

Our Economic World

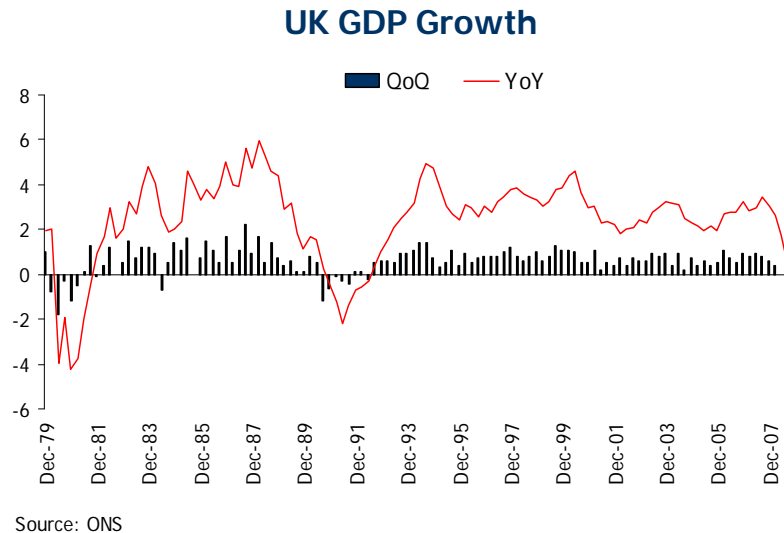
Interest rates, the housing market and lending

Fionnuala Earley
Nationwide Building Society

Outline

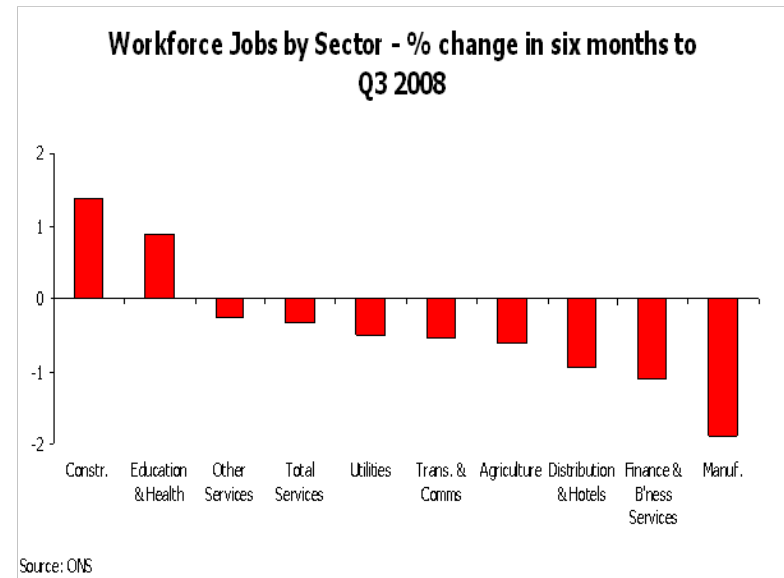
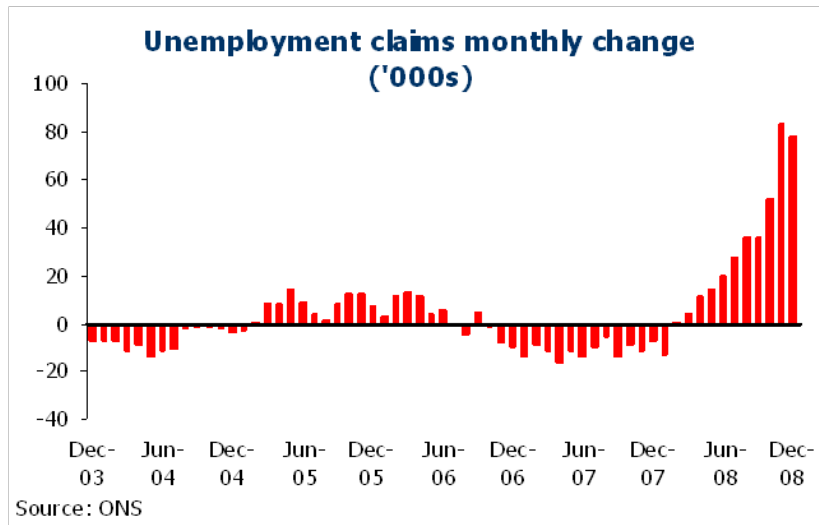
- Economic outlook
- Deflation
- Housing Market
- Lending - supply of or demand for credit?
- Conclusions

Economy in recession



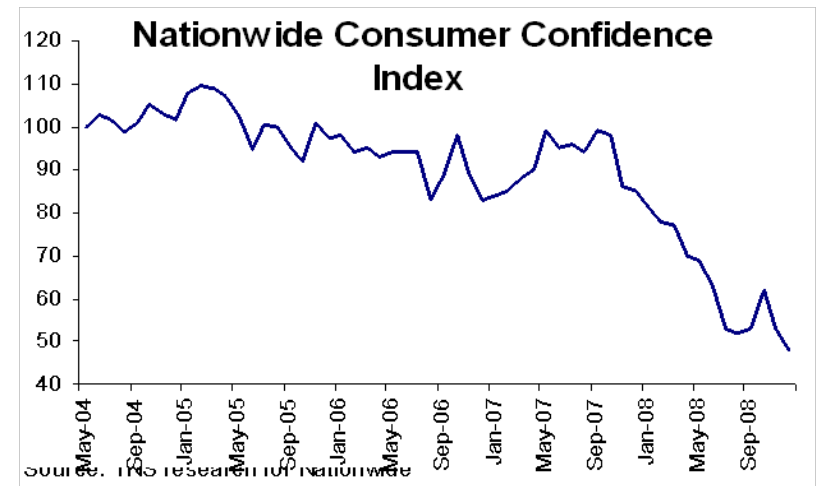
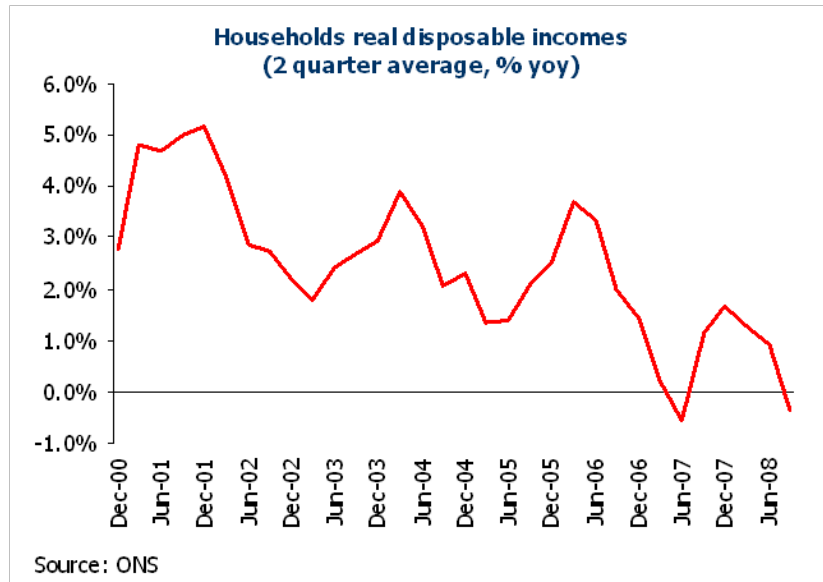
- Economy now technically in recession
- Q4's 1.5% q/q fall in GDP was worst since 1980
- Lead indicators suggest Q1 won't be much better
- Closer to 1980's rather than 1990s downturn

