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Residential Analysts Ltd

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The Problem With The New-Build Premium

The new-build market has a mortgage problem. Mortgage lenders are less willing to lend at high loan-to-value ratios on new-build homes than existing ones. They have concerns over the pricing of new-build and how well the price of a new home will hold relative to the market over time. Our analysis looks to investigate whether these concerns are appropriate, the role of the Help to Buy equity loan scheme in bridging the gap between lenders' concerns and market demand, and what might happen to the new-build market when Help to Buy ends.

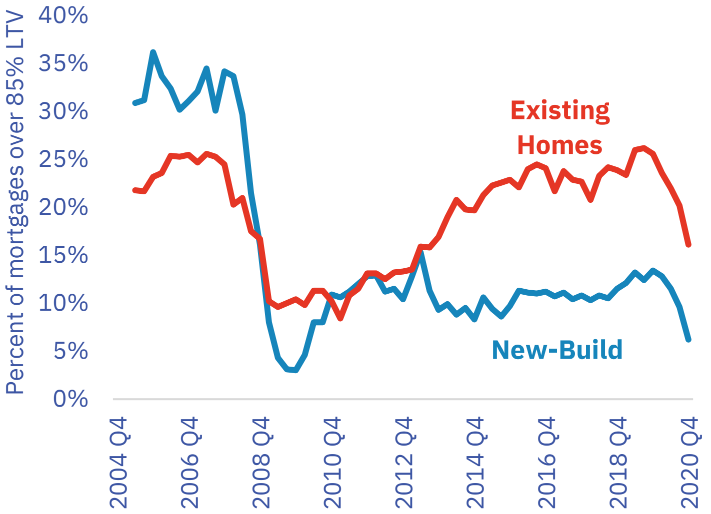
New-Build's Mortgage Problem

At the core of the mortgage problem is the new-build premium and the cautious approach lenders may take when the support offered by the Help to Buy equity loan scheme reduces. This could limit the housebuilding sector's ability to build new homes.

Much if not most of the political and policy attention tends to be focussed on the inputs and processes of housebuilding and planning. But it is also important to consider the size of the market for buyers of new housing – the numbers who can afford to buy the new homes that will be built, which may be homeowners, buy-to-let investors, or increasingly institutional investors. For housebuilders selling to homeowners, much of that demand is determined by mortgage availability and affordability. The challenge for housebuilders is, as Fig 1 shows, mortgages at higher loan-to-value ratios are more constrained for new-build homes than in the wider market.

Fig 1: High LTV Mortgages

Source: FCA Product Sales Data, UK



The reason mortgage lenders are less willing to lend at higher loan-to-value ratios on new-build stems from concerns about the new-build premium. The case for a new-build premium is clear. Simply put, many buyers of second-hand homes need to invest further money making repairs or doing up the homes to tailor them to their taste and needs. They may also have to buy new appliances. This is clearly less of an issue for new homes. But critically, the money spent by buyers of second-hand homes after purchase generally comes from a separate pot than the mortgage. Whereas, for new-build it is wrapped up in the price, which may, in the eyes of lenders, have been raised further by any incentives used to encourage buyers.

When looking at a new home lenders concerns are based on two questions. Firstly, whether the price paid for the new home that their loan is secured against is an appropriate value. Secondly, if this value will be sustained over time or if the new-build premium will be eroded. This can lead to greater depreciation relative to existing homes in the local market and result in buyers not building an equity buffer as quickly as their peers in the wider market. Lenders' approach to the new-build market is grounded in their own analysis of the risks. While we cannot know exactly what analysis they have done, we have used our own approach to assess what happens to the price of new-build homes after they have been sold by the developer.

Importantly, the results of our analysis suggest that lenders' concerns about the new-build premium and longer-term values are well founded. The research shows an under-performance in the change in value of new-build homes relative to local market benchmarks. It finds that, while new-build homes may appreciate faster than the local market benchmark in the short-term, this premium can disappear within a couple of years.

