Brexit and the UK mortgage market

by Bob Pannell, Economic Adviser to the Intermediary Mortgage Lenders Association

- Brexit represents a momentous economic change for the UK and huge uncertainties are associated with it.
- Mortgage lenders hope that our departure from the EU can be an orderly one.
- But the odds of a disorderly no deal Brexit, with adverse short-term consequences for the wider UK economy, have shortened over recent months.
- Policy-makers have extensive tools to mitigate any adverse effects in the housing market and are likely to deploy them.

Introduction

It now seems more likely than not that Brexit will happen over the coming months. We should not absolutely rule out the possibility of further delay or even a second referendum, given the roller-coaster nature of domestic politics, but such events would further extend the state of limbo that has descended upon the UK.

This article explores how Brexit has been affecting our housing and mortgage markets and what the next couple of years might look like.

In all honesty, any longer-term prognosis would be highly speculative and potentially deeply misleading.

Amid the shrill and divisive political debate surrounding Brexit over recent years, it has been easy to lose sight of the fact that our departure from the EU represents the single most important economic event in Britain's post-war history. We are looking to unwind our economic and financial relationship with the remaining EU27 countries – our biggest trading partner of the past half a century – and to reshape our place in the world. A bold experiment, and one that is taking place against a deteriorating global economic backdrop and mounting trade tensions.

The uncertainties associated with such a tectonic shift are necessarily enormous.

The current "deal or no deal" brinkmanship of eleventh hour discussions add to these, as they have the potential to dramatically shape the tone, nature and substance of our future relationships with EU partners and further afield.

Such uncertainties allow proponents to map out very different longer-term scenarios for a post-Brexit UK. Many of these are plausible, but as with all experiments, we will only learn from doing and it will be down to future economists, with the benefit of hindsight, to debate the wisdom of our current actions.

Back to the present, how has Brexit been shaping things to date?

Background

The first thing to note is that the course of the housing and mortgage markets over the past few years has largely been unaffected by Brexit.

From a mortgage lender's perspective, a number of key policy measures (as it happens, for the most part introduced before the 2016 EU referendum result) have been more important to shaping how the market evolves. Such measures include MMR conduct rules, macro-prudential speed limits, less generous income tax treatment for landlords, the extension of Help to Buy and the 3% stamp duty surcharge on second properties.

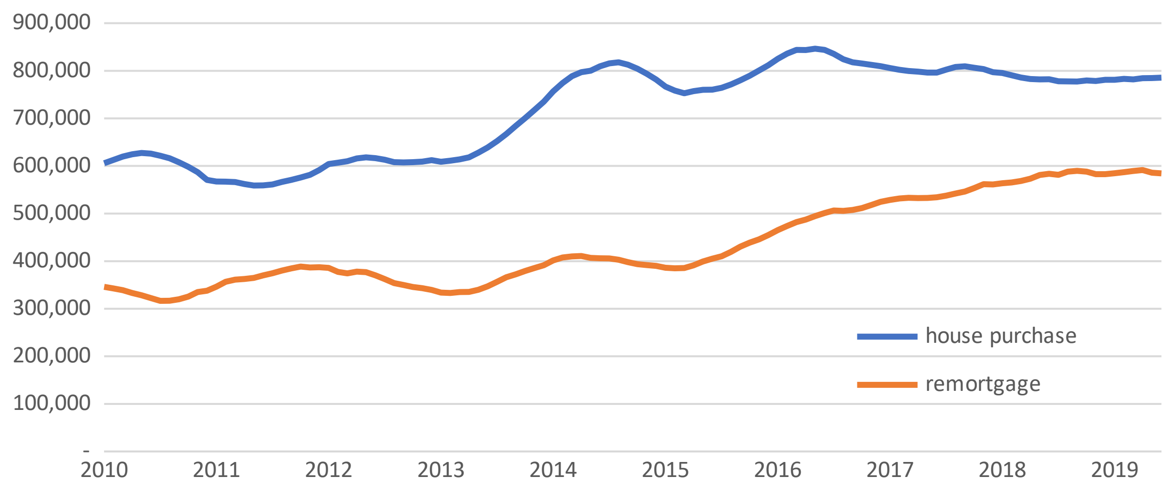
It is very rare for domestic politics to affect housing market activity, and general elections tend to come and go with barely a flutter.

The housing market did register a brief hiccup following the 23 June 2016 EU referendum result, presumably reflecting the element of surprise that it engendered. But the effect only lasted for a few weeks and had already run its course by early August when the Bank of England implemented a precautionary package of measures - including its Term Funding Scheme (TFS) and a 0.25% cut in base rates - to support economic growth.

For much of the subsequent period, the market has been underpinned by a relatively benign macro-economy, strong jobs market and recovery in lenders' risk appetite and competition.

