The new ‘normal’ – prospects for 2016

Is the march back to a sustainable market on track?

February 2016

Executive summary

- **UK recovery on track.** The UK has entered the seventh year of the current economic recovery. The rate of growth may have been disappointing relative to earlier upturns, but growth has been fairly consistent and inflation has trended down. This brings back memories of the period before the financial crisis that Mervyn King dubbed the NICE (non-inflationary consistent expansion) decade.

- **Mortgage rates at record lows.** The UK recovery may be on track but the overseas backdrop has deteriorated since last year with emerging markets from China to Russia and Brazil struggling. This has increased uncertainty about the economic outlook for the UK, but for the housing market it has had the positive effect of pushing back the point at which Bank Rate is likely to rise, which, coupled with the continued improvement in banks' appetite to lend, has fuelled record low mortgage rates on new loans. The average 2 year fixed rate mortgage at 75% loan-to-value (LTV) fell below 2% for the first time last year and the average fixed rate mortgage at 90% LTV fell below 3% for the first time.

- **Mortgage affordability hits new high.** Cheap mortgage deals have supported buyer affordability despite house prices continuing to rise faster than wages. Measured by the proportion of income that the median home buyer spends on mortgage interest, affordability has hit a new peak with buyers spending a record low 8.6% of their income on interest by Q3 2015 and even first time buyers spending only 9.7% by November. We estimate that average first time buyer mortgage repayments are lower than average rents in every region of Britain.

- **High LTV loans get cheaper.** The marginal cost of higher LTV lending has also seen a substantial decline over the past year. The implied marginal cost of borrowing between 75% and 90% LTV, which was as high as 21.3% in mid-2010 had fallen to 12.9% by the end of 2014 and was only 7.8% by December 2015. However, the government's decision to terminate the Help to Buy mortgage guarantee scheme at the end of the year could reverse this trend, making it harder for future first time buyers to enter the market.

- **New 'NICE' era.** If we have entered a new NICE era, and the government Office for Budget Responsibility (OBR) forecasts that we are set for at least another five years of consistent growth and low inflation, the outlook for housing should be positive and stable. But this should not be thought of as a sustainable equilibrium as the UK's housing shortage is becoming progressively more acute.

- **The politics of a rationed housing market.** In mid to late 2015 we got a glimpse of how inadequate housing supply is reshaping the political environment. New taxes on buy-to-let and second homeowners amounted to a tacit admission by government that the previous policy of stimulating new supply had failed to reverse the housing shortage. Instead government is now set on a path of

managing demand, as well as trying to stimulate supply, to meets its over-riding policy objective of sustaining owner-occupation.

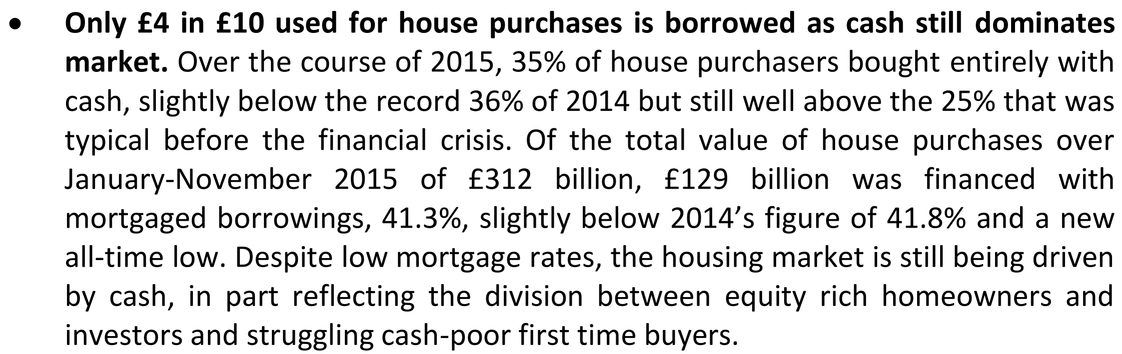
- **New buy-to-let taxes will not derail the sector.** We do not expect the tax increases aimed at buy-to-let investors to reverse the growth of the private rented sector (PRS) or the buy-to-let mortgage market, although they could slow the rate of growth of buy-to-let house purchase lending. The restriction on mortgage interest tax deductibility can be avoided through the use of a limited company and for long term property investors the stamp duty surcharge of 3% is small once amortised over the full investment horizon. We estimate that the new taxes on landlords' incomes (restriction of mortgage interest deduction and loss of wear and tear allowance) represent a 1.8% rise in taxes on landlords' aggregate estimated rents of around £50 billion. The PRS will remain the pressure valve that accommodates most of the increase in population expected over the next few years as landlords continue to respond to rising tenant demand.

- **Deposits outstrip mortgage balances.** The stability of lenders' mortgage funding continued to improve during 2015. While government and central bank action has supported funding markets since the financial crisis, the underlying trend which has gradually improved funding conditions is the growth of retail deposits relative to mortgage balances. While aggregate mortgage balances exceeded retail deposits by a record £136 billion in Q3 2007, equilibrium between the stock of deposits and mortgages was restored by the middle of 2011 and since then the growth in deposits has continued to outstrip that of mortgages: by Q3 2015, retail deposits exceeded mortgage balances by a record £215 billion (17%).

- **Mortgage market recovery continued in 2015.** As we had predicted, the market recovered over the course of last year. Once the full year's figures are released we expect 2015 to have been another year of growth in the mortgage market with gross lending reaching £220 billion, a rise of 8% on 2014 despite the subdued level of lending in the first half of last year. Net mortgage lending surged towards the end of the year, and we expect the figure for the whole of 2015 to be around £34 billion, 44% up on 2014.

- **Gross lending to hit £240 billion this year.** We forecast that gross mortgage lending will rise further in 2016 to reach £240 billion, 9.1% above 2015's total with a further increase to £263 billion set for 2017. We forecast net mortgage lending of £45 billion this year rising to £50 billion in 2017. By comparison the OBR's implicit net mortgage lending forecast for 2016 is £66 billion and £72 billion for 2017.

- **Gross buy-to-let lending to reach £43 billion this year.** We forecast that gross buy-to-let lending will continue to increase faster than other segments of the market despite the adverse tax changes, reaching £43 billion in 2016 and £48 billion in 2017, when buy-to-let lending will constitute over 18% of all lending. We expect buy-to-let remortgaging to continue to provide the majority of the growth in total buy-to-let lending.



- **Only £4 in £10 used for house purchases is borrowed as cash still dominates market.** Over the course of 2015, 35% of house purchasers bought entirely with cash, slightly below the record 36% of 2014 but still well above the 25% that was typical before the financial crisis. Of the total value of house purchases over January-November 2015 of £312 billion, £129 billion was financed with mortgaged borrowings, 41.3%, slightly below 2014's figure of 41.8% and a new all-time low. Despite low mortgage rates, the housing market is still being driven by cash, in part reflecting the division between equity rich homeowners and investors and struggling cash-poor first time buyers.