Labour market weakening



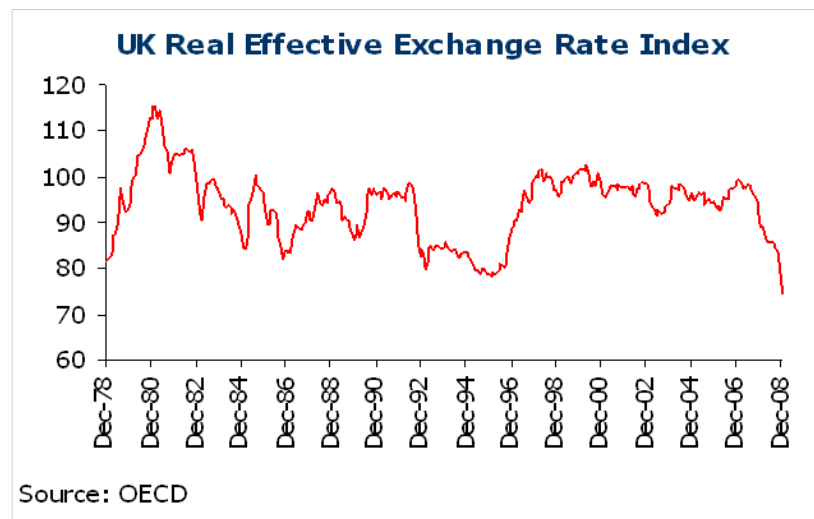
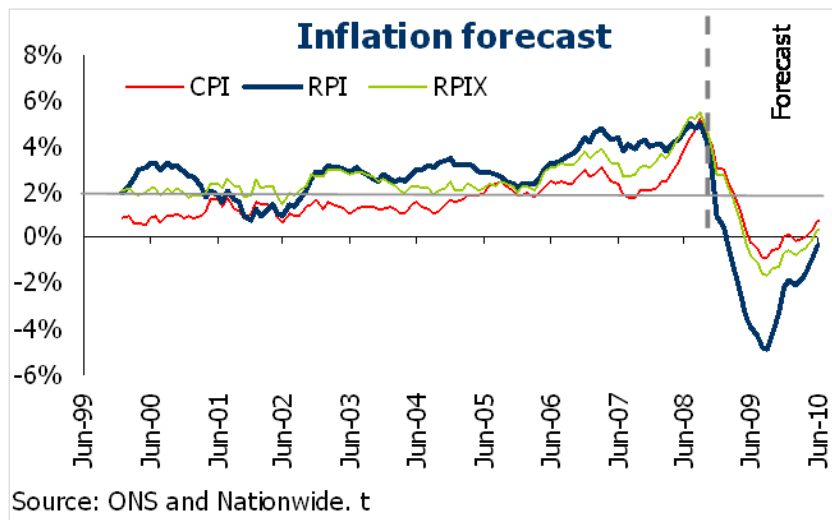
- Unemployment increasing quickly while vacancies fall sharply
- Only public sector employment showing resilience
- Confidence in future job availability waning

Household incomes still under pressure



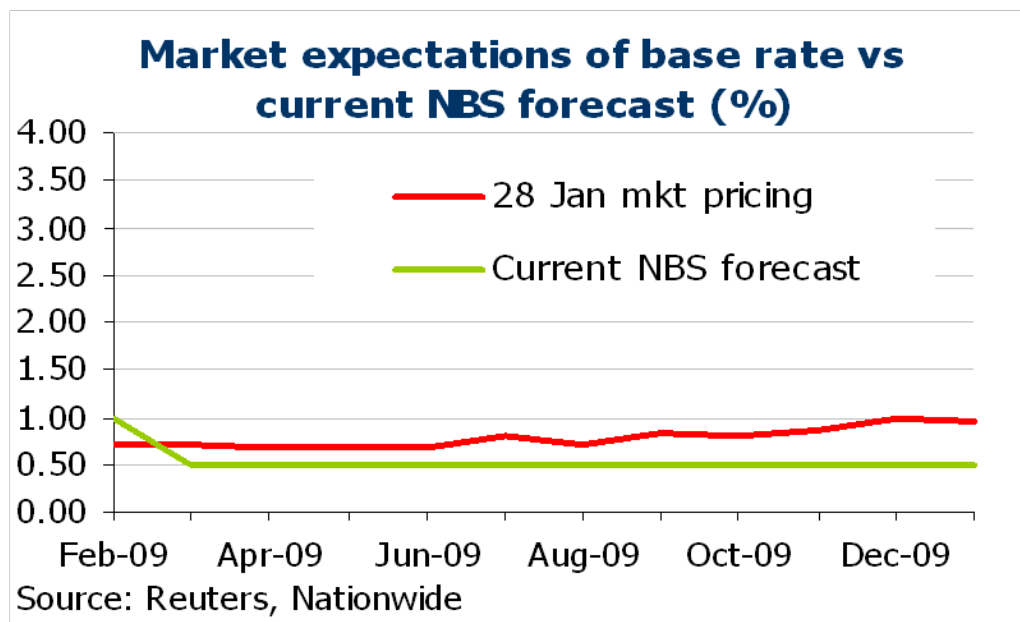
- Real disposable income still under pressure in spite of falling inflation
- Weaker consumer confidence will rein in borrowing and spending

