Mortgage Advice Bureau

New Build:

Mortgage finance - the silent engine driving new build

April 2015

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Executive summary

Mortgage finance - the silent engine driving new build

- **The UK's housing shortage is growing more acute** with housing completions below 150,000 a year since 2010. Despite the government's latest pledge to support 100,000 new homes through its 'starter homes' scheme, official population projections suggest that the resident population will increase by 420,000 a year for the next decade. Radical change will be required to deliver the higher new build output needed over the coming years.

- **The shortage of mortgage finance has been one of the key factors holding new build back since the financial crisis. Despite the recovery in the mortgage market over the past five years, lack of high loan-to-value (LTV) mortgage availability still casts a shadow over the new build sector.** This is evidenced by the reliance on government's Help to Buy equity loan scheme, which has funded more than 25% of all new home sales in England since it was launched in April 2013. It is also evidenced by the marginal cost of borrowing between 90% and 95% loan to value (LTV) which has widened considerably in the wake of the financial crisis and recession.

- **Mortgage lenders have been more cautious about lending on new build property since the financial crisis as a result of concerns about the new build premium and builder incentives.** Although the new build premium has fallen back and incentives are now fully disclosed, new build is a specialist sector for mortgage lenders, reducing the appetite of many lenders.

- **The lack of development finance for builders is also holding new build back.** Small builders are particularly vulnerable to the shortage of funding from banks, given their lack of access to the capital markets. As a result the number of active house builders registered with the NHBC halved between 2007 and 2013 from 5,600 to 2,800.

- **The speculative house building model prevalent in the UK is not working well for stakeholders.** It makes house builders more vulnerable to economic downturns, it creates more credit risk for mortgage lenders who are faced with builder sales incentives and the new build premium, and it lands buyers with limited control over design and a higher price tag. By making builders and lenders more cautious, the speculative building model holds back overall output.

- **An alternative solution is custom build.** Consumers select a plot of land on a site with infrastructure in place. Their new home can be built to their specifications with the builder paid in staged payments. This dramatically reduces the risk to the builder and the working capital they require, which can lead to savings of 15% or more, meaning the average custom builder accrues £22,000 of instant equity.

- **Existing planning permission rules can help unlock custom build's potential.** Section 106 can be used to better effect by local councils to introduce planning obligations that are favourable for custom or self build. This would involve requiring elements of custom build to be present in new developments, thereby improving access to land for custom builders and speeding up the planning process.

Section 1 - The vital role of mortgage finance in new build

1.1 The underplayed role of mortgage finance

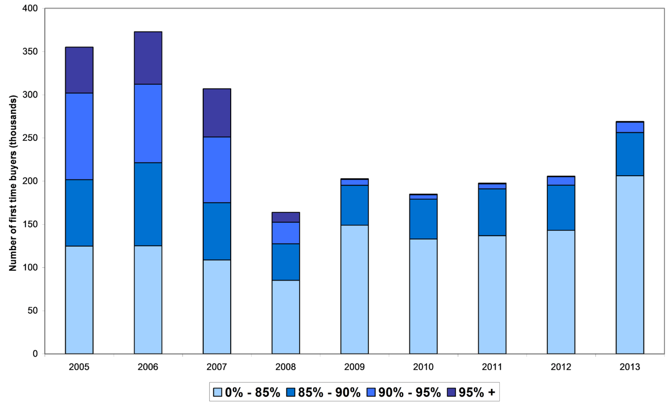
In the debate about house building in the UK, mortgage finance rarely gets the attention it deserves. The focus is more often attached to a range of other issues such as planning, brown versus green field land, infrastructure, builder land banking, garden cities, skills shortages, carbon reduction and public versus private sector delivery. But without an adequate supply of finance to home buyers and builders, the whole engine that is new build would grind to a halt.

The relatively low profile that the availability of finance plays was perhaps understandable prior to the financial crisis, when it was generally assumed that new home buyers and developers would always be able to find the funding they required. But this all changed when the financial crisis hit.

1.2 When the well ran dry

In early 2008, in the wake of the bail out and emergency takeover of the US investment bank Bear Stearns, global lending markets become so dysfunctional that UK mortgage lenders found they had to severely restrict the finance they made available to ordinary mortgage borrowers. Not surprisingly, lenders chose to eliminate the riskiest segments of their lending, sharply reducing maximum LTVs. The impact was a dramatic reduction in lending above 90% LTV (see Chart 1) – traditionally a staple product for first time buyers.

Chart 1 – LTV distribution for UK first time buyers



Source: Prudential Regulation Authority

Most lenders imposed even larger reductions in maximum LTVs on new homes, fearing that losses on these properties could be higher because new homes typically sell at a premium and because concerns had already arisen around some new build markets where a glut of properties had started to lead to lender losses. Some lenders went as far as imposing maximum LTVs of 65% on new build flats with few offering more than 80% LTV on any new build property.

The dramatic shrinkage in mortgage supply had an immediate impact across the whole housing market. But no segment was worse affected than new build. Traditionally around 40% of new homes had been sold to first time buyers requiring high LTV mortgages – so the virtual withdrawal of loans above 80% LTV left house builders with a substantial pipeline of almost unsellable homes and the need to drastically cut back production.

1.3 The advent of builder shared equity

To start selling their stock of unsold starter homes, builders started to offer equity loans. These were second charge loans on which no interest was charged but where the loan balance would rise or fall in line with the market value of the property. When the owner comes to sell they will have to repay the same percentage that they borrowed from the builder.

