Low Cost Home Ownership in the UK Downturn

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Abstract

Low Cost Home Ownership (LCHO) has been championed by the UK Government mainly as a means of enabling households who cannot afford to purchase on the open market to enter into home ownership. Over the last few years as house prices rose the emphasis on LCHO also increased, especially as shared ownership could be readily negotiated through the planning system within Section 106 agreements and involved relatively little government subsidy.

There have been two main effects of the credit crunch and the growing recession in the UK: the market for shared ownership has declined dramatically, but the government has seen investment in LCHO as one way to keep the housing market moving, particularly through giving first time buyers easier access to home ownership.

This paper reflects on recent research exploring the impact of the credit crunch on the role and effectiveness of LCHO in the context of the downturn in the housing market and problems in the wider UK economy.

The paper focuses on the impact of the downturn on LCHO, looking at what is happening to sales of LCHO in different housing markets and exploring the impact on LCHO of competition from the new shared equity products being offered by the major housebuilders. The paper looks particularly at who now wants LCHO and the difficulties that they face given the changing finance market and local market conditions and highlights the strategies HAs are adopting in response to changing circumstances. The paper considers what the future of LCHO may be, examining the potential role of LCHO products in this uncertain market and in the future.

Introduction
Low Cost Home Ownership (LCHO) has been promoted by the UK Government as a means of enabling households who cannot afford to purchase on the open market to enter into home ownership. Over the last few years as house prices rose the emphasis on LCHO also increased, especially as shared ownership could be readily negotiated through the planning system within Section 106 agreements and involved relatively little government subsidy.

LCHO products are intended to enable households on lower incomes to access the housing market and to improve the affordability of market housing for these households. LCHO enables households to access home ownership through products that involve part-buying, part-renting a property or through a hybrid mortgage product. It is likely that these products will have been heavily affected by the credit crunch as they are aimed at marginal buyers, they are very complex, there is a lack of finance due to the credit crunch and the recession has led to rising unemployment and greater uncertainty.

There have been two main effects of the credit crunch and the growing recession in the UK: the market for shared ownership has declined dramatically, but the government has seen investment in LCHO as one way to keep the housing market moving, particularly through giving first time buyers easier access to home ownership. LCHO has become a key item on the housing policy and political agenda.

This paper reflects on recent research exploring the impact of the credit crunch on the role and effectiveness of LCHO in the context of the downturn in the housing market and problems in the wider UK economy. It does not discuss the impact on Housing Associations, but looks at the supply of and demand for LCHO and the changes to consumer finance and how it has been affected by the credit crunch in the UK.

The paper focuses on the impact of the downturn on LCHO, focusing on shared ownership products. It looks at what is happening to sales of LCHO in different regional housing markets and explores the impact on LCHO of competition from the new shared equity products being offered by the major housebuilders. The paper looks at who now wants LCHO and the difficulties that they face given the changing financial market and local market conditions, and highlights the strategies HAs are adopting in response to changing circumstances. The paper concludes with some reflections on what the future of LCHO may be, examining the potential role of LCHO products in this uncertain market and in the future.

The products
There are a variety of LCHO schemes available in England. As they are a response to analysis of particular barriers that might face potential owners in particular circumstances or in particular places, this specificity means that there have been numerous (sometimes quite complex) schemes that differ in the details of their design (Munro, 2007).

The core LCHO product is new build shared ownership which has remained fundamentally unchanged since the 1980s – in that it is only available on new build and major regeneration homes; the purchaser buys a proportion of the leasehold property; the HA maintains ownership of the freehold and charges rent on the rest of the property; and both the purchaser and the HA may borrow against the value of the property. There have been variations in the product over time, for example, the proportions that can be offered for sale, the rent chargeable on the rest of the property, the size and types of property and the eligible households have changed.

The main alternative to shared ownership is shared equity – where again the principle is unchanged since the original programme was introduced in the late 1990s – i.e. the purchaser buys a share of an existing dwelling with a conventional mortgage, and is enabled to provide 100% of the value of the property as collateral; the equity mortgage is delivered through the HA with government support, initially at zero interest. There have, however, been far more changes in the details, and the names, of the different schemes in this category as compared to shared ownership. Over time, there have been lots of changes to the source of funds for shared equity products, the size of the equity shares sold and to the conditions attached to the products.