Deflation is the greater near term risk



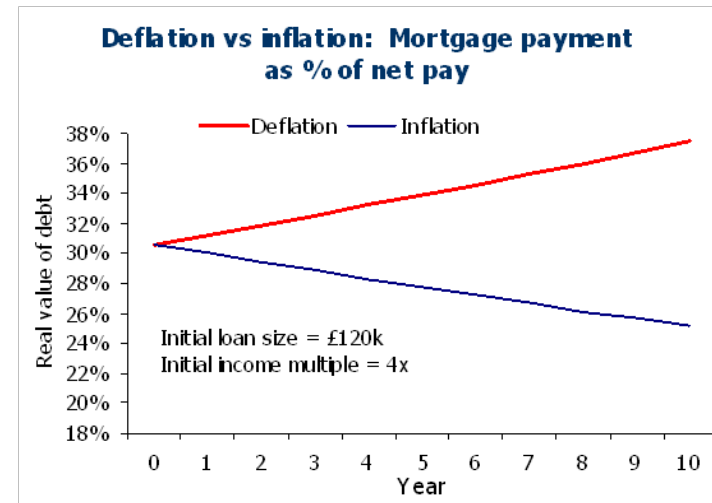
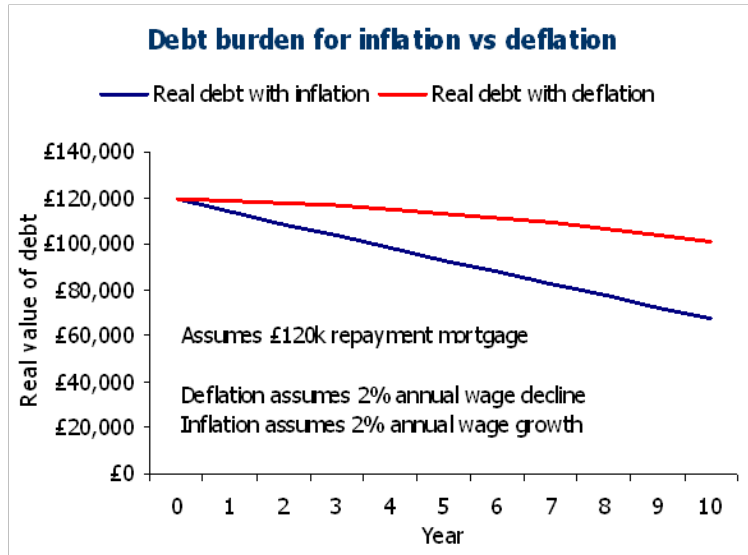
- Good chance of negative CPI inflation in H2 2009
- Widening output gap and commodity price collapse are main deflationary forces
- Sterling depreciation won't stop CPI undershooting target, but it does mitigate deflation risks somewhat

Base rate to be cut further and quantitative easing may be needed



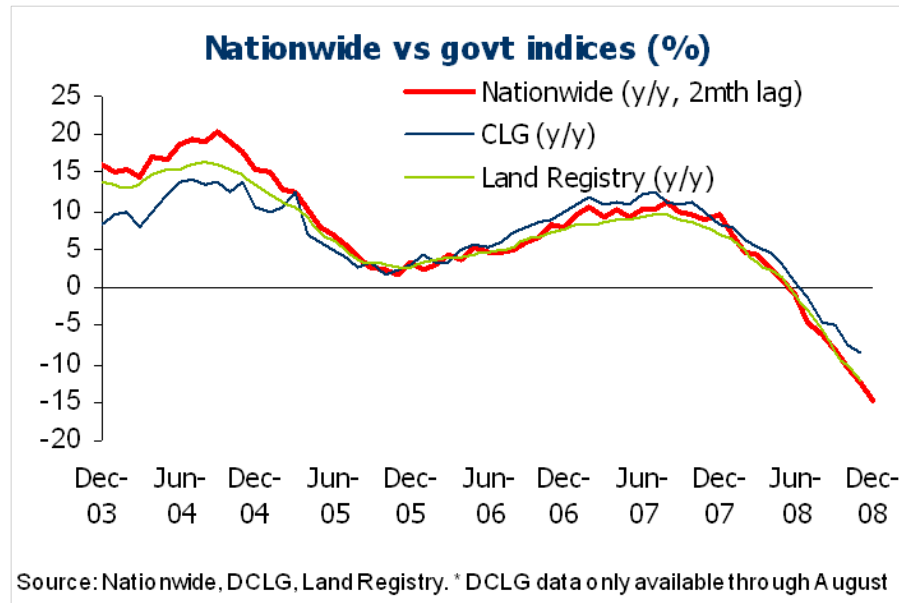
- Desire to avoid protracted deflation will lead to further rate cuts
- Expect base rate to fall to 0.5% in 2009
- BoE £50bn asset purchase programme could be pre-cursor to quantitative easing

