The new 'normal' – prospects for 2017

Is the march back to a sustainable market on track?

April 2017

Executive summary

The landscape

- **Economy firm in face of Brexit vote but risks remain.** Since last year's report was published the UK has taken the dramatic step of voting to leave the EU. Nine months on from that vote, data on economic activity has held up better than was generally predicted. And since 18 January the country has had more clarity on the form that Brexit will take, with Theresa May setting out plans to leave the Single Market and seek a comprehensive trade deal with the EU. This policy announcement was generally well received by the financial markets but risks remain, particularly around whether a new trade deal can be agreed before the UK formally leaves the EU.

- **Housing market remains robust.** The housing market continued on a course of moderate recovery with house prices up 7.5% in 2016 and turnover still moving ahead very slightly. The Royal Institution of Chartered Surveyors (RICS) UK Residential Market Survey continued to pinpoint a lack of properties as the main factor holding turnover back. As housing is the ultimate "big ticket" purchase, the relative solidity of demand since the referendum provides a reassuring insight into consumer sentiment.

- **Another year of solid growth in the mortgage market.** Against the backdrop of rising house prices and higher transactions unsurprisingly the mortgage market enjoyed another year of expansion. However, two-thirds of the £24 billion rise in gross lending to £245 billion occurred in the remortgage market. Within the purchase market, three quarters of the growth in lending came from first time buyers as the number of home movers fell back.

- **Housing white paper: missed opportunity to fix a broken housing market.** The government's housing white paper was willing to admit the dysfunctional nature of the UK housing market (its title was 'Fixing our broken housing market'). But it lacked the policy proposals needed to produce a serious step change in housing supply.

- **Mortgage rates hit record lows.** The Bank of England's decision to cut Bank Rate to a record low of 0.25% in August 2016 paved the way for further falls in mortgage rates, which had already been tracking lower as a result of intensified competition amongst mortgage lenders. The average 2 year fixed rate mortgage at 75% loan-to-value (LTV) fell below 1.5% for the first time last year and the average 2 year fixed rate mortgage at 90% LTV fell below 2.5% 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 moving homeowners

spending a record low 7.2% of their income on interest in 2016 and first time buyers spending a new low of 9.1%.

The outlook

- We expect the steady growth in gross and net mortgage lending that has been evident since 2011 to continue in 2017 and 2018.

- **Gross mortgage lending to reach £260 billion this year.** We forecast that gross lending will rise for the seventh year in a row to reach its highest level since 2007. Similarly, we expect **net mortgage lending to also hit its highest level since 2007 at £45 billion**, suggesting that the stock of mortgage debt will grow by 3.4%, slightly outpacing the growth of disposable income expected by the government's Office for Budget Responsibility (OBR).

- **Remortgaging to reach £90 billion in 2017.** We expect remortgage activity to continue to be the most buoyant element of the market in 2017, with total remortgaging reaching £90 billion, 35% of total lending. In 2018 we see the remortgage market growing to £92 billion in line with the growth in the broader mortgage market.

- **Gross buy-to-let lending to fall to £38 billion this year.** We forecast that gross buy-to-let lending will decline by 6% year-on-year in 2017 before recovering to £40 billion in 2018. House purchase buy-to-let drives this decline, falling by nearly 17% to £12.4 billion in 2017. However, we think that the monthly total of buy-to-let lending has already reached its bottom, even for house purchase activity.

1. Introduction

A calm market but political turbulence

One year ago the Intermediary Mortgage Lenders Association (IMLA) published the second update of its report '*What is the new 'normal'? Mortgage lending in 2014-15 and the march back to a sustainable market*'. While the mortgage market has remained stable over the past year as we anticipated in last year's report, the political environment has been anything but predictable.

In the wake of the unexpected vote to leave the EU in June 2016 we soon had a new Prime Minister who quickly put her stamp on the government with major changes in the cabinet lineup and new policy priorities. In the realm of housing, the housing white paper ('Fixing our broker housing market'), published on 7 February 2017, confirmed a shift in policy away from the strong pro-home ownership line of the Cameron administration and back towards a more tenure neutral approach, at least in tone. But it was timid in its proposals (see Section 5).

Regulation marches on

But behind the scenes the factor that has kept lenders busy is the ever-growing body of regulation, which seems impervious to changes in government or any other influences. The latest rules include the Senior Managers Regime and a serious ramping up of regulation in the buy-to-let market with both new Bank of England powers of direction and new affordability rules from the Prudential Regulatory Authority (PRA) that came into effect in January 2017.

2016, a year of solid progress for the mortgage market

Despite the political whirlwind and tightening regulation, a range of mortgage market indicators showed that in 2016 the market continued its long return to more normal conditions. Total mortgage lending increased by 10.7% to £245 billion and lending to first time buyers hit the record figure of £53 billion (see Section 4).

Average mortgage rates for new business fell to new all-time lows and the differential between these rates and lenders' SVRs rose further, suggesting intensified competition amongst lenders for new business. The differential in pricing of lower and higher LTV loans was broadly flat over the year. These indicators point to a market with healthy competition for business despite the growth in the overall size of the market.

Buy-to-let knocked back

One segment of the mortgage market which did not manage to grow in 2016 was buy-to-let house purchase lending. It has suffered in the wake of tax changes from the previous Chancellor George Osborne, particularly the restriction on mortgage interest deductibility and the 3% stamp duty surcharge. Through these measures, government

had sought deliberately to choke back demand from buy-to-let investors to make more space for first time buyers, in a tacit recognition that its policy of stimulating housing supply had failed.

Although the May government has rowed back on emphasizing the expansion of homeownership, political commentators are not forecasting a reversal of the new taxes on buy-to-let. With new affordability rules coming into effect in 2017 as well, we would not expect this year to see a significant rebound in buy-to-let activity. However, if tenant demand continues to grow, upward pressure on rent levels could gradually bring landlords back into the purchase market. Although Britain's exit from the EU could reduce inward migration, which has been a strong source of demand in the private rented sector (PRS), the possible scale of the impact is highly uncertain.

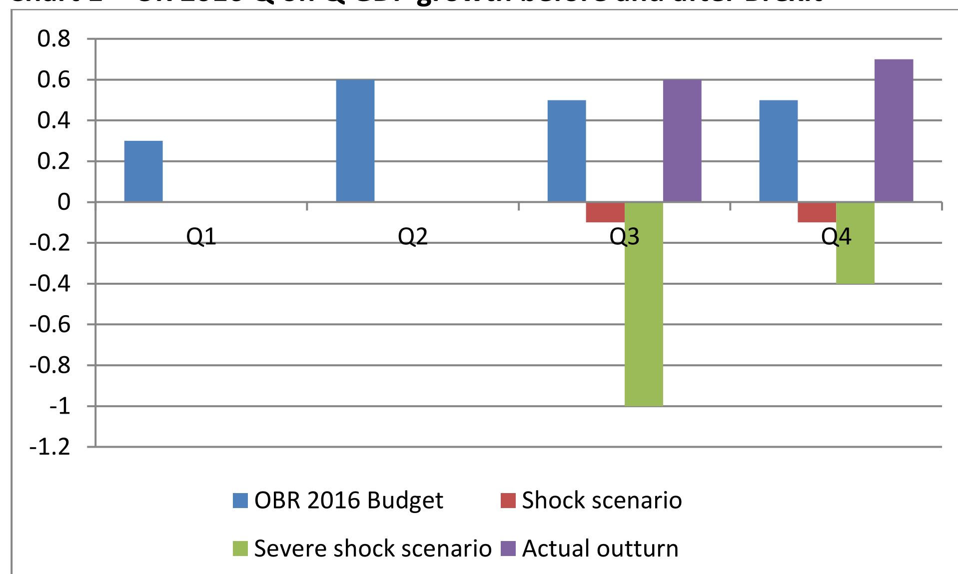
2. The economic background

The impact of Brexit

By far the most significant political event of the past 12 months has been the vote to leave the EU. Yet the performance of the UK economy has shown few signs of distress despite some dire predictions in the lead up to the referendum. The blue bars in Chart 1 show the OBR's GDP projections for 2016 published alongside the March 2016 budget. The red bars show the OBR's scenario based on a projected Brexit vote and the green bars show the outturn the OBR projected if Brexit caused a severe shock (a kind of worst case scenario).

