Rebuilding the U.K. economy after the corona virus pandemic: a new Home Equity Release Method (U.K.HERM)

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By

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Introduction

In the U.K., at the time of writing, the corona virus pandemic has not reached its peak yet. Once it has, hopefully in the next couple of weeks or months, the recovery process can begin. With a nearly total lock down in place on many economic activities, the future for incomes, business survivals and the wealth of the U.K's citizens has and will come under a severe strain.

The U.K. government has promised a "Whatever it takes" cash injection into the economy. The real question is about a delivery on time and in the right format.

Just as an indication: the Footsie 100 stock index reached its peak this year at just over 7600 by the 17th January. Just about two months later, by the 19th March, the index had dropped to just under 5200; a drop of 31.6% in values in just over 8 weeks.

Another indicator, published by the Office for National Statistics (ONS) was the unemployment rate, seasonally adjusted for all 16 years and over. Over the period November 2019-January 2020 the unemployment rate reached a near long term low of 3.9%. One has to go all the way back to the same period in 1974 to find such a low unemployment rate. The corona virus crisis has and will change all this.

The Center for Economics and Business Research (CEBR) was quoted in a number of U.K. newspapers as indicating that the average home values will drop by £30,000 by the end of 2020; equivalent to 13% of such average values. The Royal Institute of Charted Surveyors in its monthly report indicated that for the next three months housing transactions have slumped to their lowest level on record,

How can the U.K. economy be rebuilt?

The answer may be in a wealth factor incorporated in the homes, owned and occupied by British households. The ONS publishes a bi-annual overview of such wealth factors; its latest report covers the period April 2016-March 2018. By March 2018 the owner occupiers' net worth was £5.1 trillion and the gross figure £6.26 trillion, which included the outstanding mortgage debt of £1.16 trillion.

With the U.K's 2019 GDP at £ 2.21 trillion, the net savings built up in U.K. homes of £5.1 trillion may well come to the rescue.

A new Home Equity Release Method (U.K.HERM} may be needed!

1. The current status in the U.K.

The U.K.'s lock down started on the 23rd March 2020. It was the day that life, as it was, changed completely. Many so-called non-essential businesses were closed. For those people lucky enough to be able to do their job from home, they were requested to do so. Overnight, for a lot of small, median and even large sized businesses, work completely stopped and incomes dried up. At the time of writing, there is no clear end date to this lockdown.

The risks for households are manifold. Firstly there are the health risks. The corona virus pandemic could affect anyone, hence the action on lockdown. It seems that only when an antivirus vaccine has been developed and produced on a large scale will there be a way back to life as before the corona virus outbreak.

Secondly there are the risks to incomes, savings and home values. The U.K. government has pledged to do whatever it takes to mitigate the financial hardship that nearly all households and businesses will experience. However at the end of the fiscal year 2019 (5th April 2019) the outstanding net government debt already represented 80.2% of GDP[1]. With the latest GDP level at around £2.21 trillion and an outlook for a declining GDP level for fiscal year 2020/2021, the government debt to GDP ratio would increase to probably close to 100% of GDP, under the assumptions as spelled out below by the Office for Budget Responsibility and the IMF.

According to the BBC[2]: The UK's independent tax and spending watchdog has warned the coronavirus pandemic could see the economy shrink by a record 35% by June. The Office for Budget Responsibility (OBR) said that this was based on an assumption that the current lockdown would last for three months. Once restrictions are lifted, the OBR expects no lasting damage to growth.

Separately, the International Monetary Fund warned the virus would push the UK into its deepest slump for a century. The IMF expects the UK economy will shrink by 6.5% in 2020, while the global economy will contract by 3%. It said the pandemic had plunged the world into a "crisis like no other".

The OBR's estimates - which focus on the virus's impact on the UK economy and public finances - are more severe. It said a three-month lockdown followed by three months of partial restrictions would trigger an economic decline of 35.1% in the quarter to June alone, following an expansion of 0.2% in the first three months of this year. The lockdown would push up the UK's borrowing bill to an estimated £273bn this financial year, or 14% of gross domestic product (GDP).

