The new ‘normal’ – prospects for 2019 and 2020

A decade after the financial crisis, how sustainable is the UK mortgage recovery?

February 2019

Executive summary

The outlook

- **Stable economic outlook underpinning housing market.** We expect inflation to remain close to 2% over 2019 and 2020, unemployment to remain close to its recent 40 year lows, and interest rates to rise only marginally. We also expect wages to be rising in real terms over the next two years. This 'goldilocks' economic background should underpin the housing and mortgage markets in 2019 and 2020 but we do not expect much change in either house prices or mortgage lending volumes.

- **Gross mortgage lending to be flat at £269 billion this year.** We forecast that gross lending in 2019 will be broadly unchanged on 2018's level. We expect **net mortgage lending to fall slightly to £43 billion**, implying that the stock of mortgage debt will grow by 3.0%, broadly in line with earnings.

- **Remortgaging to be slightly higher at £102 billion in 2019.** Remortgage activity has been the main driver of increased mortgage lending over the past few years. But we now expect remortgage volumes to be up only 1% in 2019 and to fall slightly in 2020. We believe that more customers will choose to take product transfers from their existing lender while a rise in the number of borrowers taking 5 year fixed rated deals in recent years will also dampen remortgage activity.

- **Gross buy-to-let lending to fall to £36 billion in 2019 and £35 billion in 2020.** The outlook for the buy-to-let sector has been transformed by the adverse tax changes enacted since 2015. Net new investment in buy-to-let has all but ceased as some smaller landlords exit the market. Buy-to-let lending was sustained in 2018 by higher remortgage activity but we expect the rise in popularity of 5 year fixed rate deals in recent years and higher product transfers to lead to a fall in remortgage volumes in 2019 and 2020.

- **Lending via intermediaries to continue to increase its share of lending.** Mortgage intermediaries undertook 74% of mortgage lending by volume in 2018, the highest share on record. We expect this trend to continue with regulated mortgage lending via intermediaries set to rise to £169 billion this year and £171 billion in 2020. As a result, the share of lending introduced by intermediaries should continue to rise to 75% in 2019 and 76% by 2020.

Market drivers

- **First time buyer numbers levelling off.** After the financial crisis in 2008-9 there was a dramatic fall in the number of people buying their first home and despite a recovery since, IMLA estimates that by the end of 2018 more than 2.4 million households that would have been expected to buy based on past trends have failed to do so. It might be hoped that many households have simply delayed buying their first home, but analysis of changes in owner-occupation by age group

suggests that there is no 'catching up' effect at present and many of these households risk being permanently excluded from homeownership unless market dynamics shift considerably. In 2018, the number of first time buyers continued to increase but at a slower pace than in 2017 and the numbers are still insufficient to dent the first time buyer shortfall of the past decade.

- **House movers constrained by affordability concerns.** While first time buyer numbers have recovered, albeit not as vigorously as might have been hoped, moves by existing homeowners have been weaker. From a peak of 887,000 in 2004, mortgaged home moves have failed to reach 400,000 in any year since 2007 and fell by an estimated 1% to c.370,000 in 2018. Owner-occupier households are now moving only once every 19.3 years on average compared to once every 7.4 years when housing transactions peaked back in 1988. Although low mortgage rates support borrower affordability, high house prices and regulatory constraints on lending such as the requirement to stress the interest rate to determine affordability, make it harder for borrowers to move up the housing ladder.

- **Product transfers far more popular than remortgages.** With UK Finance publishing mortgage product transfer numbers (where borrowers switch deal with the same lender) for the first time in 2018, we now know that more than twice as many borrowers are taking product transfers as remortgages. If it is sustained, the rise in popularity of product transfers and longer term fixed rate mortgages (5 to 10 years) that lenders report could lead to a slight reduction in remortgage activity over the next few years.

- **Mortgage lender profitability being squeezed.** The last 5 years has seen increased competition in the mortgage market with 23 new lenders and higher lending volume targets from many incumbent lenders. Consumers have benefitted from the resulting reduction in mortgage spreads, particularly at higher LTVs, which have more than offset the 0.5% increase in Bank Rate at 90% and 95% LTV. But with lenders having to hold more capital against mortgages as a result of the changes to the Basel regime it may be that mortgage spreads cannot go much lower.

1. Introduction

1.1 An ageing mortgage recovery

This report is the sixth in the Intermediary Mortgage Lenders Association (IMLA) annual series entitled *the new 'normal'*. Over this period we have witnessed a healthy recovery in mortgage volumes that started back in 2010 but we have stressed that much like the broader economic recovery, the mortgage market upturn has fallen short by the standards of previously recoveries.

The mortgage market has been constrained not only by the weakness of the macroeconomic recovery, with for example real wages still 6% below their 2008 peak, but also by a more cautious approach from lenders and in particular the creation of a framework of regulation that has dampened activity and inhibited the natural rebound in lending that has characterised past upswings.

Evidence of the detrimental impact of this new normal in the housing market is not hard to find. IMLA estimates that by the end of 2018 more than 2.4 million people who would have been expected to buy their first home based on past trends have failed to do so since the financial crisis despite government attempts to support first time buyers through the Help-to-Buy scheme and reduced stamp duty. As well as swelling the ranks of private renters, many of these people are living with parents - Labour Force Survey data shows that between 2003 and 2017 the number of 20 to 34-year-olds living with their parents increased by 1 million, from 2.4 million to 3.4 million. Broader liquidity in the housing market also remains depressed, with the average homeowner moving only once every 19.3 years against a low of 7.4 in 1988 and 13.5 as recently as 2007. Housing transaction levels have plateaued since 2014 with a slight downturn in 2018.

With heightened political uncertainty (see Section 1.2 below), adding to the caution about moving felt by homeowners and buy-to-let investors scaling back the level of investment they are committing, there is little impetus to push mortgage lending for purchase higher at present. As IMLA stated in its paper '*Approaching the limits to lending growth?'* (April 2018), a lack of growth in housing transactions is a key factor keeping the growth in the stock of mortgage debt down. Growth peaked at 3.5% in 2017 and has since fallen to 3%, which is broadly in line with earnings growth.

When looking at gross lending levels remortgage activity has sustained the upturn trend in recent years but remortgage volumes may plateau or fall slightly in the coming years as the recent popularity of 5 year fixed rate deals reduces future market 'churn'. Lenders have also made it easier for customers to take a product transfer through streamlined online application processes and have started offering brokers procuration fees on product transfers, with the potential to displace some remortgage activity.

One of the great unknowns is whether the 'missing' first time buyers of the past decade will start to swell the ranks of future first time buyers adding new life to the

market or whether many have become permanently excluded. Unfortunately, evidence we presented in last year's report suggests that many will have been locked out of the market completely unless we can shift from the current market paradigm.