Eight months on from the vote we can see that the profile of growth through the second half of 2016 showed no sign of a Brexit effect. Indeed, growth was slightly higher than the OBR projection based on a remain victory.

Chart 1 – UK 2016 Q on Q GDP growth before and after Brexit



Source: Capital Economics, HM Treasury and OBR

The most noteworthy consequences of the surprise vote were the Bank of England's decision in August to introduce a package of measures to stimulate the economy including more quantitative easing (QE) and a cut in Bank Rate from 0.5% to 0.25%, the government announcement that it would delay attempts to eliminate the fiscal deficit and a sharp decline in the value of sterling.

This easing of monetary and fiscal policy and the fall in sterling are stimulants to the UK economy. Although concern has been expressed about the squeeze on incomes that could result from higher inflation and the dampening effect this could have on consumer expenditure, it is likely to be offset at least to some extent by the improved terms of trade for the country. One striking example is the Port Talbot steel works in South Wales. Prior to the vote, owners Tata Steel had announced plans to sell out as

the plant was loss making but the fall in sterling has restored the plant to profit and Tata has shelved plans to sell.

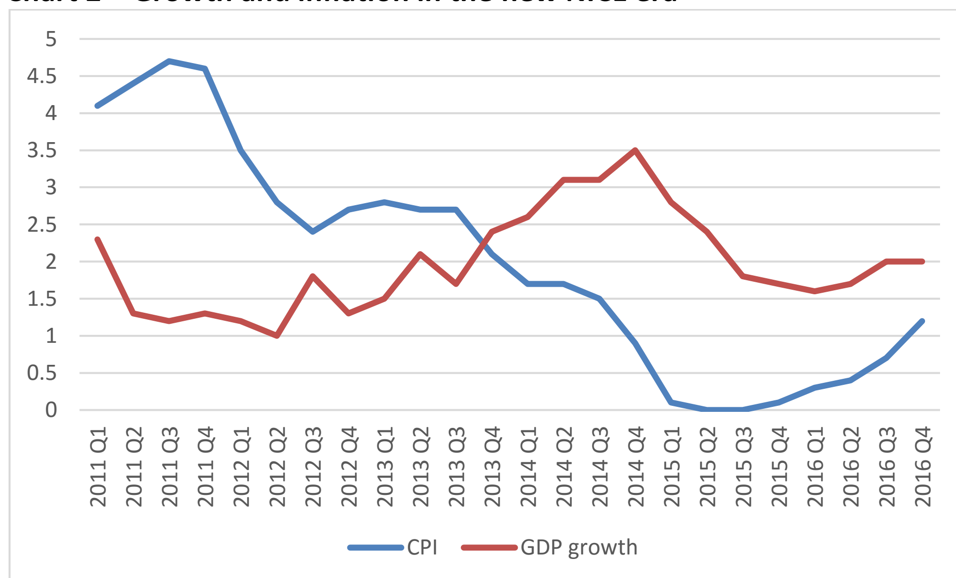
However, this positive effect will be counterbalanced to some extent by the outward migration of jobs that are less sensitive to the exchange rate. We have already seen announcements from major banks that some jobs, particularly those related to processing euro transactions, will be relocated to the continent.

We can simplify the possible outcome of Brexit negotiations into three main scenarios: that the UK and EU agree a comprehensive trade deal in time for it to be in place when the UK leaves the EU, which is most likely to be around March 2019; that the UK and EU are not able to implement a deal by the time the UK leaves but that there is progress towards a deal and agreement to have transitional arrangements in place until a comprehensive deal can be finalized; or that the UK and EU fail to reach agreement and trade between the two reverts to World Trade Organization (WTO) rules.

It is hard to place a probability on these outcomes but the latter seems unlikely as the economic cost to both to the UK and the EU would be considerable. The complexity of comprehensive trade deals given the need to agree terms on trade in a vast range of goods and services suggests that implementation of a full deal within the two year timescale is also very challenging. If the government invokes Article 50 in March, the UK will leave the EU in March 2019, and we may not have a good idea whether a satisfactory trade deal will be achievable until much closer to that time. Thus there may not be much additional hard ‘news’ on Brexit during 2017 and possibly even 2018.

Economic performance

Chart 2 – Growth and inflation in the new NICE era

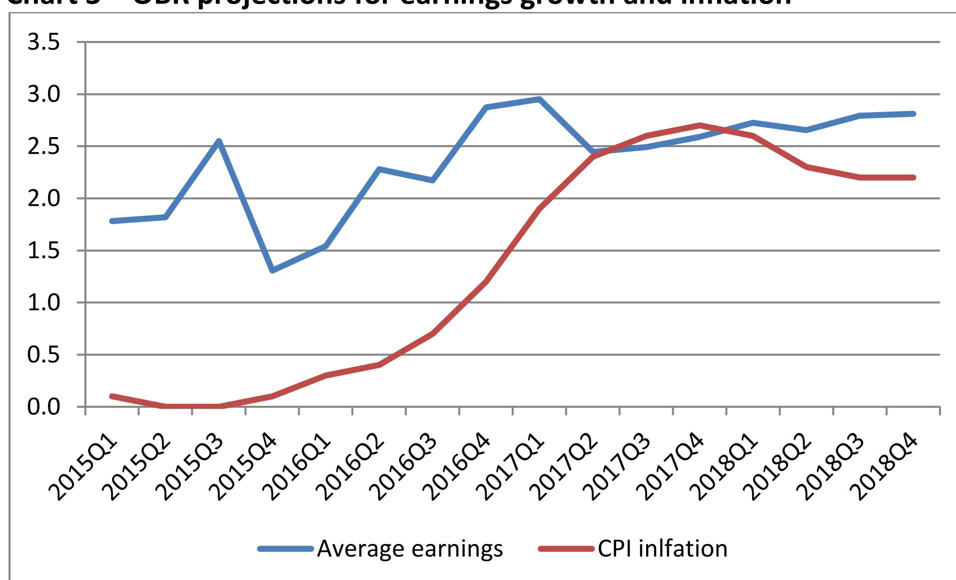


Source: ONS

Last year we noted that since the financial crisis the economy has settled into a fairly stable pattern of modest growth and low inflation. We likened this performance to the earlier period from the mid-1990s to the mid-2000s dubbed the NICE decade by the then Governor of the Bank of England, Mervyn King (NICE standing for non-inflationary consistent expansion). Although inflation has been on the rise since the middle of 2015 with a faster rate of increase since the Brexit vote pushed down the value of sterling, as Chart 2 shows, inflation remains unusually low, even by recent standards.

