Understanding lender funding, product availability and pricing

A Q&A guide
for mortgage professionals

In association with

AMI & imla

Contents

Introduction

In the low interest rate environment we enjoyed from 2008 to 2022, you only needed to know about lender funding models, hedging strategies and pipeline management processes if these things were part of your day job. But ever since we entered into a market of volatile interest rates and product withdrawals, these topics have become important for everyone to understand.

That is why AMI and IMLA decided to put together this Q&A guide. It is designed to be accessible for anyone in the industry and assumes no prior knowledge. The explanations come from technical specialists in the lending sector.

The guide also provides a foundation for lenders to explain to brokers the challenges they are facing, and suggests ways in which some of these challenges might be mitigated.

We hope this document will help to clarify the motivations and constraints lenders are operating within during periods of interest rate volatility. We want all brokers to be equipped with the knowledge and understanding to engage in productive conversations with lenders about how things can be improved.

Equally, we encourage lenders to maintain open dialogue with brokers, listen to their concerns, and take action in response to feedback.

The wider issues may take time for industry to resolve, but it is in all of our interests to minimise consumer harm, support healthy working patterns and maintain strong lender-broker relationships.

Q&A

What role does funding play in modern mortgage lending?

Mortgage funding is not simply about raising cash to lend back out to borrowers. This is how traditional building societies worked until the mid-1980s, with borrowers waiting in a 'mortgage queue' until a building society accumulated sufficient deposits from savers to lend out as mortgages. Modern lending works differently – and it is a delicate balancing act.

Banks and building societies make their money from the difference between income generated by their assets (e.g. their mortgage loans), and the costs of servicing their liabilities (e.g. interest on customers' savings accounts or money borrowed from other institutions). They also need a steady supply of liquid funds to meet their short-term obligations (e.g. customers withdrawing money) and overheads.

Without funding, lenders would run into cashflow difficulties, as they can't control the timing of inflows and outflows so that everything remains in sync. The regulator also requires lenders to hold enough capital to provide a buffer against financial shocks.

Funding keeps liquid cash pumping through the system, so that banks can keep the lights on, pay their staff, balance their books and meet their obligations to customers, investors, regulators and other banks and building societies.

If lenders get their funding models wrong, they risk making significant losses – or in the worst-case scenario, becoming insolvent.

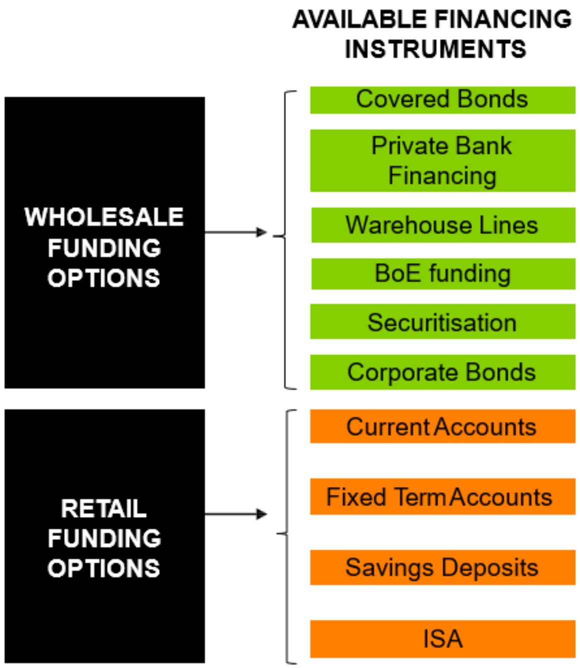
Q&A

What are the main sources of mortgage funding?

