Market Commentary

Residential Analysts

United Kingdom – September 2022

- **Truss Turned It Terrifying**
- **Price Falls & Negative Equity**
- **Long Lasting Impact**

Last month we wrote this is getting scary. Since last week's mini-budget, it has turned terrifying. There is still a great deal of uncertainty about the future and a housing market downturn is not guaranteed. However, the events of the last week have accelerated the market towards what was its worst case scenario and the opportunities to avoid it are reducing. Even a full reversal would leave a long lasting impact on the mortgage and housing markets.

Truss Turned It Terrifying

Rising energy costs and increasing interest rates were already threatening to hit the housing market in coming months while creating financial hardship for many. The events of the last week have accelerated that process and increased the probability of a worst case scenario – a severe housing market crash. Interest rates have rocketed past previous expectations and, while the situation is highly volatile, mortgage rates are hitting levels last seen during the 2007-09 downturn. The rapid rise in mortgage rates will almost certainly reduce market activity and, in combination with the worsening outlook for the economy and the cost of living crisis, could trigger a price crash.

Higher rates will lead to higher repayments for those taking out new mortgages. Figure 1 shows the trend in average actual new mortgage repayments as a percentage of borrowers' income. As shown previously, small increases in mortgage rates will have a much bigger impact than in previous periods because of higher loan-to-income ratios. E.g. an increase in mortgage rates to 6% would take repayment affordability above the level immediately prior to the 2007 downturn and just below the peak level in 1990.

Mortgage rates at these levels will limit the size of mortgage new borrowers can access, constraining their buying power. Using the same data as Figure 1: to maintain current repayment affordability, mortgage rates at 5% would lead to a 28% fall in the average loan-to-income ratio. Meanwhile mortgage rates at 6% would require a 35% fall. A shift to wealthier and higher income buyers may help slightly offset the impact of this but transactions are still going to be hit hard.

Fig 1: Mortgage Repayments as % of Income*
*Source: Calculated using BoE, ONS – *gross household income*

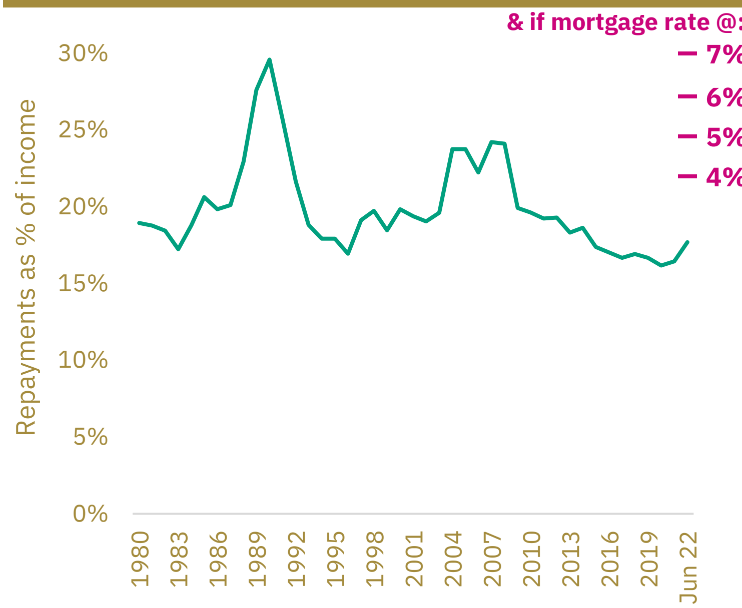
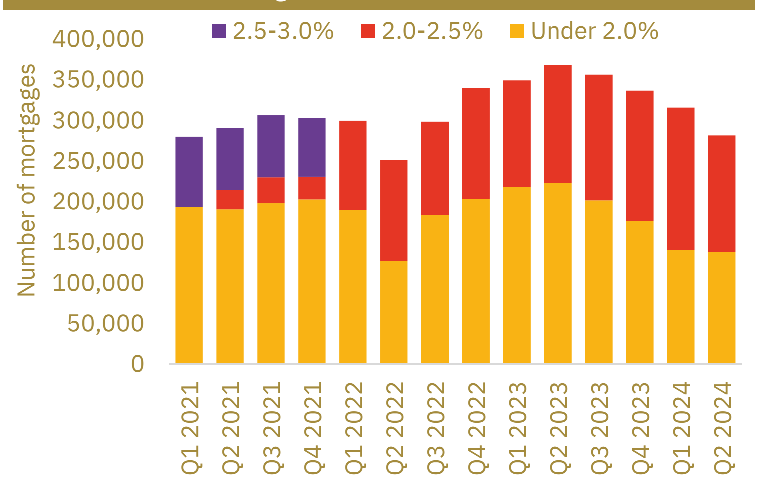


