The new ‘normal’ – prospects for 2020 and 2021

Rob Thomas, Principal Researcher,
Intermediary Mortgage Lenders Association
(IMLA)

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Executive summary

The outlook

- **Uncertainty partially lifted by likelihood that the UK will leave the EU under terms of Withdrawal Agreement.** After 3 years of uncertainty about the direction for the UK's relationship with the EU, we do now seem to have clarity on the direction of travel. Although the detail of the future trading relationship with the EU remains unclear, sentiment should improve relative to that pervading the market prior to the general election.

- **A global economic slowdown has helped to push interest rates down still further.** For an interest rate sensitive sector of the economy such as housing, the impact of lower interest rates at a 5 or 10-year maturity may more than offset the impact of slower global growth. Lower bond yields also suggest that Bank Rate is unlikely to rise from its current 0.75% during 2020 and 2021.

- **Real wage growth should support economy in 2020 and 2021.** CPI inflation is now comfortably below the Bank of England's 2% target while wage growth is above 3%, significantly lifting real wages. This should underpin the housing and mortgage markets in 2020 and 2021 allowing a modest recovery in housing transactions, house prices and mortgage lending volumes.

- **We expect gross mortgage lending to rise to £268 billion this year.** We forecast that gross lending in 2020 will be 1.4% ahead of last year's level, driven mainly by higher lending for house purchase. We expect **net mortgage lending to rise slightly to £48 billion**, implying that the stock of mortgage debt will grow by 3.3%, broadly in line with earnings.

- **Remortgaging to be flat over forecast period at £100 billion a year.** Remortgage activity was the main driver of increased mortgage lending until 2018. But this is likely to change from now on as more customers take product transfers and higher sales of 5-year fixed rate loans reduce the rate of market churn.

- **Gross buy-to-let lending to fall slightly to £40 billion in 2020 and £39 billion in 2021.** The recent slump in buy-to-let house purchase lending is set to continue, as the mortgage interest tax deduction is fully removed from April 2020. But buy-to-let remortgage activity, which compensated for falling lending to house purchasers until 2018, could also show a slight decline this year as higher take up of 5-year fixed rate loans reduces the frequency of remortgages.

- **Lending via intermediaries to continue to increase its share of lending.** The share of mortgage lending going through intermediaries continued to rise in 2019, reaching an estimated 76.6% by volume. We expect intermediaries to continue to gain market share over the forecast period, reaching over 77% by 2021.

Market drivers

- **First-time buyer numbers levelling off.** Up to October 2019, first-time buyer numbers were flat compared to the same period of 2018. This follows a strong upward trend in previous years and should concern policymakers who want to see declining owner-occupation rates amongst younger households reversed. In particular, with Help to Buy facing new regional price caps from April 2021 policymakers need to explain how they propose to help aspiring first-time buyers going forward.

- **House movers constrained by affordability concerns.** UK homeowners are moving less frequently than in the past. This reflects a number of factors, including the demographic profile of owners, with more older people, who move less often. But the cost of moving up in the housing market is a large concern despite the attractive mortgage rates on offer.

- **Product transfers have gained in popularity relative to remortgages since the start of 2018**. Lenders say that there has been a long-term trend towards more people taking product transfers, and since the start of 2018 this trend has continued with product transfer volumes rising 13.3% between Q1 2018 and Q3 2019 while remortgage volumes rose only 3.3% over the same period.

- **Mortgage lender profitability being squeezed.** The squeeze in lenders' profit margins continued in 2019 although the rate of decline has slowed, suggesting that margins may now be close to a practical minimum.

1. Introduction

1.1 Reduced uncertainty should boost confidence

Since the June 2016 Referendum on leaving the European Union, the UK has faced a prolonged period of uncertainty. Many firms contemplating major investments have found it made more sense to delay until the outlook for our future relationship with the EU became more settled. Ordinary households contemplating a house purchase have felt the impact of the same uncertainty. This is particularly true in London, where the economy and housing markets are especially geared to international developments.

The election of a majority Conservative government on 12 December has at least provided a sense of direction regarding Brexit: even though the details of the future trading relationship between the UK and the EU are as yet unsettled, we at least have a clear outline of the direction of travel. The sense that the country has a path towards resolving the previous Brexit deadlock should help those that have been delaying investment plans to look at them afresh. This should include those households looking to buy homes who have been put off by Brexit uncertainty. We should not overstate this effect: more deep-seated issues in the housing market have played a larger role. But at least the sense of Brexit paralysis has been lifted.

What does a post-Brexit future look like and how might the housing and mortgage markets respond? Generally, economists do not see much likelihood of a rapid rebound in the economy. Two factors in particular inform this conclusion: firstly, there is the aforementioned uncertainty about the detail of the future trading relationship with the EU which will not be settled until the end of 2020 or later, and secondly the global economic outlook has deteriorated over the past 12 months.

1.2 Interest rate environment continues to improve

However, for an interest rate sensitive, domestically focused, sector such as housing, the current uncertain economic outlook has a silver lining. Interest rates across the yield curve have fallen over the past year. 10-year government bond yields were 1.3% at the start of 2019 and are now below 0.8%. Even 30-year government bond yields are now below 1.3%. These unprecedentedly low longer-term funding costs have driven down the cost of longer-term fixed rate mortgages, and indeed encouraged lenders to offer longer term products such as a 15-year fix. It also suggests that the markets believe that short term interest rates have peaked at 0.75%, a sentiment supported by two members of the Bank of England Monetary Policy Committee (MPC) voting for a rate cut in November and CPI inflation falling to 1.5% in October and November.

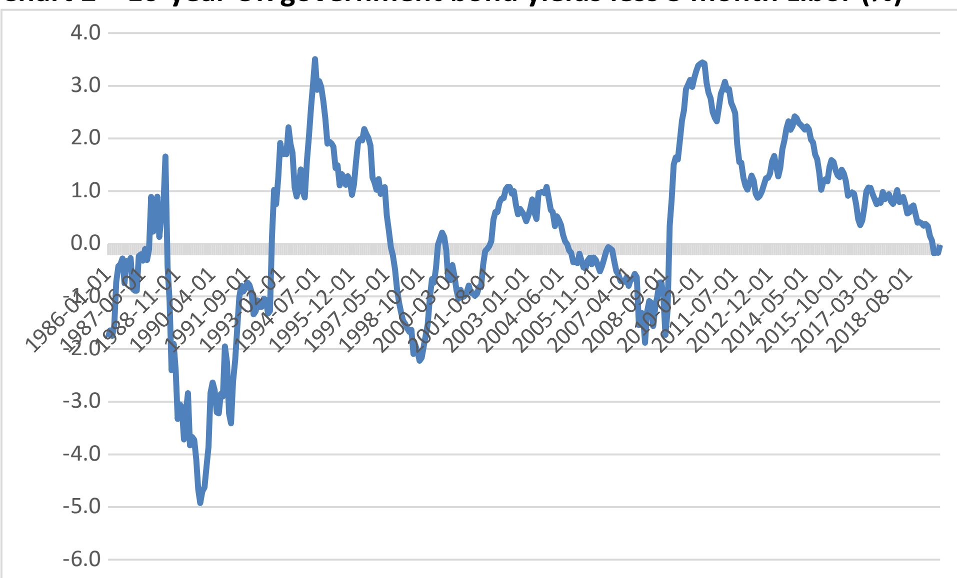
Chart 1 – UK 10-year government bond yield (%)

Source: Federal Reserve Bank

1.3 Long-term fixed rate mortgages back on the agenda

Just how profoundly the interest rate environment has shifted is illustrated by Chart 1. Longer term fixed rate money has never been cheaper and while the differential between short and long-term interest rates had been positive for the past decade, long-term rates have recently been below short-term rates, creating an inverted yield curve (see Chart 2). This combination of very low interest rates and a flat to inverted yield curve would seem to be the ideal conditions for the development of a long-term fixed rate mortgage market. Indeed, this year has seen the emergence of 15-year fixed rate mortgage products with rates starting below 3%.

