APRIL 2020

MORTGAGE AND PROPERTY REPORT

Kensington

Welcome to the first edition of Kensington's Special COVID-19 Update Series. In this series, we look at the impact of the pandemic on the UK mortgage and RMBS market. In this first edition, we discuss how government initiatives are helping different types of customers and focus on initial trends in customer behaviour around the use of mortgage payment holidays to deal with financial difficulties. We will periodically update this analysis to reflect any changes in behaviour as more data becomes available.

Key Highlights

- The COVID-19 crisis has impacted the UK economy with unprecedented speed and breadth
- Government schemes will go a long way to support businesses and consumers, but certain classes of workers are unlikely to get the support they need
- The behaviour of customers in financial difficulties is not the same across all loans and seems to be driven to some extent by their previous financial performance.

Introduction

The current COVID-19 Pandemic crisis has impacted the whole of the UK (and global) economy in an unprecedented manner. In the first few months of the year the virus appeared to be a problem which, while having some impact on global markets, would remain largely localised to its source in China. The first signs that this was not the case where felt in Italy in late February, and by mid-March, the UK was firmly in the midst of the crisis. The most hard-hitting initial signs for most of the population were economic. The initial victim was the aviation industry as travel was discouraged, followed by the cancellation of large events, and days later, advice against even small gatherings. At the same time, infection rates and reported deaths started increasing, leading the government to announce a full lockdown on March 23rd, putting restaurants, pubs, most service businesses, and all non-essential shops (if they hadn't closed already) out of business overnight. Within the span of weeks, an extraordinary number of UK workers were suddenly out of work, with limited to no possibility of finding new sources of employment. The government swiftly reacted with a range of initiatives to help customers and businesses. Unlike other crises which build up more gradually, the hardships currently experienced by customers set in very quickly and across almost all aspects of the economy. In this newsletter, we look at how the crisis has impacted mortgage customers specifically, and what long-lasting effects the industry is likely to feel.

Government Response: The Coronavirus Job Retention Scheme and Self-Employment Income Support Scheme

As soon as the economic impact of the crisis started to be felt, the UK Government announced a series of measures to support the economy. In addition to a 0.65% cut to the Bank of England (BOE) base interest rate, these include schemes such as the Term funding Scheme with additional incentives for SMEs (TFSME), the Covid Corporate Financing Facility (CCFF), and the Coronavirus Business Interruption Loan Scheme (CBILS), all of which are designed to support businesses through temporary financial difficulties, hopefully enabling them to continue operating and employing their workforce. Consumers are

Fig 1: Timeline of Key COVID-19 Events

Late Jan	Late Feb/Early March	WC March 9	WC March 16	March 19/20	WC March 23
Public Health England raises risk from Virus from Very Low to Low First 2 cases diagnosed	Worst week for global stock markets since 2008 Crash First cases of local transmission and deaths	BOE Base Rate cut to 0.25% and new TFS Scheme and other measures to support the economy announced	Announcement of 3mths mortgage payment holiday and repossession moratorium Social Distancing Advised	Further BOE rate cut, more extensive economic support, 80% wage support announced Schools, restaurants and shops close	UK goes to full lockdown Economic support further expanded and includes self-employed Large spike in infections and deaths

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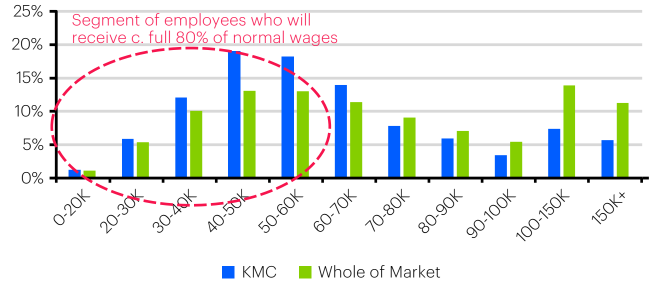
also receiving direct support, both from the government and lenders. As a huge portion of the UK workforce faces significant loss of income for an extended period, the government has announced 2 key schemes for wage support for both the employed and self-employed, which will initially be in place for 3 months.

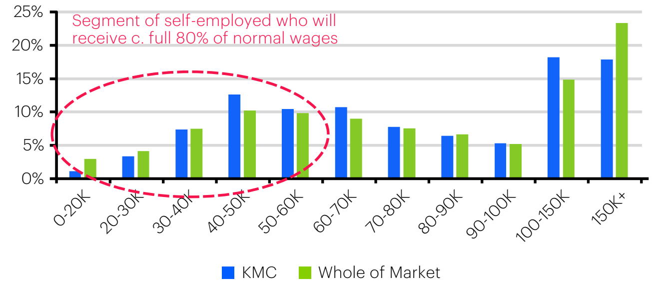
Fig 2: Income Distribution of UK Mortgage Customers (Joint) who are Employees



For employed workers, the support comes through the Coronavirus Job Retention Scheme (CJRS), which encourages employers to furlough employees rather than lay them off. Through the scheme, the government will provide employers a grant that covers 80% of their employees' usual monthly wage costs, up to £2.5K a month gross per employee (i.e. equivalent to an annual salary of £36K), plus the associated Employer National Insurance contributions and minimum automatic enrolment employer pension contributions on that wage. This will be crucial income for much of the workforce, although there are some restrictions which may hurt certain types of employees. Income available through the scheme is based on salary and overtime, but excludes bonuses and commissions, which means those workers for whom this represents a significant portion of monthly wages will experience a decrease in income greater than 20%, even with the scheme. Moreover, anyone earning more than £36K will see a greater reduction in income in any case given the monthly cap. Helpfully, employees can be on any type of employment contract, including full-time, part-time, agency, flexible or zero-hour contracts. The scheme is also accommodating to customers with more than one job, as they can be furloughed for each job, and the cap applies to each employer individually. Employees can also receive a furloughed payment in one job but continue working for another employer and receive their normal wages, allowing those with multiple roles to maximise their income, and encouraging them to carry on in any roles which they are able to perform safely from home or which are key to the economy.