In response to the collapse of sales of market housing in the UK, developers recently began to offer their own version of LCHO products, HomeBuy Direct, to encourage potential purchasers to make the commitment to buy. Most of the schemes were offered on a shared equity basis. A purchaser buys around 70% of the equity and the remaining 30% is lent to them for ten years at minimal interest rates, part of which is funded by the government and part by the developer.

How is shared ownership delivered?

The idea of using land-use planning mechanisms to stimulate or expand the supply of lower-cost housing became increasingly popular in a number of countries (Paris, 2007). Over the last two decades England has been developing a system by which the majority of new affordable housing will be produced with the help of the land-use planning system (Whitehead, 2007). There has therefore been a growing emphasis on new provision primarily through market mechanisms with an increasingly residual role for social housing (Paris, 2007).

The current policy on provision of affordable housing through the planning system operates through Section 106 of the Town and Country Planning Act 1990 as amended by the Planning and Compensation Act 1991 (Stephens et al, 2005). Section 106 agreements can be used in the context of a planning permission to provide mitigation against the impact of development, such as additional infrastructure, or – increasingly – to require the inclusion of affordable housing requirements (Burgess et al, 2007). They allow local authorities to seek cash or contributions in kind from developers to mitigate the impact of development. This is intended to ensure that local residents are essentially no worse off as a result of the development (Barker, 2006).

Section 106 has three distinct objectives, that of providing the land for affordable housing; providing mixed communities and a mix of affordable housing appropriate to the area; and increasing financial contributions, implicit and explicit, from developers and other stakeholders (Stephens et al, 2005). One type of affordable housing delivered in this way is shared ownership. Over the last few years as house prices rose in the UK, the emphasis on LCHO increased, especially as shared ownership could be readily negotiated with developers through the planning system within Section 106 agreements and involved relatively little government subsidy.

It is through this mechanism that shared ownership can be delivered at a reasonable cost, but delivery is very closely tied to the supply of market housing. The research looked at what the impact of the housing market downturn has been on the supply of shared ownership delivered in this way.

The downturn in the UK

In essence, a credit crunch is a rapid fall in the general availability of loans, which is often coupled with a rapid rise in the cost of borrowing, investment capital becomes difficult to secure and normal economic activity, which depends on the flow of credit to finance it, becomes disrupted (CIH, 2009).

The credit crunch began in August 2007. It is a worldwide phenomenon, but was triggered by the securitisation (bundling up and onward sale) of large amounts of very risky mortgage loans made in the US during a major housing boom (ibid). When the US housing bubble burst in 2006, huge amounts of securities based on the repayment streams from these mortgage loans and traded between financial institutions or used as collateral for interbank loans could not be priced leading to a drying up of interbank lending (ibid). The present crunch has complex roots (ibid) and has had a global impact.

CIH Scotland highlight that multi-directional linkages between financial conditions, house prices and macroeconomic circumstances have long been recognised (see for example Goodhart and Hofmann, 2008; Muellbauer and Murphy, 2008). The impact of the credit crunch was soon felt in the UK.

The mortgage and housing crisis in the UK saw liquidity in the finance market as a whole (the credit crunch) and the mortgage market in particular reduce dramatically. Lending criteria were quickly tightened in the wake of fears about default (which began as what is termed the ‘sub prime’ crisis). There was a rapid reduction in the demand for housing in the context of great uncertainty and tightened lending.

The financial crisis spread to most financial institutions. The wider UK economy moved into a recession which is expected to be of much longer duration than originally predicted and rising unemployment is increasingly seen as being the most pressing issue.

The impact on the UK housing market was dramatic. Confidence and demand has fallen across the housing market and house sales have fallen significantly. Land registry data showed that between May 2008 and August 2008, transaction volumes decreased by 46 percent compared to the same period in 2007. Land registry data show that the number of sales averaged 31,315 per month in the months November 2008 to February 2009. In the same period the year before, the average was 75,374.

House prices have fallen; the November 2008 Land Registry House Price Index data showed a decline in house price change of 12.2 percent over the year. The April 2009 Land Registry House Price Index data showed a decline in house price change of 16.2% over the year.

