ZURICH | Topical Thoughts
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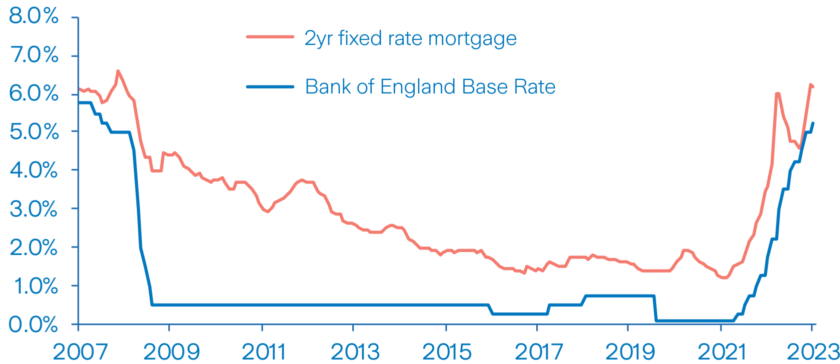
Is a UK housing crisis in the offing?

UK mortgage rates have dramatically increased over the past two years and are now back at levels seen 15 years ago. Furthermore, gilt yields are currently trading around levels that accompanied the pension fund crisis in the fall of 2022. With house prices falling at the sharpest pace in almost two years, this raises the question whether the UK mortgage and housing markets are vulnerable to a crisis.

Mortgage rates have surged in the UK



Source: Bloomberg

A surge in interest rates is impacting UK real estate market

The Bank of England raised its Bank Rate by another 25bps in early August, delivering its fourteenth consecutive rate hike since December 2021. The mortgage market was one of the first financial sectors to be impacted by the monetary policy tightening and mortgage rates have consequently surged. Mortgage rates that were around only 1% just two years ago are now above 6%. At the same time, the Bank of England kept its forward guidance unchanged, warning that further tightening may be required if inflationary pressures persist. For the borrowers who need to roll over a fixed-rate mortgage at the end of its term or who have mortgages based on variable rates, higher market rates will cause a material increase in their monthly instalments. This sharp increase in mortgage costs comes at a time when households' personal finances are already stretched by the higher cost of living from inflation and energy prices that have led to a decline in real incomes. Consequently, market participants are questioning the sustainability of these higher payments for UK households and the potential impact it may have on the real estate sector and the mortgage market.

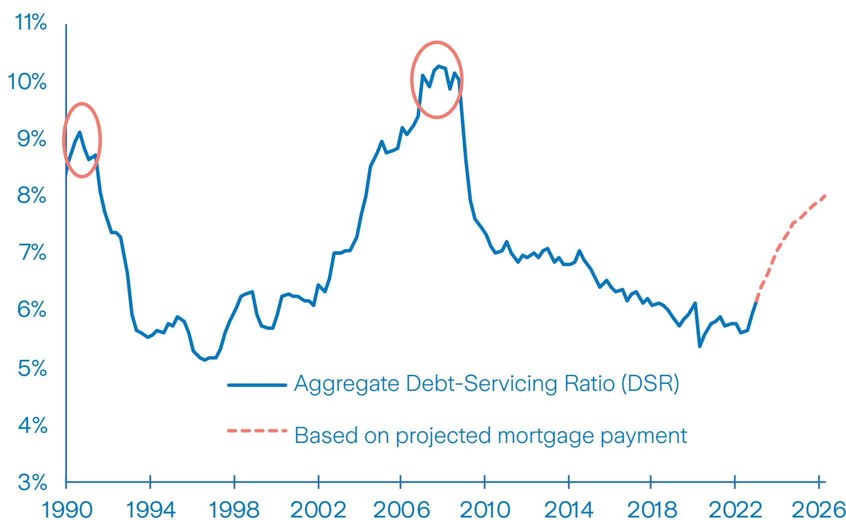
The first signs of weakness have already started to emerge in the real estate sector with house prices falling at the sharpest pace in almost two years. Both Halifax and Nationwide Building Society reported declining prices during recent months, confirming a reversal of the positive trend that has prevailed since 2012 that saw an almost continuous appreciation in house prices. Worryingly, mortgage repossession claims also increased materially during the second quarter of 2022 but seem to have since tentatively stabilised. We expect delinquencies and defaults to deteriorate in the coming quarters with higher unemployment a key driver. Unemployment in the UK picked up from 3.57% last September to 4.3% in July and would be a key risk for delinquencies were the trend to continue.

