Segmenting the UK mortgage market

October 2015

Executive summary

This is the third in a continuing series of research reports issued by IMLA in 2015, and examines the key issues facing the main segments that make up today's mortgage market. The reports do not represent the specific views of individual members or associates but are provided as a collective contribution to the key issues of the day. IMLA draws on this material as part of its on-going debate and dialogue with government and regulators.

The key messages are:

Buy-to-let – let it be

- Despite the election of a Conservative government the policy environment has become less supportive for the private rented sector (PRS) with July's adverse tax changes, talk of tighter regulation of landlords and the Bank of England's Financial Policy Committee (FPC) identifying buy to let as an area of concern with recommendations on new macro-prudential regulation expected soon.

- However, the increasingly unfavourable policy environment will do little to restrain the forces driving the expansion of the PRS. Excess tenant demand driven by population growth and inadequate new housing supply will continue to underpin the sector. Against this background, measures that deter further investment can only push up rents, harming tenants more than landlords.

First time buyers – the stars align

- Over the past year first time buyers have benefited from an unusual constellation of positive factors: interest rates have fallen to new lows, saving the average first time buyer £840 a year; average earnings are rising at close to 3% while inflation is around zero (providing an average benefit of £1,080); the change to the stamp duty regime, which will save the average first time buyer £970; and more help from government in the form of the Help to Buy ISA which launches in December and the proposed Starter Homes Initiative.

- Even though the first time buyer house price to earnings ratio is, at 4.0, high by historical standards, first time buyer mortgage affordability has never been better. In the second quarter of 2015, the average first time buyer spent 10.2% of their income on mortgage interest, the lowest figure on record and less than half the proportion recorded at the end of 2007.

Home movers – log jammed

- The number of home mover transactions has not picked up in line with first time buyer numbers. The ratio of mortgaged home movers to first time buyers fell from 1.66 to 1.14 over the five years to Q2 2015.

- With baby boomer homeowners, who are now in their 50s and 60s, moving less frequently the outlook for home mover transactions remains constrained until downsizing becomes a more appealing or accessible option, which could be two decades away.

Remortgaging – priced to go

- Conditions seem perfect for the resurgence of the remortgage market: at just under 3% the price differential between standard variable rates (SVRs) and discounted variable rate deals is greater this year than ever before; interest rates are expected to rise; and for the first time in Q2 2015 UK households' aggregate housing equity surpassed the £5 trillion mark. Only 20% of gross UK housing wealth is now mortgaged, the lowest proportion since the early 1980s.

- But despite the supportive conditions remortgage volumes remain subdued. A modest recovery has taken place since 2010 but without gaining momentum. However, this may be changing as in Q2 2015 volumes were up 11% on the previous quarter to record the best performance since 2009.

Lifetime mortgages – coming of age

- For many years lifetime mortgage volumes were expected to rise on the back of an ageing population and inadequate pension incomes. The market failed to live up to its potential, but this may be changing as 2014 saw a 21% increase in lifetime lending volumes to £1.5 billion after an 18% rise in 2013.

- The pension freedoms implemented in April this year could alter perceptions in the lifetime mortgage market. The changes bring pension pots into an individual's inheritable estate alongside housing wealth and other assets. The purchase of an annuity is likely to come to be seen as far more corrosive to inheritable wealth than a lifetime mortgage.

Further advances – flat lining

- Further advances stands out as the worst performing segment in our analysis. Despite rising 12% on the previous quarter, Q2 2015's figure of £1.3 billion was still less than half the quarterly average of 2008, when the financial crisis was raging.

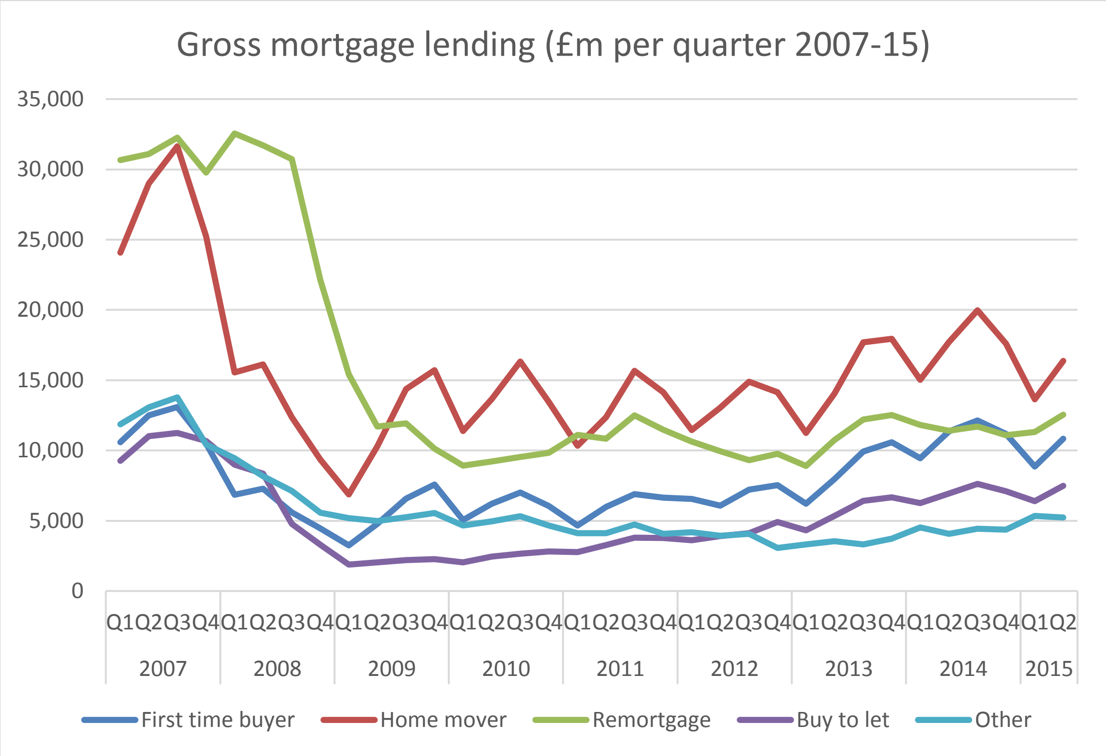
- The contraction of the market in further advances largely reflects households' more cautious approach to borrowing to fund consumption since the 2008-9 slump. In aggregate households pumped a record £13.7 billion of equity into the housing market in Q1 2015.

Introduction

Although the mortgage market is often discussed as a single entity and analysed accordingly, it is helpful to think of it as a series of markets (further advances, loans to first time buyers, to moving homeowners, to buy-to-let investors, to lifetime borrowers and to remortgagors), which are interlinked but distinct.

Chart 1 shows the evolution of lending volumes in the main sub-markets since 2007. While it shows the common pattern of sharply falling lending in the financial crisis in 2008-9 and modest gains since, some segments have clearly performed much better than others. But these are not the segments one might have guessed would have outperformed. Before the financial crisis, the best performing categories of lending were buy-to-let, powered by the growth in demand for private rented accommodation, and remortgages.

Chart 1



Source: Prudential Regulatory Authority (PRA)

Yet these two categories of lending suffered the heaviest declines in the wake of the financial crisis. Remortgaging volumes fell 60% between 2007 and 2009 and buy-to-let a dramatic 81% against a more modest 53% for first time buyers and 56% for home movers. The buy-to-let performance came despite the continued robust growth of the PRS. These shifts could best be described as the product of lenders retreating to the traditional core market of lending to home purchasers.

