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Structural resilience in UK RMBS

November 2020

M&G Asset-Backed Securities

- An estimated 2.5m mortgage payment holidays have been granted since the FCA scheme's inception in March. However, over 70% of those whose deferrals have ended have resumed full repayments.
- While short-term pressure on the economy is likely to increase, we believe the structural resilience of senior RMBS should limit the impact on highly rated securities.

Mortgage payment holidays offer respite for UK borrowers

In March of this year, the FCA announced temporary mortgage relief measures to ease the financial difficulties of UK borrowers during the Covid-19 pandemic. According to UK Finance, an estimated 2.5m 3-month payment holidays have been granted, with 1.8m in place concurrently in June, equivalent to 17% of the mortgage market[1]. The scheme was extended in May, enabling borrowers to participate in up to 6 months of combined payment holidays and was expected to end in October. However, a second national lockdown has led the FCA to propose an extension until the end of January 2021. Those who have not previously utilised the scheme would be eligible for two deferrals of up to 6 months in total. Meanwhile, borrowers currently on a payment holiday, and those who resumed repayment after an initial deferral, would be eligible for a second break of up to 3 months.

Within UK RMBS markets, the scheme's extension, as well as wider government support measures, requires investors to consider the potential effects on RMBS structures and the impact on future mortgage delinquencies and default rates. Encouragingly, mortgage holiday uptake has steadily declined since June. UK Finance estimates that, of those whose deferrals have ended, over 70% have resumed full repayments, despite fears that the scheme's extension would increase pressure on mortgage pool cashflows. However, with further economic challenges ahead, we believe the structural resilience of senior RMBS will play an increasingly important role.

What has driven payment holiday uptake?

The initial impact of the Covid-19 lockdown and subsequent reduction of payment holiday uptake since early summer can be observed in RMBS transaction reporting data. JP Morgan estimates that the cumulative current balance of loans granted Covid-19 payment holidays fell by more than 40% between July and September, from £16.7bn to £9.7bn. As such, the aggregate proportion of loans subject to Covid-19 payment holidays stood at around 10.5%, compared to 18.6% previously (see Figure 1). Within UK Prime RMBS master trust programmes, only 5.6% remained on payment holidays (see Figure 2).

Figure 1. Aggregate % of mortgages subject to payment holidays[2]

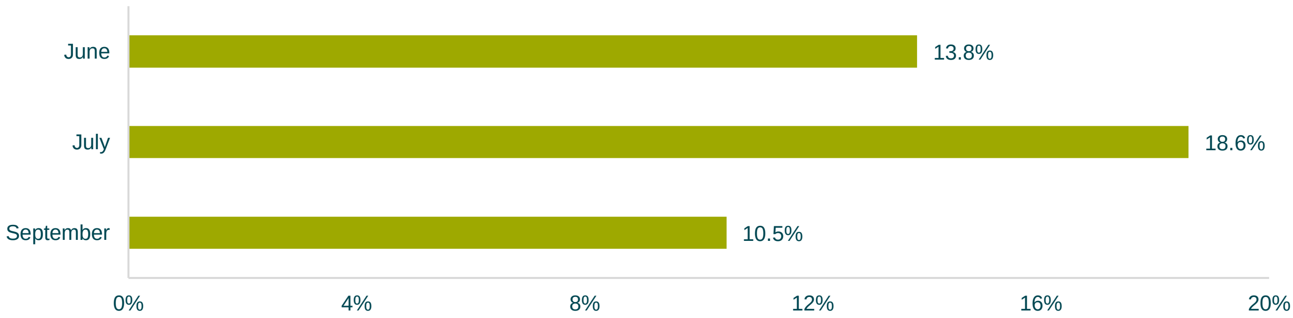


Figure 2. Aggregate payment holidays by collateral type, September 2020[3]

