

## **Why mortgage scenarios are helpful**

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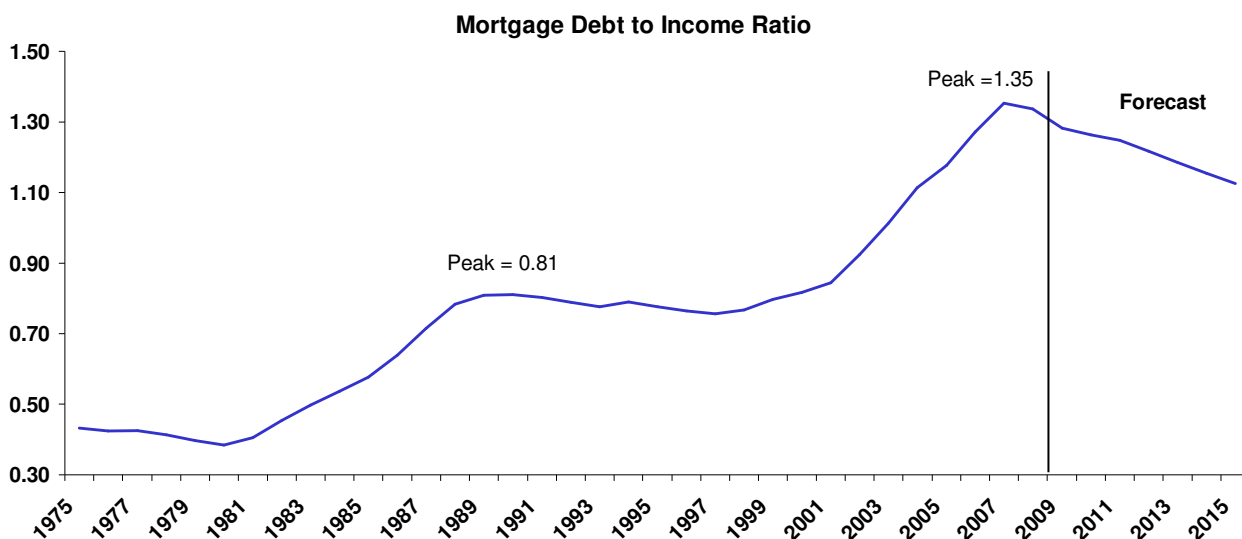
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### **Hometrack**

As we run up to the General Election with all the political and economic uncertainties this generates it is difficult to get people interested in the longer term assessment of market prospects. Focusing on the micro variations in policy only adds to the feeling that perhaps in the real world the overall impact of the final election result on the mortgage market will be small in the medium term. In many senses it is the economics of the situation and the need for balance sheet adjustment from both government and consumers that is driving the final outcome. Whoever wins the election will inherit an extremely difficult portfolio of challenging problems many of which will not be addressed in 10 years let alone 5. I do not expect housing and mortgages to be high on the priority list as it is left to the regulator to control the perceived excesses of the mortgage lending industry. The boundaries between regulation and macro-economic policy look set to merge in several key areas as policymakers widen their remit into such areas as macro-prudential supervision and product regulation.

However, I think it is a good time to look more closely at the balance sheet adjustment we have seen so far and to assess the likely implications for mortgage lending in the medium term. We have seen a sea change in the performance of the household sector in relation to debt as the impact of the recession and the lack of new credit supply has taken effect. The actual balance sheet of the household sector has seen a real de-acceleration in the growth of mortgage and other debts whilst income growth has remained resilient. In addition the financial assets of the household sector have recovered from the record lows as the equity market has risen sharply.

The chart below shows the mortgage debt to income ratio over the last 35 years. There are two distinct peaks one in 1989 and the more recent peak in 2008. At the time of the 1988/89 boom many commentators believed the debt to income ratio had risen as far as it could go when it reached 0.81.