Subsequent segmental performance has varied considerably. By far the most robust recovery has come in buy-to-let (lending volumes up 219% between 2009 and 2014) but this must be placed in the context of the previous sharp decline. Nonetheless, when expressed as a percentage of total lending, buy-to-let has never been more prominent at 17.1% in the first half of 2015. Remortgaging and further advances are the only lending segments to have shown a further decline since 2009 despite a recovering appetite on the part of lenders to seek new business.

Taking the 2007-14 period as a whole, first time buyer lending volumes held up best, falling only 4%, followed by home mover volumes which were down 37% and buy-to-let down 40%. The worst performing of the major segments was remortgage lending which fell 64%.

2015 – Another game of two halves?

In our paper on the outlook for 2015 (*The new 'normal' – one year on: Is the march back to a sustainable market on track?* April 2015) we described 2014 as a game of two halves. As Table 1 shows, a very robust recovery at the start of 2014 gave way to a much more subdued market in the second half of the year with gross lending actually falling by November, compared to a year earlier.

2015 may be shaping up as something of a mirror image of 2014. Until May total lending was running below its 2014 level but since then there has been a sharp recovery. Subdued lending in the first half of the year may have reflected uncertainty in the run-up to the general election. The clear cut election result has removed this uncertainty, which could be a factor behind the sudden bounce. But the bedding down of the Mortgage Market Review (MMR), which disrupted some lending on its introduction in 2014, is also a factor.

Table 1 – Increase in gross mortgage lending over 2014 compared to a year earlier

	First time buyers	Home movers	Buy to let purchase	Remortgage	Total
Jan 14	55.0%	36.1%	28.6%	36.8%	37.6%
Feb	63.2%	38.2%	50.0%	34.3%	37.9%
Mar	32.0%	17.9%	50.0%	32.4%	32.3%
Apr	50.0%	43.2%	50.0%	22.9%	34.4%
May	30.0%	18.8%	25.0%	-4.5%	11.8%
Jun	27.3%	22.4%	42.9%	8.9%	19.5%
Jul	26.5%	23.2%	33.3%	0.1%	14.6%
Aug	8.1%	10.0%	11.1%	2.0%	7.2%
Sep	21.9%	15.7%	22.2%	0.1%	9.3%
Oct	16.7%	6.8%	33.3%	-8.2%	3.8%
Nov	2.8%	-5.3%	11.1%	-15.1%	-5.7%
Dec	0.0%	-1.8%	37.5%	-8.9%	-2.8%
Jan 15	-6.5%	-8.2%	22.2%	-8.6%	-8.5%
Feb	-9.7%	-8.5%	11.1%	-8.8%	-8.4%
Mar	6.1%	8.7%	33.3%	8.2%	6.1%
Apr	-5.6%	-5.7%	33.3%	-1.7%	-4.1%
May	-10.3%	-8.8%	20.0%	5.2%	-4.1%
Jun	4.8%	10.0%	40.0%	30.8%	12.8%
Jul	7.0%	10.1%	33.3%	24.4%	12.3%

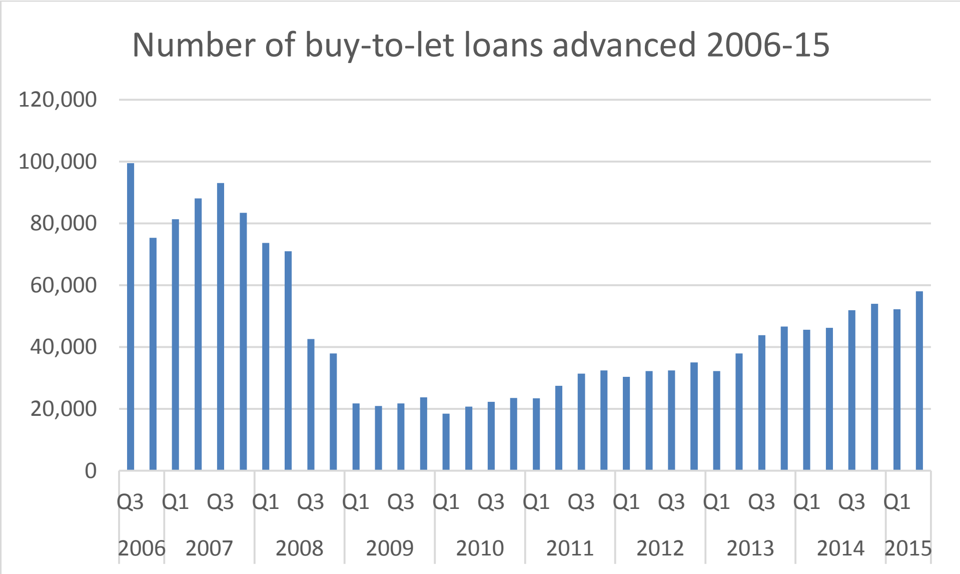
Source: PRA

If this nascent recovery is sustained through the final months of the year, 2015 could yet see lending surpassing 2014's total despite the poor conditions of the first half. We now turn to a closer examination of developments in the main mortgage segments.

Section 1. Buy-to-let – let it be

Buy-to-let is the mortgage segment which has enjoyed the most robust recovery over the last five years. Advances of £16.6 billion in the first half of 2015 were four times the £4.1 billion recorded in the first half of 2010, with a similar rise in the number of buy-to-let loans advanced (see Chart 2).

Chart 2



Source: Council of Mortgage Lenders (CML)

This recovery reflects the post-financial crisis landscape, where larger deposit requirements and tighter lending restrictions have held back the flow of traditional owner-occupied borrowers, supporting a further rise in the size of the PRS. At the same time, lower interest rates and rising house prices have supported strong investment returns. Coming on top of the excellent returns landlords enjoyed in the long upswing up to 2007, this has given buy-to-let something of a Teflon quality in the eyes of many investors.

But could landlords have had too much of a good thing? Perhaps it was inevitable that landlords' stellar returns and the gradual reshaping of housing tenure in favour of the PRS would provoke some kind of political reaction. But it still came as a shock to many in the sector that a Conservative government took action to curb returns via the tax system.

The policy environment darkens

It has been a matter of considerable debate just how 'tenure neutral' government policy has been in recent years. Commentators who believe that policy has been broadly neutral have tended to see the rise of the PRS as a phenomenon driven by market forces. Those who emphasize the role of policy cite the lack of investment in the social rented sector and the demise of mortgage interest tax relief for owner-occupiers.

But regardless of views on what has caused the expansion of the PRS, the sector's success has triggered heightened scrutiny from government. While most of this has been focused on attempts to raise minimum standards of accommodation, politicians of all stripes have not been shy to voice their preference to see owner occupation remain the majority tenure. For most politicians it would seem the PRS is still seen as a second class option.

July tax changes

In his post-election budget, George Osborne announced two significant changes that will increase the tax burden on buy-to-let: Firstly, the 10% wear and tear allowance available to landlords of furnished property will not be available from next year. Instead landlords will be able to offset the cost of new furnishings against income, but for many landlords this shift will entail a significant reduction in their tax deductions as the cost of furnishings for many consumes less than 10% of their rental income.

