

A dynamic analysis of mortgage arrears in the UK housing market

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Abstract

The UK economy has enjoyed an unprecedented period of positive economic growth since the early 1990s. The absence of recession for more than a decade has been accompanied by a sustained decline in the level of mortgage arrears, as reported by major lenders. This paper seeks to examine the factors which have driven the reduction in mortgage arrears and, in doing so, identify those factors which are most likely to cause arrears to increase in the future, should economic conditions deteriorate.

The paper employs the Johansen methodology to test for the presence of multiple co-integrating vectors. An error correction model is estimated in order to examine long-run and short-run dynamics in mortgage arrears. In line with previous research concerning the causes of mortgage arrears, the results presented here emphasise the importance of changes in the rate of unemployment, loan-to-income and debt to service ratios. More importantly, our results highlight the statistical significance of unwithdrawn housing equity as an explanatory variable with respect to mortgage arrears.

Keywords: mortgage arrears, housing market, cointegration

JEL classification: C22, R21, R31

1. Introduction

According to official statistics for the UK, more than 389 thousand properties were possessed by lenders between 1990 and 1996, which affected more than one million individuals (Council of Mortgage Lenders, 1997). Possessions are invariably the result of an extended period of financial distress during which individuals and households have accumulated arrears. This paper seeks to examine those factors which influence the aggregate level of arrears on the mortgage book of a number of major UK banks and building societies.

The UK housing market has experienced considerable turbulence since the early 1980s (Ford, 1997). The market has witnessed several periods of rapidly rising house prices, such as occurred between 1982 and 1989. However, between 1990 and 1992, a sharp downturn in activity was reported, resulting in a dramatic reversal in house price inflation. Since 1992/1993, the UK economy has enjoyed a period of steady growth, accompanied by a sustained decline in unemployment and a strong rise in earnings. As a consequence, the market has again reported record increases in average house price inflation across the UK, originating in London and the South East region, with the consequent “ripple effect” northwards. This latest boom has renewed fears that the UK housing market is again overheating, thereby increasing the probability of another crash similar to that experienced in the early 1990s. It is in this context of a sustained

house price boom that the level of mortgage arrears has significantly decreased, as accounted by the UK major lenders.

This paper seeks to examine the variables which have driven the reduction of mortgage arrears, and in doing so, identify those factors which are most likely to cause this situation to reverse should conditions in the UK economy deteriorate in the future. We examine the path of mortgage arrears in the period from 1993 to 2001, based on a unique data base compiled from the detailed profile of borrowers from a consortium of major mortgage lenders. In the context of our analysis, it should be noted that we are only concerned with arrears involving mortgages for a specific subsection of the UK housing market, namely the owner-occupied sector – we are not concerned with arrears involving rents in the public and private sector.

The remainder of the paper is organised as follows. Section 2 presents the past and more recent developments in the UK housing market in order to put the study reported here into context; section 3 examines the pattern of mortgages, mortgage arrears and mortgage possessions since the mid-1980s; section 4 describes the framework, which we employ to model mortgage arrears and a description of the data; section 5 sets out the econometric methodology, while section 6 presents and discusses the empirical results. Finally, section 7 summarises and sets out the main conclusions of the paper.

2. Developments in the UK housing market

The structure and nature of the UK housing market is the result of a trend which has seen the proportion of personal sector wealth held in the form of owner-occupied dwellings increase dramatically over many years. Owner-occupied dwellings accounted for approximately 40% of the net wealth of the personal sector in 1990 compared to around 20% in 1960. The UK has one of the highest owner-occupation rates in the world, and one of the lowest levels of private renting. In 1991, 68% of households were owner-occupied, whereas this was a mere 10% in 1914 (Miles, 1993). The period 1981 to 1989 saw a rapid growth in the number of home owners from 11.9 million to 15 million, and the number of mortgage holders grew from 6.2 million to 9.1 million households (MacLennan and Gibb, 1993).

The early 1980s saw a sharp downturn in housing market activity, with house prices remaining almost static in 1980 and 1981¹. This stagnation has to be placed in an historical context. A Conservative government came to power in 1979 with an agenda which encouraged home ownership (Moore, 1992). Two specific areas of government policy were central to the growth of home ownership. First, a 'Right-to-Buy' policy saw 1.45 million properties transferred from the 'social rented' sector to the private owner-occupied sector between 1980 and 1992 (Atkinson *et al.*, 1987)². At the same time,

deregulated financial markets generated a highly competitive financial environment (Coakley and Harris, 1992) as well as the end of credit rationing (Michie and Wilkinson, 1992). This policy, combined with the liberalisation of financial markets in the 1980s, the Financial Services Act 1985 and the Building Societies Act 1986 (Harrington, 1996), were key drivers of the turbulence in the housing market in the late 1980s and early 1990s.

Increased competition between lenders resulted in borrowers being able to acquire loans which were a greater percentage of the value of their properties and a higher multiple of their incomes. This resulted in household sector mortgage indebtedness increasing from less than 25% of annual disposable income in 1980 to around 75% in 1992 (Brookes *et al.*, 1994). The average mortgage advance increased from 46.1% of the house price in 1980 to a peak of 60.1% in 1986, remaining at 58% for the rest of the 1980s. For first-time buyers, the average advance increased from 73.8% of the house price in 1980 to a peak of 84.4% in 1988 (Housing Finance, 1994).

