UK FINANCE

TRENDS IN THE ECONOMY AND LENDING

Prospects for mortgage customers refinancing in a price-pressured environment

June 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 closer look at how mortgage customers are placed as we navigate a period of high inflation and rising interest rates – two pressures new to an entire generation of borrowers.

KEY FINDINGS

- Three quarters of mortgage customers, including almost all recent borrowers, are on fixed rates and so will see no increase in payments in response to Bank Rate increases through 2022.
- 1.3 million customers are set to reach the end of their fixed rate deals this year and, unless they remortgage, will move on to their lender's Standard Variable Rate (SVR). On average, we estimate the combined impact of cost-of-living and remortgage onto a new deal would result in around a seven per cent decrease in their free disposable income.
- Nine per cent of the 1.3 million borrowers will see their disposable income after cost-of-living increases and refinancing constrained to less than ten per cent. Although these borrowers' remortgaging options on the open market may be more limited, the widespread availability of internal Product Transfer deals mean almost all will be able to access a new mortgage deal at competitive rates.

2022 - A NEW AND CHALLENGING CLIMATE FOR HOUSEHOLD FINANCES

As we reach the midpoint of the year it has become clear that – at least on the domestic front – 2022 has seen the escalating cost of living replace Covid-19 as the biggest threat to households' wellbeing. This has not crept up on us without warning; many commentators (including UK Finance) signalled the inflationary headwinds on the horizon last year, feeding into our **forecast** of a moderation in mortgage demand as household budgets come under increased pressure.

Despite these approaching pressures, the year began fairly strongly for household spending and borrowing, as we set out in our **Q1 Household Finance Review**. However, the bulk of the cost-of-living pressures were not seen until April, when both the rise in National Insurance Contributions and energy price rises came into effect.

Meanwhile, overall CPI inflation hit 9.1 per cent in May, driven by the persistent supply chain issues that began with Covid-19, and the global economic fallout of the ongoing crisis in Ukraine. The Bank of England now predicts inflation will peak this year at over ten per cent. Responding to escalating CPI, the Bank has raised rates four times in the first six months of 2022.

While this is not unprecedented – RPI was over 12 per cent in 1981, and almost 25 per cent in 1974 – two generations of current mortgage customers were not yet born at the time and have had no experience of a UK in which inflation was a cause for widespread national or personal concern.

A key difference – and an additional pressure for households – is that wage growth, while certainly more robust than in recent years, is not expected to keep up with price growth in the way that it did in those two previous periods of high inflation. While this avoids an economy-wide wage-price spiral, it also means that households are set to see a significant contraction in real incomes.

PREVIOUS ANALYSIS SUGGESTS MOST RECENT BORROWERS WILL COPE WITH RISING COSTS

In our **Q1 Household Finance Review** we looked at the potential impacts of these cost-of-living pressures on the affordability position of recent borrowers. We found that, on average, the combined impact of inflation, income and tax changes would knock around three per cent off of the "wiggle room" that borrowers would have.

This suggests the majority of these recent borrowers would still qualify for the same mortgage this year. However, there would likely be some at the margins, and particularly among lower-income brackets, who would no longer pass the same affordability test as they did last year.

Most of these recent borrowers, seeing this three per cent average decrease in their wiggle room, are therefore likely to be able to absorb these increased costs and still afford their mortgage, helped by the fact that virtually all new mortgages are currently fixed rate deals, and over half of these are fixed for five years or more. This means that those recent borrowers will not see increases in their mortgage payments as other costs rise through this year.

As well as almost all new borrowers, 75 per cent of all outstanding homeowner mortgages are currently on fixed rates. However, some 1.3 million of these customers are set to reach the end of their fixed rate deals this year and most would roll onto their lenders' Standard Variable Rate (SVR) unless they take a new deal rate, either with their existing lender or remortgage on the open market. For these customers, the revised affordability equation varies, depending on their individual circumstances.

OVERALL AFFORDABILITY IMPACT VARIES DEPENDING ON WHEN CUSTOMERS BORROW

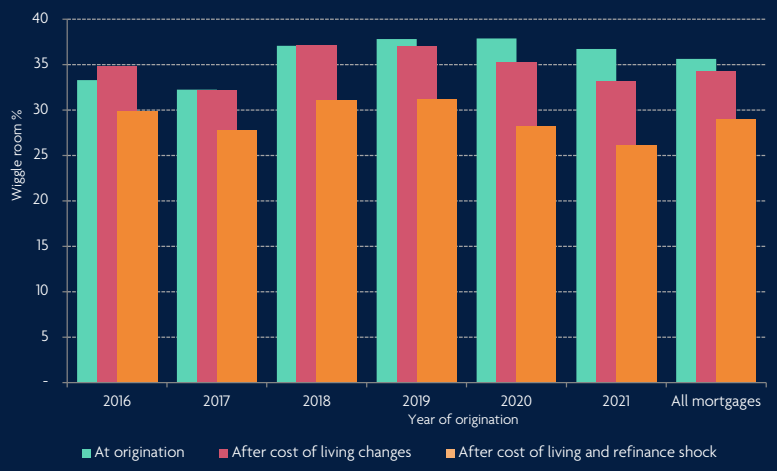
Updating our previous analysis, we have looked at our loan-level data on these 1.3 million maturing fixed-rate deals to simulate the potential impact of any refinancing rate increase, combined with the cost-of-living pressures we looked at previously for more recent borrowers (updated to reflect revised inflation forecasts).

