BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

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Housing, leverage and stability in the wider economy – speech by David Miles

In a speech given at the Dallas Federal Reserve, David Miles, member of the Monetary Policy Committee, argues that greater use of outside equity in financing house purchases may help counteract some of the macroeconomic problems created by excessive leverage in housing markets.

Miles argues that interest rates can be a blunt instrument with which to attempt to stabilise housing markets, as their impact on borrowing and spending unrelated to housing may well be greater than the effect on the intended target. In addition, the expected rate of return on houses in a boom period may well be much higher than any level of interest rates that can be sustained for more than an extremely brief period.

Miles says: “That problem with using monetary policy to stabilise the housing market would be acute if housing markets were overheating when the wider economy was not and consumer price inflation was low even though house price inflation was high.”

He notes that variations in permitted loan to value (LTV) and loan to income ratios, as well as in capital requirements, are likely to have some impact on leverage. But greater use of outside equity funding could permanently reduce the average level of gearing and might much reduce the need to rely on macro prudential or monetary policy levers to be pulled hard in cyclical upswings because those upswings, and their consequences, would be less severe.

One answer is to require home buyers themselves to provide more equity funding, which could be done through permanent limits on LTV ratios. However, this would substantially push back the point in their lives at which individuals could hope to become owner occupiers.

Instead, Miles argues outside equity funding could develop. This would allow outside investors to share the risk – and rewards – of home ownership. He considers forms of funding where the repayment value is explicitly linked to the value of the home, where the return to the outside funder comes in the form of a final payout which is linked to the value of the property at an agreed horizon, such as when a property is sold.

Miles notes this approach presents some problems. For example, if providers of equity funding took a high proportion of downside risk in house prices, homeowners would have little incentive to maintain their

property if it started to slip in value. This is a moral hazard problem. It would also be critical to ensure home owners fully understood the contracts involved.

However, Miles argues that switching even just 10-20% of funding from debt to outside equity would very substantially reduce leverage – and that the moral hazard at that scale might be low enough to make such contracts commercially feasible.

Miles concludes that while getting a market in equity loans established is not easy, and some shared equity products have an uneven success rate, the recently launched equity loan product provided by the UK government for new build homes under its Help to Buy has already proved popular.

He concludes: "High leverage is at the heart of problems in housing market. Monetary policy and macro prudential policy can influence leverage. But more fundamentally, use of outside equity might be a way of permanently bringing down reliance upon debt financing."