7th January 2022

Market Commentary

Residential Analysts

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United Kingdom – 2021 Review

- **Transaction Taxes & A Tax Cut For The Top End**
- **The Credit Crunch & Levelling Up House Prices**
- **Supply Squeeze & Looking Ahead**

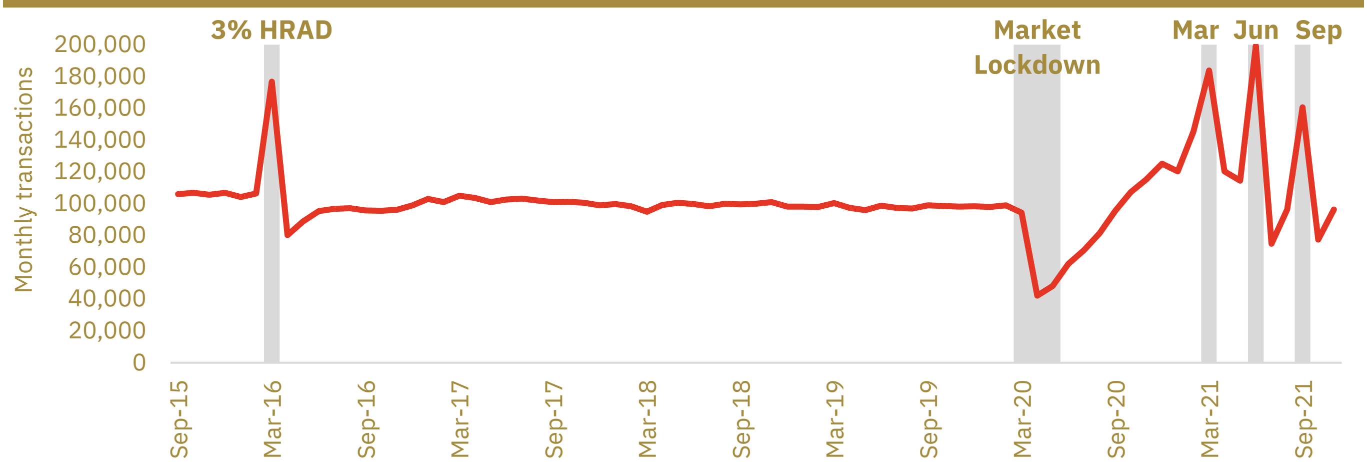
The housing market in 2021 was full of stamp duty deadlines, soaring transactions, and rampant house price growth. The top end of the housing market boomed while first time buyers struggled thanks to a credit crunch and renewed interest from buy-to-let investors and second home owners. The housing market now faces a supply squeeze with a lack of homes available for sale while the threat of rising interest rates looms large. This note provides a brief review of the housing market in 2021 and looks ahead to what might happen next.

Transaction Taxes

The start of 2021 was dominated by the rush to beat the stamp duty holiday deadline at the end of March. Housing market activity had quickly recovered from the market lockdown in early 2020 and transactions were rising rapidly by the end of the year. As 2021 started, there were already record numbers of sales agreed trying to beat the tax deadline, with the added complication of a lockdown constraining capacity in the house buying process. There was also uncertainty about what would happen when the stamp duty holiday ended and support for the economy was withdrawn. It was still not clear how much of the strong housing market activity was simply due to the tax cuts and whether other drivers such as the race for space and the roll-out of the vaccination programme would continue to support the economic recovery and higher levels of activity in the housing market.