The length of time taken to sell properties has increased and possessions have increased. Construction activity has fallen dramatically as developers have reduced output; the five largest house builders announced large scale job losses in 2008. Mortgage lending has decreased significantly; the decrease in mortgage approvals between November 2007 and November 2008 was 67 percent. Gross mortgage lending declined to an estimated £10.4 billion in April, down 9% from £11.4 billion in March and 60% from £26.1 billion in April 2008, according to the Council of Mortgage Lenders.

The credit crunch and recession must impact on LCHO. The products are aimed at marginal buyers, they are atypical products and there is less money overall in the system. The credit crunch stops the flow of finance into mortgages for the products, and the recession is likely to increase the marginality of the potential buyers. Even though average house prices have fallen, these are complex products and marginal buyers and the institutions lending finance have become increasingly conservative, for example, taking lower valuations, and restricting access to the products.

The cost of borrowing had at first increased, although the costs of borrowing and living are now coming down and interest rates are at a historic low. In response to the crisis, there have been a number of government initiatives including HomeBuy Direct, a mortgage rescue scheme; suspension of stamp duty on properties purchased at £175,000 or less and the Home Owner Mortgage support scheme (announced in December 2008). The research explored how the government's LCHO products were competing with those now being offered by the major housebuilders.

The research

The research on which this paper is based was conducted for the Tenant Services Authority (formerly the Housing Corporation) by the Cambridge Centre for Housing and Planning Research (Burgess et al, 2008 and 2009). The research was commissioned before the impact of the credit crunch had fully been felt and began when the enormity of the impacts were first being recognised in May and June 2008. Further research took place between October 2008 and January 2009.

The main objective of the research was to examine the impacts of the changing financial and housing markets on LCHO. The aims of the second phase of the research were to explore the nature of regional markets for LCHO since the downturn and to explore the impacts of private developer shared equity schemes on HAs.

The research involved semi-structured interviews with Housing Associations, Housing Corporation investment managers, developers of market housing and major mortgage lenders. Some quantitative data analysis was carried out of CORE, Land Registry, ONS, CML and CLG data, but the degree to which these data could shed light on what was currently happening was limited due to the time lag between sales being agreed and when they appear in the data systems.

LCHO in the downturn

The LCHO sector receives considerable public subsidy, so it is vital that the products be continually monitored to ensure they are meeting policy goals and making best use of public funds. There is a slight tension between the notion that, in principle, falling house prices will make owner occupation more affordable and therefore reduce the need and demand for intermediate housing, and the continued government emphasis on the importance of the LCHO sector in keeping the housing market and development going in these economic conditions. For example, in 2008 the government announced a new shared equity product, HomeBuy Direct, in response to the housing market downturn. This is initially aimed at helping developers clear their backlog of unsold properties on a shared equity basis. There are up to 10,000 mortgages available, offering 30% equity mortgages for first time buyers funded by the Homes and Communities Agency and the developer. The scheme directly competes with shared ownership because the properties are on similar, or even the same, estates and the first time buyers go through the same agents.

It would be expected that if the economy entered a downturn, and house prices fell relative to incomes, then the need or demand for intermediate housing will also fall. But the financial crisis, followed by recession, has created a complex set of economic conditions that have not simply made housing more affordable through price falls.

The key issue addressed by this paper is what the collapse in the UK housing market means for the provision of LCHO. This paper is looking at the market changes in what is essentially a small, though important, sector of the wider housing market in England. It draws on recent research to explore the recent changes in the LCHO market in England and questions what the decline of the development of market housing means for LCHO and on the delivery of social housing. Recent policy and press announcements make it clear that the government believes there is a vital need to keep this sector of the market developing as private, market development dries up. The research found that HAs regarded LCHO as crucial to their financial and development plans for its role in cross-subsidising their provision of social housing.

The paper explores the variations in regional LCHO markets and the dynamics of LCHO markets at the local scale. It reflects on current tensions between the original policy goal of this housing product and the need to manage risk in the current economic climate, and the problems that have arisen in maintaining the supply of affordable housing as the building of market housing collapses.

