Levvel

INNOVATION IN HOUSING AND PLANNING

3

Affordable Housing Viability Study

For

Colchester Borough Council

APPENDIX 3

CURRENT AND PROJECTED ECONOMIC CONDITIONS

April 2013

Contents

1.0 Introduction

1.1 The Levvel analysis of viability is a dynamic one and takes into account past economic trends in order to assess how future residential markets might perform. While past history has its own specific characteristics which may be peculiar to the period in question, there are still fundamental principles that can be seen that might suggest how markets might perform in the future. This will not inform a single assessment of how the market will change but will give us the main parameters within which we can test possible scenarios.

1.2 It is important to note that our analysis is limited to the residential market. Where we discuss the general economy this is in the context of its action upon the housing market both nationally and locally. It is not our purpose, here, to predict general economic conditions either locally or nationally. However, we do look at the effects of the economy on the housing market both in terms of price trends and affordability.

2.0 Market Trends

2.1 Although local housing markets are contingent upon local conditions, they are also subject to both the economic conditions internationally and nationally. More specifically, they are subject to national regulation and constraints. In particular, the availability and cost, generally, of finance dictates the price that home owners are able to afford. The costs of finance for individuals will be influenced by financial institutions' lending practices and interest rates. These, in turn, are influenced by the national economy and, increasingly, the role of international markets is also important.

2.2 Looking at past market performance can only give trends and the interpretation of how markets act must be considered carefully. For instance, the housing market recession of the late 1980s and early 1990s has been considered to be due to the dramatic increase in base interest rates and the cost of finance. While this admittedly caused a number of home owners into financial difficulties, some commentators[1] have pointed to the possibility that the housing market had already been in decline and that the fall in values had already started to take place.

2.3 The housing market recession of the 1990s is likely to have happened in any case notwithstanding the effect of Black Wednesday in 1992. The housing market was beginning to recover just before that stage and the dramatic increases in the cost of borrowing immediately following Black Wednesday heralded a further period of house price stagnation. However it is still not clear whether this was part of the general cycle in house price inflation/deflation and, in particular, Fred Harrison points to an approximate 18 year boom and bust land and property cycle that has been evident over the long-term.[2] In other words, it may be possible that these property price fluctuations occur despite (not because of) general economic trends and, indeed, may be their very cause.

2.4 Another peculiar feature of the housing market is the positive price:transaction volume correlation.[3] When prices inflate, the number of transactions increases; trading is more frequent and volume is higher when prices go up and vice versa.[4] This means that a more dynamic approach to the assessment of the performance of the housing market has to be examined.

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[1] See especially Fred Harrison "Boom Bust: House Prices, Banking and the Depression of 2010" Shepheard Walwyn 2005, Andrew Oswald "The Great 2003-2005 Crash in Britain's Housing Maket" November 2002, Cameron Muellbauer and Murphy "Was there a British House Price Bubble? Evidence from a Regional Panel" March 2006

[2] Gordon Brown, as Chancellor of the Exchequer, acknowledged the effect of a volatile housing market : "Most stop-go problems that Britain has suffered in the last 50 years have been led or influenced by the more highly cyclical and often more volatile nature of our housing market" - Gordon Brown, Chancellor of the Exchequer, House of Commons, June 2003

[3] The effect of the ability to borrow and asset value is discussed by Lamont and Stein where "over some regions, a fall in asset prices can actually lead to reduced asset demands, because it impairs the ability of potential buyers to borrow against the assets". Owen Lamont (University of Chicago) and Jeremy C Stein (MIT Sloan School of Management) "Leverage and House-price dynamics in US Cities"

[4] See Wenlan Qian "Heterogenous Agents, Time-varying Macro Fundamental and Asset Market Dynamics." Haas School of Business University of Berkeley (2008)

2.5 Rady and Ortalo-Magny[5] suggest a model to explain the underlying reasons for "boom-bust" housing market cycles. It assumes households will generally prefer home-ownership and that the incomes of young households play a critical role in the fluctuations in the market. The market is sensitive to income "shocks" amplified by credit constraints which affect the timing of household moves that explains the positive price:transaction volume correlation.

