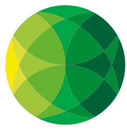

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ASSET MANAGEMENT

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Hard or Soft Brexit: The Case for UK RMBS

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Vontobel

Hard or Soft Brexit: The Case for UK RMBS

A disastrous Salzburg summit has brought the risk of a 'no deal' Brexit into sharper relief for fixed income investors.

When UK Prime Minister Theresa May travelled to Austria in September to meet with European Union leaders, she was hoping to find enough support for her Brexit proposals to move negotiations forward with a view to a final agreement by November.

Instead, May was told that her Chequers plan – so named for the country residence where it was formulated – simply wouldn't work. Widely interpreted as a humiliation for the UK, the summit left the prospect of the country leaving the EU in March 2019 without an agreement on future trading arrangements looking much more likely.

Markets in the weeks since Salzburg have reflected growing unease. Sterling, which before the summit had touched a two-month high against the US dollar of $1.33, has retreated below $1.30. We've seen spreads in the sterling investment grade corporate bond market widen slightly, though demand has been robust, and high yield issuers are continuing to show a reluctance to print bonds in the currency.

For investors, the most concerning aspect of the Salzburg standoff must be the level of apparent miscalculation of intentions on both sides. The UK government had interpreted positive comments from EU leaders about the Chequers plan being a "good starting point" for a Brexit deal at face value, as a sign that a future trade deal could be worked out broadly on those terms. EU leaders, meanwhile, misjudged the restraints placed on May's government by internal divisions within her ruling Conservative Party, which render her apparently unable to compromise on key sticking points such as free movement and the Irish border.

While a compromise deal and a 'soft' Brexit remains our base case, and more recent comments from EU leaders have softened the negative tone of Salzburg, it is reasonable to expect a period of heightened volatility ahead. The increased prospect of 'no deal' has caused understandable anxiety among fixed income investors around UK assets, including UK residential mortgage-backed securities (RMBS).

We have consistently held a meaningful exposure to the UK RMBS sector, and regardless of the ultimate outcome of the Brexit negotiations, we wanted to share our rationale for maintaining this holding. We believe the features of UK RMBS outlined below will help protect prices and preserve investors' capital if volatility rises, and investors willing to look through the headline risk to the fundamentals will have an opportunity to pick up a material spread premium.

THE UK RMBS MARKET

UK residential mortgage-backed securities (RMBS) form the largest and most established component of the European ABS market. The very first deal was issued in 1987, with that year seeing around £1bn issued. Today the outstanding market totals almost £100 billion, or 29% of the total outstanding European ABS market, and is almost entirely floating rate. Year-to-date in 2018, we have seen 25 deals issued totalling €25 billion equivalent and representing 36% of primary issuance in European ABS.

As well as being the largest single European ABS sector, the UK RMBS market is experiencing net growth after a number of years of shrinkage. This is perhaps no surprise, given the UK is moving forward with its orderly normalising of monetary policy, incentivising commercial banks to leave their Bank of England (BoE) support behind and migrate to a more conventional long term funding plan – RMBS is a key part of this. The BoE and the European Central Bank (ECB) have also championed the broader European ABS market as a vital tool for long term funding, making ABS a key form of collateral for their repo and asset purchase programmes.

All this means there are established and active primary and secondary RMBS markets in the UK, a mature investor base, and longstanding residential lending performance.

UK MORTGAGES ARE CONSISTENTLY STRONG PERFORMERS

The £1.3 trillion UK mortgage market was outperformed only by the Dutch through the most recent recessionary period in 2009, when the UK experienced its worst default rate of recent times of just 0.43% (the Dutch saw an even more remarkable 0.32% in 2014). Compare this to Italy, where household defaults in 2017 were still 1.3%, and the US, which had a mortgage default rate of 2.23% in 2010.

There are a few key ingredients to the robust performance of the UK's mortgage market. Firstly, a strong legal and regulatory framework are the backbone to responsible lending. The UK has managed to strike a fair balance between the commercial interests of lenders and the protections that consumer borrowers need. Italy's legal system has historically made it very difficult to foreclose on a bad debt, and lenders can subsequently take typically between five and seven years to make a recovery on a residential property. In the UK, a recovery is typically achieved within six months of repossession, and without ill regard for the circumstances of the borrower.

Nevertheless, the need to improve in the UK after the financial crisis was recognised, and the Prudential Regulation Authority (PRA) took an active role in supervising high level risk taking, with measures such as capping the proportion of high loan-to-value (LTV) lending banks can originate and setting guidelines for measuring affordability. The Mortgage Market Review in 2014 introduced sweeping changes to how lenders could advise consumers, and the practice of self-certifying income (intended to help self-employed borrowers but ultimately open to abuse) was banned in 2010.