Fig 1: Residential Transactions - UK

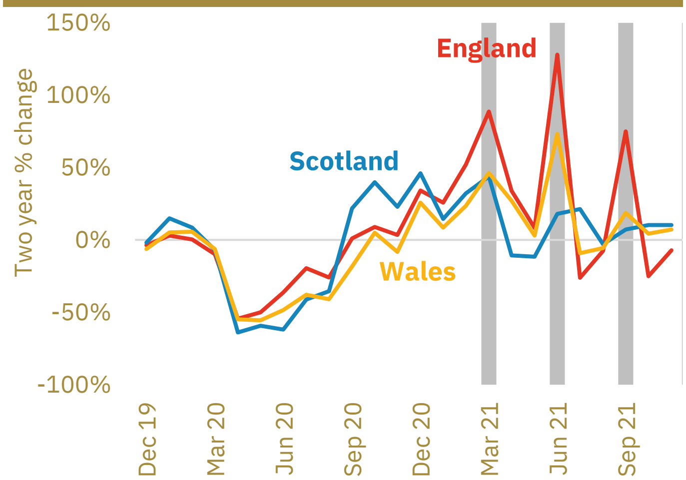
Source: HMRC – seasonally adjusted



The original March deadline for the tax holidays to end was shared across the UK. But, following widespread reports of large numbers of sales agreed unable to complete and the threat of a collapse in transactions in the following months, the Chancellor announced a late extension of the stamp duty holiday in England & Northern Ireland at the Budget in early March. The Welsh government also extended their deadline. However, the Scottish government held firm and it was the only one that ended in March. The Welsh tax holiday was extended through to June. In England and Northern Ireland it was extended through to September but with a tapering in June with the tax-free threshold falling from £500,000 to £250,000. These tax deadlines have had massive distortionary effects on housing market activity in 2021 but the differences between England and Scotland since March (Fig 2) offer some clues to what might have happened in its absence.

Fig 2: Transactions by Country

Source: HMRC – not seasonally adjusted



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A Tax Cut For The Top End

The stamp duty holiday has regularly been blamed for the high transaction levels and rapidly rising house prices recorded across the UK in 2021. While it undoubtedly bears some responsibility for what happened last year, rising house prices in multiple countries (including Scotland since March) suggest other factors such as the race for space and low interest rates have also played a part. The exact impact each of these and other drivers of housing demand have had on the market will no doubt be subject to future academic research.

