Calnea Analytics - The UK Mortgage Market - Outlook and Commentary 2nd Quarter 2009

A review of Calnea's mortgage market estimates following publication on 15th September of the FSA's MLAR statistics for the second quarter suggests that the future loss potential embedded in the balance sheets of UK mortgage lenders stands at £27.1bn[1].

This is the expected cost of repossessions that will emerge over the next ten years. It represents 69.2% of the estimated Pillar 1 capital base and 2.53% of total outstanding mortgage loans.

Although house prices have stabilised recently, 47% of all mortgage loans are potentially "at risk" from loss on repossession because the outstanding loan is currently more than 70% of the current value of the property. This figure includes second mortgages and other secured borrowing, but excludes other forms of unsecured debt that mortgagees may be exposed to.

Commenting on the analysis Troy Martin, Director of Calnea Analytics said, "The MLAR statistics make very interesting reading. They show that the market has avoided going into free fall due mainly to the radical reduction in interest rates, but that it will be some time before the effects of the recession, notably increasing unemployment, permeate through the system"

He added, "The figures show some necessary balance sheet rebuilding by lenders and that they are making a significant effort to help customers in arrears avoid possible repossession. This forbearance helps both parties by avoiding the crystallisation of current losses in the hope that with economic recovery such losses will be reduced or even eliminated. However, the ultimate levels of loss embedded in the system suggested by our models, coupled with the uncertain economic outlook and the need for the Government to finance its bail outs, mitigate against a quick return of economic growth and confidence"

He concluded, "One year on from the demise of Lehman Brothers, there is a danger that the expectation of economic recovery is greater than the reality. Property prices are not expected to increase back to their previous level quickly and unemployment is unlikely to peak before 2010. Against this background, mortgage losses are likely to continue to grow for some considerable time in a regulatory environment that looks almost certain to become more conservative".

A summary of our key findings:

[1] See Appendix I - based upon our "medium/medium" scenario assumptions

Overview: the 2009-Q2 MLAR statistics indicate subdued new business growth and muted competition between lenders. Reducing borrowing costs, coupled with lender forbearance initiatives, are tending to slow the development of arrears and repossessions.

- **Embedded losses:** our mid range loss forecast[2] is £ 27.1bn. This is 2.53% of the outstanding loans by value and 69.2% of estimated Pillar 1 capital. Securitised business appears to have a much higher embedded loss potential than un-securitised business.

- **Mortgage market demand and property prices**: new lending volumes, while growing, remain modest and are yet to reach a level that would underpin a sustained recovery in property prices.

- **Current Loan to Value distribution:** we estimate[3] that for the market as a whole 22% of properties are in negative equity and 47% of properties have an LTV of 70% or greater.

  Such high LTV ratios suggest that the recovery in property prices is likely to be drawn out unless lenders can increase substantially the flow of funds for new lending.

- **Affordability:** rates continue to fall, giving some relief to arrears and repossessions although, on a rolling 12 month basis, both these figures have continued to increase. An early increase in interest rates, in conjunction with increasing unemployment, would worsen this situation considerably.

- **Lenders' margins**: these have widened significantly helped by a considerable moderation in competition between lenders. Many borrowers are effectively bound to their existing lenders due to negative equity and the current restrictive underwriting criteria for new borrowing. There is a delicate balance between the borrowers' needs and those of lenders for higher margins to compensate for: increasing loss provisions; strengthening balance sheets; and the possibility of a more conservative regulatory regime going forward.

- **Macro-prudential regulation**: there is a strong likelihood that the regulatory regime will become more conservative as a result of the credit crunch. Retail mortgage lending can only expect that its regulatory capital ratios will be increased in line with other classes of lending.

Conclusion: While a lot has been learned since the last mortgage crisis of the 1990s, it seems almost inevitable, given the depth of the recession and the scale and nature of mortgage lending prior to the credit crunch, that repossessions and their associated losses will continue to increase from their current levels through 2010 -2013

[2] See Appendix 1 for detailed loss estimates
[3] See www.calnea.com for our latest analysis of UK LTV distribution – a summary table is also included in Appendix 1.

Q2 Market commentary

Volume changes: net lending volumes increased marginally during the quarter although the loan count actually reduced. There has been a degree of switching within the overall figures from re-mortgaging in favour of new business.

	Year on year change MLAR data			
	2008-Q3	2008-Q4	2009-Q1	2009-Q2
Loans:				
Values	5.1%	3.4%	1.8%	1.1%
Numbers	1.1%	0.3%	-1.9%	-1.8%

New business credit criteria: new business income multiples and LTV ratios remain conservative. While the level of loans where income was "not-evidenced" has declined in the quarter, it remains relatively high at 27% of the total.

There would appear to be a lack of competition between lenders.

Interest rate structure: there has been a continuing shift towards variable rate lending which is now at a significantly higher margin against the Base Rate than the brought forward portfolio, indicating that lenders are using lending margins as one route to rebuilding balance sheets.

