The new ‘normal’ – prospects for 2023 and 2024

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Executive summary

- **Mortgage lending has held up well in 2022 despite rising interest rates and the worsening cost of living crisis, but the market dislocation that followed the mini-budget in September triggered a slowdown towards the end of the year.** We estimate that gross lending will total £310 billion in 2022, slightly above 2021's strong performance. The figures were boosted by stronger re-mortgaging, which reached an estimated £108.5 billion. However, both lending for house purchase and net lending were down on 2021, by 12% and 16% respectively.

- **The dramatic rise in fixed-rate mortgage costs following the mini-budget and Bank of England announcement that it would start selling government bonds to unwind QE triggered a sharp shift in market sentiment.** The mostly timely data, the Nationwide and Halifax house price indices, both fell in October and November. We expect market sentiment to remain negative with house prices set to fall 2.5% year-on-year in 2023 but comparing December 2023 to December 2022 the expected fall is 6%, with further declines in 2024.

- **The buy-to-let market has seen record gross lending in 2022 of an estimated £56 billion.** But this has been driven by a 33% rise in remortgages by value. Buy-to-let lending for house purchase is down an estimated 5% to £17 billion. Net buy-to-let lending has been higher though, at more than £15 billion, the best performance since before George Osborne's adverse tax changes of 2015. This was despite the burden of much higher mortgage rates from late September onwards.

- **The most important determinant of the economic outlook in 2023 and 2024 is the future path of inflation.** We forecast that Bank of England Bank Rate will reach 4.5% by the end of 2023, which sounds low against the backdrop of today's double-digit price rises, but inflation should be falling in 2023 due to base effects and we expect CPI inflation to be down to 5% by the end of 2023. However, we think the Bank of England may have under-estimated second round price effects, which will create inflation persistence, possibly forcing further tightening in 2024.

- **We expect gross mortgage lending to fall to £265 billion in 2023 and £250 billion in 2024.** Net lending is also expected to decline, to £48 billion in 2023 and £45 billion in 2024. These falls reflect the much tougher economic conditions we have entered with higher interest rates and a record squeeze on living standards.

- **2022 saw a significant rise in intermediaries' share of distribution from around 80% to 84%.** The relentless rise of the intermediary has been driven in large measure by the advantages that lenders see from this channel, including lower fixed costs, flexibility in controlling volumes and some insulation from conduct risk issues. We believe the intermediary share will continue to rise and could reach 90% of distribution by 2024.

- **IMLA projects negative equity of only 16,000 by Q4 2024.** IMLA projects that falling house prices will not trigger negative equity on the scale seen in the 1990s or during the financial crisis of 2008-9. Focusing on those who bought up to the end of 2022, on our house price forecast we expect only 16,000 of these households to be in negative equity by Q4 2024 with average negative equity of £4,300, also lower than in previous downturns. Even if house prices fell 25%, we project that the number of households in negative equity would remain below 500,000, mainly because of much lower levels of high LTV lending than in the run-up to previous downturns.

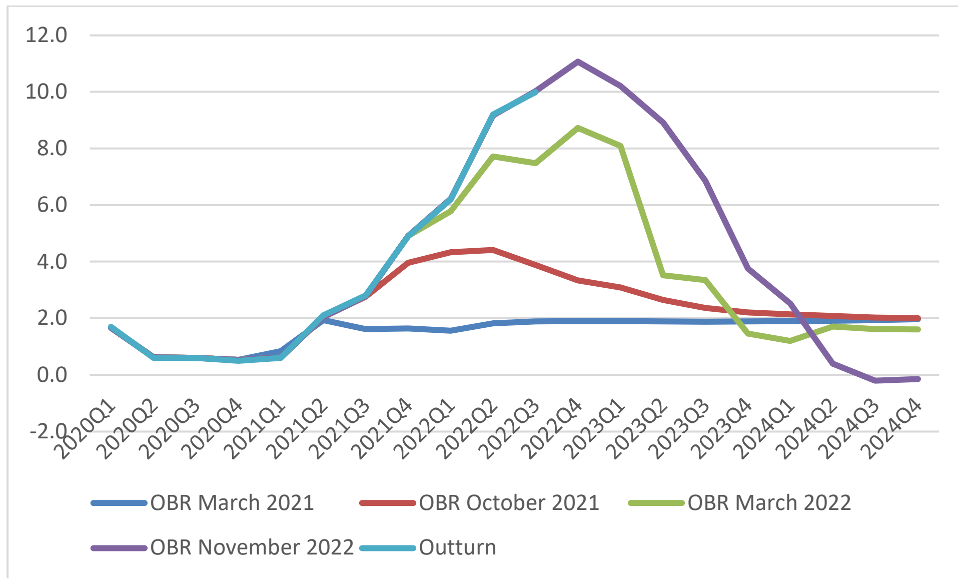
1. The market in 2022

1.1 No 'new normal' for inflation

After the disruption wrought by Covid and the associated lockdowns in 2020 and 2021, 2022 justifiably could have been expected to be a year when normality started to return to the global economy. This was not to be. Firstly, the fragility of supply chains was exposed as the world's economy opened back up, exacerbated by continued lockdowns in key manufacturing countries such as China. A shortage of key supplies such as microchips impacted the production of a range of goods from consumer electronics to cars, sending prices up sharply.

Then on 24 February Russia invaded Ukraine, starting what has turned out to be the most destructive war on European soil since WWII. The invasion and the resulting sanctions imposed on Russia have resulted in soaring prices for a range of commodities, first amongst them being natural gas, which is several times more expensive than the immediate pre-war level.

Chart 1 – OBR CPI inflation forecasts and outturn



Source: OBR, ONS

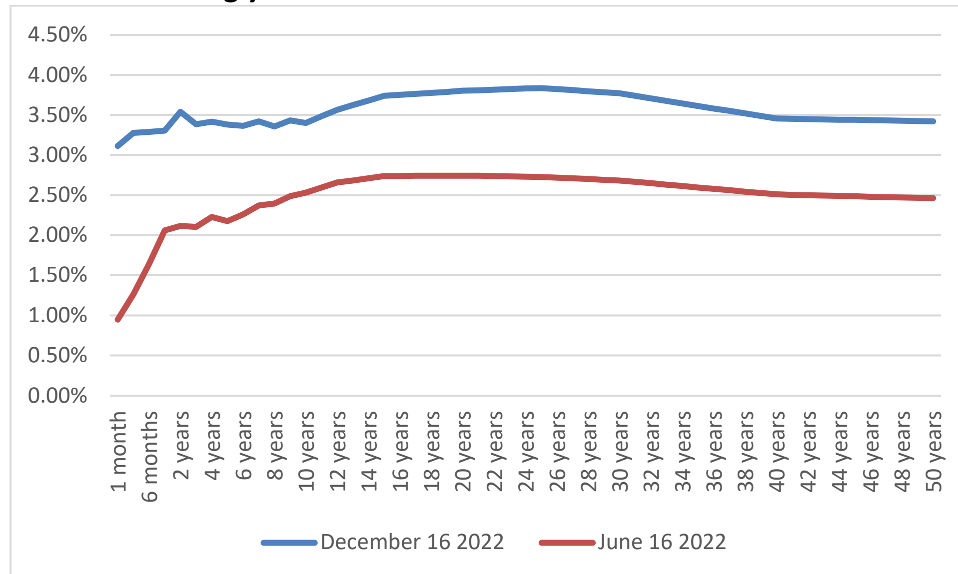
The combination of international supply chain disruption and the war in Ukraine has resulted in the largest import price shock since the 1970s, sending inflation up rapidly across the globe. The extent to which this shock was not anticipated is demonstrated by Chart 1, which shows the government's Office for Budget Responsibility (OBR) forecasts for CPI inflation. As recently as March 2021, CPI inflation was not expected to exceed the 2% target over the forecast horizon.