Purchasers of LCHO

There have been recent calls in the UK to encourage LCHO to be targeted at households currently in social housing and therefore most likely to be on lower incomes within the eligible group for the products, because this will free up social housing and ensure that public subsidy achieves the best value for money. In 2006, the National Audit Office recommended that the department for Communities and Local Government and the Housing Corporation should further develop the choice of low cost home ownership products available for lower income groups (NAO, 2006). However, HAs participating in the research reported that people on lower incomes in the eligible group can no longer afford LCHO because of the greater restrictions on mortgage borrowing and need for relatively large deposits. Instead, LCHO was being purchased by households with rather higher incomes, suggesting that the recent changes are undermining the potential of LCHO products to meet the NAO agenda and provide an affordable step into owner occupation, particularly for social tenants.

Mortgage finance problems

The research showed that the lack of mortgage finance is the greatest hindrance to the LCHO sector at the moment as the difficulty in securing mortgage finance is the greatest inhibitor to sales, as it is for full purchases. Any potential purchaser that appears to pose even the slightest risk to lenders is no longer easily able to secure mortgage finance.

The research also found that mortgage lenders were not so keen to lend on traditional shared ownership products in comparison to shared equity products, because they consider there to be more financial risk for the lender attached to shared ownership if the property is repossessed. This is largely due to the priority with which debts are paid off on repossession. For shared equity the lender has first charge, meaning that they have priority on repossession funds, followed by the HA and the property purchaser. But for shared ownership, the repossession proceeds are split according to the share. This means that in a market where values are falling, with concerns about negative equity, lenders face a greater chance of losing money if a shared ownership property is repossessed.

The combination of a preference for lending on shared equity products and the general tightening of lending are problematic for sales of traditional shared ownership and lead us to question how this product fits within the current, constantly changing, suite of LCHO products.

Whilst the initial fears of many HAs were related to cash flow worries, recent research is showing that more recently they have been purchasing units from developers who are now unable to sell properties on the open market. Whole schemes originally intended to be market housing with a proportion of affordable housing are being bought by RSLs and will now be 100% affordable, often with a mix of social rent, shared ownership and rent to buy.

Uncertainty and falling sales

The research found that many HAs were worried that they would struggle to sell, or were already struggling to sell, new build LCHO units. This was creating concern about the impact of falling revenues from sales and of falling receipts from existing owners staircasing up and buying a greater share of their property. HAs were worried that falling revenues would impact on their future development programmes and particularly on their ability to use the revenues from LCHO sales to go towards funding the provision of social housing.

The downturn in the housing market and related problems in the financial markets were reflected in close monitoring of business plans by HAs and regular amendments to their development programmes and financial models. HAs were having to sell smaller initial tranches in response to the downturn. Some HAs were also looking at their revenue streams and considering changing the tenure of completed, but empty, properties from what were intended to be LCHO units to intermediate rental (below market rental rate) units instead.

The cost of borrowing increased so HAs faced higher costs. There were concerns that some HAs were quite highly geared and more vulnerable to the increased cost of borrowing. This would be particularly relevant when they come to re-finance and find themselves unable to access rates as favourable as their previous rates. There were suggestions that some HAs could face cash flow problems in the future. Some HAs would need to re-visit their business/financial plans, for example, where they are dependent on cross subsidy from LCHO sales and/or where their borrowing costs increase when they need to re-finance.

The downturn has also had an impact on the pipeline for LCHO units. Some HAs reported that developments were still being completed but that they would be reviewing future planned schemes. A few HAs have had schemes that have not been completed because of developers going out of business. For HAs in a stronger financial position, there have been increasing opportunities to purchase completed units from private developers who cannot sell them outright. However, many of these units are not in the right location or of the right standards, type and size. Despite the units being offered to HAs by the major housebuilders, the supply of LCHO properties through mixed tenure Section 106 schemes is likely to decrease over the longer term because developers are facing financial difficulties related to the overall market conditions and may not go ahead with new planned developments. The research showed how important LCHO is to Housing Associations (HAs) for its capacity to cross subsidise the provision of social rented housing where affordable housing is being delivered through the planning system.