	2007-Q4	2008-Q1	2008-Q2	2008-Q3	2008-Q4	2009-Q1	2009-Q2
Gross advances							
Less than 2% above	95.66%	95.13%	94.92%	92.43%	44.54%	28.61%	16.33%
2 < 3 % above	3.27%	3.52%	3.93%	6.41%	19.65%	18.29%	15.79%
3 < 4 % above	0.55%	0.67%	0.65%	0.73%	18.68%	23.90%	30.33%
4% or more above	0.51%	0.68%	0.49%	0.43%	17.14%	29.21%	37.55%
Outstanding balances							
Less than 2% above	84.35%	91.73%	90.55%	89.61%	36.27%	32.36%	32.52%
2 < 3 % above	13.95%	7.45%	8.65%	9.58%	28.43%	11.90%	12.50%
3 < 4 % above	0.82%	0.39%	0.43%	0.44%	25.55%	10.10%	9.37%
4% or more above	0.88%	0.43%	0.37%	0.37%	9.75%	45.64%	45.61%
Difference							
Less than 2% above	11.31%	3.40%	4.37%	2.83%	8.27%	-3.75%	-16.19%
2 < 3 % above	-10.68%	-3.93%	-4.71%	-3.17%	-8.78%	6.39%	3.29%
3 < 4 % above	-0.27%	0.28%	0.22%	0.28%	-6.87%	13.79%	20.96%
4% or more above	-0.36%	0.25%	0.13%	0.07%	7.39%	-16.43%	-8.05%
BoE quarter end interest rate %	**5.5%**	**5.3%**	**5.0%**	**5.0%**	**2.0%**	**0.5%**	**0.5%**

Affordability: the table below illustrates how reducing Base Rates has affected the average cost of both fixed and variable loans. Over the last 12 months the average market rate has dropped by 200 basis points – a relative decrease of almost a third in the cost of mortgage money. However, this is less than the actual reduction in Base Rate, hence the evidence of margin rebuilding.

	2007-Q4	2008-Q1	2008-Q2	2008-Q3	2008-Q4	2009-Q1	2009-Q2
Gross adavnces weighted interest rates							
Fixed rate loans	6.01%	5.92%	5.82%	6.12%	6.05%	5.31%	4.85%
Variable rate loans	6.14%	5.87%	5.83%	6.11%	4.33%	2.91%	2.76%
All loans	6.07%	5.90%	5.83%	6.11%	5.08%	4.05%	4.12%
Outstanding balances weighted interest rates							
Fixed rate loans	5.42%	5.52%	5.59%	5.70%	5.71%	5.70%	5.67%
Variable rate loans	6.55%	6.15%	5.95%	6.03%	4.12%	2.71%	2.43%
All loans	5.95%	5.83%	5.77%	5.86%	4.88%	4.03%	3.81%
Difference in weighted rtaes							
Fixed rate loans	0.60%	0.40%	0.23%	0.42%	0.34%	-0.39%	-0.82%
Variable rate loans	-0.42%	-0.28%	-0.12%	0.08%	0.21%	0.21%	0.33%
All loans	0.12%	0.07%	0.06%	0.25%	0.20%	0.02%	0.31%

It seems that the interest rate structure may be bottoming out with the rate of decline of outstanding loans decreasing and that of new lending increasing.

Over the medium term, given that base rates are currently at their lowest ever point, it is likely that rates will be increased. In addition, as low fixed rate deals end and revert to variable rates borrowers will be exposed the "income shock" of increased borrowing costs. Coupled with rising unemployment, this will impact adversely upon arrears and potentially thereafter, repossessions and losses.

Lenders' margins: although the costs of the funds to the lenders themselves are higher than the Base Rate, the interest rates reported in the MLAR indicate that margins have increased significantly over the last 7 quarters; this is seen as an inevitable consequence of a lack of liquidity and absence of competition. Lenders' priorities seem firmly focused on profitability through loan management rather than market share.

Arrears development: arrears' development has slowed significantly in Q2. This appears to be largely a consequence of reducing interest rates. However, the year on year change of both arrears values and the number of cases show a significant increase Prospective increases in interest costs and unemployment both look likely to push arrears higher in the medium term.

MLAR Arrears Devlopment

Arrears	2008-Q3	2008-Q4	2009-Q1	2009-Q2
Values £m	£1,832	£2,054	£2,179	£2,224
Y-on-Y increase	*59.1%*	*54.7%*	*52.1%*	*46.1%*
Numbers	340,770	376,587	398,991	402,640
Y-on-Y increase	*24.6%*	*30.6%*	*33.3%*	*30.0%*
Avearge value arrears £'s	£5,377	£5,455	£5,460	£5,525
Y-on-Y increase	*27.7%*	*18.4%*	*14.1%*	*12.3%*

The "Arrears Band Transition by Numbers" table, developed from the MLAR statistics, illustrates the slow dynamic development of arrears and shows a pattern of reducing but persistent ageing of arrears relative to loan values.