Table 1 – Net number of people entering owner-occupation

Age	1996-2006	2006-2016
16-34	2,961,000	1,854,000
35-54	449,000	- 191,000
55 plus	- 1,690,000	- 1,947,000
Total	1,720,000	- 284,000

Source: House of Commons Library

As Table 1 illustrates, while 450,000 35-54 year olds entered owner-occupation between 1996 and 2006 in net terms, amongst the following cohort of 35-54 years olds between 2006 and 2016, owner-occupation actually fell by 190,000. Moreover, people born between 1962 and 1971, who were aged between 35 and 44 in 2006 saw homeownership rates decline by 2016, when they were 45-54 years old, from 71.2% to 69.4%. This evidence suggests that there is currently no discernable 'catching up' effect where households who missed out on buying up until their mid-forties are able to get onto the housing ladder later on.

1.2 Political uncertainty

The UK faces an unusual degree of uncertainty because of the Brexit process. Although some of the projections based on a 'no deal' Brexit look overwrought, the UK's growth rate has slowed since the referendum in mid-2016, led by a contraction in business investment. The final shape of the Brexit deal is still unclear but it does have the potential to improve business confidence if it allows trade with the EU to continue without tariffs and customs administration.

If, however, it becomes clear that the deal will involve new frictions in cross channel trade, business investment could weaken further in the short term. But even under this scenario the negative impact on the economy may prove to be a good deal less severe than some predictions. If there is no agreement by 29 March the UK will still leave the EU, potentially causing considerable short term disruption, but this outcome should be given a low probability given that both sides can agree an extension of the two year Article 50 period in the event that they cannot conclude a withdrawal agreement before 29 March and the UK can unilaterally revoke Article 50 if necessary.

What effect is this uncertainty likely to have on the mortgage market? The most significant channel is via the housing market. When consumers are uncertain about their prospects they are less likely to commit to a major purchase such a house. For the 3 million EU nationals living in the UK the uncertainty is much more direct, no doubt impacting their housing decisions. Some landlords have faced lower tenant demand as net immigration from the EU has fallen, although the latest immigration data suggest that non-EU immigration is offsetting this decline. All this points to a

period of subdued housing turnover and mortgage lending for house purchase until the time that our future relationship with the EU becomes clearer.

Once an agreement is reached on the future relationship with the EU, the trajectory for the housing and mortgage markets will be determined by the broader economic response. In the short term, a deal that minimizes trade frictions would be likely to produce the most positive outcome but the impacts on the housing market could be quite modest. If the UK leaves the EU without a deal, as well as the economic dislocation, there could be disruption to wholesale funding markets such as securitisation which could limit the supply of mortgage credit. But again, this outcome is unlikely.

We know from the market's response to the referendum result in mid-2016 that political events can have quite a limited effect on consumer behaviour unless people feel a direct threat to their livelihoods. We would therefore conclude that the Brexit process has had little effect on the housing and mortgage markets to date and may continue to have only a limited impact as Brexit comes to a conclusion. Nonetheless, at the margin Brexit has been and remains for the time being another negative factor constraining activity.

2. The mortgage market outlook for 2019 and 2020

2.1 Background environment in 2019 and 2020

Table 2 outlines our projections for key assumptions behind our mortgage market forecast. We expect the UK recovery to continue through 2019 and 2020, but at a slightly slower pace than previously expected, partly engendered by the uncertainty surrounding the Brexit process. We have assumed that the UK negotiates an Article 50 extension to negotiate a withdrawal agreement. In the event that the UK holds a second referendum and votes to remain in the EU, growth could be slightly higher.

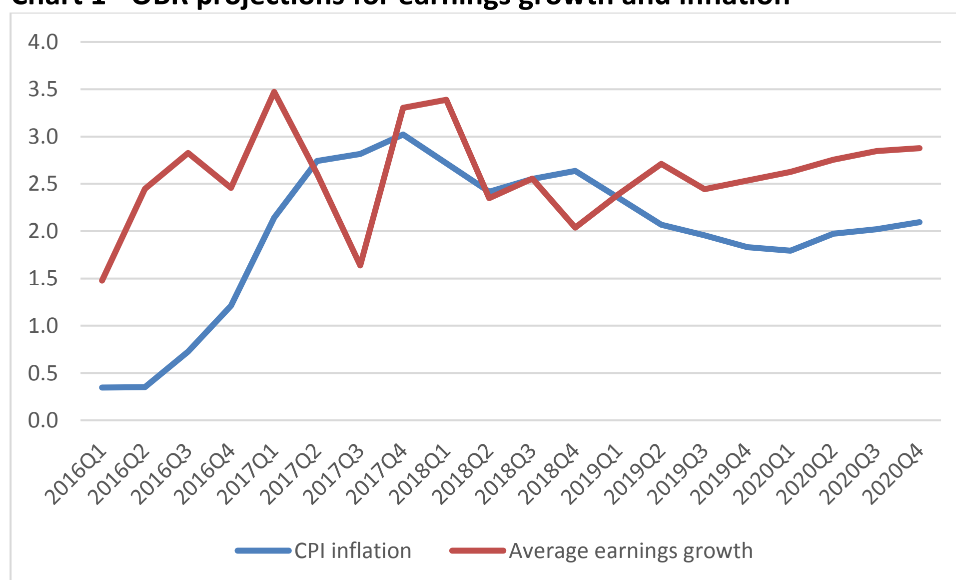
Table 2 – key forecast assumptions

	Past values		Forecast values		Percentage changes		
	2017	2018e	2019f	2020f	2018/17	2019/18f	2020/19f
GDP (£bn)	2,005	2,032	2,062	2,095	1.3%	1.5%	1.6%
Unemployment (Q4)	4.4%	4.1%	4.0%	4.0%	-6.8%	-2.4%	0.0%
House prices (average for year)	221,244	228,603	233,000	236,000	3.3%	1.9%	1.3%
Housing transactions (UK, thousands)	1,220	1,195	1,180	1,180	-2.1%	-1.2%	0.0%
Bank Rate (end of year)	0.50%	0.75%	1.00%	1.00%	50.0%	33.3%	0.0%

Source: IMLA, ONS and HMRC

Although the current economic recovery is quite long by historical standards, it has been unusually weak, suggesting that the forces that normally bring a recovery to an end (typically a monetary policy response to an overheating economy) may still be some years off. One factor holding the economy back has been weak wage growth but the latest data suggest that earnings growth is now comfortably outstripping inflation. But the low GDP growth we are forecasting suggests that the gap between potential and actual output will not be shrinking, which should contain inflationary pressures.