The impact of the continued downturn on future pipelines for LCHO is unclear and is a matter of concern, particularly as new social housing is closely dependent on LCHO to help subsidise its delivery. The way in which the delivery of new affordable housing is linked to the development of market housing may be problematic now that market housing development has declined so significantly. If the underlying fundamentals of housing demand and demographics of household formation remain little changed by recent events, there is still a need for social and intermediate housing. It is not clear how this housing will be delivered through the current system in this economic climate.

Differences in regional markets

Although the LCHO market is relatively small in terms of the number of units delivered in comparison with the overall market for new build housing, the LCHO market has its own dynamics. Whilst the research took place within a depressed general housing market, there was significant variation in sales of LCHO units between regions; within regions; and even within localities.

The North West and the West Midlands regions of England have seen the largest decline in sales of LCHO, mainly apartments. These regions had already seen a slowing of overall sales even in the buoyant market so it is not surprising that LCHO is particularly affected in these regions. In the East of England region, sales of LCHO were stronger in the higher value 'Growth Areas' e.g. Cambridge and the London Commuter Belt than the lower value areas in the north of the region and areas such as Bedfordshire. Flats in all regions were generally more difficult to sell than houses. However, in parts of London, the London Commuter Belt and the growth areas of the East of England, flats were still selling well relative to other areas.

In London there was a lot of variation in the success of LCHO schemes between boroughs. HAs reported that it very much depended on the area. Kensington and Chelsea, West Camden and Hackney for example were selling well, whilst in Croydon the properties were not selling. The differences were linked to very local scale area characteristics and the nature of the developments. There were differences in sales rates for similar units even down to post code level.

This was generally true across all regions; the location of LCHO units is now influencing sales success at a very local scale. Whereas previously this had been a buoyant market, similar properties in developments in close proximity to one another now have very different sales rates. Local people are aware of area characteristics, which are the 'best' streets to live on, the catchment areas for good schools, the best transport links etc. The capacity for potential purchasers to choose was more restricted when the market was buoyant, but purchasers can now be more discerning in choosing a property, as there are so many for sale and reduced demand for the units, and it is leading to very variable sales rates.

All HAs reported that their LCHO units were being valued at less every time the units were assessed by mortgage providers for potential purchasers. The extent of down valuations on LCHO units by mortgage providers varies by location and property type, with flats worst affected. HAs reported that similar properties on the same development may be down valued by quite different amounts by those conducting valuations for different financial institutions. The reductions in house prices and down valuations have three main impacts; on HA finance;

on the confidence and capacity of the potential purchaser to pay; and on the capacity to obtain finance.

The general picture is one of falling sales and lower demand, although this is more marked in lower value areas of the country. There is still interest in the products but there are considerable difficulties for potential purchasers in terms of affordability because of the new, higher deposit requirements and in terms of the ability to secure a mortgage to purchase a LCHO property.

New private developer shared equity products

In response to the collapse of their market sales, private developers have begun to offer their own version of LCHO schemes in most areas of England. They generally offer properties for sale on a 75/25 percent shared equity basis. Most schemes allow a purchaser to buy 75% of the property with a normal mortgage, with an interest free loan for ten years from the developer for the remaining 25%. They were more likely to offer these deals on apartments than houses. One developer reported that their shared equity scheme had been very successful in the higher value areas of the south, but that the same product had not worked well in the lower value north of the country. Availability of the shared equity option can be limited as the schemes are very costly for developers to offer and depend on both their pipeline and market sales.

The schemes were regarded by developers as a way in which stock may be sold in a difficult market in which property values were falling and as a way to generate much-needed cash flow, not as part of a long term strategy. Young first time buyers, singles and couples are the target group for developers, largely because the shared equity schemes were being offered on small units and apartments. The developers felt that purchasers of their shared equity schemes would have been able to have bought 100% of the property with a mortgage before the downturn but were now hampered by the limited availability of mortgage finance and the need for a larger deposit.

However, the developer-led schemes are sometimes in competition for the same potential LCHO purchasers as HAs. Private developers have a range of schemes and incentives on offer. They are being used as a marketing tool to increase interest in their products. In response, HAs are offering more incentives to purchasers, such as free carpets and curtains, but they were relatively small in comparison to the incentives offered by private developers. Despite the increased competition, HAs felt that they were able to compete with the developer shared equity schemes as they believe they offer a better product; are more trusted; and provide long term support to purchasers. HAs are aiming to offer products that can help people over a longer period. The only concerns were that developers can offer a wider range of incentives and have more flexibility.