Deflation awful



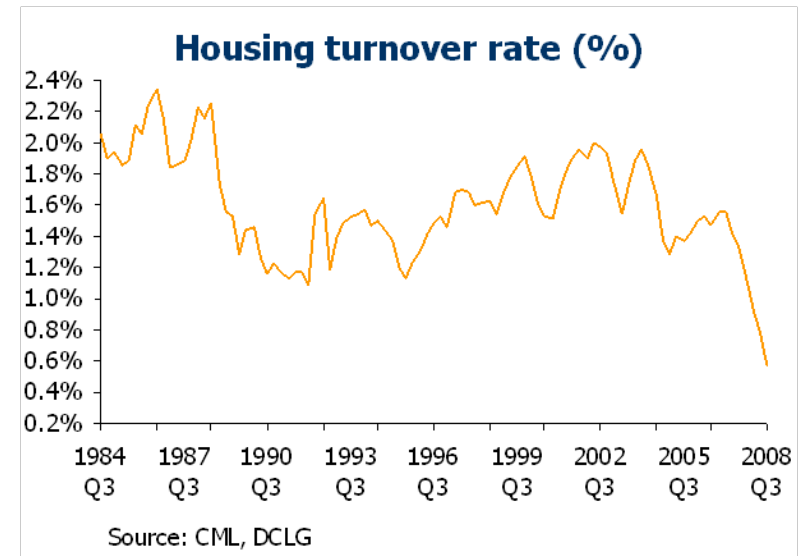
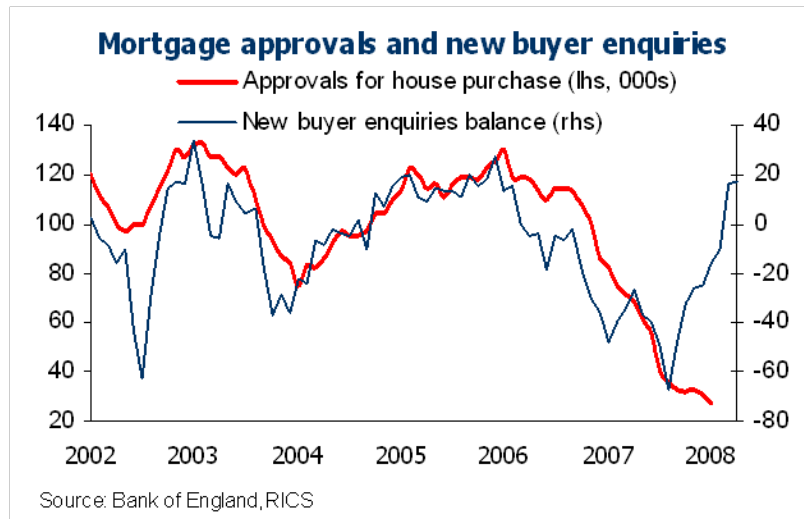
- Prolonged deflation is one of the most adverse economic scenarios imaginable - Japan's lost decade
- Falling prices - delayed spending - unemployment - falling asset prices - falling wages - rising real value (and burden) of debt - reprise

Housing market



- House prices falling rapidly
- UK annual rate of fall 16.6%
- Fall from peak (Oct 07) 18%
- No real difference between measures, other than timing

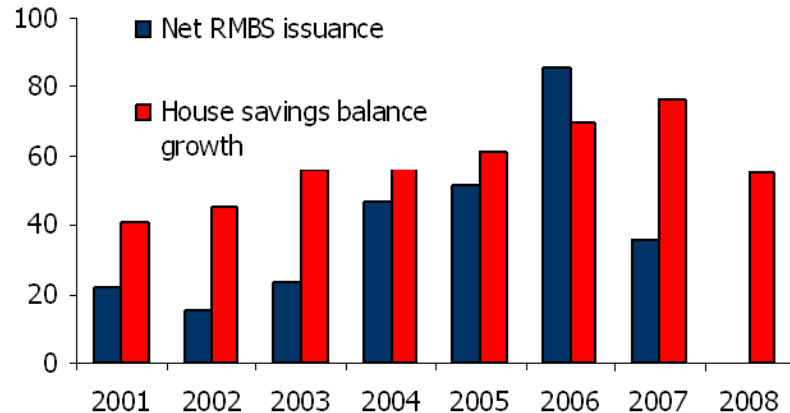
Housing market activity has collapsed...



- Evaporation of activity since 2007 and traditional relationships broken down
- Housing turnover fallen to lowest levels on record, due to:
 - Severe rationing of credit
 - Unprecedented pressure on affordability
 - Evaporation of buyer confidence

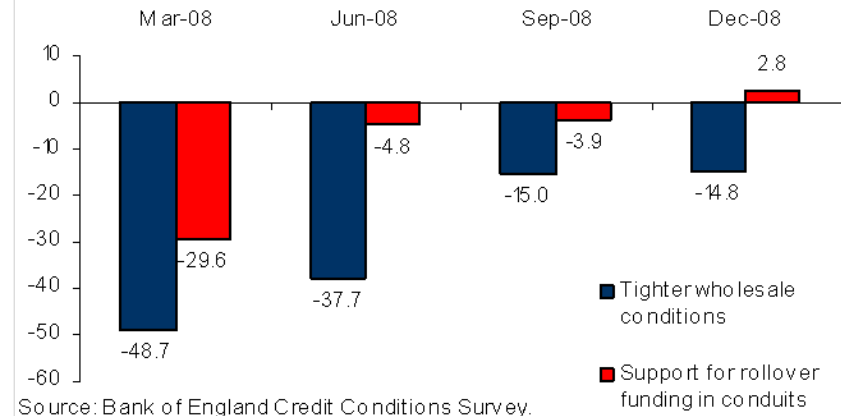
How important is wholesale funding?