1.2 A shock to interest rates

In the face of rising inflation, one of the most positive indicators in 2021 and the first half of 2022 came from the bond market, which showed long-term interest rates

anchored at around 2% (see Chart 2). All that changed in September when Chancellor Kwasi Kwarteng unveiled a mini-budget that seemed to jettison fiscal discipline, following the announcement a day earlier by the Bank of England that it would start unwinding QE by selling government bonds bought under that programme back into the market.

Chart 2 – Sterling yield curve



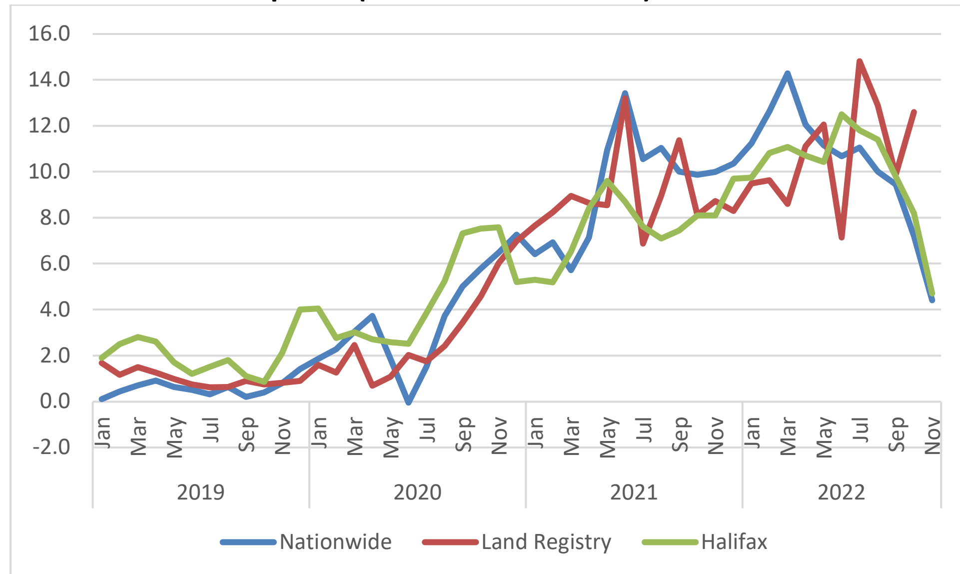
Source: World government bonds.com

The prospect of the Bank of England becoming a seller in the gilt market coupled with the risk of higher inflation stemming from much larger than anticipated government deficits sent the bond market into turmoil. The impact on consumers was felt immediately by those seeking new fixed-rate mortgages, the price of which in some cases more than doubled as other lenders withdraw fixed-rate products due to the difficulty pricing them with such volatility in the interest rate swaps market.

1.3 Housing market at a turning point

The Covid-related bounce in house prices, stemming partly from large fiscal and monetary injections and partly from higher demand as buyers altered their lifestyles in the 'race for space' continued to influence the market in 2022 (see Chart 3). The market remained surprisingly resilient until the Autumn, perhaps reflecting the acute shortage of supply and the overhang of cash deposits that had built up during Covid lockdowns. In the 2½ years between February 2020 and September 2022 house prices nationally rose 28% from £231,000 to £296,000.

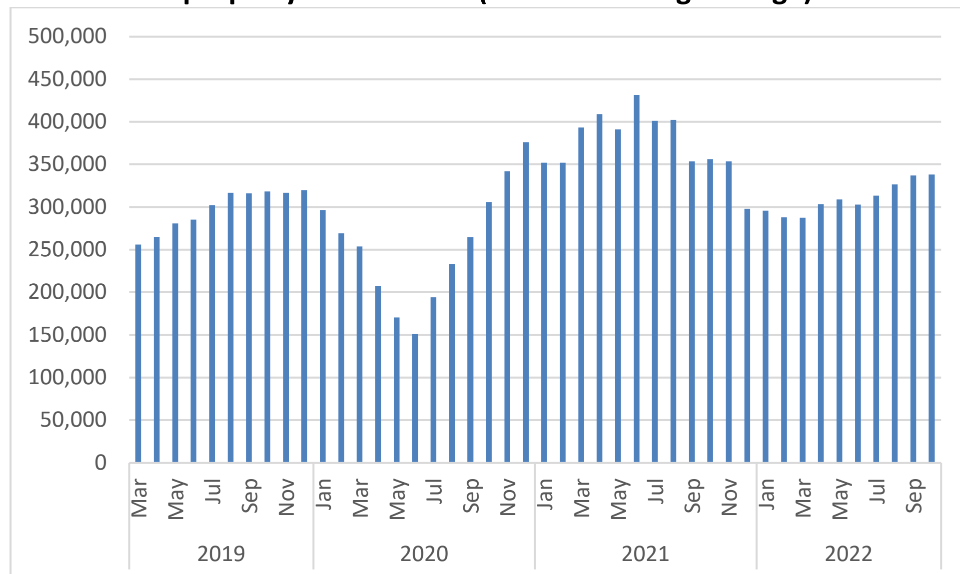
Chart 3 – UK house prices (12 month % increase)



Source: Nationwide Building Society, Lloyds Banking Group and HM Land Registry

But housing market sentiment changed almost overnight in September as fixed-rate mortgage pricing soared in response to the spike in bond yields (10 year government bond yields, which had been below 2% at the end of July hit 4.5% by the end of September). Such was the volatility and uncertainty in the interest rate swaps market (which is driven by the differential between short and long rates) that many lenders pulled their fixed-rate products altogether, leaving buyers to reassess their options and what they could sensibly afford to do.

Chart 4 – UK property transactions (3 month rolling average)



Source: HMRC

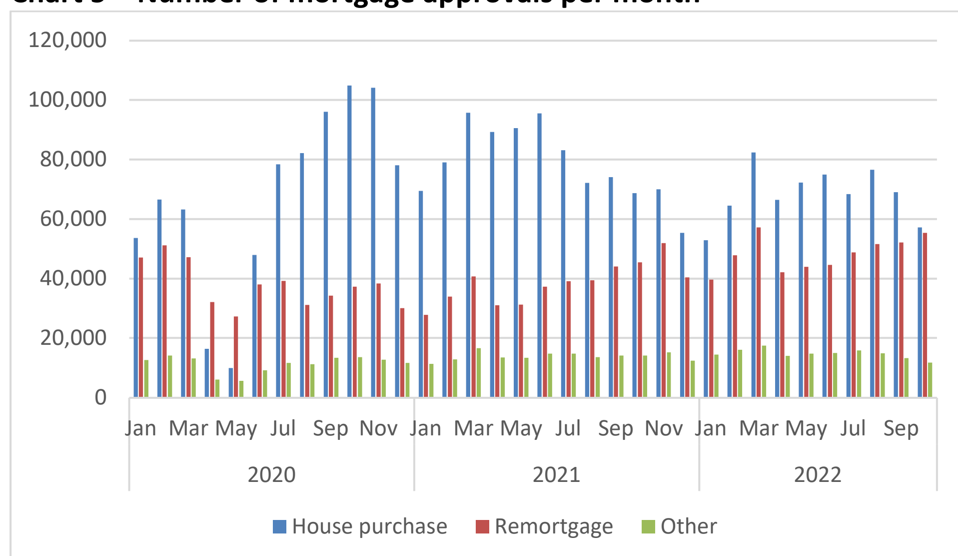
While house prices continued to rise until Autumn 2022, housing transactions during the first three quarters of the year were already below 2021's level, which had been artificially stimulated by the extended stamp duty holiday (see Chart 4). Nonetheless, the level of transactions, like house prices, was surprisingly strong given the backdrop of soaring energy prices and weak economic growth.

