CREDIT SPREADS IN THE NOVEMBER 2015 FORECAST

Recommended reading for the Benchmark meeting

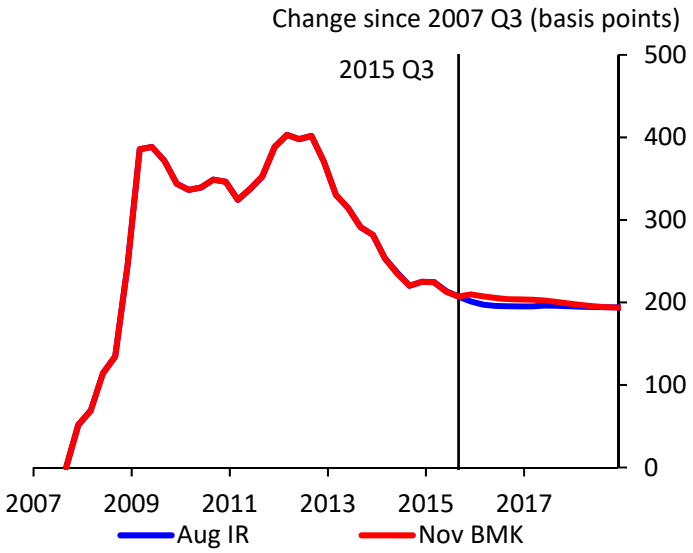
MASD

Main message: The overall outlook for aggregate bank credit spreads is little changed on the quarter, as we continue to anticipate a small further easing. In the near term, the forecast for credit spreads is slightly higher, reflecting an increase in bank funding costs and lagged pass-through of a fall in swap rates. However, in light of intense competition across a number of key lending markets, this revision is limited and by the end of the forecast aggregate credit spreads are broadly unchanged relative to August.

Key message

- While aggregate credit spreads fell as projected in 2015 Q3, the Benchmark projection for credit spreads is slightly higher over the near term than that underlying the August *IR* (**Chart 1**).

Chart 1: Summary measure of credit spreads (Aggregate CSA)



- That reflects two factors. First, the large fall in the swap curve pushes up on credit spreads in the near term, as these lower rates are only gradually passed through to the rates facing households. Second, UK bank funding spreads are around 30bps higher than expected at the time of the August *IR*. While the direct impact of China on UK banks' funding costs appears to be modest, the associated generalised increase in financial market volatility has pushed up on the cost of funding. Although some of this is expected to unwind gradually over the next few months, bank funding costs are now close to our projection for their steady state levels.
- Set against this is more evidence of continued competition in household and corporate credit markets, which has led us to revise down the steady state levels of some household bank lending spreads, partly reflecting falls in the data.
- Higher credit spreads relative to the August projection push down on the forecasted level of GDP by a little under 0.1% by end-2016. Combined with a slightly easier forecast for corporate spreads, which boosts potential output, the output gap is also around 0.1% lower. But by the forecast horizon, the downwards revision to the steady state level of household credit spreads leaves the level of GDP slightly higher than in August, and the output gap little changed. In the absence of that judgement, the level of GDP would be around 0.15% lower by the end of the forecast than projected in August.
- In absolute terms, the profile for credit spreads is for a small further easing. That reflects further small falls in household spreads, partly offset by a gradual increase in corporate credit spreads.
- The biggest single identified risk to our central projection remains the transmission of global developments to UK banks' funding costs.

This note describes the November 2015 Benchmark outlook for credit spreads. The first section focuses on the central projections for household and corporate credit spreads and their impact on the main forecast. The second section discusses some of the key risks around the central case. A box provides a more detailed discussion of the outlook for the UK mortgage market.

Section 1: The November Benchmark projections for credit spreads

UK banks' wholesale funding costs are higher than expected in August, following the increase in financial market volatility around developments in China, while swap rates have fallen materially. Both of these are expected to push up slightly on credit spreads in the near term.

1. UK banks' wholesale funding costs have increased by around 20 basis points on average since the August *Inflation Report* (**Chart 2**), and are 30 basis points higher than expected. Over half of the increase since the August *IR* is accounted for by a rise in senior unsecured bond spreads (**Chart 3**). While the majority of the widening in secondary market spreads followed the increase in financial market volatility associated with developments around China, contacts noted that the increase in spreads also reflects other factors such as a significant pickup in issuance.[1] Overall, although the increase is material relative to developments over the past couple of years, the impact of events around China on banks' funding spreads over the quarter has been fairly modest, consistent with the judgement last quarter that the strengthening of banks' balance sheets over recent years has reduced their sensitivity to external shocks.

