RBC Global Asset Management

Rate Reality Check

Navigating the UK Mortgage Markets ‘New Normal’

September 2023

Securitized Credit Team

BlueBay Fixed Income Team

“Should volatility increase due to negative headlines surrounding the UK mortgage market, as an active manager, we remain positioned to take advantage of opportunities that arise.”

Over the past few months, much has been written about the pressure on the UK economy and housing market from rising inflation and interest rates.

While the issues of higher rates have been well flagged, we anticipate that headlines surrounding rising arrears and delinquencies in the mortgage market will increase in the wider press. In this piece, we will dive into the underlying dynamics and impacts on the performance of the UK Non-Conforming (NC) and Buy-to-let (BTL) mortgage backed transactions and how we have managed these growing risks.

Key takeaways

- The Institute of Fiscal Studies (IFS) estimates that should mortgage rates maintain their current high levels, 1.4 million individuals in mortgage-holding households in Britain could lose at least 20% of their monthly disposable income after refinancing.
- The transmission of higher rates and inflation has begun to impact the consumer, as we have seen a modest pickup in 30+ days of arrears, but still relatively minor to what we witnessed following the Global Financial Crisis (GFC).
- Between July 2021 and May 2022, we reduced UK residential mortgaged-backed security (RMBS) exposure from 24.4% to 5.2% in our flagship Investment Grade strategy, the BlueBay Securitized Credit Investment Grade strategy, driven by these concerns and tightening valuations.
- Today, we hold no exposure to BBB or lower-rated UK RMBS in our flagship strategy and prefer more defensive profiles that are shorter in duration and have lower loan-to-values within the underlying mortgages.
- Should volatility increase due to negative headlines surrounding the UK mortgage market, as an active manager, we remain positioned to take advantage of opportunities that arise.

Definitions

Within UK RMBS, there are typically three types of transactions: Prime, Non-Conforming (NC), and Buy-to-Let (BTL). We will focus on both the NC and BTL RMBS markets as this is where the stress feeding through from rising interest rates will be felt most acutely.

NC RMBS transactions comprise of residential mortgages that do not conform to high street prime origination criteria. NC mortgage origination plays a significant part in the UK due to the number of individuals who are either self-employed, have impaired credit history or are unable to conform to rigid underwriting processes for other reasons. Morgan Stanley estimates that the median NC borrower falls somewhere around the 7th-8th income decile versus the 8th to 9th income decile for the median UK mortgage borrower.

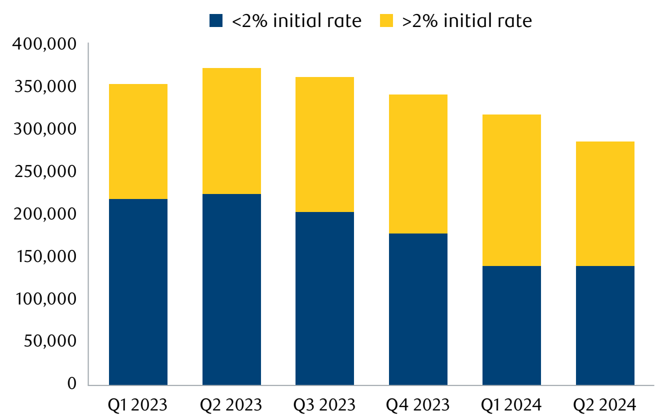
BTL RMBS transactions consist of mortgages originated based on the rental income generated from a property, with the underlying borrower typically a higher income earner. There is a double protection element to BTL mortgages, which is why 30+ arrears data tends to be extremely low. Firstly, should the landlord default on a mortgage payment but the tenants remain in place, the servicer can step in to collect the rental income to make mortgage payments. Secondly, should tenants step away from the rental property, it is likely that the landlord will continue to pay the mortgage due to full recourse laws and potential cross-collateralisation with other properties.

Introduction

The outstanding value of mortgages in the UK is over £1.6 trillion (as at 30 June 2023), with approximately 1 in 3 adults holding a mortgage. Over the next 12 months, an estimated 1.3 million mortgages will exit fixed rates, with about 50% currently on a rate of less than 2%. Interest rates in the UK, as of the 22 August, are forecast to peak around 6.0% by the end of 2023, resulting in mortgage rates which are typically priced using the 5-year swap at 5.7%.

