The new 'normal' – prospects for 2021 and 2022

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Executive summary

The outlook

- **News that effective vaccines are being rolled out in scale provides the basis for optimism that 2021 will see a robust recovery despite the New Year lockdowns imposed across the UK.** After the worst annual economic performance since records began in 2020, as a result of measures to control the Covid-19 pandemic, we expect a 6% rise in GDP in 2021 with unemployment ending the year at 5.6%.

- **As interest rate sensitive sectors of the economy, housing and mortgages are beneficiaries of lower interest rates and accommodative monetary policy.** The government's economic policy response to Covid-19 has been unprecedented. One element of this: looser monetary policy, is already supporting a stronger housing market and this is set to continue during 2021 and 2022.

- **Economists have consistently underestimated the momentum in the housing market since lockdown ended.** Many forecasters still expect house prices to fall in 2021 and 2022 despite the prospect of a robust economic recovery coupled with stronger household incomes. We expect house prices to continue to rise even after the stamp duty holiday ends, based on a recovering economy and continued structural under-supply of housing.

- **We expect gross mortgage lending to rise to £283 billion this year.** We forecast that gross lending in 2021 will be 17.3% ahead of last year's level, with lending for house purchase being the main driver. We expect **net mortgage lending to rise 13.6% to £50 billion**, implying that the stock of mortgage debt will grow by 3.3%.

- **By late November only 127,000 borrowers were on payment deferrals.** The speed with which most borrowers came off mortgage payment deferrals and the continued fall in 3-6 month mortgage arrears in Q3 2020 supports our view that household finances generally remain robust.

- **Gross buy-to-let lending to reach £40 billion in 2021 and £41 billion in 2022.** The rate of growth in outstanding buy-to-let mortgage debt remained robust through 2020, and some landlords are taking advantage of the stamp duty holiday to expand their portfolios. This points to a reasonably strong performance in 2021 barring further major adverse tax changes.

- **Lending via intermediaries to fall back slightly from 2020's exceptional level.** Mortgage intermediaries coped well with the pandemic and there was a marked rise in their share of lending to an estimated 79% in 2020. As more normal conditions return, we expect the intermediary share to fall back marginally to 78% in 2021, before resuming its upward trend in 2022.

- In light of the strains that the recent lockdowns will impose on housing related professions, **IMLA is calling for an extension to the stamp duty holiday beyond**

31 March 2021 to ensure that buyers who anticipated transacting before the end of the holiday are not faced with an unexpected stamp duty bill.

- IMLA also welcomes the decision by the Financial Policy Committee (FPC) of the Bank of England, outlined in the minutes of its December meeting, to review the 3% stress applied to the reversionary rate in the affordability test and the 15% limit on the proportion of new mortgages extended at or above 4.5 times a borrower's income. **IMLA has consistently argued that market conditions no longer support a 3% stress**, given that long term interest rates have fallen substantially since the stress was put in place in 2014.

1. Introduction

1.1 2020: a year like no other

2020 is a year that nobody will forget with coronavirus and the public health response causing social and economic dislocation on a scale that compares to full-scale war. The UK has been one of the worst affected countries both in terms of the health impact, with a current toll of more than 80,000 deaths recorded of people with the infection, and in terms of the economic impact. UK GDP is now estimated to have fallen by 11% between 2019 and 2020, the worst annual contraction in output of the last 200 years.

The economic fallout was due almost entirely to the impact of measures introduced by the government to slow the spread of the virus. The most dramatic measure was the first national lockdown, which commenced in March and lasted until May in England. However, relief that the lockdown had successfully pushed down infection rates was soon replaced with concern about a second wave and decisions to progressively easy restrictions were soon followed by rebounding infection rates.

By the autumn, localized restrictions in areas with high infection rates were failing to stem the spread of the virus and in early November the government in Westminster felt compelled to follow the Welsh government and announce a national lockdown in England. The subsequent New Year lockdowns across the UK confirm that 2021 will not see a rapid return to normality.

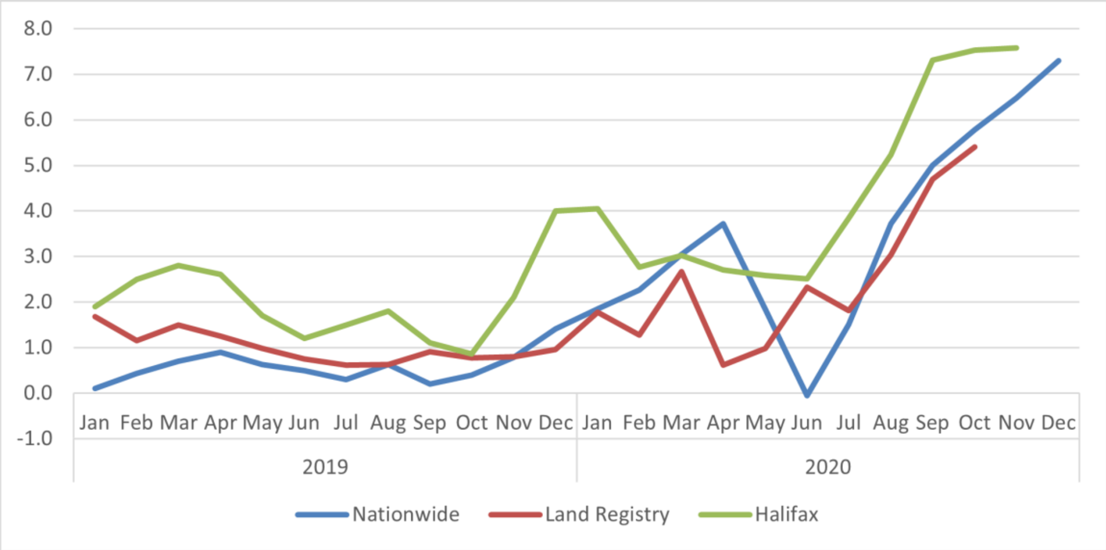
However, news that two vaccines had been approved with the roll-out starting in December provides hope that the virus can be controlled during 2021. The government's ambitious plan to vaccinate the majority of those in vulnerable groups by the end of February could provide a path out of restricts and the corresponding economic disruption from the second quarter.

1.2 Housing/mortgage markets: great challenges and amazing responses

If the Covid-19 pandemic is seen as a test of the resilience of sectors of the UK economy, the housing and mortgage markets should be seen as sectors that have proved their stamina and durability. Mortgage lenders have had to maintain operations as the bulk of staff have been working from home while also implementing a mortgage payment deferred programme that at its peak was taken up by over 1.8 million borrowers. For the most part, lenders have shown themselves to be remarkably successful at meeting these challenges while maintaining customer service standards.

The housing market confounded many of the experts by rebounding sharply after it emerged from lockdown. A surge in buyer interest exacerbated a shortage of supply, squeezing prices upward even before the announcement of a stamp duty holiday had time to affect the market. But with the holiday in place the market moved ahead even more strongly and by October house prices nationally were up 7-8% (see Chart 1).

Chart 1 – UK house prices (12 month % increase)



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

1.3 Brexit deal

The free trade agreement reached with the EU in late December came as a relief to businesses that trade with the continent and more broadly to economists who feared the longer term consequences of the UK moving to trade on World Trade Organisation (WTO) rules with the EU. A period of disruption is still likely as customs checks start to impact the flow of goods in and out of the UK, but the wider economic impact is likely to be significantly less severe than the WTO option would have been.

1.4 A way forward in 2021 and 2022

Back in March, as Covid-19 spread rapidly across the globe, it was already clear that an effective vaccine was likely to be the only mechanism by which the virus could be contained without further widespread controls on human activity. The news in November that several vaccines had proved highly effective in trials provided, for the first time, the prospect of a path out of social distancing and economic disruption, and back to normality. A full scale vaccination programme is a major logistical exercise but the operation is already advancing well in the UK, with 1.3 million people vaccinated by early January.

