

U.K. Nonconforming RMBS: Looking Beyond Headline Arrears

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S&P Global
Ratings

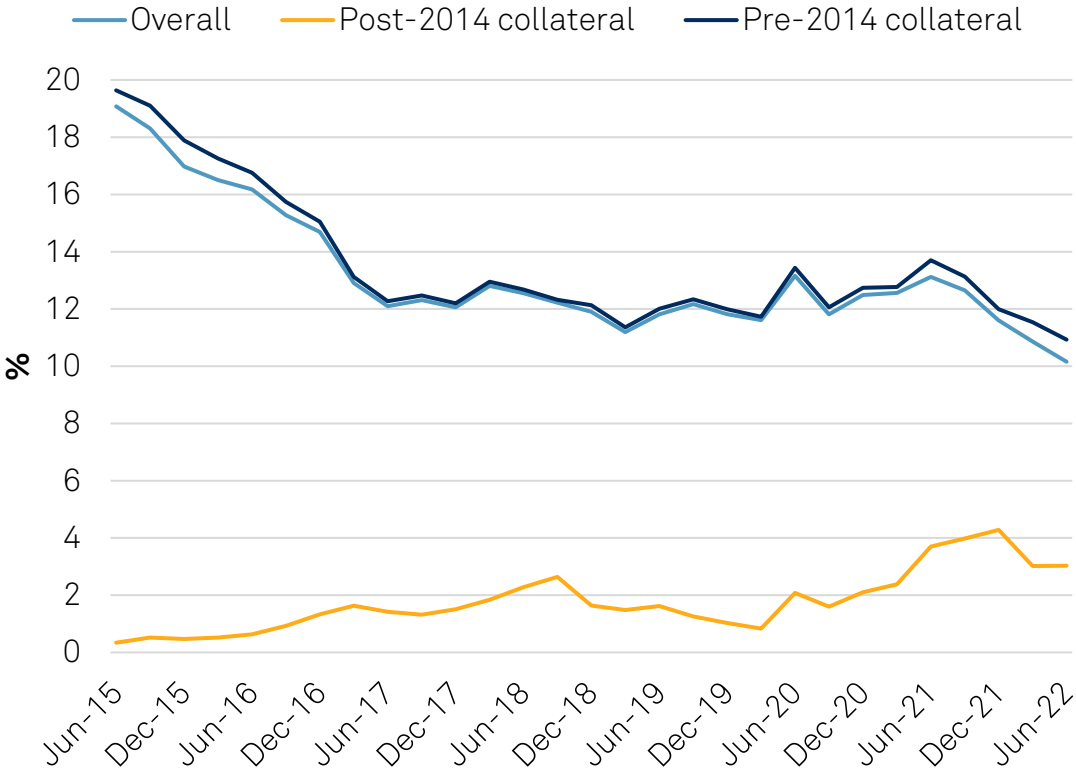
This report does not constitute a rating action.

Key Takeaways

- Total arrears in S&P Global Ratings' U.K. nonconforming RMBS index stood at 10.16% at the end of Q2 2022, the lowest level since we began producing the index.
- Current cost of living pressures could soon cause arrears to rise. Borrowers with variable-rate loans could see additional stress due to the accompanying rise in mortgage rates and higher mortgage payments.
- In this article, we look beyond headline arrears figures to alternative metrics that we will monitor during the cost of living crisis. We believe that these metrics could provide early signals of future deterioration in RMBS transaction performance.
- In our view, nonconforming RMBS collateral will be more severely affected by the cost of living crisis than the collateral typically backing prime and buy-to-let transactions, as discussed in our recent publication: "[Cost Of Living Crisis: How Bad Could It Get For U.K. RMBS?](#)," published on May 20, 2022.
- Based on our most recent macroeconomic forecasts, we have maintained our mortgage market outlook for the U.K. to reflect uncertain economic conditions and increased credit risk. This continues to affect our 'B' foreclosure frequency assumption for the archetypal pool (see "[Residential Mortgage Market Outlooks Maintained For 15 European Jurisdictions Following Revised Economic Forecasts](#)," published on April 28, 2022).

