Impact of Covid on UK housing and mortgage market
- One year on

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Executive summary

- **The economy has staged a strong recovery from the Covid-19 lockdown induced slump.** UK output in May 2021 was only 3.2% below that of February 2020, before lockdown restrictions were imposed. Unemployment, which the Office for Budget Responsibility (OBR) expected to reach 7.5% by Q2, was only 4.8% in April, down from 5.2% in November. Labour shortages are now being reporting in some industries, exacerbated by the exodus of EU workers during the pandemic.

- **The UK housing market has defied economic forecasts and staged a sharp recovery in terms of prices and transaction levels.** The housing market has been characterised by inadequate levels of supply since the middle of last year, exacerbated by the stamp duty holiday. But a bifurcation of the market has opened up with the price of houses rising much faster than flats, which have been adversely affected by a lockdown induced desire for outside space and fire safety concerns since the Grenfell Tower disaster.

- **The strong housing market has stimulated a surge in mortgage lending.** During the first five months of 2021, lending for house purchase was not only 87% above the same period last year but 51% above the same period of 2019. Remortgage activity has been weaker but the number of product transfers has risen to record levels.

- **Longer term implications of Covid crisis are becoming clearer.** A growing number of firms are implementing a hybrid office and home working model which is likely to result in more office space becoming available for conversion to homes and workers having greater choice over where to live. Homeowners' 'race for space' is therefore likely to continue and city centres will need to reinvent themselves with a greater focus on entertainment. Government will need to manage the withdrawal of excess liquidity from the economy carefully to avoid an overheating economy and rising inflation.

- **IMLA forecasts that house prices will be broadly flat in the second half of 2021 but will rise 1.6% in 2022.** The stamp duty holiday has pushed up house prices and a more subdued picture can be expected after the holiday fully ends in September. House prices are only likely to fall if interest rates have to be raised substantially.

- **IMLA is raising its forecast for mortgage lending from £283 billion to £285 billion in 2021.** IMLA was already forecasting that 2021 would see the highest level of mortgage lending since 2007. However, we have cut our forecast for gross lending in 2022 from £286 billion to £280 billion, reflecting the level of activity brought forward to 2021 by the stamp duty holiday.

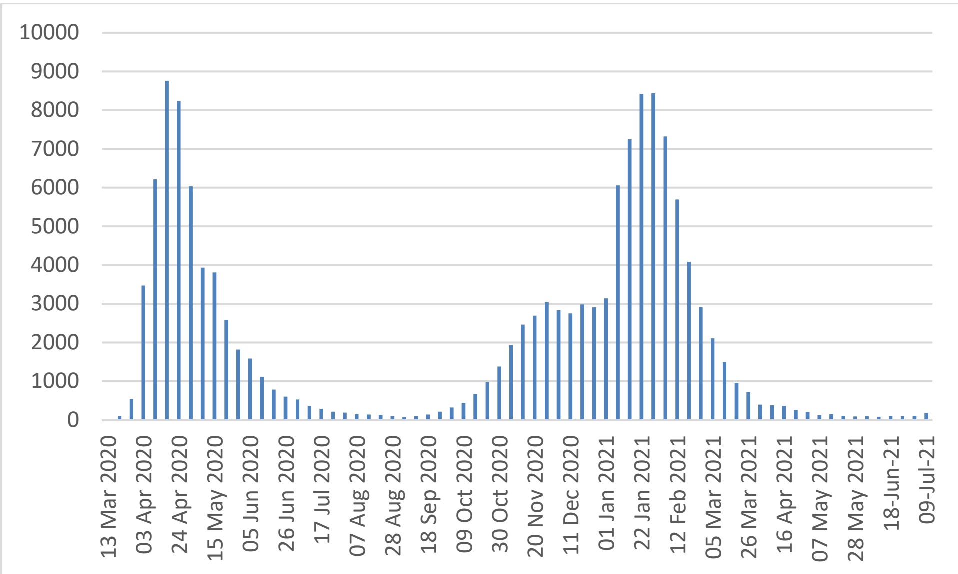
1. The impact of lockdown

1.1 The surprising recovery

It was clear from the earliest days of lockdown in March 2020, that the Covid-19 induced economic slump would be unlike any we had experienced before. As governments in the UK and around the world were requiring large parts of the economy to be shut down for public health reasons, it was necessary for the Treasury to put in place mechanisms of financial support that would go way beyond what could be expected in a ‘normal’ downturn.

The story since September 2020 when IMLA published *The Impact of Coronavirus on the UK Housing and Mortgage Market* is of the virus proving a greater challenge than was first assumed with a second wave peaking in November and third wave peaking in early 2021 that tragically has resulted in thousands of additional hospitalisations and deaths (see Chart 1). But we have also witnessed sustained government intervention, both fiscal and monetary, that has provided broad based support for firms and individuals, cushioning most of them sufficiently to counteract the negative financial impact of lockdown and providing a platform for a robust economic recovery.

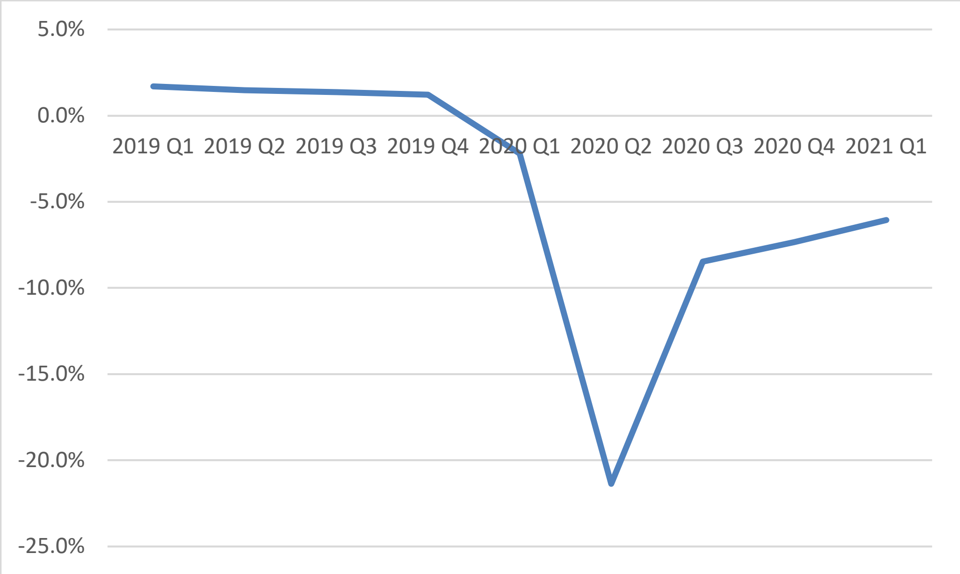
Chart 1 – Deaths with a positive Covid test (England and Wales)



Source: ONS

As Chart 2 shows, by the first quarter of 2021 the economy was still smaller than it had been in the first quarter of 2020 but was, nonetheless, nearly 17% larger than it had been during the first lockdown in Q2 2020. Monthly data for April and May showed a further improvement, as lockdown restrictions were eased, with output up 2.1 and 0.7% respectively. Compared to February 2020, the final month before Covid restrictions were applied, output in May 2021 was a modest 3.2% lower despite some continued restrictions being in place.

