UK FINANCE

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HOUSEHOLD FINANCE REVIEW - Q3 2022

December 2022

This review explores trends in household spending, saving and borrowing through the third quarter of 2022. The ongoing war in Ukraine, escalating inflation and energy prices and the market turmoil created by the September fiscal event have put upward pressure on interest rates and seen consumer confidence fall below already record low levels. Here we look in detail at how this has affected household spending and borrowing patterns to date.

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With consumer spending remaining relatively strong overall in Q3, and house purchase activity broadly consistent with pre-pandemic trends, it might seem the full impacts of surging inflation and higher interest rates had yet to feed through to UK households. But a deeper dive into the data reveals signs of increasing financial stress for at least some consumers.

The clearest indicator is the continuing decline in consumer confidence, which fell even further from its already record lows, perhaps partly reflecting the political and economic turmoil that followed the September mini-budget. While greater stability has now returned, other findings confirm that people are bracing for tougher times ahead.

For example, personal borrowing to fund larger purchases fell during the quarter. And half of the borrowers taking out a mortgage opted for terms over 30 years, seeking to stretch affordability. What's more, 1.8 million fixed-rate mortgages are scheduled to mature in 2023. As these borrowers look to refinance, the new rates will put real pressure on their disposable incomes after paying for basic expenditures.

There are also two aspects to banks' responses towards customers. On the one hand, they're taking steps to help households weather the storm, providing advice and developing propositions to help improve financial literacy and support saving. On the other, financial stress for households is already translating into operational stress for banks, as their contact centres deal with a rising tide of queries and requests.

As a result, banks face the twin challenges of keeping pace with customers' needs at a difficult time while also acting to reinforce their operational resilience. I believe a big part of the solution in each case will be better and smarter use of data and AI to zero in on actionable insights. This is just one of the actions banks can take now to not only ride out the turbulence – but also to accelerate their own transformation and ensure they're future-ready.

Q3 2022 HIGHLIGHTS

- Despite the continuing collapse in confidence during Q3, spending remained strong overall, although inflation masked weaker activity in some sectors.
- Personal loan borrowing to fund larger purchases fell away, suggesting the “make hay while the sun shines” effects seen in Q2 may have abated.
- House purchase activity remains on trend with pre-Covid-19 levels but weakness is expected ahead in the face of increasingly stretched affordability and a softer labour market in 2023 as we head into a recessionary period.
- Refinancing remains robust by virtue of a strong maturity schedule, but inflation and interest rate rises make the prospects yet more challenging for the 1.8 million fixed rate loans set to mature next year, with significant numbers seeing the flex in their budgets eroded.
- There are tentative early signs of stress in unsecured borrowing, but aggregate data likely masks more significant difficulties among lower-income cohorts. Headline mortgage arrears were essentially flat overall, but earlier arrears rose, suggesting that the expected upturn in the arrears cycle may have begun as cost-of-living increases and higher interest rates begin to take their toll.
- Even with an expected softening in the labour market and escalating cost-of-living pressures, we anticipate most customers will be able to maintain payments, while business as usual forbearance options offered by lenders to customers in difficulty will help them

UK ECONOMIC CONTEXT AND OUTLOOK

The main economic news during the period covered by our Household Finance Review was the September “mini budget” and the market turmoil which followed. However, the implications for consumers and household finances will only be evident in our data in the quarters ahead.

The September mini-budget brought forward a large package of support for households and businesses in the face of rising energy bills as well as substantial tax cuts for higher rate taxpayers and corporations. While the then chancellor pitched the measures as focused on boosting the UK’s trend rate of growth, the lack of accompanying forecasts from the Office for Budget Responsibility (OBR) and concerns that the scale of the package would result in large rises in government borrowing spooked financial markets. The result was a sharp increase in long-dated gilt yields and a fall in sterling. The impact on the real economy was a spike in mortgage rates, with some lenders removing products from the market to reprice and also in response to a surge in demand.

A change of chancellor (and a few weeks later a change of prime minister) and a reversal of many of the budget announcements, including reducing the duration of the energy price support package for households, restored some calm to financial markets. Bond yields eventually fell back to pre-budget levels, the pound saw a recovery and expectations of the extent of monetary tightening by the Bank of England lessened. More normal service in the mortgage market, in terms of product availability, also resumed.

The government has since delivered the Autumn Statement in November, alongside which the OBR produced its economic and fiscal assessment of the package and the outlook for the economy. Despite undoing much of September’s significant fiscal loosening, the rise in debt servicing costs led the chancellor to announce further measures to stabilise the public finances and bolster financial market confidence in the government’s fiscal credentials.

Policies that will be felt by households included freezing personal income tax thresholds and lowering the threshold for the top rate of tax. However, there was more targeted support for households in the face of high energy costs and cost-of-living pressures, including a means tested £900 cost-of-living payment next year and a commitment to maintain the pensions triple lock. Additional health and education investment was also announced.

Overall, the OBR judged that the various fiscal packages have led to a material increase in government borrowing this year and next compared with its March 2022 forecast, but with borrowing starting to come down thereafter and debt to GDP stabilising at the end of the forecast period. While there is an increase in spending and borrowing in the near term, the OBR assessed the package of measures to be supportive of economic growth against a challenging global outlook.

Which brings us to the economy. The backdrop to this Q3 review is a further slowing in the economy, with GDP falling by 0.2 per cent in the three months to September after a modest and upwardly revised 0.2 per cent increase in the previous quarter. The sector picture was mixed with construction output rising, production seeing a marked decline and services activity flat. Within services, however, there was some weakness in consumer-facing services and retail, pointing to emerging signs of cost-of-living pressures feeding through to economic output. Notably, combined with ONS revisions to previous data, the fall in Q3 means the UK economy remains smaller than before the Covid-19 pandemic. Indicators such as the purchasing managers’ indices point to further weakness ahead.