The combination of increased demand for housing, due to rising incomes, and increased competition to supply mortgage lending fuelled house price inflation. According to official statistics, real house prices rose, on average, by over 4.5% per annum during the 1980s, with nominal house price inflation peaking at 28% in 1988. As house prices increased, borrowers increased their gearing and

those at the lower end of the income scale with no deposit were amongst the most highly-gearred borrowers. Accelerating property prices also increased the equity which many long term borrowers have in their property. By 1989, it was estimated that 24% of borrowers had extended their loans and drawn down the equity in their property values.

However, the price inflation generated by the 'Lawson Boom'³ of the late 1980s (Coakley and Harris,1992)⁴ led to the inevitable adoption a restrictive monetary policy and a tightening of interest rates – with mortgage rates doubling during a sixteen-month period from September 1988 to January 1990, peaking at over 15%.

The combination of a restrictive monetary stance and the ensuing economic recession of the early 1990s caused the housing market to weaken considerably - nominal house prices across the UK fell, on average, by around 7.5% between 1990 and 1992 which was unprecedented in the previous forty years (Housing Finance, 1994). The severity of the decline in house prices was also matched by the longevity of the slump in the housing market. Real prices declined by 6.25% per annum from 1989 to 1994 and by a further 2.5% in 1995 (Pain and Westaway, 1997). A significant number of households found themselves in the position where they were unable to meet their mortgage repayment schedules and they fell into arrears, ultimately resulting in an increased level of

possessions by lenders, up from 16,000 in 1989 to 75,500 in 1991 (Malpass and Murie, 1999).

Borrowers in arrears came from a wider spectrum of home buyers than had previously been the case in terms of age, occupational status and family composition. Job losses due to redundancy, small business failure and reduced earnings were the major triggers of arrears. Retrospectively, lenders were perceived to have responded slowly to the growth of arrears, only securing the earlier intervention contact and assessment after a period of time.

Ortalo–Magné and Rady (1999) argue that a sustained growth in incomes, combined with a relaxed credit constraint for younger borrowers were critical in explaining the boom in the 1980s property market. They further argue that the negative credit market shock, which the UK mortgage market experienced in the late 1980s and early 1990s, was a unique event and was unlikely to be repeated.

3. The Pattern of Mortgage Arrears

The impetus for the research we report in this paper stems from the observed pattern of mortgage arrears in the UK housing market since the mid-1980s. In the past, financial institutions typically developed a ‘score card’ methodology

to predict future refinancing problems on the part of mortgage borrowers. Such an approach seeks to identify a series of trigger events that are associated with mortgage arrears. By the late 1990s, this score card approach systematically overestimated the actual level of arrears. The observed behaviour of mortgage data generated a second concern, namely that the incidence of arrears had shifted from its long-run equilibrium level. In the context of these recent developments, this paper develops an econometric model, in order to assess the extent to which the incidence of mortgage arrears has diverged from its long-run equilibrium level and how swiftly it may return to that level.

As can be seen from Figure 1, the number of mortgages granted in the UK increased steadily over the period considered in this paper (1985 to 2001).

[Insert Figure 1 here.]

Nevertheless, since 1993, the number of mortgages in arrears has decreased significantly, along with the number of possessions, (Figure 2) despite the 1995 changes to the entitlement to welfare benefit concerning mortgage interest⁵ and growth in the mortgage payment protection insurance (MPPI)⁶. Later in the paper, empirical tests provide evidence of the fact that the above factors did not contribute to structural breaks over time in the model presented.

[Insert Figure 2 here.]

Three main factors appear to be responsible for the decline in the number of mortgage arrears and possessions. Firstly, after the “boom and bust” of the late 1980s and early 1990s, it may be argued that banks and building societies have improved their procedures for measuring the risk associated with supplying mortgages to different types of borrowers. This, therefore, has equipped them with a greater depth and refinement of information for assessing lending risk and the probability of mortgage default. Second, it may also be argued that borrowers have become better informed and more cautious about choosing particular mortgage products than previously. Finally, competitive pressures have resulted in many financial institutions nowadays offering low-margin mortgages (Harrington, 1996)⁷. The outcome is that customers have become less loyal to lenders, more discerning about financial products and hence, more active in searching for the best value offerings in the market, resulting in reduced monthly mortgage payments for many, as suggested by Aoki *et al.* (2001).

As a result, the negative impact of the abolition of tax relief on mortgage interest on house prices, housing consumption and, ultimately, home ownership was offset by changes in borrowers’ behaviour and household leverage, as claimed in Hendershott *et al.* (2002).⁸

With respect to the analysis of mortgages in arrears, three main periods are normally considered: 3-6 months in arrears, 6-9 months in arrears and over 12 months in arrears. Figure 3 below shows that mortgages in arrears follow the same pattern in the three periods analysed.

[Insert Figure 3 here.]

It will be seen that the general pattern of mortgages in arrears increased sharply from the end of 1989 to 1992. Thereafter, the number of arrears has been in a downward trend. This has been *in tandem* with a steady decline in the national level of unemployment in the UK, which has reached historically low levels. Moreover, the nature of this unemployment has tended to be primarily short-term (so called, frictional unemployment), further contributing significantly to the decrease in arrears.

However, the number of mortgages in arrears for 3-6 months seems to be more volatile than the number of mortgages in arrears in the other two periods. This is due to the fact that many borrowers will typically attempt to delay the payment of their mortgage instalments for a few months, when they are faced with what they perceive to be temporary changes in their net income and/or expenditure. In such circumstances, mortgagors will rectify the delay in paying their instalments without any major action being taken by the financial

institutions concerned. Moreover, many mortgage borrowers make use of the net asset value contained in their property – i.e. the property value minus the outstanding value of the mortgage (referred to as “unwithdrawn equity”) – and, as a consequence, negotiate new contracts with the bank or building society.

