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LENDERS



Low Demand in the Owner Occupied Sector: Issues for Lenders

CML | Research

LOW DEMAND IN THE
OWNER-OCCUPIED SECTOR:
ISSUES FOR LENDERS

Ken Gibb
and
Ade Kearns
University of Glasgow

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Council of Mortgage Lenders
3 Savile Row, London W1S 3PB

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PREFACE

This report has been written by Ken Gibb and Ade Kearns
at the University of Glasgow.
It forms part of the CML commissioned research programme
on strategic and policy issues related to
the mortgage and housing market.

Every effort has been made to ensure the accuracy of information
contained within the report but the Council of Mortgage Lenders
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The opinions expressed in the report are the responsibility
of the authors alone and are not necessarily the views of the
Council of Mortgage Lenders.



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Executive Summary

INTRODUCTION

- The Council of Mortgage Lenders (CML) commissioned the authors to investigate the emerging problem of low demand in parts of the private housing stock. This is traditionally viewed as a social housing sector problem but, in fact, it is increasingly widespread in the private sector in Northern England and elsewhere.
- Low demand is an imprecise concept but generally refers to a sustained mismatch between supply and demand in spite of falling prices. Research has indicated that in 2000, as much as 2.6% of the private housing stock or 375,000 private sector housing units may have been in low demand.
- This research involved a review of the relevant research and policy literature, interviews with a number of lenders and a small case study of three local low demand markets in Greater Manchester. The main aims of the research were to uncover the main issues of low demand and examine what implications these have for lenders. A number of questions are raised for future discussion.

BACKGROUND TO LOW DEMAND: CAUSES AND CONSEQUENCES

- Low demand is caused by a number of factors operating in different ways across local and regional housing markets. Key issues include: employment-led outward migration, income polarisation creating an inability to leave depressed areas (for those on lower incomes) that is reinforced over time, lagged house price reductions following economic decline, and cumulative processes of deteriorating housing and neighbourhood quality.
- Recently, several policy statements have taken up the low demand issues, including the private sector dimension. The Policy Action Team Unpopular Housing Report, the DETR/DSS Green Paper (and subsequent Government responses), the DETR Urban White Paper and the review of Compulsory Purchase Orders (CPO) present a fairly consistent picture recognising the importance of the problem of low demand and the intractability of tackling it through traditional housing market intervention.
- Policy responses to low demand can be categorised around revenue-based and capital-based funding policies and policies based on clearance and redevelopment. Bramley et al (2000) suggest that the traditional responses of Renewal Areas, Empty Property Strategies, strategic use of CPOs, etc, have failed or are simply inappropriate.



LENDERS' VIEWS

- Interviews with lenders about low demand identified a number of the key issues for the mortgage industry. Some of the main points arising were that different lenders had different views of the low demand issue depending, as might be expected, on their own experience and involvement with the issue. Low demand was attributed variously to a combination of economic decline, de-population, neighbourhood problems and management failure by local government and other public agencies.
- Lenders distinguished between cash flow risk and security risk. If a loan is being repaid, the fact that its security is threatened by local market decline will not register. The security risk is much more of a concern for new lending business. This led to different views about the ways in which lenders and valuers could work better together.
- The lenders' discussion of possible policy responses included extending improvement grants, extending local authority mortgage guarantees or other forms of mortgage insurance innovations, equity release and a range of mortgage rescue and portable negative equity schemes such as 'Homeswap'. It was clear that a major obstacle to co-ordinated lender response was the sheer scale of numbers of lenders that could be involved in a very small area of 'low demand'.

CASE STUDY OF GREATER MANCHESTER

- The context varied in the three locations. But each case study area (East Manchester, Salford and Oldham) had problems of predominantly poor quality Victorian terraced housing, falling house prices, problems of abandonment, physical decline and speculative landlordism. In each case, the local authorities were seeking to develop policies that would allow distressed home-owners to move and involvement of lenders was seen as central to their regeneration policies.
- In East Manchester, the local authority are seeking to clear and redevelop large tracts of increasingly obsolescent mixed tenure housing and to replace it with affordable new private housing at lower densities. This is a pivotal part of a much wider regeneration programme in the area.
- In Salford, a regeneration scheme involves the strategic clearance of an area and the proposal to use a combination of policies creatively so that home-owners can move out to better homes within the wider area – utilising the CPO, relocation expenses and a land charge to overcome the negative equity problem.
- In Oldham, the market has been sustained by an active minority ethnic population but this has not overcome the fundamental problems of declining values and physical quality. Again, innovative policies have been suggested to allow home-owners to move and to escape negative equity while allowing redevelopment to take place.

CONCLUSIONS: ISSUES FOR LENDERS

- Associated with wider economic re-structuring and localised decline, low demand is a cumulative process that requires sustained policy responses – lenders are only a part but an important part of that process. Lenders stated that they wanted to take part in these regeneration projects and there needs to be more work on how co-operation can be organised.
- There is a need for a wider framework of policies to enable long term intervention by public agencies: on improvement grants, on housing repair log books (and other incentive-based mechanisms), on CPO and in equity release. Lenders also have a role to play in promoting negative equity schemes and getting involved at the local level with, for example, Homeswap schemes.





CHAPTER 1 Introduction

The Council of Mortgage Lenders (CML) commissioned the authors to investigate the emerging problem of low demand in parts of the private housing stock. This is traditionally viewed as a social housing sector problem but, in fact, it is increasingly widespread in the private sector especially in Northern England. Indeed, a senior official in Manchester City Council described it as *the* problem to be resolved for the future of their city-region.

The growing evidence of unpopular owner-occupied housing in certain parts of the UK raises questions about market processes, has implications for mortgage lenders and suggests policy responses for all parties (including lenders). We also argue that it would be foolhardy to believe that the issue will remain confined to specific housing market niches, product types and locations. The long term nature of a mortgage suggests that lenders should be aware of the implications of low demand for the existing mortgage book, for new lending and for new markets in urban regeneration areas.

THE RESEARCH BRIEF

The aim of this research is to describe all the significant factors causing low demand and consider implications for lenders. This involved preparing an accessible review of the relevant research and policy literature. Additionally, the work has considered the:

- scale of the problem;
- indicators of existing low demand/unpopular housing for the private sector and for lenders;
- broad reasons for there to be existing or potential areas of low demand;
- implications for local housing markets, existing owners and lenders such as levels of arrears, possessions, negative equity;
- public authorities' responses to the problem; and
- role of lenders and the range of options available to them in tackling decline.

OUR APPROACH

Part of the research examined relevant research literature. In addition, other data was collected from detailed interviews with a selection of lenders operating in low demand markets and through a small case study. The range of issues that lenders may, in principle, be concerned with include:

- can the public and private sectors share data to develop low demand indicators?
- is there a need to review valuation practices in areas of low demand?



- are there issues for the joint working of professionals in the housing industry (also including builders) arising from low demand phenomena?
- what responses follow a higher probability of mortgage default in such areas?
- are regionally or locally based lenders distinctive in their response to low demand?
- are there lessons to be learned from this local perspective?

Two further areas are of interest to public authorities. Firstly, lenders' awareness of the consequences of low demand in parts of the UK and secondly, whether and how lenders should be involved in local area strategies that deal with low demand neighbourhoods and housing markets. For example, whether lenders could combine to aid specific areas? We have not been able to answer all of these questions. However, the primary purpose was to uncover issues and air them for debate, as a first examination rather than the final one of proposing policy responses.

REPORT STRUCTURE

The report is in five chapters. After the introduction, there is a background chapter that looks at what is meant by low demand, how it might be measured and the evidence about the probable extent of low demand. This includes a brief review of research and policy literature (Chapter 2). This is followed in Chapter 3 by the results and implications of interviews with lenders. Chapter 4 presents the findings from a case study of local low demand in Greater Manchester. Chapter 5 draws out the main issues confronting mortgage lenders.



