

Retail funding and the limits to mortgage growth

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Gary Styles

Strategy, Risk and Economics Director

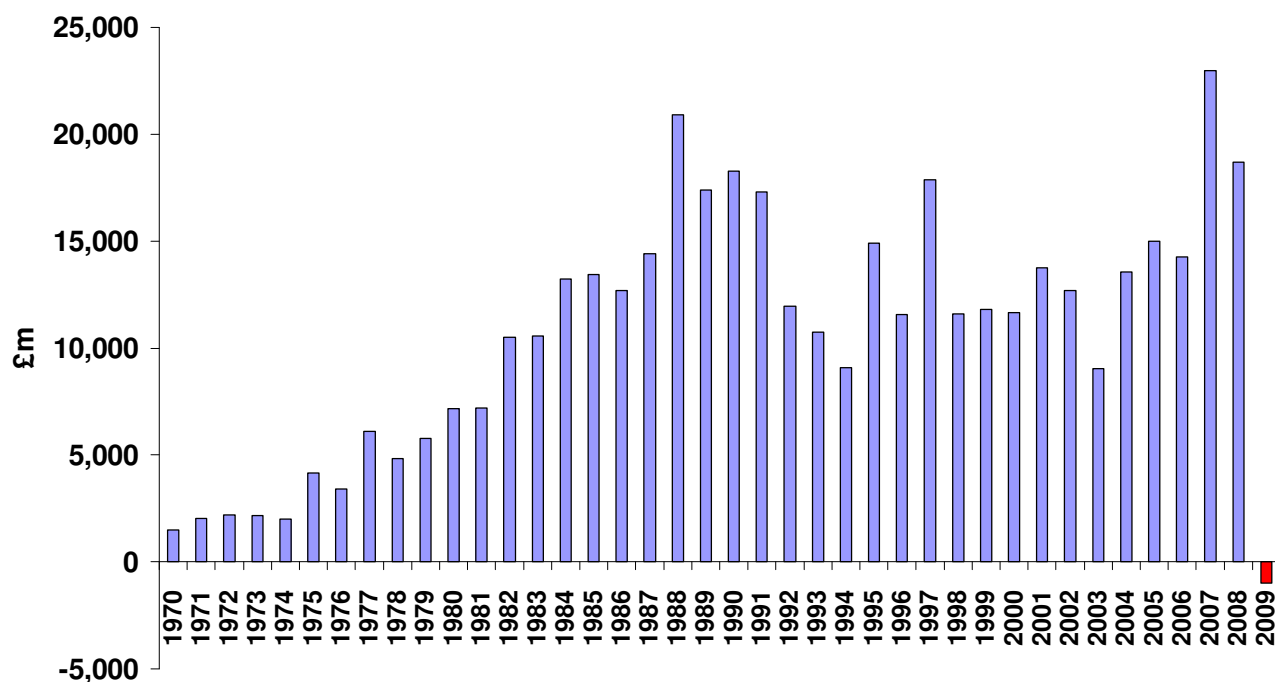
Hometrack

2009 is likely to be remembered as the major turning point in the mortgage market. House prices have now broadly stabilised and house purchase mortgage lending has finally picked up from the record lows experienced in early 2009.

As I discussed last month the economic picture remains far from robust and the policy backdrop of tighter fiscal policy and potentially higher interest rates are not supportive of a strong overall recovery. However, I would like to turn my attention to retail funding and the likely limits this will place on both competition and mortgage growth for the next few years. This represents one of the key structural issues shaping any recovery in the mortgage and personal finance markets over the next few years. Existing models are struggling to cope with the size of the shifts in this market and their likely policy impacts.

The retail savings market has been hit by historically low interest rates and a consumer who has chosen to run down short-term savings to maintain consumption levels in the downturn. Low inflation and low interest rates make funding for pure retail funded lenders very difficult and this is aptly highlighted in the declining retail savings flows seen in the building society sector. Building societies traditionally offer attractive retail savings interest rates to ensure they are able to fund targeted levels of mortgage lending for house purchase. The chart below shows the change in retail balances for building societies back to 1970. The performance in 2009 represents the worst retail flows since the 1950's.