1. Introduction

One year ago the Intermediary Mortgage Lenders Association (IMLA) published the first update of its report '*What is the new 'normal'? Mortgage lending in 2014-15 and the march back to a sustainable market*'. After another busy year for lenders, this report examines the mortgage market's performance over the past 12 months and again looks ahead to offer a view on how the market might evolve over the coming two years and beyond.

A range of indicators suggested that the return to a more normal mortgage market continued in 2015, underpinned by a stable UK macroeconomic background. But if the economic picture is one of relative stability, the political background appeared to undergo quite a radical change of course in 2015.

In a tacit recognition that its policy of stimulating housing supply has failed, the government now seems committed to managing demand to meet the policy objective of sustaining owner-occupation. As a result, the broadly supportive political environment that had existed for landlords since the 1988 Housing Act appeared to come to an end as the government announced a raft of tax measures designed to disadvantage buy-to-let investors.

Whether the government's renewed emphasis on promoting homeownership will reverse the decline in this tenure is an open question. Much hinges on why so few younger households are entering owner-occupation. The view that housing has become unaffordable as the house price earnings ratio has climbed can be questioned in some respects. First time buyers have never spent a lower proportion of their income on mortgage interest and households across the regions are spending more on average on rents than they would on a typical monthly mortgage payment, although the average first time buyer's deposit has risen significantly.

More attention needs to be paid to why younger households are not entering owner-occupation on the same scale as earlier generations despite the apparent cost advantage relative to private renting. It is possible that higher deposit requirements and tighter mortgage lending criteria are a larger barrier than many assume. If the government wishes to promote homeownership it should re-examine these barriers to see if they are creating an unjustified obstacle to prospective first time buyers. In particular, they might revisit the decision to end the Help to Buy mortgage guarantee scheme, which might reduce the supply of higher LTV mortgages from next year thus making it harder for some first time buyers to enter the market.

But ultimately a rising population demands more homes regardless of their tenure. In the absence of such new homes, governments can seek to manage demand to promote one tenure at the cost of another but only at the cost of one segment of society or another. Promoting homeownership without sufficient new supply can thus only succeed at the cost of a diminished social rented sector and a squeezed PRS with higher rents for tenants.

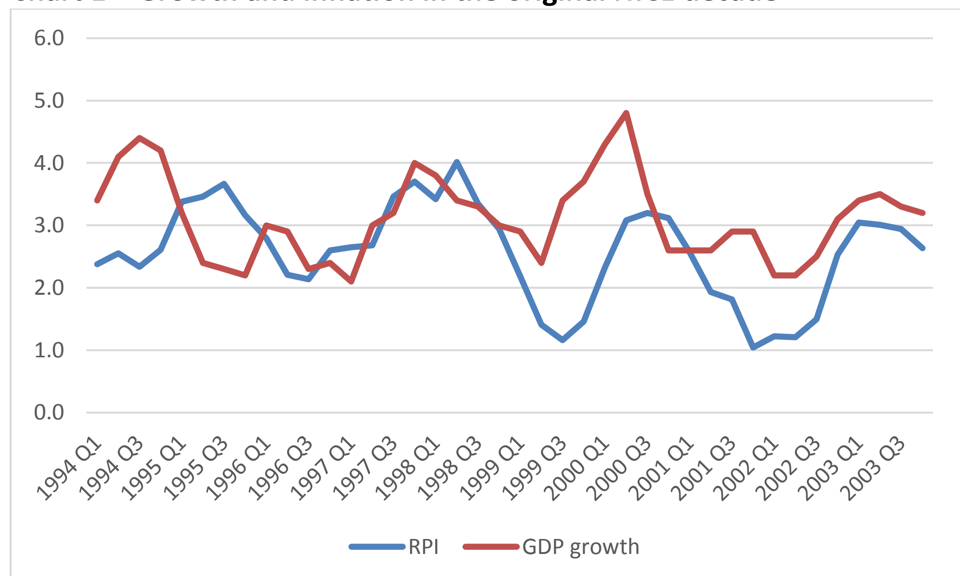
2. The path of recovery in 2015

The economic background

Gradually over the past few years, the shadow of the financial crisis has begun to lift from the economy as it has re-established a steady path of growth and low inflation. As it has, a new, relatively stable mortgage market has also emerged. Lenders face a more predictable economic environment now with, for example, funding no longer being the source of uncertainty that it was in the wake of the financial crisis (see Section 4), while consumers have gradually regained their confidence.

The low inflation and consistent growth of recent years gives rise to a sense of de-ja-vu. In 2003 the then Governor of the Bank of England, Mervyn King, made his now famous speech explaining how the UK economy had enjoyed a period of non-inflationary consistent expansion (the N-I-C-E decade) from the mid-1990s. Chart 1 shows the course of GDP growth and inflation as measured by the Retail Price Index (RPI) for the decade up to 2003. Over this period both of these variables remained in a narrow band by historical comparison, with GDP growth between 2-5% and inflation between 1-4%.

Chart 1 – Growth and inflation in the original NICE decade



Source: ONS

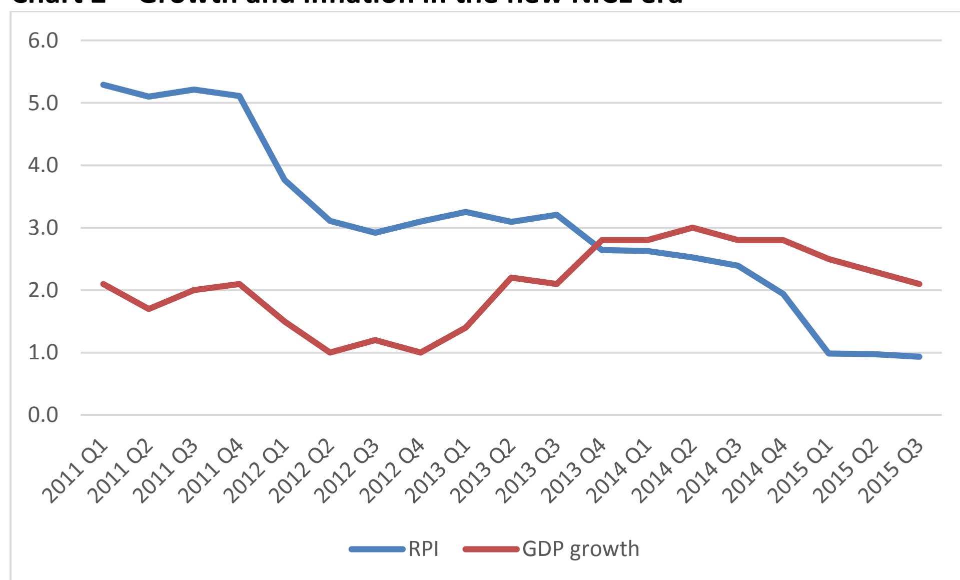
The NICE decade was to continue for another five years and ended not as earlier British economic cycles had with a balance of payments crisis and rising inflation and interest rates but in the turmoil of the global financial crisis.

