Association of AMI Mortgage Intermediaries

Quarterly Economic Bulletin

Volume 41 • Q3 2018

Association of AMI Mortgage Intermediaries

Executive Summary

- The economic reality facing the UK – particularly given the ongoing lack of resolution on Brexit – is perhaps harsher than the Bank of England admits

- Europe is being increasingly difficult about the potential ways that UK financial institutions can passport into the EU, with the ECB now clear that European subsidiaries may not provide sufficient access

- Without a deal, the cost of UK bank finance will likely rise and have a knock-on effect on mortgage rates

- Without the extension of Help to Buy new build LTVs, which have been rising, are likely to fall back. Mortgage approvals on purchases are also likely to stumble, putting more pressure onto the remortgage market to support gross (and net) lending. Capital values on new build and surrounding areas may suffer

- The recent publication of product transfer lending figures calls into question whether the right measures are being used to consider the flow of money around the housing sector

- AMI believes a stronger focus on net lending is needed

- The recent mortgage market study interim report proposed the market focus on helping consumers to compare advice based on price

- We would urge careful consideration of what measures constitute consumer value – service, speed, efficiency, ease, communication, effectiveness - and how they can be consistently measured across all channels

- It would be more beneficial to consider how this information might be better used and shared to inform consumers when they are trying to make a decision about how and where to buy in this market

Economic Overview

Just a few weeks after the Bank of England published its most recent inflation report, the media reported that the Bank's governor Mark Carney had suggested that no-deal on Brexit could trigger a collapse in house prices by as much as 30 per cent. His actual comments were taken out of the context of a worst-case scenario stress test for the banks - but the damage was done. It was wildly out of kilter with the Bank's message in its August inflation report, which outlined a moderately positive outlook for future GDP and central forecasts estimating economic growth of around 1.75 per cent on average over the next three years. This, together with robust employment, only just above target inflation and relatively little slack in the wider economy, justified the Monetary Policy Committee's decision in August to raise the base rate for the second time in 12 months, leaving it standing at 0.75 per cent today. It also paved the way for a further rise as soon as February next year.

While AMI does not agree that no deal would see property lose a third of its value, the terms of Britain's deal on its exit from the European Union remain undecided and politicians from both Labour and Conservative camps seem more intent on destroying their internal party alliances than settling their differences to secure a decent divorce from Europe. Business leaders are spooked. The latest confidence survey from the Institute of Directors suggests they are now more pessimistic about the outlook for the British economy than at any point this year, with rising rates and trade tensions both piling pressure on the so-far unsatisfactory outcome of Brexit negotiations.

The government itself has published scores of no-deal worst-case scenario papers that include the possibility of British firms suffering restricted access to European money markets. The European Central Bank has stepped up warnings that a perceived loophole to UK companies passporting into the EU will not be tolerated; it warned in early September that merely having an EU-based subsidiary with senior managers remaining in a UK-based head office would not be sufficient to serve continental customers.

The most recent Financial Policy Committee statement also raised passporting as a red flag, stating: 'Absent EU action, £69 trillion of contracts EU members currently have with UK CCPs will need to be transferred or closed out by March 2019.' This poses very serious implications for banks of all sizes, investment and retail as well as for trading houses, fund managers and particularly stock exchanges and other trading markets based in the UK. The cost of finance will be materially affected.

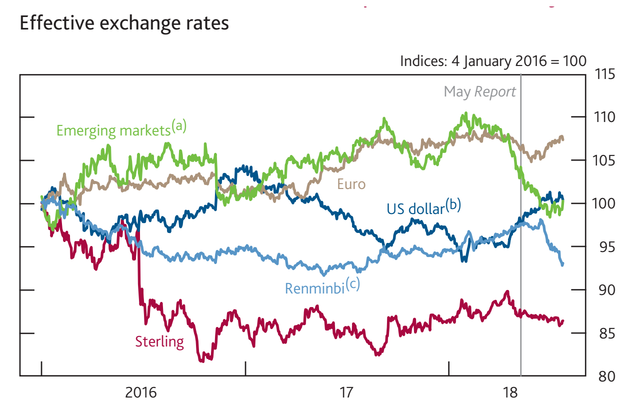
Though he may not have intended to stir up the storm on house prices that he did, Mr Carney was right to sound a warning bell to the country's politicians highlighting that they cannot simply hope for the best. Preparing for the worst may be necessary.

