Jon Cunliffe: Momentum in the housing market – affordability, indebtedness and risks

Speech by Sir Jon Cunliffe, Deputy Governor for Financial Stability of the Bank of England, at the Worshipful Company of International Bankers dinner, London, 1 May 2014.

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In 2007, the average house in the West Midlands cost around £170,000[1] Transactions in that region were running at 10,000 a month.

By 2009, the average price had fallen by around 15% to around £145,000 and transactions to around 5,000 a month. And, while prices and transactions bounced back in 2010, prices were subsequently pretty flat in the West Midlands until spring last year.

Over the 12-months to March, prices grew by a little under 10% in the West Midlands. The average house in the region now costs around £160,000 – 7% off the peak. Transactions in the region look to have averaged around 7,000 a month in 2013.

I mention the West Midlands because the level and growth rate of house prices in that region broadly matches the median for the country as a whole. The point is the rapid growth in the UK housing market is not just a London story.

For the country as a whole, prices at the end of March were also up around 10% on their level a year ago, back to where they were in late 2006. For 10 out of the 12 regions of the UK prices grew by more than 5% in the year to 2014Q1. That puts the house-price-to-earnings ratio back to its level in 2003. Transactions are running at 2005 levels – a little over 110,000 a month.

Looking at the most recent data, there has been a slowing in the monthly pace of increase. In the three months to February this year, prices grew at an annualized rate of 11% and transactions increased at an annualized rate of over 50%. But the very latest figures for March, however, could suggest a pause in the growth in prices and activity – prices were flat on the month and transactions actually fell by 5%.

And the latest mortgage approvals numbers, which came out this morning and tend to lead transactions, fell again in March leaving the number of approvals for house purchase down 12% on their January peak. Discussions with the lenders suggest that the checks that lenders now need to do under the FCA's new Mortgage Market Review rules, about which I will speak later, may be slowing the speed with which approvals can be processed.

But just as one cuckoo does not signal spring, it is far too early to say, on a couple of month's figures, whether this is the beginning of a turning point in the market.

Indeed it would be dangerous to ignore the momentum that has built up in the UK housing market since the spring of last year. Despite the recent pause, the forward looking indicators we have suggest that the period of rising prices is set to continue, with a number of survey indicators of housing market activity consistent with a double digit annualized rate of house price growth in the near term.

Sustained momentum in house prices and transactions have in previous episodes in the UK led in turn to rapid growth in aggregate mortgage debt and overall household indebtedness. That increase in indebtedness proved to be a vulnerability for borrowers and lenders subsequently contributed towards economic and financial instability. During the house price correction in 1989–92 and 2007–9, a number of lenders were dangerously exposed to a

[1] Measured on the average of the lenders' indices.

tightening in conditions in wholesale money markets and nursed large losses on their riskier property lending.

We have yet to see a return to rapid growth in aggregate debt. Gross flows of new mortgage lending have grown pretty sharply, by over 40% over the past year. But a large part of that has been offset by higher gross repayments. The stock of mortgage debt has been growing at a rate of around 1.5% a year, some way below the growth rate of house prices. Past experience, however, suggests that growth in net mortgage lending tends lags growth in house prices and transactions.

For the Bank of England and the Financial Policy Committee, we have to decide whether to address the momentum in the housing market and to rates of growth in prices and transactions which, in the past, have tended to lead to rapid growth in mortgage debt.

What has been driving this momentum in the housing market and is it a risk to financial stability? And if it is, is it a faint yellow light blinking on the Financial Stability dashboard that requires watching but may well go away by itself? Or a brighter one that needs some proportionate action?

