SEPTEMBER 2023

MORTGAGE AND PROPERTY REPORT

Welcome to the September 2023 edition of the Mortgage and Property Report. In this issue, we look at the market for long term fixed rate mortgages in the UK. We compare the supply and demand of these products in the UK to other countries and discuss the role funding and regulations plays in this.

Key Highlights

- Unlike other developed countries, the UK mortgage market has for decades been dominated by short term fixed mortgages which customers regularly refinance for a new short-term fixed rate product
- The dominance of these products makes UK mortgage customers much more susceptible to rate shocks and has a knock-on effect on house prices
- High street banks are not well suited to fund longer term fixed mortgages; and regulations makes it unattractive for insurance companies to fund them, despite their similar asset and liability maturities
- The market works very differently in other countries, where long term fixed loans are far more prevalent

Introduction

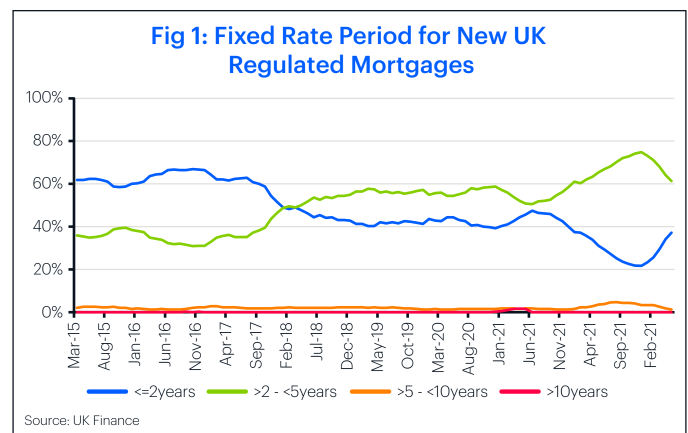
The UK mortgage market is unusual amongst developed economies in that products with short fixed rate periods dominate the market. This is in sharp contrast to many European countries and the United States, where it is common for the interest rate on mortgages to be fixed for a longer period, if not the full term of the loan. In this newsletter, we look at the key reasons for this difference, exploring both the supply and the demand side of the market, and discuss what changes could be made and how these would benefit customers and potential funders, as well as how this compares to other countries.

The UK Mortgage Market

The UK's affinity for short fixed-rate mortgages dates back decades. Customers take out loans with short teaser periods with the expectation that they will easily refinance onto a new teaser rate once the previous one ends. While in recent years there has been an increase in the percentage of customers taking loans with fixed rate periods of up to 5 years, anything longer than that remains extremely uncommon (fig 1). Customers favour short fixed rate products, as in a normal rate environment, they are usually the cheapest. Fixed rate loans also almost always come with early repayment charges (ERCs), which are typically highest for longer fixes. Opting for short term fixed rate loans allows customers to retain the flexibility to refinance if rates come down or they want to sell the property without paying higher ERCs.

On the supply side, the key reason for the prevalence of these products is that the mortgage market is dominated by high street banks who are primarily funded by retail deposits. Wholesale funding in the form of RMBS also plays a role, especially for non-bank specialist lenders, but this is much smaller. The short term nature of retail and RMBS funding is best suited to fund short term fixed rate products. Other types of funders exist but their role in the market is relatively small. Life insurance companies in particular should be well suited to fund long-dated fixed mortgages, as they seek the types of low–risk, long-duration returns these provide, but they generally don't operate in this space (other than in equity release mortgages). This is because despite the similar maturity in assets and liabilities, they don't qualify for lower capital requirements under the Solvency 2 matching adjustment rules due to the inherent prepayment risk in mortgages. As a result, they have higher capital requirements, which would then be passed on to mortgages prices through higher rates, making the products unattractive to customers. While there are a very small number of long-term fixed

Fig 1: Fixed Rate Period for New UK Regulated Mortgages



Source: UK Finance

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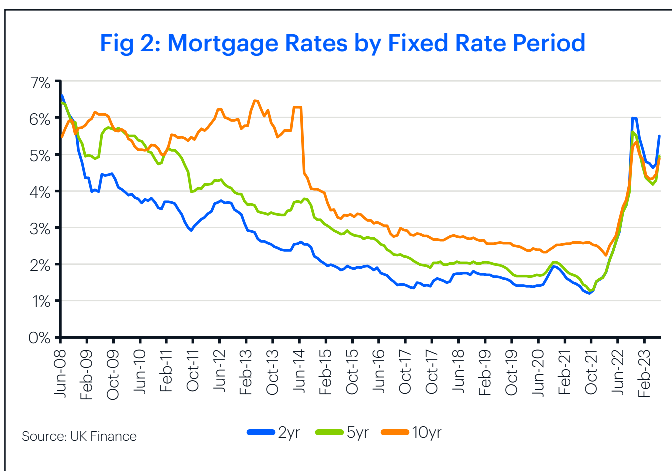
mortgages in the UK, including a product launched by Kensington (but funded through an insurer) in 2021, it remains difficult for these to compete with shorter-dated products on pricing.

