

DECEMBER 2020

MORTGAGE AND PROPERTY REPORT



Welcome to the sixth edition of Kensington’s Special COVID-19 Update Series. In this newsletter, we look at how the COVID-19 crisis has impacted mortgage prepayment rates, which have slowed down noticeably during and following the Spring lockdown. We examine how this has impacted different types of collateral and discuss which drivers are likely to have a temporary effect and which may be more long term.

Key Highlights

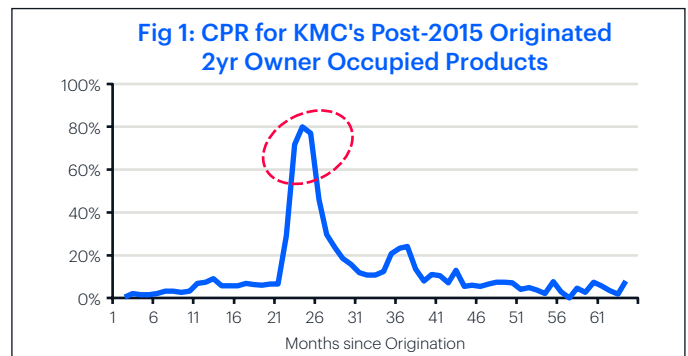
- The expected voluntary prepayment speed of a mortgage pool varies by collateral type, and is an important driver in the valuation of the portfolio
- A mix of COVID-related factors have led to a slow down in CPR in recent months across legacy and new originations
- This has been followed by a correction caused by the stamp duty holiday and pent up demand, but an expected rise in unemployment and decrease in house prices could reverse this again in early 2021

Introduction

When valuing mortgage portfolios, many factors are considered, but a key one is usually the collateral’s constant prepayment rate (CPR). Higher than expected CPR adversely impacts both the amount and timing of cashflows received off the loans, as the interest paid over time will be lower if principal is repaid early. On the flip side, much lower than expected CPR can result in the mortgages (and consequently mortgage-backed bonds) remaining outstanding longer than anticipated. This means accurately gauging the expected CPR is essential when valuing mortgage assets.

A key consideration when forecasting CPR is the nature of the collateral, as a mortgage pool’s expected prepayment rate will vary depending on the characteristics of the underlying mortgages. In pools backed by recently-originated mortgages such as those in Kensington’s own Finsbury Square or Gemgargo securitisation programmes, the biggest predictor of a loan pre-paying is whether the initial fixed rate period has ended, and how many months have passed since it has, with almost no loans repaying during the initial period, but a huge proportion doing so when it ends (as seen in fig 1). Most UK mortgage customers face a significant rise in the rate they pay when the loan moves onto its reversionary rate (sometimes more than doubling), which creates a strong financial incentive to refinance onto a new fixed rate when or soon after this increase happens. This refinancing is of course reliant on a mortgage with a lower fixed rate being available to the customer, something that has generally not been problematic in recent years as competition in the sector was very high and lenders were increasingly willing to take on more risk.

The drivers of CPR for more seasoned collateral such as the loans in Kensington’s RMS and Trinity Square securitisation programmes are more varied and complex, and often a combination of different factors which make it difficult to generalise in the same way as with newly originated collateral. With these loans outstanding for more than a decade, customers’ failure to refinance is often a mixture of inability to (i.e. past arrears, low affordability), deliberately choosing not to (i.e. certain desired product features no longer offered) and



complacency. That being said, CPR on legacy loans will generally stabilise over time, so recent past performance is almost always a good indicator of what to expect going forward, absent of any major changes in the wider macro-economic environment, house prices or the mortgage market specifically.