Indeed, the OBR forecasts (the most relevant guide to the outlook as they incorporate the detail of the Autumn statement) show GDP contracting by 1.4 per cent in 2023. The UK is already in recession and is not expected to emerge from it until late 2023. A near two per cent decline in household consumption is the main contributor to the fall. Households' disposable income is under pressure, as we have discussed in previous reviews and will be a theme in this one, and the OBR expects the squeeze on real incomes to be more than three per cent this year and next. There is also expected to be some run down of the savings accumulated during the pandemic to support household spending.

Persistent inflation is the culprit. CPI inflation rose to its highest level since 1981 – 11.1 per cent – in October, driven by high energy costs and accelerating food price inflation. The OBR and the Bank expect the peak to be around this level in the final quarter of 2022, with analysis suggesting that the energy price package will result in CPI coming in lower than might have been the case in its absence.

High inflation is expected by both the Bank of England and the OBR to present well into 2023. To that end, the MPC increased Bank Rate by 75 basis points in November to three per cent. While market expectations on how much further the Bank will hike rates have moderated since the October turmoil, further rate rises are expected into mid-2023. However, the Bank and some MPC members have communicated that rates are not likely to peak as high as market predictions (over five per cent when the November forecasts were published). To that end, the average forecast across those published by HM Treasury is for Bank Rate to end 2023 at four per cent.

In addition to higher inflation, which is global in nature and in large part one of the economic consequences of the war in Ukraine, the UK labour market also remains tight. Unemployment edged down further in the three months to September compared with the previous quarter to 3.6 per cent, and while vacancies dropped back again in the quarter they remain at historically high levels. In addition, wage growth remained elevated at six per cent in September, although the stark gap between public and private sector pay growth (2.4 per cent and 6.8 per cent respectively) is worth noting.

The overall outlook is slightly gloomier than three months ago. While the fundamental challenges of high inflation, squeezed households and slowing global growth remain broadly as they were three months ago, these have been overlayed with the recent political, and resulting economic, uncertainty. In addition, the reality of higher energy costs will now be starting to really bite as we head into winter. For many households this will feel like a deeper recession than the headline numbers might imply.

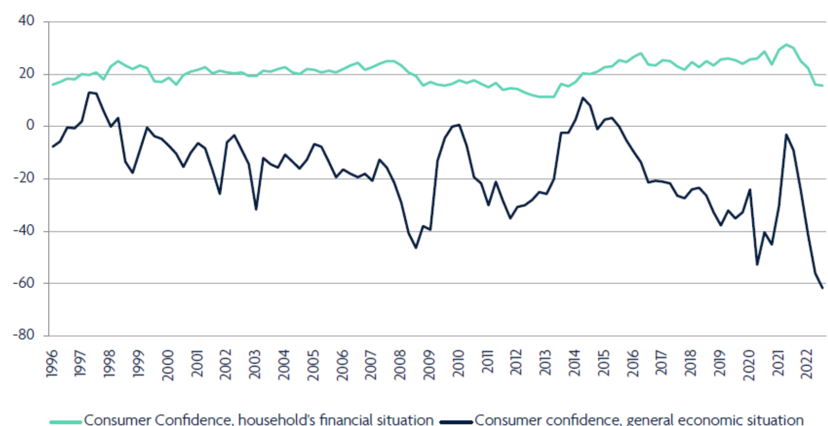
CONFIDENCE SINKS FURTHER AS INFLATION BITES

In Q2, as households began to feel cost-of-living pressures weigh more heavily on their finances, consumer sentiment saw a dramatic collapse, to record low levels not seen either during the pandemic or at the height of the Global Financial Crisis (GFC) – the two previous troughs in confidence indicators.

In Q3 the nation's mood came under further assault from continuing rapid inflation, even starker warnings of the extent of future energy and wider price increases to come and, finally, the turmoil caused by the September mini-budget and the resulting market dislocations.

In the face of this, sentiment plunged yet further below these already-record lows. Households' confidence in the economy fell to an all-time low reading of -62, although the continued collapse in confidence readings did at least slow in pace compared to the fall seen in Q2 (**Chart 1**).

Chart 1: Consumer confidence



SOURCE: GfK

Households' confidence in their own position stabilised, but at a weak level. However, this likely reflects the fact that while the market impacts of the mini-budget were immediate and starkly negative, they did not have an immediate impact on consumers, with second order effects (including on inflation and interest rates) yet to come.

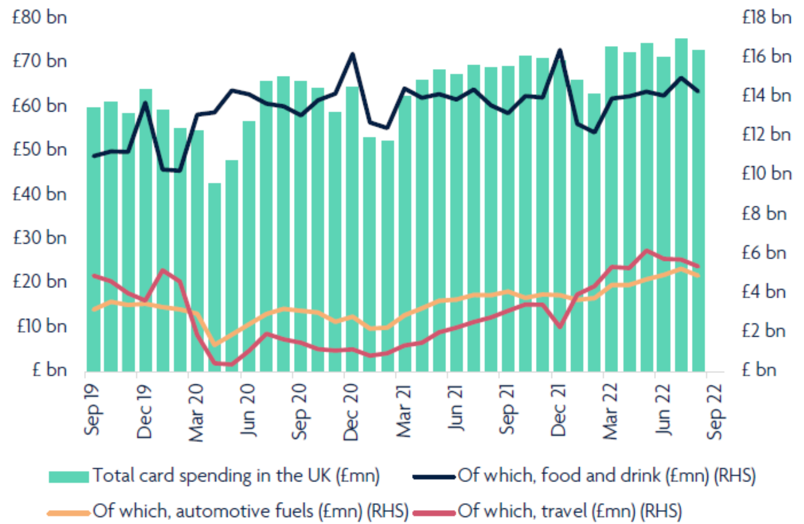
SPENDING STILL HOLDING UP RELATIVELY WELL SO FAR...

Despite record weak consumer sentiment, card spending continued to hold up relatively well overall, both in terms of number and value of transactions.

