enforced, are appropriate in less developed countries. Basel 2 may be the "cutting edge" of regulation, but is not appropriate for most emerging markets.

These points are relevant to housing finance as they are to banking generally.

Creating the framework in which housing finance can develop requires governments to remove unnecessary obstacles to bank lending, most of which are directly relevant to the two priorities noted above. There are also a limited number of positive steps that governments might also take -

- Ensuring that urban land policies to not prevent investment in housing by lower income people.
- Ensuring that the necessary infrastructure is provided for new housing developments.
- Encouraging a professional surveying and valuing profession.
- Building up and making readily accessible a database of information of house prices, rents and transaction.
- Regulating estate agencies.
- Considering whether mortgage insurance might help to promote mortgage lending.

Mortgage insurance

Mortgage insurance may have a role to play in "pump priming". This is a specialist form of credit insurance which provides protection to the lender. In the event of a borrower defaulting on their loan and the property being taken into possession and sold but not at a price sufficient to cover the outstanding debt and costs then the insurance policy pays out to the lender. One form is for the "top slice" of the loan to be insured, that is, for example, any amount in excess of say 70% of the valuation. An alternative is for a proportion of the whole loss to be met by the insurance company.

Mortgage insurance schemes can take various forms but a common feature of most schemes now, particularly after substantial losses were incurred on mortgage insurance business in the 1990s, is an element of co-insurance whereby the lender assumes some of the risk. As this paper has already explained, in the UK mortgage insurance has largely disappeared, mortgage lenders finding it more economical to put in place their own arrangements.

Most mortgage insurance, even in industrialised countries with sophisticated financial systems, is provided by specialist government agencies. These were often established in difficult and different circumstances when an element of government "pump priming" was needed to help a mortgage market develop. It proves very difficult in practice for such institutions to divest themselves of their business even when they are able to do so.

In the USA there are a number of specialist private insurance companies, which are now seeking to operate internationally.

Mortgage insurers do not simply accept the risk that is presented to them by the lender, although a number did in the past with serious consequences. As a condition of insuring loans, the mortgage insurer will normally insist that a number of criteria must be met, for example –

- A maximum loan to value ratio.
- A maximum loan to income ratio.
- The property meeting defined characteristics, for example in relation to the type of construction.
- The borrower should not previously have defaulted on a loan.
- A reasonable spread of loans in respect of type of property and location.
- A protocol according to which accounts are serviced.
- The provision of data on lending and prompt notification of loans falling into arrears.

Mortgage insurance, if properly managed, can offer considerable benefits to the lender and to those purchasing houses. The lenders will be able to offer either a greater volume of lending or more high percentage loans than would otherwise be the case because the risk that they face is reduced. House buyers will be able obtain higher percentage loans than would otherwise be possible.

The criteria imposed by the mortgage insurers impose an element of external discipline on the lenders that can help ameliorate moral hazard, prevent them making bad loans and ensure that they are run in a sound way.

The criteria established by mortgage insurers become generally accepted as standard lending criteria. They may be used, for example, by regulators to determine which loans qualify for reduced capital backing. Where there is any form of secondary market then the criteria are likely to determine the loans that qualify to be sold or to be securitised.

Mortgage insurance facilitates the collection, analysis and dissemination of data on mortgage lending, in particular the relative risks of particular types of loan characteristic or borrower. In many countries it is the mortgage insurers who often provide most of the key data about the operation of the mortgage market. The best example of this is the Canada Mortgage and Housing Corporation, originally established as a mortgage insurer and which now is the source of data on the housing market.

However, being in the mortgage insurance business also carries risks. The business must be treated as insurance, subject to the disciplines that apply to other insurance arrangements. The business must be properly underwritten and the premium charged to the lenders must be a fair reflection of the risk of the business being taken on. Where mortgage insurance is given too easily, this is likely to facilitate bad lending, ultimately at a significant cost to the insurer. Where the insurer is a government agency there is a temptation, often not resisted, to use mortgage insurance as a weapon to require mortgage lenders to behave in a way that is not commercial or prudentially sound. For example, mortgage insurance might be made available on favourable terms in respect of a particularly risky group of borrowers for political reasons. Lenders may find that if they wish to do business they have no choice but to do the business that the mortgage insurers want even if in their own minds they know that it is not sound.

For a country developing a housing finance system, mortgage insurance can play a useful part. It is the one area where government intervention is required and can be provided at a reasonable cost in a way that is even handed and not distortive of competition, provided of course that the risk business is run on sound insurance lines.

If the government takes some of the risk this can discourage other damaging government actions, such as restrictions on lenders realising their security.

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The author

Mark Boleat has over 25 years' experience in trade associations in the housing and finance sectors in the United Kingdom. Between 1986 and 1993 he was Director General of the Building Societies Association. During this time he was responsible for a demerger which created the Council of Mortgage Lenders, of which he was also Director General. He was Secretary General of the International Union for Housing Finance and Managing Director of the European Federation of Building Societies from 1986 to 1989. From 1993 to 1999 he was Director General of the Association of British Insurers, the largest trade association in Britain.

He has chaired one of the largest housing associations (organisations which provide subsidized rental housing) in Britain and for five years was a member of the Board of the Housing Corporation, which funds and regulates housing associations.

Mark Boleat is the author of the first ever study of housing finance at the international level *National Housing Finance Systems: A Comparative Study* (1986) and he was the founder editor of *Housing Finance International* (1986 – 89), the flagship publication of the International Union for Housing Finance. He has undertaken consultancy work on housing finance for the World Bank, the International Finance Corporation, the OECD, the United Nations, the Government of Jersey and major banking institutions.

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Mark Boleat is a director of the St Paul Travelers Insurance Company, Chairman of Hillingdon Community Trust and the Association of Labour Providers and Vice Chairman of the Association of Charitable Foundations. He has previously been a director of Countryside Properties (a large British house builder and developer), the Comino Group (a software company) and three life insurance companies. He is also a member of the Gibraltar Financial Services Commission and the Court of Common Council of the City of London.

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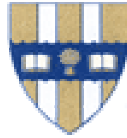

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