The 1985–1993 Housing Market in the United Kingdom: An Overview

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Abstract

Between 1985 and 1993, the housing market in the United Kingdom experienced a boom, followed by the most severe slump of recent times. The slump has raised several major policy issues related to arrears and possessions, negative equity, and mortgage insurance. Specifically, the slump has had significant consequences for the structure of the mortgage lending industry and the nature of the owner-occupied market.

The boom resulted from a combination of macroeconomic developments and factors specific to the housing market. The slump is largely the product of macroeconomic conditions, particularly the reduction of inflation to a notably low rate. Less efficient lenders have been squeezed out of the market, lending criteria have been tightened, and the nature of mortgage insurance has changed dramatically. Housing is increasingly seen as a consumer good rather than an investment. Accordingly, the market rental sector is playing an increasingly important role, especially for younger households.

Introduction

This article presents a broad overview of the major developments in the owner-occupied housing market in the United Kingdom between 1985 and 1993—a period that embraced a boom followed by the most severe slump of recent times. The slump has raised several major policy issues related to arrears and possessions, negative equity, and mortgage insurance. Specifically, the slump has had significant consequences for the structure of the mortgage lending industry and the nature of the owner-occupied market.

The boom resulted from a combination of macroeconomic developments and factors specific to the housing market. On the other hand, the slump is largely the product of macroeconomic conditions, in particular the reduction of inflation to a notably low rate. Less efficient lenders have been squeezed out of the market, lending criteria have been tightened, and the nature of mortgage insurance has changed dramatically. Housing is increasingly seen as a consumer good rather than an investment.

Accordingly, the market rental sector is playing an increasingly important role, especially for younger households.

The 1985–1988 boom

During the 1980s, the housing market enjoyed a period of sustained growth that was tied to the strong performance of the economy as a whole (see table 1). Beginning in 1982, gross domestic product (GDP) growth in each year was positive; indeed, the period between 1985 and 1988 was characterized by particularly rapid growth. Real personal disposable income declined modestly between 1980 and 1982 but then grew strongly until 1989. Unemployment declined steadily from its peak in 1986 until 1990.

Table 1. **The 1980s Boom**

Year	Change in GDP[a] (%)	Change in RPDI[b] (%)	Average Unemployment (thousands)	Net Mortgage Lending (million £)	Increase in House Prices (%)
1980	−2.0	1.7	1,665	7,282	15.5
1981	−1.1	−0.8	2,520	9,308	2.1
1982	1.7	−0.5	2,917	14,142	3.0
1983	3.7	2.6	3,105	14,319	11.9
1984	2.0	3.5	3,160	17,108	7.8
1985	4.0	3.3	3,271	19,184	7.7
1986	3.8	4.1	3,289	27,372	14.9
1987	4.6	3.6	2,963	29,573	16.0
1988	4.5	5.9	2,426	40,203	22.7
1989	2.1	4.6	1,841	34,203	14.5

Source: First three columns: *Economic Trends Annual Supplement*, tables 2, 5, and 21, respectively. Net mortgage lending: *Financial Statistics*, table 9.4. Increase in house prices is the series for all houses at mortgage approval stage: *Housing Finance*, table 16.
[a] GDP = gross domestic product.
[b] RPDI = real personal disposable income.

Under these circumstances, strong demand for owner-occupied housing could be expected. As with any durable consumer good, the housing market has shown a pronounced cyclical trend. The market experienced a significant boom in the early 1970s, followed by a slow period and then a miniboom between 1978 and 1980. The miniboom led to a downturn, but by early 1982, house prices reached a historically low relationship with earnings. The average house price in that year was 3.13 times average earnings, a relationship lower than at any time since 1961.

As the economy moved out of recession in 1982, declining unemployment and strong growth in real personal disposable income

triggered an increase in demand for owner-occupied housing. The trend is documented by rising figures for net mortgage lending. House prices increased modestly in 1981 and 1982 but more rapidly in 1983.

The period from 1985 to 1988 saw an unprecedented boom in the housing market that was related to the general performance of the economy. Between 1984 and 1988, GDP rose by more than 20 percent and real personal disposable income rose by 22 percent, while unemployment fell by 23 percent. Mortgage lending increased from less than £15 billion (net) in 1983 to £27.4 billion in 1986 and £40.2 billion in 1988. House prices began to increase more rapidly in 1986 and accelerated further into 1987 and 1988. Economic variables were largely responsible for the boom. The reduction in unemployment made consumers confident about future job prospects. The increase in real personal disposable income gave consumers considerably more spending power. In addition, interest rates fell from 15 percent at the beginning of the decade to around 11 percent by 1987.