Forecasts also point to a lower peak in inflation than in 2008 in the wake of sterling's last serious bout of weakness, when CPI inflation reached 5.2%. The OBR expects CPI inflation to peak at only 2.7% in Q4 2017 (see Chart 3), while it projects that average earnings growth will slip back to 2.4% in the second quarter of 2017 before rising again to 2.8% by the end of 2018, underpinned by a low unemployment rate. If these projections prove accurate there will only be a brief period of gentle falls in real earnings later this year before they start to rise again. This suggests that comparatively little of the feared squeeze in real incomes will come about.

Chart 3 – OBR projections for earnings growth and inflation



Source: OBR March 2017 forecast

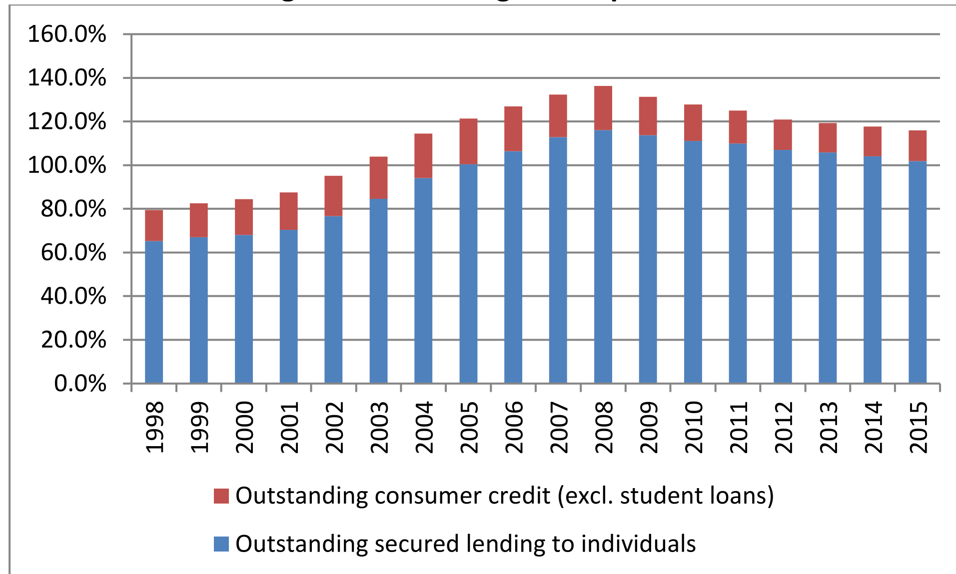
Consumer indebtedness

Modest inflation and interest rates coupled with consistent economic growth and low unemployment provide conditions that are likely to make consumers more relaxed about taking on more debt. Indeed, there has been a considerable amount of media coverage about rising debt, particularly unsecured debt, much of it presented in a somewhat alarmist tone.

But to what extent has it been rising consumer debt that has powered the recovery and should we be concerned? Chart 4 shows outstanding UK consumer debt relative to gross disposable household income. What Chart 4 shows is reassuring because

disposable incomes have outpaced household debt, rising by 23.2% between 2008 and 2015 while the total level of debt rose by only 4.9%. Moreover, the level of unsecured debt, which has been the focus of most media and Bank of England angst, actually fell by 14.5%. Despite a slight uptick in the consumer debt to income ratio during 2016, by the third quarter the ratio was slight below where it was in 1999 and 29% below its 2005 peak.

Chart 4 – Outstanding debt as a % of gross disposable household income



Source: ONS and Bank of England

Interestingly, the official government forecast for household debt has been raised since the autumn after several years when it was scaled back. The OBR's March 2017 forecast predicts net mortgage lending of £44 billion in 2017 against an autumn 2016 projection of £35 billion. Over the next 5 years the OBR predicts average net mortgage lending of £53 billion a year but this still only represents a 3.9% increase per annum, slightly ahead of projected household disposable income growth. Against the background of the reduced indebtedness shown in Chart 4 and ultra-low interest rates, there must be a good chance that borrowing will rise significantly faster than the OBR predicts, which would underpin consumer spending.

3. The performance of the housing market

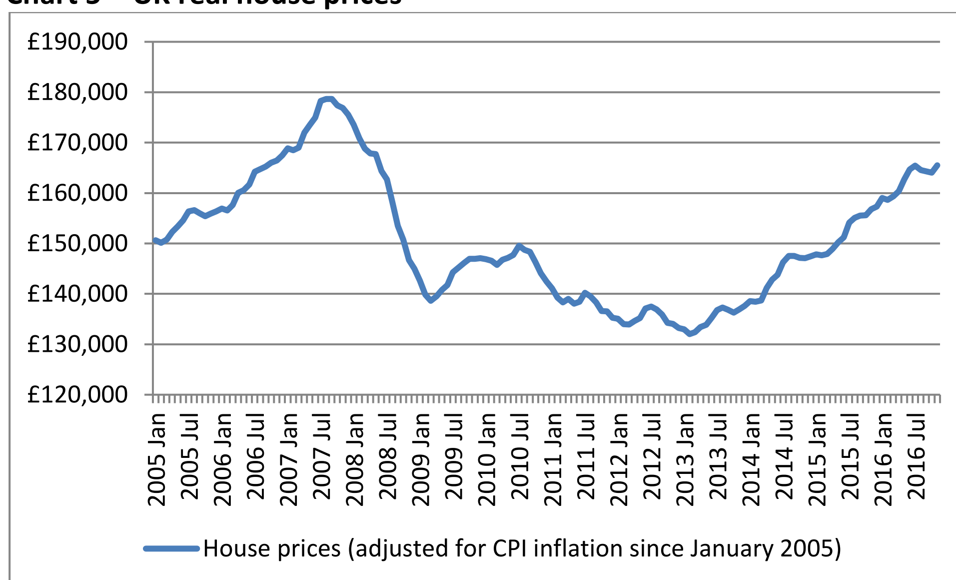
The UK housing market is now in its eighth consecutive year of recovery. House prices rose 7% over the course of 2016, somewhat faster than most forecasters had predicted. Turnover also edged up to 1,236,000 transactions, the best annual total since 2007. Regulators and market participants can take some comfort from this new normal of modestly improving conditions.

Housing values

Indeed, there was less to concern regulators and policymakers in 2016, as the central London property market cooled sharply after several years of rapid growth. As a consequence, the ripple effect that had pushed up property prices radiating out from the centre of the capital, and caused some concern at the Bank of England, now appears to be dissipating.

As conditions in the central London housing market are often a leading indicator of the market more broadly, the subdued conditions now seen in central London could point to a slowdown in the market nationally over the coming months, although the higher rates of stamp duty on properties above £937,000 may have altered the relative performance of the market in inner London and elsewhere.