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[1] https://tradingeconomics.com/united-kingdom/gdp
[2] https://www.bbc.co.uk/news/business-52279871

This would represent the largest deficit as a share of GDP since World War Two. While borrowing is expected to jump, the OBR said the government's unprecedented financial help for workers and businesses would help to limit any long-term damage.

It expects half of the sharp drop in growth in the second quarter to be reversed in the three months to September as the economy starts to recover.

2 The corona virus pandemic

The most remarkable element of the corona virus pandemic is that it has affected the way in which each U.K. citizen has had to change his or her lifestyle, with the risk of being infected and the potential of not surviving the disease.

Such a massive change in social behaviour has not happened in well over a few centuries. The last major epidemic was the Great Plague of 1665-1666. Even war times required less social behaviour changes than those caused by the corona virus pandemic.

Why is this important in economic terms?

The external threat to life has already had and will have enormous effects on the U.K. economy, some of which have already been mentioned in the above.

For instance, what has a disease to do with mortgages, house prices and incomes? The answer can only be nothing and everything. Why should U.K. house prices be expected to drop on average by £30,000 this year as predicted by the CEBR? Before and after the corona virus crisis, they are still the same houses that each and everyone lives in. What the pandemic has changed for many households is their cash flow, not their homes.

The U.K. government has already offered cash flow help through a system of "furloughing" workers who temporarily cannot work till the lockdown period comes to an end. U.K. banks and building societies have already introduced a "mortgage holidays" period. The latter means don't pay now, but later.

However while such changes are very welcome in the short run, they do not solve the problem of more government debt in the long run, which needs to be repaid at some stage and the mortgages that grow bigger and also need to be repaid at some stage.

What is needed is a cash flow mechanism that is based on savings built up in the values of the housing stock: a U.K. Home Equity Release Method (U.K.HERM).

3. The loans that should be loans and those that should not

There is one element of a household's wealth that can be used, but is currently not being used effectively. To analyse this phenomenon, one has to understand how the banking world works. If an individual or a household wants to buy a first home –in contrast to some practices preceding the 2007-2009 financial crisis- at least a 10% down payment needs to be made in order to obtain a 90% mortgage. The mortgage amount acceptable to a bank is linked to the income –which means cash flow level- of the (family) household. The bank will furthermore require that the loan be linked to the property acquired. In case the customer defaults on the loan, the banks do give themselves priority over all other lenders to claim all outstanding monies back from the property and banks will evict the occupants from the premises.

So far this is the current practice.

A household's intention is generally to repay the outstanding mortgage loan over a fixed period, usually over 30 years for the lower and median income families. What these monthly payments do is to pay for the borrowing costs of the mortgage loan. Such costs have an interest and a savings element. The savings element is the equity base owned by the household. This equity element gradually grows from the 10% down payment to 100% after 30 years if all payments were made on time.

If a bank takes a risk on a customer by providing the 90% loan to acquire a home, it is logical that this loan is financed as a loan, to be repaid over an agreed period and in fixed amounts. Such loans should be loans.

However, there is another category of finance and that is based on the release of equity built up over time in a home. Such equity represents savings made during the lifetime of the original loan. The word "savings" already implies that the ownership of some of the property has shifted from the bank to the homeowner.

Households commonly undertake selling some part of their property. However, financial institutions generally only want to finance such action as a loan. An asset is turned into a liability. When an individual sells any other item to a third party, like a car or some jewelry, it is a cash transaction and not a loan.

Why is it that financial sector companies do not want to do this? The answer is simple. Banks only hold other peoples monies and these others expect a return over their savings they lend to a bank.

The main point is that macro economically speaking, banks are in a good position to finance the acquisition of a home when the prospective owner needs the 90% funding for completing a purchase. Banks are in a poor position to acquire the savings built up in home, as they have to use other peoples' savings in order to do so.