Credit conditions are clearly tightening for consumers as seen in bank lending surveys. It is not just the cost of credit that has moved up but the supply of credit has shrunk. In addition to higher interest rates, the choice of mortgage products is being reduced as some banks decided to pull their mortgage offers, restrict loans to new customers or tighten eligibility criteria. Smaller or specialist lenders, who usually rely on financial markets to fund their loan origination, were among those to withdraw products as they needed to reassess the impact of soaring interest rates. UK real estate agents have already reported a plunge in inquiries from potential new home buyers and the number of mortgage approvals has dropped significantly. The value of new mortgage commitments (lending agreed to be advanced in the coming months) during the first quarter of 2023 was 16.1% less than the previous quarter and 40.7% less than a year earlier, at GBP 48.9bn. This was the lowest level since the second quarter of 2020.

The billion pound question is whether higher mortgage rates are a ticking time bomb for residential mortgage and housing markets?

Compared to other European markets where borrowers can opt for long fixed-rate periods, UK mortgages tend to be linked to variable rates or have only a limited fixed-rate period (usually between two and five years). At the end of this period, borrowers will be switched to the lender's standard variable rate (SVR) or may opt for a new fixed rate period based on the current lender's conditions. Mortgage products also comprise of tracker mortgages, which are tied to the Bank of England's base rate. This makes the UK mortgage market more sensitive to market rate volatility as mortgage payments can be adjusted by banks on a monthly basis.

Is another housing crisis on the cards in the UK?



Source: Bank of England – Financial Stability Report July 2023

Note: Projected mortgage payments are based on market expectations for Bank Rate using swap curve as of end of June 2023

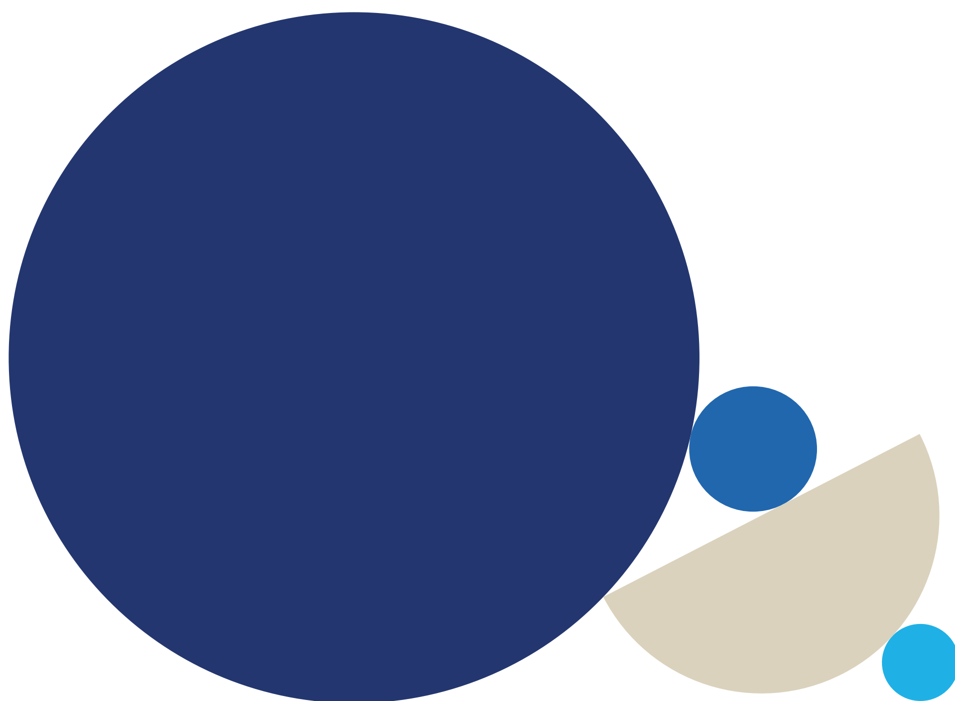
The first shoe to drop is likely to be non-conforming borrowers and the buy-to-let market