The key insight behind the NICE acronym was that the traditional inflationary pressures that came from a prolonged period of economic expansion no longer applied in the way they had in earlier decades. A more globalized and flexible economy had reduced supply constraints, making it harder for producers to push up prices even at times of high demand.

This especially applied to the labour market where reduced union power, greater international labour mobility and the ability to source more labour services from across borders (think of the rise of Indian call centres), all dampened the ability of workers to push up wages even when unemployment was comparatively low.

With the UK economy now entering its seventh straight year of economic growth, we can stand back and consider how the current economic recovery compares to Mervyn's NICE decade. Since the financial crisis, inflation and interest rates have ratcheted down still further and GDP growth has been in a steady band between 1-3% - lower than in the original NICE decade but relatively constant. Although real wages remained depressed for much of the past seven years, the labour market has performed well with unemployment now down to 5.1%. Just as in the mid-1990s a collapse in global commodity prices has, over the past 18 months, accentuated the trend towards lower inflation and boosted real wages. In short, we appear to have entered a new NICE era (see Chart 2).

Chart 2 – Growth and inflation in the new NICE era



Source: ONS

What might a new NICE era mean for the mortgage market? Low and steady interest rates coupled with consistent economic growth and rising living standards provide the conditions that should engender a feel good factor that encourages consumers to borrow more. This is reflected in the OBR forecast, which shows such positive conditions powering a sustained recovery in new borrowing over the next few years.

The OBR predicts that over the five years between the fourth quarters of 2015 and 2020, outstanding mortgage debt will rise by £409 billion (£82 billion a year), including

increases of £66 billion and £72 billion in 2016 and 2017 respectively. It also forecasts that mortgage debt will rise from 107% of disposal income to 115%. But although these forecasts seem high when compared to the mortgage market's recent performance, they represent a compound growth rate in mortgage debt of 5.6% per annum, low in comparison to previous upswings.

Despite the recovery, the regulations that have been enacted in response to the financial crisis have created a very different kind of mortgage market from the one that accompanied the original NICE decade. Consumers' ability to act on any renewed exuberance has been curbed by a much sharper regulatory focus on affordability and by the higher capital requirements imposed on lenders.

The tighter regulatory environment might ensure that the economic stability the UK is currently enjoying does not precipitate too rapid an accumulation of consumer debt, reducing the risk that the new NICE era will eventually fall victim to financial instability in the way that the earlier one did, although that earlier instability came from external events. But the new regulatory regime is relatively untested and carries with it the risk of thwarting the ambitions of many future homeowners, undermining government policy to support owner-occupation.

Housing market

Although policymakers can take comfort from the controlled nature of the current recovery in the mortgage market, they are alive to the risk that low interest rates can create instability in asset markets and fuel excessive leverage. The housing market remains on their list of concerns because low rates have contributed to increases in house prices that have consistently outstripped wage growth.

In 2015, the housing market was more settled after the double digit price growth seen during 2014. By November 2015 house prices were running 6.5% ahead of their value of a year earlier according to the Office of National Statistics (ONS). This is roughly midway between the annual growth rates recorded by the Nationwide Building Society (4.5% up in the year to December) and Lloyds Banking Group (9.5% up on a year earlier in the three months to December).

Shortage of supply both of new build and second hand properties continued to be a major factor pushing prices up, with turnover levels only fractionally up between 2014 and 2015 despite good levels of demand. Royal Institution of Chartered Surveyors (RICS) surveys have shown the stock of available property on the market at record lows in recent months and housing starts in England were still running at less than 140,000 in the year to Q3 2015, well below the level implied by demographic trends.

Once again buyers with cash dominated the market, although their presence eased back slightly from 2014. In the year to November, 34.6% of property buyers paid for their home entirely by the use of cash against 36.1% in 2014, but as recently as 2006 this figure was only 23%.

Using ONS house price data, the estimated total value of UK property transactions in the year to November 2015 was £312 billion, an increase of 5.7% on the same period of 2014. Mortgage loans financed £129 billion of this total, meaning that only 41.3% of the funds used to buy UK residential property were borrowed, slightly below the 41.8% recorded in 2014 and a new all-time low. Research by Savills published in January 2016 also showed that the total value of UK homes passed the £6 trillion mark for the first time in 2015, with total housing equity reaching a record £4.8 trillion. The report highlighted that the aggregate equity held by landlords had, at £1,077 billion, passed that of mortgaged owner-occupiers for the first time.

Mortgage market – another game of two halves

Last year we noted that the growth in mortgage lending divided 2014 into two very different halves, with a strong market heading into the year tailing off rapidly in the second half, in part as a result of the introduction of the mortgage market review (MMR), which seemed to hit remortgage activity particularly hard.

2015 turned out to be something of a mirror image, with the weakness found through the first half giving way to a much strong performance from June. Table 1 illustrates this turnaround by showing each month's gross mortgage lending relative to the same month the previous year. This comparison removes any seasonality and shows the extent to which the market bounced in the summer and autumn, especially for remortgages.

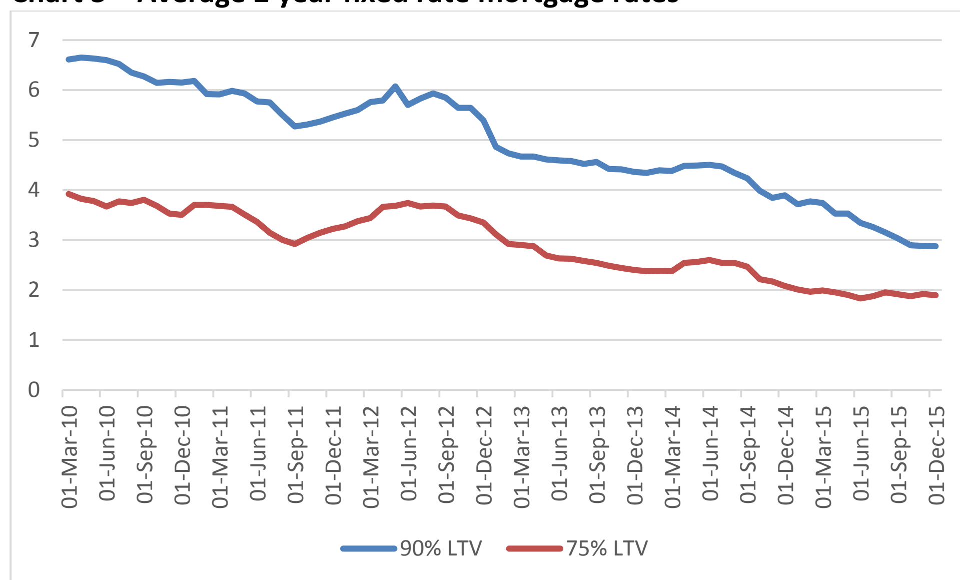
Table 1 – Increase in gross mortgage lending compared to a year earlier

		House purchase	Remortgage	Other	Total
2014	Oct	11.1%	-8.2%	14.9%	3.8%
	Nov	0.7%	-15.1%	-3.4%	-5.7%
	Dec	1.2%	-8.9%	11.5%	-2.8%
2015	Jan	-7.2%	-8.6%	-12.1%	-8.2%
	Feb	-7.7%	-8.8%	-2.4%	-8.1%
	Mar	5.3%	8.2%	-5.8%	5.1%
	Apr	-5.3%	-1.7%	-1.0%	-4.5%
	May	-7.9%	5.2%	-1.1%	-4.5%
	Jun	6.3%	30.8%	16.7%	12.5%
	Jul	7.1%	24.4%	3.5%	12.0%
	Aug	6.4%	17.0%	9.9%	9.9%
	Sep	11.2%	13.5%	22.4%	13.1%
	Oct	12.7%	35.7%	3.9%	19.1%
	Nov	20.3%	43.6%	13.6%	27.1%

Source: Bank of England.