The latter transformation turns savings into debts, something that in no other use of savings is done. Cash in a current account in a bank can be withdrawn, without a penalty. However equity –i.e. savings- locked into the value of a home cannot be turned into cash through the banking system other than turning equity into debt titles. Such method is, economically speaking, inefficient.

4. A new U.K. home mortgage equity release method (U.K.HERM)

The U.K. Office for National Statistics produces bi-annual statistics on the savings levels incorporated in the home values. The latest Statistics are for fiscal years 2016-2018[3]. These statistics indicate that by 2018 the values of home property for the U.K were a net £ 5.09 trillion. The total value of outstanding mortgages was £1.16 trillion.

If one compares the £5.09 trillion with U.K.'s GDP for 2018 of £2.21 trillion, it is easy to conclude that the savings embedded in home values were 2.3 times annual 2018 GDP.

The question is how can these savings be mobilized, turned into cash flow and subsequently converted into consumer expenditure without any need for borrowings.

In a previous paper by this author[4]: "How home equity can be used to fight a recession. A U.S. case study", it was explained that the first priority can be to change the cash withdrawal mechanism from turning part home equity into cash. The same method can be used in the U.K.

The second priority can be that income levels could determine the level of savings to be converted into home equity. In the HERM method, lower incomes would lead to lower home-related payments. However one would still apply a fixed percentage of home-related payments out of the variable income levels. Savings in home equity could go up when incomes go up in high economic growth periods and savings could come down in recession periods. Dissaving –home equity withdrawal into cash- could be stimulated in recession periods.

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[3]https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/totalwealthingreatbritain/april2016tomarch2018#total-household-wealth-by-age-of-household-reference-person-hrp

[4] RePEc:pra:***mpra***:99037

The first priority is to change the cash withdrawal mechanism. If an individual household decides that there is more than 10% of equity in the property -owned and occupied by the household- and the household requires some cash, for instance in the current environment of a temporary loss of income, then in the current circumstances the only option is to take out a financial sector loan. In no other financial transaction, like selling shares or bonds or cars or other valuables, would the buyer not pay cash for the item that is handed over. The suggestion is that a part share of a home is treated equally to all other purchases and be paid for in cash.

The second suggestion is to simultaneously sign up the homeowner to agree to a payment ratio for the home of 28% of the monthly (or annual) gross income. This a recommended percentage, used by many banks in the western world.. However, the current practice is that banks fix the amounts to be paid on day one of the mortgage contract, irrespective of future income developments of the client. The HERM application can change this and allow a fixed 28% payment of a variable income level, to be verified by U.K. tax returns.

Can banks operate within these priorities? Highly unlikely! The experience with banks is that self-preservation has the priority. They will do what is good for their shareholders but this may be unsuitable for the macro economic developments. For instance banks cannot cope with monthly payments based on declining income levels. However such a payments structure provides households with a relatively higher level of spending power –cash flow- on consumer goods, when economic growth levels are in decline. Secondly U.K. banks do not buy part shares in a home; as such exposure will mean that the banks are exposed to housing market price risks. They prefer to relate a home loan payment just to income levels and therefore, for better or for worse, the payment risks are fully transferred to the banks' customers. This is fine for a starter mortgage, but not for a loan for a home equity conversion.

In conclusion system changes are needed to bring U.K. banks' customer interests in line with macro-economic interests. A new Home Equity Release Method is needed for the U.K.

4.1 How could a U.K. HERM be implemented?

The U.K. government could consider setting up a separate vehicle to accommodate the changes that could facilitate funding the purchase of parts of a home, once households own equity levels exceed 10% of the market price. Such a vehicle could be called: A Mortgage Debt Stability Fund (MDSF).

Why should the U.K. government consider the set up of such MDSF vehicle?

