UK HOUSING CRISIS REPORT 2014

LET'S HOUSE BRITAIN.

The UK is short of houses. This is pushing up prices, making ownership unaffordable and driving people into temporary accommodation or worse, onto the streets. As one of the leading property investors in the UK we have an opportunity to help, so all of Britain has a place to call home.

EVERY DAY MATTERS.®

Legal & General

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EVERY DAY MATTERS.

Our aim is to build a company, that, every single day, becomes even better at understanding, serving and rewarding our customers and shareholders. To do this we must recognise that customers are at the heart of our business and, consequently, we must work hard to build long-term positive relationships with them.

SECTION 1: WHY HOUSING MATTERS.

The UK has had a housing crisis for about 25 years. Successive Chancellors from Tony Barber onwards have welcomed rising house prices: even the initial stages of successive housing bubbles felt good politically. The 2007 record for the highest house prices relative to earnings – over six times – is still held by Gordon Brown, but George Osborne is coming up fast. Prices have risen dramatically recently, particularly in London and the South, and home ownership is in decline, having become all-but unaffordable for younger people.

For homeowners of my generation, housing has been free – capital gains have far exceeded interest payments. Meanwhile, throughout my adult life, renting has been economically unattractive. Baby-boomers are sitting on huge, under-used housing equity, but we risk leaving our children a legacy of £1.3 trillion in government debt, £50bn of student loans, poor job prospects and unaffordable homes. Housing is an intergenerational issue.

Housing completions have fallen to historically low levels of around 125,000 per year (compared with post-war highs of around 400,000), and the National Audit Office has stated that there has been no consistent growth in private housing since 1970. So what can be done to address the supply-side challenges in the UK housing market?

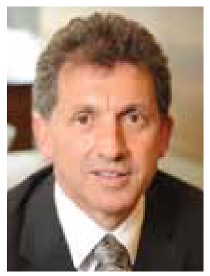
Planning reform is urgently required but is politically difficult to deliver; the process remains slow and is easily derailed. Help to Buy Two attempted to address affordability for homeowners, but risks further exacerbating the supply-demand imbalance as more money is thrown at the market. The UK risks a situation where the housing market becomes dependant on the props of state funding and guarantee, with withdrawal politically impossible.

We cannot expect demand to lessen. The desire for home ownership remains unabated. As a result, the private rented market has been slow to develop, and is largely a cottage industry. Short-term tenancies on high rents add to state welfare costs; there has been little to replace council housing in the social segment following the sell-offs of the early 1980s. Vast amounts of wealth (over £1 trillion for retired people alone) is locked up in UK housing without a supply of relevant properties to downsize to, or a functioning large-scale equity release market to unlock this value in order to offset pension saving (which, regardless of recent reforms, is itself too low to fund long-term care).

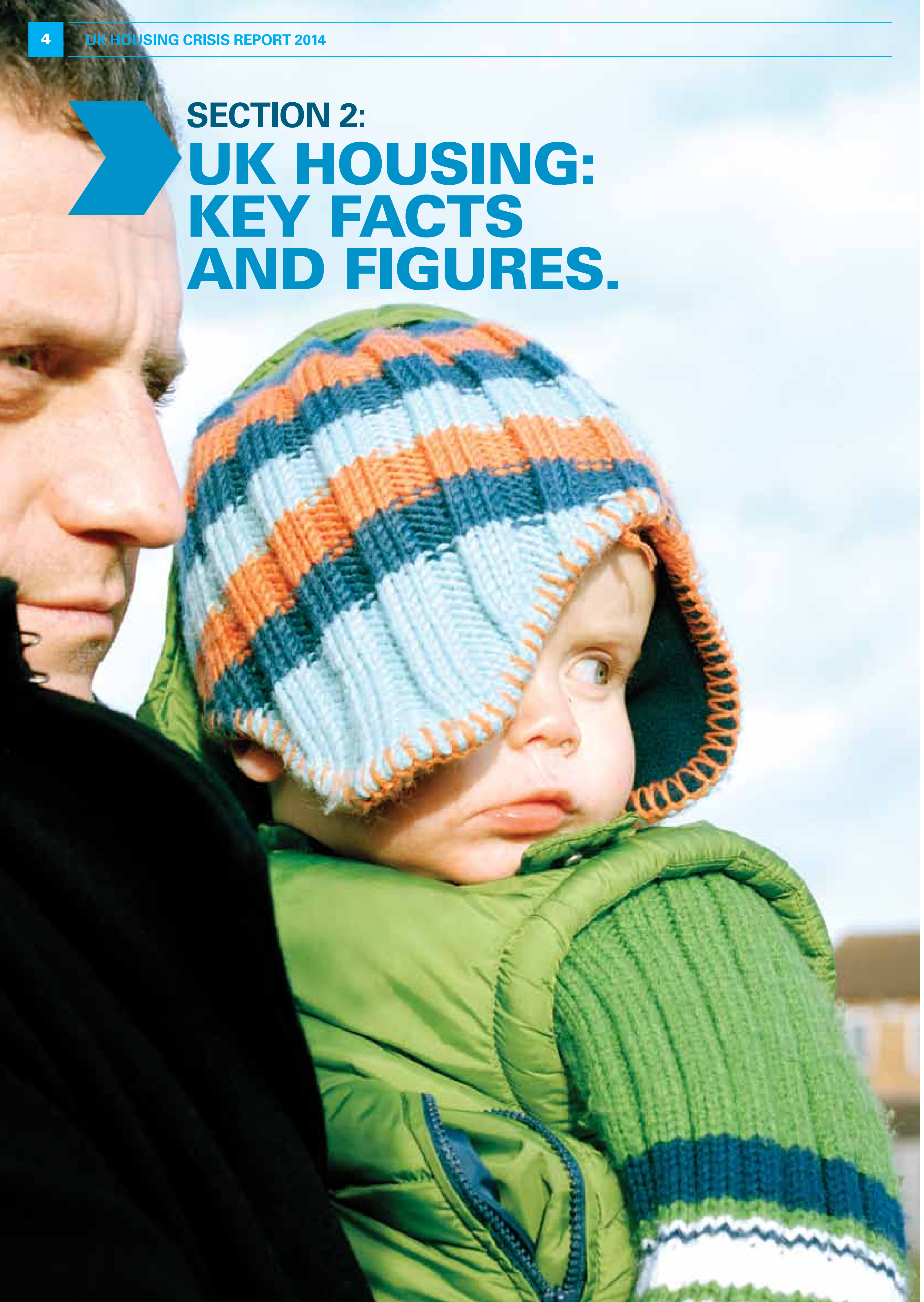
This complex, challenging picture needs to be viewed with sustainability in mind, through a holistic approach that integrates environmental impacts into economic decision making. Key environmental risks that need to be understood and managed include climate change, pollution, contaminated land, building design and energy use.

Against this backdrop, this timely paper summarises some of the key facts surrounding housing in the UK, hopefully provides some clarity to the main issues and offers recommendations based on Legal & General's view of the housing market's present and future challenges.