Fundamentally, a borrower who falls into financial difficulty will always be incentivised to make their mortgage payment the last bill to go unpaid – they may be able to get by without a nice car, but nobody wants to lose their house. UK borrowers who do fall into trouble are now better assisted by lenders in finding a solution to bridge a short term financial issue or otherwise selling the house to recover the loan. Additionally, loan servicers are regulated and must follow best practice.

Robust lending markets should have strong alignment of interest. In the UK, borrowers cannot simply walk away from a bad debt, it follows them for a multi-year period, which influences borrower behaviour. In the US, the opposite was and still is true. One of the triggers of the US subprime mortgage crisis in 2008 was the ability of borrowers to simply abandon homes that fell into negative equity, being worth less than the value of their mortgage.

FUNDAMENTALS NOT RHETORIC

Mortgage loan performance is primarily influenced by changes in fundamentals, not financial market volatility or geopolitical factors affecting market sentiment, such as trade wars or Brexit negotiations. Pools of loans backing UK RMBS only generally weaken when borrowers cannot pay their loans, and in the event they subsequently default, only then is the value of the house relevant. In the UK, house price falls do not create defaults, remember – it does not matter what your house is worth, borrowers cannot just walk away from their debt. This is important as the UK has seen some house price weakness over the past 12 months, primarily confined to London and its surrounding areas, and in part driven by unfavourable tax changes.

To put this in context, Chart 1 shows the state of key fundamentals during the two most severe UK recessions we have data for and the resulting aggregate mortgage loan default and loss numbers.

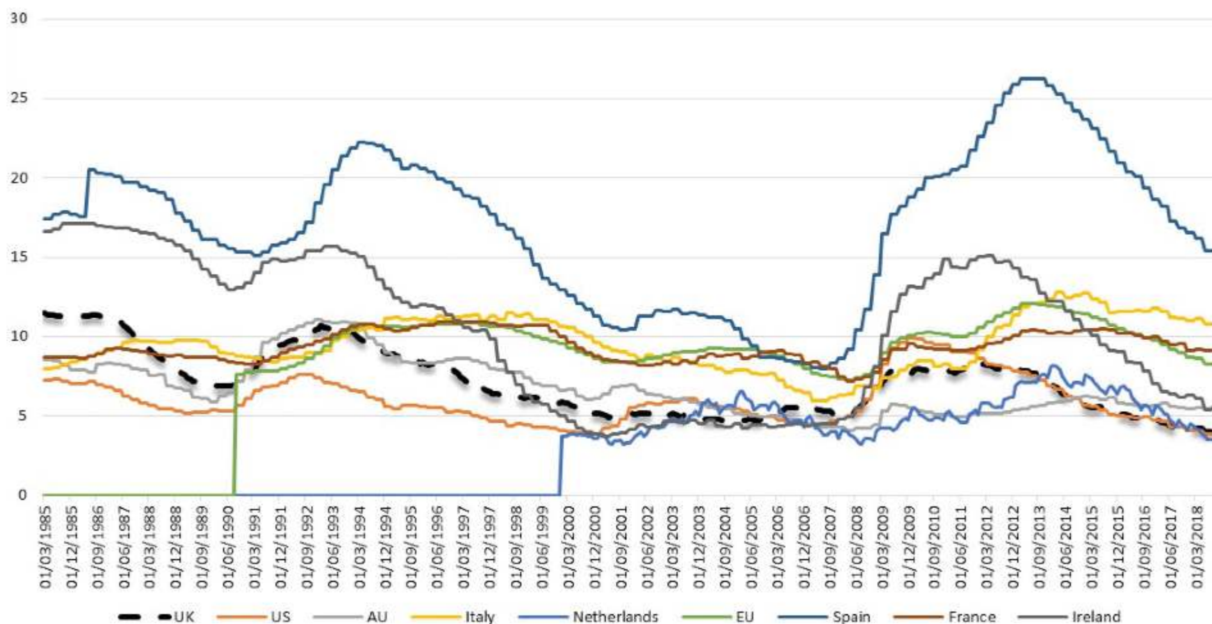
Chart 1: UK recessions vs. 2018 starting point

Sector	1989-1993	Global Financial Crisis	Current
Unemployment	10.7%	8.5% peak	4.0%
Real Income Change	N/A	-6.5% peak to trough	+0.1%
Interest Rates	14.88%	5.75%	0.75%
House Price Peak to Trough*	-17.3%	-25.9%	+1.8% YoY
House Price to Earnings Peak	5.78	8.47	8.39
Loan Default %	0.77%	0.43%	0.07%
Assumed Loss Severity	25%	25%	25%
Resulting Losses	0.19%	0.11%	0.02%

*Through recessionary period, Halifax House Price Index for 1989-1993, Nationwide House Price Index for GFC

If a recession were to hit the UK today, the starting position is also worth noting. Unemployment is at its lowest level since 1975 and incomes are growing, though real income growth is limited. If we compare unemployment across Europe and select other G7 nations in Chart 2, the UK looks favourable. We take comfort that while the economic situation may worsen, fundamentals tend to deteriorate gradually and the UK is starting from a relatively healthy spot.