Chart 1 - OBR projections for earnings growth and inflation



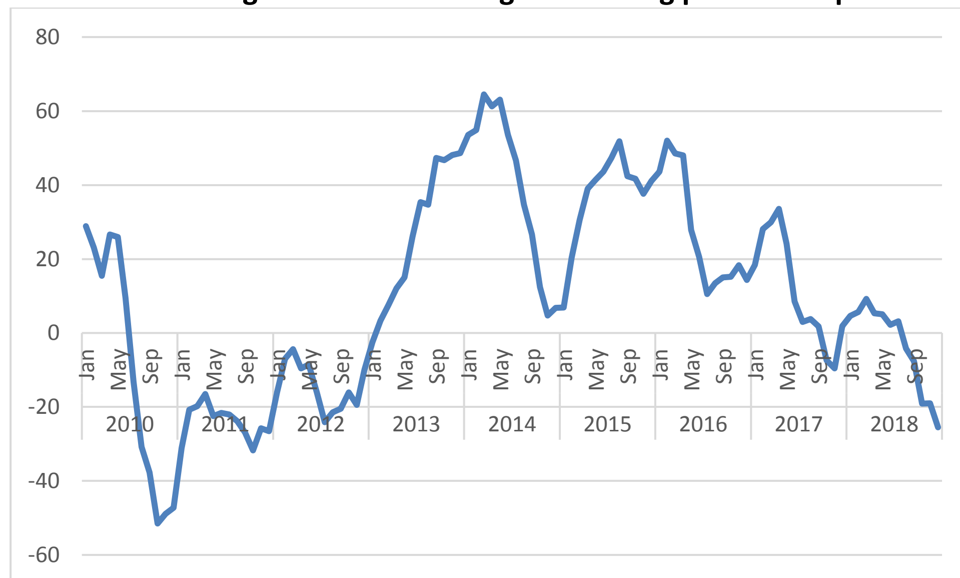
Source: OBR October 2018 forecast

Chart 1 shows the Office for Budget Responsibility (OBR) forecasts for CPI inflation and earnings growth. The OBR expects inflation to remain close to the Bank of England's 2% target with wages rising comfortably faster throughout our forecast period. However, the Bank of England has a slightly higher inflation forecast, with CPI inflation not returning to its 2% target over the next 2 years, suggesting that the Monetary Policy Committee (MPC) may still feel empowered to raise Bank Rate to 1%. In the August Inflation Report the Bank stated: 'even as inflation is projected to fall back towards 2% — Bank Rate is likely to need to rise gradually in order to keep inflation at the target. But…any rises in Bank Rate are expected to be limited'.

2.2 Impact on UK housing market

This stable economic environment of low unemployment, interest rates and inflation and rising real wages would normally be considered ideal for the housing market. But house price growth has been slowing since 2016 and housing transactions actually fell slightly in 2018. The RICS survey for December 2018 showed a continuation of this deteriorating trend with a balance of 26% of estate agents reporting that house prices fell in the previous three months (see Chart 2). It also reported a further slide in both supply and demand with a balance of estate agents expecting both prices and sales to fall over the following three months. Brexit uncertainty is having some impact but the current malaise of low activity in the housing market is more a function of affordability pressures and underlying demographic forces with older homeowners sitting tight.

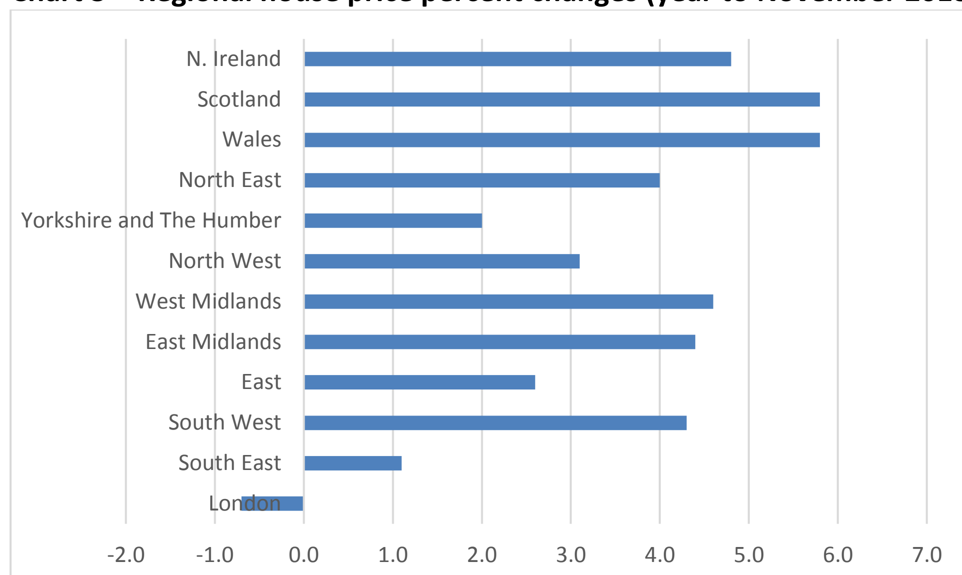
Chart 2 – Estate agents' view of change in housing prices over previous 3 months



Source: RICS

Turning to the regional picture, London's housing market has been weak since the summer of 2017, with the Southeast faring a little better. As Chart 3 shows, elsewhere the picture is brighter, with the best performing regions being outside southern England, where affordability is not as constrained.

Chart 3 – Regional house price percent changes (year to November 2018)



Source: ONS

Over the past few years consumers have benefitted from falling mortgage margins, which has meant that despite two 0.25% rises in Bank Rate, 90% and 95% LTV loans have never been cheaper. However, the decline in margins on low LTV loans may have played itself out as the spread over Libor is now below 1% and may not be able to fall much further. Also, lower mortgage rates may not have had as much impact on the market as in the past as regulatory requirements now force lenders to assess affordability on an interest rate 3% above the reversionary rate where the loan is not fixed for 5 years, far higher than the rates on offer.

Based on these trends we see a period of stability for the housing market during 2019 and 2020. We forecast that house prices will average £233,000 over 2019, only 2% above their average of 2018, but this is mainly due to the growth of prices during 2018. Over the course of 2019 and 2020 we expect house price growth nationally of little more than 1% a year. At a regional level we expect the pattern of the last two years to be maintained in 2019 and 2020, with London experiencing modest price falls and the strongest price gains to be found outside southern England, where prices lagged over most of the current decade.

Similarly, we expect housing transactions to remain flat during 2019 and 2020 at 1,180,000 a year, slightly below 2018's total, reflecting both demographic factors (with more older homeowners who move less frequently) and the constraints imposed by mortgage regulation. Combining our forecasts for house prices and transactions suggests that the aggregate value of housing transactions in the UK will be up less than 1% this year and slightly more than 1% in 2020.