The rising property market coincided with, and some would argue was caused in part by, the changing structure of the financial markets. Until the early 1980s, banks had not been major participants in the mortgage lending market largely because of the balance sheet constraints under which they operated. When the constraints were removed between 1979 and 1981, however, banks responded by rapidly capturing a significant share of the mortgage market. Further, the entry of banks into the mortgage market led to the breakdown of the collective arrangements established by building societies—the main mortgage lenders—for setting interest rates. Thus, rather than remaining under the control of the building societies, mortgage rates quickly settled down to a steady premium over money market rates. In turn, this encouraged new entrants into the mortgage market, raising their funds wholly from the wholesale markets and making loans through intermediaries. Amid the general presumption that house prices could not fall substantially (if they fell at all), the steady appreciation in house prices imbued lenders with the confidence that they had excellent security.

At the same time, building societies themselves were gradually deregulated, particularly by the Building Societies Act of 1986. Until the early 1980s, mortgages were rationed, and many borrowers were unable to obtain the amounts they wanted when they wanted them. But by the mid-1980s, the mortgage business had become highly competitive, as reflected in some relaxation of lending criteria and, in some cases, positively dangerous lending.

Generally, however, little distinguished the 1983–87 boom from previous booms. By 1987, the house price earnings ratio had risen to 3.8, the level at which it had peaked in 1979, but it was still substantially lower than the peak of 4.95 recorded in the 1973 boom. Toward the end of 1987, there were signs that the boom was probably coming to an end. Some thought that the stock market crash in October of that year would cause the market to slow down. Yet several factors combined to push the market to a new peak.

The turning point: 1988–1989

During 1988 and 1989, the market accelerated to a peak and then rapidly turned down (see table 2).

Table 2. **The Peak, 1988–1989**

Period		Net Mortgage Lending (million £)	Mortgage Rates, End Period	Changes in House Prices (%)		Transactions in England and Wales, Seasonally Adjusted
				Greater London	National	
1988	Q1	8,170	10.0–10.3	4.8	4.2	530,000
	Q2	10,403	9.5–9.8	8.3	9.3	528,000
	Q3	12,502	12.75	6.9	10.4	583,000
	Q4	9,036	12.75	1.6	6.6	505,000
1989	Q1	7,272	13.5	–1.1	2.7	440,000
	Q2	8,761	13.5	–1.0	4.1	410,000
	Q3	9,183	13.5	–2.9	0.2	372,000
	Q4	8,918	14.5	–3.7	–2.0	364,000

Source: Net mortgage lending: *Financial Statistics*, table 9.4. Mortgage rates: *Housing Finance*, table 25. House price figures: Halifax Building Society, standardized index, all buyers, all houses. Figures for property transactions: *Economic Trends*, table 40.

In January 1987, bank base rates stood at 11 percent; by April they had fallen to 9.5 percent. The base mortgage rate fell over the same period from 12.3 to 11.25 percent. In October 1987, the share price index fell by 30 percent. The government responded by inducing a reduction in bank base rates such that by the end of the year they were at 8.5 percent, the lowest level since March 1984. Correspondingly, the base mortgage rate fell to a little above 10 percent. At this time, almost all mortgages in Britain were variable-rate instruments; thus, any change in short-term interest rates was reflected in a parallel change in mortgage rates.

Real incomes continued to rise strongly, and the boom continued during the first quarter of 1988. In fact, the budget in March 1988 played a major part in prolonging the boom. To begin, the budget's further reduction in interest rates caused the base mortgage rate to be cut to 9.5 percent. In addition, the budget reduced the top tax rate from 60 to 40 percent. The reductions had an immediate impact on consumer confidence. Further, the government announced that double tax relief would be withdrawn as of August 1988. (Since 1974, tax relief on mortgage interest had been limited to a set amount of loans—£25,000 until 1983 and £30,000 thereafter. However, in the case of joint mortgages where the borrowers were not married, each borrower was entitled to tax relief on a loan up to £30,000. This provision was generally regarded as an anomaly.) The prospective withdrawal of tax relief gave consumers who had not previously contemplated a house purchase four months in which to seek out partners, houses, and mortgages—seemingly in the belief that if they failed to get on the housing ladder with the available tax advantage, they might never do so. Immediately after the August 1 deadline, the number of transactions declined sharply.

The decline in transactions coincided with the end of the boom in the general economy. By the summer of 1988, the government accepted that the economy was expanding at an unsustainable rate, causing increased inflationary pressure and a worsening of the balance of payments. Base rates, which reached a low of 7.5 percent in May, were gradually increased to 10.5 percent in July. Mortgage lenders responded by increasing mortgage rates from 9.5–9.75 to 11.5 percent. Further increases in base rates occurred in the autumn; a second hike in mortgage rates was implemented in September/October, increasing the typical lending rate to 12.75 percent. Following further raises in base rates toward the end of November, most mortgage lenders increased their rates to 13.5 percent at the beginning of 1989. Thus, mortgage rates had risen by 4 percentage points in a six-month period. The rate of increase of GDP also began to slow down from the middle of the year, as did the rate of growth in real personal disposable income.

The final quarter of the year witnessed a marked reduction in activity in the housing market. Nationally, average house prices stopped rising and started falling; regional variations, however, were marked. The house price earnings ratio peaked in the middle of 1988 in southern parts of the country but continued to rise well into 1989 in the North, Yorkshire and Humberside, and Scotland. In some cases the increase continued into 1991.

