Homeowner housing equity through the downturn

- Falling house prices have once again raised the prospect of negative equity for borrowers. Although negative equity may reduce a household's coping strategies should they encounter payment difficulties, it does not of itself affect the ability to keep up mortgage payments or create a risk of repossession.
- It is vital that borrowers do not voluntarily give up possession of their property when negative equity arises. They remain liable for any shortfall debt on sale, and lenders will offer help to those who can continue to make regular payments.
- One positive message from the protracted and deep housing market recession of the early 1990s is that the vast majority of borrowers paid their mortgages in full and on time throughout.
- Negative equity estimates are very sensitive to the methodology and assumptions on which calculations are made. The information we have on individual loan characteristics from the Regulated Mortgage Survey has allowed us to undertake a detailed analysis of the housing equity held by individual homeowners.
- The geographic pattern of house price movements is also important. In the early 1990s downturn, house prices nationally only fell by 13%, but for much of the south of England the peak-to-trough declines were 25% or more. Since 2007, we have already exceeded the 1990s average decline. However, we estimate that 900,000 owner occupiers are now in negative equity, substantially less than estimates of the peak of negative equity in the 1990s.
- The nature of negative equity appears different from the early 1990s. Back then, the lion's share of negative equity sat with young first-time buyers. This time around, homeowner negative equity is much more widely spread across first-time buyers, movers and remortgage customers, and borrowers of all ages.
- The absolute size of negative equity is currently small, with the value significantly less than £10,000 for two thirds of all borrowers in negative equity.
- With relatively few homeowners in negative equity, modest shortfalls and negative equity more widely distributed across borrower types, ages and geographies, its impact is not yet as severe as in the 1990s market.
- But, it is important to recognise that for borrowers there is little practical difference between negative and low positive equity, with significant numbers of borrowers also in this second category. The effect of both is to make mortgage credit difficult to obtain, and moves less easy to complete, which is a market feature likely to persist in the short term.

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Introduction

At the end of 2008, house prices had fallen nationally by about 18% from their peak levels just over a year previously. There were around half as many house sales in 2008 as the previous year, lower than any point in the last three decades. There can be no doubt that we are experiencing a substantial downturn, with few indications that we have reached the bottom yet. Naturally there is considerable interest in near-term prospects for the housing market and ramifications for the wider economy.

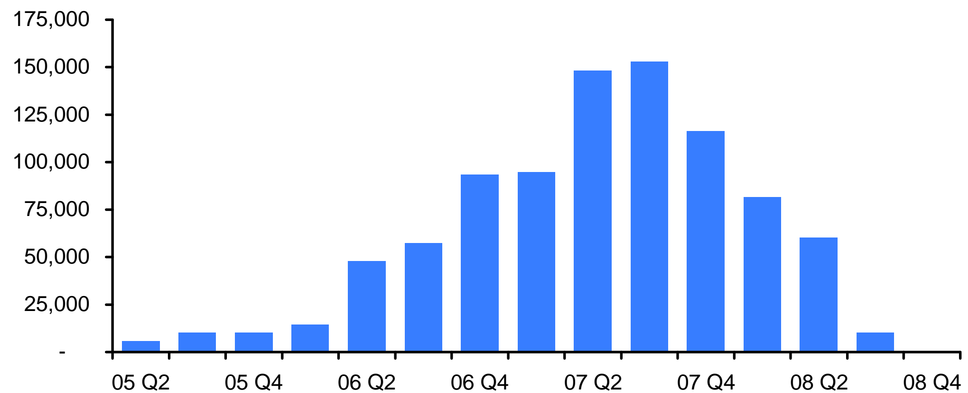
In the housing market downturn of the early 1990s, house prices fell by an average 13% from peak to trough and by considerably more than this in parts of southern England. Such nominal house price falls, unprecedented in the post-war period, gave rise to the phenomenon of negative equity – where the size of a mortgage exceeded the market value of the property. During the trough of the market in early 1993, published estimates of households in negative equity were upwards of 1.5 million. The subsequent evolution of negative equity closely echoed that of house prices, remaining a significant part of the landscape until the late 1990s.