CHAPTER 2 Background to Low Demand

CONTEXT: THE ISSUE OF LOW DEMAND

Low demand is an imprecise concept but generally refers to a situation of sustained disequilibrium where in spite of falling prices there remains a mismatch between supply and demand. Low demand is a housing and urban issue with high salience. The problems of obsolete housing, falling market values, neighbourhood decline and abandonment and deteriorating housing quality are issues concerning Government, commentators, housing practitioners, planners and regeneration professionals. The issue of low demand has recently been highlighted in several linked key official publications:

- The Urban Task Force identified low demand as a key agent in the decline of Northern cities and proposed a range of corrective policy measures (DETR, 1999a).
- The Policy Action Team 7 (PAT7) Unpopular Housing report (DETR, 1999b) focused on low demand housing in both social and private sectors and set out recommendations to tackle the problem. This was the first comprehensive, systematic quantification of the problem across England.
- The 2000 DETR/DSS Housing Green Paper and its follow-up partner document (The Housing Policy Statement) were major consultative documents on housing, echoing the 1977 Housing Policy Review and, as one of its key problem themes, low demand featured prominently throughout the documents, although primarily in the context of social housing and residential neighbourhoods.
- The DETR Urban White Paper (DETR, 2000a) followed on from The Urban Task Force and in tune with the Government's desire to use recycled urban land for the majority of future housing requirements. The diagnostic part of the White Paper and its accompanying technical papers focused on symptoms of urban decline, one being the collapse of obsolescent terraced housing in Northern England. The revitalisation of these markets is seen as critical to the success of the re-urbanisation of the UK.
- The report reviewing compulsory purchase order powers (DETR, 2000b) argued that there was insufficient strategic use of CPO powers by local authorities and that this was inhibiting strategic clearance and redevelopment. The Review recognised problems in facilitating clearance for home-owners with negative equity and highlighted some of the more effective initiatives by public agencies to tackle the problem.
- Bramley, Pawson and Third (2000) updated work in the PAT7 report and argued that supply needed to be brought back into balance in areas of low demand through extensive strategic clearances.

Each one of these reports focused, in part, on the nature and incidence of low demand for private housing. Problems in the urban private housing market, in both the private rental and owner-occupier markets are familiar themes from previous housing analysis and policy discussion (eg, Housing Policy Review, 1977).

While benign policies were put in place to tackle these issues in the 1970s and 1980s, many cities (such as in our case studies) have found continuing decay since then rather than a reversal of decline in specific neighbourhoods. The present context of low demand, however, is different and involves fewer, more targeted regeneration resources, structural weaknesses in housing improvement policies and significant tenure change towards home-ownership since the 1970s.

How does one measure or identify low demand? The PAT7 Unpopular Housing report suggests the following key indicators:

- particularly low and/or falling property values;
- high numbers of empty properties;
- high private tenancy turnover;
- many long term empty or abandoned properties; and
- visibly high number of properties for sale or to let.

These are sensible, if vague, criteria. The evidence suggests that social housing low demand is normally also apparent in areas of private sector low demand. Indicators of voids, turnover rates and falling waiting lists in the social sector may also therefore give a useful indication of low demand in the private sector.

Note that these measures differentiate different types of problem. In our case study research in Salford (Chapter 4) the low demand areas were not unfit and would not fall under CPO criteria. The forms of low demand, above, should be differentiated from very specific problems of blight that arise from sites of contaminated land, defective housing, former mining areas and from situations such as ex-RTB (Right to Buy) properties in high rise flats. While the resulting low demand in these latter cases is wholly genuine and can be severe, it does not follow the same path or necessarily have similar consequences to the more generic form of problems.

HOW EXTENSIVE IS LOW DEMAND?

Research included in the PAT7 Unpopular Housing report for England as a whole indicated that 22% of local authorities report that they have areas of unpopular private housing (owned and rented). This accounts for 3% of the total private sector stock, around 461,500 properties. This compares with 61% of local authorities identifying low local authority sector demand (11.5% of the national stock, representing 377,000 dwellings) (DETR, 1999b). Revisions of these numbers by Bramley et al (2000) for the DETR suggest that 2.6% of the private stock (375,000 units) and 471,000 social sector units are in low demand. No equivalent studies have been undertaken in Northern Ireland, Scotland or Wales.

Table 1 shows strong regional variations. The private sector problem is concentrated in the North West, Yorkshire and Humberside and the West Midlands; thus, local authorities in the North typically report that 3–8% of their private stock is in low demand compared with less than 1% in the South (Table 1). More than four in five authorities that have problems in the private sector also have unpopular local authority housing. The evidence reported by Bramley suggests that low demand public sector housing may exist independently of the private market but private sector low demand tends to be associated with wider housing system failure. The relative scale of private sector low demand and its spatial spread is generally more limited than the social sector problem (Bramley et al, 2000). The PAT7 Unpopular Housing report found that low demand was increasing as a problem (comparing indicators in 1995 and 1998), although this varied across the country.

TABLE 1: INCIDENCE OF PRIVATE SECTOR LOW DEMAND BY STANDARD REGION

Standard Region	No. of dwellings	% of stock
North East	20,200	2.8
North West	173,700	8.6
Yorkshire and Humberside	55,300	3.8
East Midlands	33,500	2.5
West Midlands	59,800	3.9
Eastern	8,300	0.9
South West	11,400	0.7
South East	6,000	0.2
London	7,300	0.4
England	375,000	2.6

Source: Bramley, et al (2000)

PROBABLE CAUSES

A number of explanations for the incidence of low demand have been put forward, singly and in combination:

- employment-led out migration;
- higher incomes increasing housing choices and reducing demand for specific housing types and sizes;
- poor management and strategic direction by local authorities;
- first time buyers stepping over traditional starter homes and moving directly to the next stage of the market;
- lagged housing value response to economic restructuring;
- the cumulative effects of Government policies in the 1980s and 1990s (the Right to Buy and the end of Housing Action Areas were both identified as adverse policy programmes in terms of long term causes of low demand); and

- cumulative processes of deteriorating housing quality and neighbourhood decline (eg, fear of crime) reducing demand from potential in-movers.

Much of the existing literature on causes of low demand focuses on social housing. However, low demand in social housing neighbourhoods is often either part of a wider problem or can at least provide generally applicable clues. Below we look first at two of the key reasons normally attributed for declining demand, those of out-migration and issues of neighbourhood which have affected both social and private sector housing, and we then draw together some of the findings of studies that have specifically examined the private sector.

Out-Migration

All the larger UK cities in the 1980s were net losers of economically active people, with the higher status occupational groups exhibiting higher rates of net out-migration than other groups (Champion and Ford, 1998). Low demand, however, co-exists with a projected increase in housing demand in England of a further 3.7 million households in the period 1991–2016. Holmans and Simpson (1999) conclude that this is a paradox resolved by differential growth in England’s regions. Job-related migration has led to a shift in demand from the North of England to the South as job opportunities have grown faster there than elsewhere. This has led to higher vacancies in local authority housing in the North of England, and produced local surpluses of housing in the least popular locations. Webster (1998) demonstrates that many of the housing surpluses identified at district level by Bramley (1998) occur where blue-collar job losses were followed by intra-regional out-migration from inner city districts.

The latest regional population projections from the Office for National Statistics, for the period 1996–2021, confirm the regional differential in demographic change: better job opportunities and higher incomes will attract people increasingly to London and the South East, where population is due to grow by 9% and 13%, whilst the North-East and Merseyside will lose population by 3.5% and 10%, respectively (Wilson, 1999). More generally, Bate et al (2000) indicate that there is urban to rural migration across the entire urban hierarchy. Out-migration from core cities is followed by migration to smaller towns and to suburban rural areas. This process (along with international migration mainly to London) now dominates the geography of migration and acts to reinforce the emptying out of cities also associated with regional out-migration.

Issues of Neighbourhood

In Power and Mumford’s (1999) study of four neighbourhoods in Newcastle and Manchester, instability and a disorderly neighbourhood environment are seen as causing highly localised low demand which can then “tip... into rapid abandonment”. Similarly, Keenan (1998) noted two simultaneous tendencies: a steady draining away of households from the part of the city suffering problems; and small areas (a street or part of a street) experienced the out-migration of long-standing residents and thereafter very rapid decline. The Joseph Rowntree Foundation’s review of low demand research concluded that the problems of low demand for housing can be extended into wider issues of the quality of neighbourhoods and their ability to meet the changing

aspirations of residents (Niner, 1999). Research in Glasgow examined both neighbourhood and city-level local housing demand (Gibb, 2000; Gibb et al, 2000). Low demand is particularly severe in Glasgow due to the combination of a large public housing stock relatively starved of funds, increasing poverty and the wider social exclusion of the social tenant base. As well as the localised problem, citywide demand is shrinking and this is impacting on owner-occupier demand through the long-term process of suburbanisation to adjoining local authorities.

