UK FINANCE

TRENDS IN THE ECONOMY AND LENDING

What can we expect from 2022?

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UK Finance collects and aggregates a wide range of data sets relating to consumer and business finance to inform the industry about the latest trends and developments across the sector. In this latest Trends in the Economy And Lending (TEAL) report we take a look at independent forecasts of macroeconomic developments and how they impact on our own forward view of **lending in the mortgage market**, published in December 2021.

UK Finance produces annual forecasts of housing and mortgage market activity over a two-year time horizon, published each December. Whilst we do not explicitly produce forecasts for the wider macroeconomic environment, these factors obviously impact on demand and supply for housing and housing finance. Therefore, a review of the independent forecasts of these macroeconomic variables is important to provide context for how the housing outlook is shaped.

Since the publication of our most recent forecasts, the escalating spread of the Omicron variant of Covid-19, and the associated public health measures, have the potential to impact on both the economy and, to a lesser extent, the housing market outlook. However, at the time of writing, we do not see this as materially impacting on our forecast numbers, and our forward view remains unchanged.

A REVIEW OF INDEPENDENT MACROECONOMIC FORECASTS

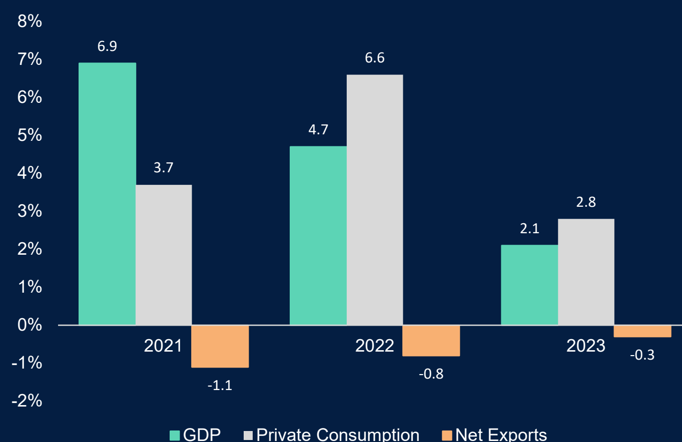
GDP

The UK economy has recovered beyond pre-pandemic levels in the opening of 2022, with forecasters predicting GDP to grow 4.7 per cent over the year. However, as mentioned in **this month's Economic Insight**, the emergence of the Omicron Covid-19 variant could hinder the UK's further recovery. Daily Covid-19 cases have remained above 100,000 since Christmas, leaving many self-isolating and others voluntarily socially distancing, placing a dampener on consumer activity within the services sector. Despite this, private consumption is forecast to drive GDP growth in 2022, as shown in Chart 1 below. This is largely due to base effects arising from the reopening of the economy in the second half of 2021 distorting consumer expenditure; these base effects will, however, dissipate as we progress through the year.

The decumulation of excess savings built up during the pandemic is also expected to contribute to UK growth, however this will vary across households. Lower-income households are less likely to show increased spending on non-essential items throughout 2022, as both National Insurance contributions and the energy price cap are set to increase in April. The National Living Wage rises from £8.91 to £9.50 in the same month, though the National Institute of Economic and Social Research (NIESR) predict this will not be enough to offset the squeeze on lower-income households from rising prices and the end of the temporary £20 Universal Credit uplift.

Net exports will continue to prove a thorn in the UK's side as imports from non-EU countries increase, driven by a rise in the importing of fuel. As supply chain bottlenecks are expected to ease throughout 2022, so is the UK trade deficit, with a gradual closing of the import/export gap over the coming years. Supply chain disruptions will likely prove the greatest challenge to UK trade in 2022, although increased checks between UK and EU exports, as well as changes to administrative procedures for the movement of goods between Northern Ireland and the rest of Great Britain, are also potential downward pressures.