The downturn

The downturn in mortgage activity led the downturn in the economy (see table 3). Growth of GDP and real personal disposable income was positive until 1991, whereas the mortgage market began turning down in 1988 and 1989, as evidenced by the steady decline in net mortgage lending, the number of transactions in England and Wales, and house prices.

House building activity in the private sector also fell, although perhaps not by as much as might have been expected. Starts peaked at 221,000 in 1988 and dropped to 121,000 in 1992. Completions peaked at 199,000 in 1988 and declined to 139,000 in 1992.

The current downturn is far more severe than previous downturns. For example, between the 1972 peak and the 1974 trough, net mortgage lending fell by just 33 percent, compared with a reduction of over 50 percent in the present downturn. The downturn in the early 1980s was even accompanied by a small increase in mortgage lending.

Interestingly, the current downturn in real house prices has been less severe than that experienced during the early 1970s cycle. Real house prices fell by 45 percent between 1973 and 1977. In the present downturn, they have fallen by about 20 percent.

The changes in the house price earnings ratio are another good indicator of the amplitude of housing market cycles. The ratio rose from 3.25 in 1970 to a peak of 4.95 in 1973 before falling back to 3.34 in 1977. The peak at the end of the 1970s was more modest at 3.82, but the ratio declined to 3.13 in 1982 at the trough of the cycle. Subsequently, the ratio increased steadily and peaked at 4.25 in 1988, a level significantly below that of the early 1970s boom. The ratio has since dipped to 3.3, which is significantly higher than the troughs in previous cycles. Indeed, the house price earnings ratio is now little different from its long-term average, perhaps suggesting that the downturn has some way to go. Invariably, the ratio finishes in the trough of a cycle at a point well below the trend line.

By far the chief distinguishing feature of the cycle has been the absolute downturn in house prices, which is without recent precedent. Nominal house prices have fallen by about 30 percent on average in East Anglia, Greater London, and the Southeast (see table 4). The national indices showed a modest decline in

Table 3. **The Downturn, 1988–1992**

Year	Change in GDP (%)	Change in RPDI (%)	Average Unemployment (thousands)	Net Mortgage Lending (million £)	Transactions, England and Wales (thousands)	Changes in House Prices (%)	
						London	National
1988	4.5	5.9	2,426	40,111	2,150	22.3	23.3
1989	2.1	4.6	1,841	34,203	1,580	2.4	20.7
1990	0.6	2.5	1,652	33,049	1,400	–5.8	—
1991	–2.5	–0.5	2,238	26,682	1,310	–5.8	–1.2
1992	–0.5	2.3	2,750	17,751	1,140	–9.4	–5.6

Source: Column 1: Central Statistics Office press release, March 12, 1993. Column 2: *Economic Trends*, March 1993, table 4. Column 3: *Economic Trends Annual Supplement*, table 21. Column 4: *Financial Statistics*, table 9.4. Column 5: *Economic Trends Annual Supplement*, table 49. Columns 6 and 7: Halifax Building Society, standardized index, all buyers, all houses. The 1992 figures for change in gross domestic product (GDP) and real personal disposable income (RPDI) are consensus estimates.

Table 4. **Regional House Price Decreases in the United Kingdom**

Region	Index Peak	Decrease, 1993 Q1 on Peak (%)
East Anglia	1988 Q4	34.5
Southeast	1988 Q4	30.7
Greater London	1988 Q4	28.5
Southwest	1988 Q4	28.8
East Midlands	1989 Q2	19.4
West Midlands	1989 Q2	10.9
Wales	1989 Q3	9.6
Northwest	1991 Q2	10.2
Yorkshire and Humberside	1991 Q2	9.3
North	1991 Q4	6.1
Northern Ireland	1991 Q4	4.6
Scotland	1992 Q3	1.3

Source: Halifax Building Society, standardized house prices, all buyers, all houses.
Note: In each region except Scotland, the index in the first quarter of 1993 was at its lowest point since the index peak. In Scotland, the maximum fall was 3.9 percent between the second and third quarters of 1992.

1990 and 1991, with a more substantive decline in 1992. The fall in nominal house prices has itself contributed to the downturn in the housing market. It has led to increases in arrears and possessions as well as to a phenomenon known as negative equity.

The particularly severe nature of the current downturn can be largely explained by the government's bringing down inflation in general. The 1973–77 downturn was accompanied by an increase from 7.1 to 24.2 percent (in 1975). The 1979–82 downturn was accompanied by a rate of inflation well into double figures. When inflation is high, adjustment of real house prices is relatively easy. Nominal prices stay fairly constant or rise modestly while other prices rise significantly. In the current downturn, however, the rate of inflation has fallen steadily from 9.5 percent in 1990 to under 4 percent in 1992. Even a smaller adjustment in real prices compared with the mid-1970s has necessitated falls in nominal prices of over 10 percent nationally and around 30 percent in the southern parts of the country.

