APRIL 2019

MORTGAGE AND PROPERTY REPORT

Kensington

Welcome to the April 2019 edition of the Mortgage and Property Report. In this issue, we look at some of the market dynamics and emerging trends that are putting pressure on new lending volumes in the mortgage sector. We examine their cause and potential market developments in response.

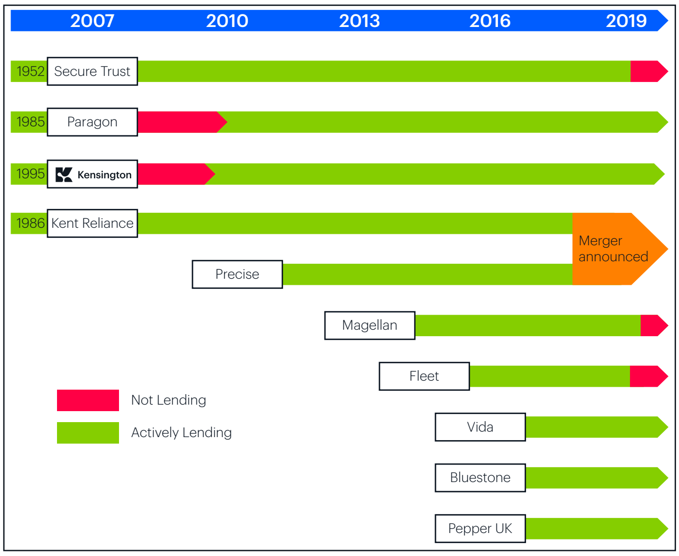
Key Highlights

- Post-crisis market conditions created an attractive environment for new specialist lenders to enter the sector, leading to increased competition
- The mortgage market has enjoyed steady growth in recent years, driven by high remortgage volumes and a healthy housing market
- An increasing number of customers have been taking out mortgages with longer initial fixed periods in order to lock in low rates, which will result in a less frequent need to refinance their mortgage
- In the face of increasing competition, lenders have gradually expanded into new niches and pushed mortgage rates lower

Introduction

The UK mortgage market, including the specialist sector, has enjoyed a strong revival in recent years, but is now starting to face pressure from increased competition and questions around whether origination levels observed in recent years are sustainable. Most specialist non-bank lenders in operation before the crisis collapsed, or exited the market when funding evaporated – Kensington and Paragon are two of the only survivors. Post crisis, mainstream lenders' risk appetite was reduced and affordability and lending criteria tightened, leading to increased demand for lending from specialist lenders, who typically lend to borrowers who do not qualify for high street loans. At the same time, historically low rates drew many borrowers with outstanding mortgages on variable rates to remortgage, and a recovering housing market led to increased transaction levels.

Figure 1: History of Specialist Mortgage Lenders

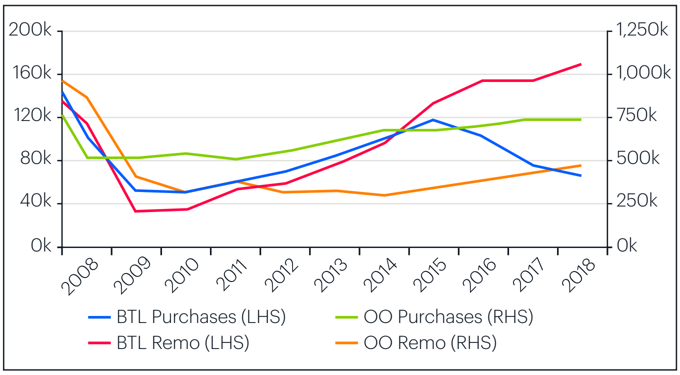


These market conditions, along with the resurgence of funding lines, led a new wave of specialists to enter the market, including lenders such as Precise, Fleet, Pepper, Vida Homeloans, Magellan, and Bluestone, amongst others. However, some of the trends that attracted these new entrants are now starting to reverse or slow down, leading to questions about the sustainability of current lending volumes, particularly as the field of competitors has become significantly more crowded.

Volume and Type of New Lending in Recent Years

Remortgaging is a key source of new originations for mortgage lenders across the market, accounting for c. 45% of new lending last year, the highest percentage since 2008. Owner occupied loans for purchase are the largest segment and account for approximately half of the c. 1.45 million new loans that were originated last year, followed by owner occupied remortgage loans, which account for c. 33%. All segments of lending have grown year on year since 2010, with the exception of new Buy-to-let (BTL) loans for purchase, which after growing steadily for years, have been declining since 2016, likely due to the tax and regulatory changes implemented

Figure 2: New Lending by Purpose of Loan (by #)



Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
Jasmine Heinen +44 (0)20 7532 9005 jasmine.heinen@kensingtonmortgages.co.uk
www.kensingtonmortgages.co.uk