Chart 2 – 10-year UK government bond yields less 3 month Libor (%)



Source: Federal Reserve Bank

So it may have been an opportune time for the Conservative election manifesto to say that a Conservative government "*will encourage a new market in long-term fixed rate mortgages which slash the cost of deposits, opening up a secure path to home ownership for first-time buyers in all parts of the United Kingdom*." Traditional lenders find it hard to fund these loans because they are predominantly variable rate funded and the long-term interest rate swaps market is illiquid. But a US-style full term fixed rate mortgage product could emerge if life and insurance companies (which need to hold long-term fixed rate assets) enter the market as they have in the Netherlands. And consumers' traditional reluctance to fix long term could be questioned in the current interest rate environment.

It is unclear what the Conservatives plan to do to encourage a long-term fixed rate market. But options include some form of tax break, a change in regulation that favours these products (e.g. removing the cap on the proportion of these loans that can be made at high loan-to-income ratios - LTIs) or some kind of support for the 'secondary market' in these loan, as they have in the US though Fannie Mae and Freddie Mac.

1.4 Consumers continue to benefit from competitive mortgage market

Falling mortgage margins have added to the benefits of low interest rates, providing mortgage holders with a total windfall of some £32 billion a year in reduced interest payments relative to a decade ago. This windfall has helped to sustain consumer spending although it has also driven inequality as non-home owning households have benefited from neither the cash windfall nor the resulting house price gains.

Surprisingly however, neither low interest rates nor higher house prices have stimulated the kind of secured borrowing surge that was typical in previous economic upswings. Housing equity injection remained around 2% of post-tax income in 2019, meaning that collectively homeowners are putting funds into their properties faster than they are taking credit out. As a result, homeowners' collective balance sheet has improved over recent years with their estimated average LTV falling to a record low of 26%.

2. The mortgage market outlook for 2020 and 2021

2.1 Background environment in 2020 and 2021

Table 1 outlines our projections for key assumptions behind our mortgage market forecast. Prolonged Brexit uncertainty coupled with a slowing world economy suppressed UK economic activity during 2019 but we see some scope for the economy to recover in 2020 and 2021, given the greater clarity over our future relationship with the EU. The outlook for the global economy should also improve over this time horizon given the recent reduction in trade tensions between the US and China, although if the trade dispute between the two largest economies worsens again it could derail any global upturn.

We have assumed that the UK concludes the kind of free trade agreement envisaged by the Political Declaration by December 2020. A slight delay to the conclusion of this deal should not have much impact on the economic outlook but if the UK fails to achieve a deal and reverts to World Trade Organization rules in its trade with the EU from December 2020, we would expect a weaker outlook in 2021.

Table 1 – key forecast assumptions

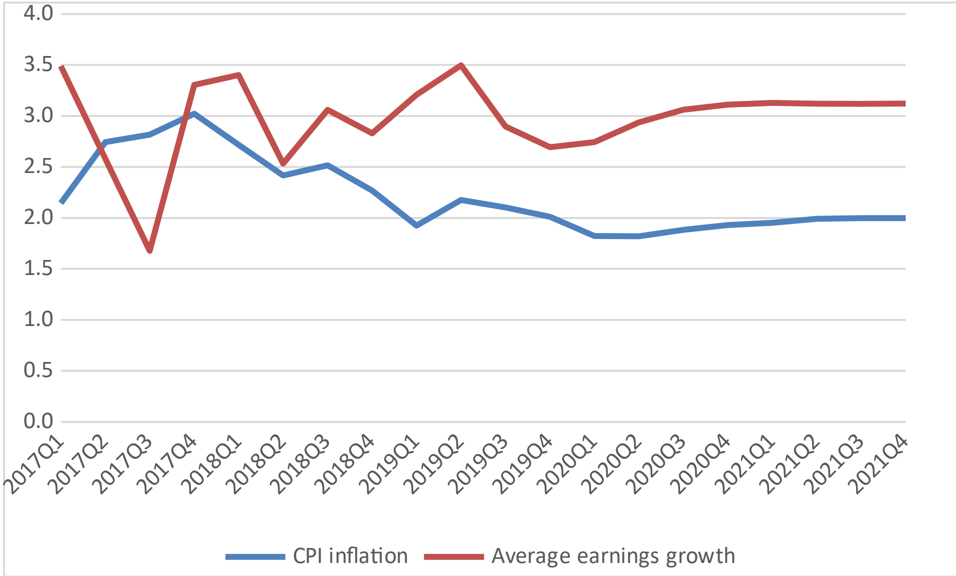
	Past values		Forecast values		Percentage changes		
	2018	2019e	2020f	2021f	2019/18	2020/19f	2021/20f
Real GDP (£bn)	2,061	2,088	2,120	2,155	1.3%	1.5%	1.7%
Unemployment rate (Q4)	4.0%	3.8%	3.8%	3.7%	-5.0%	0.0%	-2.6%
House prices (average for year)	228,400	231,300	236,000	242,000	1.3%	2.0%	2.5%
Housing transactions (UK, thousands)	1,191	1,180	1,200	1,220	-0.9%	1.7%	1.7%
Bank Rate (end of year)	0.75%	0.75%	0.75%	0.75%	0.0%	0.0%	0.0%

Source: IMLA, ONS and HMRC

The UK continues to benefit from low inflation and unemployment, although a slight fall in job vacancies suggests that the labour market has softened marginally. The outlook for inflation has improved in recent months: CPI inflation fell quite sharply during the second half of 2019 and the recent rise in Sterling should keep price rises down. Lower inflation is helping to drive the fastest rise in real wages since 2015, which should support consumer spending during 2020.

Below target inflation coupled with continued sluggish growth could also trigger a cut in Bank Rate from 0.75%. However, we have not included a cut in Bank Rate in our forecast because the Bank of England MPC could be quite resistant to cutting interest rates from such a low base. The MPC's greatest concern at present is that wage rises, which were 3.2% in the 3 months to October, are not being matched by productivity gains, which could push inflation higher later in the year. If growth improves in line with our forecast, a rate cut is not the most likely outcome despite that fact that inflation could remain below the target rate of 2% for some time.

Chart 3 - OBR projections for % earnings growth and inflation (March 2019)



Source: OBR

Chart 3 shows the Office for Budget Responsibility (OBR) forecasts for CPI inflation and earnings growth from March 2019. Because of the general election the OBR did not publish an October forecast. The most striking feature of the OBR forecast is that solid real wage growth is expected throughout our forecast horizon. However, developments in inflation and wage growth since March 2019 suggest that inflation will be even lower, leading to faster real wage growth than predicted by the OBR.

2.2 Recent performance of the UK housing market

A stable economic environment of low unemployment, interest rates and inflation and rising real wages would normally be considered ideal for the housing market. But the market has actually been quite weak: house price growth has been slowing since 2016 and was less than 1% up in the year to October 2019, while it is likely there will have been slightly fewer transactions in 2019 than in 2018.