Chart 2: UK unemployment vs. selected economies, 1985-2018



One other key defence, not unique to the UK, has been the willingness of the BoE to use its full tool kit to maintain the strength of household finances when faced with a period of turbulence. Two rate rises in the past two years gives a degree of room to cut rates again should the need arise and ease the affordability of households when paying mortgage loans, something the Monetary Policy Committee frequently cites. The BoE also provided significant support to banks to firstly ensure liquidity and then funding availability was maintained. The Funding for Lending Scheme (FLS) and later the Term Funding Scheme (TFS) were pivotal in maintaining mortgage credit availability at affordable levels, by reducing the credit premium banks were charging. Given the success of these policies and familiarity markets have with them, they are now tried and tested should they be needed again.

Whatever the outcome of the Brexit negotiations, this empirical data provides a compelling starting point for UK RMBS stress scenarios.

RMBS STRUCTURES AND TURBULENT PERFORMANCE

One of the reasons European ABS has traditionally offered a premium to other fixed income instruments is the relative complexity of the bond structures and the greater level of analysis and modelling required to invest in them. Ironically, the same structural complexity is a key reason why historical RMBS defaults rates are among the lowest in fixed income.

Some of the common structural features which contribute to the credit strength of UK RMBS through absorbing losses are as follows:

Homeowner's Equity – The first loss is absorbed by the home owner's equity in the property, which on a 70% loan-to-value mortgage, for example, would be 30% of the value of the property. Even mortgage pools with a relatively high average LTV, perhaps 80%, still have a significant cushion of homeowner's equity as a first line of defence against losses on the bonds. In other words, before ABS bondholders suffer any losses, three things would need to happen: on average house prices would have to fall more than 20 percent, homeowners would need to default and the other protections mentioned below would need to be exhausted.

Excess Spread – the revenue left once expenses and bond interest is paid, in other words the net profit for the issuer, which they are incentivised to maintain.

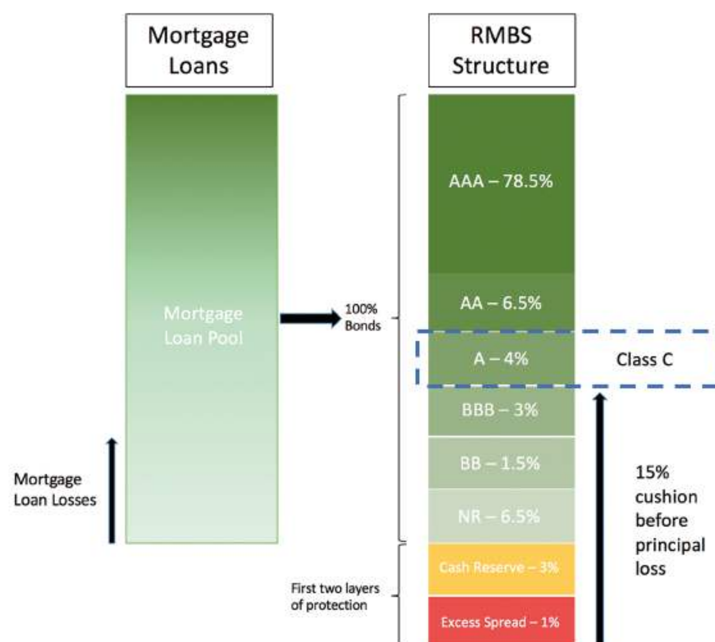
Cash Reserve – a cash fund established to ensure bond coupons are paid in periods where the profit margin may be exhausted and to offset losses.

Subordination – finally, losses are assigned to the most junior bonds first before impacting more senior and therefore better rated bonds.

It is also worth noting that losses occurring in one period which use the Cash Reserve or record losses against a bond can be cured in future periods, should pool performance improve and Excess Spread is again available.

When stressing RMBS bonds we generally use two separate approaches. Firstly, we use a single point in time stress to see when a deal 'breaks'. This helps us understand, if we get a recession of the severity of 1929 or 2009, what normally needs to happen for us to start writing off principal. Chart 3 uses an existing UK RMBS deal to show how mortgage loan losses firstly eat into Excess Spread and then the Cash Reserve before finally impacting bond principal from the most junior bonds upwards.