One possible explanation for this pattern was that political uncertainty in the run-up to the general election held consumers back. With a decisive outcome in the election, mortgage activity quickly recovered. This explains house purchase lending and is mirrored in the pattern of housing transactions, which also bounced sharply in June after being subdued earlier in the year.

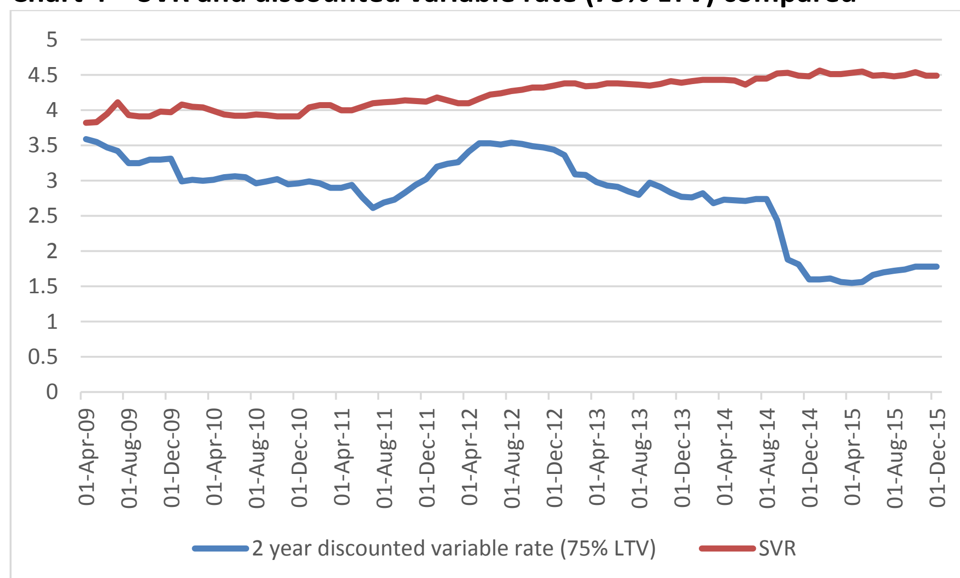
Chart 3 – Average 2 year fixed rate mortgage rates



Source: Bank of England

But the election is unlikely to have had much effect on the rebound in remortgage activity. Instead, it seems that intensified competition amongst mortgage lenders, which has driven mortgage rates down to record lows, is the main explanation. As Chart 3 shows, 2015 saw the downward trend in 2 year fixed rate deals continue. February saw the average 2 year fixed rate at 75% LTV fall below 2% for the first time and by October the average 2 year fixed rate at 90% LTV slipped below 3% for the first time (see the discussion on mortgage funding in Section 4 below for one factor driving rates down).

Chart 4 – SVR and discounted variable rate (75% LTV) compared



Source: Bank of England

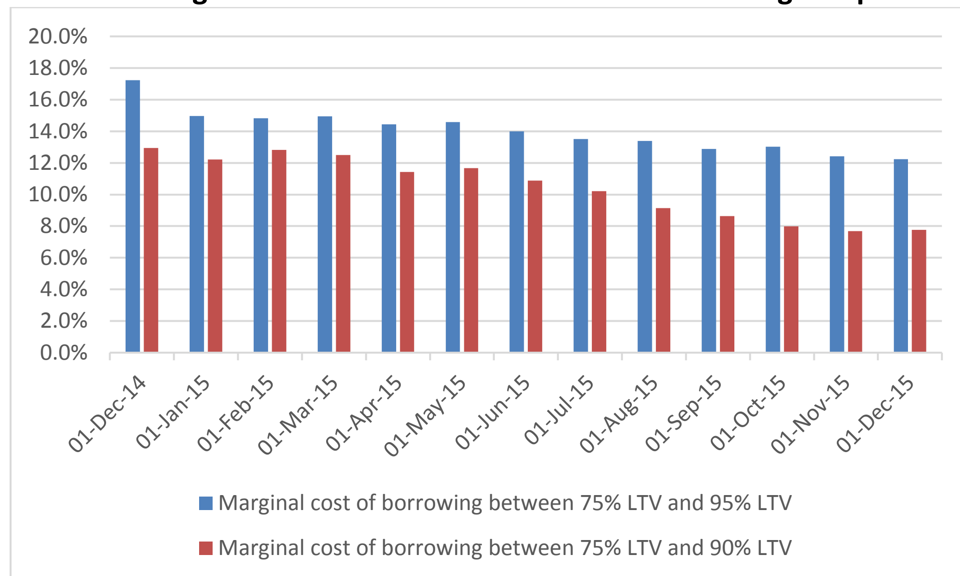
The extent to which lenders have sought to win new business is illustrated by Chart 4 which compares the average standard variable rate (SVR) with the average 2 year

discounted variable rate available on new loans. The interest rate differential reached new highs in 2015 as the average SVR actually rose slightly against a sharply lower average discounted rate. This points to a healthy level of competition between lenders but does raise the question of why lenders are having to discount so intensely to generate higher mortgage volumes.

Another sign of the return of a healthy mortgage market in 2015 could be found by examining the differential between the pricing of 75% LTV, 90% LTV and 95% LTV mortgage products. From the price difference you can calculate the implied cost of the top slice of the loan. For example, an average 2 year fixed rate deal at 75% LTV had an interest rate of 1.89% in December 2015 while the average 2 year fixed rate deal with a 90% LTV was 2.87%. If the 90% loan was considered as two separate loans – a 75% LTV one at 1.89% and a top up loan between 75-90% LTV, you can calculate the implied interest rate on the top up element.

The results are shown in Chart 5 for the marginal cost of borrowing between 75-90% and between 75-95%. Chart 5 shows a sharp decline in the marginal cost, particularly the cost of 75-90% LTV borrowing which fell from 12.9% in December 2014 to 7.8% by December 2015. This is the sharpest repricing of higher LTV loans since the financial crisis and illustrates how competition in the low LTV market has spilled over into a repricing of higher LTV products, a part of the market which had previously remained decidedly underserved.