Chart 5 – UK real house prices



Source: Land Registry and ONS

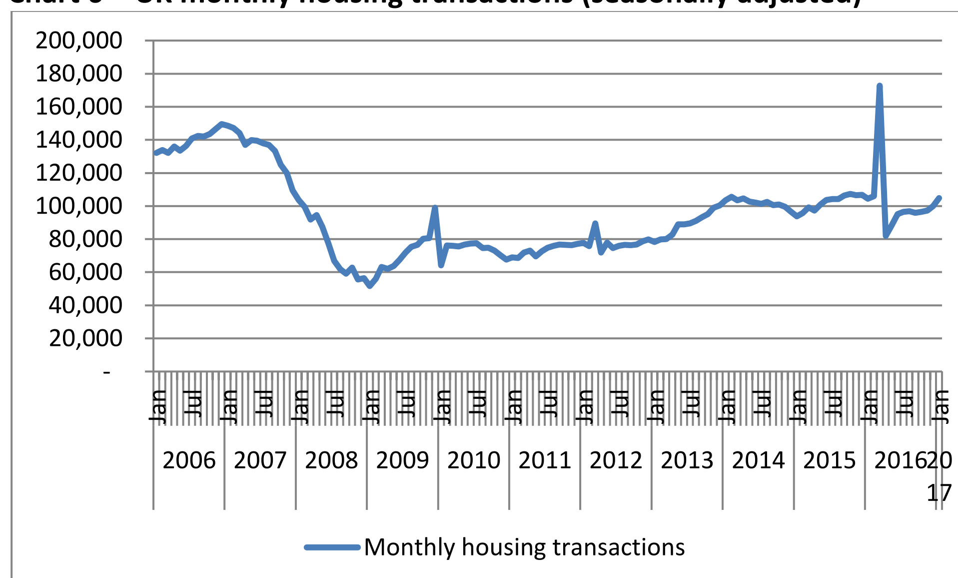
Placed in a long term context the current UK housing recovery looks relatively weak. Chart 5 adjusts house prices for inflation and shows that, at the end of 2016, national average prices in real terms were still slightly below those of a decade earlier, making this the slowest housing recovery of modern times. And given the slow rates of inflation seen in recent years most households have seen only modest nominal increases in the value of their home (£3,200 a year on average). In the North East at the end of 2016 house prices remained 7% below the nominal peak reached in 2007.

Housing turnover

Clearly, one of the key factors that has underpinned house prices since the financial crisis is the relative shortage of supply. This is true of both new supply and the flow of second hand properties onto the market. At a UK level, house building fell sharply from 224,000 in 2007 to 136,000 in 2010, and although the latest available data for 2015 showed a marked rise to 171,000, commentators agree that this is well below the required level given population growth, which is currently running at an annual rate of around 500,000.

The second hand market has been suffering from a similar problem. The RICS February UK Residential Market Survey reports that vendor sales instructions have failed to show a positive reading for twelve consecutive months and the stock of properties per agent remains near all time lows. Unsurprisingly therefore turnover levels remain subdued compared to pre-financial crisis levels (see chart 6). Comparing transactions levels to the private housing stock, the average homeowner is moving once every 19 years compared with once every 13 years as recently as 2006.

Chart 6 – UK monthly housing transactions (seasonally adjusted)



Source: HMRC

Digging deeper into the statistics, while the number of first time buyer transactions has recovered well in recent years, the number of moving homeowners has been stuck at historically low levels over the past decade (see 'First time buyers and moving homeowners' in Section 4). This reflects a number of factors including the difficulties homeowners are having trading up given the modest amounts of equity many have accumulated, the high level of current house prices relative to incomes and stricter mortgage affordability rules. Those wishing to trade down have also been adversely affected by the lack of choice of properties on the market and, in the case of older homeowners, the limited availability of purpose build accommodation for retirees.

But another factor that has contributed to the relative strength of the recovery in first time buyer transactions is government assistance for purchasers. The Help-to-Buy equity loan and guarantee schemes have helped 150,000 first time buyers since 2013, accounting for over 40% of the increase in first time buyer numbers. Over the same period only 38,000 moving homeowners benefitted from these schemes.

How housing transactions are being funded

One feature of the market that we have monitored in previous years' reports is the extent to which the transactions that are taking place are funded by cash or mortgage borrowings. By multiplying total transactions by the Land Registry figure for the average house price we can calculate the total value of UK residential property transactions and compare this to mortgage lending for house purchase. In 2016, the total value of transactions was £263 billion, 8% above 2015's figure of £243 billion (see Table 2 in Section 6).

Total lending for house purchase reached £152 billion in 2016, meaning that 58% of the funds used to purchase UK residential property last year were borrowed. This percentage compares with 60% the previous year and over 60% in prior years. This underlines the extent to which cash has become a growing force in the housing market even as the mortgage market recovers.

4. The performance of the mortgage market

Mortgage volumes

Against the background of a robust housing market the UK mortgage market experienced solid growth in 2016, continuing its recuperation since the financial crisis, with gross lending of £245 billion against £222 billion in 2015 and net lending of £40 billion (£35 billion in 2015). Gross advances hit their highest level since 2008 and net advances since 2007.

Table 1 shows how market growth evolved over the course of 2016. The year was something of a mirror image of the previous year, with the market strength of late 2015 being sustained into the early months of 2016. But this strength was artificially buoyed by the stamp duty surcharge for buy-to-let and second homes which was announced in November 2015 and took effect in April 2016. As a result, the flurry of activity which occurred in March quickly gave way to a more subdued profile.

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

		House purchase	Remortgage	Other	Total
2015	Oct	13.4%	14.1%	10.4%	19.4%
	Nov	21.3%	36.3%	20.2%	27.6%
	Dec	20.4%	44.4%	27.0%	22.2%
2016	Jan	14.6%	26.0%	23.9%	24.1%
	Feb	25.2%	42.1%	40.3%	31.7%
	Mar	77.6%	44.2%	44.8%	61.1%
	Apr	-8.2%	29.1%	33.8%	9.4%
	May	0.4%	42.4%	42.8%	10.5%
	Jun	3.9%	28.5%	9.0%	6.2%
	Jul	-12.5%	10.9%	-8.8%	-3.4%
	Aug	2.3%	19.2%	7.4%	11.8%
	Sep	-3.7%	37.2%	-9.1%	1.1%
	Oct	-14.6%	13.5%	-8.2%	-6.9%
	Nov	-3.6%	9.5%	22.2%	3.2%
	Dec	-1.2%	14.8%	-11.5%	1.1%
2017	Jan	-4.4%	9.0%	2.4%	6.4%

Source: Bank of England

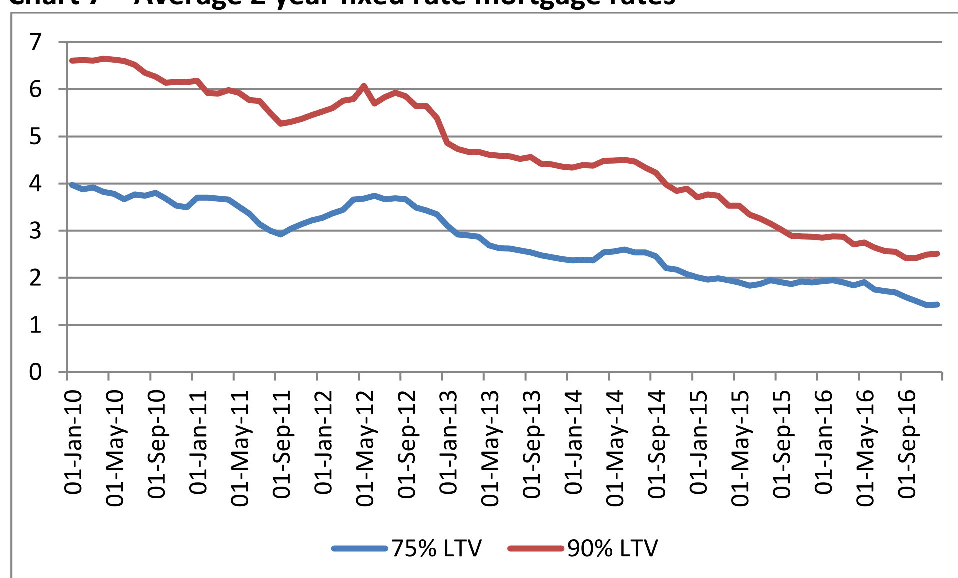
The distorting effect of the introduction of the 3% stamp duty surcharge in April can only be estimated but mortgage lending showed no clear uptick until March, when house purchase lending was nearly £8 billion above the average of the previous two months. The following two months saw gross purchase lending which was around £3 billion a month below the subsequent two months, suggesting that, for the most part, the distortion was concentrated in the March-May period, with the leap in March mostly unwound in the following two months. Interestingly, buy-to-let house purchase lending spiked by roughly £3 billion in March, suggesting that second homeowners rushing to beat the stamp duty surcharge were the larger element, at least amongst mortgage buyers.