Chart 2: Projected bank funding costs over swaps

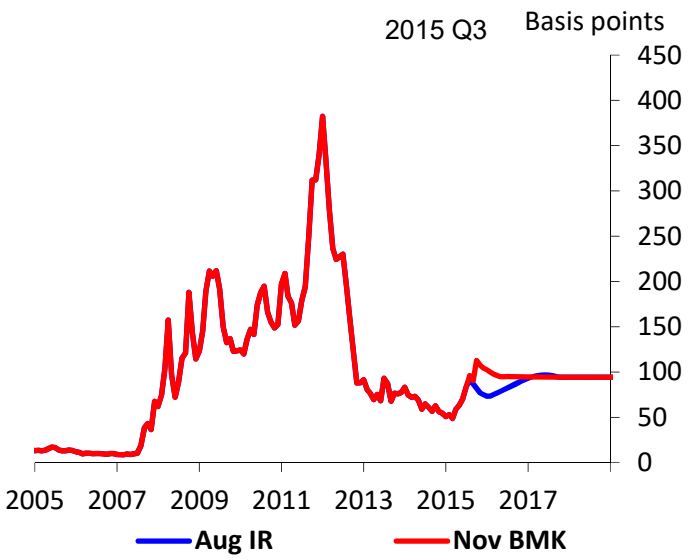
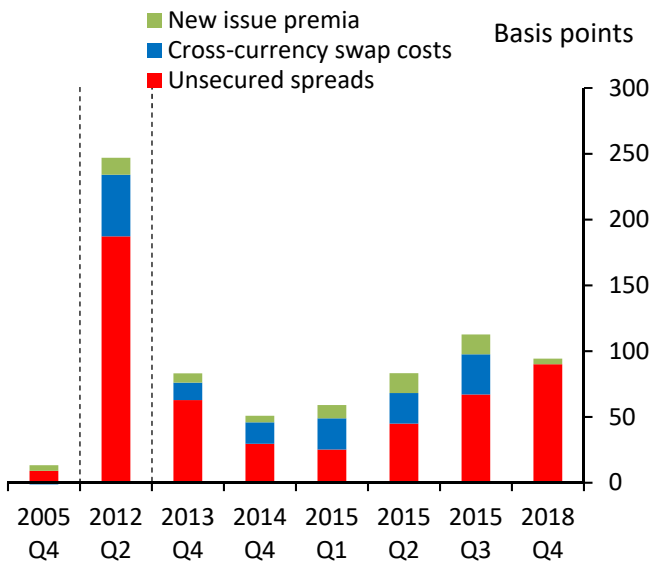


Chart 3: Components of 'all-in' funding spreads



2. Although the majority of the increase in funding spreads is attributable to unsecured bond spreads, other factors have also pushed up 'all-in' funding spreads (**Chart 3**). In particular, the cost of swapping debt issued in euros into sterling increased slightly over the past quarter. Market contacts have attributed that to the renewed demand to issue in euros following the hiatus around developments in Greece and the re-opening of euro funding markets after the summer break. [2]

3. We have not revised our view of medium-term funding spreads in light of developments over recent months. All-in funding spreads are now reasonably close to that medium-term estimate, such that funding spreads are projected to be broadly flat over the forecast. This is consistent with expectations of the major UK lenders that senior unsecured spreads are unlikely to fall below their current levels.[3] However, while overall funding spreads are expected to remain broadly stable, within this we expect a gradual increase in senior unsecured bond spreads to be broadly offset by a decline in cross-currency swap costs and new issue premia (**Chart 3**).

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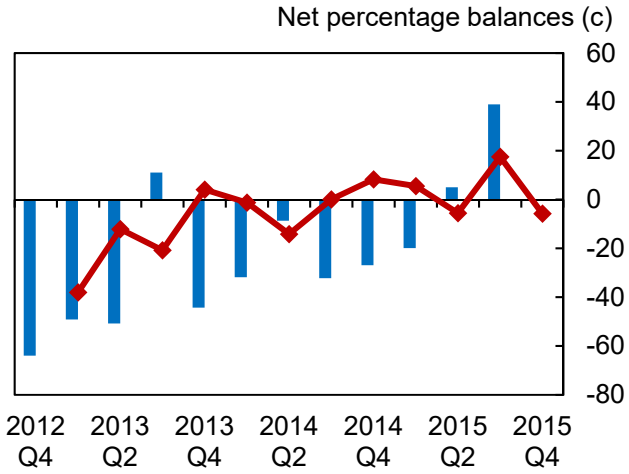
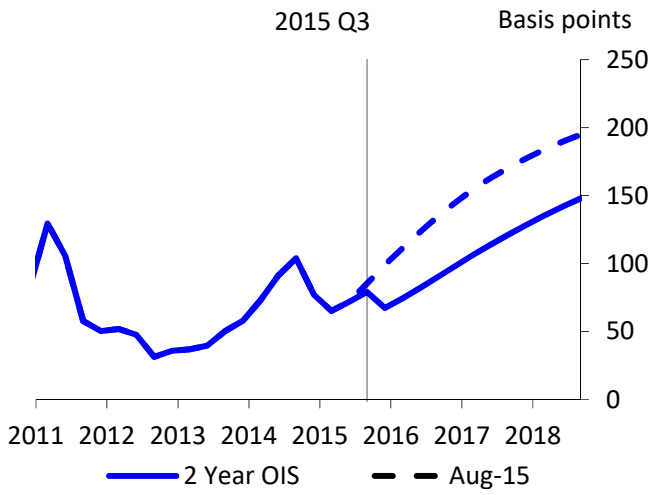
4. The higher profile for funding spreads in the near term is expected to push up slightly on credit spreads. Although banks were able to postpone issuance last quarter during the volatility associated with developments in Greece, and so avoid issuing while funding costs were elevated, banks have resumed issuance in August and September. It is therefore likely that banks will pass through at least some of these higher funding costs to their internal transfer prices. Consistent with this, lenders reported in the *Bank Liabilities Survey* that transfer prices had increased significantly in 2015 Q3, and more than had been expected in 2015 Q2 (**Chart 4**).

Chart 4: Banks' reported change in transfer prices[(a)]



Source: Bank Liabilities Survey
(a) The blue bars show the responses over the previous three months. The red diamonds show the expectations over the next three months.

Chart 5: Forward 2-year OIS swap rate[(a)]



Latest data are for 6 October 2015.

5. Swap rates are materially lower in September than projected in the August *IR*, having fallen around events in China and the September FOMC meeting (**Chart 5**). While the fall in the swap curve delivers lower household lending rates over the forecast, in the short term it pushes up on credit spreads as lower swap rates take time to pass through fully.

Intense competition across a range of domestic lending markets is expected to offset some of the increase in household credit spreads resulting from higher funding costs and lower swap rates.

