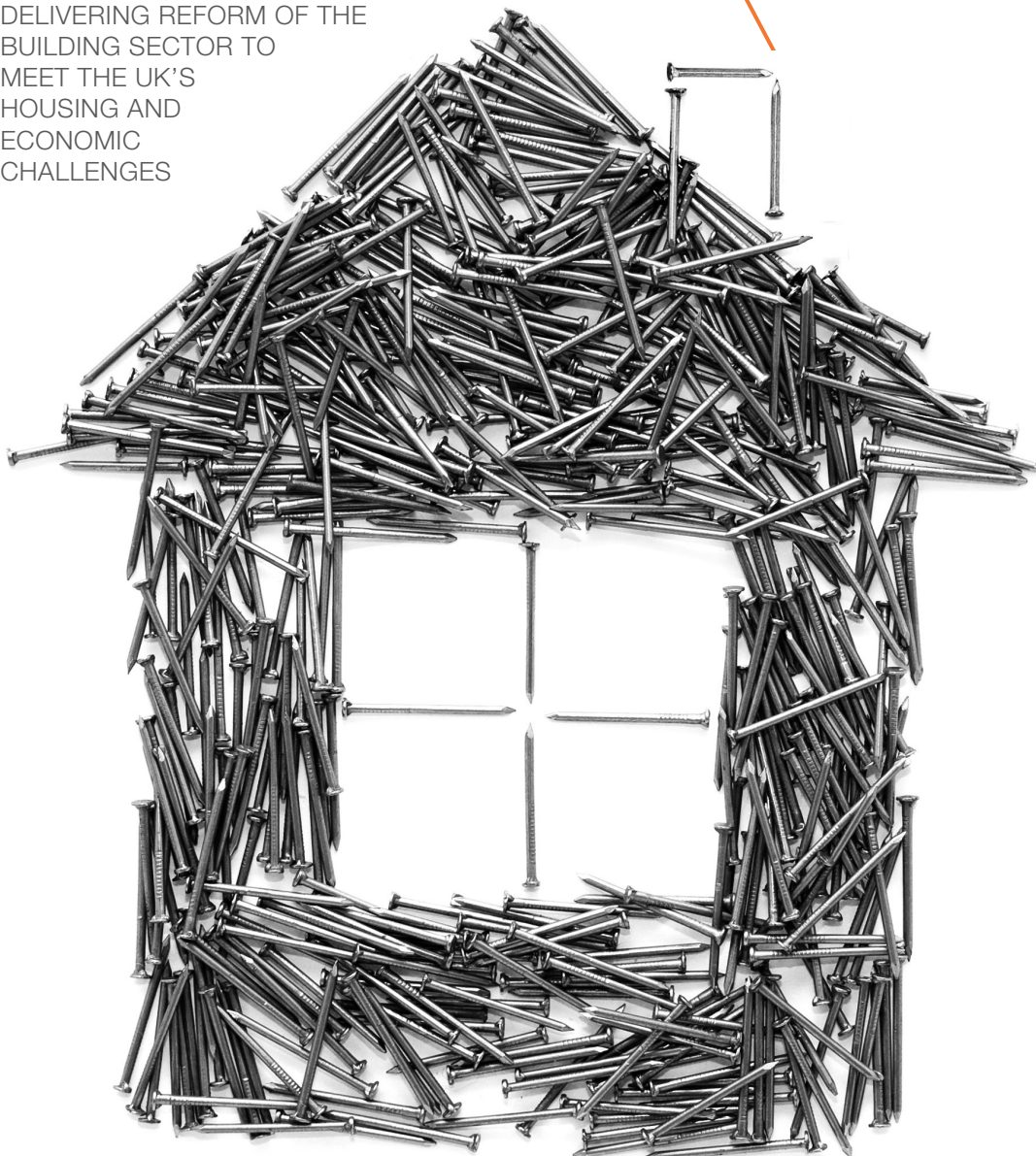


REPORT

WE MUST FIX IT

DELIVERING REFORM OF THE
BUILDING SECTOR TO
MEET THE UK'S
HOUSING AND
ECONOMIC
CHALLENGES



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ABOUT THE AUTHOR

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IDEAS to
CHANGE BRITAIN

CONTENTS

Preface	2
Executive summary	3
1. Introduction	5
2. Why cheaper land matters	7
3. The missing piece of the jigsaw	10
3.1 Long-term weaknesses in the building sector	10
3.2 Bricks, boom and bust: the impacts of the credit crunch upon the building sector	16
4. The costs of ducking reform	22
4.1 Previous ‘lost decades’ in house building: 1974 and 1990	22
4.2 Deja-vu all over again?	25
5. The causes of failure	27
5.1 The land market and the building sector	27
5.2 UK builders’ business strategies	28
5.3 Coping with land and development risk	28
5.4 Land as a reason for conservatism in business strategies	29
5.5 Planning, land and the UK building business model	29
5.6 Land and housebuilder consolidation	31
5.7 Land as a barrier to entry	32
6. Existing policy misses the target	34
6.1 Will current and proposed solutions work?	34
7. Ways forward	41
7.1 What then is the way forward?	42
7.2 Land market transparency	42
7.3 The obstacles to change.....	43
7.4 Short-term release of land.....	43
7.5 Long-term planning reform.....	44
8. Conclusion	48
References	49

PREFACE

This is the fourth in IPPR's series of analytical briefing papers as part of its fundamental review of housing policy.¹ We will publish our detailed policy prescription in a final report in early 2012. This paper's explicit focus is the need for development industry reform.

In our first paper, on housing demand, *The Good, the Bad and the Ugly: Housing Demand 2025* (Schmuecker 2011), we projected a significant gap between housing supply and demand, present already and likely to be exacerbated in the years ahead. We believe this conclusion is shared by most policymakers and politicians, across all parties. In our second paper, *Forever blowing bubbles? Housing's role in the UK economy* (Dolphin and Griffith 2011), we demonstrated that volatility in the housing market has played a destabilising role in the economy as a whole; that, in order to reduce this negative macroeconomic effect, house prices need to be stabilised; and that, in order to effect this stabilisation, alongside various fiscal and monetary policy interventions and improved credit control, increasing housing supply is vital. In our third paper, *Build now or pay later? Funding new housing supply* (Hull et al 2011), we suggested ways in which this new house building could be financed in a context of fiscal constraint. In this present paper, we argue that, even with the release of new funding and land, we will not see the increase in housing supply we need unless we look also to reform the development industry itself.

¹ See <http://www.ippr.org/research-projects/44/7.132/housing-policy-a-fundamental-review>.

EXECUTIVE SUMMARY

In the long run, the only way to end the UK's chronic housing crisis is to build many more homes. But are Britain's big builders willing and able to deliver the new houses we need? Even if the vexing problems of planning and finance can be solved, will our developers then develop?

The long-term record of UK housebuilders' levels of output tells a story of consistent underdelivery. Largely unresponsive to increasing demand, the supply of new homes has been found inadequate a long time before the recent financial crisis, but the crash has made the situation even worse. The value of land has risen faster than that of almost any other commodity over recent decades, so the development industry has come to prioritise trading land over building homes. The sector has also tended towards consolidation, limiting competition and effectively creating an oligopoly in a marketplace that is vital to the country's economy as a whole.

The sector lacks economic resilience, particularly when compared with its international counterparts, and is still reeling from the credit crunch. The major housebuilders, amid their many mergers and acquisitions, bought up large land banks at high prices during the boom. As the housing market and land prices collapsed in the wake of the crash, Britain's big builders found both their cash flow and their balance sheets in crisis. As a result, with their asset values and share prices tumbling, land written down and banking covenants broken, new homes did not get built: housing completions last year sank to the lowest level since the first world war. Yet forbearance on the part of over-exposed banks, reluctant to realise asset prices at current market values, has kept otherwise moribund building firms alive.

The case for industry reform has never been stronger. And the lessons of previous recessions suggest the alternative is dire. Downturns in 1974 and 1990 each precipitated a lost decade in UK house building. We cannot afford a repeat. And yet, if we duck reform at this critical juncture, that is exactly where we are heading, only, this time, worse. But the government's new Housing Strategy does not demand the reform that is needed. Instead, it offers the major housebuilders public land, money and guarantees without articulating a serious quid pro quo. The result, as things stand, is likely, as in the past, to be subsidised stagnation. If we want a can-do supply-side response, government must demand more bang for the taxpayer's buck.

Reform is needed to diversify the industry, with an emphasis on bringing in new entrants. Key to this is a new approach to land. For decades our developers have focused more on playing the land market and the planning system than on building homes: we must break this link. All land ownership and sales should be registered with the Land Registry, with serious penalties for those who fail to comply. Strict conditions should be applied to public land release, requiring rapid build-out and lower profit margins. A fifth of this land should be earmarked for self-build, and all of it should be supplied through a system of 'joint venture partnerships'. This would share fairly the uplift in value created by development between the government, communities and developers, while reducing the risk posed by fluctuating land prices. Financially unviable builders producing sub-par outputs should be allowed to go to the wall, and government should act as a 'clearing house' for their land banks. Community land auctions should commence and modern garden cities should be firmly on the agenda. Crucially, land should be de-risked by splitting the development process into two separate parts – the trading of land and the building of houses – much as 'casino banking' activity needs to be firewalled from banks' retail operations. Only by reshaping how development happens and changing how land is controlled and released can we arrest the downward spiral that grips our delivery of new homes.

To continue the banking analogy, if government is to bail out the builders, it needs to ask for more in return. This has to be a two-sided bargain of both give and get. If we really want to tackle our growing housing crisis – and use construction to drive desperately needed economic growth – then development industry reform must become an integral part of housing policy. The stakes are too high to let our housebuilders underperform any longer.

1. INTRODUCTION

The UK house building sector has a long record of underdelivery. The number of households in England is projected to grow by 232,000 a year until 2033, yet we are currently building less than half this number of new homes annually (HM Government 2011). This is not just a credit crunch phenomenon: housing supply has failed to respond adequately to high levels of demand for decades, and there is substantial evidence that the performance of our housebuilders is getting worse. The sector also has a dismal record of consumer delivery: we have seen deteriorating levels of space and quality set against increasing price. The sector bears poor comparison to other UK economic sectors and to its international building counterparts.

Central to current government housing policy is an attempt to address a crisis in housing affordability through stimulating the additional supply of market housing. House building sits prominently in the package of government reforms designed to stimulate economic growth. The prime minister commented that the aim of the government is to ‘Get Britain building again ... to help drive local economies and create jobs’.² The government’s flagship Housing Strategy states: ‘[T]he Government is clear that we need to get the housing market – and in particular new house building – moving again. This is central for our plans for economic growth’ (HM Government 2011).

The twin focus of reform has been attempting to stimulate new house building by liberalising the planning regime and channelling new direct and indirect subsidies into the major housebuilders.

However, the practical success of the proposed reforms is highly dependent upon the ability and willingness of the UK building sector to translate government subsidy, a more liberal planning system and the availability of more residential land into cheaper and more plentiful housing supply.

This paper sets out a widespread concern that the UK building sector, as it currently stands, may not only be less than willing, but also unable to deliver this side of the bargain. The reasons for this are outlined below.

- The **fallout from the credit crunch** has left a damaged sector at low levels of output with unhealthy balance sheets. The market shock led to a collapse in the health of the sector’s land holdings. Too many of the largest building companies bought too much land at too high a price at the height of the boom leading to too much debt. Land writedowns have further weakened balance sheets and have occurred alongside increased sectoral and banking liabilities. This creates significant obstacles to the sector delivering cheaper housing at the volumes needed.
- The **historical experience of past recessions** contrasts with the government’s public optimism for a strong supply-side response from the building sector. The past two British house building recessions, starting in 1974 and 1990, resulted in ‘lost decades’ for housing output. Attempts by the sector to recover from major shocks to balance sheets have resulted not in innovation and sectoral improvement, but in stagnation and consolidation over a lengthy period. **The current trajectory of the sector is to deliver another lost decade for market housing output.**
- The current shock comes alongside **long-term trends of failure from the building sector**. We have seen: a failure to increase output or respond adequately to growing demand; a poor record on quality, price, size and consumer delivery; a trend towards

2 Comments by the prime minister on the launch of the new Housing Strategy, Number 10 website, 21 November 2011

consolidation within the sector over output growth; and a growing cyclicality and vulnerability to external shocks. These trends reinforce themselves, making for a consistent decrease in supply relative to demand, exacerbating volatility and worsening quality, which in turn can lead to lower supply. There is little reason to think that this pattern of behaviour is likely to change without reform.

- **Previous and current government intervention makes another lost decade of market stagnation more likely.** Government intervention since 2007 has been high in cash terms. However, it has been poorly conceived, captured disproportionately by the major housebuilders and focused on short-term concerns at the expense of sectoral reform. It has too often rewarded failure and made cheaper housing and new market entrants less likely. There is no long-sighted quid pro quo demanded of builders by the government to achieve a better housing sector that delivers for the consumer, despite the huge amounts of taxpayer money that have flowed to particular housebuilders. Current policies chase short-term headlines rather than fixing structural problems, and can make the long-term situation worse, not better.
- **The proposed government changes to the planning regime through the National Planning Policy Framework (NPPF) are unlikely to force significant reform in the building sector or increase housing output.** Proposed changes will not lead to sectoral improvement, new market entrants or innovation, but will favour existing market actors and not lead to a significant increase in new house building.

Like the UK banking sector, the UK building sector is a ‘broken transmission mechanism’, likely to impede attempts at kick starting economic growth.

Just as the government’s attempt to increase bank lending has broadly failed, with a banking sector more concerned about recapitalisation and risk management, so the attempt to encourage the major UK housebuilders to increase supply may also fail due to their overriding focus on restoring their damaged balance sheets and entering into a long period of risk aversion and stagnation.

For policymakers to succeed, there needs to be much more attention paid not just to planning reform, but also to development industry reform that encourages dynamism and growth.

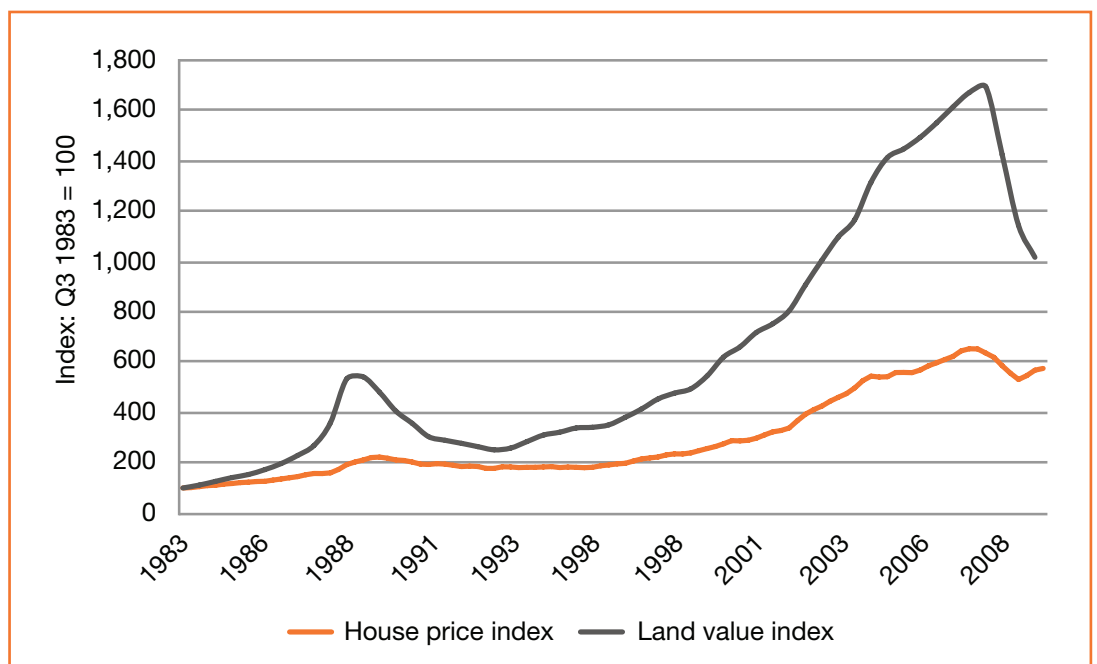
Now is exactly the time to put in place reform that creates a framework for a housing sector that delivers more and better market housing.

- **Cheaper land** presents an opportunity to reduce housing costs drastically and reward sectoral innovation and new entrants who are able to deliver.
- **Planning reform** that increases the release of land for house building and helps make land cheaper over time also creates a space in which greater competition and reform incentives can be placed upon the building sector.
- **Past changes to the UK building sector have always happened in the wake of recessionary shocks.** The government now has the leverage to ensure this happens in the right way.
- **The banking sector** is currently exercising significant forbearance in its financial relationship with several major housebuilders. **It is likely to be looking to reassess its relationship with these major housebuilders over the next few years**, including debt writedowns and restructuring. The government can look to ensure this does not result in a drift towards a lost decade of output, but contributes to greater innovation and housing output by ensuring that as housebuilders falter, their land is built on, rather than being passed on simply to enter another land bank.
- In addition, **the government needs to boost growth without spending money**, which the reforms set out in this paper would achieve.

2. WHY CHEAPER LAND MATTERS

The high price of land forms one of the central blockages to the UK being able to deliver cheaper market housing. Land prices have risen at a much faster pace than house prices for the past two decades (see figure 2.1). The implication of rising land prices has been that a growing percentage of the cost of residential development has been taken up by land costs.

Figure 2.1
Land value and house price change, 1983–2009



Sources: Land values, VOA (England and Wales, excluding London); house prices, Nationwide

Residential land prices between 2000 and 2007 rose by 170 per cent, compared to a 124 per cent increase in house prices.³ Over a longer time period, land prices rose 1,595 per cent between 1983 and the end of 2007, compared to a 553 per cent increase for house prices.⁴ Research by Savills, unsurprisingly, found that between 1992 and 2002 the proportion of the cost of a new home made up from land rose from 15 to 34 per cent (Savills 2003).