Deposits and securitisation as a source of funding



Source: Lehman Brothers, Bank of England, Nationwide estimates

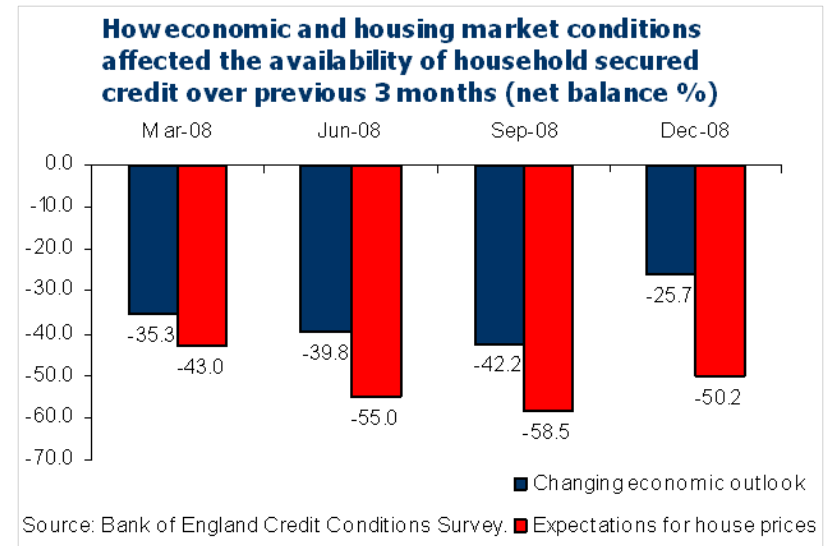
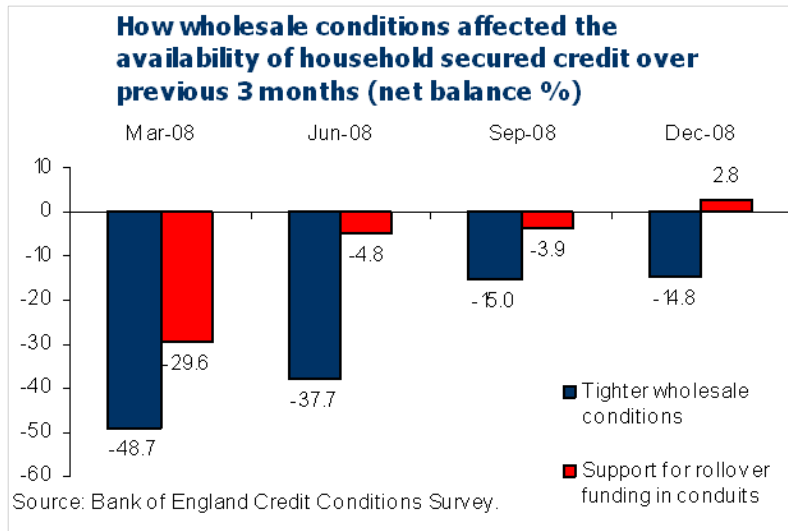
How wholesale conditions affected the availability of household secured credit over previous 3 months (net balance %)



Source: Bank of England Credit Conditions Survey.

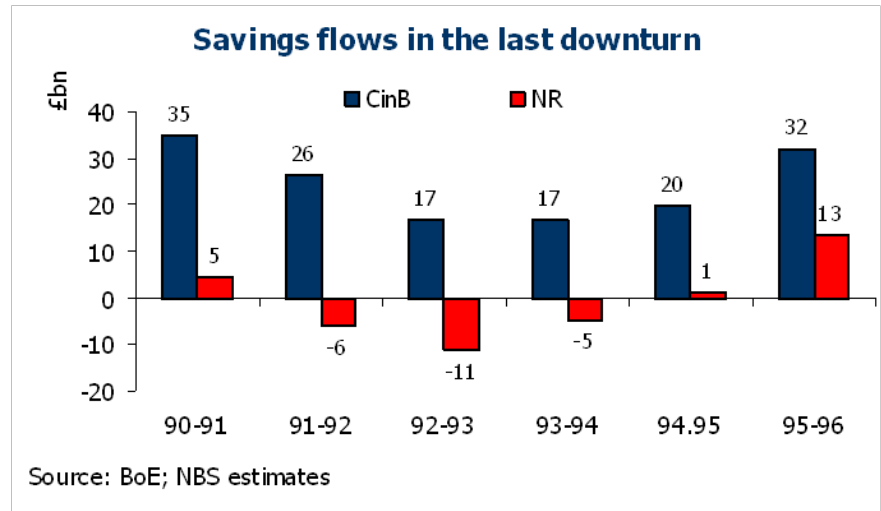
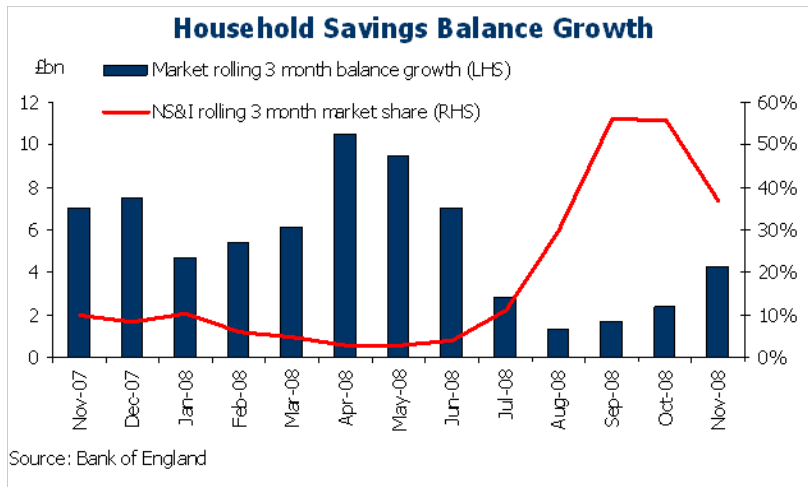
- Dramatic fall in amount of funding from RMBS
- Lenders still see wholesale conditions as a hindrance to secured lending
- Measures to improve this should be welcomed

But is this the whole story?



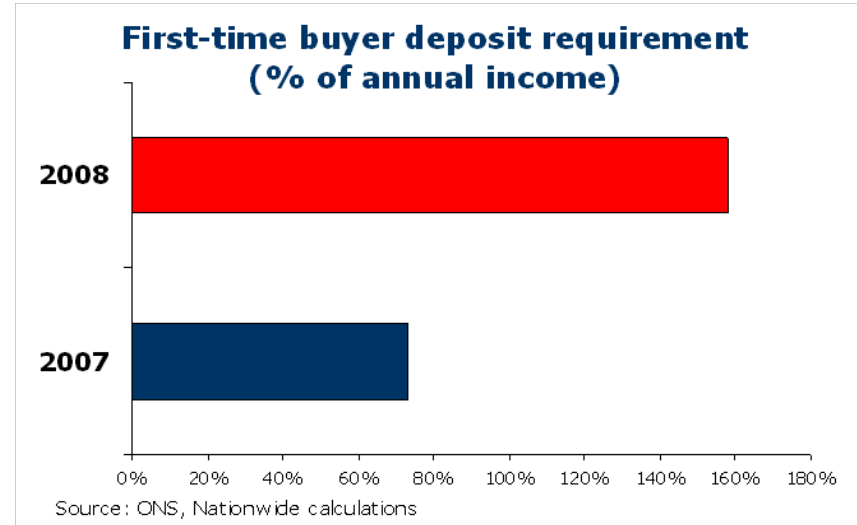
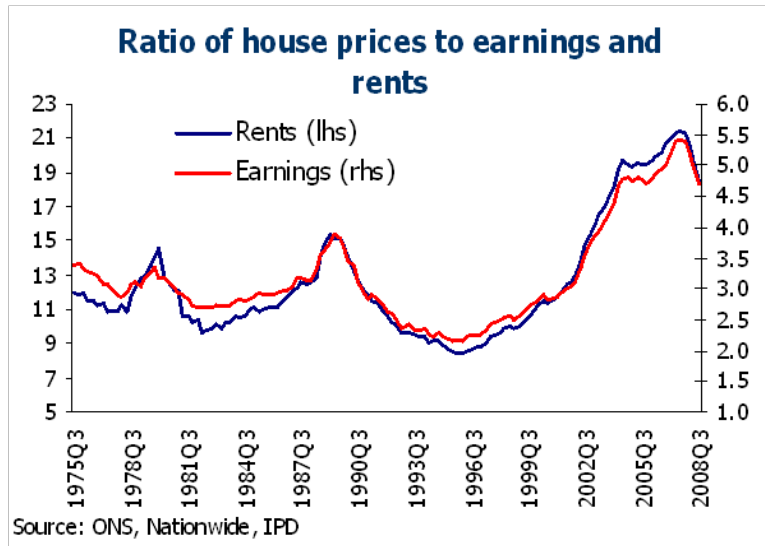
- Economic and housing market conditions have become increasingly important
- Indicates risk has become overriding issue
- Responsible lending plays a role in reducing availability of funds to willing (but maybe not able) borrowers