Over the longer-term, there is evidence for an under-performance in total price growth relative to the local market. For some homes, typically houses, this would effectively be regarded by lenders as a one-off discount to the market reflecting the disappearance of the new-build premium over seven years or so. However, for other homes such as flats, there is evidence from our research, which is likely to be mirrored in lenders' data, for a continued and growing discount relative to the local market benchmark.

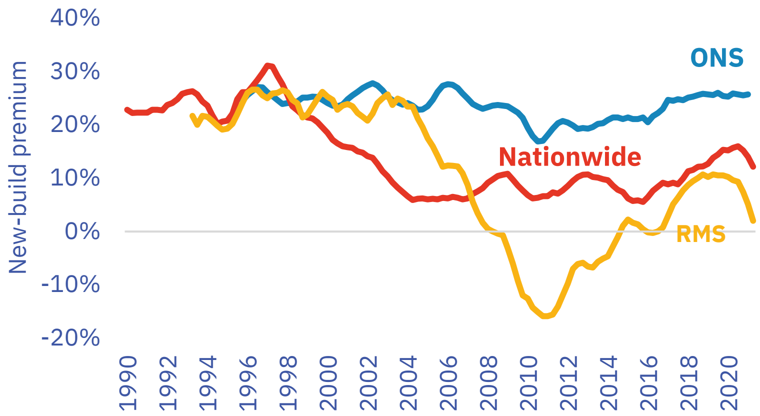
These findings suggest lenders are right to be concerned about the longer-term value of the homes their lending is secured against. The findings also highlight the importance of the Help to Buy equity loan scheme in narrowing the gap between lenders' risk aversion and the public's appetite for buying new-build homes. This risk gap is further highlighted by Nationwide's announcement this week that they will be lending on new-build homes via the Deposit Unlock scheme, a private sector insurance scheme that aims to bridge this gap.

Measuring the New-Build Premium

The existence and size of the new-build premium can be contentious due to the difficulties in accurately measuring it. That there is a premium when new homes are first built appears to be backed up by simple analysis of published house price indices. For example, Fig 2 shows the apparent premium according to three different measures. Based on the ONS house price index, the premium has been consistently around 20% since the mid-1990s, while the Nationwide house price index suggests it was at this level in the 1990s but has fallen to around 10% in recent decades. Meanwhile, unweighted data taken from the Regulated Mortgage Survey shows there is considerable variation in the premium, even turning negative. However, this tends to reflect changes in the mix of new-build homes. So, a shift to more flats being built during the mid-2000s reduced the average new-build price.

Fig 2: New-Build Premium

Source: ONS (Eng. & Wales), Nationwide (UK), RMS (UK)



The truth is none of these measures provide a meaningful measure of the new-build premium, as they are affected by several issues. These include the changes in the mix of homes being built over time and the initial starting price of the indices. There is also the question of what measures are used. Measurement could be based on total price, price per bedroom or price per square metre. A premium on one measure could easily reflect a compromise on another.

Adding to the complications is the need to compare the actual net price of the home sold. This has been a constant concern of valuers and lenders over many years, given the fluctuating use of sales incentives in the new-build market.

Accurately identifying a new-build premium at the point of sale can be challenging, irrespective of the chosen approach. Automated and traditional valuations can help but the priority for lenders is to understand what the value of the home might be in the event they have to take possession of the property at some point in the future.