It is unclear exactly how much of an additional drag the vote to leave the EU imposed on the market, but the broad sweep of data suggests a fairly limited impact. It seems that many borrowers shrugged off the vote, and the performance of the housing market since June seems to show more of an impact from previous tax changes, such as the replacement of the slab system for stamp duty with a graduated tax with a higher top rate. This has adversely affected higher value transactions which has disproportionately impacted the central London market.

Another aspect of the market's performance that is apparent from Table 1 is the strength of remortgage activity relative to house purchase. £15 billion of the £24 billion increase in gross lending in 2016 was in the remortgage market. The strength of remortgage activity in part at least reflected the level of competition amongst lenders for new business and has occurred despite the increased effort of some major lenders to encourage borrowers to take an internal product transfer.

The competitive environment

Chart 7 – Average 2 year fixed rate mortgage rates



Source: Bank of England

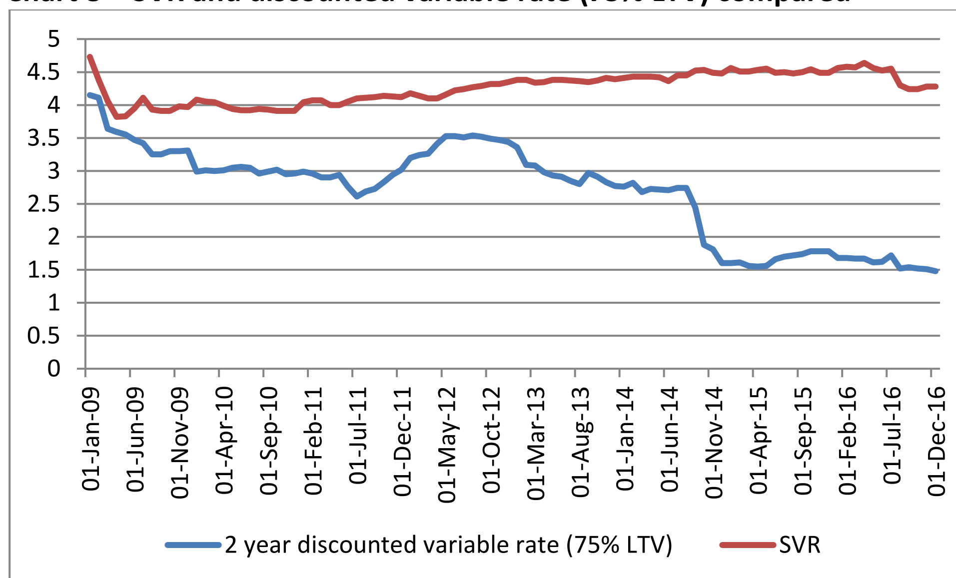
Strong competition was reflected in record low mortgage rates (see Chart 7). By the end of 2016, the average 2 year fixed deal at 75% LTV was only 1.4%. The corresponding rate for 90% LTV borrowers did rise slightly towards the end of the year, but at 2.5% still represented extraordinary value compared to rates in earlier years.

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 moving homeowners spending a record low 7.2% of their income on interest in 2016 and first time buyers spending a new low of 9.1%.

Increased competition is visible across the range of market segments. There has been an increase in the number of lenders over the past few years as well as attempts to broaden product choice, for example with lending into retirement where some lenders have relaxed age restrictions and innovated in product design.

The extent of competition for new business is also illustrated by Chart 8 which compares the average standard variable rate (SVR) with the average 2 year discounted variable rate available on new loans. The interest rate differential, which had soared in 2014 and 2015, rose further towards 3 percentage points over the course of 2016. Such a wide differential provides a strong incentive for customers who are on or about to come onto SVR, to search for a better deal, helping to explain the rise in remortgage activity.

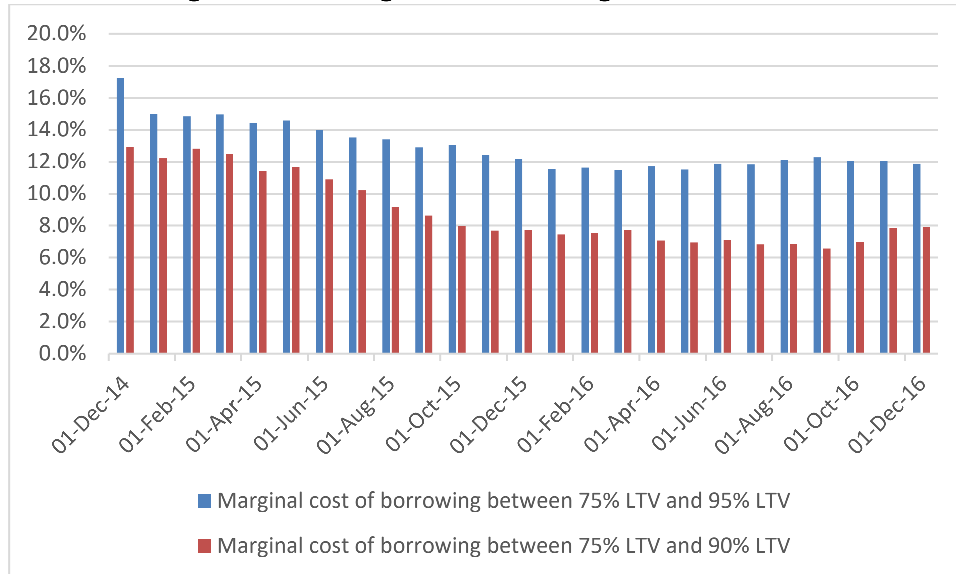
Chart 8 – SVR and discounted variable rate (75% LTV) compared



Source: Bank of England

As Chart 7 illustrates, intensifying competition amongst lenders did not lead to a material decline in the high LTV pricing premium in 2016 in contrast to the previous year. Rates for 90% and 95% LTV customers fell over the course of the year but the differential with rates for lower LTV customers was broadly unchanged (see Chart 9). Lenders' cautious approach to high LTV mortgage pricing might have partly reflected concern around the impact of the government's decision to end the Help-to-Buy guarantee scheme at the end of 2016.