PRIVATE SECTOR RESEARCH

Nevin et al (1998) argue that aspects of low demand relate particularly to the characteristics of the housing stock and that certain property types, as well as locations, are increasingly unpopular. The PAT7 Unpopular Housing report (DETR, 1999b) criticised planning policy for not paying sufficient attention to the existing stock and the issue of low demand when assessing the need for new dwellings. Bramley argues that, beyond economic and social changes, abandonment is related to the underlying supply and demand situation in the local housing system. It is widely accepted that an area can become trapped in a spiral of decline – ‘accumulative negative effects can set in’ (Bramley, 1998). These problems are exacerbated in the owner-occupied market with negative area expectations leading to falling values creating a ‘market failure’ and contributing to a much less attractive area for potential buyers. This may reduce the incentive to repair and maintain property – ‘it may eventually make economic sense to abandon it’ (Bramley, 1998).

Markets would be expected, normally, to adjust to changes in demand and supply through price variation. However, Bramley et al (2000) argue that this is a simplistic view for a number of reasons:

- Private renting, an important feature of many low demand markets, is heavily influenced by a Housing Benefit system that is characterised by a lack of price signals.
- In the owner-occupied market, the price mechanism can fail to work where demand is weak.
- Essentially, these borrowers face high user costs for their housing because the capital gain rate is negative. Moreover, this will not be removed by moving.
- The risk of capital loss by moving into these areas will be a disincentive to would-be buyers (and lenders) considering purchase.
- Another consequence is the reduced incentive to invest in repair, maintenance and to combat depreciation to the dwelling or to the neighbourhood. Northern UK cities are argued to provide instances of the classic spiral of abandonment and decline found in some American cities in the 1970s.

Bramley et al (2000) suggest that the incidence of private low demand is associated with adverse economic and labour market conditions, physical housing problems and the over-supply of planning permissions, ie, permitting new supply in a context of falling demand. Groves and Niner (1998) studied renewal in three inner city housing markets in Birmingham. They found that properties that only underwent partial renewal

deteriorated quickly thereafter. The GVA Grimley (1999) report provides case studies of policy responses to low demand. In Benwell, Newcastle, an SRB initiative led to a neighbourhood renewal area covering 3,500 properties. The improvements, however, did not impact significantly on the market. A second case study of Smethwick, Birmingham, involved the declaration of a renewal area and 600 out of 2000 units were cleared (plus £35 million spent on the remaining stock). This case study *did* provide evidence of a positive impact on the local market in terms of higher house prices.

Bramley et al (2000) argue that private sector low demand is difficult to tackle through the current policy framework. There is, first, a relative absence of control over the private sector in terms of policy instruments and managerial control. Second, the plight of the worst private housing areas has lower political saliency. Third, it is private not public assets that are at risk. Fourth, public spending programmes tend to be small-scale and vulnerable, which reduces the likelihood of long term improvements. Fifth, there remains a view among some policymakers that the market will somehow sort it out. Sixth, the diffused nature of property ownership makes the cost and complexity of resolving problems almost intractably difficult. Some key policy responses are examined at the end of this chapter.

LIKELY IMPACTS OF LOW DEMAND

Home-owners are directly affected by falling values that may result in negative equity, preventing them from moving. While this has no direct bearing on their capacity to repay their loan, this may nonetheless increase the likelihood of mortgage default, particularly if there are indirect effects as a result of deteriorating housing quality throughout the neighbourhood. The evidence in Greater Manchester suggests that property abandonment is an issue in some of the areas studied. The situation may not be so bad financially for outright owners but low selling prices can still be serious for them. If local policies are aimed at area clearance, then the issues of negative equity, compensation and capacity to remain in owner-occupation are paramount.

Housing repairs, clearance and related policy solutions to the above problems all can have significant public expenditure implications (the average private sector demolition may cost as much as £25,000 before relocation and compensation). The local council taxpayer is further disadvantaged if low demand hastens the flight to the suburbs, reducing the local tax base. Wider neighbourhood decline also has direct and indirect costs in terms of policing, additional public sector management and the intangible effect on the attractiveness of the wider location to potential in-movers, employers and other economic agents. From an urban policy perspective, then, the contagion costs of 'allowing' low demand to take root are extensive and can have long-term consequences.

From the lender's perspective, there are several possible impacts arising from localised low demand. Falling values undermine individual mortgage securities, although if repayment continues, this may be less troublesome. Falling values also appear to be associated with disrepair and less care of the property because, in part, of the co-ordination failure discussed above. The introduction of speculative private renting into

these areas tends to worsen housing and neighbourhood quality. Cumulative processes of housing market and neighbourhood decline may, furthermore, increase the probability of default. New lending markets in regeneration areas, finally, can be frustrated because of negative equity problems slowing clearance of sites for new development.

TYPICAL POLICY RESPONSES

Solutions to low demand have to be adequately tailored to local circumstances. It is likely that a range of flexible policies will be required, for instance, just to tackle the different circumstances of negative equity owners who need to be moved from a neighbourhood targeted for clearance. Public policy responses to low demand operate, however, within a context of constrained resources and limited powers. First, public agencies have limited resources. Local authority private sector grants must compete with other priorities across the general capital programme. Regeneration vehicles can only put a proportion of their funds into housing renewal and redevelopment programmes. Second, local authority powers to intervene are limited (eg, for Compulsory Purchase Orders (CPOs)). Third, public agencies require wider partnerships involving private sector constituencies, as well as the directly affected communities. These coalitions are typically more difficult to marshal and maintain than similar ventures on social housing estates. Bramley et al (2000) suggest that the prospects for co-ordinated responses to tackle the expensive problems of private low demand are generally bleak.

Despite the problems, many authorities and regeneration agencies are working to tackle low demand and unpopular private housing in parts of the North West, Yorkshire, the North East and the Midlands. GVA Grimley (in association with the University of Birmingham, 1999) suggests three broad policy approaches (which may operate complementarily or alone):

- Revenue-based policies – often relating to neighbourhood management and enforcement.
- Capital-based policies – ranging from home security and defensible space measures, environmental works, remodelling of flats into homes, etc, block or area renewal, individual improvement grants, Care and Repair, etc.
- Clearance and redevelopment – this may be piecemeal or wider and strategic in focus and will typically involve the CPO process and a range of palliative measures to allow households with low property values to move.

Recent studies of low demand analyse some past policy responses and put forward additional suggestions. Bramley et al (2000) argue that Renewal Areas have been few in number and patchy where they have been employed, partly as a result of the means-tested improvement grant regime that makes it difficult to produce area-based renewal. They go on to say that low demand housing may be poor quality but not necessarily technically unfit (a problem that resurfaces with clearance and granting CPOs). Empty Property Strategies rely on the assumption that there is a housing shortage and not a surplus. Private renting is important to many of these local markets but a regulatory

squeeze on landlords may simply empty marginal properties. Wider toleration of the sector may not however be acceptable, particularly, as it can undermine sanctions for anti-social behaviour.

The main solution for Bramley et al (2000) is strategic clearance. Clearance, however, is politically sensitive and requires extensive consultation. CPO is also complex and fraught with uncertainties; for example, there is an unwillingness to use CPO powers when properties are not technically unfit. There is also concern about the implications of Human Rights legislation for residents because CPO might infringe residents' rights. Bramley argues that the main problem, however, is economic and concerns the cost of clearance. Each owner is entitled to receive current market value compensation as a result of the CPO and limited home loss and disturbance payments. They may also additionally qualify for home relocation support (this is discretionary). Demolition costs typically cost £25-30,000 per unit (as much as ten times the cost of public sector clearance). Bramley et al (2000) estimate that demolishing 20,000 units per annum (a tenfold increase) for ten years would remove more than 50% of the low demand stock but at a cost of £5 billion. They conclude that market forces (a general economic upswing) and planning restrictions on private sector new build may in time help to generally reflate the market but "it is difficult to offer much prospect of relief from the blight of gradual decline and abandonment in the short term" (Bramley et al, 2000).

The Urban Task Force (DETR, 1999a) sought to identify key changes to the policy framework. A new package of powers and incentives would include:

- streamlined planning consents;
- speedier CPOs;
- tax incentives for developers, investors, owners and tenants; and,
- access to targeted private public investment funds.

Urban Priority Areas would be a key mechanism to tackle deprived neighbourhoods. The PAT7 Unpopular Housing Report concluded that specific existing policy regimes undermined the capacity to tackle low demand neighbourhoods, for example, concerning demolition and CPO powers and the renewal of old stock. They recommended that DETR review the adequacy of renewal and group repair policies and whether current area regeneration policies adequately tackle the needs of run down areas of private housing. It was also recommended that DETR should review the CPO guidance, the adequacy of the powers possessed by local authorities and the scope for differentiation of compensation.