Current economic performance

At home, reasonably solid employment figures do not necessarily reflect the money in people's pockets. At just 4 per cent in August, unemployment might be at its lowest level since 1975, but Office for National Statistics figures show earnings have outstripped inflation for much of this year, only just tipping the balance in August. The latest figures showed annual wage growth of 2.7 per cent excluding bonuses for the three months to August, matching inflation that month.

While September saw a small dip in consumer prices, taking inflation to 2.4 per cent, the Bank of England forecasts inflation to remain just above 2 per cent through most of the next three years, hitting 2 per cent by 2021. Yet, oil prices have risen 55 per cent in dollar terms since this time last year. The pound has also

CHART: Currencies have depreciated since May



Source: Bank of England

suffered considerably at the hands of ongoing political indecision and in-party backstabbing, putting additional pressure on costs for UK citizens. Many rail fares will increase by 3.2 per cent next year, in line with the retail prices index in July.

Added to this, the Bank's Funding for Lending Scheme has closed and mortgage pricing remains highly competitive at all risk levels. Deposit takers have also not raised the rates they offer to savers by as much as the base rate rise last month. The Bank itself notes that spreads on all forms of funding for UK mortgage lenders have widened over the past few months, pushing up the cost of finance. Yet, the committee has also revised guidance on the level of Bank rate at which it would consider starting to reduce the stock of purchased assets, reducing that to around 1.5 per cent compared to the previous guidance of 2 per cent.

The Bank of England's chart 1.D below, reveals a 41 basis point fall in the average two-year fixed rate at 90 per cent loan-to-value between May 2016 and August 2018, a period that saw the base rate rise twice by a collective 0.5 per cent from trough to peak. Five-year fixed rates at 75 per cent LTV meanwhile saw a 60 basis point drop over the same period. Margin pressure for lenders shows little sign of abating, raising the spectre of shifting risk appetites to maintain market share once again. This is particularly important given the housing market context.

TABLE: Household borrowing rates have remained low

Retail interest rates on lending and deposits[a]

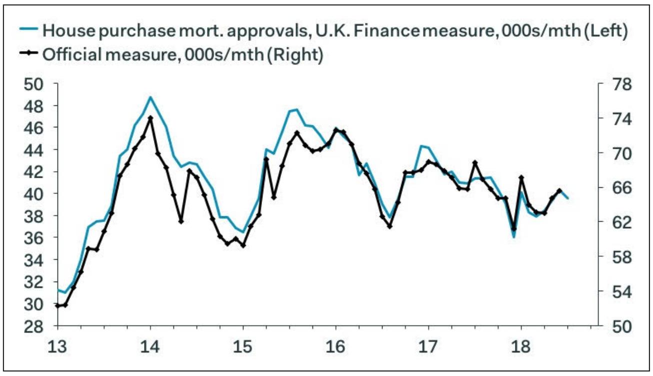
	Level (per cent)	Changes since (basis points): May 2018	August 2017	May 2016
Households[b]				
Mortgages:				
Two-year variable rate, 75% LTV	1.56	-3	17	-5
Two-year fixed rate, 60% LTV	1.79	10	55	9
Two-year fixed rate, 75% LTV	1.76	2	33	-15
Five-year fixed rate, 75% LTV	2.04	-2	8	-60
Two-year fixed rate, 90% LTV	2.34	1	1	-41
Consumer credit:				
£10,000 unsecured loan	3.76	3	-3	-57
Deposits:				
Instant access savings	0.21	1	7	-19
One-year fixed-rate bond	0.86	6	0	-5
One-year fixed-rate ISA	1.34	14	23	27
Two-year fixed-rate bond	1.34	20	18	14
Two-year fixed-rate ISA	1.25	1	15	9
PNFCs[c]				
Outstanding floating loans	2.96	4	38	21
New floating loans	2.48	-3	19	-3