Chart 9 – Marginal cost of high LTV borrowing

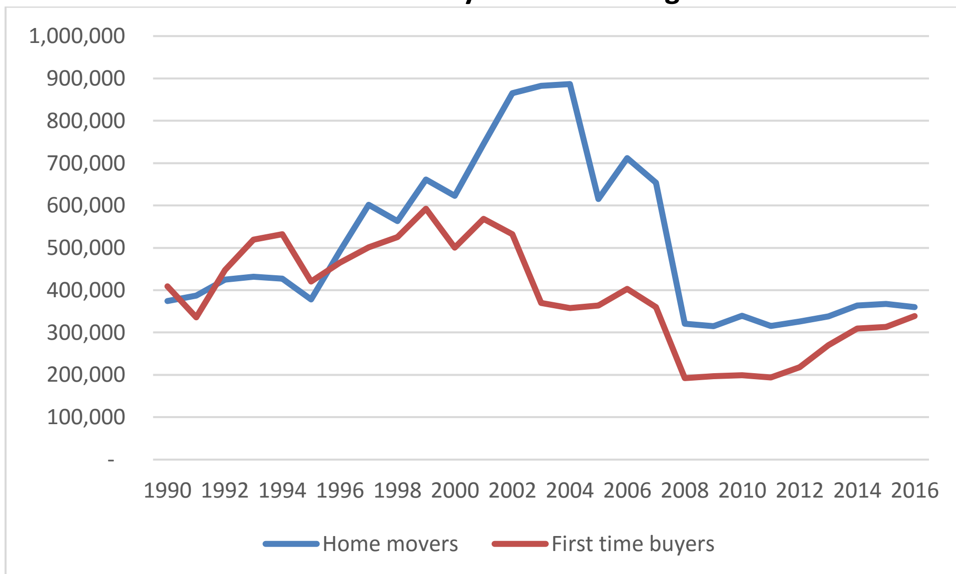


Source: Bank of England

First time buyers and moving homeowners

The house purchase market comprises two distinct segments: first time buyers and moving homeowners, and these segments have shown quite different profiles in the recent past. As Chart 10 shows, the number of mortgaged first time buyers exceeded the number of mortgaged moving homeowners in the early 1990s. This was the time when the baby boomer generation born in the early to mid-1960s were entering the housing market in large numbers.

Chart 10 – Number of first time buyers and moving homeowners



Source: Council of Mortgage Lenders

But during the late 1990s and early 2000s the number of moving homeowners surged ahead, peaking at 887,000 in 2004, more than twice that year's total of first time buyers. Again, the baby boomers no doubt played a key role as this period coincided

with the time when many of those who had entered the housing market in the late 1980s and early 1990s were moving up the housing ladder.

But the story of the last decade is of the collapse in moving homeowner transactions while first time buyer numbers have held up quite well. Between 2006 and 2016 moving homeowner transactions halved while first time buyer numbers declined a comparatively modest 16%. As can be seen in Chart 10, by 2016 there were nearly as many first time buyers as moving homeowners. In terms of the value of mortgage advances, the difference in trends is equally startling. While moving homeowner advances declined from a peak of £108 billion in 2006 to £74 billion last year, first time buyer advances, which were £49 billion in 2006 reached a record £53 billion in 2016.

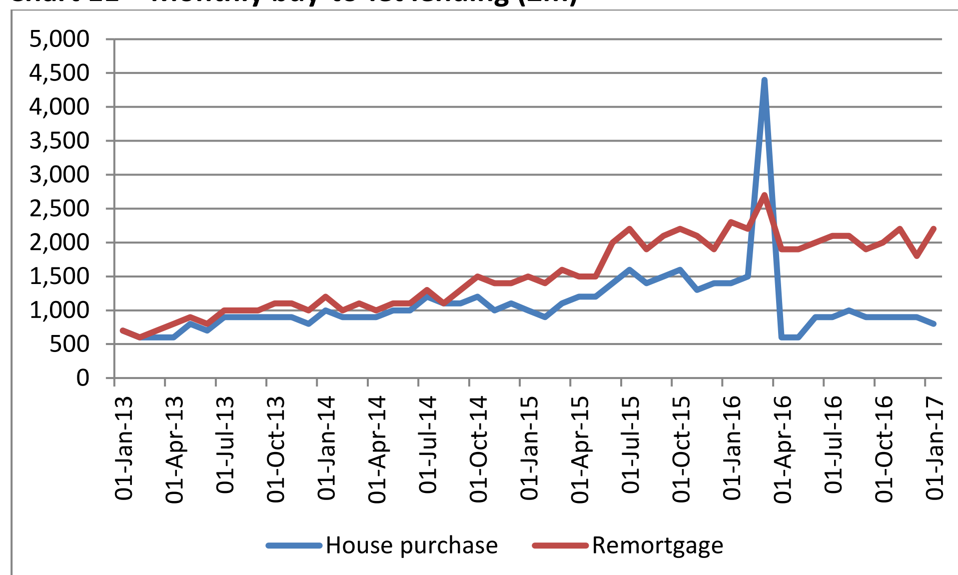
What accounts for the relatively strong performance of first time buyer demand and the subdued level of moving homeowner transactions? The government's Help-to-Buy equity loan and guarantee schemes have assisted 150,000 first time buyers since 2013, adding more than 40,000 transactions per annum. This accounts for over 40% of the increase in first time buyer numbers since Help-to-Buy was introduced. But more broadly after a period when first time buyer numbers were well below what would have been expected given demographic trends, we are probably now seeing the impact of new purchasers who had previously delayed the decision to buy.

At the same time, high house prices and moving costs have increased the cost of moving home while the baby boomer generation is now in its fifties, an age when households start to move less often. But although we can rationalise the decline in homeowners moving house, it is not a healthy development for the market to have such low liquidity and, in effect, large sections of the housing market locked away. Policymakers should recognise the benefits of a healthy level of turnover and address policies that disincentivise people from moving and trading down (see Section 5 on the housing white paper).

Buy-to-let market

The headline figures for the buy-to-let market in 2016, which showed gross lending up from £37.9 billion to £40.6 billion, gave little hint of the tumultuous nature of the year. Still absorbing the news from July 2015 that mortgage interest would no longer be fully deductible against income, in November of that year the then Chancellor George Osborne announced the 3% stamp duty surcharge for buy-to-let and second homeowners, to come into effect in April 2016.

Chart 11 – Monthly buy-to-let lending (£m)



Source: Council of Mortgage Lenders

Chart 11 shows the impact on monthly lending and it suggests that almost all the buy-to-let lending to those rushing to beat the stamp duty deadline took place in March, when house purchase lending hit £4.4 billion. This is perhaps not surprising given the relatively short notice period landlords had to make a decision to buy and complete the purchase (at most 5 months).

Chart 11 also shows that the spike in house purchase lending in March was followed by abnormally low months in April and May (with lending of £600 million a month), mirroring the profile of the wider market. After May the monthly figures did not return to the pre-April norm (when lending had been running at around £1.5 billion a month), but rather settled at around £900 million a month. Over the June-December period as a whole, house purchase buy-to-let lending was down 37% on the same period of 2015.

So, the roughly £3 billion of extra lending in March was clearly not fully unwound in April and May, suggesting that subsequent months are still likely to be reflecting lower borrowing by those landlords that brought forward transactions, rather than a more permanent shift downwards. If you assume that the new normal monthly lending volume is something in the region of £1.1 billion, then roughly £2.3 billion of the £3 billion of brought forward lending had been unwound by the end of 2016, suggesting that buy-to-let purchase activity is still artificially depressed.

