

Cost Of Living Crisis

How Bad Could It Get For U.K. RMBS?

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Ratings

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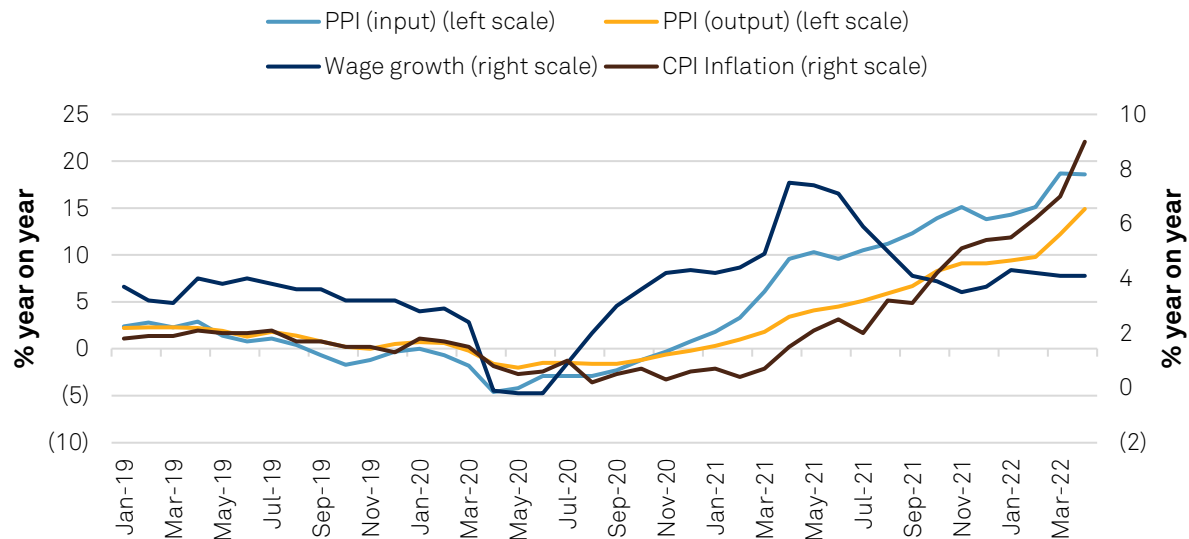
Key Takeaways

- U.K. mortgage borrowers' cost of living is rising at a rate not seen for decades, as consumer price inflation surges and monetary policy tightens in response. We currently expect U.K. consumer price inflation to average 7.6% in 2022 before falling to 3.6% in 2023. We expect interest rates to rise further in 2022 and beyond.
- While arrears levels in U.K. RMBS collateral pools are, for now, generally stable, there are borrowers who, while currently up to date with mortgage payments, have been in arrears at some point in the past two years. We consider these borrowers to be the most vulnerable to the cost-of-living crisis and to falling into arrears.
- For owner-occupied collateral, for every borrower currently in arrears we estimate that on average the same number again are likely to miss a mortgage payment at some point in the next year. So, if total arrears are 5% for a given transaction, another 5% of loans are vulnerable to nonpayment. If this trend is replicated across the wider mortgage market, where 2.5% of the U.K.'s 11 million mortgage borrowers are in arrears, this would see an additional 275,000 households enter arrears in the coming year.
- Borrowers backing legacy U.K. nonconforming RMBS transactions have a relatively low monthly payment, averaging approximately £500 per month. Despite this, they already exhibit high arrears levels, typically averaging 10%-20%. They are almost exclusively paying a variable rate and will face stress from both cost-of-living pressures and rate rises. Most legacy loans are also interest only, and as none of the borrowers' monthly payments is principal they are further compromised by a rising rate environment. Given the combination of low monthly payments, expected increase in debt servicing cost, and already compromised performance, a material increase in late-stage arrears is possible.
- Although we expect arrears to rise, not all borrowers vulnerable to nonpayment will fall into arrears at the same time. The recent rise in house prices will give servicers and borrowers tactical options to avoid repossession, such as capitalization of arrears.