The market value of new land has always tended to rise and fall faster than house prices. This is largely explained by the geared nature of the process used to calculate the price that buyers are prepared to pay for land, where developers use a 'residual value calculation' which includes assumed levels of house price inflation.⁵

However, the house is generally not built and sold until several months, or even years, after the land has been bought. So, if house prices have not risen as fast as anticipated, the overall cost of land ends up taking up a higher proportion of the sale price.

- 3 Land values date from spring 2000 to July 2007 for England and Wales (VOA), house prices measured from Q2 2000 to Q2 2007 for the UK average (Nationwide).
- 4 Land values date from autumn 1983 to Jan 2008 for England and Wales (VOA), house prices measured from Q3 1983 to Q4 2007 for the UK average (Nationwide).
- 5 In the residual value calculation, a valuer subtracts from the anticipated price of the home both the estimated cost of building it and the targeted profit margin. What is left is the price the buyer is prepared to pay. Assuming the anticipated price of the house goes up and the build costs and profit margin stay the same, the land value will go up by a greater percentage than the increase in the house price.

Rising land prices have a negative impact on the quality and size of new housing being built. After the cost of land is taken into account, ‘the returns to housebuilders for investing in quality barely justify the effort’ (Callcutt 2007).

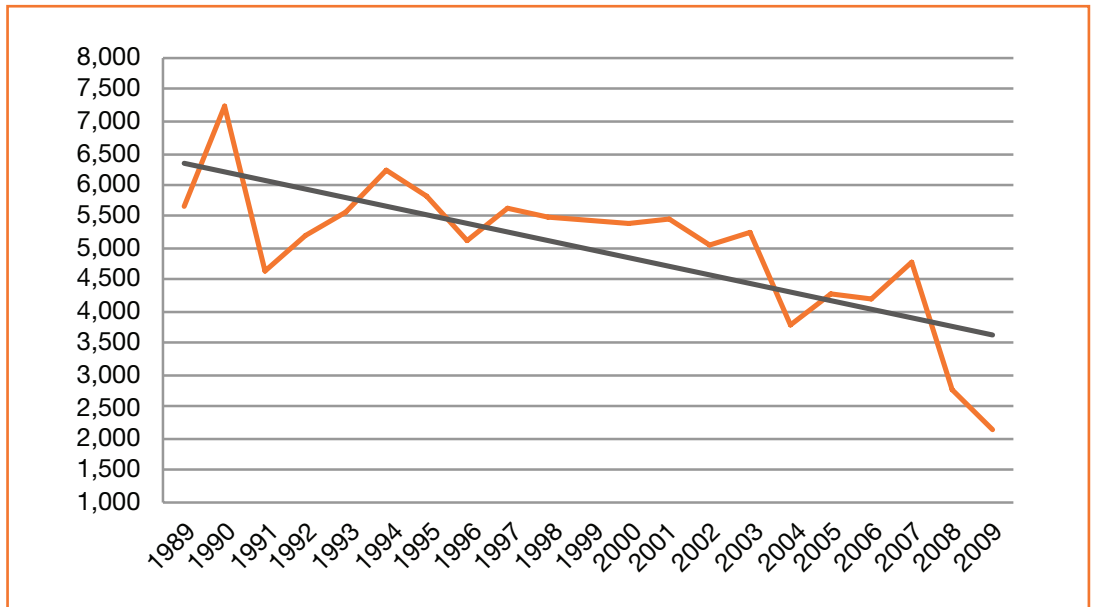
In order to maintain profit margins, UK builders try to squeeze all other areas of their product: reducing spend on design, putting pressure on input costs and trying to maximise densities on the land that is available.⁶ The result is ‘rabbit hutches on postage stamps’ (Evans 1991).

As we outline below, the rising cost of land also raises the risk levels for the UK building sector, exposing them to greater levels of financial risk, debt, vulnerability to economic shocks and reinforcing business strategies based on low output.

Any attempt to achieve the desired goal of cheaper housing rests upon the ability to release more, and therefore cheaper, land. Given that construction costs – largely wages, and the cost of materials – are much more likely to rise than fall, stable house prices require falling land prices.

Much of this depends upon reversing the trend of ever-lower levels of land being approved through the planning system and used by housebuilders. As figure 2.2 below shows, the amount of land developed has been on a downward trend since 1994 and has fallen in nine out of the 13 years between 1997 and 2009.

Figure 2.2
Amount of land used
for house building in
England, 1989–2009
(hectares)*



Source: DCLG Table P222

*Data has been spliced from 1998 to 2000, as unavailable for 1999

As the respected *Foresight Report on Land Use Futures* sets out, future land-use decisions will involve policymakers being mindful of the need for a balance between environmental, social and economic goals set against increased land-use pressures. But it also found that the level of restrictions currently imposed was excessive:

‘There is a strong economic case that planning controls on land in some areas, especially in the South East of England, are tighter than can be justified by current valuations of the net costs of development. Releasing land for development in areas of high demand can confer large social welfare gains and would require some relaxation of planning policy.’

Foresight 2010

6 In this they were encouraged by government planning policy that specified higher densities and favoured development on brownfield land, both of which led to smaller amounts of land available for housing.

Releasing more land is also, in practical terms, one of the few routes we have to delivering cheaper housing. The government lacks the money to subsidise sufficient new house building and the banking system lacks the capital to create the private demand necessary to re-inflate the mortgage market.

Releasing more land, either via the planning system or through using public land holdings, and the reduction in land costs that this should bring, is therefore the method on which any hope of building the homes we need now rests.

Housing 'success' is therefore now in large part dependent upon the ability and willingness of the building sector to use lower land costs to build cheaper, good quality and more plentiful housing. This report outlines the obstacles the industry faces in achieving this, and what can be done to overcome them.

3. THE MISSING PIECE OF THE JIGSAW

LONG-TERM FAILURES IN THE BUILDING SECTOR AND THE IMPACT OF THE CREDIT CRUNCH

This chapter goes where policymakers have rarely dared to venture: under the bonnet of the building sector itself. But this is essential if the government's other policies to tackle our housing supply crisis are to deliver on building the new homes we need and ensuring value for money at a time of major fiscal constraint.

To understand the nature of the challenge, this chapter addresses two key issues: first, the long-term weaknesses in the building sector; and second, the way these weaknesses have been compounded (not alleviated) by the impact of the credit crunch.

The analysis presented here shows that the building sector has consistently underdelivered. This raises major concerns about whether it is capable of delivering now and into the future.

3.1 Long-term weaknesses in the building sector

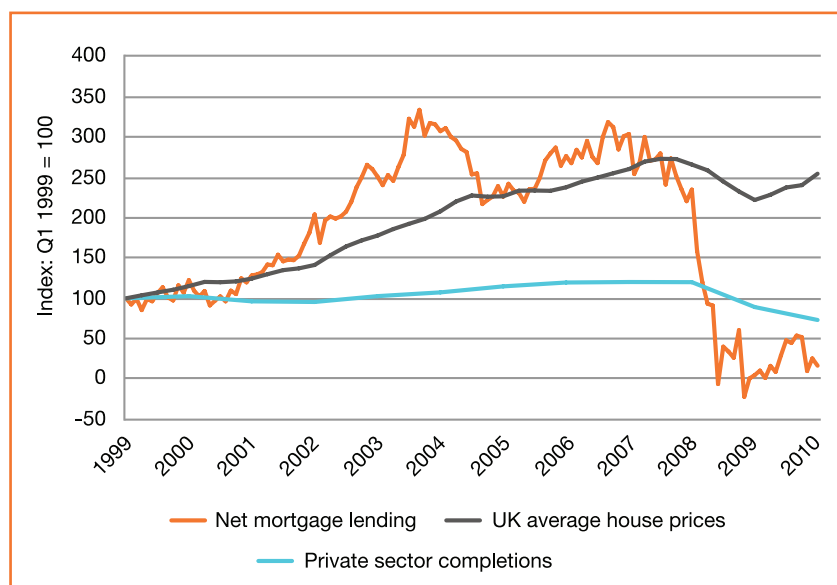
There are a number of structural weaknesses in the UK building sector that have developed over time and which have limited its performance significantly.

3.1.1 Lack of responsiveness to demand

The UK house building sector has a long record of failing to produce enough new houses to meet market demand. This matters: the UK has seen a trend of deteriorating affordability and unmet housing need that is contributing to a growing housing crisis. Yet private housebuilders have not responded in a way that we would expect.

Most recently, a decade of soaring house prices and mortgage lending have failed to lead to a commensurate increase in housing supply. Between 1999/00 and 2007/08, new private housing completions rose from 124,470 to 145,450 per annum, an increase of just 17 per cent.⁷ This is compared to an increase of 173 per cent in UK house prices and 182 per cent in total mortgage credit.⁸

Figure 3.1
House prices, mortgage-lending volumes and private market housing output, 1999–2010



Source: Bank of England, Nationwide and DCLG

⁷ Department of Communities and Local Government: Private house building completions

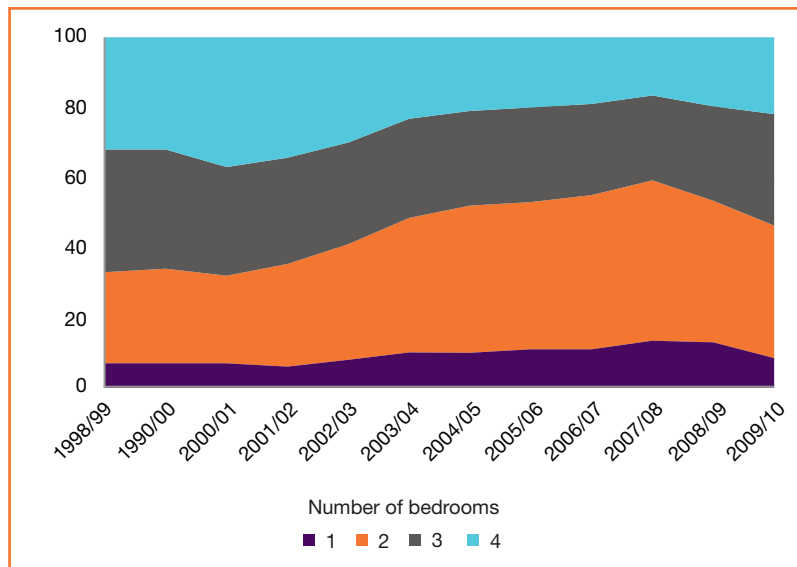
⁸ House price data from Q1 1999 to Q4 2007 (Nationwide), mortgage-lending data, annual mortgage lending for 1999 and 2007 (Bank of England)

The responsiveness of supply in the UK to higher levels of demand is low by international standards: at half the level of Japan and less than a quarter of the US, according to recent OECD analysis (OECD 2011a).⁹ Swank et al report a price elasticity of supply of 0.3 for the United Kingdom, compared to 0.45 for the Netherlands, 1.1 for France, 1.4 for the US and 2.0 for Germany (Swank et al 2002).

Meanwhile, analysis for the Barker Review found that the responsiveness of UK house building actually *declined* as house prices rose. The Barker report found that from the beginning of the 1990s ‘supply has become almost totally unresponsive, so as prices have risen, the supply of houses has not increased at all’ (Barker 2003). An earlier study by Meen finds that the price elasticity of UK supply was very limited and falling (Meen 1996).

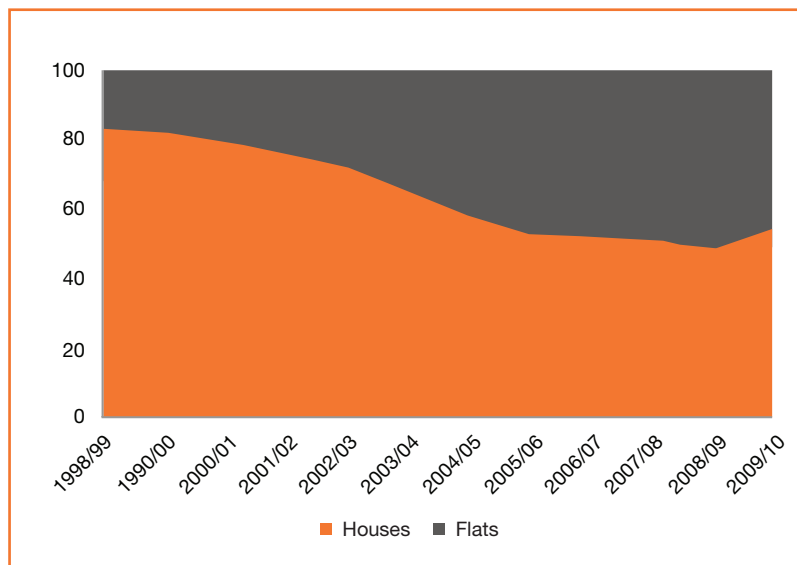
In terms of new dwellings per 1,000 households among the EU15, the UK was second from bottom in 1985, third from bottom in 1995 and second from bottom in 2002 (Morton 2009). Indeed, the focus on unit output of ‘homes’ greatly flatters the performance of the UK building sector over the past decade. As figures 3.2 and 3.3 show, a growing number of new ‘homes’ were small one- and two-bedroom flats, making the rise in housing supply even smaller than it initially appears.

Figure 3.2
New-build completions
by number of bedrooms,
England, 1998/99–
2009/10 (%)



Source: DCLG Live Table 254

Figure 3.3
New-build completions
by dwelling type,
England, 1998/99–
2009/10 (%)



Source: DCLG Live Table 254

⁹ Other OECD estimates imply that a one per cent increase in real house prices raises UK residential investment by only 0.4 per cent in the long run (Caldera Sánchez and Johansson 2011).

The number of new flats as a percentage of private sector completions rose from 12 per cent in 1997/98 to 46 per cent in 2008/09.¹⁰ Yet when polled by Mori only two per cent of the UK population expressed a desire to live in modern apartments.¹¹

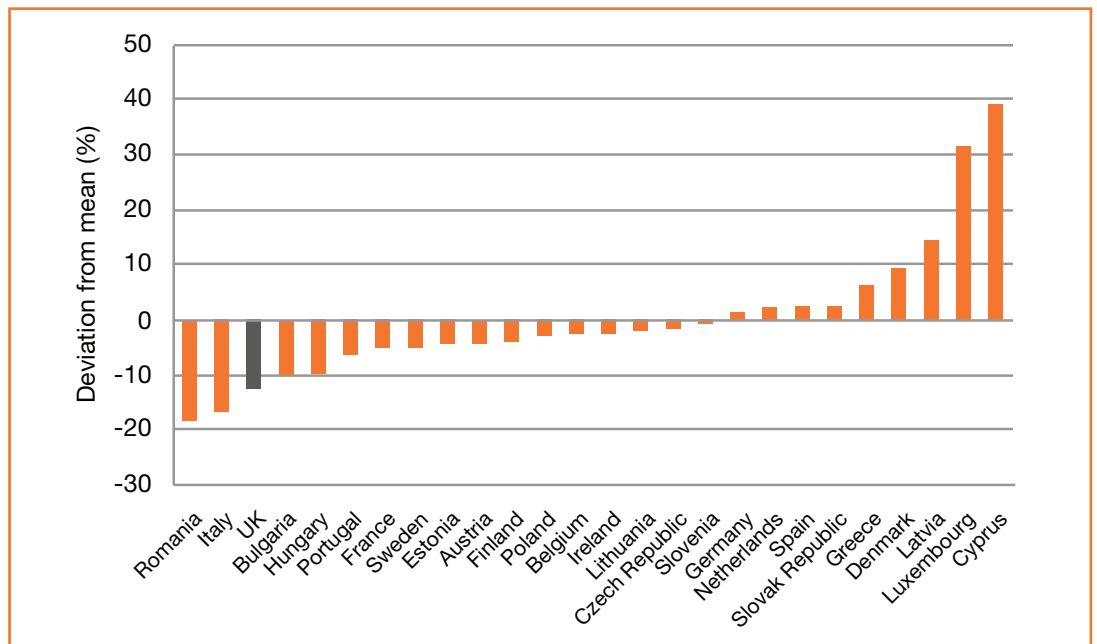
3.1.2 Declining size and poorer quality

This record of declining output sits alongside a record of declining delivery for the consumer.

The Royal Institute of British Architects (RIBA) has criticised the homes the size of a ‘shoe box’ being built in Britain. The average new three-bedroom house is eight per cent smaller than the recently adopted standard for homes in London, with floor space of 88m² (947ft²). That is 8m² short of the recommended space, the equivalent of a single bedroom. One-bedroom properties, at an average of 46m², are 4m² short of the recommended size. RIBA suggests that potential buyers are being short-changed with ‘shameful shoe-box homes’ (RIBA 2011).

As figure 3.4 shows, UK new homes are among the worst performing in the EU in terms of size. The average floor space in new dwellings is 82.7m² in the UK, the third smallest in the European Union after Italy and Romania (Dol and Haffner 2010). This is not just about the UK comparing poorly to European architectural sophistication: UK housing stock is also both older and smaller than most countries in the OECD (André 2011).

Figure 3.4
Floor space of new homes in the European Union, comparison with average floor space



Source: Housing Statistics in the European Union 2010

What is particularly interesting from a UK perspective is the example of the Netherlands, where a restrictive planning system and a highly populated country still manages to deliver large homes. Poor UK delivery cannot be entirely explained by population pressures and a tight planning regime.

¹⁰ DCLG Live Table 254

¹¹ Source: Ipsos Mori 2002: <http://www.ipsos-mori.com/researchpublications/researcharchive/poll.aspx?oltemId=972>.

The falling size of new British homes occurs alongside a poor record on product, innovation and design. The housing minister recently criticised UK housebuilders for producing an ‘identikit Legoland box’.¹² The Barker report found that ‘housebuilders have little incentive to compete for consumers’ and have a ‘weak record of innovation’ (Barker 2003). While the leading academic on the sector notes that ‘British house[]building has an exceptionally poor record at introducing innovation in design and production methods’ (Ball 1999, see also Neale 2009).

