



## **The Maths of First Time Buying**

A fascinating speech was recently given by the economist David Miles (a member of the Monetary Policy Committee) to the Home Builders Federation. The theme was whether the housing market was broken or “merely” in transition into a “post crunch” world.

This is not a dry as it sounds. The central point he makes is that mortgage pricing had by 2007 lost all linkage to risk. It's common sense that efficient markets “price in” risk; credit risk in lending markets always sets premiums for unsecured loans. However, by 2007 there was little difference in the cost of mortgages between new self certified applicants and those with years of payment history and low loan to values (“LTV's”). The credit crunch was a reaction to this break in the laws of economics. This much we know.

The key point though is the effect on housing markets of this “correction”. The result has been not only a re-pricing of mortgages but the effective disappearance of loans with LTV's over 90% (from more than 1600 in 2008 to around 200 in 2011). It is this change that drives the maths. Assume in 2007 a First time buyer (“FTB”) could expect to need a 5% deposit. If FTB's borrow 4 x income this deposit represents 20% of annual income. If the FTB saves 5% of earnings annually this deposit might take 4 years to accumulate.

If the market then changes to require 10% deposits this will immediately add a further 4 years to the period FTB's need to save. The impact on the market is sudden but temporary as buyers save the extra now required for those 4 years.

However, there is a longer lived secondary effect. The postponement of ownership by 4 years results in a smaller number of owner occupiers in total. This simple model actually compares well to real data. In 2006 the owner occupation rate in the UK was 70% and has now moved down to 67%.

Of course it's only a simple model. Market forces are already seeing higher LTV mortgages reappear and product innovation provide loans which allow Mum and Dad to help the FTB through a guarantee or a helping hand by using savings as security.

Professor Miles' conclusion is that what we are seeing today is the transition which, although uncomfortable, is not a signal of real change. I agree and welcome the clarity of his thoughts on the maths of the market.

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