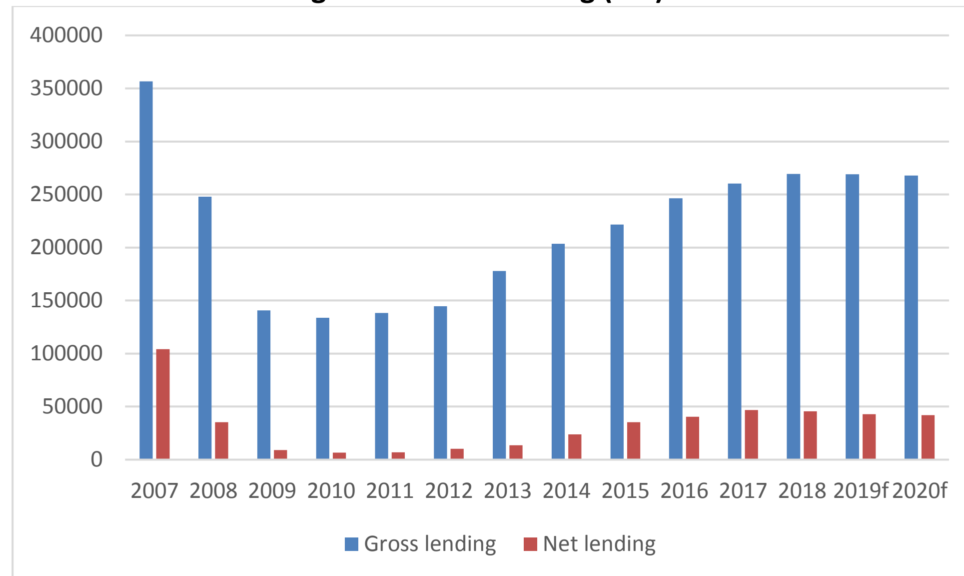
2.3 Outturn relative to previous year's forecast

In last year's report IMLA forecast gross mortgage lending of £265 billion and net lending of £47 billion for 2017. 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 outturn was £269 billion and £45 billion respectively.

2.4 Mortgage market forecast

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



Source: Bank of England and IMLA

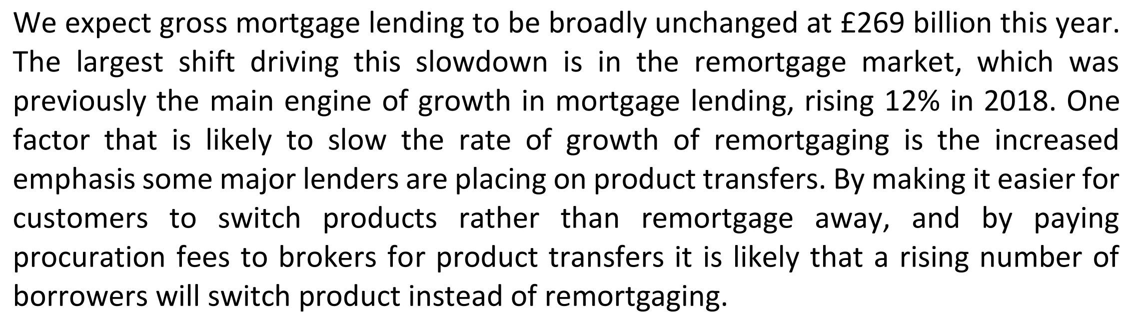
Given the flat picture in the housing market and the underlying shift from remortgage activity to product transfers we expect the rise in gross mortgage lending seen since 2010 to stall in 2019 with a slight dip in 2020. With a flat forecast for gross lending and lower transactions levels we expect net lending to fall in both 2019 and 2020. The net lending we are forecasting implies that the total stock of mortgage debt will rise by around 3% in 2019 and 2020, broadly in line with earnings growth.

Table 3 – Mortgage market forecast

	Gross mortgage lending (£m)				Percentage changes		
	2017	2018e	2019f	2020f	2018/17e	2019/18f	2020/19f
House purchase	158,149	157,125	156,000	157,000	-0.6%	-0.7%	0.6%
Remortgage	90,056	101,045	102,000	100,000	12.2%	0.9%	-2.0%
Other	12,205	11,082	11,000	11,000	-9.2%	-0.7%	0.0%
Total	260,410	269,252	269,000	268,000	3.4%	-0.1%	-0.4%
of which:							
Buy-to-let lending	35,800	37,300	36,000	35,000	4.2%	-3.5%	-2.8%
of which for house purchase	10,600	9,000	8,500	8,500	-15.1%	-5.6%	0.0%
Buy-to-let share of total	13.7%	13.9%	13.4%	13.1%	0.8%	-3.4%	-2.4%
Lending via intermediaries*	153,300	166,000	169,000	171,000	8.3%	1.8%	1.2%
Share of total*	71.6%	74.3%	74.8%	75.7%	3.7%	0.6%	1.2%
Net lending	46,663	45,456	43,000	42,000	-2.6%	-5.4%	-2.3%

* Regulated loans only

Source: IMLA, Bank of England, UK Finance


We expect gross mortgage lending to be broadly unchanged at £269 billion this year. The largest shift driving this slowdown is in the remortgage market, which was previously the main engine of growth in mortgage lending, rising 12% in 2018. One factor that is likely to slow the rate of growth of remortgaging is the increased emphasis some major lenders are placing on product transfers. By making it easier for customers to switch products rather than remortgage away, and by paying procuration fees to brokers for product transfers it is likely that a rising number of borrowers will switch product instead of remortgaging.

We now know that in the first three quarters of 2018 product transfers totalled £114 billion, already far outstripping remortgage volumes (see Section 3 for a fuller discussion of product transfers). Although we are not providing a forecast for product transfers for 2019 and 2020 because of the lack of data showing past trends, we do expect them to increase.

We expect the trend in intermediaries' share of regulated mortgage lending to continue its recent gradual upward trajectory. In 2019, we expect intermediaries to support £169 billion of lending, just under 75% of the total, and £171 billion in 2020, slightly under 76% of total projected regulated lending that year (see Table 3) and the highest share on record.

One segment of the mortgage market which showed continued strong growth in 2018 was lifetime mortgages. For the year as a whole, equity released reached £3.94 billion, 29% above 2017's level. We expect this niche to continue to grow robustly over the next two years and beyond, reflecting the growth in the number of older households with a combination of high housing wealth and disappointing retirement income, in part a reflection of the gradual transition from defined benefit to defined contribution pensions.

2.5 Buy-to-let mortgage market forecast

The buy-to-let mortgage market was stronger in 2018 than many had expected with gross lending reaching an estimated £37 billion, in line with IMLA's prediction for the year. However, the market was buoyed by a 12.5% increase in remortgage activity and since remortgaging represents over 70% of buy-to-let gross lending, this was more than enough to offset weaker house purchase lending, which fell 15% to £9 billion, following a 29% fall the previous year.

We do not expect the stronger performance of 2018 to be repeated in 2019 (see Table 4). We forecast that total buy-to-let lending will fall 3.5% this year to £36 billion with both house purchase and remortgage volumes in decline (see Section 2.6 for a discussion of the expected fall in remortgage volumes). In 2020, we expect the decline in buy-to-let lending to continue, with a further fall in remortgage activity although we think that lending for house purchase will stabilise at around £8.5 billion as some portfolio landlords take the opportunity to buy from smaller landlords exiting the market due to rising taxes and regulation.

