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MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

JOHN LOOS: HOUSEHOLD AND PROPERTY SECTOR STRATEGIST: FNB HOME LOANS

011-6490125
John.loos@fnb.co.za

THEO SWANEPOEL: PROPERTY MARKET ANALYST
FNB HOME LOANS
011-6320604
tswanepoel@fnb.co.za

MORTGAGE MARKET BAROMETER

Key 2015 Themes in the Residential Mortgage Market – Stronger near term growth in new lending, and a possible increase in competition levels between lenders

An acceleration in the growth rate in Residential Activity Levels during the 2nd half of 2014 is expected to feed through into some lagged resurgence in the growth in the value of new Household Sector mortgage loans granted, taking this growth rate back up into the 10-15% range during the 1st half of 2015. However, new lending growth is not expected to be sufficient to halt the multi-year declining trend in the real value of mortgage debt outstanding.

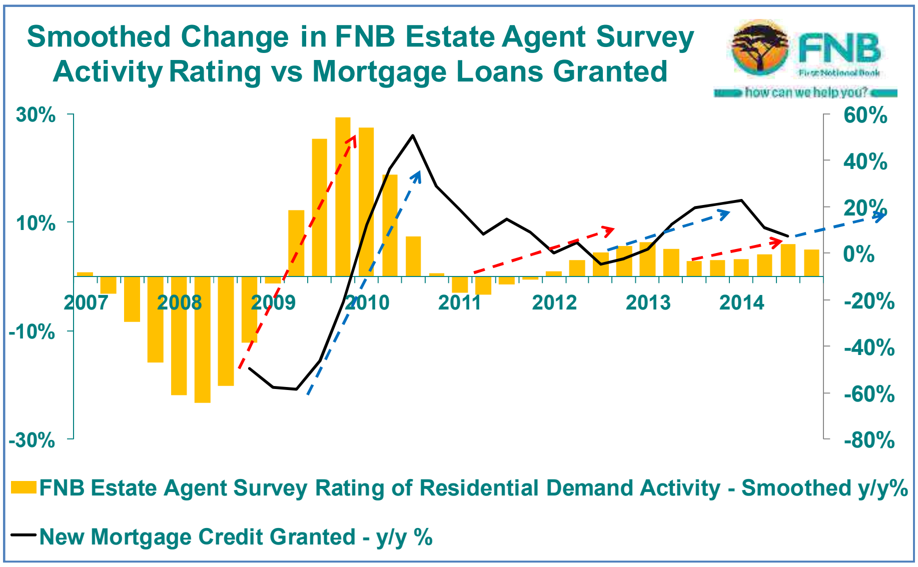
IT APPEARS TIME FOR ANOTHER BOUT OF STRONGER GROWTH IN NEW MORTGAGE LENDING IN THE 1ST HALF OF 2015

Recent events suggest that we should see some renewed strengthening in Household Mortgage Credit demand growth to come

While the Residential Mortgage Market appeared to be in something of a "growth lull" with regard to new lending in the latter stages of 2014, the signs are there that we should perhaps expect the 1st half of 2015 to bring some renewed strengthening in growth in the value of new mortgage lending. Our expectations are based firstly on our reasoning that we have entered 2015 with a noticeably improved economic outlook, given the late-2014 drop in global oil prices, and to a lesser extent food prices. Questions remain as to how long the low oil prices will last, but we expect them to last long enough for CPI inflation to drop into the 3-4% range this year, which not only boosts Real Household Disposable Income growth but also raises the probability of interest rates moving sideways through 2015.