The following Section provides a detailed overview of the outlook for 2021 and 2022 based on the latest information regarding vaccination as well as our assessment of the impact of the new trade relationship with the EU.

2. The mortgage market outlook for 2021 and 2022

2.1 Background environment in 2021 and 2022

Table 1 outlines our projections for key assumptions behind our mortgage market forecast. It shows that we expect a robust recovery from the lockdown induced slump of 2020, from the second quarter of 2021 and during 2022, based on the assumption that a vaccine is successfully rolled out during the first half of 2021.

There are broadly two schools of thought about the recovery. One says that we can expect the economic fallout to be quite prolonged with the economy not regaining its previous peak until 2023 as the OBR expects. The other sees the potential for a swifter rebound with output returning to pre-lockdown levels by 2022. Our forecast follows the latter trajectory.

Table 1 – key forecast assumptions

	Past values		Forecast values		Percentage changes		
	2019	2020e	2021f	2022f	2020/19e	2021/20f	2022/21f
Real GDP (£bn)	2,169	1,923	2,040	2,170	-11.3%	6.1%	6.4%
Unemployment rate (Q4)	3.8%	4.8%	5.6%	4.5%	26.3%	16.7%	-19.6%
House prices (average for year)	230,600	238,000	253,000	257,000	3.2%	6.3%	1.6%
Housing transactions (UK, thousands)	1,177	1,044	1,200	1,220	-11.3%	14.9%	1.7%
Bank Rate (end of year)	0.75%	0.10%	0.10%	0.25%	-86.7%	0.0%	150.0%

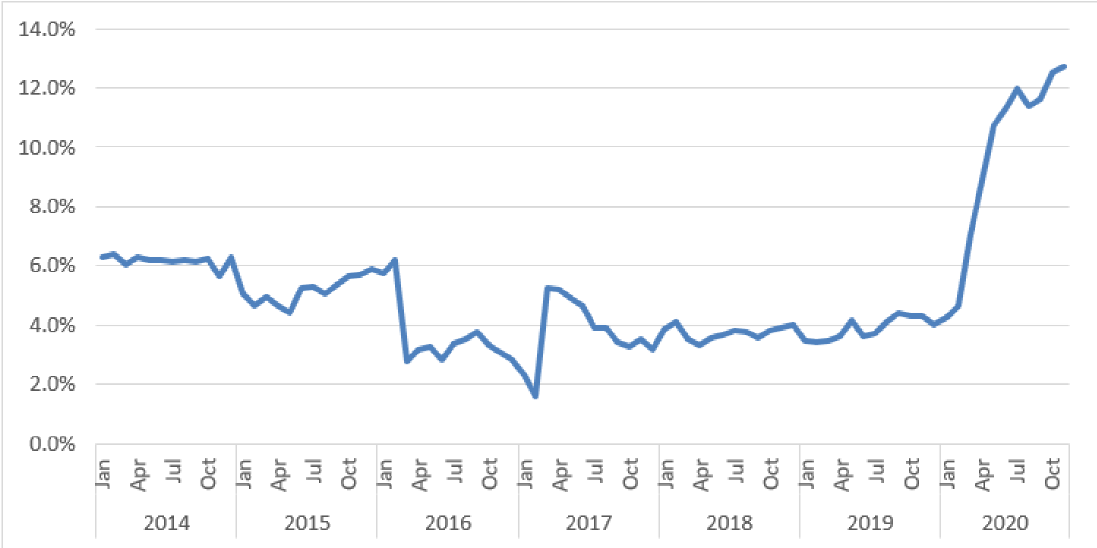
Source: IMLA, ONS and HMRC

Our view that a relatively rapid recovery can be expected from Q2 2021 is based on the scale of fiscal and monetary easing seen during 2020 and early 2021 and the extent to which this has bolstered household and corporate balance sheets. On the fiscal front, the OBR predicts that the UK government deficit for 2020-21 will hit a peacetime record of 19% of GDP (£394 billion), compared to 2.5% in 2019-20 or £56 billion.

On the monetary front, we have seen Bank Rate cut to a record low of 0.1% and the level of QE double from £445 billion at the start of 2020 to £895 billion by November. The Bank of England also introduced the Term Funding Scheme with additional incentives for SMEs (TFSME) in March 2020, which provided cheap funding to banks to lend to commercial businesses. Financial support has also been provided directly to larger corporates through the joint HM Treasury/Bank of England lending facility named the Covid Corporate Financing Facility (CCFF) and to smaller business through the Coronavirus Business Interruption Loan Scheme (CBILS) and coronavirus Bounce Back Loan Scheme (BBLS). Grants for the self-employed have been made available through the Self-Employment Income Support Scheme (SEISS).

We know that much of the additional cash injected into the economy via either fiscal or monetary means has remained in the private sector. Sterling M3 rose by £326 billion during the first half of 2020, an increase of 10%, and between February and November retail deposit balances rose £222 billion, or nearly 13% (see Chart 2), an average of £13,400 for a family of four. Household holdings of notes and coins have also risen, up by £11 billion between the end of February and the end of November.

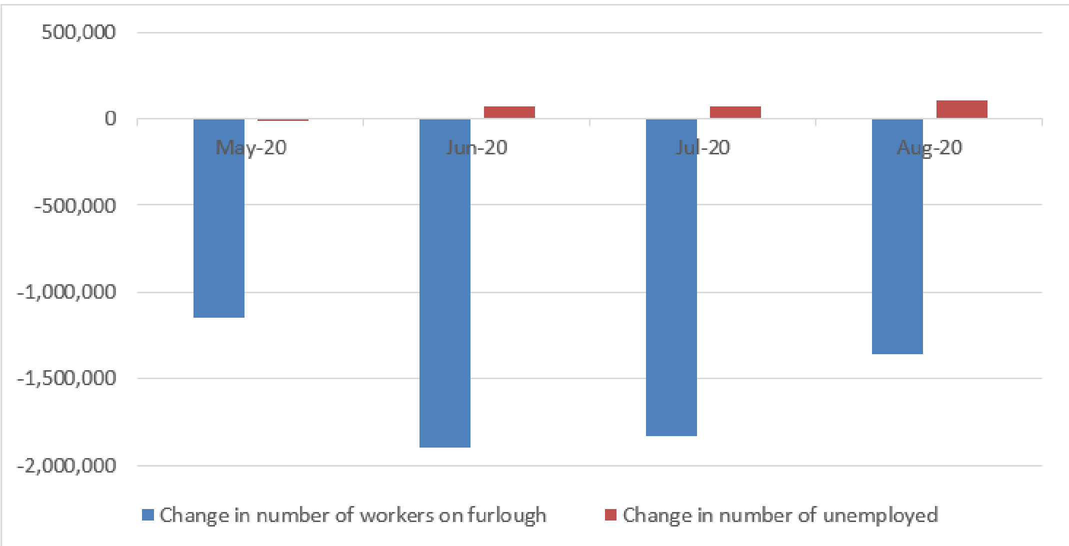
Chart 2 – UK retail deposits (% growth on a year earlier)



Source: Bank of England

This abnormal build-up of household cash balances, which accounts for close to two thirds of the rise in the money supply, is partly the product of forced saving, as families found themselves unable to book holidays or spend on normal leisure activities. We expect a good proportion of this to unwind, as household spending returns to more normal patterns and people spend excess savings.