Chart 5 – Marginal cost of 90% LTV and 95% LTV borrowing compared



Source: Bank of England

However, improving affordability of higher LTV loans in 2015 did not spark a rise in aggregate high LTV lending or the number of first time buyers, which fell back slightly in the year to November 2015 compared to the same period of 2014. Given the emphasis that government has put on promoting homeownership this is a disappointing result that should prompt an analysis of why comparatively few people are choosing to enter owner-occupation (see Section 4 for a discussion on affordability).

Moreover, lenders are concerned that the end of the government's Help to Buy mortgage guarantee scheme at the end of 2016 could reverse the recent improvements in high LTV loan pricing, damaging first time buyer affordability. An IMLA survey of members and brokers published in March 2015 found that almost two thirds of lenders (65%) believed that competition in the high LTV market will fall if the scheme is allowed to expire without a permanent replacement.

Buy-to-let

Buy-to-let had another strong year in 2015. In the year to November gross buy-to-let lending reached £34.8 billion, 40% above the same period of 2014, with no sign of a let-up in the pace of growth as Q3 was 49% above the previous year's figure. This took buy-to-let lending to a record 17.7% of all mortgage lending in the third quarter.

Although the growth of the PRS has been the underlying engine for growth in buy-to-let mortgage lending, it is actually remortgage activity that has led the growth in recent years. This was again the case in 2015, with remortgage lending up 48% in the year to November against a 31% rise in house purchase lending. As a result, buy-to-let remortgage lending reached 60% of the total of buy-to-let lending by November 2015 and 33% of all remortgaging.

However, it is too early to understand the impact on lending of the unexpected tax changes announced in the July budget which included restricting the deduction of mortgage interest to the basic rate of tax for landlords. The impact will be compounded by further tax changes announced in the autumn statement, most notably the imposition of an additional 3% stamp duty for buy-to-let and second homeowners which will take effect from April 2016.

While these changes are likely to slow the growth of buy-to-let lending for house purchase, they could actually stimulate higher buy-to-let remortgage activity as the restriction on the deduction of mortgage interest will increase borrowers' incentive to seek out lower mortgage rates. As a result, our forecast for buy-to-let lending presented in Section 3 below sees the total continuing to rise in 2016 and 2017. The tax changes affecting buy-to-let are discussed in more detail in Section 4.

2015 lending totals

Based on the positive trends that were established over the course of 2015, we expect total mortgage lending to reach £220 billion, 8.2% up on 2014 and the highest annual total since 2008. The strongest contribution is likely to come from the remortgage market, which could total £68 billion, 19.1% up on 2014. As is usually the case, the rise of gross lending is likely to have a disproportionate effect on net lending, which could total as much as £34 billion, 44% above 2014's level. However, this only represents a modest 2.6% growth in the stock of mortgage debt.

3. The outlook for 2016 and 2017

The wider economic environment

Going into 2016 the global economic outlook remains mixed. The recent US rate rise marks a milestone on the return to 'normality', although even there the recovery has been unusually weak and commentators are not anticipating a return to the level of rates seen in the past. Elsewhere, the outlook is less favourable. Commodity based economies such as Russia, Brazil and Saudi Arabia are suffering, China's slowdown seems to be continuing and growth in Europe and Japan remains sluggish.

But the slump in commodity prices should provide a boost to developed economies including the UK, as it improves the terms of trade and boosts real consumer incomes. Also, as lower commodity prices suppress inflation, the likelihood of an early interest rate rise in the UK is receding.

Barring unexpected events, we would expect the UK economic recovery, which is already entering its seventh year, to continue through 2016 and 2017. This new NICE era or goldilocks economy (not too hot and not too cold) is a positive backdrop for lenders and consumers, which should underpin the continued recovery of the mortgage market.

Housing and mortgage markets in 2016 and 2017

In keeping with the broader economy, the housing market is entering the seventh year of recovery. This has been a weaker housing recovery than that of the mid-1990s or mid-1980s and 2015 was a year of relatively modest price increases after the exuberance of 2014.

Table 2 – key forecast assumptions

	Past values		Forecast values		Percentage changes		
	2014	2015e	2016f	2017f	2015/14	2016/15f	2017/16f
House prices (ONS average for year)	264,697	280,000	295,000	305,000	5.8%	5.4%	3.4%
Housing transactions (UK, thousands)	1,219	1,231	1,250	1,300	1.0%	1.5%	4.0%
Value of housing transactions (£bn)	322,600	344,753	368,750	396,500	6.9%	7.0%	7.5%
% of transaction value that is mortgaged	41.8%	41.2%	42.0%	42.6%	-1.4%	2.1%	1.4%
Bank Rate (Q4)	0.5%	0.5%	0.5%	0.5%	0.0%	0.0%	0.0%

Source: Instinctive Partners, ONS and HMRC

Table 2 outlines our projections for key assumptions behind our mortgage market forecast. We do not expect the Bank of England to raise Bank Rate this year and believe that a rate rise could be delayed beyond 2017 given the exceptionally benign outlook for inflation. We expect house prices and turnover to continue on a path of modest recovery, given the relatively stable environment and broad balance of positive and negative forces acting on the market.

The strongest positive forces at present are lower mortgage rates, rising real incomes and continued strong population growth. The most prominent factor holding the market in check has been the constraints holding first time buyers back, which some commentators see mainly as an issue of poor affordability (see Section 4 below for a fuller discussion).

To date, government policy has supported demand through schemes aimed at assisting borrowers such as Help to Buy and those that have supported lenders such as Funding for Lending. But 2015 marked a significant change in the direction of policy as George Osborne announced a series of measures designed to manage down demand from buy-to-let investors. The government hopes this will shift demand from investors to first time buyers but it is unlikely on its own to reverse current trends in tenures as these reflect wider forces (see Section 4 for a fuller discussion).

Table 3 – Mortgage market forecast

	Gross mortgage lending (£m)				Percentage changes		
	2014	2015e	2016f	2017f	2015/14	2016/15f	2017/16f
House purchase	134,719	142,000	155,000	169,000	5.4%	9.2%	9.0%
Remortgage	57,073	68,000	75,000	83,000	19.1%	10.3%	10.7%
Other	9,712	10,000	10,000	11,000	3.0%	0.0%	10.0%
Total	203,285	220,000	240,000	263,000	8.2%	9.1%	9.6%
of which							
Buy-to-let lending	27,400	38,000	43,000	48,000	38.7%	13.2%	11.6%
Share of total	13.5%	17.3%	17.9%	18.3%			
Lending via intermediaries*	98,000	115,000	127,095	138,649	17.3%	10.5%	9.1%
Share of total	61.9%	68.9%	70.0%	70.0%			
Net lending	23,539	34,000	45,000	50,000	44.4%	32.4%	11.1%

* Regulated loans only

Source: Instinctive Partners, Bank of England, CML

Table 3 shows our forecast for the main mortgage variables. We expect the strength of the market in the second half of 2015 to be maintained into 2016 and 2017. Total gross lending could reach £240 billion in 2016 and £263 billion in 2017. We expect the strongest growth to occur in the remortgage market where the recovery has to date lagged that of the purchase market, but is now benefitting from the presence of very attractive new mortgage deals.