Shortly after announcing the CJRS, the government came under pressure to support the significant portion of the UK workforce who are self-employed (c. 15% based on latest ONS data) and a key customer base of the specialist mortgage sector. They responded with the Self-Employment Income Support Scheme (SEISS), under which the government will also pay the self-employed 80% of average profits up to £2.5K per month. However, even this scheme is only available to those whose annual profits are under £50K, and who have filed a tax return for FY18/19 (thereby excluding those who have recently become self-employed). Unlike employees, the self-employed can receive this and continue to work. A key group of workers who are more akin to the self-employed, but not helped by the scheme are the individuals who operate via limited companies and pay themselves an income through dividends (rather than PAYE), as the government support will not extend to dividend income. Importantly, all income received is also subject to normal income tax and national insurance contributions.

Fig 4: Income Distribution of UK Mortgage Customers (Joint) who are Self-Employed



Mortgage Payment Holidays – How do they work and who is using them?

The schemes will not offer perfect solutions for everyone but will go a long a way in supporting the economy. However, many of them, including the wage schemes will take some time to implement, and even longer for cash to actually flow through to those who need it most. In the meantime, consumers still have bills to pay. For mortgages, which generally represent customers' largest monthly outgoings, the chancellor announced on March 16th that lenders would grant any customers who needed it a 3 months Mortgage Payment Holiday (MPH) to ease this pressure.

Figure 3: Types of Workers Supported by Government Scheme

	Scheme	Support offered	Limitations
Full- and Part-Time, Agency, Flexible and Zero Hours	CJRS	80% of income including overtime, up to £2.5k/month	Salary and commissions are not included – severely limiting income for those reliant on this. Must have been employed as of 28/02/20
Multiple Jobs	CJRS	80% of income including overtime per job, and ability to continue working in non-furloughed roles	Salary and commissions are not included – severely limiting income for those reliant on this. Must have been employed as of 28/02/20
Self-employed	SEISS	80% of average profits up to £2.5k/month, and workers can continue to work	Annual profits must be below £50K, and 50% of income needs to come from self-employment. Must have filed tax return for 18/19 tax year (leaving questions for workers who became self-employed later
Limited Company Directors	CJRS	80% of PAYE element can be furloughed up to £2.5k/month	Unlike self-employed, not allowed to continue working Any income paid as dividends is not eligible

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A payment holiday allows customers to defer their monthly instalment, but the payment is still due and importantly interest continues to accrue. This means that it will help customers with cashflow issues, but ultimately, they will owe slightly more money and should thus only use this deferral if necessary. MPHs are available to both residential and Buy-to-Let (BTL) customers, with the latter intended for cases where tenants' income is impacted by COVID-19, and the relief is to be passed on to tenants as a rental payment holiday.

Given the sudden onset and widespread impact of the crisis, many customers jumped on this lifeline. Lenders, including Kensington, reported an unprecedented surge in customer contact regarding payment holidays. This has presented operational challenges across the industry, as even the most conservative stress tests don't model for an entire economy to grind to a halt overnight, and even lenders like Kensington who are set up to deal with complex and arrears cases, could not fully prepare for this type of surge. These challenges are even more pronounced for lenders who rely on an offshore call centre, where home working may be more difficult to set up.

Unlike a simple missed payment, MPHs should be agreed in advance with a lender, and as they are designed not to impact the customer's credit file (i.e. not reported as arrears), need special designation in servicing systems. Credit reporting agencies have been heavily involved in industry discussions over the last few weeks to help find a solution whereby MPHs do not impact credit score. This means that unfortunately, data around take up rates is still unreliable.

What does this mean?

While exact figures are not available, initial reports suggest that more than 1 million mortgage holidays have been granted in the UK to date, which represents c. 10% of the market , and this is still early in the cycle. Kensington services c. 110K loans, which is split c. 20/80 between new originations (post-2010) and legacy loans respectively. As is generally the case across the industry, arrears on the legacy portfolio are higher than on the new originations book. Interestingly, early indications suggest that the request for MPHs in the new originations portfolio are markedly higher than in the legacy book. One hypothesis for this is that for customers who have previously been in arrears, the perception of a missed mortgage payment is less daunting, making them less likely to contact their lender to discuss the situation prior to cancelling a direct debit or failing to make a payment. Moreover, a significantly lower portion of the legacy book than the new originations book pays by direct debit, meaning that unlike the latter, who have to cancel a DD payment in order to stop paying, these customers don't need to take any action at all, making simply not paying quite straightforward. It is of course key to support any customers who are facing financial difficulties, so an important initiative for lenders is to have conversations with these customers to understand their circumstances, and correctly categorise these failures to pay so that customers are not penalised for COVID-related difficulties.

The significant take up rate across the industry also raises important questions about how these amounts will eventually be repaid. It is still not clear what happens at the end of the 3 months - either the MPH is extended (which will further hit lender's financial position and increase customers' debt) or it is not, which could result in higher arrears in the future. The mortgage industry is likely to deal with these issues for many more months to come and Kensington will continue this special series to answer these and other questions and release detailed figures as soon as they become available.

NVG/CM/8001/011/APR20