The depth of the recession is partly attributable to other factors. Mortgage borrowing has itself become relatively less attractive as a consequence of government actions that have reduced both mortgage tax relief and tax rates and, therefore, the value of tax relief. In the mid-1970s higher rate tax payers could count on mortgage tax relief to pay 80 percent of their mortgage interest. The government has held the tax relief limit constant at £30,000 (the limit introduced in 1983) rather than increase it into six figures to maintain its real value in 1974 pounds (when the

limit was introduced at £25,000). A reduction in the basic tax rate from 35 to 25 percent has accompanied the reduction in tax relief. In addition, the higher tax rates have been cut, and in 1992 the government abolished higher rate tax relief such that no borrower could obtain relief at more than the basic rate of 25 percent. In March 1993, the government announced that as of April 1994 tax relief would be set at 20 percent.

The liberalization of the rental housing market has also had an effect. The 1988 Housing Act effectively freed new rentals from both security of tenure and rent controls. New households in particular, which perhaps were previously reluctant to become owner-occupiers, have been able to remain tenants. These renters have been able to take advantage of lower monthly expenditures than they would have as owner-occupiers without feeling that they were falling behind on the housing ladder.

The nature of the recession has also had an important impact on the housing market. Unlike previous recessions, the current downturn has disproportionately affected England's South and East—areas of the country noted for their traditionally low rate of unemployment, a belief that jobs were always available, and an economy that was always thought to be booming. The downturn has been sufficiently deep generally to produce an adverse effect on the housing market, but in London and the Southeast, the downturn has been much more severe. Further, it has come on top of a greatly overheated housing market.

In short, the main distinguishing characteristics of the current downturn are the fall in nominal house prices and the striking regional variations. In particular, the downturn is most marked in London and the Southeast.

Arrears and possessions

There was a marked increase in both possessions and arrears from 1988 to 1991 (see table 5). In 1992, possessions fell but arrears continued to increase. Several studies of the causes of arrears and possessions have yielded generally similar results. They have concluded that most arrears problems result from relationship breakdowns, a severe loss of income, or, frequently, both. Generally, borrowers who experience difficulty in meeting their mortgage repayments trade out of the problem by moving into less expensive owner-occupied accommodations or rental accommodations.

Table 5. **Arrears and Possessions, 1986–1992**

	Properties Taken into Possession in Period		Loans Six or More Months in Arrears at End of Period	
Period	Number	Percent of Loans at End of Period	Number	Percent of Total
1986	24,090	0.30	65,100	0.80
1987	26,390	0.32	70,450	0.85
1988	18,510	0.22	53,090	0.62
1989	15,810	0.17	80,640	0.88
1990	43,890	0.47	159,210	1.69
1991	75,540	0.77	275,350	2.81
1992	68,540	0.69	352,050	3.55
1990 H1	16,560	0.18	109,370	1.18
1990 H2	27,330	0.29	159,210	1.69
1991 H1	36,610	0.38	221,900	2.30
1991 H2	38,930	0.40	275,350	2.81
1992 H1	35,750	0.36	305,140	3.10
1992 H2	32,790	0.33	352,050	3.55

Source: Council of Mortgage Lenders.

Arrears and possessions began to increase as the unemployment rate rose in 1989 and as mortgage repayments increased sharply with the increase in mortgage rates. At the same time, the downturn in the housing market made it difficult for those in arrears to trade out of their problems. In turn, the increase in arrears and possessions has contributed to the market downturn. To some extent, therefore, a circular process has been at work.

Arrears and possessions have become a major problem for mortgage lenders who have instituted intensive arrears management programs designed to catch arrears at an early stage and to take whatever remedial action is possible. Lenders have helped many owner-occupiers who might otherwise have lost their homes remain in those residences by, for example, permitting them to make payments that are well below those required by the mortgage contract but that are reasonable given borrower income.

For its part, the government offers generous support (£1 billion per year) to people who have mortgage loans but no income. Income support pays borrowers' mortgage interest indefinitely (although only half the interest is paid during the first 16 weeks of a claim). The government initially paid income support directly to borrowers but found that not all of the funds found their way to lenders. The government changed the system in 1992 and now pays income support directly to lenders.

Lenders have tried to develop mortgage-to-rent schemes for their borrowers who will never be able to afford full mortgage repayments, but such schemes have proved unpopular with borrowers. Shared ownership schemes, on the other hand, have been more popular. In addition, lenders, recognizing the depressing effect of repossessed properties, adopted innovative policies to take such properties off the market. Strategies include renting out properties on the commercial market, incorporating them into business expansion schemes (tax shelters), and leasing them to local authorities and housing associations to provide social housing in general and housing for the homeless in particular.

Negative equity

The fall in house prices since 1988 has introduced a new concept to the British housing market: negative equity. It is of particular significance in Britain because of the long-standing practice of making high-percent advances to first-time buyers. The almost total absence of a market rental sector necessitates the advances and motivates individuals to purchase homes at a very early age. In 1989, for example, 42 percent of first-time buyers put down a deposit of less than £1,000; an additional 25 percent made a deposit of between £1,000 and £4,000. Slightly more than one-third of first-time buyers received a 100-percent advance, while another one-third received advances of between 90 and 100 percent. The fall in house prices has therefore quickly eroded homebuyers' equity, leaving mortgage lenders with debts for which they have no effective security.