Fig 3: Transactions Indexed by Price Band

Source: HMLR – England & Wales

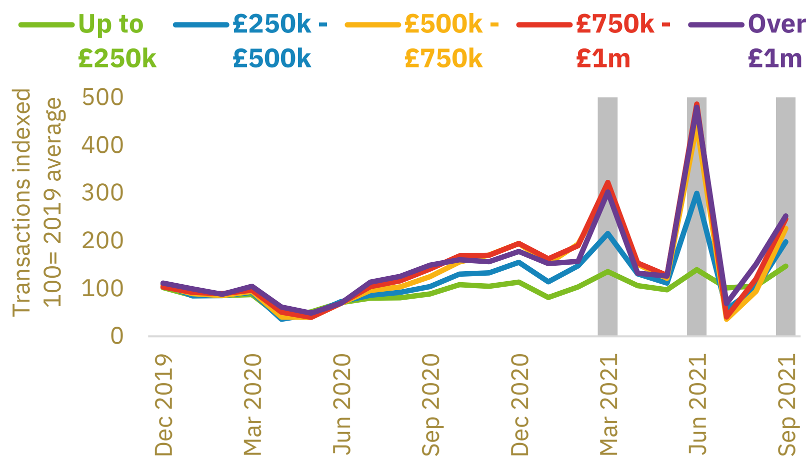


Fig 4: Transactions Indexed by Rural-Urban

Source: HMLR , ONS - England

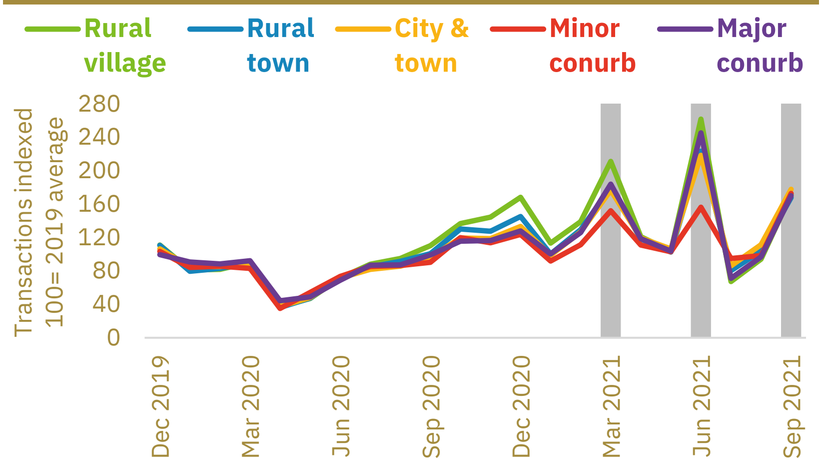
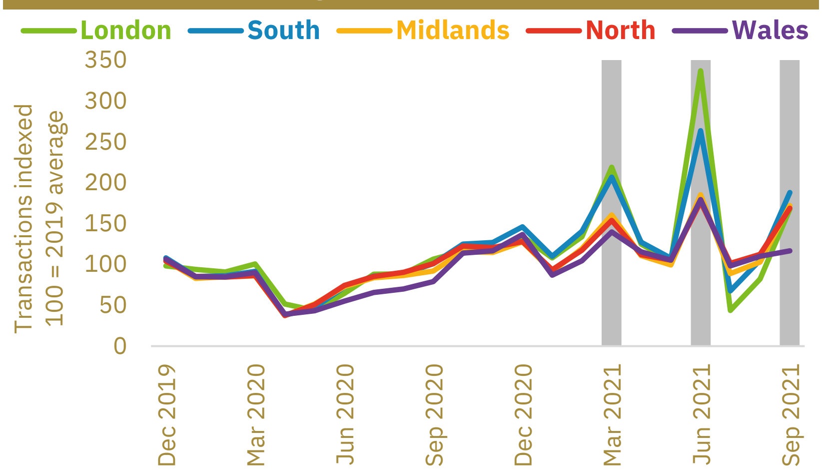


Fig 5: Transactions Indexed by Region

Source: HMLR, DLUHC – England



In the meantime we have updated our analysis of how different types of transactions were affected by the multiple tax deadlines in 2021. The data for the latest two tax deadlines is still a partial sample but we have grossed it up using other sources so it can provide a useful guide to the first nine months of 2021.

Although the stamp duty holidays were targeted at the mid to lower end of the housing market (e.g. under £500,000 in England), analysis of transactions by price band (Fig 3) shows the greatest impact relative to the 2019 pre-pandemic trend was actually for those homes selling for prices above the tax-free limit. These transactions were still liable for stamp duty but had a much lower rate then prior to the holiday as they still benefited from the tax-free amount. As a result, in both March and June, the biggest spikes in transactions were for homes selling above £500,000. When the tax-free limit was reduced to £250,000 from July to September in England and Northern Ireland, there was still a large rise in transactions across all price bands though the variation across them was lower.

Another popular housing market narrative since the pandemic hit has been the flight of home buyers to the country. Our analysis in Fig 4 appears to confirm this trend with a stronger rise in transactions in locations classified as "rural villages". This trend continued through the first two tax deadlines in 2021 but there was also an increase in transactions in major conurbations. This reflects an increase in transactions in London (Fig 5) which is perhaps surprising given both the flight to the country and race for space narratives. However, most homeowners moving to the country would also have sold a property in London. The housing market in London had also stagnated prior to the pandemic which may also account for the larger bounce back relative to the 2019 trend in transactions.

In summary, it appears the stamp duty holidays (at least in England) were a tax cut for the top end of the housing market with large numbers of investors and second home buyers also taking advantage of the savings.

The Credit Crunch

The housing market was booming in early 2021 but there was one group of buyers that were finding it tougher than normal: first time buyers. Although the housing market was booming, there was still widespread concern about future house prices when the stamp duty holiday ended and support for the economy was eased. Lenders reacted to this uncertainty by cutting back on their riskiest lending and this primarily affected first time buyers.

The reduction in risky lending resulted in the rising cost and reduced availability of high loan-to-value (LTV) mortgages. This situation mostly affected first time buyers with small deposits though self-employed and other higher risk borrowers also struggled to get a mortgage during this period. The impact of the credit crunch is apparent in the collapse in the volume of high LTV mortgage lending (Fig 6) and the rapid increase in average quoted mortgage rates on high LTV mortgages (Fig 7).