CHAPTER 3 The Views of Lenders

INTRODUCTION

The purpose of this report is to identify issues for lenders arising from localised low demand in the owner occupied sector. Apart from assessing the evidence and drawing out its implications, it clearly makes sense to pull together the views of mortgage lenders themselves. Evidence from other projects suggests that this type of consultation with experts can be a valuable adjunct to other research instruments because it focuses on the priorities of decision-makers, it is contemporary and it allows the research team to develop and refine the arguments tested elsewhere in the project.

This stage of the work allowed the researchers to analyse both national lenders' perspectives (at the UK level) with local case study lenders who have specific expertise 'on the ground'. To do this, two main strategies were pursued. First, a small number of lenders (and a representative of the valuation profession) were interviewed within a fairly open semi-structured format. Second, the CML provided a broad summary of the findings of an unpublished survey of members regarding both the perception of and the response to issues of low demand. This survey revealed a high degree of divergence over the nature, extent and response to the issue. This largely reflects varying degrees of exposure to low demand (and also to local responses and experiences) but it does also suggest fundamentally different positions on what low demand means for lenders and how (if at all) it should be best tackled.

The main themes that arose from both the interviews and the lenders' survey can be grouped under the three following headings:

- Measuring and identifying low demand;
- Valuation and competition;
- Responses to low demand.

MEASURING AND IDENTIFYING LOW DEMAND

Lenders did not have a singular view on what constituted low demand. While some focused on the existence of excess supply, others stressed the wider notion of low demand. The causes of low demand, unsurprisingly, varied according to the direct experiences of those interviewed. While housing market factors were in some cases stressed (wider housing choices, obsolescence of older terraced housing, the negative amenity value of declining neighbourhoods, declining physical quality, etc), others felt that wider social and economic dynamics were at the root of the problem. One interviewee went as far as to argue that low demand was nothing to do with the housing market *per se*.

The main non-housing causal factors for low demand that came over from the interviews were:

- Economic re-structuring reducing local labour demand;
- Transport policies eliminating vulnerable areas as likely commuting locations for new jobs (because, for example, roads by-pass the often older housing areas);
- De-population particularly among key buyer groups;
- The cumulative process of neighbourhood decline leading to a downward spiral in house prices, property quality, abandonment, speculative landlordism, selective (ie, non-strategic) demolition further blighting local areas;
- Failure by local government to see emerging problems and to tackle them early enough to make a difference (eg, enabling home improvements).

Lenders were asked about how one measures and identifies low demand. Most of the lenders argued for the concentrated use of the standard indicators suggested by the PAT7 Unpopular Housing Report, pointing out that local house prices often cannot be compared meaningfully to regional house price indices. Indeed, one lender suggested that what was required was nothing less than a matrix linking neighbourhood housing stock to local prices and labour demand. Others commented on the need for accurate 'demand' information in the form of job losses, school closures and housing list patterns in the social sector. Several interviewees pointed out that it was market dynamics that matter and that in addition to indicators of relative price levels, they had to have leading indicators such as house price change at the local level. However, other lenders said that relative house price inflation would not normally be a key indicator.

It was clear from the discussions that different definitions of the spatial scale of local housing markets were being used by interviewees. This is of course only reasonable but it pointed out the difficulty in utilising indicators and data not necessarily consistent with the functional housing market boundaries across which real households exercised choices. Land Registry data is a good example that provides spatially-disaggregated house price information but it is only really meaningful if:

- there is only one type of property in the area in question; and
- the post code sector (or whatever is used) is an accurate geographical representation of the neighbourhood or local housing market.

The reality is that most housing market indicators are crude and potentially unreliable. The lenders generally recognised this weakness without prompting and looked elsewhere for fine grain analysis of local markets, primarily from property values.

Understandably, lenders want to be able to manage cash flow and security risk properly and that means being able to distinguish between 'healthy or sustainable' local markets, 'vulnerable' markets that might tip over and markets already manifesting 'low demand'. In the majority of cases, the important group is the second category of those areas that might be about to take a downward spiral. The chief source of market intelligence regarding these areas is, of course, the valuation process. Accurate valuation is hampered

both by thin markets and by dynamic markets. It should not be surprising, therefore, that valuation in such circumstances can be difficult. However, it was suggested by lenders and the surveyor interviewed that in vulnerable markets, the valuer should look wider, not just for comparables, but also for a sense about the longer-term viability of the area, its labour market prospects and the quality of the stock. It was pointed out by one lender that this focus on long term demand and its determinants was perfectly normal for Large Scale Voluntary Transfer (LSVT) valuations in the RSL sector, so why not for owner-occupation? However, this approach would result in a higher cost valuation for a lower value property and lenders and borrowers may not always consider the price of such a survey worthwhile.

VALUATION AND COMPETITION

The valuation is a critical matter for mortgage lending in any circumstance but particularly so in situations of actual or potential low demand. The main issues from the lenders' perspective concern three main risks.

First, there is the risk that valuations on property that were the basis for mortgage loans have not been borne out because the local market has subsequently collapsed. This increases the exposure of existing mortgage books, although as one lender argued, provided the loan is repaid on time, the fact that the security is undermined by a collapsed market may not even register with the lender. The key for the lender is whether the fact of negative equity raises the probability of default and whether they are exposed more widely on several loans in a particular local market or if this is confined to a small number of mortgage contracts (and is there a critical threshold to the extent of this risk)?

A related problem for the existing mortgage book is the presence of marginal borrowers (ie, borrowers at the threshold of their affordability limits). More than one lender pointed out that lending to households who are likely to be financially-stretched undermines the capacity of households to maintain and upgrade their property, and in the long term, this may threaten the mortgage security. Operating on relatively conservative lending criteria in low value areas may seem counter-intuitive but the longer-term perspective requires a degree of prudence. Similarly, local knowledge of labour markets and the income security of individual borrowers will be a requisite to help manage cash flow risk.

Second, valuation of current loan applications in low demand areas and vulnerable markets has to accurately reflect current values, taking account of wider demand and the likely future for the area. Lenders can claim against erroneous valuations but it must be recognised that the valuation process confronts genuine uncertainties and difficulties in thin but dynamic markets. As already noted, one interviewee argued in favour of widening the basis of valuation to take into account social and economic trends driving demand and stock quality, as is the case, typically, with social housing lending.

Third, valuation is central to the CPO process where public agencies are seeking to clear homes, compensate households and facilitate the movement of these households to new homes. This bears directly on lenders because it crystallises negative equity and determines the financial ‘gap’ facing the household in question. Below, we look at a number of strategies aimed at facilitating mobility for households with low or negative equity and the role that lenders can and do play.

Mortgage lending is, of course, a competitive industry and competition between lenders has a number of implications for the capacity of the industry to play a role in addressing low demand issues. One issue concerns local discretion on the part of lenders for both new loans and in providing products that can overcome negative equity and related problems. All of the interviewees stressed the general shift away from local discretion to national ‘rules’ in lending reflecting wider competition and cost control. The uncompetitiveness of these lower volume products was also emphasised. In other words, it is more difficult to develop a profitable niche product to cope with, for instance, negative equity compared with standard high volume mortgage products.

Lenders did not believe that competition in this area was damaging or a factor that facilitated local low demand. However, two further points did come through the interviews. First, the activities of fringe lenders (ie, non-CML members, non-high street – often direct lenders and finance companies) in particular low demand areas makes it difficult if not impossible for co-ordinated area-based responses by lenders (through, for example, the CML). Second, the combination of wider economic restructuring (creating adverse labour market change for borrowers) and lending close to or up to maximum loan to income ratios may have left disproportionate numbers of marginal owners in low demand areas. Not only does this increase the risk of cash flow problems and defaulting but it also reduces the resources available to marginal home-owners to maintain their property. Echoing the point made by Bramley et al (2000) about the adverse user cost of capital, one interviewee argued that the housing market had to be viewed as a long-term consumption activity rather than as an investment, with a focus on repair and improvement. This would also hold out better long-term hope to retain value.

RESPONSES TO LOW DEMAND

A number of suggestions have been made (and in some cases, experienced or implemented by individual lenders) as to how to address low demand and protect commercial interests. These include:

- Increasing local authority improvement grants;
- Extending relocation grants;
- Local authority mortgage guarantees;
- Last resort local authority mortgages;
- Secondary market mortgage insurance on similar lines to the US Federal model acting as the underwriter to lenders in poor areas;
- Buy back schemes applied to any negative equity properties rather than only former RTB properties;

- Mortgage rescue, shared ownership and shared equity vehicles;
- Equity release to fund home improvements;
- Co-ordination of early repair to properties;
- ‘Homeswap’ and other creative financial deals to allow owners with negative equity to move.