For example, on a £100,000 property a buyer with a £5,000 deposit could borrow £75,000 on a conventional mortgage and the remaining £20,000 as an equity loan from the builder. If five years later the borrower sold the house for £120,000, making a 20% gain, they would have to repay the builder £24,000: 20% more than the original equity loan.

For builders who needed to generate cash flow quickly and clear unsold stock, equity loans made a great deal of sense as they immediately received 80% of the sale proceeds with the prospect of the rest at a later date. But given the high cost of capital faced by builders, delaying 20% of the sale proceeds undermined the economics of future starter home production. As a result the advent of builder equity loans could not prevent a collapse in house building and builders soon looked to government to step in.

1.4 Government interventions to support new build customers

A series of government initiatives were launched to overcome the dearth of high LTV mortgages and support new home sales starting with HomeBuy Direct in 2008. This scheme was an equity loan provided in joint shares by the government and the builder. It was restricted to first time buyers with earnings of less than £60,000. After the 2010 general election the Coalition government ended HomeBuy Direct but in the absence of a recovery in mortgage availability soon brought out FirstBuy, which operated in the same fashion.

FirstBuy was followed in 2012 by the launch of NewBuy. This government backed scheme saw lenders provide 95% LTV mortgages where the builder placed 3.5% of the property sale proceeds in a fund to protect the lender against credit losses, with additional second loss protection provided by government. HomeBuy Direct, FirstBuy and NewBuy have collectively supported some 40,000 transactions over the six years since 2008.

Help to Buy equity loan scheme

Finally, in 2013 the government announced the Help to Buy equity loan scheme as well as the Help to Buy mortgage guarantee scheme. The Help to Buy equity loan scheme represents a considerable step up in the level of public support with government providing the entire equity loan on a new home, with the scheme not restricted to first time buyers and those earning under £60,000.

With no cost to the builder and few eligibility restrictions on purchasers, it is unsurprising that the Help to Buy equity loan scheme has generated a far faster rate of sales than the earlier government-backed schemes. Table 1 shows that by the end of 2014 more than 41,000 new homes had been purchased using the Help to Buy equity loan scheme, representing over a quarter of all private sector completions in England, where the scheme operates.

Table 1 - Help to Buy equity loan completions relative to total

	Help-to-Buy equity loan completions	Private sector housing completions (England)	Help-to-Buy equity loans as % of total completions
2013 Q2	1,175	22,280	5.3%
Q3	4,193	22,150	18.9%
Q4	7,499	22,750	33.0%
2014 Q1	6,522	22,710	28.7%
Q2	7,127	23,230	30.7%
Q3	7,328	23,410	31.3%
Q4	7,689	24,220	31.7%
	41,533	160,750	25.8%

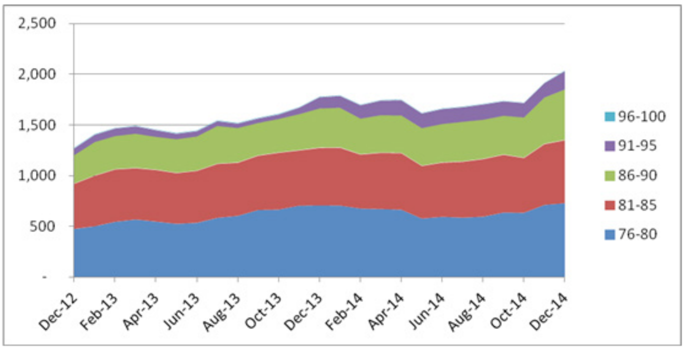
Source: Department for Communities and Local Government

Moreover, in the first four full quarters of its life from Q3 2013, the Help to Buy equity loan scheme accounted for all of the increase in private housing starts in England. So excluding this government scheme, there has been no meaningful recovery in house building from the exceptionally low levels it had reached in the wake of the financial crisis.

Worried that builders had not been able to generate a recovery in unsupported home sales and that Help to Buy assisted sales might fall back in the lead up to the planned termination of the scheme in 2016, in March 2014 the government announced that the scheme was going to be extended from 2016 to 2020. Despite their decision to extend the scheme, it must be clear to government that Help to Buy has failed to drive a step change in housing output but rather has simply supported the existing model of house building.

1.5 The future of shared equity

Chart 2 - number of high LTV mortgage products



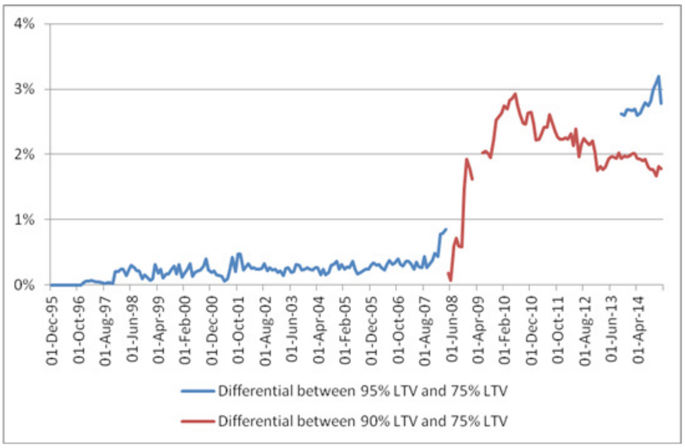
Source: Moneyfacts

Since shared equity loans were introduced as an emergency response to the withdrawal of high LTV mortgages following the financial crisis, you might expect that as the mortgage market gradually recovers, the need for shared equity would start to wither. But despite a clear recovery in the mortgage market and increasing numbers of high LTV mortgages on offer (see Chart 2), the need for shared equity in the new build market seems to remain.