Inflation continues to place pressure on household budgets, including on weekly essentials, with shortages in grain and cooking oil in particular arising from the ongoing war in Ukraine, leading to significant and rapid increases in the price of staple foods. This was reflected in a further increase in card spending on food and drink spend in supermarkets in the quarter (**Chart 2**).

Partly offsetting this, however, was a decrease in spending in the travel sector. This had seen significant growth in Q2 as households returned in numbers to take the foreign holidays which Covid-19 had prevented for the previous two years. However, as we signalled in our Q2 Review, airline and airport capacity-linked restrictions on flights - a ripple effect from the lay-offs seen in that industry through the Covid-19 era - put a brake on demand in Q3.

Chart 2: Card spending in month



SOURCE: UK FINANCE

Although by far the greatest decline within the travel sector was seen in spending on flights, other holiday-related expenditure items also fell away somewhat. It is likely that at least some consumers opted to cut back on this (debatably) non-essential expenditure as price rises for more unambiguously essential items have seen their household budgets become increasingly squeezed.

While consumers anticipate yet harder times ahead – as reflected in the consumer confidence figures – we have not yet seen the full effect of the energy price increases, which took effect in October. The government support for households on energy bills will mitigate, but not fully defray, these increases and the now time-limited nature of the current support package leaves uncertainty as to the prospects for household budgets from next spring. While the Autumn Statement brought forward additional cost-of-living support for those on benefits and for pensioners, the forecast pressure on real incomes that will extend well into next year will bear down on spending.

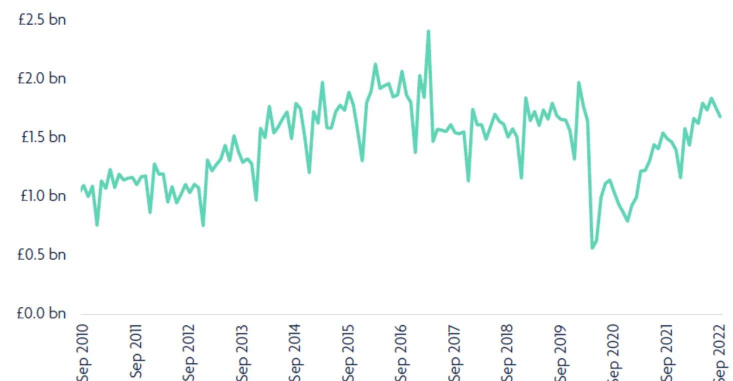
To that extent, spending may be in something of a holding pattern through Q4 and into the new year. The continuing pressure from non-energy inflation will, however, continue to take its toll, particularly on lower-income households for whom food and drink and other essential spend items are a greater share of wallet.

...BUT PERSONAL LOAN BORROWING SHOWING LIMITED SIGNS OF SOFTENING

Having seen strong growth through the first half of 2022, borrowing via unsecured personal loans - generally used to fund larger purchases – dropped away somewhat in the third quarter (**Chart 3**).

In our Q2 Review we suggested that some of the earlier strength in borrowing (and in card spending), even as prices rose rapidly, was driven by a "make hay while the sun shines" rationale. That is, some households were electing to buy more expensive items, such as white goods and holidays, while they were still affordable, anticipating that they may become out of reach in the near future.

Chart 3: Amounts of new personal loans from banks



SOURCE: UK FINANCE

The drop off in borrowing activity now may indicate that this behaviour has run its course (or, even that the tipping point of affordability has been reached). However, these data are somewhat volatile from month to month, and more data points over the next few months are required to confirm this.

IMPACT OF TEMPORARY MARKET DISRUPTION FROM THE MINI-BUDGET WILL NOT BE SEEN UNTIL Q4 DATA

In the final days of the third quarter, the extreme negative market reaction to the mini-budget caused a temporary disruption to product availability and pricing in the mortgage market. While short lived, a number of fixed rate mortgage products were temporarily withdrawn from the market. Lenders were unable to immediately price these products due to the extreme volatility in the forward money markets used to fund fixed rates, and those lenders with products still on the market were overwhelmed with demand levels amid this reduced supply. Alongside this, there was an upwards re-pricing of fixed rate deals available.

In the days and weeks that followed, product availability rose and is currently approaching the levels seen immediately prior to the mini-budget, as much of the content of that package was rolled back and money markets readjusted. Pricing too has edged back down to reflect that readjustment in the funding markets.

Mortgage market activity in Q3 does not reflect any of this period of turmoil, as virtually all mortgages completed by the end of the quarter were arranged well before the mini-budget announcements were made. Any resulting impacts on mortgage activity would, therefore, not be seen until the final quarter of this year.

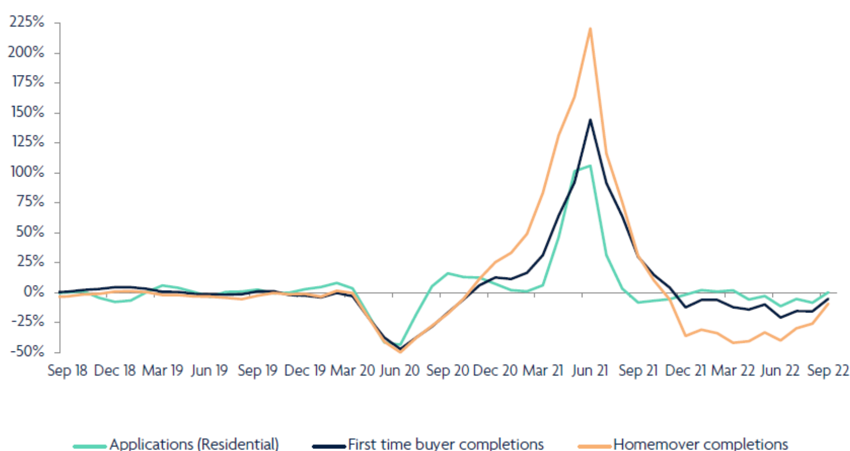
HOUSE PURCHASE ACTIVITY IN Q3 BROADLY FLAT YEAR-ON-YEAR FOLLOWING POST-STAMP DUTY HOLIDAY ADJUSTMENT

House purchase borrowing activity, having seen continuous year-on-year contraction since Q4 2021, rose through the third quarter to reach a little under the levels seen in Q3 2021 in the final months of the stamp duty exemption (**Chart 4**).

