Developments in the UK Mortgage Market

by Adrian Coles

INTRODUCTION

The UK residential mortgage market grew rapidly during the 1980s. The amount of mortgage debt outstanding rose at a compound rate of around 13% a year between 1979 and 1989 even after allowing for inflation. This paper looks at the background to that growth, examining trends in tenure, government policy, the institutions taking part in the mortgage market, product innovation and securitisation. It also describes the more depressed market conditions that have so far characterised the 1990s.

TRENDS IN TENURE

Britain has been unusual among industrialised countries in experiencing a period of rapid growth in the proportion of dwellings that are owner-occupied. In 1961 just 42% of houses in Great Britain were owner-occupied, but this figure had risen to 50% by 1971, to 57% by 1981 and currently stands at around 67%. This increase in owner-occupation may be the result of the British outlook on life and "the Englishman's home is his castle" mentality; undoubtedly there is a strong individual desire in the United Kingdom to own one's own home. Nevertheless it is important to recognise that government policy, under both major political parties, has played an important part in the expansion of owner-occupation in recent years.

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The first strand to this policy is the controls that have been put on the other tenure that, in the normal course of events, would have competed with owner-occupation. In 1914 it is estimated that 90% of all dwellings were privately rented but by 1991 the figure had fallen to about 7%, an extremely low figure in international terms. The major reason for the decline in the private rented sector has been the existence of government controls since they were "temporarily" introduced during the first world war. Controls on rents have made it unattractive for many investors to put their funds into the private rented housing market; a more attractive return has been available elsewhere. Moreover, the rules on security of tenure have arguably been loaded in favour of tenants so that it has been difficult for investors to regain control of their property except under what many potential landlords regard as extreme circumstances. During 1989, the Conservative government removed some of the controls on new lettings, having previously introduced fiscal incentives to encourage investment in private rented housing. This may, at least, result in a deceleration in the rate of decline of the sector.

The major providers of rented housing in the UK have been the local authorities. At its peak in the late 1970s the public rented sector accounted for almost 32% of the entire housing stock of the UK and during the 1970s around half of all new house building was for the public sector. However, in 1980 the Conservative government introduced a right to buy policy which enabled tenants of public sector dwellings to purchase the property in which they lived on extremely attractive terms, with discounts ranging up to 70% of the open market valuation. Over the last few years there have been significant sales of local authority and new town dwellings. The figure peaked at over 220,000 in 1982 but, nevertheless, in the mid-1980s a steady stream of over 100,000 dwellings a year was sold. The figure rose again to around 200,000 in 1988 before falling away in more recent years. The public rented sector currently accounts for around 22% of the housing stock in Great Britain.

While government policy has broadly been hostile to the rented sector, individuals have been encouraged to purchase their own houses. This policy has been developed in a number of ways. Perhaps the most important has been the existence of mortgage interest tax relief. The interest on loans of up to £30,000 used for house purchase is eligible for tax relief and this has had a significant effect in reducing the cost of mortgage finance to home buyers. Nevertheless, the importance of tax relief has been declining in recent years with the £30,000 limit having been in place since 1983. The previous limit, £25,000, was set as long ago as 1974. The sharp increase in house prices in the 1980s resulted in a significant reduction in the real value of the tax relief limit. Also, in 1988 the Chancellor of the Exchequer removed tax relief on new loans for improvement and shifted the basis of the relief to dwellings, rather than individuals, so that separate tax units jointly purchasing the same dwelling were eligible for only one set of tax relief rather than up to four. Finally, in 1991 tax relief was restricted to the basic rate of tax, having previously been available at the borrower's marginal rate. Tax rates have also gradually been reduced, further limiting the value of tax relief. It is clear that although the present government is committed to maintaining tax relief for house purchase it is, nevertheless, not averse to restricting its application.

Secondly, housing is, arguably, privileged in that owner-occupied dwellings are exempt from capital gains tax; that is the gains made on the resale of a dwelling are not taxed in a way that the gains made on other similar investments would be. It should be noted, however that there are a number of concessions in the way in which capital gains tax works, and an increasing number of investment schemes offering tax free income and capital gains, so that to a large extent the exclusion of housing is more apparent than real.