We expect net lending to follow its normal pattern of reflecting trends in gross lending but with an amplified effect. The £45 billion and £50 billion figures we are projecting for 2016 and 2017 represent a growth in the stock of mortgage debt of 3.4% and 3.6% respectively, reasonably modest rates of growth. These forecasts can be contrasted with the much higher implied OBR net lending forecast of £66 billion in 2016 and £72 billion in 2017, although they are well above the Council of Mortgage Lenders (CML) forecast of £31 billion and £39 billion for 2016 and 2017.

We expect the growth in mortgage lending for house purchase to slightly outstrip the rate of growth in the aggregate value of housing transactions over 2016 and 2017. As

a result, while we estimate that 41.2% of funds for house purchase were borrowed in 2015, this figure will climb slightly to 42.0% this year and 42.6% in 2017, reversing the trend towards cash (see Table 2).

Table 3 also shows forecasts for the level of buy-to-let lending and lending via intermediaries. We see the rate of growth of buy-to-let lending slowing sharply this year and next. But the strength of buy-to-let remortgaging and the momentum provided by the growth in the PRS should be enough to ensure that buy-to-let continues to increase its share of total mortgage lending to 17.9% this year and 18.3% in 2017, when buy-to-let gross lending could hit £48 billion for the first time. As explained in Section 4 below, tax measures introduced in 2015 aimed at landlords are likely to be insufficient to reverse the growth of the sector against the background of strong tenant demand.

Lending via intermediaries received a substantial boost from the MMR, as it abolished so-called non-advised sales. Since then, the share of lending introduced through brokers has risen quite sharply and has been close to or at 70% in recent months. We expect intermediaries' share of lending to plateau at 70% in 2016 and 2017 as a segment of the customer base remains comfortable accessing deals directly with lenders, but it is entirely possible that intermediaries' share could creep higher still.

4. Events shaping the housing and mortgage markets

Government targets buy-to-let

In a tacit recognition that its policies had failed to solve the crises of inadequate housing supply and falling owner-occupation, in his July 2015 budget George Osborne announced an unexpected change of direction. In an attempt to manage housing demand from investors, the Chancellor announced two adverse tax changes for landlords:

- Restricting the deductibility of mortgage interest for landlords to the basic rate of income tax.
- Removing the wear and tear allowance for furnished rented property.

In the Autumn Statement two further changes followed:

- Applying a stamp duty surcharge of 3% for landlords and second home buyers.
- Requiring capital gains tax to be paid within 30 days of the sale of a rented property.

The scale of the tax hikes on landlords is significant. HM Treasury estimates that in its first full year of implementation in 2020-21, restricting the mortgage interest tax deduction to the basic rate will raise £665 million. The 3% stump duty surcharge is expected to raise £625 million in 2016-17, mostly paid by landlords. The reduced window for payment of capital gains on residential property is expected to bring in £230 million in 2020-21 and the reform of the wear and tear allowance is expected to raise in £205 million in its first year, 2017-18. Adding together these measures, the exchequer will receive additional revenues of about £1.7 billion a year.

At the same time, the regulatory environment for buy-to-let lending is under review. The government is consulting on the form of new macro-prudential powers of regulation for the Bank of England Financial Policy Committee (FPC) to control the buy-to-let market. This would bring it broadly into line with lending for owner-occupiers and potentially allow regulators to limit buy-to-let by LTV and income cover ratio (the equivalent of loan-to-income in the owner-occupied sector).

Although new macro-prudential tools to control the buy-to-let market may not be used straight away, it is clear that regulators are concerned about the market. The Bank of England has expressed concern at the rate of growth in buy-to-let lending and sees risks to the stability of the wider housing market if a change in conditions, such as a sharp rise in interest rates, forces large numbers of landlords to sell up. If past behaviour is any guide these concerns may be overstated, as landlords have in the past been reluctant to sell when the market was distressed but it is possible that a different set of conditions in the future could create a different response.

Likely impact on buy-to-let

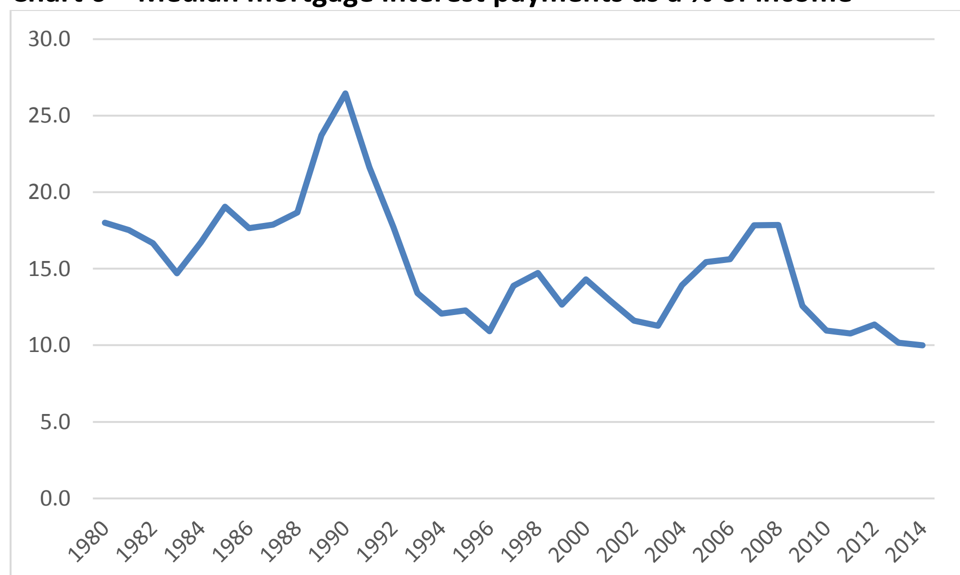
The additional *income tax* burden on landlords of around £870 million (from the restriction of the mortgage interest deduction and the end of the wear and tear allowance) is equivalent to 1.8% of the £50 billion estimated revenues of the PRS as a whole. Although significant, this is unlikely on its own to seriously dent landlord ambitions at a time when tenant demand and rents are rising, although some highly leveraged landlords will face much higher tax bills.

Moreover, landlords can avoid the restriction on the deduction of mortgage interest on future purchases by incorporating. And, once averaged over the life of a typical buy-to-let investment (which the Association of Residential Letting Agent's landlord survey estimates to be 20 years) the 3% stamp duty surcharge costs a modest 0.15% a year, and may not be applied to landlords with larger portfolios.

However, there may be a bigger psychological effect and a fear that further taxes increases will be imposed if the current measures fail to stem the rise of the buy-to-let sector. The general political environment is becoming more hostile to landlords with rent controls now being advocated by many on the left. For example, the Scottish National Party's latest programme for government contains a Private Tenancies Bill which includes measures to "provide more predictable rents and protection for tenants against excessive rent increases, including the ability to introduce rent controls for rent pressure areas".

