CALNEA ANALYTICS™

UK Loan to Value Distribution
Analysis of Unregulated Loans

Introduction:

Calnea Analytics estimates the distribution of Loan to Value (LTV) ratios as part of its whole market loss forecasting[1]. This study also includes a breakdown for the unregulated sector.

The analysis concentrates on establishing the distribution of mortgage loans at 70% of the current value of the property and above because these are the loans that are most likely to generate losses for both lenders and borrowers upon repossession and sale of the property. The study focuses upon outstanding mortgages at 1st January 2009, for which there is comprehensive data. As the movement in house prices between 1st January and 30th June 2009 has been virtually static, the LTV distribution at 30th June is likely to be essentially the same as at the beginning of the year.

Other recent studies of the current LTV distribution have focussed mainly upon negative equity for first charge, regulated mortgages. This study has been extended to cover the LTV distribution for the whole market and thereby illustrates the difference between the regulated and unregulated market sectors.

The base data for this study has been taken from the FSA, Bank of England and CML.

Summary:

Decomposing market data into its first mortgage and second mortgage charges, and Buy to Let (BTL) segments allows each sector to be analysed individually to create a whole market consolidated analysis.

The principal observations drawn from taking this approach are:

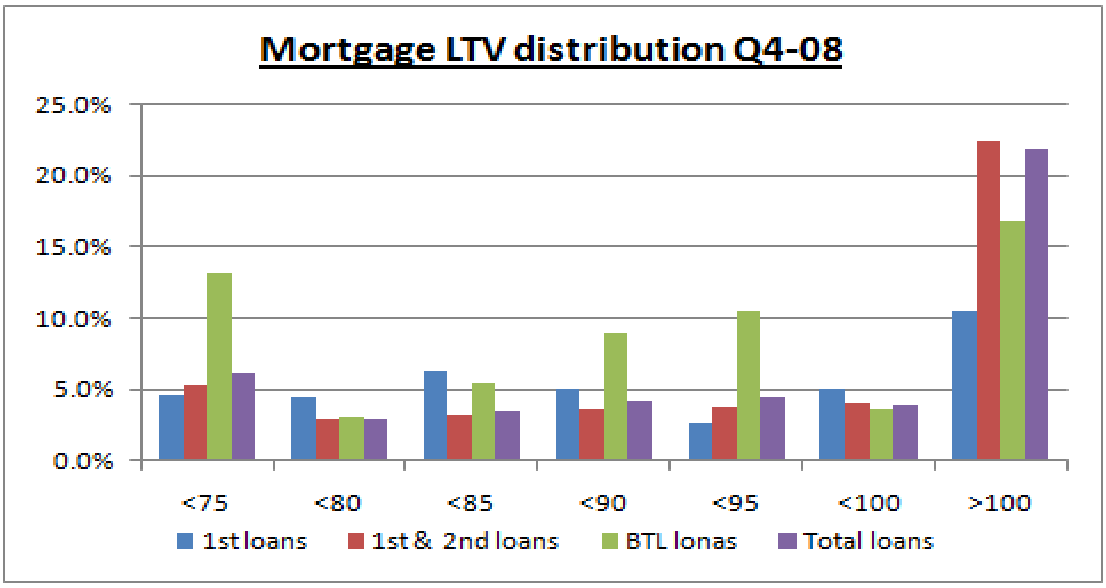
- Unregulated mortgages (pre-M-day first mortgages, second mortgages and BTL mortgages) are a significant proportion of the whole market. They represented approximately 30% by value but 43% by number of the UK total mortgage loans at 1st January 2009.

- The inclusion of second charge mortgages in combination with first charge mortgages increases the aggregated LTV ratios for mortgaged property significantly. For example, the proportion of all mortgaged properties with LTVs greater than 100% at 1st January 2009 increases from 10.5% to 16.0%.