Fig 2: No. of Fixed Rates Ending by Initial Rate
Source: Calculated using BoE data



The situation for existing borrowers is no less severe despite the large number of fixed rate mortgages. Most fixed rate mortgages are for only two or five years (e.g. Fig 1 here) and there is a constant churn reaching the end of their fixed rate period. There's a lack of public data on their number and so we have projected Bank of England data on new lending to provide an estimate (Figure 2). It suggests around 300,000 fixed terms end per quarter but will peak at 370,000 in Q2 next year – two years after the spike in stamp duty holiday transactions – and with a total of 1.4 million in 2023. However, this is probably an underestimate as it does not include rate switches etc and UK Finance put the figure at 1.8 million. Many of these will be coming off rates at under 2.5% to much higher repayments.

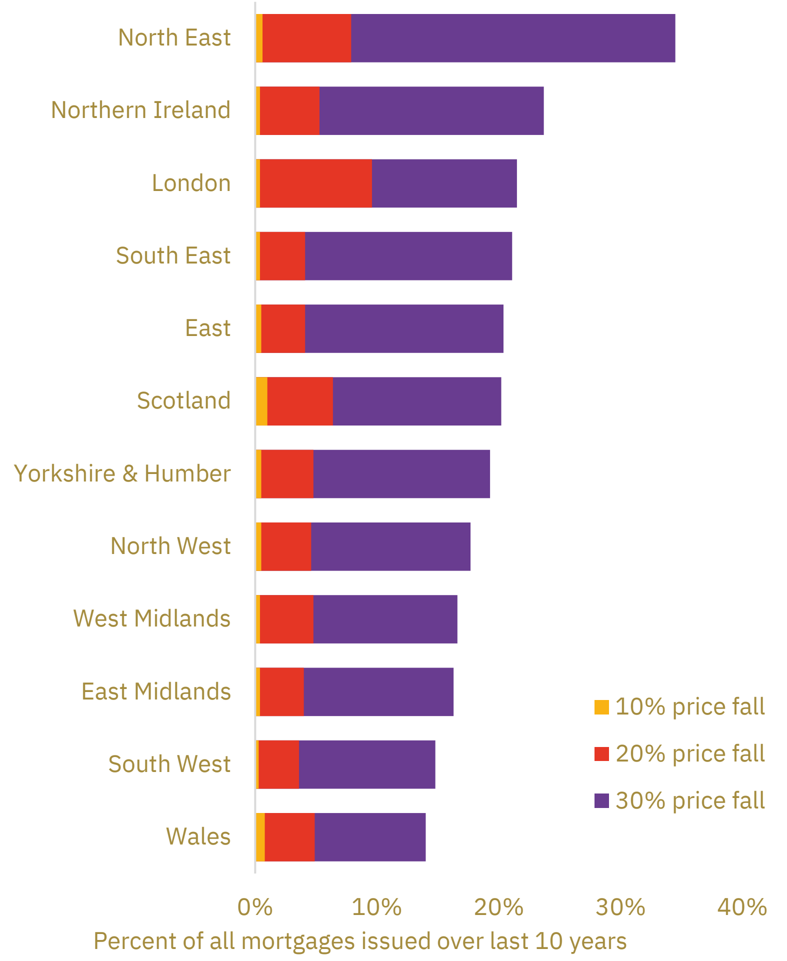
Price Falls & Negative Equity

The risk of a double-digit fall in house prices rose sharply this week. Many homeowners own their home outright (54% in England) and the number of owner-occupier mortgages is stuck down at levels last seen in 1989. But house prices are determined just by those properties that actually transact. We have already highlighted the role that forced sellers play in triggering large price crashes. With the rapid rise in mortgage rates, worsening outlook for the economy, cost of living crisis, and, potentially, large cuts in public spending, the possible drivers of forced sales are all present. Combined with the sharp shifts in the underlying fundamentals of house price affordability along with likely falls in transactions and we could easily see price falls of the scales seen in previous downturns.

To understand the potential impact of a price crash we have created a simple model using house prices and the distribution in loan-to-value ratios to estimate the number of mortgages falling into negative equity. The results are shown in Figure 3 and expressed as a percentage of total new mortgage lending over the last ten years. It is worth noting that these figures are likely an over-estimate as they do not account for capital repayments or mortgages ending (paid off, sold etc) over the period. They do however offer an insight into the potential regional pattern of negative equity under three different price scenarios:

Fig 3: % of Mortgages Falling into Negative Equity

Source: Calculated using ONS & FCA data