In large part this is to do with problems such as lack of competitive pressure and low levels of choice, derived from low sectoral output. As the Callcutt report observed: ‘[T]hose developers with a poor reputation for quality do not appear to have suffered appreciable financial damage’ (Callcutt 2007).

This matters not just because British consumers are living in small and poor quality houses, but also because people are less likely to favour development if it is done badly, creating a vicious circle of NIMBYism which forces house and land prices up further.

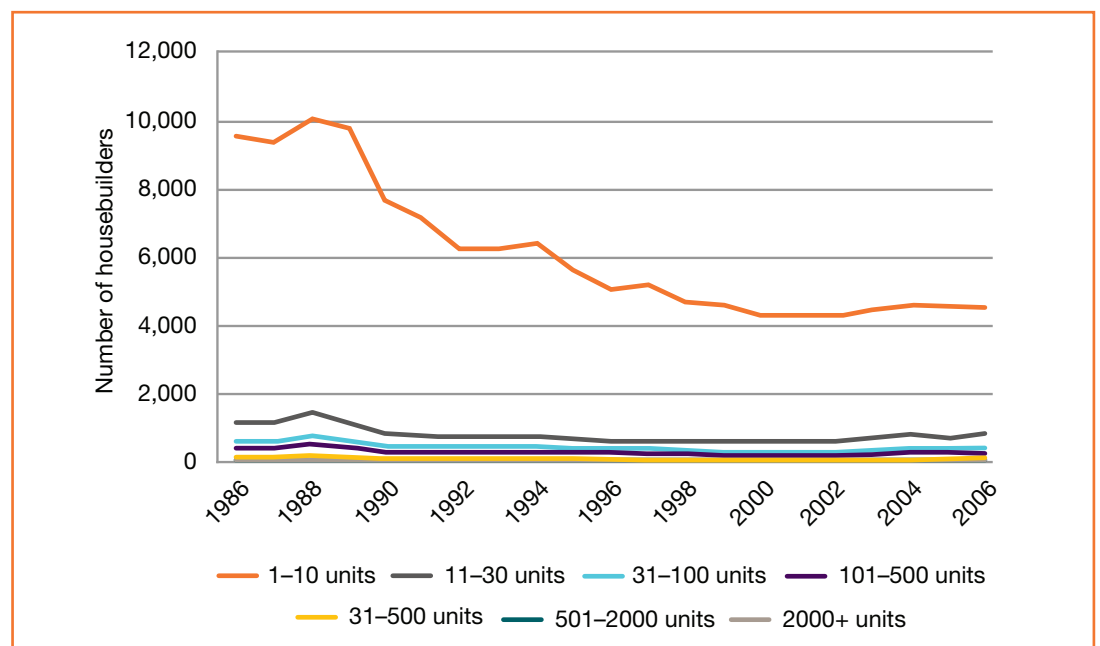
3.1.3 Declining competition

The UK building sector has also displayed a long-term trend towards ever-greater sectoral consolidation, undermining competition which would drive up quality and improve value for money.

In the 1930s – the golden age of UK house building, with the highest levels of private market house building ever achieved in the UK – the top 10 housing companies had a market share of no more than six to seven per cent. The success of the 1930s was based upon a highly diversified set of smaller building companies (Wellings 2006).

During the 1960s, the top 10 housing companies had eight to nine per cent of market share. In the 1970s, the top 10 housebuilders by market share rose to approximately 17 per cent in 1973. There then followed two recessionary periods of major consolidation. In the first post-recessionary period after 1974, the share of the top 10 builders went from 17 per cent in 1973 to 28 per cent in 1980. In the 1990s, the market share of the top 10 major housebuilders rose from 27 per cent in the late 1980s to 47 per cent in 2002. Both periods coincided with a significant shake-out of smaller players within the industry.

Figure 3.5
Number of UK housebuilders, by size category, 1986–2006



Source: NHBC

¹² See <http://www.communities.gov.uk/news/corporate/1860817>.

As figure 3.5 above shows, the major industry change since 1986 has been the precipitous decline of the UK small builder. Smaller builders more than halved from 9,771 firms in 1989 to a trough of 4,255 in 2001.¹³ Yet among policymakers, ‘this remarkable decline has gone virtually unnoticed’ (Ball 2010).

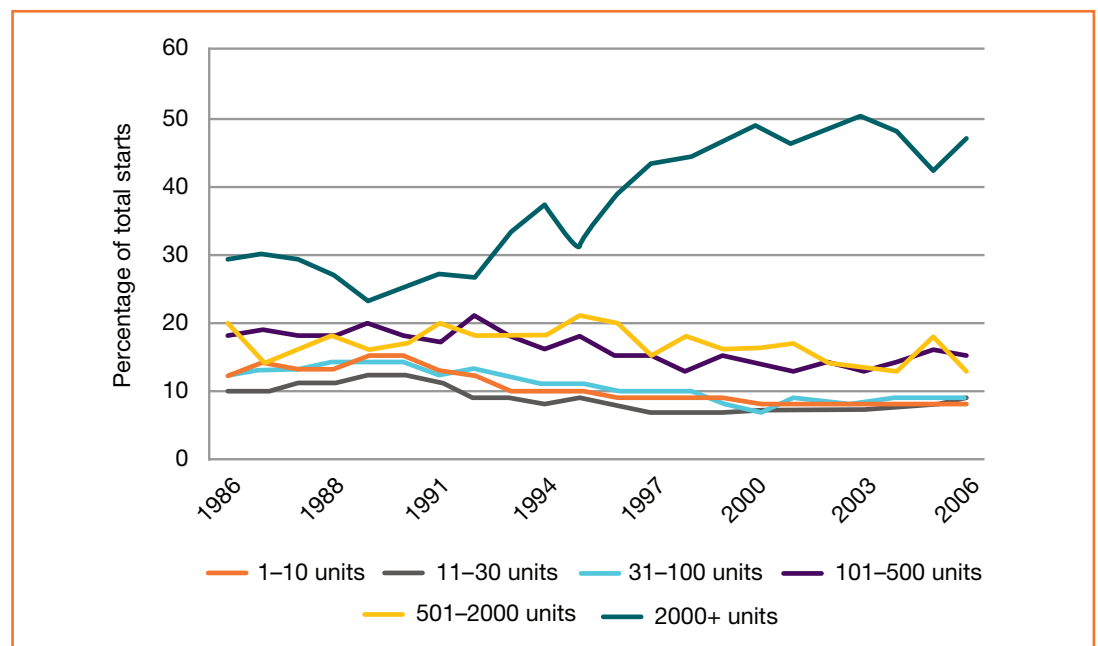
This has impacted on the overall diversity of the sector. Over the past 20 years, according to National Home Building Council (NHBC) data, the number of active firms has fallen from around 12,000 to only 4,000; mainly due to a substantial loss of small firms. These detrimental trends in declining industry diversity are not just confined to the loss of smaller builders, but also to the squeezing of the self-build sector.

UK self-build output appears to have been gradually declining in the past two decades.¹⁴ Callcutt estimated that self-build made up approximately 15,000 to 18,000 units a year, or 10 per cent of total current UK production in the mid-2000s. This is lower than in other European countries, and ‘far below’ that in France (where it accounts for between 40 and 50 per cent of building output), Belgium (over a half), Sweden (where it is a third), Germany and Japan (OFT 2008, Dol and Haffner 2010).

This trend in decline is mirrored (see figure 3.6) by the increasing dominance of the largest UK builders in housing output. UK housing is now made by a small number of large builders. By 2007, just three companies (Taylor Wimpey, Barratt Developments and Persimmon) dominated the league table of housing completions, accounting for over a third of all new homes built in the UK that year (Callcutt 2007).

As shown below, this trend has coincided with greater economic vulnerability and a declining record on output. The sector is less responsive and less resilient as a result.

Figure 3.6
Percentage of total starts
in UK by companies of
different size categories,
1986–2006



Source: NHBC

Market change in the building sector in the past 40 years has been driven either by post-recessionary consolidation or by merger- and acquisition-based consolidation (and often by both). As the historian of the UK building sector, Fred Wellings, observes:

¹³ This decline failed to reverse in the recent boom, with the number of small builders increasing only slightly to 4,566 in 2006 (Callcutt 2007).

¹⁴ Accurate information about self-build is hard to find (see Callcutt 2007, and Ball 2010). Some estimates use VAT receipts to estimate that 20,000 self-build units are built in the UK annually, the Office of Fair Trading (OFT) puts the figure at 16,000 houses annually, Ball puts the figure for England at substantially lower at approximately 5,000–6,000, or two to three per cent of annual housing units. Both authors agree that self-build appears to have been declining.

‘There has been not one suggestion that firms have declined or failed because they have been left behind technologically, that their product has been the cause of failure ... It was not a quality or technological issue: housebuilders failed because they misjudged the market.’

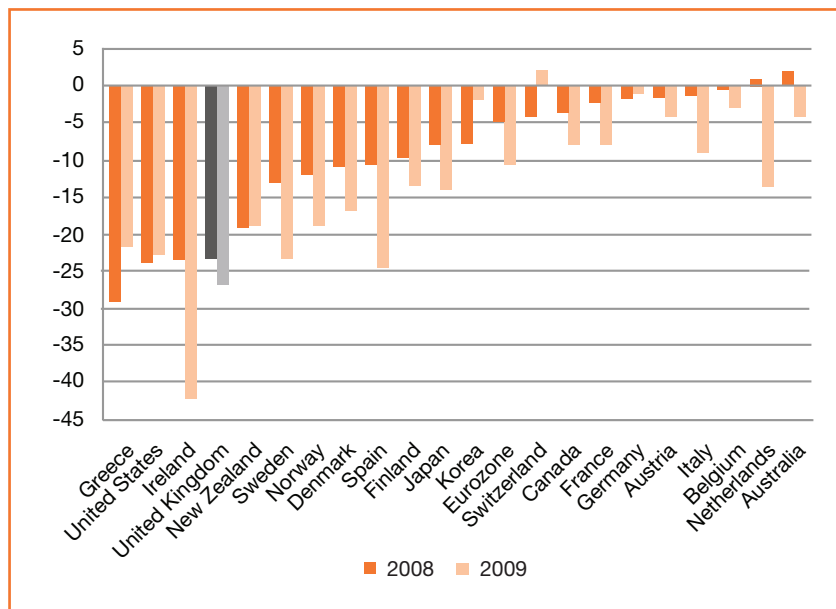
Wellings 2006

3.1.4 Greater vulnerability to economic shock

The UK house building sector also suffers from a lack of economic resilience, which is highly striking when considered in an international context. This lack of resilience is not just a problem for the rates of UK house building, it is also a source of macroeconomic instability for the UK economy as a whole (OECD 2011b).

Britain has a lower share of residential building as a percentage of construction sector output: 26 per cent, compared with over a third in France (35 per cent), Germany (49 per cent) and the US (46 per cent) (Blake et al 2004).

Figure 3.7
Percentage change
in OECD residential
investment,
2008 and 2009



Source: OECD

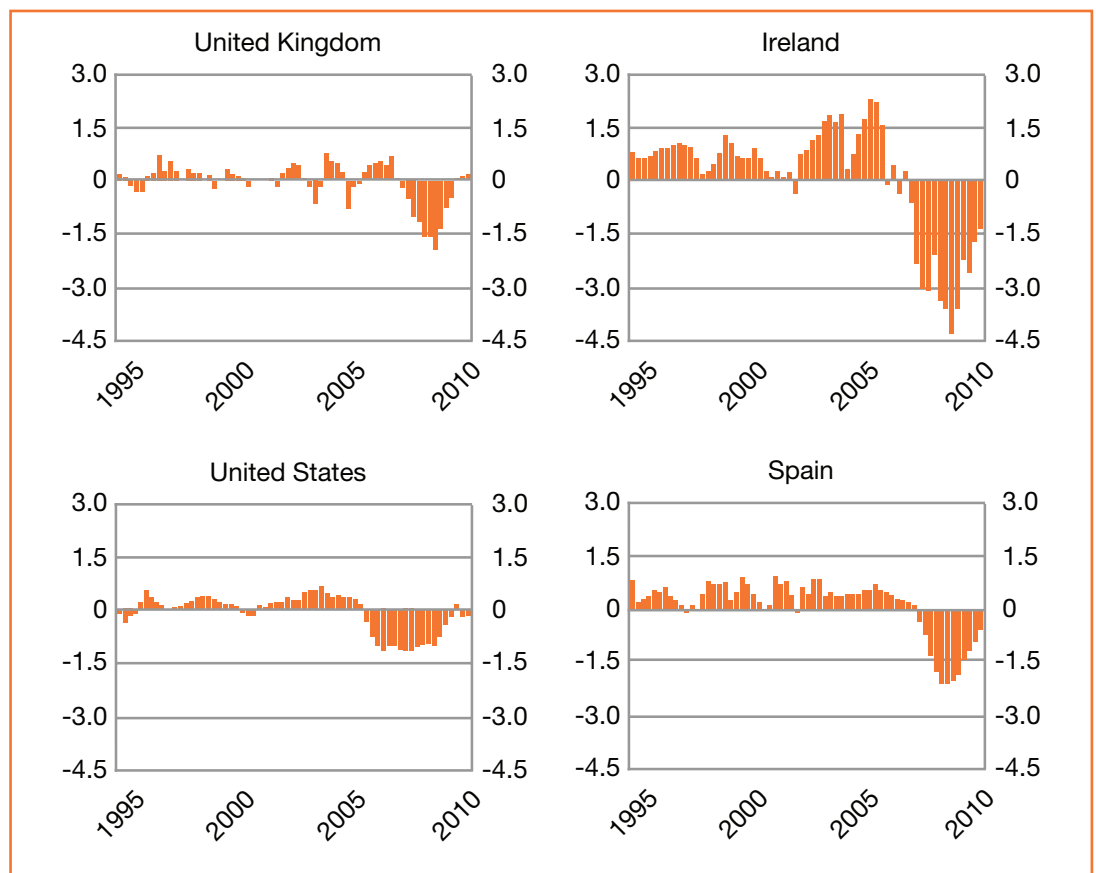
The UK house building sector added modest upside economic gains during the boom, but suffered from larger downside vulnerability in the bust.

Despite, by international standards, very sluggish increases in residential investment during the boom, the crunch saw UK residential investment drop very steeply and very quickly. Only Ireland and Greece, both peripheral eurozone countries with serious economic crises and larger house building booms, fell more. The UK performed worse than Spain, the US, Portugal and the euro area. The drop in residential investment was little short of spectacular, falling 50 per cent from peak to trough (André 2011).

During the decade of economic expansion between 1995 and 2006, residential investment contributed only modestly to UK GDP growth, adding on average 0.15 per cent per year, considerably less than other countries experiencing comparable house price increases (OECD 2011b). Yet, since the credit crunch, the collapse of residential investment has contributed significantly to the contraction in UK GDP.

A similar picture of lopsided economic vulnerability is evident in associated employment markets. Between 1997 and 2008, more than half a million construction jobs were created, nearly one in five jobs created over that period. But between the third quarter of 2008 and the first quarter of 2010, about 300,000 construction jobs were lost: *about half of all UK job losses during the downturn* (ibid).

Figure 3.8
Real residential investment, contribution to year-on-year GDP growth, selected OECD countries, 1995–2010 (%)



Source: OECD Economic Database

3.2 Bricks, boom and bust: the impacts of the credit crunch upon the building sector

Even before the 2007 financial crisis, there were major, long-term structural weaknesses in the building sector. The credit crunch has only exacerbated those problems, leaving the sector – and the wider housing market – in a perilous state. This section describes how the credit crunch has impacted on the building sector and outlines the consequences for its ability to deliver on the government’s goals for it now.

The housing market suffers from strong boom and bust cycles. This includes participants engaging in momentum behaviour and taking risks not justified by underlying economic fundamentals. The hubris of 2004–2007 was not just confined to banks and home buyers. Housebuilders were as vulnerable to bubble behaviour as other market actors, and had strong pressures on them to engage in dangerous financial activity.

Despite their conservative record on housing output, most of the largest UK housebuilders were notably *not* risk averse in the final years of the boom as many had been building up land banks and involved in heavy merger and acquisition activity (Ball 2010). This seemed to affect the larger housebuilders disproportionately.¹⁵

3.2.1 Driving up the price of land through speculation

Market valuations for land and development became excessive and based upon more and more unrealistic calculations of land value and house price growth.

Just as housebuyers have misplaced optimism about ever-rising house prices (Case and Schiller 1988), studies also show that as land prices become more elevated,

¹⁵ In theory, larger companies should be in a better position to exploit the cyclical swings of the land market. Greater financial clout should allow them to buy land over a greater period and exploit cheaper land prices when financial pressures may lead to other smaller actors struggling to access capital. This business strategy, although creating conservative output levels, should make them more immune to housing downturns and better able to exploit lower land prices. However, this did not happen (Adams et al 2008, KPMG 2008).

housebuilders become more optimistic about future trends and will pay more for land (Gillen and Fisher 2002, Leishman et al 2000).

‘Where land is in short supply and competition between developers is intense, housebuilders must assume the highest possible sale prices in order to make winning bids for land.’

Adams et al 2008

Encouraged by competition within the market and from the stockmarket-based model of funding, companies were forced to buy land at high prices in order to maintain output.

This was exacerbated by new sources of speculative land purchase and competitive bidding which gave landowners greater ability, and willingness, to hold out for higher prices.

Private equity and developers backed by finance institutions entering the market in the final years of the boom had much higher levels of gearing than traditional housebuilders, and financed development by ‘re-leveraging the balance sheet’ (KPMG 2008). This saw private equity muscle into the top 10 UK housebuilders.¹⁶

All this led to a very strong upward surge in land prices (see above). The higher-priced land acquired during the boom constituted a larger and larger percentage of land holdings, and this put greater and greater pressure on profit margins and viability (Callcutt 2007).