The interviewees made a number of useful comments (though not always of the same view) about the policy options open to them and the necessity or otherwise of intervention. First, intervention for its own sake was not wanted. Repeatedly, it was made clear that intervention has to be both justified by the level of low demand and an appropriate or measured response. A point that was also made by more than one lender was that in stable markets, when a household runs into financial difficulties, they have to deal with their responsibilities. There is always some degree of credit risk for each individual borrower. However, the difference in low demand areas is that there is a generalised collapse in values that no individual can influence and that this requires a market-wide response in the form of appropriate intervention by public agencies perhaps in partnership with lenders. It is important, nonetheless, to distinguish cash-flow (specific individual non-payment) from security (generalised value collapse) problems. The case for intervention (and a positive role for lenders) is undeniably stronger when it relates to actions that support the security compared with the cash-flow position of the loan repayment. Despite this, once low demand and neighbourhood decline take hold the two problems may be interdependent. It seems that most lenders would share the aim of stabilising or normalising distressed local markets for mortgage security protection reasons but there was far less agreement about the means or the extent of intervention required to achieve that goal.

A common solution suggested by lenders concerned insurance. This embraces several responses. One possibility would be the underwriting of new loans in low demand areas by a dedicated and capitalised vehicle similar to the government backed Fannie Mae in the USA (the Federal Mortgage Insurance provider). Others suggested local authorities could underwrite loans. Lenders raised a number of issues and concerns about taking this general direction. They recognise that it could be perfectly possible to extend lending in low demand areas provided the attendant risks are properly priced and insured. Some lenders favoured the Fannie Mae approach but others pointed out that it would be a new and uncertain type of insurer in the UK context. It would require large amounts of capital and thus would be an expensive innovation. Others welcomed the idea of a larger role for local authorities as insurers. However, it was also argued that previous experience of local authority mortgage insurance had been costly and had higher default rates. Assuming that any insurance solution could be set up and could be designed to be incentive-compatible, it has to be borne in mind that as a solution, it only works for new lending, not the existing mortgage book. However, if new lending was underwritten and could work at proper commercial rates, this may have a positive effect on market confidence.

A recurring theme in the discussions with lenders has been the responsibility of the individual owner to maintain their property and failure by all parties to coordinate their

actions in the face of falling prices, neighbourhood decline and the physical deterioration of adjacent properties. Lenders acknowledged the problems with improvement grants (inadequate resources, grant 'dependency cultures', the need for area approaches to renewal, etc). However, several lenders raised the possibility of releasing equity held by outright owners as one option to tackle concentrations of disrepair faced by older owner-occupiers. One key to developing equity release products for this type of purpose has involved generating political support for reform to Consumer Credit legislation. The recent introduction of a new Financial Services Authority regulated regime for mortgages means that loans for home improvement will no longer be restricted by the Consumer Credit Act. As a result, the mortgage industry now believes that competitive mortgage products for this market could shortly become available. However, the appetite for making this type of product available in very low value areas is far from clear.

Alternative proposals for mortgagors as well as outright owners involved examining possible insurance products tied to annual inspections of properties but it is not at all clear that such a market exists for these types of product innovations. Lenders also talked of the need to work in partnerships led by local authorities (local authorities have the widest information and the long term stake in the community as a whole and have access to public resources). The nature of these partnerships varied from talking about problems to involvement in urban regeneration programmes. They also included deepening the relationship with RSLs. In particular, lenders raised the issue of RSLs purchasing some of the vacant property and also acting in mortgage rescue schemes. While there may be limited scope for this and shared ownership initiatives (or other forms of equity sharing that might help sustain and improve housing quality) in some of the markets failing in Northern England, it is also clear that some RSLs are trying to extricate themselves from these markets and are not pursuing such opportunities. Indeed, pepper-potting of activities and widespread stockholdings without a core community basis is often part of the problem not the solution in mixed housing market areas. Their scope as major players tackling private sector low demand seems inevitably to be a limited one. The scope for partnership between lenders and local authorities is returned to below in the case study.

The main housing market question inevitably concerns effective responses to negative equity – helping households to move and allowing CPO to take place in order to facilitate clearance and redevelopment. Lenders presented a number of different views about tackling negative equity. In the first place, it was pointed out that if loans continue to be repaid, many lenders will not be aware of any problem until defaults occur or valuers highlight market weakness or if security is undermined by falling sales values. Second, there is an incentive incompatibility among lenders in any one market area because typically there will be many lenders operating in even a neighbourhood housing market – the spread of lenders makes co-ordinated action difficult and may prevent area-base clearance. Furthermore, buy back schemes may actually put further downward pressure on house prices (a point noted by one of the lenders from direct experience).

Nonetheless, it was recognised that there were a number of lender actions and public policies that could be used to tackle individual negative equity cases and collective actions to reflate low demand markets. In the following section we will look at some of the proposals to move negative equity households to other homes in the same area (eg, Homeswap). These schemes and other variants (involving shared equity, traditional shared ownership, flexible mortgages and others involving the constructive use of compensation and other public resources) were widely discussed by lenders. The main constraint was how can these be achieved at low cost to all parties and how the financial position of the lender can be protected. Some lenders argued that the industry had to take a long-term view and consider present remedial action as an investment in areas that would generate new lending in the redeveloped urban regeneration areas with wider spillovers into adjacent markets. However, this is an appeal to lenders in the absence of any guarantee that the individual lender will win any of the new business that might be created. It is more feasible to retain the business of the individuals moving out of areas to be cleared than it is to predict the market share in properties still to be built and sold to households in the future.

Lenders also supported, to differing degrees, policies that would address the wider symptoms of the housing market such as economic restructuring and more activist regional policies aimed at job creation and widening the regional economic base. Urban regeneration was seen as vital to the main market areas in trouble but it was recognised that the required interventions would require significant public resources for clearance, area renewal and associated environmental improvements. However, housing had to be at the centre of targeted regeneration.

IMPLICATIONS

Discussions with a small number of lenders who have direct experience of a major problem that is geographically concentrated (and the varied knowledge of the problem evidenced in the CML survey) implies that not all CML members will have direct experience of the issue and that the interview responses reported above may not be typical. This is identified by the CML's own unpublished survey of low demand. The main issues that stood out from the material discussed in this section can be summarised below:

- Lenders were concerned to make prudential, commercially-robust lending decisions in all areas. However, lenders are often already widely exposed to the consequences of market failure. New lending is generally not independent of the existing mortgage book and it will often not be viable in security terms to lend on properties, which are difficult to value but are already at very low values in dynamically unstable local markets. Lenders did not discuss proposals to curtail new supply as a way to tighten markets.
- Another way to protect mortgage security is through improvement work, which appears to require intervention. Lenders recognised that improvement policies and resources were presently inadequate.

- Negative equity is a typical result of low demand and lenders recognised that, in a generally buoyant economy, there is no single or simple policy solution. Policies have to be flexible and tailored to individual circumstances. Equally, this very fact makes it difficult to develop comprehensive solutions.
- Lender attitudes to the problems found in low demand areas did vary significantly but there were no straightforward divisions between types of lenders.
- Valuation is inherently more difficult in dynamic, unstable and low value markets.

In the next section, we examine many of the issues raised by lenders more closely by focusing in on three local markets experiencing low demand in Greater Manchester.



CHAPTER 4 Case Study: Greater Manchester – responding to localised Low Demand

INTRODUCTION

The case study examines low demand issues more closely. Three areas in Greater Manchester were chosen after discussions with the CML as these local areas are operating within a similar wider regional economy and the local authorities are all developing solutions to their particular neighbourhood problems:

- Salford (Seedley and Langworthy);
- East Manchester (Beswick); and
- Oldham Metropolitan Council's housing stock.

Although different problems were faced, the three local markets have several key features in common:

- An over-supply of traditional Victorian terraces in declining neighbourhoods of mixed tenure, generally poor quality housing.
- Extensive problems of deep negative equity, in other words, properties currently valued at less than £10,000 but with loans secured on the properties in excess of £20,000.
- The markets operate within the same broader regional economic and demographic background.
- Each area, to different degrees, is considering clearance of private sector housing for redevelopment and therefore anticipates solutions involving public-private partnerships, including compulsory purchase.
- In each case, piecemeal, unsustainable and undesirable 'market' solutions are taking hold, including speculative landlord activity, worsening neighbourhood problems.
- The CML has received approaches from local authorities in the region about whether lenders could combine to aid specific areas.