The RICS residential market survey for November 2019 suggests that the housing market remained subdued in the final quarter. A small balance of agents reported price falls in the previous 3 months with a larger balance reporting lower transaction levels. But agents were becoming more positive about the immediate outlook with a balance expecting sales to rise over the following 12 months.

With wages rising faster than house prices, affordability has been improving since mid-2018 and the improvement is greatest in London where affordability has been most stretched. Affordability has also been enhanced by the continued declined in mortgage rates, driven mainly by a further squeeze on lenders' margins. Average 2-year fixed rate 75% LTV mortgage rates fell by 28bp over the year to 1.45% while the corresponding 5-year fixed rate average fell by 32bp to 1.69%.

2.3 Outlook for the UK housing market

Based on the expected macroeconomic environment, we anticipate a modest recovery for the housing market during 2020 and 2021. We forecast that house prices will average £236,000 over 2020, 2.0% above their average of 2019, but this is mainly due to the growth of prices during 2019. Over the course of 2020 we expect house price growth nationally of around 1%, with a pick-up to 2.5% in 2021. At a regional level we expect the pattern of the last two years to be maintained in 2020 and 2021, with London experiencing modest price falls coupled with a more robust picture outside southern England, though even here price growth is likely to be lower than in recent years.

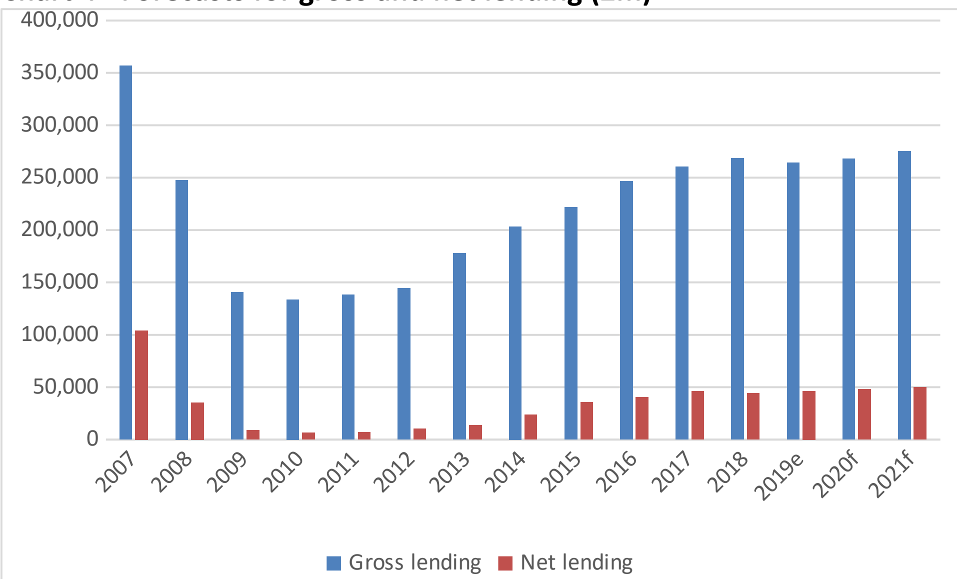
We expect housing transactions to recover modestly in 2020 to 1,200,000 having been slightly reduced by Brexit uncertainty in 2018 and 2019. We expect a further recovery in 2021 to 1,220,000 transactions. Combining our forecasts for house prices and transactions suggests that the aggregate value of housing transactions in the UK will be £283 billion in 2020 and £295 billion in 2021, both up more than 3% on the previous year. Mortgage lending will thus fund c.55.5% of the value of transactions over this period.

2.4 Outturn relative to previous year's forecast

In last year's report, IMLA forecast gross mortgage lending of £269 billion and net lending of £43 billion for 2019. By way of comparison, UK Finance forecast gross and net lending of £260 billion and £43 billion respectively while the November 2017 OBR forecast net mortgage lending of £44 billion. The estimated outturn was £264 billion and £46 billion respectively.

2.5 Mortgage market forecast

Chart 4 - Forecasts for gross and net lending (£m)



Source: Bank of England and IMLA

After the slight weakening of gross mortgage lending in 2019, we expect a modest improvement in 2020. This reflects both an improvement in the economic environment with rising real incomes, and lower mortgage rates. It also reflects reduced uncertainty after a prolonged period when it was unclear how the country was going to proceed after the Brexit referendum. We expect economic conditions to underpin a further slight pick-up in the market in 2021.

Table 2 – Mortgage market forecast

	Gross mortgage lending (£m)				Percentage changes		
	2018	2019e	2020f	2021f	2019/18e	2020/19f	2021/20f
House purchase	156,525	153,987	157,000	164,000	-1.6%	2.0%	4.5%
Remortgage	101,045	99,871	100,000	100,000	-1.2%	0.1%	0.0%
Other	11,082	10,476	11,000	11,000	-5.5%	5.0%	0.0%
Total	268,652	264,334	268,000	275,000	-1.6%	1.4%	2.6%
of which:							
Buy-to-let lending	40,500	41,000	40,000	39,000	1.2%	-2.4%	-2.5%
of which for house purchase	10,700	10,300	10,200	10,500	-3.7%	2.9%	3.8%
Buy-to-let share of total	15.1%	15.5%	14.9%	14.2%	2.9%	-3.8%	-5.0%
Lending via intermediaries*	161,440	166,034	170,000	177,000	2.8%	2.4%	4.1%
Share of total*	74.5%	76.6%	76.9%	77.3%	2.9%	0.3%	0.6%
Net lending	44,349	46,470	48,000	50,000	4.8%	3.3%	4.2%

* Regulated loans only
Source: IMLA, Bank of England, UK Finance

We expect gross mortgage lending to rise to £268 billion this year and £275 billion in 2021 (see Table 2). We expect lending for house purchase to drive this growth with remortgage activity remaining flat at £100 billion a year in both 2020 and 2021. Up to 2018, remortgaging had been the source of most growth in mortgage lending but now the rising popularity of 5-year fixed rate deals and high levels of product transfers are denting the growth in remortgage activity.

Product transfer data, which has been available from UK Finance since the start of 2018, confirms the scale of product transfers relative to remortgages. In the first half of 2019, excluding buy-to-let, remortgage advances totalled £39.6 billion but product transfers totalled £80.6 billion. With a limited length of data on product transfers it is too early to see a clear trend although product transfer volumes were up 9% between the first half of 2018 and the first half of 2019.

We expect the upward trend in intermediaries' share of regulated mortgage lending to continue over 2020 and 2021. In 2020, we expect intermediaries to support £170 billion of lending, 76.9% of the total, and £177 billion in 2021, over 77% of total projected regulated lending that year (see Table 2) and the highest share on record.

One segment of the mortgage market which disappointed in 2019 given its recent robust growth was lifetime mortgages. The Equity Release Council report that in the first half of 2019 there were 21,600 equity release plans taken out, 13% below the figure of the previous six months. It is unclear what was behind the decline, which followed a period of rapid growth. Given that equity release mortgage rates fell below 5% on average for the first time in 2019 and more households than ever fall into the eligible category of older homeowners, we expect the upward trend in volumes to resume. Although some consumer resistance to these products remains, their market penetration remains low, providing opportunities for medium to longer-term growth.

2.6 Buy-to-let mortgage market forecast

Gross buy-to-let mortgage lending in 2019 looks likely to have been marginally up on its 2018 level at a revised £41 billion. This slightly better than expected performance was the result of higher remortgage activity, with lending for house purchase likely to have been down around 4%. Lending for house purchase has been depressed mainly as a result of the adverse tax changes that have been introduced since 2015 but the rate of decline has slowed significantly.