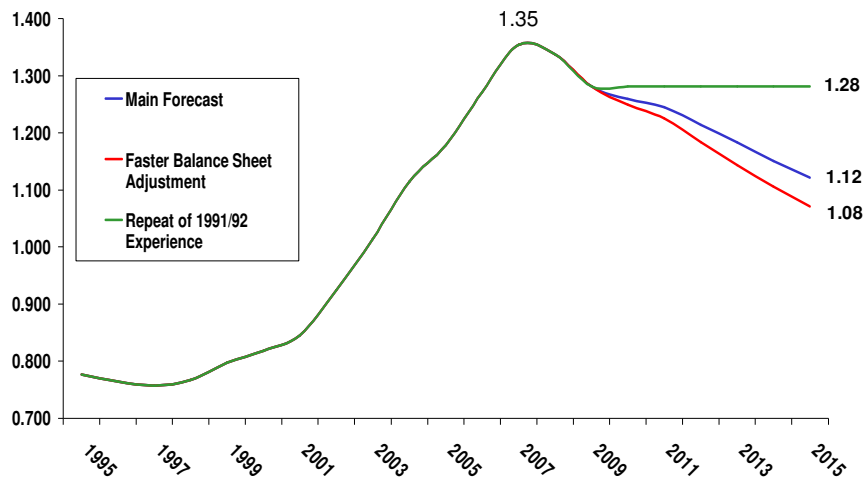
Source: Hometrack / Office for National Statistics

But following the protracted economic downturn experienced in the early 1990's this ratio started to rise quite sharply again from around 1999 reaching a record 1.35 in 2008 before easing to 1.28 in 2009.

The likely path of the debt to income ratio and indeed the corresponding wealth to income ratio will have a major bearing on the size and growth in the mortgage market. Using this highly simplified and stylised approach makes it easier to look at the broad scenarios and issues facing us as an industry. We must however accept that in practice the feedback loops and macro policy changes will affect the path but perhaps not the final destination of the ratios.

The chart below shows our main forecast for the debt to income ratio from 2010 to 2015 (shown in blue). In addition I have added a more optimistic scenario (1991/92 – flat debt to income ratio) and a more pessimistic forecast where the rate of balance sheet adjustment accelerates and the debt to income ratio returns to 2002 levels.

## Simple mortgage debt income scenarios



Source : ONS, Bank of England, Hometrack



Source: Hometrack / Office for National Statistics

These relatively modest scenarios have quite dramatic implications for the likely size of the gross and net lending markets over the next 5 years.

## Scenarios -Gross Lending (£bn)

	2007 (Peak)	2009 (Latest)	Average 2010-2015
Main Forecast	361	143	186
Faster Balance Sheet Adjustment	361	143	171
1991/92 Experience (Flat DTY)	361	143	231

Source : Hometrack



## Scenarios -Net Lending (£bn)

	2007 (Peak)	2009 (Latest)	Average 2010-2015
Main Forecast	108	11	16
Faster Balance Sheet Adjustment	108	11	6
1991/92 Experience (Flat DTY)	108	11	47

Source : Hometrack



The main forecast shows the debt to income ratio easing over the next 5 years from 1.28 to around 1.1 at the end of the forecast period. This implies that gross lending would average around £186bn a year over the next 5 years with net lending of around £16bn a year (one sixth the 2007 level).

The faster balance sheet adjustment scenario shows the debt to income ratio falling to around 1.08. This scenario results in net lending averaging only £6bn a year over the forecast period and a gross lending figure of nearer £170bn. This represents gross lending of less than half the level recorded in 2007 and much closer to the levels experienced in 2001. The scenario is more likely to prevail in a period of depressed equity markets and below trend economic growth. Higher interest rates may actually accelerate the rate of adjustment if combined with poor UK economic health.

The 1991/92 type scenario shows a more upbeat assessment with a quicker recovery in confidence and borrowing. Under this scenario the debt to income remains flat at 2009 levels and sees mortgage debt grow in line with income throughout the forecast period. This scenario implies net lending of around £50bn a year and gross lending of nearer £230bn. For this to happen we would need to see a continued robust recovery in the UK housing market and economy and an absence of heavy regulation / macro-prudential policy.

As we all know the short term outlook for the mortgage market remains gloomy as lenders focus on rebuilding balance sheet strength. However, significant debt adjustment has already occurred in the household sector and much of that pressure should start to ease in the next couple of years. Adjusting balance sheets now will put the market on a more stable and sustainable footing in the longer term - if only government deficits could be turned around so efficiently.

GPS

11<sup>th</sup> March 2010