MORTGAGE AND PROPERTY REPORT

Kensington

Welcome to the November 2019 edition of the Mortgage and Property Report. In this issue, we look at how the mortgage needs of different segments of customers vary, and specifically the role that intergenerational differences, the macroeconomic backdrop, demographic trends, and regulatory changes play in this. We also examine how these needs have changed over time and the different ways lenders can and are addressing them.

Key Highlights

- Mortgage needs across different generations vary, and these differences can be exacerbated by macro and regulatory changes
- Available mortgage products and current lending criteria are generally not tailored to more complex mortgage needs
- Lender adaptability to changing demographic trends and customer requirements are important, both for customers and for lenders to remain competitive

Introduction

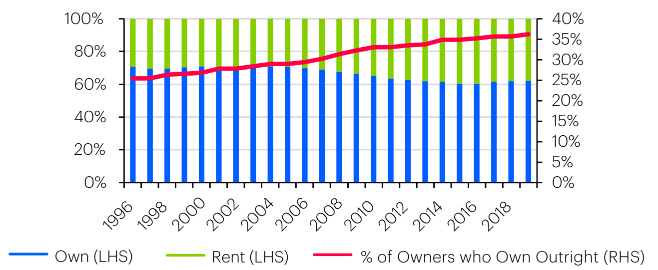
The needs and expectations customers have of their mortgage lender change over time, in relation to both their own circumtances as well as general developments in the market. These changes are driven by a number of factors, including the current life phase a customer is in (i.e. student, new worker, starting a family, retiree, widow, etc), wider demographic trends (i.e. gig economy, marrying later etc), external macro economic pressures (i.e. rising house prices, lower interest rates), as well as regulatory changes (i.e. more strigent affordability requirements, new pension rules, changing fiscal treatment etc), to name a few. The latter two categories usually impact a large proportion of customers at similar periods in time, and lenders are generally well equipped to react to these changes with large-scale adjustments to their product range or lending criteria. The different needs of customers which are driven by their individual circumstances (which are often also influenced by macro and regularotry changes) have historically been less well addressed, leaving customers to try to make their circumstances fit into a lender's criteria, rather than having access to products that are designed to fit their needs.

The divergence in the needs across generations is more pronounced now than ever. While younger customers have always had different requirements than older ones, these differences have become more distinct in recent years. For example, the impact of the rise in house prices over the last few decades has impacted different customer segments in different ways - e.g. older homeowners need a way to release property wealth to finance their longer lives, while aspiring first time buyers need a solution to get on the housing ladder with smaller deposits – vanilla mortgage products don't fit those requirements. In this issue, we examine these as well as other differences in more detail to determine how well customer needs are being met and establish how lenders have and can continue to provide appropriate products to address changing needs in the future.

A More Constrained First Step

First time buyers (FTBs) are an important segment of the market, accounting for c. 50% of all new mortgages for house purchase. Rising house prices and more stringent affordability rules have made it more difficult for aspiring home owners to climb the property ladder and become a part of this group. As seen in Figure 1, the trend in the UK over the last decade has been one of decreased home ownership. This is particularly true for the 25-44 age group – while 61% were home owners in 2008, this has dropped to 48% in 2018.

Fig 1: UK Home Ownership Trends



As such, we haven't seen a dramatic change in the profile of FTBs, but are seeing bigger differences in the type of mortgage they need and are consequently taking out. For example, while the average age at which FTBs buy a property in the UK has been broadly steady at around 31 years old, the average mortgage term has increased by close to 5 years over the same period (this works out to a monthly payment that is c. £100 lower on a £180K loan with an initial fixed rate of 1.55%). Similarly, average income multiples have increased from around 3X to 3.5X (Fig 3). Interestingly, the average mortgage payment as a percent of borrower income has decreased since 2005 from c. 21% to c. 17% today. The key driver for this has been

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lower interest rates, which mean that the interest component of the mortgage payment, which stood on average at 17% of income now stands at just over 8%. The decrease in interest rates has thus helped balance out the impact of the increase in house prices, which led to larger loan sizes and higher monthly capital repayments.