1.4 A shift to remortgaging

Despite house prices continuing to head higher during most of 2022, thanks to the lower level of housing transactions, the number and value of house purchase mortgage advances fell. But a surge in remortgage activity, as borrowers became concerned about future interest rate rises, offset the fall in house purchase lending, leaving overall lending slightly up on 2021's strong figure. Remortgages reached an estimated £108.5 billion, the best performance since 2008.

Mortgage approvals data tell a similar story. In the year to October there were 1,315,000 approvals, just below 2021's number: a 16% decline in house purchase approvals being offset by a 31% rise in remortgage approvals (see Chart 5).

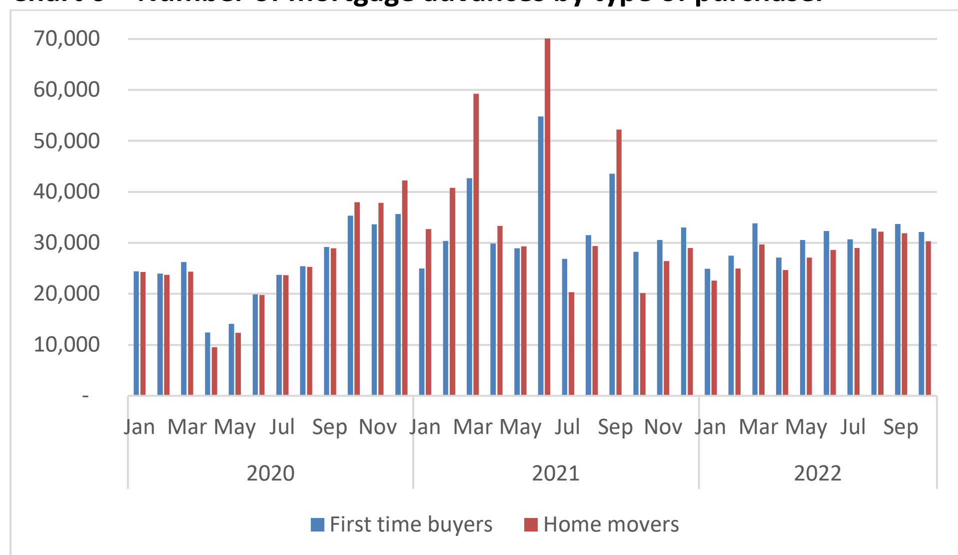
Chart 5 – Number of mortgage approvals per month



Source: Bank of England

Another aspect of lending that has experienced a shift in 2022 is the breakdown within house purchase lending between first-time buyers and home movers. In the year to October, first-time buyer numbers held up quite well, falling only 11%, while home movers were down 28% (see Chart 6). This reflects the strength of home mover activity in 2021, spurred by the stamp duty holiday. Still in 2022, home mover numbers have been broadly in line with immediate pre-pandemic levels while first-time buyers have been 5% ahead of the corresponding period of 2019.

Chart 6 – Number of mortgage advances by type of purchaser



Source: UK Finance

1.5 Record year for buy-to-let

The fallout from the market turmoil following the mini-budget was, if anything, more keenly felt in the buy-to-let market than for owner-occupiers. As most landlords borrow on an interest-only basis, the impact of higher rates was more severe. Most lenders pulled their fixed-rate products in late September but the few deals that remained on offer had rates up to around 7%, a point at which some landlords struggle to meet affordability requirements. However, rates have subsequently fallen substantially, easing these pressures.

Despite the Autumn market dislocation, 2022 has been an exceptionally strong year for buy-to-let with gross lending reaching a record estimated £56 billion. But this has been driven by the strength of the remortgage market in a year when landlords have been looking to protect themselves against rising interest rates. Lending for house purchase has fallen 5% to an estimated £17 billion, but this was unsurprising given the stamp duty benefits available in 2021 and 2022's figure actually represents a strong number relative to recent years: an estimated 100,000 buy-to-let purchases in 2022 was a third up on 2019's pre-Covid level.

After the adverse tax changes and increasing regulation of the private rented sector in recent years, landlords might have been expected to be exiting the market. In fact, record numbers of buy-to-let properties have been sold over the past 2 years (170,000) suggesting that while some landlords are indeed finding the current regulatory and tax environment difficult, anecdotal evidence suggests that other more professional landlords are stepping in and buying many of these properties. High tenant demand and average new rents rising by 11% in the year to November (according to Homelet) have no doubt attracted some landlords to expand their portfolios but supply is still failing to keep pace with demand.

2. The mortgage market outlook for 2023 and 2024

2.1 Background environment in 2023 and 2024

Table 1 shows our forecast for key variables underpinning our mortgage market forecast. It shows the impact of surging global energy and food prices, much of it stemming from the Russian invasion of Ukraine. Without an early end to the war in Ukraine and western sanctions on Russia, which seems unlikely, many global commodity prices will remain elevated. The impact in importing countries like the UK is a reduction in our real national income, which we expect to drive lower output and higher unemployment.

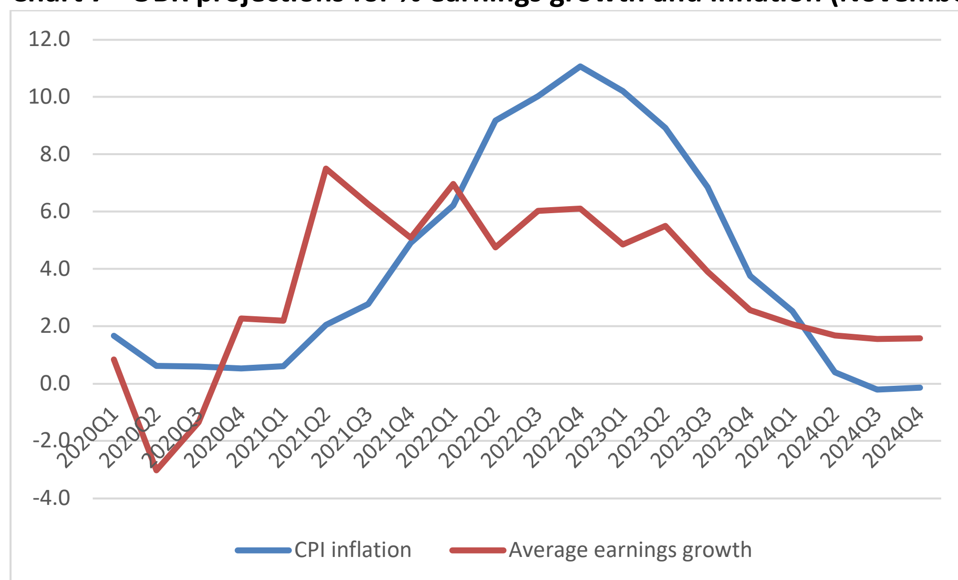
Table 1 – key forecast assumptions

	Past values		Forecast values				
	2021	2022e	2023f	2024f	2022/21f	2023/22f	2024/23f
Real GDP (£bn)	2,141	2,235	2,210	2,200	4.4%	-1.1%	-0.5%
Unemployment rate (Q4)	3.7%	4.3%	5.0%	5.5%	16.2%	16.3%	10.0%
CPI inflation rate (Q4)	4.9%	10.5%	5.0%	3.8%	114.3%	-52.4%	-24.0%
House prices (average for year)	258,500	285,200	278,000	267,000	10.3%	-2.5%	-4.0%
Housing transactions (UK, thousands)	1,476	1,230	1,100	1,050	-16.7%	-10.6%	-4.5%
Bank Rate (end of year)	0.25%	3.50%	4.50%	5.00%	1300.0%	28.6%	11.1%

Source: IMLA, ONS and HMRC

The big shock since the last New Normal report is the surge in inflation. This has made the future path of inflation the pivotal factor driving the rest of the outlook. There are two camps: first are those who see inflation falling rapidly over the next two years. The latest OBR forecast in November 2022 falls firmly into this camp with inflation projected to be negative by the second half of 2024 (see Chart 7). This would set the scene for a sharp cut in Bank of England Bank Rate and a robust economic recovery.