The earlier year-on-year contractions were in line with expectations, as the elevated levels during the stamp duty holiday were not expected to continue, with many purchases brought forward from this year (and possibly beyond) to take advantage of the tax break.

Looking ahead to the final months of the year, mortgage applications recovered from a position of annual contraction to a broadly flat year-on-year picture by the end of Q3, suggesting completions in Q4 will be similarly flat. Within this, however, there is likely to be a divergence between remortgaging, which we expect to show continued growth with still-strong levels of borrowers coming off fixed rates looking to refinance, while house purchase is likely to start to soften, in the face of tighter affordability and weaker market sentiment.

Chart 4: Mortgage applications and completions, 3-month moving average, year-on-year change



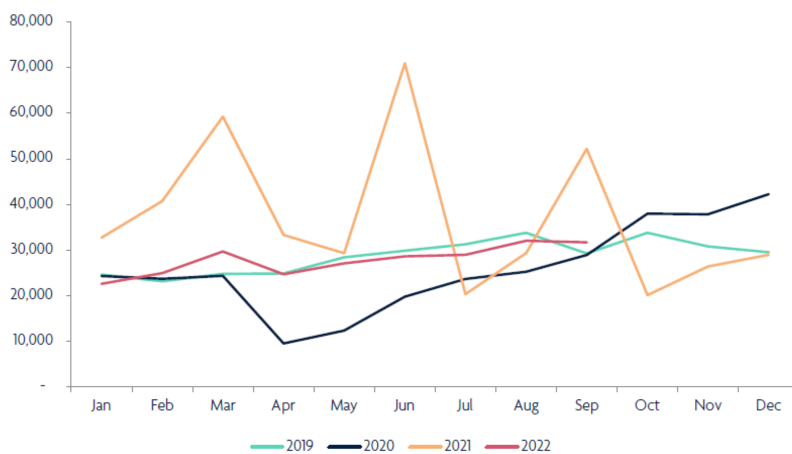
SOURCE: UK FINANCE

FOR NOW, PURCHASE ACTIVITY REMAINS BROADLY IN LINE WITH PRE-COVID TRENDS

Year-on-year comparisons, whether of housing market activity or other indicators of consumer and economic behaviours, remain difficult to interpret because both last year and the year before were anything but normal. Pandemic-related distortions have pulled activity levels first one way and then another, in ways which bear no resemblance to historic norms.

However, after stripping out the dislocations of the past two years, first from the social and economic upheaval caused by Covid-19, and then from the stimulus effect of the Stamp Duty holiday, we can see that borrowing for house purchase has followed a trend path closely resembling that of the period immediately before the pandemic in 2019 (**Chart 5**).

Chart 5: Number of loans to homemovers, 2019 to 2022



SOURCE: UK FINANCE

Overall, this suggests that 2022 activity resembles something like a "normal year" of house purchase activity. Although Q4 has the potential to change full-year outturn in either direction, the applications data we have to date suggest that any divergence from the current path is unlikely to be significant in the final months of the year.

Looking beyond this year, however, a softening of demand is expected. Although house price growth looks to have peaked in Q1 this year, September figures for all the major indices put annual growth around the ten per cent mark, well in excess of wage growth. This, combined with rising interest rates, mean that affordability is likely to be a barrier for more would-be buyers next year. Beyond this, the onset of a protracted, if shallow, period of recession, and a more challenging labour market environment, all point to weaker demand.

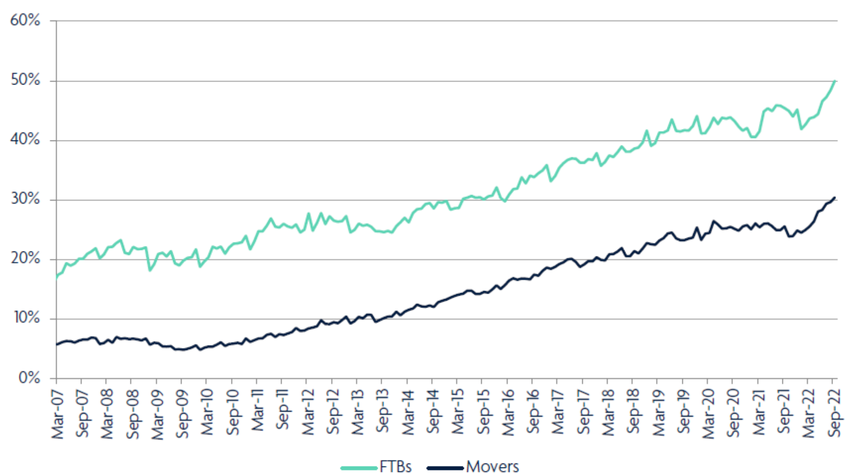
AFFORDABILITY STRETCH BY EXTENDING TERM ACCELERATED OVER 2022

While the past two years have seen rapid house price growth, we have not seen a commensurate rise in the income multiples at which new borrowers take out mortgages. In fact, the typical FTB income multiple fell slightly through Q3.

Rather, we have seen the incomes for new borrowers rise, with the average income used for a FTB mortgage application in Q3 standing at a shade under £60,000, 17 per cent up on the same quarter last year. During this time, wage growth has been well below this, leading to a shift towards higher-income households being the ones entering the market.

For those on lower incomes or otherwise affordability-constrained, FCA rules in place since 2015 limit many potential options used in previous generations to stretch affordability in order to qualify for the mortgage they need. However, one avenue still open is to borrow over a longer mortgage term. This reduces the monthly payments, although the total sum repayable will be greater. However, given that most FTBs will move house well before that first mortgage reaches the end of its term, the cost over time may be a more minor consideration for many.