The sudden awakening of the housing market after the spring last year was probably due to economic confidence beginning to return to the UK and to mortgage credit beginning to become more available. These factors, in turn, have likely released pent-up demand. Over the period 1997–2007, homeowners were moving on average every 10 years and housing transactions were running at around 1.5 million a year. In the years following the crisis, that slowed by over 50%. Homeowners moved on average every 17 years and transactions fell to around 900,000 per year. Compared to pre-crisis rates of housing transactions, over 3 million housing transactions have been “lost” between 2008 and 12. Many of those, of course, have almost certainly been truly “lost”. But housing transactions for most are strongly linked to life cycle changes and many have probably only been delayed until economic and credit conditions and confidence about the future improved.

In London, an additional source of demand has come from foreign investors looking for alternative sources of return amid a global environment of low interest rates. The government’s help to buy scheme may have also played a role though it is early days. Transactions are still quite low.

How much pent up demand exists and how quickly it will come through, is of course unknowable. But it is not at all implausible that it could add significantly to pressure on the market for the next few years. Use of the government’s help-to-buy scheme continues to expand. All of this paints a picture of further pressure on transactions that could take us quickly to pre-crisis rates. Despite the dip in March, housing transactions are still up 30% on their level a year earlier. Were transactions to grow at that pace from here on, we would go past the 97–2007 average level of around 120,000 per month before the end of this year; and be back at 2007 levels by the first half of next year.

Nor can we look to increased supply to help to quickly relieve some of this pressure. Housing starts, insufficient to meet demand before the crisis, dropped from around 230,000 to an average of a little over 120,000 between 2008–12. They have begun to recover – indeed, dwellings investment has been a major part of the recovery in economic growth over the past 12 months. But the increase in housing starts seen over the past few years has lagged behind growth in transactions.

The history of our housing market for the last 25 years is one in which the supply of housing in the place and of the type that people want has not kept up with demand. In 2004, Kate Barker – a former MPC member – concluded in her extensive report on the housing market that, if we wanted to reduce the trend in annual real house price growth to 1%, we needed to build an additional 120,000 private sector homes annually in England, an increase of almost 100% relative to the 2002–3 level. In the end, and despite a credit boom, the increase in annual housing completions up to the crisis was only 25%.

There are many reasons for the failure of the supply of housing to keep up with demand in the UK which go well beyond the remit of a central bank. But the effect is that when demand grows strongly house prices can keep rising quickly for a long time. This is a movie that has been seen more than once in the UK.

So it is not surprising, given the history of our housing market that the recent sharp increase in house prices and transactions appear to have fuelled growing expectations of an ever accelerating market. Contrary to the received wisdom in the rest of the world, the strength of housing market rather than the weather may be the dominant topic of conversation in the UK. With the possible exception of Australia, I don't know if any other country has a word for "gazumping". In April, over 500 newspaper headlines referenced house prices, around two thirds more than the total seen in that month last year.

Central banks are very well aware of the impact that expectations about prices can have in the generation of inflationary pressures across the economy – the way in which expectations of future prices increases or decreases change people's behaviour and actions.

And while inflation expectations in the UK are generally well anchored around the MPC's 2% inflation target, it is a very different story when it comes to expectations for house prices.

Though expectations for sharply rising housing prices are not an issue of inflation pressure generally, they can matter a lot for the actions of people and the choices they make. Expectations of a fast rising market put pressure on potential buyers to get into the market as quickly as possible for fear of being priced out. And on sellers to delay and ask for higher prices. And expectations of future increases in the value of homes can make people more willing to take on debt to get on the ladder or to reach for that next rung.

It is difficult to know how much expectations are driving the current market. But there is good reason to believe that a mutually reinforcing combination of strong demand, weak supply and expectations of a rising market could lead to a period of sustained and very powerful pressure on house prices in the UK.

The extent to which that will jeopardise financial stability depends on whether that pressure actually results in more transactions at higher prices, whether that in turn leads to an increase in household indebtedness and where that debt is concentrated.

These are, of course, all linked. The laws of supply and demand must, in the end, apply also to housing even in the UK. House prices cannot grow faster than earnings indefinitely. While households may be prepared to spend an increasing amount of their income on housing, there is a level at which house prices are simply not affordable.