Chart 7 - OBR projections for % earnings growth and inflation (November 2022)

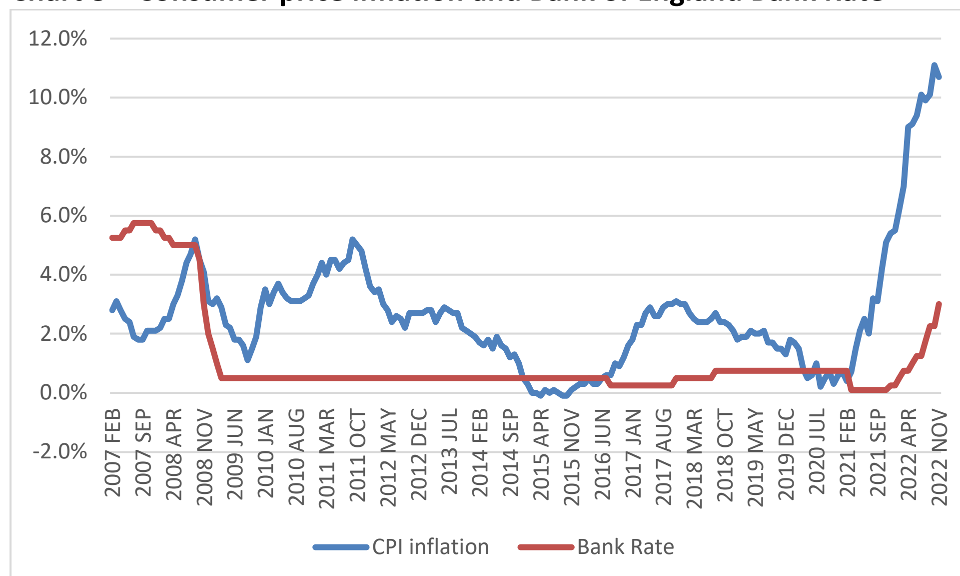


Source: OBR

The second camp, which this forecast falls into, rejects such a rosy scenario. So-called second-round effects, where domestic prices and wages are raised in response to rising input prices, are already clearly evident and once producers and workers have become accustomed to higher rates of inflation they will feel the need to push the cost of their goods or labour higher to preserve real incomes.

As a result, even as global energy and food prices stabilize, we expect domestic inflationary pressures to be strong enough to keep overall inflation close to 4% by the end of 2024. Not only will this provide no scope for Bank Rate cuts but is likely to require rates to go higher still, as the Bank of England will need to respond to what by then will be more domestically driven inflation. The dovish noises coming out of the Bank at the moment, which suggest that 4% Bank Rate may be seen as sufficient, reflect the view that inflation can be contained relatively quickly but we believe this downplays the scale of the self-perpetuating forces at work when inflation is driven higher.

Chart 8 – Consumer price inflation and Bank of England Bank Rate



Source: ONS, Bank of England

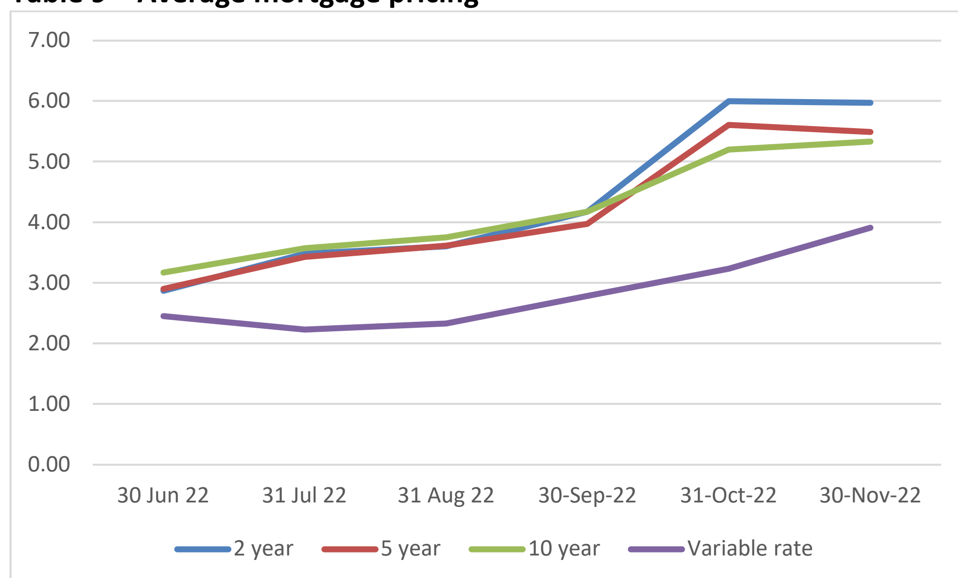
With Bank Rate at a record low of nearly -8% in real terms (see Chart 8), the Bank of England has come in for criticism from some quarters for its comparatively dovish tone on the possible profile of future rates. But the economic slowdown will itself reduce inflationary pressures and too great an increase in interest rates when the economy is so fragile risks causing excessive economic pain. So the Bank's current stance could well be the most effective way to balance the need to show its commitment to the 2% inflation target with the desire to avoid excessive economic dislocation.

On our forecast, Bank Rate will be positive again in real terms by 2024. This is a healthy position that will help to bring inflation down beyond the forecast horizon but with the labour market remaining relatively tight and supply chains localizing, we think that inflation will take longer to bring back to target than official forecasts would suggest.

2.2 Outlook for the UK housing market

There is now something of a consensus that the UK is facing a housing market downturn during 2023 and 2024. The OBR projects that between the fourth quarter of 2022 and the same period of 2024 house prices will fall 9%. Lloyds Banking Group has warned of an 8% fall in 2023 and Savills expects house prices to fall 10% in 2023 before recovering by one percent in 2024. We expect a 10% fall between Q3 2022 and Q4 2024 (note our projected fall in yearly average prices is less at 6% between 2022 and 2024). But as is usual in housing downturns we expect turnover to fall proportionately further as people delay housing moves. We expect transactions to decline from an estimated 1,230,000 in 2022 to 1,100,000 in 2023 and 1,050,000 in 2024.

Table 9 – Average mortgage pricing



Source: Bank of England

The largest single factor behind this weaker market is the sharp rise in mortgage rates and corresponding deterioration in buyer affordability. Mortgage rates have been rising since late 2021 but it was not until the mini-budget of September that buyer confidence was shaken by the dramatic jump in fixed rates. As Chart 9 shows, variable rate loans have seen the shallowest rise, reflecting the path of Bank Rate, but amongst fixed-rate products, 2-year fixed rates have experienced the largest rise. The average 2-year fixed-rate mortgage went from 3.6% to 6.0% in two months as turmoil in the bond market, exacerbated by margin calls facing pension funds using the liability driven investment strategy, impacted swap prices.

Going forward, we expect Bank Rate to be the main driver of higher mortgage rates. As long as the bond market believes that inflation will return to target over time, long-term interest rates are unlikely to experience the volatility seen after the mini budget, although a General Election must be held before the end of 2024 and this could raise market anxiety about the future course of fiscal policy.

While higher mortgage rates is the largest factor driving a housing downturn over the forecast horizon, it is not the only one. Squeezed real incomes will reduce the size of advance that is deemed affordable for many households while rising unemployment is likely to create greater buyer caution. But we expect unemployment to rise only modestly to 5.5% by Q4 2024, which should limit the number of distressed sellers.