Second and more controversially, the tax deduction for mortgage interest will be restricted to the basic rate of income tax rather than the landlord's actual tax rate. Landlords who use a limited company to hold their properties will be unaffected but for higher rate landlords who own property in their own name, the impact could be significant. The tax change could even push some landlords that are currently basic rate taxpayers into the higher rate band, as the portion of the interest cost that is no longer tax deductible is added to the borrower's statutory taxable income.

Table 2 – Impact of restricting mortgage interest tax deduction to basic rate

Gross rental income	£12,500
Cost of replacing furnishings	£500
Maintenance and other costs	£2,500
Mortgage interest	£8,000
Total costs	£11,000
Profit	£1,500
Wear and tear allowance	£1,250
Taxable profit	£250
Tax @ 40% - current regime	£100
Value of mortgage deduction	£3,200
Value of deduction @ 20%	£1,600
Tax @ 40% - new regime	£2,000

Table 2 shows an example of how these two tax changes could affect a landlord in the 40% tax bracket. Currently the landlord described in Table 2 is lightly taxed, paying a tax bill of £100 at the 40% rate despite having positive buy-to-let cash flow of £1,500, thanks to the impact of the wear and tear allowance as this landlord spends only £500 a year on replacing furnishings but can deduct £1,250 for wear and tear. This saves the landlord £300 in tax.

More significant in this case is the elimination of higher rate relief on mortgage interest, which will be phased in over four years from 2017/18. Mortgage interest of

£8,000 currently reduces the tax bill of our landlord by £3,200. When restricted to the basic rate of 20%, this figure will half to £1,600. Adding the two tax changes, our landlord, with a pre-tax profit of £1,500, will see their tax bill rise from £100 to £2,000, pushing them into losses after tax and raising the effective tax rate on their buy-to-let to 133%.

Of course, each landlord will face their own calculation and those that do not borrow or rent out furnished property will experience no adverse impact. But as our example above illustrates, some landlords could see otherwise viable businesses become a drain on their cash flow.

Possible impact of the budget changes

The tax changes might be expected to lead to a reassessment of investment intentions, particularly on the part of some higher rate tax paying landlords. It may also affect the amount that lenders will lend higher rate landlords, as restricting the interest tax deduction impacts on the affordability of the loan.

Because corporate landlords will continue to receive full interest tax deduction, they will be in a stronger position relative to individual buy-to-let investors. Some landlords may shift to using limited companies to hold their buy-to-lets, although this creates other complications as profits cannot be released from the company without tax implications. However, even corporate landlords will be affected by the removal of the wear and tear allowance.

A higher tax burden for landlords will slightly skew the market in favour of owner-occupied house hunters as it should reduce the price that landlords are prepared to pay for any given property. But by discouraging investment in the PRS the changes will put more upward pressure on rents.

These impacts chime with the Chancellor's stated aims for the tax shift. He explained that they were aimed at 'levelling' the playing field in favour of owner-occupation. The government has made no secret of the importance it attaches to homeownership and hopes to reverse the fall in the rate of owner-occupation. The government has also favoured a more professional PRS, actively encouraging greater institutional investment.

In August 2012 the Montague review (*Review of the barriers to institutional investment in private rented homes*), was published. The government accepted a number of its recommendations, which were announced in its Housing Stimulus Package in September 2012. Subsidies have been provided through the Build-to-Rent scheme and the PRS housing guarantee. The tax changes could be seen as a further measure to shift PRS provision to large scale 'professional' landlords.

The threat of mortgage regulation

Bank of England Financial Policy Committee (FPC) powers

The FPC - the body responsible for spotting risks to the economy – already has the power to recommend that the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) impose limits on residential mortgage lending such as loan-to-income (LTI) or loan-to-value (LTV) ceilings. In September last year the FPC called for the power to direct the PRA and FCA to require banks to limit loan-to-value (LTV) ratios and the interest coverage ratios used by lenders to assess affordability on buy-to-let loans.

Under the heading 'Buy-to-let lending could pose a risk to financial stability', the Bank of England's Financial Stability Report published on 1 July discussed buy-to-let stating: 'HM Treasury will consult on tools for the FPC related to buy-to-let lending later in 2015, with a view to building an in-depth evidence base on how the operation of the UK buy-to-let housing market may carry risks to financial stability'.

Minutes from the September 23 meeting of the FPC stated that 'buy-to-let mortgage lending had the potential to amplify the housing and credit cycles', explaining that 'Any increase in buy-to-let activity in an upswing could add further pressure to house prices. This could prompt owner-occupier buyers to take on even larger loans'.

The minutes made clear that the FPC is not seeking to use any new powers it may be given at this stage, stating 'The FPC judged that there was, at present, no immediate case for action in the buy-to-let mortgage market'. This chimes with our view that the expansion of buy-to-let lending mirrors, and is a response to, the growth in tenant demand in the PRS, so it is unsurprising that it is outperforming other segments of the mortgage market. Landlords also generally have low levels of leverage. It is understandable that the FPC wishes to have these powers as a precaution, but it is hard to see anything in today's buy-to-let market that could sensibly be described as a threat to financial stability.

Implementation of the Mortgage Credit Directive (MCD)

The EU MCD includes an option for national governments to exempt buy-to-let lending from its detailed requirements and instead put in place an alternative framework for its regulation. The UK government has confirmed that it will use the option and put in place an alternative framework, and that this need not apply to landlords operating as a business. However, the government believes that so called 'accidental' landlords, who may have inherited a property, would need to be covered by the framework, which would require lenders and intermediaries conducting this business to be registered.

The government also confirmed earlier this year that it will be changing the legal distinction between a regulated and a buy-to-let loan to comply with the EU MCD. Under current UK legislation a regulated mortgage is one where at least 40% of the property will be occupied by the borrower or their relative. The MCD defines a buy-to-let mortgage as one which includes a requirement that the property cannot be occupied at any time by the borrower or a family member. This will result in a portion of UK buy-to-let lending becoming regulated.

Outlook for the buy-to-let sector

With strong population growth influenced by factors including net immigration, in the absence of a substantial upward shift in housing supply, it is difficult to see how the July tax change or the possibility of tighter regulation of the buy-to-let market can reverse the underlying trend towards a larger PRS.

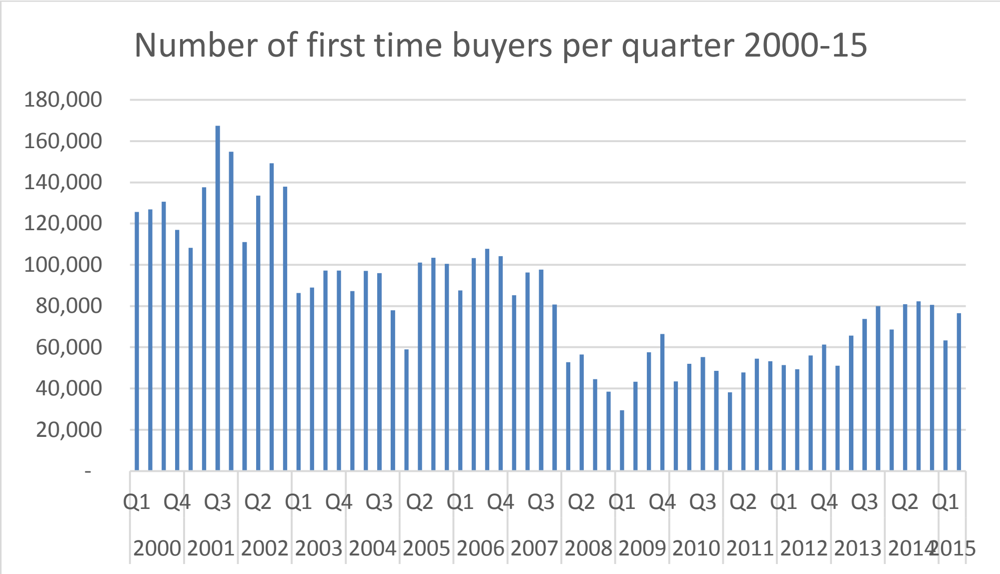
The risk is that July's tax changes and the threat of tighter mortgage regulation will constrain the new supply of rented property from buy-to-let investors at a time when the fundamentals are driving an increase in demand, and that institutional investment will fail to make up the gap. Although a small number of additional first time buyers may be able to access the market, in the PRS the result of a less supportive policy environment can only be higher rents, ironically hitting the tenants that politicians say they want to help.