Part of the explanation lies in the regulatory changes that have been implemented in the wake of the financial crisis. Under Basel 3 lenders are required to hold much higher levels of capital against their loan books. This has had a particular impact on high LTV lending, where capital levels were already much higher under Basel 2. So the figures in Chart 2 are somewhat misleading – as Chart 1 showed there have been far fewer high LTV loans completed and where they are, the differential in interest rates with lower LTV loans is dramatic.

Chart 3 shows the respective difference in interest rate between the average 2 year fixed rate 90% and 95% LTV loan and the average 2 year fixed rate 75% LTV loan. From these rates we can calculate the average marginal cost of borrowing between 75% and 90% and the average cost of borrowing between 90% and 95%. Both have grown significantly in the wake of the financial crisis and recession, although recent rate cuts have slightly softened the impact.

Chart 3 - Interest rate differential



Source: Bank of England. Breaks exist where data is unavailable due to large scale product withdrawals during the financial crisis and a lack of comparison points during and after the credit crunch.

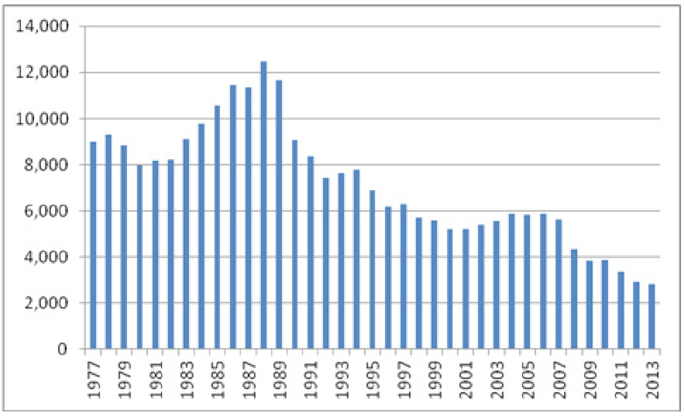
Given the small number of high LTV loans being granted, the price differential compared with lower LTV loans, and the likelihood this situation will continue with tough capital rules in place, there would seem to be an ongoing place for shared equity top up loans. But builders find it expensive to offer these products because of the high cost of capital they face and no private sector alternatives have emerged.

This leaves only the taxpayer-funded Help to Buy schemes to fill the gap. But although the equity loan scheme has been extended to 2020, this was meant as a short term prop and not a permanent feature of the market. In the medium to longer term, government needs to find ways to maintain new build output in the traditional high LTV starter home category that do not involve such a large implicit subsidy to the builder.

1.6 Development finance

House buyers were not the only ones affected by the sudden reduction in credit availability when the financial crisis struck. Many builders use debt to fund part of their working capital and at exactly the point when buyer demand fell away because of lack of mortgage availability, developers found their own access to credit severely restricted. This accelerated an existing trend towards consolidation in the house building industry (see Chart 4).

Chart 4 – number of house building firms on NHBC register



Source: NHBC

The decline in the number of house building firms highlighted by Chart 4 has been an established trend for the past 20 years. A range of factors have been cited to account for this phenomenon:

- The lengthening of the time it takes to get a project from start to finish including the increased complexity of the planning system. This means that capital has to be tied up for longer in land before it can be released through the eventual sale of houses which can impose a strain on small firms with limited capital.

- Increased regulation has a harder impact on small firms who cannot spread the cost of compliance in the way that large builders can. These regulations cover a wide range of issues from energy efficiency to rainwater harvesting. Government is now undertaking reforms to reduce regulation, for example consulting on a proposal to exempt small development sites from the zero carbon requirement.

- Larger builders can afford to hold land for longer which provides a degree of protection from cyclical changes in the market for land. For example, when the property market is strong small builders without a significant land bank will have to bid aggressively for land when the price is already high. This leaves them vulnerable to any subsequent market downturn.

The capital constraints that many smaller builders face mean they are not in a position to delay receipt of 20% of the sale proceeds and therefore are unable to fund equity loans, which have become a significant part of the market. By removing the need for the builder to contribute to the equity loan, Help to Buy has made a difference but this scheme is not set to last beyond 2020.

The financial crisis added a major additional hurdle for builders in the withdrawal of debt for working capital. And it was the smaller builders that were hit hardest as banks perceived them as higher risk. As UK builders mostly build speculatively they usually only receive their revenue when a property is completed. This requires the builder to carry a significant amount of working capital. They must acquire land, seek planning permission and build homes before their revenues come in.

For small builders there are few alternatives to bank debt to fund this working capital, being too small to raise equity finance or debt from the capital markets. This has left many smaller builders unable to fund new development projects which has in turn contributed to the accelerated decline in the number of registered builders shown in Chart 4.

The government has attempted to help smaller builders with, for example, the £525 million Builders Finance Fund to help restart and speed up housing developments between 5 and 250 units. The fund's main objective is to address the difficulties in accessing development finance faced by smaller developers. But small builders remain at a disadvantage in the current system.

1.7 Lender concerns with new build and lending concentration

When considering whether to buy a new or 'used' house, the last thing that would trouble most customers is the thought that it might be harder to obtain a mortgage on a new property. But in fact from a mortgage lenders' perspective the new build market is a specialism with a range of issues that do not apply to the rest of the market.