2.6 The actions, generally, of first-time buyers is to access the market at a level that can be afforded but with the prospect that they will increase housing consumption as their means allow. Thus, as their income increases, they are able to increase their ability to pay and as income increases for first-time buyers in turn then this will increase the capital for those wishing to make purchases further up the housing ladder. Liberalisation of the finance market has a similar effect to increasing income especially at the bottom of the market. Similarly, an increase in the cost of finance has a similar effect to reducing income.

2.7 Credit liberalisation coincided with the high rate of property price inflation during the 1980s. Together with the increase in tax allowance in the 1983 budget for Mortgage Interest Tax Relief at Source (MIRAS) and the ability for couples to pool their resources, access to mortgages for young first time buyers helped many on to the housing ladder. Right to Buy social housing (following 1980) also encouraged many tenants to enter the housing market and thereby increased the potential market for subsequent homebuyers in the latter part of the 1980s. As Rady and Ortal-Magny have pointed out, all of this "prompted a major adjustment of the distribution of debt and housing across households, hence a period of exceptionally many transactions". They point to the rapid increase of transactions in the 1980s to "repeat buyers bringing forward their moves up the property ladder".

2.8 House price growth, however, only remains sustainable in the long term while incomes are able to support values. As we have pointed out, the main driver of this is first time buyer (starter home) purchase, typically those households in the 24-35 age group. Pressure on these households is strong because, generally, these are the most highly geared (their loan to income ratio is the highest). Subsequent movers in the late 1980s – those that had bought in the early 1980s – were dependent upon the generation of high levels of equity in order to realise their progression in the housing market.

2.9 The Council for Mortgage lenders (CML)[6] has remarked on the supply of housing being unresponsive to prices being for two main reasons. Firstly, the durability of housing being such that new housing becomes only a small proportion of the total stock and, secondly, that bringing new housing to the market is both lengthy and has significant barriers.

2.10 Taking these factors into consideration, the inelastic supply of housing leads to the "demand driven" increases in price. Any increase in demand due, say, to

[5] Rady and Ortalo-Magny "Housing Market Dynamics: On the Contribution of Income Shocks and Credit Constraints" Department of Economics, University of Munich (2001)

[6] Ibid pp11 - 12

demographic changes locally or increases in incomes, will lead directly to high housing market inflation.

2.11 While certainly it is undeniable that constraints on supply, including the constraints imposed through the planning system, have an effect on the housing market, this will have different effects regionally and demand side influences would appear to be more easily modelled.

2.12 It is clear that the high interest rates of the late 1980s and early 1990s were a contributing factor in the unaffordability of housing but it becomes more difficult to prove a direct causal link to house price inflation or deflation. Interest rates and the cost of money has become less during the period since 1997 when the government gave control of monetary policy to the Bank of England. While this period coincided with the house price inflation of the mid 2000s, the control of interest rates has failed both to control the rapid increase in prices (2000 to 2007) and the subsequent crash in prices. However, interest rates have remained at their lowest level (0.5%) since the beginning of 2009 and although the cost of mortgages for new buyers has still been difficult this has undoubtedly meant that pressures on the cost of housing has been alleviated. This can partly explain the rallying in values since that time.

2.13 Other economic factors, both internationally and nationally, have occurred which will have directly affected the housing market to some extent or another. These include the economic recession of 1979-1980; the abolition of exchange rate controls in 1979; the high unemployment rates and miners strike during the mid 1980s; the subsequent period of strong economic recovery and income growth; the abolition of dual income tax relief of mortgage interest in 1988 that caused a sudden stimulation to the market; the discontinuation of membership of the ERM in 1992 (Black Wednesday); the introduction of the minimum wage by the incoming Labour government; the Bank of England given the power to set interest rates by the incoming Labour government; and the recent worldwide recession ("Credit Crunch"). All of these factors have affected both supply side and demand side factors in the housing market.