And some Leading Indicators also point to this possibility

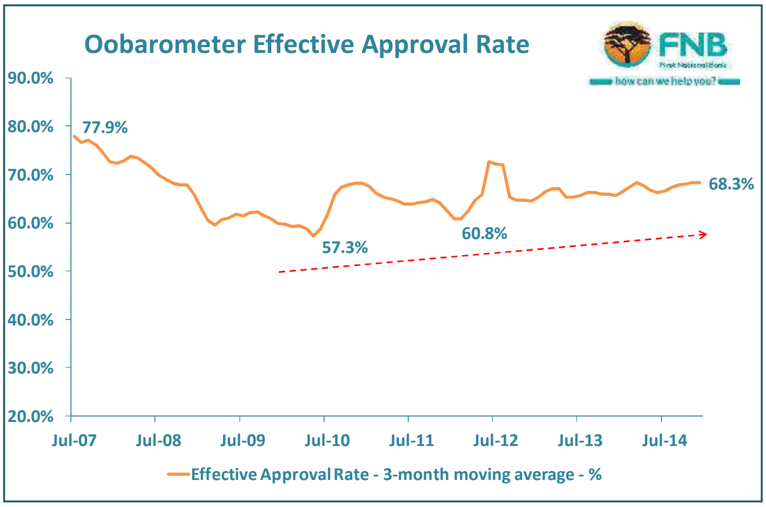
Secondly, our expectations are led by one of our key leading indicators. On a smoothed basis, the FNB Estate Agent Survey showed a year-on-year growth acceleration from 3.1% at the end of 2013 to 5.9% by the 3rd quarter of 2014. Typically, the year-on-year growth direction in the value of new mortgage loans granted can lag the Residential Activity Index by 2-4 quarters. So, while the final quarter of 2014 saw a mild slowdown in growth in the Activity Indicator, the prior acceleration through much of 2014 has not yet been seen in a lagged response from new mortgage loans growth.



BESIDES A MILDLY STRONGER ECONOMY, A MORE RELAXED BANK CREDIT APPETITE MAY ALSO PLAY A ROLE IN SUPPORTING NEW LOANS GROWTH IN 2015

Banking sector home loan approval rates have been on a gradual rising trend

Besides a mildly stronger economy and elevated property market activity supporting mortgage lending growth in the 1st half of 2015, some further increase in banking sector approval rates/effective relaxation in lending criteria is not out of the question. Low levels of banks' non-performing mortgage loans in recent times are possibly encouraging some mildly more relaxed lending criteria, even although the levels of bad debt are not a good indicator of current risk.



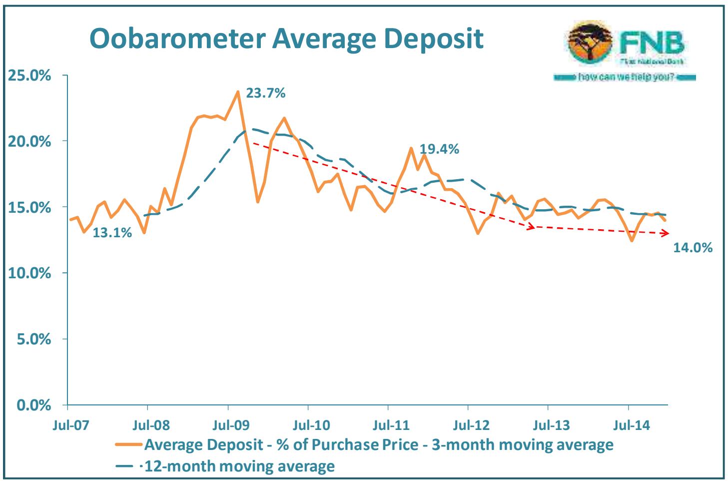
At the end of 2014, the gradual trend towards higher levels of bank approvals of mortgage loan applications was still very much intact, according to mortgage originator, Ooba. After ending 2013 with an "Effective Home Loan Approval Rate" of 64.4%, on a 3-month moving average basis, the last 3 months of 2014 saw a higher 68.3% Effective Approval Rate, continuing a broad rising trend since the multi-year low of 57.3% for the 3 months to May 2010.

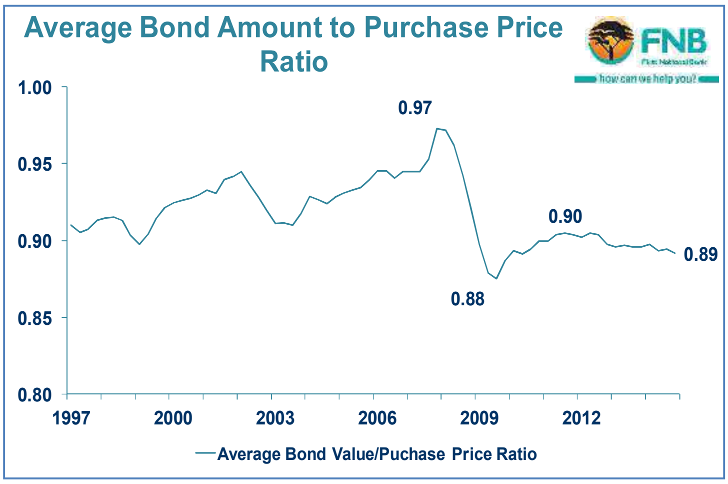
Required home loan deposits are well off 2009 highs, but the average Loan-to-Purchase Price Ratio has not gone "through the roof"