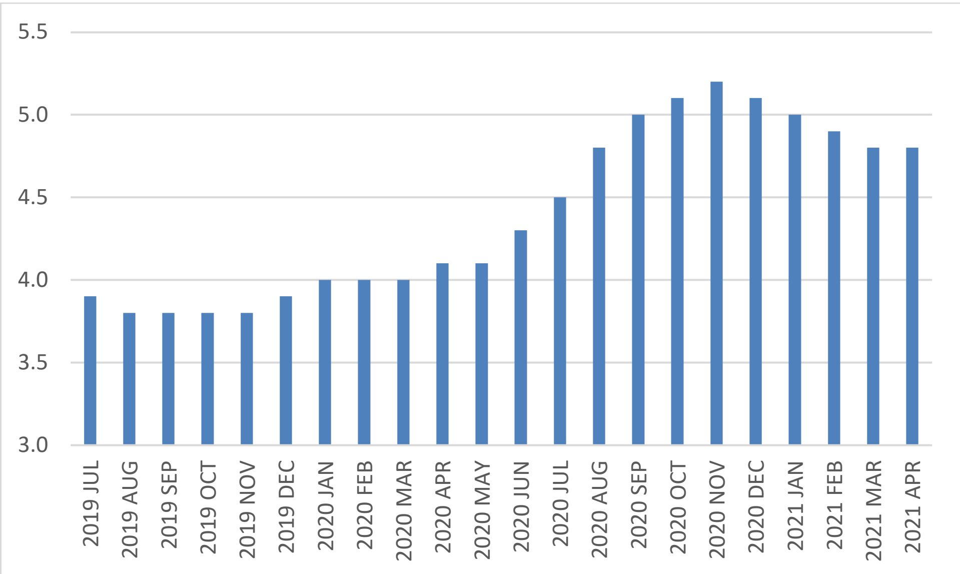
Chart 2 – UK GDP (Change on a year earlier)



Source: ONS

One market that has not performed as expected by most economists is the labour market. Forecasters were expecting a substantial increase in unemployment in 2021 as the economy emerged from its most recent lockdown and the Job Retention or furlough Scheme was brought to a close. For example, the Office of Budget Responsibility (OBR) November 2020 forecast projected unemployment of 7.5% in the second quarter of 2021 against the latest unemployment rate of 4.8% (April 2021), which continued a downward trend seen since the November peak of 5.2% (see Chart 3), as businesses have adapted to social distancing rules and many workers have shifted to occupations where demand has expanded such as delivery drivers.

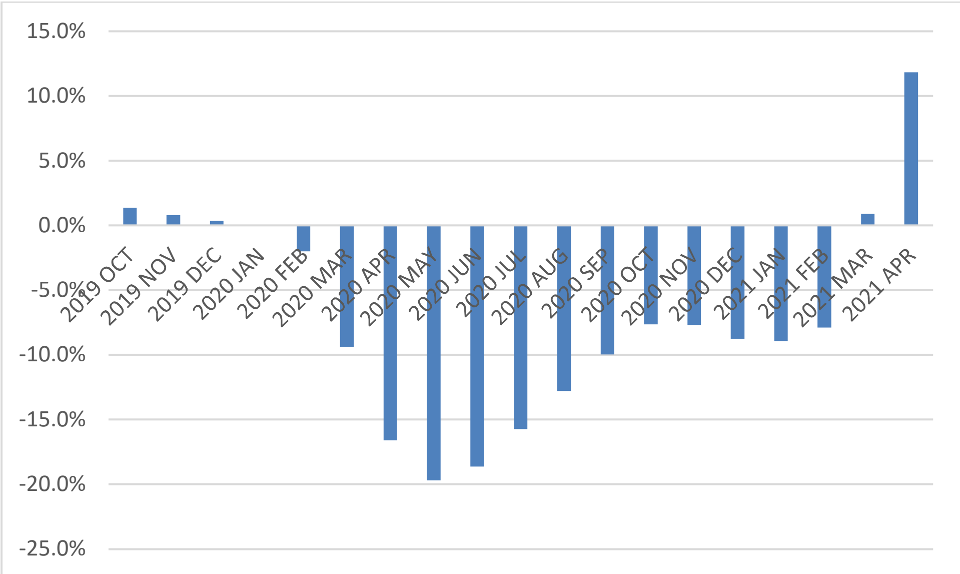
Chart 3 – % unemployment rate



Source: ONS

Two key factors have supported the stronger than expected jobs market. Firstly, the furlough scheme was extended and is now planned to end in September 2021. But much more importantly, the expected impact on employment caused by the economic disruption from Covid has been largely ameliorated by government financial support to the economy which has ensured that after each lockdown has ended demand has been sufficient to ensure that the overwhelming majority of workers coming off furlough have been brought back into work rather than joining the ranks of the unemployed. A good measure of labour market activity is total hours worked and Chart 4 shows how this has evolved during the Covid crisis. By April 2021, total hours worked were above the level of March 2020 and only 4.9% below the level of February 2020.

Chart 4 – Total weekly hours worked (% change on a year earlier)

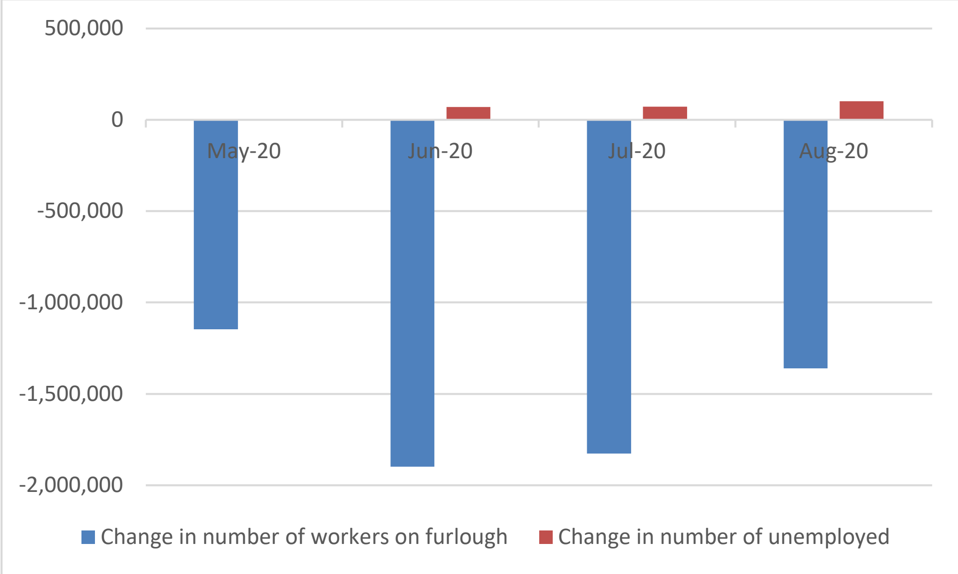


Source: ONS

In our report on Covid published in September last year we pointed out that after the first lockdown ended it was already clear that the overwhelming majority of furloughed workers were returning to their jobs with only 4% becoming unemployed in net terms (see Chart 5). This trend was even more marked this year: between mid-January and the end of April, 1.6 million workers came off furlough yet unemployment fell marginally. And by late May, it is estimated that only 7% of workers remained on furlough.

Indeed, as the recovery picks up there are increasing signs of labour shortages. These seem to have been exacerbated by the UK leaving the EU, with many workers from Eastern Europe, who had undertaken low paid work in sectors such as hospitality, agriculture, food processing and care, returning to their country of origin during lockdown and not coming back to the UK.

Chart 5 – Decrease in workers on furlough and rise in unemployment (summer 2020)

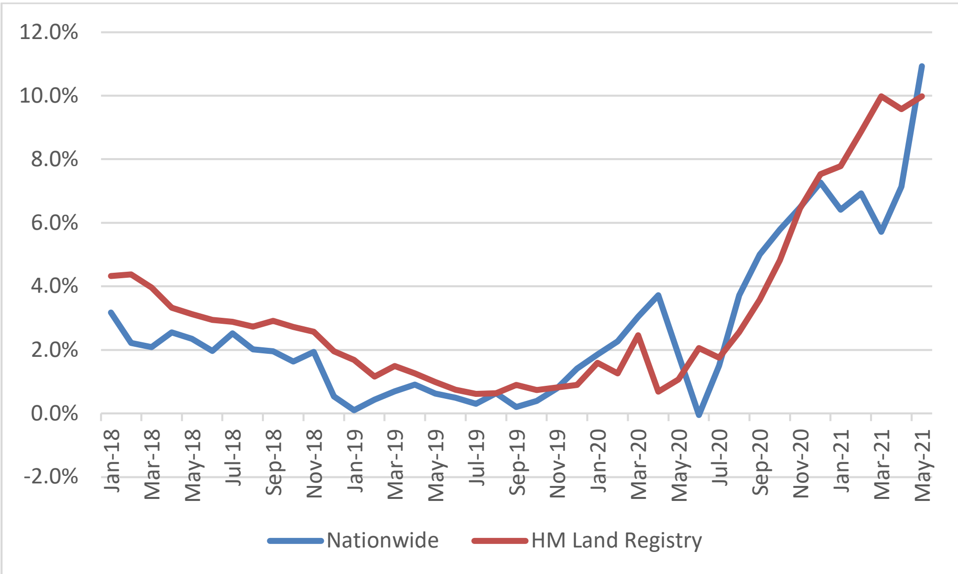


Source: ONS

1.2 The impact on the housing market

If the strength of recovery in the wider economy and labour market has taken economists by surprise, the performance of the housing and mortgage markets has completely defied expectations. By summer 2020, many mainstream forecasters were pencilling in sharp falls in house prices in the second half of that year and in 2021. Even as late as November 2020, the OBR was forecasting that house prices would fall by 8.3% between the fourth quarters of 2020 and 2021.