There was a weakening of long-held development appraisal models in order to justify rising prices (Adams et al 2008). Site ‘viability’ increasingly became based on numbers that did not add up, at just the time that builders expanded their land banks significantly. KPMG calculated that land banks for the major listed builders grew from an average of 4.6 years in 2002 to six years by 2007 (KPMG 2008).

This was compounded by the growing dominance of high density city centre brownfield sites in developers’ portfolios, and the greater uncertainty these sites created about valuation. These sites also had much more speculative and financially vulnerable sources of demand.¹⁷

3.2.2 Mergers and market consolidation

Surging land and house prices were intensified by a ‘mania’ for merger and acquisition activity (Ball 2010).

Merger activity grew strongly in the early 2000s. The most significant examples included Persimmon acquiring Beazer Group in March 2001, George Wimpey buying Laing Homes in November 2002, Taylor Woodrow buying Wilson Connolly Holdings in October 2003 and the acquisition by Persimmon of Westbury in December 2005.

But the peak of mergers occurred just before the housing market itself peaked. Berkeley acquired the remaining 50 per cent stake in St James during its 2007 financial year, Bovis

¹⁶ Crest Nicholson was bought by a consortium of HBOS and Sir Tom Hunter for over £700 million in March 2007 and McCarthy & Stone bought by HBOS for £1.1 billion in June 2006. Other private finance owned companies included Gladedale and Countryside Properties who were both heavily backed by bank lending. Countryside Properties was a stockmarket-listed company but was taken back into private ownership in 2005 and then part bought by Copthorn Holdings Ltd. It is now jointly owned by the founding family and HBOS.

¹⁷ Notably the small investor reliant upon funding from untested capital markets in the form of Residential Mortgage Backed Securities and the greater role of ‘Non Banks’ (Dolphin and Griffith 2011).

acquired Elite Homes during 2007, Barratt acquired Wilson Bowden in early 2007 for £2.2 billion: what one industry analyst called ‘top whack’ prices.¹⁸ Finally, in March 2007, Taylor Woodrow and George Wimpey agreed to merge to form the UK’s biggest housebuilder in a deal that was worth £5 billion.

Describing this merger ‘frenzy’ and sharp increase in overall leverage in the final few years of the boom, Ball observes that the major housebuilders ‘borrowed heavily’ in a ‘classic defensive strategy against acquisition as well as a means to buy competitors and to expand land banks and output’. While they were rising, asset prices masked the level of total gearing within companies.

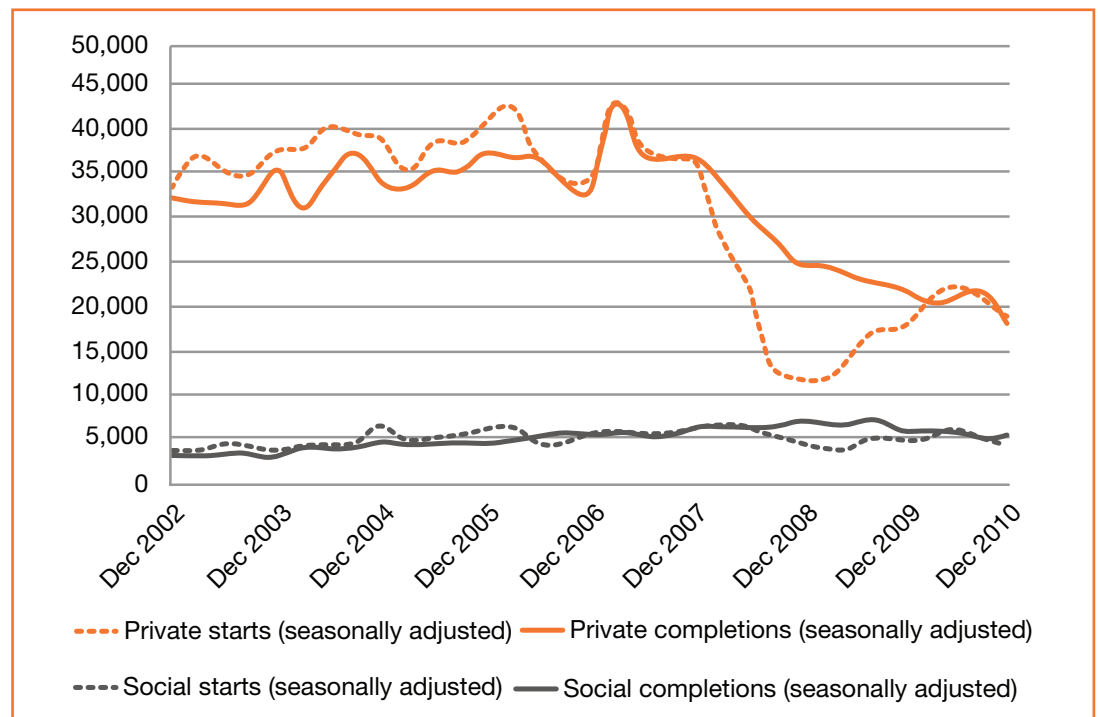
‘The outcome was disastrous as firms entered 2007/08 heavily indebted, with high costs and tumbling sales. It was one of the worst busts on record, leaving most housebuilders in dire financial straits.’

Ball 2010

3.2.3 The impact of the crash: a collapse in prices and profits

The credit crunch caused the collapse in the housing market and land prices. There followed a steep decline in housing sales, combined with a sharp drop in firms’ asset values¹⁹ and an increase in overall debt levels: a cash flow crisis combined with a balance sheet crisis.

Figure 3.9
Housing starts and completions in England (quarterly), 2002–2010



¹⁸ See <http://www.thisislondon.co.uk/markets/article-23873716-barratts-building-back-after-being-shaken-to-foundations.do>.

¹⁹ Notably current built stock and land

Housing starts fell 75 per cent between the first quarter of 2007 and the final quarter of 2008. Private housing market completions fell by 55 per cent from their peak by the beginning of 2010.²⁰

Table 3.1
Relative performance of the major housebuilders in completions, 2007–2009 (%)

	Taylor Wimpey						England total
	Barratt	Persimmon	Bellway*	Redrow**	Bovis	Berkeley***	
	-40	-44	-40	-56	-38	-55	-44

Source: Company reports, DCLG

Note: The major housebuilders do build elsewhere in the UK, so England market share has been somewhat overstated.

* February 2007–January 2008, etc; ** July 2006–June 2007 etc; *** November 2006–October 2007 etc

Both falls have been of a much greater magnitude than the previous two housing market recessions and were the largest in British post-war history. Housing starts in the last quarter of 2008 were lower than any period in the past 60 years and housing completions in 2010 were the lowest since the first world war.

In the short term, the cash flow crisis forced most of the major builders to stop housing starts and build ongoing projects as quickly as possible to realise sales. Many also focused on sharply stripping back capacity, through shedding offices, staff and equipment.²¹ This strategy of ‘eating themselves’, through shedding capacity and assets in order to pay down debt, hit builders’ current and future capacity to stay afloat.²²

The three largest UK builders were all hit hard, both at an operational level and through land writedowns. Persimmon made a yearly loss of £780 million in 2008.²³ Barratts made a loss of £592 million in the second half of 2008.²⁴ Taylor Wimpey suffered an even more spectacular £1.5 billion half yearly loss in 2008.²⁵ Taylor Wimpey shares fell 85 per cent in one year.²⁶ Shares in Barratts fell 92 per cent in 18 months.²⁷

3.2.4 Major land writedowns

The drop in land values hit balance sheets hard. Under UK accounting rules, land values have to be written down immediately. In 2008 and 2009, large losses impacted on all of the major builders.²⁸ Taylor Wimpey wrote down £600 million in one year. Persimmon wrote down £710 million in 2008 and 2009.²⁹ Barratt wrote down £100 million in 2008 and a further £494 million in 2009.³⁰ Redrow wrote down 30 per cent of its total assets in 2008.³¹

Industry analysts estimated that land writedowns would total between £10 billion and £15 billion, with the big six stockmarket-listed builders facing writedowns in the region of

20 The peak level of completions was in Q4 2007, measured until Q1 2010 (DCLG).

21 Taylor Wimpey closed 13 of its 39 regional offices in just one year (2008), Persimmon shed more than half of its staff in 2008, Redrow cut 40 per cent of its workforce in 2008.

22 Quotation from author, conversation with a UK housebuilder

23 See <http://www.investorchronicle.co.uk/2011/09/09/shares/news-and-analysis/persimmon-builds-on-housing-recovery-iiEU62oPfhjbpPa1AMg31H/index.html;jsessionid=17648271139F4277DB42C6DAE86E118E.mps-apr-02-8109>

24 See <http://uk.reuters.com/article/2009/02/25/uk-barratt-idUKTRE51O21B20090225>

25 Partly caused by land value writedowns worth £690 million, and goodwill and brand writedowns of £816 million. <http://uk.reuters.com/article/2008/08/27/uk-taylor-wimpey-idUKWLA856620080827>

26 See <http://www.telegraph.co.uk/finance/newsbysector/constructionandproperty/5296019/Taylor-Wimpey-raises-510m-to-cut-debt.html>

27 See <http://uk.reuters.com/article/2009/01/15/barratt-idUKLE37602020090115http://uk.reuters.com/article/2009/01/15/barratt-idUKLE37602020090115>

28 ‘During [2009] significant writedowns impacted heavily on housebuilders. These were mainly taken as a result of reviewing the net realisable value of land. The more notable exceptional items are: Taylor Wimpey £1012.8 million, Persimmon £911.1 million, Crest Nicholson £406.9 million, Barratt £255.0 million, Redrow £233.4 million, Bovis Homes £93.1 million, Crosby Homes £80.4 million, Bloor £64.8 million, Fairview £23.0 million, Galliford Try £11.5 million’. <http://www.theconstructionindex.co.uk/market-data/top-25-house-builders/2009>

29 See <http://www.telegraph.co.uk/finance/newsbysector/constructionandproperty/5766010/Persimmon-encouraged-by-housing-market.html>

30 See <http://uk.reuters.com/article/2008/07/06/uk-barratt-writedown-idUKL0656419020080706> and <http://www.independent.co.uk/news/business/news/barratt-books-163494m-writedown-on-land-bank-1632422.html>

31 See <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arQQk2rDKefA&refer=uk> and <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arQQk2rDKefA&refer=uk>

£4 billion.^{32,33} Those who expanded their land holdings most at the peak were hardest hit. This included the largest builders, but also hit the second tier of builders owned by private equity or other financial institutions.

Land writedowns leave two negative implications for the health of the building sector and its ability to increase output. The first is that although the land has lost value, the debt remains the same, which has implications for builders and banks that we examine below. The second is that because land writedowns are based on a land value with an assumed profit margin of zero per cent (where a 'normal' operating margin is around 15–20 per cent), it still leaves a significant issue of viability in the sector's revalued land banks. Revalued land banks still require much to be done to restore builder profitability.

Developers now have a choice of: building out impaired land, which dilutes their overall margins; keeping volumes low; or buying new land with positive margins and building on this in preference to older impaired land. It appears that the larger developers prefer currently to pursue the second and third options.³⁴

3.2.5 High levels of debt and constraints on access to capital

High gearing strategies can backfire, often spectacularly. Loans are unable to be paid back, initial investment capital is eroded, liabilities rise sharply while asset values fall, all of which makes debt burdens higher and harder to deal with. The crisis among housebuilders therefore quickly became a crisis for their lenders.

There was widespread breaking of banking covenants: Taylor Wimpey, Persimmon, and Barratt all broke bank covenants and had to renegotiate debt terms.³⁵ It is harder to assess the damage caused to firms owned by private equity – due to the lack of public disclosure of company data – but their higher levels of gearing will have hit their financial backers harder.

This led to higher debt levels and debt payments and more restrictive terms, due to greater perceived risk. Barratt had a peak debt of £1.65 billion in 2008.³⁶ It then achieved a debt refinancing package in the region of £1 billion lasting until 2015, but at high interest rates of 7.5 to 8.0 per cent.³⁷ Persimmon had to extend its borrowing to over £1 billion in 2009 and its borrowing rate rose from 3.6 per cent to 6.2 per cent.³⁸

Taylor Wimpey had one aborted rights issue in an attempt to raise emergency capital in 2008 and its debt was downgraded to junk status by ratings agencies.³⁹ It had a peak debt of £1.9 billion in the first quarter of 2008.⁴⁰ It then managed to secure a refinancing deal from lenders at £1.5 billion worth of debt, which it has since been focused on repaying.

But the level of exposure to UK residential property firms has meant that UK banks are as vulnerable to losses as their borrowers. As in the 1990s, banks are as fearful of realising their assets as they are of losing their loans.

This was highlighted in the debt restructuring negotiations at Taylor Wimpey. According to *Building Magazine*: '[T]hroughout the deal, the bankers insisted it would not be in the

32 Brickconomics, 19 September 2009

33 Data on land writedowns needs to be treated with some caution, due to the differing incentives on developers to publish higher or lower writedown estimates. Builders that write down land earlier can boost their potential profitability when the market starts improving. Those that delay the writedowns will keep their asset values higher for longer, which could be a benefit if they intend to raise capital (which has been a pressing post-crunch short-term concern).

34 Taken from discussion of author with a City house building analyst

35 Persimmon was least seriously impacted, with only elements of its covenants broken compared to much more serious breaches by Taylor Wimpey and Barratts. <http://www.ft.com/cms/s/0/2ac562f4-c1e5-11dd-a350-000077b07658.html#axzz1Xqao8KoS>

36 See <http://www.thisislondon.co.uk/markets/article-23873716-barratts-building-back-after-being-shaken-to-foundations.do>

37 Interim Trading Statement for the period 1 January to 8 May 2011

38 See <http://www.cnplus.co.uk/news/persimmon-agrees-debt-refinance-deal/1994499.article>

39 See <http://www.guardian.co.uk/business/2008/jun/18/taylorwimpey.construction>

40 See <http://www.reuters.com/article/2008/07/02/us-taylor-wimpey-idUSL0234444920080702>

lenders' interest to pull the plug because of their own weakness. The last thing the banks wanted was a busted housebuilder'. As one banking party to the negotiations said:

'There was always the danger in the air that Taylor Wimpey could say, "Sod this, we're handing the company over to you", which would completely screw up our books. I remember the odd sarcastic threat – you know, "Quite frankly if you're going to be this belligerent you can have the bloody company".'⁴¹

Although there has been a concerted (and, in some cases, successful) attempt by most large builders to pay down debt in the four years since the credit crunch, the combination of the sheer amount of lending to the major housebuilders during the boom, coupled with direct exposure at higher gearing levels to firms backed by private finance, mean that a large number of UK banks still have uncomfortably high levels of exposure to UK residential developers.

This exposure is a real problem. It means that UK banks have become very reluctant to realise asset prices at current market values. This is a particular problem for builders backed by private finance where banks appear to be keeping alive businesses that are no longer viable. This hinders the release of cheaper land and market adjustment. But it also makes banks reluctant to restart lending to healthier builders who could be in a position to resume market activity.

This section has shown how the effects of the credit crunch and its fallout on the building sector have been to deepen a number of its pre-existing major, structural weaknesses. Many of these weaknesses have been developing for many years, and have not been addressed by either government policy or wider trends and pressures in the housing market.

It is hard not to draw the conclusion that the building sector as operating currently is not capable of addressing the challenge of delivering a significant rise in house building, especially when this is going to have to be delivered at lower cost than has been the case in the recent past.

This is a cause for major concern, especially given the lessons from what has happened to the building sector and the housing market following previous recessions.

41 See <http://www.building.co.uk/news/finance/revealed-behind-the-scenes-of-the-taylor-wimpey-debt-deal/3140478.article>

4. THE COSTS OF DUCKING REFORM

LESSONS FROM PAST RECESSIONS AND THE RISK OF A 'LOST DECADE'

Long-term weaknesses and the short-term shock of the credit crunch have left the building sector poorly prepared to recover its own health and meet the country's need for new homes at an efficient price. This provides a strong case for reform.

The consequences of ducking reform are driven home even more clearly by considering the fallout from previous recessions.

The UK has experienced two major house building slumps in the past 40 years. But rather than familiar reassurance, this feeling of déjà vu should instil a sense of unease among policymakers, not least about the likely health of any recovery.

4.1 Previous 'lost decades' in house building: 1974 and 1990

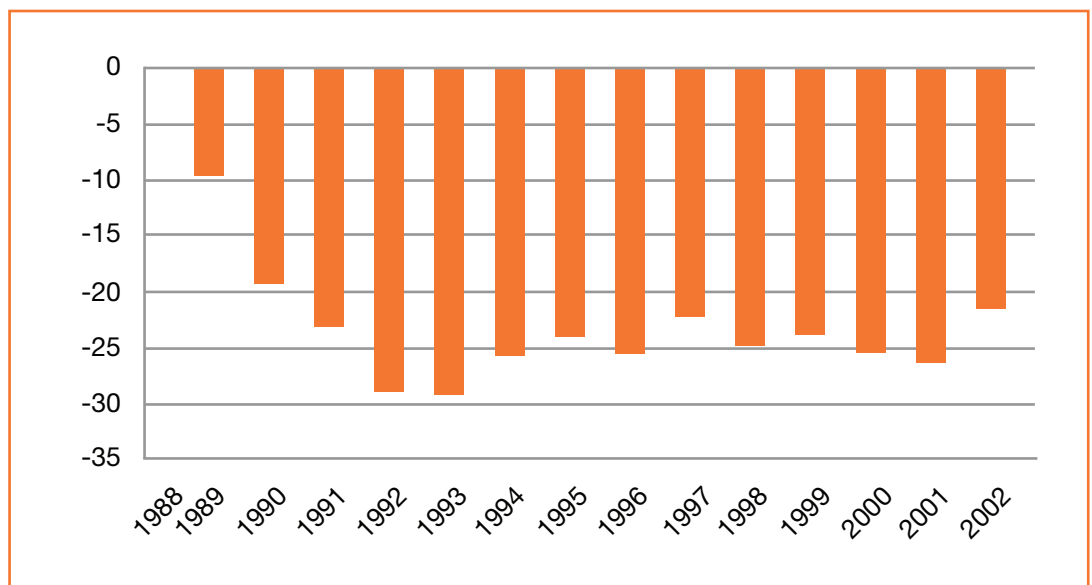
The historical experience of past recessions contrasts with the government's current public optimism for a strong supply-side response from the building sector. The past two British house building recessions, starting in 1974 and 1990, both resulted in a 'lost decade' for housing output. There are good reasons to believe the current trajectory of the building sector is following a similar path to deliver another lost decade for market housing output.