U.K. Nonconforming RMBS Arrears Have Been Broadly Stable So Far

U.K. Nonconforming RMBS Total Arrears Index

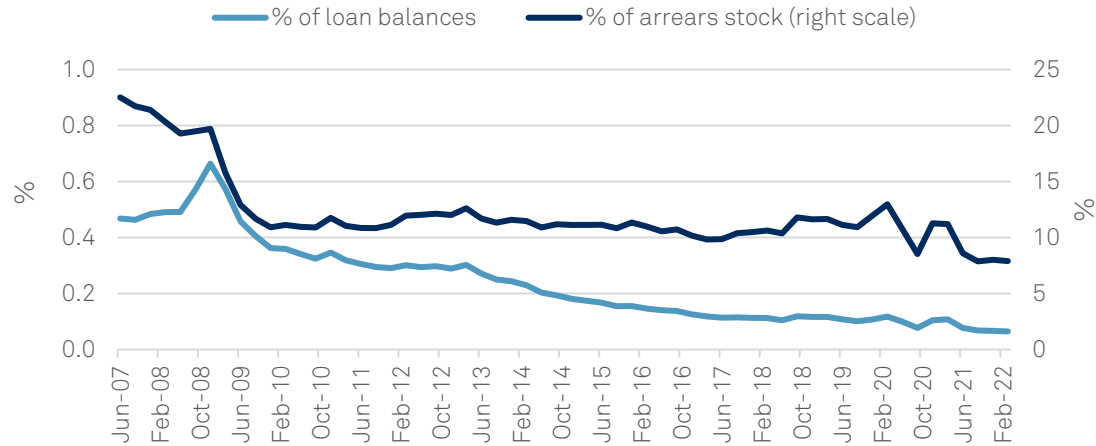


- S&P Global Ratings' total arrears index for U.K. nonconforming RMBS stood at 10.16% at the end of Q2 2022--the lowest level since we began producing the index.
- This latest downtrend is driven by a decrease in arrears for pre-2014 collateral, slightly offset by an increase for post-2014 mortgage loan originations, which to some degree reflects the respective assets' seasoning and the expected build-up of some arrears from a low level at transaction issuance.
- However, headline arrears figures alone give only a limited indication of future arrears performance.

Source: S&P Global Ratings.

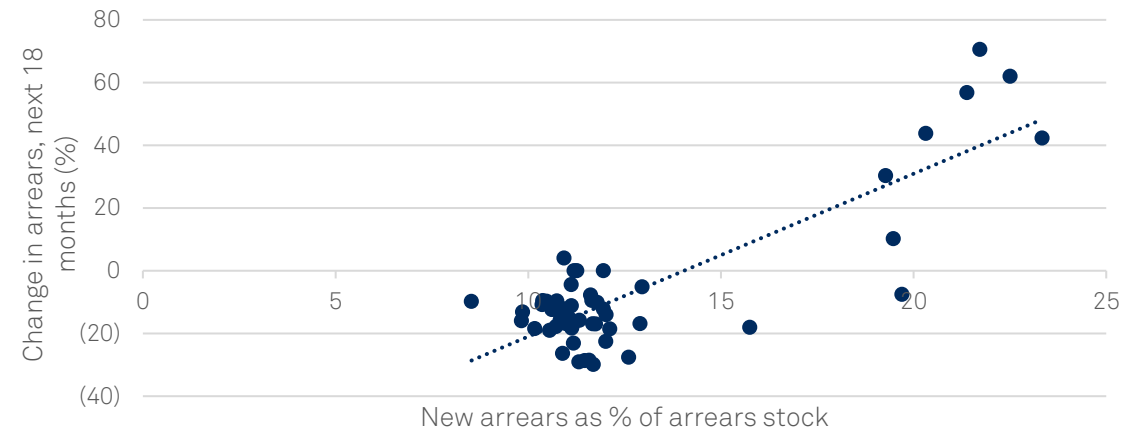
New Arrears Could Be A Leading Indicator Of Future Arrears Growth