Building Society Retail Funding (Change in Retail Balances)

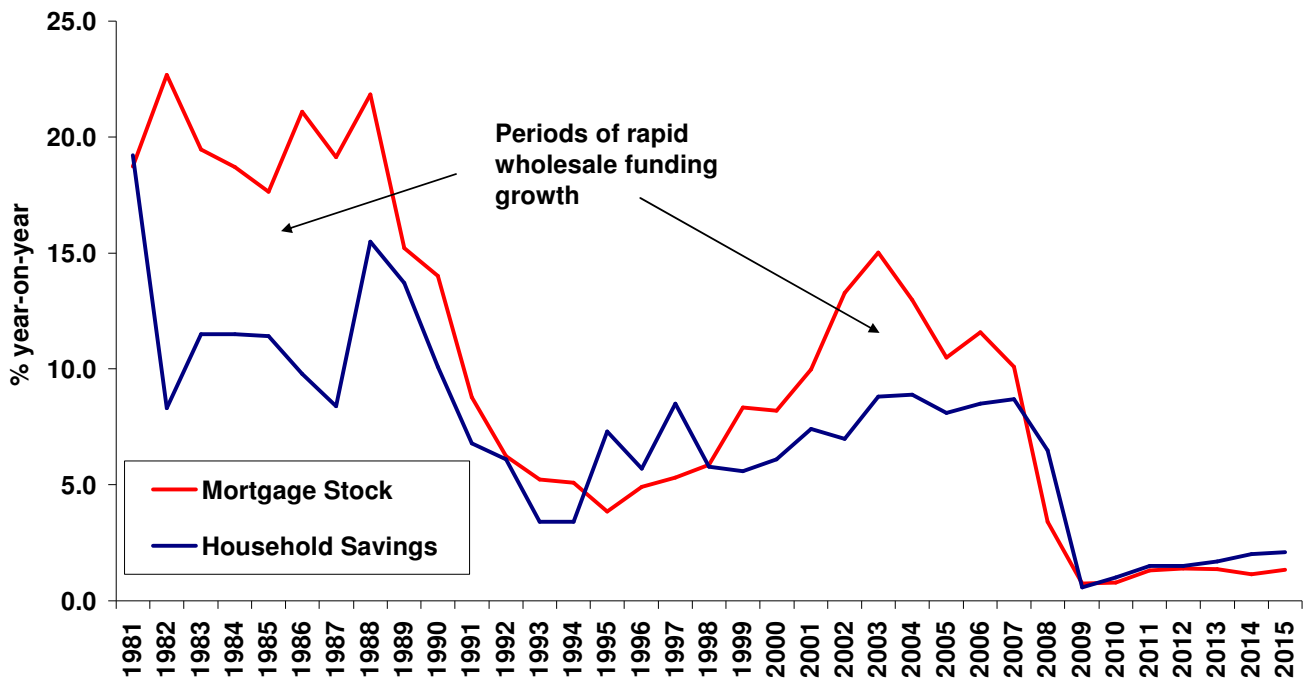


Source: BSA / Bank of England

Although the size of the building society sector has been dramatically reduced by conversions to plc status and mergers the core funding issue remains the same for all retail funded lenders. The absence of a healthy flow of retail funds either from over the counter deposits or interest accrued to accounts makes lending difficult for many lenders and not just building societies.

The overall position is further highlighted by the simple chart below showing the growth in household liquid savings when compared to mortgage lending growth. For large periods of history the two series have tracked each other closely as lenders matched mortgage lending to retail funding, the exception being in the mid 1980's and in 2002-2007 when wholesale funding/ securitisation became the major source of new lending growth.

