Bank of England is Missing a Trick

The Bank of England's effort in the November Inflation report to provide comfort around the risks associated with variable mortgage rates was, in a word, one-sided. Hopefully this is a purposeful effort to allow the BOE the time and space needed to resolve the problem without drawing too much attention to this structural vulnerability. More likely than not, the lack of proper analysis of the vulnerability is what it seems….complacency.

The UK Mortgage Market Creates an Unnecessary Structural Risk

The Bank of England has an emerging market-style structural problem, and like some Emerging Market Central Banks, they don't want to admit it. Brexit however is not the core of that problem, rather it just the catalyst that can cause the structural risk to materialise. The Bank of England's structural weakness is a combination of:

1. Irresponsible interest rate mismatches for mortgage holders that threaten demand as rates rise (72% of mortgages equivalent to half of GDP are variable or fixed for no more than 2 years)
2. A need to respond to devaluation driven cost-push inflation that is traditionally more of a challenge for central banks in emerging markets, rather than for those that print reserve currencies.

Governor Carney's duty should be to try and rectify this structural weakness. Instead he seems to be crossing his fingers that Sterling won't weaken, meaning rates won't need to rise that much….or perhaps he is relying on an ability to pass the blame to Brexit should things go very wrong.

Brexit is not the core of Mr. Carney's problem

Yes Brexit creates uncertainty that weighs on the economy. However when it comes to Brexit the Bank of England is a price taker, and there is little they can do beyond respond (a bit like Emerging Market Central Banks' vulnerability to global risk off). The more problematic issue for the Bank of England is the simple fact it is being compelled to hike rates due to devaluation driven cost-push inflation, rather than inflation caused by strong demand (sounds a bit like the Fragile 5). Were mortgage borrowing in the UK largely at longer duration fixed rates (closer to matching the duration of the home loan as largely happens in the US), rate hikes would not be too big a problem. In that case the impact of rate hikes would largely dent future propensity to borrow, rather than hitting current borrowers. But in the UK, 40% of mortgage borrowing is fully variable and immediately gets more expensive as rates rise. While Governor Carney sticks to mathematical truth and tries to comfort us by

saying “the majority of mortgage borrowing is fixed rate,” that’s more a PR message than a realistic analysis of risks. It is not so comforting when the fixed rates he is talking about include a further 32% of mortgages that are only on two year fixed terms (with an average tenure of just a year). So fully 72% of mortgages reprice within two years, while the average mortgage borrower will need 16 years to repay their loan.

Asking wrong question, it’s about demand destruction, not defaults

To the extent data is provided in the BOE November inflation report, the conclusions seem quite comforting. Just a third households have mortgages, and the percent of households with debt servicing above 40% of income is just 1.5%. Governor Carney also noted that almost half of mortgage holders have taken out their mortgages since the 2014 regulation requiring borrowers to be stress tested to withstand rates rates 300bp higher (near 7% according to Governor Carney). Yet this stat is probably misleading as roll-overs of variable and short term fixed borrowing from the same bank would presumably not require a new credit decision (those that switch banks would). Additionally isn’t it a sign of how bad the problem is when fully 50% of mortgages have been re-set in less than 3 years? He also notes that savers will benefit, but banks only need to pass this on fully if lending growth is strong (Governor Carney's argument that the banks profitably passed the reductions to savers when rates fell doesn't hold water as an indicator for what they will do when rates rise). Additionally the inflation report notes that the impact on consumer spending from higher savings returns is substantially less than from higher borrowing costs.

This is not about a housing bubble, it's about household consumption

It is easy to be reassured by Governor Carney’s statistics when it comes to overall macro credit quality and the risks to the housing sector (when you have structural undersupply you can't be too worried about house prices). So yes**, do not worry too much about repayment capability, the loan quality of banks, or any forced selling leading to a collapse in UK house prices**. But the problem Governor Carney faces is not one of popping a bubble, it is the fact that when the BOE raises rates it has an immediate impact on household cashflow. That is fine when the economy is strong as it provides a very efficient mechanism to achieve a cooling objective just by tweaking rates. But with the outlook uncertain, the BOE is not trying to slow the economy. Rather what they are trying to achieve is maintenance of credibility and an anchoring of inflation in a period when it is obvious rates are structurally too low. It won’t take long before the contractionary response to rate hikes limits the Bank of England’s fire power to respond to imported inflation.

If the BOE has to sustainably deal with devaluation driven inflation, this arguably leaves the UK as one of the world's most exposed economies to the normalisation of global rates. While it is a very obvious headwind, at the November press conference Governor Carney notes the "unusual period of underperformance (of the UK economy)." He's clearly referring to Brexit. But Brexit or not, if he doesn't take policy action to lengthen the rate-fix of mortgages, there will be nothing unusual about UK economic under-performance vs peers in the coming decade.