2.14 Curiously, base interest rates have been at the lowest point ever since March 2009 and house prices continued to increase through to early 2010 albeit at a consistently falling annual rate. Since that time prices have fallen away slightly. Nationwide report in their regional index series that at 3Q2012 house prices in the East were some 1.5% lower than a year ago based on mortgage valuation data, although nationally prices are down 1.6% compared to a year ago. Contrastingly, Acadametrics, whose data includes both mortgages and cash sales, report for their October 2012 HPI report that:

a. Average house prices registered a 0.1% monthly increase in October and that this was the first time prices had risen since May 2012;

b. Year on year national house price growth slowed to 2.3%, in part buoyed by the performance of the London market in contrast with the rest of the country; and

c. The number of transactions in October rose by 24% in the month, in part due to the temporary hiatus and lull caused by the Olympics. Over the past year transaction volumes have remained between 40,000 and 60,000, approximately

half of the pre 2008 volumes. In October 2012 transactions of just over 60,000 are projected.

2.15 Some commentators were suggesting in the early and mid 2000s that the house price increases were sustainable and that the volatility of the past had been "due to a combination of unstable demand and unresponsive supply".[7]

2.16 The Council for Mortgage Lenders in 2001, in line with many commentators at the time, were suggesting that the housing market booms and busts were a thing of the past for the following reasons:

a. There are less likely to be large swings in interest rates;

b. Large swings in financial liberalisation are less likely;

c. There is likely to be more macroeconomic stability;

d. Greater financial products increase the flexibility of loan conditions.

Finally, the CML believed at that time that:

"The risk to consumers is now lower than during the last house price boom, but it seems more likely that borrowers – rather than lenders – are misperceiving the risks".

2.17 Other economic factors have been important recently. For example, it is clear that the sub-prime crisis in America which led to the worldwide recession has affected the UK economy generally and the affects affordability in the housing market. This may not have been foreseen but it is also clear that house prices generally and starter homes in particular, had reached an unsustainable level. This suggests that there may be some further falls in property prices in order to enable affordability to return to the market. If we are return to our suggested 3.5 times income analysis then prices in the UK may have to fall further, compounded with the effect of the recession on household incomes.

2.18 Other factors, particularly the higher rate of unemployment, are also relevant here for a number of further reasons:

a. Unemployment has been increasing and the recession is likely to continue, though these indicators are beginning to stabilise;

b. There is pressure on incomes generally;

c. Finance is increasingly difficult to obtain, high loan-to-value (LTV) mortgages (especially for first-time buyers) are difficult to obtain and, despite low base interest rates, finance is expensive (particularly for those wishing to enter the

[7] CML 2001 page 18

market for the first time), whilst the banks are also being required to bolster their balance sheet reserves;

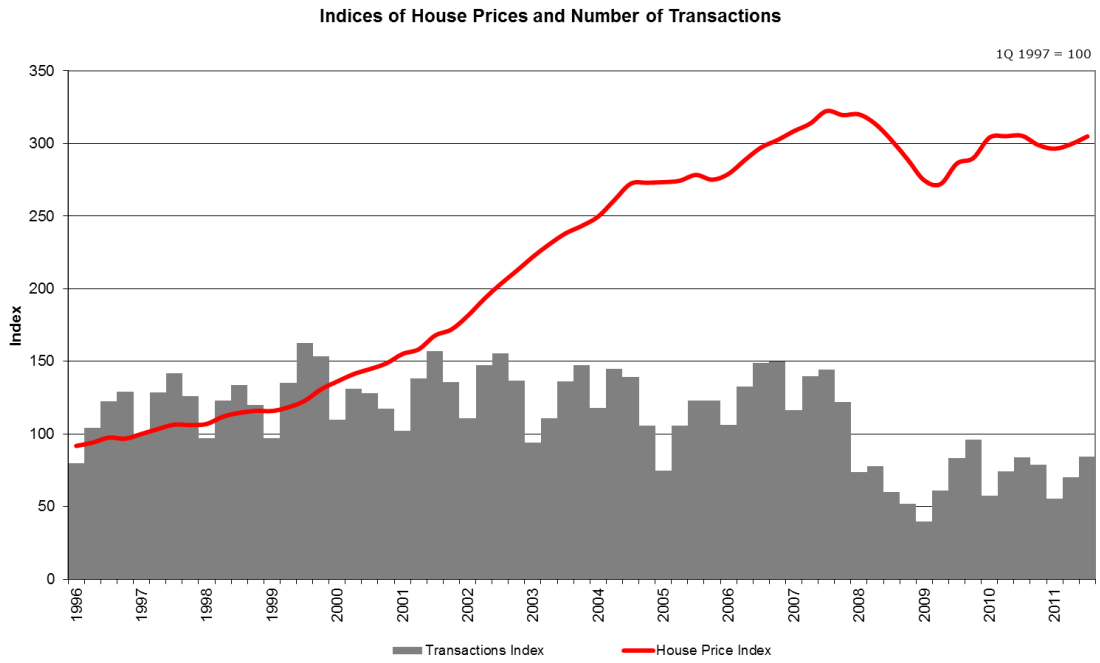
d. Market confidence is low and households expect prices to fall further.