Fig 2: UK FTB Average Age and Mortgage Term (in years)

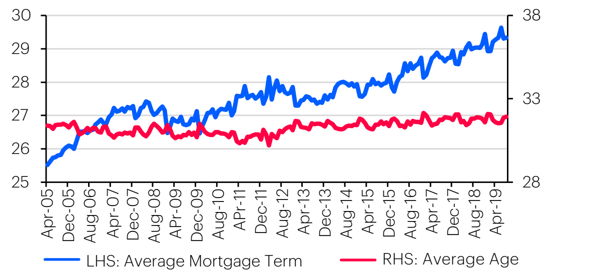
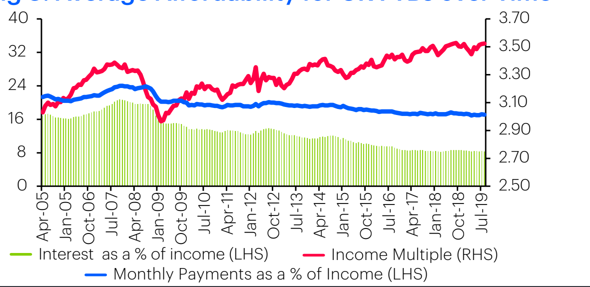


Fig 3: Average Affordability for UK FTBs over Time

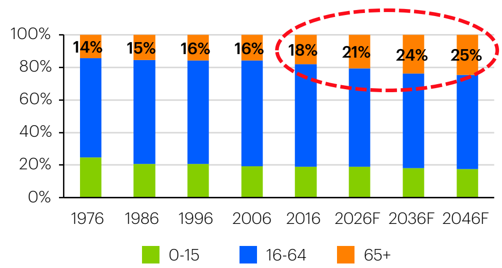


While lower rates are helping FTBs who already have a mortgage, affordability is still a huge problem for aspiring buyers. Even with rates at historic lows, the stresses applied can be a stumbling block for many. While the average 2yr fixed rate currently stands at 1.55%, the average variable rate that applies at the end of the fixed rate period is 4.29%, and lenders have to apply a 3% stress to this rate when assessing a customer's ability to pay. So while the 1.55% mortgage may be very affordable, many prospective buyers will be constrained by the fact that they have to prove they could afford to pay the loan if the rate were 7.29%. Customers' inability to meet this criteria is a key factor that has led to lenders offering longer terms and lend to a later age, so that the payments can be spread out over longer period of times. The other key issue facing FTBs is the need for bigger deposits to counter rising house prices, particularly in London. The easiest way for lenders to deal with this has been to increase maximum LTVs, and we've seen the average LTV for FTBs increase from c. 73% in August 2009 to c. 78% in August 2019. Government schemes, such as Help to Buy have also been important, although these tend to have restrictions which mean they are not for everyone, e.g. limited to New Build homes. When the scheme ends, we would also expect to see further increases in LTVs for new buyers.

An Ageing Population

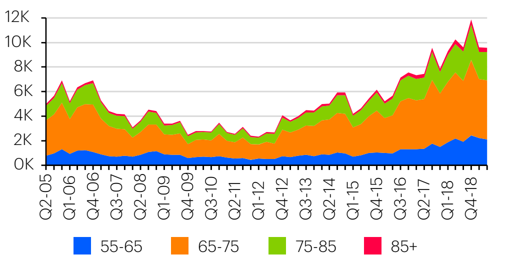
At the other end of the spectrum are older borrowers. The percentage of the UK population aged 65 and over increased more than 2% in the 10 years between 2006 and 2016, and almost 4% between 1976 and 2016 (Fig 3). In real numbers, that's an additional 2.1 million adults who are over 65 years old. A further 2.5m are expected by 2026. Life expectancy for UK males increased from c. 71 years in the early-mid 1980s to just under 80 years in 2017 – while overall this is positive, financially it translates into retirees needing to fund on average an extra decade of life. As most borrowers of retirement age today will have bought their current property many years ago, they have likely benefited from significant price appreciation. As they need to fund longer lives and in many cases long-term care, releasing property wealth becomes an important requirement.

Fig 4: Age Distribution of the UK Population



In parallel, future retirement income is likely to be impacted by new rules introduced in 2010. While these have led to a significant increase in the percent of the population enrolled in a workplace pension (from 47% in 2012 to 76% in 2018), most of this growth has been in defined contribution schemes, with defined benefit contributions only accounting for 36% of all pensions in 2018. Contributions tend to be lower in defined contribution schemes and pension income smaller and less certain.

