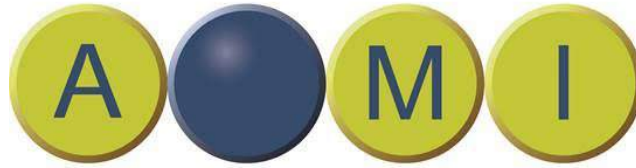


Quarterly Economic Bulletin

Volume 38 • Q4 2017

Executive Summary

- **Despite a small uptick in mortgage rates following the November rise in the Bank base rate, AMI expects margins to remain narrow for the next 12 months and rates very competitive**
- **Stamp duty cut for first-time buyers in the Budget is about politics not housing policy**
- **High LTV rates and new build rates may rise gradually during 2018 as a result**
- **Brexit now poses a question over the delivery of government's promised housing completions as construction firms warn skilled workers are returning home in Europe**
- **Demographic shifts are already beginning to show in mortgage trends with terms becoming longer and joint applications increasingly common**
- **Household debt make-up is changing with 'safe' mortgage debt falling as student debt rises**
- **Mortgage approvals and housing transactions are likely to be flat in 2018 with gross lending likely to rise to £265bn as remortgage continues to gently expand**
- **Brokers continue to offer value, particularly in specific markets including buy-to-let, self-employed, lending into retirement and first-time buyer**
- **Lenders expect brokers involved in product transfers to have taken the customer through the same advice process as remortgage**
- **Open banking rules and liability has finally been given some further clarity by the regulator – this poses some significant questions for mortgage brokers and the digitisation of advice**

Economic Overview

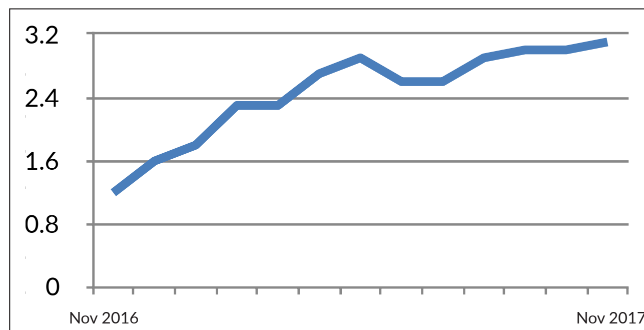
The fourth quarter of 2017 marked several important economic milestones. The Bank of England raised the Bank base rate for the first time in a decade, from its all-time historic low of 0.25 per cent back to 0.5 per cent where it had been prior to August 2016 since March 2009. The rise was widely expected and the weeks preceding it saw swap rates tick up by around 0.3 per cent, allowing lenders to justify raising mortgage rates by around the same margin. This has not continued into December and mortgage rates are unlikely to see much change in the early part of 2018.

Markets had been pricing in a further rise in the base rate for February 2018, though uncertainty surrounding Brexit negotiations and the weakest growth forecasts ever published by the Office for Budget Responsibility in November may serve to stay the Monetary Policy Committee's hand a while longer. The OBR expects GDP growth to slow to 1.5 per cent this year, before dipping to just 1.3 per cent in 2019, when the UK is due to leave the European Union. Growth picks up to 1.6 per cent only in 2022, still below the 1.8 per cent seen in 2016.

On the flipside, inflation hit 3.1 per cent in November after strongly rising oil prices last month. This is its highest rate in six years and has forced Bank governor Mark Carney to write to the Treasury explaining the breach in the MPC's inflation target, which will add to pressure on the Bank to lift base rate again to bring it back under control. However the risks are that as these are supply side cost impacts not demand led, increasing rates may just add to economic uncertainty without reducing inflation.

Rather than average mortgage rates rising as a result of this however, AMI is of the view that higher risk lending may see rates start to climb disproportionately. The majority of lender appetite is for low loan-to-value clean credit lending; competition is likely to remain heated in this part of the market throughout 2018. The larger lenders will compete aggressively in this market, supported by the relatively cheap funding afforded by the Term Funding Scheme. Given suggestions that Help to Buy has contributed to higher house price inflation, particularly in areas of the UK that have seen prices rise significantly over the past 12 months including the north of England, we would expect lenders to remain wary of lending too freely at high LTVs without the aid of the scheme.