Mortgage lending activity has continued to rise, although the figures have been flattered by stronger levels of remortgage activity.

Chart 1: Approvals for house purchase and remortgage, rolling 12-month totals



House purchase activity has in fact been fairly lacklustre over recent years, but for reasons not related to Brexit.

The overall picture has been one where affordability challenges and macro-prudential rules have been inhibiting activity, particularly across much of southern England. In London, which saw earlier property price gains and where the burden of higher stamp duty rates falls most heavily, property prices have edged lower, a phenomenon now also being seen across the South East.

Successive policy changes have tilted the mix of transactions away from investment properties to home ownership. Within the latter, first-time buyer numbers have continued to nudge higher, supported by the Bank of Mum and Dad, Help to Buy and the improved availability and keener pricing of higher LTV loans. The affordability hurdles for second-steppers have been similarly daunting, but their numbers have stagnated over the years in the absence of targeted help.   Later life home-owners represent the only sector to have shown significant growth in activity over recent years, reflecting the significant ageing of home ownership and their ability to rely on cash to downsize or effect some other home move.

Brexit uncertainties surface

it is difficult to be precise about when Brexit first began to affect the housing market or indeed by how much.

It is possible that Brexit uncertainties have been weighing on the market for some while, but were being obscured by various factors supporting activity, such as the better availability of higher LTV loans and the recovery in real earnings.

Brexit only really seemed to emerge prominently as an issue from late 2018, when the combination of a slowing global economy and Brexit uncertainties began to bear down on UK growth and household confidence and the proximity of the original 29 March deadline for leaving the EU loomed.

Whatever the case, market surveys have more or less routinely cited Brexit uncertainties as a drag on the housing and mortgage market through 2019, holding back both buyers and sellers or depressing market sentiment. A household survey, conducted for the Bank of England in April, suggests that one in five households planning to move home have delayed moving due to Brexit-related uncertainty.

Whilst it may well be that Brexit is having these effects, this is not showing through at all clearly in activity levels, with most measures (although not HMRC completions) pointing to things running a little higher than year-earlier levels. Some commentators have suggested that households, keen to get on with their lives, have put Brexit uncertainties to one side, and decided to take advantage of competitive mortgage deals and a less frenetic housing market to transact.

The above findings are not necessarily incompatible, given that we do not know what activity levels might have been in the absence of Brexit considerations, but they do suggest that we should be wary of attributing too much to Brexit in advance of it actually happening.

Gauging the impact of Brexit

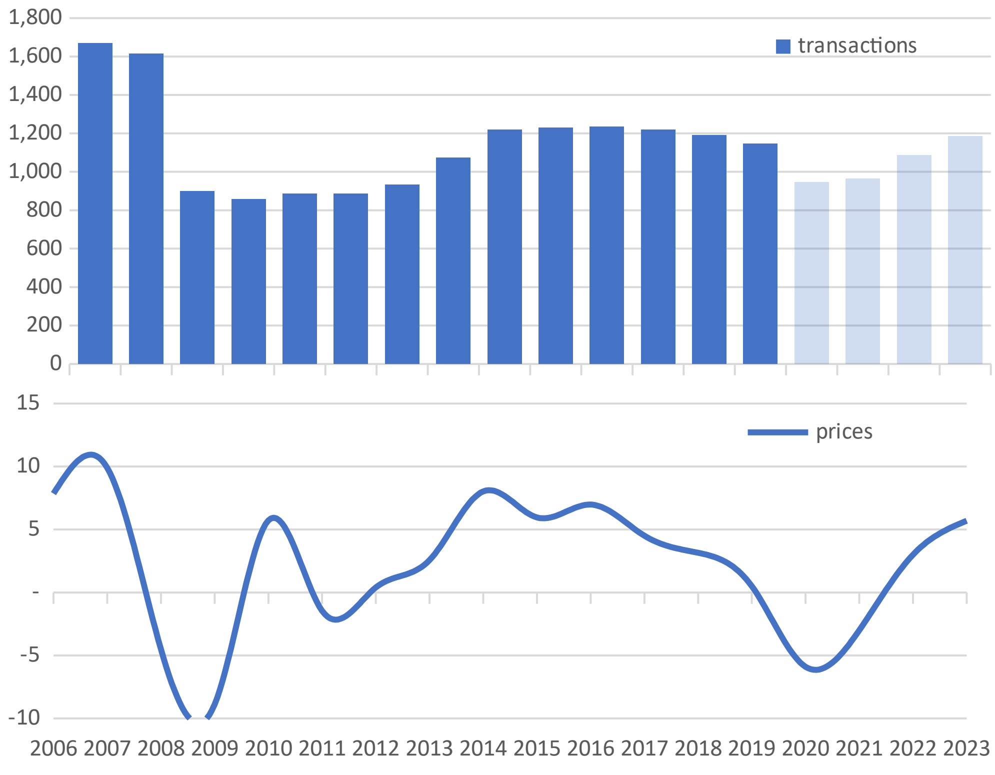
One of the few things concerning Brexit that most commentators agree on is that our departure from the EU will have adverse economic effects for the UK over the next 2-3 years.