Finally, mortgage interest is eligible for income support. If a mortgage borrower becomes unemployed and his income from other sources, and his savings, are below certain levels, then he is eligible to apply for a state benefit which will pay the interest due to the lender. This is an extremely important factor in helping to underwrite the mortgage market because it limits the number of people seeking to sell their homes when they become unemployed and assists in limiting the numbers of arrears cases.

THE TRADITIONAL POSITION IN THE MORTGAGE MARKET

Against this background the mortgage market was, during the 1980s, an extremely attractive one for financial institutions to enter. Nevertheless, during the 1970s and early 1980s building societies were effectively the only institutions offering mortgage finance. Before examining the reasons for the absence of other institutions it is important to understand the role which building societies played during these years.

Building societies are specialised financial institutions with two principal functions - to accept deposits from members of the public and to provide loans to people who wish to buy their own homes. They are mutual institutions owned by their customers and operate under specific building society legislation rather than the more general company or banking laws. At the end of 1992 there were 105 building societies, although the degree of concentration was such that the largest three societies controlled 45% of the assets of the industry and the largest thirteen controlled 85%.

Building societies' natural competitors, the banks, were prevented from playing a full part in the mortgage market by controls on the growth of the money supply, which was defined in terms of bank balance sheets. In essence those banks that grew too quickly were penalised by having to place special non-interest earning deposits with the Bank of England. Banks were also subject to official exhortation to concentrate their lending on industry and commerce rather than individuals. The result was that whereas in most industrial countries commercial banks regarded residential mortgage finance as one of their major activities the British banks restricted this type of lending to their staff and to bridging finance.

Building societies, therefore, faced little external competition in their major markets. Internally, competition was controlled by the BSA's recommended rates system. This ensured that all major societies paid and charged the same rate of interest and arguably that the interest rate margin was set at a level sufficient to guarantee a profit to the more inefficient societies.

The 1970s was also characterised by political concern over the level of the mortgage rate. Under the British variable rate mortgage system an increase in interest rates affects all existing borrowers as well as new borrowers and the mortgage rate is, therefore, seen as an important factor in determining the popularity of the government of the day. Pressure to keep the mortgage rate below other rates of interest during the 1970s meant that not only was mortgage funding seen as a particularly advantageous form of borrowing, but also that the supply of funds was restricted because building societies were not able to pay the rate of interest in the savings market that was necessary to attract the funds to meet the level of mortgage demand that emerged. The result was that customers had to queue for mortgages and building societies were forced to adopt various non-price rationing devices in order to regulate this queue. Examples of this practice included restricting the advance to a set proportion of the purchase price, making people wait for three or six months after they made their mortgage application before making funds available, making potential borrowers save with the society for a number of years before allowing loan applications to proceed or asking for a particular proportion of the loan to be placed in an investment account before considering a mortgage application.

All of these factors made it relatively easy to run a building society during the 1970s. Societies offered just two products, there was no competition in the markets for these products and there was a queue of people wanting to purchase one of the products. There was no need for marketing of mortgages nor was there any need for product innovation. Indeed the last thing which societies wished to do was to stimulate further demand for mortgage finance.

NEW LENDERS

In 1979 and 1980 the removal, by the new Conservative government, of the remaining non-market controls on bank balance sheets meant that they were free to exploit the retail financial markets. As has already been noted residential mortgage finance is a natural market for the banks to enter and between 1980 and 1982 the banks' share of new mortgage lending rose from 8% to 36%. The banks immediately adopted a more rational pricing policy than had building societies.

Building societies traditionally charged a higher rate of interest on larger loans than on smaller loans and also a higher rate on endowment loans than on repayment loans. It was argued during this period that those borrowers wishing to obtain a relatively large slice of a scarce resource should pay for the privilege and building societies also needed the revenue generated by such schemes in order to pay the premium rates of interest which they were then offering on special savings accounts. On endowment mortgages it was argued that societies needed a higher rate of interest to compensate them for the fact that they received no capital repayments which they could relend to new borrowers. At a time of mortgage shortage repayments of principal were an important source of new funds for lenders.