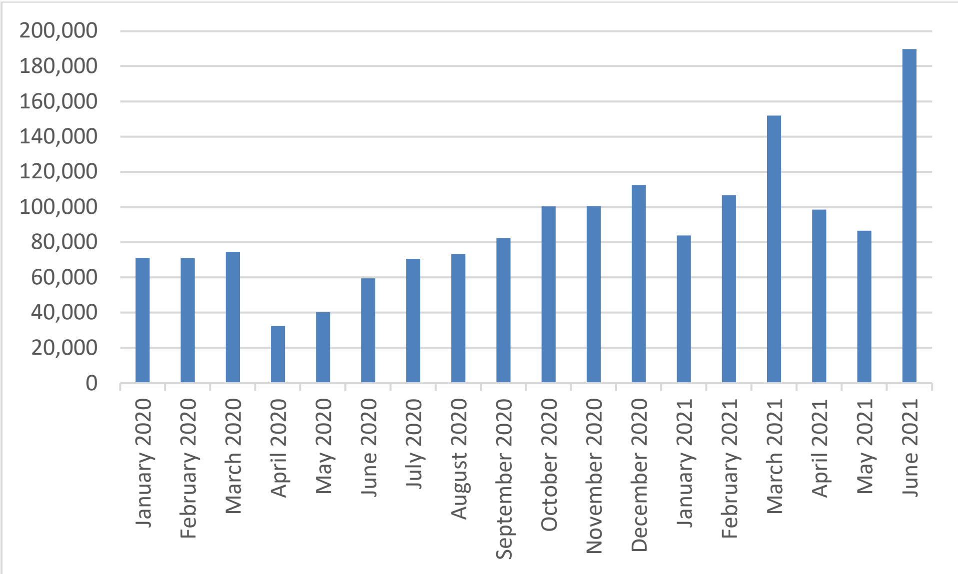
Chart 6 – House prices (% change over previous 12 months)



Source: HM Land Registry, Nationwide Building Society

Instead, we have seen house price growth pushing into double digit percentages on the main indices (see Chart 6), helped by the rush to meet the original deadline for the end of the stamp duty holiday in March 2021. But a close examination of the available data shows that even before the government announced a stamp duty holiday in July 2020 the market was facing an intensified shortage of properties, putting upward pressure on prices. This shortage of available stock has continued to be a feature of the market even past the original stamp duty holiday deadline with the RICS Residential Market Survey showing falls in average stock per surveyor branch in recent months. This points to an absence of downward pressure on prices over the coming months despite the number of transactions brought forward to meet the original stamp duty deadline in March and the second deadline in June (see Chart 7).

Chart 7 – Residential property transactions



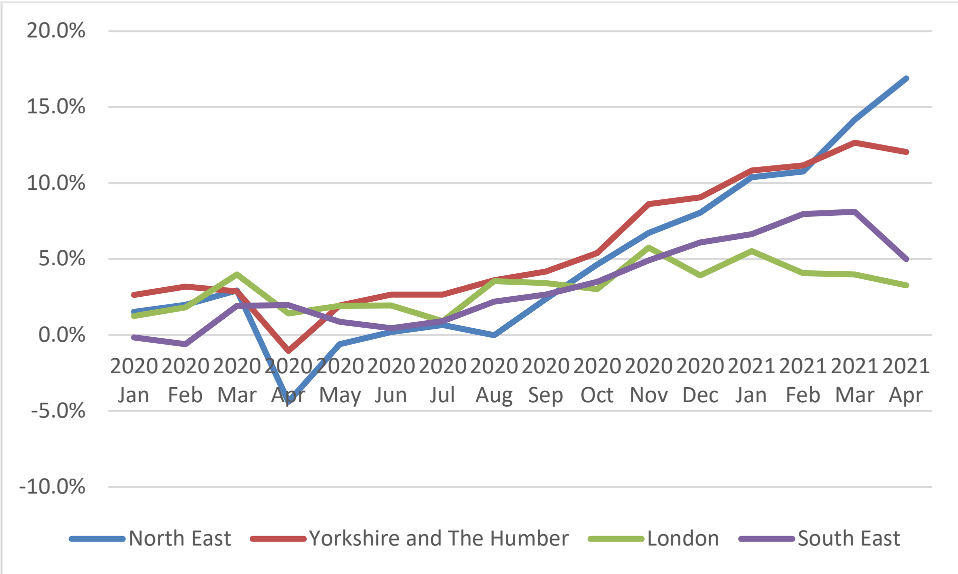
Source: HMRC

The surge in transactions has been driven primarily by moving homeowners. Comparing the first quarter of 2021 with the same period in 2020, which was mostly unaffected by the lockdown, mortgaged moving homeowner purchases increased by 84%, unmortgaged transactions by 60% and mortgaged first time buyers by 32%. This was unsurprising given that the stamp duty holiday offered no benefit to the overwhelming majority of first time buyers as they were already exempt from paying the duty on properties up to £300,000. Additionally, the withdrawal of 95% LTV mortgages disproportionately affected first time buyers and these products did not return to the market until March after the government announced that it was establishing a new mortgage guarantee scheme.

The 'race for space' that has characterised many buyers' priorities since lockdowns were first mandated has benefitted houses with gardens and rural and suburban locations over inner cities. This trend has been reinforced by the widely publicised concerns with fire safety in flats following the Grenfell Tower disaster. Coupled with wider concerns about leasehold properties, these factors have driven the most pronounced bifurcation of the market between flats and houses seen in modern times.

Between Q2 2017, when the Grenfell Tower fire occurred, and Q1 2021, flat prices rose by 2.7% against 10.7% for terraced houses and 12.9% for detached houses according to Nationwide data. Flat owners with cladding that is now deemed unsafe face large potential bills while other fire safety concerns have emerged from other, less well publicised, fires in flats that have highlighted concerns with wooden balconies and poorly or unfitted fire breaks within cavity walls. As a result of these issues many flats have become all but unsellable. The funds government has made available to help to fix these problems are insufficient leaving many who bought in good faith with unaffordable repair bills.

Chart 8 – annual house price growth in selected regions



Source: HM Land Registry

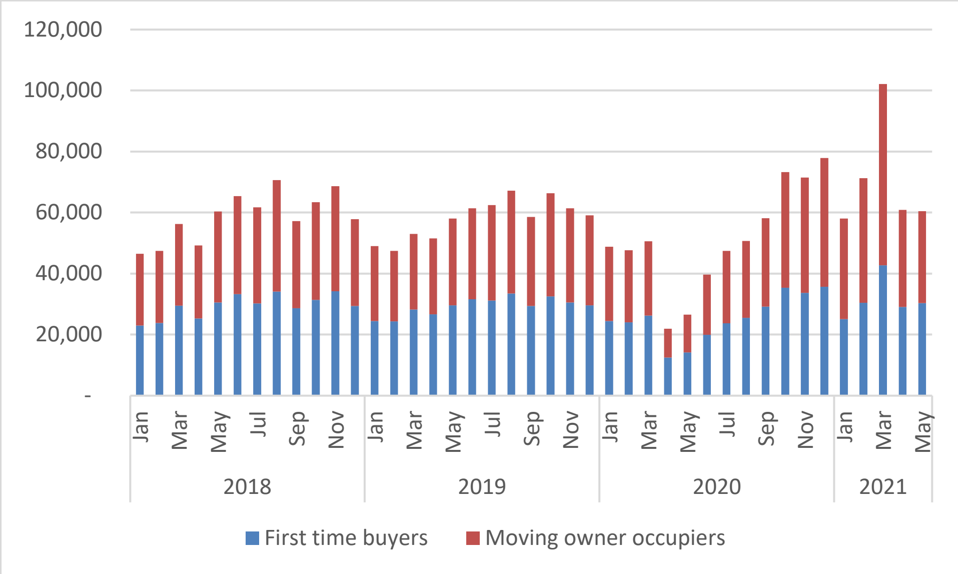
The response to Covid has also impacted the regional pattern of house price growth. While all regions benefitted from the boost to demand that came after the first lockdown, more recently London and the Southeast have shown markedly slower price growth than other regions (see Chart 8), perhaps reflecting buyers' growing confidence that they will be able to live much further from their previous place of work if working from home or hybrid working models become the norm.