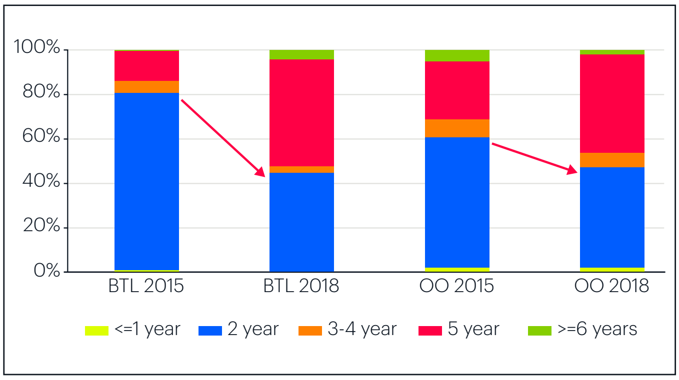
around that time. BTL is a significant portion of specialist lending, particularly Limited Company BTL products, which high street lenders tend to shy away from due to their complexity.

Across all segments, most new lending has been in the form of fixed rate loans with a cheap initial period. For many years, the 2yr fixed rate was the most popular choice as it was the cheapest by a wide margin – in 2015 the average difference in cost between a 2yr and a 5yr mortgage was 96bps – by 2018 this has decreased to 34bps. With this in mind, it's not difficult to explain why in recent years, borrowers have been moving away from 2yr products and are increasingly taking advantage of the cheap longer-term fixed rates available in the market. As seen in figure 4, 3 years ago, c. 60% of borrowers taking out an owner occupied fixed rate loan opted for a 2yr fixed mortgage, but by the end of 2018 this was down to c. 45%, meaning more than half of borrowers now opt for loans fixed for a longer period, typically 5 years. The trend is even more pronounced in the BTL market, where new affordability rules made 5yr fixed products more attractive several years ago (as discussed in our September Issue).

Fig 3: Average Quoted New Lending Rates – Owner Occupied

Source: BOE	2yr	5yr	10yr	Diff between 2yr and 5yr
2015	1.92%	2.88%	3.43%	0.96%
2016	1.72%	2.50%	3.04%	0.78%
2017	1.46%	2.06%	2.78%	0.60%
2018	1.68%	2.02%	2.72%	0.34%

Fig 4: Fixed Period for New OO and BTL Loans in 2015 vs 2018

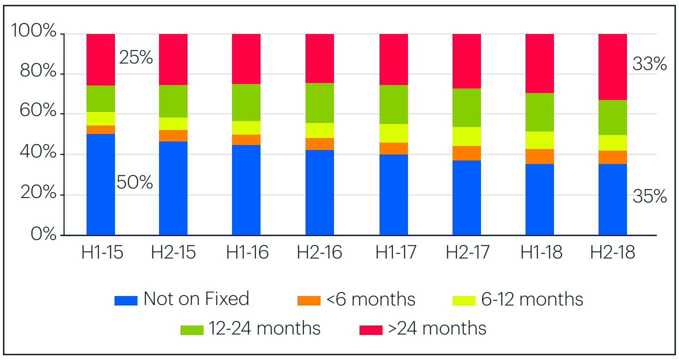


Pressure on Origination Volumes

Given the importance of the remortgage market as a proportion of lenders' new origination volumes, the move towards longer fixed rate loans is expected to impact lenders' ability to sustain current origination levels, and in the case of specialist lenders, much of the growth they have experienced in recent years. Borrowers in the UK typically refinance onto a new mortgage within 6 months of their fixed rate period ending. As more borrowers opt for longer fixed rate loans however, this window is pushed further and further out. As can be seen in Figure 5, while in the first half of 2015, more than 60% of all owner occupied mortgages outstanding were either not on a fixed rate, or within less than 12 months of it ending, this breakdown is quite different today. Moreover, the percentage of loans with more than 2 years left on their initial rate, which held steady at around 25% of the market through 2017, has now increased to 33%.

The 4 million mortgages on a variable rate in 2015 have already decreased to less than 3 million as of the end of last year (even as the total number of mortgages outstanding has held steady). Some of these borrowers may also be holding on to low rates or other features of their mortgages and have no intention to refinance in the future.

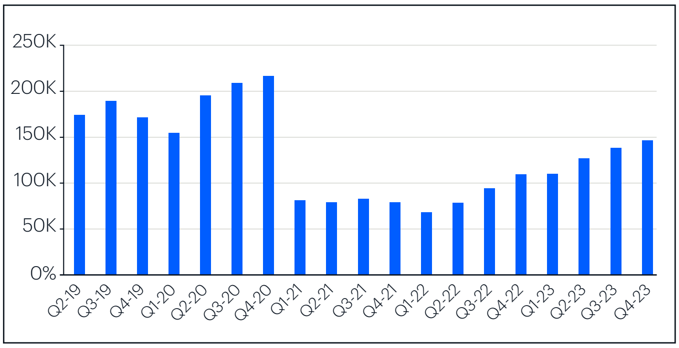
Fig 5: Time Left on Fixed Rate (by #) on Outstanding OO Mortgages



Remortgaging comes primarily from borrowers who are not on a fixed rate, which usually come with early repayment charges, and as the stock of loans which qualifies for this in the near term decreases, it is unlikely that lenders will be able to keep up the lending volumes they have experienced in recent years. Figure 6 demonstrates the striking number of loans originated between 2015 and 2018 which won't reach the end of their deal until 2023.