Chart 3 – Decrease in workers on furlough and rise in unemployment



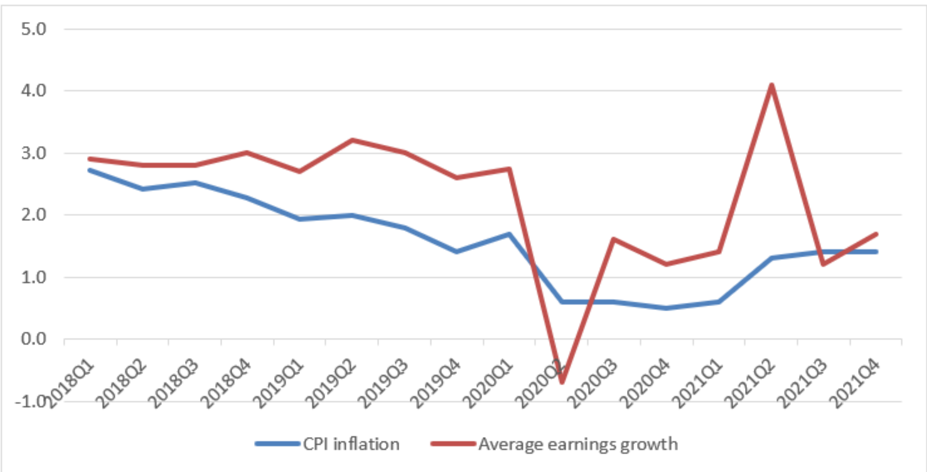
Source: ONS

Although this will be tempered somewhat by increased job insecurity, most of the jobs that have been lost due to Covid-19 are in sectors such as hospitality where rebounding demand is likely to require relatively rapid rehiring, so unemployment may fall back more rapidly during 2021 than official forecasts suggest. And fears that the end of the furlough or Job Retention Scheme at the end of April 2021 might lead to much higher unemployment can be questioned based on the experience in 2020. Between May and September 2020, the number of workers on furlough fell from 8.9 million to 2.6 million while unemployment increased by 240,000, suggesting that only 4% of furloughed workers became unemployed. It is not clear why this percentage should be much higher coming out of the current lockdown.

There has been much discussion of some of the more permanent changes to the economy that may result from the pandemic. Lifestyles have changed with millions of office workers becoming accustomed to working from home while the switch from physical to online retail has been sharply accelerated. These changes are likely to be sustained to some degree and do point to changes in the future composition of aggregate demand.

For example, demand for office space is likely to fall back as firms embrace part or full-time home working. Business travel is another area where firms will eye potential savings by maintaining the use of video conferencing. Households are also likely to spend more online and less on the high street. But such compositional changes in demand do not automatically imply a fall in aggregate demand. Funds saved in one area will become available for use elsewhere: for example, companies faced with lower travel and office costs may see increased profitability, allowing them to pay higher dividends. Indeed, productivity improvements that might arise from less travel and commuting could enhance economic activity in the medium term.

Chart 4 - OBR projections for % earnings growth and inflation (November 2020)



Source: OBR

Chart 4 shows the latest Office for Budget Responsibility (OBR) forecasts for CPI inflation and earnings growth published in November 2020. Two features driven by Covid-19 stand out. Firstly, inflation fell sharply from early 2020. Although this is expected to partially reverse in 2021 and 2022, CPI inflation is expected to remain below the Bank of England's 2% target for the rest of the forecast horizon. As a result, there is likely to be modest pressure on the Bank of England to raise interest rates, meaning monetary policy is likely to remain accommodative.

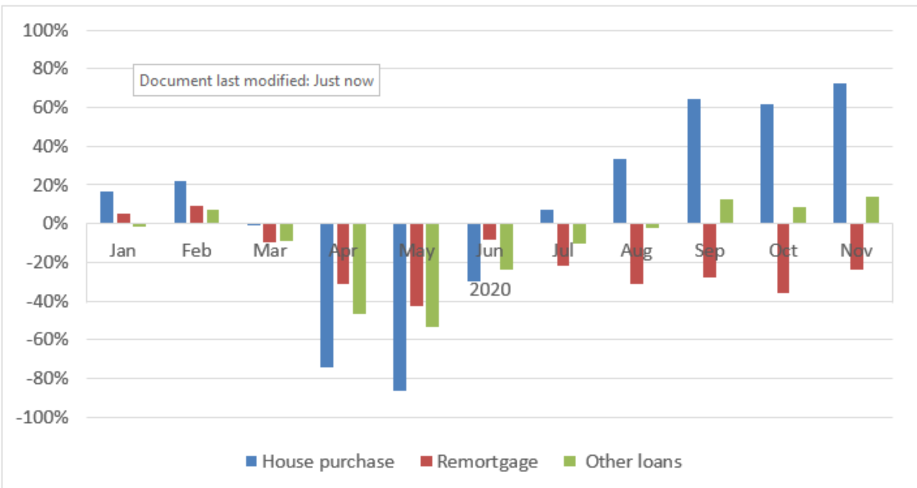
Secondly, earnings growth has become much more volatile, obscuring the underlying trend, but over the forecast period, earnings growth is still expected to be positive once inflation is taken into account. This positive real earnings growth, coupled with a likely rebound in employment once Covid-19 related restrictions are lifted, should ensure that real personal disposal income (RPDI) growth is positive in 2021 and 2022, which will help to boost sentiment.

2.2 Recent performance of the UK housing and mortgage markets

It is difficult to estimate precisely how many property transactions were prevented by the closure of the housing market during lockdown from March, but comparing monthly transactions during the April to August period to the same months of 2019 suggests something like a 185,000 shortfall. Yet our estimate of transactions over 2020 as a whole is only 11% below the 2019 total, suggesting that a significant proportion of the shortfall (about a third) was subsequently made up. The stamp duty holiday, announced in July, has played an important role in helping the recovery in transaction levels.

In the mortgage market, unsurprisingly the lockdown impacted lending for house purchase harder, with remortgage activity holding up better, given the extent to which remortgaging can be conducted with social distancing. House purchase lending fell to less than 50% of its 2019 level in April and May while remortgaging was running at 82% of its 2019 level. But since then, house purchase lending has picked up strongly, aided by the stamp duty holiday, while remortgage activity has started to lag. By November remortgaging was running at only two thirds of the 2019 level.

Chart 5 – Mortgage approvals (monthly % change on 12 months earlier)



Source: Bank of England

Mortgage approvals, which lead lending by several months, point to an even stronger rebound in the house purchase market. Approvals for house purchase were 62% and 72% ahead of their 2019 level in October and November respectively (see Chart 5), pointing to strong lending heading into 2021 but remortgage approvals were down 24% in November, which may have resulted from lenders prioritising house purchase activity while capacity remained constrained by social distancing requirements.

For mortgage lenders, the requirement to reorganize operations to support working from home coupled with the need to offer existing borrowers a mortgage payment deferral put severe pressure on capacity. At the same time, mortgage redemptions fell away, reducing the pressure on lenders to maintain the pipeline of new lending. As a result, lenders chose to restrict lending, particularly by restricting credit availability in the higher LTV segment.

Lending to higher risk borrowers was impacted by the closure of the securitisation market, which temporarily hobbled the non-deposit taking lenders, who in the residential segment (i.e. non buy-to-let) focus on non-standard borrowers. Although the wholesale funding markets recovered more quickly than expected, allowing the non-deposit takers to resume lending quite rapidly, taking the pressure off the non-standard lending segment, high LTV lending has remained heavily rationed, reflecting the broader operational pressures on lenders still trying to manage a workforce mainly working from home.

Chart 6 shows the profile of borrowers with mortgage payment deferrals. The government's decision to term the deferral a payment 'holiday' created confusion amongst some borrowers, with many thinking they were being offered a reduction in payments rather than just a deferral. As a result, at the peak over 1.8 million borrowers had taken advantage of the deferral, 17% of all borrowers, far higher than the rate of non-payment of rent reported by large private landlords, suggesting that many borrowers who took up the deferral could have afforded to keep paying.

Chart 6 – Number of mortgage deferrals in place

Source: UK Finance

By 20 November, less than 1.2% of mortgage borrowers were on a deferral, close to 1.7 million below the peak level, yet 3-6 month arrears continued to fall in the third quarter to 0.28% the lowest figure since current records began. Arrears is something of a lagging indicator and some uptick is to be expected in 2021 but the rapid fall in borrowers on a payment deferral from early July strongly suggests that we do not face an arrears crisis and the vast majority of borrowers are continuing to successfully manage their financial commitments.