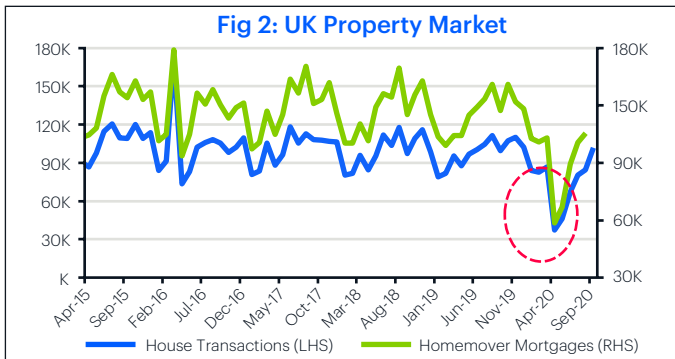
The Impact of COVID-19

As would be expected, the normal CPR trends for both types of collateral have been impacted by the ongoing COVID-19 crisis. A combination of factors have caused this. To begin with, the initial lockdown led to a short-term drop in housing transactions, as potential buyers were unable to view properties and valuers unable to assess them in person. As seen in figure 2, transactions dropped to the lowest levels seen in years during the peak of lockdown, and the number of new mortgages for homemovers suffered as a consequence. The cut to stamp duty announced over the summer led to a resurgence in the ensuing months, but the short term dip was nonetheless felt in the sector.

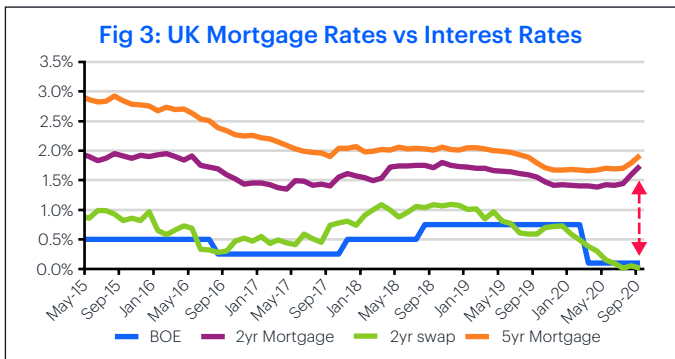
Interest rates have also been impacted. While benchmark rates have decreased as a result of the crisis (one of the Bank of England’s first moves was a rate cut to a historic low of 10bps) to the point that the market is predicting negative interest rates in the near term,

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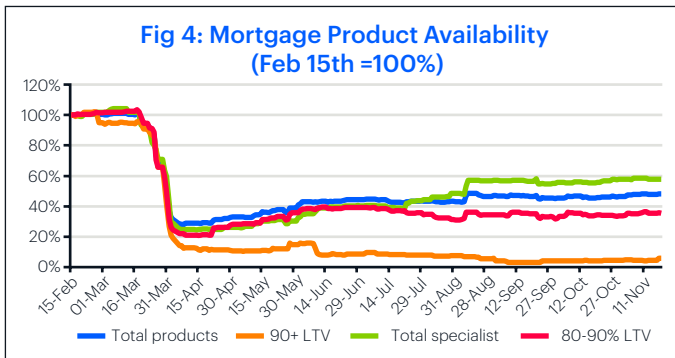
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mortgage rates, which normally follow, have actually increased over the same period (fig 3). There are a number of reasons for this. Lenders have become more risk averse in the face of uncertain future house prices and the prospect of mass redundancies. The latter hasn't been felt yet, but as government support schemes draw to an end, a large spike in unemployment is expected, which will coincide with the end of the furlough scheme in March.