1.3 Impact on the mortgage market

It is hard to disentangle the impact of the stamp duty holiday announced in July 2020 from the broader recovery in confidence that followed the end of the first lockdown last summer. We know that many households have saved significant sums of money as a result of Covid restrictions and feel confident about their own prospects and that lockdown has led many to reassess the property features they value most. But there can be no doubt that for many homeowners the stamp duty holiday helped to crystalise the decision to move.

The scale of the rise in lending and the extent to which it has been driven by home movers is evident in Chart 9. Lending to first time buyers has averaged £5 billion a month since 2018 and since September this has increased by 22% to £6.1 billion but since September lending to home movers has averaged £9.6 billion, 41% above the monthly average since 2018.

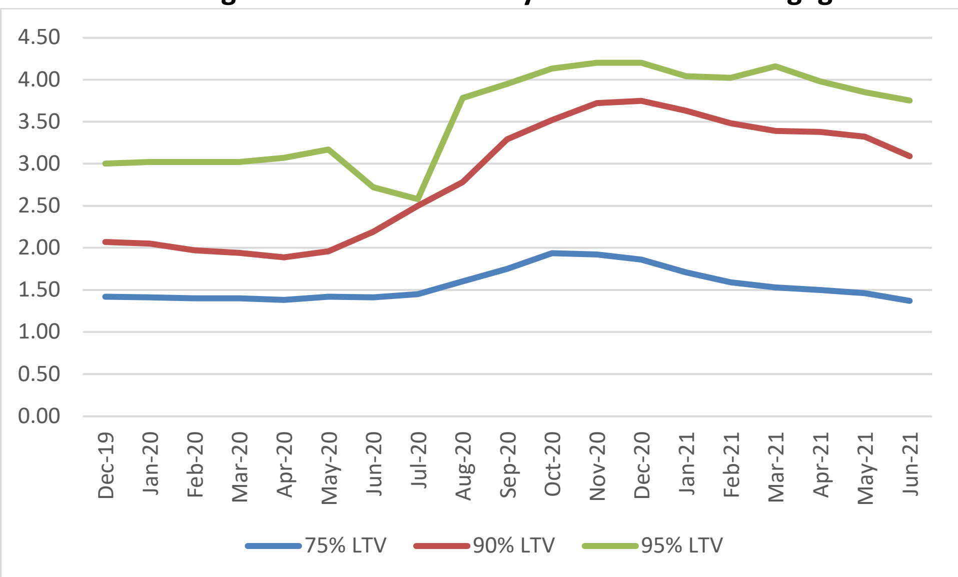
Chart 9 – Mortgage lending for house purchase (£m)



Source: UK Finance

One factor that has constrained first time buyer demand is the lack of availability of high LTV lending and its increased price. Most lenders pulled back from 95% and even 90% LTV lending after the first lockdown as a result of capacity constraints and concerns about house price falls. Even when many lenders returned to 90% LTV lending in late 2020 and 95% in March 2021, interest rates on these products had jumped relative to those on lower LTV loans (see Chart 10). In May 2021, rates on 75% LTV 2-year fixed rates were almost back to their February 2020 level but the average rate on a 95% LTV 2-year fixed was 0.73 percentage points higher.

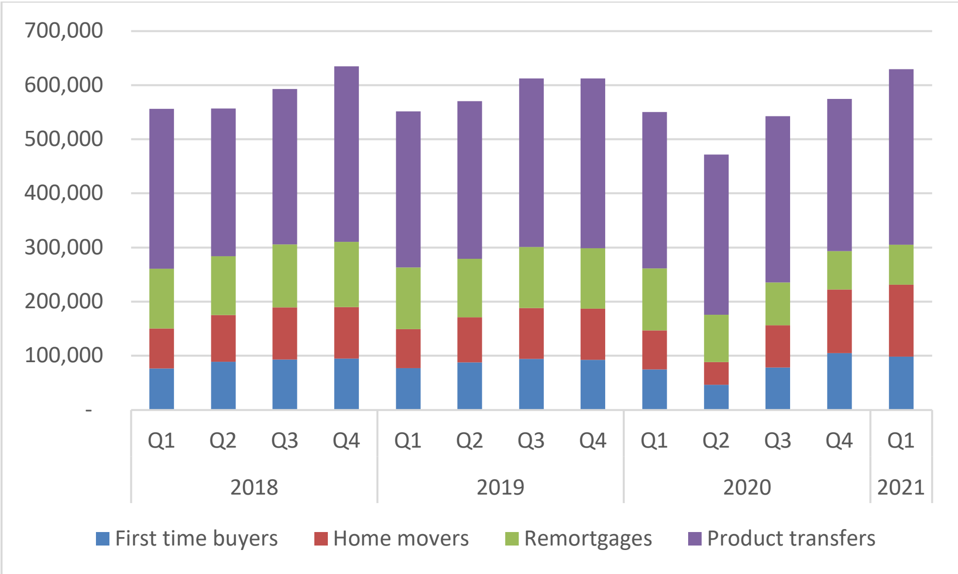
Chart 10 – Average interest rate on a 2 year fixed rate mortgage



Source: Bank of England

Remortgage activity by contrast has been subdued which may partly reflect lenders' need to prioritise house purchase lending ahead of the deadline for the end of the stamp duty holiday during a period when administrative capacity was still constrained by Covid restrictions. The number of remortgages, which averaged 112,000 a quarter in 2019, was only 74,000 in Q1 2021, below the level of Q2 2020 despite the lockdown (see Chart 11). Product transfers have held up better, perhaps reflecting the ease with which borrowers can switch products with their lender using automated online systems that do not stretch administrative resources in the way a remortgage does. Q1 2021 saw the highest recorded number of product transfers on record.

Chart 11 – Number of mortgage transactions

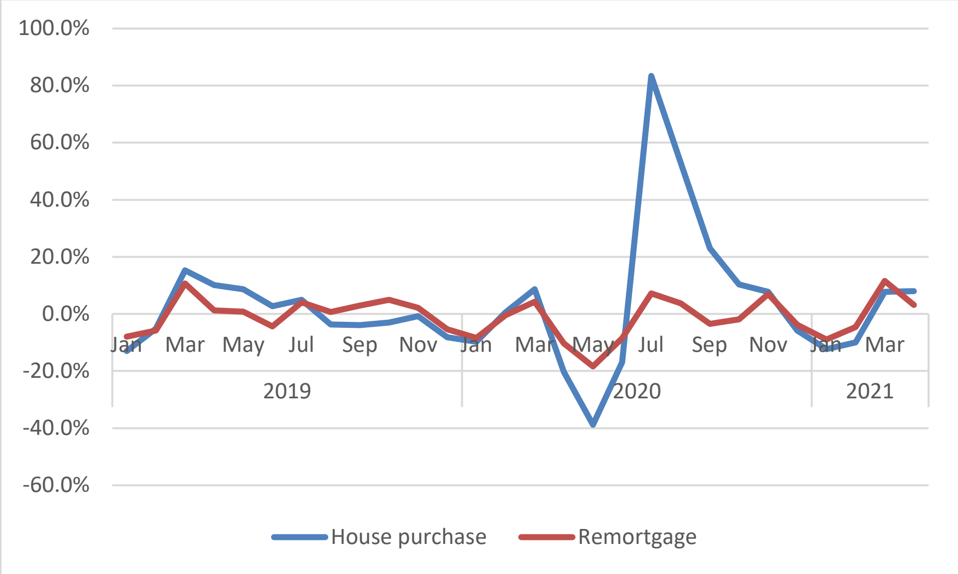


Source: UK Finance

Mortgage approvals give an insight into lending levels in around three months' time and therefore provide valuable insight into the likely trend of lending volumes over the next few months, a period when it might be expected that lending would be lower given the number of buyers who were able to complete before the end of the initial deadline for the stamp duty holiday at the end of March. Buyers hoping to meet that deadline would have had to be applying for a mortgage several months in advance and indeed the number of approvals for house purchase mortgages peaked at 305,000 in November.