Chart 6: proportion of new house purchase mortgages taken out with over 30-year term



SOURCE: UK FINANCE

As **Chart 6**, shows, the proportion of mortgages borrowed over longer terms has increased, almost continuously, since the GFC through to the start of the pandemic. Since late 2021, however, we have seen this proportion rise much more sharply.

By the end of Q3, one half of all FTBs, and over a quarter of home movers, were borrowing at over 30-year terms. This compares with around a quarter of FTBs and fewer than one in ten homemovers just ten years ago.

While this is a relatively low-risk option for borrowers to increase their borrowing potential, it does, however, limit the ability of borrowers to save or invest in other areas – for example their pensions – for a longer period while they are still paying off their mortgage. In the long run then, this may have wider implications, both at the individual and wider societal level. It also limits the potential to use term extension as a forbearance tool, should the customer subsequently experience a period of financial difficulty.

CONSUMER SPENDING AND LENDING: SUMMARY

At this stage, neither the escalating cost-of-living pressures gripping the country nor the deterioration in consumer confidence have resulted in a drop off in either spending overall, or in house purchase borrowing activity. There are, however, some signs that patterns within overall spending may be adjusting, with some softening in demand for non-essentials. Looking ahead, underlying consumer spending, after stripping out the effect of price growth, is likely to come under increased pressure, with food and energy taking up an increasing share of wallet and leaving less for other items. At the same time, borrowing for house purchase is expected to soften in the face of the twin headwinds of tighter affordability and a deteriorating economic backdrop.

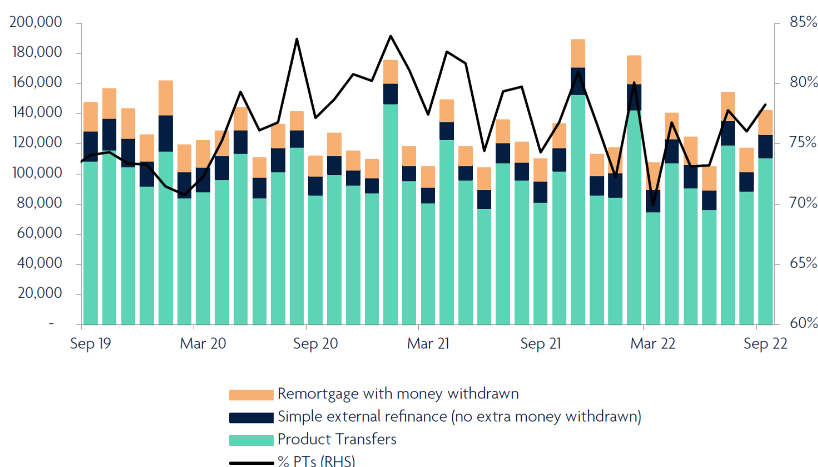
REMORTGAGORS SHIFTING TOWARDS USE OF BROKERS TO FIND A GOOD DEAL ON THE OPEN MARKET OR ELSE TAKING NEW DEAL WITH THEIR EXISTING LENDER

Refinancing activity was relatively strong in Q3. However, in contrast to the growth in external remortgaging seen in Q2, there was a shift back to internal product transfers (PTs) in Q3 (**Chart 7**).

The split between internal and external refinancing is, to an extent, driven by the maturity schedules of individual lenders and their retention strategies. However, it is also likely that this is partly the result of the much tighter affordability situation faced by borrowers in the face of rising cost-of-living and interest rates, with PTs not subject to the same degree of affordability assessment as external remortgage.

As we highlighted in Q2, while borrowers still typically had a good degree of wiggle room in their budgets even after taking into account increased mortgage payments after refinancing this year, around one in five borrowers could have less than ten per cent of their income left over. At these low levels, some may find external remortgaging options more limited.

Chart 7: Number of residential remortgages and internal product transfers



SOURCE: UK FINANCE

Also reflecting this increased difficulty in finding a remortgage deal on the open market, Q3 saw a rise in sales of remortgages – both with and without equity withdrawal – arranged via a broker. While intermediaries account for the majority of most mortgage sales, those looking to refinance – who by definition are more experienced in the mortgage market – are somewhat less likely to use a broker. It is likely that this increased reliance on brokers through Q3 reflects the greater difficulty in finding a suitable remortgage deal on the open market.

We expect refinancing activity to remain strong in Q4 and into 2023, with 1.8 million customers set to reach the end of their fixed rate deals next year. The ongoing challenges around affordability in the face of rising interest rates and cost-of-living point towards a continuation of the current strength in internal PT markets and greater reliance on intermediaries to source external remortgage deals.

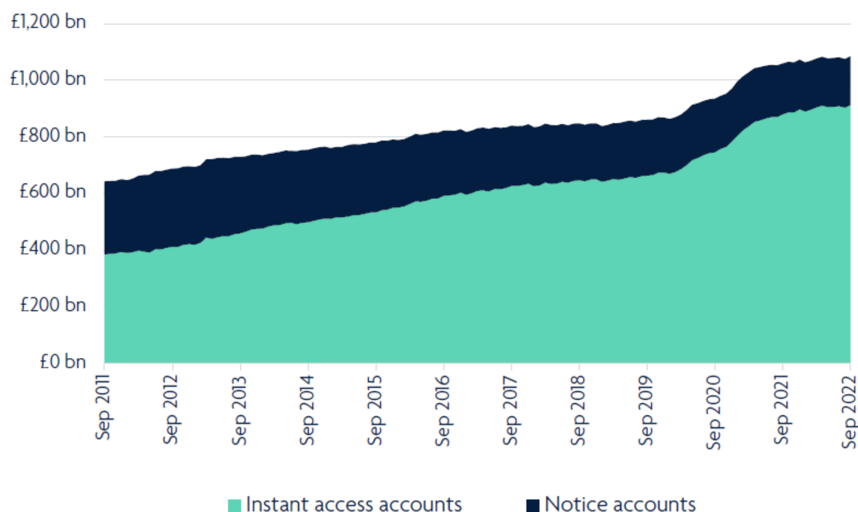
HOUSEHOLD DEPOSITS STATIC THROUGH Q3

Following the period of rapid growth in household savings through 2020, as social restrictions reduced spending, deposit growth began to ease through 2021 with the lifting of restrictions and the commensurate rebound in consumer spending. By Q2 2022, this growth had ground to a halt, as the escalating cost of living put pressure on household budgets and limited the potential to save.

