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COMMENTARY:

Shock Headline but BoE looking at Multiple Scenarios – this is just worse-case

BUT BoE does have an impossible balancing act in supporting Sterling whilst at the same time not penalizing mortgage holders.

Even in worse case scenario, impact will not be felt immediately as not all mortgages are trackers.

Even with increase in rate we are unlikely to see high default rates as UK Mortgages are full recourse and the MMR has certainly made borrowing criteria more stringent.

But might we see negative equity in property – possibly.

Given the potential problem – might it now be time to review Stamp Duty – we need to make it easier to sell property.

The Governor of the Bank of England maintains that there may be a 35% decrease in house prices if the UK "Brexit's" with No Deal. We examine the headline:

Firstly and most importantly the Bank is there to ensure financial stability in the UK so it must examine worst-case scenarios – it does not mean that this will happen but forewarned is forearmed and given the criticism raised over the lack of Brexit planning by the Government, the Governor is wise to ensure his bases are covered.

Secondly, his worst-case forecast is that prices would fall by 35% over 3 years not 35% overnight.

However the Governor is addressing a real problem. If the UK crashes out of the EU, then sterling will fall against other world currencies. This will make importing good very expensive. In order to manage the currency, the Bank will have to raise interest rates (the Bank of England Base Rate) – and in so doing encourage investors to buy Sterling against other currencies. Simplistically if Investors are paid a higher interest rate for holding Sterling, more investors will seek to buy sterling and the currency will strengthens (or go up) against other currencies (such as the Dollar or Euro). This makes our imports cheaper and lowers the costs for consumers.

The balance that the Governor has to consider however is the effect of increasing Bank of England Base Rate to support our currency against the increasing cost of mortgages which are also pegged to Base Rate. The higher the rate, the higher your monthly mortgage payments if you are on a Standard Variable Rate Mortgage. The higher the mortgage rate, the more a household has to pay each month and the less money is available for them to spend on goods which in turn supports business, which supports jobs and ultimately the economy as a whole.

So are we likely to see a 35% fall in prices? We think this is unlikely. Firstly our research shows that approximately 50% of borrowers are on a fixed rate mortgage with the other 50% are on a tracker, standard variable or discounted rate product. So any immediate increase in the Base Rate would not create a payment shock across the whole housing market. Secondly, Mortgages in the UK are full recourse, meaning that if a borrower defaults, the lender can attach (or seek to monetise) to the borrowers assets (including their income) for a period of 7 years post default. This tends to encourage borrowers to pay. Thirdly, as there is no tax relief on mortgages, borrowers tend to be less levered, than for example our friends in the USA and certainly the introduction of the MMR (Mortgage Market Review) ensured that mortgage affordability was more stringently checked than it was during the 2008 crisis.

We will see however a fall in prices? Yes but not immediately:- If the base rate increases, the cost of borrowing goes up which means that potential buyers can borrow less and therefore pay less for a new home. Conversely this also means that any buyer looking to sell and then acquire a new home will cntd/…

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Cntd…

Also end up paying less for their new home. Those seeking to sell outright may well make less than they bargained for.

As to Negative Equity in the property, whilst the MMR restricted the Loan To Value Ratio on mortgages, recent figures from the Bank of England suggest that the Residential mortgage LTV Ratio (mean above the median) is now 87% (Buy to Let 56%) with household debt to income at 133% and total debt to mortgage income at 97% - so there is a possibility that we will see some borrowers experience negative equity in their properties if Mr Carney's worst-case predictions are realised.

However we have a housing shortage in the UK so any fall in prices in real terms will be quickly exploited by buyers waiting to acquire. We are also confident that the BoE will, if this situation occurs, provide some form of quantitative easing allowing the banks to continue to lend. This would be both the in BoE's and the banks best interests as increasing Loan to Value ratio's in a bank's mortgage lending book is a trigger for further capital reserves on balance sheet. This is a terrible use of money for a bank as it reduces their return on equity and puts High Street Banks at greater risk.

In conclusion, we see the headline figure of 35% as unlikely as the Bank of England will be very sensitive to increasing interest rates too quickly as it will impact consumer spending but all borrowers should expect a rate rise – the base rate is historically low and has only one way to go – up! We don't see the comments as anti-Brexit or part of Project Fear but one of many scenarios' the Bank has quite rightly considered. As far back as 2014, and before Brexit, Mr Carney gave an interview on Sky as to his fears of the housing market, the high household debt to income ratio and borrowers ability to pay for these loans. Fast forward 4 years and the situation we find ourselves is being blamed solely on Brexit which is not entirely accurate.

As a leaving thought however, if we are to expect a fall in house prices, might it now be the right time for the Government to review the Stamp Duty Land Tax. The last thing the market needs, even if there is a small fall in prices, is an inability to transact as a result of this punitive tax.