We think that first-time homebuyers are likely to be worst affected by higher mortgage costs, more conservative underwriting standards, a reduced range of products and lower competition between lenders. While existing homeowners and prime borrowers will probably have fewer opportunities when refinancing their debt than in the past, a good financial track record and credit history should help them access competitive offers. Furthermore, so far it seems that margins on loans have not widened meaningfully as seen from the chart on historical mortgage rates. The bulk of the increase in mortgage rates has hence come from the rise in underlying central bank rates and yields. The risk of course is if the margins were to rise in response to a deterioration in delinquencies, this could worsen the outlook.

We believe that delinquencies and defaults will likely be concentrated in two niche segments: non-conforming borrowers and the buy-to-let market.

The non-conforming borrower segment consists of borrowers who do not satisfy the standard lending criteria of mainstream lenders, like large banks or building societies. It may be due to irregular sources of income or self-employed status. Some non-conforming borrowers may also have an impaired credit history, including previous personal bankruptcy or County Court Judgments if they have missed payments to creditors or suppliers in the past. Because these borrowers are perceived as a bigger risk by the lenders, their mortgage loans tend to have higher interest rates, higher charges and stricter conditions attached to them. All these features imply a higher debt service-to-income ratio and make these borrowers more sensitive to interest rate increases. Another headwind for non-conforming borrowers comes from the fact that lenders targeting this niche usually rely predominantly on financial markets to fund their balance sheets and are forced to pass on any rate increases to their customers.

The buy-to-let (BTL) market is the other sector showing particular signs of vulnerability. The private rented sector is an important part of the UK housing market, accounting for around 19% of households. Landlords tend to carry high leverage on their investment portfolio and rely mostly on their rental income to service their debt. Incentives for BTL mortgage borrowers to remain current on their debt are different from those of owner-occupied mortgage borrowers. We think that mortgage cost increases will have a more severe impact on landlords than homeowners and push delinquencies and forced sales higher. However most BTL investors are professional landlords who usually have a portfolio of properties. This can give them some flexibility to offset higher costs linked to a specific investment, but nevertheless they will remain exposed to a widespread increase in interest costs across properties. Meanwhile, the ability of the landlord to pass part or all of the mortgage increase on to their tenants through rent changes can help to mitigate a surge in the interest-to-income ratio. The Office for National Statistics reported that private rents paid by tenants in the UK increased by 5.3% in the 12 months preceding July 2023, representing the largest annual percentage change since this UK data series began in January 2016.

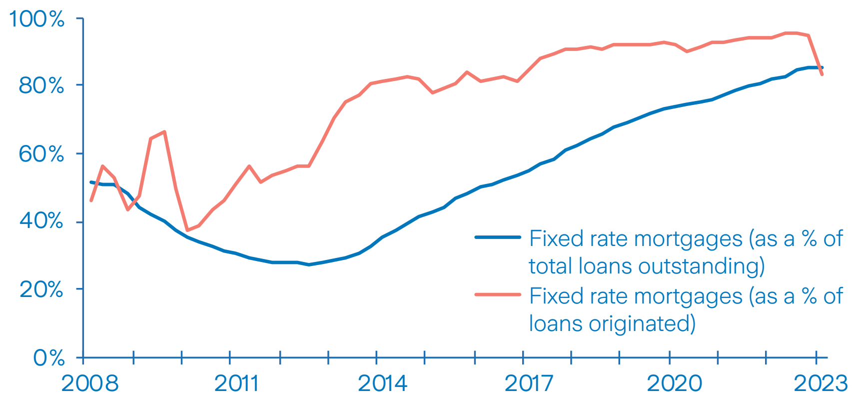


Despite the risks, a 1990s or 2008 type crisis is unlikely

Despite elevated risks, especially if unemployment picks up notably, our base case expectation is that a 1990s or 2008 type of crisis is unlikely provided interest rates eventually decline in line with our expectations. The characteristics of the UK mortgage market have evolved considerably since the global financial crisis. That is due to significant changes in prudential rules and the lender's code of conduct leading to more disciplined and stricter lending criteria but also to the low rate environment we experienced since 2009.