I hope it makes for interesting reading. We would welcome your feedback to **nigel.feedback@landg.com**



Nigel Wilson, CEO, Legal & General



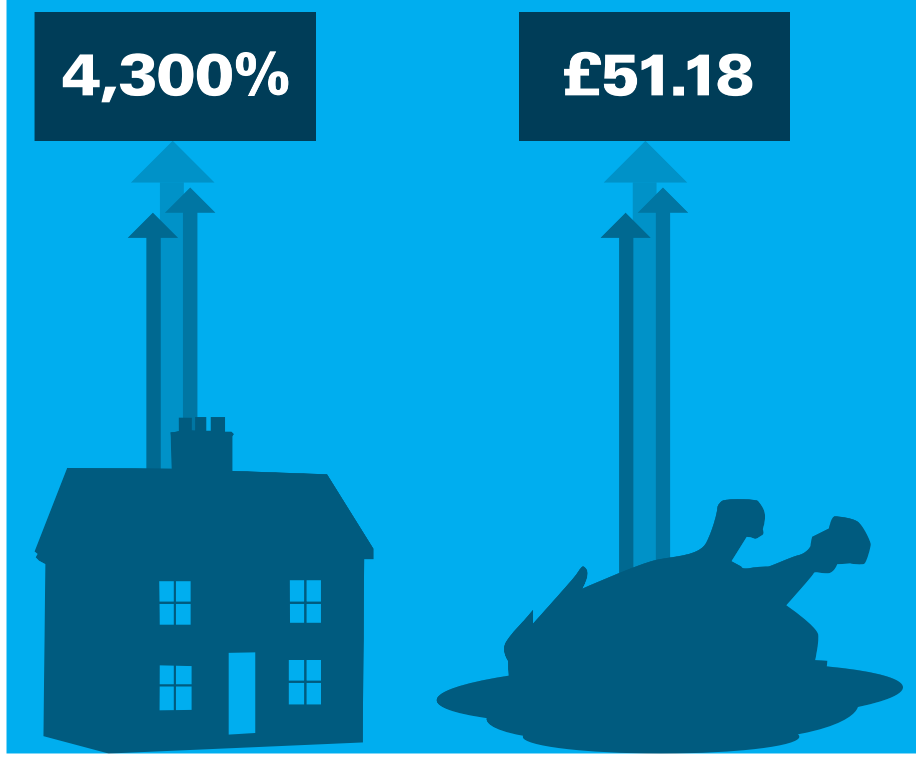
SECTION 2: UK HOUSING: KEY FACTS AND FIGURES.

IF WAGES HAD RISEN AS FAST AS HOUSE PRICES...

– A couple with children would earn an extra £44,000 a year
– A single person would earn an extra £29,000 a year
– A couple without children would earn an extra £59,000 a year.[1]

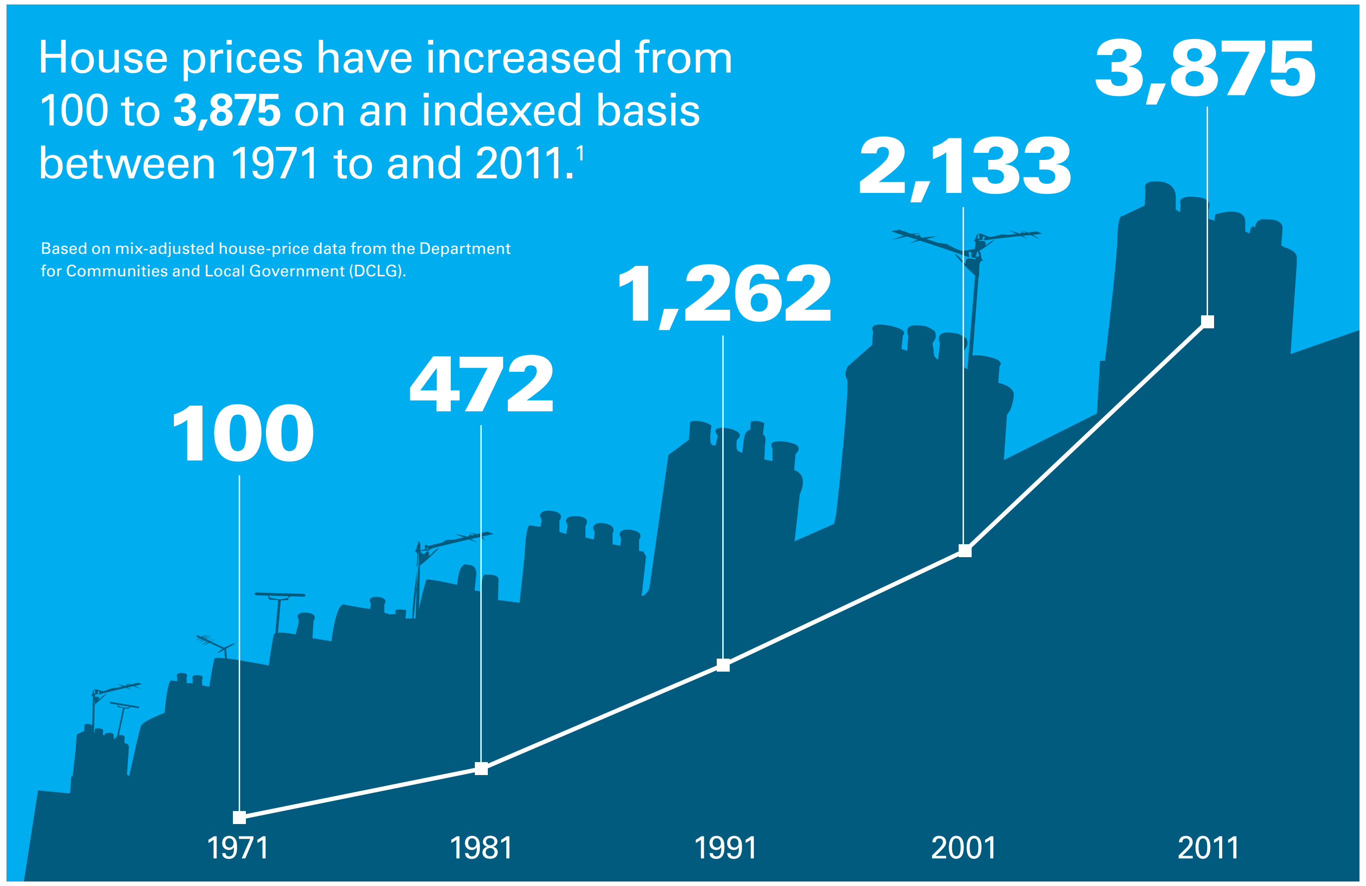
HOME STEEP HOME: THE RISE AND RISE OF PRICES.