With most house price indices recently reporting annual rises of around 10%, a 10% fall in prices would lead to relatively few cases of negative equity. This is also helped by the limited lending above 90% loan-to-value.

A 20% fall in house prices would take house prices back to their levels around the beginning of the pandemic across most regions and an estimated 5% of mortgages would be in negative equity. The biggest exception is London where house price rises have been much more subdued and a 20% fall would take them back to 2015 levels. Nearly 10% of mortgages in London would be affected. This is also a region where rises in mortgage rates would have a bigger impact negative effect on repayment affordability given higher loan-to-income multiples.

The impact of a 30% fall in house prices would be much broader based and more severe. It would take house prices back to 2016 levels in most regions (except London and the North East) and hit a larger number of borrowers further down the loan-to-value distribution. While negative equity is only of direct importance to those needing to sell or remortgage, at this scale it would have negative consequences for the wider economy given housing's role in households' wealth, consumer sentiment, and (while perhaps less than previous periods) as a source of financing for smaller businesses. Price anchoring by owners – irrespective of whether they have a mortgage or not – would also be a drag on housing market activity in the years following a crash.

Long Lasting Impact

The worst case scenario of a large housing market downturn has become much more likely over the last week. However, it is still not guaranteed. Unfortunately, even a full reversal to the economic and political conditions of early last week would leave a long lasting impact on the mortgage and housing markets. For example, there was some debate about the removal of the three percentage point stress test by the Bank of England over the summer – some forecasters even increased their house price forecast on the back of it. However, anecdotal evidence suggests lenders have continued to stress test at three percentage points under the FCA's MCOB rules and the events of the last week suggest that even this may not have been high enough. The memory of this week will also live long in the Bank of England's future banking stress tests.

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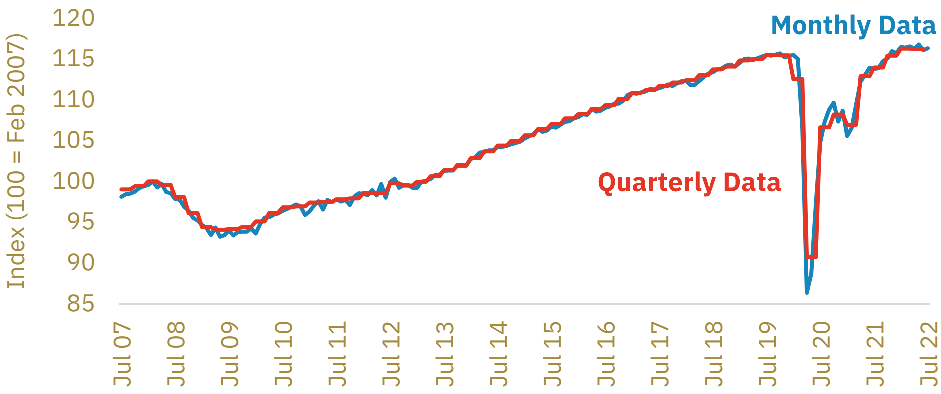
Market At A Glance