In the early and mid-2000s, the UK experienced another strong cyclical upturn in the housing market and housing equity. But the global credit crunch triggered a sea-change in UK housing market conditions over the past year or so, however, and significantly falling house prices mean negative equity has once again become a reality for many. This paper estimates the scale of this and looks at what it means for market prospects.

How many borrowers are affected?

Our estimation method, based on the CML's Regulated Mortgage Survey (RMS) data, is set out in the accompanying technical note. Amongst homeowners who have taken out mortgages from Q2 2005 (the starting point of the RMS data set) through to the end of 2008, we estimate that 900,000 - about 13% - are now in some degree of negative equity (see Chart 1). Predictably, the greatest numbers of negative equity cases are seen for mortgages taken out at the peak of house prices (Q2-Q3 2007).

Chart 1: Borrowers in negative equity, by when mortgage completed



Source: Regulated Mortgage Survey, CML/Banksearch
Notes: These figures relate to regulated loans only; buy-to-let borrowers are excluded

It is important to note that, in the current climate, household equity positions are changing at broadly the same fast pace as house prices. House price indices are subject to monthly fluctuations, more so in the current environment when there are few transactions. In fact the major indices differ considerably as to movements since the start of the year. Halifax estimates prices have actually risen by 0.5% from December to February, whilst Nationwide estimates a 3.5% fall. This would potentially give a range for total borrowers in negative equity as at the end of February of between 870,000 and 1.18 million. This variation demonstrates the sensitivity of estimates to the house price measure used, and the danger of monitoring changes in equity over too short a timeframe.

Comparing other negative equity estimates

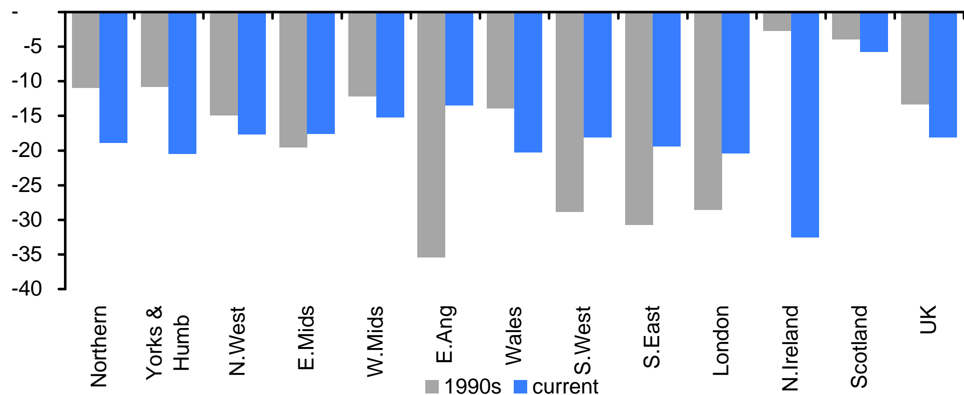
A number of estimates of negative equity were published in early 2008. Since then the house prices have evolved so rapidly that it is difficult to make comparisons between earlier estimates and those presented in this paper. But earlier internal work based on the same methodology as we use here gives numbers that were in the same range as the more granular of these earlier published estimates (those from Standard & Poors and Hometrack).

Recently GfK (February 2009) estimated almost four million borrowers are now “at risk of negative equity” rising to around 5 million by the end of the year - alarming numbers indeed. We do not have sufficient detail on the GfK methodology used, but it seems implausible that they could be more accurate than the consensus range of estimates, within which our figures sit comfortably.

Negative equity experience is not uniform

The house price declines seen since late 2007 have differed across UK regions (see Chart 2). Whilst it is likely that we have not seen the full extent of current price falls, there are already some very clear differences between the regional pattern seen now and that in the early 90s. Most strikingly Northern Ireland, having experienced very brief and modest price falls last time, is now seeing a very pronounced decline - the flip side of the meteoric price increases seen there in the preceding few years. East Anglia, which saw the most severe price falls in the early 90s, has experienced lower than average declines this time. And London, which also had some of the worst house price declines in the 1990s, is much closer to the national average in the current downturn.