The banks charged a flat rate, irrespective of the size of the loan, and this meant that they undercut building societies, particularly at the more lucrative top end of the market. The banks also began to advertise that mortgages were available, the first time for many years that mortgage advertising had taken place. During the early 1980s the banks placed particular emphasis on the speed of their service, the lack of queues and the eagerness with which they wished to undertake mortgage business. This contrasted with the approach of the building societies during the 1970s. Very often the lack of funds and the imposition of rationing devices meant that societies had neglected to offer a service to their customers; rather, on occasion, societies were accused of putting across the idea that they were doing their customers a favour by granting them a loan.

The effect of the increased competition was to change the relationship between mortgage interest rates and interest rates in the rest of the economy. It no longer made sense for interest rates to be held under the general level of rates. Building societies had tried this and it led to mortgage queues while the banks clearly had no interest on lending funds at a loss. Gradually, by the mid-1980s, the mortgage rate had emerged at a steady 1-1.25% above money market interest rates and this encouraged the entry of new institutions into the market.

In September 1985 the National Homes Loans Corporation was established and during the following year or so two other centralised mortgage lenders, The Mortgage Corporation and the Household Mortgage Corporation were set up. By the late 1980s a number of centralised lenders had been established, many subsidiaries of overseas based financial institutions. These organisations undertake their business very differently from banks and building societies in that they have deliberately avoided creating branch networks. They operate out of only one or two administrative offices and use direct advertising and insurance sales forces as vehicles through which to market their loans. The increased importance of the endowment method of repaying a mortgage loan is discussed in a subsequent section but it is sufficient to say now that around three-quarters of new building society mortgages are repaid through the endowment method. This has created intense interest in the market from life assurance companies which now sell a high proportion of their products in tandem with mortgage loans.

THE CHANGING ROLE OF THE ESTATE AGENT

In the early 1980s in the United Kingdom, it is estimated that there were 11,000 estate agency companies with 14,000 branches between them. The largest branch network probably comprised no more than 40 outlets. However, some analysts have suggested that the change in conditions in the mortgage market has placed the estate agent in an extremely powerful position. During the 1970s building societies controlled the scarce resource, the mortgage finance, and they were, therefore, able to control the market, making allocations of funds to house builders and estate agents in return for, perhaps, a guaranteed flow of investment funds. During the 1980s, however, mortgage finance has been plentiful and rather it is the customer that has been relatively scarce. Those institutions that have the first chance to influence the customer are, therefore, in a particularly powerful position.

Over 80% of all dwellings in the United Kingdom are sold through an estate agent and the estate agency is the natural first port of call for any potential house buyer. As the purchase of the house is virtually always the most important financial transaction of any person's life it is clear that there are significant opportunities to sell financial products at the same time as a house is sold. Realising this, financial institutions have invested heavily in the estate agency business during the 1980s, and now all of the large estate agency chains are subsidiaries of insurance companies, banks and building societies. Large networks are owned by General Accident Insurance Company, Royal Life Insurance Company, Hambros Bank, Lloyds Bank, Nationwide Building Society, Halifax Building Society and Abbey National plc.

All of these institutions realised that an individual requires, at the same time as he purchases a house, a mortgage loan, a life insurance policy, house and contents insurance, possibly an unsecured loan with which to purchase furniture and fittings for the new dwelling, possibly a new credit card as the personal budget is extended a little at the time of a house move, and overall general finance advice. Modern estate agents are, therefore, multi-product outlets capitalising on their strong position in the market place, although this did not prevent many estate agency businesses losing significant sums during the depression in housing market activity that began in 1989. Losses at Prudential Estate Agents, at one stage the largest network, were such as to lead the parent company to withdraw from the market.

PRODUCT INNOVATION

For many years around 80% of new building society mortgages were made on the understanding that they would be repaid on an annuity basis. On the assumption that interest rates did not change, the constant monthly repayments comprised, in the early years of a mortgage, a small proportion of capital and a large proportion of interest. Gradually, as the capital was paid off, a lower proportion of the monthly payment was interest and an increased proportion was capital. At the end of 25 years the entire loan was paid off. On each change of interest rates the repayment profile was recalculated so as to complete the repayments within the 25 year term. This type of loan had a number of advantages. It was possible to extend the term of the mortgage if borrowers found it difficult to meet an increase in the mortgage rate and it was also possible to move the loan onto an interest only basis so as to reduce payments even further for borrowers facing severe difficulties. On the other hand, many borrowers accelerated their repayments so as to complete the repayment of their loan well within the 25 year nominal period. Flexibility is, therefore, a keynote of the repayment mortgage.