Improving housing affordability

Chart 6 – Median mortgage interest payments as a % of income



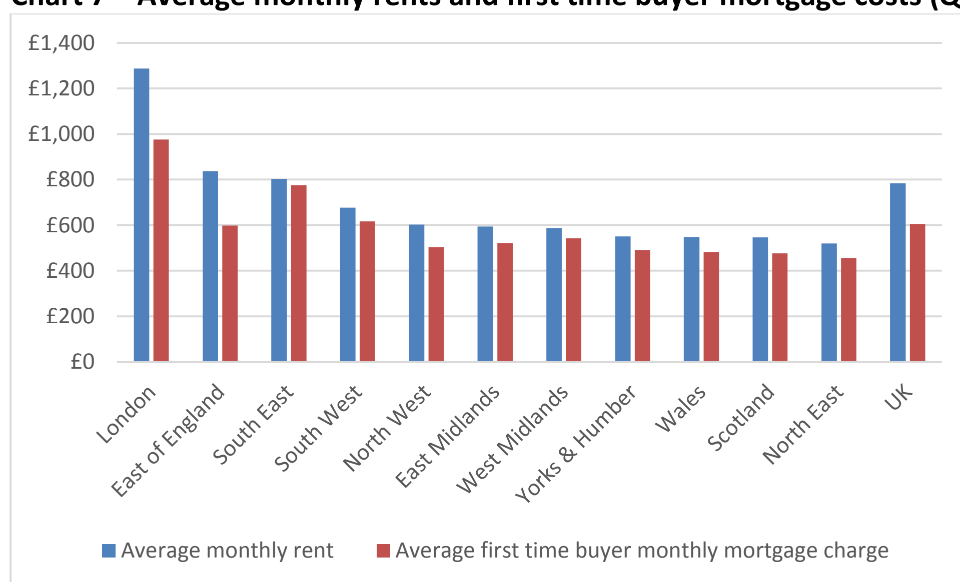
Source: CML

Paradoxically, while the media and politicians have focused on the unaffordability of housing as measured by the house price to earnings ratio, the proportion of the median mortgaged home buyer's income spent on mortgage interest slumped to its

lowest recorded level of 10.0% in 2014 (see Chart 6), with a further reduction to 8.6% reported by the third quarter of 2015. The figure for first time buyers was 9.7% in November 2015, also an all-time low.

The relative affordability of mortgage costs is confirmed by a comparison of estimated average rents and mortgage costs for first time buyers across the UK (see Chart 7). Even though this comparison uses the full capital and interest payment on a repayment mortgage, in 2015 mortgage payments for the average first time buyer were lower than the average rent as measured by Your Move, in every region of Britain. This concurs with the findings of a Santander report of December 2015 using a slightly different methodology, and it inevitably begs the question that if homeownership is unaffordable, how are people managing to meet their monthly rent?

Chart 7 – Average monthly rents and first time buyer mortgage costs (Q3 2015)



Source: CML and Your Move

It suggests factors other than mortgage affordability are holding back first time buyer demand. Either more younger households prefer the flexibility of private renting or feel it better suits uncertainties in their lives (e.g. lack of job security) or other barriers stand in their way. There is some evidence of a modest increase in those choosing not to buy. The latest Halifax Generation Rent report shows that the proportion of 20-45 year olds who do not own and do not wish to rose from 13% in 2011 to 16% in 2015.

But clearly, this shows that the overwhelming majority of younger households do still wish to own their own home at some point. Higher deposit requirements and tighter lending criteria may be factors holding back a significant segment of this cohort and more work should be conducted into why so many potential first time buyers have not yet bought a home despite the potential cost savings from doing so.

If the government's over-riding concern is to ensure that the next generation can enter owner-occupation, they will need to consider why strong mortgage affordability has not been translated into more first time buyers and consider the implications for

policy going forward. For example, implicit in the decision to raise taxes on landlords is the view that this will "level the playing field" in favour of first time buyers, helping them to outbid buy-to-let investors more often.

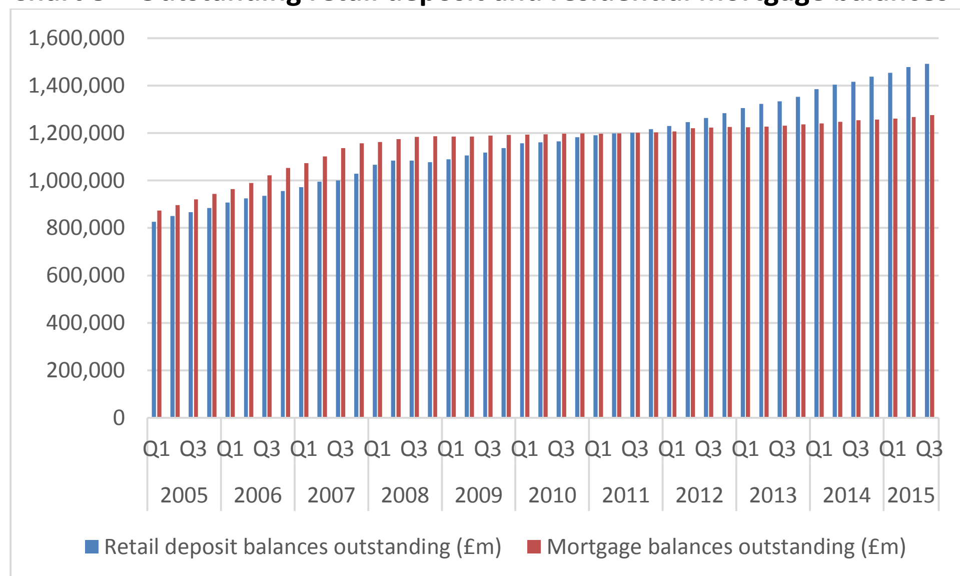
But as homeownership is more affordable, in the sense that mortgage payments are a record low share of buyer income, other factors such as high deposit requirements may be more significant barriers, and policy may need to be redirected to focus on such issues. The decision to terminate the Help to Buy mortgage guarantee scheme at the end of the year could be revisited for example.

Mortgage funding – retail deposits on the rise

Retail deposits have always been the mainstay of mortgage funding in the UK. And despite the large mismatch in the legal maturity between short term and mainly instant access deposits and mostly 25 year mortgages, in most circumstances they have proved a highly stable source of funding.

Even during the financial crisis when wholesale funding markets were in turmoil retail deposit balances remained remarkably stable with a few notable exceptions such as Northern Rock. After the run on Northern Rock deposits the government raised the deposit guarantee from 90% to 100%. With the Financial Services Compensation Scheme now providing a 100% guarantee on deposits up to £75,000, it is unsurprising that deposits continue to be a highly dependable source of funding.