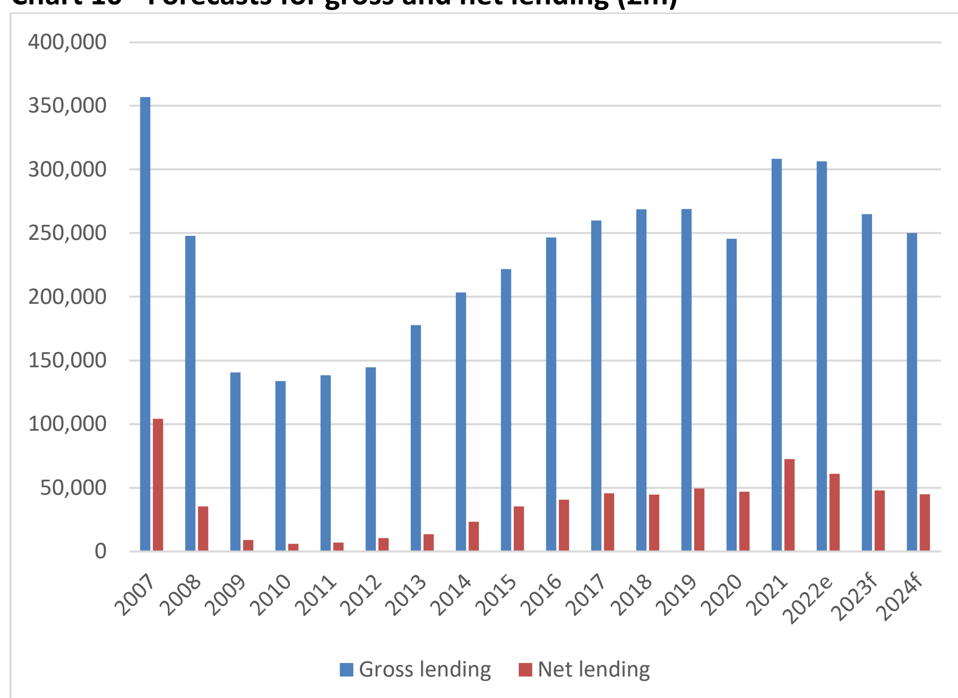
Moreover, as more borrowers are on fixed rates with longer fixed periods on average than in the past, the impact of rising mortgage rates will be more drawn out than in previous downturns. This should limit the number of distressed sales resulting from payment shock but, for households who fixed at the competitive rates seen in recent years, the scale of monthly increase they face when their deal ends will represent a real challenge to many household budgets.

2.3 Outturn relative to previous year's forecast

In last year's report, IMLA forecast gross mortgage lending of £275 billion for 2022 including £175 billion for house purchase and net lending of £52 billion. By way of comparison, UK Finance forecast gross lending of £281 billion (£174 billion for house purchase) and net lending of £47 billion while the November 2021 OBR report forecast net mortgage lending of £52 billion. The estimated outturns were gross lending of £310 billion, of which house purchase was £188 billion with net lending of £61 billion. Last year, IMLA and UK Finance forecast buy-to-let lending of £44.5 billion and £40 billion respectively for 2022. The outturn was an estimated £56 billion.

2.4 Mortgage market forecast

Chart 10 - Forecasts for gross and net lending (£m)



Source: Bank of England and IMLA

We expect total gross mortgage lending to fall by 15% to £265 billion in 2023, with a further fall to £250 billion in 2024 (see Chart 10). We expect net lending to fall more sharply by 21% to £48 billion in 2023 with a further fall to £45 billion in 2024. As Table 2 shows, the fall is driven both by lower lending for house purchase and re-mortgaging. This in turn is driven by lower housing turnover and a likely further shift towards product transfers in an environment where affordability pressures could reduce what many borrowers will be able to borrow when a full affordability assessment is performed for a remortgage.

Table 2 – Mortgage market forecast

Gross mortgage lending (£m)

	2021	2022e	2023f	2024f	2022/21f	2023/22f	2024/23f
House purchase	213,316	188,000	165,000	155,000	-11.9%	-12.2%	-6.1%
Remortgage	82,612	108,500	88,000	83,000	31.3%	-18.9%	-5.7%
Other	12,542	13,500	12,000	12,000	7.6%	-11.1%	0.0%
Total	308,470	310,000	265,000	250,000	0.5%	-14.5%	-5.7%
of which:							
Buy-to-let lending	47,449	56,000	47,000	46,000	18.0%	-16.1%	-2.1%
of which for house purchase	17,847	17,000	14,000	13,000	-4.7%	-17.6%	-7.1%
Buy-to-let share of total	15.4%	18.1%	17.7%	18.4%	17.4%	-1.8%	3.7%
Lending via intermediaries*	204,392	212,000	185,000	182,000	3.7%	-12.7%	-1.6%
Share of total*	80.1%	84.3%	86.0%	90.1%	5.2%	2.1%	4.7%
Net lending	72,635	61,000	48,000	45,000	-16.0%	-21.3%	-6.3%
Product transfers	192,800	182,000	175,000	170,000	-5.6%	-3.8%	-2.9%
2.5%+ arrears (thousands Q4)	85,660	81,000	120,000	150,000	-5.4%	48.1%	25.0%
Possessions (thousands)	2,250	4,300	10,000	20,000	91.1%	132.6%	100.0%

* Regulated loans only

Source: IMLA, Bank of England, UK Finance

We expect mortgage intermediaries' share of lending to keep rising in 2023 and to hit a record 90% in 2024. Costs, relative flexibility and conduct risk issues have all played a part in lenders' decisions to increase their use of brokers to source mortgage business and we see these factors continuing to support further gains in market share by intermediaries.

Last year for the first time we included a forecast for arrears and possessions in Table 2. Contrary to our expectation, arrears of 2.5% plus of the loan balance fell in 2022, perhaps reflecting the low interest rates borrowers were able to lock into in late 2021 and early 2022 as well as lower unemployment. So far there are limited signs of distress but we expect this to change in 2023, leading to a 48% increase in arrears followed by a further 25% rise in 2024. This would still leave arrears below the level they reached in the financial crisis of 2008-9 and, given that interest rates were falling then and rising now, the risk of higher arrears must be significant.

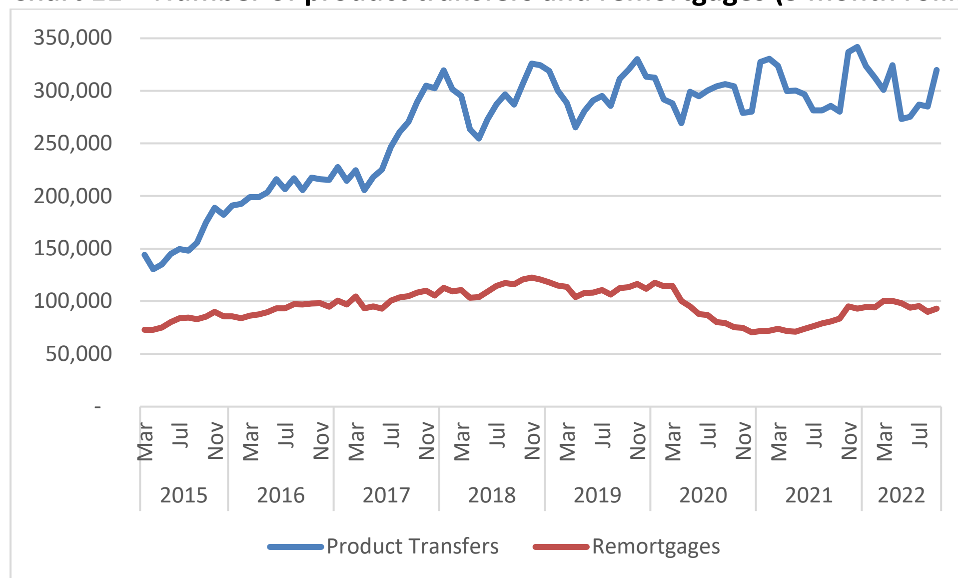
Possessions have also been lower in 2022 than we projected at only 4,300. We expect possessions to more than double in 2023 to 10,000 and reach 20,000 in 2024. In a

longer-term context these are still low numbers: in 2009 49,000 properties were taken into possession and therefore, again, the risks to our forecast are on the upside. Forbearance rules have helped to keep possession rates down and lenders will continue to be supportive but the most serious arrears cases (10% or more of the loan balance) have not fallen in line with other arrears, pointing to a cohort of customers who are vulnerable to any further financial shocks.