Inflation Outlook | Likely To Peak In The First Half Of 2022, But Its Effect On Individual Borrowers Is Difficult To Assess

- We expect the U.K. CPI (Consumer Prices Index) inflation to average 7.6% in 2022, and drop to 3.6% in 2023 and 1.3% in 2024. The effect of inflation for individual households will depend on their consumption habits, and some households may be more or less affected than the average CPI rate. In addition, for some borrowers, pay rises will erode the effect of inflation.
- The effect of inflation also depends on borrowers' income. For example, lower income borrowers will likely be hit harder by increases in the U.K.'s energy price cap. Some U.K. RMBS transactions are characterized by a high proportion of borrowers who are in arrears but have relatively low current monthly payments and, so, are likely to have lower incomes.

Inflationary Pressures In The U.K. Are Building



PPI--Producer Price Inflation. Source: S&P Global Ratings, ONS.

- Our current estimates factor in the effects of recent and proposed increases to the energy price cap.
- The ongoing Russia-Ukraine conflict has introduced significant ongoing uncertainty and possible downside to these forecasts.
- Price inflation is not the sole source of consumer stress: Recently introduced National Insurance rises will exacerbate the reduction in Working Tax Credits already implemented.

Rates Outlook | Rate Outlook Points To An Enduring Stress For Legacy Loans

- Interest rates are expected to rise further in 2022 and beyond as they are used to target inflation.
- Importantly, many mortgage loans originated before 2014, which back both legacy and newly issued U.K. RMBS transactions, pay a variable rate of interest, and we would expect their interest rate to rise in lockstep with market rates. These borrowers are typically among the worst-performers from a credit perspective and when hit by both CPI stress and rate rises will likely show performance deterioration.
- Although the characteristics of individual RMBS transactions vary from the averages presented below, the distribution around these averages is tight and we therefore consider the averages to be representative for most transactions.

Average U.K. Pre-2014 S&P Global Ratings-Rated Nonconforming Collateral Characteristics

Pre-2014 S&P Global Ratings-rated U.K. nonconforming collateral	Collateral characteristics
Current balance (£)	11,200,429,772
Number of loans	113,080
Average balance (£)	99,048.72
Currently paying a floating rate (%)	99.96
Weighted average month payment (£)	507
Currently paying a fixed rate (%)	0.04
Interest only, including "part and part" (%)	81.76
Weighted-average current total arrears (%)	17.17
Number of transactions	53

Source: S&P Global Ratings.

S&P Global
Ratings

- In the analysis below, we consider pre- and post-2014 vintages separately for two reasons.
- Firstly, the majority of pre-2014 collateral is floating rate, while the opposite is true of post-2014 nonconforming originations.
- Secondly, owner-occupied collateral originated after 2014 has been underwritten to more stringent regulatory affordability standards.
- As the vast majority of collateral is interest only, sensitivity to rate rises is higher than for repayment loans where a portion of the payment is for principal.
- Despite modest monthly payments, performance is already weak. As arrears are calculated as overdue amount divided by monthly payment, the expected £1,400 increase (October 2021 to October 2022) in the average dual fuel energy cap alone could translate into a portion of vulnerable borrowers becoming 90+ days past due ($\text{£1,400}/\text{£500}=2.8$ months).

Rates Outlook | Prime Owner-Occupiers Are Mainly On Fixed Rates And Are Therefore Insulated For Now

- The U.K. mortgage market has recently evolved from two-year fixed-rate loans to five-year and longer-term fixed-rate products. This provides some insulation from the immediate threat of rate rises for newer collateral. However, depending on when fixed rates elapse, borrowers may be exposed to a rate hike shock as there will be an increasing gap between their old, fixed-rate payments and their new variable rate payments. On average, prime transactions are insulated for approximately one year from rate rises.
- In addition, it is important to highlight that since 2014, lenders have been required to stress borrowers' affordability assessment assuming that interest rates rise. Although some lenders have reverted to using the five-year fixed rate (allowed under regulation) rather than a higher rate, many lenders continue to stress assuming that borrowers need to pay rates in the 5%-7% range.
- Prime owner-occupied collateral has a lower proportion of interest only and, as part of the monthly payment is principal, will have lower sensitivity to rate rises than transactions that are entirely interest only.