Lenders fund their mortgage loans in various ways, broadly divided into ‘retail’ and ‘wholesale’:

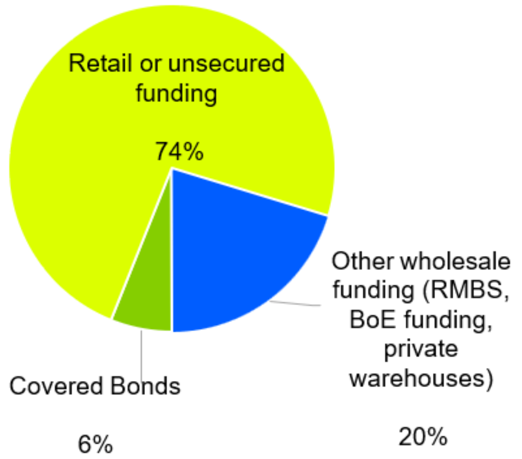
- **Retail funding** includes deposits from savers – including savings products, fixed-term accounts (savings bonds) and ISAs. It can also include cash held for current account holders.
- **Wholesale funding** options include covered bonds, private bank financing, warehouse lines, Bank of England funding, securitisation and corporate bonds.

FUNDING STRUCTURE



OUTSTANDING MORTGAGES IN THE UK

- Total of £1,631 billion outstanding residential mortgages in the UK
- Wholesale funding is circa 26% of all mortgages funded



Q&A

Most lenders draw on many of these sources, but the exact split varies from lender to lender. The type and split of funding a lender uses impacts its ability to react when interest rates are volatile, as they have been since September 2022 – hence the variation in notice periods from lender to lender.

Banks and building societies

Banks and building societies generally use retail and wholesale funding - the wholesale markets are sometimes cheaper.

Building societies

Building societies typically fund a larger proportion of their mortgages from retail deposits, their traditional model. There are also limits on the amount of wholesale funding mutual societies are allowed to use.

Lenders that do not have a banking license

Lenders without banking licenses cannot raise deposits so they rely on wholesale funds. These lenders often operate in the specialist space.

Q&A

How are fixed-rate mortgages funded, and what is a swap?

Lenders make profit by 'borrowing' from savers and investors and lending to other customers in the form of mortgages and loans. The lender charges the borrowers interest, passes some of this to its savers and/or investors and keeps the rest to cover its costs and return value to shareholders or members.

Variable rate mortgages are relatively easy to fund.

Let's assume a lender's funding costs are Base Rate +1%. If the lender charges its mortgage borrowers Base Rate +2%, it can keep the 1% difference for itself. If the Base Rate rises, the lender can increase the variable rate charged to maintain its margin, as illustrated below:

Simple variable rate mortgage funding example			
Base rate	Funding costs	Mortgage rate	Lender margin
0.50%	1.5% (Base rate +1%)	2.5% (Base rate +2%)	1.0%
1.00%	2.0% (Base rate +1%)	3.0% (Base rate +2%)	1.0%
1.50%	2.5% (Base rate +1%)	3.5% (Base rate +2%)	1.0%
2.00%	3.0% (Base rate +1%)	4.0% (Base rate +2%)	1.0%
2.50%	3.5% (Base rate +1%)	4.5% (Base rate +2%)	1.0%

Fixed rates are different.

If Base Rate is 0.5%, and initial funding costs are 1.5% (Base Rate +1%), the lender still makes a 1% profit charging a fixed-rate borrower 2.5% - at first.

Q&A

But if Base Rate increases to 1%, the lenders' margin is halved to 0.5%. If Base Rate goes to 1.5%, the profit is wiped out, as funding costs (Base Rate +1%, or 2.5%) are now equal to the income from the fixed-rate borrower. If Base Rate goes up again, the lender makes a loss, as shown below:

Simple fixed-rate mortgage funding example (without swaps)			
Base rate	**Funding costs**	**Mortgage rate**	**Lender margin**
0.50%	1.5% (Base rate +1%)	2.5%	1.0%
1.00%	2.0% (Base rate +1%)	2.5%	0.5%
1.50%	2.5% (Base rate +1%)	2.5%	0.0%
2.00%	3.0% (Base rate +1%)	2.5%	-0.5%
2.50%	3.5% (Base rate +1%)	2.5%	-1.0%

This is where swaps come in. The lender can 'hedge' or take the risk out of their fixed rate mortgage lending by buying a set amount or 'tranche' of money from a counterparty in the financial market, fixed at a particular 'swap' rate for a specified period of time.