Table 4 – Buy-to-let and wider mortgage market forecasts compared

	2017	2018e	2019f	2020f	Percentage changes 2018/17	2019/18f	2020/19f
Whole market							
Outstanding debt (£bn)	1,370	1,411	1,454	1,496	3.0%	3.0%	2.9%
House purchase lending (£m)	158,149	157,125	156,000	157,000	-0.6%	-0.7%	0.6%
House purchase % churn	11.7%	11.3%	10.9%	10.6%	-3.7%	-3.6%	-2.3%
Remortgage	90,056	101,045	102,000	100,000	12.2%	0.9%	-2.0%
Remortgage % churn	6.7%	7.3%	7.1%	6.8%	8.7%	-2.0%	-4.8%
Total % churn	19.3%	19.4%	18.8%	18.2%	0.2%	-3.0%	-3.2%
Buy-to-let market							
Outstanding debt (£m)	236,200	240,000	242,000	244,000	1.6%	0.8%	0.8%
House purchase lending (£m)	10,600	9,000	8,500	8,500	-15.1%	-5.6%	0.0%
House purchase % churn	4.6%	3.8%	3.5%	3.5%	-17.1%	-6.7%	-0.8%
Remortgage	24,350	27,330	26,500	25,500	12.2%	-3.0%	-3.8%
Remortgage % churn	10.5%	11.5%	11.0%	10.5%	9.5%	-4.2%	-4.6%
Total % churn	15.4%	15.7%	14.9%	14.4%	1.7%	-4.6%	-3.6%
Buy-to-let % of total market							
Outstanding debt	17.2%	17.0%	16.6%	16.3%	-1.3%	-2.1%	-2.0%
House purchase lending	6.7%	5.7%	5.4%	5.4%	-14.5%	-4.9%	-0.6%
Remortgage	27.0%	27.0%	26.0%	25.5%	0.0%	-3.9%	-1.8%
Total lending	13.7%	13.9%	13.4%	13.1%	0.8%	-3.4%	-2.4%

Source: Bank of England, UK Finance and IMLA

The most significant issues facing buy-to-let at present are the adverse tax changes that have been announced since 2015, changes to the regulation of buy-to-let mortgages and changes to the regulations covering rented properties. The most important tax changes are the imposition of a 3% stamp duty surcharge and the restriction of the mortgage interest deduction to the basic rate of tax, which is being phased in until 2020-21.

In 2017, the Prudential Regulatory Authority (PRA) introduced tighter rules covering affordability assessments for buy-to-let landlords and the requirement that lenders employ a specialist underwriting process for portfolio landlords. The most significant changes to regulation of the private rented sector (PRS) itself were the changes to housing in multiple occupation (HMO) rules enacted in 2018, mandatory registration and a new standard tenancy in Scotland and the increased use of selective licencing powers by local authorities in England. The roll-out of Universal Credit has also led to higher arrears for many landlords catering to tenants receiving benefits. According to the Residential Landlords Association, 61% of landlords with tenants on Universal Credit have seen them go into rent arrears, up from 27% in 2016, with the average level of arrears up 49%.

For a minority of landlords, these changes represent a 'perfect storm'. With PRS regulation raising costs and higher rate tax payers facing higher tax demands, some landlords will have little choice but to reduce the size of their portfolios. For others the changes represent enough of a shift in the relative balance of benefits and disadvantages that they have crystallised a decision to sell one or more properties.

Estate agents report that the number of landlords selling has increased markedly since 2015. This number is not a flood and clearly some landlords are taking advantage of sales to selectively increase their portfolios but the restriction of the mortgage interest tax deduction has not fully come into effect and when it does there is a concern that more unincorporated landlords may decide to sell.

The impact on landlord purchases however, is already clear. In 2018, buy-to-let landlords purchased an estimated 66,000 properties, 44% down on the 117,500 figure recorded in 2015. Our forecast for house purchase lending is consistent with 59,000 and 58,000 individual house purchase transactions in 2019 and 2020 respectively, suggesting that landlord purchases will have halved since 2015. The combined effect of higher sales and much lower purchases is that the PRS and buy-to-let sectors appear to have ceased growing. Government data show that the PRS shrank by 65,000 in 2017 in England while UK Finance reports that the number of buy-to-let mortgages declined by 7,000 in Q3 2018.

So it is clear that, as a result of the tax and regulatory pressures on landlords, net new investment in the PRS has effectively stalled. This is reflected in our forecast (see Table 4), which shows the stock of buy-to-let mortgage debt increasing by only 0.8% in 2019 and 2020, below the rate of inflation.

2.6 Buy-to-let remortgages

The Buy-to-let remortgage market requires some discussion in its own right as it comprised more than 70% of buy-to-let lending in 2018 and showed strong growth in contrast to house purchase lending. We expect a reversal of the growth seen in 2018 for several reasons.

Firstly, many lenders have introduced competitive product transfers in the buy-to-let market and offer procuration fees for intermediaries on product switches. Secondly, 5 year fixed rate mortgages have been particularly popular with landlords in recent years, reducing the frequency with which these borrowers will want to remortgage. And finally, the new PRA rules on lending to portfolio landlords, which were introduced in September 2017, are making it more difficult for some portfolio landlords to remortgage their loans. As a result, we see buy-to-let remortgage volumes falling from an estimated £27.3 billion in 2018 to £26.5 billion in 2019 and £25.5 billion in 2020.

3. Product transfers and remortgages

3.1 The headline numbers

For the first time, during 2018 UK Finance released data on product transfers (where mortgage borrowers switch from one product to another with the same lender). Table 5 shows the reported level of product transfers in 2018 and compares it to remortgage figures (all data excluding buy-to-let loans). No data is available for product transfers prior to 2018.

Table 5 – Product transfers and remortgages

	PRODUCT TRANSFERS			REMORTGAGES		
	Number	Value (£bn)	Average loan size	Number	Value (£bn)	Average loan size
Q1 2018	297,900	38.8	130,245	115,900	20.3	175,151
Q2 2018	275,200	36.0	130,814	113,700	20.5	180,299
Q3 2018	291,900	38.7	132,580	121,900	22.1	181,296
Total	865,000	113.5	131,214	351,500	62.9	178,947

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

Over the first three quarters of 2018 product transfers were running at an annual rate of 1.15 million with a value of £151 billion. This is 80% more than the level of remortgages in value terms and more than twice the level of remortgages in terms of the number of loans, despite the fact that remortgages have been running at their highest level since 2008. Indeed, £151 billion is equal to 58% of total mortgage lending over the same period.

Because UK Finance has not been able to produce historical data we do not know the trend prior to 2018 but lenders report that product transfers have been growing in popularity. There are a number of reasons for this. One is that, while it has always been easier for a customer to enter into a product transfer than a remortgage because switching from one lender to another involves a legal process and often a physical valuation, it has become even easier to undertake a product transfer since a number of lenders have started to streamline the process using digital technology.

Another factor in the reported growth in product transfers is the decision of many lenders to start paying brokers a procuration fee when the broker recommends that a customer takes a new deal from their existing lender rather than a remortgage. Although UK Finance provides no breakdown of whether the product transfer was arranged by a broker or the lender itself, it does provide a breakdown between advised and execution only sales. While all the execution only sales are provided by lenders a sizeable share of advised product transfers are made through brokers as some lenders do not offer advice on product transfers.