As households roll off their fixed-rate mortgages, this could profoundly affect the UK consumer, especially if rates and inflation remain at this level for longer. On average, the increase in monthly payments will be £276, equating to 8.3% of disposable income.

Figure 1: Mortgages Rolling Off

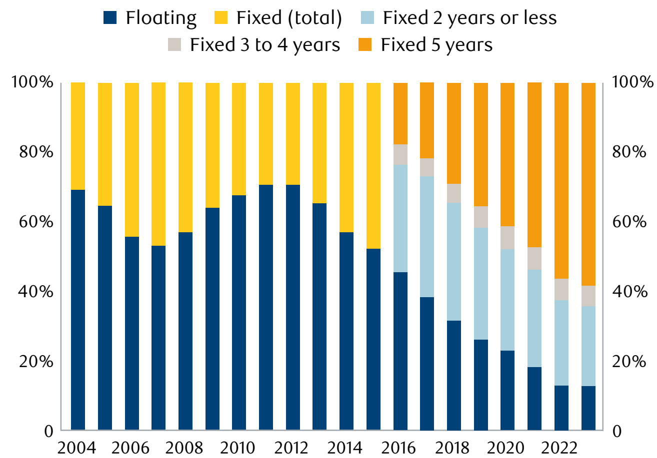


Source: ONS, as at January 9, 2023.

An important aspect to consider is the ratio of fixed to floating household mortgage debt. Over the past decade, there has been a structural shift, with a large reduction of floating-rate mortgages. These accounted for roughly 70% of the outstanding stock a decade ago but just 12.5% as of Q1 2023. In addition, an increasing number of households with fixed-rate mortgages have opted to fix for five years rather than two. This shift means that the transmission of higher policy rates to the effective interest rate on the stock of outstanding mortgages is playing out much slower this cycle.

Despite the slower transmission, the UK mortgage market remains more exposed than the euro area and the US due to the greater share of shorter-term fixed-rate mortgages between 1 to 5 years. Furthermore, as the likelihood increases that rates will stay higher for longer, it is anticipated that a greater number of mortgage holders will be impacted, as refinancing at higher rates will lead to a fall in disposable income. In addition to elevated inflation rates, which remain stubbornly high, this could lead to a pickup in delinquencies as consumers are simply unable to afford increasing costs, which will impact on the performance of UK NC and BTL RMBS.

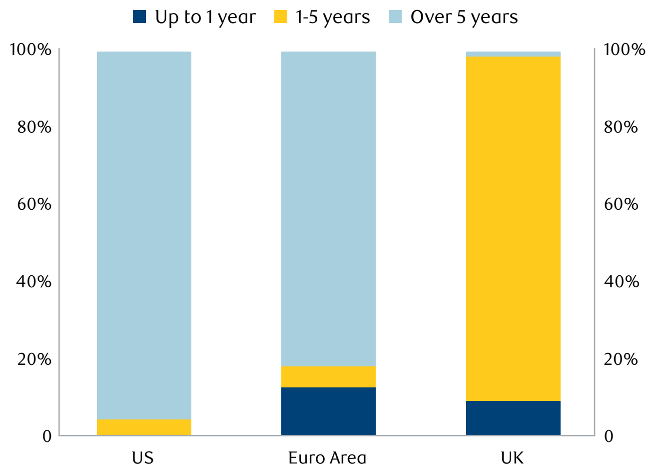
Figure 2: Breakdown of outstanding household mortgage debt



Source: Goldman Sachs, as at July 7, 2023.

Figure 3: Regional Comparison

Mortgages by length of initial fixation (estimated)



Source: Goldman Sachs, as at July 7, 2023.

Some mitigating circumstances are supporting the performance of the sector:

1. High-quality mortgages - mortgages underwritten post-GFC are much higher quality than pre-GFC. In the period before the GFC, there was a considerable amount of fraud during the underwriting of mortgages, and proof of income was a significant area where the checks were extremely poor.
2. Lower loan-to-value (LTVs) – in Q2 2007, the total percentage of mortgages underwritten with an LTV greater than 90% was 14.8%. As of Q1 2023, this stands at 4.0% (Bank of England).
3. Unemployment outlook – the biggest driver of mortgage delinquency rates is unemployment. The current unemployment rate is 4.2% (as of August 2023), and we forecast over the next 12 months for this to reach around 5%. Wage growth has also remained robust, with the year-on-year 3 month weekly average earnings growth most recently at 8.2%.