Chart 1 : Forecast changes in UK GDP, Private Consumption and Net Exports



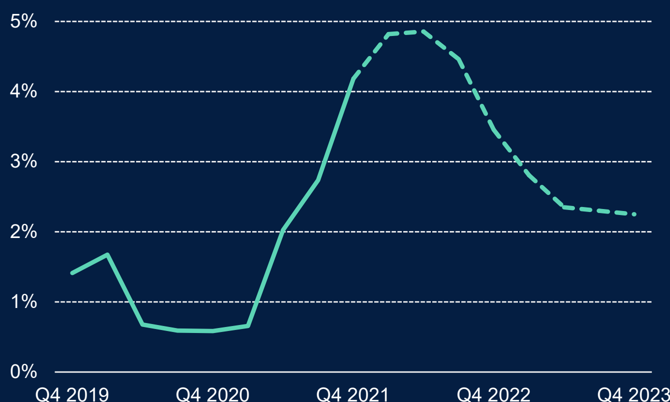
Source: OECD

INFLATION

Consensus forecasts collated by HM Treasury indicate CPI will grow in the UK by 3.1 per cent in 2022. Inflation is set to accelerate further in the early months of this year and the Bank of England predicts a peak of around 6 per cent in April, with significant contributions from rising energy prices, continued supply chain disruptions and lingering base effects. Although price growth will drop off sharply in the latter half of this year it is expected to remain above target levels until at least 2023 (Chart 2).

In December, the Bank of England increased the Bank Rate by 15 basis points to 0.25 per cent in response to signals of a strong labour market and persistent price increases. Forecasters have a range of opinions with regards to further increases in Bank Rate in 2022, however most think it will rise at least once more this year to help anchor inflation expectations.

Chart 2: CPI Inflation Forecast



Source: OECD

LABOUR MARKET

The latest ONS data shows that the labour market continued to recover in 2021, with an estimated decrease of 0.4 percentage points in the unemployment rate to 4.1 per cent in the three months to November. Despite the end of the Coronavirus Job Retention Scheme in September, unemployment was estimated to be only 0.1 percentage points above pre-pandemic levels. In 2022, dampened economic activity due to Omicron may cause delays to recovery, however, the signs are that this will be short-lived. The average forecast is for a modest uptick in unemployment to 4.3 per cent by the end of this year.

Official earnings growth statistics have been skewed over the past couple of years by the composition of furloughed employees. However, underlying earnings growth hovered at around 4 per cent in 2021. There are signs of some upward pressure on wage growth, notably the significant increase in vacancies across all sectors of the economy and challenges facing businesses seeking to recruit. This is pushing up salaries in some occupations and for new hires. However, surveys are not pointing to a significant increase in salary budgets in 2022, which will mean that earnings growth lags inflation, squeezing real incomes this year.

HOUSING AND MORTGAGE MARKETS

A RETURN TO STABILITY IN PURCHASE MARKETS

Against a backdrop of an improving economic outlook as set out above, and a housing market, which has proven remarkably resilient to the challenges presented by Covid-19 for the previous two years, our forecast view for this year and next is, essentially, for a return to pre-Covid-19 stability.

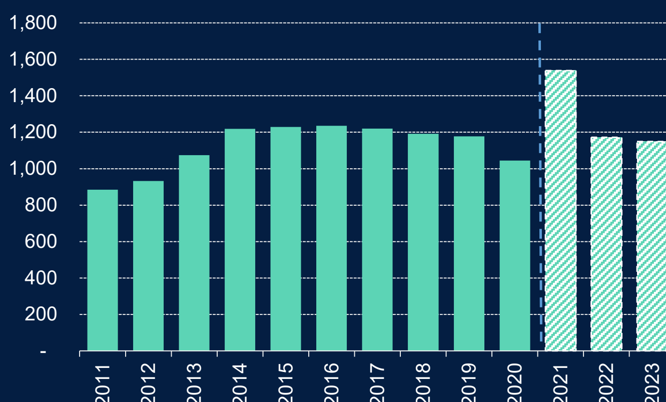
As we noted in our **Housing Finance Review**, 2021 is set to be a post-Global Financial Crisis (GFC) peak for residential property purchase transactions. However, we need to control for a number of factors that have governed the path of the housing market over the past two years before we can incorporate recent behaviour into any forward view.