Deposit levels remained static in Q3, as these pressures continued to increase. However, at this stage we have yet to see any decumulation in savings at the aggregate level (**Chart 8**).

Within the aggregate, however, there is likely to be a divergence of experience. Those households who had been able to build up excess deposits are typically those on higher incomes, while those on lower incomes, who spend a greater proportion of their income on essential items, were less able to do so.

Chart 8: Personal deposit account balances



SOURCE: UK FINANCE

As cost-of-living pressures build this higher-income cohort of households will also find a more constrained capacity to save. Some, in particular those at the lower end of the income scale, may now be drawing down on those previously built-up savings. At this stage, however, any such decumulation is offset by others who are still able to save a proportion of monthly income – potentially as a precautionary measure - leading to the overall flat picture.

As cost pressures continue to rise, including those from increased mortgage payments following refinancing, we are likely to see deposit levels fall somewhat as some households start to draw on savings to cover their increased costs. In that respect, a second order effect of the pandemic is that a proportion of households do at least have this additional savings buffer, which they otherwise might not have been able to build up ahead of this period of cost pressures.

While interest rates on notice accounts have risen sharply over recent months, real rates have fallen due to the more rapid pace of inflation over the same period. Beyond the negative real return on longer-term savings, households with the ability to save will be acutely aware of the rising cost pressures felt across the country. As costs continue to rise there is little incentive to tie up money in notice accounts if it may soon be needed to cover monthly outgoings, particularly if the real rate of return remains negative (albeit far higher than for instant access accounts). As such, deposits held in notice accounts have continued to gradually fall through the quarter.

HOUSEHOLD REFINANCING AND SAVINGS: SUMMARY

Mortgage refinancing continues to show robust activity as borrowers on fixed rates reach the end of their deals and look for new ones. But, with rates rising and affordability more pressured, borrowers are looking more to brokers and internal Product Transfer markets for their follow-on deals.

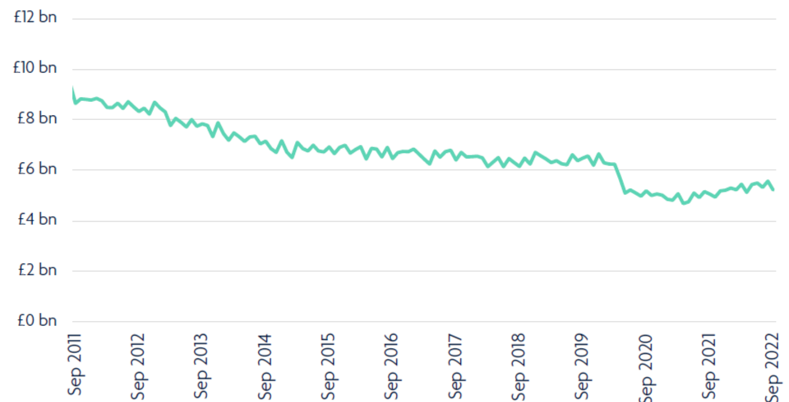
On the savings side, the static nature of aggregate household deposit data likely masks a degree of decumulation of savings bult up by some households during the pandemic who now need to draw on these excess savings to cover the rising cost of living.

OVERDRAFT UTILISATION TICKS UP SLOWLY

As with the static picture on household savings we are not, as yet, seeing any sign of household stress from cost-of-living pressures reflected in overdraft utilisation. Rather, overdraft debt continues to tick up but, because of the widespread paying-down of overdrafts seen during the pandemic, aggregate levels still remain well below those seen before the pandemic (**Chart 9**).

It is also probable that, as with savings, the tick-up is concentrated amongst lower-income households, with less flex in their budgets to absorb cost-of-living pressures and who were less able to build up savings during the pandemic to now draw upon.

Chart 9: Overdraft balances outstanding



SOURCE: UK FINANCE

CREDIT CARD DEBT GROWTH EASING OFF

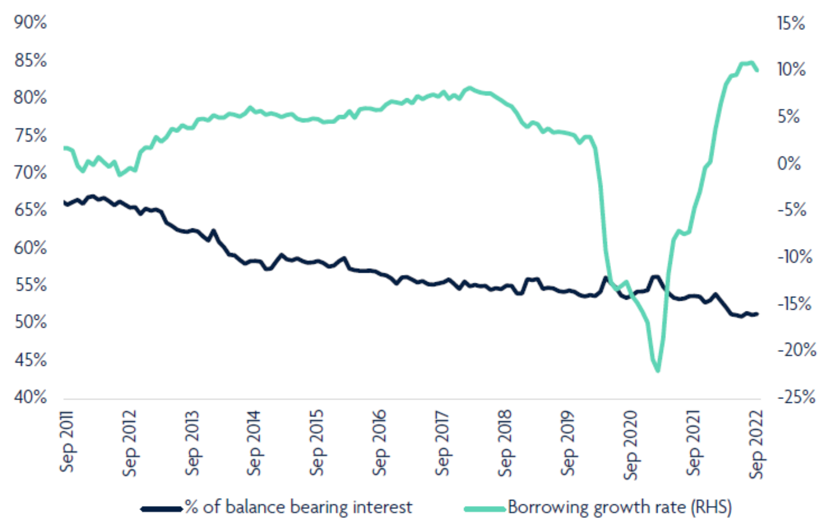
Growth in outstanding credit card debt eased a little in Q3, having reached ten per cent annual growth in Q2 as activity recovered strongly from the prolonged period of contraction seen through the pandemic when social restrictions restricted the avenues for spending (Chart 10).

This easing is likely to reflect reduced activity in some areas which are more discretionary – for example the drop-off in spending for travel that we noted earlier in this Review.