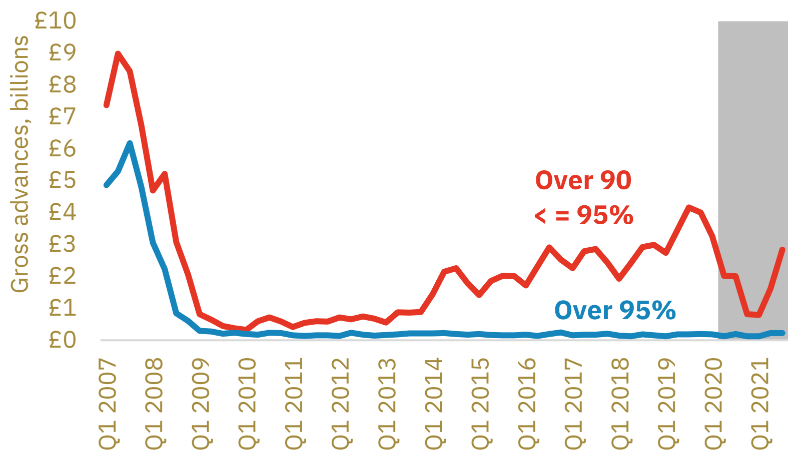


Fig 6: High Loan-to-Value Lending - UK
Source: BoE/FCA MLAR

Despite the collapse in high LTV lending, total first time buyer numbers were initially unaffected but they began to struggle during early 2021. Initially, many prospective first time buyers managed to save more than usual during lockdown and so, along with a temporary shift to higher income buyers, the number of first time buyers recovered in line with the wider market during 2020. However, the stamp duty driven growth in mortgaged mover numbers during the first quarter of 2021 (Fig 8) was not replicated by first time buyers. This reflected both the tightening of the credit crunch and first time buyers being crowded out by investors thanks to the stamp duty holiday. The housing market might have been booming in early 2021 but prospective first time buyers were struggling to buy a home and rents began to rise outside of London.

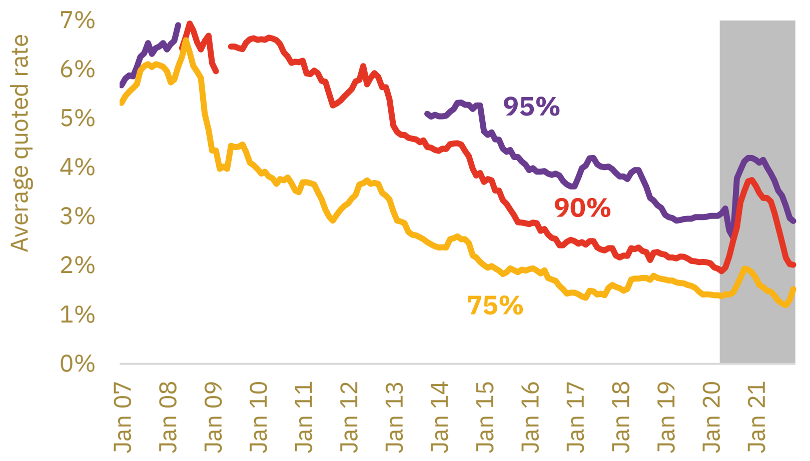


Fig 7: Mortgage Rates by Loan-to-Value Ratio - UK
Source: BoE

The Budget on the 3rd of March brought news that the stamp duty holiday was being extended in England and Northern Ireland but it also marked the end of the credit crunch. The introduction of the Mortgage Guarantee Scheme was a repeat of the original Help-to-Buy scheme launched in 2013. Although initial data on the number of mortgages supported by the scheme has been disappointing, its primary role was to reassure mortgage lenders by the signalling of the government taking a stake in the housing market. Lending at higher LTVs has since recovered (Fig 6) while average mortgage rates have fallen back to pre-pandemic levels (Fig 7). This has led to a recovery in first time buyer numbers (Fig 8) though the challenges that many prospective first time buyers faced prior to the pandemic still remain, and in many cases have worsened thanks to higher house prices.