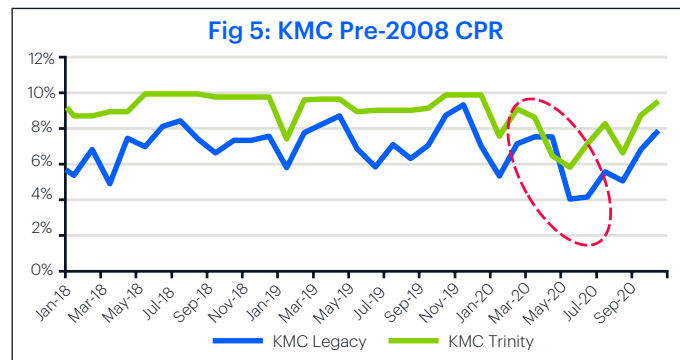
At the same time, lenders have struggled to keep up with the surge in demand they've seen since the summer. This has come alongside difficulty with staffing levels brought on by the lockdown and the shifting focus from originations to processing payment holidays at the peak of the crisis. These factors together have resulted in many lenders pulling a large number of products. As would be expected, this started with the riskiest (and most in demand) higher LTV products. As seen in figure 4, product availability has decreased significantly, and while in some segments it is recovering (notably specialist lending), the number of 90% LTV products on the market is continuing to decrease.



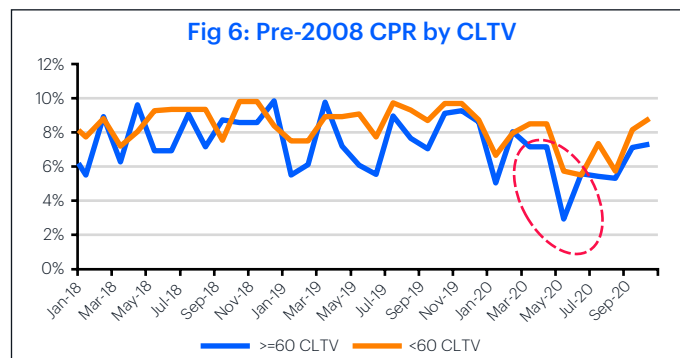
Moreover, many customers have taken payment holidays since March, which were widely offered to UK customers to help them with short term cash flow problems brought on by the lockdown. While these are designed not to impact credit files, many lenders are reluctant to lend to customers on payment holidays, likely making it more difficult for these to refinance in the near future. At the peak, c. 15% of all UK mortgages were on a payment holiday, and an even larger proportion of more recently originated loans.

Changes in CPR for pre 2008 collateral

All these factors taken together create exactly the conditions that disrupt the normally stable CPR we see in legacy mortgage pools. As seen in figure 5, CPR dropped c. 2% lower than it has been on average over the previous 2 years on all the KMC pre-2008 assets, split here into "KMC Legacy" which includes assets Kensington originated as well as a small acquired pool (currently securitised in the RMS programmes), and "KMC Trinity," which are GE-acquired assets (positively selected and thus with lower arrears than the wider legacy pool). The drop has reversed in recent months, as the pent-up demand and current stamp duty holiday has increased housing transactions, but these corrections are likely to be temporary and we expect CPR to drop again.



The impact of the COVID-19 crisis on CPR is even more pronounced when we look at higher LTV loans in the legacy asset pools (combined KMC and Trinity). As these loans have significant seasoning, higher LTV is considered 60% and above (The weighted average CLTV of the pool is 57%). As the book continues to season, CPR on lower LTV loans is naturally expected to decrease as the fixed cost of refinancing can become disproportional to the benefit of a lower rate for smaller loans. This has accelerated since March, but the loans with LTVs equal to or greater than 60% have seen an even sharper decrease in CPR, dropping as low as 3%, vs. a historical average of c.7.5% over the previous 2 years.