We expect total buy-to-let mortgage lending to fall around 2% in 2020 to £40 billion (see Table 2), reflecting both another slight fall in house purchase lending and a reduction in remortgage activity. By 2021, we expect the fall in house purchase lending to have stopped in volume terms as the market adjusts to the new tax regime and greater regulation in the PRS. But remortgage activity could be lower, reflecting similar factors to those seen in the owner-occupied market, namely the popularity of product transfers and 5-year fixed rate deals.

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

					Percentage changes		
	2018	2019e	2020f	2021f	2019/18	2020/19f	2021/20f
Whole market							
Outstanding debt (£bn)	1,409	1,455	1,503	1,553	3.3%	3.3%	3.3%
House purchase lending (£m)	156,525	153,987	157,000	164,000	-1.6%	2.0%	4.5%
House purchase % churn	11.5%	10.8%	10.6%	10.7%	-6.1%	-1.3%	1.1%
Remortgage	101,045	99,871	100,000	100,000	-1.2%	0.1%	0.0%
Remortgage % churn	7.4%	7.0%	6.8%	6.5%	-5.7%	-3.1%	-3.2%
Total % churn	19.7%	18.5%	18.1%	18.0%	-6.1%	-1.9%	-0.7%
Buy-to-let market							
Outstanding debt (£m)	251,000	261,000	270,000	278,000	4.0%	3.4%	3.0%
House purchase lending (£m)	10,700	10,300	10,200	10,500	-3.7%	-1.0%	2.9%
House purchase % churn	4.5%	4.0%	3.8%	3.8%	-9.8%	-4.5%	-0.3%
Remortgage	28,840	29,670	28,700	27,300	2.9%	-3.3%	-4.9%
Remortgage % churn	12.0%	11.6%	10.8%	10.0%	-3.7%	-6.7%	-7.8%
Total % churn	16.9%	16.0%	15.1%	14.2%	-5.2%	-5.9%	-5.5%
Buy-to-let % of total market							

Outstanding debt	17.8%	17.9%	18.0%	17.9%	0.7%	0.1%	-0.4%
House purchase lending	6.8%	6.7%	6.5%	6.4%	-2.2%	-2.9%	-1.5%
Remortgage	28.5%	29.7%	28.7%	27.3%	4.1%	-3.4%	-4.9%
Total lending	15.1%	15.5%	14.9%	14.2%	2.9%	-3.8%	-5.0%

Source: Bank of England, UK Finance and IMLA

Landlords have had to absorb a lot of new regulations as well as tax changes and despite the re-election of the Conservatives in December more adverse changes are likely. The government has already announced that it plans to abolish Section 21 of the Housing Act (so-called no-fault evictions). If this is accompanied by a streamlining of the process for evicting for fault (i.e. for rent arrears), landlords should be protected. But in the absence of such ameliorating changes many landlords fear that it will become more expensive and time-consuming to evict tenants who do not pay or damage the property. However, Section 21 has already been removed in Scotland without a serious impact of supply.

The key medium to longer-term issue in the buy-to-let market is whether the tax and regulatory changes designed to limit the desirability of buy-to-let as an investment and shift power from landlord to tenant will reverse the growth of the PRS. With little indication that the social rented sector will be expanded sufficiently to meet the growth in demand for rented accommodation, it seems that the PRS should remain reasonably robust in the face of higher tax and regulation.

Looking at the growth of outstanding buy-to-let debt, this has been running at around 4% per annum, slightly faster than the wider mortgage market despite the tax and regulatory changes. This suggests that the fundamentals of strong tenant demand have prevented a net exodus of buy-to-let landlords. We expect this pattern to continue in 2020 and 2021 with modest increases in outstanding buy-to-let mortgage debt reflecting gently rising house prices and a small increase in the number of buy-to-let mortgages, but with the potential to see faster growth in the medium term.

2.7 Product transfers and remortgages

Data on product transfers (borrowers switching products with the same lender) was released for the first time in 2018, so we now have the first year-on-year quarterly comparisons to indicate whether a trend is discernible. Table 4 shows the reported level of product transfers up to Q3 2019 compared to remortgage figures (all data excluding buy-to-let loans). No data is available for product transfers prior to 2018.

Table 4 – Product transfers and remortgages

	PRODUCT TRANSFERS			REMORTGAGES		
	Number	Value (£bn)	Average loan size	Number	Value (£bn)	Average loan size
Q1 2018	295,000	38.4	130,179	110,770	19.4	175,007
Q2 2018	272,500	35.6	130,673	109,010	19.6	179,899

Q3 2018	289,700	38.6	133,181	116,190	21.1	181,466
Q4 2018	326,800	45.4	138,855	120,470	21.5	178,370
Q1 2019	290,000	39.2	135,187	113,610	20.3	178,336
Q2 2019	292,500	41.4	141,573	108,220	19.3	178,663
Q3 2019	311,400	43.5	139,702	112,260	20.0	178,396

Source: UK Finance. Excludes buy-to-let loans

Over the first three quarters of 2019, product transfers were running at an annual rate of 1.19 million with an annualised value of £165 billion. Compared to the first three quarters of 2018, these figures were up by 4% and 10% respectively with the average size of a product transfer rising by 6%. However, looking at the quarterly data it is hard to discern a clear trend, with activity peaking in Q4 2018. There may be a seasonal pattern which accounts for the strong Q4 figure from 2018 but we do not have enough data to know. The volume of product transfers relative to remortgages increased between Q1 2018 and Q3 2019 from 198% to 217%.

In the medium term, the relative balance of product transfers and remortgages will be influenced by changes in technology and regulation. The FCA could alter the regulatory landscape to make it easier for customers to buy without advice as discussed in its Consultation Paper CP19/17. This Consultation Paper acknowledged the potential that digital technology has to change the mortgage buying process. Online mortgage brokers may be able to provide a service where customers feel it is significantly easier to find a competitive remortgage deal, but lenders are also investing in digital technology to improve the product transfer process. Our central forecast is that the volume of product transfers will rise by 4% in 2020 to £172 billion and by a further 2% in 2021 to £176 billion.

One consistent feature of the comparison of remortgages and product transfers is the larger average balance of remortgages. This suggests that borrowers with larger mortgage balances prefer remortgages because even a small saving in rate can be worth a lot while those with smaller balances prefer product transfers, which usually come without up-front fees.

2.8 Product transfers and advice

As well as providing the headline product transfer numbers, UK Finance provides a breakdown between advised and execution only sales. As Table 5 shows, advised sales have been increasing as a proportion of the total by volume with the same trend evident in the number of product transfers. By Q3 2019 over 58% of product transfers by volume were advised compared to 51% in Q1 2018.

Table 5 – Advised and execution only product transfers

	ADVISED		**EXECUTION ONLY**		**% advised**
	Number	**Value (£bn)**	**Number**	**Value (£bn)**	**(by volume)**
Q1 2018	148,300	19.7	146,700	18.7	51.2%

Q2 2018	144,300	19.5	128,200	16.1	54.7%
Q3 2018	155,500	21.4	134,100	17.2	55.5%
Q4 2018	174,200	24.8	152,600	20.6	54.6%
Q1 2019	161,100	22.7	128,900	16.5	57.8%
Q2 2019	164,100	24.4	128,400	17.0	58.9%
Q3 2019	175,900	25.4	135,500	18.1	58.5%

Source: UK Finance

The increasing prevalence of advised product transfers may reflect the fact that many lenders have moved to offering procuration fees to brokers who advise a customer to take a product transfer. It may also reflect a change in the mix of lenders as some lenders require all product transfers to be advised while others have developed streamlined execution only offerings.