House prices are a national obsession in the UK, and it is easy to understand why. For the vast majority of homeowners, where they live is their most valuable asset, with most relying on its value in order to live out a comfortable retirement. Over recent decades, sharp increases in house prices have seen buy-to-let investors make huge profits (on paper) on their initial investment, and even the 2008 financial crisis only temporarily stymied the seemingly inexorable rise in prices.



House prices have risen **4,300%** in the UK in the last 40 years. If the price of food had risen at a comparable rate over the same period, buying a whole chicken at a supermarket would cost **£51.18**.[2]

1. The house price gap – Analysis of house prices and earnings, Shelter, February 2014.
2. Food for thought: Applying house price inflation to grocery prices, Shelter, January 2013.

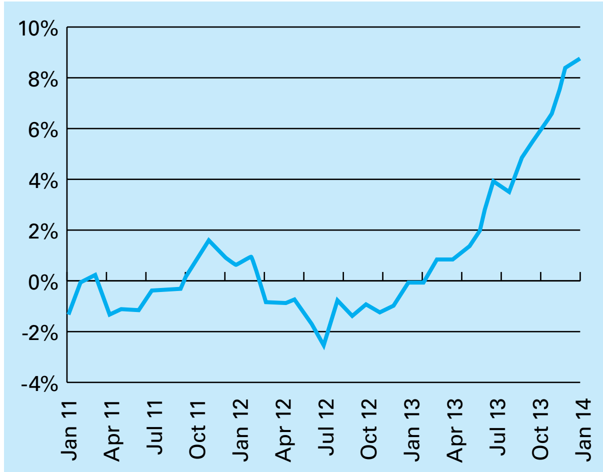


In real terms, house prices have **doubled** since the mid-1990s.[2]

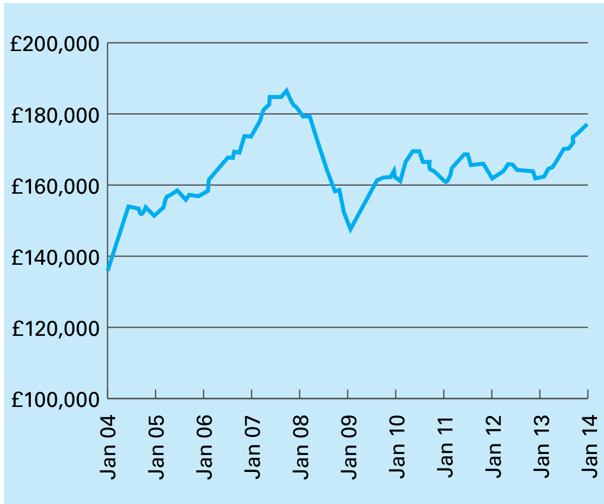
- Between 1975 and 1995, the average UK house price rose in real terms by 3.5%, but between 1995 and 2009 the average house price rose in real terms by a historically unprecedented **120%**: jumping from **£72,659 to £160,000.**[3]
- In real terms, between 1971 and 2001 UK house prices rose at over **twice the European average.**[4]
- Higher house prices have fed through to higher rents. Average private rents rose 64% between 1996-1997 and 2007-2008, despite the supply of rental properties rising 40%. Rents for government owned housing, social rents, which are linked to private ones, **rose by 57%**.[5]
- There is no sign of the rise in prices abating. Property values are already **5.7%** above their pre-crisis peak. Across England as a whole – where the average house costs 3.54 times the median wage in 1997 – by 2011, **a house cost 6.65 times the median wage**, barely down from the 2007 multiple of 7.23.[6]

1. Abundance of Land, Shortage of Housing, Kristian Niemietz, 10 Apr 2012.
2. The Economist house price indicators, Clicks and mortar. Our interactive overview of global house prices and rents, 2012.
3, 4, 5. Making Housing Affordable: A New Vision for Housing Policy, Policy Exchange, Alex Morton, ed. Natalie Evans, 2010.
6. Burning Down the House: Why Help to Buy will Ruin Britain's Housing Market, Preston Byrne, Adam Smith Institute, 2013.

- According to the Halifax House Price Index, January saw an annual increase of **7.3%**. The Nationwide House Price Index calculates an 8.8% annual increase over the same period. The Halifax House Price Index puts the **average house price at £175,546**[7], while the Nationwide House Price Index puts the typical UK home at **£176,491.**[8]



ANNUAL PERCENTAGE CHANGE IN HOUSE PRICES[9]



AVERAGE UK HOUSE PRICE[9]

MONTHLY UK HOUSE PRICE INDEX

UK house prices: July to September 2013

- Average house price: **£164,835**
- Detached: **£259,321**
- Semi-detached: **£155,744**
- Terrace: **£124,616**
- Flat: **£156,759**
- Total number of sales: **218,099**
- Annual change in house price: **5.1%**
- Quarterly change: **2.3%**

7. Halifax House Price Index, October 2013.
8. Nationwide House Price Index, January 2014.

THE BEST LAID PLANS OF LOCALISM...

Localism has been a key priority of the Coalition Government, particularly through the Localism Act 2011 and the Growth and Infrastructure Act 2013. However, translating policy into practice is proving difficult with local authorities failing to deliver on the expectations of central government.

Less than half of local authorities have a Local Plan, nine years after the legislation was passed that required them to do so.[1]

Less than half of local authorities will have a Community Infrastructure Levy charging schedule in place by the April 2015 deadline, creating a confusing, two-tier system of planning obligations.[1]

A NORTH-SOUTH DIVIDE.

Housing markets differ across regions, with the most unaffordable in London and the South East; however, the prohibitive cost for first-time buyers remains a national challenge. The ongoing practice of conservative mortgage evaluations in the North acts as another barrier, slowing sales and making developers more reluctant to increase supply. Successive government reforms have so far failed to abate the seemingly inevitable rise in prices; evidence suggests that its latest scheme – Help to Buy Two – will also fail in its bid to help first-time buyers.