CHART: CPI 12 month rate



Source: Office for National Statistics

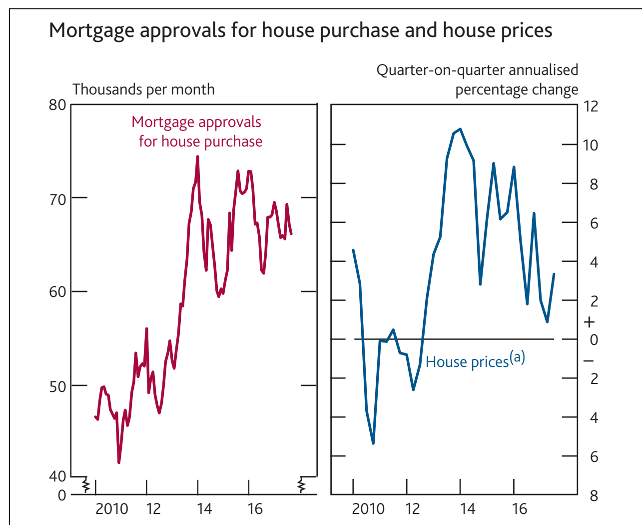
Additionally, Chancellor Philip Hammond delivered his first Autumn Budget revealing a package of measures aimed at tackling the shortage of new homes being delivered each year along with a crowd pleaser for first-time buyers in the form of removing stamp duty on first-time purchases up to £300,000.

This may contribute further to lender reluctance to offer super competitive rates at high LTV after the OBR warned any savings made by first-time buyers in stamp duty were likely to add to price inflation. Tackling the stamp duty conundrum was needed, but AMI is of the view that restricting the changes to first-time buyers will do nothing to aid mobility in the market or boost transactions, which remain sluggish.

Although the latest figures from the Royal Institution of Chartered Surveyors showed a slight improvement in transactions in late Q3, consensus suggests that this could have been partly down to the expectations of an imminent rate rise in November as well as consistently low mortgage rates encouraging some households to move.

Landlords continuing to offload properties being bought up by first-time buyers could also be a factor, as the effect of switching from tax relief on mortgage interest to a tax credit continues to prompt smaller scale buy-to-let investors to exit the market. Evidence to date indicates this is still a trickle rather than a flow. That said, RICS expects lower price inflation and sales volumes over the next few months, marking more depressed activity in the market than during the same period in 2017.

CHART: House price inflation has stabilised having slowed earlier in 2017



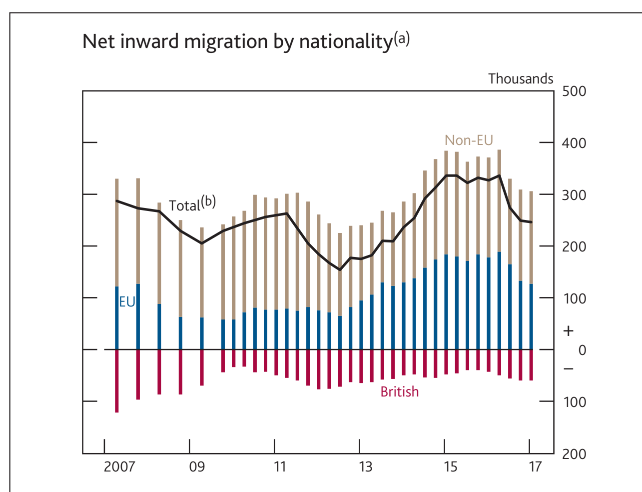
Sources: Bank of England, IHS Markit, Nationwide and Bank calculations

CPI inflation has risen further above the 2% target as companies pass on the higher costs stemming from the lower level of sterling. Unemployment has continued to fall and the extent of spare capacity in the economy now seems limited. Moreover, the pace at which the economy can grow without generating inflationary pressure has fallen over recent years. Over the MPC's forecast period, conditioned on a path for Bank Rate that rises to 1% by the end of 2020, demand is projected to grow at a pace that uses up the remaining slack in the economy. As imported inflationary pressures wane, domestic pressures build. Inflation is projected to remain slightly above the 2% target at the three-year point. At its meeting ending on 1 November 2017, the MPC voted to increase Bank Rate to 0.5%.