2.19 While these factors are influential on the market, the government has (in the 2009 budget and with additional subsequent announcements), attempted to support the housebuilding industry through a number of measures. It is not yet clear how these measures will affect the property market either in the short or the long terms. On the other hand, it is likely that budget constraints following the Comprehensive Spending Review 2010 in order to deal with the large deficit will have an effect on spending generally and the economy as a whole though support for housebuilders continues .

2.20 Therefore, a number of factors have affected and will affect the housing market and the affordability of housing. These include macro-economic influences and the worldwide recession. However, there are also systemic pressures from within the workings of the housing market which affect the affordability of housing and, ultimately, how the market works. In the next section we look at the regional situation.

3.0 East of England Regional Context

Price/Volume correlation



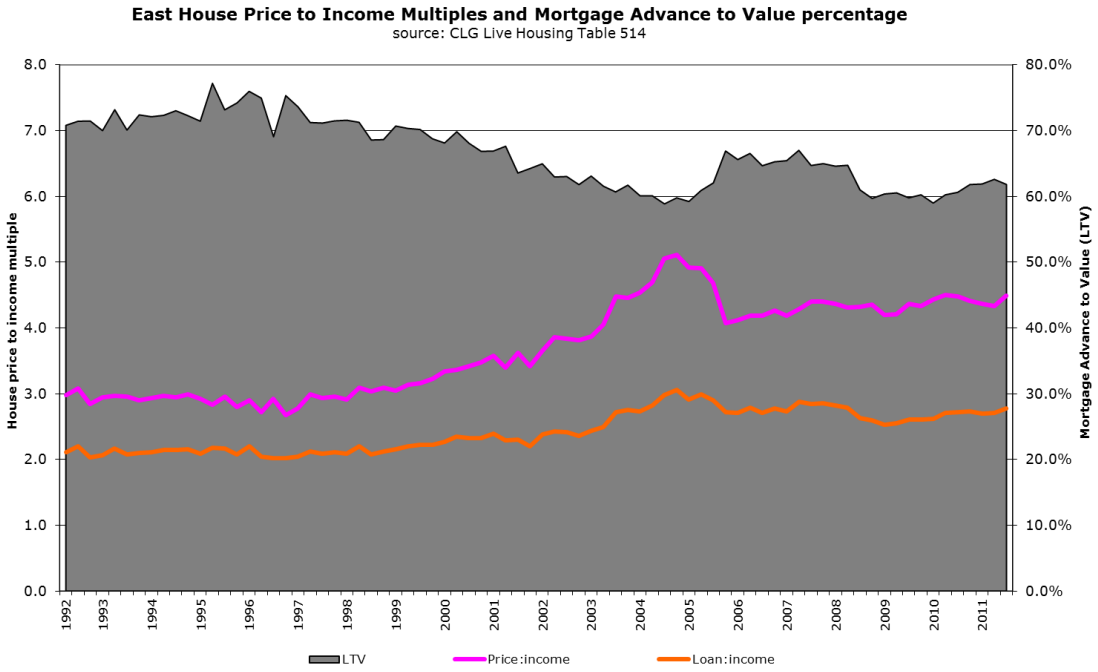
3.1 The graph above demonstrates the approximate correlation between house prices and sales volumes across the East of England region.