6. Our summary measure of household credit spreads fell slightly in Q3, broadly as expected (**Chart 6**). Mortgage spreads fell by around 15 basis points in 2015 Q3, slightly less than projected in the August *IR* reflecting the unexpected fall in swap rates (**Chart 7**). But within this, spreads and rates on high LTV mortgages continued to fall materially, with the 40 basis points fall in 90% LTV spreads in Q3 relative to Q2 much larger than that projected in the August *IR*. Over the next year and a half, mortgage spreads are expected to be slightly higher than projected last quarter as lower swap rates and higher funding costs are gradually passed through (**Chart 7**).

7. This quarter we have reviewed the implications of recent intense competition in some sectors of the mortgage market. We expect that this competition in both low and high LTV mortgage markets will continue, leading to a smaller increase in spreads than otherwise would have been the case, given the rise in bank funding spreads and lower swap curve, and to a fall in mortgage spreads by the end of the forecast. In low LTV markets, we do not expect spreads to fall further given the compression in margins over the past year and the recent levelling out in spreads (**Chart 8**). But intense competition is expected to ensure that lower swap rates are passed through to low LTV mortgage rates more quickly than normal. Competition is also expected to continue to spill over to the high LTV mortgage market where margins are higher and lenders think that there is greater scope for spreads and rates to fall further. We have therefore taken a judgement to materially revise down our estimate of the medium-term level of high LTV mortgage spreads by around 60 basis points (**Chart 8**). While there are signs that lenders have increased their risk appetite recently, we do not expect this reduction in high

LTV spreads to be associated with a significant loosening in quantity restrictions, given the level of banks' risk appetite and as deposit and affordability constraints continue to bind. As such, we have not mapped lower spreads into a marked pickup in the availability of secured credit to those currently unable to get a mortgage. These judgements, and the associated risks around them, are discussed further in the box on page 5.

Chart 6: Summary measure of household credit spreads

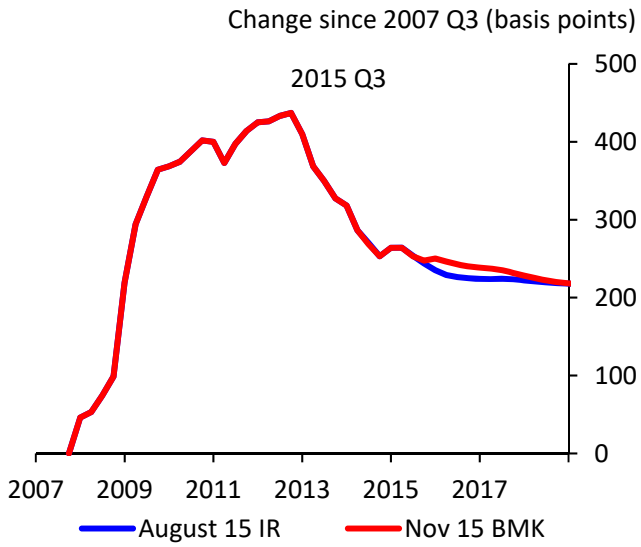
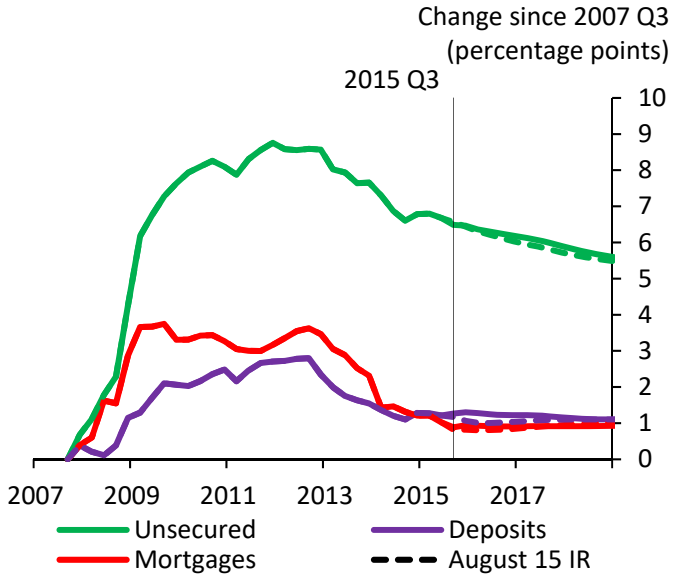


Chart 7: Household credit spreads by sector



8. Unsecured household spreads fell by around 20 basis points in Q3, 10 basis points more than expected (**Chart 7**). This reflected further reductions in quoted personal loan rates, which have fallen sharply over the past few years.[4] Over the course of the forecast, however, unsecured spreads are a little higher than projected last quarter because rates on credit cards and overdrafts are expected to remain unresponsive to changes in swap rates, as they have been since the start of the crisis. As with mortgage spreads, this increase in spreads on credit cards and overdrafts is expected to be partly offset by continued intense competition in the personal loans market, particularly from non-bank lenders. As part of this judgement, we have materially lowered our medium-term estimate of spreads for £5k personal loans reflecting a 1.4pp fall in rates on this product over the last three months, which we have taken as a signal about the steady state level of spreads (**Chart 9**).