New Arrears Per Quarter



Source: U.K. Financial Conduct Authority, Bank of England

New Arrears Versus Next 18-Month Arrears Growth



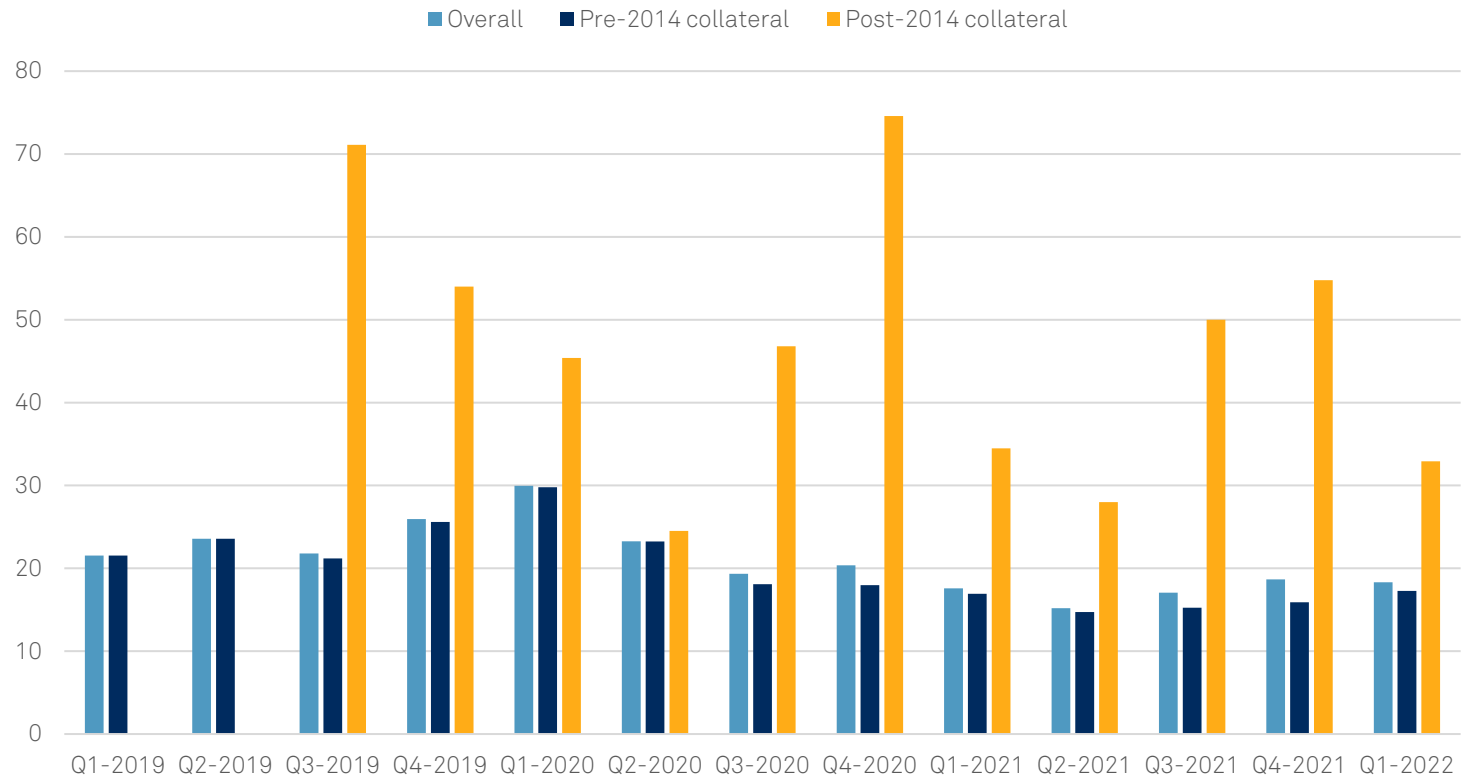
Source: U.K. Financial Conduct Authority, Bank of England