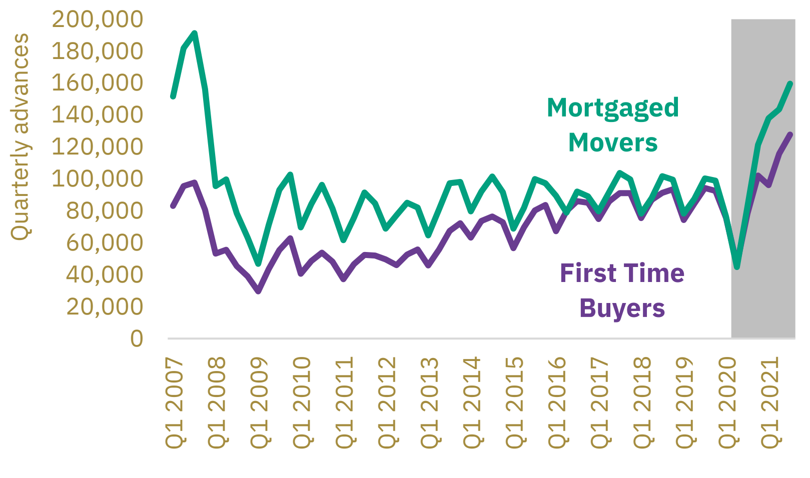


Fig 8: Mortgage Advances by Buyer Type - UK
Source: Calculated using BoE/FCA MLAR & ONS RMS

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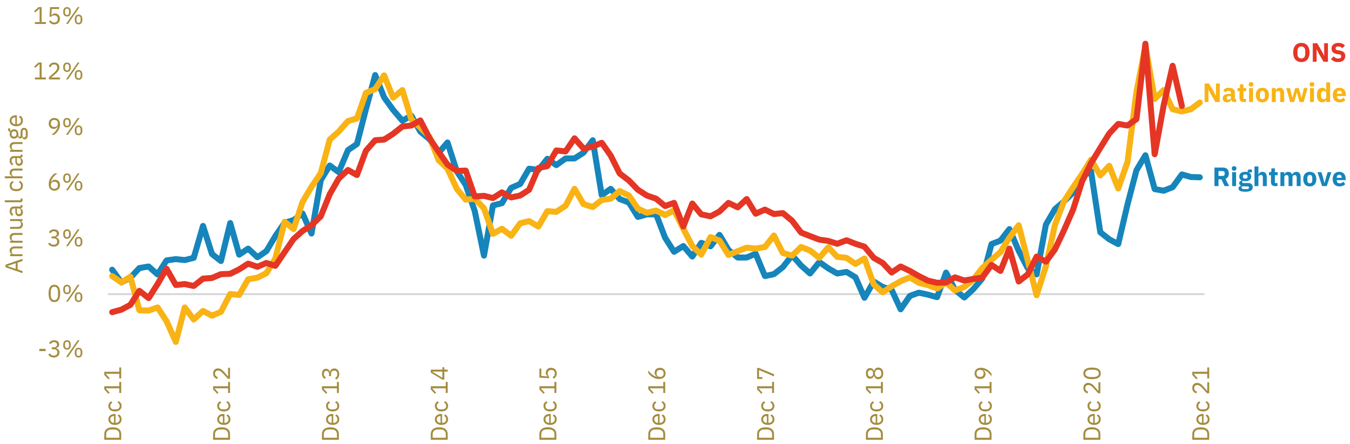
Levelling Up House Prices

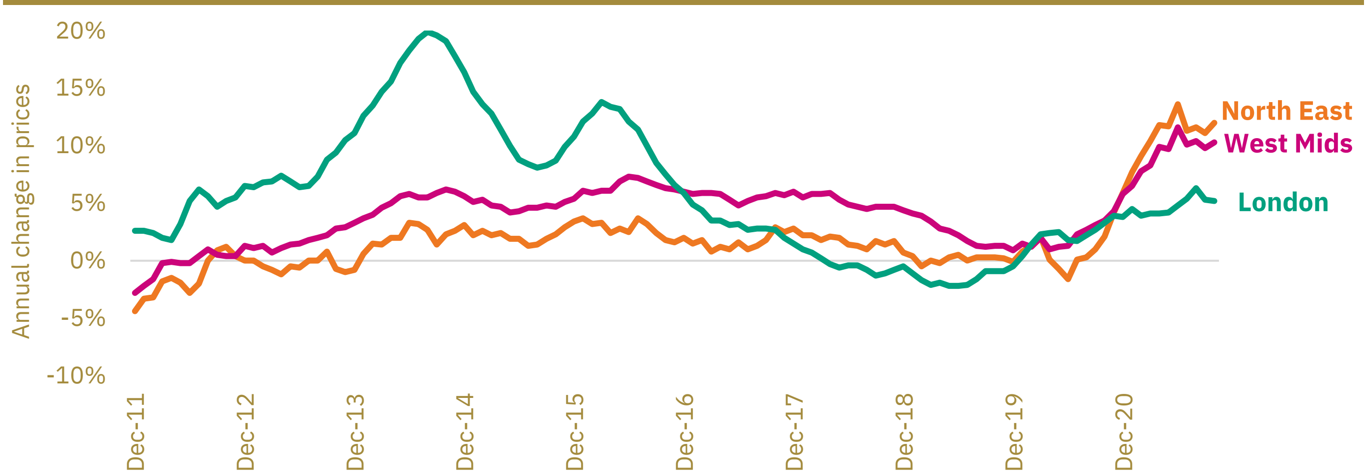
Housing market transactions and house prices tend to be positively correlated and 2021 was no exception. Periods with rising house prices tend to also see an increase in transactions while both tend to fall together during a market downturn. However, it's not always clear which one leads the other and there are plenty of feedback loops between the two that can complicate the relationship. Given this relationship, it's no surprise that in a year with the highest number of transactions since 2008, house prices also increased by their fastest rate in over ten years. Although house price growth has slowed slightly since its peak in June, most major house price indices are reporting growth of between 6% and 10% by the year-end. The range of year-end estimates reflects differences in how and what the various house price indices measure, and there is some geeky debate about whether the changing mix of transactions since the pandemic has inflated some indices relative to others. Irrespective of these minor issues, it is clear that house prices defied early expectations and rose rapidly during 2021.