Because of this specialist nature, some lenders avoid lending altogether while others seek to limit their participation. This leaves less choice for consumers. Only two lenders, Nationwide and Lloyds Banking Group, have shown a consistent commitment to understanding the new build sector in depth, employing staff with specialist knowledge to oversee their new build lending. Unsurprisingly, these two lenders have accounted for a disproportionate share of lending on new build property, which leaves the sector somewhat vulnerable.

For example, it is normal for lenders to impose 'site limits' to control their exposure to individual new build developments. This means that on a particular building site a lender might decide that it will not finance more than say 25% of the buyers. This can create challenges if Nationwide and Lloyds Banking Group have reached their site limits, further reducing choice for mortgage customers.

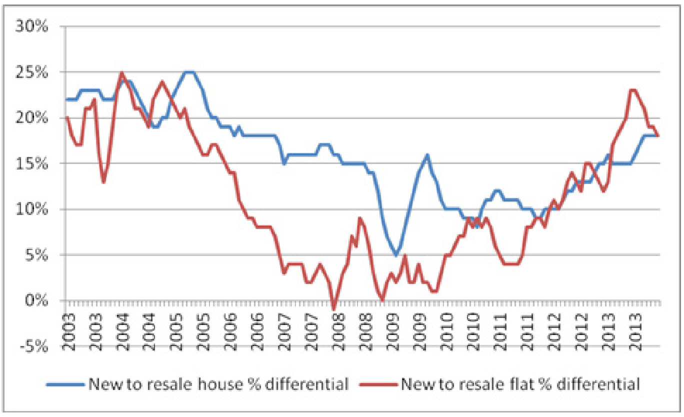
Two issues head the list of mortgage lenders' concerns with new build: the new build premium and builder incentives. Both of these have the potential to make the sale price a poor guide to the realisable value of a property in the event that the lender has to take possession, which exposes the lender to risk.

New build premium

Just as consumers will pay more to drive a new car out of the showroom, so buyers of new properties typically pay a premium over similar properties in the second hand market. This premium is a concern to lenders because in the event that they have to take possession of the property the new build premium may have disappeared, eating into the lender's LTV cushion.

Part of the new build premium will be justified as a new property should need lower maintenance, is likely to be more energy efficient and benefits from an NHBC or similar guarantee, where the builder is responsible for fixing structural problems that arise in the first ten years. For lenders and their valuers the difficulty is in assessing how much of the new build premium is justified. There is no simple answer and it will ultimately come down to the surveyor's (valuer's) judgement.

Chart 5 - New build premium



Source: Hometrack

Chart 5 shows the scale of the new build premium for flats and houses. While the benefits of new properties mentioned above should be relatively constant the new build premium has, at least over the past decade and a half been quite volatile and cyclical. The premium fell in the financial crisis but has been recovering over the past two years. Although the current premium of around 20% is below the level seen in 2004/5, it remains a concern to lenders and requires skill on the part of the valuer to determine whether it is fully justified.

Builder incentives

The other major concern for lenders relates to sales incentives offered by house builders. Such incentives can take a number of different forms: most commonly it could involve the builder agreeing to include items in the home such as carpets, curtains or white goods in the sale price. But it has on occasion included a free car or substantial cash payments.

In the buoyant property market of the mid 2000s it became quite common for developers to give buyers cash incentives which could be used as part of the deposit. For example, a developer might list the value of a property as £200,000 but be prepared to offer the buyer £10,000 in cash towards their deposit. If the buyer obtained a 95% LTV mortgage (£190,000) they could purchase the property without putting any of their own money down. For the lender what appeared to be a 95% LTV loan on a £200,000 property was actually a 100% LTV loan on a £190,000 property, a higher risk proposition.

Lenders have put considerable effort into tightening up their requirements so that builders have to disclose the full range of incentives being provided. In 2008 the mortgage industry trade body, the Council of Mortgage Lenders (CML), introduced the disclosure of incentives form, which required builders to detail all incentives and discounts offered to the buyer and provide this information to the valuer. This has reduced lenders' concerns about the manipulation of value but it underscores the differences with this specialist lending market.

1.8 Lenders' collective versus individual interest in new build

Lenders collectively recognise the important role that new build property plays in the wider UK housing system. They understand that without an adequate supply of new homes, the market risks becoming more unstable with prices squeezed up even faster when the economy is buoyant followed by the risk of larger falls when consumer optimism declines.

It is thus clearly in the collective interest of the lending industry to ensure that sufficient mortgage finance is available to borrowers buying new properties and that builders have access to the working capital they need to meet demand. But the current UK business model in which house builders build speculatively and then attempt to maximise the sale price on each home throws up a range of problems for lenders as outlined above, from the new build premium to the need it creates for relatively risky development finance.

Section 2 - Rethinking the new home financing model

2.1 – Builders as risk takers

The UK private sector house building business model is geared around the sale of speculatively built properties. Because of the long lead times from the purchase of a piece of land to the sale of finished homes, builders are exposed to significant risk, particularly as the housing market is notoriously cyclical. As a result of being exposed to these risks investors demand that builders set high target returns.

Table 2 - Calculating residual land value

Selling price	100
Building costs	-50
Sales and marketing costs	-3
Target gross margin	20
Residual land value	27
Operating outcome (level prices and costs)	
Gross Profit (as above)	20
Central overheads	-6
Operating profit	14
Return on Capital Employed (ROCE)	
Turnover	100
Capital employed required	60
Operating profit	14
ROCE 23.3%	23.3%

Source: Callcutt Review

Table 2 is taken from the Callcutt Review of Housebuilding Delivery and shows a stylised representation of profits for a typical UK house builder. The target gross margin is 20%, which with the builder's central overheads taken into account produces an operating profit or net margin of 14%. As capital employed is typically 60% of turnover, this implies a target return on capital employed (ROCE) of just over 23%.