3.2 Firstly, examination of the transactions index on a quarter by quarter basis shows the seasonal nature in the number of transactions, with numbers falling typically in Q1 due to the preceding holiday period. Overall, however, transactions generally remained constant to mid 2003 and represented a period of steady house price growth. Transaction volumes after that period then began a slight decline to 2005 following which transactions increased again, although prices rose steeply and then continued a steady climb towards the price peak in mid/late 2007.

3.3 As the availability of mortgage finance became heavily restricted due to the global credit crunch the price correction is evidenced as the transactions fell to a quarter of their volume at price peak.

3.4 Indeed it would appear that prices are holding in current circumstances because of the very limited number of transactions taking place in the market at below half that of peak.

Affordability/Lending trends



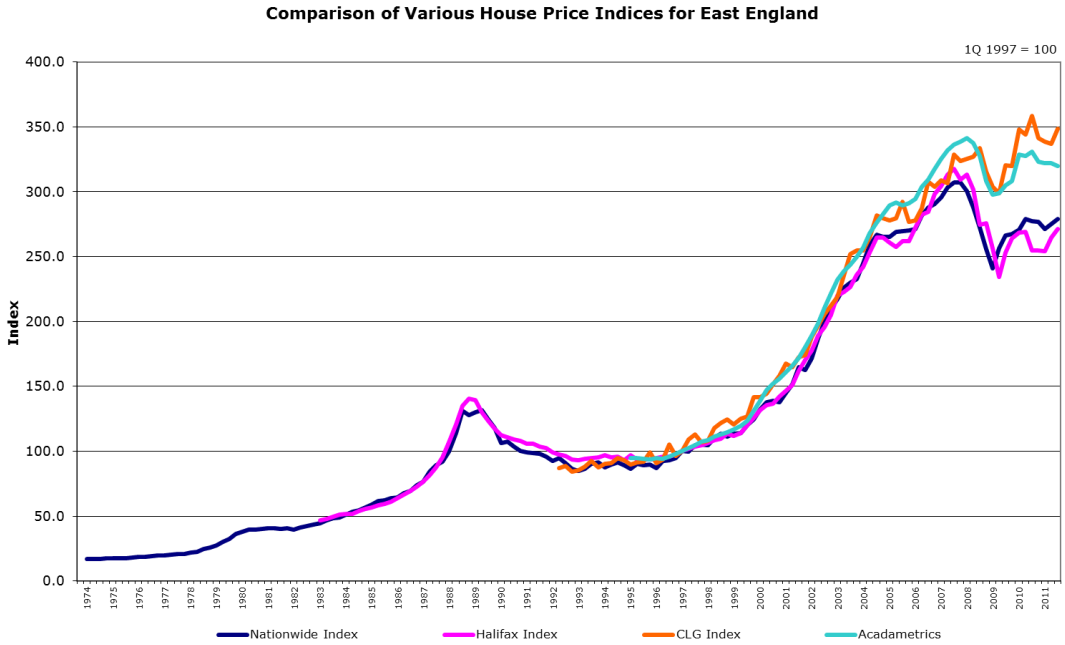
3.5 From the plot above of Loan:income ratios of mortgages completed on it can be seen that as prices rose to their peak in late 2007 the typical loan:income ratio remained consistently between 2 and 3 times household income.

3.6 It should be noted that there was a substantial peak in house price:income ratios in mid 2004, corresponding to the steep climb in house prices at that point and a rise in the loan:income ratio above its historic standard of approximately 2. It is interesting to note that the corresponding period did not see a continuation in the loan to value (LTV) ratio but a reduction. This would suggest a short term change in the way households accessed housing finance, drawing on other resources to fund their house purchase.

3.7 Subsequent to that period house price:income ratios fell suggesting that as housing became more expensive it was only those households with a sufficiently high income to access mortgage finance who were able to afford to purchase.

3.8 The overall trend for increasing deposits on house purchase can also been seen, represented by a decline in LTV ratios, most significantly since early 2006. This is probably due to the dominance in later years of home movers with significant levels of equity, though this has risen slightly in recent quarters.