Fig 9: Annual Change in UK House Prices
Source: ONS, Nationwide, Rightmove



The positive relationship between transactions and house prices might have held at a national level during 2021 but there was an inverse correlation when looking at lower levels of geography. As highlighted earlier in the report (Fig 5), transactions increased most at the top end of the market, particularly in London and the south of England during 2021. However house prices have risen fastest in the midlands and north of England over the same period, with London reporting the slowest growth of any region (Fig 10). This pattern in house prices appears to be a continuation of the pre-pandemic housing market cycle. Affordability in London and the south of England was already stretched with limited capacity for mortgage lenders to increase lending multiples. Therefore lenders were increasingly targeting more affordable markets outside the south of England that typically require smaller deposits and offer more room to increase loan-to-income multiples under the 4.5x income soft-cap. Despite the continuation of the pre-pandemic market cycle, the ratio of house prices in London to those in the North-East has only fallen from 3.9 times in 2017 to 3.4 times in 2021. That's still well above the 2.1 recorded in 2009. It appears the housing market cycle has some way to go before homeowners in the north of England see a similar house price windfall to the one homeowners in the south have already benefitted from over the last ten years.

Fig 10: Annual Change in Selected Regional House Prices
Source: ONS – three month moving average



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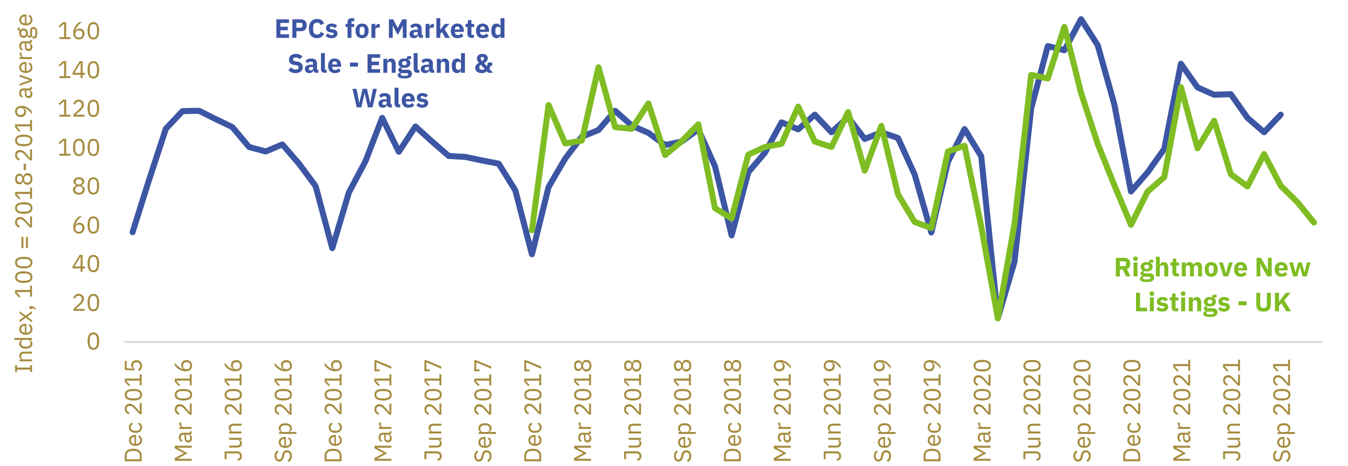
Supply Squeeze