There are basically three reasons for it:

The first one is macro-economic. An MDSF, once established, is capable of buying up part shares in homes at a speed of its own choosing. In other words, when economic circumstances deteriorate, like in the current climate, it can open the window for households to transfer such home ownership elements to the MDSF and simultaneously support households with an additional cash flow. The MDSF can decide on behalf of the government, how much of a total money injection into the economy it wants to see. When such level has been reached it can slow down or even close the window again. Rather than expanding government expenditure levels, the request to obtain the HERM facility is made by private households. The latter are only likely to do so if they are in need of immediate cash for current expenditure. Private households will facilitate the boost to an economy, rather than the government doing so. As of December 2019 private consumption in the U.K. contributed for about 60% to GDP.[5] HERM represents a move away from Keynesian economics, whereby a government takes the initiative to stimulate an economy. In the HERM concept, individual households will stimulate the economy through using some of their savings incorporated in their homes.

The second element related to the MDSF is linked to the assets that are provided. Quantitative Easing, as the Bank of England has applied it, was directed at purchasing existing securities. This method changed the ownership of such securities from private hands into public ownership. What matters is what the individuals or institutions who owned such securities before, would do with the cash received. Most of these holders were or are already cash rich, so their incentive to spend the money received on consumption will be less than the one by a group of homeowners, who often have no other savings than their home equity. This is especially the case for lower and median income families. They should get priority from the MDSF. They are most likely to spend their home equity, converted into cash flow, on consumption of goods and services.

The third reason is that Quantitative Easing of this type does not incur costs to a government. The Bank of England creates the money. The benefit to the government is indirect. HERM will cause sales and income taxes to go up as part

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https://www.ons.gov.uk/economy/nationalaccounts/satelliteaccounts/bulletins/consumertrends/octobertodecember2019#household-final-consumption-expenditure-revisions-and-changes-quarter-4-oct-to-dec-2019 and parcel of the additional consumer spending levels. Lower unemployment levels will also help individual households as well as the wider economy.

Under the HERM scheme, a sale and buy-back arrangement for part units of homes can be implemented at 0% interest rates. Such arrangements help the U.K. economy to grow and pay more taxes. The latter will help the U.K. government to reduce faster its recently approved £ 65 billion additional government debt burden[6]. The latter amount has been pledged for fighting the effects of the corona virus epidemic. HERM is a win for households, a win for economic activities, including employment levels, a win for the U.K. government in its tax receipts and magically also a win for the banking sector as they will notice a much lower level of doubtful debtors as a consequence of this cash-flow method.

There is one operational element to be considered. Just funding the share of a home to be purchased by the MDSF will leave the rest of the mortgage loan in limbo. It would therefore be necessary to bring the whole remainder of the outstanding mortgage loan over from the existing lender to the MDSF.

The borrowers should make such a transfer request. Standard terms should be worked out for such transactions, but such terms should be neutral or generous to the borrowers, as banks have made mistakes in judging future income flows. No one could ever have foreseen a corona virus pandemic, but the result would still have been a credit risk misjudgment by the banking sector.

The mistakes made by U.K. banks during the previous financial crisis were less related to U.K. home mortgages, even though substantial sums had to be written off, but more with either the funding structure as in the case of Northern Rock or with the exposure to U.S. home mortgages either directly or indirectly through mortgage backed securities as was the case with Royal Bank of Scotland and a few others.

A transfer of mortgage obligations to the MDSF will have two implications: the first one is that among the transfers there will be a substantial number of households, who, due to no fault of their own, would have gotten into financial difficulties as a consequence of the lockdown. Notwithstanding the temporary relief of mortgage payments, they would likely have become doubtful debtors. Therefore such transfers to the MDSF will help banks. It will also help the customers as the new MDSF mortgage payments are related to income levels. The second implication is that banks save more equity capital and can thereby focus more fully on corporate lending, which will be vital during the recovery period.

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[6] https://www.bloomberg.com/news/articles/2020-03-26/u-k-s-sunak-pledges-coronavirus-support-for-self-employed

This only leaves the matter of house price valuation for the part purchase of home equity. The only reason that the forecasts are so negative for U.K. house prices is that they are totally linked to the corona virus pandemic. The U.K. government would do well to ignore this extraneous factor –something the banking world cannot do- and accepts that the normalized house prices would be the level of house prices of February 2020.

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