Any increase in rents that the restriction on interest tax deductibility causes will provide a windfall for corporate and unleveraged landlords as well as lower earning buy-to-let investors. For those investors who are in or may be pushed into the higher income tax bracket, further leveraged investment may have to be undertaken in a corporate structure to be viable.

Section 2. First time buyers – the stars align

The hurdles facing those who want to take the first step into the property market have been well documented in recent years. Deteriorating affordability in the early years of the new century, driven by house price rises outstripping wage growth, was followed by a leap in the minimum deposit required by lenders in the wake of the financial crisis in 2008. This precipitated a collapse in first time buyer numbers from which the market is still recovering (see Chart 3).

Chart 3



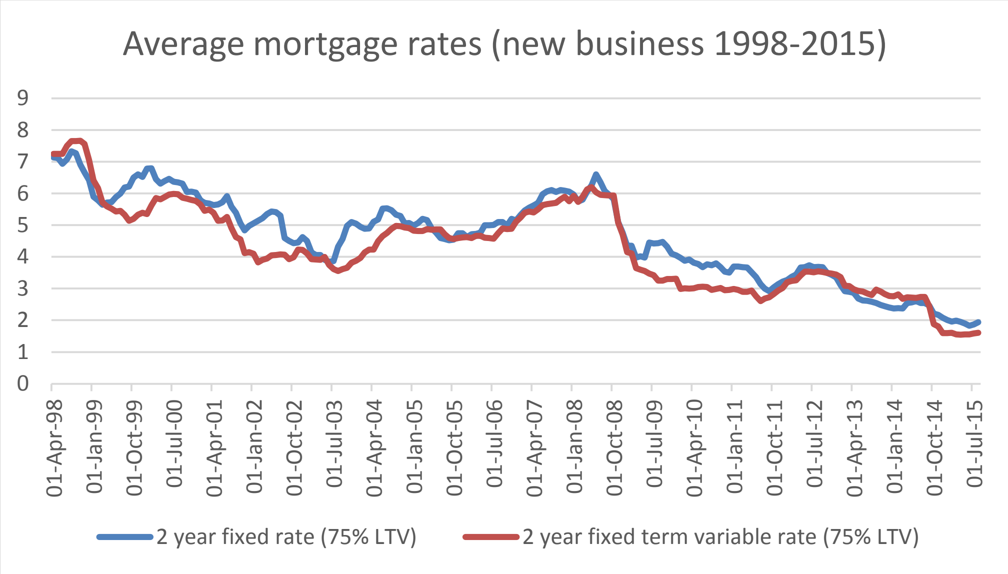
Source: CML

Deposit requirements have eased and house prices have come down relative to earnings across much of the country from their 2007 peak. This has helped first time buyer numbers to recover, although at 76,600 in the second quarter of 2015 they remain well below their 35 year quarterly average of 104,000. But commentators continue to emphasize the difficulties facing prospective first time buyers.

What has been less well documented is the range of factors that make this an excellent time to buy a first home. These factors include:

1. Record low mortgage rates

Chart 4



Source: Bank of England

For those in the market for a new loan, rates have never been lower (see Chart 4). Bank of England data show that at the end of August, the average 2 year discounted variable rate deal at 75% LTV was 1.61% and the average 2 year fixed rate mortgage at 75% LTV was 1.94%, just above the record low recorded in June. Although rates at higher LTVs are more, they too have come down sharply in recent months.

With the average first time buyer borrowing £125,500 in Q2 2015, the monthly cost of a 25 year capital repayment mortgage was £508 for an average 2 year fixed term variable rate loan. If interest rates had remained unchanged from their level of a year earlier the monthly payment would have been £578, a saving of £840 a year.

2. Reduced stamp duty

The shift from the old 'slab' system to a graduated rate of stamp duty in the 2014 Autumn Statement has had quite a dramatic effect on the stamp duty bill of many first time buyers. At the median first time buyer purchase price of £153,000 in Q2 2015, the old system would have delivered a stamp duty bill of £1,530 but under the new system the tax amounts to only £560, a saving of £970.

3. Help to Buy

The government's Help to Buy scheme, first introduced in 2013, was designed to help buyers with modest deposits. Under the Help to Buy equity loan scheme, government provides a loan of up to 20% of the value of the property to allow borrowers with as little as a 5% deposit to access mortgage finance at 75% LTV on a new build. This will run until 2020. Under the Help to Buy guarantee scheme, lenders are encouraged to make 95% LTV loans available by providing a government guarantee on the amount above 80% LTV. The government has announced that this scheme will end in 2016.

Up to 30 June 2015, the Help to Buy equity loan and mortgage guarantee schemes together supported over 90,000 first time buyer advances (80% of advances made under the scheme). Many of these buyers could not have bought without the assistance of these schemes.

In 2015, the government added the Help to Buy ISA savings scheme, which comes into effect in December, where prospective first time buyers can save up to £200 a month with the government providing a 25% top up. The maximum total top up is £3,000 for those that save £12,000.

4. Rising earnings and absence of inflation

Until 2014 average earnings were failing to keep pace with inflation, adding to the hurdles facing first time buyers. But since then the picture has been transformed with inflation, measured by the 12 month change in the consumer price index (CPI) falling to around zero since the start of 2015 and average earnings picking up to 2.9% on the latest figures. With the average first time buyer earning £37,400 in 2014, we calculate that buyers are on average £1,080 better off than a year ago.