Funding - retail funding is as much of an issue as wholesale



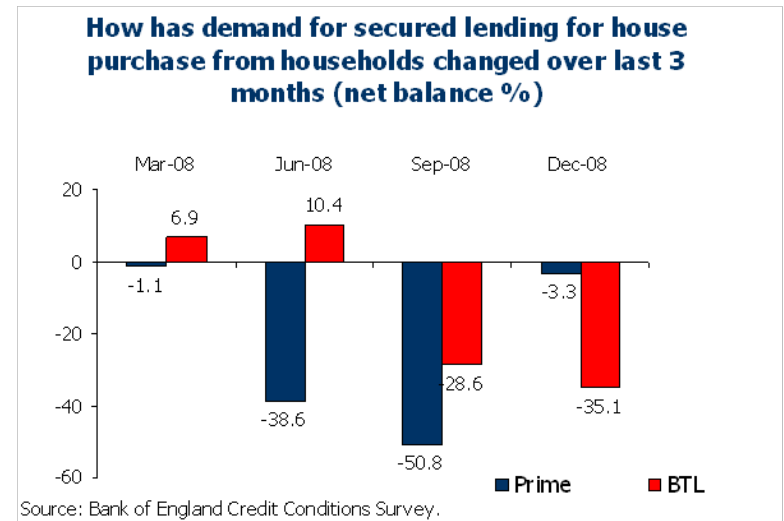
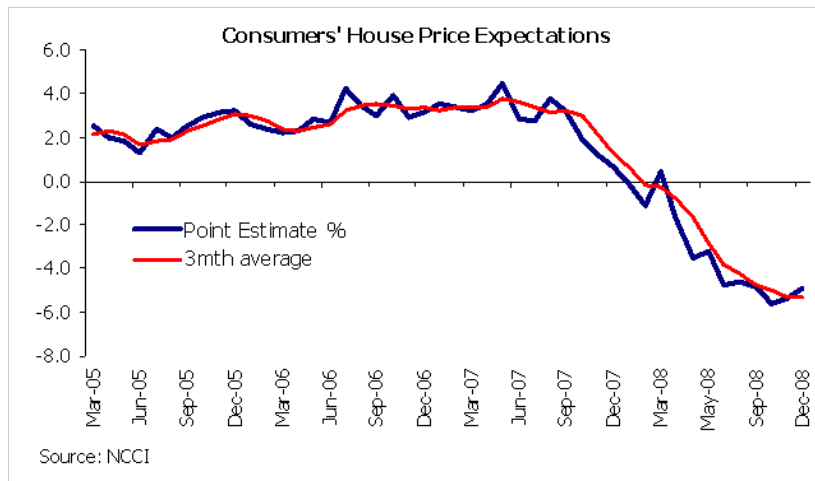
- Contraction in retail funding due to smaller inflows and lower interest capitalisation
- Flight to safety of NS&I is stark
- Experience of previous downturn suggests we should expect further falls in savings flows

Affordability still very stretched



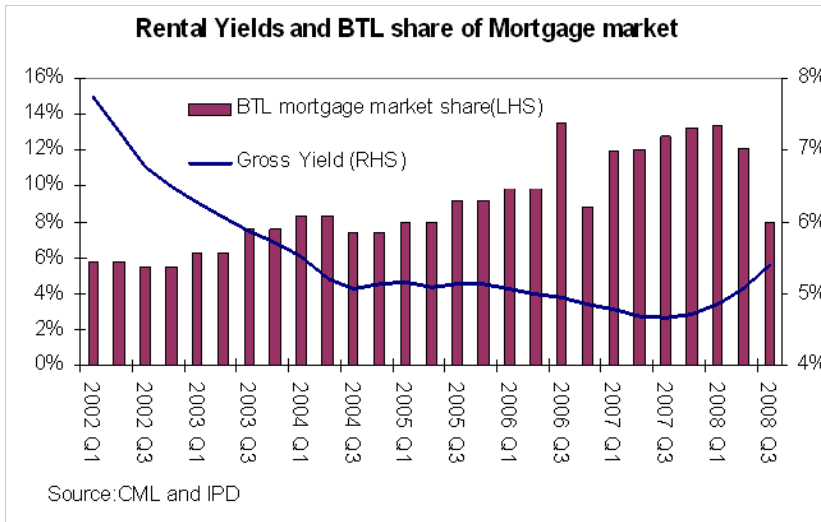
- Despite 16% house price fall, affordability remains stretched
- House prices remain out of line with earnings and rents
- Most affordable rates now restricted to 75% LTV
- Deposit requirement for typical FTB has doubled

Borrower demand



- Demand curtailed by credit conditions but also weaker economic and housing market conditions
- House price expectations have fallen rapidly
- Labour market weakness is leading to postponement of new borrowing