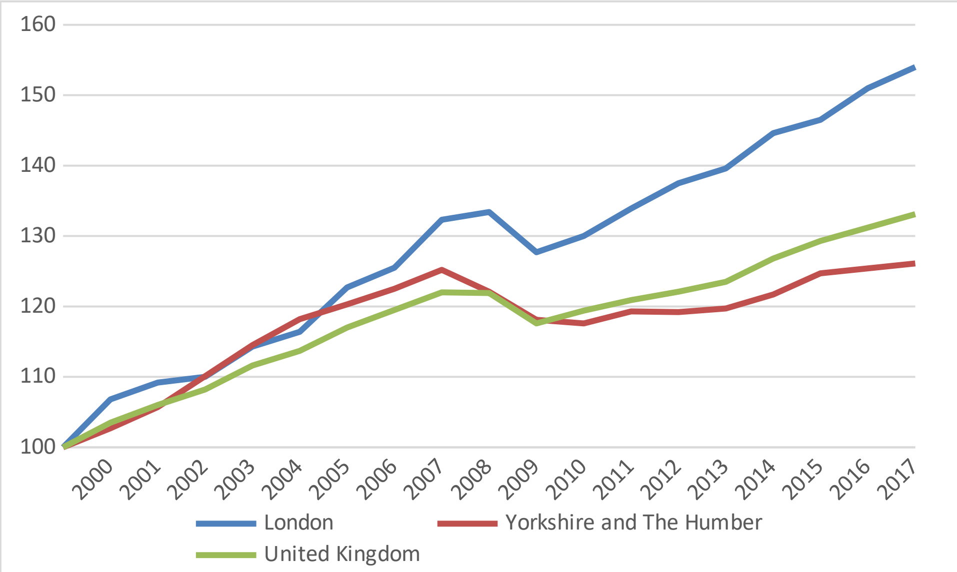
Comparing advised product transfers with advised remortgages shows that 55% of all advised transactions by volume were product transfers in the first three quarters of 2019 compared to 50% a year earlier. Comparing the number of transactions, product transfers were higher still, representing 60% of all advised sales during the first three quarters of 2019, up from 57% over the same period of 2018.

3. Regional housing and mortgage market performance

3.1 A long-term view

While it is normal to talk about the UK housing and mortgage market, it is worth remembering that they are actually formed of a patchwork of local markets that can vary significantly from one another, driven largely by the relative prosperity of each area. Indeed, regional disparities are nothing new in the UK. As far back as the inter-war years, the nation's northern industrial heartlands were struggling economically while the south and midlands prospered. By the 1970s and 1980s, economic decline again impacted the manufacturing centres of northern England, Scotland and Wales while southern England remained relatively prosperous. The housing market reflected these regional variations.

Chart 5 – Gross Value Added (start of year 2000 = 100)



Source: ONS

The biggest story of the twenty-first century is a significant widening of the gap economically between the nation's capital and other regions, particularly those outside southern England. Chart 5 shows economic activity measured by gross value added (GVA), which the ONS uses to measure regional economy performance. This shows that London has eclipsed all other regions in economic growth since 2000, seeing its economy grow by 54% compared to 35% for the next best performing region (Scotland), 33% for the UK as a whole and 26% for the worst performing region (Yorkshire and The Humber).

Economic growth creates jobs, drawing people into the regions where the economy is expanding fastest. This effect can be seen in the first column of Table 6 which shows population changes over the 1993-2017 period. The most striking feature of Table 6 is how much faster London's population expanded than any other region – 29% against 20% in the next fastest growing region (the East) and only 2% in the North East.

The natural market response to this rapid rise in population in London would be more house building. But London's high population density means there is less land for development and often resistance to building on previously undeveloped land. So house building has failed to keep up with demand with the result that London is the only region of the country where the number of persons per dwelling rose between 1993 and 2017 (see final column of Table 6).

Table 6 – Demographic and housing trends 1993-2017

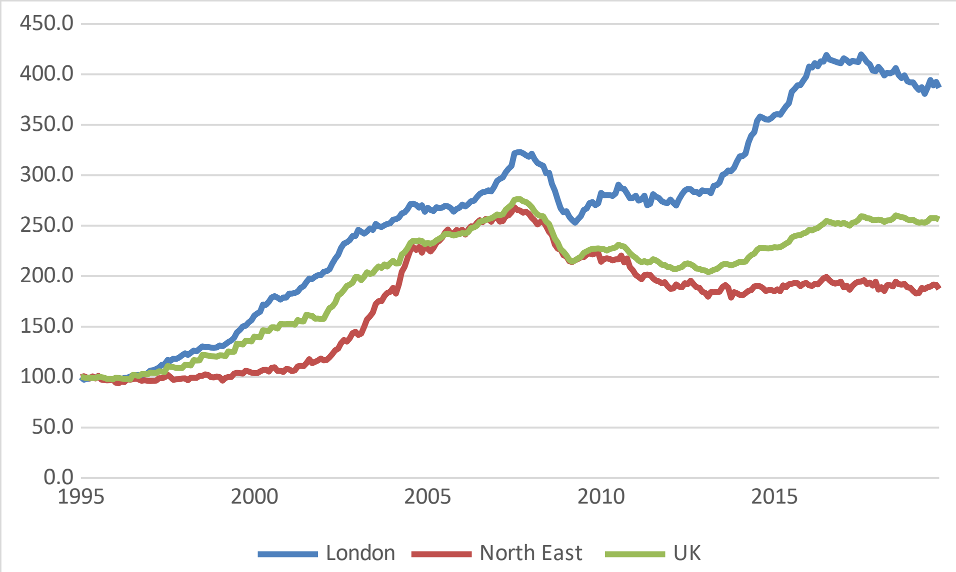
	Population increase	Increase in number of dwellings	Change in persons per dwelling
North East	2.0%	12.5%	-9.4%
North West	6.0%	15.0%	-7.8%
Yorkshire and The Humber	10.0%	17.2%	-6.2%
East Midlands	17.6%	23.6%	-4.8%
West Midlands	11.7%	16.8%	-4.4%
East	19.7%	24.0%	-3.5%
London	28.9%	19.4%	8.0%
South East	18.3%	22.3%	-3.2%
South West	17.4%	25.7%	-6.5%
England	15.6%	19.7%	-3.4%
Wales	8.4%	17.9%	-8.1%
Scotland	6.5%	17.9%	-9.6%
N. Ireland	14.4%	32.8%	-13.8%
United Kingdom	14.4%	19.8%	-4.4%

Source: ONS

Interestingly, the number of persons per dwelling fell by 4.4% between 1993 and 2017 across the UK. This reflects changing demographics, with an increased number of older people living alone, so for younger households housing remains in short supply. Generally, Table 6 shows that the further you get from London the more persons per dwelling has fallen. Table 6 also shows that the substantial house building we have seen, with 4.7 million extra dwellings between 1993 and 2017, has not been geographically well correlated with demand. However, the potential solution of building more homes on open spaces in London and the south of England may prove politically difficult for any future government.

Unsurprisingly, this rising housing demand relative to supply has pushed up London house prices. Chart 6 shows the rise in house prices in London, the North East of England and the UK as a whole since January 1995 in real terms (adjusted for CPI inflation). London again stands out from other regions, with real house prices up 287% against a UK average of 156% and 87% in the North East, the worst performing region. But while London is clearly ahead of all other regions on economic growth and has seen the largest shortfall in new housing supply relative to demand, house prices have also risen quite sharply in the South East and Eastern regions, reflecting a ripple effect from the capital.