Chart 8 – Outstanding retail deposit and residential mortgage balances



Source: Bank of England

When in 2007-9 wholesale financial markets such as securitisation seize up, only massive central bank and government intervention stabilised funding markets and supported lenders through the crisis. Since then government intervention through a series of funding support mechanics such as the Special Liquidity and Funding for

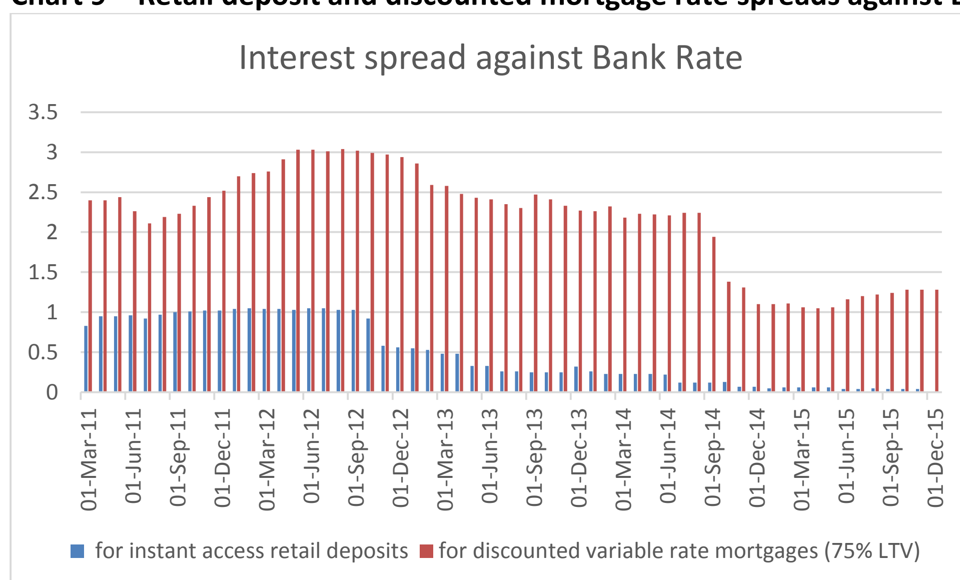
Lending schemes, have helped to restore confidence both in wholesale funding markets and in the participating banks and building societies.

But less visibly, the stability of lenders' aggregate funding position has been improving as the underlying balance of funding and mortgage lending has shifted emphatically towards a surplus of deposits. This can be seen in Chart 8 which compares the outstanding level of UK retail deposits with the outstanding level of residential mortgage balances.

Although retail deposits can fund a wide range of bank and building society assets, given the traditional dominance of retail funded building societies and ex-building societies in the provision of mortgages, there has always been a clear funding link from deposits to mortgages in the UK. And historically the balances of these liabilities (deposits) and assets (mortgages) have tended to broadly balance in aggregate.

After a period when aggregate retail deposits exceeded mortgage balances, in 2003 there was broadly a balance between the two. The subsequent strength of the mortgage market increased competition for deposits amongst lenders and led many to look for new sources of funding. As a result the UK residential mortgage backed securities (RMBS) and covered bond markets took off. By Q3 2007, total mortgage debt outstripped deposit balances by a record £136 billion.

Chart 9 – Retail deposit and discounted mortgage rate spreads against Bank Rate



Source: Bank of England

But from late 2007, the financial crisis drove a rapid unwinding of this asset 'overhang', as wholesale funding markets shrunk, lenders restricted mortgage availability and savers retrenched to the safety of deposits. Balance was restored by mid-2011 but since then there has been no let-up in these divergent trends with, by Q3 2015, deposit balances exceeding mortgage balances by a record £215 billion (17%). As Chart 9 shows, this shifting balance of deposits and mortgages has had a marked impact on interest rate spreads across the industry.

Chart 9 shows lenders' aggregate deposit and mortgage spreads, measured against Bank Rate, which was 0.5% through this period. As can be seen in the chart, for most of 2012, lenders were paying more than 1% above Bank Rate to instant access depositors (a negative spread on deposits). But as deposits have flowed in, competition amongst lenders to attract depositors has lessened to the point where the average instant access account pays around 0.5% (a zero deposit spread).

Lenders have passed these lower negative deposit spreads onto new mortgage borrowers in a substantially lower spread between discounted variable rate mortgage deals and Bank Rate. Between 2012 and 2015 this spread fell from 3% to a little more than 1%. This is clearly good news for prospective borrowers but can also be thought of as a symptom of the continued conservative behaviour of households, who in aggregate are prioritising saving over borrowing.

Wholesale funding markets

The increased availability of retail deposits has reduced lenders' need to access wholesale funds. But within wholesale funding some markets have remained more resilient than others. Unsecured senior bank debt issuance has been underpinned by the markets' belief that banks are now financially stronger following increased capital requirements and more conservative liquidity policies. The UK covered bond market has benefitted from comparatively low issuance costs due to the existence of an established investor base in Europe and the benefit of dual recourse (to the issuer and the mortgage assets).

The UK RMBS market has not performed as well. The total level of outstanding bonds continues to decline and issuance has been sporadic with no particular trend. The RMBS investor base is far smaller than it was before the financial crisis but equally fewer issuers are attracted to this market, which is seen as being relatively expensive.

Although the EU has been much more supportive of the covered bond market over the past 8 years, it has acknowledged the benefits of a vibrant securitisation market. As a result, the EU has attempted to work with the industry on the creation of a more standardised securitisation market. In February 2015 the EU issued a consultation document '*An EU framework for simple, transparent and standardised securitisation*'. This is part of a concerted effort to establish a standardised market which might then be granted less onerous regulatory requirements.

But to date, Europe has struggled to find a standardised model for securitisation that the regulators are comfortable with. Structured finance markets like RMBS grew up with flexibility and innovation and therefore do not necessarily fit easily within a standardised structure in the way that a covered bond does. Nonetheless, the US agency market shows that standardised securitisation markets are achievable and Europe should continue to strive toward a form of securitisation that regulators feel sufficiently comfortable with to improve the regulatory treatment. In the meantime, the UK RMBS market will continue to function but not reach its full potential.

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About IMLA

IMLA is the specialist trade body representing the interests of mortgage lenders who market their products through brokers, rather than solely direct or through a branch network. Its directors and members are drawn from the senior ranks of mainstream banks, building societies, 'challenger' banks and specialist lenders.

IMLA provides a unique opportunity for senior industry professionals to meet on a regular basis to discuss key current initiatives and contribute actively through IMLA and other industry forums.

IMLA was formed in 1988 as the Association of Mortgage Lenders and was instrumental in the creation of the Council of Mortgage Lenders (CML). It changed its name to IMLA in 1995. Subsequently IMLA helped bring the Association of Mortgage Intermediaries (AMI) into being and was instrumental in bringing the mortgage advisers qualification CeMAP to fruition. For more information, please visit www.imla.org.uk

About the report

This report does not necessarily represent the views of individual IMLA members. It is designed as a discussion paper covering trends in the UK mortgage market with the aim of stimulating further debate with interested stakeholders.

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.