The extent of negative equity is extremely difficult to measure. A 1992 study published in the *Bank of England Quarterly Bulletin* concluded that 876,000 households had negative equity in the second quarter of that year. The problem was concentrated in the southern part of the country, where house price declines have been greatest (see table 4). The study also found that about two-thirds of all first-time buyers who had entered the market since 1988 were likely to have accumulated some negative equity. The total amount of negative equity was estimated at £3.6 billion for first-time buyers and £2.3 billion for former owner-occupiers, with an average of £6,000 per household. The subsequent further fall in house prices has obviously increased the number of households with negative equity. By the fourth quarter of 1992, the Bank estimated that the number of people with negative equity had increased to 1.5 million. In an unpublished study, Daniel Dorling of Newcastle University estimated that by October 1992, 15 percent of those who borrowed in 1989,

30 percent of those who borrowed in 1990, and 20 percent of those who borrowed in 1991 had negative equity. The proportions ranged from 1 percent in Scotland to 41 percent in the greater London area and 31 percent in the outer Southeast.

The negative-equity problem has had several effects. Perhaps the most significant—and the one that was not fully appreciated initially—was the macroeconomic effect. The British economy failed to expand as had been confidently predicted in 1992. This failure is partly attributable to the effect of negative equity, which has made people at a given income level less willing to spend. Of course, it is not only those with negative equity who are affected. Common sense suggests that someone with £100,000 of equity is far more likely to spend additional income than someone with £1,000 of equity, let alone someone with £20,000 of negative equity. Toward the end of 1992, the housing market's impact on the economy was widely recognized and the government accorded high priority to reviving the market.

For mortgage lenders, negative equity has obviously precipitated the possessions problem. In fact, almost all possession cases involve negative equity. Where equity does exist, borrowers are far more likely to trade their way out of difficulty. A latent problem, however, remains for lenders. Clearly, a time may come when some borrowers—recognizing that they would be better off making a fresh start elsewhere (albeit at the expense of their credit rating)—will simply turn over their keys even if they can afford the repayments. However, little evidence suggests that borrowers default merely in response to negative equity.

A third aspect of the negative-equity problem is the restriction on mobility within the market. Some people need to move, perhaps for employment reasons. Some with negative equity might even wish to move upmarket if they experience a substantial increase in income. Nonetheless, the mere existence of negative equity has severely limited trading up, which has been a traditional feature of the British housing market.

Some borrowers with negative equity have been able to move by borrowing from relatives, particularly parents, to meet any shortfall; borrowing from another source (e.g., taking out an unsecured loan) to meet any shortfall; or renting out the original property and renting a new one. Lenders have considered how they might help negative-equity borrowers move. A few have even announced packages, although the problems remain considerable. If, for example, a homeowner moves from one £80,000

house with a £100,000 mortgage to another £80,000 house with a £100,000 mortgage, the borrower's position is unchanged. One obstacle relates to mortgage insurance. Insurers have generally been reluctant to transfer coverage from one property to another, thus placing the lender at much greater risk. For building societies, an additional problem was the £10,000 limit the government placed on unsecured loans.

In October 1992, the Council of Mortgage Lenders and the government announced packages of measures to help persons with negative equity who wished to move:

1. The borrower could take out a loan on the usual terms on the new property. The shortfall would technically take the form of an unsecured loan but would be secured by the new property. The security would become effective as house prices rose. The government increased the unsecured loan limit for building societies to £25,000; other lenders are not subject to any limit.

2. The borrower could take out a loan on the usual terms on the new property. That part of the previous loan that the borrower could not pay off would be left outstanding and secured by the new property in much the same way as if a formal new unsecured loan had been issued.

3. The new property could be substituted in the mortgage contract for the borrower's existing property despite the security shortfall.

In practice, all three methods are similar in that the position of both borrower and lender remains largely unchanged. It seems, however, that negative-equity borrowers are not disposed to move. Many of those who do move select the rental option. Lenders have also seemed less than enthusiastic about the alternatives because of the complexity of the arrangements and the difficulty of obtaining adequate mortgage indemnity insurance.

Mortgage insurance

For several years, a major feature of the British mortgage market was the ready availability of high-percent loans from the principal mortgage lenders. First-time buyers have typically secured loans of 90 to 95 percent, although 100 percent loans have been relatively easy to obtain. Lenders have protected themselves from losses on such loans by insuring the "top slice,"

generally that part of the loan above 75 or 80 percent of the valuation. The borrower has paid a one-time premium that amounted to between 3 and 7.5 percent of the top slice. In effect, lenders were protected against not only a decline in the value of the property but also unpaid interest and the costs of realization. In reality, the security enjoyed by both lenders and mortgage insurers was inflation. As a result, possessions were few and seldom yielded losses. The entire mortgage insurance process was, accordingly, fairly lax. Four composite insurers—Royal, Sun Alliance, Eagle Star, and Legal and General—have largely shared the mortgage insurance business. The same companies also provided building insurance. Until the late 1980s, the business was highly profitable.