Source: Bank of England

Housing and property markets

The usual bump in purchase activity over the summer did not materialise this year. The UK Finance approvals figure for purchase showed a fall in July to 39,600 from 40,300 the previous month, far below the consensus expectation of 40,700. The RICS residential market survey did not serve up much in the way of hope that this subdued activity would reverse in early autumn, with the balance of new buyer enquiries close to zero in July. According to Pantheon Economics, the

CHART



Source: Pantheon Economics

number of people searching for "mortgage" on Google—a good leading indicator of lending activity—was down 3.8 per cent year-over-year in July.

While usually a quieter month, the RICS figures for August were no better. New buyer enquiries dropped back to a seasonally-adjusted balance of -6, from +1 in July. The new sales instructions balance fell to -16—its lowest since March—from -3.

UK asking prices fell by an average 2.3 per cent in August, driven by a 3.1 per cent fall in prices in London, according to property listing portal Rightmove. Halifax data meanwhile suggested that agreed house prices per square metre plateaued in Greater London for the first time in eight years over the summer. Property values in the North and South East fared little better, showing just a 2 per cent annual uptick.

"Without an extension of Help to Buy, new build LTVs could start to fall back"

The latest statistics on Help to Buy revealed that 81 per cent of total first-time buyer purchases in 2017 was boosted by the scheme. But following results season this month for the major builders, Help to Buy has increasingly come under the microscope with several allegations made that it has done more to support developers' profit margins and inflate house prices than help would-be homeowners onto the property ladder where without the scheme they would have been unable to buy.

The Government has remained tight-lipped on whether it plans to extend its funding of equity loans under the scheme after 2021. Without it, there are several potential areas that could suffer. New build LTVs, which had been rising, are likely to fall back. Mortgage approvals on purchases are also likely to stumble, putting more pressure onto the remortgage market to support gross (and net) lending. Capital values on new build and surrounding areas may suffer.

The landscape for commercial property is stagnating with forecasts from Capital Economics suggesting a significant reduction in investment this year compared to last. They estimate annual investment activity will decline to around £54 billion this year, from £64 billion in 2017. The total value of investment in UK property in July was 25 per cent lower than a year ago, at just £3.5 billion.

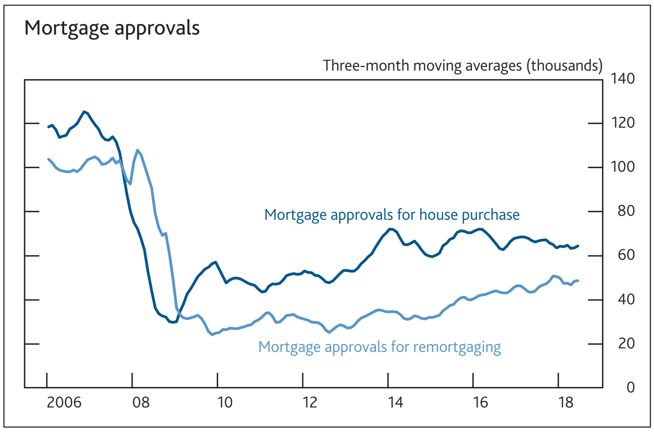
Moreover, according to the research house, the level of investment in the retail and industrial sectors to date appears weak compared to previous years. The significant pressure on the high street in the retail sector is taking its toll on investor sentiment. The latest RICS Commercial Market Survey suggested that a net 42 per cent of surveyors experienced a fall in investment enquiries.

Lending

Gross residential mortgage lending so far in 2018 has been stable but below the levels hoped for. Approvals for house purchase are forecast to average around 65,000 a month for the remainder of the year by the Bank. Its economists also note that in the near term, 'modest real income growth and accommodative credit conditions should support housing market activity'.