5. Starter Homes initiative

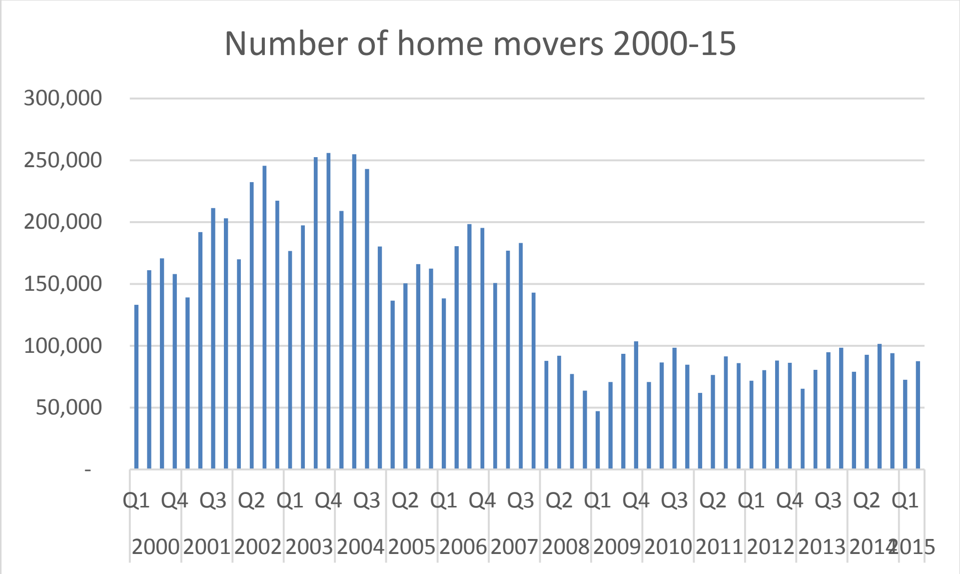
The latest government initiative to assist first time buyers will go further than any previous scheme in the support it provides, offering buyers under 40 years of age a 20% discount on their first home. Under the scheme, builders will offer new homes at 80% of market value where planning requirements such as section 106 agreements have been eased to reduce development costs. The government hopes to support 200,000 sales under the scheme by 2020.

Overall affordability

The positive factors above show that today's first time buyer is likely to be thousands of pounds better off than their counterpart just a year ago with further government support to come. Of course, rising house prices can offset the benefits of lower interest rates and higher real earnings. But the Council of Mortgage Lenders (CML) tracks interest payments as a percentage of income for first time buyers, which takes into account any increase in house prices, and in the second quarter of 2015 interest payments equaled 10.2% of first time buyer incomes, the lowest figure on record and less than half the 20.6% recorded in Q4 2007.

Section 3. Home movers – log-jammed

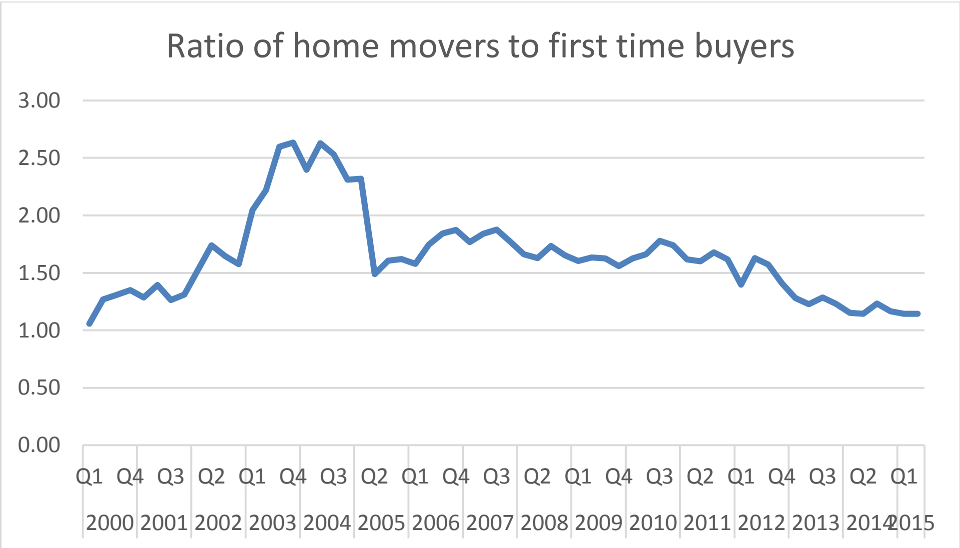
Chart 5



Source: CML

It is often said that first time buyers are vital to facilitate the house moves of existing homeowners and the collapse in first time buyer numbers in 2008 did seem to cause a ceasing up in the wider market. But the subsequent revival in first time buyer numbers has not had the traditional effect on transactions in the rest of the market (see Chart 5). After falling by 56% between 2006 and 2009, by 2014 the number of home mover transactions had only rebounded by 17% from the trough. This left the ratio of mortgaged home movers to first time buyers sliding downwards to 1.14 in Q2 2015, from 1.66 five years earlier (see Chart 6).

Chart 6



Source: CML

Despite a slight pickup in mortgaged home mover transactions in the second quarter, the latest evidence suggests that a sustained bounce is unlikely despite the positive effect of the general election result on buyer sentiment. The Royal Institution of Chartered Surveyors (RICS) reported in their September residential market survey that the stock of properties for sale per surveyor had fallen to 47, the lowest figure on record.

The shortage of properties coming onto the market is creating a logjam effect where buyers find it difficult to locate an appropriate property and people who are considering moving home decide not to place their property on the market when they are unable to find a suitable property to move to.

One of the main causes of the lack of supply in the secondhand market is the high rate of homeownership amongst the baby boomers born in the 1950s and 1960s. Studies have shown that home moves decline sharply as households move into their forties, remaining low amongst those in their fifties and sixties[1]. With a bulge in the population in this age group, a substantial portion of the housing market is locked away, much of it the most sought-after family homes.

High house prices exacerbate the problem, making each step on the housing ladder an increasingly expensive exercise. Lloyds Bank's Home Movers Review of August 2015 showed that the average extra price for a home move in the first six months of 2015 was £52,870 (25%) more than the typical home mover paid in 2010. In London the jump was even greater at £153,535 (45%). And the upper end of the market is being adversely affected by the 2014 stamp duty changes, with for example stamp duty payable on a £2 million property transaction jumping from £100,000 to £153,750.

The demographic trends that are driving down the number of home moves are long term, unlikely to be substantially reversed for the next two decades, until the baby boomers start to downsize in serious numbers. The implication for mortgage lenders is that home movers will be a stagnant market which may increase the pressure on them to target alternatives such as the remortgage or equity release market.

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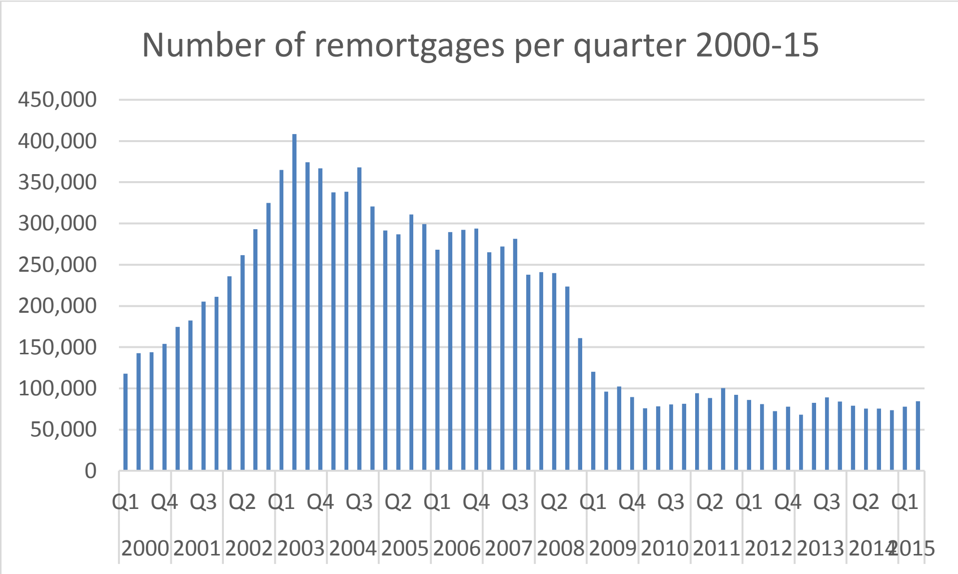
[1] See Housing Mobility and Downsizing at Older Ages in Britain and the USA, James Banks, Richard Blundell, Zoe Oldfield and James P. Smith http://www.ucl.ac.uk/~uctp39a/Manuscript.pdf

Section 4. Remortgaging – priced to go

Traditionally, borrowers have remortgaged for three main reasons - the 'three Rs' - rate reduction, rate capping and releasing equity. The 2008-9 slump reduced all three motives: lenders were no longer chasing new business so up-front rate discounting greatly reduced; stable low interest rates reduced the fear of rate hikes; and falling house prices reduced the amount of equity available to be extracted.