Fig 5: New Lifetime Mortages by Age of Borrower



The backdrop of smaller pensions and increasing demand for old-age care has resulted in a growing demand for solutions to lend into and during retirement. This has led to an increase in equity release and lifetime mortgage products on the market (with the key difference being that interest doesn't roll up in lifetime mortgages, allowing customers to retain the equity in the home). While we've seen the number of new lifetime mortgages increase, particularly in the 65-85 segments (Fig 5), the reality is that for many customers, especially those that need them most (i.e. those on an IO product), they may not be available. Affordability is generally assessed on the income of the surviving spouse, which is deemed to be the lowest of the two and most deals are only available at lower LTVs. Many lenders have historically also struggled to offer these loans, as underwriting them is more complex since it requires assessing retirement income and mortality rates. The long-term fixed rates sought by customers borrowing into old age are also not always available

Changing Demographics

While customers in the mid-life segment, particularly ones who are already homeowners, have generally been better served by the mortgage market, changing demographics means that more complex needs are becoming more common. A key change over the last decade has been an increase in the size of the self-employed population (Fig 6).

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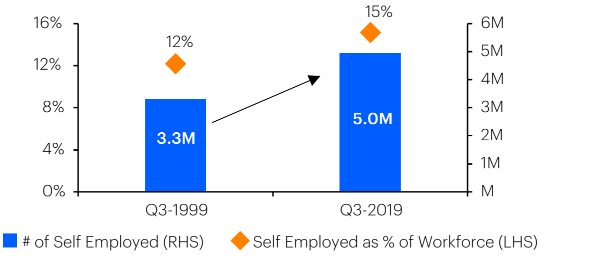
Fig 6: UK Self Employed Population Over Time



Specifically, more and more people are taking more flexible (but also less secure) jobs, with more unpredictable income, often on a part time or temporary basis. This have resulted in an increasing need for products that support multiple, complex and irregular incomes, reflecting idiosyncrasies of working patterns in individual sectors. Lenders, particularly high street ones, are especially unequipped to deal with this issue, as it makes it far more difficult for customers to demonstrate affordability over time.

Demographic trends are also continuing to change in other ways. For example, buying a property has historically been a common step for a married couple, as they settle down. However, marriage rates have been on a steady decline since the mid-1970s, while the age at which people marry has steadily increased. Yet, young people still have a desire to live independently, either on their own but also increasingly with friends rather than a spouse or partner. Lenders are only starting to adapt to these new needs and offer mortgages that accommodate this.

What This Means for Lenders

Lenders have to adapt to the changing needs of these growing customer segments and provide them with products that suit their requirements in order to grow, or in some cases just maintain their market share. Too often, high street lenders try to address these simply by moving up the risk (LTV) curve and relaxing lending criteria. We've seen a number of lenders move in this direction over the last year, as discussed in our April 2019 issue. While for some customers this provides a solution, there should be better, more tailored options available.

Fig 7: Mortgage Needs Across Generations

Age of Customer	Key Issue	Current Solutions Available	Areas for Development
Millennials/ FTBs	• Affordability Constraints • Deposit Constraints	• HTB • Shared Ownership • Guarantor Mortgages • Stamp Duty Relief	• Shared Ownership for existing properties • Lending with step-up affordability
Mid-Life	• Lack of speedy and simple mortgages • Increasing Income Complexity	• Product transfers (existing lender) • Some complex income products	• Quicker and Online Only execution • More tailored affordability for complex cases
55+	• Need to release Property Wealth	• Higher maximum age limits • Some equity release	• More affordable Retirement Interest Only • Lending to later age

For example, FTBs, particularly as they take out longer-term mortgages, need products that take into account not just their current situation, but also their earning potential over their lifetime. They are the age group with the highest earning increase potential, yet they are penalised if affordability is assessed on the starting salary – there should be more products to solve for this and it is important for lenders to explore this further. Mid-life customers are currently the best served segment, but improvements can also be made for them. For vanilla mortgages, simpler and online-only execution should be available. For more complex customers, better affordability assessments need to be developed. As more people live longer, it also becomes increasingly important for the market to adapt to accommodate the new requirements of an older population. Specialist lenders are generally in a better position to provide all these options, as they have more experience assessing complex cases and their business model already allows them to spend more time looking at individual circumstances. They are likely to play an increasingly important role in the market going forward.

Sources:

Figure 1: Labour Force Survey
Figure 2, 3 and 5: UK Finance
Figure 4: ONS – Overview of the UK Population
Figure 6: ONS - Trends in self-employment in the UK

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