Long term track of house prices

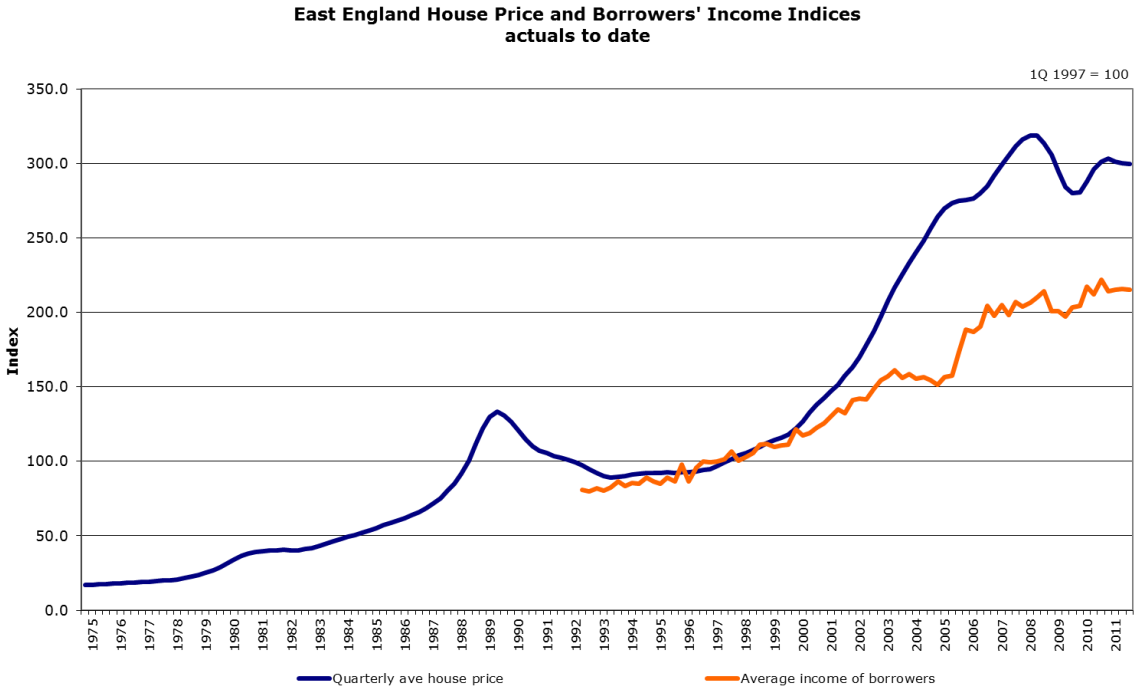


3.9 Above is a long term track of published average house price data from Nationwide, Halifax, CLG and LSL Acadametrics. Available data does not cover the same period for all data providers and average house prices have been indexed to First Quarter 1997 to allow comparisons to be drawn with smoothing to reduce seasonal fluctuations.

3.10 Firstly it is apparent that, whilst the profile of all the indices is similar to peak of market, there is a lag in the data points of CLG and Acadametrics. This is because of the way in which the data is compiled using Land Registry data from completed transactions, rather than Halifax and Nationwide data which is collected at mortgage valuation stage.

3.11 The approximate 18 year peak to peak market cycle can be seen between 1989 and 2007, with the very substantial price increases in the later half of the cycle, followed by a tailing off and then price falls as the cycle begins again.

3.12 Whilst all data sources are mix adjusted for property types there is an increasing difference between them over time. We have therefore averaged and smoothed the indices to generate a single combined index which can be used for forward growth predictions.



3.13 The graph above shows the smoothed, averaged house price index to 1Q 1997. In addition the index of household incomes receiving mortgages is plotted as a reference. Extrapolating this back suggests that the rate of change of household income index is approximately constant over time and just intersects with the house price curve during periods of steady growth at early/mid cycle (assuming the cycle runs peak to peak). This is an important reference for projecting forward house price growth and also demonstrates the significance of price bubbles in the UK market.

4.0 Future House Price Growth Scenarios

4.1 Our analysis of past trends, and taking into account the continuing pressures of the recession, suggests that there may be a long period of stagnation in the property market despite the recent regional price increases shown in the house price index data sources. Information from housing market indicators suggests that this period of stagnation is well underway.