However, the number of approvals has remained buoyant beyond the original deadline (see Chart 12), and although some of this reflected buyers hoping to beat the new 30 June deadline announced by Chancellor Sunak in the Budget on 3 March, this is unlikely to account for all of the rise in approvals to 91,000 in May, 37% above the 2019 monthly average, as buyers obtaining a mortgage approval in May could find themselves struggling to meet a June deadline for completion. The on-going strength of mortgage approvals illustrates the extent to which the pool of interested buyers remains strong despite the sizeable number of people who brought forward their purchase to meet the March and June deadlines.

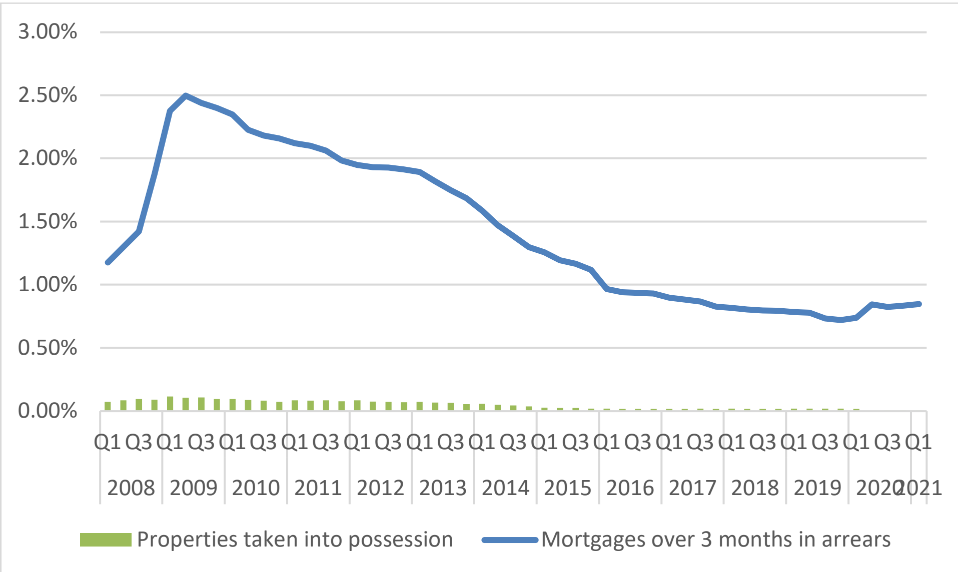
Chart 12 - % change in 3 month rolling average number of approvals



Source: Bank of England

With data now available up to the first quarter of 2021 it is possible to get a reasonable impression of the impact of the Covid crisis on mortgage arrears. Chart 13 shows that arrears of over 3 months have risen from their low in Q4 2019 of 0.72% of all loans to 0.85%. This is a modest increase and, as there are now fewer than 30,000 borrowers on a mortgage deferral, it suggests that arrears are unlikely to spike much further, particularly given the strong performance of the jobs market. In addition, the moratorium on repossessions that has been in place since the second quarter of 2020 has reduced repossessions by around 6,500 based on previous rates, leaving these loans in arrears, and this accounts for roughly half of the rise in total arrears.

Chart 13 – % of mortgages taken into possession and over 3 months in arrears

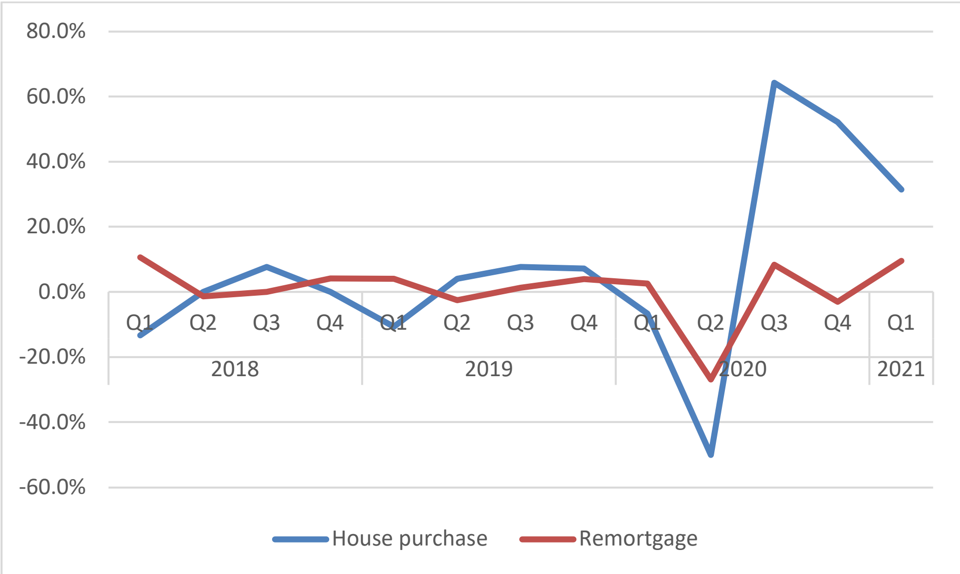


Source: UK Finance

1.4 Buy-to-let performance

The buy-to-let market has held up well since the onset of the Covid crisis but there are also indications of growing pockets of distress. The total number of outstanding buy-to-let mortgages has increased faster than that of homeowners and lending for house purchase has rebounded in line with the broader market as landlords have also benefitted from the stamp duty holiday, although they are still required to pay the 3% surcharge that is added to standard stamp duty rates for purchasers, including investors and second home buyers, who already own a property. Remortgage activity also mirrors the wider mortgage market, being much more subdued than house purchase lending (see Chart 14), perhaps reflecting the increased popularity of 5-year fixed rate loans in recent years, which reduces churn rates, as well as the prioritisation lenders have been giving to purchase transactions ahead of the stamp duty deadlines.

Chart 14 – Buy-to-let lending (% change on a quarter earlier)



Source: UK Finance

Although data is patchy, it appears that rent arrears and voids have not been as large a concern as many landlords feared. Despite the moratorium on evictions for arrears it seems that the overwhelming majority of tenants have been able to maintain rental payments. However, some landlords have been hit hard by Covid-related arrears and voids have also risen in some areas, in part reflecting the loss of EU workers who returned home during the pandemic. Arrears data reflects these pressures with buy-to-let arrears climbing much faster than those of homeowners even though landlords were eligible for payment deferrals, which are not recorded as arrears. Between the first quarters of 2020 and 2021 there was a 42.9% increase in the number of buy-to-let mortgages with arrears of more than 3 months and a 77.3% rise in the number of mortgages with arrears of more than a year, in part reflecting the moratoria both on repossessions and tenant evictions.

The Covid crisis triggered a sharp geographic divergence in the rental market. While the house purchase market initially held up well in London, the rental market was much weaker from the first lockdown and London has continued to show weakness in rent levels compared to other regions. London rents had been falling on an annual basis up until May according to the HomeLet Rental Index while pushing upwards quite sharply in some other regions. The June Homelet Rental Index showed an improved picture in London, with rents up 1.5% on June 2020, but also showed rents outside the capital jumping by 8.0% with the South West and Wales both experiencing double-digit rental growth.