Source: Bank of England

Brexit

CHART: Net inward migration has fallen



Sources: ONS and Bank calculations

After getting a reasonably positive response from markets trading immediately after Prime Minister Theresa May reached a divorce deal over how Brexit talks would progress in early December, relations between the European Union and Government appear still to be on relatively moveable ground.

Key considerations affecting the housing and mortgage markets include migration and trade agreements as these will have significant impacts on the value of sterling, foreign investment appetite and resource to deliver homes promised by the UK government. The Governor of the Bank of England, in his discussions after the last inflation report, was clear that the path indicated was based on a smooth Brexit with continuing open trade and no limitations on financial services transactions. Anything less would adversely impact the Bank's assumptions.

Construction firms have openly warned that their workforces are already leaving the UK and returning to Europe, partly due to the

uncertainty of their tenure and citizenship status in Brexit's aftermath. But the continued lack of clarity around major trade agreements is also continuing to weigh on the pound, strengthening the euro and reducing the value of taking British construction work over European work.

A recent report by the Home Builders Federation found more than one in six people working on house building sites across Britain come from other EU countries while in London, more than half of site workers come from Europe. The HBF found more than half of those come from Romania, with 12 per cent from Poland and almost 10 per cent from Ireland. In London some building skills are dominated by EU workers.

More than 70 per cent of carpenters, 63 per cent of demolition and ground works workers, 61 per cent of general labourers, 54 per cent of plasterers, painters and decorators, 44 per cent of bricklayers and nearly 40 per cent of roofers come from other EU countries.

According to the Bank of England's analysis net migration to the UK is also falling already, from 327,000 in the year to Q1 2016 to 246,000 in the year to Q1 2017, mostly driven by fewer arrivals from the EU. This not only has massive implications for the number of skilled workers available to support the construction of new homes in the UK, it also raises the almost opposite question of whether our existing population growth forecasts are accurate following Brexit.

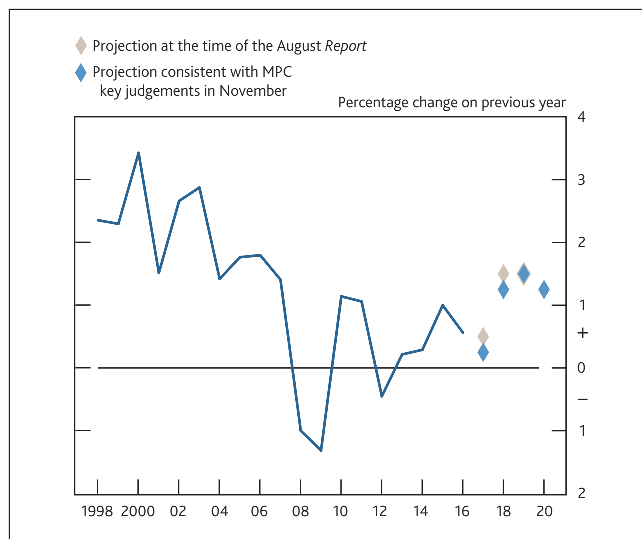
The Office for National Statistics already believes net migration will continue to slow, but by how much remains 'very uncertain' according to the Bank of England. Do we really need as many homes as government is projecting if our population is not growing so fast?

Problems delivering the number of new homes promised by government could be felt further should UK productivity not improve. As noted in several previous AMI bulletins, productivity has failed to recover following a pick up in GDP and employment following the financial crash in 2008.

CHART: Productivity has barely risen over the past decade

Sources: ONS and Bank calculations

CHART: Productivity



Sources: ONS and Bank calculationscalculations.