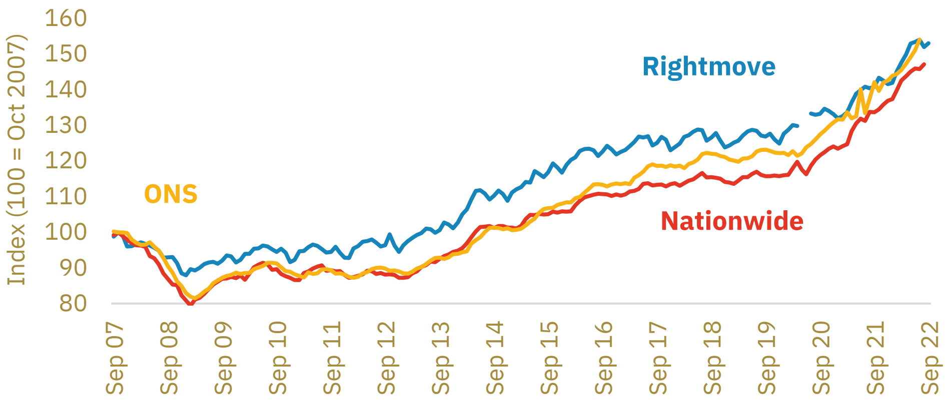
Economy - UK

The ONS monthly estimates reported GDP was 2.3% higher in July 2022 than the same month in 2021. This left monthly GDP just 0.7% higher than the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



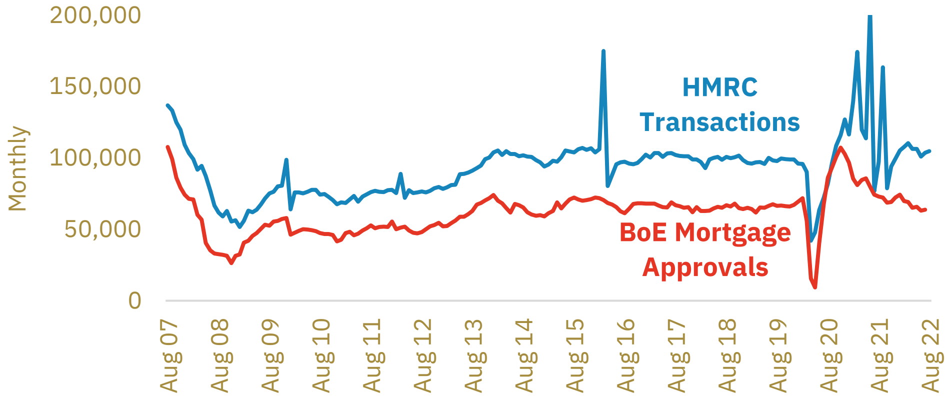
House Prices - UK

Rightmove reported a 8.7% annual rise in asking house prices in September 2022 while Nationwide reported a 10.0% annual rise in their mortgage approval based index in the year to August 2022. Meanwhile, the ONS reported 15.5% annual growth in its sales agreed index for the year to July 2022.



Transactions – UK

HMRC provisionally reported 105,000 residential transactions in August. This was 7.3% higher than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were 5.8% lower in July 2022 than the same month in 2019.



New Supply - England

The latest net additions data for 2020/21 reported a 216,490 net new homes in England with 194,000 new build completions. The latest quarterly house-building data suggests there were 214,000 completions in 2020/21 while there were 243,200 new build Energy Performance Certificates in the year to Q2 2022 – a leading indicator for net housing supply.