Firstly, there is the distorting effect of the stamp duty holiday. This had the effect of bringing forward many transactions which would normally have occurred at some later date, and potentially also encouraged some to buy when this may not have previously been in their short-term plans. With the stamp duty exemption now over, volumes this year and next will be dampened to the extent that some activity was brought forward from these years.

However, the other major stimulus to house purchase demand over the Covid-19 era has been the change in working patterns towards increased homeworking, which we have highlighted in previous **Household Finance Reviews**. This has stimulated activity across the board for relocation to geographies further away from major city centres.

With these flexible working patterns now increasingly embedded in long term employment policies, this is likely to remain a factor boosting demand for house purchase mortgages, particularly amongst homemovers and buy-to-let (BTL) landlords. Although the extent and duration of this phenomenon as a demand stimulus remains to be seen, we anticipate it will provide a modest boost to transaction numbers through 2022, partially offsetting the post-stamp duty holiday drop-off in activity (Chart 3).

Chart 3: Residential property transactions (000s), UK



Source: HM Revenue and Customs, UK Finance forecasts

RISING COST OF LIVING TO BEAR DOWN ON MORTGAGE DEMAND

Another factor likely to impact on demand for mortgages next year is the rapidly escalating cost of living. In November 2021 inflation spiked above 5 per cent for the first time since 2011 and is set to remain high through 2022, compared with recent years. With energy costs in particular contributing strongly to increased household expenditure (although rises have been seen across most sectors of spending) the squeeze is likely to be felt particularly strongly amongst lower-income households, who spend more of their income on household bills.

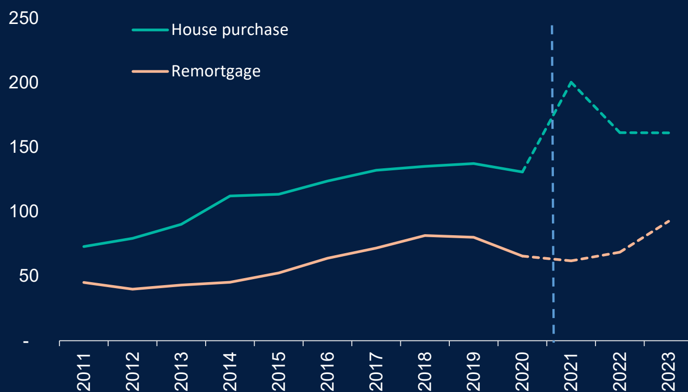
As household outgoings are part of the income-expenditure affordability test applied to most new mortgages, this will bear down on effective demand for mortgages, particularly at the lower-income end. This dampening effect is likely to particularly impact on first-time buyer numbers, given their relatively younger age profile (and are therefore, on average, commensurately earlier in their career and income progression than existing homeowners).

As set out above, Bank rate is expected to rise modestly through 2022 and 2023 in response to above-target inflation. Whilst the initial rise (from 0.1 percent to 0.25 per cent) in December 2021 will not impact materially, the cumulative effect of further rate rises over the next two years will incrementally bear down on affordability and thereby effective demand.

GROWTH IN REMORTGAGE SUPPORTING STRONG GROSS LENDING

Whilst house purchase activity is set to drop back (compared with the elevated volumes seen in 2022) to a picture of broad stability in line with pre-Covid-19 levels, gross mortgage lending overall will be supported by increased levels of remortgaging. Tranches of fixed rate lending, including five-year fixed rate loans taken out in 2017 when preferences started to shift materially towards longer-term fixes, are due to expire in 2022, and this number of maturing fixed rates increases further in 2023. Borrowers with these maturing deals will, in the main, look to refinance at the end of their current deal and this will be reflected in increased remortgage volumes over our forecast horizon (Chart 4).