4.1.1 Shock and slump

In the 1970s, the initial recessionary shock led to private sector house building completions collapsing from 191,000 in 1972 to 140,000 in 1974: a 27 per cent fall. Housing starts between 1972 and 1974 fell by 55 per cent.⁴² While in the early 1990s, house building completions fell from 200,000 in 1988 to 141,000 in 1992: a 30 per cent fall. Housing starts in this period fell by over half at 65 per cent.

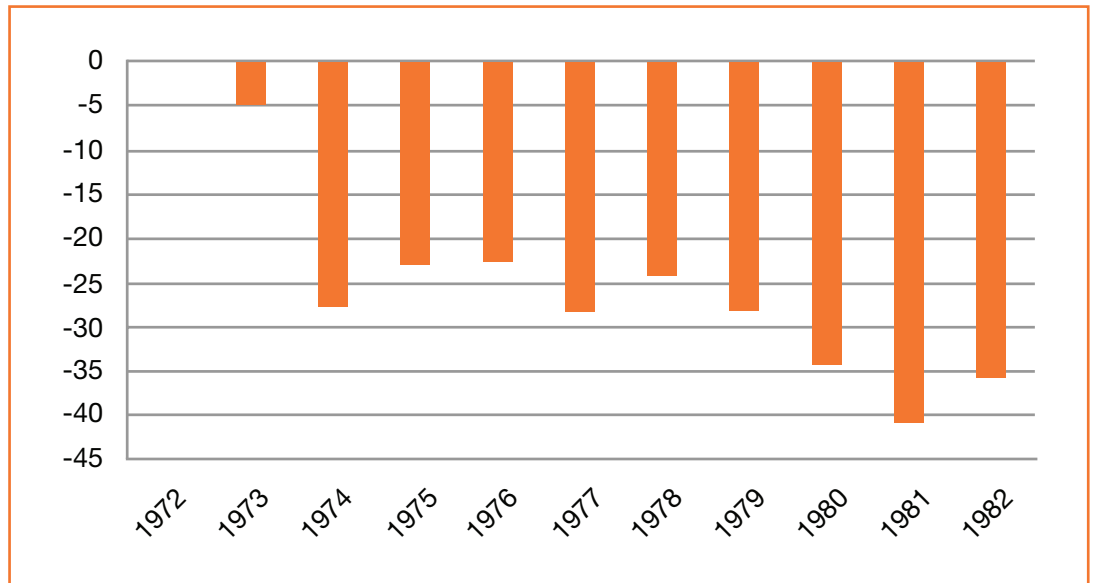
Worryingly, the current downturn has led to falls in both completions and starts that are substantially worse than both these periods, and from a much lower base.

Figure 4.1
Percentage of peak
output in private market
completions, 1988–2002



⁴² Figures for the UK, Housing and Construction Statistics, 1969–1979, HMSO

Figure 4.2
Percentage of peak
output in private market
completions, 1972–1982



After the 1974 slump, the sector saw a continued slow deterioration of output throughout the decade, reaching a low of 118,590 in 1981, 13 years from the market peak. In the 1990s there was also a decade of stagnant output at recessionary levels, with levels of completions in 2001 still at 26 per cent below the 1988 peak. Output only recovered to higher levels with the emergence of the 2004 boom, and never returned to 1988 levels.

This is part of a longer-term 50-year trend of declining total output over successive market cycles. Meen finds evidence of a structural change downwards in housing market output after the 1990 crash (Meen 2005). To understand why output slumped and then stagnated we need to understand what was happening within the building industry in these periods. We also need to understand why the development industry and planning system are trapped in a cycle that leads construction ever downward in the longer term.

Like the current slump, the two previous recessions provided major shocks to the building sector's balance sheets. Both recessions saw the collapse in the value of land and a major slowing in income. In the 1970s, land prices fell by 32 per cent between 1973 and 1975⁴³ and in the 1990s the value of land fell by 54 per cent between 1989 and 1993.⁴⁴

In both periods, the business models of the building sector had again become reliant on assumptions of continued rising house prices in making land-purchasing calculations. In the 1990s, this pressure was added to by falling nominal house prices, which hurt the value of unsold building stock considerably more, and caused land prices to fall much further and balance sheets to deteriorate more.

4.1.2 Impact on the building sector

The 1970s saw a significant rate of failings: Northern Developments were brought down by buying too much land with debt, and David Charles builders fell through a combination of high borrowings and buying land at 'astronomical prices' (Wellings 2006).

In the 1990s, there was a major shake-out of building firms, but these were all among small and medium-sized builders. In 1992 and 1993 the numbers of building insolvencies ran at 3,830 and 3,189 respectively (Barker 2003). There were no major housebuilders who went under, although many suffered major financial damage.

After a major expansion in land acquisition, much without planning permission, which became unsellable, 1974 saw substantial land writedowns alongside individual firm bankruptcies. 'The 1990 recession ... had a similar effect on land holdings ... there were extensive provisions, estimated at around £3 billion between 1990 and 1992' (Wellings 2006).⁴⁵

43 Data from Wellings 2006

44 Fall between spring 1989 and spring 1983 for residential land in England and Wales (source VOA).

45 Four housebuilders had land write-offs of over £100 million each, while another seven builders had losses

The short-term industry fall-out in both past recessions was heavily influenced by the behaviour of the banking sector. In the 1970s, a wider secondary banking crisis and less forbearance led to several major housebuilders collapsing. Although in the 1990s the financial impact of the slump was worse, there were no bankruptcies. Beazer, Mowlem, McCarthy, and Stone & Raine all breached banking covenants. Other companies relied on banking acquiescence to survive, including Trencherwood, Fairbriar, and Charles Church.

The echoes of the 1990 banking experience can be heard readily today. The level of banking exposure to residential investment led to a decision to exercise forbearance over building companies with deeply damaged asset books, '[b]elieving their best chance of repayment lay in the management building out the assets in a controlled manner' (Wellings 2006).

In 1991, the deputy director of RBS was quoted in the *Financial Times* about their rescue of one housebuilder:

'It is not in our interests to have a fire sale. We would probably be looking at a substantial loss if residential and commercial property assets were sold ... It obviously is preferable if companies can continue trading while prices recover.'⁴⁶

Although this avoided immediate bankruptcies, it still led to a building sector hobbled by damaged balance sheets for the next decade.

4.1.3 Stagnation and consolidation

Attempts by the sector to recover from these major shocks resulted not in innovation and sectoral improvement, but in stagnation and consolidation over a lengthy period.

The response of the sector was to focus not on expanding output, but in the twin tasks of rebuilding profitability, and managing and controlling losses and recessionary damage. Rather than act as a catalyst for sectoral change and improvement, recessionary shocks created a long period of retrenchment and underperformance.

Many builders were prepared to do this by allowing volume levels to shrink dramatically. In the wake of the 1970s recession, of the top 10 builders only one company (Barratt) increased output by any extent; all others stagnated or shrank. Examples of this include the builder Whelmar, third largest builder in 1974, which shrank to the 10th largest builder by 1980. Wimpey built no more houses in 2004 than it did in 1972.

But it also meant that, in a stagnant total market, business growth occurred not through increasing house building, but through replacing rivals via either longevity or acquisitions: '[L]arger housebuilders took a significantly larger share of a much reduced market' (Callcutt 2007).

In both periods, this led to significant consolidation of the industry. Industry change came not from new entrants and innovation, but through merger and acquisition activity which squeezed smaller and medium-sized builders and reinforced the dominance of larger underperforming firms.

Between 1989 and 2004 within the top 10 builders there were 'six straight takeovers, including five of the top seven, and each was the product of financial weakness' (Wellings 2006).

In the 1990s, the industry had to wait for the restoration of profits through the return of rising house prices 10 years later and the re-emergence of stockmarket-driven financing, rather than rely on improvement to business models.

Critically, cheap land in the wake of the crisis was not released. It took half a decade for land writedowns to finish and Wellings sees the wave of takeovers that happened from 2000 onwards as the final result of financial damage inflicted after the 1988 collapse.

of over £50 million. Federated Builders, for example, were critically weakened in 1990 by 'overambitious expenditure on land at the wrong time in the housing cycle' (Wellings 2006).

46 From the *Financial Times*, 17 August 1991, quoted in Wellings 2006

Rather than see market change, based on lower land costs, lead to innovative new players reshaping the post-recessionary industry, we saw a 12-year period in which damage to balance sheets was muffled in a long period of sub-par performance before finally being exploited by the surviving larger housebuilders.

4.2 Deja-vu all over again?

The parallels with the 1990s recession are striking. If anything, the current state of the sector and the wider macroeconomic picture are considerably worse than in the wake of the 1990 recession.

No major builders have gone bankrupt, unlike the large number of smaller unlisted firms. Many smaller firms have 'shut up shop' entirely, or switched focus away from house building (Ball 2010). In contrast to the wider UK corporate sector, UK builders remain indebted and are focusing on the restructuring of these debts. The cost of capital for the sector has also increased markedly: 'Leverage still remains high' (Ball 2010).

A significant minority of building companies have real questions about their viability as businesses: particularly, but by no means confined to, the second tier of private-financed builders with high gearing and debt levels. The challenge for this group is not a long journey back to increasing output, but a slow battle to postpone bankruptcy.

Margins have been substantially squeezed: many of the major housebuilders are operating at half the levels of their pre-crunch margin. The average margin of the five largest housebuilders in 2004 was 20 per cent (Wellings 2006). These levels have slumped since 2007, with Barratt (for example) operating at margins in the range of only one to three per cent in the wake of the crunch.⁴⁷

Large land writedowns have happened across the sector, making the ratio of assets to liabilities worse. These actions have gone some way to allowing builders (although not banks) to realise losses, but it has not restored land viability. Margins for written down land will still be close to zero per cent and, given the length of the boom and the size of pre-bust landholdings, this poses a major problem for hopes of increasing housing output in the future.⁴⁸

But rather than seeing a release of new developable land to new market actors, for most builders 'land sales are the last option' (Adams et al 2008). Land is such a central business resource in the UK building sector that firms are extremely reluctant to sell, particularly at lower market prices than those that they originally paid. According to one house building insider: 'There are virtually no cheap sales of land and land prices are still just too high. We are at an absolute impasse'.^{49,50}

After an initial crisis period, builders are now focused on rebuilding balance sheets, repaying debt, prioritising margins and restoring cash flow rather than attempting to increase output.⁵¹ Historical experience suggests that this is likely to take another five years, and possibly much more.

The UK banking sector is overexposed to UK residential property and UK residential land. It appears to be taking a strategy of extracting cash flow from its borrowers but deferring

47 See <http://uk.reuters.com/article/2009/01/15/barratt-idUKLE37602020090115><http://uk.reuters.com/article/2009/01/15/barratt-idUKLE37602020090115>

48 It is important to recognise that the written down value of impaired land on builders' balance sheets is unlikely to be the true market value. Accounting rules insist that land should, effectively, be written down to a zero per cent operating margin. This is clearly not what another buyer would pay for it. The price would have to be reduced to a level that would, typically, generate a 15 per cent margin. This may go a long way to explain why there has been relatively little appetite by developers and banks to sell land.

49 Conversation with the author, September 2011.

50 There is also a question of the balance between market supply and demand. Such is the cost of land as a proportion of the value of properties, builders have little interest in releasing additional houses at volume, as this increase in the level of supply reduces the likelihood of recouping the original land value retained in the asset.

51 For example, in an interview with the chief executive of Persimmon in 2010, he said: 'Our focus is to rebuild our margins' and debt reduction, not expansion or increasing output. <http://www.investorchronicle.co.uk/2011/09/09/shares/news-and-analysis/persimmon-builds-on-housing-recovery-iiEU62oPfhjbpPa1AMg31H/index.html;jsessionid=17648271139F4277DB42C6DAE86E118E.mps-apr-02-8109>.

realisation of bad debt. This both hampers market recovery and starves credit from healthy builders and possible new entrants into the sector.

Both the house building sector, and their banking partners, thus appear to be looking at a long wait for the slow, hoped for, return in demand in the shape of a return to steady house price inflation, land value inflation and greater mortgage lending.⁵²

These facts have two important implications.

The first is the lack of impetus to deliver new homes on the part of existing actors. Expanding production is not on the agenda. As one industry analyst put it: 'Financially, housebuilders are geared up for more retrenchment rather than growth'.⁵³ Existing builders will not be driving growth of house building in a way that our housing and economic growth strategies require.

'The majors will retreat from less favourable schemes and will hold out for better prices, even though this means sacrificing production.'⁵⁴

The second is the barriers this de facto freezing of activity puts in the way of new actors entering the market to revitalise delivery, the two most obstructive being lack of access to cheap land and development finance. Both implications point to a very real danger of a slow stagnation in delivery and a further 'lost decade' for UK house building.

The challenge of returning to delivering over 300,000 homes a year, necessary given the long-term undersupply of homes, looks extremely daunting based on sectoral arithmetic alone.

The largest three volume builders are now building at approximately 10,000 units a year.⁵⁵ It is unlikely that, over anything but the long term, these builders will raise production above 15,000 units per annum. In the medium term, over the next five years, it looks like a challenge to raise production to above 13,000 units per year. Our historical survey suggests even this may be a struggle. The top 10 builders are simply not going to deliver the homes we need.

One house building analyst suggests that, based on transaction, completions and starts data, house building at 80,000 to 90,000 private sector houses per year is the new likely level of completions for some time to come.⁵⁶ The 'general picture emerging is of a rebased market with house sales and house building running at about half their pre-recession levels'.⁵⁷

52 Given how low inflation is now compared to the 1990s and, even more, the 1970s, the impact of the current downturn may be even longer and more serious, as land values will not be pushed up by general inflation.

53 Bricknomics, 7 October 2010

54 Bricknomics, 7 October 2010

55 Taylor Wimpey completed 9,962 units in 2010, Barratts completed 11,377 units in 2010, and Persimmon completed 9,384 units in 2010 (sources, respective 2010 annual reports).

56 Bricknomics, August 18 2011

57 Bricknomics, August 18 2011

5. THE CAUSES OF FAILURE

HOW THE PLANNING REGIME AND THE BUILDING SECTOR INTERACT

Why does the UK have a building sector that is failing to respond to market demand, fails the consumer, and has a combination of conservative levels of housing output combined with heightened vulnerability to economic shocks?

This question usually has two answers: either it is the builders themselves, or the fault of the UK planning system.

The answer, of course, is both. The UK building sector and the UK planning system have been responding to and interacting with each other since the 1947 Town and Country Planning Act introduced the post-war planning system. The UK planning system is the skeleton around which the body of the UK building sector has grown.

Efforts to reform the UK planning system need to understand the likely reaction of the UK building sector if they are to succeed in improving its performance.

At the centre of this relationship has been the control of, and the market for, land. The planning regime – in its designation of areas that are and are not suitable for development – has created a new market (including new market incentives and dynamics) for land, based upon land scarcity. It is within this market that the UK building sector acts and responds.⁵⁸

5.1 The land market and the building sector

Land scarcity has created two critical sets of tensions for the building sector.

- **Value and reward:** The regulation of land use creates scarcity, but this also creates value, and with it the opportunity for reward. Land which is designated as having planning permission automatically becomes much more valuable than land without. This creates an easy financial windfall for whoever owns this land and is able to add value to it. Value is added by creating economic value – via using the land for development – but it is also added by the stroke of a planning official's pen. Achieving the latter offers an easier way to make money than the former.
- **Volatility and risk:** Land scarcity also creates volatility. Land prices rise and fall. They rise and fall because of external changes in market conditions or because of changes to the planning system. For those who seek to capture land value uplift, this creates both large potential upsides, but also large potential downsides.

The UK building sector has been profoundly shaped by these two sets of tensions. And these tensions have been intensifying in the past two decades.

The gap between the price of land that has planning permission and that which does not has been growing steadily since at least the 1980s.

There has been a growing chasm between the cost of residential land prices and agricultural land prices. A hectare of residential land in England and Wales cost £1,770,000 in July 2009 compared to £12,335 for a hectare of land used for dairy farming: 143 times as much, even after the collapse in residential land values. In high

58 It is important to note that this is a post-war phenomenon. In the pre-war period 'the rise of the price of land since the 1920s was of comparatively little importance, for although the biggest single capital outlay ... it constituted only a relatively insignificant proportion of total development costs' (Carr 1982, quoted in Wellings 2006). Wellings also quotes the AGM minutes of one of the major UK builders in 1953 stating: '[B]efore the war the supply of building land available and suitably planned greatly exceeded the demand in many areas and thus kept the pre-war price of virgin land very moderate indeed' (Wellings 2006).

demand areas such as the south east of England, these multiples reach over 400 times the value of agricultural land (VOA 2009). As land supply decreases, rewards intensify.

Land price volatility has also become more marked. As we noted above, UK residential land prices have a cyclical pattern of boom and bust with residential land prices more volatile than house prices. Greater rewards have the potential to become intensified losses.

Housebuilders argue that their land price appraisals have always been based on then current house prices and build costs. KPMG, however, find that land prices reflect *expected* changes to house price inflation, rather than *actual* house price inflation, calculating that an extra three per cent in forecast house price inflation adds an extra 10 per cent to land values (KPMG 2008). This adds to the land market an extra volatile impetus in a housing market with already marked tendencies to depart from economic fundamentals.

These tensions, and their intensification, have implications for how the UK building sector has operated.