BACKGROUND TO GREATER MANCHESTER

The Greater Manchester region is inhabited by 1 million households. The economy as a whole and consequent employment rates have improved significantly over the past decade. However, authorities like Manchester and Salford have narrow Council Tax bases, and there are extremes of wealth inequality within their authorities.

Greater Manchester has a high proportion of older homes compared to other English regions as well as high levels of poor condition and unfit housing (Table 2). The region also has a significant number of empty homes – 30,500 (DETR, 2000b). Greater Manchester does have strong local markets most notably in Manchester city centre. Paradoxically within a mile of these thriving markets are areas with stagnating and falling prices, unsold properties and declining neighbourhood quality.

TABLE 2: HOUSING CONDITIONS IN GREATER MANCHESTER, 1991

Authority	1991 % owner occupation	1991 % private renting	% Pre-1919 dwellings*	Private dwellings unfit per 1,000
Bolton	69.8	8.3	42.8	76.4
Bury	76.6	7.4	33.8	54.5
Manchester	41.2	20.3	56.8	104
Oldham	67.3	8.3	42.1	76.2
Rochdale	64.1	8.1	41	73.5
Salford	52.7	12.1	41.7	81.8
Stockport	77.8	8.7	26.4	48.1
Tameside	66.9	8	38.4	72.7
Trafford	72.8	10.2	29.6	67.5
Wigan	70	5.9	33.4	62.9

Source: 1991 Census and DETR estimates, quoted in Townroe, 1998, p.41

Note: * based on 1986 figures

Manchester City Council explained the low demand problem by reference to the poor quality of the wider environment and the aspirations of households to escape the lowest rung of the ladder by by-passing it directly to modern semi-detached homes. The most problematic part of the regional stock are rows of monolithic, pre-1919 terraced housing which are characteristic of East Manchester, Salford and Oldham.

EAST MANCHESTER

The long-term regeneration of East Manchester is now focused through the East Manchester Urban Regeneration Company, which will provide up to £500 million of investment, mainly physical, in the community and in developing the Commonwealth Games stadium (New Deal for Communities Delivery Plan 2000). The unemployment claimant count is three times the national average, the proportion of households receiving Housing Benefit and Income Support is double that of the City as a whole.

The Delivery Plan argues that the physical deterioration of private (and social) housing has had a huge negative impact on the community identifying the poor physical condition of pre-1919 terraced housing with little or no demand as the significant factor.

Two bedroom terraced properties in Openshaw selling for between £26,000 and £30,000 in 1992 have now fallen in value to recent sales of only £5,000 to £9,000 (some as little as £1,500).

Features of the local area include:

- Nearly two-thirds (62%) of residents are in social housing and the quality of social housing is known to play a key role in the sustainability of the private sector;
- 96.6% of properties are in council tax band A;
- There are more than 900 empty properties in the area;
- 40% of residents wish to move out the area.

The plan, therefore, is to bring forward the strategic clearance of much of this housing and then, over 25 years, to free up the land for private housebuilding on a large scale (up to 12,500 units). The plan argues that there is no longer demand for the old private stock as it is 'past its useful life' and it should be replaced by modern housing, at affordable prices and lower densities. The main issue revolves around the movement of existing home-owners out of the properties that are to be cleared (both mortgagors and outright owners).

The Council would like to see home-owners with existing mortgages move to new property with any debt transferring to the new property. In some circumstances the Council envisages lenders writing off any outstanding balance when the combination of compensation payments available leaves the borrower with an unsustainable outstanding debt. The authority argues that clearance is an investment which will provide for a long run return for lenders (because the consequent new build will generate new lending opportunities and increase values). The Council believes people do want to stay in the area (although a significant minority – 40% – say they want to leave) and that it can be a sustainable housing market if the new development can take place.

This will only happen if the parties can combine to provide the resources to tackle the negative equity that is keeping people from moving to new properties (it might be £5,000-10,000 per property of subsidy required). However, CPO powers cannot be used for low demand; only for unfitness or condition defects. They need to find ways to facilitate clearance. Even if the powers are strengthened the markets are likely to remain fragile.

Council staff argue that there are some fundamental problems in achieving the clearance policy:

- A large number of different lenders, including 'fringe' lenders have mortgages in the key areas.
- Around 75-80% of loans are endowment based with repayment of capital due at the end of the loan period. CPO data suggests that properties currently being investigated are valued at between £7,000 to £8,500 but have outstanding loans of around £25,000.

- However, they cannot pursue widespread CPO if people cannot move on – the local press reported the anger of local residents faced with compensation based on current market value after CPO and negative equity in Beswick in September 2000.
- The view of the Council is that the cumulative success of the project increasingly turns on the capacity of lenders and the other partners in the regeneration process to address the negative equity problem. The Council stress this is not about resources except insofar that it requires lenders to take account of the negative equity issue as a wider problem relevant to their business (ie, the undermining of local housing markets and mortgage security). They argue that a united lenders' voice would be an important partner in lobbying Government for the additional public funds required to alleviate the negative equity problem. They also want lenders to be more willing to consider flexible solutions that allow households to move as being central to the wider success of the regeneration of the City.

The City Council reckon that the cost of moving households on by rolling over negative equity is only about £3 million in East Manchester such that households could move house without being significantly worse off financially. Moreover, the Council believe that a range of instruments are available (as were examined in the previous section) that do not necessarily require the lender taking a loss in each case. Loans are moved on to new properties which should have better security and value retention than was the case previously (either new homes or improved homes in sustainable markets). The diffuse nature of the housing market meant that initially the City Council had some difficulty establishing a dialogue with lenders. However, that is now underway in conjunction with the Cities of Salford and Liverpool.

SALFORD

This case study involves the areas of Seedley and Langworthy in the City of Salford, and constitutes a Single Regeneration Budget Scheme (SRBS) partnership building on previous initiatives in the area. The area has 3,300 dwellings, 2,000 of which are private and around 800-900 are empty. The Regeneration plan document contends that, within an area of terraced housing, 25% of the properties are empty and 76.5% require repair. House prices have fallen from £30,000 to £4,000 in seven years. Nearly one in five properties are privately rented, often in difficult to let areas. The project is seeking to demolish 1,000 dwellings and replace them with several hundred new private homes.

The officials interviewed suggested a number of reasons for low demand taking hold in this part of Salford:

- Salford's population is declining and it was not foreseen by the authority that increasing home-ownership, generally, would encourage people to leave the area.
- The market for new cheap starter homes displaced demand for terraced housing.
- Development of student flats and student accommodation in multi-storeys displaced traditional private rented demand.
- Stronger powers to deal with anti-social complaints have transferred difficult tenants into the bottom end of the private rented sector.

- This led to a downward spiral of key neighbourhoods – more disreputable landlords, falling values, etc. Seedley and Langworthy are the most extreme examples. Extreme criminal elements have taken over certain streets.
- The causes of tipping into abandonment are numerous, leaving a core of trapped people: they include the macro-economy, crime and the local authority's past policies.

Finances are in place for some of the redevelopment of the area (in partnership with a major developer and the local RSL) but it will not, following a scoping study by independent consultants, be enough to renew the area as a whole. As in the case above, the issue is about securing mechanisms that allow households to move without financially disadvantaging themselves. Below, we consider one such mechanism in detail but first consider the background more closely.

A core objective, therefore, is to stabilise the housing market. To do this, several policies are proposed:

- Private/public joint venture partnership vehicle to do the clearance and new build.
- A new vehicle to manage social housing.
- Declaration of a renewal area to concentrate resources on private sector improvement. Local authority capital spending can be matched by the project's environmental funds.
- Create a community housing regeneration company, initially aimed at improving the retained housing stock.
- Pilot a landlord accreditation scheme to improve the management and maintenance of privately rented stock and to ensure support networks for private landlords.
- Develop a range and variety of new or improved housing in contrast to the traditional terraced monoliths of the area. This will be of high standard, secured by design and will contribute to a recognisable centre for the area.
- Considerable strategic clearance will be required to make this possible.

In this respect, the Salford partners in Seedley and Langworthy face the same problems as their neighbours in East Manchester: how can clearance be facilitated, without financially damaging existing households and succeeding to retain as many of those households as possible within the existing area? More than one solution is required to deal with the different needs of individual households. However, Salford have proposed one scheme which lenders have agreed to back in a pilot study.

Homeswap

The Homeswap policy is an attempt to use available resources and legislation to achieve the core objectives of:

- Achieving strategic clearance.
- Allowing negative equity home-owners to move to improved homes within the same area, encouraging existing residents to stay.