The purchase market has also been slowing down in recent months, and according to RICS, the number of new properties listed for sale and the number of new buyer enquiries is continuing to decrease month on month. Continuing Brexit uncertainty is not helping this.

Fig 6: End of Fixed Period (by #) for OO Mortgages originated since 2015

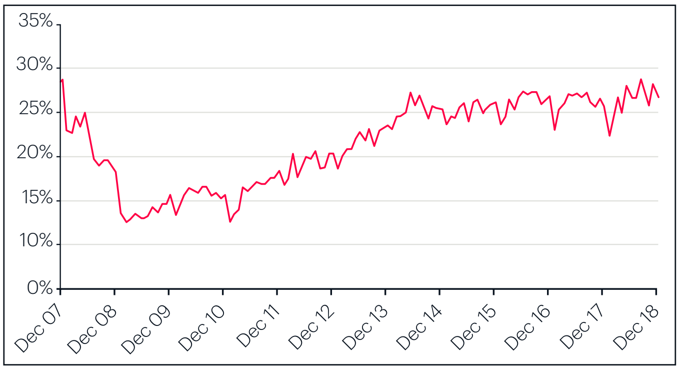


These market dynamics are impacting both high street and specialist lenders, however the tools each segment has to deal with them are different. If the opportunities for new lending in the normal course of business decrease, lenders will need to launch new innovative products or expand into existing segments which they don't currently operate in to maintain their origination targets.

Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
Jasmine Heinen +44 (0)20 7532 9005 jasmine.heinen@kensingtonmortgages.co.uk
www.kensingtonmortgages.co.uk

It is comparatively easy for high street lenders to move into the market occupied by specialist lenders (if they are willing to underwrite more complex loans), but the reverse is not true. High street lenders have more flexibility to lower their prices and can also increase their risk appetite to win new business – this could come in many forms, e.g. higher LTV products, more relaxed lending criteria, or moving into more complex products such as limited company BTL or loans for self-employed borrowers. In fact, we've repeatedly seen this behaviour in the past few months, with lenders like HSBC and Clydesdale starting to accept 95% LTV loans, Virgin announcing it would consider borrowers with recent CCJs, and TSB increasing its income multiple to 4.75X, to name just a few. As can be seen in Figure 7, the percent of new loans with an LTV over 85% is back to 2007 levels, evidence the market as a whole is taking on more risk.

Fig 7: % of New OO Loans with LTV >=85%



Conversely, a specialist lender would need to be able to compete on price in order to move into the territory occupied by the high street – without access to deposits or central bank schemes, specialist lenders' funding is constrained and more costly, and originating more expensive products is key to keeping margins at a profitable level. They also have less room to loosen their lending criteria, as they already operate in a more complex part of the market.

If remortgage levels start to drop off as we expect them to, and the high street increasingly moves into specialist territory, more and more lenders will ultimately be competing for business from a shrinking market. This has already resulted in a number of specialist lenders exiting the market in the face of funding constraints, pricing pressure, and an overcrowded sector. Fleet mortgages withdrew their entire range at the beginning of the year and stopped lending for 3 months before returning to market last week. Secure Trust also ceased new originations due to increased competition and lower new lending margins in January. Magellan followed in March, citing the simultaneous decrease in mortgage rates, rise in funding costs, and increase in credit risk as unsustainable. More may yet follow.

Nonetheless, one upside of borrowers taking out mortgages with longer initial fixed terms is that the lenders they are currently with will have those loans on their balance sheet for longer. This will particularly benefit specialists, who generally have lower retention rates as borrowers tend to refinance away from them. For the same reason, at least some customers of specialist lenders will continue to prefer shorter term fixed loans, which they see as a path to the high street – i.e. a short term solution to a credit issue or complexity in their situation which they expect to correct.

Conclusion

If nothing else, recent developments make clear that to compete in the specialist space, lenders need to have a genuine competitive advantage in a specific niche. Simply offering more expensive products in exchange for looser lending criteria is unlikely to be enough to win business in a crowded market. With mortgages for borrowers with special circumstances, such as being self-employed, older, or complex becoming more widely available, borrowers don't just have one option anymore, but many to choose from. The market is moving from being one where lenders can take their pick of borrowers to one where borrowers can take their pick from a multitude of lenders. This means that in the future a new set of criteria is likely to determine which lenders succeed and which don't. Customer service and ease and speed of execution are becoming more important. It is telling that the newer lenders and brokers who are entering the market are marketing themselves not by emphasizing the "needs" they can fulfil, but also the "wants" of customers: a customer needs a mortgage that accepts his self-employed status, but he also wants one that is executed efficiently (likely online) and quickly. The specialist lenders of the future are likely to be the ones that succeed at fulfilling both.

Please contact Alex Maddox +44 (0)20 7532 9845 alex.maddox@kensingtonmortgages.co.uk
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