Chart 6 – Real house prices in selected regions (Jan 1995 = 100)



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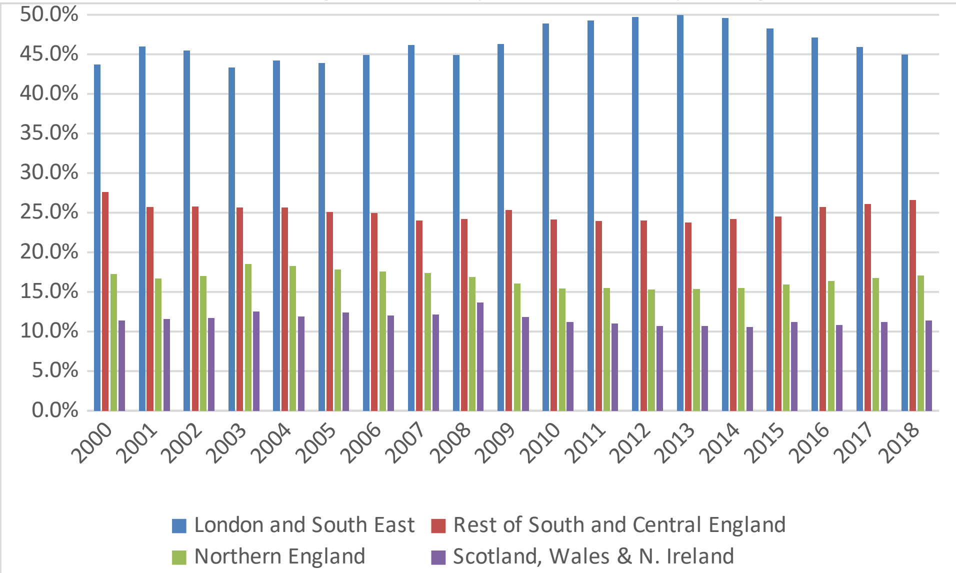
Source: HM Land Registry

The disparity of regional house prices has been particularly severe since the financial crisis. While London prices raced ahead and are still 20% above their 2007 peak in real terms despite recent softness, in much of the country house prices are still lower in real terms than they were in 2007 and 30% lower in the North East.

Chart 7 – % of UK lending for house purchase in 'super regions'



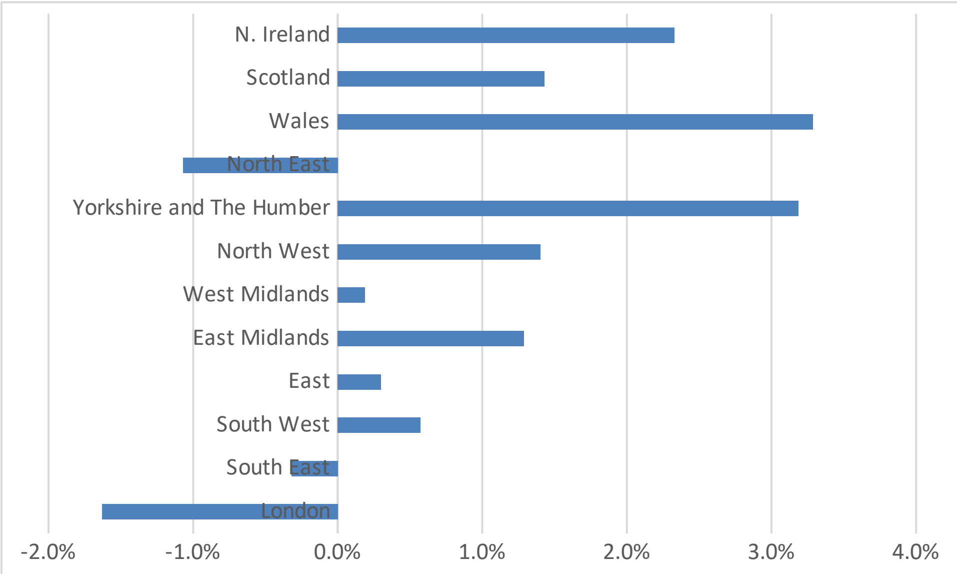
Source: UK Finance

What impact have these trends in house prices had on regional mortgage markets? Chart 7 groups the UK into four super regions: London and South East; Rest of South and Central England; Northern England; and Scotland, Wales and N. Ireland, showing the share of UK lending for house purchase in each. The clearest trend is that as the country recovered from the financial crisis London and the South East led the way in home lending, with its share rising from 45% to 50% but since 2013 the rest of the country has been catching up with London and the South East back to 45% of lending.

3.2 Today's regional picture

While house prices in London have powered ahead of the rest of the country since the mid-1990s, their performance since mid-2017 has been weak. London continued to lie at the bottom of the growth table in 2019 (see Chart 8). This reflected higher taxes on overseas buyers and the constraints imposed by stretched affordability.

Chart 8 – Regional house price changes (October 2019 on a year earlier)



Source: ONS

London is also suffering from low housing turnover, which is often associated with falling prices as many sellers are resistant to cutting prices leading to a stand-off between buyers and sellers. From a post-financial crisis peak of 122,000 transactions in 2014, London had only 90,000 in 2018 (down 26%). Transaction levels were also down in the other southern regions but up in the rest of the country.

3.3 Future outlook for regional housing markets

What can we say about the potential future direction of regional housing markets in the UK? Firstly, it is a well-established pattern that housing market performance and in particular house prices are driven by economic performance. So, regions where the economy strengthens are likely to see the strongest housing markets going forward. It is therefore of some concern that, while there is still some uncertainty about the shape of our future trading relationship with the EU, we will be leaving the customs union and any resulting trade frictions could adversely affect manufacturing. This is likely to hit the UK's industrial regions in the north and midlands while having little impact on London, where manufacturing is a smaller component of output.

So, it is possible that Brexit could exacerbate existing regional disparities in housing markets. More generally, there is a long-term trend in the UK economy away from manufacturing and towards services. If in recognition of this trend, in the post-Brexit era the UK positions itself as a global centre for finance and technology, this could disproportionately benefit London given its dominant position in these sectors, placing still more pressure on the housing stock in this region.

But in the shorter term, the outlook for London may be weighed down by several factors. Firstly, the depressed level of transactions suggests that house prices have not yet fallen to the point where buyers are ready to return. Secondly, the Conservative election manifesto included plans to add a stamp duty surcharge on non-resident purchasers. This will hit London hardest given the high proportion of foreign buyers in the capital.

And thirdly, the planned restriction of the Help to Buy equity loan scheme in 2021 and its termination in 2023 could have a greater impact on London prices because the equity loan is up to 40% of the purchase price in the capital, double the level available elsewhere in England. Some commentators believe that Help to Buy has kept London prices, which were already inflated when the scheme was introduced, at an artificial level to a degree not seen in other regions as buyers have used the 40% equity loan to pay more than they otherwise could have done.

Much will depend on what replaces Help to Buy, which has supported over 220,000 new home sales since 2013 across England. Two potential private sector schemes have emerged: Market Mortgage, where the lender offloads the top slice of lending at 95% LTV onto an investor with the risk appetite to take the higher LTV risk in exchange for a higher margin; and Nautilus, where the builder pays into a bankrupt-remote fund which provides the lender with mortgage insurance on high LTV lending on the properties built by that builder[1].