One of the contributing factors to the current high levels of house price growth has been a squeeze on the supply of homes available for sale. The housing market lockdown in spring 2020 inevitably led to a sharp drop in the number of new homes being listed for sale but this situation rapidly reversed when the market reopened in the summer. With large numbers of existing homeowners looking to move, the autumn of 2020 saw a very large number of homes being listed for sale (Fig 11). The amount of stock available for sale on the market rapidly increased, peaking in November 2020, and in turn encouraged more buyers to make a move. However, the situation in 2021 has been more fragile. The recovery in first time buyers and purchases by investors and second home owners have rapidly reduced the number of homes available for sale. The situation heading into 2022 is severe with Rightmove, Zoopla, and RICS all warning about low levels of stock available for sale. Estate agents and prospective buyers will be hoping that the coming months bring more owners looking to sell their home.

Fig 11: New Stock For Sale

Source: DLUHC, Rightmove (based on sample size for house price index)

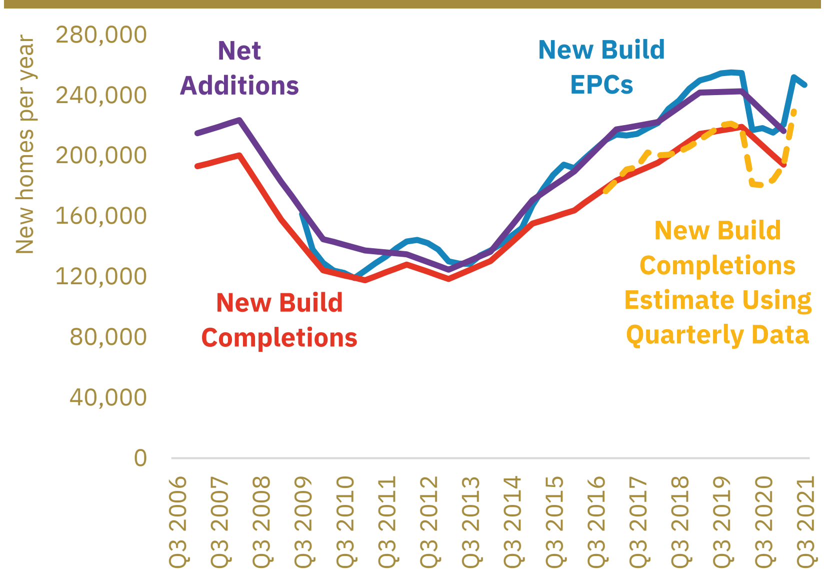


The new build market appears to have benefitted from the lack of homes available on the wider market in 2021 though it has perhaps failed to make the most of the situation. The latest comprehensive supply data from DLUHC showed a fall in the 2020/21 financial year, as it covered the period of the 2020 housing market lockdown. However, leading indicators suggest the market has recovered back to previous levels. Energy Performance Certificates on new build homes tend to provide a leading indicator for net additions and suggest they had recovered to 245,000 homes in the year to Q3 2021. Meanwhile, the quarterly DLUHC housebuilding data suggests new build completions rose to 230,000 in the year to Q2 2021. This would be a record high but there's no sign of any stamp duty induced spikes in delivery to match wider housing market activity.

This perhaps highlights the challenges faced by housebuilders when faced with rapid changes in the scale, type and location of demand for housing. Housebuilders had been preparing for the post Help to Buy market with smaller and cheaper homes, while the pre-pandemic market cycle pointed towards stronger demand in the midlands and north of England. Instead, as our analysis shows, transactions have risen fastest for more expensive homes in the south of England. This has helped some housebuilders complete existing sites but there's little sign of the sector preparing for large scale future growth, especially given the uncertainty around the government's planning reforms. Meanwhile, the building safety crisis continues to cause problems for the higher density flat developments though other parts of the new build market such as Build to Rent have continued to grow.