Collateral Type	# of Deals Reporting Payment Holiday Info	Outstanding Bal. (£mm)	Bal. Granted Payment Holiday (£mm)	Agg. % Granted Payment Holiday	# Granted Payment Holiday	Min. % Granted Payment Holiday	Max. % Granted Payment Holiday
BTL	39	£24,333	£2,210	9.1%	12,426	0.0%	44.9%
NCF	50	£15,916	£3,031	19.0%	36,790	1.2%	45.5%
Non-Standard	12	£9,388	£1,592	17.0%	19,311	7.4%	33.3%
Prime	23	£16,278	£1,362	8.4%	6,983	2.6%	58.4%
Prime MT	4	£26,361	£1,481	5.6%	9,611	4.0%	8.9%
Total	**128**	**£92,276**	**£9,675**	**10.5%**	**85,121**	**0.0%**	**58.4%**

Naturally, this data lags anecdotal evidence from individual lenders. Kensington, one of the largest non-bank UK mortgage lenders, notes that payment holiday applications peaked in early June, declining thereafter as lockdown restrictions eased and many people returned to work. The lender also found a large number of customers chose not to extend beyond the initial 3-month holiday period. In its most recent update, Kensington indicated that, of the 26,000 borrowers who took payment holidays, only around 7,000 remain on the scheme.

During the scheme's initial phase, there was a significant uptake from younger borrowers and the self-employed. However, those most likely to still be using payment holidays are those with higher monthly payments and employees within the leisure and tourism sectors. This indicates that the size of the borrower's monthly repayments and their employment sector have been the key drivers of payment holiday uptake.

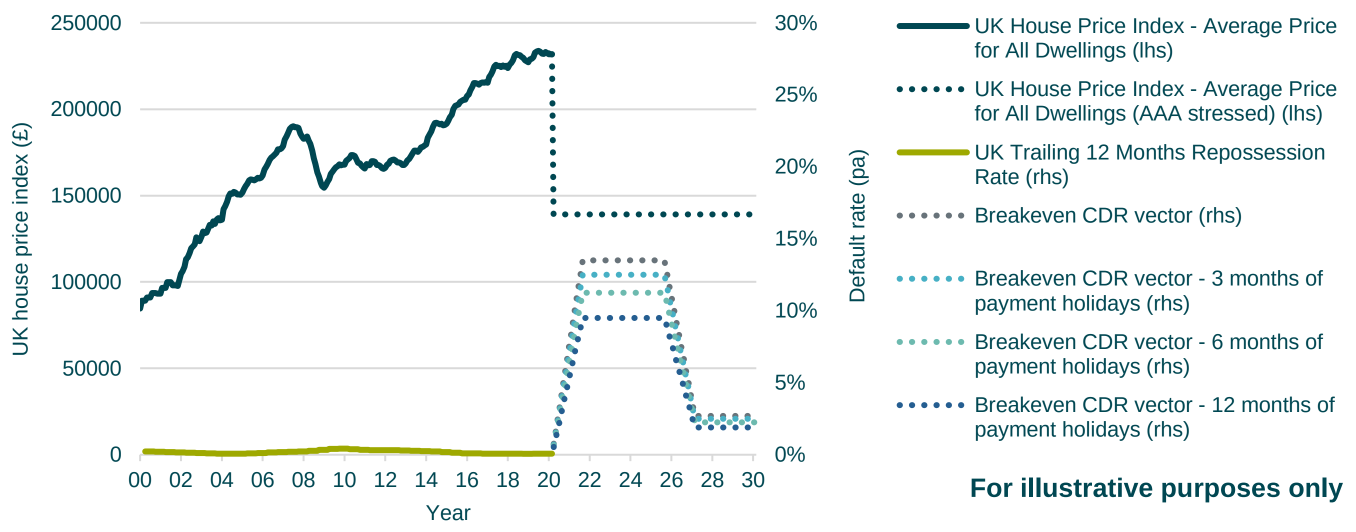
How resilient are UK RMBS?

In the early phase of the pandemic, M&G stress-tested the structural resilience of a typical UK RMBS bond against severe potential Covid-19 conditions, including extensive mortgage payment deferrals. The model assumed the following:

- An immediate 40% decline in UK house prices, with no future recovery
- Prepayments falling to 5%
- A 6-month payment holiday on the entire mortgage pool (compared to the current 10.5% uptake of 3-month payment holidays)

For the Class A UK Prime AAA RMBS in Figure 3 to incur a principal loss, the constant default rate (CDR) would need to reach 11.3%p.a for four years, before falling to a 2.5%p.a CDR over the long term. This would equate to a 41% cumulative default rate on the mortgage pool. In comparison, the highest annual UK default rate on record, which occurred in 1992, is 0.79%.