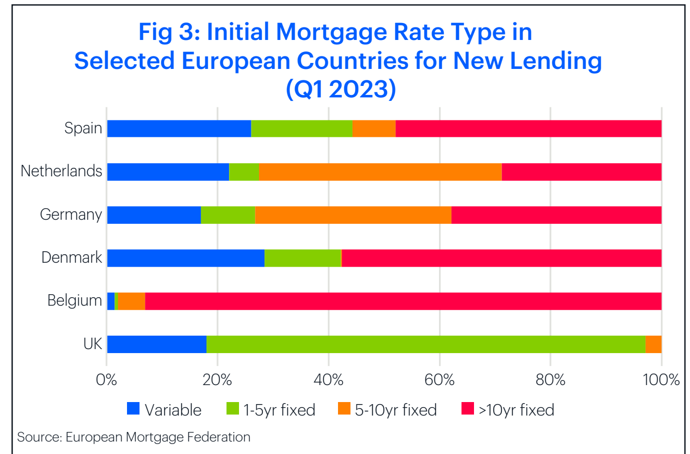
While long term fixed rate products are not common in the UK, they do have the advantage of being very easy for consumers to understand and for brokers to explain. This is important as brokers play a very important role in the UK Mortgage market with over 80% of loans sold via intermediaries in 2022. There is a risk however, that mortgage advisers may be cautious about recommending long term fixed rate loans due to the perceived likelihood of future customer complaints if rates subsequently decrease, and the concern around possible penalties for terminating the mortgage early if the customer's circumstances change and they need to sell the property. It's important that the other characteristics, beyond price, that make the product suitable for customers, including the increased affordability arising from there there being no requirement to stress the loan at a possible higher future variable rate, and the lower risk of payment shocks, are also considered in the advice process. Currently, there is a possible mismatch between broker interests and customer interests as the former's businesses depend on the repeat custom of mortgage holders since each new mortgage comes with a procurement fee. Together these factors create a structural obstacle to these products being sold,and raises the question of whether changes to regulation on mortgage advice should be made.

Nevertheless, while interest rates were at record lows, the strategy of refinancing every few years generally worked well for customers, especially as short fixed-rate products, which are priced attractively over swaps, offered the cheapest rates (fig 2). Their continued availability meant little consideration was given to other products, and changes in teaser rates from one loan to the next were normally minimal. However, the recent rapid increase to interest rates has revealed the downside of this approach, and UK mortgage holders have been impacted by rate shocks in an outsized way compared to borrowers in countries where longer fixed rate products are more prevalent. These rate shocks have fundamental impacts on borrower affordability, and have pass through implications to house prices, leading to greater volatility than seen in countries with mortgages fixed for longer periods.

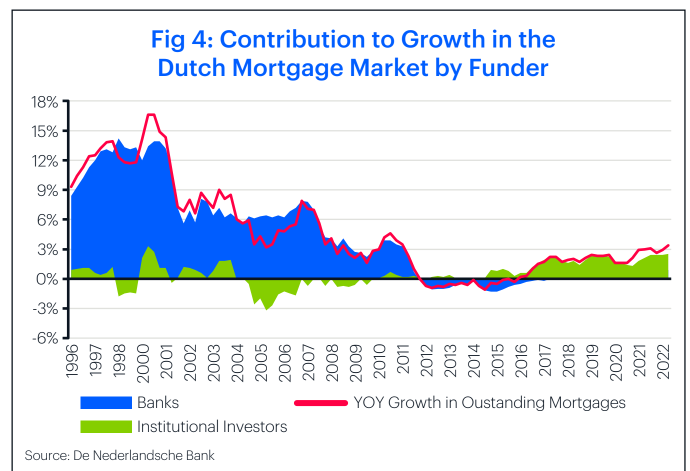


Comparison to Other Countries

The mortgage landscape in the UK is very different to that of both the United States and many countries in Europe. Most European countries have a mix of variable and fixed rate products, with a large share of the latter fixed for long durations, as seen in figure 3. While the numbers vary across countries, the UK really stands out for not having any apparent volume of loans fixed for greater than 10 years.



