One million new home-owners

A proposal for an intergenerational rent-to-buy scheme

Michael and James Bartholomeusz
February 2018

Executive summary

The UK is in the grip of a housing crisis, one aspect of which is the gap that has opened up between older home-owners and younger renters. A generation ago many people on middle incomes enjoyed a good prospect of owning their own property. Today, many in stable jobs – nurses, teachers, office workers – cannot hope to do so.

This paper proposes a new intergenerational rent-to-buy scheme that could help redress the problem. A small portion of the wealth of older generations held in pension funds (estimated to total over £2 trillion) would be invested in a social impact housing fund. This fund would provide mortgage loans to help renters with an established payment record purchase a share in their home. As well as providing greater security of tenure, renters could begin to build an ownership stake in a home, as previous generations have done.

The key to making a rapid impact would be to enable a market in shared ownership of existing residential properties. It is estimated that there are in excess of five million residential properties currently being rented in the UK. If 10% of these were targeted for shared ownership between tenants and landlords, assuming an average of two adults per household, an additional one million renters could start building an ownership stake in their home. This would require a redirection only around 2% of total pension fund investments. At current rental yields (around 5%) and mortgage rates (around 3%) renters' overall housing costs would be reduced.

When sufficient equity in the property has been build up, the initial mortgage loan could be re-financed with a remortgage from a conventional lender, which in turn would redeem the initial pension fund investment. Landlords could use the proceeds of a part-sale of their rental properties to invest in another shared ownership property, enabling other renters to purchase a share in their home as well. Landlords also benefit by being able to spread their portfolio risk across more properties, whose occupants bear an ownership incentive to look after the property.

The scheme would not only help address a major current challenge, but it would work in the commercial interests of all parties. It would require no additional public spending and would complement other essential measures, principally an increase in the supply of new homes.

The UK is in the grip of a housing crisis. A great divide has opened up between those who own a home and those who do not, with bridges to home-ownership increasingly narrow. In the 1990s it took on average three years to save for a deposit; today, it takes 20. At the same time, one-tenth of the adult population owns two or more homes, while four-tenths own no home at all,[1] yet rental yields are around double the level of current mortgage rates. Meanwhile, the proportion of people renting homes privately has increased from 8% to 19% at the same time as low-income tenants' spending on rent has increased by 33%, from an average of 21% to 28% of their wages. The situation is even more acute in London, where the proportion has increased by 53%.[2] The inequality between those who own a home and those who do not has the potential to cause significant social and economic damage if left unchecked.

The dramatic fall in home-ownership has a number of causes. Property prices have inflated hugely in the last few decades, the result of population growth, a chronic lack of new supply on the market, and investor flight to the comparative shelter of the property market in the wake of the financial crash. With high deposits needed to access an affordable mortgage and rental costs taking up a higher proportion of household incomes – while those incomes stagnate – even middle-income households are struggling to make the leap to owning their own home.

Thanks in part to tireless campaigning by groups like Shelter, the housing crisis has finally made it onto the political agenda. In particular, since the millennial generation made its first major electoral impact in June 2017, political attention has focussed on winning the support of the victims rather than the beneficiaries of the crisis. While some initiatives such as help-to-buy and the lifetime ISA have been launched over the last few years, these alone can by no means address the burgeoning housing need. The central component of any new housing policy must be a significant increase in supply of the right sort of homes in the right places across the country, and modern prefabricated housing is a welcome addition to the range of solutions. Nevertheless, a novel approach to housing finance could complement these interventions and help many more people become home-owners. With a new intergenerational rent-to-buy scheme, we estimate that up to one million people could become home-owners over a relatively short period.

The key innovation would be the creation of a not-for-profit social impact housing ownership fund (SIHOF). The SIHOF would issue bonds to pension funds, thereby tapping into the wealth of older generations, using the proceeds to purchase shares in homes. (This could be seen as an extension of help-to-buy to a portion of the five million households currently renting privately, but funded by private pension funds rather than public spending.) Returns to investors would be at market rates for comparable financial instruments. The scheme could be implemented on a significant scale relatively quickly, and would exist for a predetermined period of time, say 25 years, at the end of which other measures such as a significant increase in new housing supply would have taken effect.