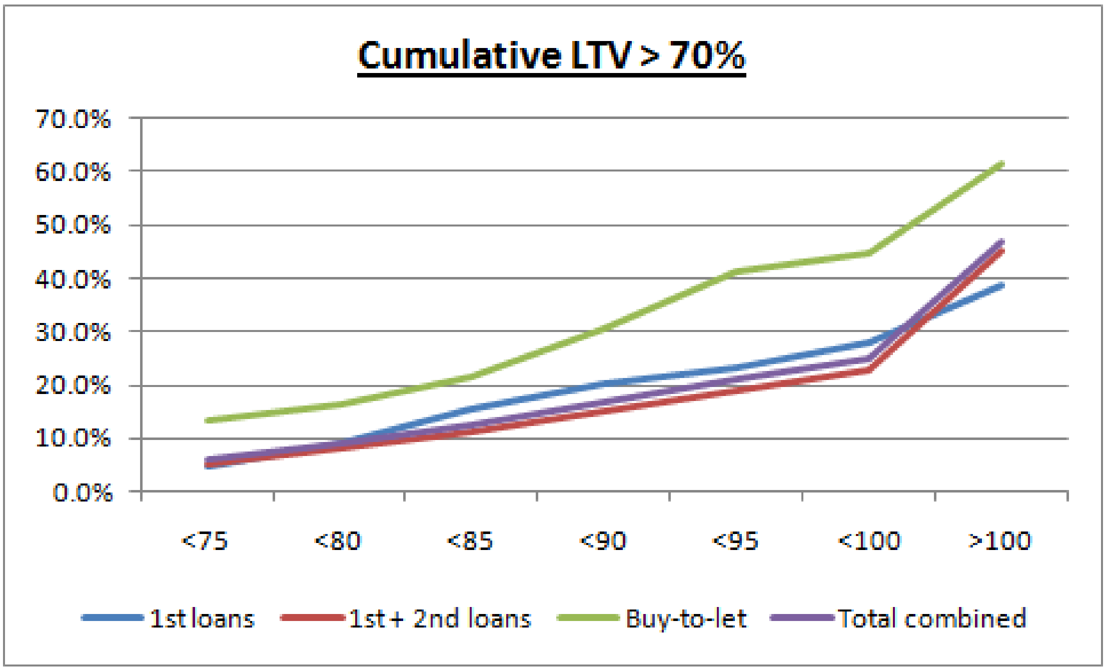
- Negative equity i.e. where the current LTV is greater than 100%, is only part of the picture when analysing the overall market loss estimates. This is because negative equity is not the sole driver of arrears or ultimate repossession. In taking an overall loss view, it is the repossession of properties with a current LTV of 70% or greater which is important because these loans are likely to lead to lender losses.

[1] www.calnea.com

The chart illustrates the distribution by market segment for LTV bands of mortgages that are at risk of exposure to potential losses upon repossession and sale. (N.B All loans below 70% LTV are excluded).



- The chart below illustrates the cumulative distribution of LTV bands above 70% as the most appropriate indicator of potential lenders' losses following repossession and sale.



The consolidated percentage of loans with LTVs of 70% and greater is 46.9% indicating that almost one half of all mortgages pose some risk of loss to lenders if repossessed.

The impact of BTL mortgages on the combined distribution is relatively small due to the limited number of such mortgages relative to the market as a whole.

- LTVs are currently extremely high in historical terms. This reflects the impact of decreasing property values over the last 18 months, which at 30th June 2009 have fallen from their peak value by 16.33%, according to the Nationwide index[2]. Together with unemployment, they constitute the main macro-prudential threats to the sector.

  Current indications suggest that property prices are unlikely to increase significantly over the medium term. By contrast, unemployment is expected to continue to increase into 2010 – implying that mortgages will remain at risk and that lenders' losses are likely to develop persistently over the next 3-4 years.

- Calnea expects market losses to be significantly higher for BTL and second charge mortgages than for first charge mortgages. It follows that lenders specialising in these higher risk market segments will face materially higher losses than those with more traditional and/or broadly based portfolios.