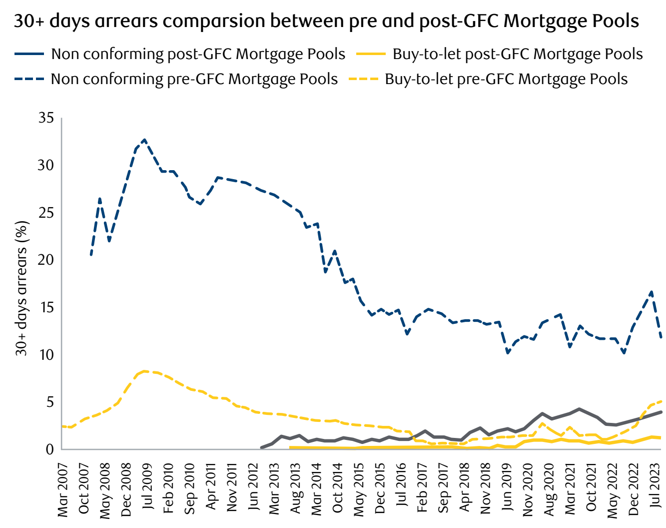
4. Risk-retention requirements – today, when an RMBS deal is issued into the market, the originator, sponsor, or original lender must always hold at least 5% of the nominal value of the securitization. This means that originators have 'skin in the game' as should any underwritten mortgages fall into arrears or default, they will also take a loss. This was not the case pre-GFC, meaning that mortgage originators could underwrite excessively risky mortgages with limited consequence.

UK RMBS Collateral Performance

When analysing the underlying collateral performance of UK RMBS in both the NC and BTL transactions, 30+ days arrears remain low historically. Compared to pre-GFC collateral, 30+ days arrears in NC and BTL transactions hit a peak of 32.8% and 8.3%, respectively. This significantly differs from where we stand today at 3.9% and 1.2%. The reason for this is two-fold, robust underwriting standards and an extremely resilient UK job market. While it is likely that delinquencies will increase over the coming months as rates stay high, the structural protection from UK RMBS is extremely robust, especially in the most senior bonds.

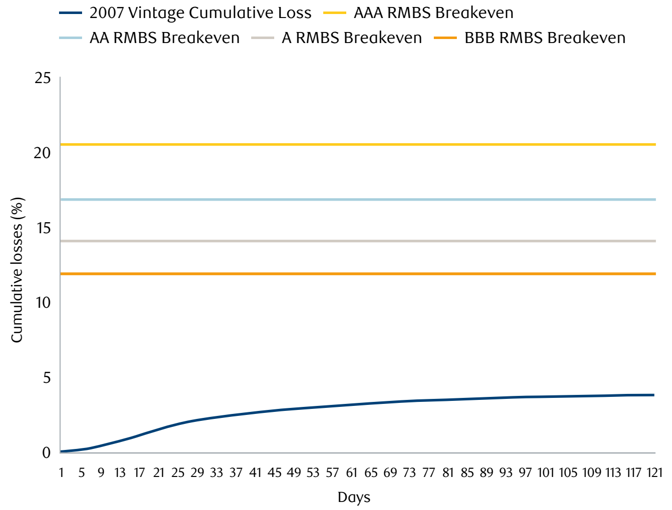
The graph, in figure 5, shows the cumulative loss rate of non-conforming mortgages originated during 2007, which is historically the worst-performing vintage of mortgages. When comparing the cumulative losses with the structural protection within RMBS bonds, the result is a bond highly unlikely to be impaired by the current default outlook. For the BBB bond to take a £1 notional loss of principal, it would require the cumulative loss rate on mortgages to be approximately 12% based on our estimate. For context, cumulative losses on the 2007 mortgage vintage hit a peak of around 4%. Higher-rated bonds then require even higher loss rates to be impaired.

Figure 4: Arrears Comparison



Source: Morgan Stanley, as at August 10, 2023.

Figure 5: UK RMBS Breakevens



Source: RBC BlueBay Asset Management, Intex, Moody's, as at August 22, 2023.

Managing RMBS exposure in the strategies

When managing the strategies, we continue to monitor and consider both the technical and fundamental risks from a top-down and bottom-up perspective. While, in our view, UK mortgages will remain challenged in the short term, it is not our view, as illustrated in figure 5, that mortgage bonds will take principal losses in the long term. However, UK RMBS remains susceptible to mark-to-market volatility against the backdrop of the weakening fundamental picture, as discussed.