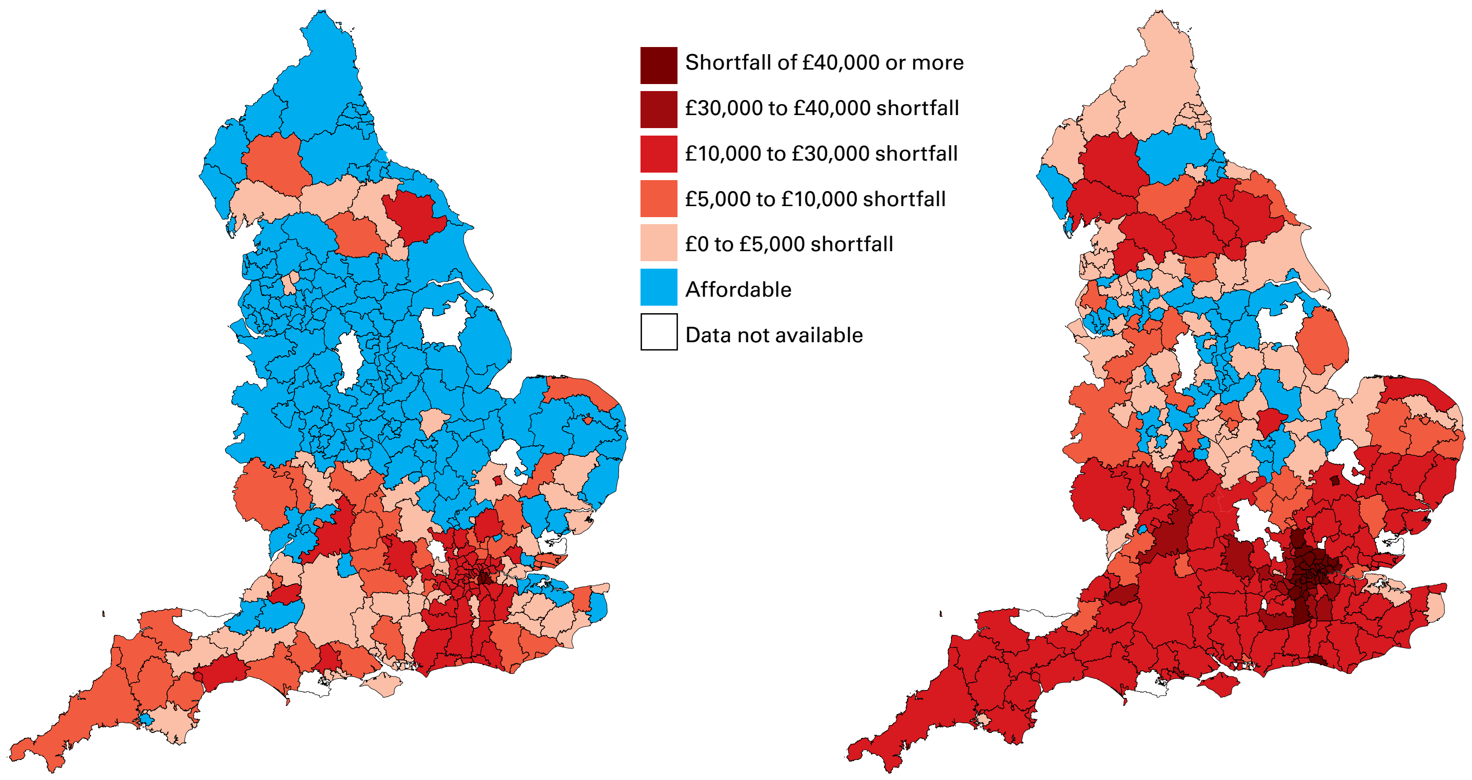
House prices are **more than five times** average earnings across each region of the UK and even more expensive in London and the South East.[2]

- Although all UK regions require significant housing investment, about a quarter of all the required new housing is likely to be concentrated in London, with **over 60%** in the four southern regions.[3]
- The Help to Buy Two mortgage indemnity scheme – which enables prospective buyers to take out a 95% mortgage up to the value of £600,000 – leaves many median earners unable to get on the housing ladder. **For those in the bottom quartile and tenth percentile the situation is largely hopeless.**[4]

1. British Property Federation key messages: planning and housing, October 2013.
2. Making Housing Affordable: A New Vision for Housing Policy, Policy Exchange, Alex Morton, ed. Natalie Evans, 2010.
3. New Estimates of Housing Demand and Need in England, 2011 to 2031, Town & Country Planning, Tomorrow Series Paper 16, Alan Holmans, 2013.
4. Homes for forgotten families: Towards a mainstream shared ownership market, Shelter, 2013.

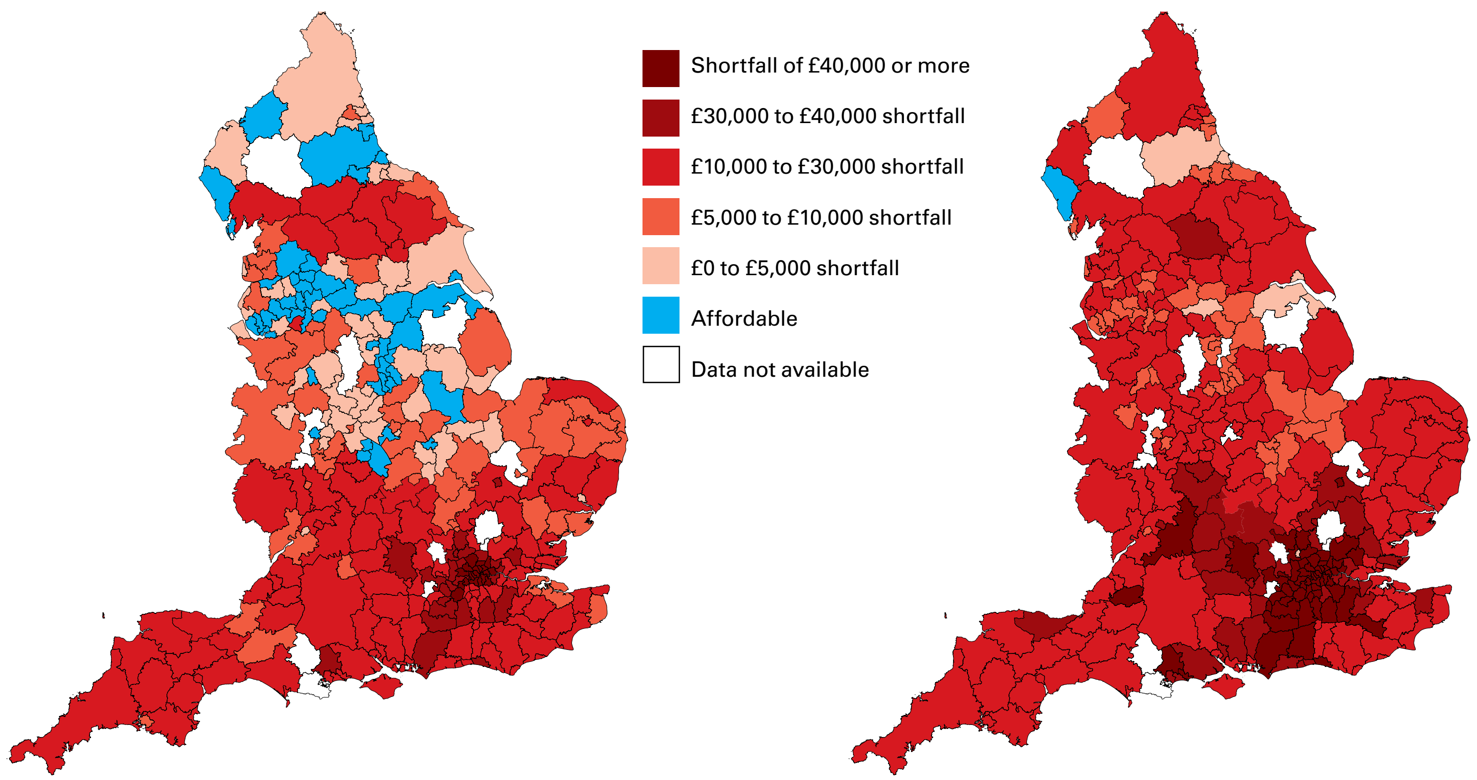
Areas affordable to median earning families with a 95% mortgage.[1]