Ten years ago, less than 30% of outstanding mortgages were fixed-rate. This has changed, however, thanks to the low interest rates of the past decade which incentivised more borrowers to opt for a fixed-rate mortgage. The latest data from the BoE show that only 15% of the current mortgage balance was linked to variable rates as of end of the first quarter of 2023. More importantly, origination has been dominated by fixed-rate mortgages, with more than 90% of new mortgages originated during the past four years having an initial fixed-rate period of two to five years. That is the reason why few borrowers will be impacted by increasing interest rates in the very short term. However, unlike in the US or Europe where mortgage terms are considerably longer, the shorter terms typical found in the UK imply that time is limited for borrowers to strengthen their finances and start to partially deleverage their debt. Although short-term stress has been avoided so far, borrowers coming close to the end of their fixed-rate terms will face a steep reset in borrowing costs. It is therefore important that rates decline notably in 2024, and the recent repricing of the rate curve to higher levels is a worrying development.

UK mortgage market moved from variable rate to fixed-rate format



Source: Bank of England

The substantial house price appreciation has boosted the equity of most borrowers. In cases of financial stress, this embedded value should lead to voluntary sales, lowering the risk of additional losses due to repossessions and forced sales. There is also a strong incentive for the borrowers to remain solvent and avoid any negative impact to their credit score and history. Given the extra savings accumulated during the pandemic and the recent wage inflation, we expect most borrowers, especially those with high incomes, to be able to cope with higher mortgage costs.

The proportion of interest-only loans has also shrunk materially, from more than 43% of the outstanding loan balance in 2010 to less than 23% in 2023. This means that most of the borrowers are deleveraging over time and have been able to increase their equity in their home on top of the positive developments coming from the recent upward trend in property prices. With their loan-to-value ratio (LTV) now lower, existing borrowers should have more flexibility to restructure their debt or move some parts of their loan to interest only status if they need to compensate for the rise in their monthly instalment.

Furthermore, based on historical cycles, higher delinquencies, defaults and repossessions are strongly correlated with unemployment. Given the overall strength of the labour market in the UK, despite the recent pick up in unemployment, we think that mortgage borrowers will do their best to keep up with mortgage payments and cut their discretionary spending. We also expect lenders to put measures in place to help their customers, in line with the payment moratorium or duration extensions that were proposed during the Covid pandemic and proved to be efficient in keeping most of the borrowers current and avoiding a rise in repossessions and forced sales.

Some measures to help homeowners were already announced by the UK Chancellor in June. Borrowers will have the option to call their lender and ask for support, or switch to interest-only temporarily before witching back, without facing a new affordability check or affecting their credit score. Customers who are up-to-date with their payments should also be able to switch to a new deal at the end of their fixed-rate period without a new affordability check, and they will also not be forced to have their homes repossessed within 12 months from their first missed payment.

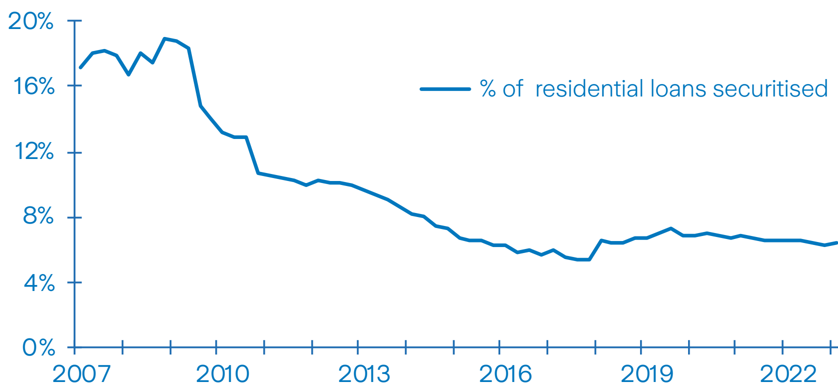
The spike in repayment costs will provide a real life assessment of the affordability test introduced by the Bank of England in 2014 to keep a lid on systemic risk in the aftermath of the financial crisis. This test remained in place until August 2022 and required lenders to assess whether borrowers could still afford their mortgages if the mortgage rate rose three percentage points higher than at the time the loan was issued—a scenario that many borrowers now face for real. It is also worth noting that origination standards have improved a lot and that lenders have been more disciplined when assessing loan applications from their customers. As an example, loans granted without proper income verification or complete financial statements, which were present in most of non-conforming pools until 2008, have now almost completely disappeared.