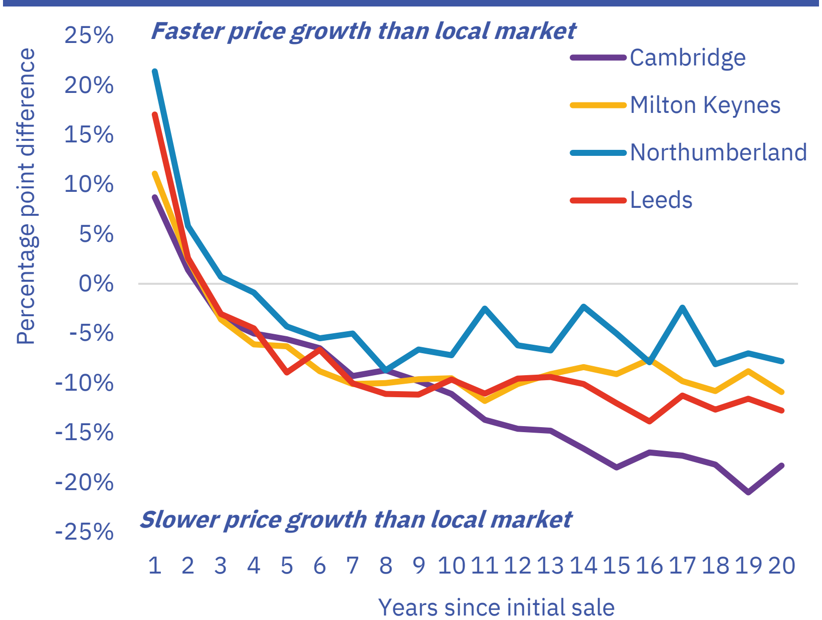
Therefore, to assess the risks lenders might see in new-build, we have chosen to analyse the price performance of new-build homes after they have been built relative to prices in the wider housing market. If new-build prices follow a similar or higher trajectory to prices of existing homes this would suggest lenders' concerns about new-build may be misplaced. If they under-perform then lenders may be rightly cautious that their money is secured against potentially under-performing assets that might struggle to sell, especially if house prices in the wider market had been static or falling over the period of ownership since the homes were first built.

Our methodology for assessing the performance of the new-build premium is based on identifying new-build property prices from the HM Land Registry price paid data and assessing how prices for those properties have changed over time in subsequent sales. We then compare the change in price of the new-build property to a benchmark based on the average change in prices across the local market during the same period. This allows us to assess how individual new-build properties have performed relative to the benchmark.

The results for selected markets are presented in Fig 3. It shows the percentage point difference in price change for new-build relative to the benchmark by length of ownership. A positive result shows new-build homes resold for prices higher than suggested by the local benchmark. A negative result shows new-build has under-performed the local benchmark when resold.

Fig 3: New-Build Versus Benchmark

Source: HM Land Registry, BuiltPlace



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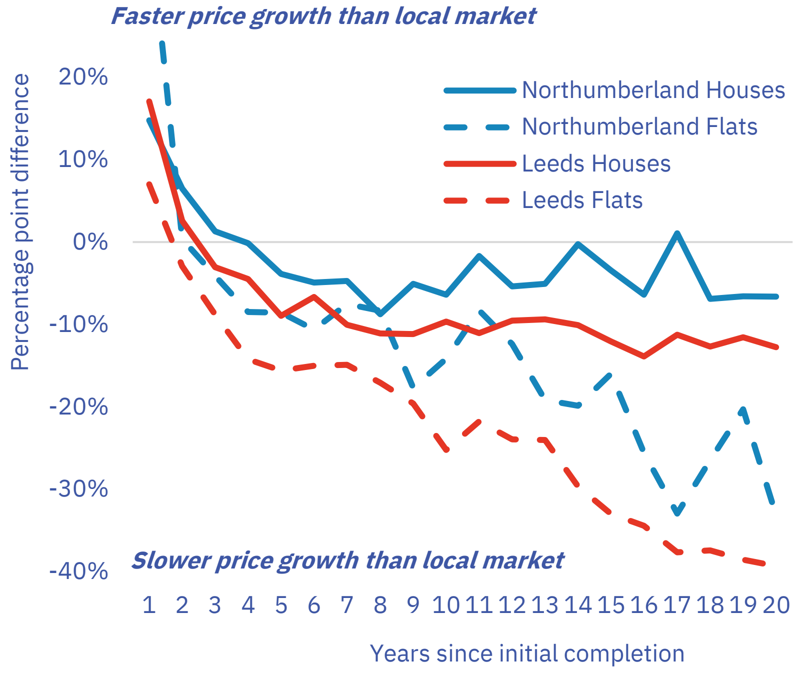
The results of our analysis reinforce the concerns held by lenders. Interestingly, the analysis shows that over the very short-term (three years or less), recent new-build homes tend to sell for a higher price than suggested by local price trends. However, this rapidly reverses in the following years with resales of new-build homes under-performing the benchmark. Although in most cases they will have still risen in actual price. Fig 3 shows that new-build homes sold seven years after their first sale had, on average, under-performed the local benchmark by around 10 percentage points. For example, if house prices in the local market had risen by 30% over the period, then the price of new-build had only risen by 20% since completion. Fig 3 also shows that the under-performance varies by location, with some areas experiencing continued declines in relative price. This is also the case when repeating the analysis by type.