However, in another potential indicator of payment stress, the long-term decline in the proportion of balances that are interest bearing – seen since at least 2011, stalled in Q3. In fact, the number and proportion of credit card balances attracting interest rose marginally.

Although there are a number of potential contributing factors, including the availability of interest-free offer periods for new accounts, it is likely that this tick up largely reflects a small increase in consumers unable to fully pay off their credit balances in the month in the face of escalating costs.

Chart 10: Credit card balances outstanding



SOURCE: UK FINANCE

Overall, while changes in these aggregate data are modest, they are suggestive of an overall picture of the escalating cost-of-living beginning to take its toll, leaving some households struggling to cover monthly expenditure from monthly income. Such issues generally manifest themselves first in the unsecured data such as that shown above, before any feed-through to mortgage payments, as households typically prioritise mortgage payments above other debt.

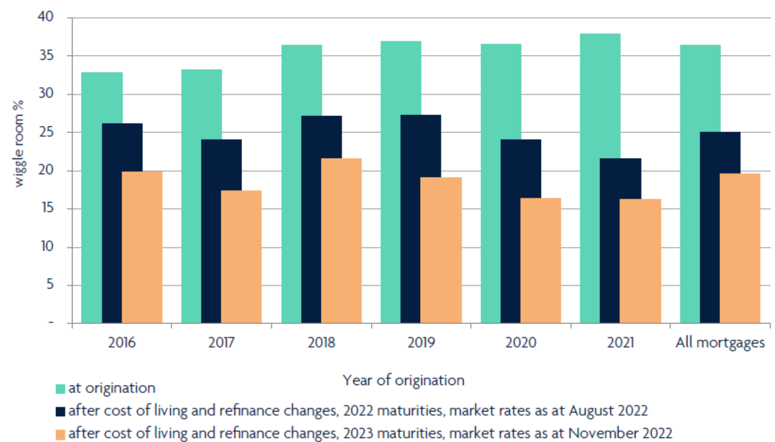
PROSPECTS FOR MATURING FIXED RATE BORROWERS ARE STILL MORE CHALLENGING NEXT YEAR

In our Q2 Review, we looked at the impact of rising cost-of-living and the feed-through of Bank Rate increases to mortgage rates on the "wiggle room" that existing borrowers would have when looking to refinance off their maturing fixed rates. Our analysis showed that borrowers looking to refinance this year would see a reduction of about 11 per cent of the wiggle room in their budgets, leaving one quarter of their net income left over after refinancing onto a new deal rate.

Since then, we have seen pricing on new mortgages jump significantly in the wake of the market reaction to the mini-budget, as the funding cost to lenders for fixed rate mortgages rose sharply.

Updating our analysis, but now looking at 2023 maturities (given 2022 is nearing an end), suggests the average borrower looking to refinance their maturing fixed rate next year would see a reduction of around 17 per cent of their disposable income, compared to the position at origination. This would leave just under one fifth of net income left over (**Chart 11**).

Chart 11: Wiggle[1] room in mortgagors' budgets, maturing fixed rate mortgages



SOURCE: UK FINANCE

Notes:

1. Wiggle room defined as the proportion of net income left after subtracting mortgage payments, basic household expenditure and credit commitments.
2. Expenditure is indexed by reference to CPI inflation seen since mortgage origination, and net income indexed by reference to average wage growth. Confirmed increases to National Insurance Contributions (NICS) are factored into net income. Any confirmed or unconfirmed changes after the time of writing are not included.
3. Refinancing rates are calculated using Moneyfacts data on rates available at different LTVs, estimating current LTV using house price and mortgage balance changes since the time of origination.

For some, and particularly amongst lower-income groups, the hit to wiggle room is greater. Overall, over one third of borrowers refinancing next year could have less than ten per cent wiggle room, post-refinancing. And, for those in lower-income brackets (under £30,000 net income) this rises to almost one half of borrowers.

These mortgagors are likely to find their options to refinance more limited on the open market, although internal PTs, which are not subject to the same affordability tests, remain available from most lenders. As we noted in the refinancing data set out earlier in this Review, we are already seeing something of a shift towards internal refinancing, as well as a greater reliance on brokers to source a deal for those looking at the wider market.

However, while most borrowers will be able move onto a new deal, the vast majority will nonetheless see their mortgage payments rise sharply, adding to the overall increased burden on household budgets. Although we expect the majority to absorb these increased costs and maintain mortgage payments (albeit with some tightening of belts in many cases), it is nonetheless likely to place some upward pressure on arrears.

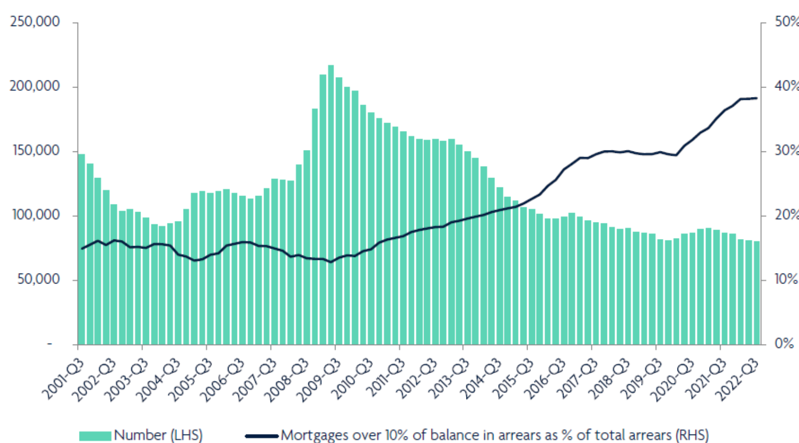
NO INCREASE IN HEADLINE ARREARS AS YET, BUT TENTATIVE SIGNS OF DETERIORATION TO COME

Despite the mounting pressures on household finances explored in this Review, including the compounded effect of bank rate rises totalling 200 basis points since the start of the year through to the end of Q3, there has been no impact on headline mortgage arrears numbers.