Background:

Mortgages with negative and limited equity pose a problem for homeowners wishing to move location. The phenomenon of negative equity attracts a certain amount of media attention as a simple measure of the level of threat posed to lenders and borrowers in the event of repossession.

The reality is that in the event of repossession, any loan with a LTV of 70% or greater is likely to lead to some element of loss to the lender and the borrower due to arrears, expenses and a "distressed sale" sale discount. It is the distribution, therefore, of mortgaged property with an LTV of 70% or above which is the key determinant of exposure to potential loss rather than negative equity per se.

There appears to be a consensus view that around 9% of first charge, regulated mortgages were in negative equity at 1st January 2009. Until now, there have been no studies of the impact of BTL and other unregulated property based loans upon this estimate.

The unregulated sector as revealed in the FSA MLAR data is a significant (though currently decreasing) proportion of the UK mortgage market. The rate of reduction in unregulated loans is believed to be largely due to the re-mortgaging of pre M-day (thus unregulated) loans which subsequently are reported as regulated loans. More recently, consolidation of some second charge mortgages to reduce borrowing costs may also have contributed to the rate of decrease.

The table on the next page shows the most recent measure of the distribution from the FSA's MLAR series.

[2] House Prices peaked in Q3 2007 and reached their lowest point in Q12009, falling by 18.69% nationally

	2007-Q3	2007-Q4	2008-Q1	2008-Q2	2008-Q3	2008-Q4	2009-Q1	2009-Q2
Regulated loans								
Values £m	£724,909	£761,654	£788,761	£812,686	£832,942	£844,668	£852,589	£862,169
Numbers	7,429,530	7,794,564	8,099,908	8,401,858	8,636,120	8,806,498	8,837,160	9,026,458
Unregulated loans								
Values £m	£412,989	£397,559	£387,761	£374,619	£362,833	£353,942	£345,137	£338,117
Numbers	8,045,470	7,710,877	7,514,542	7,205,337	7,007,647	6,748,753	6,485,418	6,294,968
Combined								
Values £m	£1,137,898	£1,159,213	£1,176,522	£1,187,305	£1,195,775	£1,198,610	£1,197,725	£1,200,286
Numbers	15,475,000	15,505,441	15,614,450	15,607,195	15,643,767	15,555,251	15,322,578	15,321,426

MLAR data is based on loans rather than mortgaged properties and therefore tends to reflect higher loan numbers than other sources.

LTV distribution of first charge mortgages:

For the purposes of the current study we identify first charge mortgages. This comprises regulated first charge and remortgages and pre M-day[3] (unregulated) first charge mortgaged properties.

The table below illustrates the estimated LTV distribution above 70% LTV as at 1st January 2009

	First charge mortgaged poperties						
	<75	<80	<85	<90	<95	<100	>100
Average LTV	72.5%	77.8%	83.2%	89.3%	93.9%	97.6%	106.0%
Mortgage numbers	442,154	438,287	601,948	488,483	259,552	481,905	1,015,222
% total	4.6%	4.5%	6.2%	5.0%	2.7%	5.0%	10.5%
Cumulative > 70% LTV	4.6%	9.1%	15.3%	20.4%	23.0%	28.0%	38.5%

It can be seen that while 10.5% of all mortgaged properties (total 9.678m) is estimated to be in negative equity when taking account of the first charge only - the percentage of properties with loss potential in the event of repossession is significantly higher with up to 38.5% of loans potentially vulnerable to loss. Since the higher the LTV, the higher the potential loss – negative equity represents the more severe losses.

LTV distribution of unregulated loans – Buy To Let and Second Charges:

For the purposes of this study the unregulated sector of the market is considered to comprise BTL mortgages and second and further charge mortgagees.