The housing literature identifies a number of particular factors in the explanation of the dynamics of mortgage arrears. The *level* of unemployment and redundancies are identified as key drivers of the aggregate level of arrears by Doling *et al.* (1988) and Ford *et al.* (1995), while Brookes *et al.* (1994) identify increased *inflows* into unemployment as an important factor. The relationship between the age of the head of household and arrears has been also examined by Ford (1993) and Nettleton and Burrows (1998). In addition, Ford and Burrows (1998) have found evidence that the younger the head of the household, the greater the probability of experiencing arrears. Furthermore, Böheim and Taylor (1999) suggest that the increased incidence of periods of unemployment experienced by younger workers explains their increased propensity to experience mortgage arrears.

Several US studies have also emphasised the importance of equity on mortgage default, such as Jackson and Kaserman (1980) and Williams *et al.* (1974). Case *et al.* (1995) claim that periods of high default rates on home mortgages in the US are closely associated with a decrease in unwithdrawn equity, derived from

decreases in real estate prices. The following framework investigates these relationships.

4.1. Modelling Framework

The theoretical model presented in this paper stems from earlier research by Wadhwani (1986), which examined the frequency of corporate bankruptcies. Brookes *et al.* (1991) were the first to apply Wadhwani's theoretical framework to the analysis of mortgage default. This original framework has been further developed by Breedon and Joyce (1993) and Brookes *et al.* (1994). The model is based on the assumption that an individual and/or household who can afford to buy a house chooses to buy instead of renting, as long as such a choice results in higher net returns. In other words, the individual wishes to maximise the expected utility:

$$E(U) = (1 - \theta(.))H(\delta - \varphi) - (c\theta(.)) \quad (1)$$

where θ is associated with the probability of mortgage payment difficulties, H is the amount of housing services, δ is the net return associated with home ownership (after subtracting mortgage payments and other debt costs, as well as maintenance costs), φ is equivalent to the rent that the occupier would pay for

the same house and c represents costs that would be incurred if payments started to be in arrears.

In the model specified by equation (1), H is treated as a continuous variable because we assume that it also depends on the size of the house and its features; c includes the cost of paying mortgage instalments late and respective consequences (such as difficulty in obtaining housing or loans from then onwards). Therefore, c is assumed to be positively related to H .

The model is initially based on two further assumptions: there is no inflation and first-time buyers are able to obtain more finance only if the value of the property (VP) is higher than the mortgage debt (MD). The individual or household may incur mortgage payments difficulties when:

$$Y - LC - \rho M + (VP - MD) < 0 \quad (2)$$

where Y is disposable income, LC stands for other living costs, ρ is interest rate paid and $(VP - MD)$ represents unwithdrawn equity. Therefore, the probability of going into arrears can be represented by the following function:

$$\theta(.) = \theta(Y, LC, \rho, VP - MD) \quad (3)$$

The situation becomes more complex when we take into consideration the effects of inflation. If the value of mortgages is indexed to inflation, then the

model remains unchanged (if borrowers have contracts with a variable mortgage rate). Nevertheless, if this is not the case and lenders refuse to provide borrowers with new loans, then borrowers will be in arrears when:

$$(Y - LC - \rho MD) < 0 \quad (4)$$

A further extension to the model is to incorporate the case when income, living expenses and interest rates rise at a rate of $\square$, while the mortgage stock remains constant. In this case, the real rate ρ is constant. Using the Fisher condition, we can write r as $(\rho + \square + \rho \square)$ and the individual or household will be in arrears if:

$$(1 + \square)(Y - LC - \rho MD - \square MD / (1 + \square)) < 0 \quad (5)$$

The above equation shows that when inflation increases, borrowers face an additional payment of $\square MD / (1 + \square)$.

When inflation and interest rates move *in tandem*, if inflation increases then the borrower's debt-service ratio also increases and this has an important impact on those borrowers with high loan-to-income ratios. This, as a consequence, increases the likelihood of mortgage arrears.

This may however be counterbalanced by the extent that house prices also increase and borrowers release (unwithdrawn) equity in order to meet mortgage

instalments. If this happens, then debt service as a percentage of the borrower's income may remain unchanged and hence the borrower will be in arrears if:

$$(1 + \square)[Y - LC - \rho MD + (VP - MD)] < 0 \quad (6)$$

In practice, due to costs such as transaction costs, borrowers can only increase their loan by a proportion of the unwithdrawn equity which puts some additional strain on payment difficulties. Under these conditions, the probability of arrears will be a function of the above variables, including the extra monthly payment required, which may produce income shocks. The unemployment rate (UR) as well as aggregate income (Y) are probably the most-widely used measures to account for these shocks. There are other factors such as age of borrower, relationships and administrative problems, which have an impact on arrears, however they are difficult to measure at a macroeconomic level, and hence they have been excluded from this model⁹. In addition, it is difficult to obtain an accurate measure of other living costs, and hence we use the loan-to-income ratio for first-time buyers (LY) as a proxy, since for most first-time buyers, mortgage debt payments reflect, by far, the largest element of household expenditure, as claimed by Stein (1995)¹⁰. Finally, we use the debt service ratio (DS) to capture the burden and risk associated with the increased debt mortgage repayment. The probability of arrears can then be written as:

$$\theta(.) = \theta(Y/p_c, UR, VP - MD, \rho, LY, DS) \quad (7)$$

where p_c is the consumer price index.