Fixed-rate mortgages have already started to decrease and we expect BoE Bank Rate to decline meaningfully to 2.5% by end of 2024, which if not accompanied by higher margins should also soften the blow to borrowers. All in all, while risks remain in the event that unemployment rises sharply or interest rates remain high for longer, several factors support our view that a crisis is likely to be avoided.

Mortgage backed securities pose a much smaller risk than in 2008

Given all the vulnerabilities of the property market and borrowers, it is worth looking at whether these weaknesses may also impact investors through their holdings of Residential Mortgage Backed Securities (RMBS). Despite remaining a large part of the European RMBS market, the size of the UK RMBS has significantly declined since the financial crisis. Securitised mortgage loans in the UK account for only roughly 6.5% of the total UK mortgage market compared to 19% in 2009. The largest banks and building societies have now put in place covered bonds issuance programmes and can also rely on customers deposits and other sources of funding. The funding of mortgage lenders was also skewed by the funding scheme set up by the Bank of England in 2020 to support lending to the real economy as well as households and small and medium enterprises. Major banks and building societies were able to draw close to GPB 200bn in funding from the scheme with a minimum four year tenor at attractive conditions compared to Prime RMBS or even covered bonds. We think that the cheap central bank loans and the conservative treatment attached to securitisations for most of the investors explains the decline of Residential Mortgage Backed Securities issuance in the UK. Most of UK RMBS issuance is now coming from smaller or specialised lenders, which cannot benefit from other source of funding or which operate in some niche sectors like buy-to-let or non-conforming. Meanwhile, the portfolios of loans backing RMBS tranches benefit from good seasonality and granularity, leading to less concentrated risk for rate reset periods and lower loan-to-value ratios as loans have been partially paid down. In conclusion, compared to the situation prevailing in 2007, we think that the transmission mechanism of mortgage market weaknesses to the financial system is far less potent.

Use of securitisation changed appreciably



Source: Bank of England

RMBS spreads seem vulnerable given the recent rally

While we remain confident that senior ABS tranches will not suffer losses from rising defaults and delinquencies, we believe that the significant tightening of RMBS AAA spreads since autumn 2022 has been excessive. UK RMBS has significantly outperformed other credit sectors like unsecured corporate bonds and appears now to be expensive on a relative basis. Market technicals, including low new issuance supply and a search for floating-rate coupons in a rising rate environment, may have been behind the demand that led to tight spreads. However, we struggle to find any particular explanation for the spread tightening given the stress induced by higher rates and the risk of an economic slowdown in the UK. We also remain cautious regarding UK Prime RMBS tranches at current spread levels. Even if non-conforming and buy-to-Let tranches trade at a higher absolute level of spread, they have experienced the same tightening trend over past months. Given their higher sensitivity to real estate deterioration and higher market rates, we don't think their current pricing level compensates for the risk of higher default and repossessions.

Conclusion

We do not believe that the current situation of high interest rates pose a systemic crisis risk to the UK mortgage market, banks or the housing market in a fashion similar to what was experienced during the financial crisis or during the late 1990s. That said, if rates remain high for longer than we expect or unemployment picks up at a faster pace, risks to our view can increase notably. The recent repricing of interest rate expectations is one worrying sign in this regard, although we expect it to reverse in coming months. Central banks need to tread a tight path of monetary policy tightening in order to contain the risks of a crisis.

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Investment Management
Mythenquai 2
8002 Zurich

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