The pattern of higher rental price inflation in the less urbanized regions no doubt reflects the greater mobility that renting allows, with tenants who were working in London or other large conurbations able to end tenancy contracts and move back to parents with more space or relocate at least temporarily to cheaper regions or more pleasant rural locations. The regional performance going forward will depend on the extent to which workers are required to return to previous places of work. It must be a cause for concern for London landlords in particular that many office workers have already been given the option to spend much less time in the office due to the introduction of hybrid office home working by many firms. This could encourage many tenants to re-evaluate their locational preferences, creating the possibility that the prevailing premium in rents that London has recorded relative to other regions will be squeezed.

2. The outlook and updated forecast

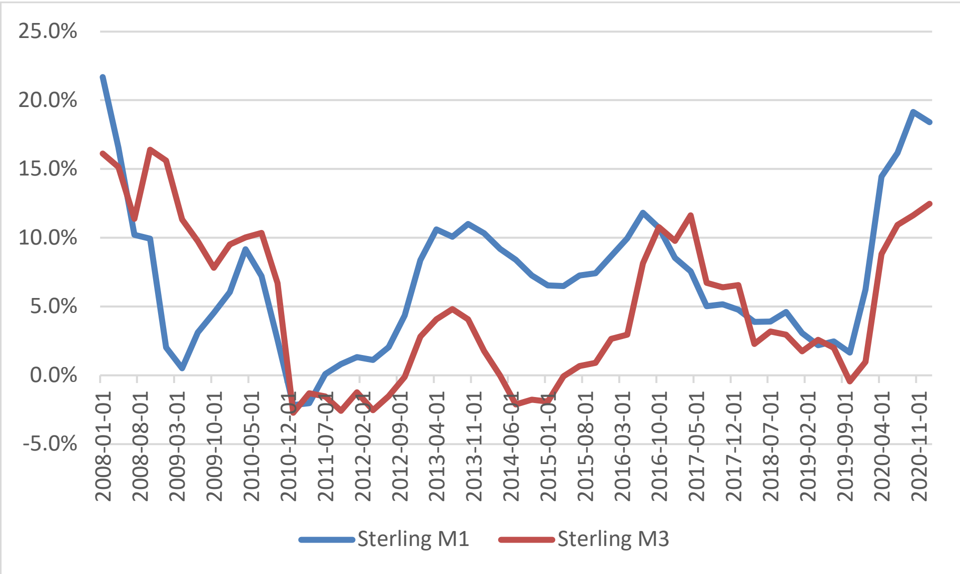
2.1 Factors underpinning recovery

The UK's vaccination programme is proceeding well with over 36 million people – around 70% of all adults - having received two doses by 22 July, and the evidence to date suggests that the vaccine is effective, reducing the spread of even the newer Delta variant and greatly diminishing hospitalisations and deaths. It therefore seems that, in the absence of new variants that current vaccines are not effective against, the UK is still on track to overcome the virus this year and be able to fully lift restrictions on a permanent basis.

There are two main reasons to be optimistic about the level of demand in this post-Covid environment. Firstly, fiscal and monetary policy has been highly accommodative with, for example, government transfers to the private sector estimated to have totalled £135.9 billion in the fiscal year 2020/21 according to the Institute for Government while the Bank of England has undertaken £450 billion of QE, which has increased the level of cash in the economy by nearly £7,000 for each person in the UK. And secondly, lockdown induced an artificial reduction in spending by the private sector (both corporates and households) that created a build-up of savings, much of which can be expected to be spent once conditions permit.

Unsurprisingly, the impact on the UK money supply has been substantial. Sterling M1, which includes notes and coins and sight deposits, which can be withdrawn on demand, rose by £344 billion over the course of 2020, an 18.4% increase (see Chart 15). Sterling M3, which includes time deposits, rose slightly more by £362 billion, but it is notable that Sterling M1 showed the greater percentage increase and this is the most liquid form of cash, available for immediate spending.

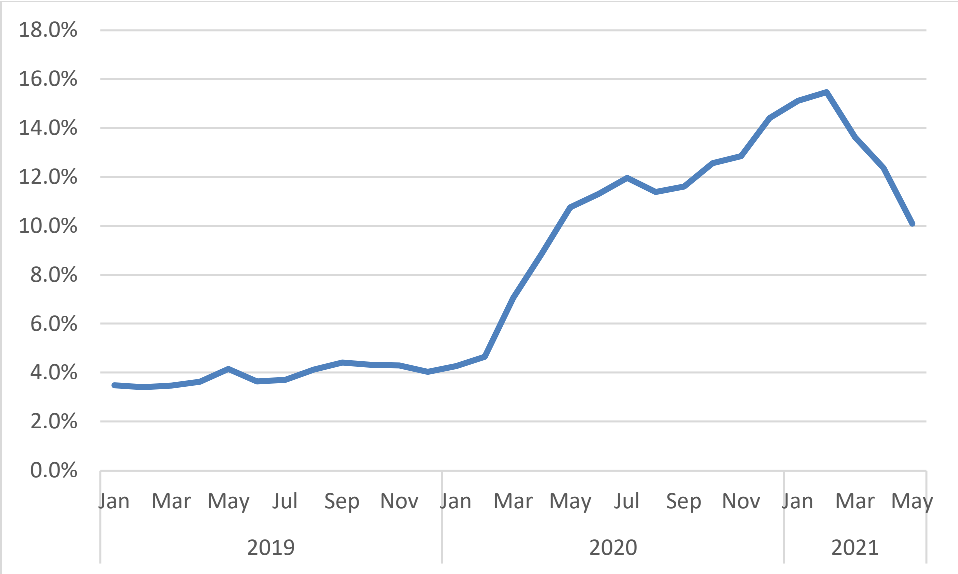
Chart 15 – UK money supply M1 and M3



Source: Bank of England

The proportion of this increased cash that is held by households can be determined by looking at the rise in retail deposits. Chart 16 shows how the rate of growth of deposits took off as soon as the first lockdown started and has continued to rise since. Between February 2020 and May 2021 the total value of retail deposits rose £331 billion, a rise of £22 billion a month, meaning that an average family of four accumulated an additional £19,900 of cash savings in 15 months.

Chart 16 – UK retail deposits (% change on a year earlier)



Source: Bank of England

2.2 Updated forecast

The IMLA publication *The new 'normal' – prospects for 2021 and 2022* published in January 2021 contained our regular forecast for the housing and mortgage markets for the following two years. Given the pace of events since then, we thought it would be helpful to update our forecast including the key assumptions underpinning it (see Table 1). We now expect growth to be slightly stronger this year and unemployment somewhat lower. We have not changed our house price forecast but we now expect an additional 120,000 property transactions as the extended stamp duty holiday should ensure that housing turnover remains reasonably buoyant in the third quarter.

Table 1 – Key forecast assumptions

	Past values		Forecast values		Percentage changes		
	2019	2020	2021f	2022f	2020/19	2021/20f	2022/21f
Real GDP (£bn)	2,173	1,959	2,090	2,200	-9.8%	6.7%	5.3%
Unemployment rate (Q4)	3.8%	4.8%	4.5%	4.0%	26.3%	-6.3%	-11.1%
House prices (average for year)	230,600	237,600	253,000	257,000	3.0%	6.5%	1.6%
Housing transactions (UK, thousands)	1,177	888	1,320	1,220	-24.6%	48.6%	-7.6%
Bank Rate (end of year)	0.75%	0.10%	0.10%	0.75%	-86.7%	0.0%	650.0%

Source: IMLA, ONS, HMRC

Table 2 – Mortgage market forecast

	Gross mortgage lending (£m)				Percentage changes		
	2019	2020	2021f	2022f	2020/19	2021/20f	2022/21f
House purchase	158,175	149,431	185,000	175,000	-5.5%	23.8%	-5.4%
Remortgage	100,905	84,137	89,000	94,000	-16.6%	5.8%	5.6%
Other	9,927	10,349	11,000	11,000	4.3%	6.3%	0.0%
Total	269,007	243,917	285,000	280,000	-9.3%	16.8%	-1.8%
of which:							
Buy-to-let lending	43,500	38,100	42,000	40,000	-12.4%	10.2%	-4.8%
of which for house purchase	10,900	10,000	13,000	10,000	-8.3%	30.0%	-23.1%
Buy-to-let share of total	16.2%	15.6%	14.7%	14.3%	-3.4%	-5.7%	-3.1%
Lending via intermediaries*	167,564	154,693	181,000	178,000	-7.7%	17.0%	-1.7%
Share of total*	77.0%	78.7%	78.0%	77.7%	2.3%	-0.9%	-0.4%
Net lending	49,434	44,853	54,000	52,000	-9.3%	20.4%	-3.7%

* Regulated loans only

Table 2 shows our updated mortgage market forecast. We expect lending for house purchase to be £13 billion higher than our January forecast at £185 billion but remortgage activity has been weaker than expected so we have cut our projection to £89 billion. As a result, we expect total gross lending of £285,000 in 2021, only £2 billion higher than our January forecast but the highest annual figure since 2007.