The Bank of England's Q2 Credit Conditions Survey, however, suggested that activity could remain under pressure this quarter. It showed

CHART: Mortgage approvals for house purchases stable but subdued



Source: Bank of England

a net balance of -4 lenders planning to reduce the supply of secured credit over the next three months, having increased it in the previous six quarters.

Unsecured consumer credit lending also slowed in July with an annual growth rate of 8.5 per cent. This is still relatively healthy, but its reduction from the previous month suggests both that lenders are relatively reserved in their appetites but also that consumers may be more inclined to pay down debts rather than ramp them up.

The ongoing bite from the government's fiscal and Bank's regulatory tightening on buy-to-let over the past few years has seen mortgage activity fall considerably. The most recent UK Finance figures show buy-to-let purchase approvals in June totalled just 5,400, a drop of 19 per cent from the previous year. By value this was £0.8 billion of lending in the month, 11 per cent down year-on-year.

With both the residential and buy-to-let markets focused heavily on remortgage rather than purchase, the Treasury's stamp duty take is down. UK Finance also agreed to publish product transfer figures for the first time this summer. According to its analysis, 390,200 homeowners switched product with their existing provider in the first quarter of 2018. By value, this represents £53.7billion of mortgage debt refinanced internally. These figures do not feature in any market data on remortgaging, or other published gross mortgage lending data. Of the total number of product transfers, 203,200 transfers, worth £29.5billion, were conducted on an advised basis and 187,000 transfers, worth £24.2billion, were execution-only.
This is clearly a very significant component of the mortgage market. In Q1 2018, gross lending to home movers and first-time buyers was £29.6billion. Remortgage lending was £20.3billion.

Rather than rely on gross lending and purchase approvals as a measure of the mortgage market, we must start to focus on net lending. The money flowing around the market is largely not new and it is not funding growth. The shape of the lending market has shifted and how we measure it is perhaps no longer fit for purpose.

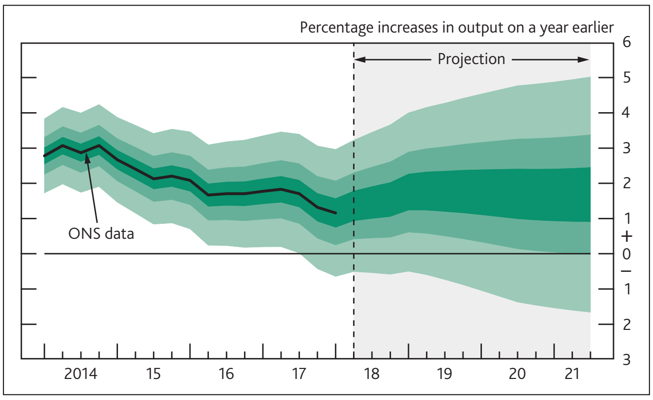
A triumph of hope over reason?

While the figures might make for slightly gloomy reading, this is the reality today. And yet, the Bank of England notes despite its commitment to keep the base rate on its upwards path, that it "continues to recognise that the economic outlook could be influenced significantly by the response of households, businesses and financial markets to developments related to the process of EU withdrawal".

It states explicitly: "Tighter financial conditions are likely to dampen growth, as are greater barriers to trade…Moreover, the prospect of a further escalation in trade protectionism – particularly if business and consumer confidence and financial conditions were to deteriorate materially – could weigh further on the global outlook."

AMI would therefore question what is causing the Bank of England's expectations of a rise in GDP against these economic realities and the rapidly nearing deadline for Brexit. Is this a triumph of hope over reason?