Average local 2 bedroom home | **Average local 3 bedroom home**



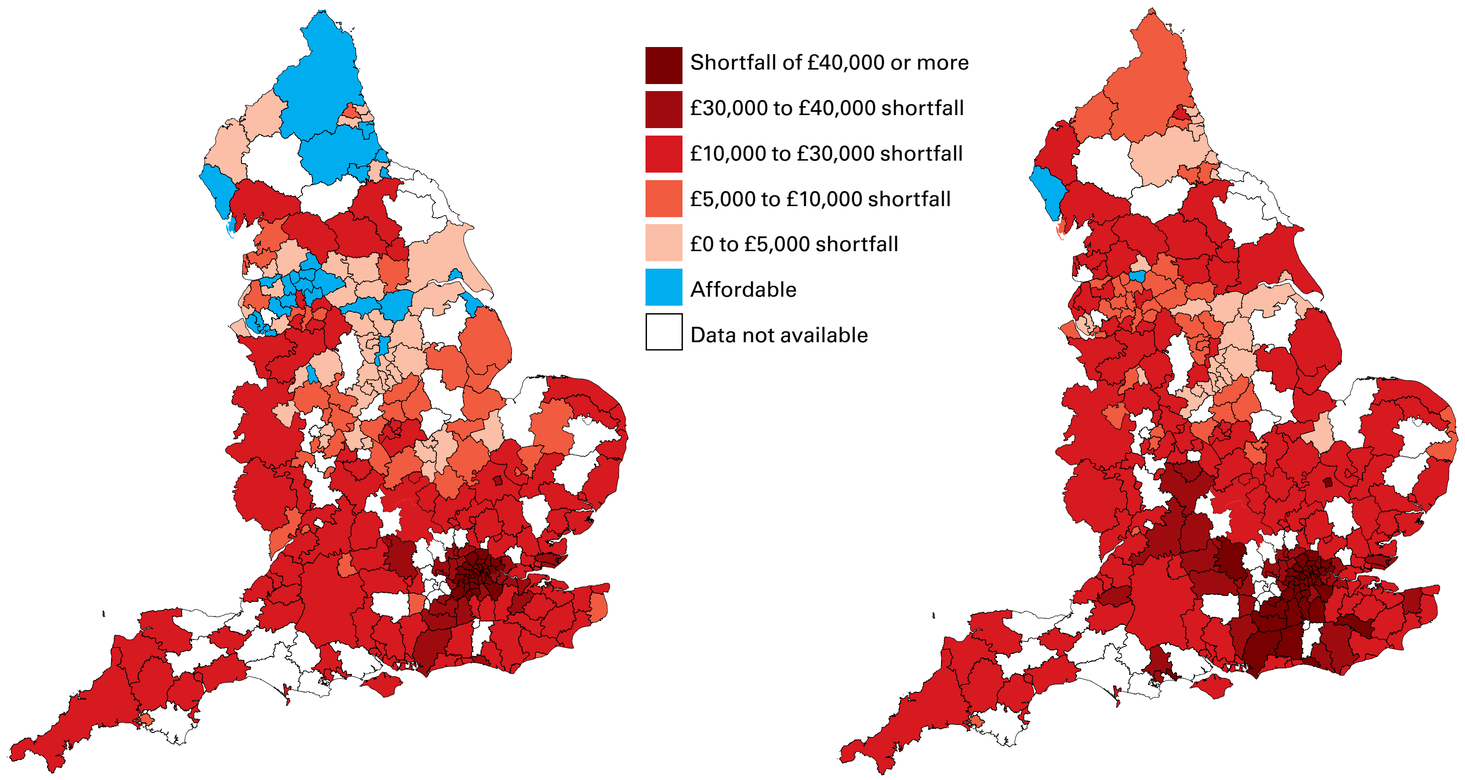
Areas affordable to lower quartile earning families with a 95% mortgage.[1]

Average local 2 bedroom home | **Average local 3 bedroom home**



Areas affordable to 10th percentile earning families with a 95% mortgage.[1]

Lower quartile local 2 bedroom home | **Lower quartile local 3 bedroom home**



- The Median Multiple (MM) is the ratio of median house prices to median annual gross income. Historically, MMs in developed English-speaking countries have clustered just below a value of 3.0. Demographia takes this 3.0 value as the definition of affordable. **The report concludes that housing in the United Kingdom remains severely unaffordable.**[2]

UK AREAS OF AFFORDABILITY AND SEVERE UNAFFORDABILITY[2]

AFFORDABLE
Median Multiple 3.0 and UNDER

NONE

SEVERELY UNAFFORDABLE
Median Multiple 5.1 and OVER

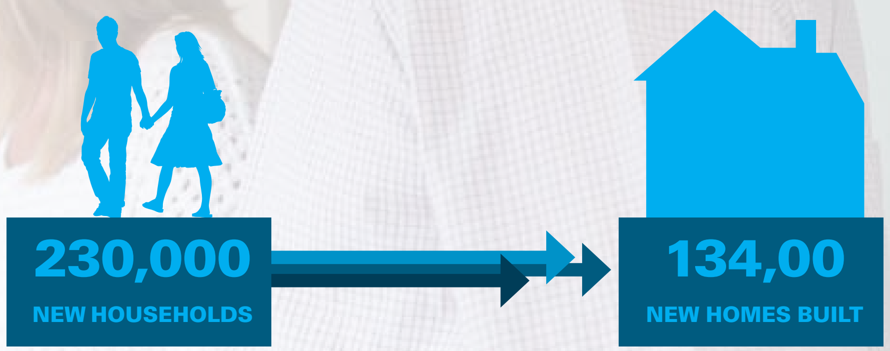
ABERDEEN
BIRMINGHAM AND WEST MIDLANDS
BOURNEMOUTH AND DORSET
BRISTOL AND BATH
EDINBURGH
LEICESTER AND LEICESTERSHIRE
LIVERPOOL AND MERSEYSIDE
LONDON (GLA)
LONDON EXBURBS (E&SE ENGLAND)
NEWCASTLE AND TYNESIDE
NORTHAMPTON AND NORTHAMPTONSHIRE
PLYMOUTH AND DEVON
SHEFFIELD AND SOUTH YORKSHIRE
SWINDON AND WILTSHIRE
TELFORD AND SHROPSHIRE
WARRINGTON AND CHESHIRE
WARWICKSHIRE

1. Homes for forgotten families: Towards a mainstream shared ownership market, Shelter, 2013.
2. Demographia, 9th annual Demographia International Housing Affordability Survey: 2013.

DEMANDING SUPPLY.