Ultimately – given purchases are in the main financed by long term mortgage lending – it is the price and availability of mortgage credit, including maximum loan-to-value and loan-to-income ratios, offered by lenders that determines the point at which affordability constraints bite on house purchasers and so how far they can stretch to match rising prices.

At present, affordability constraints do not seem to be having a braking effect on the rise in prices. But prices are still below their 2007 levels in most regions and the house-price-to-earnings ratios a multiple below its pre-crisis peak. If prices continue to grow faster than earnings, affordability will increasingly be an issue for purchasers and for lenders. The proportion of loans at high loan-to-income multiples has already gone through pre-crisis levels in London.

When that has happened in previous episodes of a sharply rising housing market in the UK, lenders relaxed lending standards as house prices – and so the value of the asset they were lending against – rose. Expectations of future price increases also probably played a role in this. The FSA's 2009 Mortgage Market Review sought to reinforce lenders' standards and the reforms recommended by the Review were brought into force this month. They should help to ensure that affordability constraints do act against pressures on house prices. But they have not yet been tested.

A key determinant of whether a loan is affordable is the level of interest rates over time, which determine the cost of servicing those debts. The substantial falls in mortgage rates over the past twenty years – with the move to a lower inflation environment in the late 1990s and later, through the late 2000s, as Bank Rate was cut to combat weak demand – have been associated with a large increase in both house prices relative to earnings and levels of mortgage debt relative to household income.

The current exceptionally low level of interest rates will need to increase once the recovery is well established. So it is particularly important at present to ensure that the current low levels of interest rates do not mask the likely cost of mortgages and so create more headroom for prices to rise.

It is possible that affordability constraints, reinforced by lenders' underwriting standards, will increasingly act as a brake on the speed at which house prices are growing and as a brake on mortgage debt. In that case, having recovered much of their fall following the crisis, we will see house price growth slow to match the pace of earnings growth – a soft landing.

This is not without precedent. In 2004, having risen at an average rate of almost 20% over the previous 2 years, house price growth began to slow with the annual growth rate falling to just 2% by the middle of 2005. The 125bps increase in Bank Rate in the 13 months to September 2004 was no doubt part of the story. It proved, however, to be short lived episode. Amid a period of easing credit conditions, the pace of house price growth began to rise again through 2006, reaching double-digit rates by 2007. But it is probably an example of how affordability can brake the market.

However, there is another way the story can play out – a major overshoot in prices and build up in debt followed by a sharp correction with negative equity and an overhang of debt for many households. The trigger for the correction can vary – in the early 89–92 episode it was a sharp rise in interest rates as the UK sought to remain in the Exchange Rate Mechanism; in 2007–9 it was a sharp tightening in credit conditions amid a collapse in confidence in an over-levered banking system – but, unfortunately, there are more precedents in UK for periods of a rapidly growing housing market to end in this way.

The question for the Financial Policy Committee, therefore, is whether the sustained momentum we are seeing in the housing market will continue and will lead to unsustainable growth in household indebtedness, undermining the resilience of the system.

Our first thought must be to the direct exposure of the financial system to the housing market and its resilience to a major housing shock. Mortgage lending amounts to two-thirds of UK bank and building societies' UK lending.

Financial institutions are better placed now than they were before the financial crisis. The reinforcement of underwriting standards that I mentioned earlier, protects both borrowers from taking on unaffordable mortgages and lenders from bad debts. Since 2008, the amount of capital in the system has increased by £150bn, with capital requirements against UK residential mortgages broadly trebling. We now have, for the first time, a new international liquidity standard, which should help to prevent long-term mortgage debt being funded from unstable short-term wholesale sources; since 2008, banks' liquid assets have broadly trebled. And, in aggregate, their lending has, for the moment, come back into line with the major banks' deposit bases, implying a substantially reduced wholesale funding requirement.

But we need to be sure that lenders have the resilience to withstand a major housing shock, particularly if, as has often proved to be the case in the UK, it is accompanied by a substantial fall in spending as many households pull in their horns.