The modelling framework, set out in more detail in Annex A, uses our loan-level data to look at these combined impacts on individual borrowers. Although the analysis necessarily uses some aggregate-level assumptions as to changes in borrowers' circumstances since the time of origination, it draws out some important differences in their current affordability situations.

MOST BORROWERS REFINANCING LIKELY TO SEE DETERIORATION IN AFFORDABILITY

Chart 1 below shows the wiggle room affordability position of borrowers on fixed rates set to mature this year at origination, alongside their position after cost-of-living pressures are factored in, and finally after also including the effects of refinancing onto the best deal available to each borrower.

Chart 1: Wiggle room, borrowers with maturing fixed rate mortgages, 2022, by year of origination



Notes:
1: Wiggle room defined as the proportion of net income left after subtracting initial mortgage payments, basic household expenditure and credit commitments.
2: See Annex A for details of the modelling framework and assumptions used.

Overall, borrowers would typically see a relatively modest decrease (1.3 per cent) in their wiggle room from combined cost-of-living and income changes, but a greater 5.3 per cent reduction from refinancing. However, both of these impacts vary significantly, depending on when the previous mortgage was taken out.

Source: UK Finance

Of particular interest are the 2017 and 2020 vintages of originations, which correspond to five and two-year fixed rate deals maturing this year respectively. Collectively these two vintages account for around two-thirds of those fixed rates maturing in 2022.

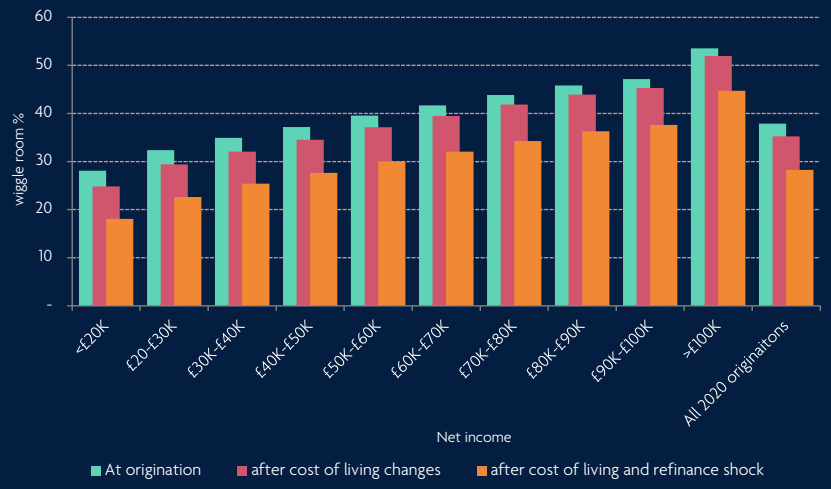
For 2017 originations, the typical cost-of-living impact is in broadly neutral, with income growth over the period since borrowing cancelling out cumulative price growth in the same period. However, there would still be a decrease from refinancing costs of around 4.3. per cent, leaving the average borrower with around 28 per cent of their net income in wiggle room.

For 2020 originations, the decreases in wiggle room are greater, with a 2.6 per cent fall due to cost-of-living effects and seven per cent from refinancing. However, borrowers in 2020 had, on average, significantly greater wiggle room at origination compared with the 2017 vintage, meaning that their typical position after refinancing in 2022 is broadly the same at 28 per cent.

Although the typical borrower would still have over a quarter of their disposable income left over, our earlier analysis shows that these effects are not evenly distributed and some, including those in lower-income brackets, would see a proportionately greater decrease.

Chart 2 below shows the new affordability position for the 2020 vintage of fixed rate borrowing, for borrowers at different income levels. As with our earlier analysis, we can see that those at the lower end of the income scale are the most impacted, seeing a ten per cent overall reduction in their wiggle room to around 18 per cent on average.

Chart 2: Wiggle room, borrowers with maturing fixed rate mortgages, 2022, by borrower net income, 2020 originations



Source: UK Finance

Of course, an average shows only the central point within a range; there will be some borrowers who have more wiggle room left over after refinancing but, equally, some will have less. Our modelling suggests around nine per cent of all borrowers with maturing fixed rate deals this year would be left with less than ten per cent wiggle room after refinancing, and a further 20 per cent would have between ten and 20 per cent wiggle room.