An Englishman's home is his castle! Actually, this is not confined to the English but applies right across the UK (and, of course, includes both women and men!). Surveys suggest that the desire for home ownership is undiminished (the latest Council of Mortgage Lenders data suggests that 79% of British adults would like to be homeowners in 10 years' time[1]), but this demand isn't being met by a concomitant rise in supply.

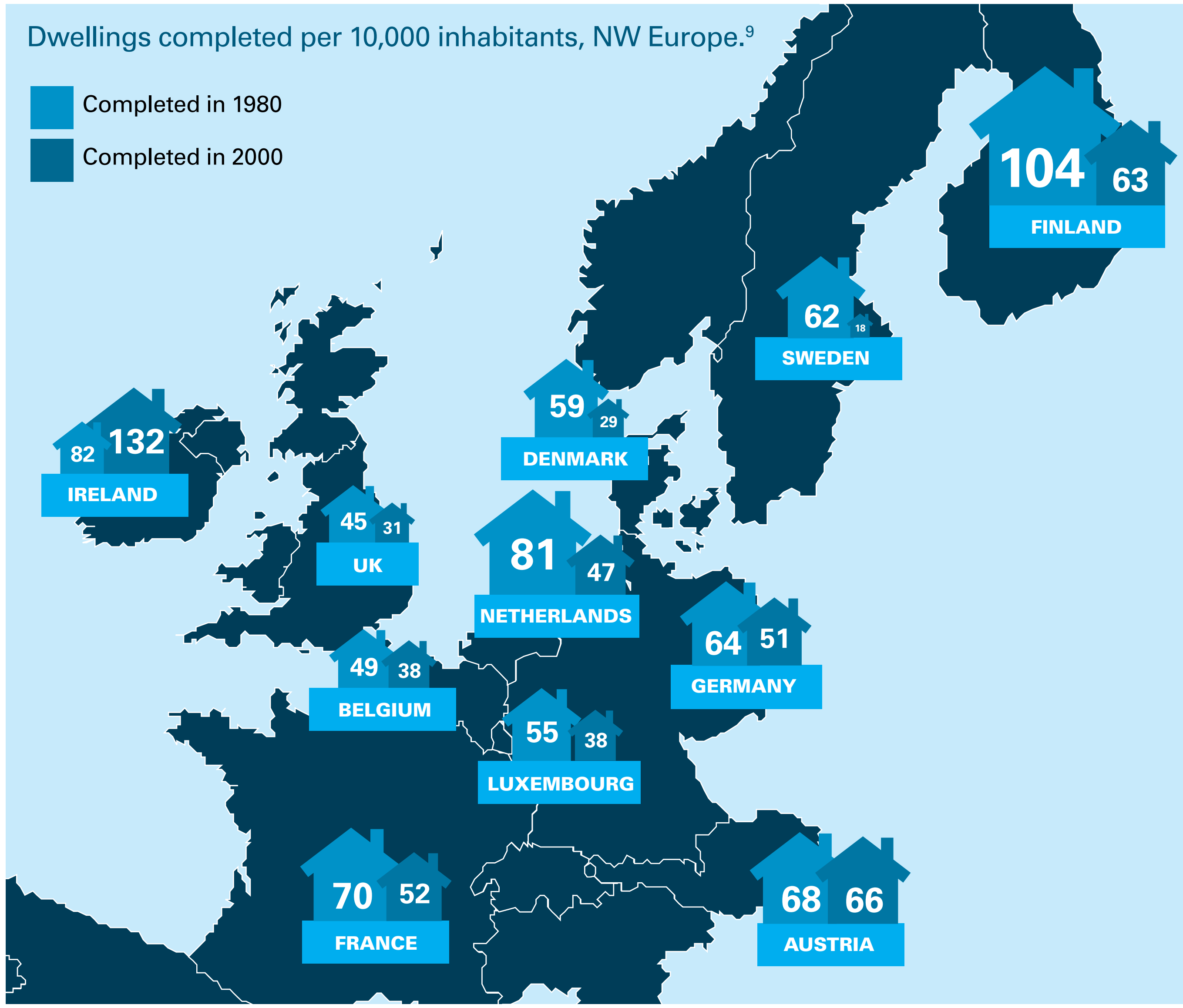
- From 1953 to 1991, the **rate of home ownership rose from 32% to 68%** (around 9% a decade), but it only rose 3% to 71% from 1991 to 2001 and then fell back to **68%** by 2008 – the first major decline since 1918.[2]
- In 2010, around **230,000** new British households were formed but just **134,000** new homes were built.[3]



- **240,000-245,000 additional homes will be required** each year to meet newly arising demand and need.[4]
- Demand for social housing vastly outstrips supply. In England alone, **1.69 million households** are currently on waiting lists.[5]

- The simple fact is that we are not building enough houses. Between 1995 and 2007 – the most intense phase of the house price explosion – **completion rates in the UK remained perfectly flat.**[6]
- New housing starts in England were up 33% in Q2 2013 compared to the same period in 2012, but this is still **36% below the levels prevailing in 2007**, which were already below that required to keep pace with household formation.[7]
- Rates of construction have significantly dropped off in the post-war period. **Between 1950 and 1980, building starts exceeded more than 300,000 annually.** Between 2004 and 2008, new starts were around 180,000 annually, plunging in 2009, and only recently 'recovering' to an annual total of around 110,000.[8]
- Since 1980, UK house building per 10,000 inhabitants has dropped every five years: from **45 per 10,000 in 1980 to 31 per 10,000 in 2000.**[9]

Dwellings completed per 10,000 inhabitants, NW Europe.[9]



1. http://www.cml.org.uk/cml/publications/newsandviews/134/508
2. Making Housing Affordable: A New Vision for Housing Policy, Policy Exchange, Alex Morton, ed. Natalie Evans, 2010.
3. Britain's Housing Crisis Disenfranchises the Young, David Klingman, 2011.
4. New Estimates of Housing Demand and Need in England, 2011 to 2031, Town & Country Planning, Tomorrow Series Paper 16, Alan Holmans, 2013.
5. ONS and DCLG, Local authority housing statistics, England, 2012-13, Housing Statistical Release, London: Office for National Statistics and Department for Communities and Local Government.
6. Oxley, M., T. Brown, V. Nadin, L. Qu, L. Tummers and A. Fernandez-Maldonado, Review of European planning systems, Leicester: De Montfort University, 2009
7. House prices continued to rise in August, Nationwide House Price Index, August 2013.
8. Housing supply: the other side of the coin, CML, 2013.
9. Eurostat, Housing Statistics in the European Union 2010.

GENERATION Y: A CLOSED DOOR?

Homeownership was attainable for the Baby Boomers (born in the 1950s) and Generation X (born between early 1960s to mid 1970s), but Generation Y (born in the 1980s and 1990s) isn't having it so easy. The 2007 financial crisis and the resulting Basel II capital adequacy rules have certainly restricted access to finance, but the supply of new houses remains the elephant in the room.

