APPROACHING THE LIMITS TO LENDING GROWTH?

Bob Pannell, Economic Adviser to IMLA
April 2018

We have seen substantial volumes of mortgage lending over the past few years.

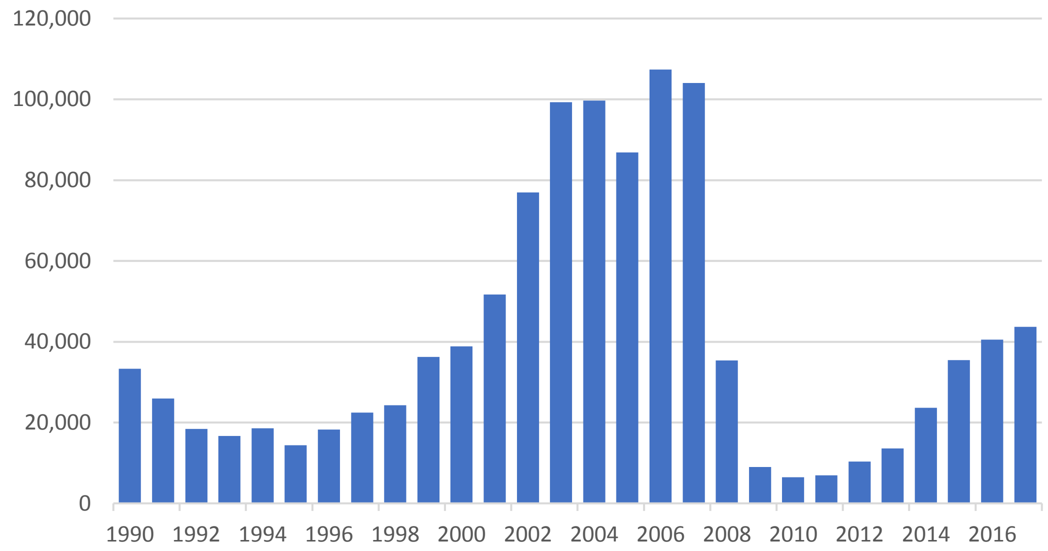
Much of it relates to refinancing activity of one sort or another. Remortgages alone were worth about £100 billion last year and this figure is likely to have been matched, maybe even exceeded, by product transfers.

So, a fantastic advert for the highly competitive nature of our mortgage market and the huge benefits that lenders and brokers provide UK consumers.

Net lending

But, beneficial as such refinancing activity is, few of us would judge a market as healthy if it was experiencing little if any organic growth. This means that industry net lending - the overall growth in mortgage balances outstanding - serves as a useful barometer for the underlying health of our market.

Chart 1: Industry net mortgage lending, £m



Source: Bank of England

Net lending has in fact been remarkably subdued since the global financial crisis a decade ago, with overall growth in mortgage debt stagnating or declining relative to nominal earnings for much of the time. Against the backdrop of regulatory concern about a sharp pick-up in unsecured credit, it is easy to lose sight of the fact that it is only in the last two years – when net mortgage lending has recovered to £40 billion - that the growth of mortgage debt has reached the “dizzying” heights of 3% annually.

Performance continued to strengthen in 2017, with net lending climbing to nearly £44 billion.

But will we see further significant gains in the years ahead?

In order to help answer this question, it is worth looking at the main sources of net lending. Here, we focus on first-time buyers, buy to let and existing owner-occupiers.

Net lending represents gross lending less any repayments associated with that activity.

As first-time buyers do not already own a property and so there is no mortgage that has to be repaid, this means that the entire gross value of lending to first-time buyers contributes to net lending. So, it should be no surprise that first-time buyers have always been the dominant source of total net lending.

House purchase activity by landlord investors acts in a similar way to first-time buyers, although in some cases landlords may be simultaneously selling and redeeming the mortgage on another property in their portfolio.

Since the early 2000s, house purchase activity by landlords has averaged less than a third of that of first-time buyers, and its pattern has been very uneven. Tax and regulatory changes have dragged down the buy-to-let sector since 2016. This is most readily seen with respect to house purchase activity, which contracted by more than a quarter last year. But policy changes also mean weaker incentives for landlords to re-leverage their portfolios, and there are early signs that remortgage activity may have peaked.

The overall contribution of buy to let to net lending continues to be positive, but the sector has reverted to the low growth rates that it experienced in the years immediately following the global financial crisis. According to UK Finance figures, buy to let contributed barely a fifth of overall net lending last year – its weakest contribution since 2006!