Buy-to-Let market offers little support

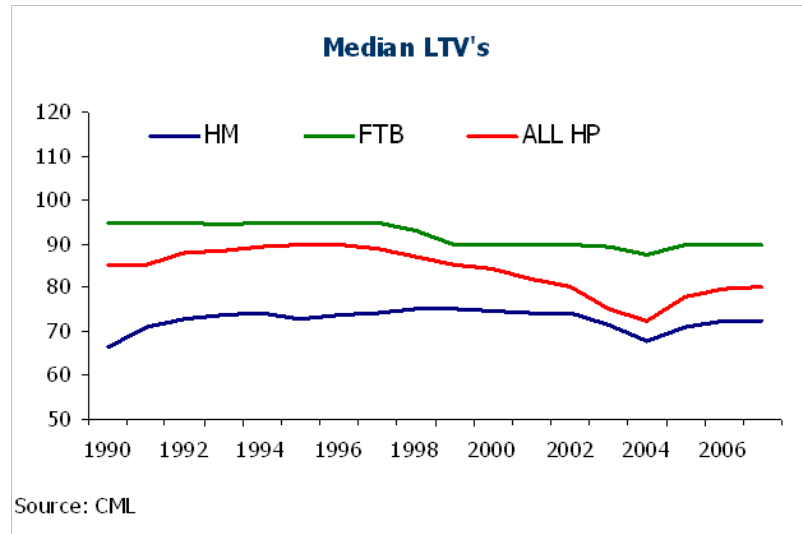
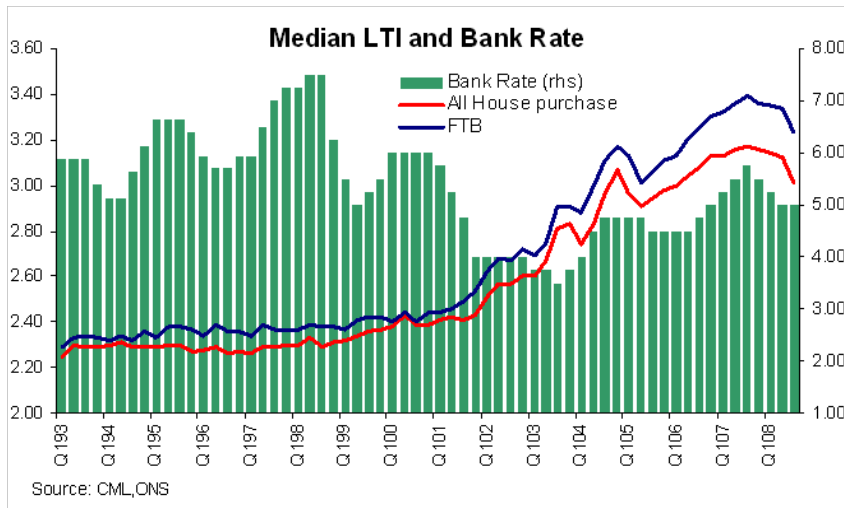


2007 Largest BTL providers, by gross advance	% BTL stock 2008H1	Taking new customers in 2008?
Birmingham Midshires & TMB	24%	Operating
Mortgage Express / B&B	18%	Not operating/Nationalised
Mortgage Works / UCB	11%	Operating
Paragon Group	7%	Not operating
Bristol & West Group	Estimated 7%	Not operating
Cheltenham & Gloucester	7%	Operating
Capital Home Loans	Estimated 6%	Not operating
Northern Rock	4%	Nationalised
Barclays- Woolwich	4%	Operating
Total	Estimate of 88%	

Source: CML

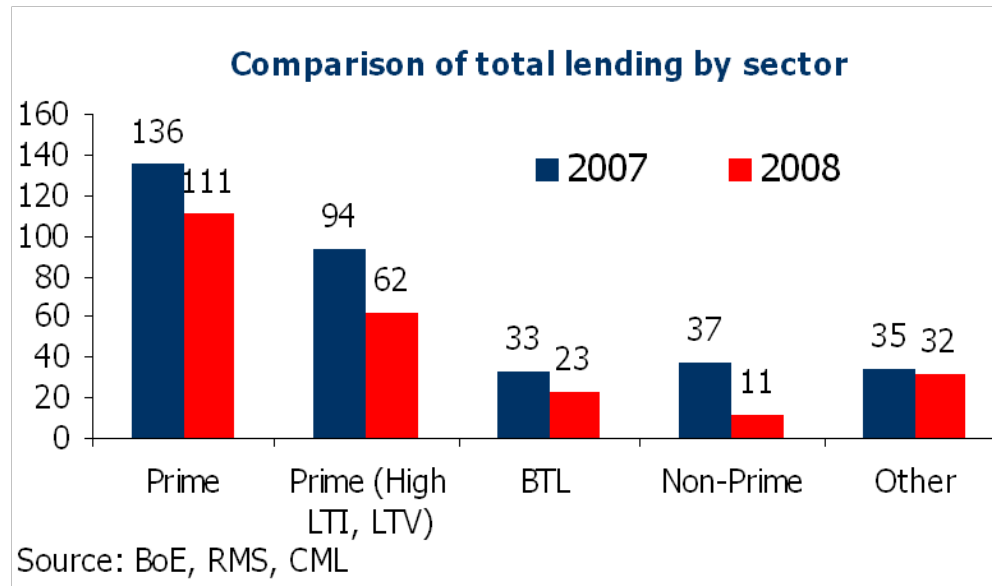
- 30% fall in BTL lending in 2008 and expected to continue to fall due to supply, risk and demand
- Collapse of several BTL lenders
- Higher perceived risks as BTL defaults pick up beyond prime levels
- Borrower demand will be muted by evidence of falling yields in 2008

Higher LTI lending increased over time



- Even in prime loans median loan-to-income ratio (LTI) has increased since start of decade as lower interest rates made debt seem more affordable
- Median loan-to-value (LTV) fairly static over time
- We define 'risky' prime loans as LTI >3.5 and or LTV >90%