4.2 However, we want to test scenarios that assume both a more optimistic position as well as the downside. Therefore, using past trends as a guide, we suggest that there are 3 potential directions or scenarios that should be tested representing a range of potential directions the market might take.

4.3 In line with the recommendations of the Harman[8] report the first five years are assumed to have nil price growth, with growth curves based on previous housing market performance feeding in thereafter.

4.4 The first of these is an "upside" position where values show an increase in prices in the very short term. We have assumed an increase in values so that 2007 average values are achieved again fairly rapidly and the profile of increases follows the same pattern as in the previous period (1992 to 2007) from this high value base (20% above average).

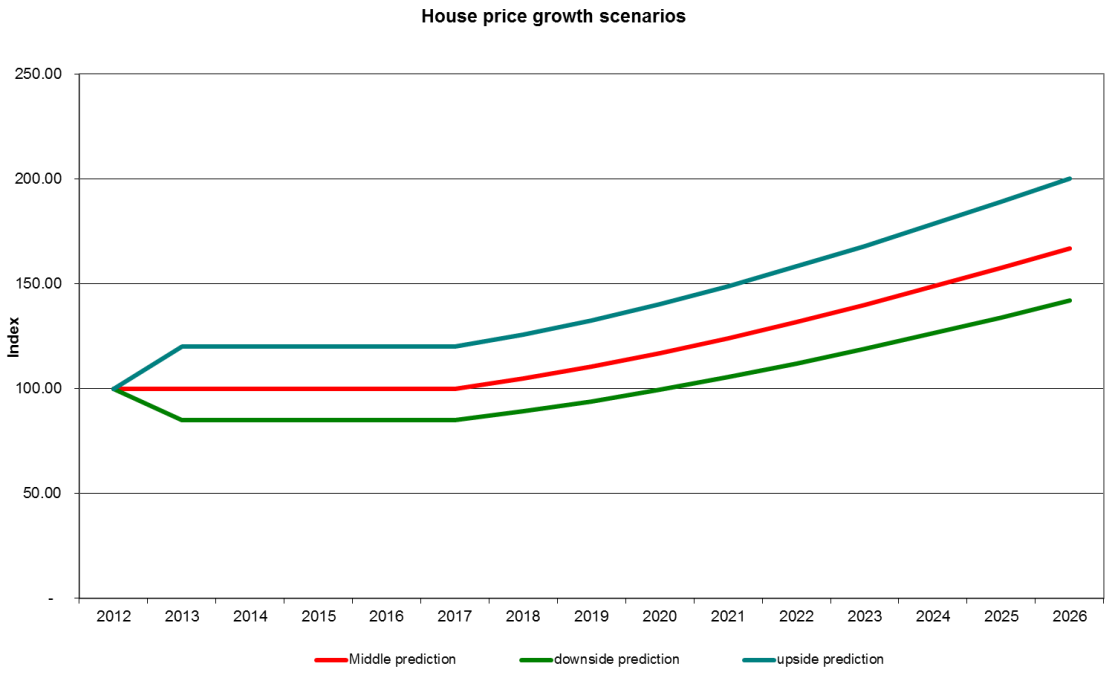
4.5 This is an optimistic view of property prices with house prices assumed to be well above the long term average from the previous period. In this scenario, affordability is likely to be a significant and continuing issue.

4.6 The second scenario is our "middle" and assumes property values follow the trend seen between 1992 and 2007. The short term follows a continuing stagnation in values with a slow recovery with affordability ratios remaining fairly benign until the later part of the period.