At the current time, little suggests that banks' mortgage lending stances are "overly aggressive yet, although it is important to bear in mind that the height of the boom almost a decade ago is not a good benchmark of what is a prudent or an acceptable level .

In terms of home loan applications that go to banks through Ooba, the average required deposit on a home loan averaged 14% of home purchase price for the last 3 months of 2014. This is sharply lower than the 23.7% peak reached in August 2009, not long after banks as a group had gone through major credit appetite adjustments following the pain of the interest rate hiking cycle from 2006 to mid-2008.

While Ooba's own stats estimate the average home loan deposit rate by end-2014 as being not too dissimilar to the 13.1% as at the 3 months to June 2008, our own estimates of the Average Registered Bond Value/Home Purchase Price ratio, using Deeds data, suggests that for the market as a whole the average Loan-to-Purchase price has not gone "through the roof", possibly even declining mildly after some noticeable rise from 2009-11.





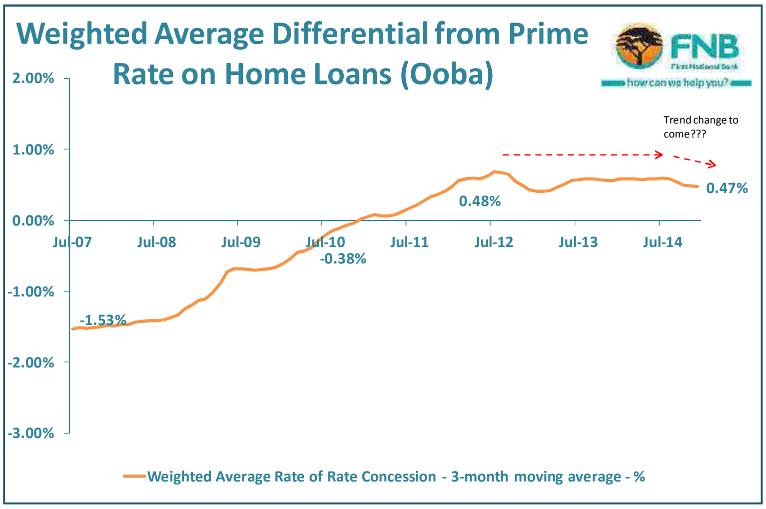
After some years of strong lending growth in the non-mortgage areas of Household Credit, which perhaps limits "further upside", and given that mortgage lending criteria don't yet appear "overly lax", it is conceivable that the banking sector may be keen to grow its new mortgage lending further in 2015, especially given the vastly improved state of bad debt in this area.

Therefore, we see it as plausible that the growth in value of new Household Sector Mortgage Loans Granted could shift up a notch in the 1st half of 2015, into the 10%-15% range, from a rate of 7.35% year-on-year as at the 3rd quarter of last year.

In a more competitive mortgage lending environment, could home loan pricing come under increased downward pressure?

While the prospects for sideways movement in interest rates, and a still-declining Household Sector Debt-to-Disposable Income Ratio, bode well from a bad debt point of view in 2015, the question is whether a "hotter" residential and mortgage market in 2015 will start to introduce more "competitive" home loan pricing levels. This is not easy to predict, but any increase in competition levels caused by a possibly greater desire to grow home loans, can conceivably lead to this.

Ooba data suggests that the home loans market has got to a level of competition where increases in the average effective home loan interest rate above Prime Rate have all but come to an end, but there is not yet conclusive evidence of the start of a declining trend. Prior to the property and mortgage market slump in 2008, big discounts below Prime Rate were almost the norm in the industry, with Ooba reporting an average discount below Prime Rate of -1.53 of a percentage point back in mid-2007, using a smoothed 3-month moving average data series. A lack of profitability in the industry at those discounted levels led to a large-scale "upward re-pricing" of the home loans market to where the average effective home loan interest rate was +0.67 of a percentage point by August 2012. From then on this average differential above Prime Rate average has moved broadly sideways (bar a temporary dip in 2012). However, of late there have been vague signs of a decline, with the 3-month moving average down from +0.58 of a percentage point above Prime in August 2014 to +0.47 of a percentage point by December.