- Giving owners who do not want to participate in the Homeswap the normal compensation from the CPO – this is unlikely to cover their negative equity.
- Avoiding paying public subsidy to speculative landlords.
- Minimising the public cost of the home swap process through the creative use of publicly funded Homeloss payments (£1,500 per case) – see below.

The scheme is a paternalistic one but, with community agreement, offers residents the opportunity to move to an improved home with greater mortgage security and equity prospects but nonetheless remaining within the same area and freeing up a strategic site for redevelopment of better housing at lower density.

The mechanics of the Homeswap process are as follows. Eligible home-owners who either do not want or cannot afford to leave the area will have their home purchased by the Joint Venture Partnership at market value. The Partnership then purchases another new/improved property in Seedley and Langworthy and, with the consent of the owner and mortgage lender, will agree to swap house deeds so that the eligible owner takes over the new/improved property and the Partnership has the old home for clearance and redevelopment. The owner gains a property of greater market value and marketability. The Authority argue that the mortgage lender will benefit from a reduced gap between money borrowed and the repossession value of the property and the SRB receives a site for clearance. Homeloss monies are used to subsidise the difference in home values and the Partnership may place a land charge against the owner's new property to cover any difference in the price of the two properties after the homeloss monies.

How would this work? A resident swaps a home to be cleared worth £7,000 for one in an improvement area worth £12,000, meaning there is a difference of £5,000. After the £1,500 homeloss money, this leaves £3,500 to be put on a land charge, designed to dissuade owners from immediately selling up. The lender has a normal first charge on the property. This innovation is supported by some lenders. However, it should be recognised that it is only a limited solution and will neither be applicable in all cases nor will it always be financially attractive to all potential home swappers. There will not always be sufficient properties in improvement areas; the required land charge may be too great and the individual's negative equity may be too large. However, it does suggest one solution among many that could be used to tackle negative equity rollover constraints.

OLDHAM

The situation in Oldham is different from the two previous cases. Rather than focus on regeneration vehicles per se, this case study looked at the more general measures suggested and taken to tackle pervasive low demand in the private stock. This includes further thinking about the problems of low demand, their consequences and vehicles to allow households with negative equity to move. Moreover, Oldham is different in that in some of the worst private sector areas, the market has been sustained by concentrations of ethnic minorities using non-traditional, informal financing to purchase homes. Even here, however, the market is fragile and likely to tip into major problems without intervention.

Background

The local market context is a familiar one. A considerable volume of older housing in central Oldham confronts severe problems of negative equity that have emerged and consolidated since the early to mid-1990s when prices began to stagnate. As we found elsewhere, many aspiring home-owners moved straight into semi-detached properties for their first home, reducing the demand for terraces. This demand has, in part, been replaced in central Oldham by the Asian community and by speculative private landlords seeking to house, among others, asylum seekers.

Presently, there is surplus housing with a considerable volume of overpriced property on the market (a local estate agent estimated well over 1,000 properties currently on the market). They stressed, however, that there was nothing particularly wrong with the valuations being carried out; the overpricing is more to do with the unrealistic prices being demanded by the vendor in response to negative equity.

Ethnic minority housing tends to be concentrated in areas of the worst housing conditions. There are complex social issues but demand in some areas is as a result quite high and properties turnover quite healthily. However, local estate agents are beginning to detect signs of a demand problem in even these areas – ethnic minorities are the only group demanding housing in these areas (no external demand) and that is probably not sustainable. The informal purchasing finance may help to explain the concentrations of ethnic minorities in overcrowded poor quality housing – a high price to pay for a more stable micro market.

Other factors thought to explain low demand included safety and crime in local neighbourhoods and endemic quality problems. There is considerable negative equity and people would move out if they could. Private renting is growing at the bottom end with further negative impacts on demand and area abandonment. Interviewees quoted bad landlordism with examples of landlords able to pay off a purchase price of £15,000 from 8-9 months of rental income from letting houses as Houses in Multiple Occupation (HMO). These landlords have generally reputations for bad maintenance and are blamed for the decline of neighbourhoods and specific blocks of terraced houses.

In short, Oldham is experiencing similar problems in the private stock associated with bad quality outmoded terraced housing built before 1919. The market appears to be in chronic disequilibrium and the palliative effect of concentrated ethnic minority housing will probably fail to stem the tide of low demand in the long run even in those very areas where until now prices have remained buoyant. Increasingly, public agencies are turning to radical solutions to address these questions.

Responses

Private sector policy response has been to either encourage sale to clear remaining debt or do something more constructive. Local estate agents cited examples of national developers offering to take old property in part exchange at a mortgage-covering price and then increasing the price of the new home to make up the part-exchange loss.

The direct response by Oldham has been to use Home Improvement grant funds. The local authority provides private sector renewal funds of around £5m annually, 80% of which goes into just two areas. However, there is completely elastic demand for improvements and a long waiting list. Moreover, it can often cost £30,000 to repair a property worth £25,000 - but it does make sense from an area-based interventionist strategy point of view. The council also promote care and repair mechanisms.

The main plank of policy, however, is strategic clearance. In the last 5 years, Oldham has pursued a clearance policy involving several hundred dwellings using CPOs to curb the growth of unfit (often at the limit of the CPO rules). This is also expensive (£25,000 per unit). One thorny problem has been that speculators have been buying up properties before they are compulsorily purchased. CPO powers allow for the household to have a full valuation carried out with which to challenge the LA's valuation, factoring-in further costs and delays to the clearance process.

The council officials feel they need to move improvement policy from an individualistic grant-dependent culture for means-tested improvement grants to a system based on strategic area-renewal through the clearance and redevelopment of the older terraced stock. It was argued by interviewees that lenders typically blame valuers when things go wrong; importantly it is difficult to accurately sense check the reliability of valuations for mainstream mortgage lending in these rapidly declining markets. The situation is further complicated by the overwhelming presence of (non-CML) 'fringe' lenders. They often find a market and are over-represented in precisely these sorts of marginal, fragile housing markets.

Negative Equity Vehicle

The Oldham interviewees stressed the need for a range of instruments that would be able to tackle the different circumstances confronting households even within a local housing market. One possible scheme would be a variation on the 'Homebuy' scheme originally set up by the Housing Corporation whereby the RSL charges rent on 75% and keeps the remaining 25% as equity. Clearly, this is not meant for clearance but for areas with potential for a rental housing market among existing properties.

Oldham MC would like to transfer the 'Homebuy' model into a vehicle for demolition and clearance by encouraging RSLs to take a 75% equity stake in a new home which they would recoup on resale. The moving owner only pays for 25%. This has the advantage that it gives a social landlord or agency a direct interest in the maintenance of the property. However, it is not clear how lenders would view such a scheme. Certainly the owners' equity stake is very low and this may act to discourage a positive approach to repair and maintenance issues.

CASE STUDY IMPLICATIONS

These three case studies raise a number of important points for our understanding of low demand as an issue, for its impact on the North West, and in terms of its implications for lenders.

- Low demand can be a significant blight on communities and it is correspondingly clear that tackling the problem comprehensively is a necessary condition of sustainable regeneration. Anyone with an interest in the good use of public funds should be concerned with tackling these problems.
- The multiple causes of low demand are complex but in the private sector they seem to have roots in economic restructuring, suburban migration, the obsolescence of a locally-dominant property type and a downward spiral between market collapse and neighbourhood decline. In the past, these problems have been worsened in some cases by ineffective policy responses such as selective clearance, inadequate improvement programmes and the market's uncoordinated responses.
- Housing planning permissions need to be linked to market demand given the likely replacement of obsolete housing by new construction on cleared sites. Even though developments such as the long-term plans of East Manchester (contingent on clearance), it is not at all clear that the planning authorities have taken sufficient account of low demand to arrive at a sensible balance between household requirements, preferences and new supply.
- The public agencies across the three areas have pulled together a number of mechanisms that will allow negative equity to be moved to properties with greater security, depending on market and personal circumstances. They have been quite critical of lenders in terms of their perceived unwillingness to commit more generally to tackling these problems or at least talking constructively about them with the public sector (a point reiterated by the CPO Review (DETR, 2000b)) although the situation has now improved considerably.
- The public agencies are looking for an industry-wide response in city-wide strategic partnerships that will allow progress to be made. Repeatedly, public agencies argued that the cost to lenders would not be large and their input would help bring Government subsidy to the table and protect their existing mortgage book. The main drawbacks involve convincing individual lenders that the mortgage security problem is sufficiently serious when loans are still being repaid to justify complex intervention in the housing market. Second, consolidation of loans, so that public agencies could then work with one or two lenders rather than 30 or 40, remains a doubtful proposition in terms of whether this can be made commercially feasible.
- There are legitimate lender worries about specific instruments in certain circumstances (for example, shared ownership tends to confine low income households to the bottom end of the market and loan swap arrangements may simply increase lender exposure) – this is why a range of instruments may need to be available to meet specific circumstances and certainly all need careful testing.
- Some commentators, for example Power and Mumford (1999), have argued strongly for the retention of neighbourhoods with solutions to low demand and abandonment based on empowerment, better management, physical and wider

renewal of these areas. It is clear that some academics strongly disagree (for example, Nevin and Bramley) and it is evident that the professionals on the ground are increasingly convinced of the need to pursue strategic clearance of areas of pre-1919 terraced housing, backed up by their replacement with larger in-demand private housing. There is also support, though to a lesser extent, for area renewal improvement policies for terraced housing that have a future. The main constraint is negative equity for existing owners, implying that the pressures to bring lenders on board will remain strong.