- The U.K. Financial Conduct Authority (FCA) collects mortgage origination and performance information from lenders through the Mortgage Lending and Administration Return (MLAR).
- These data show a historical relationship between the scale of new arrears in a quarterly reporting period and the longer-term growth in arrears over, say, the following 18 months. In other words, there is a degree of "momentum" in arrears growth.
- There are clearly some limitations to this data. For example, the limited history beginning in 2007 means that observations surrounding downturn performance are effectively only based on the 2007-2009 period. The MLAR also covers a broad swathe of the U.K. mortgage market, rather than being solely focused on the type of collateral backing U.K. nonconforming RMBS.
- However, we would expect similar behavior for nonconforming collateral and will monitor new arrears as a potential indicator of future arrears growth.

New Arrears Are Typically Higher For Nonconforming Collateral

- We have used loan level surveillance data to calculate a new arrears metric for the pools backing U.K. nonconforming RMBS transactions that we rate, based on loans in arrears in the current period that were not in the prior period.
- Overall, the recent scale of new arrears per quarter has been 15%-20% of the outstanding arrears stock. This is somewhat higher than the 5%-10% figure implied by MLAR data for the wider U.K. mortgage market, confirming that nonconforming pools see a higher rotation of borrowers moving in and out of arrears.
- For transactions with post-2014 collateral, new arrears are running at a higher level still. This is to be expected given that transactions typically start life with a low level of arrears and some transactions in this group have low seasoning. In these cases, a larger proportion of arrears are new arrears.

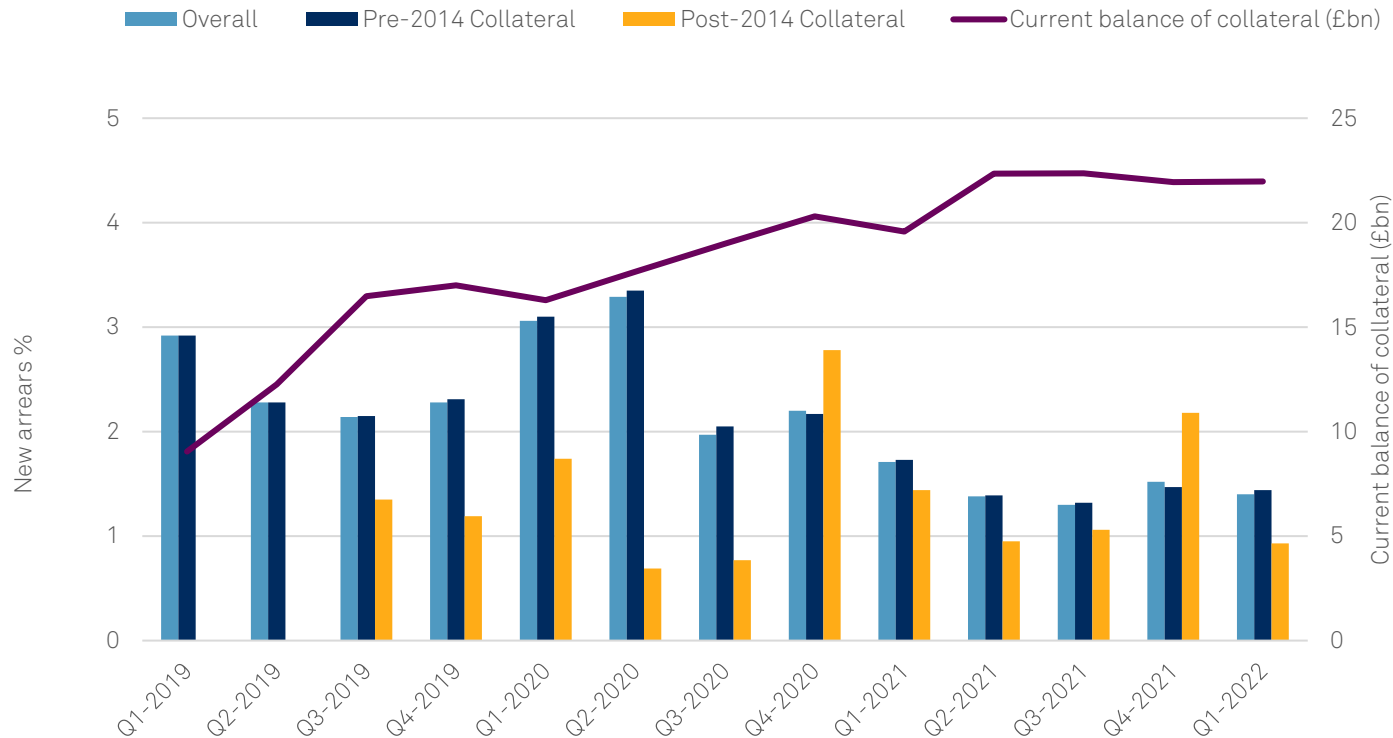
New Arrears As A Percentage Of Arrears Stock, U.K. Nonconforming RMBS