Household Liquid Savings and Mortgage Growth

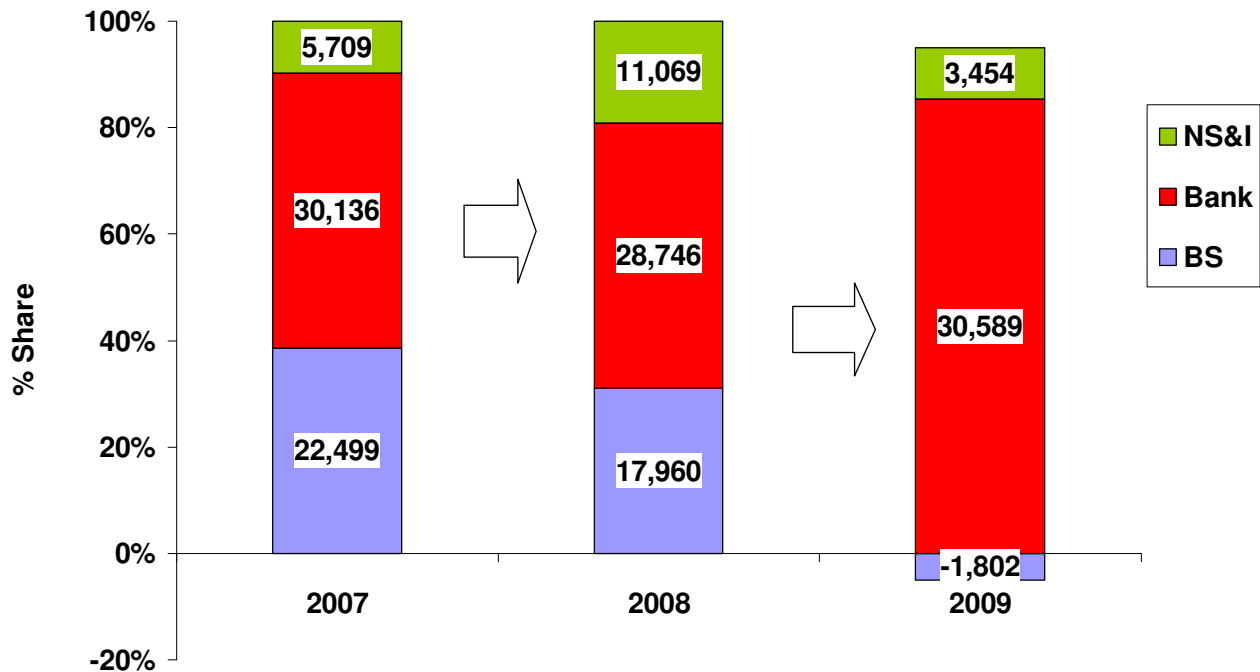


Source: National Statistics / Bank of England

The business model of building societies and indeed regulation compels lenders to fund the majority of their mortgage activity from retail savings whereas banks can choose to fund from almost any available source including commercial deposits, securitisation, covered bonds and indeed wholesale borrowing.

In addition to the overall low growth in retail savings the composition of institutions tapping into retail funds has become far more dominated by banks and National Savings in the last couple of years. The chart below shows the split of retail funding between banks, building societies and National Savings between 2007 -2009. I would expect the pressure from National Savings to increase further as funding of the public finances become more acute in the coming years and unless there is a large change in investor appetite for RMBS or covered bonds banks will continue to actively drive retail savings flows.

Retail Savings Market Shares



Source: Bank of England / BSA / National Savings

Looking at the prospects for retail savings for the next 2-3 years it is difficult to see where the funding growth is going to come from for pure retail funded lenders. Although mortgage lending is only expected to grow modestly in the next few years the composition of retail funding and competition in the savings market will make a pure retail strategy very challenging.

So what should we expect to see?

If we carry on as at present the pressure on building societies to consolidate or hibernate will become ever greater. Many of the retail banks who currently benefit from government support and funding will find it increasingly difficult to justify paying 3-4% for new savings whilst charging existing borrowers 2.5-4% for mortgage lending.

We need to see a healthier outlook for retail savings and this will of course be helped in 2011/2012 by higher market interest rates. The government could do much more to help encourage long term savings from the household sector and perhaps extending the support given to equity investments to liquid savings for a period is one very attractive option. It is in all our interests to have a diverse group of lenders in the market funded from a wide range of

sources including household retail savings, wholesale markets, commercial deposits and indeed RMBS and covered bonds. Our short term priority should be to help this sector by encouraging liquid savings and thus supporting the necessary funding for the UK mortgage market.

G P Styles