2.5 Product transfers and remortgages

As Chart 11 shows, the number of product transfers has been on a rising trend since 2015 while the number of remortgages has been broadly flat. While in 2015 there were two product transfers for each remortgage, by 2021 there were nearly four. However, 2022 saw a reversal of the trend with remortgage levels rebounding, as rising interest rates encouraged borrowers to shop around more, and product transfers falling back. As a result, the ratio of product transfers to remortgages fell quite sharply to 3.1 in the year to September.

Chart 11 – Number of product transfers and remortgages (3 month rolling average)



Source: UK Finance

While there are still many more product transfers than remortgages, the average value of remortgages was higher at £213,000 in the year to September 2022 versus £155,000 and has grown faster since 2015, increasing by 31% against 21% for product transfers. This reflects the larger savings available from remortgaging for customers with bigger mortgages. As brokers have increased their share of distribution they are having a greater impact on customers' choice of product transfer or remortgage, potentially creating better outcomes for those who may not be able to determine which option is more advantageous for their particular circumstances without professional assistance.

2.6 Buy-to-let mortgage market forecast

We expect buy-to-let lending to fall to £47 billion in 2023, faster than the fall in lending to owner-occupiers. We expect the steepest fall to come from the house purchase market. While personal circumstances drive many house purchase decisions for owner-occupiers, buy-to-let purchases are discretionary and in a falling market there is a disincentive to purchase if buyers expect prices to continue to fall. On the other hand, buy-to-let investors may be able to capitalise on 'motivated' sellers who will accept a reduced price to obtain a quick sale in a slow market.

The future evolution of tenant demand and rent levels will no doubt play a significant role in determining how well buy-to-let purchases hold up in the medium term. Recent high net immigration figures and a likely slowdown in house building rates suggest that rental demand is likely to remain strong.

Table 3 – Buy-to-let and wider mortgage market forecasts compared

	2021	2022e	2023f	2024f	2022/21f	2023/22f	2024/23f
Whole market							
Outstanding debt (£bn)	1,566	1,627	1,675	1,720	3.9%	3.0%	2.7%
House purchase lending (£m)	213,316	188,000	165,000	155,000	-11.9%	-12.2%	-6.1%
House purchase % churn	13.9%	11.8%	10.0%	9.1%	-15.3%	-15.1%	-8.6%
Remortgage	82,612	108,500	88,000	83,000	31.3%	-18.9%	-5.7%
Remortgage % churn	5.4%	6.8%	5.3%	4.9%	26.2%	-21.6%	-8.3%
Total % churn	20.1%	19.4%	16.1%	14.7%	-3.5%	-17.3%	-8.2%
Buy-to-let market							
Outstanding debt (£bn)	281	296	303	310	5.5%	2.4%	2.3%
House purchase lending (£m)	17,847	17,000	14,000	13,000	-4.7%	-17.6%	-7.1%
House purchase % churn	6.4%	5.9%	4.7%	4.2%	-8.2%	-20.7%	-9.3%
Remortgage	27,857	37,000	30,500	30,000	32.8%	-17.6%	-1.6%
Remortgage % churn	10.0%	12.8%	10.2%	9.8%	28.1%	-20.6%	-3.9%
Total % churn	17.1%	19.4%	15.7%	15.0%	13.8%	-19.2%	-4.4%
Buy-to-let % of total market							
Outstanding debt	17.9%	18.2%	18.1%	18.0%	1.5%	-0.6%	-0.4%
House purchase lending	8.4%	9.0%	8.5%	8.4%	8.1%	-6.2%	-1.2%
Remortgage	33.7%	34.1%	34.7%	36.1%	1.1%	1.6%	4.3%
Total lending	15.4%	18.1%	17.7%	18.4%	17.4%	-1.8%	3.7%

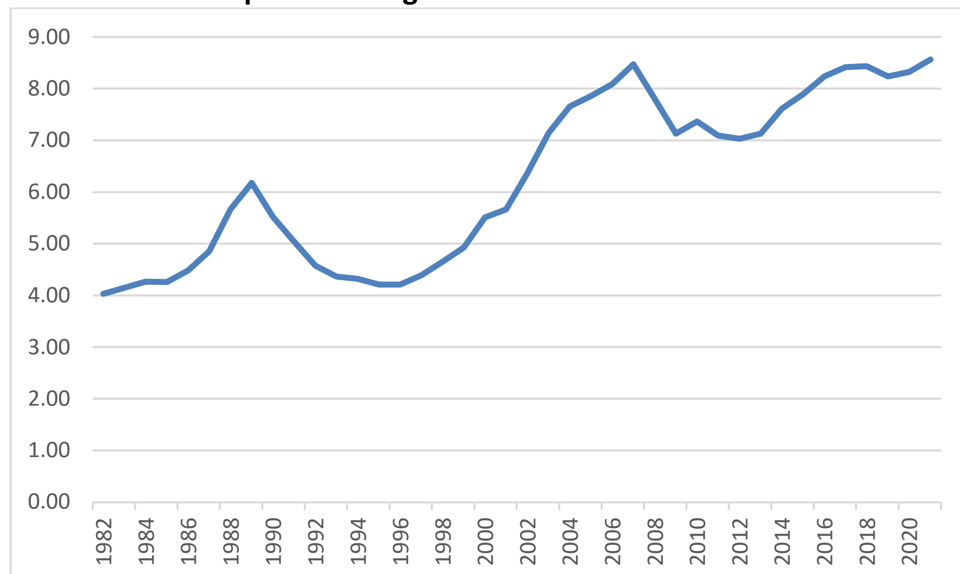
Source: Bank of England, UK Finance and IMLA

3. Mortgage affordability: how serious is the decline?

3.1 The longer-term context

Perhaps the most widely recognized measure of housing affordability is the house price to earnings ratio which is often cited to show how unaffordable housing has become (see Chart 12). In 2022, house prices relative to average earnings hit a record high, passing 9 times for the first time.

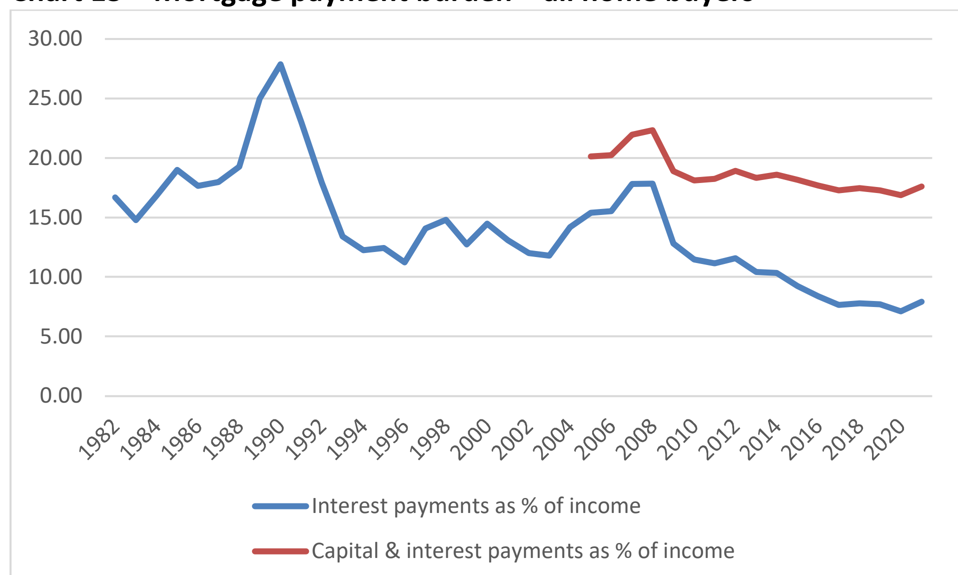
Chart 12 – House price earnings ratio



Source: ONS

However, as IMLA has pointed out before, such has been the fall in mortgage rates since their peak in the early 1990s, that affordability measured by the level of interest or mortgage payments relative to income has actually been on a downward trend and reached record lows in recent years (see Chart 13). Indeed, this improved affordability largely explains the rising house price to earnings ratio as buyers have been able to comfortably afford larger mortgages relative to their income.