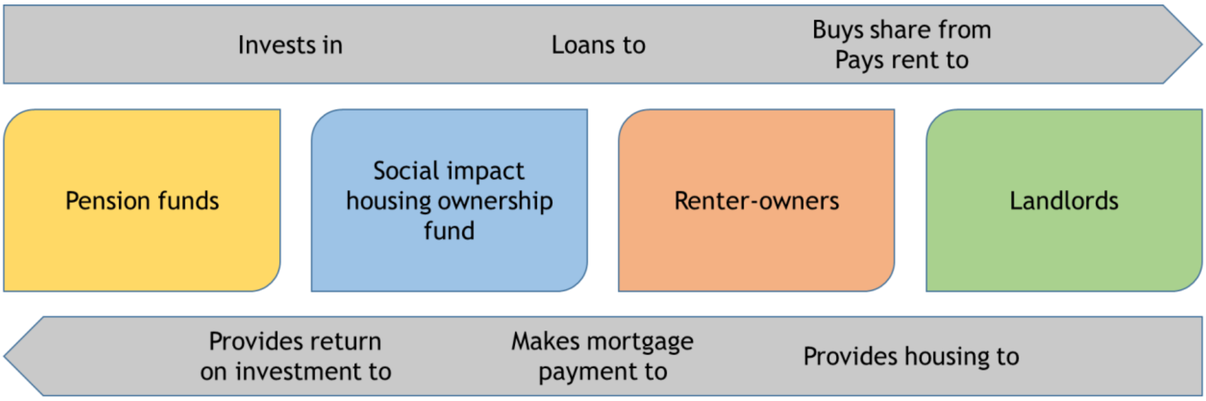

Figure 1: the process of the scheme

There is estimated to be more than £2 trillion held by defined benefit and defined contribution pension schemes in the UK. Assuming around 2% of that total (£50 billion) could be diverted to investment in the SIHOF - making it about the same size as a large building society - it could provide a £100,000 mortgage loan to 500,000 households of two working adults i.e. one million people. Taking an average residential property value of £300,000, this loan would allow renters to buy a one-third stake in a home. These renter-owners would continue to pay rent on two-thirds of the property to the landlord while paying interest on the mortgage loan to the SIHOF on one-third of the property.

The SIHOF would hold this debt for a limited time – seven years, for instance, representative of a typical housing market cycle in recent decades – after which the renter-owners would remortgage with a conventional for-profit lender such as a bank or building society, having built an equity cushion of their own. The SIHOF would therefore receive the principal in full after seven years (and interest along the way) and be able to repay the initial investment provided by the pension funds. Government support for the scheme over its life would ensure a good uptake by all parties - pension funds, mortgage lenders and private landlords - without the need to provide direct funding.

Consider a private rented property valued at £300,000, on which 5% rent is paid per annum. The renter might buy one-third of the property for £100,000 with a SIHOF mortgage. The new renter-owner would continue to pay rent to the landlord on two-thirds of the property, and pay a fixed interest rate of around 3% per annum (equivalent to current residential mortgage rates) to the SIHOF on one-third of the property for the seven year lifetime of the loan. The renter-owners would therefore pay less overall, around 4.3% of the full value of the property per annum.