2.3 Outlook for the UK housing market

Going into 2021, the most significant short-term issue affecting the housing and mortgage markets is the stamp duty holiday. Given that the surge in purchase activity has put on a strain on available resources in fields such as conveyancing, valuation and mortgage lending itself, with the new lockdown IMLA believes many buyers will find it even more challenging to complete their purchases before the end of the stamp duty deadline for reasons beyond their control. We are therefore calling for an extension to the stamp duty deadline.

There is considerable concern about the level of activity in the housing market after the end of the stamp duty holiday and the knock-on effect on house prices. For example, the OBR now expects house prices to fall 3.5% in 2021 and a further 2.6% in 2022. In contrast, we expect house prices to keep rising over this period despite the end of the stamp duty holiday, buoyed by a rapidly improving economy, low mortgage rates and the clearing of a backlog of delayed transactions from 2020.

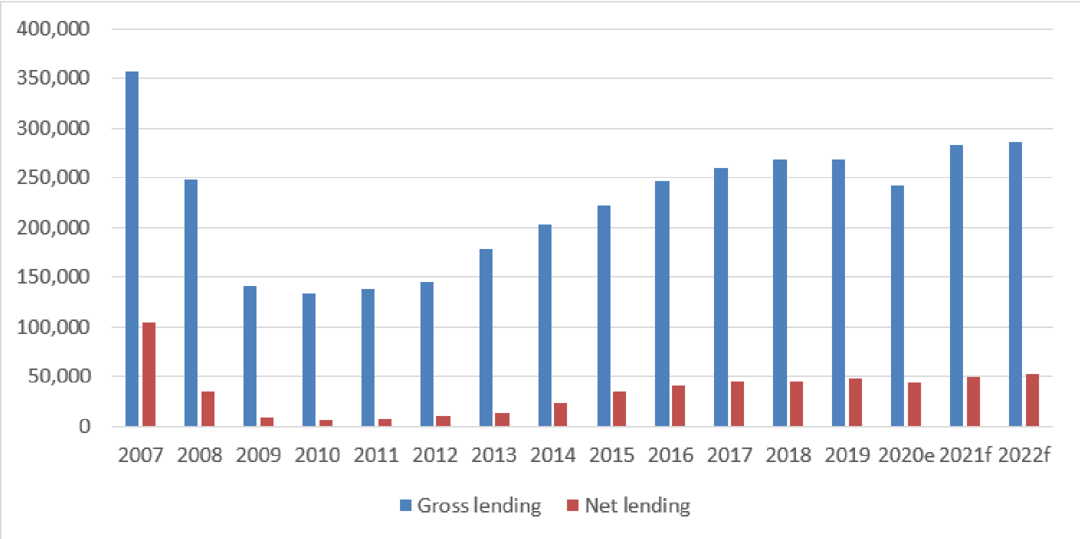
It is worth remembering that many of the housing transactions that did not take place during the Spring lockdown (an estimated 185,000 between March and August), are likely to have been delayed rather than permanently cancelled. As we estimate that only 60,000 of these ‘lost’ transactions were made up later 2020, there remains significant potential pent-up demand going into 2021. This includes 65,000 fewer first time buyer purchases in 2020 compared to 2019. As first time buyers paying up to £300,000 pay no stamp duty, their numbers could rise after March 2021 if lenders return more fully to high LTV lending as Covid-19 restrictions ease in Q2.

Other important milestones include the end of the mortgage payment deferral, which the FCA has confirmed will fully end in July 2021 and the move to the new Help to Buy equity loan scheme from April 2021. The new scheme will be restricted to first time buyers, with additional quite restrictive regional price caps. Housebuilders estimate that around 20,000 purchasers who would have been expected to use the old Help to Buy scheme to buy a newly built home each year will now need an alternative. Several lenders are expected to launch 95% LTV mortgages under a new commercial scheme in Q1 where the builders pay for insurance that protects the lender, allowing borrowers excluded from Help to Buy, or those that do not want an equity loan, to purchase with a conventional mortgage[1].

[1] The author of this report is a consultant to Gallagher Re, the firm managing the commercial scheme.

2.4 Mortgage market forecast

Chart 7 - Forecasts for gross and net lending (£m)



Source: Bank of England and IMLA

We expect gross mortgage lending of £283 billion in 2021, a sharp recovery from 2020 and the best performance since 2007 (see Chart 7). We expect net lending to also show a strong performance, reaching £50 billion, again the best outturn since 2007. The improvement in lending will be powered by a strong recovery in house purchase activity. The stamp duty holiday will provide a significant boost to lending, even if it is not extended, but economic recovery during 2021 should support activity later in the year.

Table 2 – Mortgage market forecast

	Gross mortgage lending (£m)				Percentage changes		
	2019	2020e	2021f	2022f	2020/19e	2021/20f	2022/21f
House purchase	157,099	146,800	172,000	175,000	-6.6%	17.2%	1.7%
Remortgage	100,905	84,500	100,000	100,000	-16.3%	18.3%	0.0%
Other	9,927	10,300	11,000	11,000	3.8%	6.8%	0.0%
Total	267,931	241,600	283,000	286,000	-9.8%	17.1%	1.1%
of which:							
Buy-to-let lending	42,200	38,000	40,000	41,000	-10.0%	5.3%	2.5%
of which for house purchase	10,600	9,500	10,500	11,000	-10.4%	10.5%	4.8%
Buy-to-let share of total	15.8%	15.7%	14.1%	14.3%	-0.1%	-10.1%	1.4%
Lending via intermediaries*	167,564	147,962	175,000	178,000	-11.7%	18.3%	1.7%
Share of total*	77.0%	78.8%	78.1%	78.8%	2.4%	-0.9%	0.9%
Net lending	48,179	44,000	50,000	52,000	-8.7%	13.6%	4.0%

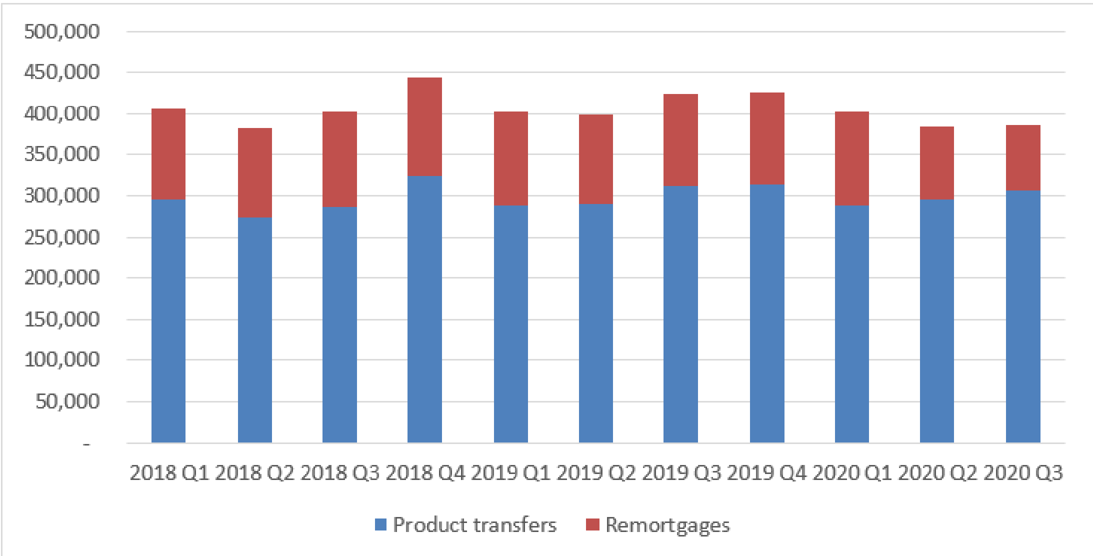
* Regulated loans only
Source: IMLA, Bank of England, UK Finance

Mortgage intermediaries showed the ability to work flexibly in the face of Covid-19, with many increasing contact with customers via video conferencing. As a result, intermediaries' share of mortgage lending reached 80% for the first time in April and averaged an estimated 79% across the year. With Covid-19 likely to be less of an issue later in 2021, it is possible that lender direct distribution may regain a little of this lost share, so we forecast that the intermediary share will dip to 78% in 2021 before resuming its upward trend to 79% in 2022 (see Table 2). However, many lenders have increased their focus on product transfers and these continued to increase in 2020 (see Section 2.5 below).