Chart 2: Peak-to-trough house price decline, early 1990s and current downturn



Source: HBOS plc
Notes:
1. 1990s peak-to-trough price falls are specific to each region. The exact timings vary, but are centred around peak-to-trough period for the UK as a whole (Q3 1989 to Q1 1993).
2. Current downturn period measured from Q3 2007 to Q4 2008

Like house prices, current experience of negative equity has a greatly different regional pattern from the early 1990s. This may contribute partly to the lower total number of negative equity cases currently than estimates of numbers in negative equity in the 1990s. However it is likely that, given the less comprehensive, less granular data available then, the estimates of 1990s negative equity were subject to a much wider margin of error.

Table 1 shows the regional breakdown of negative equity. The concentration of negative equity (that is, negative equity cases relative to the total owner occupied housing stock), is by far the greatest in the North, where almost 10% of owner-occupied houses are estimated to be in negative equity. And East Anglia, having seen significant negative equity in the 1990s, has very limited experience currently. In Scotland too, very few borrowers are in negative equity – just 1% of total owner occupiers.

Table 1: Estimated number of owner-occupiers in negative equity, by region

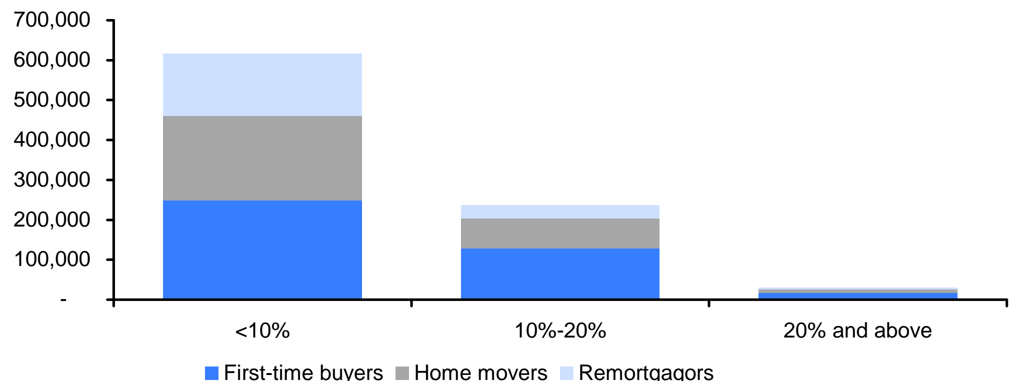
	Mortgages taken out in:				Homeowners[5]	
	2005 (Q2-Q4)	2006	2007	2008	Total	in negative equity %
Northern	6,000	20,000	32,000	11,000	749,000	9.2
Yorkshire and Humberside	4,000	31,000	52,000	16,000	1,546,000	6.7
East Midlands	3,000	22,000	39,000	12,000	1,398,000	5.4
East Anglia	-	2,000	11,000	3,000	1,771,000	0.9
Greater London	-	19,000	79,000	21,000	1,820,000	6.5
South East	1,000	24,000	97,000	28,000	2,636,000	5.7
South West	2,000	19,000	42,000	11,000	1,703,000	4.3
West Midlands	1,000	20,000	43,000	12,000	1,645,000	4.6
North West	4,000	33,000	61,000	21,000	2,180,000	5.5
England	22,000	189,000	456,000	134,000	15,449,000	5.2
Wales	4,000	17,000	29,000	9,000	968,000	6.1
Scotland	-	-	12,000	4,000	1,587,000	1.0
Northern Ireland	-	7,000	14,000	4,000	523,000	4.8
UK	26,000	213,000	512,000	152,000	18,637,000	4.8

Source: Regulated Mortgage Survey (CML/BankSearch), DCLG

How much negative equity?

As Chart 3 shows, two thirds of borrowers currently in negative equity are only modestly so. That is, their shortfall is less than 10% of the value of their property. The vast majority of the rest have between 10% and 20% shortfall, with very few cases with a bigger shortfall than this.