Chart 13 – Mortgage payment burden – all home buyers



Source: UK Finance

Mortgage rates reached their trough in late 2021 but affordability was already deteriorating that year because the decline in rates was not sufficient to outweigh rapidly rising house prices. In 2022, the deterioration in affordability accelerated sharply as house prices continued to rise until the Autumn despite rising mortgage rates, and then the spike in rates caused a much sharper deterioration in affordability.

Although fixed-rate mortgage pricing has fallen back since October, it remains elevated relative to the level in the summer and further Bank Rate increases are expected in 2023. How concerned should we be? There are two effects to consider: the impact on property purchasers, and corresponding impact on the housing market, and the impact on the wider population of existing homeowners, which would be expected to show up as rising mortgage arrears and ultimately impact the level of possessions.

3.2 Impact on house buyer demand

As stated above, mortgage affordability was improving in recent years because the rise in house prices was more than offset by the fall in interest rates. The reverse is likely to be the case over the forecast horizon. By the end of 2024, buyers will benefit from house prices being around 9% lower than today on our forecast, as well as some wage inflation, but we expect new mortgage rates to average around 5.5%. This would result in interest payments as a percentage of income rising from around 11% in October 2022 to 15%.

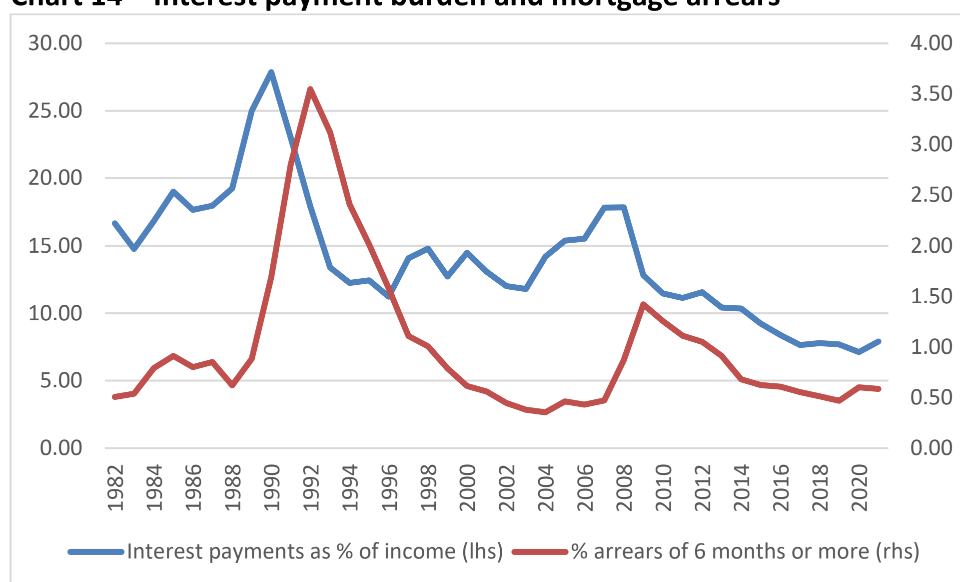
On the face of it, this near 40% rise in the interest burden sounds high but it translates into less than a 20% rise in monthly mortgage payment on a capital repayment mortgage. Moreover, it takes new buyer affordability back to where it was in 2005 and 2006, a period when the housing market was strong. So actual affordability may be less of a concern than general sentiment. Buyers will no longer be reaping the benefits

of ultra-low interest rates, but will not face a high mortgage payment burden compared to the historical average. How borrowers feel about this transition to more normal levels of affordability will be key to determining future levels of buyer demand.

3.3 Impact on existing mortgage borrowers

As Chart 14 shows, there is a strong causal link between mortgage interest as a percentage of income and mortgage arrears. If we are right in predicting that the interest burden will reach 15% by the end of 2024, this will take it to its highest level since the financial crisis. Between 2008 and 2009, 6 months plus arrears rose from 0.5% to 1.4% but there had been a more muted deterioration in the payment burden in the preceding years and indeed the payment burden was falling sharply from 2008.

Chart 14 – Interest payment burden and mortgage arrears



Source: UK Finance

Today we face a much sharper deterioration in the mortgage payment burden because borrowers have been used to ultra-low interest rates. People have grown accustomed to spending on other things and it will undoubtedly be hard for them to channel more spending to their mortgage at a time when the cost of so many basic necessities is rising faster than most incomes.

However, there are factors that should ameliorate the impact of deteriorating affordability on the existing population of mortgage borrowers. Most significantly, far more borrowers are now on fixed-rate deals of 5 years. Many of these customers will not need to remortgage until 2025 at the earliest, by which time interest rates may have started to fall. Also, forbearance rules allow lenders to switch customers to interest-only contracts where this is deemed appropriate. When customers face an unexpected and hopefully temporary shock to other costs, a temporary switch to interest-only could be an appropriate way of alleviating financially pressured households and limiting arrears.

4. How serious is the risk of negative equity?

4.1 Previous downturns

The term negative equity first gained common usage in the housing downturn of the early 1990s, when many first-time buyers on high LTV mortgages found that a fall in the market value of their home had taken it below the mortgage balance. Estimates at the time suggested that at the peak 1.8 million households were affected and the scale of the problem certainly worsened the repossession crisis, as it limited owners' ability to sell if they were struggling financially. Many borrowers, faced with such burdens, simply handed their keys back to their lender, leaving them at risk of being pursued for the outstanding debt.

In the financial crisis of 2008-9, negative equity returned after a fall in house prices of around 20% over an 18-month period. The Bank of England paper *The economics and estimation of negative equity* (Quarterly Bulletin 2009 Q2) suggested that between 700,000 and 1.1 million households (around 7%–11% of owner-occupier mortgagors) were in negative equity by Q1 2009. However, lower interest rates ensured that, for most borrowers, mortgages remained affordable, limiting the scale of arrears and possessions and reducing the media focus on negative equity.

Today, with most forecasters expecting significant house price falls over the next two years, there is again talk of negative equity. Some lenders have expressed concern about continuing to lend at high LTVs when borrowers could subsequently face negative equity and media stories warning buyers of the risks are again starting to appear. But how serious might negative equity become in this housing downturn?

4.2 IMLA negative equity projections

To answer this question we have modelled the course of negative equity over the forecast horizon (up to the end of 2024), a period when most forecasters, including ourselves, expect significant house price declines. We have modelled four different scenarios: the IMLA house price forecast, the OBR forecast and two more pessimistic projections, a 20% and a 25% decline in house prices.