Chart 8: High and low LTV mortgage spreads

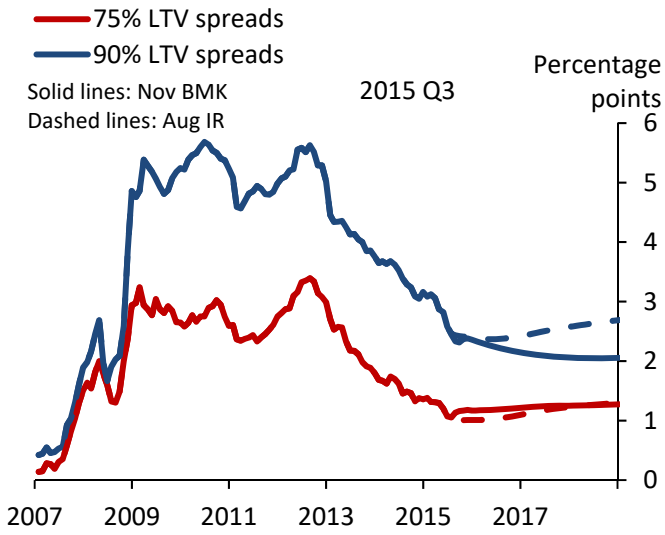
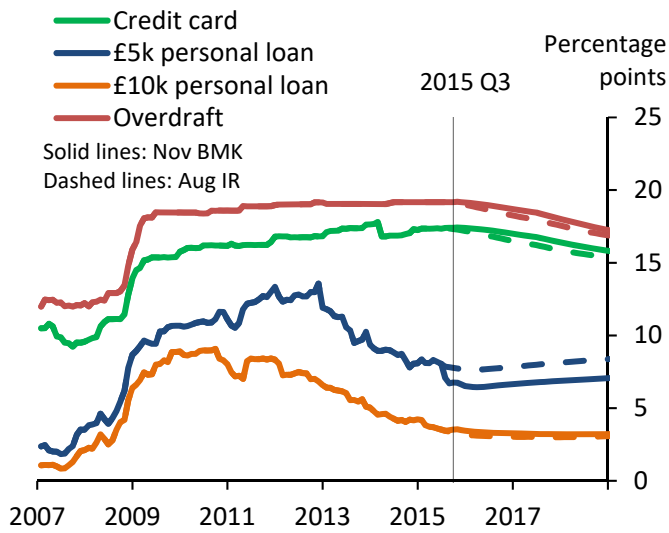


Chart 9: Unsecured spreads



[4]

9. Household deposit spreads were around 10 basis points higher in 2015 Q3 than projected in August, largely reflecting the fall in swap rates. Spreads remain slightly higher over the forecast. This partly reflects a lag in the pass-through of lower swap rates to deposit rates. But we also have revised up our forecast for instant access deposit spreads slightly. This reflects intelligence from the major UK lenders that most expect to pass through some of the first few increases in Bank Rate onto savings rates, in part due to political pressure. But thereafter they expect to rebuild margins by increasing deposit rates more slowly than Bank Rate.

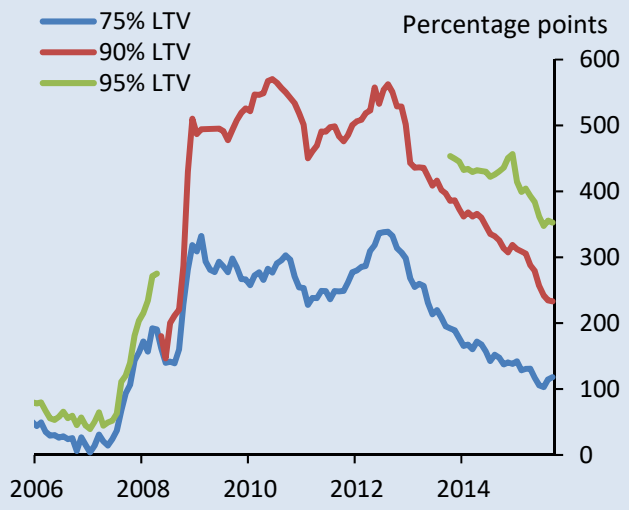
Box: Outlook for the UK mortgage market

Over the past few years, mortgage spreads have fallen sharply (**Chart A**). And while we expect mortgage spreads to be persistently higher than immediately before the crisis, due to factors such as higher bank funding costs, there may still be scope for spreads on some products to fall further. This box discusses the extent to which that might occur and the implications for credit availability.

What has driven the fall in mortgage spreads?

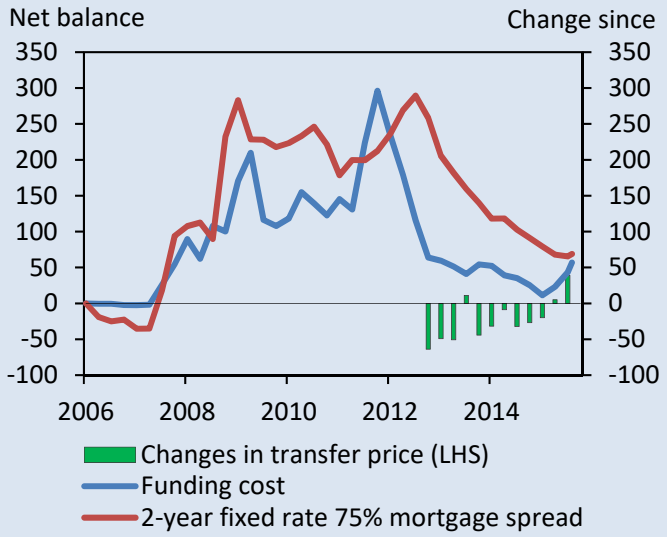
Much of the fall in mortgage spreads since 2012 has reflected lower and stable wholesale bank funding costs – in turn, reflecting the FLS and Draghi's commitment to do "whatever it takes" – which has led to reductions in lenders' transfer prices (**Chart B**). But intense competition has also led to an erosion of margins, even as bank funding spreads and transfer prices have stopped falling. Intelligence from the lenders, Agents and colleagues in the PRA points to a number of factors behind this competition including: increased focus on mortgages as an attractive return on equity given low capital charges, as well as on domestic markets more generally; the rising share of broker-intermediation increasing borrowers' price sensitivity; and unexpectedly low consumer demand making it harder for lenders to meet their annual lending targets.