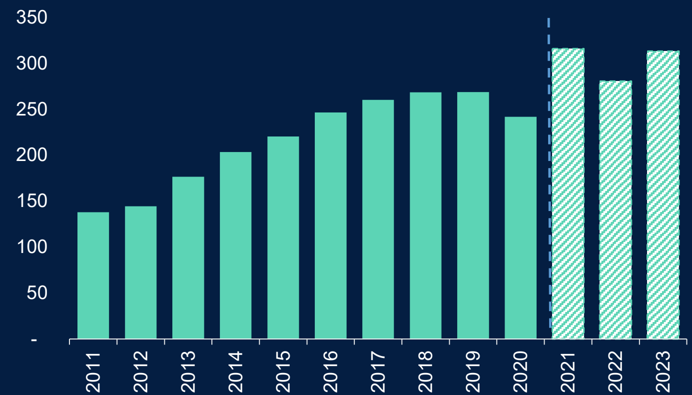
Chart 4: Residential mortgage lending, £ bn, UK



Source: UK Finance

These stronger remortgage numbers, together with higher house prices partially offsetting the drop in purchase activity, will support gross lending overall. Whilst we expect gross lending to fall back to £281 bn in 2022, down from an expected £316 outturn for 2021, this would represent a 4 per cent increase on lending in 2019. In 2023, lending is then expected to rise to £313 bn, supported in particular by the rise in remortgage business, with purchase lending forecast to be broadly flat compared with 2022 (chart 5).

Charts 5: Gross mortgage lending, £ bn, UK



Source: Bank of England, UK Finance forecasts

A caveat to our forecasts for remortgaging, and its contribution to gross lending overall, is that not all refinancing activity is reported in gross lending. Specifically, simple pound-for-pound remortgages (with no extra money taken out) are generally only included in gross lending figures if the borrower moves to a different lender. Simple internal switches onto a different product and/or interest rate - commonly called product transfers (PTs) - do not form part of gross lending, although UK Finance collects data on this sector separately.

PTs can be transacted quickly compared to an external remortgage and are commonly conducted via remote channels, including online. Because of this, they have seen an increase in popularity through the Covid-19 era. Should this fall back to pre-Covid-19 patterns going forwards, we may see a shift back towards more external remortgaging. Whilst this would result in higher overall gross lending figures, there would be a compensating decrease in volumes for PT business, with no change in the overall numbers of refinancing transactions.

ARREARS TO INCREASE MODESTLY AS COST OF LIVING BITES

Since the onset of the pandemic in early 2020 Payment Deferral (PDs) schemes and additional government support for incomes - most significantly via the Coronavirus Job Retention Scheme – (CJRS) - have kept arrears increases to a minimum, and numbers remain close to historic lows. With the CJRS ending on 30 September 2021, any delayed longer-term labour market impacts are only now starting to emerge. However, as set out above these are now expected to be less significant than previously anticipated, and unemployment is expected to see only modest further increases. This will, therefore, place less upwards pressure on arrears than indicated in previous forecasts.

However, the same factors placing upwards pressure on initial affordability, namely inflation and interest rates, will have a similar effect on mortgage arrears, as household budgets are squeezed. With respect to interest rates, a strong mitigating factor is that some three quarters of current mortgage holders are on fixed rate deals and will therefore see no immediate increase in their mortgage payments, either from the 15 basis point rise in December or from further increases over the forecast horizon, through the term of their current fixed rate deal.

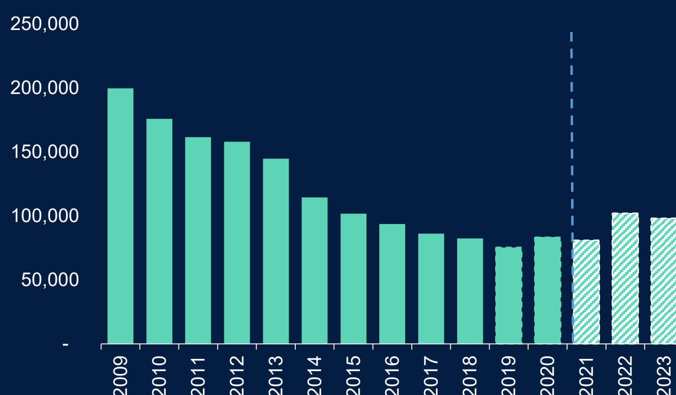
As we have observed previously, the minority of borrowers currently on variable rates will see an average rise of between £10 and £15 per month in additional mortgage payments from the December Bank Rate increase. We do not expect that, in isolation, this will result in any material uptick in arrears, as most borrowers will be able to absorb this additional cost relatively easily. However, the cumulative effect of this and any subsequent rate increases will place upwards pressure on arrears numbers amongst borrowers on variable rates. This, together with cost-of-living pressures and any post-CJRS increases in unemployment affecting all borrower segments, will see arrears increase beyond their current low levels.