5.2 UK builders' business strategies

The result of a complex planning system and the volatility of land prices is that housebuilders have become 'inherently land focused' in their business models (Adams et al 2008). Barker noted, 'the most important objective for a housebuilder is to obtain land where people want to live' (Barker 2003). As one UK builder commented, 'you need to fight harder at land buying than at final sales because that is where you make your money' (Adams et al 2008). Builders' business behaviour has, understandably, sought to maximise reward and minimise risk in its approach to land acquisition and housing development.

5.3 Coping with land and development risk

Land development is potentially much more economically rewarding than building new houses.

Land value increases have massively outstripped economic growth rates in the UK economy for at least the past 30 years (Callcutt 2007). In this context, a 'savvy' business strategy would sensibly focus more on capturing land value uplift than the prosaic business of building homes.

Some academic studies of the UK building sector see land speculation as an important and widespread component of business behaviour (Short 1982, Barlow 1999).⁵⁹ Using land uplift to contribute to growth can be profitable, but it is not without risks or opportunity costs (KPMG 2008).

Land development is, however, much riskier than house building. This is not just the result of the greater volatility of land prices, but also in terms of the cost of investment and the length of time between capital investment and gaining a final return.

Land has 'the longest time horizon and the most uncertain income-generating time profile' (Ball 2010). Land acquisition is also capital intensive, requiring more capital to be invested upfront, while returns only happen after the development is completed and sold.

Land also constitutes a disproportionate amount of current assets and working capital investment. Land value fluctuations therefore hit total liability-to-asset ratios hard (Callcutt 2007). If caught on the wrong side of the market cycle, the damage of falling land prices causes great financial distress and failure.

But, as we have seen, over-investment in land remains a powerful temptation to companies in the height of a boom.

59 Barlow (1999) claimed that 'from the 1960s to the late 1980s their main business strategy focused on capturing inflationary gains from housing and land markets', although the viability of this approach is dependent upon significant levels of house price inflation.

5.4 Land as a reason for conservatism in business strategies

The temptation to over-expand coupled with the delays of the planning system and the risks of failure mean that UK builders respond to risk differently to other businesses. The primary response has been through focusing on tighter supply management and conservatism in output.

As an overarching risk management tool, most homebuilders aim to avoid having too much production in any one year concentrated on any one site (KPMG 2008).

Most housebuilders appear to prefer to concentrate on smaller levels of controlled output at larger margins (capitalising on maximum land value uplift), rather than increase production, even if this may mean short-term absolute profits are lost. This can be characterised as either realistic risk management (Ball 2006) or the behaviour of a stagnant and unresponsive business sector (Morton 2011). As one housebuilder put it when interviewed about its growth strategy: 'We'll double in size, but halve the margins, so what's the point?' (Wellings 2006).

The high levels of risk⁶⁰ keep production levels down. How to deal with and mitigate these levels of risk is therefore an important issue for policymakers.

5.5 Planning, land and the UK building business model

Responding to these risks and rewards has, in the UK's case, led to a novel set of institutional innovations. These include a) a 'land first' approach to development, b) 'vertical integration' of land acquisition and housing development, and c) land banking.

5.5.1 A 'land first' approach to development

Larger UK housebuilders have become more focused on land trading and adding value through the planning system than the actual business of building houses. The Callcutt Review put it succinctly: '[I]dentifying, acquiring, preparing, developing and selling land is the key activity of all [UK] house building companies'.

The Office of Fair Trading (OFT) gives more detail:

'Large homebuilding businesses are driven by their land acquisition units with key corporate decisions on expansion, mergers and financial structuring most heavily influenced by the need to acquire land. Indeed, rather than thinking of homebuilders as construction firms that have integrated upwards into land development it may be more realistic to think of land developers who have integrated downwards into home construction.'

OFT 2008 [author's emphasis]

5.5.2 The 'vertical integration' model of UK housebuilders

The focus on land trading has led UK housebuilders to develop a unique business model within Europe, based on the 'vertical integration' of land and housing development.

UK housebuilders aim to control the whole of the development cycle, from the sourcing and purchase of initial land, through its processing through the planning system, to the final construction and marketing of houses.

This model is not shared widely elsewhere. Most European countries employ other business strategies, as do the US and Australia.

Vertical integration helps UK builders capture value throughout the development process, but it also raises risk, by increasing the level of capital investment needed and extenuating the time period in which business is vulnerable to changing market conditions. As we have seen, this model has significant costs in low output and enhanced economic vulnerability.

⁶⁰ As well as lack of competitive pressures.

5.5.3 Land banks and land banking

Land banking is a central part of UK builders' business model. It is how builders react to external pressures imposed on them by the planning system (both land scarcity and long delays and uncertainty of outcome).

It also helps builders cope with the external pressures of the land market: both from the rising (and falling) of land prices and the demands of landowners for higher and higher prices (Adams et al 2008). It is also a method of control to extract the maximum uplift from land values.

There is much debate around the use of land banks. Some view them as a method by which the building industry seeks to constrain supply and speculate on land value increases (CIH 2003, RTP1 2007). Another, more prosaic, risk-focused explanation is that land banks are an inevitable mechanism through which developers try to cope with the risk and uncertainty involved in the development process (KPMG 2008, OFT 2008, Callcutt 2007).⁶¹

Both sets of views represent a particular take on the way in which builders use land banks to try to capture rewards but minimise risk. But there is little doubt that land banks are a function created by the operation of the planning system. UK builders' behaviour is, to a large extent, a rational business attempt to respond.

Land banks are often split into two categories.⁶² The first is '**current**', with planning permission, **or short-term land banks**, through which short- to medium-term development needs are met. This is the most commonly used definition when discussing land banks. These short-term land banks will include land that has been, or is close to being, granted planning permission.

The second is '**strategic**' **land banks**, through which builders control and access larger amounts of land that may become developable through the planning system in the medium to long term. Strategic land banks do not contain land that has been granted full planning consent. Strategic land banks are usually bought on 'option' rather than bought outright.

The Barker report found the average 'current' land bank was equivalent to three to seven years production. The OFT found that within current land banks the average amount of land with planning permission was equivalent to 3.2 years of production.⁶³ The OFT also found that the 'vast majority' (82 per cent) of land held by builders was strategic land, and these strategic land banks were an average of 14.3 years long (OFT 2008).

In focusing on land that has not yet been granted planning permission, strategic land banks aim to capture more of the uplift on land value. The margins on strategic land have 'generally been significantly higher' than those on short-term land (Callcutt 2007).⁶⁴

61 The OFT, in an enquiry into competition within the building sector, found that 'homebuilders' land banks appear to be largely explicable in terms of the amount of time it takes to promote land through the planning system, and the risks involved in doing so' (OFT 2008).

62 Housebuilders are also often split into two camps: long and short land bankers. Companies that take several years to develop land can benefit from cumulative house price inflation, as they can end up with higher margins than originally used to value the land. This is less pronounced with short land banks, which are developed more rapidly. But there is greater capital tied up in long banks, thus potentially lower return on capital employed. Companies also potentially take longer to react to falling house prices if they carry a longer 'tail' of land.

63 Information on land banks and the residential land market is dogged by a lack of clarity. According to one of the leading academics of UK house building 'not much is known about the operation of the residential land market' (Ball 2010) while others complain that 'published data on land banks does not tend to be particularly accurate' (Ball et al 2008). This is partly a definitional problem: different building companies release different sets of data, with little consistency in definitions or classification (KPMG 2008). But it is also a problem of commercial sensitivity and conflicting incentives. Land banks are critical to the business health and growth strategies of the major builders, which makes them reluctant to disclose too much detail publicly. The size of land banks is a politically sensitive matter, leading to critical attacks that housebuilders are 'sitting on land'. But at the same time, the size of land banks is seen by industry analysts as a key indicator of company strength, an important matter for stockmarket-listed housebuilders. UK builders are pulled in different directions on land banks and some dissembling and contradiction is a consequence.

64 And due to high levels of house price inflation and land scarcity 'strategic land has grown in value at a considerably higher rate than the housebuilders' cost of capital. This has meant that strategic land banking has been profitable.' 'It has therefore been cheaper to acquire, and hold, a very large quantity of un-consented land for a long time and process it through planning to extract development plots, than it would be to purchase a smaller quantity of short-term land to fulfil the same plot quota' (Callcutt 2007).

Although margins can be higher for strategic land, these are counterbalanced by the unpredictability of the process, the level of overhead required to process planning applications and the risk that builders may be compelled to buy the land if house prices are falling to unprofitable levels when consent is finally granted.

Strategic land is generally bought on 'option'. The developer does not buy the land outright, but agrees to handle the planning process on behalf of the landowner. This can take years and may not be successful. If planning consent has been achieved, the option agreement sets a discount to an open market valuation at the time of permission being granted. The level of discount has been declining for some years, from often 50 per cent to around 10 per cent.⁶⁵ Over 60 per cent of land banks were found to be under 'option'-type agreements by the OFT.

Land banks have very important implications for the patterns of growth in the building sector, its vulnerability to economic shocks and the problems it faces recovering from these shocks.

Land banks embody the two sets of tensions outlined above. They are an attempt to maximise control and reward from the development process. But they also create a 'long tail' of risk. The larger UK housebuilders' land holdings are, the more exposed they are in capital, debt and land price risk.

As we have seen, this has important implications for their exposure to economic shocks and their ability to recover from these shocks. If builders are unable to offload all land risk before a downturn, they can only build when land prices return to previous levels or if they are able to 'mix adjust' their existing land holdings with cheaper land over a longer time period to make their land holdings viable. This helps explain the situation in past recessions, when developers appeared to have to wait until land and house prices started to rise before building returned to higher levels.

5.6 Land and housebuilder consolidation

The overriding focus on land by the building sector has been a key factor driving greater consolidation in the industry and squeezing diversity by pricing out smaller companies and self-builders. Land not only gives a strong rationale that drives consolidation, it also presents major barriers to entry to any new market actors who may attempt to enter the industry.

The business of land management creates several reasons favouring consolidation within the sector.

The first is financial. Land banks, and the competitive advantage they bring, need larger financial reserves. Although land without planning permission is much cheaper than 'oven ready' sites with planning permission, buying this land requires access to major financing arrangements that require size and clout.

The increasing role of 'brownfield first' within the planning system has further exacerbated this. Brownfield sites, with higher density development and major remediation and infrastructure costs, are more capital intensive (KPMG 2008), so require larger borrowings and favour larger firms with access to capital markets and greater financial power.

The second is organisational. Access to land that is likely to be available through the planning system requires significant levels of both capacity and knowledge. Accruing strategic land banks requires the ability to find, negotiate and 'option' a future land supply, manage contracts with landowners and progress plots through the planning system. The last of these can be particularly cash-, time- and people-intensive, and favours larger firms who have the capacity and economies of scale necessary to deal successfully with the planning system, both at the local authority and national level.

Land, as well as stockmarket pressures on major housebuilders to deliver earnings growth, has also been a central driver of merger and acquisition activity. The basic fact

⁶⁵ Taken from discussion of author with a City house building analyst.

of land scarcity means that business expansion is easier via taking over companies' land banks than trying to acquire your own.

The role of land in driving mergers and builders' growth strategies has been outlined in some depth in Michael Ball's analytical work on UK housebuilders' strategies (Ball 2006 and 2007). In the six OFT reviews of proposed mergers between 2001 and 2007 'in most cases' access to land banks were cited as part of the rationale.⁶⁶ Other building sector representatives agree that land is the major reason for merger and acquisition activity and the primary driver in nearly all large mergers since 2000.⁶⁷

Control of land and land banks has thus played a central role in both industry change and the reshaping of the building sector in the wake of recessionary shocks. This latter point is of critical importance for current policymakers.

Worryingly for those concerned with raising levels of UK house building, consolidation via mergers is also strongly associated with decreasing levels of housing output among the affected firms. Analysis of the five merger and acquisition deals with values over £500 million by KPMG after 2000 found that 'all appear to have resulted in the combined entity producing fewer units in the subsequent year, compared to their combined output in the previous year'.⁶⁸

Table 5.1
Estimated housebuilder post-deal volumes after acquisitions and mergers, since 2000*

Acquirer	Target	Date	Units sold (pre deal)	Units sold (post deal)	Volume change
Wilson Connolly	Wainhomes	April 2001	5,953	4,002	-33%
Persimmon	Beazer	Jan 2001	13,671	12,352	-10%
George Wimpey	McAlpine	Oct 2001	14,466	12,124	-16%
George Wimpey	Laing	Nov 2002	13,410	11,813	-12%
Taylor Woodrow	Wilson Connolly	Sep 2003	9,941	9,053	-9%
Persimmon	Westbury	Jan 2006	16,701	15,905	-5%
Barratt	Wilson Bowden	Jan 2007	20,087	17,168	-15%
Taylor Woodrow	George Wimpey	July 2007	21,910	13,394	-39%

Source: Annual reports

* Notes: Units sold pre-deal have been estimated by amalgamating closest full year results before the transaction date of the acquirer and target. Units sold post-deal are based on the earliest available full year results which combine both entities.

5.7 Land as a barrier to entry

Land acts as a barrier to new entrants into the house building market, reducing the dynamism of the sector and its ability to create cheaper and better homes.

The problem of land acquisition as a barrier to entry was a finding of the Barker Review and the Callcutt Review, which saw it as a 'de facto barrier for new entrants'. The study by the Office of Fair Trading of the UK house building sector found that entry and exit into the top 10 builders was almost entirely dependent upon merger and acquisition activity, rather than organic business growth (OFT 2008).

The barrier is particularly important for small firms who try to expand into medium and large firms, and also as a barrier to foreign firms looking to enter the UK market.

'Increasingly it is land rather than finance that becomes the most significant barrier to further expansion. Many of the very largest firms have had to acquire land through purchasing other homebuilders and their land holdings'

OFT 2008

66 'Many of the mergers that have created larger firms have been in part motivated by a desire to obtain land ... Acquisition of a greater number of sites becomes a critical part of these fast growing homebuilders' expansion strategies ... for a homebuilder looking to grow rapidly the key is to acquire more sites rather than expand production on the sites that it already has' (OFT 2008: 69).

67 Conversation with a major UK housebuilder.

68 This was put down to a combination of risk management, post-merger rationalisation and a scaling back of output to meet market demand.

The reasons for land presenting this barrier echo some of the issues already examined, financial strength and organisational capacity being two.

But one of the most important factors is knowledge. This includes knowledge of the planning system (particularly at a local level, where intimate relationships are built up with local planning staff) and knowledge of local land markets and landowners. Strategic land banks are not just collections of land, they are collections of land that is at the right price and in the right place.

The land buying market thus depends on local knowledge. This dependence is so pronounced in UK residential land that some doubt whether an 'open market' exists for the majority of UK residential land purchases.

'[Larger developers] retain estate agents, especially in pressured areas, to bring sites to their attention. Such agents are expected to know when potential development sites are likely to be marketed, who owns them, when any lease will expire and whether planning permission can be easily obtained ... Competitive bidding for sites 'on-market' is thus a last resort, when other more informal methods have failed to procure enough sites 'off-market' ... The local network and localised knowledge are seen as an important source of competitive advantage.'

Adams et al 2008

As one interviewed housebuilder put it: '[T]he best way to buy land is through contacts. We only occasionally buy [land] that is fully in the market' (quoted in Adams et al 2008).

Therefore, new entrants face a series of serious obstacles to acquiring cheap, developable land. Large strategic land banks are legally owned via options agreements by existing builders; existing builders know well and work through the local (and national) planning system; and a network of local agents and buyers is usually first off the mark in terms of finding potentially available new land.

Strategic land banks ensure that any land released by the planning system (in which 'allocated land' is of central importance) is highly likely to have been retained by existing actors, while the vertical integration model of UK builders ensures that this land is captured far upstream of the actual building process. As Paul Cheshire describes it, the planning system 'gives monopoly power to developers who own particular patches of land where large proportions of development [are] being made available'.⁶⁹

The result is that very few new entrants succeed in breaking into the market. The record of foreign entry into the UK market (so common in most other economic sectors) is thus dismal, and its rare success is reliant upon companies entering by buying strategic land banks via company acquisitions (OFT 2008).

One major Dutch developer interested in entering the UK market said that 'direct land purchase and development posed too many risks due to knowledge and information barriers' (quoted in Ball 2010). While the OFT found that barriers to foreign firms were 'significant' (OFT 2008), particularly the vertical integration of UK firms and the control over land purchase activity.

For smaller UK builders, these land-related barriers mean that developable sites are scarce and, by the time they get to market, very expensive.

Small builders thus tend to specialise in contract work for existing larger builders rather than buy sites themselves, while self-build suffers from high land prices and lack of opportunities. Despite the growing popularity of the idea of self-build, we have seen a decline in actual uptake. Barlow (2001), Ball (2010) and the OFT (2008) argue that rising land values have led to self-build only being a viable option for increasingly well-off households, given the costs and upfront capital outlays involved in land purchase.

69 Paul Cheshire, Emeritus Professor of Economic Geography, London School of Economics and Political Science, speaking at the House of Commons CLG Select Committee, 10 October 2011

6. EXISTING POLICY MISSES THE TARGET

PLANNING REFORM, SUBSIDIES AND LAND RELEASE WON'T BE ENOUGH ON THEIR OWN

The problems identified in the previous chapters are not widely acknowledged within policy debates about housing – and have certainly not been part of government strategies to address housing supply challenges.

The previous Labour government focused on steps to help first-time buyers get on the housing ladder and allowed the mortgage market to be relaxed, making it easier to borrow to buy. However, this tended to drive up prices rather than encourage new supply. It is also a much less viable strategy now, given the fiscal position and much tighter credit conditions.

In the aftermath of the financial crisis – and during the recession – the government invested large amounts of money into the building sector, to protect construction jobs and boost economic activity. While this stabilised the financial position of the leading building firms, the evidence suggests it delivered poor value for money in terms of securing employment or spurring economic activity.