> *The average outstanding mortgage balance in June 2017 was around £125,000 with an average repayment term of 16 years remaining. Once passed on in full, a 25 basis point rise in rates would lead to an increase in the servicing cost (of the average interest-only variable mortgage) of around £312 p.a. That's very manageable (circa 1% of average UK household income and much less presumably for the actual borrowers). But naturally this gets multiplied with each hike. For every 100bp rise in mortgage rates, in time this will lead to reductions in cashflow income equivalent to 4% of average household income (for mortgage holders). Or put another way with 50% of GDP in mortgages set to re-price within two years, a 100bp increase in the respective borrowing rates would mean the rise in household mortgage expenses would equal to 0.5% of GDP. In the US households get the full savings gain, without the corresponding hit to expenditures.*

Variable mortgages makes monetary transmission too efficient

Simply, the nature of mortgage borrowing in the UK does not allow for rates to rise as much as they will in the rest of the world without a disproportionate hit to demand. As currency markets are zero sum, and a combination of confidence, growth and rates ultimately drive currencies - don't be surprised if Sterling is among the world's biggest losers from the global rate normalisation. Just about every forecast you see regarding the pound weakening is driven by Brexit. That's too simplistic. If the pound falls below parity with the USD (yes USD) over the next 3-5 years, it will be exacerbated by Brexit - but will ultimately be caused by the market realising that it is too painful for the BOE to raise rates enough to anchor inflation. Brexit or not, expect the GBP to be a structural loser from global rate normalisation. With the inflation that a weaker GBP causes, there is scope that the BOE will often have to weigh hikes to constrain inflation that is devaluation rather than demand driven. That is something many emerging market economists will recognise.

Casual Carney?

Unlike Brexit, this is a problem of the Bank of England's own making and one it should be proactively trying to address. Instead, the November inflation report oozes

complacency and crossed fingers, rather than any serious agenda to address the Great British Mortgage MisMatch. Praying for a stable pound isn't enough. A window exists for the UK to use macro-prudential measures to reduce its structural vulnerability to the seemingly inevitable rise in global rates over the next decade. But if mortgage holders are not actively discouraged from such short duration interest rate fixes, Britain will remain a country where stagflation over the coming years remains a credible risk. Naturally if Sterling stabilises the Bank of England can muddle through by just tweaking policy based on demand driven inflationary pressures. But if global markets decide that the Bank of England's justifiable reluctance to raise rates is enough of a reason to sustain pressure on the currency - then Britain will face a serious risk of persistent low grade stagflation until rate normalisation has run its course. This could be a difficult decade.

Envy the SARB & what do Turkey, Greece & UK have in common?

The only way to avoid this risk (Brexit or not), is to get to a stage where the economy becomes less sensitive to currency moves. This would then allow the currency to act as an economic safety valve rather than a source of pain (it's notable the South Africa Reserve Bank has an ability to largely ignore the Rand due to a lack of structural vulnerability to currency weakness - leaving the SARB better positioned than the BOE when it comes to worrying about the currency). In theory, a weaker currency should be good for a country on the view it improves competitiveness. Accordingly, some countries actively try to weaken their currencies to "win the currency war." As it stands, the UK, like Turkey, has structural reasons why a weak currency is not a net positive (in Turkey it is the corporate sector's short FX position). The Bank of England can do nothing to ensure that currency weakness boosts exports, and until resolved, Brexit will likely constrain the investment required to take advantage of the improved competitive position that a weaker currency brings (a bit like how perennial default risk constrains Greece's ability to get the investment needed to drive export investment despite the sharp wage cuts). While the UK government could try to pursue polices to reduce inflation pass through from a weaker pound - that can only happen over time and is not the responsibility of the BOE. However, one thing the BOE can do to limit the scale of demand destruction as rates rise, is to address the interest rate mismatch in the mortgage market. Compelling banks and mortgage holders to lock into longer duration rate fixes, would, in time, give the BOE more flexibility to adjust rates to cope with inflation even if it is just devaluation rather than demand driven. There is a solution, but the BOE must first recognise its structural vulnerability.

The BOE has to exploit the current window to fix the problem

The answer then is for the Bank of England to develop an active policy to extend interest rate duration in the mortgage market. Once that has been rectified, then and only then, can the Bank of England be free to pursue a rate policy capable of anchoring inflation without unduly hitting household demand. Luckily the promise of the Bank of England to sustain QE until rates have risen further presents a perfect backdrop to facilitate this shift. Indeed, as Governor Carney rightly notes, at current rates those rolling over 2 year fixes will see a 30bp improvement on average rate while those rolling off five year deals will see rates almost 2 percentage points lower. However rather than use that as an opportunity to push borrowers to extend maturities, Governor Carney only mentioned those stats to reassure that the recent 25bp hike will not be so negative for homeowners. While he is correct, he is also missing the opportunity that those low longer duration rates create to close the duration mismatch.