Builders use this kind of equation to calculate the price they are willing to pay for a piece of land with planning permission, the so-called residual valuation method. The target gross margin of 20% is a stable input and as building costs, marketing and overheads are also relatively stable, builders can calculate the price they are prepared to pay for land by working back from the expected revenue from house sales, deducting these other costs and their margin.

The process of getting a site with planning consent from the drawing board to a completed community is a long and complex one, with significant risks to the developer before they can count their profit. By contrast, the process of gaining consent through the planning system, although itself often arduous, has potentially far more immediate commercial rewards. According to the Institute for Public Policy Research (IPPR) a hectare of residential land in England and Wales cost £1,770,000 in July 2009 compared to £12,335 for a hectare of land used for dairy farming: 143 times as much.

Moreover, if house prices are rising faster than building costs, the residual value of land will be rising even faster and vice versa. So house builders with substantial land banks have an incentive to keep house prices rising, and can control their rate of building to this end.

It is important to recognise that large volume house builders need to remain profitable and are obliged as commercial businesses to do the right thing for their shareholders. Nevertheless, in terms of the broader housing shortage the IPPR's report 'We must fix it: delivering reform of the building sector to meet the UK's housing and economic challenges' of October 2011 argues that the combination of the planning system and the speculative house building model has been the main barrier to raising supply, stating that 'For decades our developers have focused more on playing the land market and the planning system than on building homes.'

Moreover, the weaknesses with the structure of UK house building were laid bare by the financial crisis and subsequent recession. Builders were shown to be vulnerable to a sudden reduction in demand as it hits their cash flow at the same time as it pushes down the value of their land. If a substantial proportion of their sizeable working capital is funded from debt, they become vulnerable to bankruptcy under such circumstances.

But the IPPR report also argues that the UK house building business model with its focus on creating value through land banks 'makes recovery much more difficult than it would be in other sectors which have less high levels of asset and borrowing overhangs.' The near-death experience of 2008-9 has made house builders very cautious about raising output for fear of over-extending themselves.

IPPR argues that, to be effective, planning reform to release more land for development must be accompanied by changes in the house building business model via changes to who has access to land and how it is utilised.

It seems the government may be beginning to come around to the view that the structure of the house building industry is holding back output. At the launch of the national infrastructure plan in 2014 Danny Alexander, Chief Secretary to the Treasury announced that the Homes and Communities Agency could build as many as 250,000 homes for sale on the open market. A pilot project is already under way at Northstowe, a former RAF base in Cambridgeshire.

2.2 Self build

An alternative to the speculative building model has been available in the UK for several decades in the form of self build. This is an established market which has been producing around 10,000 new homes a year for some considerable time. It is estimated that some 12,000 self build homes were completed in the year to September 2012. This represents almost 11% of private house building.

Self builders source and buy a building plot, draw up plans to their specifications and seek planning permission. Once building work commences, the homebuyer acts as project manager, overseeing or directly participating in the construction of their home.

The self builder's efforts are not only rewarded by having a home that meets their particular requirements and aspirations. The self builder's 'sweat equity' also substantially lowers build costs, even where the self builder is subcontracting the actual building work, because the builder margin that they would otherwise be paying is largely eliminated. It is estimated that a completed self build home is typically worth 20%–25% more than it costs to build, providing the owner with substantial instant equity.

Government has enthusiastically backed self build with a range of initiatives. Under Right to Build individuals will have the right to register their interest in building their own home and their local authority will have a duty to ensure that suitable affordable plots are made available by granting planning consents.

New planning practice guidance will be introduced to ensure councils establish the demand for self-build in their area, as well as taking steps to help aspiring self-builders. This will include compiling a local register of people who want to build their own homes so they can be given first priority when new brown field sites become available. Community self builders will be able to apply for a share of £65 million from the Affordable Homes Guarantees Programme to build the affordable homes they want in their area.

Self build mortgages

It is estimated that around 60% of self builders require a mortgage. In the wake of the financial crisis a number of the larger lenders restricted lending to this sector but at the same time some smaller regional building societies took a renewed interest in self build as part of a refocusing on their local areas. Today there is a good range of mortgages available to those who want to build their own home.

The key difference between a self build mortgage and a traditional mortgage is that with a self build mortgage funds are released in stages as the building work progresses rather than as a single amount. These staged payments can be made either in advance or in arrears.

Traditionally with self build mortgages payments have been made in 'arrears' i.e. the lender releases mortgage funds once each stage of the building process is completed and this has been confirmed by a valuer appointed by the lender. This type of loan suits self builders who have sufficient funds to pay for materials and contractors as the work progresses.

However, self builders can now receive payments in advance of each stage of the building work being carried out, using the Accelerator Mortgage Scheme. This provides the self builder with the cash to buy materials and pay contractors, so it suits self builders with more limited funds. It also lends a generous percentage of the costs - up to 90% of the cost of the land and up to 90% of the cost of the build.

With these funding options available there should be no reason why home buyers should be deterred from considering the self build option on account of limitations around financing.

Limiting factors for self build

For some homebuyers, the confidence and time required to lead and manage the self build process may seem daunting. Although support is available to help self builders find land, arrange finance and purchase necessary materials, the real limiting factor is the amount of plots that are made available for this kind of project. The UK has a high proportion of protected land, and there is strong competition from commercial developers in high-demand areas. There is also no guarantee that available plots will have appropriate planning permission and the planning process itself can put consumers off. Identifying free plots of land is a real challenge: despite websites such as Plot Search and other property-hunting portals that do allow self builders to search for land listings, not enough is done to promote the sale of land to individuals for residential development. As a result, a central register for self build land is a number one priority.