Repeating our analysis with a split between flats and houses shows significant variation between the two broad property types. Fig 4 shows the result for Northumberland and Leeds. It illustrates the longer-term underperformance of new-build houses as the new-build premium is lost but it appears to be a one-off cost that does not increase beyond around seven years. The results for flats, especially in Leeds, are more severe with a continued decline relative to the benchmark over the period of our analysis.

For example, flats that were new in 2000 had under-performed the Leeds benchmark by 40 percentage points when sold 20 years later compared with 25 percentage points when sold 10 years after completion. This continued decline in flat prices relative to the benchmark is concerning and supports lenders' more conservative approach to risk when lending on new-build flats than new-build houses. Whatever the detailed reasons for the performance, to a lender it represents risk.

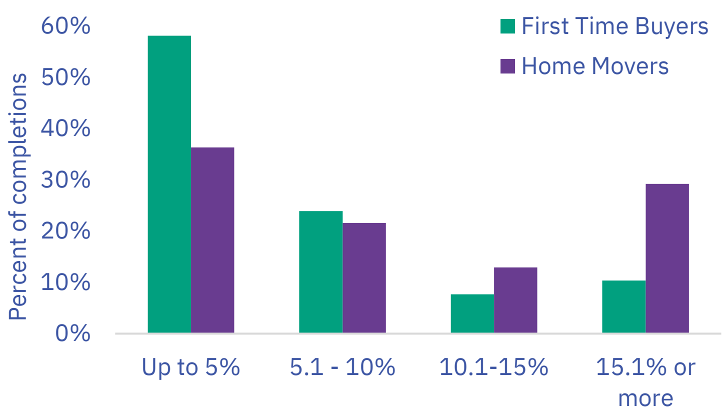
Fig 4: New-Build Versus Benchmark
Source: HM Land Registry, BuiltPlace



The Importance of Help to Buy Equity Loan

Our analysis suggests that lenders are right to be cautious about the longer-term value of new-build homes. Thankfully, for lenders and housebuilders, there is a policy that bridges the gap between mortgage lenders' reduced risk appetite for new-build and the public/government's aspirations for housebuilding and homeownership: Help to Buy equity loan. The equity loan scheme was launched when the overall market for higher loan-to-value lending was constrained following the credit crunch. Since then, it has been extremely successful in allowing deposit constrained buyers to purchase new-build homes. However, unlike the mortgage guarantee scheme that was launched around the same time, the equity loan scheme has remained in place.

Fig 5: H2B Deposit as % of House Price
Source: MHCLG, England



It is almost impossible to know what might have happened to the new-build mortgage market if the equity loan scheme had ended sooner. However, we do know what has actually happened. So far, it has helped people buy over 300,000 homes with 82% of purchases by first time buyers. As Fig 5 shows, most of those buyers had deposits of just 5% of the purchase price. That suggests, in the absence of the scheme, they would have required a 95% loan to value mortgage to buy their new home. However, one of the scheme's nicknames (help to buy bigger) hints at the challenges in accurately assessing the impact of the scheme as many buyers changed their property preferences to larger homes based on their improved borrowing capacity through the scheme.