Both these schemes involve the customer taking a conventional 95% LTV loan rather than a 75% LTV mortgage and an equity loan, meaning the customer will be assessed on a correspondingly larger loan amount, potentially reducing the number of buyers who meet affordability requirements. This is a particular concern in London given that the larger percentage equity loan reduced affordability constraints on buyers more than in other regions.

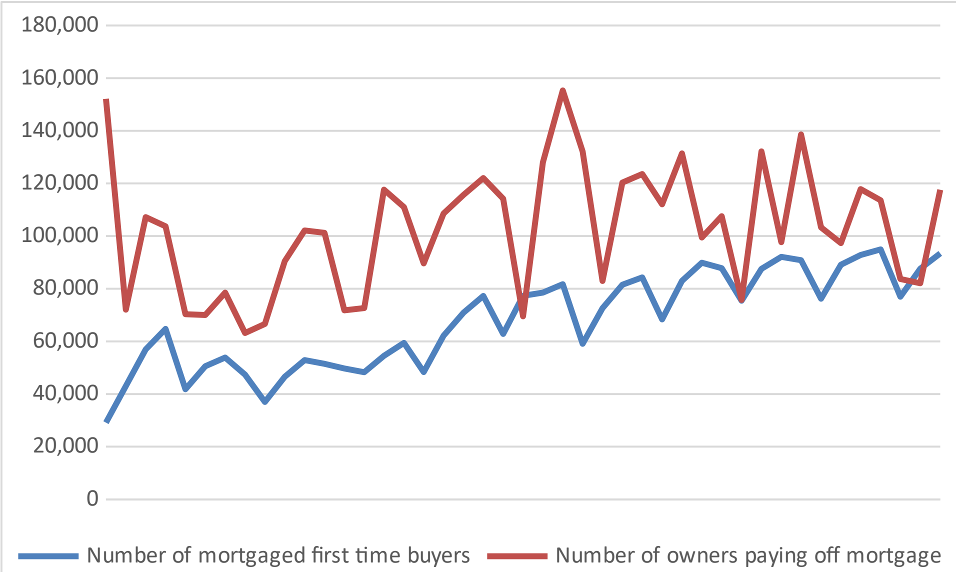
[1] The author is engaged in the Nautilus scheme.

4. Where will the growth come from?

4.1 The shrinking traditional mortgage market

The new normal series of articles, which started in 2014, has emphasised that the UK is experiencing an unusually slow recovery in the mortgage market. A number of factors have contributed to this trend including increased lender caution and enhanced regulation. One of the most significant factors is demographics, with the baby boomer generation, which achieved a high rate of homeownership, reaching the age where many households are now paying off their mortgage.

Chart 9 – Number of first-time buyers versus those paying off mortgage (quarterly)

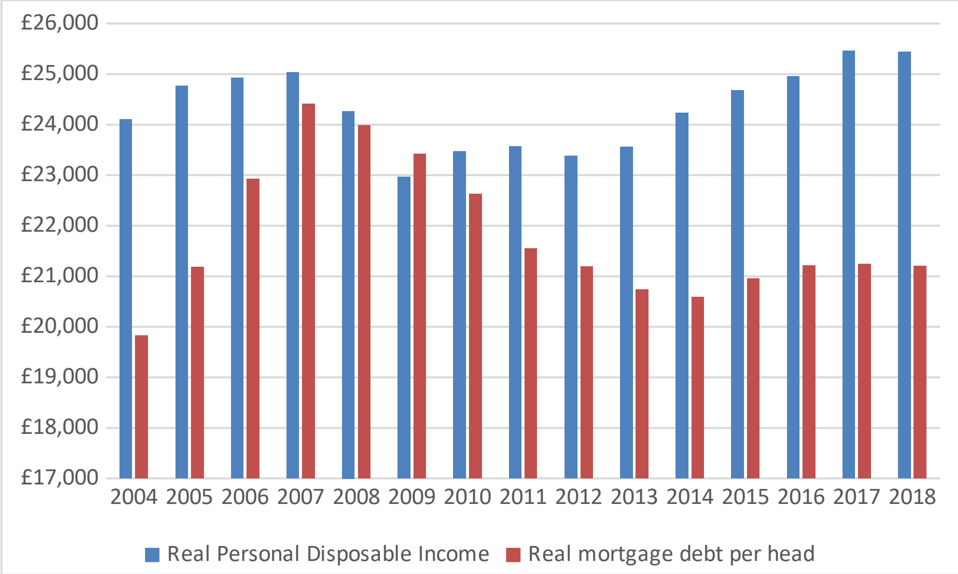


Source: UK Finance

Chart 9 shows the total number of households who paid off their mortgage (i.e. became mortgage-free) compared to the number taking on a mortgage for the first time. Although the number of mortgaged first-time buyers has shown a strong recovery since the financial crisis, these numbers are still insufficient to replace all those who are becoming mortgage-free. As a result, between the first quarter of 2008 and the third quarter of 2019, the number of owner-occupied mortgages fell by 1.7 million to 9.0 million.

A degree of 'money illusion' may have disguised this trend of a shrinking customer base. That is to say that the outstanding amount of mortgage debt has continued to grow from £1,186 billion at the end of 2008 to £1,409 billion ten years later. But once inflation is taken into account, the mortgage market as a whole is shrinking even though new mortgages are getting larger reflecting higher house prices. In 2018 money (adjusted for CPI inflation), 2008's mortgage debt was £1,486 billion.

Chart 10 – Real Personal Disposable Income and real mortgage debt per head



Source: ONS, Bank of England

Chart 10 shows per capita mortgage debt adjusted for inflation and compares this to Real Personal Disposable Income (RPDI), based on the total UK population. It shows the sharp squeeze on disposable income that followed the financial crisis but RPDI has now recovered to levels surpassing the 2007 peak. By contrast, real mortgage debt per head has fallen from a peak of £24,400 in 2007 to £21,200 in 2018, a 13% decline, with the figure flat since 2016.

4.2 How can lenders respond?

Lenders are aware of the limited opportunities for growth in their core owner-occupied market and many, particularly new entrants, have sought out different niches. Until 2015 the buy-to-let market was a source of considerable growth but the subsequent changes in tax and regulation have transformed buy-to-let from the fastest growing segment of the market to one experiences modest growth.

Later life lending is an area of considerable interest. If the baby boomers are paying off their mortgages, surely there is an opportunity for them to take a lifetime or retirement interest only mortgage? But although this market has seen faster growth in recent years, the sector softened in 2019 and it is unclear how it will evolve in the years to come.