Chart 3: Number of owner-occupiers with negative equity, by % degree of shortfall

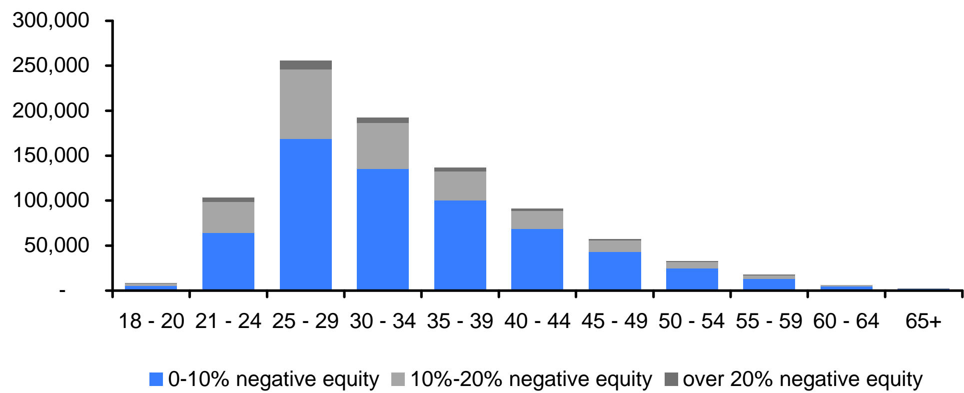


Source: Regulated Mortgage Survey, CML/Banksearch
Notes: These figures relate to regulated loans only; buy-to-let borrowers are excluded

In the early 1990s, the overwhelming majority of negative equity cases were thought to be younger borrowers, predominantly first-time buyers, reflecting the highly leveraged nature of typical borrowing and their large absolute numbers during the upswing. However as Chart 3 shows this time round negative equity is more evenly spread across all types of borrower (both for modest and more significant cases).

And although young borrowers generally are still proportionately much more likely to face negative equity, there is a significant proportion of older borrowers in negative equity too. Almost a quarter of borrowers now in negative equity were aged 40 or above when they took out the mortgage (Chart 4). There is no clear link between younger borrowers and greater extent of negative equity.

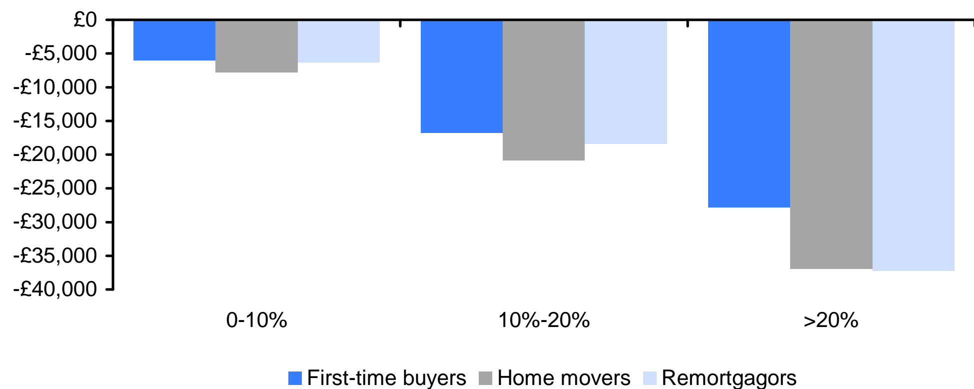
Chart 4: Number of loans in negative equity by age of borrower and extent (percent) of negative equity



Source: Regulated Mortgage Survey, CML/Banksearch
Notes: Figures relate to regulated loans only; buy-to-let borrowers are excluded

But percentages tell only part of the story. The number most pertinent to a borrower in this position is “how big is my shortfall?” As Chart 5 illustrates, the absolute size of shortfalls echoes how deeply in negative equity households are, and as we have seen already, most borrowers in negative equity are only very modestly so. For the two thirds of borrowers with shortfalls less than 10% of the property value, the average size of this shortfall is £6,000 for first-time buyers and £8,000 for home movers. For the few borrowers with larger percentage shortfalls (over 20% of the property value), negative equity is £28,000 on average for first-time buyers and £37,000 for home movers.