Chart A: 2-year fixed mortgage spreads by LTV[(a)]



(a) Spreads over 2-year OIS rates.

Chart B: Bank senior unsecured spreads and transfer prices[(a)]



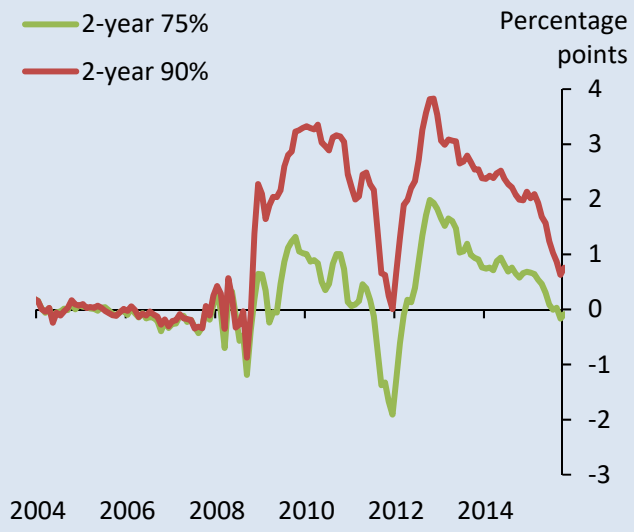
(a) The green bars show the net balance of responses over the previous three months for changes in transfer prices from the Bank Liabilities Survey.

Are mortgage spreads likely to fall further?

There appears to be broad agreement across the lenders, colleagues in the PRA and the Agents' contacts that spreads on low LTV mortgages not falling much further was a plausible modal projection, but that there is greater scope for higher LTV mortgage spreads to continue declining. Other metrics such as margins and the compression of the distribution of spreads appear to broadly support these judgements.

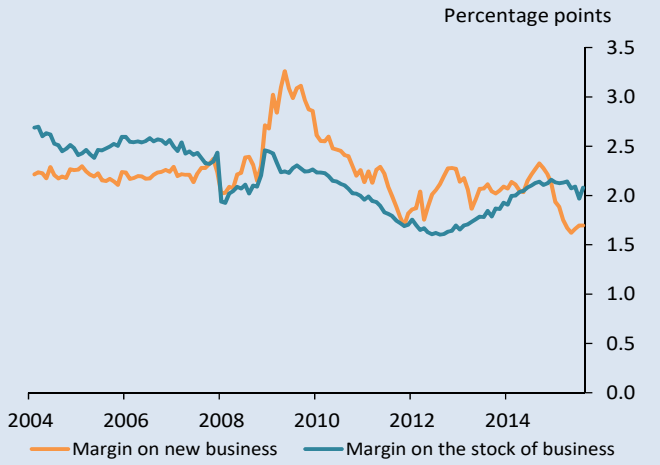
Although low LTV mortgage spreads have fallen for most of this year, in recent months spreads have levelled out (**Chart A**). Most of the major UK lenders believed that, while competition was likely to keep low LTV mortgage spreads low, they were unlikely to fall much further, citing the compression of margins over the past year.[5] Indeed, looking at two basic proxies of margins there does appear to be have been a material compression in margins on new business to levels close to or below those seen pre-crisis (**Charts C and D**). In addition, the distribution of mortgage rates has become more compressed with few signs that there are market leaders currently positioned to drive future rates lower (**Chart E**). Indeed, Lloyds/Bank of Scotland – which had offered the lowest rate of the B6 in the market – recently increased their low LTV mortgage rate.

Chart C: CSA proxy for margins on new business relative to 2004-05 average[(a)]



(a) Mortgage rate minus funding costs, expected losses and capital costs.

Chart D: Margin between mortgage and deposit rates – new business and stock[(a)]



(a) Stock margin is defined as the effective rate on the stock of mortgages minus the effective rate on the stock of deposits. Flow margin is defined as the effective rate on new mortgages minus the effective rate on new deposits. Data are unavailable on the share of time and instant deposits, so the share of the stock is used as a proxy.

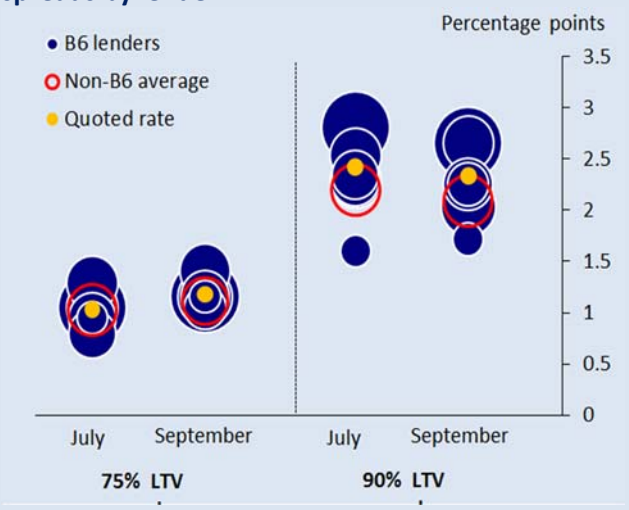
The risks around this central projection for low LTV mortgage spreads are two-sided, but are likely to be skewed to the downside. Lenders report that their margins remain "healthy" and they may be able to recoup profits on their backbook while running lower margins on new low LTV business. Profits from upfront fees and product tie-ins may also give lenders room to cut spreads while retaining profit margins. On the other hand, if the level of competition wanes then low LTV spreads may increase more than projected.