2.5 Product transfers and remortgages

While intermediaries managed to increase their share of lending during 2020 at the expense of lender distribution, lenders were able to forge ahead with product transfers. Many lenders have invested in online systems that allow borrowers to take a product transfer on a non-advised basis with the minimum amount of fuss and these systems proved effective during lockdown.

Chart 8 – Number of product transfers and remortgages



Source: UK Finance

As Chart 8 shows, since data has been available on product transfers (where the borrower moves between products with the same lender), it has been clear that the majority of borrowers who refinance are doing so with a product transfer. But until the lockdown, there was no discernible trend in the proportion taking a product transfer, which remained in the low 70%s of those refinancing. But in Q2 and Q3 2020, product transfers increased their share of refinances to 77% and 79% respectively. This resulted from a decline in the number of remortgages, which fell 19% in Q2 relative to a year earlier and 30% in Q3. In contrast, product transfers were up 2% in Q2 on a year earlier and down only 1% in Q3.

The relatively stronger performance of product transfers in 2020 may well be because they are particularly easy to execute with social distancing requirements, given that most lenders offer product transfers on a non-advised basis through online portals while broker remortgages involve advice. While many brokers now offer advice through video conferencing not all customers are comfortable with the technology. Also, lenders agreed to permit borrowers on a payment deferral to transfer to a new deal.

2.6 Buy-to-let mortgage market forecast

We estimate that overall buy-to-let lending in 2020 was down slightly more than residential lending, falling 10% to £38 billion. But buy-to-let house purchase lending performed slightly worse, falling 10.4% to an estimated £9.5 billion. However, the underlying growth in outstanding buy-to-let mortgage debt remained broadly constant during 2020, and the number of buy-to-let mortgages increased by around 2%, showing that the buy-to-let market remains quite robust in underlying terms.

We expect a modest recovery in overall buy-to-let lending in 2021 to £40 billion, powered by a sharp rebound in house purchase activity, rising from £9.5 billion to £10.5 billion. This partly reflects the opportunity provided by the stamp duty holiday, which has reduced stamp duty for landlords alongside other buyers (although they still face the 3% surcharge). We expect buy-to-let remortgaging to increase only slightly to £28.2 billion in 2021 reflecting an expected increase in product transfers.

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

					Percentage changes		
	2019	2020e	2021f	2022f	2020/19	2021/20f	2022/21f
Whole market							
Outstanding debt (£bn)	1,453	1,497	1,547	1,599	3.0%	3.3%	3.4%
House purchase lending (£m)	157,099	146,200	172,000	175,000	-6.9%	17.6%	1.7%
House purchase % churn	11.0%	9.9%	11.3%	11.1%	-9.7%	14.0%	-1.6%
Remortgage	100,905	84,600	100,000	100,000	-16.2%	18.2%	0.0%
Remortgage % churn	7.1%	5.7%	6.6%	6.4%	-18.7%	14.6%	-3.2%
Total % churn	18.7%	16.4%	18.6%	18.2%	-12.7%	13.7%	-2.2%
Buy-to-let market							
Outstanding debt (£bn)	261	272	281	290	4.1%	3.5%	3.2%
House purchase lending (£m)	10,600	9,000	10,500	11,000	-15.1%	16.7%	4.8%
House purchase % churn	4.1%	3.4%	3.8%	3.9%	-18.3%	12.4%	1.4%
Remortgage	30,030	28,920	28,200	28,600	-3.7%	-2.5%	1.4%
Remortgage % churn	11.7%	10.9%	10.2%	10.0%	-7.4%	-6.1%	-1.8%
Total % churn	16.5%	14.7%	14.5%	14.4%	-11.1%	-1.2%	-0.8%
Buy-to-let % of total market							
Outstanding debt	18.0%	18.1%	18.2%	18.1%	1.1%	0.1%	-0.2%
House purchase lending	6.7%	6.2%	6.1%	6.3%	-8.8%	-0.8%	3.0%
Remortgage	29.8%	34.2%	28.2%	28.6%	14.9%	-17.5%	1.4%
Total lending	15.8%	16.2%	14.1%	14.3%	2.7%	-12.6%	1.4%

Source: Bank of England, UK Finance and IMLA

Proposals from the Office for Tax Simplification (OTS) to reform capital gains tax have concerned some landlords as it raises the possibility that capital gains tax rates could be increased to mirror income tax rates. For additional rate tax payers this could increase the rate of capital gains tax on residential property from 28% to 45%. The OTS also proposed reducing the annual capital gains tax exemption from £12,300 to £5,000.

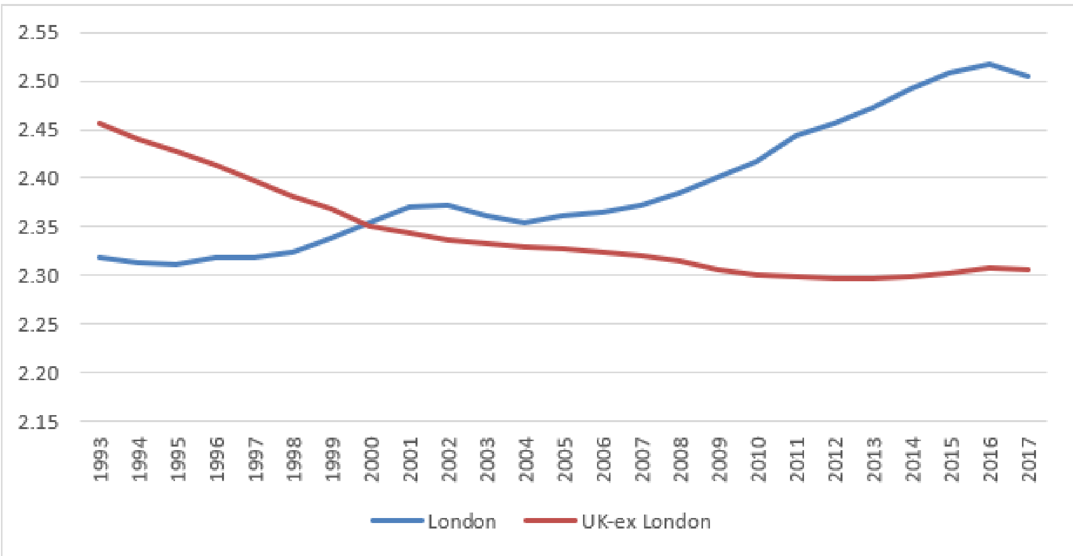
But there are also broader concerns that the government's support for new measures to encourage the expansion of homeownership will push it into finding new ways to encourage landlords to the exit the market to free up homes for first time buyers. In October, Boris Johnson committed the government to backing the development of a market in 95% LTV full term fixed rate mortgages for first time buyers. Aware that increased numbers of first time buyers could push up house prices, the government seems to have acknowledged that further tax changes might be needed to encouraged landlords to sell, which could involve the threat of higher taxes in the future (for a fuller discussion of the high LTV full term fixed rate proposal see Section 3 below).

3. Can 'resentful renters' get onto the housing ladder through a government backed mortgage?

3.1 The nature of the UK's housing crisis

In late 2019, the Centre for Policy Studies published a paper by Graham Edwards, a businessman and policy guru, entitle *Resentful Renters: How Britain's housing market went wrong, and what we can do to fix it*. In this paper, Graham Edwards laid out his diagnosis of the cause of the UK housing crisis and what might be done to alleviate it[2]. He questioned the widely held view that the UK has too few properties for its growing population, pointing to the falling ratio of persons per dwelling outside London (see Chart 9).