In the early 1980s the importance of the endowment mortgage gradually increased and by 1989 over 80% of new building society loans were written on the endowment basis, although the figure fell to 75% in the early 1990s. Under this method a borrower pays interest only to the lending institution while simultaneously making premium payments to an insurance company. The insurance policy is designed to mature in 25 years and to pay off the mortgage debt outstanding. Many of the low cost endowment policies now available have an initial sum assured of less than the size of the loan but the expectation is that the investment performance of the insurance company will ensure that the addition of bonuses during the term, and at the end of the 25 year period, will produce a sum at least large enough to pay off the mortgage debt. In many cases the sum is well above the amount necessary and borrowers have the advantage of obtaining a tax free lump sum as well as paying off their outstanding loan. A further advantage of the endowment method is that borrowers enjoy life assurance throughout the mortgage term.

An understanding of advanced mathematics is necessary in order to appreciate the reasons for the growth in the popularity of the endowment mortgage. In simple terms, endowment mortgages become more attractive as interest rates decline. With the annuity mortgage not all of the benefit of declining interest rates is received in the form of lower payments. The formula used for calculating repayments means that any reduction in the rate of interest is accompanied by a slightly accelerated pattern of capital repayments. A 10% reduction in the mortgage rate (from, say 10% to 9%) is accompanied by perhaps only an 8% reduction in actual mortgage payments, as there is a slight increase in the amount of capital repaid. Correspondingly, on an increase in mortgage rates of 10% (from, say, 10% to 11%) total mortgage payments increase by somewhat less than 10%. In contrast, on the endowment mortgage the full impact of any change in interest rates is passed on. A change in the rate of interest applied to the mortgage account has no implication whatsoever for the premium payments to the insurance company.

The implications of the mathematics of annuity mortgage repayments became extremely important at the time of the introduction of mortgage interest relief at source (MIRAS). Until March 1983 borrowers had obtained their tax relief on their mortgage interest through an adjustment to their Pay As Your Earn coding, paying the gross amount of interest due to their lender. From April 1983 tax relief was obtained via the lender. That is, a net amount of interest was paid by the borrower to the lender with the latter reclaiming the tax relief due from the tax authorities direct. With a gross mortgage rate of 10% and a tax rate of 25% this meant that, in effect, borrowers paid a net rate of 7.5% to the lender. This had exactly the same mathematical effect as a reduction in the mortgage rate. The entire reduction was passed on to endowment borrowers but because of the accelerated repayment of capital inherent in the annuity system, repayment borrowers did not benefit to the same extent. The difference was enough to shift the balance of advantage to the endowment mortgage and sales of endowment mortgages have increased significantly since 1983. They fell a little in 1984 following the withdrawal of life insurance premium relief on new life policies but, nevertheless, quickly recovered to their present market share.

A variant on the endowment mortgage has recently become more popular. This is the pension mortgage where borrowers again, pay interest only to the lending institution but simultaneously make contributions to a pension policy which provides sufficient proceeds to pay off the outstanding loan at the end of the loan period. The pension mortgage has an advantage in that payments into a pension fund are tax deductible and this can make the entire arrangement extremely tax efficient. On the other hand, a pension is not assignable to the lender, unlike a life insurance policy, which reduces the security available to the lender. Also, the borrower has a smaller pension available to him when he eventually retires. In mid-1992 pension linked mortgages accounted for just two percent of new loans.

A further recent option has been to arrange for the repayment of the loan through the proceeds of a series of Personal Equity Plans - a government scheme that enables individuals to invest in the stock market without paying income or capital gains tax on the proceeds of the investment. This type of repayment mechanism accounted for less than 0.5% of new loans in mid-1992.