Spreads on high LTV mortgages appear to have greater potential to fall further. Margins on high LTV mortgages appear to remain somewhat elevated relative to pre-crisis levels (**Chart C**), and the lenders and colleagues in the PRA expect competition to continue to spill over from low LTV mortgages where margins are more compressed. There remains a wide distribution of rates available in the market – with HSBC and some non-B6 banks pricing themselves well below the average market rate (**Chart E**), suggesting scope for other lenders to respond if they begin to lose market share. And the recent increase in 95% LTV products, as well as Natwest's decision to re-introduce interest-only mortgages to select customers, might also be indicative of a generalised increased in lenders' appetite for riskier lending (**Chart F**).

This judgement, however, is conditional on impairment rates remaining at low levels, particularly during a prospective tightening cycle – one reason we do not expect high LTV spreads to return to their pre-crisis levels is that lenders will price in a greater risk of impairment than before the crisis. That said, one factor behind some lenders' decisions to begin offering 95% LTV mortgages outside of the Help to Buy 2 scheme is that they judge the scheme's guarantee to be less valuable than previously thought given continued low impairments.

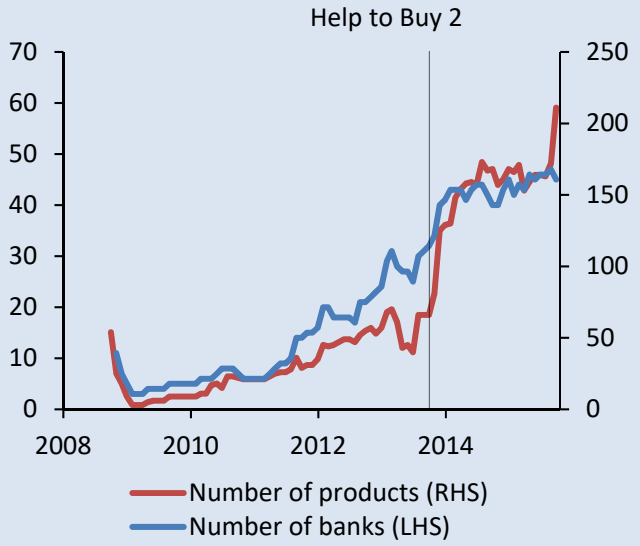
[5]

Chart E: Distribution of 2-year fixed mortgage spreads by lender[(a)]



(a) Size of the circle represents the weight of the lender in the Quoted Rate series.

Chart F: Number of 95% LTV products[(a)]

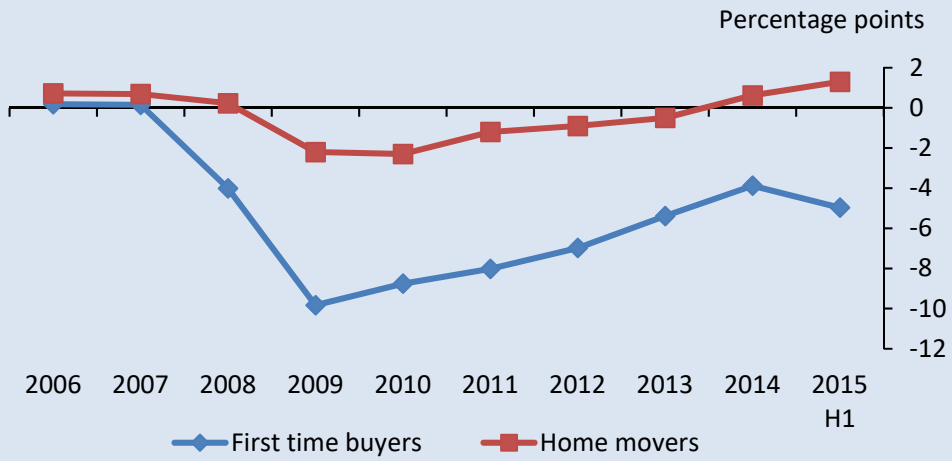


What do lower high LTV spreads mean for the availability of secured credit?

While we expect secured credit to become more cheaply available for those already able to get a high LTV mortgages we do not expect the fall in spreads to be associated with a significant loosening in the availability of credit to those currently unable to get a mortgage. Lenders are expected to compete more fiercely for the same broad group of borrowers, and as a result, we have left the proportion of people able to access secured borrowing in the CSA unchanged.

This judgement reflects the fact that although lenders expected to have to compete for high LTV business, none reported a desire to grow their high LTV book considerably. While the proportion of new mortgages with an LTV above 90% rose from 7% in 2014 Q4 to 10% in 2015 Q2, this was driven by one institution and lenders overall reported in the *Credit Conditions Survey* that they do not expect a significant change in the availability of these mortgages during 2015 Q4. In addition, the average LTV for a first time buyer – controlling for borrower characteristics like age and income – does not appear to have increased in the first two quarters of 2015 relative to a year or two ago (**Chart G**). Moreover, the average income of 90% LTV borrowers has followed a similar trend to those on lower LTV mortgages. As such, it does not appear that lenders are materially loosening deposit or affordability restrictions for borrowers on higher LTVs.

Chart G: Change in average LTV on new mortgages controlling for a given set of borrower characteristics, relative to 2005[(a)]



(a) Controls for age, gross income, property value and region.

Bank lending conditions facing companies continued to improve in 2015 Q3, albeit at a slower pace than earlier in the year. Corporate credit spreads are expected to pick up slightly over the forecast.