The current government is focusing its efforts on reforming the planning system and increasing the availability of land. Both are important and valuable steps – but if they are not accompanied by changes to the building sector, their impact will be far more limited than might otherwise be the case. Surprisingly, the Housing Strategy also saw a return to the previous government's emphasis on channelling subsidy to the major housebuilders: a repetition that is also unlikely to be successful in increasing long-term levels of housing output.

Yet a vigorous supply-side response is now a central plank of UK government strategies for both housing and economic growth.

This chapter considers these policy approaches to increasing the supply of housing, and sets out why they are ineffective, and now risk being counterproductive.

6.1 Will current and proposed solutions work?

The government has not demanded a clear reformist quid pro quo from housebuilders, despite high levels of state subsidy and intervention. There are clear dangers that poorly conceived intervention will cut against an effective longer-term strategy for raising housing supply. Without a clear idea of what we want the future building sector to look like, intervention becomes much more vulnerable to institutional capture and dissipation of intent.

We outline three areas where intervention is at risk of failing to address the challenges of building sector reform. These are:

- intervention using direct government subsidy which postpones reform and is used primarily as a way to rebuild balance sheets of failing builders rather than foster future growth in housing output and the entry of new market actors
- demand-side stimulation without sectoral reform that is likely to lead to higher land and house prices rather than higher output
- planning reform that does not deal with issues of access to new land and the health of the building sector, and the danger that this will deliver a very muted level of new house building.

6.1.1 The impact of emergency recession measures

Government intervention in the building sector since the financial crisis has been significant in cash terms, but poorly conceived in terms of policy impact. These mistakes are now being repeated.

The credit crunch and the collapse of the mortgage and land markets led to a major gap between the value of major housebuilders' assets and the new market price for housing, reflected in a widespread lack of viability for current and future sites.

The reaction of the government has been to try to bridge this gap through various fiscal interventions.⁷⁰

First, the government intervened through direct subsidy to housebuilders, through the £400 million Kick Start package from 2009 and the £400 million Get Britain Building fund announced in the recent Housing Strategy in November 2011. These two programmes aimed to restart unviable current developments by providing a direct capital grant to housebuilders.

Second, the government also attempted to fill in the shortfall between available mortgage funding and the sector's asset values through shared ownership schemes and mortgage guarantees. This included the Labour government's flagship HomeBuy Direct (introduced in 2008), the Coalition government's FirstBuy scheme (introduced in 2011), and the newly introduced Mortgage Indemnity Guarantee (MIG) scheme for new build announced in November 2011. Although purportedly first-time buyer initiatives, in practice these schemes have been additional government subsidy programmes for the major housebuilders.

Thirdly, government has seen public land as a way to inject lower input costs into the building sector, both by selling land at lower, or nil cost, or by restructuring the repayment terms, so that it is paid for after the final development is sold, thus relieving upfront financing costs for builders. This occurred under the Labour government, for example the Public Land Initiative in 2010, and an alternative scheme was announced under the Coalition government as the Build Now, Pay Later scheme in March 2011.

Government has seen these interventions as a way to maintain current output levels for a sector in financial difficulties. Although they have helped maintain short-term output, unfortunately nearly all these approaches have failed to understand the current position of the housebuilders and the sector's likely medium-term business response. Nor have they set intervention within a strategy for raising longer-term output.

One of the major downsides of these forms of subsidy is that they have helped housebuilders to pursue a post-recessionary business strategy of repairing balance sheets while maintaining a new low-output growth model. They have enabled financially troubled housebuilders to offload unviable developments, maintain cash flow in order to pay off debts and consolidate their threatened position within the market.

Public land programmes are more promising, in helping to neutralise land risk within the development process, but they must be done well if they are to lead to greater levels of housing output. Providing subsidised public land may merely help builders 'mix adjust' their current production to prioritise developments with higher margins, yet lead to less production elsewhere, with no net overall gain in house building. Unless strict criteria are imposed there will be a temptation for these schemes to be used to repair existing builders' balance sheets rather than increase levels of overall output. We discuss this more in our recommendations below.

70 These are one of the few areas of housing policy where the efforts of the Coalition government are almost identical to its predecessor, a testament to the strength of the relationship between the housebuilding lobby and DCLG officials.

HomeBuy Direct

In 2008, most large housebuilders were faced with a major supply overhang. They had too many units on their hands (concentrated particularly in one- and two-bedroom city centre apartments) and the market price was now substantially lowered.

HomeBuy Direct enabled the government to provide subsidised finance in order to allow the building sector to sell units at arguably significantly above the market price, with the cost burden falling primarily on the consumer via a lower equity share in the property.

Rather than release cheaper housing onto the market, intervention allowed builders to sell oversupply at a higher price to the consumer. Discussing the HomeBuy Direct product, one housebuilder quoted in the *Financial Times* said: '[H]ouse prices would have fallen further had it not been for these products, so people would have bought cheaper'.⁷¹

These emergency shared ownership schemes also enabled some larger builders to shift liabilities from immediate market losses into equity shares which could be hidden as longer-term liabilities, which could hopefully be sold off balance sheet once liquidity had returned to the market. As Persimmon's finance director observed in an investors conference call: 'It does de-risk that [shared ownership] asset to a certain degree, compared [to] doing it all on our own balance sheet'.⁷²

The benefits for first-time buyers from these programmes is much less clear. Participants will have bought a house (or usually a flat) in which there was usually a strong degree of oversupply, at above market value in a falling market and with only a partial share of ownership. The programmes were also structured to give greater selling power to the developer over the consumer.⁷³ It is hard not to come to the conclusion that the primary beneficiary of these schemes has been the house building industry and not first-time buyers.

IPPR analysis also highlights that government post-crunch fiscal initiatives have been disproportionately captured by the larger builders.⁷⁴

Of the £213 million spent on HomeBuy Direct between 2008 and 2011, 64 per cent (worth £137 million) went to the four largest housebuilders, 84 per cent went to the largest 12. One in four sales at Persimmon was through HomeBuy Direct and Shared Equity in 2009.⁷⁵

Over 50 per cent of the £169 million of government allocations of FirstBuy funding in 2011 went to the top four largest building companies. Taylor Wimpey, Barratt and Persimmon alone captured over £80 million, or 47 per cent of available funding. Approaching 75 per cent of allocated FirstBuy funding went to just the top 15 UK builders.

In the second tranche of Kick Start funding, worth £174 million, 50 per cent of funds went to the top 12 UK builders, with 19 per cent of money spent going to just one builder (Persimmon).⁷⁶

71 See <http://www.ft.com/cms/s/0/694b7480-cd93-11df-9c82-00144feab49a.html#axzz1aTlAgGb9>

72 Comments by Mike Killoran, group finance director, Persimmon plc, on the HomeBuy Direct product at an investors conference call on 25 August 2009: http://production.investis.com/psn/investor/presentations/2009/hy09_trans/hy09_trans.pdf

73 The units sold were selected and brought forward by the developer (making it likely that it was a channel for developers to sell off the least sellable stock) and sold at a price where there was no room for price negotiation downwards by participating first-time buyers, unlike other units being sold on the open market.

74 The Homes and Communities Agency was not prepared to share funding data with us beyond that of HomeBuy Direct and the National Affordable Housing Programme on grounds of commercial sensitivity. The following data has been secured via the HCA's website or previous HCA data releases.

75 See http://production.investis.com/psn/investor/presentations/2009/hy09_trans/hy09_trans.pdf

76 It is worth noting that the first tranche of Kick Start, which IPPR has not been given data for, was criticised for being difficult for smaller builders to access. The second tranche of Kick Start was altered in order to give access to more small and medium-sized housebuilders.

Although the vast majority of government spending on the National Affordable Housing Programme (NAHP) budget went to housing associations, the top 20 housebuilders still received significant levels of this taxpayer funding, totalling £345 million between 2008 and 2011.

The government rationale for intervention has been driven by two important short-term considerations. Before the election, the primary concern was one of reducing the employment shock of the recession, after the election it has become increasingly one that is concerned about the impact of the building sector on headline GDP growth, to which the construction sector is a volatile contributor. Both governments have also been concerned with preserving the capacity of the major builders, who are seen within DCLG as key partners and allies in housing delivery.

But as we have seen, all three of these assumptions have serious flaws: despite intervention, employment in the building sector still plummeted as major builders shed contractors rapidly and concentrated on core head office functions; the 'capacity' of the major builders also collapsed, as large builders slashed inventory, and the collapse in residential investment has still had a substantial negative impact on GDP figures.

These interventions also have two longer-term negative side-effects. The first is it makes the release of cheaper land much less likely. The second is that it reinforces further consolidation within the building sector, stifling innovation and preventing the emergence of new firms who are most likely to be able to capitalise on falling land prices and new market opportunities. Larger firms benefit from being seen as 'too big to fail', but smaller firms have become increasingly frozen out of access to credit and government support packages.

6.1.2 Easy credit and stimulating demand for mortgages

The damage to the UK mortgage market after 2007 has meant that a significant thrust of the house building lobby since has been to try and get government to resuscitate demand, particularly mortgage demand, to 2007 levels.

The industry rationale is understandable. They have high levels of investment that was only (just) viable at 2007 prices, which in turn was dependent on having buyers take on 2007 levels of debt. Reopening the taps of credit seems an easy way in which to restart the house building machine, or at least make current asset holdings more viable.

This approach has been encapsulated by the recent Mortgage Indemnity Guarantees for new-build properties announced in the November 2011 Housing Strategy.

Some lobby groups (the Confederation of British Industry [CBI], Council of Mortgage Lenders [CML], the House Builders Association [HBA] and the Home Builders Federation [HBF]) have at various times also pressed for more wide-ranging government intervention in the mortgage market, either replicating the recommendations of the Crosby Review (Crosby 2008) for the state to underwrite guarantees on mortgage market debt issuance or to see a variant of quantitative easing involving the mortgage market adopted.⁷⁷

The lobby for government to stimulate mortgage finance also poses three questions: whether it is achievable, whether it is desirable, and whether it would be effective?

On achievability, the UK mortgage market now has a very large funding gap following the credit crunch, which removed securitised lending.⁷⁸ Not only does the UK banking sector face significant capital shortages, but so do the European and American banking sectors. The current residential housing cycle in the UK still looks to be firmly in its downward phase, long-term metrics suggest housing is still overvalued and investors are likely to steer clear of the residential investment market for some time. The market is not going

77 See, for example, the HBF and CML response to the Crosby Review, CBI (2011) or the HBA on mortgage finance. <http://www.telegraph.co.uk/finance/newsbysector/epic/psn/3269221/Housing-gloom-deepens-as-Persimmon-announces-600m-writedown-of-land-values-financial-crisis.html>

78 One recent estimate puts Residential Mortgage Backed Securities at approximately 75 per cent of UK mortgage lending in 2007 (Carver 2011).

to provide the capital needed to return mortgage lending to previous levels. Increased mortgage market demand is therefore only going to occur through some form of state intervention.

As well as the practical and economic difficulties involved – and there are many⁷⁹ – there are distributional reasons not to go down this route. It would represent a de facto large transfer of wealth from non-property owners to property owners (in practice from poor to rich) and would be a regressive transfer between generations.

But the strongest reason for concern is doubts about whether this approach would be effective at stimulating house building.

Firstly, mortgage credit levels increased by 182 per cent between 1999 and 2007⁸⁰ with little impact on housing supply. Restarting the flow of mortgage credit would, on this evidence, be an inefficient way of achieving more house building.

Secondly, the length of time in which housebuilders respond to increased demand will be several years. This is likely to mean that in the short term, stimulating greater mortgage finance will lead to a period of sharply rising house prices before we see a supply response, and historical experience suggests this supply response will be very weak.⁸¹

Thirdly, this supply response relies upon output decisions by builders who have many current business reasons not to increase output. Intervention may help some rebuild margins, but it is unlikely to lead to sustained or much greater levels of housing output. In addition, it is reliant on their confidence that mortgage stimulus would be sustainable, continued and low risk. Given the risky nature of government or central bank intervention in the mortgage market, and the wider context of deep global financial market uncertainty, this is unlikely to be the case.

Finally, previous increased credit also had a powerful effect on increasing land prices, which would mean that mortgage stimulus is likely to further cut against the ability of the sector to deliver cheaper housing.

The more targeted Mortgage Indemnity Guarantee scheme for new builds avoids some of these risks and may give the incentive for housebuilders to start or complete new building. But it has other serious downsides; not least that it is likely to be used by housebuilders to proceed sales at prices that are inflated above market prices as a way to deal with currently unviable assets. Other concerns about poor consumer protection⁸² were borne out in practice by the previous government's HomeBuy Direct scheme with which the new MIG shares several characteristics (see above).

6.1.3 Planning reform

One of the boldest moves by the current government is its intention to reform the planning system. As we have seen, the UK planning system has not been releasing nearly enough land to meet housing demand. Restrictions in land supply, particularly in places where people want to live, have raised levels of costs, debt and risks for the building sector and pushed the price of new housing up for the consumer.

Reforming the planning system therefore needs to be central to the aim of releasing cheaper land into the development pipeline. But although necessary, it is not sufficient. In order for planning reform to lead to an increase in cheaper, better quality, housing it is reliant upon having a building sector that can use cheaper land to build cheaper housing.

79 Not least the fact that UK households already have higher levels of mortgage debt to GDP than any other country and increasing this debt looks unsustainable in market terms and increases the likelihood of a decline in investor confidence.

80 Bank of England: Mortgage lending data, annual mortgage lending

81 For an eloquent explanation of this dilemma see a recent paper by Robert Carver for Pro Bono Economics (2011).

82 The MIG scheme puts the exposure to the risk of capital falls on the consumer in an asset that appears overvalued, making negative equity more likely. There are also concerns about the market power of housebuilders in sales and the possibility of unhealthy relationships between builders and mortgage lenders, given the exposure of some banks to housebuilders' liabilities.

Planning reform therefore needs to think carefully about how it will interact with the building sector and how any land released by better planning rules is likely to be used.

The draft National Planning Policy Framework requires local authorities to provide sufficient land through the planning system for future perceived development need as part of their local plans. In the absence of up-to-date and adequate local plans there will be a Presumption in Favour of Sustainable Development to grant planning permission for schemes put forward to local planning authorities by developers.

How is this system likely to work, given our knowledge of how the UK house building sector operates, and will this create the spur to new development expected? There are four areas of concern where the NPPF looks unlikely to overcome the barriers presented by the dynamics of planning reform, the likely behaviour of the building sector, and the control of and access to land with planning permission:

(a) The behaviour of local authorities

The politics of local authorities make most reluctant to prioritise housing development, as anti-housing groups have greater clout at the ballot box than the more dispersed interests of those who need housing.⁸³ Local authorities will be required to use need assessments to calculate their housing plans, but these assessments underestimate housing need, particularly in high demand housing markets. Local authorities are therefore likely to release limited amounts of new land for house building, and only in order to satisfy central government pressure. This will almost certainly be land that was likely to be designated as planning land over a short to medium time frame.

(b) The control of land likely to be granted planning permission

Given the time and investment of the larger housebuilders in building up strategic land banks (and lobbying local planners), allocated land is highly likely to be already under their control via option agreements or direct ownership.

Although 'options' agreements on land are in theory tradable they require the agreement of the relevant housebuilder to sell.⁸⁴ In a stagnant market, with lower land prices than the original purchase price and banking forbearance on option holders, this appears less likely to happen, maintaining a barrier to entry for potential new market entrants in their access to land. Option agreements eventually lapse, but as many are held for 10 years or more, this will mean optioned land will take some time to re-enter the market.

Banking forbearance will not add pressure on housebuilders with balance sheet issues to sell existing land to third parties. A land market in which there is no sustained downwards pressure on land prices may make landowners generally more reluctant to sell at lower prices to new market entrants.

(c) The viability of land released by planning reform

With a legal hold on the small amount of new land released, existing builders will have little incentive to bring it forward for development unless it meets their viability criteria. Development decisions will thus be taken within the framework of viability assessments for businesses that have either large balance sheet problems or land bank viability problems, both of which make development less likely.

Land designated as allocated for development is also likely to be larger strategic plots, which larger housebuilders had concentrated on acquiring before the credit crunch. These sites now have particularly severe viability problems, given the current muted level of demand and the scale of infrastructural investment needed to develop them.

Builders will utilise any released cheaper land in 'mix adjusting' their current land stock as a medium-term strategy to improve the overall viability of their land banks slowly. But

83 Demographic change has reinforced this negative political dynamic as those areas where house building is easiest and most needed (suburban and greenfield sites in the south east, east and south west of England) have become older and wealthier due to in migration and declining owner occupation rates among the young.

84 The Barker report (2003) thought that this tradability was a key factor in preventing builders 'hoarding' development land, but based this presumption on examples of transactions in a rising market populated by broadly financially healthy housebuilders.

this will dilute the impact of cheaper land being released via the planning system and the overall market impact of cheaper land on providing lower cost housing.

Existing builders will use the Presumption in Favour of Sustainable Development to 'cherry pick' the best sites, and use lower prices to prioritise higher margins over higher output.

(d) The ability of new entrants to break into the market

Other actors, more able to exploit cheaper land prices, will not have access to this newly released land. Smaller builders, self-builders or new market entrants will lack both the capacity to lobby for new land in the local authority plan and the finance to purchase land to be included within the new planning framework. The NPPF is likely not to challenge continuing consolidation within the industry.

The proposed changes within the NPPF therefore look insufficient to revitalise the performance of UK housebuilders, and are unlikely to drive sectoral reform through greater pressure from market forces. The end result for government may well be greater levels of political tension between central government and local authorities without any substantial increase in new homes.

7. WAYS FORWARD

We have a planning system and a building sector that have for the past 50 years increasingly failed to deliver. The UK building sector has just gone through the worst slump in post-war history – much of it self-inflicted – which has had a significant negative impact on the UK's economic performance.

The UK's housebuilders haven't built enough homes and now look even less likely to break from this pattern of underperformance. We must do better, but in order to do so we need to think intelligently about the path ahead.