Chart 9 – Number of persons per dwelling

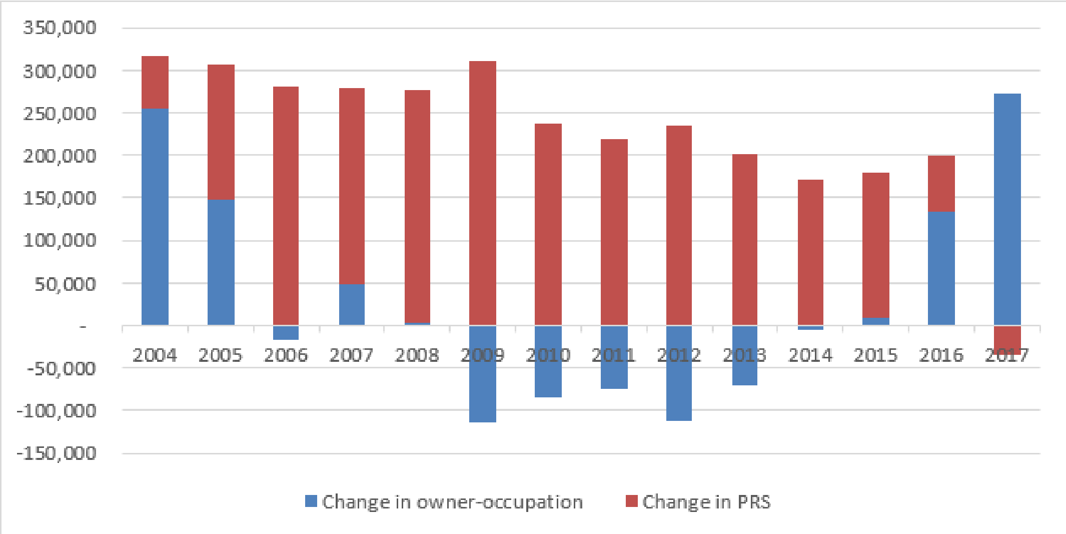


Source: ONS

Instead, the paper suggests that the most serious problem in the UK housing market in the 21st century is the shift in ownership of properties from owner-occupation to private renting as landlords outcompeted first time buyers. To illustrate this point, the paper presented Chart 10 below, which shows that in the decade from 2006 to 2015 the PRS expanded by 2.3 million units, against total housing completions of 1.6 million, meaning that in net terms 400,000 properties moved from the owner-occupied sector to the PRS as well as some 300,000 moving from the social rented sector to the PRS.

[2] The author of this IMLA report is a consultant to Graham Edwards.

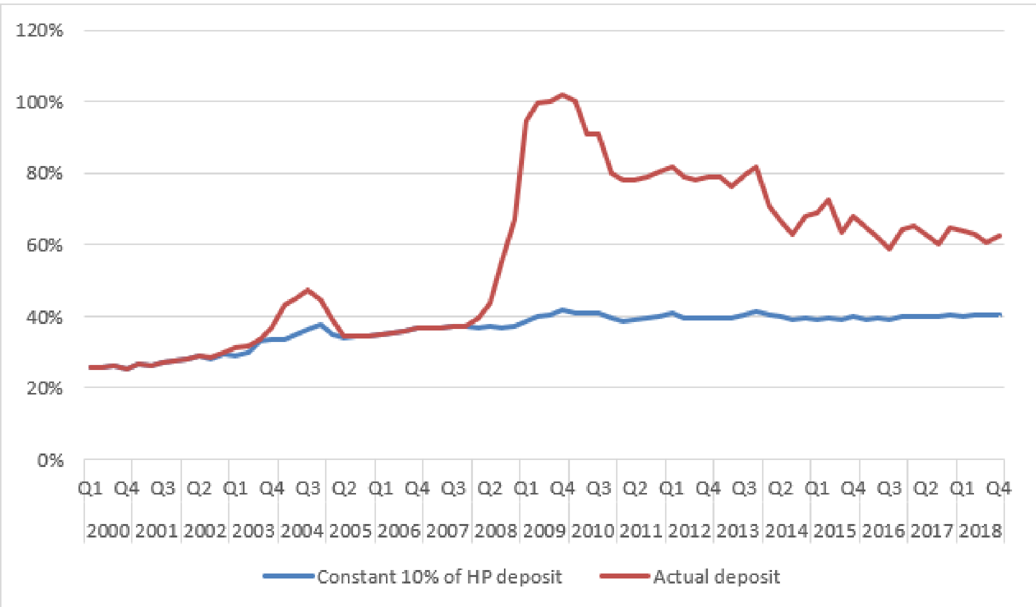
Chart 10 – Change in the size of PRS and owner-occupied sectors



Source: MHCLG

The paper points out that rising house prices, which is often blamed for reducing first time buyer numbers, does not appear to be the true cause because, as Chart 11 illustrates, in the decade after the financial crisis average first time buyer incomes rose as fast as first time buyer house prices. This means that a 10% deposit on the average first time buyer property would consume no higher a proportion of income in 2018 than it did in 2009 (see Chart 11).

Chart 11 – Median first time buyer deposit as % of annual income



Source: UK Finance

Instead, Chart 11 shows that the average first time buyer has had to find a substantially larger percentage deposit since the financial crisis due to increased deposit requirements. The paper argues that this higher deposit requirement coupled with more stringent affordability requirements imposed by regulators has disadvantaged first time buyers, thereby increasing the number of young households forced to rent, which in turn has encouraged landlords to buy, with these landlords also benefiting from falling interest rates. The paper estimates that there are now 3.57 million resentful renters in the UK (people who would previously have bought but are currently in private rented accommodation).

3.2 High LTV full term fixed rate mortgages as the solution for resentful renters

In his *Resentful Renters* paper Graham Edwards suggests that the solution to the ownership crisis is to provide first time buyers with a financially stable way to access homeownership which would avoid the need to apply onerous stresses in the affordability calculation imposed by the regulators. He sees the answer as full term fixed rate mortgages of the kind found for many decades in the United States and Denmark.

The benefit to first time buyers of taking out a full term fixed rate mortgage is that they will know that their monthly mortgage payment cannot increase, which is particularly valuable to this group of buyers because they typically have to devote a larger proportion of their income to their mortgage payment than more established homeowners. Fixing the rate for the life of the loan should thus make it lower risk for both the borrower and the lender, potentially justifying a higher LTV.

The benefit of not being subject to a stress test in the affordability calculation is also potentially valuable, as borrowers taking short term fixes or variable rate loans are required to be assessed at the reversionary rate plus 3% (which at most lenders produces a stressed rate above 7%), although the rules do not require the stress to be applied when the loan is fixed for 5 or more years. The *Resentful Renters* paper estimates that 1.8 million potential first time buyers would meet affordability requirements at 2.35% but fail them at a typical stressed rate of 7.26%.

3.3 How could long term fixed rate mortgages work in the UK?

The Resentful Renters paper is not prescriptive on how full term fixed rate mortgages could come about in the UK but states: “This proposal would not necessarily require significant regulation or legislation, or even any extra money from Government. It could just require the appointment of a minister to champion this new market and make it clear that the Government supports and welcomes the proposal. Alternatively, if the state wished to reasonably quickly meet the housing aspirations of hundreds of thousands of people, it could turbo-charge the proposal with tax incentives or by providing an agreed template for the bonds and mortgages issued by the private sector".

Some pension funds and insurance companies that invest heavily in long term fixed rate assets such as gilts have shown interest in funding full term fixed rate mortgages in the UK, following on from markets such as the Netherlands where similar products have been successfully launched. However, the Conservative government has also been keen to promote the development of this idea, backing it in its 2019 manifesto, which stated: "We 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". And at the Conservative Party virtual conference in October 2020, Boris Johnson trumpeted 95% LTV full term fixed rate mortgages as a way of turning Generation Rent into Generation Buy, raising the prospect that government could provide some form of guarantee to help establish the market.