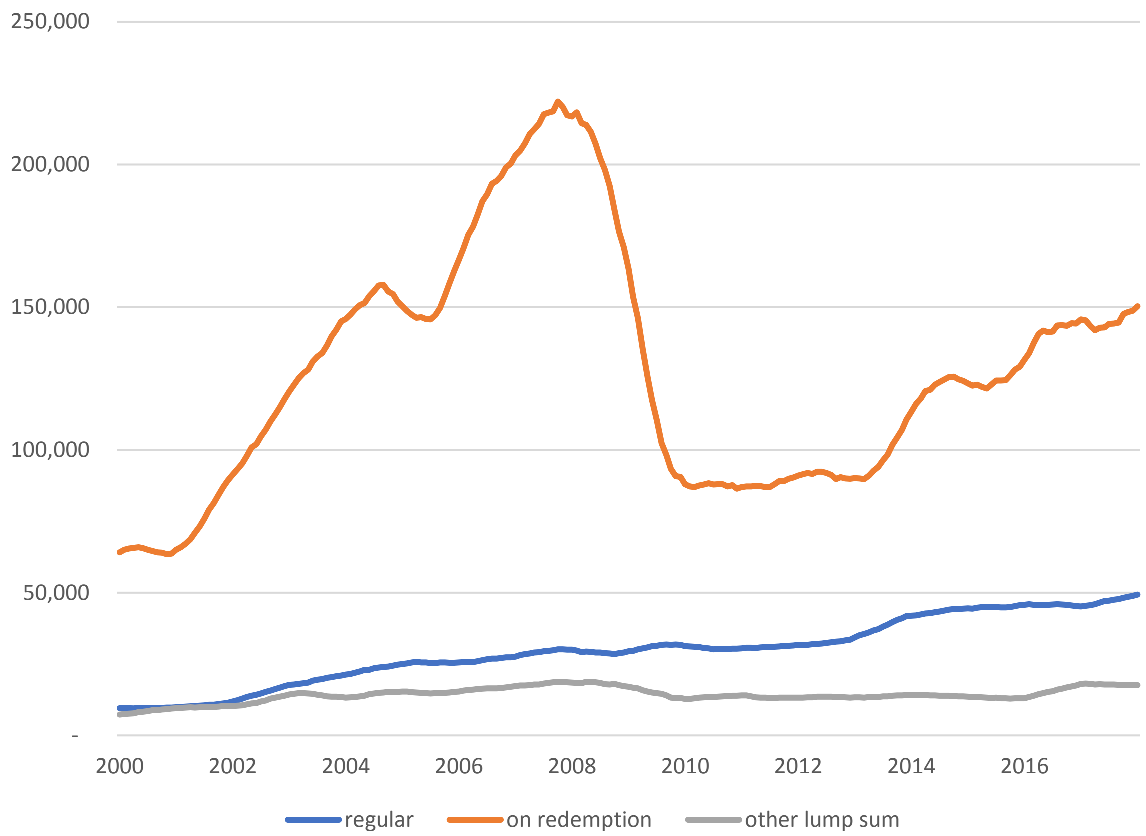
Elsewhere, the missing element from our picture is the significant deleveraging by existing borrowers – to the tune of £25-30 billion a year over the past decade.

Repayments

Although not widely reported, the Bank of England’s figures on capital repayments offer some helpful insights into what has been going on.

Repayments are split into three types: the capital repayment element of regular monthly payments, repayments on redemption (typically when the borrower moves home or refinances) and other (irregular) lump sum payments.

Chart 2: Capital repayments, rolling 12-month totals, £m



Source: Bank of England

As we can see from Chart 2, lump-sum payments are relatively modest in scale. They have increased modestly over the past couple of years, but have consistently accounted for 10%, or a little less, of total repayments.

Regular repayments - those associated with contractual monthly payments - have grown convincingly over the past decade. This reflects a mortgage stock that is now nearly a fifth higher, the progressive switch from interest-only to capital and interest mortgages and also the arithmetic effect that low mortgage rates have in lifting capital repayments in the early years of the mortgage term.

Regular repayments totalled £49 billion last year, nearly a quarter of total repayments. Over the past decade, the increase in regular repayments averages out as an extra £2 billion annually. This will have nudged net lending a little lower over the period, but is clearly not the central story.

For that, we have to look at repayments on redemption. As the Chart shows, these easily form the largest element of total repayments, and they have been hugely volatile over the past decade.

In fact, in broad outline, they echo gross lending business volumes. This makes sense - when house purchase and/or remortgage activity levels fall away sharply, so too does the need for existing loans to be repaid.

In normal market conditions, a proportion of existing mortgage borrowers will be moving up the housing ladder and seeking to borrow more on their new mortgage than the one that will need to be repaid. Similarly, some of those remortgaging will be looking to withdraw some equity on the way.

What we find is that repayments on redemption are typically much less than 100% of the new lending for moving house or remortgage. And the implication that flows from this is that higher (gross) lending activity is associated with higher net lending.

Much of the depressed state of net lending post global financial crisis and its subsequent revival can in fact be traced to the corresponding profile of gross lending activity.

But there is something else too.

The relationship between gross lending and repayments is not set in stone, and it has actually varied quite significantly since the early 2000s.

In the liberal market conditions that prevailed before the global financial crisis, repayments on redemption were little more than half of the corresponding gross lending.

in the years immediately after the global financial crisis, when there was restricted mortgage credit availability and soft house prices meant little improvement in borrowers' LTV positions, those remortgaging or moving house found it less easy to take on additional borrowing. During this period, about £70k of repayments were associated with every £100k of borrowing.

So in this period, not only did lower market activity depress net lending, but also the more limited opportunities to re-leverage meant that the capital repayment associated with such activity was higher, diminishing net lending still further.

This picture has gone into reverse over the past few years.

As the economic and financial picture and household confidence have improved, lending activity has recovered. And with better credit availability, and higher house prices strengthening the LTV positions for many households, those higher levels of activity have been associated with lower rates of repayment/greater recourse to borrowing.

Today, about £60k of repayment is associated with every £100k of borrowing, similar to the position in 2005-6.

This tells us that the fundamental reason why net lending has not reverted to the £100 billion mark that characterised the market peak is due to the much lower levels of market activity that we are seeing. Despite some recovery in mortgage activity, house purchase transactions (818,000 last year) and remortgages (585,000) are respectively 36% and 55% lower than in 2016.

Prospects

With today's regulatory oversight and the prospect of modestly higher interest rates, the current availability of mortgage credit appears to be about as good as it gets.

So, when we ask about the prospects for net lending in the coming years, our question really becomes whether we expect a fresh major step-increase in lending activity across the board.

I suspect that the answer is no.

And I am in good company.

Forecasts for net lending from the Office for Budget Responsibility, UK Finance, and IMLA all cluster in the £40-50 billion range for this year and next. Generally speaking, a little higher than in 2017, but not dramatically so. Such outturns are eminently plausible, especially if government actions can support some further growth in first-time buyer numbers.