4.7 Finally, the "downside" scenario assumes a long term trend 15% below the historic (1992 to 2007) position.

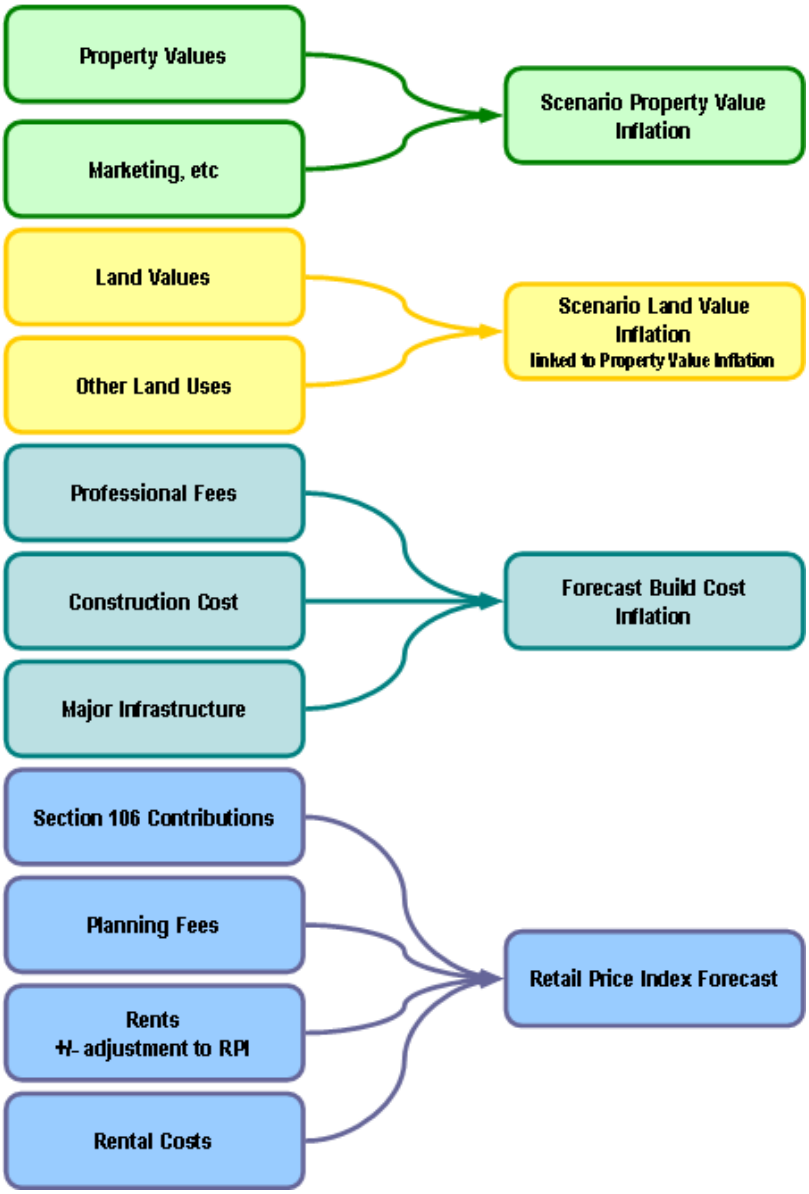
[88] Page 26, "Viability testing Local Plans: Advice for planning practitioners" Local Housing Delivery Group chaired by Sir John Harman, June 2012.

4.8 All three scenarios can be seen in the following diagram (index Q1 2010=100):



4.9 We propose a dynamic assessment of viability. To do this we will use the three scenarios to feed into our viability analysis by taking the house price indices that are generated. House price inflation is one component of our proposed future proofing methodology and we will combine projections for other elements of the inputs including Retail Prices Index, Construction Cost forecasts and land value forecasts. We will then use these forecast indices to inform the viability assessments over the length of the development periods as well as to assess variable development start dates. A matrix of costs will be used which uses the property price values described above together with some assumptions on RPI and cost construction indices.

4.10 It is anticipated that these projections will remain constant between the different property value scenarios so that the relative effect of the upside, downside and middle projections for values can be assessed. The following diagram illustrates how different cost and value elements are linked to the various indices. For example, professional fees will be linked to construction cost inflation while planning fees may be linked to RPI.



4.11 Sites will be coming forward through the planning process over different timescales. Therefore, our dynamic approach will allow us to consider developments with completions up to 2026 and beyond. Clearly, projections at later dates must be treated with caution but this will give a general indication about possible long-term viability. This may allow the council to look at a flexible approach to policy setting over the time of the plan that will enable challenging but realistic targets for affordable housing to be set.