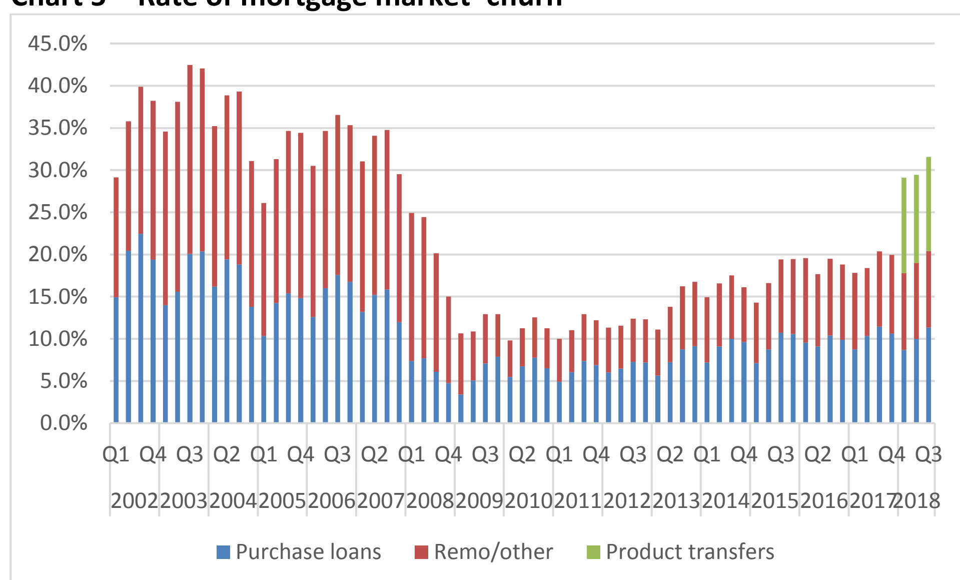
One surprising feature of product transfers is the relatively small average loan size (around £131,000) compared to remortgage cases (£179,000). The most likely explanation of this difference is that product transfers do not usually come with an

initial charge whereas most remortgage deals do. If a remortgage deal carries a £1,000 charge with a more competitive interest rate thereafter, customers with larger mortgages will find it worthwhile remortgaging while those with smaller balances may find the product transfer better value.

3.2 The new view of the overall mortgage market

Now that we have product transfer data we can view the broader mortgage market in a new light but the lack of historical data makes it difficult to establish trends. One fact is clear however: despite lenders' view that product transfer volumes have increased in recent years when you add product transfers to other mortgage lending and compare it to the stock of outstanding mortgage debt, you find that total churn is well below its early 2000s peak (see Chart 5), running at around 32%. In the second half of 2003, churn peaked at over 40% excluding product transfers.

Chart 5 – Rate of mortgage market 'churn'



Source: UK Finance

So we know that the average mortgage borrower is changing loan every three years today against every 2½ years, even excluding product transfers, in 2003. It seems that churn rates have increased a great deal since the financial crisis in 2008-9 when mortgage availability was constrained, but not to the level seen in the pre-crisis era. What accounts for churn rates failing to reach their previous level?

The lower rate of house moves is one factor that is evident from Chart 5. The number of house moves is some 30% below its pre-crisis level. Another factor is the rising popularity of longer term fixed rate mortgages, particularly 5 year fixed deals and in addition, a sizeable number of customers remain on pre-crisis deals that are still competitive, particularly those with Bank Rate trackers at thin spreads over Bank Rate. So rates of churn today suggest a healthy market with a high degree of competition but not a return to the type of market seen in the pre-crisis period.

3.3 Product transfers and advice

As well as providing total volumes, UK Finance has provided a breakdown of product transfers between advised and execution only sales (see Table 6). During the first three quarters of 2018 it reported that 48% of product transfers were execution only, far higher than the proportion of remortgages that are execution only. This reflects the importance of direct to consumer offers from lenders, increasingly supported by digital technology that minimises the time required to complete a product transfer, although some lenders require customers to take advice when entering into a product transfer. At 412,600, there were more execution only product transfers over this period than total remortgages, which numbered 352,000, highlighting the success lenders have had in building this channel.

Table 6 – Advised and execution only product transfers

	ADVISED		**EXECUTION ONLY**	
	Number	**Value (£bn)**	**Number**	**Value (£bn)**
Q1 2018	149,700	19.9	148,100	18.9
Q2 2018	145,700	19.7	129,500	16.3
Q3 2018	156,900	21.4	135,000	17.3
	452,300	61.0	412,600	52.5

Source: UK Finance

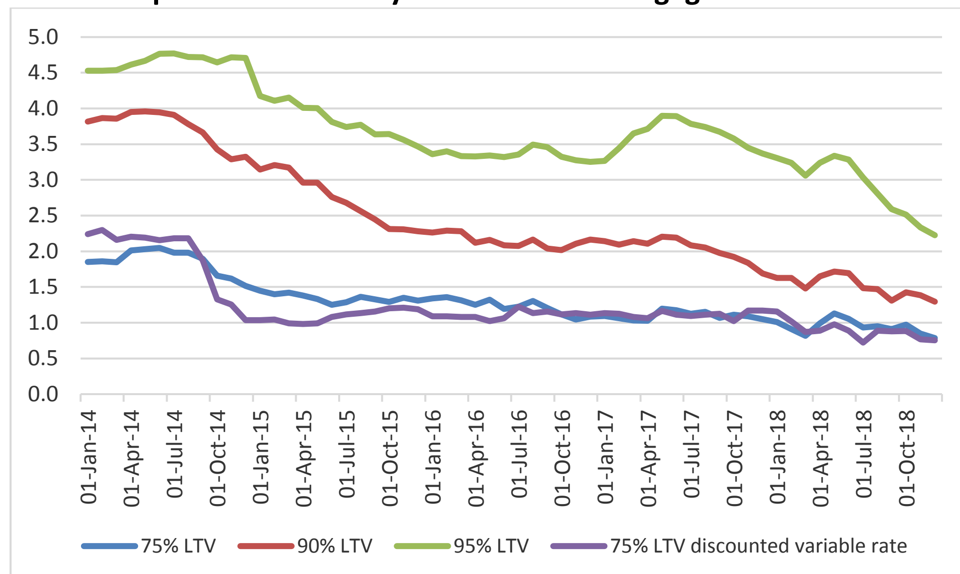
Despite the popularity of execution only product transfers the number of advised product transfers was even larger at 452,300 with a total value of £61 billion (an annual rate of £81 billion, almost as high as total remortgaging). While all the execution only product transfers were undertaken by lenders a sizeable share of these advised switches will have been conducted by intermediaries and now that many lenders are paying brokers for product transfers it is likely that they will continue to figure heavily in the market going forward.

4. Profitability of mortgage lending

4.1 Mortgage spreads

A key guide to lender profitability is provided by the spread between mortgage rates and funding costs. This also provides an indication of the relative strength of supply and demand for mortgage credit as falling spreads implies that the supply of credit is expanding faster than demand for it.