Figure 3. For a typical AAA UK Prime RMBS to incur a principal loss, cumulative defaults would need to reach over 40% of the underlying mortgage pool[4]



A number of structural features also help to support senior RMBS transaction liquidity and protect interest payments to noteholders, even if interest collections were to drop significantly. This includes sizeable liquidity reserve funds, which can be used to pay interest on the notes, and waterfall mechanisms that allow the principal to be used to pay interest. A recent study from Moody's indicates that only 11% of the 788 UK RMBS tranches rated by the agency have less than 6 months of interest coverage available[5]. Furthermore, for bonds purchased below par value, accelerated amortisation via any potential foreclosure prepayments can provide additional returns.

The resilience of these transactions is evidenced by the absence of rating agency downgrades for UK RMBS bonds since the start of the pandemic. According to Deutsche Bank, only 17 UK RMBS tranches have been downgraded since the pandemic began. None of these tranches were post GFC structures with original ratings of A- or above. Across Europe, including the UK, downgrades have totalled 77, representing 1.4% of outstanding volumes[6]. Unlike corporate debt, the structural protections for RMBS, particularly investment grade tranches, mean that future rating downgrade risks are low, in our view.

What are the current opportunities?

We believe current market dynamics offer a compelling opportunity to deploy capital, as spreads remain elevated from pre-Covid levels, and ABS structures have become even more robust, due to increased rating agency stresses at each rating level. Transactions are also being syndicated among a smaller number of investors, enabling better access to bonds for large institutional investors, such as M&G, which in turn reduces execution risk for issuers.

One example is the AAA rated senior UK non-conforming RMBS transaction from Together Personal Finance, which has been lending in the market for almost 50 years. The SONIA +145 coupon, which increases to SONIA +290 if the transaction is not called in June 2024, has the highest step-up coupon of any currently issued UK RMBS senior bond. The Class A offers 23.50% credit enhancement and is backed by 57.5% weighted-average indexed LTV residential property collateral. Additionally, the transaction is structured to include a Covid-19 reserve fund within the general reserve. Cashflows are diverted away from the originator after the first optional redemption date if the deal is not redeemed, which is designed to accelerate the senior bond amortisation.

M&G was one of the small number of investors consulted prior to this trade coming to market and, following negotiations on structure and pricing, we secured substantial, protected allocations across the capital structure. By way of reference, AAA bonds with this sort of profile were trading at around SONIA +95 in February, which illustrates the extent of the additional premium now available.

Outlook

While the recent trend in payment holidays has been positive for RMBS transactions, the full extent of economic hardship is unlikely to be revealed until the government's support schemes are withdrawn early next year. At this juncture, we will begin to better understand the viability of businesses operating under the constraints of social distancing, the proportion of furloughed roles that will translate into redundancies, and the resulting effects on UK mortgage delinquencies and defaults. Despite this uncertainty, in our view, the credit risk to senior UK RMBS tranches is low, due to their high levels of structural resilience. Meanwhile, pricing looks attractive relative to other fixed income securities of comparable ratings. As such, we believe investors that possess the extensive resources required to rigorously assess transactions should be well-positioned to access compelling investment opportunities in this market.

M&G ABS team

References

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2. *J.P. Morgan UK RMBS COVID-19 Payment Holiday Tracker, 2nd October 2020, 10th July 2020, 12th June 2020*

3. *J.P. Morgan UK RMBS COVID-19 Payment Holiday Tracker, 2nd October 2020*

4. *M&G, Council of Mortgage Lenders, ABSxChange, Nationwide, 27th May 22020*

5. *Moody's, Sector In-Depth Research, UK RMBS, 14th July 2020*

6. *Deutsche Bank Research, European RMBS Monthly, 15th October 2020*

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