Arrears Band Transition by Numbers

	Q3-08	Q4-08	Q1-09	Q2-09
Nil to 1.5%	0.2%	0.3%	0.2%	0.1%
1.5% to 2.5%	28.2%	31.8%	26.7%	16.5%
2.5% to 5.0%	17.9%	18.1%	17.4%	13.2%
5.0% to 7.5%	41.2%	39.2%	37.9%	30.0%
7.5% to 10+%	81.7%	73.6%	72.6%	59.8%

If interest rates increase in the second half of 2009, then the effect on arrears will be manifest in 2010 and 2011. Nevertheless, one might argue that a benefit of the current slowdown, from a lender's perspective, is that it facilitates forbearance and mitigates against repossession and having to pay its associated costs and losses right away.

Repossessions: while repossessions reduced in Q2, they remain significantly higher than a year ago, continuing to increase on a 12 month rolling basis.

	2008-Q3	2008-Q4	2009-Q1	2009-Q2
Qtly repos	13,464	13,150	14,825	13,610
Y-on-Y increase	*96.9%*	*61.6%*	*61.6%*	*22.8%*
Rolling 12 months	35,229	41,855	46,870	52,521
Q-on-Q increase	*18.8%*	*12.0%*	*12.1%*	*4.8%*
Arrears numbers	340,770	376,587	398,991	402,640
Qtly repos as % arrears	*4.0%*	*3.5%*	*3.7%*	*3.4%*

Repossession is a drastic decision for both lenders and borrowers. Forbearance and deferment policies are based on the assumption that property prices and the borrowers' ability to repay will recover in the future as the impact of recession through unemployment abates. The issue faced by both parties is whether the (multi-year) timescale of such improvements compensates for (accounting period) increasing levels of arrears.

Increasing accruals and the nature of the cycle poses real questions for regulatory and reporting regimes. That is to what extent such accruals should be provided for as they develop and the degree to which such loans should be valued on a mark to market basis or as long term lending commitments.

Conclusion: While a lot has been learned since the last mortgage crisis, it seems almost inevitable, given the depth of the recession and the scale and nature of mortgage lending prior to the "crunch" that repossessions and their associated losses will increase significantly from their current levels through 2010 -2013

Appendix I

Summarised cumulative 10 year loss estimate totals

	Unsecuritised loan losses			Securitised loan losses		
Scenarios bases	£bns	% loan balances	% Pillar I capital	£bns	% loan balances	% Pillar I capital
Low/low	-£12.6	-1.4%	-40.3%	-£5.8	-2.8%	-79.4%
Med/med	-£18.6	-2.1%	-58.6%	-£8.5	-4.2%	-114.5%
High/high	-£29.6	-3.5%	-89.5%	-£13.4	-6.8%	-173.1%
Extreme	-£36.7	-4.3%	-119.5%	-£16.7	-8.5%	-233.2%

Unsecuritised annual projected loan losses as percentage of underlying loan principal

Scenario	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
Low/low	-0.2%	-0.3%	-0.3%	-0.3%	-0.2%	-0.1%	-0.1%	0.0%	0.0%	0.0%	-1.4%
Med/med	-0.2%	-0.3%	-0.3%	-0.4%	-0.3%	-0.2%	-0.2%	-0.1%	-0.1%	0.0%	-2.1%
High/high	-0.2%	-0.3%	-0.4%	-0.5%	-0.5%	-0.5%	-0.4%	-0.3%	-0.2%	-0.1%	-3.5%
Extreme	-0.3%	-0.4%	-0.6%	-0.7%	-0.7%	-0.6%	-0.5%	-0.3%	-0.2%	-0.1%	-4.3%

Securitised annual projected loan losses as percentage of underlying loan principal

Scenario	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
Low/low	-0.4%	-0.5%	-0.6%	-0.5%	-0.4%	-0.2%	-0.1%	-0.1%	0.0%	0.0%	**-2.8%**
Med/med	-0.4%	-0.6%	-0.7%	-0.8%	-0.7%	-0.5%	-0.3%	-0.2%	-0.1%	-0.1%	**-4.2%**
High/high	-0.5%	-0.6%	-0.9%	-1.1%	-1.1%	-1.0%	-0.7%	-0.5%	-0.3%	-0.2%	**-6.8%**
Extreme	-0.6%	-0.8%	-1.1%	-1.4%	-1.4%	-1.2%	-0.9%	-0.6%	-0.3%	-0.2%	**-8.5%**

UK market LTV distribution weighted by property numbers

LTV band	<50	<55	<60	<65	<70	<75	<80	<85	<90	<95	<100	>100
Loan numbers	3,715,432	498,491	543,363	414,768	487,233	505,963	519,889	566,467	339,624	352,437	478,179	2,439,036
Percentag	**34.2%**	**4.6%**	**5.0%**	**3.8%**	**4.5%**	**4.7%**	**4.8%**	**5.2%**	**3.1%**	**3.2%**	**4.4%**	**22.5%**
Cum % > 70%						**3.9%**	**8.4%**	**13.3%**	**16.2%**	**19.1%**	**23.0%**	**42.4%**