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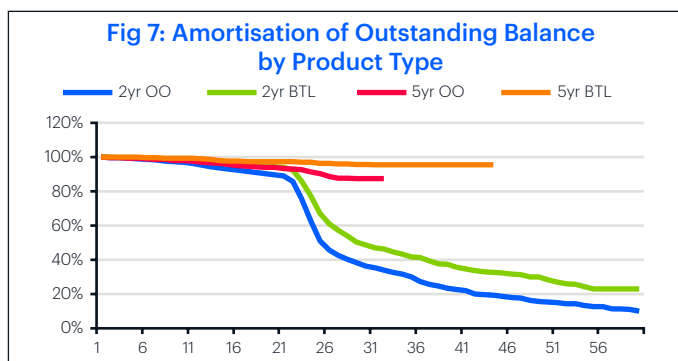
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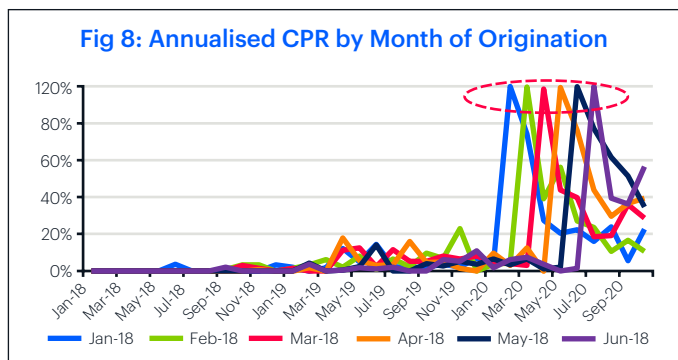
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Changes in CPR for post 2008 collateral

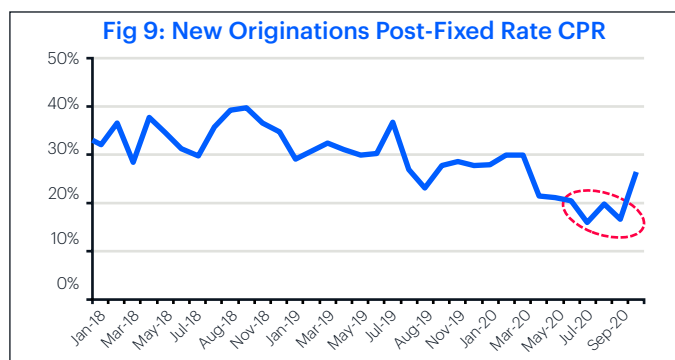
As noted in the introduction, the key driver of CPR on new origination pools is the transition from the fixed rate period, during which an early repayment charge (ERC) is payable, to the floating rate period (with no ERC). The CPR during the fixed period is always near zero, and this has not changed as a result of COVID-19. While loans are on a low fixed rate, the penalty costs of an early repayment charge mean it is very unattractive for customers to refinance, even if lower rates are offered elsewhere. The same pattern is true for all product types, although our data can only clearly demonstrate this for 2yr products currently, as Kensington only started originating 5yr products more recently.



The CPR spike at the end of the term is so pronounced that we have not seen a significant change in this either (fig 8). We have, however, observed a drop in the post-fixed rate CPR for our new originations since the first lockdown (fig 9). This has historically been between 30-40%, but dropped below 20% in the Spring. As with legacy loans, there has been a correction in recent months, although CPR has not yet returned to normal pre-COVID levels.



We expect CPR on new originations to be impacted by the rise in unemployment which is likely to start materialising more fully in Q1 2021. Government support schemes have kept unemployment artificially low to date, but once this support is withdrawn, it is inevitable that some roles which were furloughed will turn into redundancies. Even if the vaccine allows for more of a return to normality in the Spring, many businesses simply cannot survive the months of forced closures mandated by the government's rules. When unemployment rises, new lending has historically slowed down significantly. As a result, mortgage brokers themselves sometimes get laid off and this has a disproportionate impact on new lending. This also usually coincides with a drop in house prices, which makes it even more difficult for borrowers to refinance.



Conclusion

As can be seen, COVID has had a wide-ranging impact on the macroeconomic environment, as well as on the normal dynamics of the mortgage market. The disease has come in waves, and its impact will undoubtedly be felt in waves as well, with changes to CPR followed by corrections, likely to be followed by further changes. It is difficult to predict exactly how this will play out in the long term, but the expected rise in unemployment in March when the job support schemes and mortgage payment deferrals come to a close, and the expected cooling of the housing market when the stamp duty holiday ends, are likely to lead to further decreases in CPR from the norms we have grown used to.

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