Chart 5: Average equity of owner-occupiers, by % degree of shortfall



Source: : Regulated Mortgage Survey, CML/Banksearch
Notes: Figures relate to regulated loans only; buy-to-let borrowers are therefore excluded

But very few cases are in anything like this position. We estimate (see Table 2) that just 30,000 - 3% of the estimated 900,000 homeowners with negative equity as at the end of 2008 - have anything greater than a 20% shortfall. However it is important to note that our analysis only considers debt on first charge mortgages, and not any additional debt on second charge or linked unsecured lending elements (see accompanying technical note for more details).

Table 2: Negative equity among owner-occupiers, by % degree of shortfall

	First-time buyers		Home movers		Remortgagors	
	Number of cases	Average shortfall	Number of cases	Average shortfall	Number of cases	Average shortfall
Negative equity as % of property value						
0-10%	249,000	-£6,000	211,000	-£8,000	156,000	-£6,000
10%-20%	128,000	-£17,000	75,000	-£21,000	34,000	-£18,000
>20%	17,000	-£28,000	9,000	-£37,000	4,000	-£37,000

Source: Regulated Mortgage Survey (CML/BankSearch), DCLG

Implications of negative equity

According to recent CML estimates, owner-occupiers currently have total housing wealth of about £3.2 trillion. Households owning their properties outright had equity of about £1.4 trillion, while those with mortgages held the rest but also mortgage debt of around £1.1 trillion. Even so, this means that UK households had £2.1 trillion of free housing wealth – that is, housing equity not subject to a mortgage. And this does not include personal ownership of private rental properties worth nearly £500 billion, of which over a third was covered by a mortgage.

Changes in house prices will have a profound influence on actual or perceived housing wealth, and this in turn might impact upon household behaviour in a variety of ways.

The Bank of England has explored the overall impact on household spending and borrowing decisions and concluded that, as housing wealth did not play a material role in the growth of consumer spending in recent years, falling house prices are unlikely to exert much impact on overall household behaviour in the downwards direction. But, it has since recognised that the current sharp weakening in housing market conditions is likely to limit the extent to which housing wealth can be accessed by consumers.

Over the past 15 years or so, UK households have become used to being able to access their housing wealth inexpensively through remortgage and similar means, and this may have left many of us comfortable with having relatively low levels of savings. In some cases, households may have come to rely on such mortgage flexibility to juggle their overall finances.

So, to some extent, it is inevitable that erosion of housing equity is shrinking the range of coping strategies where households are hard-pressed. Specifically, those struggling with overindebtedness have fewer options to consolidate expensive unsecured debt into relatively cheap mortgage debt. And those borrowers who fall into arrears on their mortgage will have less scope to use their housing equity as a means of solving their problems (for example by remortgaging or trading down).

But to explode a key myth regarding negative equity, there is no direct causal link between being in negative equity and struggling to keep up with mortgage payments. Debt problems tend to stem from unexpected spending, reduced income or some other change in circumstances, such as accident or relationship breakdown, as CML recently explored in our News and Views publication. During the early 1990s recession an increase in unemployment of more than a million and associated drop in earnings was a major catalyst (alongside record high mortgage rates) for housing market woes at the time. Despite extensive negative equity and protracted economic weakness, the vast majority of borrowers met their mortgage payments in full and on time every month.

For some borrowers with payment problems, negative equity may contribute to a feeling of helplessness and increase temptation to give up trying to recover from arrears. But there is a second key myth to explode here: shortfall debt does not disappear with possession. So walking away is rarely the best option. Nowadays there is a strong message to borrowers to talk to their lender if they find themselves struggling. And this

is strongly echoed by government, both in words and in the range of measures recently introduced to help struggling mortgage borrowers, which serve to underpin and complement the already extensive range of forbearance policies operated by lenders. These give borrowers every reasonable chance of recovering from payment problems and staying in their homes.

Falling house prices may well affect the ability and willingness of households to move house, especially in the current context of tighter credit conditions and lower demand. The most important manifestation of negative equity (and indeed low positive equity) in the early 1990s was probably its contribution to subdued property turnover.