Economists continue to disagree as to the reasons for this but, should it remain flat or in negative growth territory, there would be potential implications for construction output when combined with a smaller resource pool of skilled workers.

The weaker pound has also weighed on foreign investment into the UK property market, with broker firms reporting across the board that they have noticed a dampening in demand. That said, limited company buy-to-let remains resilient, with landlord appetite moving out of the South East of England and further north where yields remain healthy. Smaller scale development and office conversion to residential also seems relatively robust.

Demographic shifts

For many decades the profile of mortgage lending remained largely unchanged. This has rapidly shifted in the past decade however, with notable changes including the lengthening of mortgage terms from 25 years to 35 years and a rise in the number of joint mortgage applications.

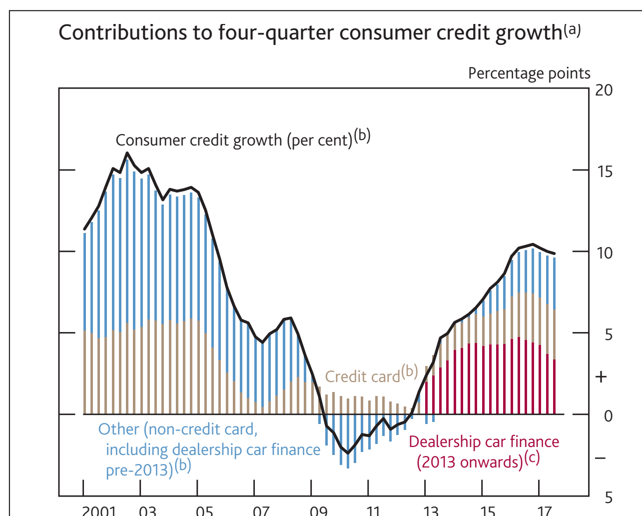
This reflects not only higher house prices and stagnant wage growth failing to keep pace putting significant pressure on affordability but also the impact that tighter regulation from both the Financial Conduct Authority and Prudential Regulation Authority has had. Higher LTV lending is already much diminished due to capital cost constraints for lenders, putting additional pressure on affordability for younger, single and lower income buyers.

At the other end of the spectrum, the market appears to be beginning to adapt to the needs of older borrowers, albeit slowly. In the past quarter we have seen several developments including a referral partnership to transform Co-operative Bank interest-only customers to lifetime mortgage borrowers with Legal & General. A similar partnership already exists between L&G and Santander. Nationwide also revealed a move to offer its existing interest-only borrowers equity release plans from its own balance sheet – a notable move given the capital treatment of equity release is assessed on an actuarial rather than individual term basis.

Household debt make up is also undergoing significant shifts. The Bank of England has noted that half of all UK households with a mortgage say they have found it easier or cheaper to get a personal loan than to raise further funds through a remortgage, second charge or further advance.

This is a worrying statistic. Consumer credit lending has risen rapidly in recent years, much to the concern of the Bank of England which has repeatedly warned lenders to show restraint in affordability assessments and the granting of interest free introductory offers spanning several years.

CHART: Consumer credit has grown rapidly in recent years



Source: Bank of England

CHART: Consumer credit has been cheap and available

Average interest rates and other terms on consumer credit lending

	Monthly averages							
	2005–08	2009–12	2013–15	2016	2017 Q1	Q2	Q3	Oct.
Interest rates (per cent)[a]								
£10,000 unsecured loan	7.8	9.0	5.3	4.1	3.7	3.8	3.8	3.7
£5,000 unsecured loan	10.0	12.7	9.7	9.2	9.3	7.8	8.1	8.2
Other terms on credit card lending								
Average 0% balance transfer term (months)[b]	8.2	12.4	19.6	25.7	29.6	28.8	28.1	n.a.
Average balance transfer fee (per cent)[b]	2.3	2.9	2.9	2.6	2.4	2.3	2.2	n.a.