In fact, arrears overall continued to fall in Q3, albeit that the decrease compared with Q2 was very small. At the end of Q3, there were a total 80,180 mortgages in arrears representing over 2.5 per cent of the outstanding mortgage balance, 540 fewer than at the end of Q2 (**Chart 12**)

Although increases in Bank Rate have fed through to mortgage rates, the fact that nearly 80 per cent of borrowers are on fixed rates means only one in five mortgage customers saw immediate impact of these increases. Adding to this, the vast majority of those mortgages currently on variable rates are considerably older, with commensurately smaller balances. Therefore, the increase in mortgage payments for these customers, while material, has been typically lower than would be seen for the average borrower.

Chart 12: 1st charge homeowner and buy-to-let mortgages in arrears[1]



SOURCE: UK FINANCE

Notes:

1. Arrears measured as those representing more than 2.5 per cent of outstanding mortgage balance

The 80 per cent of borrowers who are on fixed rates – which includes almost all new borrowers – are shielded from rate rises for the period of their fixed rate deal. However, most of these borrowers will see materially increased payments when they come off these fixed rates, including the 1.8 million fixed rate deals set to mature next year. Again, we expect most to be able to absorb these increased costs and maintain their mortgage payments, but there will inevitably be some upwards pressure on arrears, and this is more likely among lower income mortgaged households who will also be feeling the wider cost pressures more acutely.

Although headline arrears continued to fall, we have seen some modest increase in the lightest bands of arrears (those representing less than 2.5 per cent, which do not form part of our headline metric).

The numbers within this category are subject to volatility, and hence excluded from headline metrics. However, this rise in early arrears was expected as the cost-of-living and interest rate rises through the year eventually fed through to mortgage payments. We expect this to then feed through into an increase in headline arrears – potentially from Q4 – as these pressures weigh more heavily on borrowers, particularly for those on variable rates and for those with higher payments following refinancing.

However, the key driver of increases in mortgage arrears has historically been unemployment. Although this is forecast to increase next year, the anticipated rise would still leave the rate relatively low by historic standards, which suggests the resulting upwards pressure on arrears from unemployment could be relatively limited. Nonetheless the headwinds of inflation, interest rates and a worsening labour market environment all point towards a period of rising mortgage arrears ahead.

Regardless of scale, any increase in payment difficulties is of concern and it is crucially important that customers worried about paying their mortgage speak with their lender at the earliest opportunity. Lenders have a range of forbearance options which they can explore to develop an appropriate, tailored repayment plan relevant to the borrower's circumstances.

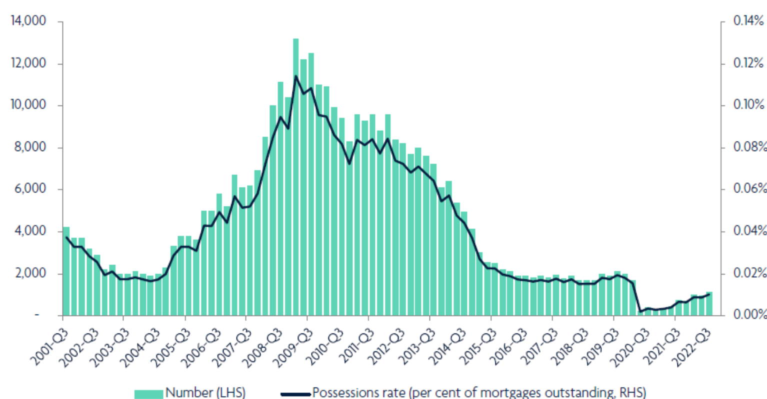
MORTGAGE POSSESSIONS ROSE IN Q3 AS THE MORATORIUM BACKLOG IS CLEARED, BUT NO RAPID ESCALATION EXPECTED

Possessions numbers continued their slow increase from the near-total cessation of activity through the early months of the pandemic, as lenders work through cases put on pause through the moratorium at that time.

There were some 1,120 possessions in Q3, up from 960 in Q2 (**Chart 13**). However, this remains substantially lower than previous norms, even compared with 2019 which was itself a low point in the cycle.

While rising possessions numbers are always unwelcome it is crucial to keep in mind that these are historic cases which relate to long-term arrears, built up over a period of years and further exacerbated by the dislocations of the Covid-19 era. Currently, the majority of arrears cases relate to mortgages taken out some time ago, in particular the period of elevated market activity in the run-up to the Global Financial Crisis. Since then, house price growth over the past decade means that there are virtually no mortgages now in negative equity, but each additional month of arrears eats into a customer's equity stake. These long-term arrears cases therefore now need to take place in a timely manner to help these customers exit unrecoverable mortgage arrears positions and realise the greatest amount of remaining equity, rather than allowing any further build-up of arrears to erode this further.

Chart 13: 1st charge homeowner and buy-to-let mortgages in arrears



SOURCE: UK FINANCE

As very few new arrears cases have arisen through the same period, there is no material "new" possessions activity currently taking place, nor is this expected in the near term, and possessions numbers will continue to be largely made up of historic cases for the next few quarters at least.

Should arrears begin to increase from Q4 onwards as we expect, this would not feed through to possessions activity – for that small minority for whom forbearance options cannot help them recover their positions – until around the back end of 2024 in most cases.

HOUSEHOLD DEBT: SUMMARY

With three quarters of data now available, the growing headwinds facing household finances have not, as yet, translated into an increase in headline mortgage arrears. However, the early indicators, both from secured and unsecured market data, point to this changing. We expect arrears numbers to rise, either by the end of 2022 or shortly after.

Although the economic situation is hugely uncertain at present, with risks both on the upside as well as down, our current expectation is for a moderate increase in arrears through 2023 and 2024, and for possessions to rise only gradually through this period. The industry stands ready to help all borrowers facing difficulties, and it is imperative that customers facing financial difficulty speak to their lender early so that they can develop an affordable solution, tailored to their specific circumstances, to help them through this challenging period.

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