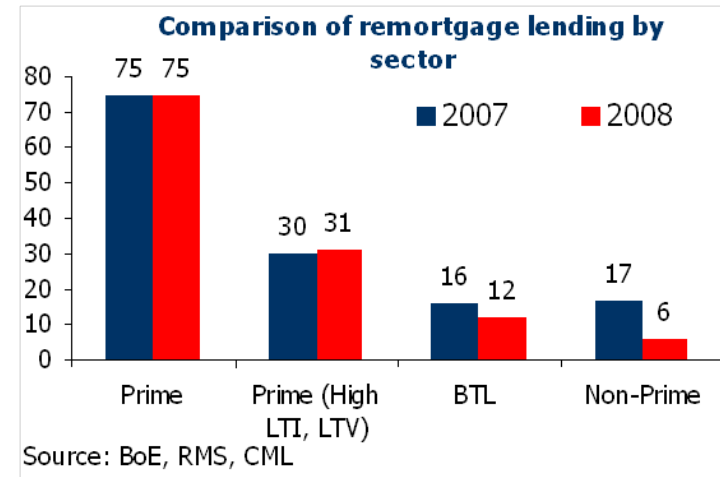
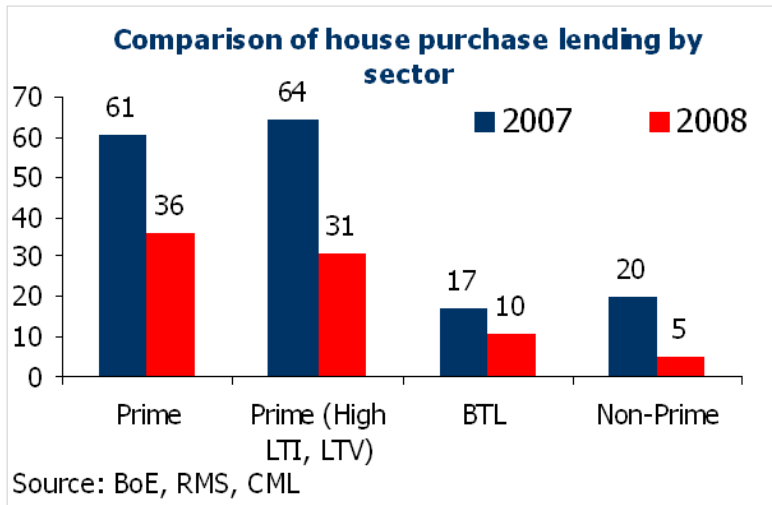
Riskier lending falling away



- Lending to 'riskier groups' made up almost half of the market in 2007.
- But the higher risk categories have seen bigger falls over 2008*

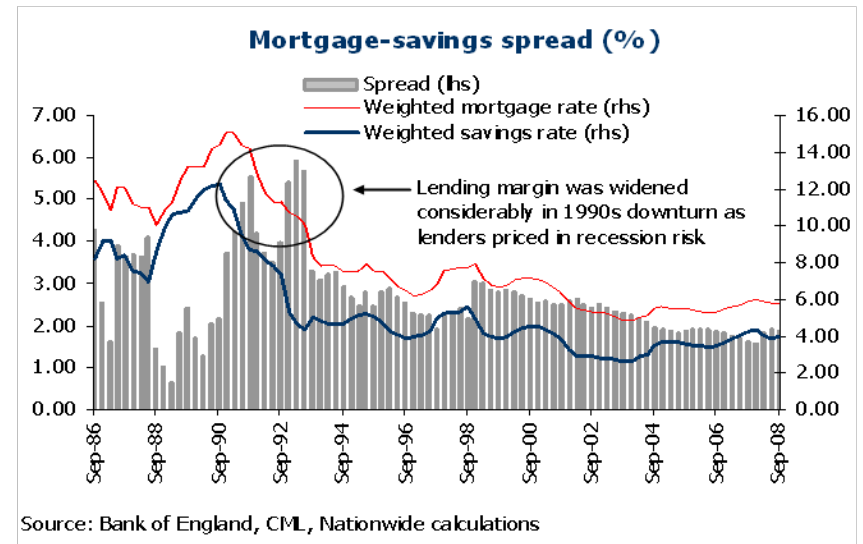
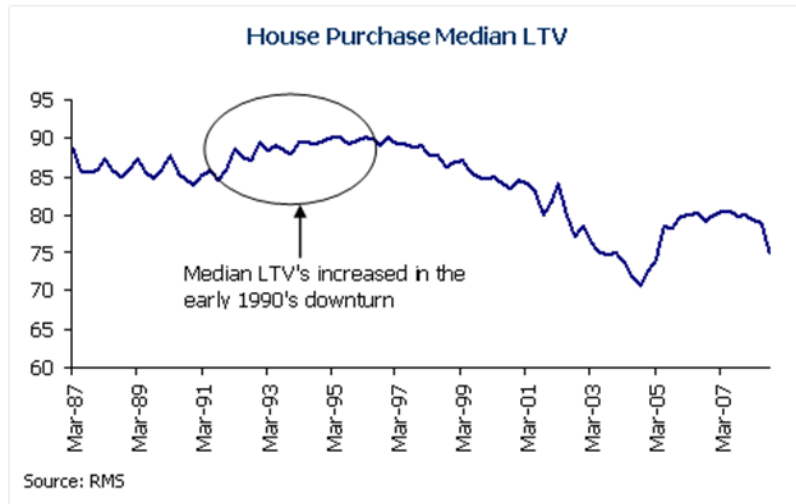
*corresponding 11 month periods in 2007 and 2008

But demand, not supply led



- Prime house purchase activity has seen a sizeable decline, but prime remortgage remains unchanged from a year earlier.
- If an issue of credit supply alone, remortgaging would have seen similar fall
- Availability of loans to creditworthy borrowers has been maintained.

Risk - and reward



- Appropriate pricing of risk fundamental to restoring lending to 'riskier groups'
- 1990s downturn characterised by high LTV lending while prices were falling AND higher margins to reflect risk
- Margin widening more difficult in a low interest environment

Conclusions

- Economic conditions are worsening
- Avoiding prolonged deflation is imperative – opening door to quantitative easing
- Housing market cannot decouple itself from the wider economy
- Wholesale funding has been a constraint on lending but growing economic and housing market weakness has overtaken this
- Borrower demand is also fundamental to fall in mortgage lending
- Creditworthy borrowers still have access to credit
- Demand for higher LTV lending can only be accommodated if risk can be priced effectively
- Current conditions do not suggest a return to lending levels of 2007 is feasible, even with greater wholesale liquidity

Our Economic World

Interest rates, the housing market and lending

Fionnuala Earley
Nationwide Building Society