The final chapter of the report draws out the main points from the discussion for mortgage lenders, and identifying priority areas for future research and debate.



CHAPTER 5 Conclusions: Issues for Lenders

The aim of this project was to evaluate the main causes of changing demand and consider their implications for lenders. The main research instruments used consisted of: literature review; canvassing the views of lenders; and a case study of three areas in Greater Manchester.

Low demand in the private sector tends to be found primarily in the towns and cities of Northern England. However, it should not be assumed that it is only of regional importance or that the unstable market dynamics found in these neighbourhoods will not spread to other markets in the future. While it primarily affects the existing mortgage book and exposure of lenders in these markets, low demand also raises difficult questions for new mortgage lending, particularly in urban regeneration markets.

Recurring themes throughout the report can be summarised as follows:

- Localised low demand involves particular problems of externalities (derived from deteriorating property quality) and consequent co-ordination failures by individual owners, lenders and public agencies, RSLs and local authorities.
- Private sector low demand tends to be associated with wider economic restructuring, migration away from the neighbourhood into other parts of the conurbation, de-population, and knock-on effects from housing market change (eg, the movement into higher quality first time homes). Also important was the process of neighbourhood decline, of cumulative causation as empty properties encourage vandalism, crime and further abandonment. This ultimately leads to falling values, high void rates and negative equity.
- Bramley and Pawson highlighted the difficulties with achieving policy success with private sector low demand areas. However, there are significant public costs associated with not addressing them.
- All of the parties repeatedly stressed the need for flexible and variable policies to allow negative equity to be rolled over in order to facilitate clearance and redevelopment of localised markets that were argued to be effectively obsolete. On the ground there was some scepticism by both lenders and some public agencies about a willingness in general to participate in partnerships that could facilitate the rolling-up of negative equity.
- In parallel to strategic clearance, public agencies promoted policies of revenue expenditure (eg, to tackle crime) and more traditional area renewal and improvement grant activities for those properties, which could be marketed with a longer term future.

- Lenders expressed different views about what constituted low demand, how it can be measured, anticipated and recognised. They also took different views about the type and extent of intervention required in order to address low demand. This is partly related to the fact that different lenders will have different experiences of low demand.
- A useful distinction was drawn between cash flow risks and those related to maintaining the security of the loan. The cash-flow depends on the capacity of the borrower to make payments but the security depends largely on the wider market. Many lenders focused on the accuracy of the initial valuation. However, valuation is fundamentally more difficult in unstable markets, suggesting the need for enhanced risk pricing through for example indemnity insurance. The outcome may mean that new lending in such areas is not commercially justifiable in the absence of intervention in the form of public insurance of some form. Some lenders supported such a development; others did not. In any case, insurance solutions do not tackle problems associated with the existing mortgage book.
- A range of negative equity products were discussed by lenders and by officials within the context of the case studies. It is clear that no one product or family of products may be sufficient to tackle all of the problems. However, there is now some acceptance that the Homeswap model may have real potential in relation to 'negative equity' transfers. This would allow households to transfer to new homes without them being financially worse off or the lender being materially disadvantaged.
- Lenders argued that they needed to be (and wanted to participate) in partnerships with urban regeneration actors at the same time. Local authorities in the case studies argued that, for most cases, lenders were slow to take up such offers. This has reflected the gulf in understanding between both parties. To some degree this has been rectified by a joint CML/BSA/DTLR working party which has included individual lenders and authorities. However, it is important not to understate the problems inherent in trying to consolidate loans or agree joint approaches between lenders and the need to safeguard as far as possible the position of borrowers.
- A major problem beyond negative equity is the depreciation of properties in the existing mortgage book. Apart from the adverse incentive structure facing home-owners in declining neighbourhoods, many home-owners are marginal mortgagors and are stretched to apply their low earnings further into repair and improvement work. Instead, they rely on means-tested and rationed improvement grants. They may also be eligible for limited care and repair support. Lenders argued successfully for regulatory change to help with equity release products for just this reason.

We now return to the main issues set out in the introduction and see to what extent they can be addressed.

- *Can information be shared through the development of indicators of low demand?*
On one level, one would have thought that lenders should be aware of developments in the performance of markets in which they are exposed. More generally, it is the valuation system that underpins new lending and this would seem, provided the costs are not prohibitive, to benefit from the wider issues examined in lending for social

housing. The types of indicators identified above by Bramley et al 2000 does appear to be a sensible way forward, in the absence of data and software that would allow for fine-grain functional analysis of local housing markets. In Scotland, housing planning partnerships are increasingly sharing data and information and this should be forthcoming as a way for public agencies to influence housing markets constructively. This may be reciprocated by lenders making more local house price and market information available as part of a wider inter-agency and public-private information exchange.

- *Is there a need to adjust lending practices in areas of low demand?*

For lenders operating nationally, we have seen that it is increasingly unrealistic to expect substantial local discretion. This is by definition not true of local lenders but it was telling that many of the lenders contacted for CPO reasons in the case study were fringe financial companies, suggesting the limited depth of competition for mortgage lending in some areas. The dilution of exposure in these markets may or may not reduce scope for discretion on the part of lenders.

Lenders argued that intervention for its own sake was not wanted. It was made clear that intervention has to be both justified by the low demand and an appropriate or measured response. The case for intervention (and a positive role for lenders) is undeniably stronger when it relates to actions that support the security compared with the cash-flow position of the loan repayment. It seems that most lenders would share the aim of stabilising or normalising distressed local markets for mortgage security protection reasons but there was far less agreement about the means or the extent of intervention required to achieve that goal.

- *How do lenders respond to mortgage default in low demand areas?*

It was not obvious from the lenders' side that forbearance was any different in these markets than elsewhere, although there was some negative comment by the local authorities in the DETR's review of the CPO process to the effect that lenders were less helpful in clearance areas than they could have been.

- *Are primarily-localised lenders different in their understanding and response to low demand than national lenders? Can we compare and contrast lender perceptions of low demand?*

Limited evidence from the case studies suggests that local lenders do have wider community interest in both their mortgage books and the future of local areas. However, several public agencies interviewed pointed to the progressive action of national lenders in helping to develop the Homeswap scheme as the best example of progressive policy development by lenders. Moreover, wider market evidence suggests that fewer lenders can genuinely be described as local in terms of their activities. In the future (and in many cases, already), the key decisions in local markets will be made by national lenders.

- *How do lenders ensure that valuations in low demand areas are valid or reliable as a basis to lend on? In other words, are there issues for the joint working of professionals in the housing industry (also including builders) arising from low demand phenomena?*

Lenders and valuers can work together and can do more to monitor market information and price signals, communicate market developments, discuss shared concerns and the like – but none of these constructive processes can change the fundamental technical problems associated with valuing property in an unstable market with an uncertain future.



Notes

- 1 This is not a new point – similar arguments about the planning system and the private stock are made in the 1977 Housing Policy Review.
- 2 The user cost of capital is an interest rate that attempts to measure the economic cost of tying up capital in housing. Its main components are appropriately measured mortgage rates, an element for maintenance, depreciation, property taxation and a, normally negative, element for expected capital gains. In boom periods, this can produce a low user cost; equally, in collapsing markets, the user cost can increase because of negative expected capital gains.
- 3 Insurance has to be designed in such a way that it would not encourage lax lending or effectively prevent lending if too onerous. As with the changes to mortgage indemnity insurance in the early 1990s, the risk of default has to be shared between insurer and lender and one way is to share the cost.



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