Another major change in the late 1980s was the liberalisation of lending criteria. Traditionally building societies limited their loans to around 2.5 times the borrower's gross income plus an allowance for any second income. Also, loans over 95% of the purchase price were extremely rare. As competition to lend has increased, institutions were prepared to lend up to three times the main applicant's income plus a sum equivalent to the secondary income. Also, loans for 100% of the purchase price became more common in the mid 1980s, although in recent years they have declined in importance as lenders found that 100% loans were more associated with arrears than other types of lending. During the late 1980s a number of lenders have offered particularly high multiples of, perhaps, 3.75 or four times income to young professional borrowers whose incomes might be expected to rise rapidly. Such schemes were always carefully targeted; even in 1988 just 3% of building society loans were for 3.75 times income or more. Some lenders also introduced non-status mortgages where no proof of income was required by the lender. The lender in this situation limits the risk which it faces by restricting the loan to, perhaps, 70-75% of the purchase price and by charging a higher than normal rate of interest. Again these became less popular as activity declined in the early 1990s. Overall, in 1991 first-time buyers received an average of around 83% of the purchase price in the form of a mortgage loan and that loan represented just over twice the average income of such buyers. For existing owner-occupiers moving house the average percentage advance was around 62% and again, borrowers were advanced about twice their average income.

The basic structure of the repayment or endowment mortgage can be applied to a wide range of other innovations that characterised the mortgage market from the mid 1980s as competition for new business has become more intense and as, more recently, lenders have become concerned to ameliorate the impact of high interest rates, and the recession.

Size related mortgage rates

In the mid-1980s the arguments in favour of differential mortgage rates began to break down. It seemed sensible to follow the practice in other large industries and give a discount for bulk purchases and also to seek to attract more up market and affluent borrowers. Most lenders now offer a discount for those borrowing sums above a certain limit. A large number of institutions also offer a discount for those purchasing endowment mortgages and this can be seen as a form of return to the customer of the commission earned by the lender on the arrangement of the endowment insurance policy. A few lenders still retain differential mortgage rates but in these cases the differential is normally determined by the riskiness of the loan with respect to, for example, income multiples and percentage advances.

Fixed rate mortgages

A major disadvantage of the British variable rate mortgage system is that mortgage borrowers are exposed to the risk of sharp increases in interest rates after they have signed their mortgage contracts. In order to overcome this problem many lenders now offer the option of a fixed rate mortgage where the rate applied to the account is unchanged for any period between two and five years; one or two lenders have offered rates fixed for ten or even 25 years. Mortgage borrowers are thus able to insulate themselves from the effect of fluctuating interest rates although they are exposed to the possibility that the variable rate mortgage may fall below the fixed rate to which they have agreed. The issue of fixed rate mortgages accelerated in 1988 and 1989 as the sharp increase in short term interest rates created a downwards sloping yield curve (that is, long term rates were lower than short term rates). It made sense for lenders to fund themselves on a fixed rate five year basis and on-lend the funds thus obtained at a lower rate than the current variable rate. In theory borrowers should be prepared to pay a premium for the certainty offered by fixed rates; nevertheless as short-term interest rates declined in 1992, fixed rate schemes continued to be sold at a discount to the variable rate. In mid-1992 about 20% of new mortgages sold were fixed rate loans.

Fixed payment mortgages

A number of lenders also operate annual review schemes on their variable rate mortgages. Under such arrangements payments are altered just once a year, taking into account changes in the mortgage rate during the previous year. Although these are not fixed rate contracts they do have the advantage of fixing payments for a year at a time. Just under half of all borrowers are members of such an arrangement. A further recent development has been fixed payment loans, where the amount charged to the account varies, but the payment remains constant; the rate of interest which is used to calculate payments is what the lender thinks that average rate will be over the mortgage term. Over-payments reduce the amount outstanding, under-payments add to it. If the sum outstanding moves outside certain limits the payment rate is recalculated. Loans of this type are not, however, common.

Cap and collar mortgages

This type of mortgage is the mid point between fixed and variable rates in that the mortgage rate is allowed to vary between lower (collar) and upper (cap) limits. This provides the borrower with some protection against extreme fluctuations in mortgage rates but still with the opportunity of benefiting from small reductions. One variation of this is to offer a capped product that limits the increase in the interest rate, while allowing advantage to be taken of reductions.