Government is still exploring how it could help to create a market in full term fixed rate mortgages but elements of the basic blueprint are already becoming clear. Government does appear ready to try to create a bond issuing platform that would provide the mechanism through which these mortgages would be financed. Bonds would be issued from the platform in a standardised format and sold to investors like pension funds and insurance companies that wanted fixed rate assets. To enhance the attractiveness of these bonds, the government could provide some kind of guarantee (i.e. take some of the credit risk on the underlying mortgages). This would reduce the yield investors required, making this a cheaper source of funding, which in turn would make the mortgage rates more attractive.

Early repayment charges (ERCs) would be a key consideration. In the *Resentful Renters* paper it is proposed that borrowers could be given the option of mortgages with or without ERCs, with the mortgages without ERCs carrying a higher interest rate to compensate investors who would face a higher risk of early repayment, particularly if market interest rates fell and borrowers could switch to cheaper deals.

Lenders and brokers would have to be incentivised to supply mortgages to the platform. In contrast to traditional UK securitisations, mortgages sold to the platform would most likely be fully off the balance sheet of the originating lender, although the lender would presumably be required to retain a 5% stake under current retention requirements. Brokers might be offered payments to assess product suitability every two or three years, which might help to equalise their income from selling long term fixed rate mortgages relative to the more typical 2 or 5 year fixed rate products.

3.4 Concerns with the proposal

The government appears interested only in addressing the high LTV segment of the market that it sees as underserved and therefore these new mortgages could be seen as additional to existing business. Government would want to ensure that any new high LTV mortgages were not overly competitive relative to existing products. But despite this, lenders are likely to be wary of this proposal as it represents a significant change relative to the current market, where mortgages are financed through lenders' balance sheets mostly with variable rate funding such as retail deposits.

There is also some scepticism in the industry about the level of demand for full term fixed rate mortgages given previous low levels of take-up when these products have been available. However, with some form of government guarantee it is possible that the cost of funding for these loans could be quite competitive which contrasts with most long term fixed rate mortgages offered in the past. Moreover, if the mortgages are restricted to an LTV bracket that is currently heavily underserved, the mortgage will be competing more with the cost of renting than with alternative mortgage products and a typical rental yield is at least 4-5%.

Another concern that has been raised is the risk that a large influx of new first time buyers will simply push up house prices. Graham Edwards acknowledged this concern in *Resentful Renters* suggesting that government would need to implement policies to incentivise landlords to reduce their property holdings to free up the stock of homes.

This could take the form of carrots (say a temporary reduction in capital gains tax) and sticks (a subsequent increase in capital gains tax). But it must be a concern to buy-to-let lenders if government is seen to be actively trying to shrink the sector and there is also some concern about reduced rental supply for those tenants that will not be in a position to become first time buyers.

3.5 Can we expect a government backed funding platform to revolutionise the UK mortgage market?

The *Resentful Renters* paper highlights a genuine concern that IMLA has repeatedly made reference to: that a large cohort of young households that would previously have been expected to buy have been unable to do so since the financial crisis of 2008-9. The paper concludes that there are 1.9 million renters who could take advantage of a 95% LTV full term fixed rate mortgage.

The Conservative government has been concerned with the trend away from buying because data on voting habits shows that private sector tenants are much more likely to vote Labour than owner-occupiers. To the current leadership of the Conservative Party, giving people a stake in society through homeownership is seen as vital to maintaining support for the current market system in the longer term.

Therefore, it is clear that the current government has a strong incentive to back solutions that might be seen as a path to restoring higher levels of homeownership. And while in the past Conservative governments were reluctant to involve themselves in markets through the use of guarantees or other support, the past decade has already seen key interventions in the mortgage market such as the Help to Buy guarantee scheme and Help to Buy equity loans, in response to perceived market failures.

Setting up a government funding platform to finance a new type of mortgage in the UK will take time, as a significant amount of work will be involved. However, ultimately government can make this proposal happen and at such time as it does, to a large extent it will be down to lenders, brokers and borrowers whether it is a success. Although there is scepticism in the mortgage industry today, if government recognises the need to properly incentivise lenders and brokers, the proposal could ultimately provide a proposition that many lenders and intermediaries will find financially attractive.

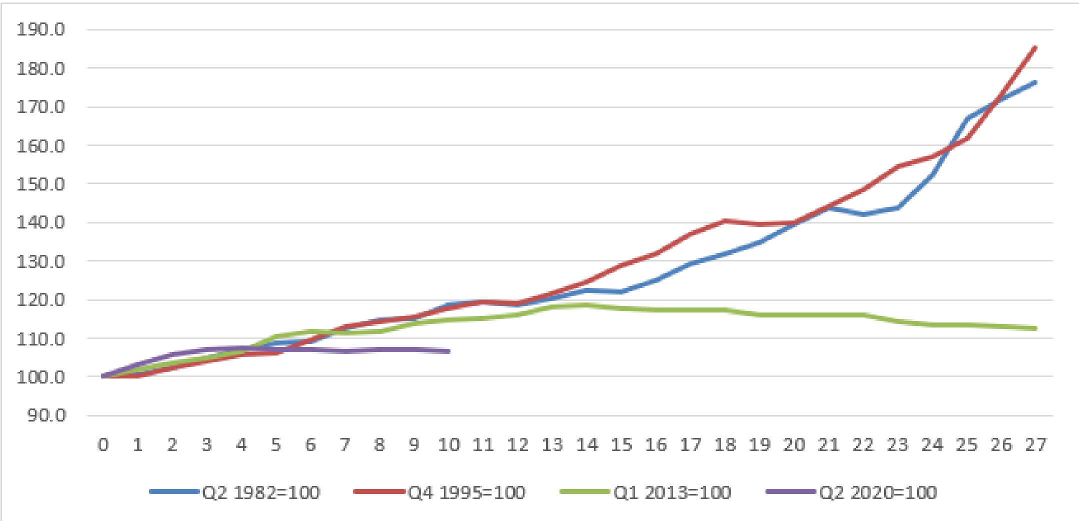
4. How might a 2021-22 recovery compare

4.1 Three past recessions and recoveries compared to our forecast

Every downturn and subsequent recovery is unique but looking back at past economic cycles in the UK it is clear that some cycles exhibit more similarities than others. Although there are some similarities between the Covid-19 induced economic crisis and the financial crisis of 2008-9, for example in the large scale fiscal and monetary interventions, the low interest rates and the restricted availability of high LTV finance, it is clear that the two crises are very different.

Banks had seen a great deal of their capital destroyed in the 2008-9 crisis and most non-bank lenders were forced out of business. This created a drag on the economic recovery as lenders were still trying to shrink their balances sheets, which impacted the speed of the recovery in mortgage lending and house prices compared to the mid-1980s and late 1990s rebounds (see chart 12, which shows the rise in real house prices quarterly from the bottom of the market). By contrast, today lenders are well capitalised and wholesale funding markets are functioning effectively, but we do not expect a strong recovery in house prices compared to previous upturns because house prices have not fallen during the Covid-19 crisis.