Although all increases in arrears are unwelcome, they can never be entirely prevented, particularly in the face of rising unemployment and higher household outgoings. However, the changes in the mortgage market since the previous downturn ensure that borrowers can afford their mortgage after their wider suite of household outgoings have been accounted for, and that they have a buffer to ensure this remains the case in the face of increases in their payments.

This puts borrowers in a stronger position as inflationary pressures take their toll through 2022 and will help mitigate increases in payment problems.

Overall, we expect arrears numbers to peak at a little over 100,000 cases by the end of 2022. Although this represents a material increase compared to the most recent picture (80,000 cases at the end of Q3 2021), this would be fewer than half the number of cases at the peak of the previous arrears cycle in Q2 2009, when arrears topped out at 216,000 mortgages (see Chart 6).

Chart 6: 1st charge mortgages in arrears of over 2.5 per cent of loan balance



Source: UK Finance

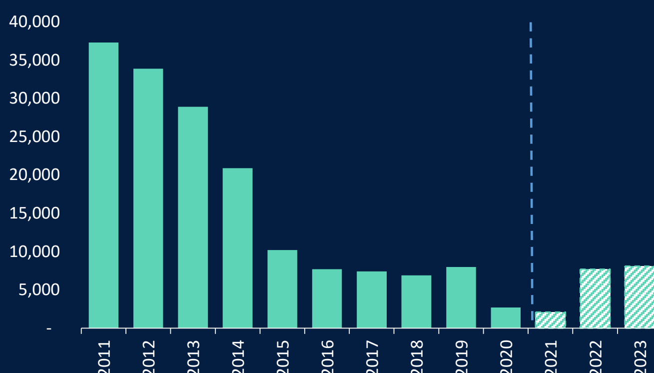
INCREASED POSSESSIONS IN 2022 RELATING TO HISTORIC ARREARS CASES

The moratorium on enforced possessions, which was effectively in place for a full year from the end of March 2021, has kept possessions numbers to a minimum through the pandemic. 2021 saw just 2,700 possessions, the majority of which were in the first quarter before the pandemic took hold. At the end of 2021 we estimated there was a backlog of around 5,000-6,000 possession cases which were already in train before the moratorium was announced, and now needed to be resolved in the best interests of the customer.

In 2022, even with the moratorium ending in Q1, only around 2,100 possessions took place, and so the backlog is still far from being cleared. Lenders will continue to work through this caseload with sensitivity but, with court capacity remaining limited, this process is likely to last through this year and beyond.

Overall, we expect to see 7,700 possessions in 2022, the vast majority of which relate to mortgages which were already in heavy arrears before the pandemic took hold and would normally have already proceeded to possession through the past two years. We do not expect to see any material numbers of possessions relating to Covid-19 or associated issues until 2023 at the earliest (Chart 7).

Chart 7: 1st charge mortgage possessions



Source: UK Finance

CONCLUSION

Overall, looking at the trends and charts, our forecasts for the housing and mortgage markets over the next two years could be summarised as "a return to normal" following the extraordinary events and interventions in the market since early 2021, but clearly both the country and the housing market are not yet close to a normal state of operations. However, we do see a return to a stable growth path for new lending following the distortions of the past two years, and a relatively modest increase in payment issues arising from the macroeconomic headwinds set out above. As always, lenders stand ready to help and any customer experiencing payment difficulties should speak to their lender at the earliest opportunity.

Inevitably, risks remain which have the potential to derail the market from its predicted course. There are considerable uncertainties, including from further variants of the Covid-19 virus or other external economic shocks. There is therefore significant potential for deviation from forecasts in either direction. However, should the wider economy and health outlook proceed in line with current expectations, we can look forward to a welcome period of stability in the mortgage market.