Source: Bank of England

Its continued growth and households' clear reliance on unsecured credit raise perhaps uncomfortable questions over whether tightening in the mortgage market, where there is underlying security with potential for capital growth and where rates of interest are consequently far lower, has gone too far and is encouraging households to take on debt in other formats.

This picture is further complicated by the growing number of households with expanding student debt – another unsecured form of credit that has no affordability assessment made whatsoever, but which poses an absolute and finite risk to the wider stability of the economy should repayments default. Particularly in light of the government's relatively recent decision to securitise student loans for resale.

Open banking

In mid December the FCA published clarification of the UK's application of the open banking rules. Many banks affected by the rules due under PSD2 from 13 January that force major retail banks and building societies to give authorised third party providers access to customer data should the customer request it had previously issued warnings to their customers never to share their login information.

The FCA has come out guns blazing against this and issued the following statement of clarification:

'Currently, businesses that provide AIS and PIS often ask you to share your bank security details with them, such as your login and passwords.

'Under existing data protection law, these businesses must protect your data and PSD2 will require these businesses to put further measures in place to keep your credentials safe and secure.

'Your banking terms and conditions should not prevent you from sharing your credentials with regulated AIS or PIS providers. Your bank cannot hold you responsible for unauthorised transactions just because you have shared your credentials with regulated AIS and PIS providers.

'If you notice a payment out of your account that you did not authorise, you should contact your bank as soon as possible. If you did not authorise it you can claim a refund. You should contact your bank to claim a refund even if you think a PIS was used to make the payment.'

This is good news for those customers who wish to take advantage of all that open banking offers. It raises some trickier questions for mortgage intermediaries however. Online brokers that wish to access customer data through the use of APIs under PSD2, will find this much easier given this gold stamp from the regulator that customers are safe to transact and will be covered if anything goes wrong.

As AMI has highlighted previously, in theory, open banking will enable a technology platform that allows customers to compare specific mortgage products from across the market, tailored to their affordability, on a quickly, accurately and personally underwritten basis. Given that mortgage underwriters should also be able to access a customer's current account, savings and other debt commitments from all providers in the market securely and automatically through these APIs, affordability assessments should become far more accurate and efficiently processed. How far particular lenders will want to go in accessing all this data remains to be seen as they will be making judgements based on new sets of information with no history cycle to apply criteria. Also there may be data that once they know they cannot "unknow". This could mean that some cases which might have flown through would now be rejected due to gambling or other cashflow data.

Our concerns around this remain unchanged and unaddressed by the regulator, despite this recent update on PSD2. Whether a product recommendation made based on quantitative data alone can be deemed personal and therefore fully regulated advice under FCA rules is still a grey area in the mortgage market. Online mortgage brokers can recommend a product based on any - and often limited - information provided by the customer, meaning the recommendation is not necessarily appropriate based on a customer's full circumstances, which may or may not include future non-financial plans such as marriage, children or divorce. They continue to call this regulated advice, which AMI considers misleading for customers. We continue to hope that the regulator will provide clarity on this distinction.

That said, change and 'disruption' is inevitable in every market and mortgage advice is not exempt from this reality. AMI expects to see online adviser volumes grow, particularly as larger and more established players enter the market. Both Countywide and London & Country have indicated plans to offer online services. Others are working very hard in the background. Brokers must embrace technology or accept that the world moves on and may leave them behind.

However, AMI is of the view that change will not be as rapid nor as instantly transformative as many predict.

The mortgage market is notoriously tricky to navigate, understand and individuals with no experience value personal advice particularly with the human touch. Complex areas of the market including limited company buy-to-let, self-employed, contractor mortgages and later life borrowing will continue to need support from advisers for the foreseeable future.

It is in the area where the move to pay retention procuration fees has been a move for good. What is critical is that customers who approach their broker for advice receive that.

All firms and brokers need to ensure that if they are recommending that the existing lender is the right solution they have evidenced their market research and provided the same documentation they would provide for a remortgage.

The FCA has done some preliminary work in this area and found limited evidence of poor practice in the firms they have looked at, but we need to ensure that all brokers are working to the same standards.