The 'swap rate' is the fixed interest rate that the counterparty demands in exchange (as a 'swap') for the uncertainty of having to pay the short-term floating or variable rate of interest for the money over the time period.

Both parties are effectively placing a bet – the lender thinks rates will go up, the counterparty thinks they will go down. If variable rates rise above the swap rate, the counterparty loses their 'bet' and has to pay the lender the difference. If rates fall, the reverse applies. This helps insulate lenders against rising rates when offering fixed-rate mortgage deals.

Q&A

What happens to swap rates in a volatile market?

Swap rates reflect the market expectations of rates over the term of the swap, unlike the Base Rate which is more a reflection of the current situation. When the financial markets predict that Base Rate will increase in future, the cost of swaps goes up correspondingly – and sometimes dramatically.

In June 2023, stubbornly high inflation led the financial markets to believe the Bank of England would increase Base Rate more significantly than previously anticipated and would keep rates higher for longer, pushing up the cost of swaps. This helps to explain why mortgage pricing and Base Rate changes sometimes appear to fall out of sync.

Rising swap rates put lenders in a difficult position. Once the funding runs out for fixed-rate deals at a particular price, the lender has to pull the deal or sell the product at a loss, compromising the financial health of the business. This is why we have seen some lenders pulling products with very little notice.

Why can't all lenders offer a minimum 24-hour product withdrawal notice period?

Lenders give varying levels of notice based on their predictions of how much funding is left in the pipeline. This can be less than less than 24 hours and deadlines can fall outside of business hours, requiring brokers to work unexpected overtime to secure the best deals for their clients.

Q&A

This is largely because the minute a deadline is announced, applications flood in, creating a dilemma for lenders, who must balance giving as much notice as possible with avoiding a surge of demand they do not have the operational capacity nor the funds to meet.

A lender might be receiving a manageable quantity of applications, but if a 'cheaper' provider withdraws suddenly, they then become lender of choice for the market and are inundated. That lender may then need to withdraw more quickly than they had planned or wanted.

Of course, this situation is incredibly challenging for brokers and consumers. To be told a product is on the shelf, only to have it abruptly vanish causes wasted time, expense and a great deal of stress and uncertainty for all involved.

Even if a product is repriced immediately, it might not then be affordable. If it is affordable, the worry continues that it could be pulled yet again, causing further anxiety for the broker and consumer.

There are no easy answers to this problem, and the solutions will require a compromise between lenders and brokers in the best interests of consumers.

Q&A

What would happen if a 24-hour product withdrawal notice period became mandatory?

This could be very unhelpful. Some lenders could simply not absorb high-volume applications if they were unable to withdraw products – so could not risk putting themselves in that position in the first place. It could lead to the disappearance of some fixed-rate deals altogether, the need to build in extra margin to all products or to take products off sale earlier. Ultimately the consumer would lose out.

In practice, lenders should always try to give as much notice as possible, but it is unlikely there could ever be a 'one size fits all' approach. If a specific period were to be adopted, it could have the unintended consequence of disadvantaging some customers.

Why can some lenders offer more notice than others?

At any given time, individual lenders' mortgage books look very different, according to:

- **The make-up of their back books**, which can be a combination of their own products and those acquired via merger with or acquisition of another lender.
- **Their current risk appetite**, which will be affected by their strategy for growth and recent performance.

Q&A

- **Their Responsible Lending policy** (required under mortgage regulatory rules).

- **Their funding mix** – lenders more reliant on more price-sensitive types of funding (e.g. wholesale) may need to pull products more quickly.