There is a range of reasons for this, as mortgage regimes vary across countries and in many cases reflect historical developments and cultural preferences. For example, in the Netherlands, mortgage insurance is very common. The Nationale Hypotheek Garantie (NHG), provided by a government backed foundation, guarantees repayment of the mortgage to the benefit of the lender with costs for this insurance paid by the borrower. This guarantee increases availability of mortgages as well as reducing the risks to banks and thereby the cost of loans. There has also been a significant increase in the role insurance firms and pension funds have played in funding the Dutch mortgage market in recent year, with institutional investors accounting for 87% of the total increase in mortgage lending between 2014 and 2021. Over that period, bank's mortgage portfolios grew by €12 billion vs €82 billion for institutional investor portfolios (fig 4).



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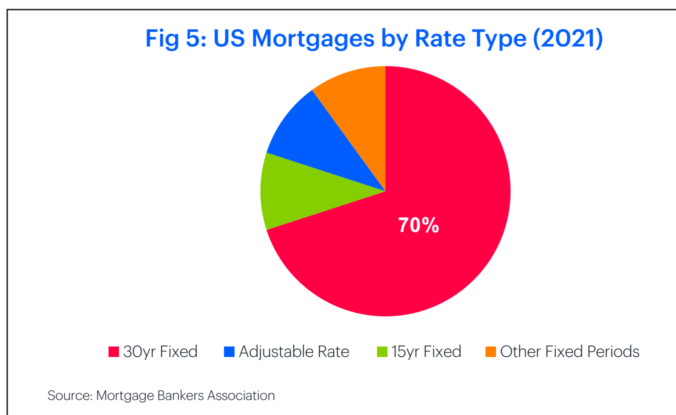
Meanwhile, in Denmark, mortgages are funded through covered bond issuance which match the cash flows of the underlying pool of mortgages exactly, and payments by customers are passed directly through to covered bond investors (less a margin for the lender). Mortgages are highly standardised, and customers can repay their loan at any time without early repayment charges, making long term fixed rates attractive to customers. The prepayment risk is passed from the lending bank on to bond investors. Danish mortgages also have other interesting features, such as allowing customers to redeem their mortgages at the current market price by purchasing the underlying mortgage bonds, which is attractive in a rising interest rate environment if the bonds are trading at a discount. Customers also have the option to "sell" their mortgage along with the property, as part of the property sale. There are however also drawbacks, for example the maximum available LTV on Danish mortgages is 80%.

Fig 5: US Mortgages by Rate Type (2021)



Source: Mortgage Bankers Association

In the United States, the most common product is a 30-year fixed rate mortgage, which accounted for c. 70% of the market in 2021 (fig 5). The key reason for this is the guarantee provided by the big three agencies; Government National Mortgage Association (better known as "Ginnie Mae"), Federal National Mortgage Association (better known as "Fannie Mae"), and the Federal Home Loan Mortgage Corporation (better known as "Freddie Mac"). Ginnie Mae is a government agency and Fannie Mae and Freddie Mac are backed by an implicit federal government guarantee. They operate in the secondary market, purchasing loans from banks and other lenders, and pooling them into securitisations. Similar to the Danish system, these agency mortgages are ultimately financed by the issuance of mortgage bonds, transferring interest rate risk and prepayment risk (but not credit risk) to capital market investors. This allows customers to access affordable long term fixed rate loans with the option to prepay without penalty.

Fig 6: Allocation of Risk in US Model vs Danish Model

	Denmark	United States
Format	Covered Bonds	RMBS
Prepayment Risk	Investor	Investor
Credit Risk	Lender	Fannie/Freddie/Ginnie for agency RMBS, otherwise Investor

Conclusion

While international comparisons are interesting and there are clear advantages to some of the structural elements of products and mortgage funding seen in other countries, they are not a replacement for the existing UK model. There is a clear role for short term fixed rate products, which are a good fit for many customers. However, there is also a case for long term fixed rate loans to become more widely available, especially for first time buyers who benefit from the increased affordability these can provide, as well as the certainty of payments they give, which is increasingly important to customers. For this to happen, institutional investors need to play a more prominent role in mortgage funding, including taking the prepayment risk, which can be achieved through reforms to matching adjustment rules. Consideration should also be given to mortgage advice regulations, to ensure brokers' risks and interests are aligned with those of customers.

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