An important point to consider in this model is that only unanticipated inflation should have an impact on the borrower's mortgage payment difficulties, which means that, in the long run, the level of inflation does not affect arrears, even though short-term changes in inflation do.

4.2. The Data

We use monthly data for England and Wales only, for the period May 1993 to April 2001. It is important to note that we have excluded data on Scotland due to the fact that there is evidence that the trends in the housing market in Scotland and the rest of the UK have differed substantially.¹¹ This may be due to the fact that the court system for arrears and possessions operates differently in Scotland. Moreover, the structural timing of the transition from renting to home ownership also differs between Scotland and England and Wales¹².

For the purpose of this study, most of the data were provided by a group of mortgage lenders. The sample constitutes approximately 36% of the total

mortgage book in the UK for the period under investigation, which is sufficiently large to be representative of the whole population. The remaining data has been obtained from the Office for National Statistics (ONS) and the Office of the Deputy Prime Minister (ODPM).

The dependent variable in our model is the number of arrears in excess of 3 months on the mortgage book (ARR) as a proportion of the total mortgages (M) and is presented as $ARRM$. The variable M includes both repayment and endowment mortgages.¹³ Data on the unemployment rate (UR) is taken from the ONS. Since it is extremely difficult to obtain an accurate measure of living expenses (beyond mortgage instalments), the loan-to-income ratio for first-time buyers (LY) is used here. The ratio of mortgage interest payments to real personal disposable income measures household mortgage debt-service ratios (DS). The level of unwithdrawn equity (UNW) is calculated by the difference between the current value of the mortgage stock minus the outstanding stock of mortgage lending as a proportion of the stock of mortgage lending:

$$UNW = \frac{(M - OSM)}{M}$$

where M is the current stock of mortgages (number), $MAHP$ is the mix-adjusted house price and $OSML$ is the outstanding stock of mortgage lending (value).

The variable MAHP was obtained from Office of the Deputy Prime Minister (ODPM).

Data has also been provided by lenders on mortgage interest rates (RM) at which most mortgage business was written. Real personal disposable income ($RPDI$) data is from the ONS.

5. Methodology

The methodology used in this article pursues the following structure: initially we examine whether the variables investigated have one or more unit roots, we specify the VAR order and determine the number of cointegrating vectors. Finally, we present a dynamic model of mortgage arrears, based on the long-run determinants of mortgage arrears.

5.1. Unit roots tests

We primarily investigate whether the variables described above are stationary or whether they have one or more unit roots. We use three tests to look at the dynamic structure of the time series: Augmented Dickey Fuller test (ADF)¹⁴,

Phillips Perron test (PP)¹⁵ and a test by Im, Pesaran and Shin (1997), which uses panel data.

The main difference between the first two tests lies in the fact that Phillips and Perron carry out a non-parametric correction to the ADF statistics. However the critical values for this test are the same as those for the ADF test (Pesaran and Pesaran, 1997). The variables are presented both in levels and in differences. The statistics presented regarding the order of augmentation of the Dickey-Fuller test are based on the Akaike Information Criterion (AIC) and correspond to an alternative adjusted form of R^2 , with a different trade-off between goodness-of-fit and parsimony (Kennedy, 1998). The AIC minimises $\ln(SSE/t) + 2k/t$, where $\ln$ is the natural logarithm, SSE is the error sum of squares, t is time and k represents the number of explanatory variables.

A way to examine whether the series as a whole is stationary (which many researchers claim to be more relevant) is the one developed by Im, Pesaran and Shin (1997). While the ADF test is regarded as considerably more powerful than other unit root tests, its power decreases with smaller samples for the alternative hypothesis $H_1: \delta = \delta_0 < 1$, when δ_0 is near unity. This does not seem to be a problem in the case of the Im, Pesaran and Shin (IPS) test because it uses panel data, as well as with the fact that a large number of observations is present. Moreover, the simple ADF test regards the size-power trade-off as

dependent on the order of augmentation. This again does not constitute a problem in the IPS test.

The IPS test is based on the average of the individual unit root t-statistics and, in its most generalised version, which accounts for possible serial correlation between the disturbances in the Dickey-Fuller regressions, it takes the following form:

$$\Psi_i = \frac{\sqrt{N} \left\{ \bar{t}_{NT}(p, \rho) - \frac{1}{N} \sum_{i=1}^N E[t_{iT}(p_i, 0) | \beta_i = 0] \right\}}{\sqrt{\frac{1}{N} \sum_{i=1}^N Var[t_{iT}(p_i, 0) | \beta_i = 0]}}, \quad (8)$$

where $\bar{t}_{NT}(p, \rho) = \frac{1}{N} \sum_{i=1}^N t_{iT}(p_i, \rho_i)$ and $t_{iT}(p_i, \rho_i)$ corresponds to the individual t statistic for testing $\beta_i = 0$ in the following ADF (p_i) regressions:

$$\Delta y_{it} = \alpha_i + \beta_i y_{i,t-1} + \sum_{j=1}^{p_i} \rho_{ij} \Delta y_{i,t-j} + \varepsilon_{it} \quad (9)$$

where $i = 1, \dots, N; t = 1, \dots, T$.

The values of $E[t_{iT}(p_i, 0) | \beta_i = 0]$ and $Var[t_{iT}(p_i, 0) | \beta_i = 0]$ are reported in IPS (1997), evaluated via stochastic simulations.