Chart 7



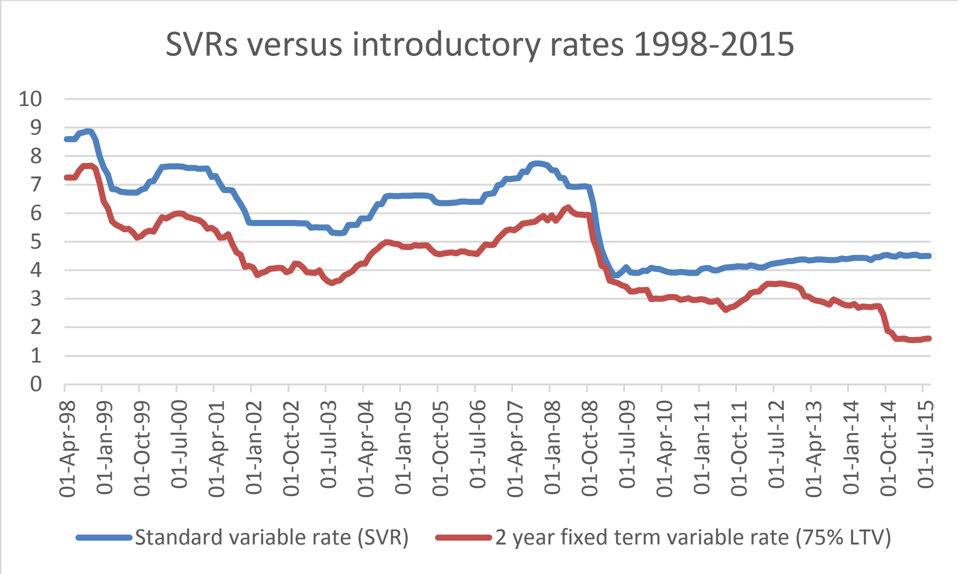
Source: CML

But it is something of a mystery why the remortgage market has subsequently failed to recover (as can be seen in Chart 7) even as lenders have regained an appetite to lend and other segments of the mortgage market have gradually come back to life. Indeed, each of the 'three R' motives to remortgage would appear to support higher activity:

Remortgaging to a lower rate deal

Perhaps the largest single spur to the remortgage market over the past two decades has been up-front interest rate discounting by lenders keen to win market share from their rivals. We can measure the scale of this discounting by comparing average SVRs with the average 2 year discounted variable rate, shown in Chart 8 respectively by the blue and red lines.

Chart 8



Source: Bank of England

Between the late 1990s and 2007 the differential between these two average rates was almost always in a band between 1% and 2%. In the wake of the financial crisis it dropped well below 1% as lenders all but stopped chasing new business, dipping below 0.25% in early 2009. The differential then recovered gradually but as late as 2012 it remained below 1%. It has since shown a remarkable recovery, reaching a record of nearly 3% this year.

If you think of this differential as a proxy for lenders' appetite to grow their mortgage business relative to consumer demand (as it is the discount to average SVRs that lenders are willing to offer to attract new borrowers), competition would now appear to be very healthy. Now is a great time to move from an SVR to a discounted variable rate.

Remortgaging to a fixed rate

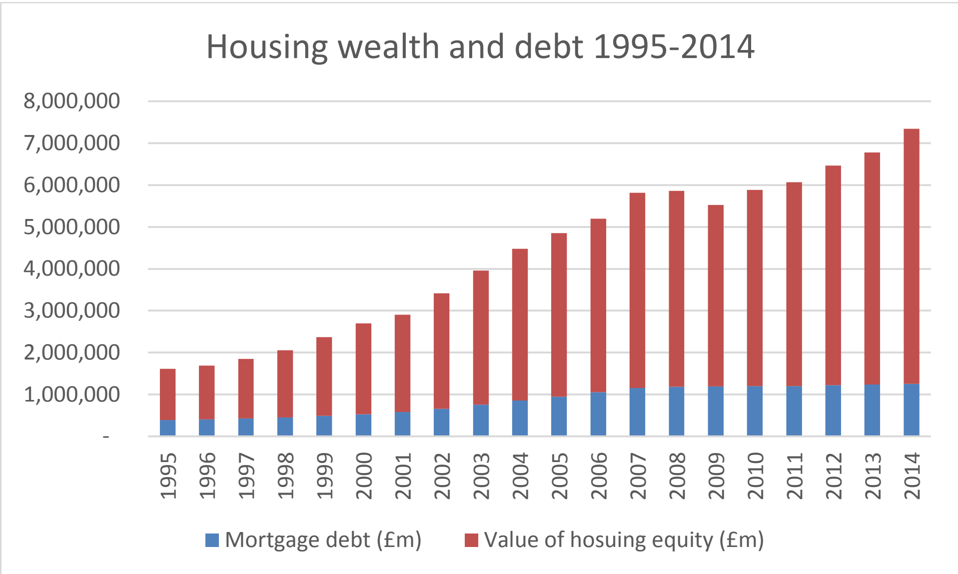
Since March 2009 Bank Rate has remained unchanged at 0.5%, the longest run without change in modern times. Unsurprisingly, this level of stability reduced fears of a rate rise. So one of the main traditional drivers of remortgaging – borrowers fixing rates to cap the risk of rate increases – was less of a factor for much of this period, although there have been increasingly competitive fixed rate deals available.

However by 2014, as the economy recovered and unemployment fell to a level seen by some economists as close to full employment (the point at which the labour market starts to exert upward pressure on inflation), talk of a rise in Bank Rate became louder. The Bank of England has gone further this year, signaling its intention to raise the Bank Rate in the near future barring unforeseen weakness in the economy. Such talk of rate rises would normally be expected to increase the number of borrowers looking to remortgage into fixed rate deals.

Releasing equity

The third main motive for remortgaging – releasing equity – is at its strongest during economic upswings when house price rises are coupled with high consumer confidence. The uncertainty invoked by the 2008-9 slump hit consumer confidence and reduced UK private housing equity from an estimated £3.5 trillion in 2007 to £3.1 trillion in 2009. But, as Chart 9 shows, since then rising house prices helped to lift total housing equity to an estimated record £4.8 trillion in 2014, more than a third above its 2007 peak, equivalent to £180,000 for each household in the country. Aggregate housing equity has increased further in 2015, passing the £5 trillion for the first time in the second quarter.