For example, between July 2021 and May 2022, we reduced UK RMBS exposure from 24.4% to 5.2% in our flagship Investment Grade strategy, driven by inflation concerns and tightening valuations. We targeted the selling on lower-rated names with all BBB exposure sold and the strategy holding onto only two favoured single A positions (with the remaining bonds all being AAA and AA rated). The average purchase price over the period was 99.72 versus the average sell price of 100.02.

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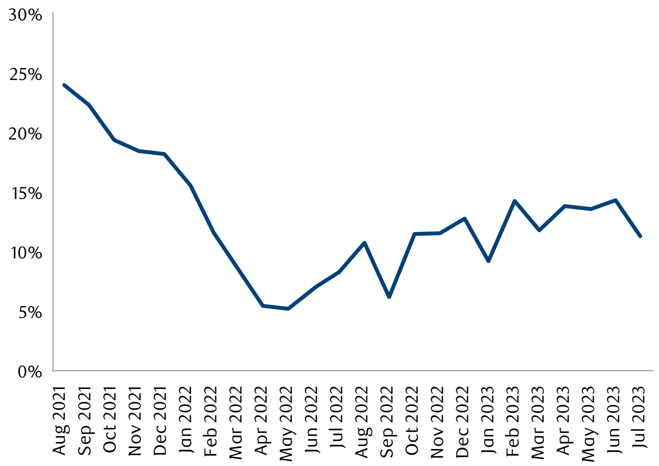
Exposure was cautiously added back during Q3 2022 as the LDI crisis supplied an opportunity to source bonds at attractive valuations. Positions were added exclusively in AAA and AA bonds at an average price of around 96 for AA risk between October and December 2022. So, while the bottom-up opportunities were presented to add UK exposure, we did so in very high-quality bonds, and overall, we remain underweight to the current period with recent activity focussed on relative value positioning.

Figure 6: Investment grade Exposure in BlueBay Securitized Credit Investment Grade Strategy



Source: RBC BlueBay Asset Management, July 31, 2023.

Today, we hold no exposure to BBB or below UK RMBS, deciding to reduce exposure and move up the curve where we can source attractive levels. As summarised in the table, we have preferred more defensive profiles that are shorter in duration and have lower loan-to-values within the underlying mortgage pools.

Figure 7: UK RMBS Exposure in BlueBay Securitized Credit Investment Grade Strategy

Asset Class	Rating	Average Yield (EUR)	Average Spread Duration	Average underlying indexed LTV	Exposure
UK RMBS	AAA	5.0	0.9	52%	2.0%
	AA	6.0	2.2	66%	8.0%
	A	6.7	1.5	65%	1.3%

Source: RBC BlueBay Asset Management, July 31, 2023.

While cutting exposure to lower-rated UK RMBS, the yield on the portfolio has been protected by rotating into attractive sub-asset classes where the strategy is able to take advantage of more compelling risk-adjusted returns, e.g., Dutch RMBS. From the current macro-outlook on the UK, we remain comfortable with the remaining exposure held in the strategy and stay nimble should opportunities arise as a result of increased volatility.

Risk Characteristics

- At times, the market for Structured Credit Securities may dry up, which could make it difficult to sell these securities or the strategy may only be able to sell them at a discount.
- There may be cases where an organisation with which we trade assets or derivatives (usually a financial institution such as a bank) may be unable to fulfil its obligations, which could cause losses to the strategy.
- Structured Credit Securities in which the strategy may invest may not be at the most senior level of the debt issued by the relevant issuer and, accordingly, the strategy may be exposed to the risk that its claims on the asset pool of any such note are subordinated to other creditors in the event of an insolvency of any such issuer, meaning in turn that the strategy could sustain losses in such circumstances if it were unable to recover its original investment.
- Structured Credit Securities are often exposed to prepayment and extension risks that may have a substantial impact on the timing and size of the cash flows paid by the underlying pool of financial assets. In the case of prepayments, this may negatively impact the return of the strategy as the income generated will have to be reinvested at the prevailing interest rates which may be lower. Conversely, extension risk tends to increase when interest rates rise as the prepayment rate decreases causing the duration of Structured Credit Securities to lengthen and expose investors to higher interest rate risk.
- BlueBay could suffer from a failure of its processes, systems and controls – or from such a failure at an organisation on which we rely in order to deliver our services – which could lead to losses for the strategy.

Portfolio Manager Perspectives
Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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