After the credit crunch, achieving a revival in house building faces three critical and interlinked problems:

- There is the widespread issue of land viability in the post-crunch world. Land costs for land held by existing builders remain too high, even after land writedowns, to be viable at present market demand. This level of market demand is unlikely to increase on a sustained footing in the short to medium term.⁸⁵
- The business model of the current house building sector is conservative and output averse. Its reliance upon land banking via vertical integration has given it a long tail of unviable assets, which means that it is still financially unhealthy: low output, focusing on cash flow and consolidation are its likely responses.
- Control of – and access to – land, via both the planning regime and the system of land banking and option agreements on the future supply of land that is most likely to be granted planning permission, creates very large obstacles to new business entrants. It places most developable land within the control of developers who are reluctant to develop.

Reform needs to focus on cracking these three interrelated issues if we are to hope to unlock output and drive economic growth.

The current government approach fails to do this. The recent interventions set out in the housing strategy, and those of its predecessors, are not a catalyst to kick start growth, but a recipe for blockages to remain within the development market. Too often the housing strategy will not galvanise growth, but instead subsidise stagnation.

Its focus on channelling subsidy to the largest builders, seeking ways to resuscitate short-term market demand and releasing land for planning permission that is under the control of existing developers will not work. It is more likely to facilitate further consolidation within the industry and assist the major builders to slowly offload unviable development onto the taxpayer or the consumer, while pursuing a low-output business model focused on cash flow, and maintaining their tight control over future developable land.

We are now approaching five years since the beginning of the high level of post-recessionary intervention from government to help the sector with the shock of the credit crunch. It is now time for government to turn away from emergency provision and set out its demands for long-term sectoral change in return for considerable fiscal outlay.

Unfortunately, the record of government in seeking reform from the sector has been very poor. The Department for Communities and Local Government appears to have suffered from institutional capture by the larger housebuilders, who have a strong lobby presence, deep connections and substantial influence in policymaking.

⁸⁵ Indeed, some respected economists think market demand will never return to 2007 levels, see for example David Miles' recent speech to the Northern Housing Consortium on 22 November 2011 (Miles 2011).

The large housebuilders are too often seen uncritically as indispensable partners in increasing long-term housing delivery. Much of recent government intervention in the sector has been heavily shaped by industry. To quote housing minister Grant Shapps on the recent Mortgage Indemnity Scheme for new builds announced in the November Housing Strategy:

‘Government is backing a scheme which the industry has come up with, this is not our scheme, it’s their scheme.’⁸⁶

As one seasoned housing journalist commented this year, the large housebuilders’ industry group, the House Building Federation ‘seems to be getting pretty much everything it asks for when it lobbies the government’.⁸⁷ Government must rediscover its critical faculty when dealing with the house building sector.

7.1 What then is the way forward?

To do this successfully we need a long-term vision for where we want to get.

Part of this vision must be diversification. We are at low point in an 80-year trend of industry consolidation. This has decreased both the sector’s performance and its economic resilience. On simple arithmetical terms alone, relying on the top 10 UK builders will not deliver the increase in housing we need.

Diversification needs to occur in two ways. The first is to attempt to reverse the increasing loss of small, medium-sized and self-builders within the industry. The second is to ensure the entry of new actors from outside of the current building sector, particularly, but not solely, from the construction sector. There are two good reasons for this: first, other companies are in much better financial health than the house building sector (indeed the Office for Budget Responsibility estimates that the UK corporate sector had a positive financial balance of 5.7 per cent of GDP in 2011, equivalent to £87 billion) and, second, other companies expect to operate on much lower margins than existing housebuilders. They are both financially more able and organisationally more willing to build.

But diversification will not happen by itself. Government intervention must now be positively focused on encouraging a diverse sector, with an emphasis on the growth of new entrants.

As we have seen above, the major obstacle to achieving this is access to and control of land, particularly cheap, low-risk land with planning permission.

7.2 Land market transparency

There is a lack of transparency within the residential land market, often to such an extent that most transactions do not occur on the open market at all. Lack of information about the land market blocks new entrants.

Greater transparency is also needed so that the benefits and costs of development, which currently fall unevenly (with some who bear costs receiving no benefit and vice versa), can be discussed more openly. Too often communities are kept in the dark about what prices are being paid and who is gaining from what is perceived as the loss of an important communal good.

Part of improving this situation is the simple matter of transparency in information. There is a ‘lack of data’ on land ownership for development and ‘no consistency’ of industry disclosure of land ownership data. Callcutt recommended greater transparency in the use and status of land for future house building, although this appears not to have progressed since (Callcutt 2007).

At a minimum, all landownership and land sales should be registered with the Land Registry.⁸⁸ Penalties should apply if ownership is not declared after one year, and after

86 Grant Shapps on *Newsnight*, 21 November 2011

87 Jules Birch, *Inside Housing*, 4 August 2011

88 Only 75 per cent of the land in England and Wales is currently registered on the Land Registry. http://www1.landregistry.gov.uk/upload/documents/Annual_Report_1011.pdf

five years all unregistered land should become public property at 50 per cent below agricultural land cost.

7.3 The obstacles to change

Releasing more land for housing is economically highly desirable, but politically very difficult, as the current government is discovering. We therefore need to think very carefully about how the land that is released will be effectively utilised.

To rely simply on releasing more land (either through public land programmes or via planning reform) to drive market-based change in the development sector is not going to be effective. The amount of newly released land needed to dislodge the grip that current housebuilders have on the development process is simply too large to be politically achievable.

Planning reform must release more land suitable for development (putting a downwards pressure on land prices), but it must also deliver reform of developers via changing who has access to this land and how it is utilised. This requires not just a greater release of land, but also a structural change to how land release happens.

We now focus on two routes to achieve this: the short-term release of land that can occur now and the longer-term release of land through reform of the planning system. Both methods focus on three objectives: releasing more land, 'de-risking' this land in the development process, and actively promoting new entrants.

7.4 Short-term release of land

Outside of the longer-term workings of the planning system, there are two available options by which we are able to release land for development quickly: land available from the public sector and land currently held by financially distressed builders.

7.4.1 Public land schemes should drive building sector innovation

The current efforts at using public land to increase housing output (the Buy Now, Pay Later Scheme) must increase output and encourage new entrants. There is a real danger that existing UK housebuilders will merely use building on public land to displace activity from less viable market sites, leading to no net increase in output.

In early 2010, the HCA as part of the Public Land Initiative established an innovative pilot model through using a Delivery Partner Panel (DPP) that released public land for new housing. The 2010 bidding round used a joint venture model to capture a percentage of land value gains for the public sector while setting out strict criteria for lower profit margins and fast build-out rates to spur investment activity. The HCA allowed 'building under license', while containing control of how development happened and who profited from it.

The successful bidders were notably from domestic and foreign construction firms (such as Lend Lease, Bouygues, Waites and Skanska), rather than traditional vertically integrated housebuilders, prepared to take lower margins in return for lower land risk. This shows that new and more competitive entrants can flourish if given access to land.

In using public land, government effectively 'de-risked' land in the development process. In doing so with a delivery panel with tight development conditions, it also separated land trading from the building process, and by putting in place joint ventures created 'profit sharing' on development value uplift between the state and the private sector. This overcame the land barrier to provide access to new entrants, reduced final build costs and profit margins and increased output. This offers important lessons to translate into the operation of the planning system (see below).

Buy Now, Pay Later should use this model across all government department land holdings: margins should be set slightly higher than pure construction levels, but significantly lower than traditional house building. Strict build-out times should be specified. New entrants should be specifically targeted in the bidding process.⁸⁹

89 The HCA has recently published its development and land disposal strategy for Build Now, Pay Later. Although it will utilise a Development Partner Panel in releasing public land to housebuilders, the strategy is vague in

It is important to prevent this new process merely replacing one set of insiders with another (albeit ones who are delivering output and are more competitive). This is particularly the case if we wish to see the return of smaller scale builders who do not have the economies of scale to engage in government bidding panels.

One simple way to do this would be to allocate a percentage of land to be given over to development by self-build – to allow the growth of the sector and encourage the re-emergence of smaller and medium-sized builders who could cater to this market. Given the size of the existing market, 20 per cent of allocations, as a starting point, should go to self-builders.

7.4.2 The government should act as a ‘clearing house’ for the land banks of failing housebuilders

As we have outlined, the credit crunch has left us with several housebuilders who have severe long-term viability problems.

Rather than see years of banking forbearance prop up large and medium builders who are financially no longer viable and producing sub-par output levels, the government should be seeking to let these firms go bankrupt.

There are hidden (and not so hidden) costs of following a strategy of assisting long-term stagnation of failing builders, in direct taxpayer subsidy and in the indirect support to an underperforming sector. Markets cannot operate effectively if the government (and banks) never allow overvalued assets to clear or poor business decisions to go unpunished. This is particularly the case in a market with as few actors and as scarce a supply of land as house building.

But, based on the historical experience of the past two recessions, merely having a land fire sale is likely to lead to land being purchased by the remaining existing housebuilders. This will help rebuild the viability of the surviving firms’ land banks, but will do little to improve the overall performance of the sector.

In order to prevent this from happening the government should act as a clearing house for bankrupt housebuilders’ land banks. Government should discuss plans to release non-performing residential land assets held by housebuilders with large debts owing to nationalised banks and seek strategically to release these holdings to new market entrants using similar joint venture models and conditions as the Private Land Initiative’s Development Partner Panel outlined above. Land that is in existing local authority five-year housing plans could be prioritised to ensure this happens within the existing planning system. Assets from strategic land banks could also be released to help spur economic growth in areas of high housing demand.

7.5 Long-term planning reform

At present, nearly all potential future residential land is captured far upstream from planning permission being granted, through land banking and options agreements between developers and landowners. Option agreements are effectively profit-sharing agreements between developers and landowners on the land value uplift granted by planning permission.

The government, in acting as a passive granter of planning permission on an applications basis from the developer, creates a lose-lose situation. It injects uncertainty and risk into the system (through granting some applications but not others, on criteria which shift over time), and also loses the land value uplift, which is captured by private actors.⁹⁰

This system rewards those developers who are most adept at procuring land and at processing it through the planning system. The planning system creates a development

detail and does not appear to set out the tighter conditions on margins nor the requirement for joint venture profit sharing that is likely to open up access to new entrants or secure land gains for the public sector. It also only applies to relatively small land holdings owned by the HCA and does not bind the other larger government departmental land holdings to dispose of their land in a similar manner.

90 The government has been trying to claw back some of this land value uplift through Section 106 agreements. The November 2011 Housing Strategy announced measures to weaken these Section 106 obligations.

industry where the single most important competitive edge for developers is the ability to play the land market and the planning regime.

At the same time, competition between large developers, their model of vertical integration and residual value calculations, and the scarcity of land, add to boom and bust cycles and squeeze build costs. This allows landowners to bid up prices, to everyone else's detriment. The scarcity that is built into the system and the land banks created by planning uncertainty also create a major barrier to entry for new actors.

7.5.1 Objective 1: Releasing more land

The first step of reform must be to release more land, ensure this land is released cheaply and do so in a way that avoids releasing land that is in the existing control of current vertically integrated housebuilders. There are two possible methods of doing this.

Through a new market-based method of land release utilising competitive inverse auction, particularly the community land auctions idea promoted by Tim Leunig from the London School of Economics (Leunig 2007).⁹¹ Land auctions propose the operation of an inverse auction for the granting of residential planning permission among private landowners. The auction would be held by local authorities and would help drive down market land prices while enabling local authorities to control land risk and separate land trading from house building.

Or through more strategic government intervention in permitting and controlling land release for development, such as that used in the building of the new towns and garden cities in the 1940s and 1960s, primarily through the strategic designation of land for development and purchase at existing land-use values.

Both systems have different ideological flavours, but have the advantage of releasing more land and doing it in ways that prevent landowners from bidding land prices upwards as they do under the current system. Both methods break the hold of landowners over future residential use land value uplift.

7.5.2 Objective 2: 'De-risking' land in the development process

Both methods of land release detailed above also have the advantage of releasing land in a transparent way that could make it available to actors other than just existing housebuilders. But this is not guaranteed.

Land auctions for example could put greater downwards pressure on the prices paid to landowners, but may do nothing to loosen control of this land from existing housebuilders, who will simply seek to capture an even greater proportion of the land value uplift from development.

The innovation of releasing new land cheaply must be coupled with an innovation in how this land is controlled and how it is released for development. This is critical to breaking the negative pattern of underperformance and boom and bust that has plagued UK market house building for over half a century. Land must be 'de-risked' from the development process.

As we have seen, the vast majority of risk in the building sector is concentrated in land development and in the pricing and timing of final house sales. As land value is the largest and most volatile component of housing costs, land risk is the dominant factor in building risk.

House building itself is fairly low risk, as the technologies and processes of building are well known, unlikely to malfunction and easily repeatable (Ball 2010).

Put simply, land should be 'de-risked' by the development process being split into two separate parts: with the building of homes separated from the purchase and trading

⁹¹ For full details of the land auctions idea see Tim Leunig (2007) *In My Backyard: Unlocking the Planning System*, London: Centre Forum. Government has promised a trial of the land auctions idea, but the Housing Strategy only contained the offer of a trial using public land, which misses the point of the original idea in failing to drive private land market prices down.

of land. This split between land trading and the actual business of building is common elsewhere, in the US and Australia for example, while in France this split is legally enforced.

All the risk and uncertainty centred on land within the current UK model of development can be in large part neutralised, to the benefit of a more stable and better performing sector. Government policy must achieve this by explicitly aiming to break apart the current model of vertical integration.

This can be achieved by creating an institutional framework to separate (and mediate) land released for development from the construction of new homes. This could happen as a replacement to the existing planning system, or in parallel to it (such as happened with new towns and garden cities⁹²).

The easiest way to achieve this is through an agency that acts as a de facto land allocations board. This agency will broker land purchase (either via land auctions or strategic purchase) and then act as a broker of development with the private sector on a joint venture basis.

This does not imply an overriding degree of state control. Land sales could happen through an open market process, such as land auctions, while land development could happen solely through private companies through joint partnership agreements, building homes for sale or to order by private individuals (for example using the self-build model). The role of broker itself could be given a corporate identity, as happened with new town development corporations, with greater or lesser degrees of state control.

But it does imply that government intervenes intelligently to resolve the twin tensions of risk and reward centred on the land market and its control.

In releasing more land in a clear and transparent way that reduces residential land prices, government could help *lower the risk and uncertainty* of land costs.

7.5.3 Objective 3: Breaking open development to new entrants

In brokering how house building then happens, the government can help ensure building prioritises the quality and quantity of output while helping to *mediate the rewards* of land value uplift between developers and the community affected and/or the taxpayer. Supplying land under license or through deferred terms makes this happen. This replaces the profit sharing between landowners and developers with profit sharing between the taxpayer and the developer, through joint venture vehicles.

This model should replicate the lessons learnt from the Public Land Initiative's Development Partnership Panel and seek to encourage new entrants and a new modus operandi for UK house building. Builders take the quid pro quo of lower profits for greater security on land risk, better access to land and lower levels of capital employed. Many new entrants would be happy to take these terms, as the DPP has recently demonstrated.

The new towns model and the Public Land Initiative's Development Partnership Panel give us examples where this has happened successfully, and both revolved around the control of land risk and the split between land trading and house building. Indeed the new town development corporations were the most successful post-war development model, achieving large-scale house building and enjoying substantial cross-party support.⁹³

In the 2011 autumn statement, the government pledged to support 'locally planned large-scale development ... which could include modern garden cities' (HM Treasury 2011). The government should ensure that, in making any moves towards these modern garden cities,

92 New towns and garden cities were outside of the then existing planning system, with substantial strategic powers for land purchase and development planning (DCLG 2006).

93 New towns development corporations 'had powers to acquire, own, manage and dispose of land and property, undertake building operation, provide public utilities and generally do anything necessary to develop the New Town. The corporations enjoyed exceptionally favourable arrangements for land purchase at existing (or close to existing) use values and were effectively able to acquire all the land needed to build the New Town. ... The very strong land acquisition, infrastructure provision, planning and especially house building powers of the development corporations were very effective in delivering the UK New Towns' (DCLG 2006).

we learn the lessons of previous large-scale planned residential developments and focus explicitly on methods to remove land risk and encourage new entrants in these plans.

Indeed these powers already exist. The Homes and Communities Agency by statute has 'a wide range of specific powers relating to the provision, facilitation and acquisition (including compulsory purchase, regeneration and development of effective use of land) of housing and infrastructure; establishing companies [and] providing financial assistance', and has the power to 'do anything it considers appropriate for the purposes of its objectives or for purposes incidental to those purposes' which include to 'improve the supply and quality of housing in England' and 'secure the regeneration or development of land or infrastructure in England'.⁹⁴

IPPR is currently undertaking further research on planning reform that will examine the lessons from these previous models in greater detail.

⁹⁴ See <http://www.homesandcommunities.co.uk/statutory-role-and-history>.

8. CONCLUSION

The existing house building model created a ‘long tail’ of risk for the sector. This long tail of risk has particular negative implications for the sector’s health in a prolonged downturn in housing, credit and land markets. It effectively makes recovery much more difficult than it would be in other sectors which have less high levels of asset and borrowing overhangs. It has exposed the sector to sustained deleveraging, risk control and aversion.

The challenge of spurring UK economic growth and increasing house building cannot afford to wait this long. We need a new business model to deal with the debilitating risk that has hobbled UK house building for decades and insist on structural change to create a functional system that concentrates on what matters: better house building. This system would tackle entrenched underperformance and the imbalance between the capture of rewards by a few private actors in the good times and the socialisation of risk during crises.

Just as banking reform seeks to isolate ‘casino-type’ banking activity from retail banking, building sector reform must likewise insulate land-based risk, and allow house building to focus on delivering quality and value in building homes.

Vertical integration has been an understandable reaction to the vagaries of the planning system by developers attempting to maximise land value uplift, but the downsides now seriously outweigh the benefits. It is time for a new approach.

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