2.3 Custom build – a spectrum of customer involvement on offer

The custom build market is much newer in the UK than self build but has been a major force in home building in many countries abroad for decades. In the UK, custom build still has a low profile. It is seen by some as an offshoot of self build as it allows the homebuyer to specify the design of their home. But the defining feature of custom build is that there is no assumption that the customer will participate in or even directly oversee the construction of the property, although they can have a high level of involvement if they wish. So custom build caters to a wide range of customers from potential self builders to those just wanting more control over the design of their home.

With custom build, land is released through partnerships of landowners and local authorities in sites of ready-made serviced plots, so roads and utilities such as water and electricity supply are pre-installed for each plot. Individuals select a plot and have a range of options of different styles when they commission the building of their home. This allows customer build to take place in higher volumes with whole communities of custom build homes being possible. Customer involvement can also speed up the building process since when the customer is in the driving seat they can do more to ensure timely completion.

Custom build is financed in a similar fashion to self build. The homebuyer can source a loan at the outset when they purchase the plot. The mortgage lender agrees to make staged payments to finance the purchase of the land and construction of the property, so the builder is paid as the work progresses.

As with self build, the staged payments can be made in arrears or in advance with the Accelerator Mortgage Scheme mentioned above. This gives those considering custom build a good range of options when seeking mortgage finance and means that even households with a quite limited deposit need not be excluded from considering the custom build approach.
Since 2012 the sector has benefited from a central portal, the Custom Build Register, where consumers can register their interest in sites on both council-owned and privately-owned land across the UK. The site allows local authorities, councils, private landowners and developers to gauge demand for self build and custom build and ensure this is incorporated into local plans.

Government support for custom build

The government's strategic housing paper 'Laying the Foundations – A Housing Strategy for England' released in November 2011 signalled strong government support for custom build. Since then we have seen a number of initiatives:
Under the National Planning Policy Framework local authorities are now under a duty to assess demand for "people wishing to build their own homes" and where demand exists, address it. Local authorities have to do two things:

- The Strategic Housing Market Assessment (SHMA) requires local authorities to assess the need for housing by people who wish to build their own homes.

- Local authorities have to create a Strategic Housing Land Availability Assessment (SHLAA) to establish realistic assumptions about the availability of land to meet the identified need for housing over the plan period, including for self build.

Other measures include:

- The £150m Custom Build Investment Fund to offer short-term loans to community groups, builders and other small organisations looking to start self-build projects.

- Community Infrastructure Relief. Custom Builders have been granted an exemption from the Community Infrastructure Levy normally imposed on developers.

- Expected Proposals for Section 106 Relief. Section 106 contributions could be scrapped for custom builders under plans currently being consulted on.

- Help to Build. The government plans to extend Help to Buy to custom build with the introduction of 'Help to Build', allowing people to self build with only a 5% deposit. This should provide access to more first time buyers.

2.4 Financial benefits of custom build

Surprisingly, it is the financial benefits of custom build that seem to have received the least attention, yet these could provide the greatest spur. Moreover, these financial benefits could address some of the weaknesses of the current UK housing development business model.

In contrast to the traditional UK model, with custom build the firm is not building property speculatively hoping to find a buyer. It acts more as a contractor, carrying out the instructions to build to the plans agreed by the homeowner. Table 3 shows how this can affect the economics of construction and can be contrasted with Table 2 above.

Table 3 - Costs of custom build

Market value	100
Building costs	50
Builder sales and marketing costs	0
Builder gross margin	8
Residual land value	27
Total costs	85
Builder central overheads	4
Builder operating profit	4
Return on Capital Employed (ROCE)	
Builder turnover	58
Builder capital employed required	15
Builder operating profit	4
Builder ROCE	26.7%

Source: Wriglesworth Consultancy

In Table 3 the building costs (materials and labour) are the same as Table 2 as is the assumed land value. But the builder no longer has to spend on marketing costs and should see its overheads greatly reduced. Crucially, the builder now needs far less working capital as it no longer holds a land bank and is paid in staged payments as it builds the property.

We have assumed that the builder requires only a quarter of the working capital of a speculative building but the proportion could be lower still, with no capital outlay possible where staged payments are made in advance. As a result the builder requires a much smaller operating profit to generate the same or higher return on capital employed (ROCE). In Table 3 ROCE, a key measure of builder profitability, is 26.7% against 23.3% under the speculative model outlined in Table 2 above.

In our example above the reduction in the builder's margin and elimination of their marketing costs reduces the all-in price of the property to 85%. Assuming the market value of the finished home is the same as in the earlier example, the custom build homeowner will have instantly created 15% equity for themselves.

2.5 Favourable planning consent could kick start custom build

Custom build offers some clear advantages over the traditional speculative building business model. It gives the homebuyer more control over the design of their home and by reducing builder costs and margins it can provide instant equity to the homeowner. This in turn substantially reduces risks for the lender. By altering the role of the builder it reduces their need for working capital, reducing the builder's dependence on development finance. This reduces risk for the builder and makes it easier for smaller local builders to compete.

But despite these advantages custom build may not be able to achieve its potential because the large national builders have the resources to spend heavily on land and battle the planning system to secure planning permissions. It is not that these larger builders wish to limit alternatives but simply that, in the face of the time and cost it takes to secure planning permission and build estates, they have the clout to stick at it, if necessary waiting many years to put their plans into action.