LIBOR-linked mortgages

This type of variable rate mortgage has a rate of interest which is linked to money market rates, typically LIBOR (London Inter Bank Offered Rate) and is, therefore, outside of the control of the lending institutions. The borrower can be certain that any change in short term money market rates is reflected fairly quickly in his own payments. This type of loan is, therefore, attractive to those borrowers who hold the view that lenders are quick to pass on increases in short term rates but slow to react to decreases. This type of mortgage is also useful in mortgage pools where it is expected that mortgages will be securitised.

Deferred interest mortgages

As a reaction to the high interest rates that characterised 1989-90 many lenders introduced loans where only part of the interest due has to be paid during the early years of the mortgage, the unpaid portion being added to the outstanding loan. Such schemes have proved attractive to those expecting their incomes to increase rapidly (young professionals, for example) and those expecting interest rates to fall. They can be relatively risky for those whose incomes do not increase as expected or who lose an income following the birth of a child, for example, but who, nevertheless, have to meet higher mortgage payments on a larger outstanding loan as the period of deferred interest comes to an end. Generally such loans were withdrawn in the early 1990s as the capitalised interest added to the account and the decline in house prices meant that effective loan to value ratios rose very rapidly.

Deferred interest mortgages for the elderly

A variant of the above involved an elderly person taking out a loan on which all interest payments are deferred until the house in sold, often on the death of the borrower. Such schemes appealed to those who have low incomes, but valuable homes. The cash raised by taking out a loan could be used to generate an income that could improve the standard of living of the borrower. The danger was that the interest accruing would increase the size of the loan more rapidly than the value of the house is rising. Most lenders will allow the loan to reach 75% of the value, but then require interest payments to be made. The elderly person may be placed in a difficult position and these loans were therefore often restricted to a small proportion of the initial valuation (say 15%) and to the relatively old (say 65 and over). Effectively they were designed for times of rapidly rising house prices. They became far less attractive products as house prices declined in the early 1990s.

Foreign currency mortgages

High UK interest rates between 1989 and 1991 increased the attractions of borrowing at low rates of interest in overseas currencies, and a small proportion of recent loans have been written on this basis. However, the danger is that exchange rates will alter so that the benefit of a low interest rate is outweighed by a decline in the sterling exchange rate and an increase in the debt outstanding in sterling terms. It has been stressed by brokers and lenders that such loans are only for the financially sophisticated.

Equity linked mortgages

This type of mortgage has been pioneered by some building societies and is essentially aimed at encouraging low income groups into the owner-occupied housing market. The schemes offer the borrower the advantage of an extremely low rate of interest on the mortgage loan. In return for this the lender takes a share of the profit on the resale of the property when the borrower chooses to move house. Overall, such loans are difficult to find.

Index-linked mortgages

This type of mortgage has not been generally available to individual borrowers but rather was thought more appropriate for institutional borrowers such as, for example, housing associations. The general principle of an index linked loan is that the rate of interest applied is relatively low, typically around 4% or 5%, but with interest payments and the principal outstanding linked to the retail price index. This is particularly appropriate for housing associations which might expect their rental income to increase over time broadly in line with inflation but, nevertheless, might be considered dangerous for individual borrowers to take on, in that if inflation accelerated they might find in any one year a very sharp increase in both their interest payments and in the total amount of debt outstanding. Such mortgages account for a negligible proportion of total loans outstanding.

Remortgages

A significant development in recent years has been the growth of competition for existing mortgage balances. Borrowers are probably moving lenders without moving house more frequently than ever-before as differences in interest rates emerge and as some lenders advertise their willingness to pay the legal and other costs involved. Others point out the attractions of increasing the size of the overall loan outstanding in order to create capital for use in other, non-housing, areas.

THE DEVELOPMENT OF THE SECONDARY MORTGAGE MARKET AND SECURITISATION

In America, the secondary market is much more developed than in this country. The market there arose basically for two reasons, neither of which has existed in the UK. The first was the American system of financing fixed rate mortgages with variable rate deposits. The savings and loans associations, or thrifts, experienced a squeeze on their earnings in the late 1970s and early 1980s that resulted from an increase in the rate of interest which they had to pay on their variable rate short-term savings balances combined with an inability to increase the rate of interest which they earned on their fixed rate long-term mortgages. In order to prevent such a squeeze occurring again many thrift institutions now immediately sell into the secondary market the fixed rate loans which they make, believing it inappropriate, in days of volatile interest rates, to hold them on their own balance sheets. Indeed, such mortgages are much more suited to organisations with much longer term commitments such as insurance companies and pension funds.