5.2. Lag specification

In order to implement the Johansen Maximum Likelihood approach to test for cointegration, a general (unrestricted) vector autoregressive (VAR) model is formulated. This summarily consists of regressing each variable in the model on all the other variables, lagged a number of times, i.e., we allow the time path of one variable to be affected by current and past realisations of some other variable's sequence and *vice versa*. The number of lags in the VAR system is then specified, based on the Akaike Information Criterion (AIC).

5.3. Cointegration tests

Engle and Granger (1987), Johansen (1988) and Johansen and Juselius (1992) have developed a methodology centred on cointegration. The technique of cointegration evolves around the idea that certain variables “should not diverge from each other by too great an extent, at least in the long run” (Granger, 1991). In other words, although the variables are nonstationary, they can be combined together into a single series which is itself stationary.

There are currently two main approaches to the problem of testing for cointegration: one is referred to as the *residual-based* approach and is based on the augmented Dickey-Fuller (ADF) test of cointegration; the other is

Johansen's Maximum Likelihood approach. The latter is employed in this paper as it appears to be more reliable and efficient, especially when more than two I(1) variables are involved, as is the case of the present study. It specifically provides a framework to test for cointegration within the context of a vector autoregressive (VAR) error correction model.

The Johansen Maximum Likelihood procedure is based on a process of n I(1) variables in an $(n \times 1)$ vector X as an unrestricted regression:

$$X_t = A_1 X_{t-1} + A_2 X_{t-2} + \dots + A_p X_{t-p} + \varepsilon_t \quad (10)$$

where $t = 1, 2, \dots, T$, p represents the number of time lags and ε_t is an independently and identically distributed n -dimensional vector with zero mean and variance matrix $\sum_{\varepsilon}$. In addition, A is a $(n \times n)$ matrix of parameters.

Equation (10) can then be re-arranged as follows:

$$\Delta X_t = \sum_{i=1}^{p-1} \square_i \Delta X_{t-i} + \square X_{t-p} + \varepsilon_t. \quad (11)$$

where

$$\square = -\left(I - \sum_{i=1}^p A_i \right)$$

and

$$\square_i = -\left(I - \sum_{j=1}^i A_j\right)$$

I is the identity matrix. The rank of $\square$ is equal to the number of independent cointegrating vectors (r) which exist between the variables in X . It can be obtained by testing for the number of characteristic roots of $\square$ that are significantly different from 1. Johansen (1988) demonstrates that this can be conducted, using two test statistics:

$$\lambda_{trace}(r) = -T \sum_{i=r+1}^n \ln(1 - \hat{\lambda}_i) \quad (12)$$

$$\lambda_{max}(r, r+1) = -T \ln(1 - \hat{\lambda}_{r+1}) \quad (13)$$

where $\hat{\lambda}_i$ are eigenvalues and T is the number of usable observations.

Johansen (1988) and Johansen and Juselius (1990) provide the critical values of both statistics, which have been generated, using simulation studies.

Once we have the number of cointegrating vectors, we then obtain estimates of the cointegrating coefficients (together with their asymptotic standard errors), which show the long-run relationships between the variables considered. Because, at this stage, we will have proved that the variables involved in this process are cointegrated, the deviations of the dependent variable (in this case,

the ratio of arrears over 3 months and outstanding mortgages - $ARRM_t$) from its long run path $ARRM_t^*$ are stationary.

5.4. A dynamic model of mortgage arrears

The next step is to develop a model in first differences which incorporates an error correction mechanism (ECM):

$$\Delta y_t = \sum_{i=1}^n \beta_i \Delta x_{it} + \gamma \left(y_{t-1} - \sum_{i=1}^n \alpha_i x_{i,t-1} \right) + \varepsilon_t \quad (14)$$

where: y is the dependent variable (ARR/M),

x represents each of the explanatory variables,

β and γ are the coefficients of the explanatory variables in the equation,

α is the estimated coefficient of each of the independent variables in the long-run relationship,

ε is the error term of the equation,

i represents the number of explanatory variables in the model and

t is the time period.

Therefore, the estimation of a spurious regression because of the presence of possible stochastic or deterministic trends in the data is not a possibility. The

model presented above is composed of a long run solution and has an ECM ($y_t - y_t^*$) when its coefficient γ is negative.

6. Empirical Results

In this section, we present the estimated results, based on the model set out above, as well as the different steps which constitute the methodology of this study.

Table 1 reports the results of unit root tests, developed by Dickey and Fuller and Phillips and Perron, on the levels and first differences of all the variables incorporated in the analysis. Note that all the variables are in natural logarithms.

[Insert Table 1 here.]

The results indicate that all the variables are integrated of degree one, i.e., they are stationary when in first differences. The only exception is the debt service ratio (*DS*) which, according to Phillips-Perron test, appears to be stationary in levels.

Therefore, it is important to look at all the variables as a data set *per se* and determine whether the panel is stationary or whether it has a unit root. The

results of the IPS Ψ_i test ¹⁶ is -18.8812 , which is significantly above the critical value of -2.27 (in absolute terms) at a 99% confidence level.

Indeed, the test statistic provides evidence that the series as a whole is stationary when the variables are in differences. Due to this fact, it is highly probable that the variables are cointegrated with each other.

The next step is to decide on the appropriate number of lags to be considered for all equations in the VAR. According to AIC and SBC, the order of the unrestricted VAR is equal to two.