Chart 3: Example Non-Prime RMBS transaction, HWKSM 2016-1



'Hawksmoor 2016-1' is a Non-Prime RMBS transaction backed by a pool of mortgages originated in 2007. The single-A rated class C note benefits from a 15% cushion, meaning 30% of the mortgage pool would have to default with a 48% loss severity (equivalent to a 88% fall in house prices) before a principal loss starts to occur.

The second stress utilises a dynamic approach where we acknowledge that recessions are multiyear events. Any European ABS we buy, we do so on the basis we would be happy to hold it to maturity. Chart 4 shows what happens to the BBB rated tranche of the same UK RMBS deal which benefits from 11% credit enhancement, when we employ differing Constant Default Rates (CDR – an annual percentage of defaults applied to the pool) and corresponding Loss Severity.

Chart 4: Cash Flow Stress Test on HWKSM 2016-1 Class D notes

LOSS SEVERITY	CDR					
	HWKSM 16-1D	0.43%	0.77%	2.0%	5.3%	6.0%
	0%	0.00%	0.00%	0.00%	0.00%	0.00%
	20%	0.00%	0.00%	0.00%	0.00%	0.00%
	30%	0.00%	0.00%	0.00%	0.00%	0.00%
	40%	0.00%	0.00%	0.00%	**8.37%**	59.25%
	50%	0.00%	0.00%	0.00%	95.36%	99.11%
	60%	0.00%	0.00%	0.00%	100.00%	100.00%
	80%	0.00%	0.00%	0.00%	100.00%	100.00%

If we again assume a conservative 40% loss severity, the BBB bond would take a principal loss of 8.37% if the default rate every year was 5.3%, a default rate almost seven times worse than the single worst year on record. Other parts of the fixed income market would likely be suffering far worse consequences in a scenario where over 5% of UK mortgage borrowers were defaulting every year. This is a key reason why ratings have been relatively stable within European ABS compared to, for example, investment grade corporates.

In addition, ABS ratings are capped at a certain number of notches above the credit rating of their corresponding sovereign. When RMBS transactions in Spain, Italy and Portugal suffered widespread downgrades and substantial price volatility during the Eurozone sovereign debt crisis, it was expected because the credit ratings of their home countries had been severely downgraded – it was nothing to do with the performance of the RMBS. At present, the UK government's credit rating would have to fall below single-A (with Moody's) for the senior notes of UK ABS transactions to be unable to achieve a triple-A rating.

TECHNICAL FALLOUT

Confidence in UK RMBS credit risk does not necessarily eliminate short term pricing volatility. We would expect to see some spread movement in the event of a disorderly Brexit outcome, however a capital exodus is unlikely as the investor base in UK RMBS contains a large component of domestic buyers. Take for example a recent Prime UK RMBS issued by Yorkshire Building Society, where 82% of the investor book was based in the UK. In addition, if RMBS were to become expensive for issuers relative to other sources of funding, banks would likely shift to other funding sources, keeping RMBS supply in check and supporting this technical backdrop. Also, some of the recent spread widening seen in June and July arguably reflected investors pricing in a Brexit premium.

On the technical side, monetary policy is again relevant when comparing UK RMBS with its continental European counterparts. Whilst the BoE has started monetary tightening, the ECB is still providing extensive support, which has undoubtedly helped spread performance but does give rise to potential spread volatility at a later stage. UK RMBS investors, having already experienced growing issuance from the banks, have to a certain extent we believe already priced in a phased transition to a more normal supply and demand balance.

VALUE OPPORTUNITY

We believe UK RMBS is a defensive holding into a period of uncertainty. Stress testing shows its resilience to even the most bearish multiples of economic downturns on record, the market is liquid and active, and a premium is achievable over other parts of European RMBS and investment grade corporates.

For example, Warwick No2, a 1.7 year single-A rated bond trades at £3mL+182bp, equivalent to €3mE+158bp when hedged, which compared to comparable Dutch RMBS represents a pick-up of 28bp. If we compare to the iBoxx EUR Financials where the average rating is also single-A, a spread of +104bp gives UK RMBS a pick-up of over 50bp.

We also believe that AAA UK RMBS backed by Buy-to-Let investment loans represent a low beta defensive position, where a three-year floating rate bond with little interest rate duration typically yields 1.75% (£3mL+95bp or €3mE+71bp hedged equivalent), which looks to us to represent strong value against comparable Gilts at 0.9%.

We intend to maintain a core holding in UK RMBS through this period of uncertainty, balanced between AAA and investment grade bonds, with a bias towards shorter credit duration positions from strong sponsors.

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