U.K. S&P Global Ratings-Rated Prime Master Trusts

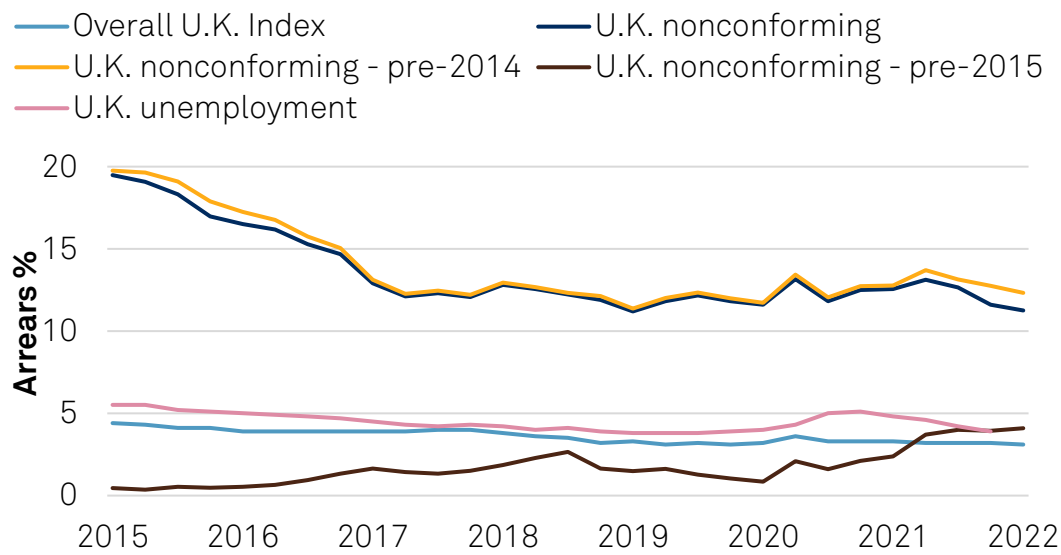
	Current arrears (%)	Currently paying fixed rate (% of pool)	Interest only, including "part and part" (%)	Weighted-average revision date	Weighted-average payment due (£)	Current balance of loans (£)	Weighted-average interest rate (%)
Master Trusts (weighted average)	1.03	64.22	23.93	10/12/2023	786	8,410,436,041	2.25

Source: S&P Global Ratings.

U.K. Nonconforming | Arrears Rates Already Elevated

- Weighted-average arrears in pre-2014 U.K. nonconforming RMBS transactions are approximately 17%, compared with 6.9% for post-2014 collateral. U.K. RMBS arrears have generally been trending lower over the past eight years. For legacy pre-2014 collateral, where arrears are approximately 17%, borrowers who are not currently in arrears but have been in the past two years account for approximately another 14% of the pools. For newly originated (post-2014) nonconforming collateral where arrears average 6.9%, approximately another 4.5% have been in arrears in the past two years.
- While arrears levels give an indication of immediate borrower stress, analysis of borrowers who are now current on their payments but have recently been in arrears may indicate the level of vulnerability to future pressures, such as the rising cost of living. These borrowers who had arrears in the recent past may lack financial resilience, such as savings, to deal with the cost-of-living stress.

Average Total Arrears, U.K. Nonconforming RMBS



Sources: S&P Global Ratings, ONS.