Based on the results obtained above, cointegration tests are conducted in a multivariate framework. The results are reported in Table 2. The trace and maximal eigenvalue test provided similar results; they reveal that cointegration is supported among the group of variables considered.

[Insert Table 2 here.]

Taking the above results into consideration, what follows is the respective cointegrating vector. This shows the long-run relationship between arrears of more than 3 months to the number of outstanding mortgages (the dependent variable) and the explanatory variables – see Table 3.

[Insert Table 3 here.]

The estimated results imply that the probability of arrears is a positive function of unemployment, the loan-to-income ratio for first-time buyers and the debt service ratio and a negative function of income and unwithdrawn equity.

The long-run relationship between arrears and unemployment is as we might expect and confirms the findings of a number of previous studies. Furthermore, the behaviour of the *LY* and *DS* variables are also consistent with our *a priori* expectation that an increased loan-to-income value for first time buyers and/or debt service ratios increase observed arrears. The role of unwithdrawn equity as a long run explanatory variable of arrears has not been examined in previous research on UK mortgage arrears. We have specifically addressed this variable here and our long run equation suggests that an increase in unwithdrawn equity has a relatively large impact in reducing arrears.¹⁷

The resulting dynamic equation based on this cointegrating vector is shown in Table 4. It is obtained by Ordinary Least Squares. The equation fits the data reasonably well. In addition to a significant cointegrating vector at 1% level of confidence, the equation includes growth terms in the unemployment rate, real disposable income, unwithdrawn equity and the mortgage rate. We have also included a dummy variable in order to capture the combined effect of changes to social security entitlement and increases in mortgage protection insurance (denoted SSMPI). As can be seen from Table 4, our estimate of the short-run

relationship suggests that changes in *UNW*, *RM* and *UR* explain short-run movements in arrears. The coefficient of changes in *RPDI* is negative as expected, however it is not significant at the 10% level of significance. Finally, changes in *SSMPI* that took place in 1995 proved statistically insignificant in the explanation of the dynamics of arrears¹⁸.

The estimated equation has a high R^2 and the t statistics and remaining diagnostic statistics are robust which shows that the estimates presented are efficient.

[Insert Table 4 here.]

7. Conclusions

This paper examines the factors which have driven the reduction in mortgage arrears in the period 1993-2001 for England and Wales. By using cointegration techniques, the results confirm the primacy of unemployment rates and unwithdrawn equity as explanatory variables of mortgage arrears.

In the long run, the loan-to-income ratio for first-time buyers as well as the debt-to-service ratio are also consistent with the existing literature and affect mortgage arrears positively. However, they do not have an effect on arrears in the short-run.

In a departure from previous studies, unwithdrawn housing equity exhibits significant explanatory power. The importance of unwithdrawn equity, not surprisingly, appears to be a long-run rather than a short-run phenomenon, suggesting that the existence of unwithdrawn equity significantly reduces the extent of housing arrears. Three main reasons seem to underpin this result. Firstly, unwithdrawn housing equity is acting as a proxy for a buoyant housing market and, in a booming housing market, we would expect mortgage arrears to be lower. Secondly, if the individual or household has a certain amount of unwithdrawn equity, he/she has the option available to sell the property and trade down. Thirdly, unwithdrawn equity may be used when remortgaging the property, in order to avoid going into arrears. These results may suggest that mechanisms should be put in place to promote the use of index-based futures and options in real estate in England and Wales, as suggested by Case *et al.* (1995) following their investigation of the US housing market.

The findings consider the housing market in England and Wales as a whole. This study does not allow for regional variations, as this needs much fuller investigation than has been possible in the paper. Therefore, further research could usefully build on the findings presented above and focus on the regional dimension of the national housing market with respect to the causes of mortgage arrears, as well as the differences from region to region.