On Tuesday, the Bank announced the details of the stress test of the major banks that will be carried this year in the UK, as part of the EU wide exercise. Its central feature will be a test of banks' resilience to a severe drop in house prices in the context of pressure on borrowers' ability to service their debts.

To be clear, this is a severe stress test, not what we expect to happen. We will test resilience against a so called "tail risk" series of events; a series of events that are very unlikely but could plausibly happen with housing at their center. The aim will be to assess whether the major banks could withstand and recover from such a stress without terminal damage to the critical functions they perform for the UK economy.

The self-reinforcing link between property prices, the financial system and the broader economy that operate within the stress test have been key to dynamics in previous UK downturns. As well as lowering homeowners' wealth, falls in house prices reduce their collateral and so their access to credit. This tends to drag on consumption. Preliminary Bank analysis suggests the most highly mortgaged households have tended to cut their consumption very materially in times of economic stress.[2] And investment in the construction of homes and other property has had a tendency to fall sharply in downturns, with this component of spending accounting for around half of the peak to trough variation in GDP growth across the 2008–9 recession. This combination of lower property prices and a fall in spending across the economy, can, through a rise in defaults, damage banks and contribute to a tightening in credit conditions, creating a further drag on economic activity.

The distribution of indebtedness is also likely to matter. Given their sensitivity to a change in economic conditions, a long tail of highly indebted households could represent a vulnerability for both the banks and the economy. The data suggest that the size of this tail is increasing. Gross lending has increased and the share of new mortgages for house purchase at a loan-to-income ratio above 4.5, at 8%, is back around its pre-crisis level. These households tend to have borrowed for long maturities and to carry higher levels of unsecured debts.

These factors could, therefore, explain why, across countries, recessions associated with housing busts have tended to be over twice as severe as those without. And why, for countries where there have been larger and faster increases in household debt levels, recessions have tended to be deeper still.

The Financial Policy Committee has already acted in response to the growing momentum in the housing market. As well as the general strengthening of bank capital, the FPC, in conjunction with other regulators and the Treasury, withdrew both the cheap funding and favourable capital treatment of mortgage lending introduced after the crisis to help support the housing market. And, we have asked the FCA that when lenders test whether prospective borrowers can afford, through time, the mortgages they seek they should bear in mind future Financial Policy Committee recommendation on the appropriate interest rate stress test to use in assessments of affordability.

Whether and how to act further if, following the pause of the last couple of months, momentum continues to build will be the most challenging judgment the FPC will have to take in the coming months. The FPC's response will depend on the nature of the risks to stability identified. The FPC's powers of direction in relation to the capital banks and building societies bear most directly on mortgage lenders' ability to weather a downturn and housing bust once it has emerged. Others, like the FPC's powers to make comply or explain recommendations to the PRA and FCA could bear more directly on the crucial underwriting standards and affordability constraints like debt service to income, loan to income and loan to value.

The FPC has said that it would take a proportionate and graduated response to evolving housing market risks. Experience suggests that momentum in the market, and an associated increase in indebtedness, can be hard to check, particularly if expectations of a rapidly rising market become deeply entrenched. A number of countries have had to take a series of actions over time to slow fast growth in housing market activity to more sustainable rates.

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2 See the Box on page 22 of the May 2013 inflation report.

To return to where I started. The Financial Policy Committee of the Bank of England is charged with looking ahead to identify and to counter risks to financial stability. There will always be a number of blinking warning lights – risks generated at home and risks coming from abroad – on our dashboard.

The growing momentum in the market is now in my view the brightest light on that dashboard. It has not yet been accompanied by a substantial increase in aggregate mortgage debt, though gross mortgage lending is growing and there are signs that debts are becoming more concentrated. This could fade as affordability and lender constraints act increasingly as a brake on momentum. But other outcomes are very possible and the Financial Policy Committee will need be both vigilant and ready to act.