U.K. Nonconforming Collateral Characteristics

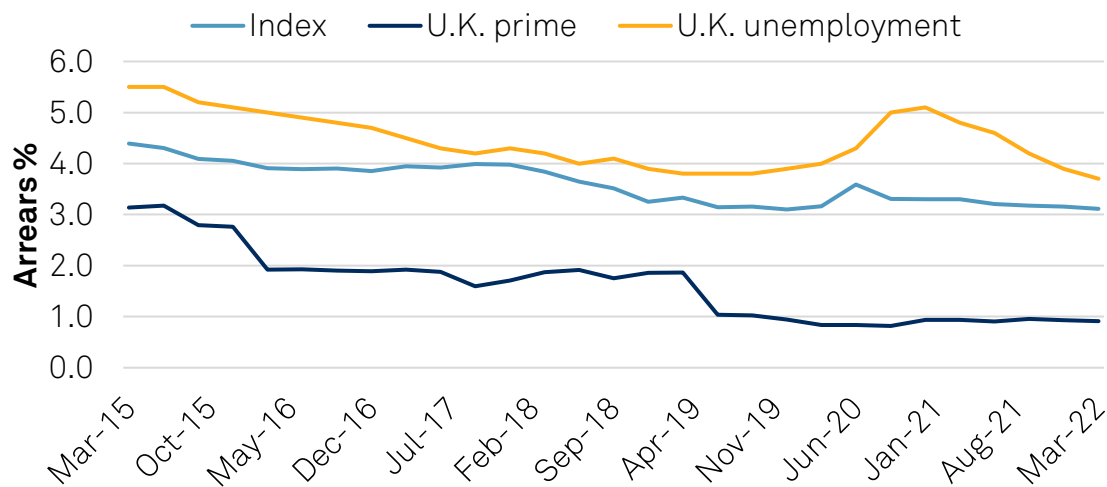
	Current arrears (%)	Current now, but have been arrears since start of 2020 (%)	Vulnerable borrowers as a percentage of existing arrears (%)
Legacy collateral pre-2014	17.17	13.87	80.78
Post-2014 collateral	6.87	4.47	65.24

- For pre-2014 era nonconforming RMBS collateral, there are almost as many of these vulnerable borrowers as there are those currently in arrears.
- Overall arrears levels for legacy nonconforming RMBS don't strongly correlate to unemployment, so we believe that arrears are more correlated to generally weak and persistent affordability issues.

U.K. Prime| Low Base Arrears And Low Overall Impact On Performance

- U.K. Finance estimates that 2.5% of the U.K.'s approximately 11 million mortgage borrowers are in arrears. S&P Global Ratings-rated prime master trust collateral exhibits lower overall arrears, between approximately 0.5% and 1.5%. Based on the analysis below, we expect between 0.75% and 1.75% of the borrowers who are not currently in arrears to enter arrears at some point in the coming year.
- Analyzing a sample of prime RMBS transactions, we found that the proportion of borrowers who are current but recently in arrears is between 100% and 160% of the current arrears level.
- U. K. prime RMBS collateral benefits from higher origination standards than legacy U.K. nonconforming collateral and has the advantage of low base arrears. Even if vulnerable borrowers did transition into arrears, the effect on RMBS pools would therefore be muted.

Average Total Arrears, U.K. Prime RMBS



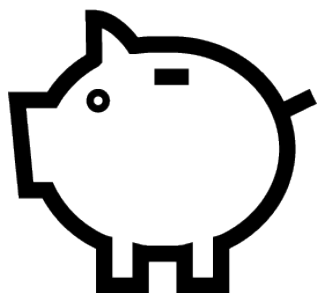
Sources: S&P Global Ratings, ONS.

U.K. Prime Collateral Characteristics

	Current arrears (%)	Current now, but in arrears since start of 2020 (%)
Master Trusts (weighted average)	1.03%	1.18%

- Although the incidence of recent arrears as a percentage of current arrears is proportionately higher for prime than for nonconforming, we would expect the cause of arrears to be more closely linked to unemployment.
- While stress could become visible in U.K. prime transactions, we would expect it to be smaller in scale and shorter lived than in legacy U.K. nonconforming RMBS.

Servicing | What Does This Mean For U.K. RMBS Performance, Defaults, And Ratings?



- Inflation is likely to be elevated throughout 2022. We expect arrears in RMBS transactions to rise over the coming 12 months.
- **Shorter-term servicing strategies:** For legacy nonconforming collateral, given approximately 90% is interest only (including part-and-part), some servicing strategies like temporary interest only and term extensions are not options. Therefore, temporary payment arrangements, that is accepting a lower payment than contracted, is the only realistic option. For more recent collateral, temporary movement to interest only may be viable as most of the loans are repayment loans.
- **Longer-term servicing strategies:** Whatever the short-term servicing strategy, unless written off, all unpaid amounts will need to be paid eventually. To do this, borrowers will need to pay an amount over and above their contracted amount. To the extent wage growth catches up with inflation in the medium term, this is a realistic scenario for recently issued collateral. If borrowers are not able to repay unpaid amounts, then capitalization of arrears is likely.