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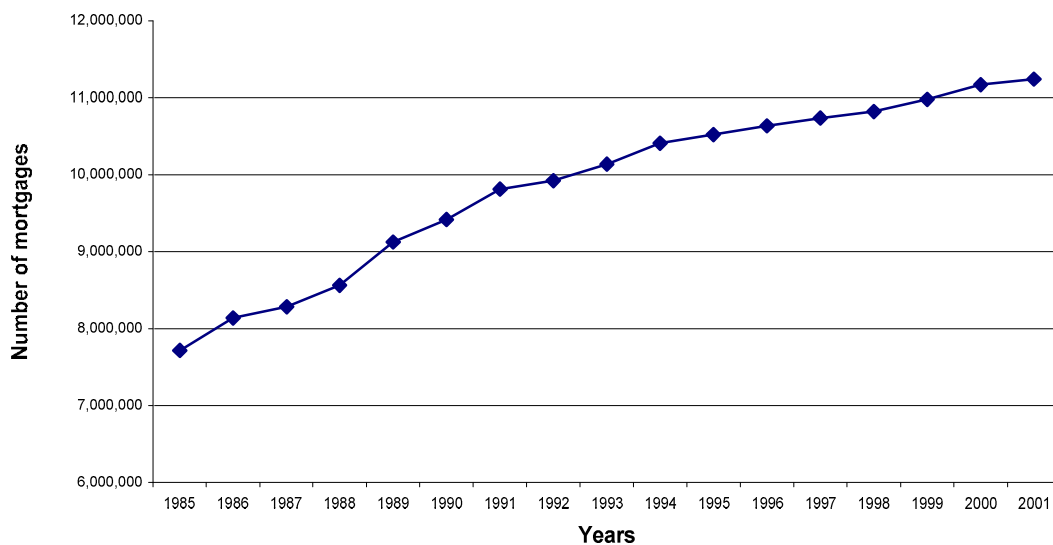
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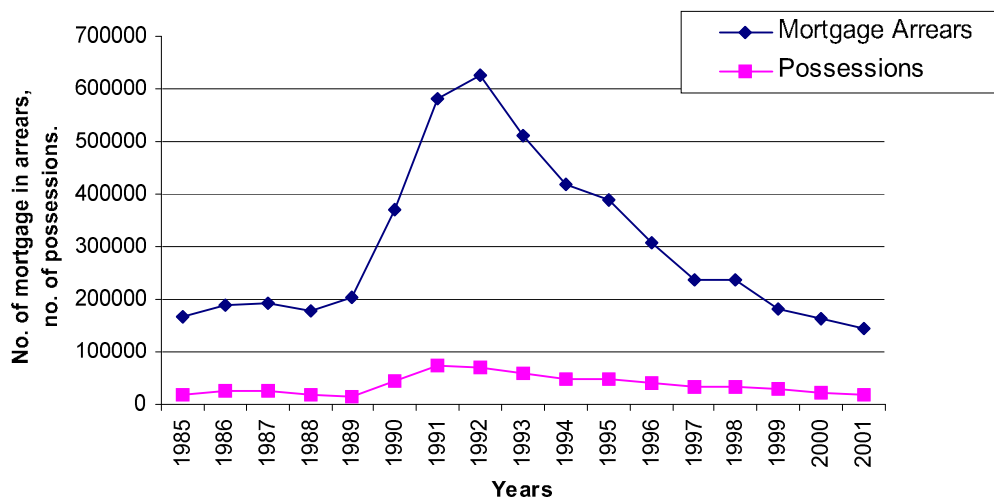
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Figure 1. UK Mortgages: 1985 - 2001



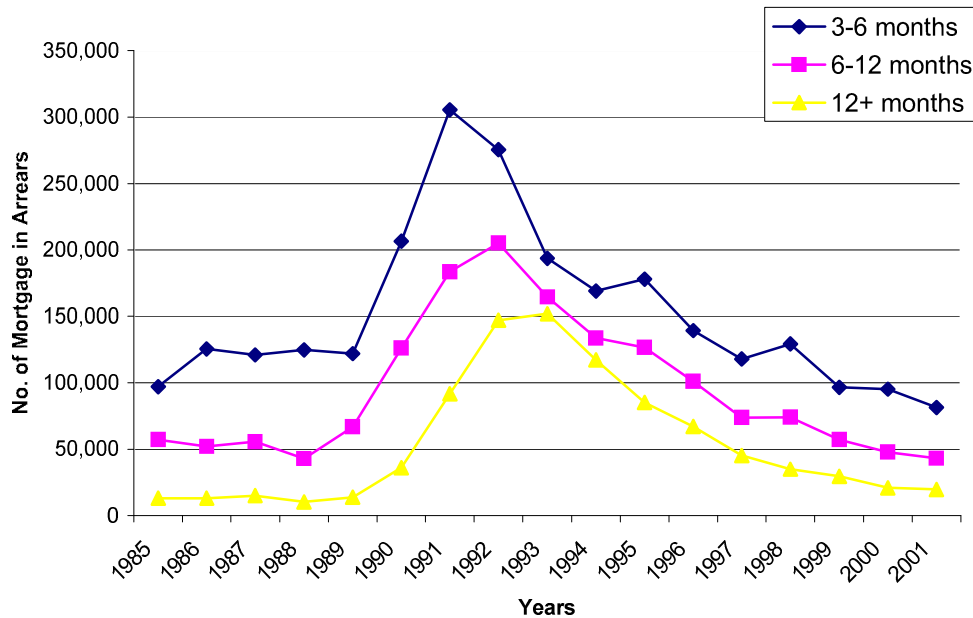
Source: Housing Finance, Council of Mortgage Lenders.

Figure 2. Mortgages in Arrears and Possessions



Source: Housing Finance, Council of Mortgage Lenders.

Figure 3. Mortgages in Arrears: 3-6, 6-9 and over 12 months.



Source: Housing Finance, Council of Mortgage Lenders.

Table 1. Unit root tests.

<i>Variables</i>	<i>ADF test</i>		<i>PP test</i>	
	Levels	Differences	Levels	Differences
<i>lnARRM</i>	-1.3305	-9.6494*	-1.1728	-29.2557*
<i>lnUR</i>	-0.1949	-7.7904*	0.0532	-7.1000*
<i>lnRPDI</i>	-0.8382	-7.1535*	0.7320	-9.2687*
<i>lnLY</i>	-2.0442	-8.2056*	-2.2073	-11.3818*
<i>lnUNW</i>	-1.1742	-9.0296*	-1.2785	-74.5768*
<i>lnDS</i>	-2.3019	-6.5044*	-3.9169*	-
<i>lnRM</i>	-2.7368	-5.5007*	-1.6888	-5.7246*

* Statistically significant at a 95% level of confidence
(95% critical value for ADF and PP statistic = -2.8963).

Table 2. Multivariate cointegration tests.

<i>lnARRM lnUR lnRPDI lnLY lnUNW lnDS lnRM</i>			
Period: 94 observations from 1993M7 to 2001M4. Order of Var = 2.			
<i>Hypothesis</i>		<i>Test Statistic (95% Critical Value)</i>	
<i>Null</i>	<i>Alternative</i>	<i>Eigenvalue Test</i>	<i>Trace Test</i>
r=0	r=1	54.3569 (39.83)	105.5291 (95.87)
r≤1	r=2	20.8347 (39.83)	51.1722 (70.49)

Table 3. Cointegrating vector, May 1993 – April 2001.