10. Bank lending conditions facing companies eased slightly in 2015 Q3, but are projected to tighten slightly over the forecast (**Chart 10**). The easing reflected continued competition for lending to large and medium-sized firms as well as a gradual improvement in conditions for small businesses.

Chart 10: Corporate credit spread forecast

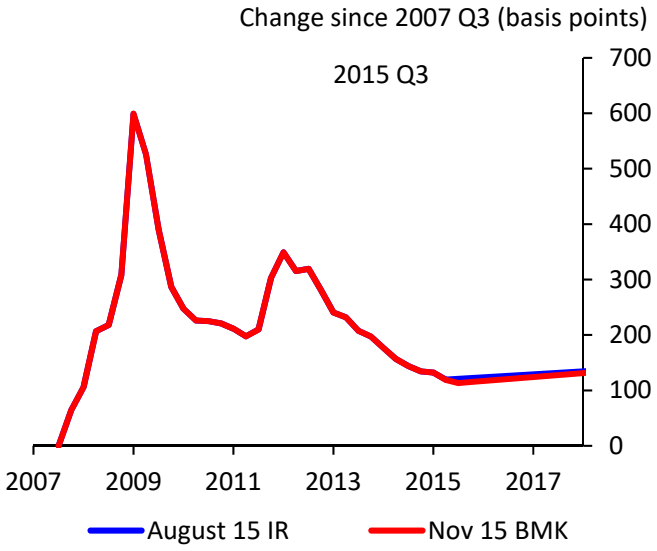
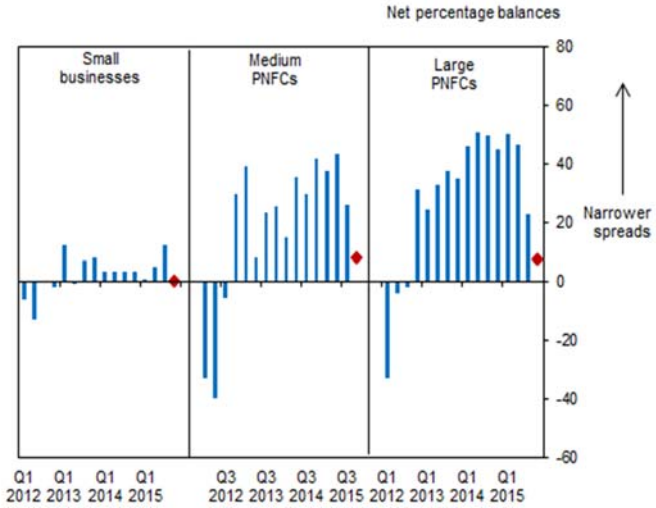


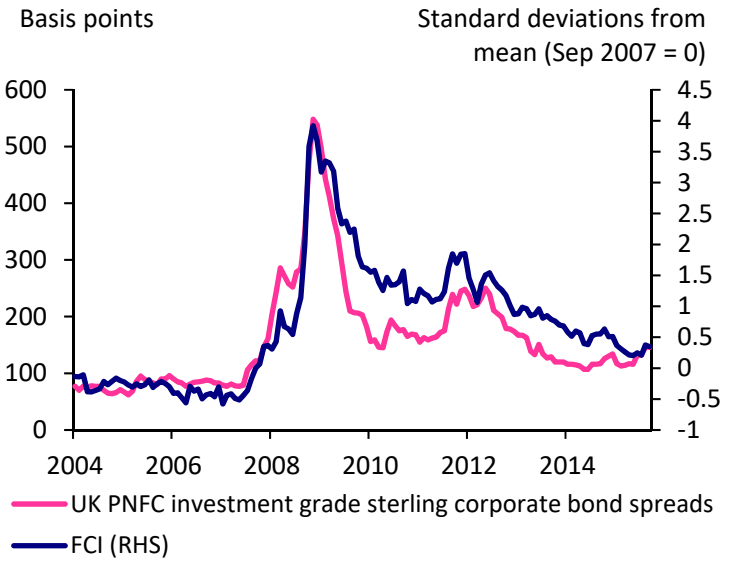
Chart 11: Credit Conditions Survey balances for bank lending spreads to companies



(a) The blue bars show the responses over the previous three months. The red diamond shows the expectations for 2015 Q4.

11. Spreads on lending to large companies narrowed a little on the quarter, but at a slower pace than earlier in the year. This reflected the reported narrowing of spreads by the lenders in the 2015 Q3 *Credit Conditions Survey* (**Chart 11**), as well as the fall in corporate bond spreads in 2015 Q2 which we believe generally affect terms on bank lending with a lag. Consistent with these indicators, intelligence from the Agents' contacts noted that price and non-price for large firms continued to ease over Q3 given high competition.[6] We have not taken a signal, however, from the pickup in corporate bond spreads in Q3 for spreads on bank lending next quarter. Intelligence from the Agents' network suggests higher bond spreads have had little influence on bank lending terms so far, with corporate treasurers' high cash holdings allowing them to delay bond issuance until more favourable market conditions re-emerge. Market contacts generally expect sterling corporate bond spreads to tighten by the end of the year. The small deterioration in wider financial conditions, however, as measured by the Financial Conditions Index (FCI) – driven in part by the increase in corporate bond spreads – might signal that financial

Chart 12: The Kapetanios, Price and Young FCI and UK corporate bond spreads



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conditions for large firms tightened a little in Q3 (**Chart 12**), even though bank lending conditions have loosened.[7] These moves in the FCI have, however, been small.