As possessions began to increase, mortgage insurers experienced a substantial rise in the number of claims. Precise figures are not available, but the estimated underwriting loss in 1991 and 1992 was £1.8 billion. The stockbroking firm UBS Phillips and Drew predicts further underwriting losses of £1.8 billion between 1993 and 1996. By any account, the amount that insurers have paid out has far exceeded both their premium income and the associated interest they have earned over the years. Insurers have found the problem particularly acute because it has coincided with other major difficulties, particularly the effects of some severe storms. Still, the insurers have been able to meet their claims because mortgage insurance is a relatively small part of their total business.

Contractual disputes have arisen between mortgage lenders and insurers, reflecting the historical nature of the business. Until the late 1980s premiums were paid, but claims were never made. Neither lender nor insurer followed underwriting practices. Contract terms were often vague and based more on custom and practice than on written statements. As claims mounted, however, insurers adopted a tougher attitude. Generally, insurers and lenders have settled their disputes, but the possibility of going to court has always been there.

Not surprisingly, insurers decided to revise the terms on which they conduct business that came into effect during 1993. A key element of the new arrangements is coinsurance; that is, in the future, insurance companies will meet only 80 percent of the amount of any loss, leaving the lender with 20 percent. Insurers have also introduced caps on both individual claims and the total amount of claims that can be made in any one year. The types of property and borrowers that are considered insurable have also

been tightened, and premiums have been substantially increased.

The new insurance business practices have left lenders with greater risk than was previously the case. Most are seeking to insure their residual risk, and some are exploring new arrangements that involve a captive self-insurer with excess-of-loss cover.

Lending criteria have also changed dramatically. The once-common 100 percent loan is now difficult to obtain (except for council house purchasers, who enjoy a substantial discount). Whereas in 1989 over 36 percent of first-time buyers obtained 100 percent loans, the proportion had fallen to less than 14 percent toward the end of 1992. Borrowers with a history of arrears now find it difficult to obtain high-percent loans, and some properties, in particular high-rise flats, are difficult to mortgage with high-percent loans. Lenders now generally charge a higher rate of interest on high-percent loans, a practice that is a form of self-insurance.

The insurance industry has hoped and perhaps even expected that new insurers, including some American companies, would enter the market. Although some companies have shown an interest, the general view is that market conditions and the lack of available data make it difficult for a new entrant to come into the market and to price risk effectively.

Clearly, the mortgage insurance market is evolving, and it is too early to forecast what might finally emerge. Some of the mainstream mortgage insurers are keen to exit from the market completely. The only reason they have not done so is that they wish to continue their building insurance business, which often is tied into the provision of mortgage insurance. Undoubtedly, new entrants will find their way into the market, and lenders will self-insure to a greater extent. Substantially more information is needed on the bad debt experience for various types of loans, thereby facilitating a more effective pricing of risk—whether that risk is carried by the lender or an insurer.

The mortgage business

The mortgage business changed radically over the period from 1985 to 1993. Until the early 1980s, building societies largely controlled the mortgage market. In operating what was effectively a special circuit, they faced little competition for either

retail deposits or mortgage loans because of the balance sheet constraints imposed on banks. They therefore had a fair degree of latitude in determining their own interest rates and they did so collectively. Following the liberalization of the financial markets in the early 1980s, however, the banks assumed a major presence in the mortgage market and contributed to the dismantling of the building society cartel. With interest rates at a market level, the way was open for new lenders funded entirely on the wholesale markets and dependent on intermediaries for their business. The booming mortgage market encouraged a range of new entrants, including several foreign banks (Security Pacific, Bank of America, Chase Manhattan, Chemical Bank, Citibank, Salomon Brothers [through a subsidiary, The Mortgage Corporation], Bear Stearns, CIBC, Royal Trust Company of Canada, Bank of Ireland, Allied Irish Banks, most of the large French banks, and all three Danish mortgage lenders). Several British insurance companies and other financial institutions also established subsidiary mortgage companies.

Some of the new lenders intended to securitize their mortgages according to American practice. Indeed, a widespread perception in the mid-1980s held that building societies would rapidly lose market share as the new, more sophisticated lenders introduced American-style methods into the British market.

This scenario changed rapidly as the mortgage market turned down in the face of rising interest rates and the mortgage business began to experience losses. Lenders who had been lax with respect to lending standards were quickly squeezed. Some had to cut back drastically the amount of new business they were undertaking. As market interest rates rose, mortgage rates lagged behind, placing a particular squeeze on the institutions funded predominantly on the wholesale markets.