The Bank of Mum and Dad is a vital source for those lucky enough to be able to access it: **half of 35-44 year olds have received financial assistance** from another member of their family.[1]

26% of people aged between 20 and 34 **live with their parents**, an increase of 25% since 1996.[2]

Between 1997 and 2010, the average income required to become a first time buyer **doubled from £20,000 to £40,000**, rising much faster than earnings, which rose around 50% over the same period.[3]

As many as **90% of first time buyers** in 2009 needed **support from their family**.[3]

The numbers of under-30s with a mortgage fell from **43% in 1997 to 29% in 2009**.[3]

Just **35% of mortgages in the 2000-09 period went to first time buyers**, down from 50% in the 1990s.[3]

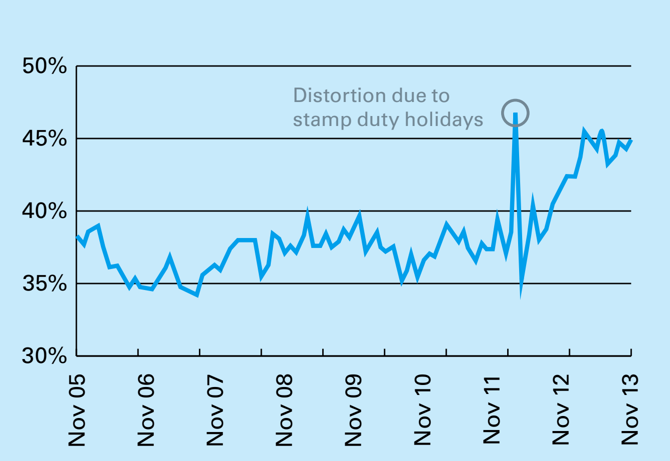
The under-50s hold just £540 billion, or **just 18%, of the £2.9 trillion** in housing wealth in the UK.[3]

18%

HELPING TO BUY: TEMPORARY RESPITE.

The Government's Help to Buy scheme (whereby the Government effectively contributes a loan of up to 20% of the purchase price for new builds in return for equivalent equity in the property), and its Help to Buy Two scheme (whereby loans are being made available to new-build homes worth up to £600,000 with a 5% deposit), are providing a fillip to the housing market. However, while the provision of equity loans has since been extended until 2020 the schemes do not address the fundamental supply-side impediments; with many economists worried that Help to Buy Two is just adding fuel to the fire of rising prices.

The January 2014 house price index from Nationwide demonstrates that first-time buyers are a key driving factor for the housing market, accounting for **44% of activity in Q3 2013.**[4]



FIRST TIME BUYERS AS A % OF HOUSE PURCHASE LOANS[3]

Home sales during the July to September quarter were **21% higher** than in the same three months in 2012.[5]

1. 35 Cubed, Legal and General, 2012.
2. The house price gap – Analysis of house prices and earnings, Shelter, February 2014.
3. Making Housing Affordable: A New Vision for Housing Policy, Policy Exchange, Alex Morton, ed. Natalie Evans, 2010.
4. Council of Mortgage Lenders, quoted in Nationwide House Price Index, January 2014.
5. HMRC, seasonally-adjusted figures, quoted in Halifax House Price Index, October 2013.

GREY MATTERS:
UNLOCKING RETIREMENT HOUSING.

Housing assets sit predominantly with the baby boomer generation. The debate over accessing this underutilised housing stock is often portrayed as a conflict of interest between hardworking homeowners versus struggling want-to-be first-time buyers. However, a significant minority of older homeowners would be willing to rightsize, but lack suitable options among the current housing stock that are fit for purpose. Changes need to be made in order to accommodate the desires of those who would be last-time buyers.

33% of over 60s want to rightsize, which equates to **4.6 million over 60s** nationally.[1]

- In England alone, **83% of over 60s own their own home**, and 64% own their own home without a mortgage. This equates to **£1.23 trillion** in unmortgaged housing wealth, which compares to their collective £769 billion in savings.[1]
- The over 60s specifically interested in rightsizing are sitting on around **£400 billion** of housing wealth.[1]
- If all those interested in buying retirement property were able to do so, 3.5 million older people would be able to move, freeing up **3.29 million properties**, including nearly 2 million three-bedroom homes.[1]

If just half of those interested in rightsizing more generally were able to do so, **4 million older people would be able to move,** freeing up 3.5 million homes.[1]

1. A new generation of retirement housing could set off a property chain reaction..., The Top of the Ladder, Claudia Wood, Demos, 2013.

SECTION 3:

THE LEGAL & GENERAL VIEW: TEN STEPS TO FIXING THE HOUSING MARKET.

1 BUILD, BUILD, BUILD. The UK needs a massive expansion of house building. Legal & General believes a minimum of 250,000 new homes per year are required across a range of tenures, with the focus on the South East where job markets are strongest.

2 PURSUE PLANNING REFORM. Planning reform remains a key challenge for house building in the UK and needs to be urgently reviewed, including via green belt swaps. Forward-thinking local authorities (including some of the London boroughs and, for large schemes, the Greater London Area) need encouragement to redevelop and use block planning approvals and Compulsory Purchase Orders where needed.

3 THINK SMALL. There is a very strong trend in the private housing sector towards solo households – driven by people living longer, increased divorce rates and young professionals marrying later in life. As such, the demand for good quality one-bedroom rental accommodation or two-bedroom accommodation for sharers is seeing a steady increase. Modern technology means that affordable 1,000 square foot housing units can be constructed for less than £100,000. We need to ensure that these types of dwellings are a key element of any house building strategy.

4 ADDRESS AFFORDABILITY. Instead of injecting additional money into the mortgage market through Help to Buy Two, the Government needs to help the market develop in ways that better reflect affordability. Options can include longer-dated mortgages, mortgage-backed securitisations and more rent-to-buy formats. While Help to Buy Two provides finance to buyers, it does nothing to address the supply-side issues. We would prefer to see financing that includes incentives to fund new-build properties.

5 ADDRESS SOCIAL HOUSING. The bill for housing benefit now tops £20 billion a year, yet there are 4.5 million people on social housing waiting lists and one million children in overcrowded accommodation. The current system is effectively a subsidy for landlords: in the late 1970s, four-fifths of house spending was on supply-side grants supporting house building, now £4.5 billion is spent on grants to support the building of new affordable homes, while in the current spending round £94 billion will go on housing benefit.[1] Social housing organisations urgently need flexible funding solutions to help them fulfil their requirements. We question whether the current mix of (not-for-profit) social housing providers is large or diverse enough, as well as the wisdom of paying housing benefit directly to tenants rather than landlords.

6 UNLOCK HOUSING WEALTH. The equity release market needs to grow alongside the planned local authorities' schemes to pre-fund care costs. Introducing a stamp duty reduction for the rightsizing elderly would be another step towards this. A secondary market for equity release assets could be built, with the local authority as the distribution mechanism. We need the Government to move from being neutral on equity release to a positive endorsement if possible, and for the UK to develop equity release into a fully functioning large-scale market. Achieving this aim will need big mortgage lenders and institutions to move in, without the fear of stigma.