Fig 12: New Housing Supply - England

Source: DLUHC,



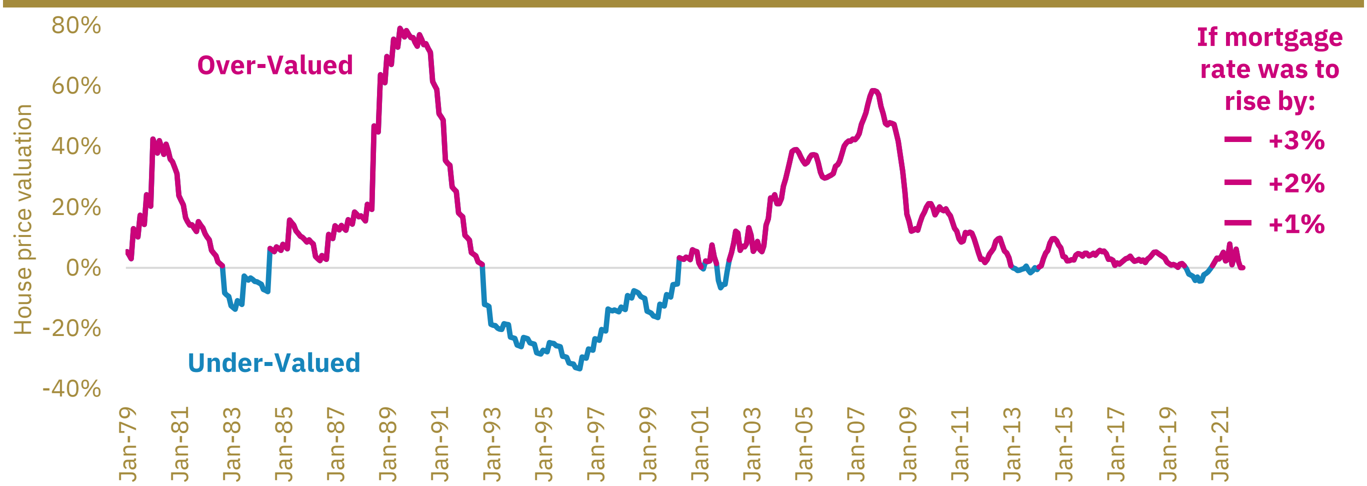
Looking Ahead

It appears highly unlikely that 2022 will see a repeat of 2021 either in terms of house price growth or transaction levels. However, the outlook for 2021 this time last year was highly uncertain and the outcome has surprised many people on the upside. While the uncertainty in 2021 was around the timing of the stamp duty deadlines and withdrawal of economic support, the uncertainty for 2022 is mostly focussed on what happens to interest rates.

Our simple of model of house prices based on underlying mortgage rates and earnings suggests that, despite the rapid rises this year, house prices are currently reasonably valued. However, an increase in mortgage rates could quickly lead to the market being over-valued at current house price levels (Fig 13). However, house prices appearing over-valued in the model would not necessarily lead to a correction. The majority of existing mortgage holders are well insulated from any immediate increase in mortgage rates given the high proportion on fixed rate mortgages, and increasingly on five-year rather than two-year fixed rate periods. Additionally, current affordability criteria and mortgage regulation suggests recent buyers are well placed to cope with higher mortgage rates.

Even if rising mortgage rates began to put stress on borrowers, lenders and policy makers have already shown their willingness to avoid transferring that stress onto the housing market through large numbers of forced sales. Instead, it is likely to be the sales market where the most stress is felt from rising mortgage rates and the higher cost of living. Most existing homeowners will be unwilling to accept lower offers due to price anchoring while a smaller proportion of the public will be able to afford to borrow the necessary amount they need to buy at higher mortgage rates. That suggests the most immediate casualty of higher mortgage rates is more likely to be transactions than house prices. In the meantime, the last ten years has regularly threatened rising interest rates but, so far, they are yet to materialise. If they don't, 2022 could be another record breaking year for house prices.

Fig 13: Actual House Prices Compared To Modelled House Prices – UK
Source: ONS, Bank of England



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37 Great Pulteney Street, Bath, Avon, United Kingdom, BA2 4DA, Company number 10502989