<i>Explanatory variables</i>	<i>Coefficient</i>	<i>Standard error</i>
<i>Unemployment rate (lnUR)</i>	1.6735	0.1371
<i>Real Personal Disposable Income (lnRPDI)</i>	-	-
<i>Loan to income ratio for first time buyers (lnLY)</i>	0.4103	0.1897
<i>Unwithdrawn equity (lnUNW)</i>	-1.021	0.1323
<i>Debt service ratio (lnDS)</i>	0.6359	0.0907
<i>Mortgage rate (lnRM)</i>	-	-

Table 4. Dynamic model of mortgage arrears.

<i>Explanatory variables</i>	<i>Coefficient</i>	<i>Standard error [t-statistic]</i>
<i>Constant</i>	0.0606	0.0207 [2.9228]**
$\Delta \ln UR$	0.2650	0.0862 [3.0742]**
$\Delta \ln RPD I$	-0.4649	0.3784 [-1.2286]
$\Delta \ln LY_{t-1}$	-	-
$\Delta \ln UNW$	0.0333	0.0185 [1.8000]*
$\Delta \ln DS_{t-1}$	-	-
$\Delta \ln RM_{t-1}$	0.2828	0.1102 [2.5662]**
ecm_{t-1}	-0.0169	0.0049 [-3.4490]**
<i>SSMPI</i>	-0.0089	0.0059 [-1.5085]
<hr/>		
<i>Summary statistics</i>		
R^2	0.9577	
<i>Standard error</i>	0.0201	
<i>Durbin Watson (DW)</i>	2.0443	
<i>Normality</i>	1.9857	
<i>Heteroscedasticity</i>	0.7685	

* Statistically significant at a 10% level of confidence;

** statistically significant at a 1% level of confidence.

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- ¹ As described by Ford (1997), during the 1980s, many borrowers lost their property, as a result of mortgage arrears and, ultimately, possession of their property, which led to a significant increase in homelessness.
- ² Since 1979, the dominant housing policy was the promotion of owner-occupation and, consequently, the national housing stock owned by local authorities was reduced dramatically.
- ³ Nigel Lawson was the Chancellor of the Exchequer from June 1983 until October 1989.
- ⁴ The “Lawson boom” is associated with the peak of the financial system’s expansion during the 1980s, which was reflected in an unsustainable credit expansion and inflation of house prices.
- ⁵ These changes were motivated by the need to increase tax revenue which was lost by the changes in welfare entitlement (Devereux and Lanot, 2003) and the fact that the expenditure was distorted toward higher income households, as suggested by Hendershott *et al.* (2002).
- ⁶ For more information on the 1995 changes in the social security and the MPPI policies, see Kemp and Pryce (2002).
- ⁷ The 1986, the Building Societies Act widened the powers of these financial institutions, and as a consequence, they started diversifying their activities and competing openly with banks on interest rates.
- ⁸ The deductibility of home mortgage interest for tax purposes has been examined by Woodward and Weicher (1989) and Follain and Malamed (1998).
- ⁹ This paper deals with annual data for England and Wales on mortgages and mortgage arrears and not with micro economic information on individual borrowers.
- ¹⁰ Stein (1995) argues that, in the case of the USA, owner-occupied homes represent the equivalent to approximately 27% of household net worth. As a result, he states that “an exogenous shock to house prices can have a large and broad based impact on household liquidity” (p.381).
- ¹¹ Even though the study of regional effects in the UK housing market is not the purpose of this paper, the level of arrears as a percentage of total mortgages does not seem to vary considerably across the various regions of the UK. Mortgages which are at least 3 months in arrears constitute approximately 1 to 3% of the total amount of mortgages across the 12 regions in the UK.
- ¹² We thank anonymous referees for their useful comments on the differences in the housing market in Scotland and the rest of the UK.
- ¹³ It should be noted that the data set used here does not allow us to distinguish between repayment and endowment mortgages. However, it is important to note that the amount of endowment mortgages has decreased from around 60% of the total amount of mortgages in 1993/1994 to 5% in 2002, as a result of the benefit changes in 1995. According to Devereux and Lanot (2003), following the changes in tax relief, the gap in costs between repayment and endowment mortgages narrowed down and therefore the additional risk associated with endowment mortgages made this type of mortgages increasingly unattractive to borrowers.
- ¹⁴ For a thorough explanation of this test, see Fuller (1976).
- ¹⁵ This test is described thoroughly in Perron (1988).
- ¹⁶ See previous section on testing for unit roots in panel data.
- ¹⁷ Data on consumer credit was used in the initial equation which models mortgage arrears but it proved to be insignificant as an explanatory variable and was therefore not included in the final set of results. These results are available from the authors, at the reader’s request.
- ¹⁸ We have tested for collinearity between $\ln UNW$, $\ln LY$ and $\ln DS$ using two different methods: correlation matrix and regression of each of these variables on the other two. Both methods showed that the three variables above are not collinear. The correlation between $\ln UNW$ and $\ln LY$ is 0.43, 0.15 between $\ln UNW$ and $\ln DS$ and -0.45 between $\ln LY$ and $\ln DS$. The R^2 of each of the three equations is 0.33 for $\ln UNW$, 0.40 for $\ln LY$ and 0.04 for $\ln DS$.