Continued QE creates a perfect chance to force longer duration

Mr Carney's situation has been seen many times before by Emerging market central banks. They have often been forced to hike at times of diminished confidence and economic weakness to anchor cost push rather than demand driven inflation. If Mr. Carney wants to diminish the risk (it's not an inevitability but it is a risk) of repeatedly facing this situation, he should act now to encourage/force banks and borrowers to lengthen the terms of fixed rate mortgages. If successful, this would dramatically reduce the efficiency of Central Bank policy transmission (which is no bad thing when we have a decade of below trend growth and tighter policy ahead of us). With the Bank of England continuing to buy long bonds and it obvious to everyone that rates have bottomed, it should not be difficult to encourage consumers to extend rate fixings. However they will need to be pushed. To make sure the banks play ball, a bit of policy coercion will probably be required to raise the price of variable and 2 year deals and to offer more 7 and 10 year mortgages. Dramatic reductions in loan to value should be mandated for any variable borrowing rollover while banks should face higher costs if they keep lending at variable rates. The BOE could support this economically structural improvement by spending resources to keep long dated mortgage rates down (it's better to address a structural vulnerability than to just buy corporate bonds). Oh, and one change that will be required but shouldn't be super difficult with UK pensions funds seeking yield and duration enhancement without currency risk - would be to dramatically reduce fees associated with early repayment of fixed rate maturities (in the event of selling a house but not refinancing).

End Variable Mortgages...period

The BOE should set a goal no less ambitious than to end variable rate borrowing for mortgages. There is no fundamentally sound reason to continue offering variable mortgages regardless of the credit quality of borrowers. Simply the variability of their cashflows creates disproportionate weakness for the UK economy (when rates rise) and as such it is in the interest of a healthy monetary policy to remove this distortion. I'd compare this with an Emerging Market where credit worthy companies borrow in FX. Individually every loan might make sense, but in aggregate the FX mismatch creates structural recessionary risk during times of currency weakness.

Will they Blame Brexit or Governor Carnage?

With the BOE continuing its bond buying program, the anchoring of the long bond allows the opportunity to encourage/push all those on variable and short term fixed rates to move into longer during borrowing in the coming 12-24 months. But if it fails to do so, effectively all the BOE is saying is they are crossing their fingers hoping that Sterling doesn't fall further. This has been seen plenty of times in Emerging Markets - that's not responsible policy making. If Mr. Carney doesn't have the stomach for this, he may have to suffer the consequences should the markets decide that the worst days for the Pound are ahead of us. He may get lucky from a PR perspective as the blame is placed on Brexit, but he will deserve his share of credit if he does nothing to fix the mortgage problem.

As Sterling's weakness has been the driver of inflation, the BOE is basically trying to do what so many Emerging Market Central Banks have been forced to do...stabilise the currency. But knowing it doesn't want to comment on the currency, the BOE instead just tries to reassure that inflation will fall once the imported inflation driven by the post Brexit currency devaluation has passed through the economy. But what happens if the pound keeps weakening? The BOE is correct not to take a view on where the pound is headed (Gov Carney was at his least confident when asked about the view on Sterling at the last press conference), but effectively that means the economic outlook which drives their policy framework assumes Sterling remains stable (translation: they are taking a currency view). While there are plenty of soothing words on economic trends, I'd venture the fate of the Pound is the most important economic variable when it comes to BOE rate policy. It is tough to imagine a 25bp rate hike and guidance that all members agree "that any future increases in Bank Rate would be expected to be at a gradual pace and to a limited extent" will fundamentally anchor the Pound - it can be said that UK rate setters simply have their fingers crossed that the currency won't fall further.

Don't telegraph the next hike

With an inability to send a definitive rate signal, there is little the BOE can do about the currency. But they can perhaps influence the pound if they communicate a bit differently. I would suggest that they do not fully condition the market for the next hike (if and when it is coming). The BOE probably has the ability to push through one further hike without disproportionately damaging economic activity, but this will be wasted if the market fully expects the hike. Accordingly that hike will do little to anchor the currency as investors will probably assume its the last hike. If I were in Governor Carney's shoes, I'd make sure the next hike is focused more on surprising the currency markets than just appeasing them. This would enhance the odds that the next hike is not just deflationary from a demand perspective, but from a cost push imported inflation perspective as well. If you are going to cross your fingers, you might as well do what you can to influence the result you want.