But the stamp duty surcharge, coupled with the earlier adverse tax changes, is also likely to have a more permanent impact on landlords' appetite to purchase more properties. This is borne out by landlord surveys showing declining intentions to purchase and even a sharp jump in the number of landlords looking to sell. In the National Landlords Association (NLA) quarterly landlord panel of July 2015 (conducted before the budget) 7% of landlords reported plans to sell property. This jumped to 19% in the January 2016 survey. Although such surveys have not been accurate

predictors of behaviour in the past, this at least shows the scale of reaction amongst landlords to the latest tax changes.

Thus a return to monthly lending of around £1.5 billion seen during the second half of 2015 seems unlikely. Nonetheless, if lending settled at around £1.1 billion a month this would still be in line with the size of the market in 2014 and above that of 2013. Whether this will be adequate to meet growing tenant demand is hard to say. One longer term influence on tenant demand could come from the Brexit vote. The PRS accommodates the overwhelming majority of recent economic migrants and lower levels of migration from Europe could slow the growth of demand. But there is great uncertainty about the extent to which the UK will reduce net immigration once it is outside the EU.

Buy-to-let remortgages

Buy-to-let remortgage activity was already the main driver of lending in the segment before the impact of the stamp duty change. In 2016, buy-to-let remortgage lending hit a record £25 billion, representing 62% of all buy-to-let lending and 31% of all remortgage lending. However, even here the monthly profile suggests that the market has settled down with no obvious upward momentum over the course of last year.

While the tax 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 higher rate tax paying borrowers' incentive to seek out lower mortgage rates. On the other hand, the new PRA buy-to-let underwriting standards which have come into effect this year will make it harder for some landlords to remortgage. As a result, our forecast for buy-to-let lending presented in Section 6 below incorporates projected remortgage activity that is broadly flat this year with a modest 4% increase in 2018.

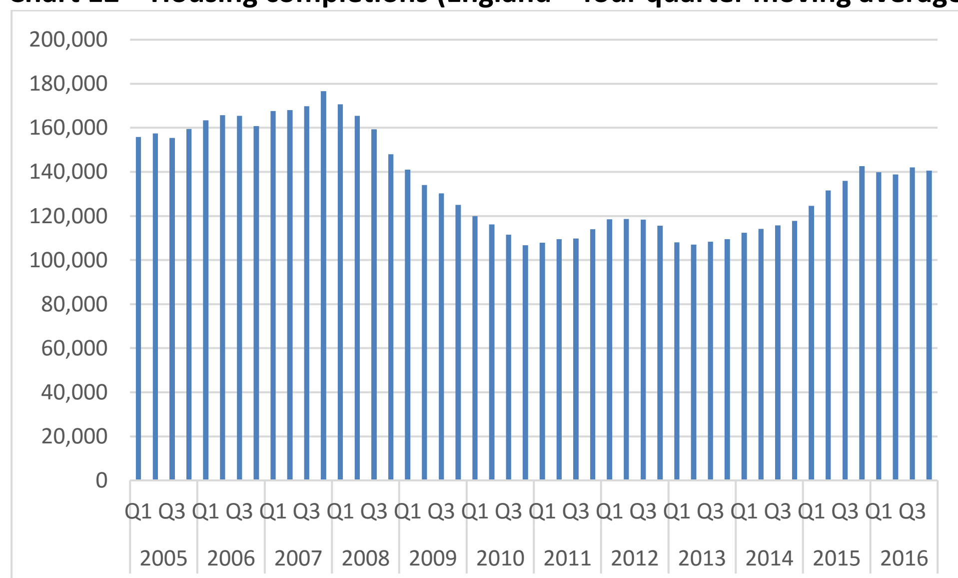
5. The housing white paper

Like homeownership itself the government's housing white paper, 'Fixing our broken housing market', published on 7 February 2017, which addresses issues relating to the housing market in England, could be described as aspirational. It lays out a range of objectives it believes needs addressing such as insufficient housing supply, poor quality private rented accommodation and inflexible tenancies. But it is much shorter on concrete solutions.

Increasing housing supply

As Chart 12 shows, house building rates in England have recovered from recent lows but remain below pre-financial crisis levels and well below the level considered necessary given population growth. The white paper acknowledges this shortfall and the undesirable consequence of unaffordable housing for ordinary families, both owners and renters.

Chart 12 – Housing completions (England – four quarter moving average)



Source: DCLG

To boost house building the white paper proposes the reintroduction of house building targets for local authorities in England. It also proposes to cut the time local authorities take to approve planning applications by offering authorities the carrot of being able to increase planning fees by up to 20% if the money is spent in planning departments to speed up the planning process.

For builders the white paper is a mixed bag. It proposes that they should face a reduction in the time between receiving planning consent and having to start construction from three to two years, something that builders see as unhelpful. But there is also an emphasis on encouraging smaller builders through the Home Building Fund and encouraging modern methods of construction to speed up house building.

Builders will also benefit from the Starter Homes initiative although the white paper proposes to scale this back relative to previous promises.

But perhaps what is more significant about the white paper is what it does not include. A relaxation of controls on building in green belt land or wholesale reform of the planning system to free up more land for development were seen by many as the steps needed to provide a boost to house building on a sufficient scale to tackle the long term shortfall. But the white paper reiterates the need to protect the green belt while the changes it proposes to the planning system have been described as little more than tweaks.

Another area that the white paper did not address, despite media speculation that it would, was the issue of downsizing and the level of housing consumption by older households. This omission reinforced the sense that the government was unwilling to discuss sensitive policy areas and seemingly unwilling to consider incentives that might make it easier for such homeowners to move.

Private rented sector

One element of the white paper that was broadly welcomed by the housing industry was the change of emphasis from promoting homeownership above all other objectives to a more balanced approached that recognises the needs of those in other tenures. But again the white paper is stronger on intentions than on initiatives. It proposes three year tenancies as standard in the build-to-rent sector to provide more certainty to tenants and measures to tackle poor quality private rented accommodation including the proposal to introduce mandatory electrical safety checks.

But there was no attempt to reverse the adverse tax changes affecting buy-to-let so the government's position cannot be considered a clean break from the Cameron era, with its emphasis on promoting homeownership by squeezing out buy-to-let investors. As a result, we may still face a growing shortage in the number of privately rented properties relative to demand, which can only exacerbate the overall housing shortage.

A missed opportunity

In conclusion if, as the government acknowledges, our housing market is broken the white paper must be seen as a missed opportunity. Rather, it seems to prove yet again that the vested interests that have conspired to prevent greater levels of house building are alive and well. It seems that the housing shortage will have to grow still more acute before the political will for more radical change has any chance of gaining ground.

Even if net immigration is much lower following our exit from the EU, and that is by no means certain, the demographic profile of the existing resident population of the UK points to rising housing need as young families compete for a squeezed supply of

homes while the baby boomer generation continues to ‘consume’ a comparatively large proportion of the housing stock. Kicking the tough decisions on supply down the road can only make our broken housing market worse.

6. The mortgage market outlook for 2017 and 2018

Background environment in 2017 and 2018

Table 2 outlines our projections for key assumptions behind our mortgage market forecast. We do not expect a change in Bank of England Bank Rate by the end of 2018 as we expect the Bank to look through any short term spike in inflation resulting from the fall in sterling following the Brexit vote. With such accommodative monetary policy, we expect house prices to continue to track modestly higher and property transactions to slightly surpass their 2016 total.