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

					Percentage changes		
	2019	2020	2021f	2022f	2020/19	2021/20f	2022/21f
Whole market							
Outstanding debt (£bn)	1,454	1,499	1,553	1,605	3.1%	3.6%	3.3%
House purchase lending (£m)	158,175	149,431	185,000	175,000	-5.5%	23.8%	-5.4%
House purchase % churn	11.1%	10.1%	12.1%	11.1%	-8.4%	19.8%	-8.6%
Remortgage	100,905	84,137	89,000	94,000	-16.6%	5.8%	5.6%
Remortgage % churn	7.0%	5.7%	5.8%	6.0%	-19.2%	2.3%	2.1%
Total % churn	18.8%	16.5%	18.7%	17.7%	-12.1%	13.0%	-5.1%
Buy-to-let market							
Outstanding debt (£bn)	261	273	281	289	4.6%	3.0%	2.8%
House purchase lending (£m)	10,900	10,000	13,000	10,000	-8.3%	30.0%	-23.1%
House purchase % churn	4.3%	3.7%	4.7%	3.5%	-11.9%	25.3%	-25.3%
Remortgage	30,980	27,070	27,700	28,600	-12.6%	2.3%	3.2%
Remortgage % churn	12.1%	10.1%	10.0%	10.0%	-16.1%	-1.4%	0.3%
Total % churn	17.0%	14.3%	15.2%	14.0%	-15.9%	6.2%	-7.5%
Buy-to-let % of total market							
Outstanding debt	17.9%	18.2%	18.1%	18.0%	1.4%	-0.5%	-0.5%
House purchase lending	6.9%	6.7%	7.0%	5.7%	-2.9%	5.0%	-18.7%
Remortgage	30.7%	32.2%	31.1%	30.4%	4.8%	-3.3%	-2.2%
Total lending	16.2%	15.6%	14.7%	14.3%	-3.4%	-5.7%	-3.1%

Source: Bank of England, UK Finance and IMLA

Lending conducted through intermediaries could reach £181 billion, up 17% on 2020 while buy-to-let lending could be £2 billion higher than previously forecast at £42 billion. The increase in buy-to-let lending has been powered by house purchase transactions, mirroring the owner-occupied market. We now expect £13 billion of house purchase buy-to-let lending in 2021, the best year since 2016.

With the stamp duty holiday driving much of the buoyancy in the housing and mortgage markets this year we expect housing transactions and house purchase lending to fall back in 2022. A modest rise in remortgage activity will be insufficient to prevent total lending from falling from 2021's level to £280 billion, less than we were predicting in January as remortgage activity could continue to be weaker, partly reflecting the growing popularity of product transfers. Although housing transactions could be significantly down in 2022, we anticipate a further modest 1.6% rise in house prices in 2022.

Perhaps the greatest risk to our forecast comes from the possibility that the economic recovery is even stronger, resulting in higher inflation. If the Bank of England comes to perceive the threat of a wage price spiral it would need to respond with higher interest rates given its mandate to target a consumer price inflation rate of 2%. We expect Bank Rate to reach 0.75% by the end of 2022 but there is a serious risk that the Bank of England will feel the need to raise rates more sharply. This in turn could lead to an economic slowdown but there is considerable uncertainty as to when interest rates might need to rise and by how much.

2.3 Lenders in robust position as economy opens up

For mortgage lenders the Covid crisis has been a very different experience to the financial crisis of 2008-9. Lenders went into the pandemic with strong balance sheets both in terms of capital reserves and liquidity and, thanks in large part to the level of support firms and households have been given by government, loan defaults remain low and may not spike much further given the improved situation in the labour market and the wider economy.

Because their balance sheets are strong, lenders are well positioned to provide the lending needed to support the recovery, in contrast to the post-financial crisis period when both banks and borrowers had over-stretched balance sheets requiring low interest rates and QE to support the recovery. In the mortgage market, we have already seen earlier caution give way to a partial normalization of lending. After the Budget announcement of the introduction of a Mortgage Guarantee Scheme, some lenders chose to return to 95% LTV lending without use of the scheme, in part because of its cost, although there has been no return to 95% LTV lending on new build without additional risk protection[1]. However, the speed with which house prices have risen over the past year is a new cause for concern as is the threat of higher inflation, with CPI inflation already reaching 2.5% in June, which could trigger interest rate rises if

[1] On 23 June Newcastle Building Society became the first lender to return to 95% LTV lending on new build using Deposit Unlock, a mortgage insurance scheme backed by the Home Builders Federation. The author of this report is a consultant to Deposit Unlock scheme administrators Gallagher Re.

sustained. With banks' and consumers' balance sheets generally in better condition now than after the financial crisis, interest rates could rise in a way that they did not after 2008-9.

3. Covid-19's legacy of enduring change

3.1 The lifestyle legacy

16 months after the start of the first Covid-19 lockdown we are beginning to see the outline of what the post-Covid world will look like. The measures introduced to curb the spread of the virus have had a profound impact on people's lives over the past year, affecting the way we worked, shopped and socialised. As life begins to get back to normal there is something of a consensus that some of the changes will have lasting impacts on lifestyles with a corresponding effect on economic activity.

Perhaps the most significant longer term change in lifestyles relates to where we work. Although working from home was practical for many workers before the pandemic, the culture of office based work remained strong. Covid-19 forced employers to adapt to a working from home model and many have been surprised by how smoothly operations have been maintained. Mortgage lenders have been amongst the firms that have had to manage higher workloads in response to the mortgage deferral scheme and, more recently, the surge in demand caused by the stamp duty holiday, while implementing the working from home model. Despite the challenges, lenders have performed well.

As a result, many employers are now questioning the old office-based model and are offering their employees the choice of working from home at least part of the week. A survey by the BBC conducted in May suggested that 43 of the 50 top companies in the UK were planning to move to a hybrid model of part time office working, including KPMG and advertising agency WPP. This has wide-ranging economic implications. The office districts of city centres will see lower footfall, leaving reduced custom for ancillary businesses such as restaurants and shops in these locations. The implementation of hot desking will reduce demand for office space which should free up office buildings for conversion to residential use, although lower demand for flats and concerns about the quality of some previous conversions could constrain demand. City centres will then have to reinvent themselves, with a greater emphasis on entertainment and although the trend to hybrid working might gradually reverse in the future if the subtler benefits of office work become clearer, there is little doubt that demand for office space will be depressed for some time.