Conclusions

The dynamics of the LCHO sector of the housing market are extremely variable across regions; localities and even streets. Shared ownership is still working relatively well in higher valued areas in regions where longer term prospects are thought to be good and is less successful in lower value areas and where there are likely to be more problems due to the recession such as higher unemployment.

There is greater competition between HAs and the developers of market housing, although their objectives are different; the type of stock they are selling may be different; and the package that developers offer is more suited to young couples and singles who are probably hoping to move on fairly soon. HAs are aiming to offer products that can help people over a longer period.

For those who are actually trying to buy, the problems with respect to mortgage availability, valuation and down payment remain the most pressing. LCHO is not more affordable than before the downturn, as even though house prices have fallen tightened lending has not improved affordability. There are more fundamental issues that relate to who is prepared to buy in this environment and should they be advised to do so; the acceptability of the product to customers in the medium term and; the extent of the pipeline of completions once the immediate backlog of unsold properties is cleared.

The research leads to some questions about the future of the LCHO sector of the housing market. The policy emphasis had been on encouraging those in social housing to move into LCHO to make best use of public subsidy and free up social housing. This is a group of households that would probably have to stretch their finances further to afford LCHO and therefore is inherently a riskier group in terms of mortgage borrowing. In the context of rising unemployment and repossessions it is unlikely that households in this category would be welcomed by mortgage lenders. Rather the research shows that it is households on higher incomes in the eligible group who are purchasing LCHO.

This suggests that for the foreseeable future, LCHO is unlikely to become the hoped for step-on from social housing. This raises the question of how to cater for the group who cannot afford LCHO but who are not eligible for social housing. It may be that if the only option is not to be the private rented sector, other housing solutions have to be sought. Some HAs have begun to offer products that allow a potential purchaser to ‘try before you buy’, renting a new build property at sub-market rates with a view to moving into owner occupation once they have saved enough cash for a deposit.

LCHO is a fine balance between the financial risk taken by the purchaser and obtaining maximum value for money from public subsidy. It would be a contradiction in the current economic climate, with new emphasis on greater risk aversion, to expect that LCHO can, or should, be for the households on the lowest incomes in the group eligible for the product. There is a tension between the goal of providing owner occupation for households on lower incomes and managing risk that is not easily reconciled. It is possible that the policy drive to assist ever marginal households into home ownership is ill founded

The research also suggests that it may be a good time for a re-assessment of the range of products available in the LCHO suite. Shared ownership, with the additional rent payment alongside mortgage repayments making more costly to purchasers than shared equity and the greater risk to mortgage lenders if there is default on mortgage payments making it less attractive to lenders, may not be the best product looking to the future. Perhaps more emphasis should be placed on shared equity products given that the economic conditions and lending restrictions look likely to continue for some time. Looking forward, it is clear the current LCHO model is very complicated. There have been recent discussions as to whether the use of Section 106 to secure planning obligations will be viable in the future. This raises questions about whether the shared ownership model can still function. It may be that the products need revisiting yet again, but to produce a far simpler range of products, and that the way in which LCHO is funded and delivered at a reasonable cost will need new and innovative mechanisms.

Under the current system of delivery of new affordable housing through the planning system, there cannot simply be a switch to building more social housing and less LCHO now that sales have fallen across the market. This is because of the way affordable housing provision is linked to the development of market housing and the way LCHO cross-subsidises the production of social housing. But affordability has not improved for UK households (because although house prices have fallen, lending is more restricted and deposit requirements higher) and the collapse of the building of market housing will undoubtedly impact upon the pipeline of affordable housing. LCHO may be a small sector of the UK housing market, but it has an important role to play in the dynamic between the delivery of market and affordable housing. The underlying fundamentals driving demand in the housing market remain little changed. When the recession ends house prices are likely to rise again. It is clear that if the LCHO sector is to deliver a supply of affordable homes, it will have to be innovative in these challenging times.

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