The experience of the early 1990s was that, generally speaking, households appeared not to be unduly concerned about nominal reductions in housing wealth, unless they wanted or needed to move, for example because of a change in family circumstances or job move, or were struggling with their household finances because of some other change in circumstances.

Although lenders developed specific schemes to help borrowers with negative equity to move, and embryonic buy-to-let arrangements also appeared, for many households selling their home for less than they had paid for it represented a huge psychological hurdle. In many cases, affected borrowers sat tight – in many cases for several years - while they sought to increase their savings to help bridge the shortfall. In parallel with negative developments in the wider economy and record levels of mortgage default, widespread negative equity acted to depress consumer sentiment and cast a long shadow over the ability and willingness of households to move home.

In many respects, of course, negative equity was just a convenient shorthand label for the wider phenomenon of reduced housing equity. While there is a psychological aspect to being in negative equity, the practical impact for a household of being a few thousand pounds in negative equity may be little different to it having a few thousand pounds of positive equity. This was certainly the view taken by Rob Thomas, then of UBS Limited, when even in the late 1990s he saw large swathes of households estimated to have less than £5,000 of positive equity as limiting their ability to finance a house move (and, by inference, contributing to the modest recovery of housing market transactions).

In the face of falling house prices and the ongoing credit crisis, lenders have unsurprisingly drawn back significantly on high LTV lending. In February of 2008 there were over 1,000 products on offer on offer in the UK with maximum LTV criteria of 90%

or above, and over 500 at 95% or above (Moneyfacts). But as of February 2009 there were less than 100 at 90% and just 10 at 95%. And those higher LTV products that remain are relatively more expensive.

Taking our analysis further, we estimate that, in addition to all those with zero or negative equity, there are around 600,000 mortgage holders in the UK who are not in negative equity, but whose equity would not constitute 5% deposit on an average priced house for a home mover in their region. And there are a further 500,000 for whom equity could fund a 5% deposit but not 10% (see Table 3). In total then, an estimated 2 million UK mortgage borrowers could not raise a 10% deposit from their equity, should they sell their house.

Table 3: Constrained mortgage holders – equity relative to deposit requirements[4]

	Equity in property equivalent to		Negative equity	Total
	5% but under 10% deposit	under 5% deposit		
	Number	Number	Number	Number
Northern	25,000	30,000	69,000	124,000
Yorkshire and Humberside	41,000	48,000	102,000	191,000
East Midlands	39,000	48,000	76,000	163,000
East Anglia	20,000	18,000	15,000	53,000
Greater London	72,000	67,000	119,000	258,000
South East	113,000	119,000	150,000	382,000
South West	41,000	44,000	73,000	158,000
West Midlands	48,000	56,000	76,000	180,000
North West	54,000	66,000	119,000	239,000
England	453,000	495,000	800,000	1,748,000
Wales	23,000	26,000	60,000	109,000
Scotland	50,000	36,000	16,000	102,000
Northern Ireland	9,000	8,000	24,000	41,000
UK	535,000	565,000	903,000	2,003,000

Source: Regulated Mortgage Survey (CML/BankSearch), DCLG

This is of course a crude measure as precise deposit requirements will vary according to the value of each household's property requirements, and these borrowers may have savings to supplement their equity stake. And whilst the range of mortgages on offer above 90% LTV is much more limited and expensive than before, these products do exist. Nonetheless this does give a broad indication, in aggregate, of the extent to which erosion of equity has significantly weakened the ability of homeowners to move. So the most likely result of negative equity today, as in the 1990s, is that it will contribute to a protracted dampening effect on transaction numbers.

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Housing Finance is an authoritative online journal which provides in-depth articles on a wide range of mortgage related issues. For free online access to other recent articles and a subject index see http://www.cml.org.uk/cml/publications/research. For up-to-the-minute statistics on the housing and mortgage markets, CML members can access statistics on the members-only part of the website. For further information on Housing Finance articles contact the editor Bob Pannell at bob.pannell@cml.org.uk.

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