To level the playing field in favour of custom build, local authorities could make better use of the planning obligations available under Section 106 to ensure a form of favourable planning consent is made available for custom or self builds. For example, overall planning for large schemes of mixed tenure properties could be dependent on elements of custom build being present throughout the site.

Some local authorities are already stipulating a requirement that 5% of the homes on sites of 20 or more units are custom build under Section 106 agreements. However, a more concerted effort by local authorities to promote custom build in this way could unlock a far greater number of land plots for custom builders and allow smaller developers to play a greater role in the output of new homes by making the planning process more accessible.

Section 3 - Conclusion

The UK has suffered from an inadequate supply of new housing since as far back as the early 1980s. But since the financial crisis this problem has grown much worse. Despite a sharp increase in the rate of growth of the resident population, UK house building has been stuck at levels last seen in the 1920s.

Remarkably, even though the economy emerged from recession five years ago, there has been barely any improvement in the rate of building and the recovery we have seen in housing starts since last year has been entirely accounted for by the government's Help to Buy shared equity scheme.

So it would seem that the current system is not delivering and we need more radical changes. The government itself seems to have recognised this with the recent announcement by Treasury Chief Secretary Danny Alexander that the Homes and Communities Agency could commission homes to be built for sale on the open market and the government's latest pledge to support 100,000 new homes through its 'starter homes' scheme.

Two factors that have played a leading part in our poor housing supply are the planning system, which has made it difficult to build particularly in the areas of highest demand, and the business model of UK house building, with the purchase of land, seeking of planning consent and building of homes all geared to speculative sale. Over the past seven years a third factor has come into play: the lack of high LTV mortgage finance.

Custom build could be a significant solution to the shortcomings of the current house building model and the lack of high LTV finance. With custom build the customer is in the driving seat, selecting a plot and agreeing on design with the builder. With the builder no longer needing to cover the cost of speculative development, the custom build approach typically saves around 15%, which becomes instant equity for the homeowner.

Custom build addresses the most serious concerns that mortgage lenders have had with new build property which has driven their cautious approach to high LTV lending in the sector. The average 15% reduction in the cost to the homeowner is likely to eliminate any unsustainable new build premium of the sort that is not uncommon with speculatively built properties and there will be no need for sales incentives of the sort often used by speculative builders to shift stock. Custom build can also support smaller builders given the much reduced need for working capital.

The government has initiated a range of measures to support self and custom build. But despite the potential provided by the Section 106 agreements, local authorities are failing to use this to its full effect to promote more land plots for custom build and essentially help to reduce the current chronic housing shortage.

Section 106 needs to be seen as an opportunity rather than an obligation: for local authorities, this means the opportunity to increase housing stock while allowing constituents to have a greater say in the design of their home and benefit from reduced costs compared to a traditional new build.

For developers, this represents an easier way of obtaining planning permission to build properties that are associated with far less risk than the speculative building model. It also enables SME builders to play a greater role alongside larger developers in contributing to the UK housing output.

Government and industry must therefore play a far more prominent role in ensuring this message is communicated to local authorities.

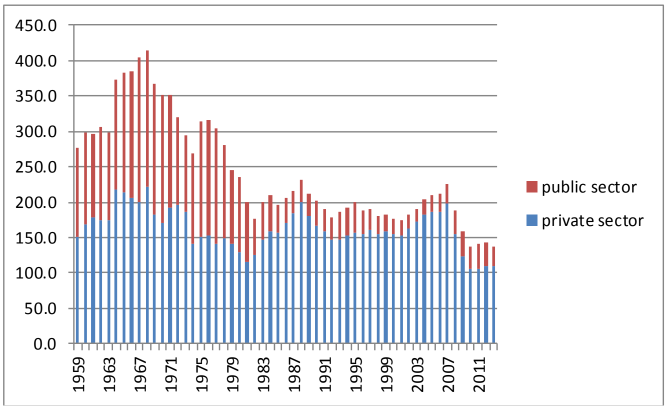
Appendix - The need to ramp up housing supply

1. A housing crisis a long time in the making

The UK is facing a growing housing crisis. It is a crisis that has been brewing since the early 1980s when new housing completions dipped below 200,000 a year for the first time in a generation (see Chart 6). Since then low rates of house building have become entrenched, with output struggling to get above the previously low figure of 200,000.

While the large fall in house building in the 1970s and 1980s was the result mainly of a sharp contraction in public housing completions, private sector output has failed to fill the gap. And the financial crisis pushed even private sector completions down to new lows of little more than 100,000 a year.

Chart 6 - UK housing completions (thousands)

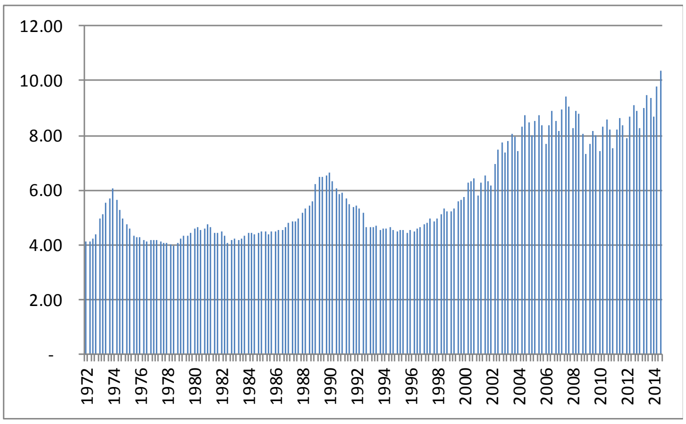


Source: Department of Communities and Local Government

Even the introduction of the government's Help to Buy equity loan scheme in 2013 has failed to spark the sustained recovery required. In the first quarter of 2013, just before Help to Buy was introduced, private sector housing starts in England numbered 22,360. In the third quarter of 2014 starts were 29,540 but with Help to Buy equity loan sales running at over 7,000 a quarter there would seem to be no improvement in unassisted housing starts.