The second reason for the development of the market in America was the geographic restrictions on banking and thrift activity. Although the rules are being relaxed, especially in the thrift sector, there is still a general prohibition on banks operating branches outside their state of origin. Transferred to a UK context that would mean that all the funds raised in, say, the retirement resorts of Sussex would have to be lent in the same county, while the demand for mortgages in a suburban area would have to be met by the savings flows obtained in the same area. Clearly there is the potential for regional mis-matches in the supply of, and demand for, funds and the secondary mortgage market is able to help balance these out. A building society based in Sussex would probably find a greater inflow of funds than there is demand for mortgages, and it could use its excess funds to purchase mortgages which were originated in suburban areas, where the demand for mortgages might well be in excess of the provision of savings deposits. Of course, in reality in Britain the funds are transferred across the country within institutions rather than through a secondary market. The American secondary market has grown rapidly basically because the primary market is so undeveloped. However, the US secondary market would not have grown so rapidly had not the Federal government implemented, through agencies, a series of guarantee and insurance programmes which reduced the risks faced by investors.

What is the rationale for the development of such activity in the UK? Building societies have so far mostly confined themselves to what might be called quasi-secondary market activity. A few medium sized societies have established agency lending schemes, mostly operated through subsidiaries. In essence such schemes involve the building society finding the customers, investigating the security which they are able to offer, and making and servicing the mortgage, that is, collecting the interest and dealing with such items as insurance for the property. However, the actual funding is provided by another financial institution. Such arrangements are attractive to building societies that have a very efficient mortgage administration department but have neither the fund-raising capabilities, nor the capital on their balance sheets, to provide the funding for the additional new mortgage business which they want to attract. Other organisations have also entered the mortgage servicing market and it is now possible to have mortgage loans that are originated by one institution, serviced by another, and financed by a third. During 1990 and 1991 a further fragmentation of the process occurred with the establishment of mortgage packaging companies. These organisations undertake the administrative work arising after a customer applies for a loan - the investigation of income, the arrangement of the valuation and so on leading the originator free to devote attention to the customer.

However, none of this is true secondary mortgage market activity. Rather, this has been pioneered by the wholesale funded mortgage corporations mentioned earlier such as National Homes Loans Corporation, the Household Mortgage Corporation and The Mortgage Corporation. The major advantage of the securitisation programme which these institutions have undertaken is that it enables lenders to liquify their mortgage assets. It may well be the case that from time to time an organisation may wish to have mortgages on its balance sheet but this does not mean that once having made a mortgage loan it would wish to keep that loan until it matures. The development of a secondary mortgage market enables this problem to be overcome with organisations being able to acquire and dispose of mortgage assets as and when it suits them. This is likely to increase the flow of funds into the mortgage market and therefore reduce the relative cost of mortgage finance.

The fragmentation of the mortgage finance function into origination, servicing and funding also means that institutions which wish to originate and service mortgages no longer need to have the capital that has traditionally been required to back the funding part of the mortgage lending process (although it should be noted that the rules designed to establish whether a particular loan requires capital backing are extremely complex). The development of a secondary mortgage market and indeed quasi secondary activity means that institutions are able to concentrate on those parts of the mortgage process in which they have a comparative advantage. No longer need such organisations offer services which they do not wish, or have the capacity, to offer. However, competition in each individual sector will become more intense. Given these advantages it may well be the case that the secondary mortgage market will grow in importance in the UK although it is doubtful whether it will ever reach the size (in relation to the total market) of its US counterpart.

THE 1980s BOOM AND THE 1990s RECESSION

Over the last five years the level of activity in the housing market has varied significantly. Reductions in interest rates and rapidly improving personal prosperity led to a boom in the housing market which peaked in 1988. During that year the number of residential property transactions in England and Wales reached almost two million, compared to just 1.6 million in 1986. This was accompanied by a rapid increase in house prices, which rose by over 30% between the beginning of 1988 and the beginning of 1989.