This is true even for an orderly Brexit, although expectations around such an outturn will for the most part already have been factored into markets (and may help to explain why there is little hard evidence of a "Brexit effect" in housing market data).

The resolve of Boris Johnson, the UK's Prime Minister, to alter our withdrawal agreement with the EU, and to do so by the 31 October deadline, raises the prospect of a much more disruptive departure, even though that is not the desired outcome.

In the author's view, any no deal Brexit is likely to be challenging for the wider UK economy, and so the housing market, over the short-term.

Chart 2: How a disorderly Brexit could affect transactions and house price inflation



Source: *Fiscal risks report*, Office for Budget Responsibility July 2019

A recent report from the Office for Budget Responsibility (OBR)[i] sets out one plausible scenario:

- CPI inflation moves higher in 2020 and 2021, due to a 10% sterling depreciation

- The UK enters a year-long recession, with the economy shrinking by just over 2%.
- Real wages decline in 2020 and unemployment rises to just over 5% in 2021
- Financial conditions tighten modestly, with interest rate spreads increasing, but mortgage rates move slightly lower because the Bank of England cuts Bank Rate to around 0.2% by end of 2020 and rolls forward Term Funding Scheme loans due to be repaid in 2020 and 2021
- Housing market experiences a temporary sharp setback, with property transactions falling by 20% in 2020 and house prices moving almost 10% lower over the course of 2020 and 2021 (see Chart 2).

The OBR analysis is helpful in part because it consciously steers away from publishing sensationalist figures, by taking as its starting point the less pessimistic of two no deal scenarios sketched out by the International Monetary Fund[ii].

One implication of the OBR work is that the short-term impact of a no deal Brexit could be gentler than the one portrayed or indeed worse.

A really important caveat, however, is that the OBR has not factored in any discretionary policy responses by the government (over and above the Bank Rate and TFS action).

This is of course hugely relevant to the market environment in which households, mortgage lenders and house-builders are actually likely to find themselves.

Whilst we can draw comfort that the Bank of England's Financial Policy Committee (FPC) is confident that the UK financial sector is resilient to, and prepared for, the wide range of risks it could face, including a worst-case disorderly Brexit, and would be in a position to continue lending, the OBR scenario set out above would nevertheless be deeply unpalatable:

- The retrenchment in housing activity would take us back to the lows of the global financial crisis, with mortgage lending likely to bear the brunt of the adjustment.
- Credit risk appetite would go into reverse, with negative implications for the needs of non-standard borrowers.
- Arrears and possessions would pick up from historically very low levels, albeit that the greater use of stringent affordability tests and large-scale refinancing onto attractive longer-term fixed rate deals should help the UK to avoid widespread debt problems.

The good news is that policymakers gained considerable experience in how to counter recessionary forces through the global financial crisis, and so have a comprehensive set of tools that they can deploy.

The signs are that Sajid Javid stands ready to be an activist Chancellor of the Exchequer, should a disruptive no deal Brexit look likely. The public finances start from a relatively favourable position and appear capable of supporting some eye-watering increases in government borrowing if that is deemed necessary.

Housing measures featured prominently in government interventions over the past decade, and there is every reason to be confident that this would also be the case going forwards.

The government has already encouraged speculation about a reform of stamp duty land tax (England and Northern Ireland). Another obvious candidate for the government would be to review the planned restriction of its Help to Buy Equity Loan scheme to first-time buyers from April 2021, and to reinvigorate or otherwise reposition it.

Conclusions

The mortgage industry, and the financial services industry more generally, hopes that the UK can achieve an orderly departure from the EU. This is still a possibility, but one that seems more remote than just a few months ago. If there is a smooth Brexit, then the hesitancy that has characterised the housing market for some months should evaporate quickly and perhaps even permit a modest bounce-back as pent-up activity finally takes place.

Although the familiar challenges around affordability and new supply would still exist, we would at least have the prospect of a reasonably stable environment within which to develop further solutions with policy-makers.

A more disruptive departure would harm the economy and take our housing and mortgage markets back a few years. This need not be a disaster, given the ability and willingness of policymakers to intervene, but would still mark an uncomfortable period for borrowers, lenders and house-builders.

[i] *Fiscal risks report*, Office for Budget Responsibility July 2019
[ii] *World Economic Outlook*, International Monetary Fund April 2019