Chart 12 – Real UK house price recoveries (market bottom=100)



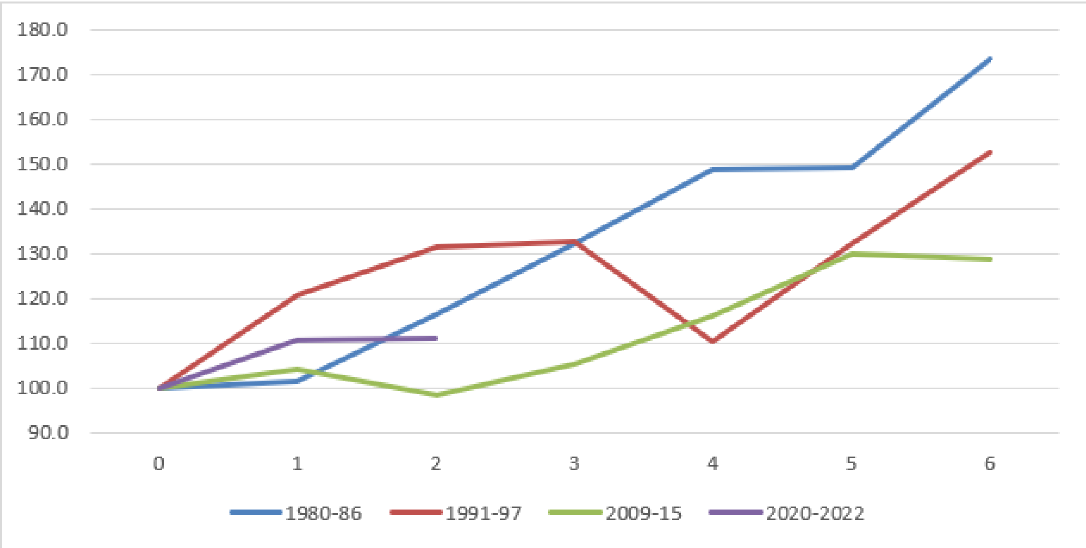
Source: Nationwide Building Society, ONS

The two earlier UK recessions (the early 1980s and the early 1990s) involved very different conditions. Both were caused by geopolitical crises and their impact on oil prices (the Iranian revolution of 1979 and the First Gulf War of 1990-1). This put upward pressure on inflation and, as a response, central banks raised interest rates.

But the early 1980s and early 1990s recessions varied starkly in their impact on the housing and mortgage markets. There was a very significant rise in unemployment in the early 1980s that continued until 1986, but house prices kept rising in nominal terms and in real terms fell by a comparatively modest 15% between 1980 and 1982. After 1982, despite the continued rise in unemployment real house prices began a solid recovery. That recession certainly illustrated that house prices can rise in real terms even as unemployment is climbing.

By contrast, the early 1990s recession created a severe downturn in the housing market even though unemployment rose by less. Between the market peak in 1989 and 1993 house prices fell 20% in nominal terms and by 37% in real terms between 1989 and 1995. The overheated housing market of 1988-89 and the subsequent jump in mortgage rates to 15% were key factors driving this housing collapse.

Chart 13 – Number of house purchase loans (base year = 100)



Source: UK Finance

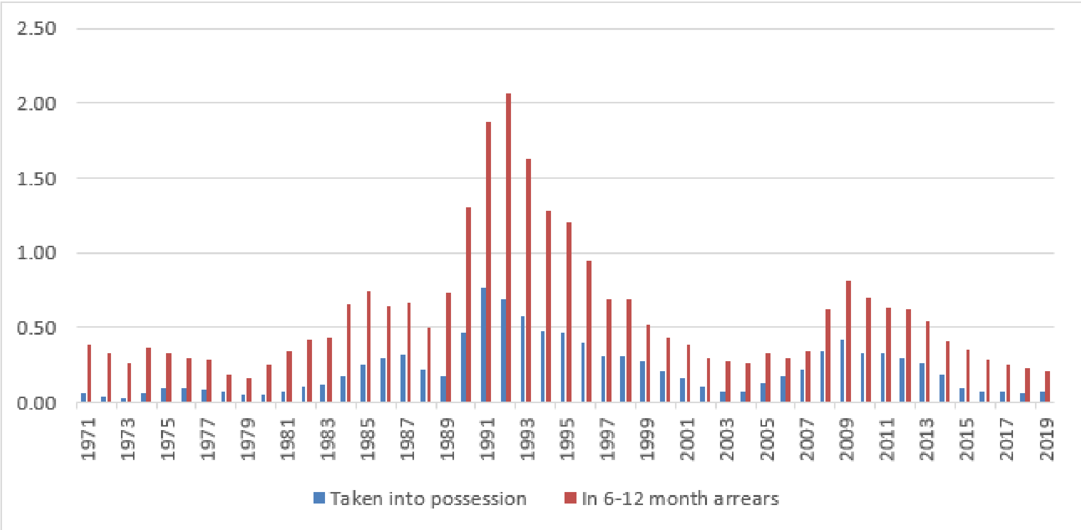
Chart 13 shows the path of recovery in mortgage lending for house purchase in the last three recoveries and our forecast (shown in years from the market bottom). It illustrates the weakness of the early years of the recovery from the financial crisis and shows that we expect a middling recovery during 2021-22.

4.2 Impact on mortgage arrears and possessions

Chart 14 shows the impact of these past recessions on mortgage arrears and possessions. We have used 6-12 month arrears as this series goes back to the 1970s. Chart 14 shows that arrears and possessions did rise in the 1980s despite rising house prices, which largely reflected weakness in some regional housing markets, but that it was the 1990s that saw by far the worse arrears and possessions crisis. The combination of very high mortgage rates, falling nominal house prices and higher unemployment proved toxic for the mortgage market. In total 4.7% of all mortgaged properties were taken into possession during the 1990s.

Arrears and possessions in the post-financial crisis period were broadly comparable to the 1980s. Mortgage rates were much lower but house prices were high relative to incomes, leaving some households with mortgages that proved too large to service once household income had dropped. The house price recovery was also focused on London and the south of England, leaving other areas of the country where house prices were very slow to regain their 2007 peaks.

Chart 14 - % of UK mortgages in arrears and taken into possession



Source: UK Finance

Although we expect some rise in arrears in 2021 and 2022, we expect arrears to remain at historically low levels. Are we facing a secular shift that will leave arrears permanently lower than in previous decades? We would argue that we are not: rather it is the nature of the economic conditions that determine the level of arrears and in 2020 we witnessed a recession which was unusual in the level of government support households received. There is no telling what form the next downturn might take and it is entirely possible that it could create more difficult conditions for borrowers.

However, one factor that has changed since the financial crisis is the level of control over lending exerted by regulators. Strict affordability requirements and macro-prudential rules have imposed higher hurdles for those seeking a mortgage. Arrears levels on lending conducted since the Mortgage Market Review (MMR) have been exceptionally low. Despite this good outturn, the regulatory framework that has been created since the financial crisis ensures that regulators continue to look for risks in the system no matter how low arrears are.

If our mortgage forecast for 2021 and 2022 is broadly correct, with the highest mortgage lending figures since before the financial crisis of 2008-9, we expect to hear regulators starting to raise concerns about the pace of the recovery. While the Bank of England may not feel justified in responding with higher interest rates given the likely subdued rate of inflation, it can always turn to macro-prudential measures to cool what it sees as overheating housing and mortgage markets.

This regulatory ‘bias’ towards dampening the market may reduce arrears but it has other consequences with fewer households able to enter homeownership. Ironically, it is these consequences that have encouraged the government to look for alternative ways to help first time buyers leading to proposals like that outlined in Section 3 above.

5. Conclusion

It is unsurprising that many economic forecasters have taken a cautious view of the outlook for 2021 and 2022 given the uncertainty following such a disruptive year. But the evidence from 2020 already provides us with a guide to how the economy can recover from the current crisis. What we know is that locking down swathes of the economy has a very substantial cost in terms of lost output. We also know that the government and Bank of England have felt compelled to provide a level of support to businesses and households that far surpasses that seen in more normal downturns or even the financial crisis.

We also have clear evidence about the path of employment coming out of furlough from the period following the first lockdown. Between May and August 2020, the number of workers on furlough fell by some 6.2 million and only 4% of this number moved on to unemployment. We have seen a similar picture with household finances. More than 1.8 million mortgage borrowers were on a payment deferral at the peak in June. By later November this figure was 127,000 but so far 3-6 months arrears have continued to fall.

Household consumption, which comprises two thirds of economic activity in the UK in a normal year, was constrained in 2020 by social distancing measures, leading to a substantial build-up of household cash balances (£222 billion between February and November, more than 10% of annual GDP). This creates the opportunity for a rapid improvement in consumer spending in 2021 if the roll out of Covid-19 vaccines allows social distancing measures to be unwound. A sharp shift in either fiscal or monetary policy from accommodating to constraining may be the most serious risk to our positive forecast, but with inflation projected to remain low and government under pressure not apply large tax increases too soon, this risk must be considered reasonably modest.

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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 entirely or predominantly via the broker channel. Its membership of 43 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.