7 HELP RETIREES RIGHTSIZE. Just 2% of the UK's housing stock meets the needs of older people – a chronic undersupply of specialist retirement housing given our ageing population. More specialised housing is needed for retirees looking to rightsize, sometimes with domiciliary care needs (100,000 retirement/supported housing/care homes per annum, according to Claudia Wood of Demos[2]). Legal & General currently plays a leading role in the retirement and at retirement markets, but has scope to do much more. For example, as suggested by the housing commission set up by the Royal Institute of Chartered Surveyors, people over the age of 65 should be exempt from stamp duty when rightsizing. Assisting the private sector to help serve older people will unlock supply and demand across every other step of the ladder.

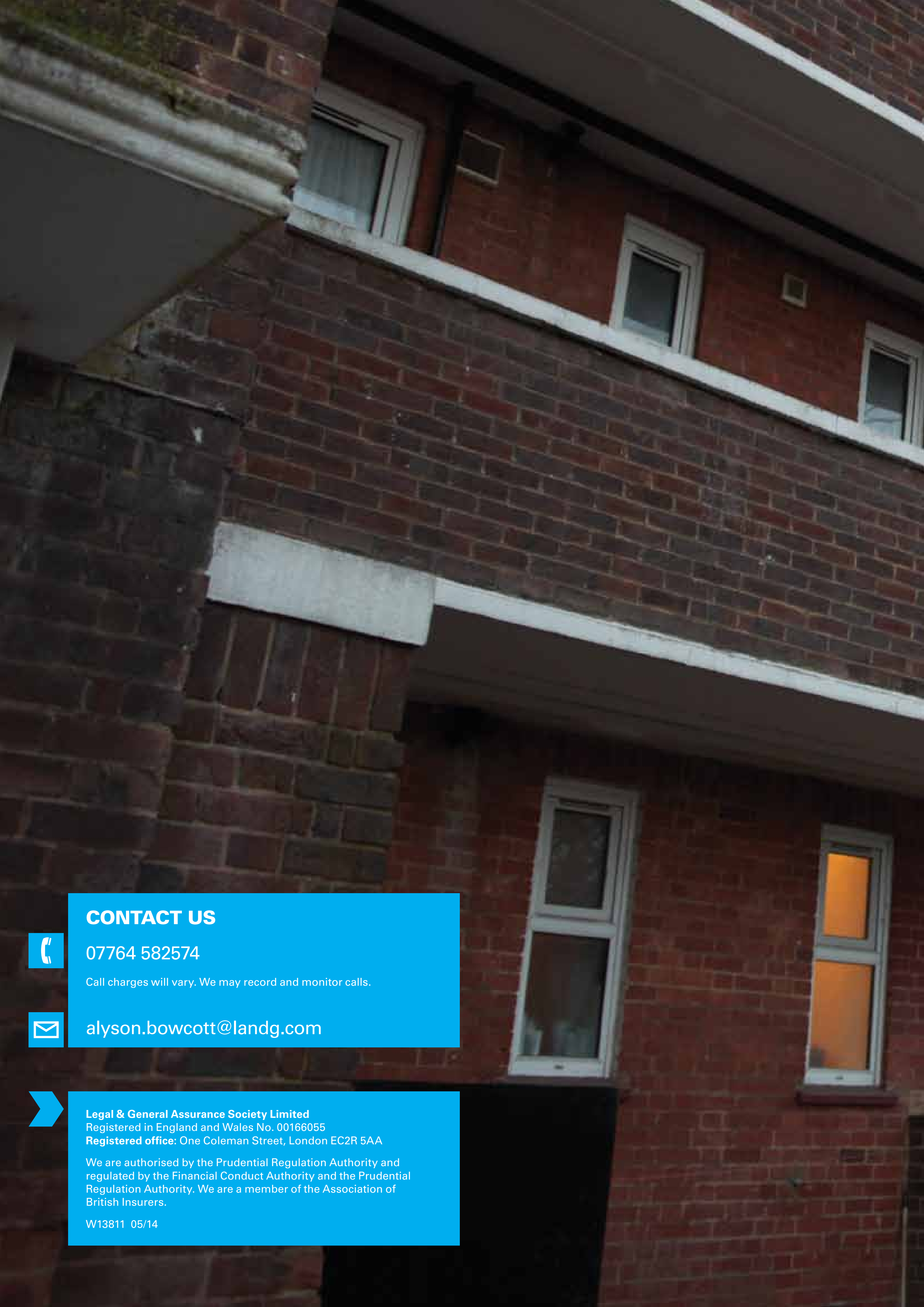
When rates do rise – they are arguably about 2% lower than they should be right now – many borrowers could struggle to meet their payments.

8 PREPARE FOR AN INTEREST RATE SHOCK. The ratio of average house prices to average earnings is well over its historic average and even above where it got to at the peak of the late 1980s. With a deposit of 20% a person on average earnings, buying an average house, would find themselves paying around 36% of their take-home pay on mortgage payments (assuming they have savings to pay stamp duty and the deposit). That is below the long-run average of just over 40%. When rates do rise – they are arguably about 2% lower than they should be right now – many borrowers could struggle to meet their payments. We need to prepare borrowers for this event.

9 PRIVATE RENTAL. The private rental market requires consolidation and scale: this is an obvious area for institutional involvement. A historic barrier to institutional investors accessing the residential sector has been the high level of management inefficiencies leading to significant income leakage. This results in sub-4% income yields to investors and an over-reliance on capital growth to deliver attractive returns. Key to delivering attractive long-term returns in the residential sector is maximising efficiency gains in site acquisition, build cost and ongoing operational expenses. Large schemes specifically developed to offer rental homes can be designed and operated to reduce inefficiencies, with the ability for a skilled asset manager to add value over the investment period. Income yields in excess of 5% on cost can be achieved through purpose-built and actively managed rental properties. Build-to-let is a mature institutional asset class in both the US and Europe, although it has not yet been established in the UK. We believe there is an appealing market opportunity to provide well-designed homes, while offering a high quality of service to customers and delivering attractive investment and social returns. There is further scope to provide added value services surrounding property transactions and ongoing requirements through, for example, offering insurance cover to the customer.

10 PROFESSIONALISE THE PRIVATE RENTED SECTOR. The private rented sector would benefit from being more professional, with other countries offering clues of how this could be done without undermining the flexibility of the current system. A national register of landlords would be the first stage, but reforming the tax system would also help. In many countries, losses from private renting can be offset against all income (including earnings). We think aligning our tax system so we are not at a disadvantage to other countries could help with attracting corporate or institutional investors, helping to further professionalise the sector.

1. Together at Home: A New Strategy for Housing, IPPR, 2012
2. A new generation of retirement housing could set off a property chain reaction... The Top of the Ladder. Claudia Wood, Demos, 2013.



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