At these levels, the new affordability calculation may mean that refinancing options in the wider market are more constrained. However, with internal Product Transfers (PTs) proactively offered by the vast majority of active lenders, almost all customers will still be able to access a new deal, either internally or on the open market, as long as they are currently up to date with payments. While this will not always be the best deal on the market, the market remains strongly competitive and pricing and demand reflect this, with almost nine out of every ten customers currently choosing an internal PT when they look for a new deal.

CONCLUSION

For the 1.3 million borrowers on fixed rate deals set to end this year, the combined pressures from cost-of-living and refinancing would result in a typical reduction in free income of around seven per cent. While this is relatively a significant hit to household finances, a thriving remortgage market, as well as the widespread availability of competitively-priced internal Product Transfer deals for those unable to refinance on the open market, mean that the industry will continue to offer good value deals to customers who come to the end of their existing fixed rates.

Additionally, with the longer-term view of inflation and interest rates easing after this current period of squeeze reflected in the money markets, lenders are able to offer longer-term fixed rate deals at similar or even lower rates than shorter-term products. According to Moneyfacts, at the time of writing the average ten-year fixed rate for a customer with a 75 per cent loan to value was 3.64 per cent, compared to 3.78 for a two-year fix and 3.85 for a five-year fix. So, customers looking to fix what is usually their largest monthly outgoing for longer, through this period of rising wider cost pressures, are able to do so at negligible additional cost, or may even be able to save money by doing so.

2022 is, as expected, proving to be a challenging year for households as they look to adjust their balance sheets to higher prices, rising interest rates and falling real disposable incomes. While mortgage customers are not immune from these pressures, the industry will continue to offer competitively-priced finance to help their customers best cope. Further, the responsible lending rules in place since 2014 ensure that, with a built-in buffer against such shocks at origination, the vast majority of customers are able to refinance affordably this year, whether internally or on the open market.

As the cost-of-living squeeze continues, with further pressures expected in the second half of the year, the overall burden is likely to put pressure on some households' payments, both in the mortgage space and for their other credit commitments. Although our analysis suggests most will be able to cope, we do expect some upwards pressure on mortgage arrears as these pressures tighten, and this is likely to be concentrated amongst lower-income households.

As always, we encourage any customers concerned about their ability to maintain payments to contact their lender at the earliest opportunity. The industry stands ready to help with a range of forbearance tools that can be tailored to best suit customers' individual circumstances.

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ANNEX A: A MODELLING FRAMEWORK, ASSUMPTIONS AND LIMITATIONS

The modelling framework for this analysis uses a "wiggle room" metric to assess ongoing affordability of mortgage customers. This is defined as the proportion of borrowers' net income that is left over after subtracting mortgage payments, normal household expenditure and other credit commitments. In broad terms this approximates the income-affordability test undertaken by mortgage lenders as part of the FCA's responsible lending rules, but excluding any interest rate stress test (as this analysis looks only at current affordability).

These data are all reported in our Regulated Mortgage Survey) (RMS) data set but only at the point of origination. In order to model cost of living impacts we then adjust borrower income and expenditure for inflation and tax changes since origination, and the customers' current LTV given loan repayments and house price inflation since origination.

In the updated analysis shown in this report, we use the Bank of England's latest inflation forecast, now expected to peak at ten per cent this year, whereas the previous published analysis used the eight per cent forecast published at the time of modelling.

To calculate the extent of any refinancing "payment shock" we assess the rates available to these customers when they come off their fixed rate deal and look to refinance this year. We take data from Moneyfacts on current rates on offer, and assume borrowers choose a 5 year fix, which is the most popular mortgage product currently. Best rate available is assessed given the customer's current LTV. The borrower's payments are then further adjusted to account for a typical arrangement fee, amortised over the five year deal period.

This then gives an estimate of the overall impact on mortgage customers' finances after inflation net income and payment changes as they come to the end of their existing deal rate this year.

ASSUMPTIONS AND LIMITATIONS

1. To estimate changes to mortgage customers' income and expenditure since origination, it is necessary to apply national-level data to each individual customers data, as these are reported only at the point of sale. This means that, for older originations, a greater degree of estimation is necessary. Whilst the framework remains valid for these aggregate analysis purposes, it should be noted that results are illustrative only and individual incomes and expenditure changes will vary from the national aggregate data.
2. We assume all borrowers refinance on the open market. Where customers instead choose an internal product transfer (PT), they would not generally pay an arrangement fee, however given PT rates will necessarily not typically be the best on the market we assume, for simplicity, that this higher rate cancels out the savings from the application fee.