Chart 6 – Spread between 2-year fixed rate mortgage and 3 month Libor



Source: Bank of England

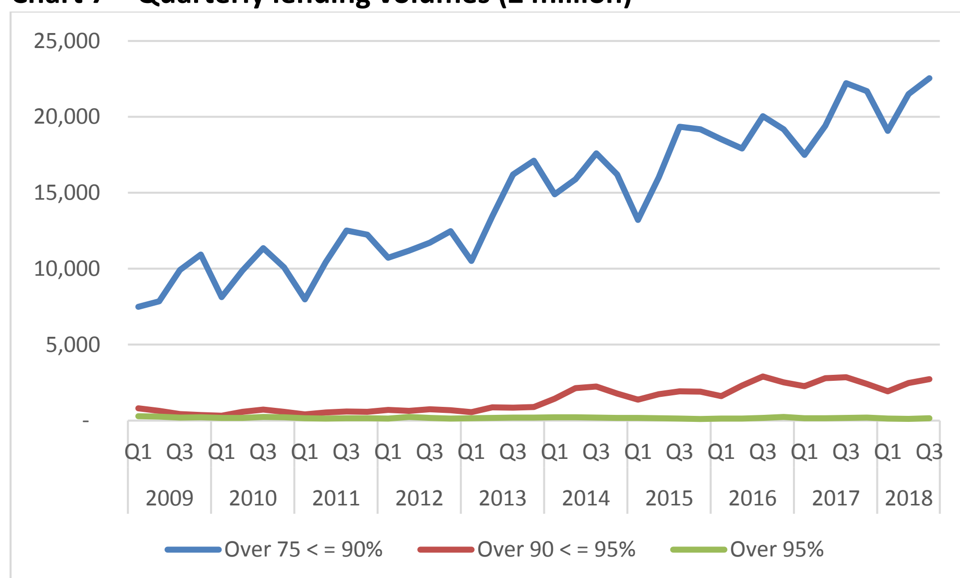
Chart 6 shows the spread between average new 2 year fixed rate mortgages at 75%, 90% and 95% LTV and 75% discounted variable rate loans against 3 month Libor. This shows that there has been a broad downward trend in mortgage lenders' spreads over the past five years, the most significant exception to which was the spike in spreads on 95% LTV loans after the termination of the Help-to-Buy guarantee scheme at the end of 2016.

However, it is worth noting that spreads on 75% LTV discounted variable rate loans have been much flatter since the end of 2014, falling only from 1.0% to 0.8%. There is probably limited room for further falls in spreads in prime low LTV mortgage lending given the need to meet origination, administration and capital costs and the impact of the changes to the Basel regime over recent years, which has increased the amount of capital lenders must hold against mortgage assets.

Narrow spreads in low LTV lending has encouraged lenders to look to higher LTV lending to maintain profitability. This has led to a much larger fall in spreads at 90% and especially 95% LTV lending, as seen in Chart 6. 2018 saw a particularly sharp fall in 95% LTV spreads from 3.4% to 2.2%.

However, as Chart 7 shows, while there has been a sustained increase in lending over 75% and up to 90% LTV, lending above 90% LTV remains very subdued, not surpassing 5% of total lending in any quarter since the financial crisis. This indicates that lenders have increased their risk appetite in a controlled manner, remaining very cautious when lending above 90% LTV, which limits their ability to offset margin compression in lower LTV lending.

Chart 7 – Quarterly lending volumes (£ million)



Source: FCA MLAR data

4.2 Marginal cost of mortgage borrowing

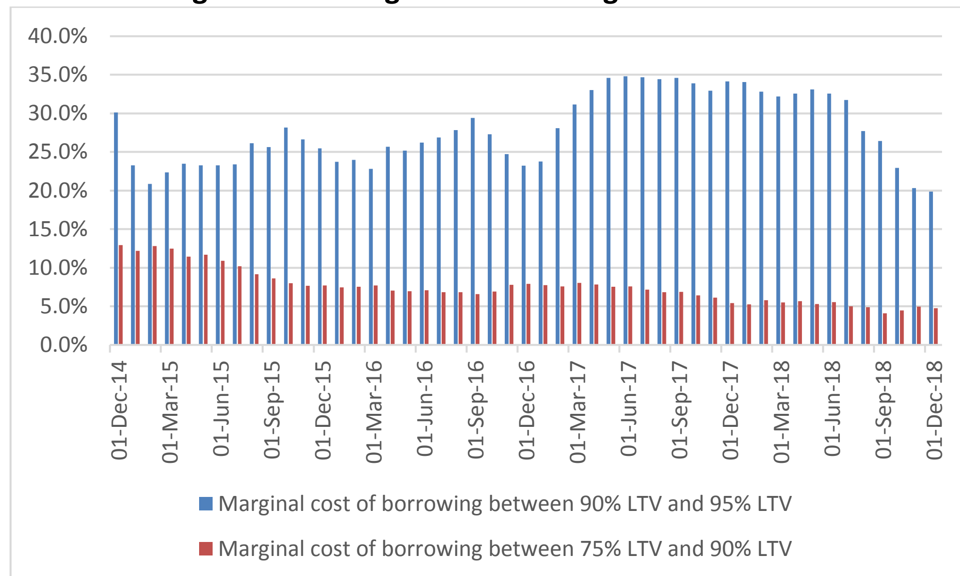
Another way of looking at mortgage margins and lenders' risk appetite is to calculate the marginal cost of the average loan on offer at different LTV bands. Chart 8 shows that, over the course of 2018, lenders reduced the marginal cost of new mortgage loans both between 75% LTV and 90% LTV loans (the red bars) and between 90% LTV and 95% LTV loans (the blue bars). The decline in the marginal cost of loans between 90% and 95% LTV was particularly steep, falling from 34% at the end of 2017 to 20% by the end of 2018.

As well as being a function of increased competition in the prime market, this apparent increase in risk appetite is partly the result of the rise in the number of lenders, with 23 new lenders entering the market in the last 5 years, and an increase in the lending targets of incumbent lenders. One factor that may explain some of the rise in lending targets amongst existing lenders is the introduction of bank ring-fencing, which took effect on 1 January 2019, and is expected to leave a significant amount of capital in core banks that needs to be deployed in conventional activities such as mortgage lending.

The falling marginal cost of high LTV lending may also reflect the strong credit performance of high LTV business written since the financial crisis and the introduction of the MMR. With tighter affordability requirements and lenders still

adopting a cautious approach to credit risk, the loans that have been advanced at higher LTVs over the past 5 years show exceptionally low arrears by historical standards, which is likely to have impacted assumed future loss rates on such business.