More on why the UK mortgage market is structurally flawed

For those who haven't seen the Big Short, if we strip the complicated US housing crisis down to its bare bones, the simple problem was that the structure of adjustable rate mortgages meant too many homeowners were vulnerable to default even if they kept their jobs. Sorry if this sounds old fashioned, but if someone takes a loan and keeps their level of income broadly steady throughout the repayment period (and avoids spending problems), why should they default? In the US crisis, it was not recessionary job losses that sparked the crisis, it was the fact that house price declines denied the opportunity to refinance before the higher rates kicked in. The result, plenty of people who kept their jobs and salaries couldn't cope with the cashflow hit from higher interest payments. A vicious spiral of forced selling and negative equity (house prices worth less than the value of the mortgage) was the result. I'd argue negative equity on its own wasn't the driver of forced selling (few will sell or walk away from their homes if the interest payments are ultimately affordable as Hungarians and Poles proved during the crisis). But as refinancing was a pre-requisite to sustaining mortgage affordability, the negative equity played a role in denying consumers that refinancing opportunity (banks won't refinance your loan if the house is worth less than the loan) But all told the problem was simple, even if US homeowners kept their job, their mortgages left too many vulnerable to default.

In the UK the problem is less complex and less likely to blow up if things go wrong. However the simple risk of the US is relevant to the UK. Namely that large numbers of even frugal mortgage holders can keep their job but feel strain from their mortgages if rates rise too much. In the US this risk has already been tested and has largely unwound, in the UK it has not. While in the US the higher rate was contractual (and hence ridiculous that the regulators allowed banks to lend with adjustable rates that would make borrowers un-bankable if they weren't allowed to

refinance before it repriced). In the UK there is nothing inevitable about the un-refinanced mortgage becoming unsustainable. However it is inevitable that if rates rise enough, there is a threshold at which a majority existing mortgage holders will suffer cashflow stress. We may be far from that threshold but suffice it to say, every hike in rates will not be welcome by mortgage borrowers. And as growth is relative rather than absolute, the fact there is a rising non-discretionary claim on household incomes is problematic.

UK'S Biggest Risk has been an Asset for a Generation

What does this mean for Bank of England Policy? With mortgage debt equivalent to 68% of GDP and fully 72% of total mortgage borrowing either fully variable or short term fixed, **consumer mortgage debt equivalent to half of GDP is enormously sensitive to Bank of England base rates.** This makes for a super efficient monetary policy mechanism (in South Africa mortgage borrowers are virtually all variable but mortgages are not nearly as widespread). During the crisis this meant that the UK consumer (Swedes & well-heeled South Africans) saw substantially increases in disposable income as interest rates tumbled and mortgage payments adjusted. To put into context, the Resolution foundation calculated that low interest rates saved a £75,000 tracker mortgage £12,400 in the five years to 2014. Or for another pretty interesting statistic from the government white paper, mean mortgage payments are now just 18% of household income vs. 50% for renters. All told, the efficiency of UK monetary policy meant pre existing mortgage holders benefitted enormously from the fall in rates. By contrast during the great financial crisis, the average American saw no benefit from tumbling FED rates because higher rates from adjustable rate mortgages could only be avoided if the borrower was financially well off enough to refinance (and if they still had positive home equity) The vicious spiral of defaults and forced home sales had to unwind for many years before lower rates could finally be offered via new mortgage issuance. Hence the FED, arguably the most important institution in the world, has considerably less direct ability to move the needle on consumer behaviour in the US than the Bank of England does in the UK. It's no surprise then that in the UK, the bottom of the housing market was found quickly in 2009 (your author got "gazumped" as soon as July 2009) as there were few forced sellers beyond those whose job situation had changed. That made the UK's post crisis transition for homeowners and consumers (and by default the BOE) much easier than for many countries.

In both the US and the UK the regulators have allowed the situation of existing mortgage holders to have the potential to dramatically change regardless of their job situation. The only difference is that the failed bet forced a painful reckoning for US homeowners. In the UK the music kept playing as rates fell. But the party looks to be

winding down. In a world where rates are normalising higher, that favourable backdrop the Bank of England and the UK economy is over.

BoE likely to support mortgage holders more than student borrowers

Until this vulnerability can be reduced (and it won't be unless there is a regulatory/policy push), the BOE's hands will be tied. Beyond one additional hike, expect they will hesitate to push through rate increases unless growth is materialising or the market puts a gun to their head (via a tumbling currency). To the extent inflation materialises, they will have to tolerate it (holders of student loans are effectively long sterling/short inflation so that won't be nice). If inflation stays above target and real wages don't rise, lower than required rates allow for sustained stimulus that protects mortgage borrowers. However, over time that increases risk of a socio-political backlash from those whose wages fail to keep up with inflation (or again those with student loans). The Bank of England will have a lot to answer for if they do not get this right.

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