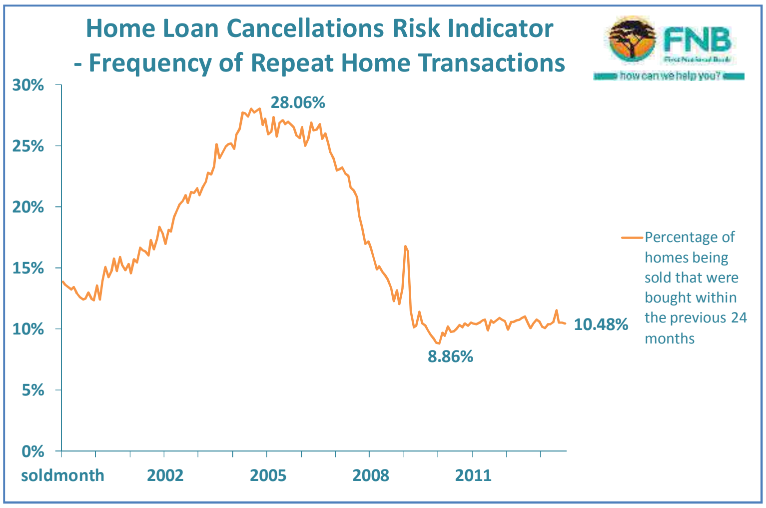


This small downward movement, however, is not yet conclusive evidence of a trend towards a lower pricing differential above Prime rate, but in the currently positive mortgage lending environment such a trend is indeed a possibility in 2015.

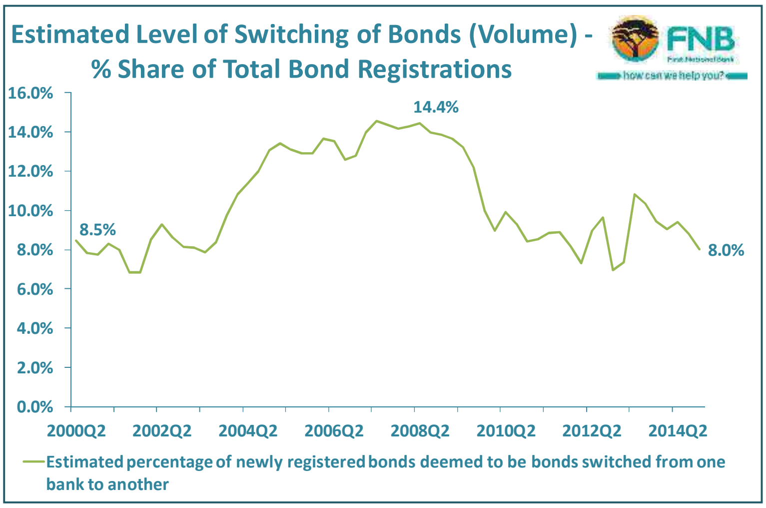
And does home loan "cancellation" risk start to increase? To date, not noticeably

Due to the significant administrative costs of placing a home loan on the books of a bank, early settlement and cancellation of a home loan can erode profitability of lending institutions. This was very much the case back prior to 2008 in the boom years, where frequency of home loan cancellation was heightened by a far higher frequency of properties being transacted, as well as a higher portion of existing home loan clients being "switched" from one bank to another.