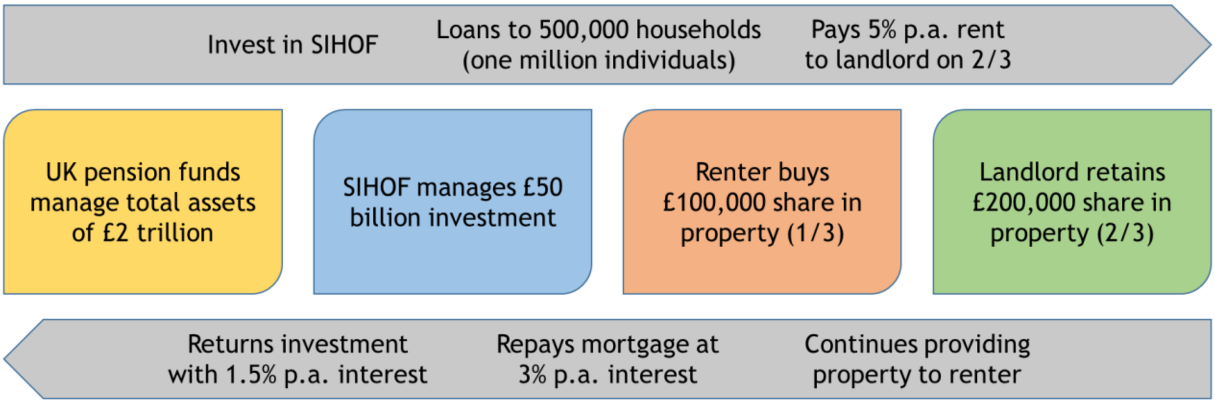

Figure 2: the potential economics of the scheme

A crucial question is what return pension funds would require to invest in the SIHOF. Even assuming a willingness among savers to accept lower returns for the sake of social impact, this level cannot be so low as to make the SIHOF an unattractive investment option. One answer would be to guarantee a return always higher than the seven-year gilt rate (currently around 1% per annum), the same duration as a SIHOF loan to renter-owners. The margin above that required by pension funds would depend upon the nature of government support for the scheme as a whole and the SIHOF in particular.[3]

If we assume a return of 1.5% per annum to pension fund investors, the SIHOF would retain 1.5% per annum (3% interest receivable on loans, less 1.5% payable on the investment). On a fund of £50 billion, this would amount to £750 million per annum to pay for the scheme, including administrative costs, loan losses, and investment in new social housing to help tackle another aspect of the housing crisis.

Another question is whether the scheme risks a further demand-led surge in property prices. This allegation has been made against help-to-buy and is potentially a valid one. However, this scheme would only act as a demand-side complement to the main policy objective of increasing the supply of new homes. Given that it will take some time to return supply to sustainable levels we cannot afford to reject measures that could widen access to home-ownership in the interim.

In order to mobilise commercial expertise and minimise market distortion the SIHOF would be administered on a not-for-profit basis by an existing mortgage provider, perhaps one of the major national UK lenders. Like any such lender, it would be regulated by the Financial Conduct Authority.

This is a scheme in which all parties gain some sort of benefit. Pension funds are able to make a secure investment while advertising their social impact credentials to society. Renters are able to overcome the financial hurdle to acquiring a stake in their home and feel more secure in their futures. Landlords continue to receive rent while stepping down (or spreading, if they choose to buy another stake in a property) their exposure to the market and the risk of their property portfolios. Conventional lenders are provided with a new remortgaging market bearing lower risk than lending to first-time buyers. And the government can take further steps towards solving the housing crisis while generating a surplus for reinvestment in additional housing supply.

In order to further develop the proposal for this scheme and make it a reality, we are looking to assemble a group of similarly motivated experts in the following areas:

- Pension fund management
- Residential property letting
- Shared home-ownership
- Mortgage regulation, underwriting and arrears management
- Residential property law, including to enable shared ownership of existing properties
- Estate agency, including to help create a secondary market in part-owned homes
- HM Treasury policy, including on government support and the macroeconomic impacts of property price changes
- Campaigns management, including to align with government policy

By applying this expertise together, we believe that a significant social impact can be delivered by widening access to home-ownership for the next generation.

The Jetram Partnership is a specialist UK financial services consultancy focussing on risk, governance and regulation. It produces commentary on the role of finance in the economy with the aim of making financial services work better for society. If you wish to further discuss the issues raised in this paper, please get in touch with the authors at *michael.bartholomeusz@jetram.co.uk* or *james.bartholomeusz@jetram.co.uk*.

[1] http://www.bbc.co.uk/news/business-40973859
[2] http://www.bbc.co.uk/news/business-41601455
[3] If an additional investment incentive is need to improve uptake, this rate of return could be combined with a capital gains tax reduction or waiver on profits from the scheme. The scheme may also prove tax-efficient for landlords. By selling an ownership share, they may be able to manage any capital gain within the annual allowances and spread these over the seven-year loan lifetime, thus reducing their tax liabilities.