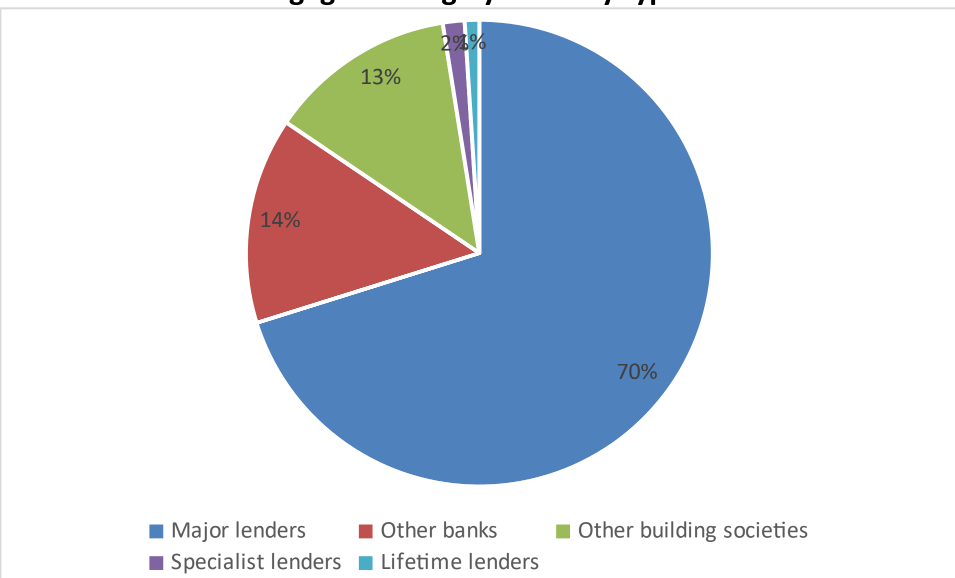
One solution for lenders is to refocus on first-time buyers to ensure that the pipeline of people entering owner-occupation equals or exceeds the pipeline finally paying off their mortgage. But the current housing market makes this a challenging strategy. While aspirations to own a home remain high among the younger generations, a range of factors still impede the flow of first-time buyers. Some are not directly related to housing. The job market is less secure, more young adults are entering higher education and delaying their entrance into the labour force, and people are delaying marriage and childbirth, traditionally factors which encouraged people to buy.

But the housing and mortgage markets themselves form part of the explanation why first-time buyer numbers do not equal those paying off their mortgages. High house prices coupled with lender caution with regard to maximum LTV and LTI and mortgage regulation affordability requirements all make it harder for first-time buyers to access the market than in previous generations. For example, in H1 2019, according to FCA Product Sales Data only 1.1% of new first-time buyer loans had an LTV over 95%.

4.3 The competitive dynamic

With demand for mortgage credit remaining subdued and demographic trends driving a decline in the size of the customer base, competition has intensified. As Chart 11 shows, 70% of gross lending is taken by the top 6 lenders: Lloyds Banking Group; Santander; Barclays; RBS; Nationwide Building Society and HSBC. These lenders have focused on automating the underwriting process to deliver volume at lower cost. They therefore focus on the mainstream market of borrowers with straightforward affairs such as those with a permanent job.

Chart 11 – Gross mortgage lending by value by type of lender

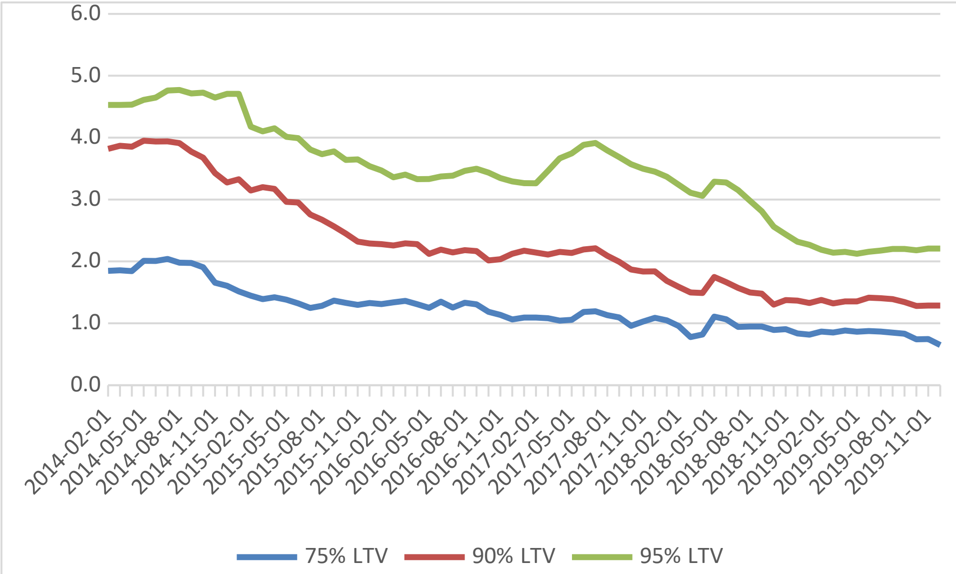


Source: UK Finance

One new factor that may be entrenching the dominance of the big 6 lenders in the mortgage market is bank ring-fencing, which took effect on 1 January 2019. This has led to the main banking groups holding a significant amount of capital in their core retail banks that needs to be deployed in conventional activities such as mortgage lending.

With the big 6 lenders having lower funding and operating costs and plentiful capital, the other lenders, comprising 30% of the market, have to focus on other market niches that are less easily automated and offer higher margins, such as borrowers with more complex incomes or circumstances or those requiring higher LTV and LTI loans. With 23 new lenders entering the market in the last 5 years, competition has intensified considerably.

Chart 12 – Average 2-year fixed rate mortgage rates less 3 month Libor



Source: Bank of England

The results of intensified competition can be seen in Chart 12. The average spread between 3-month Libor and mortgage rates has been falling over recent years, with a particularly sharp fall at higher LTVs. This trend continued during 2019, albeit at a more gradual rate. It is possible that mortgage spreads are now close to a practical minimum given the need for lenders to meet operational costs, allow for future credit losses and make an adequate return on capital. For example, the average spread on a 2 year fixed rate 75% LTV loan was only 65bp at the end of November 2019 while as recently as 2014 it was 200bp.

5. Conclusion

2019 was a subdued year in the housing and mortgage markets. Although we do not yet have the full data for lending in 2019 it appears that gross lending was down 1-2% on the previous year. The signs are that the next two years will look a little brighter. With clarity on the direction of travel regarding Brexit there is scope for a modest recovery in housing transactions and house prices. Downside risks remain however if, for example, the international picture deteriorates as a result of renewed trade friction between the US and China or if the UK fails to negotiate a trade deal with the EU. But our central forecast suggests that the next two years will see a modest recovery in the housing and mortgage markets.

Looking further ahead, demographic factors are set to weigh heavily on the market. Many of the baby boomer generation born in the two decades following WWII have already or soon will pay off their mortgages. The majority of these homeowners will stay put, many for two or three decades to come which will exacerbate the housing shortage facing younger households, although it should also provide lenders with more later life lending opportunities.

Politicians have already shown themselves to be alive to the problems created by this generational divide. They have attempted to boost new housing supply through the Help to Buy equity loan scheme and to curtail demand from buy to let investors through tax and regulatory changes to the PRS. Government may draw comfort from the data showing that the long decline in homeownership has reversed, but it will be looking for further policy initiatives that help more first-time buyers. A reassessment of the current affordability requirements is an option government should consider as it has the ability to boost first-time buyer numbers at no cost to the exchequer.

Another solution that government has again mooted is long-term fixed rate mortgages. These would be assessed for affordability at the rate the customer pays, helping more customers to borrow the amount they need to purchase a home. It remains to be seen whether these mortgages will make inroads in the market but innovations are likely to be needed to overcome the challenges that have made the goal of homeownership such a distant dream for so many young people.

Media contacts

For further information please contact:

- Rob Thomas, Director of Research, on 020 7427 1406
- Nick Seymour at Rostrum, on 020 7440 8670

imla@rostrum.agency

About IMLA

The Intermediary Mortgage Lenders Association (IMLA) is the trade association that represents mortgage lenders who lend to UK consumers and businesses via the broker channel. Its membership of 40 banks, building societies and specialist lenders include 16 of the 20 largest UK mortgage lenders (measured by gross lending) and account for approximately 90.6% of gross mortgage lending and 89.4% of mortgage balances.

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), 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.