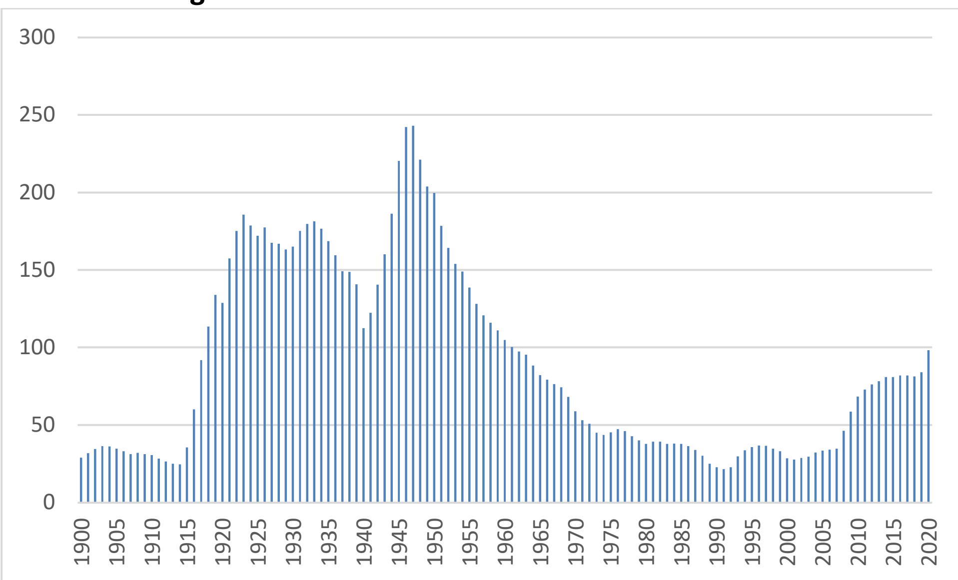
Two other areas where permanent change can be expected is shopping and travel. More consumers have become accustomed to online shopping, potentially reducing the amount of physical shopping space required. As with offices, this could lead to redundant space that can be converted to residential use but unless this process is managed there is a serious risk of blight where shops are left vacant for long periods of time as well as the risk of conversions being of poor quality. The widespread adoption of video conferencing via tools such as Zoom or Teams and reduced office working implies lower demand for business and commuter travel, which is likely to have the greatest impact on rail network usage.

3.2 The longer term economic impact

The lifestyle changes outlined above are likely to create significant shifts in economic activity. Reduced demand for offices, shops and travel will reduce expenditure in these areas freeing up resources for other uses. This implies some frictional unemployment if workers in fields such as retail cannot rapidly retrain. But perhaps a greater legacy relates to the fiscal and monetary response to Covid-19, which has bolstered the balance sheets both of firms and households in aggregate, as well as promoting a sense that government will act to mitigate people's risks. This combination could stoke excess demand, overheating the economy over the coming months and years which could put upward pressure on inflation, in turn suggesting interest rates may need to rise.

Managing the process of draining some of the excess liquidity that has built up out of the economy will be a challenging one for government. An overly accommodating stance over the next year or so could lead to the need to tighten both fiscal and monetary policy harder in future years, with the risk of tipping the economy into recession. A longer term legacy may be that people will expect the exceptional support that government has provided in response to Covid-19 to be repeated during future recessions, making them less risk averse financially. But the deterioration in the government's finances (see Chart 17) implies little room for future largesse, suggesting that such expectations will most likely be disappointed.

Chart 17 – UK government debt to GDP ratio since 1900



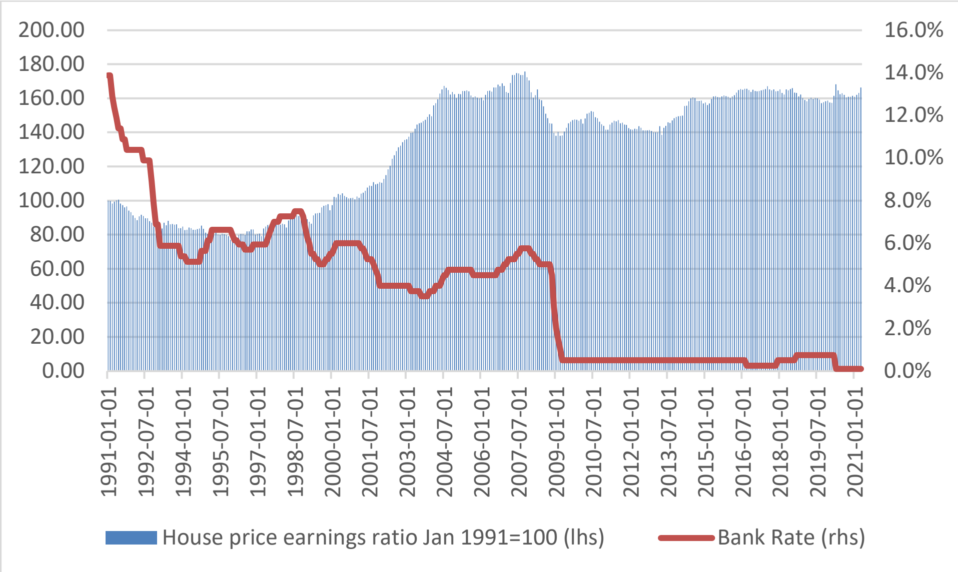
Source: UK Public Spending

3.3 The longer term impact on the housing market

The stamp duty holiday and increased liquidity in the economy has provided a short term boost to housing demand and house prices. The consequence of these higher house prices is that already stretched house price to income ratios have increased further across the country, making it harder for first time buyers. However, if mortgage rates remain at their current low levels, affordability will remain excellent, suggesting that once buyers have overcome deposit constraints and regulatory stress requirements they will find their mortgage comfortably affordable.

If the post-Covid rise in inflation proves sustained as a result of excess demand, interest rates will need to rise and affordability will deteriorate. But as Chart 18 shows, Bank of England Bank Rate would need to rise considerably before it returned to its pre-financial crisis level when the house price to income ratio was higher than it is today. This points to a considerable amount of headroom for interest rates before the majority of borrowers would find their monthly payment difficult.

Chart 18 – House prices relative to earnings and interest rates



Source: ONS, Bank of England, Nationwide Building Society

In years to come it will be possible to say whether Covid-19 catalyzed an inflection point where the long term decline in inflation and interest rates reversed, or whether any post-Covid rise in inflation was temporary, caused by data distortions, supply bottlenecks and excess liquidity. But if we do see sustained inflationary pressures we could enter an environment of rising interest rates that would be less favourable for house prices than the past three decades have been.

3.4 The longer term impact on mortgage lenders

For mortgage lenders the sustained legacy of the Covid-19 pandemic will include a rethink in the way they deliver their services to customers. This could include an acceleration in the shift away from branch distribution since more customers have become accustomed to transacting remotely. Like other employers with largely office-based staff, many lenders including HSBC and Lloyds Banking Group have also decided to move to a hybrid working model, reducing the amount of office space they will require.

As a result of £450 billion of QE, commercial banks' balance sheets have become more liquid, giving them the opportunity to expand lending. Borrower demand for loans may also rise as the policy response to the Covid-19 crisis may have given some consumers the impression that government will provide support when economic conditions deteriorate, making them less risk averse financially. There is a risk that some consumers could become overly confident about future prospects, paying too little attention to risks such as rising interest rates and future downturns. It is too early to know whether consumer behaviour could undergo such a change but lenders should be mindful of the risk of some consumer over-exuberance in the coming months and years.

4. Conclusion

We are only just emerging from the Covid-19 pandemic and the economic shock that social distancing measures generated. Yet already we are starting to get a picture of the legacy that this crisis could leave.

The government has been successful at ameliorating the financial impact of the virus through the provision of unprecedented levels of fiscal and monetary support. But this has left the authorities with the challenging task of ensuring that this extra liquidity does not stoke an overheated economy, pushing inflation upwards. How successfully the government manages this task will determine the stability of the economy over the next few years, with a real risk that inflation becomes a concern that requires higher interest rates to combat.

Our lifestyles may also have witnessed enduring changes with considerable economic consequences. More of our activity has shifted online with less in physical spaces, pointing to a likely sustained reduction in demand for office space, shops and business travel and commuting. The dislocation associated with the declining fortunes of these sectors and the rise of others, most notably technology, is likely to lead to more corporate restructuring and higher business failures.

The digital transformation of lenders is also likely to accelerate as a consequence of the hybrid office/home working model and lower use of physical branches now that more customers have become accustomed to remote banking. There is a positive aspect to these changes as they reduce costs, which is likely to be passed on to customers. Workers could also benefit if they are able to reduce time spent commuting and have more flexibility around where they work. But it will be important for lenders and other businesses to ensure that staff continue to spend time in an office environment to exchange ideas and, in the case of younger workers, learn from more experienced colleagues and benefit from the social aspects of an office environment.

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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 via the broker channel. Its membership of 44 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), 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.