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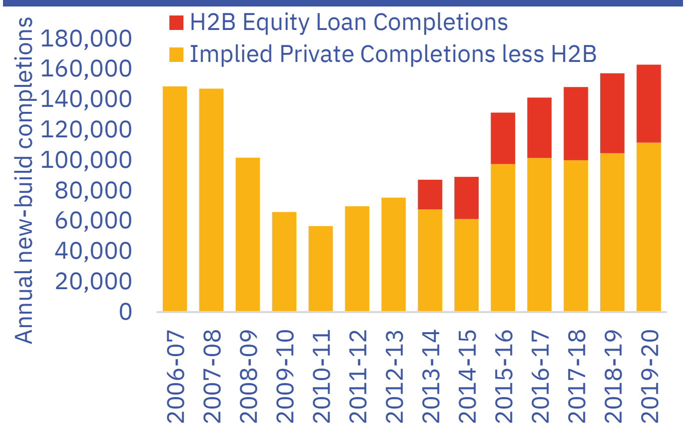
Fixing The Premium Problem

Our analysis suggests that mortgage lenders are rightly cautious about lending on new-build homes but the end of the existing Help to Buy equity loan scheme is rapidly approaching. That presents a serious problem for the housebuilding sector and government. Simple analysis of new-build activity in England compared with overall market activity suggests that private housebuilding completions could fall by around a third in the absence of a suitable replacement (Fig 6). In terms of replacements, it is unlikely that First Homes or shared ownership will be able to fill the hole left by the disappearance of Help to Buy equity loan. However, there is more hope offered by the private sector Deposit Unlock scheme, with Nationwide announcing their participation this week. The scheme, developed by Gallagher Re and the HBF, provides mortgage indemnity insurance for lenders on new-build homes. The scheme appears to offer buyers access to higher loan-to-value mortgages at similar terms to the mortgages available for existing homes though the small print suggests that not all property types and locations will be covered. While welcome to housebuilders and buyers, the solution highlights the continued reluctance of lenders to offer higher loan-to-value mortgages on new-build. Hopefully the trends highlighted by this research have been factored into the development of the scheme.

There are of course opportunities for housebuilders to create more sustainable new-build premiums that decay slower and, therefore, present less concern to lenders. This would mean building in features that more permanently advantage new homes in comparison with the existing stock. Here, the environmental agenda should help housebuilders, as much of the existing stock needs substantial investment to bring it closer to net zero. How this pans out will rest very much on public attitudes to improving the environmental performance of their homes, how much pressure is put on them to act, and on the path of household energy bills.

Fig 6: Private Housing Delivery

Source: MHCLG - England



Ultimately, this situation suggests the need for greater understanding of what is driving the under-performance of new-build homes over time. Our analysis has clearly shown substantial variation in terms of location and property type. This suggests there may be opportunities for further analysis of new-build resales to identify what helps preserve their value. This knowledge could then be used to help educate lenders and enable them to take more informed approaches to lending on new-build homes.

Appendix - Creating a House Price Index

To undertake our analysis of new-build premiums over time, we needed to create our own house price indices. These would provide a benchmark for changes in existing local house prices that we could then cross-reference new-build homes against. We could simply use the ONS indices but, due to differences in methodology, we were not certain that they would be appropriate. To create our own indices, we used HM Land Registry price paid data to create matched pairs of sales and perform a repeat sales regression. This was the approach previously used by HM Land Registry, but the ONS published house price indices now include other data sources that allows them to use a hedonic regression model.

Our repeat sales regression model is simpler and involves identifying properties that have sold two or more times since the data started in 1995. Knowing the initial purchase price, sale price, and holding period, we then filtered the data to exclude any properties that had sold as new-build during the period or been held for very short periods (six months or less). Once we had created a dataset of matched sales for the area in question, we used the modelling software R to perform the actual regression. The results for Milton Keynes are shown opposite compared to the ONS published index. It appears our repeat sales regression closely matches the ONS published data so perhaps we could have saved some effort, but it is a useful test and allows us to create house price indices for bespoke geographies.

Fig 7: Price Index, Milton Keynes

Source: ONS, HM Land Registry, BuiltPlace