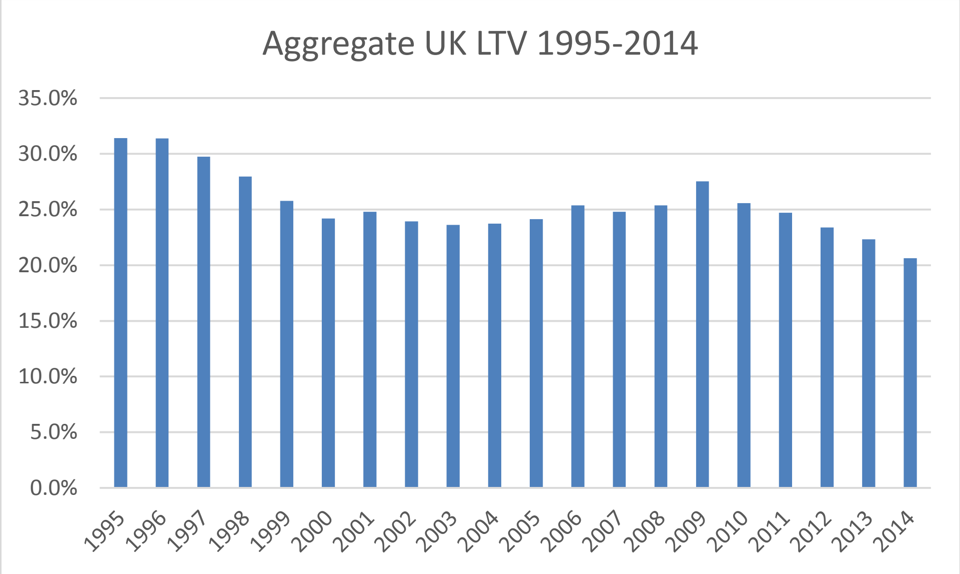
Chart 9



Source: ONS, Bank of England

The strength of UK homeowner's balance sheets is further underlined by Chart 10. This presents aggregate mortgage debt as a percentage of the total value of the UK housing stock – an aggregate LTV for the UK housing market. In 2014 this fell to an estimate 20.6% – the UK housing market had not seen a lower debt burden since 1983. We estimate that, by Q2 2015, there was a further fall in the aggregate LTV ratio to 20.0%.

Chart 10



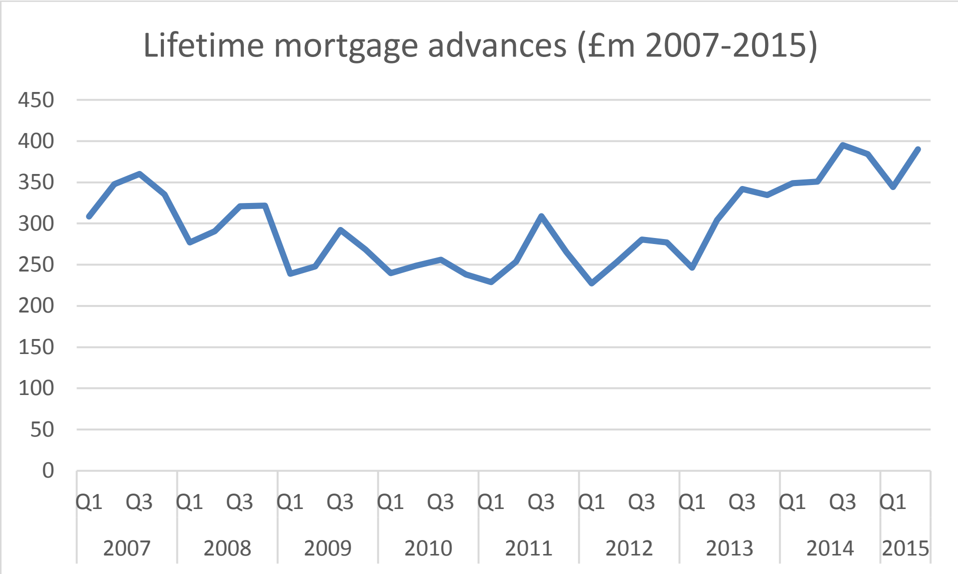
Source: ONS, Bank of England

The above analysis suggests that remortgage activity ought to have picked up more strongly than it has. Moreover, if homeowners continue to move less often than in the past, they are probably likely to remortgage more frequently to ensure they have the best available rate. Nor can we explain the lacklustre performance of the remortgage market by borrowers switching deal with their existing lender more frequently. Figures from the PRA show that the value of these so called internal remortgages was less than 10% of the value of external remortgages in 2014, half the proportion recorded in 2010. This points to the remortgage market as a potential source of growth over the coming years, but is it still unclear why the recovery to date has been so muted.

Section 5. Lifetime mortgages – coming of age

For many years, the equity release market and more particularly lifetime mortgages have been seen as significant potential growth areas of financial services. Conditions for the development of these markets have seemed right, with the UK facing a sustained increase in the population in retirement, low investment returns and greater uncertainty over pension income as defined contribution schemes replace defined benefit pensions. These factors have increased the potential size of the population needing to enhance their income and for most homeowners over 55 years of age, equity release will be one possible solution.

Chart 11



Source: PRA

Finally, since 2013 the lifetime mortgage market has started to experience solid growth. After an 18% rise in advances in 2013 to £1.2 billion, 2014 saw a further 21% increase to £1.5 billion. The above mentioned factors of more retirees and more uncertain retirement incomes have no doubt played a major role in this growth.

But a perceptional barrier remains which has meant that lifetime mortgages have never captured more than a tiny proportion of the theoretical potential market of retired homeowners. In England alone there are 6.3 million homeowners aged 55 and over without mortgages on their homes and Key Retirement calculates that homeowners aged over 65 who own their home outright now hold property wealth of £873.8 billion.

Despite the safeguards in place that ensure that the customer can remain in their home indefinitely, even if the lifetime mortgage balance exceeds its market value, many retirees have an aversion to encumbering their property and a concern that their children will not receive the inheritance they were expecting.

However a policy change that, on first impressions, has little to do with equity release may yet prove as significant as any factor as it could change perceptions about the relative value of equity release. This policy change was the 2014 budget announcement on pension freedom. Under the old rules, individuals with pension pots were required to use these funds to purchase an annuity (a guaranteed income for life) by age 75 at the latest or face a punitive tax charge for releasing funds from their pension.

From April 2015, individuals have been able to withdraw funds from their pension pot once they have reached 55 years of age, paying income tax on money withdrawn at their marginal tax rate. This provides much greater freedom for individuals to use their pensions to boost income. On the face of it, this might appear to reduce the need for equity release.

However, it also creates the risk that some retirees will misjudge their longer term financial needs, depleting their pension to the point where they face a serious squeeze in income in later years. For homeowners in this category equity release could be an alternative source to make up that lost income.

However, a more fundamental change comes with pension freedom. Now, pension pots are potentially part of the inheritable estate, available to be handed down to beneficiaries. As the new rules become better understood beneficiaries will come to see pension pots as part of an inheritable estate just as much as houses or savings accounts. In this new environment, annuities, with their instant expunging of pension capital may come to be seen as the greatest demolishers of inheritable wealth.