Chart 8 – Marginal cost of high LTV borrowing

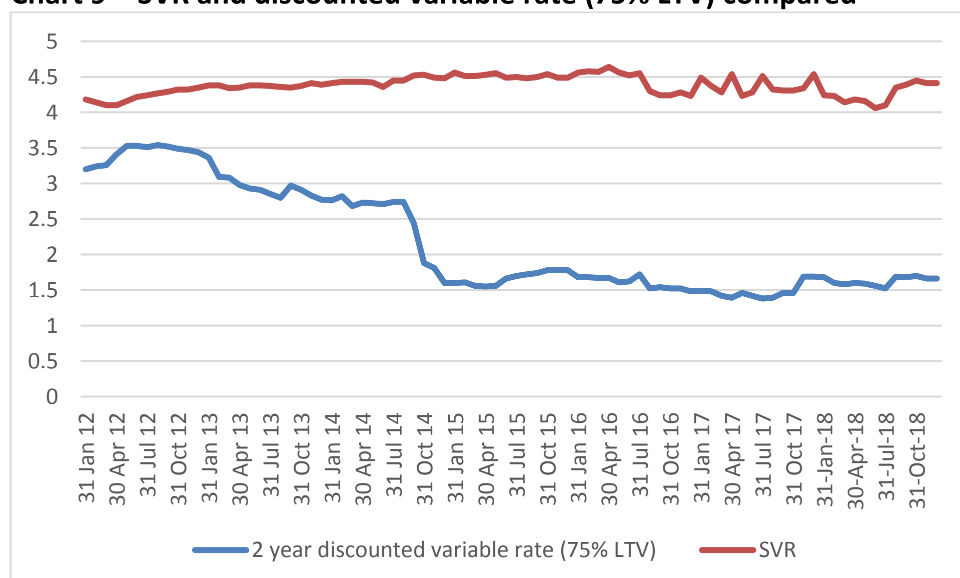


Source: Bank of England

4.3 Front book, back book pricing differential

We can also assess the extent of competition for new business by looking at trends in the front book/back book pricing differential. Chart 9 compares the average 2 year discounted variable rate available on new loans with the average standard variable rate (SVR) paid by customers on the 'back book', as this shows the extent to which lenders are actively seeking new business.

Chart 9 – SVR and discounted variable rate (75% LTV) compared



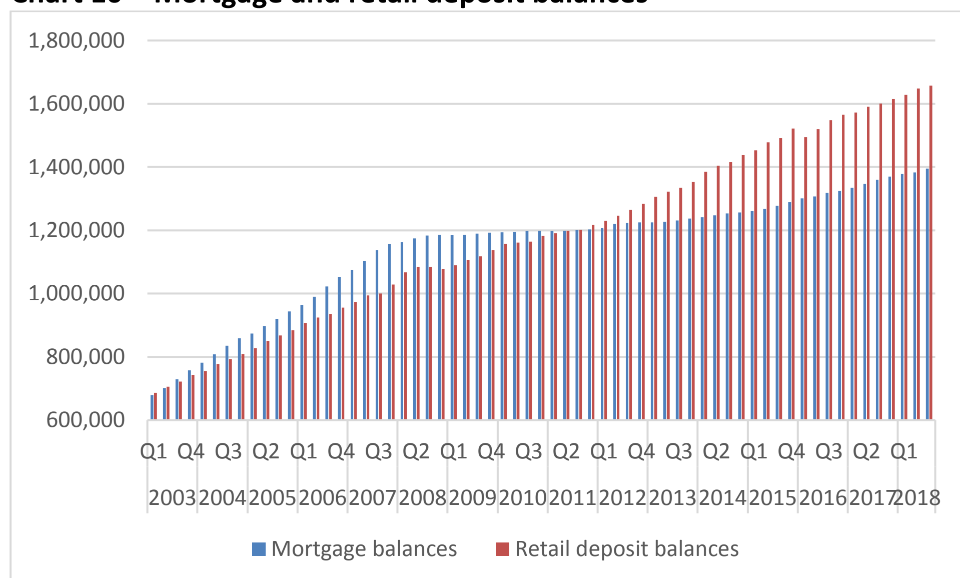
Source: Bank of England

The differential between the two rates soared in 2014 and 2015 and has remained at a record of close to 3 percentage points since. While lenders passed on the full 0.25% rise in Bank Rate in August this year on their SVRs, the rise in new 2 year fixed rates was substantially less, again reinforcing the extent to which competition for new business is constraining lenders' pricing.

4.4 Net interest margins

Mortgage spreads do not tell the whole story of lender margins however, because they do not take account of shifts in average funding costs against Libor. For example, most banks and building societies fund a substantial proportion of their mortgage business from retail deposits and rates on retail deposits can vary significantly from Libor.

Chart 10 – Mortgage and retail deposit balances



Source: Bank of England

What is clear from Chart 10 is that retail deposit balances at UK lenders have grown much faster than mortgage balances since 2007. This trend continued in 2018, as the stock of retail deposits grew by 3.9%, roughly 1 percentage point faster than the growth in mortgage balances. So those lenders that can access retail deposits are under less pressure to raise rates to savers enabling them to offer competitively priced mortgage products. The same deposit taking lenders also have access to the Bank of England Term Funding Scheme (TFS) which has provided cheap four year loans to banks and building societies to encourage lending to the real economy. The TFS ceased providing new loans in February 2018 but banks still benefit from cheap TFS funds on their balance sheets, which allow them to keep mortgage rates down, although much of this debt will mature in 2020 and 2021.

The net interest margin of the larger mortgage lenders seems to confirm that overall margins have been broadly maintained through managing the saving spread while the mortgage spread weakened. For example, Nationwide Building Society reported that

in the year to 4 April 2018 its net interest margin fell to 1.31% against 1.33% in the previous year, citing pricing pressures in the mortgage market for the fall.

5. Conclusion

Throughout the series of papers entitled *the new normal* IMLA has emphasised the fact that the UK mortgage market has undergone a structural change – we have had a robust recovery in lending volumes since the low of 2010 but in many respects the market is not functioning as one would expect it to. We have had record low mortgage rates yet aggregate LTV ratios are well below those of the pre-crisis era, a larger share of the funds used to purchase property come from cash and households are injecting equity into the housing stock, something that normally only occurs in recessionary periods.

These are all symptoms of a market that has failed to support first time buyers and those moving up the housing ladder in the way it did for previous generations. Tighter affordability criteria requiring lenders to use heavily stressed interest rates, limits on lending at higher loan-to-income ratios and higher capital requirements have come together to create a market that is constrained in its ability to help these groups of borrowers.

Ironically, it is a government initiative, the Help-to-Buy equity loan scheme, which best demonstrates how the current regulatory environment is failing young aspiring homeowners. Without the equity loan many of the borrowers using the scheme would either fail to meet current affordability requirements or fail to have a sufficient deposit. Yet lenders report that borrowers using the Help-to-Buy scheme have had an exemplary payment record. Now the recovery in the mortgage market is slowing it is a good time for regulators to reassess the costs and benefits of the present regulatory structure, recognising that the costs for those locked out of homeownership can be considerable and lasting.

Media contacts

For further information please contact:

- Rob Thomas, Director of Research, on 020 7427 1406
- Lee Jones and Andrea Borbely at Instinctif Partners, on 0207 427 1400 imla@instinctif.com

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 unites 42 banks, building societies and specialist lenders, including 16 of the top 20 UK mortgage lenders responsible for almost £180bn of annual 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.