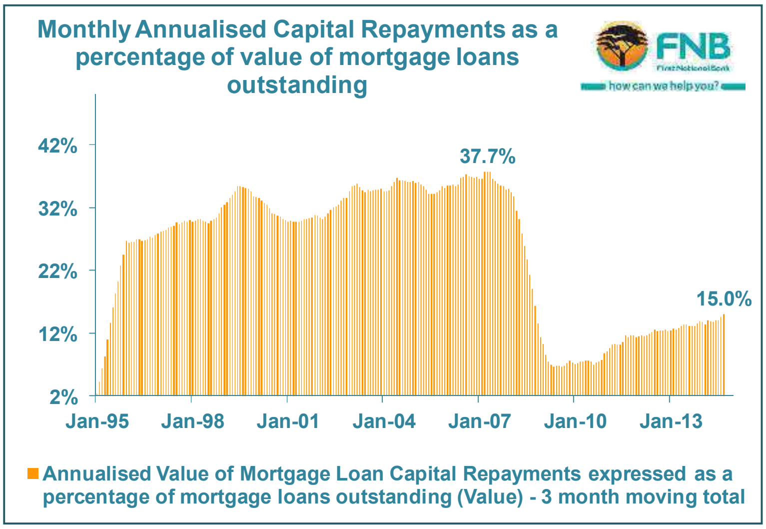
Currently, the frequency of homes being transacted remains low compared to the crazy highly-speculative boom days. We have developed one proxy for such "cancellation risk" by using Deeds data to examine what percentage of homes sold in any month were



last bought within 2 years prior to this sale. As at July 2005, an extreme 28.05% of homes were identified as having been bought within 2 years prior to that month, a reflection of the crazy period of high frequency speculative activity as well as a strong desire to sell and upgrade properties. By comparison, the post-recession period from 2009 onward has seen a far greater percentage of people "staying put" for longer, and the percentage of homes being sold within 2 years of last being bought remained fairly moderate at 10.48% by September 2014. This reflects only a marginal rise from an 8.86% low reached in 2010.



We also don't yet see any meaningful increase in risk emanating from greater levels of switching of home loans between banks. Using Deeds data, we estimate that as at December, 8% of total bond registrations were "switched" bonds from one bank to another. This remains significantly below the 14.4% peak reached in the 2nd quarter of 2008, as lenders with their "switching campaigns" tried to extract the last life out of the property boom.



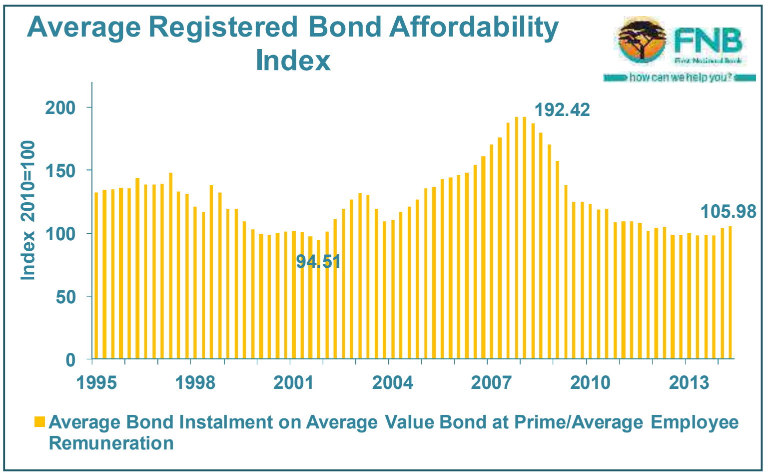
Therefore, to date we see a "settled" residential and mortgage market where lower rates of property turnover and switching are arguably key to a lower pace of capital repayment on home loans.

SARB mortgage data shows the pace of the total value of annualized capital repayments as a percentage of the value of mortgage loans outstanding (includes commercial mortgages but residential dominated) having risen to 15% by the 12 months to September 2014, from a lowly 6.8% in mid-2009, but the level remains far lower than the boom time peak of 37.7% in April 2007.

Therefore, our set of "home loan cancellation risk" indicators don't show an apparent high level of such risk at present, but any possibility of higher levels of competition between banks, or a stronger residential property market, can raise such risk in future.