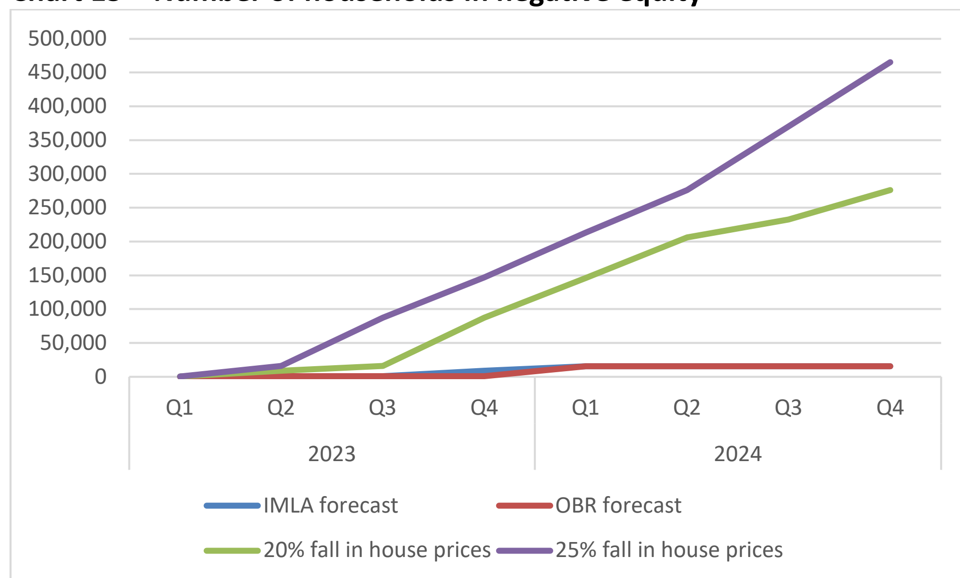
To construct our projection for negative equity, we have taken UK Finance data on the number of mortgage advances by region since Q1 2020 and FCA data on the proportion of advances at LTVs of: over 75% and up to 90%; over 90% and up to 95%; and over 95%. To be conservative, we have assumed that all borrowers borrow the maximum LTV within each band (e.g. we have assumed that all borrowers in the over 90% and up to 95% band borrowed 95%). We have assumed that all over 95% LTV borrowers borrowed 100%.

We then use amortisation schedules to project the mortgage balance of borrowers going forward (we have assumed all high LTV borrowers are on repayment mortgages) assuming a 30-year repayment term and a 5% mortgage rate. Using these data and

assuming that house prices fall uniformly across all regions, we then compare the house price in each region to the projected mortgage balance in each quarter up to Q4 2024. Our estimates only relate to those that bought up to the end of 2022.

Chart 15 shows the model's results. On the IMLA or OBR projections, which both have prices falling around 9% between Q4 2022 and Q4 2024, negative equity reaches a peak of only 16,000 by the end of 2024. Even with a much higher fall of 25%, negative equity is unlikely to breach the 500,000 level. And the projected average amount of negative equity is also low compared to the early 1990s. By Q4 2024, on IMLA's house price forecast negative equity would average £4,300 per affected household. However, a 25% fall in prices would deliver a much higher average of nearly £23,000 and total negative equity of £10.5 billion.

Chart 15 – Number of households in negative equity



Source: UK Finance, FCA, IMLA estimates

4.3 Why negative equity should be lower in this downturn

So why do we expect negative equity to be so much less of a problem during this housing downturn? There are three main factors at work. Firstly, the proportion of lending at high LTVs is much lower now than in preceding downturns. In the late 1980s and early 1990s, 95% was fairly consistently the median LTV for first-time buyers, meaning half borrowed 95% or more. Prior to the financial crisis in 2007, high LTV lending was already much reduced with 14.2% of all borrowers taking mortgages greater than 90% and within this 5.7% taking loans above 95%. But in recent years the proportion borrowing at high LTV has been much lower still. Between 2020 and H1 2022, 3.3% borrowed more than 90% with only 0.2% borrowing over 95% LTV.

The second factor limiting the likely scale of negative equity is the rapid rise in house prices since the start of the Covid pandemic. Between February 2020 and September 2022, house prices rose 28%, so even many recent buyers have already accumulated

substantial housing equity. The third factor is the greater prevalence of capital repayment mortgages, which ensure that the mortgage balance declines from the first monthly payment.

When mortgage rates reached 15% in the early 1990s the amount of capital being paid off in the early years of a loans was quite small. But with today's lower rates, substantially more capital is repaid in the early years. Assuming a 5% mortgage rate and 30-year term, after 5 years 8.2% of the balance will have been repaid, taking a 95% LTV loan down to 87%.

Since negative equity is a key factor determining the level of possessions, as it limits homeowners' ability to sell up when mortgage payments become unaffordable, our low negative equity projections underpin our view that the UK will not experience a possessions crisis of the kind that occurred in the 1990s. As to the conduct risk issues that some lenders have flagged as a concern with new high LTV lending, it is worth bearing in mind that buyers generally see the purchase of a home as a long- term commitment of at least 5 years, over which time the mortgage balance will have reduced quite significantly.

5. Conclusion

Rapidly rising global commodity prices caused by surging demand and supply chain disruption as the world came out of Covid lockdown, exacerbated by the Russian invasion of Ukraine, ended the long era of low inflation and interest rates that had been so beneficial to housing markets around the world. Yet despite the gloomy economic background, UK housing and mortgage markets remained surprisingly resilient during most of 2022.

It was only when a loss of confidence in the UK government's commitment to fiscal discipline sent the bond market into turmoil that homeowners saw just how quickly that benign environment of low interest rates could turn. Although the government has managed to calm concerns about the fiscal outlook, stabilising the bond market and allowing fixed-rate mortgage pricing to start falling back, sentiment in the housing market has changed. Given the cost of living crisis and likely recession, commentators are not expecting sentiment to recover in the housing market in 2023.

Looking further ahead, the key to prospects will be determined by how quickly inflation falls back. If, as the OBR predicts, CPI inflation will be negative by the second half of 2024, we can expect falling Bank Rate and the prospect of a recovery in both the economy and the housing market. IMLA is not as optimistic about the prospects for inflation. We believe that the rise in domestic prices and wages triggered by the global price shock will not subside so quickly. Some prices are inherently sticky. For example, the Homelet index for new rental contracts has shown rents rising by more than 10% in recent months while the ONS index based on existing contracts, which feeds into the CPI, showed a more modest rise of 4.0% in the year to November. Over time an existing rental series such as the ONS index will reflect the higher rents being negotiated now, contributing to a rise in the CPI stretched out over a longer period.

If the IMLA forecast is right, CPI inflation will remain well above the Bank of England target of 2% in 2024, requiring the Bank to be raising, not lowering, interest rates. This suggests that we could face a longer downturn both in the economy and the housing market, without a clear path to recovery by the end of 2024. However, with the more conservative mortgage market of the last upswing and stringent affordability checks, there are few signs of excesses and therefore every reason to believe that most mortgage borrowers are relatively well placed to weather the difficult conditions ahead. As a result, we do not expect a repeat of the negative equity and possessions crisis of the early 1990s or financial crisis.

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About IMLA

The Intermediary Mortgage Lenders Association (IMLA) is the trade association that represents mortgage lenders who lend to UK consumers and businesses wholly or predominantly via the broker channel. Its membership of 52 banks, building societies and specialist lenders include 18 of the 20 largest UK mortgage lenders (measured by gross lending) and account for approximately 93% of gross mortgage lending.

IMLA provides a unique, democratic forum where intermediary lenders can work together with industry, regulators and government on initiatives to support a stable and inclusive mortgage market.

Originally founded in 1988, IMLA has close working relationships with key stakeholders including the Association of Mortgage Intermediaries (AMI), Building Societies Association, UK Finance and the Financial Conduct Authority (FCA).

Visit www.imla.org.uk to view the full list of IMLA members and associate members and learn more about IMLA's work.

About the author

Rob Thomas is a Director of Research at Instinctif Partners. He previously served as an economist at the Bank of England (1989-1994), a high profile analyst at the investment bank UBS (1994-2001) and as senior policy adviser to the Council of Mortgage Lenders (2005-12). He was also the project originator and manager at the European Mortgage Finance Agency project (2001-05) and created the blueprint for the government's NewBuy mortgage scheme.