Source: S&P Global Ratings.

Another Metric: New Arrears As A Percentage Of Collateral Balance

New Arrears As A Percentage Of Pool Balance, U.K. Nonconforming RMBS



Source: S&P Global Ratings.

- In addition to monitoring new arrears as a proportion of the existing arrears stock in transactions, we also monitor new arrears as a proportion of the pool balance.
- Our analysis indicates that for U.K. nonconforming RMBS transactions that we rate, this proportion stood at 1.4% at end-March 2022.
- Although transactions with post-2014 collateral showed higher new arrears as a proportion of the arrears stock, new arrears as a proportion of the pool balance was less than 1% for post-2014 transactions in March 2022.

Some Borrowers Are Current On Payments But May Be Vulnerable

- Another potentially informative way to analyze arrears beyond the headline figures using loan-level data involves identifying borrowers who are current on their monthly mortgage payments but were recently in arrears.
- For example, in our article "[Cost Of Living Crisis: How Bad Could It Get For U.K. RMBS?](#)," we considered that transactions backed by pre-2014 collateral had 17% of loans balances in arrears, but also identified that a further 14% of balances corresponded to borrowers who were current but had been in arrears at some point over the prior two years.
- Combining these two groups implied that just under one in three borrowers in the pre-2014 nonconforming RMBS grouping could be vulnerable to non-payment in the face of the current cost of living crisis. For post-2014 nonconforming collateral, the figure was closer to one in 10 borrowers.
- We believe these cohorts of borrowers are likely to be the first to be affected if financial pressures increase. If headline arrears levels remain flat but the proportion of vulnerable borrowers in a transaction increases, this may warrant additional sensitivity analyses in our cash flow modeling, to explore the effects of these vulnerable borrowers going into arrears.

Related Research

- [European RMBS Index Report Q2 2022](#), Aug. 2, 2022
- [Russia-Ukraine Military Conflict: Key Takeaways From Our Articles](#), July 21, 2022
- [EMEA Structured Finance Chart Book: July 2022](#), July 7, 2022
- [Credit Conditions Europe Q3 2022: Pain On The Horizon](#), June 28, 2022
- [Cost Of Living Crisis: Mapping Exposures In European RMBS And Covered Bond Markets](#), June 27, 2022
- [U.K. Economic Outlook For Q3 2022 Signals The Great Inflation Squeeze](#), June 27, 2022
- [European RMBS Market Update Q1 2022: Challenges And Opportunities From Rising Interest Rates](#), June 1, 2022
- [Cost Of Living Crisis: How Bad Could It Get For U.K. RMBS?](#), May 20, 2022

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