The BTL segment has been estimated from CML data[4]. The principal assumptions are:

- Loans biased above 65% LTV and capped at a maximum of 80% LTV at origination
- Interest only loans
- Mortgages in 2006 and 2007 only are estimated to have been transacted at a premium of 11% to realisable value (aka overvaluation)

[3] M-day was 31st October 2004. Pre M-day Remortgages of pre M-day loans are reported as regulated. For consistency purposes in this study, pre M-day mortgages are treated as if they were regulated first mortgages
[4] Table MM6 – Annual data

- Indexation applied using the Nationwide Flats index to 1st January 2009

The table below illustrates the estimated LTV distribution as at 1st January 2009.

	Buy to Let mortgages						
	<75	<80	<85	<90	<95	<100	>100
Average LTV	73.8%	79.8%	80.7%	86.6%	92.9%	99.3%	104.5%
Loan numbers	150,505	35,100	62,081	102,310	120,999	41,045	192,046
% total	13.1%	3.1%	5.4%	8.9%	10.6%	3.6%	16.8%
Cumulative > 70% LTV	13.1%	16.2%	21.6%	30.5%	41.1%	44.7%	61.4%

Second charge mortgages:

There are a number of challenges estimating the impact of second charge and higher mortgages:

- Second charge mortgages are generally smaller than first charge mortgages – borne out by the MLAR quarterly data, which shows that the ratio of second charge to first charge mortgage values is approximately 40%.

- In combination with first charge mortgages, second charges have a significant impact on the LTV distribution of domestic mortgaged property.

- Arrears on the second charge mortgage can trigger repossession on the associated first charge mortgage. While losses fall to the second charge mortgagee, in the first instance, losses can also be incurred by the first charge mortgagee if repossession sales' proceeds are less than that required to repay the outstanding debt on the first charge mortgage.

  Second charge mortgages are, therefore, a source of additional risk with a material impact on LTV, repossessions and losses.

The distribution of second charge mortgages has been estimated using the following principles:

- Identifying second and higher charge gross mortgage-lending volumes by year of origination by deduction of other categories from overall gross lending volumes.

- Allocating original gross lending on second loans to original LTV band inclusive of first charges by applying the same basis of distribution for second charges as for first charge re-mortgages.

- Capping lending inclusive of a second charge at a maximum of 90% original LTV.

The table below illustrates the current LTV of combined first and second charge mortgages as at 1st January 2009.

Combined first and second mortgages							
	<75	<80	<85	<90	<95	<100	>100
Average LTV	72.6%	78.0%	82.3%	87.4%	92.4%	97.8%	112.6%
Loan numbers	512,335	275,770	308,303	350,881	364,605	386,458	2,168,926
% total	5.3%	2.8%	3.2%	3.6%	3.8%	4.0%	22.4%
Cumulative > 70% LTV	5.3%	8.1%	11.3%	15.0%	18.7%	22.7%	45.1%

The impact of combining first and second charge mortgages is to increase the proportion of mortgages in the higher LTV bands so that almost one half of mortgaged property had a current LTV of 70% or greater as at 1st January 2009.

Despite the media attention during recent months focussing upon property prices increasing slightly, the fact remains that they are little changed from the beginning of the year and, therefore, provide little relief from the greater threat now posed by the increasing level of unemployment and short term working which is expected to increase through into 2010.

Combined LTV distribution:

The table below combines the impact of the BTL sector with that of first and second charge residential mortgages. The position deteriorates further although BTL is a relatively small element of the total market.

Combined market total							
	<75	<80	<85	<90	<95	<100	>100
Average LTV	72.9%	78.2%	82.0%	87.3%	92.5%	97.9%	111.9%
Loan numbers	662,840	310,871	370,383	453,191	485,604	427,503	2,360,972
% total	6.1%	2.9%	3.4%	4.2%	4.5%	3.9%	21.8%
Cumulative > 70% LTV	6.1%	9.0%	12.4%	16.6%	21.1%	25.0%	46.9%