Affordability can start to gradually be more of a challenge

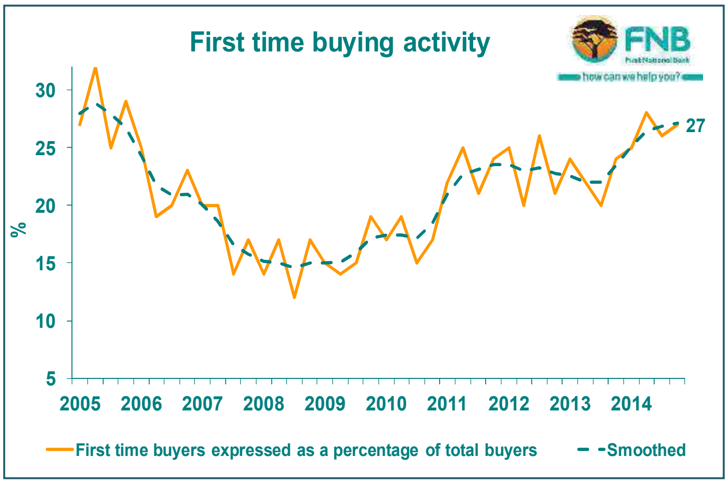
While we don't expect a home loan affordability deterioration to yet slow the pace of new home lending in the currently positive property and interest rate environment, the start of affordability deteriorations may start to gradually become more of a challenge, and could see a portion of home demand shifting towards the lower end of the residential market.

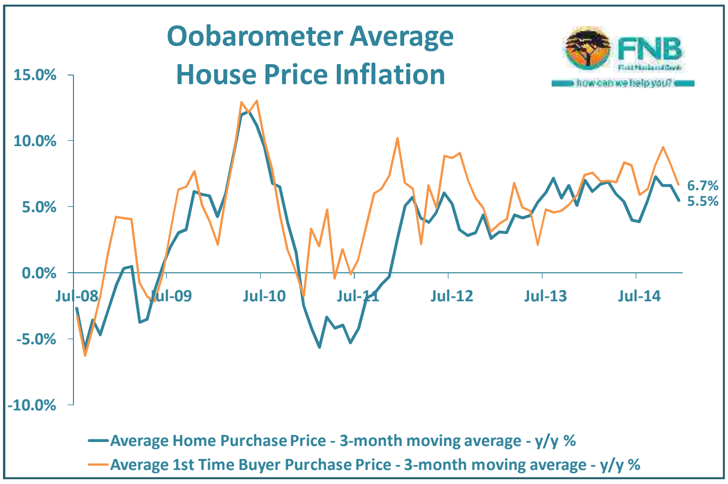


Home loan affordability still remains at relatively low levels compared to the 2008 peak of relative "in-affordability". However, based on Deeds data for bond registration values, our bond affordability index showed a slight upward (deteriorating) turn in the 1st half of 2014. The Installment Value on the Average Bond/Average Employee Remuneration Index rose by 7.9% from end-2013 to the 2nd quarter of 2014, due to the average bond value growing at a faster rate than average employee remuneration, and of course there was a January interest rate hike.

Our forecasts of house price inflation moving higher into the 8-9% range during 2015 are expected to lead to further mild deterioration in home loan affordability this year as house price inflation exceeds employee remuneration growth. However, with interest rates forecast to move sideways in 2015, such affordability deterioration would probably still be moderate.

Has a mounting affordability challenge had any impact yet? If one examines 1st time buying patterns, perhaps. Certainly, our Estate Agent Survey shows very strong levels of 1st time buying, at an estimated 27% of total home buying, and no hint of slowing. But Ooba data does show that through much of 2014 the year-on-year growth in the average 1st time buyer house price (5.5% year-on-year average for the 3 months to December) was lower than the inflation rate in the overall average house price (6.7% year-on-year average for the 3 months to December), suggesting that 1st time buyers may be having to "cut their coat according to their cloth" to a greater extent than the less affordability-sensitive repeat buyer group.





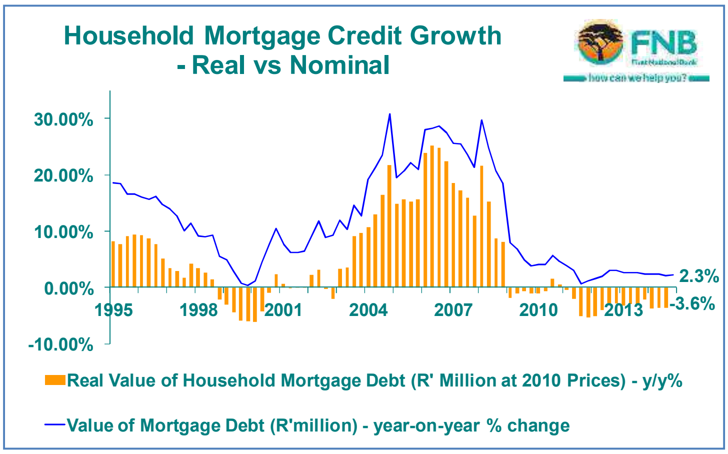
BUT THE "DOWNWARD REAL CORRECTION" IN THE REAL SIZE OF THE HOUSEHOLD SECTOR MORTGAGE BOOK LOOKS SET TO CONTINUE IN THE NEAR TERM