The result of this continuous shortage in new building has been both higher house prices and a more volatile housing market. As Chart 7 shows, house prices relative to average earnings have been on a sharp upward trend since the 1980s and we have experienced two significant booms in house prices in the late 1980s and the 2000s.

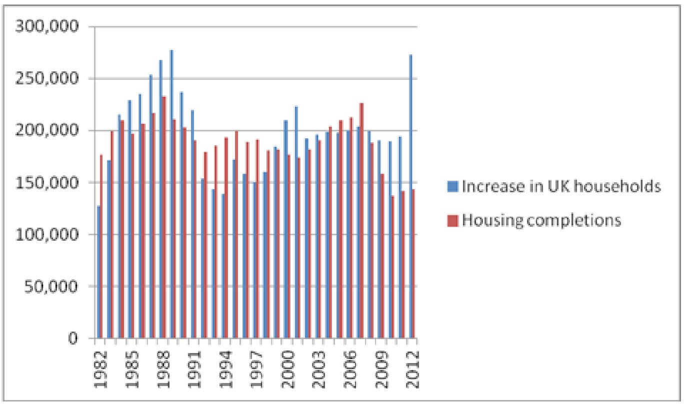
Chart 7 - UK house price to earnings ratio



Source: ONS

The role of an inadequate supply of new homes was identified as a cause of rising house prices as far back as the 1980s. The issue took a back seat after the housing crash of the early 1990s in part because although the UK's population was trending steadily upwards, as Chart 8 shows the growth in the number of households fell back sharply during the early 1990s recession as many younger people delayed leaving the family home.

Chart 8 - Increase in UK household numbers and housing completions



Source: ONS and DCLG

As the economy recovered house prices picked up and by 2003 the government was sufficiently concerned about deteriorating affordability that it commissioned economist Kate Barker to undertake a review of housing supply. Kate Barker's report concluded that inadequate housing supply was the main factor pushing house prices up and that in order to reduce the rate of house price growth to the EU average of 1.1% a year in real terms an additional 120,000 houses would need to be built each year.

Still not everyone concluded that inadequate housing supply was the main problem. Vince Cable MP argued that cheap and plentiful mortgage credit was responsible for the housing boom and felt vindicated by the fall in house prices following the financial crisis of 2008-9. But the underlying upward trend in house prices reasserted itself remarkably quickly in 2009: reminding us that even after a deep recession the underlying shortage of property will quickly reassert itself.

One feature of the market since 2008 which is particularly striking is that the growth of new households has easily exceeded new house building despite the economy having suffered a severe recession, which would normally be expected to lead to lower household formation as more young people stay with their parents. The number of 'disguised households' (people who wish to form a new household but are currently unable to) appears to be rising sharply too since the ratio of total population to number of dwellings has been rising since 2009 against a long term downward trend.

So today, few commentators would dispute the link between inadequate new supply and high house prices, and something of a consensus exists that the UK needs substantially more homes to be built.

2. Looking to the future

Table 4 shows the official government forecast for the UK's population to 2037. This shows that in the 25 years between 2012 and 2037 the UK is expected to see an increase of just under 10 million in its resident population. This increase of nearly 400,000 a year is substantially higher than the rate of growth seen in previous decades, suggesting that demand for accommodation will be expanding at an unusually high rate relative to the existing stock of property.

Table 4 - Population projects (millions)

	2012	2017	2022	2027	2032	2037
England	53.5	55.4	57.3	59.1	60.7	62.2
Wales	3.1	3.1	3.2	3.2	3.3	3.3
Scotland	5.3	5.4	5.5	5.6	5.7	5.8
Northern Ireland	1.8	1.9	1.9	2.0	2.0	2.0
United Kingdom	**63.7**	**65.8**	**67.9**	**69.9**	**71.7**	**73.3**

Source: ONS

These projections worry policymakers because they know that the UK's traditionally weak housing supply response has become even more anaemic in recent years, with house building falling well short of the level required to keep pace with the growth in household numbers. Clearly, a very significant step change is required in UK house building going forward and politicians know that the pressure on them to kick start that change can only grow more intense.

About us

Contributors and contact details

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This report was authored for Mortgage Advice Bureau by Rob Thomas, Director of Research at Wriglesworth Research and formerly a Bank of England economist, high profile analyst at the investment bank UBS and senior policy adviser to the Council of Mortgage Lenders.

Rob was also the project originator and manager at the European Mortgage Finance Agency project and created the blueprint for government's NewBuy mortgage scheme.

About Mortgage Advice Bureau

Mortgage Advice Bureau is the UK's best-known independent mortgage broker*, winning national awards for the quality of its advice and service in each of the last four years. It has over 600 advisers offering expert mortgage advice on a local, regional and national level to consumers across the UK.

Mortgage Advice Bureau handled record levels of mortgage applications in 2014 and currently arranges £9bn of loans each year. It was the first – and is currently the only – mortgage intermediary to have floated on the London Stock Exchange, having joined the Alternative Investment Market (AIM) in November 2014.

**Based on Opinium Research among 2,002 UK consumers, May 2014*

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