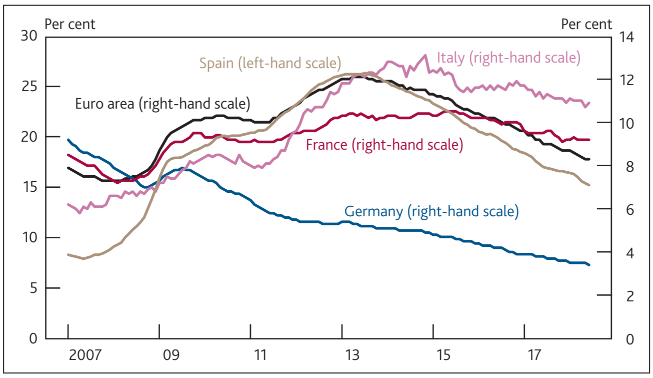
CHART: Bank of England's GDP projection



Source: Bank of England

We cannot see the tangibles to justify the Bank's position. Liquidity in Europe is still expanding: the ECB made no change to its policy rates in either June or July and provided guidance suggesting rates would remain at present levels for another 12 months at least. Euro-area unemployment sat at 8.3 per cent in June and is particularly high in Spain where it has been over 15 per cent since 2009. Two of the best-known banking names on the British high street are owned by Spanish banks: Santander and TSB Bank, owned by Banco Sabadel.

CHART: Unemployment remains elevated in some euro-area countries

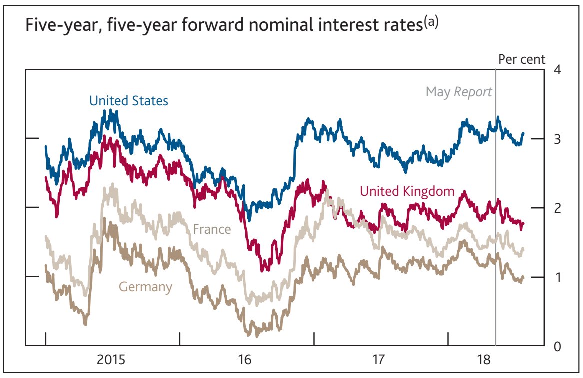


Source: Bank of England

The strong economic growth in the US has prompted increasing expectations of a further five rate rises at the Federal Reserve, two 25 basis point hikes this year and a further three next year. Bank economists warn that, given the US is the UK's second largest trading partner, this together with a rise in US government debt issuance could push up longer-term interest rates. This would put additional pressure on funding costs for UK banks, further ramping up the risk of margin compression and subsequent changes to criteria.

The UK still has huge liquidity risks at its heart. A hard Brexit or deal that falls short of certain crucial trade agreements could cause GDP to crash in the UK and result in hundreds of thousands of British workers losing their jobs.

CHART: Five-year forward nominal interest rates



Source: Bank of England

Value and MS16/2.2

Turning to regulation. The price of things isn't necessarily the value of things. The original Mortgage Market Review recognised this and created an architecture for the exchange of money and security that allowed the customer to determine what value meant to them, and pay a price according to it. The number and variety of routes to accessing mortgages allowed not only for execution-only and advised, direct and intermediated, fee-free and paid-for but also within these options a choice. That choice is critical if the market is to maintain value.

The recent market study raised several questions on value, particularly in relation to customers being given the tools to identify it. This could be within the context of better technology that improves the efficiency of a service or it could be the ability to compare offerings consistently.

While fees, charges and commissions are a key consideration for any consumer of a service, price is only one measure of value. Service – its speed, efficiency, ease, communication, effectiveness – makes up, arguably, a larger component when it comes to choice. People have the right to shop at Primark, Tesco or Matalan if price is the most important element for them. If service is, they might choose to pay (far) more for a personal shopper experience at Selfridges. Now, there are also monthly subscriptions for those who don't want to shop at all, but allow data on our previous clothing preferences to intelligently anticipate what we want to wear next week.

None of these approaches is the best nor the worst. Value is about protecting choice. There are already multiple providers of services that compare firms on price; they have been found ill-equipped, especially in markets that sell products as complex as mortgages.

Rather than focus on comparing advice based solely on price, we would urge careful consideration of what measures constitute value, how they can be consistently measured and how this information might be better used and shared to inform consumers when they are trying to make a decision about how and where to buy in this market.

Association of AMI Mortgage Intermediaries