The changing structure of the mortgage market is well illustrated by the shares of mortgage lending of the major groups of lenders (see table 6). As the boom developed in the mid-1980s, building societies lost market share, initially to the banks but then also to the miscellaneous financial institutions (a term that covers most of the new lenders, although not those that are bank subsidiaries). In 1988, the building society market share had fallen to 56.5 percent, compared with 76.7 percent three years earlier. Miscellaneous financial institutions had increased their share of the market. When the market turned down, the building societies and the banks regained market share but at the expense of the miscellaneous financial institutions. In 1992, however, the mortgage balances of these institutions declined

Table 6. **Shares of Mortgage Lending, 1985–1992**

	Building Societies		Banks		Miscellaneous Financial Institutions	
	Balances (%)	Net Lending (%)	Balances (%)	Net Lending (%)	Balances (%)	Net Lending (%)
1985	76.3	76.7	16.6	22.0	0.8	2.6
1986	75.6	71.4	16.8	19.0	2.2	9.4
1987	71.6	51.0	19.6	34.2	4.1	13.4
1988	68.5	56.5	20.0	25.9	7.6	17.0
1989	58.3	69.0	30.3	20.6	8.0	10.6
1990	60.0	73.0	29.1	19.4	8.2	8.5
1991	61.4	78.4	28.1	17.8	8.1	7.7
1992	62.2	78.1	28.4	33.6	7.4	–7.7

Source: Housing Finance, table 3.
Note: The Abbey National converted from a building society to a bank in the third quarter of 1989, causing a discontinuity in the statistics in that year (indicated by lines under the figures). This conversion accounted for almost the whole of the change in the share of balances between the two groups. Percents do not add up to 100 because of a small amount of lending by other institutions.

substantially. Thus, the institutions found themselves in the somewhat unusual position of having negative market share.

It is in some ways more interesting to consider the fate of individual institutions. Among the non-building societies, the rise and fall of National Home Loans has attracted the greatest attention. National Home Loans was established with a stock exchange flotation in 1985. It rapidly built up a large mortgage business and obtained its business entirely through intermediaries. It funded itself on the wholesale markets and refinanced its loans through securitization. By 1990, it had assets under management of £3.3 billion and was operating profitably. Its share price increased from £1.00 initially to £2.40. The quality of its loan book, however, was poor. The company's after-tax loss was £46 million in 1991 and £147 million in 1992. Shareholders' funds fell from £219 million in 1990 to £11 million in 1992 while the share price collapsed to virtually nothing. The company subsequently made arrangements with its bankers and underwent significant management changes, and it continues to try to work itself out of its difficulties. Even though National Home Loans share prices have recovered modestly, the company is undertaking virtually no new lending.

Among the other large centralized lenders, Household Mortgage Corporation, an independent company, has continued to operate

profitably. No published statistics are available for The Mortgage Corporation, the subsidiary of Salomon Brothers. Clearly, Mortgage Express, a centralized lender established by the British banking group TSB Bank (itself formed by an amalgamation of the savings banks), has not been as successful as its counterparts. Mortgage Express has incurred spectacular losses and is not taking on new business.

Several foreign banks have withdrawn from the market, and others that would like to exit by selling their mortgage portfolios have not been able to do so. Among the American banks, Bank of America sold its mortgage business to Bank of Ireland, Chase Manhattan and Bear Stearns exited from the market, and Chemical Bank sold its business to the French bank BNP. All three Danish lenders withdrew from the market after incurring large losses.

The British retail banks, unlike the building societies, did not traditionally make high-percent loans; instead, they concentrated on the middle and upper ranges of the market. Accordingly, their bad debt experience has not been as extreme as that of the building societies. Nonetheless, the banks have suffered heavily in the commercial property market, which in some cases has limited their ability to take on new business. It is significant that the banks sharply increased their share of net mortgage lending in 1992 (see table 6).

Building societies have emerged from the recession in a relatively strong position, notwithstanding the total concentration of their lending in mortgage loans and their traditional role in making high-percent loans to first-time buyers. Much of the credit for the condition of the building society industry must go to the Building Societies Commission, which was established by the Building Societies Act of 1986. The commission put in place an appropriate regulatory regime that responded to both the deregulation of the building societies and the downturn in the market. The commission also required a considerable increase in capital and required societies to demonstrate that they had established adequate control systems and lending policies.

Obviously, building societies have experienced a substantial increase in their bad debt provisions. In 1985, provisions and losses were equal to just 0.01 percent of mean assets. By 1991, that figure had increased to 0.53 percent, and a further increase in 1992 was likely. Provisions for bad debts have increased from virtually nothing in the mid-1980s to £429 million in 1990, £1,227 million in 1991, and close to £2 billion in 1992. Despite

this trend, building societies have managed to increase their capital by widening their operating margins and raising new forms of capital on the market, including subordinated debt and permanent interest-bearing shares (which can be likened to preference shares of public limited companies). At the end of 1991, each building society exceeded the 8 percent minimum solvency ratio under the European Community directives. Those directives implement the international standards for capital adequacy. The weighted average for all societies was 11.8 percent, an increase over the estimated figure of 11.2 percent for the previous year. The figure for 1992 showed an increase to 12.2 percent.