Servicing | What Does This Mean For U.K. RMBS Performance, Defaults, And Ratings?



- Capitalization is often the remedy of last resort for servicers as it adds to the balance of the loan and potentially increases the risk of loss on sale in the event of default. It also increases the instalment for the borrower and so is not suitable in all cases. However, we consider that recent strong house price growth de-risks this as an option for lenders.
- Although arrears are expected to grow, repossession activity may not move in parallel. As during the COVID-19 pandemic, we anticipate that borrowers who communicate with servicers are given leeway during the period of peak inflation, and that repossession is used only in scenarios where the borrower has no prospect of recovering.
- Our ratings approach considers current levels of arrears directly, with upwards adjustments to foreclosure frequency assumptions for borrowers in arrears. We will continue to monitor transaction performance as part of our ongoing surveillance activity. Our 'B' to 'AA+' anchor foreclosure frequency assumptions are currently elevated in the light of rising inflation. Please refer to "[Residential Mortgage Market Outlooks Maintained For 15 European Jurisdictions Following Revised Economic Forecasts](#)," published on April 28, 2022.

Summary Of Analytical Approach | Current Arrears Plus Loans Recently In Arrears Are Vulnerable To Inflation And Rates Increases

- In this report, we analyzed loan-level data from U.K. RMBS transactions that we rate.
- We looked back to identify borrowers who have been in arrears at any point in the past two years.
- For this purpose, we define "arrears" as being 30 days or more past due, therefore excluding "technical" arrears.
- The analysis covers 64 transactions covering originations from 2004 and totals £42.2 billion of collateral spread over approximately 406,000 properties.
- We consider any borrower who has been in arrears at any point in the past two years as being unlikely to have personal financial reserves, such as cash savings or liquid investments, to absorb the shock of increased prices and rate rises.
- We also estimated the increase in living costs that borrowers may face in the near future and compared this with current monthly payments to estimate additional worst-case 90+ days arrears levels.
- We excluded transactions backed by buy-to-let (BTL) loans from the analysis. For an analysis of BTL collateral in a stressed environment, please see "[Why U.K. Buy-To-Let Has Defied Gravity Through COVID-19](#)," published on Aug. 3, 2021. Although BTL tenants are not immune from inflationary pressures, the ability to replace non-paying tenants provides some insulation to landlords.
- Referenced transaction data is correct as at the date of the analysis. Subsequent data may have become available between analysis and publication.

Related Research

- [EMEA Structured Finance Chart Book: May 2022](#), May 18, 2022
- [European RMBS Index Report Q1 2022](#), May 16, 2022
- [Residential Mortgage Market Outlooks Maintained For 15 European Jurisdictions Following Revised Economic Forecasts](#), April 28, 2022
- [Credit FAQ: What Is Prefunding And How Does It Affect U.K. RMBS Transactions?](#), March 24, 2022
- [Asset Price Risks: Inflated Property Values Mean Higher Loss Assumptions In European RMBS And Covered Bonds](#), March 21, 2022
- [The Future Of U.K. Nonbank Mortgage Lending And How It Will Affect RMBS](#), Feb. 9, 2022
- [S&P Global Ratings' U.K. Second-Lien Mortgages Primer](#), Jan. 31, 2022
- [European RMBS Performance And Issuance At A Crossroads](#), Jan. 27, 2022
- [Credit FAQ: How We Analyze Small Ticket Commercial Real Estate Assets In European Structured Finance](#), Jan. 19, 2022
- [European RMBS Market Update Q3 2021](#), Nov. 24, 2021
- [European Housing Market Inflation Is Here To Stay](#), Nov. 2, 2021
- [Why U.K. Buy-To-Let Has Defied Gravity Through COVID-19](#), Aug. 3, 2021

Source: S&P Global Ratings.

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