Table 2 – key forecast assumptions

	Past values		Forecast values		Percentage changes		
	2015	2016	2017f	2018f	2016/15	2017/16f	2018/17f
House prices (average for year)	197,890	212,711	224,000	230,000	7.5%	5.3%	2.7%
Housing transactions (UK, thousands)	1,230	1,236	1,240	1,250	0.5%	0.3%	0.8%
Value of housing transactions (£bn)	243,321	262,924	277,760	287,500	8.1%	5.6%	3.5%
% of transaction value that is mortgaged	59.8%	57.9%	56.5%	55.7%	-3.2%	-2.3%	-1.5%
Bank Rate (Q4)	0.5%	0.25%	0.25%	0.25%	-50.0%	0.0%	0.0%

Source: Instinctif Partners, ONS and HMRC

We see little reason why the resilience that the economy has so far shown in the wake of the Brexit vote should be reversed until it becomes clearer what kind of agreement the UK can reach with its former EU partners (which may well not be until 2019), and only then if it appears that the UK will be manifestly disadvantaged. In the meantime, the UK economy is benefitting from looser monetary conditions as a result of lower interest rates and the lower value of sterling as well as looser fiscal policy. As noted in Section 2 above, OBR forecasts suggest we are likely to see only a modest and transitory reduction in real incomes this year, although this probably will slow the rate of growth of consumer spending.

Table 3 – Mortgage market forecast

	Gross mortgage lending (£m)				Percentage changes		
	2015	2016	2017f	2018f	2016/15	2017/16f	2018/17f
House purchase	145,415	152,173	157,000	160,000	4.6%	3.2%	1.9%
Remortgage	65,794	81,262	90,000	92,000	23.5%	10.8%	2.2%
Other	10,569	11,966	13,000	14,000	13.2%	8.6%	7.7%
Total	221,778	245,400	260,000	266,000	10.7%	5.9%	2.3%
of which:							
Buy-to-let lending	37,900	40,600	38,000	40,000	7.1%	-6.4%	5.3%
Share of total	17.1%	16.5%	14.6%	15.0%	-3.2%	-11.7%	2.9%
Lending via intermediaries*	119,200	136,000	145,000	150,000	14.1%	6.6%	3.4%
Intermediary share of total	69.7%	71.8%	72.5%	73.0%	3.1%	0.9%	0.7%
Net lending	35,451	40,303	45,000	50,000	13.7%	11.7%	11.1%

* Regulated loans only

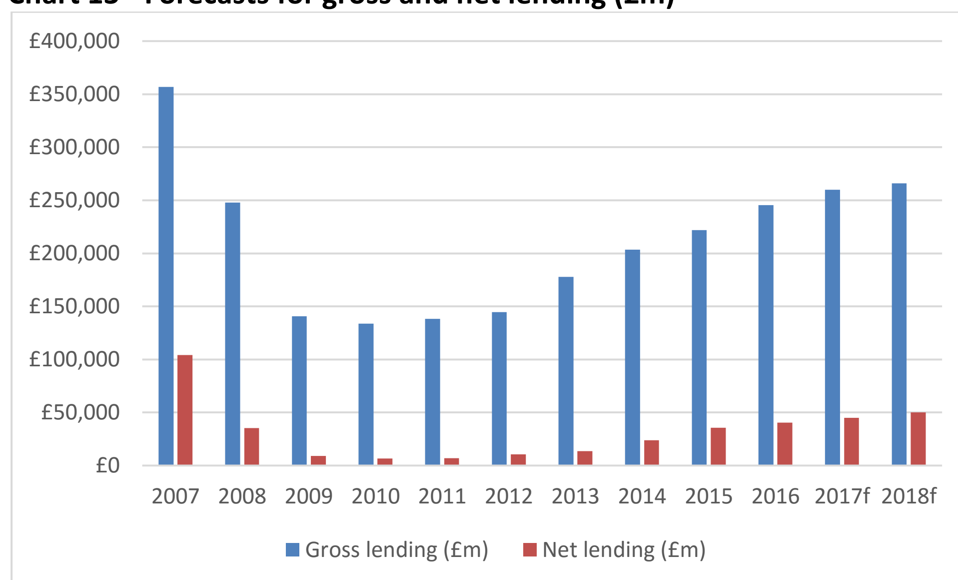
Source: Instinctif Partners, Bank of England, CML

Mortgage market forecast

Against this reasonably positive background we expect the steady mortgage market recovery to continue in 2017 and 2018 (see Table 3). We expect gross mortgage lending to reach £260 billion this year, the highest figure since 2007. In keeping with 2016, we expect remortgage activity to be the most buoyant segment of the market, aided by very attractive offers from lenders but lending for house purchase should continue to grow modestly to £157 billion in 2017 and £160 billion in 2018.

But one factor that is likely to slow the rate of growth of remortgaging is the increased trend towards product transfers. With lenders constantly improving the product transfer proposition to support brokers in achieving good customer outcomes, it is likely that a rising number of borrowers will switch product instead of remortgaging. However, projecting the scale of the increase in the product transfer market is difficult given the limited public data available on product transfers.

Chart 13 - Forecasts for gross and net lending (£m)



Source: Bank of England and IMLA

Chart 13 puts our forecast for gross and net mortgage lending in its longer term context. While the improvement since the market bottomed out in 2010 has been impressive, the rate of growth has slowed as the recovery has aged and we expect a further slowing in the rate of improvement over 2017 and 2018. Also, of course it is worth noting that the market remains well below its 2007 level.

Despite these expected improvements in mortgage lending, cash is still likely to remain king in housing transactions. In Table 2 we show the proportion of total funds used in housing transactions that were borrowed. In 2016 58% of the funds used to finance total house purchases of £263 billion were borrowed, a figure that has been declining in recent years. We expect the declining importance of debt to continue over

the next two years, with the ratio falling to 56.5% in 2017 and 55.7% in 2018. This trend mirrors the declining proportion of mortgaged households reported in the latest English Housing Survey.

The narrowing availability of mortgages in the wake of the financial crisis and as a result of the mortgage market review (MMR) may be responsible. The decline in 2016 was despite the introduction of stamp duty on buy-to-let and second homes, which would have been expected to choke back transactions where cash buyers and large deposits are more common.

The one weak spot in the mortgage market in 2016 was buy-to-let. We expect buy-to-let lending in 2017 to be some 6.4% down at £38 billion but looking at the monthly profile we believe that a gentle recovery is already underway. The fall in house purchase buy-to-let lending between 2016 and 2017 is projected to be greater at 17%. But as we believe that house purchase buy-to-let volumes have bottomed out as well as buy-to-let remortgage volumes, we expect total buy-to-let lending to rise modestly to £40 billion in 2018 (of which £26 billion is expected to be remortgage activity).

Finally, we expect the trend in intermediaries' share of mortgage lending to continue its recent gradual upward trajectory. By 2018, we expect intermediaries to support £150 billion of regulated lending, 73% of the total.

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About IMLA

The Intermediary Mortgage Lenders Association (IMLA) is the trade association that represents mortgage lenders who lend to UK consumers and businesses via the broker channel. Its membership unites 34 banks, building societies and specialist lenders responsible for over £180bn of annual lending across all distribution channels in 2015, including 16 of the top 20 UK mortgage lenders.

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), Council of Mortgage Lenders (CML) and 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.