The big squeeze

James Ferguson looks at why rising UK base rates are not feeding through to higher mortgage costs and suggests bank ring-fencing may be one of the reasons

Is monetary policy exhausted? Despite two 25-basis-point (bps) rate rises since August 2017, the UK two-year fixed, 75 per cent loan-to-value (LTV) mortgage rate had only risen by 28bps by the end of March this year and the five-year fix is barely any higher. The reduced policy effectiveness of this poor pass-through of the base rate to household interest rates was even the subject of a speech that Michael Saunders, external member of the Bank of England's Monetary Policy Committee, gave on 6 March at Imperial College Business School.

After several years of crisis and resolution, when policy rates were lowered dramatically but real economy borrowing costs were slow to decline, the Bank of England (BoE) now finds itself facing the opposite problem: rising rates are not feeding through into higher mortgage costs. Two- and five-year fixed-rate 95 per cent LTV mortgages have actually become more than 100bps cheaper, according to BoE monthly data even as base rate has risen by 50bps. What is going on?

The proximate cause of this latest breakdown in the monetary policy transmission mechanism appears to be an unintended consequence of the impact of ring-fencing on the larger retail banks. A lot of the blame for intensifying price competition in the UK mortgage market has been laid at the door of HSBC UK Bank. Launched as a ring-fenced entity in 2018, HSBC UK has total assets of £239bn, of which customer loans are £175bn and risk-weighted assets (RWA) are £92bn. The regulator requires HSBC UK to hold a minimum of £4.1bn of Common Equity Tier 1 (CET1) capital (4.5 per cent of RWA) and at least £7.35bn in total capital (8 per cent of RWA).

> *"Whereas once almost all mortgages were floating rate, today most, and up to 80% of new ones, are fixed rate*

Yet minimum capital ratios need to be bolstered by large safety buffers; HSBC has its reputation to protect, after all. So, HSBC UK was christened with a generous £11.7bn of CET1 capital and £16.8bn of total capital. While this was prudent on the bank's behalf, it has left it rather over-capitalised. In the first six months of its existence, the bank increased lending to customers by £7.8bn (+9.3 per cent annualised), most of which appears to have been mortgage loans.

Only large banks are allowed to determine their own risk-weights using models based on internal ratings and it is noticeable that such risk-weightings always end up substantially lower than the standardised risk-weights imposed on the challenger banks. This results in large banks requiring far less capital to support new mortgage loans, which allows them to undercut smaller banks when it comes to pricing, yet still make a wider margin. If this sounds unfair and oligopolistic, that is because it is. But just because the challenger banks are hypersensitive to being crowded out by the incumbents does not mean this is the end of the story. The financial crisis cast a long shadow and to gain a fuller perspective, we need take at least one, if not two steps back.

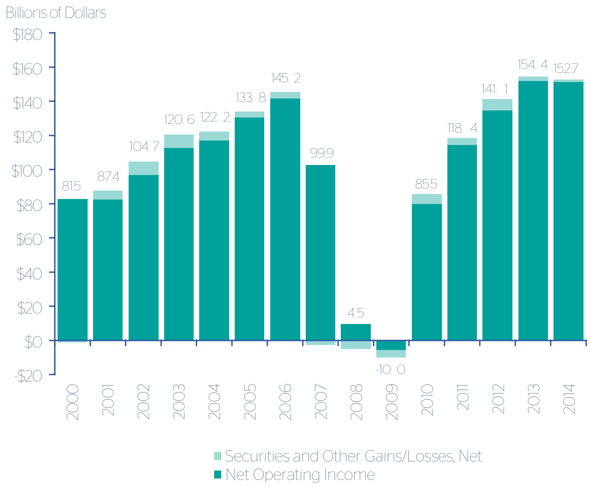
Although Saunders points out that spreads between mortgages and deposit rates are lower now than they were pre-crisis (and significantly so for new mortgages) – suggesting intensifying competition – the UK mortgage market has changed over the past few years. Whereas once almost all mortgages were floating rate, today most, and up to 80 per cent of new mortgages, are fixed rate.

Fixed-rate mortgages are priced off the appropriate duration bond yield. The spreads on both two-year and the five-year 75 per cent LTV fixed-rate mortgages have been narrowing steadily since 2012, but they remain wider than they were for the decade pre-crisis. This is especially so for mortgages at 95 per cent LTV, typically made to first-time buyers, which became so scarce after mid-2008 that the BoE had no data for five years until late 2013. But, while the spreads on 95 per cent LTV mortgages, which were consistently only around 100bps pre-crisis, have narrowed by 100bps over the past two years, they remain almost 300bps above the same duration gilt. So, spreads are actually trending towards previous levels.