- **Their hedging strategy** – strategies differ over how many days of funding to hold, which impacts product withdrawal notice periods.

In normal trading conditions, this variety of approaches is a good thing, creating choice and healthy price competition. The downside is that some lenders are forced to withdraw products more quickly than others in adverse market conditions.

This all contributes to each lender needing to control its flow of funds carefully. Decisions can't be made in isolation: if competitors suddenly increase their prices, any lender which doesn't follow suit is likely to be swamped with applications which it can't fund profitably, and can't service.

Any funding risk will bring the lender into potential conflict with its supervisors and prudential regulators (not to mention its board), and the detrimental impact on service levels will only increase the degree of dissatisfaction experienced by intermediaries and borrowers.

In short: just because one lender has a commitment in place, doesn't mean all should be able to follow suit.

Q&A

Can product withdrawal deadlines be kept within the 9-5, Monday-Friday?

Product withdrawal deadlines outside of core business hours affect work-life balance and create stress and uncertainty.

We are therefore encouraging lenders to consider operational changes that could have a positive effect on ensuring sensible product withdrawal timeframes, such as internal committees meeting earlier in the day and/or more frequently.

Committing to notice periods within core hours may not be feasible right away if IT systems or internal processes need to be modified. But as interest rate volatility looks set to continue, the mortgage industry needs to consider new ways of working to adapt to the new normal.

AMI, IMLA and other trade bodies are engaged in ongoing discussions to see how all parties can work more effectively in the best interests of consumers.

What needs to happen next – what can lenders and brokers do?

Honest communication and engagement is key. With every decision there are trade-offs, and open dialogue about the decisions being taken, the discounted alternatives, and the reasons behind these decisions can make all the difference in supporting brokers to explain what is happening to their clients.

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This ties in with the Consumer Duty requirement to put consumers in a position to make 'informed decisions'. Broker firms reviewing their product panels may wish to keep track of lender notice periods and communications to see which deliver more certainty and stability for clients, and feed this into their recommendations accordingly.

Clients with a higher risk appetite may be prepared to tolerate the risk of an unexpected or short-notice product withdrawal if it means the potential for a better deal. More cautious consumers however may prefer to go with a lender with a track record of offering longer notice periods and prompt and transparent communications, even if the product isn't the cheapest (so long as this is documented in accordance with the cheapest rule).

Product pulls outside business hours may cause more consumer harm than good if technical and administrative support is not available after 5 or 6pm, or at the weekend. So, lenders should consider whether deadlines set at unsociable hours truly deliver the extra time promised, or whether they are unfairly disadvantaging some consumers and their brokers who run into technical difficulties.

Lenders can promote good consumer outcomes by working to ensure product pulls come with a clear explanation as to why, and are communicated via all reasonable channels at the lender's disposal.

Any consumer-facing guides or other collateral that lenders can offer about what to expect in the current climate would also help brokers to keep clients well-informed and aware of the setbacks they may encounter. Lenders are welcome to share this guide as a starting point.

Conclusion

Ultimately, lenders do not want short notice product pulls. Service, profitability and relationships suffer and so there is no incentive to remove products at short notice other than to mitigate potential harm. Lenders do not take product withdrawal decisions lightly and understand the grief such a decision can cause to both brokers and consumers.

Equally, it is important that systems, processes and IT infrastructure are capable of meeting the needs of consumers in volatile market conditions. This will be an ongoing process and may take time, but we can no longer count on a return to the status quo. As an industry we will need to evolve.

That is why it is important for the industry to work collaboratively; better communication and understanding on all sides are key.

Mortgage firms and professionals concerned about stress, burnout and mental health in the workplace are encouraged to visit the Mortgage Industry Mental Health Charter website, which contains a wealth of resources and signposting that you may find helpful.

There are also some additional guides and resources on wellbeing in the workplace on the Working in Mortgages website.