The voice of banking
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Your mortgage and the markets

Why you pay the mortgage rate you do

The mortgage market has changed enormously since the credit crunch. Although property prices across the UK have fallen, first-time buyers now have to build substantial deposits before getting on to the property-owning ladder. This pattern might seem familiar to anybody who bought their homes prior to the 1990s but it has set back the expectations of prospective borrowers seeking the kind of low deposit, low interest rate mortgage deals which preceded, and to some extent precipitated, the credit crunch.

Additionally, many of the economic indicators previously used as proxies for the cost of mortgage funding, including the Bank of England base rate or the rate banks pay to borrow from one another in the wholesale money markets, no longer reflect the actual cost to the bank of providing mortgages, with the result that margins between these traditional indicators and high street mortgage rates have widened substantially.

Those wider margins are due to the measures the markets, governments, regulators and banks are taking to make banks stronger, ensure financial stability and secure economic recovery. They should not be confused with profit margins, as the increased price of bank funding reflects increased costs to the industry rather than profits. Indeed banks' net interest margins – the gap between the interest rate at which a bank borrows to fund a mortgage and the rate it charges to the mortgage borrower - continue to narrow.

In short, the cost at which banks raise funding – from retail depositors or the wholesale markets - have increased substantially compared to historical standards:

- while banks will still fund themselves using a mix of wholesale money and deposits, the balance has been shifting as regulators encourage banks to fund a greater portion of their mortgage portfolios with longer term retail deposits provided by savers. As a result deposits are a more dominant part of the funding mix, which means the wholesale market rate is less of an influence on the cost of mortgages than the rates banks pay to savers;

- where banks borrow money from savers, they presently do so at rates of up to two to three per cent higher than the Bank of England base rate (currently standing at 0.5 per cent): the direct opposite of the situation before the credit crunch, when savings rates were typically below the base rate. Banks are competing for savers' funds, pushing the cost of this funding even higher as they offer more attractive rates. This benefits savers but correspondingly makes mortgages more expensive for borrowers;

- some lenders have continued to face much higher borrowing rates in a tighter wholesale money market;

- regulators now require UK banks to hold more than twice the capital that they were holding before the credit crunch, and banks will have to further increase their capital in stages until 2019, when the EU Capital Requirements Directive is fully implemented. There is a cost associated with holding these higher amounts of capital which is being passed on to borrowers;

- the securitisation market, which enabled banks in the past to convert parts of their mortgage book into attractive financial products for big investors (and therefore providing more relatively inexpensive funding for new mortgages), is yet to return to its previous activity levels. The US subprime problem, based on such repackaging, was one of the root causes of the worldwide credit crunch;

- although mortgage defaults and repossessions are being kept as low as possible, inevitably the lending risk has gone up. The banks are also helping customers in financial difficulty to stay in their homes, in some cases by temporarily reducing monthly mortgage payments, but are at the same time being required by the FSA to hold more capital against mortgages subject to such forbearance programmes, which adds to their costs.

For most people, mortgages from banks remain significantly cheaper than they were before the credit crunch: the vast majority on base rate trackers and standard variable rates (SVRs) saw their monthly payments slashed in 2008 and 2009.

How the cost of your mortgage is set

The Official Bank Rate

The Official Bank Rate (to give the Bank of England base rate its proper name) has served as a peg for some mortgage loans during the past decade (those on standard variable or tracker rates). Although the Bank of England maintains that the full effects of a rate change takes more than a year to feed into the economy, the habit of expectation has grown in recent years that a cut in the official bank rate will be followed immediately by a fall in the cost of mortgage interest.

Nobody borrows money for free. Nor does anybody borrow it at the current Bank of England base rate of 0.5 per cent. Borrowing from the Bank of England is normally conducted at the base rate plus a margin, depending on how the Bank of England assesses the risk it is assuming.

Banks can only borrow from the Bank of England for relatively short maturities. Banks wanting to borrow money for longer periods (as the regulators are increasingly demanding) typically do so from other banks in the wholesale market – which brings us to LIBOR.

LIBOR

LIBOR is the world's most widely used benchmark rate for short term interest rates on unsecured cash. It is sometimes referred to as the rate of interest at which banks borrow funds from each other but this is misleading on two counts: pension funds, investment funds, hedge funds and more also contribute to the money markets; and banks are seeking principally to lend to their customers rather than to each other.

LIBOR is owned by the British Bankers' Association but is compiled independently on our behalf by Thomson Reuters and governed by an independent committee. Although LIBOR rates are influenced by changes in central bank interest rates, they are a reflection of overall market conditions at a given time: in contrast the Official Bank Rate targets an inflation rate two years away.

Not all those banks and other institutions who borrow money for the wholesale market can do so at rates close to the LIBOR benchmark. The major banks which contribute to the benchmark are the largest and least risky. Smaller institutions may well be perceived as having a higher risk and so the cost of their borrowing is commensurately higher.

When banks needs to fund longer terms (such as the two- or five-year fixed rate mortgages, for instance) they need to pay an additional premium above LIBOR to access this longer term funding.

Savers’ funds and wholesale funds

Banks have always funded their mortgage lending from a mix of customer deposits (placed by individuals and companies) and wholesale funding. Retail deposits on their own can never fund all of a bank’s lending, either because they are not available in the same quantity or they mature at the wrong time, but regulators are increasingly demanding that more mortage lending should be funded by longer term customer deposits. Imagine a mortgage of £100,000 for 10 years: if average savings deposits were £5,000 and were held on average for five years, you would need 40 such accounts to be able to provide that single mortgage over its lifetime – and that's before adding in the cost of providing the associated banking infrastructure or the risk of a customer defaulting and not paying back the mortgage.

Raising funds from savers is even more expensive than raising them in the wholesale market: currently the difference might be two per cent or more. Competition for savers’ funds is obliging the banks to offer ever better deals to savers willing to place deposits for more than just a few months, pushing up the cost even further, which is ultimately passed on to borrowers.

Securitisation

Before the credit crunch, banks could also generate funds by creating financial instruments which they could sell as securities to institutional investors (such as pension funds and hedge funds). These instruments included bonds and other securities backed by the steady income stream from mortgages (hence the so-called asset-backed securities).

When the credit crunch hit, investment activity slumped. Investors shied away from asset-backed securities that had uncertain or much-reduced intrinsic market value. And the credit ratings of banks fell, affecting the price of these securities where they were available. The securitisation market – a major source of mortgage funds for banks – effectively closed and is only now starting to re-open.

Where we are now

Banks’ credit ratings are stabilising thanks to increases in the amount of capital they hold, greater confidence that losses have been disclosed and, in a few cases, direct intervention by governments. The cost of short-term money in the wholesale markets has steadily fallen since governments worldwide acted in concert to support the banking system in October 2008. But new regulatory requirements for lenders are now in place, obliging them to better match their funding maturities to their lending maturities – in other words they cannot use short-term money to fund long-term lending - and longer-term borrowing remains considerably more expensive than the usually quoted three-month LIBOR rate.

Summary

In a depressed economy money is harder to come by for banks as well as for customers. As the lessons of the credit crunch are absorbed, banks must strengthen safeguards against future downturns and their impacts. They continue to lend to responsible borrowers: banks currently approve four in five mortgage applications, a ratio that has remained steady for the past decade. However lenders can no longer offer mortgages at the unsustainable interest rates of the easy-credit era.

There will continue to be a significant difference between official or market rates and high street mortgage rates for the foreseeable future. Put simply, your mortgage rate is reflecting the banks’ increased costs of obtaining appropriate funds, more than any other factor, although higher regulatory capital and liquidity requirements are also having a significant impact.

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