As banks become more comfortable with offering 95 per cent mortgages again, the rate at which the spread is narrowing may continue to run faster than the speed at which the BoE raises the base rate. Normalisation is not the only other factor at work here though. An even bigger step back reveals why ring-fencing was deemed necessary at all.

After the first two years of the Great Financial Crisis 2008-09, it was thought that many retail banks that had moved into investment banking had done so by taking advantage of safe, cheap deposit funding, guaranteed by the state. The greed of these "casino" banks, it was thought, had nearly brought

Annual net income (all FDIC-insured institutions)



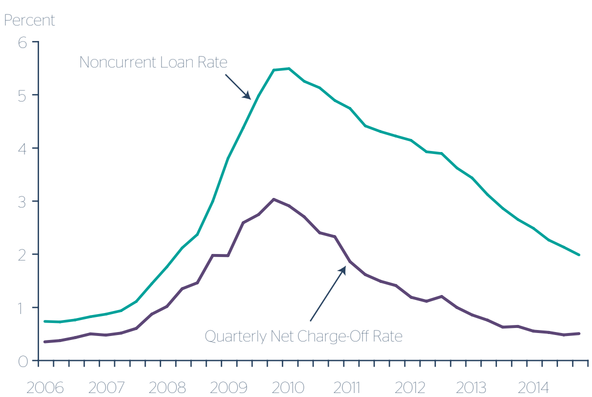
Source: FDIC

down the whole financial system in their pursuit of financial market gains and had put the entire payment system at risk.

The solution was the separation of retail/commercial and investment banking, with banks involved in both activities "ring-fencing" their basic bank activity into separate legal entities with their own capital structures. Even if banks were not forced to split themselves up and hive off their investment bank units, legally and financially retail and investment banking would now be separate units – the thinking being that in the event of a re-run of the financial crisis, the investment banks could be let go, while the retail/commercial bank units could sail on relatively unharmed.

While there was a lot of truth to the fact that banks' capital had largely been used up absorbing losses from the securities write-downs that peaked around Q1 2009, the implication behind the ring-fence idea was both that the crisis was confined to the period mid-2007 to mid-2009 and that

Non-current loan rate and quarterly net charge-off rate (all FDIC-insured institutions)



Source: FDIC

all the trouble stemmed from securities, particularly US subprime retail mortgage-backed securities. But the idea that US commercial banks' plain vanilla loans were relatively untouched and would have survived unscathed if it had not been for their disastrous flirtation with subprime and other securities was ultimately proved entirely fallacious.

Despite the stock market bottoming in Q1 2009 and the Great Recession officially ending in June 2009, US commercial bank net operating income did not return to new highs until 2013, with net loan charge-offs (aka non-performing loans) continuing at elevated levels until the end of the following year, while the non-current (ie longer-term) loan rate only normalised to pre-crisis levels late last year, according to the Federal Deposit Insurance Corporation (FDIC).

Even using conservative assumptions, cumulative plain vanilla loan losses (almost $850bn by my estimate) were spread out over at least seven years and ultimately added up to three times the size of total net securities write-downs (around $275bn). Therefore, the idea of ring-fencing banks' retail/

> *In another financial crisis, investment banks could be let go, while retail bank units could sail on unharmed*

commercial banking arms to keep them "safe" from the next crisis betrays a misunderstanding of the nature of the last one. Banks cannot be protected from losses if borrowers find themselves unable to payback loans. What is required is not ring-fencing but adequate loss-absorbing capital buffers and a simplification of complex regulation that the banks can hide behind and game.

Ring-fencing well-capitalised domestic retail/commercial banking arms, as the UK is now insisting internationally diversified banks do, does, however, make banks safer, but only because it gives the various units increased dedicated capital. Unfortunately, ring-fencing will also reduce competition, especially if the risk-weighting playing field is not levelled – and, assuming the loopholes in the risk-weighting rules are not tightened, it could itself sow the seeds of the next crisis. ■

James Ferguson *founded the MacroStrategy Partnership in early 2013. After starting his career at Nomura more than 20 years ago, he worked for a variety of bulge bracket firms in London and Tokyo, rising to chief strategist roles at Pali International and Arbuthnot*