The building society industry has not been without its casualties. Nine building societies of the 117 on the register at the end of 1990 transferred their engagements to larger societies after incurring or predicting operating losses. Some of these societies were small, but several fell in the medium-size range. The largest society to transfer its engagements—Town & Country Building Society—was the 19th biggest society in the industry. Its assets at the end of 1991 totaled £2,191 million. The Woolwich Building Society, the third largest society in the industry, accepted Town & Country's engagements. In no case has a building society become insolvent, nor have investors' funds been at risk. Larger societies have always been willing to accept a transfer of engagements from smaller, troubled societies, thereby helping to preserve the integrity of the building society industry as a whole.

It is interesting to note the effect of the most recent cycle on the emergence of a secondary mortgage market in the United Kingdom. The secondary mortgage market is patterned after the American model but does not enjoy support through government-backed secondary mortgage market agencies. By early 1988, the "new lenders" had accounted for nearly 20 percent of new mortgage lending and were refinancing their activities by selling mortgage-backed securities. Banks and building societies, however, have generally not found the secondary mortgage market attractive, largely because they have been able to raise funds more cost-effectively through other channels. In addition, they have not been subject to pressure on capital such that they have needed to move assets off their balance sheets. Accordingly, the secondary market has continued to play a modest role in the total U.K. mortgage market and has not taken off in the way that some had anticipated. Further, the fall of National Home Loans has eliminated one of the major issuers of mortgage-backed securities. The industry has also suffered from a downturn in house prices and the difficulties associated with

obtaining security enhancement. Yet the secondary market has persisted and now accounts for about 10 percent of total mortgage finance—a share that it is expected to retain for the immediate future. While building societies are unlikely to become significantly involved in the secondary market, two of the large banks have indicated that they are seriously considering secondary market operations.

The new market

A new housing and mortgage market is evolving, but it will probably be several years before the nature of that market becomes clear. At 68 percent, the United Kingdom's rate of homeownership is at the upper end of the range for industrialized countries. Perhaps surprisingly, survey evidence suggests no long-term decline in the demand for owner occupation. Consumers, however, no longer see the purchase of a home as necessarily a good investment. Until four or five years ago, conventional wisdom held that people should buy their first houses with the largest possible mortgage as soon as they could and then trade up regularly. Any delay could mean that a consumer would never get on the housing "escalator." Now the purchase of a house is perceived as risky, and decisions to purchase are made on the basis of housing factors rather than investment factors.

Perhaps coincidentally, since passage of the Housing Act of 1988, a suitable framework has evolved for private rental housing. Until that time, laws on security of tenure and rent controls effectively prevented the existence of any form of market rental housing. It has not been a question of private landlords entering the market and building or acquiring properties to be rented; rather, developers and individuals unable to sell homes have instead rented them out through real estate agents. The extent of this new market is not known because there is no systematic method of measuring it. However, newspapers now carry lengthy columns of properties to let as well as properties for sale. Newspaper articles regularly compare rents and mortgage payments. Until the middle of 1992, rents were generally significantly lower than equivalent mortgage payments; it was therefore attractive for young people and for others intending to live in an area for only a short time to rent rather than purchase. Some potential home buyers decided not to buy, choosing to invest their savings elsewhere until they thought house prices had stopped their decline.

In September 1992, following an exchange rate crisis, the United Kingdom withdrew from the exchange rate mechanism of the European Community. Market interest rates fell from 10 to 6 percent, leading to reductions in mortgage rates to under 8 percent. This reduction has radically changed the relationship between mortgage payments and rents, but it does not in itself seem to have precipitated increased demand for homeownership. Renting is now perceived to be safer than owner occupation and therefore carries a premium.

Over the longer term, perhaps the major effect of the housing market collapse has been to shift upward, perhaps by as much as five years, the average age at which people become first-time buyers. If so, Britain will find itself in a position similar to that of the United States. Clearly, in that five-year transitional period, the overall demand for owner occupation will be sharply reduced. Because young people will in the future have a choice between renting and buying, the need for high-percent loans will decline. Both mortgage lenders and mortgage insurers have grown less willing to provide or insure such loans. Loans above 95 percent of valuation will be difficult to obtain, and those between 90 and 95 percent of valuation will be more expensive than other loans.

The entire mortgage lending process has become much more sophisticated. Until the mid-1980s, there was almost no mortgage underwriting as such because, it was assumed, losses could never be incurred. Now lenders rely on tight underwriting standards that are reinforced by their insurers' requirements. Some lenders even use credit scoring systems. As a result of these developments, some borrowers find it difficult to obtain loans at all and some properties have become difficult to mortgage, in particular properties in high-rise flats that were formerly owned by local authorities and sold to their tenants.

A housing market that allows people a choice between renting and homeownership and in which housing no longer automatically performs better than other investments must be preferable to the market that existed in the 1980s. However, the transition is a painful one, and it is made all the more painful by the fact that it is occurring at a time of low inflation, which makes the adjustment of real prices difficult. General expectations hold that the housing market will remain relatively depressed for the next year or two at least. The hope is that a more stable market will emerge in the mid-1990s—a market less capable of damaging the economy as a whole or causing arbitrary redistributions of wealth.

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