12. Our estimates of bank lending spreads for small and medium-sized firms fell slightly in Q3, with conditions improving more quickly for medium-sized firms than for smaller ones. Lenders reported in the *Credit Conditions Survey* that spreads continued to tighten on bank lending to medium-sized firms in 2015 Q3 (**Chart 11**). This is consistent with reports from the Agents' contacts that conditions continued to ease for medium-sized companies as spreads tighten for large corporates and competition spills over.[8]

13. Credit conditions remain tighter for small businesses than for medium-sized firms, but there are signs that price and non-price conditions are improving gradually. In addition to the small narrowing in spreads reported in the *Credit Conditions Survey* (**Chart 11**), the Federation of Small Business *Voice of Small Business Index* reported that perceptions of the cost and availability of credit for small businesses continued to improve slightly in Q3, although the net balances remained negative. The index also reported an increased in the proportion of small businesses making successful applications for credit, consistent with the increase in the proportion of approvals reported by lenders in the *Credit Conditions Survey* for 2015 Q3.

14. Corporate credit conditions overall are projected to tighten slightly over the course of the forecast. This largely reflects developments in conditions for large companies, consistent with the view from the Agents' contacts that availability was slightly above 'normal'. Conditions for small firms, however, are likely to still have room for improvement and are expected to continue to ease gradually over the course of the forecast.

Impact of credit spreads in the Benchmark forecast

The overall impact of the change in credit spreads since the August *IR* is slightly negative for GDP in the near term. The peak impact of higher credit spreads on the level of GDP is just under -0.1% by the end of 2016. But by the end of the forecast, this is offset by the downwards revisions to the steady state level of some credit spreads, such that the level of GDP is slightly higher three years ahead. The fall in corporate credit spreads has a very small positive impact on potential productivity, which pushes down slighlty on the output gap. As discussed above, assumptions about competition and downwards revisions to our steady state assumptions offset some of the impact of higher funding spreads and lower swap rates. Without these judgements – so purely taking account of the news in the data, swap rates and funding costs – the peak impact on the level of GDP would be around -0.2%, with the level around 0.1% lower by the end of the forecast.

Section 2: Risks to the central projection

There are a number of risks to our central projection for credit spreads. These are outlined in the table below, including an assessment of how these risks have evolved since the August *IR*.

Risk	Impact /Δ since August *IR*[9]	Comment
Risks from global developments transmitting through financial markets		Banks' wholesale funding spreads have picked up over the last six months in response to global developments. The possibility of them increasing sharply in response to adverse global developments remains the single largest identifiable risk to the outlook for UK credit spreads. In August, we highlighted the risks to bank funding costs from a Greek exit from the euro area. These risks have evolved to also focus on those from a potential slowdown in emerging market economies and associated financial market volatility. A more pronounced slowdown in China, and other EMEs, than projected could spill over to the wider economy via the shadow banking sector, and affect a wider range of asset prices, posing an upside risk to UK bank funding costs. Some UK banks have large direct

[7]

[9] Arrows indicate impact on spreads; text indicates change on the quarter.

	 Increased	exposures to EMEs, in addition to indirect exposures to other bank and non-bank systems. Given the continued signs of vulnerability in Chinese financial and economic indicators, these risks are likely to be higher than last quarter.[10] Although, as with last quarter, a number of factors might be expected to have reduced the likely impact on UK banks' funding costs of a given external shock since 2011/12 - UK banks look more resilient, and policymakers have well defined instruments to tackle increases in funding costs. A Greek exit from the euro area remains a risk to future UK bank funding spreads. ID judge, however, that risks around Greece in the short term have decreased a little since Eurozone finance ministers agreed to a new bailout in August, but remain in the medium term and so do not offset the increase in risks from EMEs this quarter. We continue to see two-sided risks to our judgement on the direct impact of ECB QE on UK banks' funding costs (see Box A in Analytical 7,169,687).
Regulatory and structural change	 Unchanged	In recent quarters, we have highlighted the challenge posed by the low level of funding spreads to our estimate of medium-term funding spreads of around 95 basis points, which incorporates estimates of the impacts of regulatory and structural changes since the crisis. 'All-in' funding spreads have risen over the past two quarters such they now lie slightly above that medium-term estimate and are projected to be broadly flat over the forecast. While funding spreads have risen, these increases appear to reflect developments around the euro area and emerging markets, rather than further consideration of regulatory reforms. Over the course of the forecast, senior unsecured bond spreads are projected to increase further, as the banking sector adjusts to regulatory reforms such as the FSB's TLAC recommendations, while other elements of all-in funding spreads reduce. These developments are projected to be broadly offsetting. There remains limited evidence to suggest that investors are any further along in pricing in the impact of regulatory changes than last quarter. The downside risks to our funding costs profile from the possibility that we have overestimated the medium-term impact of cumulative changes in regulation since the crisis therefore seems broadly unchanged since August. At the same time, it remains plausible that the implications of removing the implicit subsidy and/or TLAC requirements for the structure and costs of banks' liabilities pose upside risks to our current estimate. We are in the process of revisiting our estimate of medium-term funding costs in light of analysis conducted as part of the Medium Term Capital Framework Project.
Markups	 Increased	Both upside and downside risks remain around our estimate of the mark-ups that banks will charge on lending in the medium term. Even though we have revised down our steady state estimates for some household products, we think that the downside risk to spreads from this source has increased since August. Continued competition may push markups and credit spreads lower than currently projected if, for instance, margins on low LTV mortgages may not be as compressed as thought or continued improvement in the quality of borrowers drives personal loan rates lower. There is also a risk that a lower level of high LTV mortgage spreads may be associated with a relaxation in quantity restrictions and mortgage availability that is not currently embodied in the forecast. Alternatively, the current high level of competition may prove to be cyclical or less persistent than thought and wane over the forecast. In this case, credit conditions may tighten rather than ease over the course of the forecast as spreads progress to a higher steady state level.