The rate of growth of the economy that formed the background to the housing boom was, however, unsustainable. The rapid increase in general economic activity led to balance of payments and inflation problems, and between the spring of 1988 and the end of 1989 bank base rates were increased from 7.5% to 15%. Over a similar period mortgage interest rates rose from just under 10% to just over 15%.

The abrupt change in the economic environment resulted in a significant downturn in housing market activity. The number of residential property transactions in England and Wales fell by almost 40% between 1988 and 1991, while house price inflation disappeared. Falls in house prices of 25-20% have been recorded in some regions while at a national level prices have fallen by perhaps 10% since the 1988/89 peak.

A particularly unfortunate consequence of the change from boom to recession has been the rapid growth in the number of possessions and serious arrears cases. The number of homes possessed by mortgage lenders rose from 16,000 in 1989 to 44,000 in 1990 and to 76,000 in 1991.

Political concern over the trend in possessions intensified during 1991. At the end of that year major policy changes were announced following a series of meetings between the government and representatives of mortgage lenders. On the part of the government the threshold for the payment of stamp duty (which had meant that anybody purchasing a house for more than £30,000 had to pay a tax equivalent of 1% of the purchase price), was lifted to £250,000 until August 1992. The government also introduced legislation to ensure that income support for mortgage interest is paid directly to mortgage lenders rather than, as previously, to borrowers, who were then able to make a choice as to how to disburse the funds received. This change was implemented from June 1992.

In exchange for the government initiatives, lenders' promised that, where income support covered the mortgage interest due, they would not initiate possession proceedings. They also indicated that they would look sympathetically at cases where borrowers were making regular repayments on their mortgage account even though the repayment did not cover the full amount of interest due. Mortgage lenders also agreed to continue to increase the resources which they make available for the management of arrears and counselling of those with repayment difficulties and also committed funds to housing associations to enable them to buy the homes of defaulting borrowers, leaving such borrowers in their homes as tenants.

This package of measures resulted in a significant reduction of possessions during 1992, although the bulk of the reduction has not been associated with the provision of loans to housing associations but rather with increased resources devoted to arrears management. However, housing market activity has continued to decline in 1992 and the future course of possessions depends crucially on trends in the economy and in interest rates. Indeed, the over-hang of unsold houses on the market is such that any increase in demand can be readily met from houses on the market. It is, therefore, likely that an increase in the number of transactions will precede any rapid increase in house prices. In a further effort to boost transactions the Chancellor of the Exchequer announced in November 1992 that he was making additional funds available to housing associations to enable them to purchase up to 20,000 existing dwellings on the open market. It remains to be seen to what extent this will stimulate the market.

CONCLUSION

The UK mortgage market has changed significantly over the last 15 years. The traditional position was of monopoly suppliers of mortgage finance being forced to employ rationing devices to ensure that scarce funds were allocated as fairly as possible between competing borrowers, a total lack of innovation in the basic design of the mortgage product, and a relative lack of concern over the level of service provided to the customer. The current arrangement is very different. A wide range of institutions compete to provide mortgage finance, mortgages are advertised extensively on television and in the press, the introduction of new products is relatively common and individuals generally are allowed to borrow what they believe they can repay (within overall prudential limits set by lenders). Effectively the mortgage market has become a market similar to that for any other type of consumer good.

While the nature of the mortgage market has changed significantly over the last 15 years the level of activity has also fluctuated markedly. The boom years of the late 1980s have been replaced with a very subdued market environment in the early 1990s, a move that has been accompanied by falling house prices and rapidly rising provisions for loss among mortgage lending institutions. Some lenders have withdrawn from the market, either by selling their mortgage books or through merger, but, nevertheless, new institutions have continued to enter the market. A major question is the extent to which the demand for housing and mortgages will recover as the economic situation improves. Some analysts have argued that the growth in possessions and the fall in house prices will act as a permanent depressant of housing and mortgage demand, leading to a lower level of demand for owner-occupied dwellings for any given level of external factors. Others have argued that the demand for owner-occupation remains high. This view was reinforced by the results of Council of Mortgage Lenders market research exercises undertaken in the spring of 1991 and the autumn of 1992 both of which showed that well over 80% of adults expected to be owner-occupiers in ten years time, compared to current levels of around 70%. Whatever the outcome it does seem clear that the extremely buoyant conditions experienced in the late 1980s will not return. ■