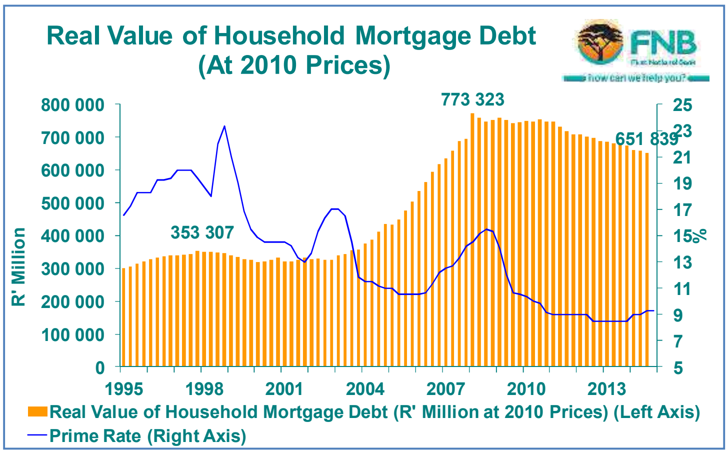
However, while we anticipate some strengthening in the value of new mortgage lending growth, this is unlikely to yet translate into growth in real terms in the overall value of Household Sector Mortgage Debt Outstanding.

As at the final quarter of 2014, year-on-year growth in total Household Sector Mortgages Outstanding (includes commercial properties mortgaged by households but residential dominates) grew year-on-year at 2.3%. Constraining the rate of growth in total mortgage debt outstanding is that huge number of boom time loans that are being paid down over time, which offsets the growth in recent new lending, given that current volumes and values of mortgage lending remain well below the peak levels of the pre-2008 boom despite recent growth.

These slow growth rates in the value of total mortgage debt outstanding remain well below consumer price inflation, implying that the value of the overall household mortgage debt burden continues to decline in real terms, a downward correction that has been in place for most of the time since late-2008.

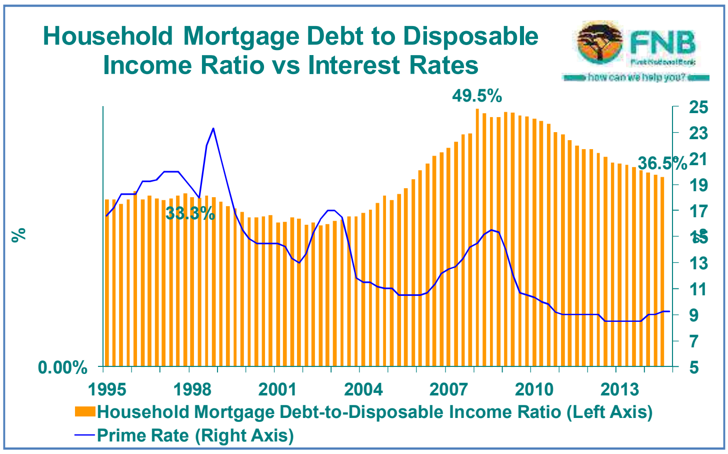
The total cumulative decline in the real value of the Household Sector Mortgage Debt Outstanding (Using PCE deflators to adjust to real terms) since the peak of since has been -15.7%.