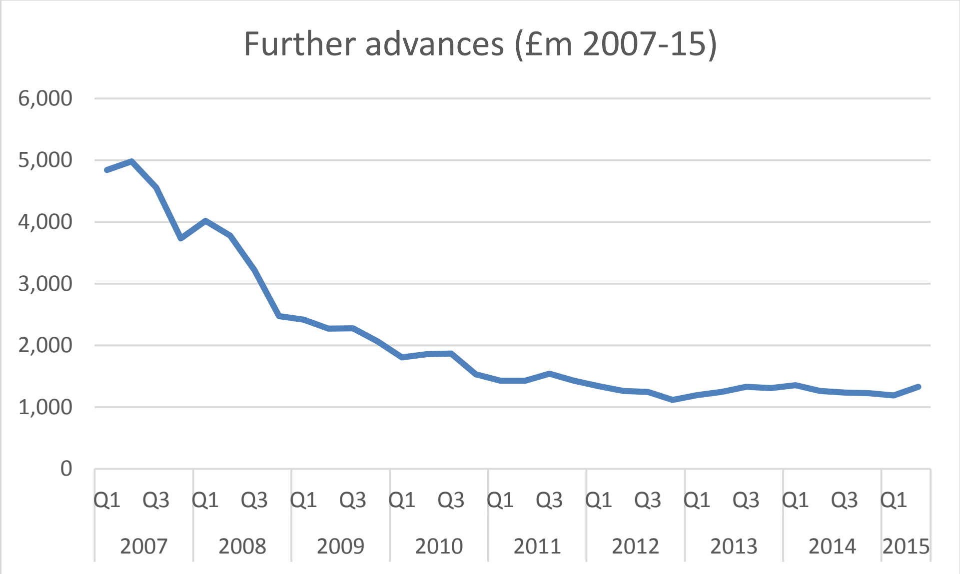
By comparison to an annuity, a lifetime mortgage offers valuable wealth preservation. Even when interest is compounded in lieu of regular repayments, the gradual (<6% a year at today’s average rates) erosion of capital that comes with a lifetime mortgage is likely to be preferred to the instance erasing of capital that comes from an annuity.

Current regulatory and trade body reviews of lending into retirement are expected to offer up views on the future shape of this market and open up ideas around product innovation. Without doubt this has finally become an important area of debate and development.

Section 6. Further advances – Flat lining

The worst performing mortgage segment in recent years has been further advances. Despite rising 12% on the previous quarter, Q2's figure of £1.3 billion was still less than half the quarterly average of 2008, when the financial crisis was raging (see Chart 12).

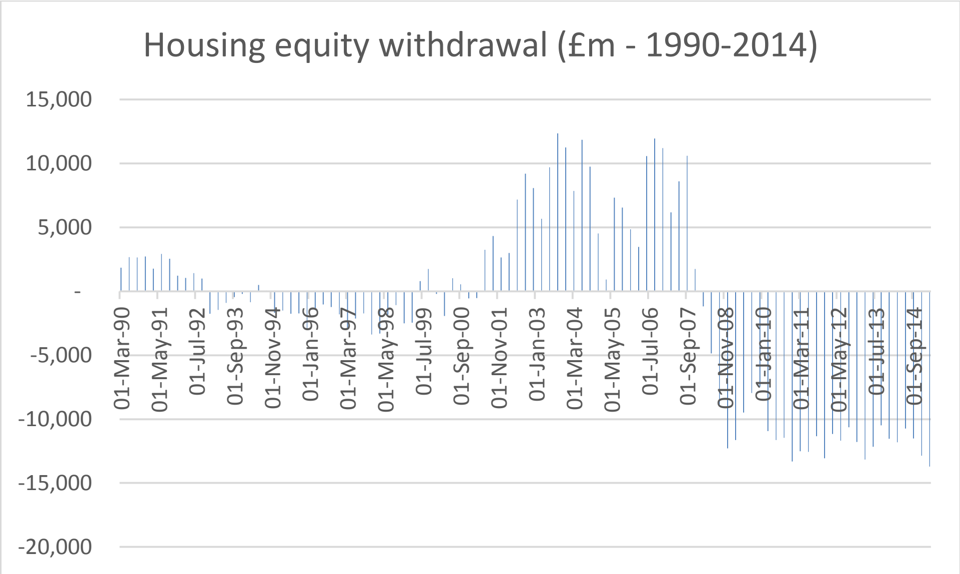
Chart 12



Source: PRA

The contraction of the market in further advances to a large extent reflects households' more cautious approach to borrowing to fund consumption since the 2008-9 slump. It therefore parallels the subdued performance of the remortgage market. Despite rising house prices, consumers still do not feel confident enough to start to release equity and use their homes as collateral for broader consumption as many did in the early part of the century.

Chart 13



Source: Bank of England. Data is not seasonally adjusted

A parallel can be seen in the Bank of England's figures for housing equity withdrawal (see Chart 13). Although these figures measure a much wider phenomenon – comparing total physical investment in residential property with the change in total outstanding mortgage debt – they do show the extent to which households in aggregate are choosing either to extract equity from their homes or plough equity in, through either physical investment in property or changes in their mortgage balance. Further advances traditionally have been one of simplest ways of extracting equity.

Chart 13 suggests we should think of the weakness of further advances in the context of a wider trend. Homeowners ploughed a record £13.7 billion of equity into their homes in Q1 2015, having injected over £10 billion each quarter since the start of 2010. This is a quite unprecedented rate of mortgage deleveraging, equal to more than 4% of households' post tax income, that the FPC should pay more attention to when assessing the threat posed by the mortgage market.

Section 7. Conclusion

Mortgage lenders are having to navigate quite difficult terrain. As well as facing a rising tide of regulation in recent years, they are having to respond to changes in the housing market that are unnerving politicians who are now firmly wedded to the belief that owner-occupation should remain the dominant tenure.

No institutions can claim a better record of supporting homeownership in the UK over the decades than mortgage lenders. But lenders must work within the environment as it stands. Until government effectively tackles the issue of new housing supply even the benign economic environment we currently enjoy will not deliver the outcomes that prospective first time buyers and politicians crave.

At least the recovery in mortgage lending appears to remain on track. Data over the past six months suggests that 2015 will see progress on last year's performance despite the sharp slowdown recorded in the latter part of 2014. Of course, record low interest rates ought to support healthy lending across the range of mortgage segments but the evidence from further advances and the remortgage market is that consumers remain deeply cautious about their finances. In aggregate, with housing equity injection running at over 4% of post-tax income since late 2008, households' caution is encouraging them to use their homes more like safe deposit boxes than the ATMs they were once caricatured as.

This report highlights the diverse nature of the market and the different drivers at work. It builds on previous IMLA research on the overall state of the market and underserved borrowers, details of which can be found on the IMLA website (http://www.imla.org.uk/Research/). IMLA will continue to offer up timely and accessible research on the UK's housing and mortgage markets over the coming years.

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About IMLA

IMLA is the specialist trade body representing the interests of mortgage lenders who market their products through brokers, rather than solely direct or through a branch network. Its directors and members are drawn from the senior ranks of mainstream banks, building societies, ‘challenger’ banks and specialist lenders.

IMLA provides a unique opportunity for senior industry professionals to meet on a regular basis to discuss key current initiatives and contribute actively through IMLA and other industry forums.

IMLA was formed in 1988 as the Association of Mortgage Lenders and was instrumental in the creation of the Council of Mortgage Lenders (CML). It changed its name to IMLA in 1995. Subsequently IMLA helped bring the Association of Mortgage Intermediaries (AMI) into being and was instrumental in bringing the mortgage advisers qualification CeMAP to fruition. For more information, please visit www.imla.org.uk

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.