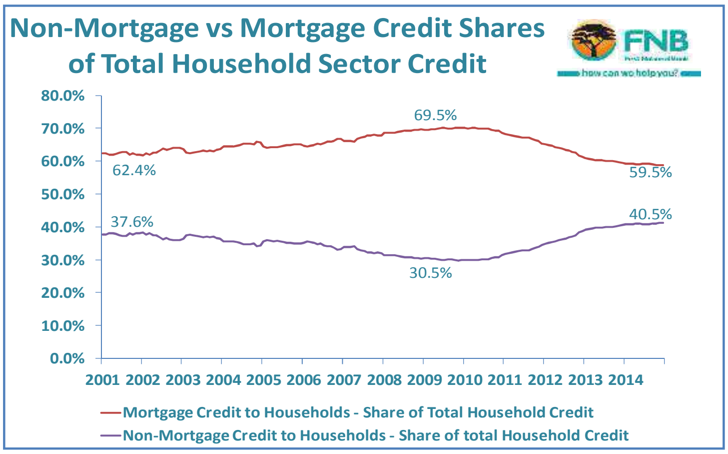




With Average Formal Sector Employee Remuneration and overall Household Sector Disposable Income growth outstripping consumer price inflation for much of the post-boom period, the decline in the size of the Household Sector Mortgage Debt relative to Disposable Income has been even more significant than it has relative to consumer prices. From a 49.5% peak early in 2008 the Household Mortgage Debt-to-Disposable Income Ratio has declined to 36.5% by the 3rd quarter of 2014. Given our nominal Household Disposable Income forecast of 7.2% for 2015, we don't expect outstanding mortgage loans growth to catch up yet, and as such expect further decline in this ratio.

One "relative" correction that looks to be more-or-less complete, however, is the percentage of Household Mortgage Debt relative to overall debt, with a most recent 59.5% of the total Household Debt amount seemingly down and back into line with the 62.4% of total debt recorded back early last decade in 2001, just prior to the meteoric boom time rise. From here on it would appear than the ratio of mortgage to non-mortgage credit won't decline too much, but both forms of credit are expected to decline a little further as a percentage of disposable income, as we anticipate some further decline in the Overall Household Debt-to-Disposable Income Ratio.





IN CONCLUSION

There exists a lag between movements in the FNB Estate Agent Survey's Residential Market Activity Rating Index, and movements in growth of new mortgage lending. Through the 2nd and 3rd quarters of 2014, both NCR (National Credit regulator) and SARB (Reserve Bank) data pointed to something of a lull in year-on-year growth in the value of new mortgage loans granted for Residential purposes and for Household Sector purposes.

However, some renewed acceleration in growth in the Estate Agent Survey Residential Activity Levels during the 2nd half of 2014 is expected to feed through into some lagged resurgence in the growth in the value of new Household Sector mortgage loans granted, taking this growth rate back up into the 10-15% range during the 1st half of 2015. Not only does the Residential Activity Index, normally a good leading indicator of new mortgage lending growth, point to this, but the expectation also appears plausible from examining some key economic indicators, with a massive drop in oil prices already starting to slow consumer price inflation. This in turn promises to delay interest rate hikes as well as promote stronger Real Household Disposable Income growth this year.

In addition, the banking sector's lending appetite appears to continue to improve, if Ooba data regarding Effective Home Loan Approval Rates are anything to go by, and with an improved economic outlook for 2015 it may be realistic to expect this trend to continue.

Does greater lender optimism on the home loans market lead to more competitive pricing of home loans in the near term? This is a possibility, as is the possibility of greater home loan "cancellation risk" emanating from a stronger residential market leading to more frequent sales of homes, along with the possibility of more competitive lender behavior leading to a greater level of home loan "switching". To date, though, we see little sign of noticeable increases in such behavior, with the residential and mortgage markets appearing largely "calm and rational".

With house price inflation expected to outstrip average household income growth in 2015, a gradual deterioration in housing and mortgage loan affordability is expected. As our Mortgage Affordability Index remains relatively low (implying high level of affordability), the start of a deteriorating trend is not yet expected to negatively impact on home mortgage loans growth in any meaningful way. However, this rising challenge may impact on the growth in value of the average home loan, as some have to moderate their aspirations and turn towards a lower priced segment of the market.

Despite our expectation of some near term strengthening in the growth in value of new mortgage loans granted, we don't yet foresee an end to the declining trend in the real value of Household Sector Mortgage Debt outstanding. Nominal Mortgage Debt remains rooted below inflation, and even further below average household disposable income growth. This is because the levels of new lending today are still well below the boom time peak levels almost a decade ago, and it is that mass of boom time loans that are currently being paid down that hamper the growth in the total mortgage book.