

Lending Strategy – October 2008

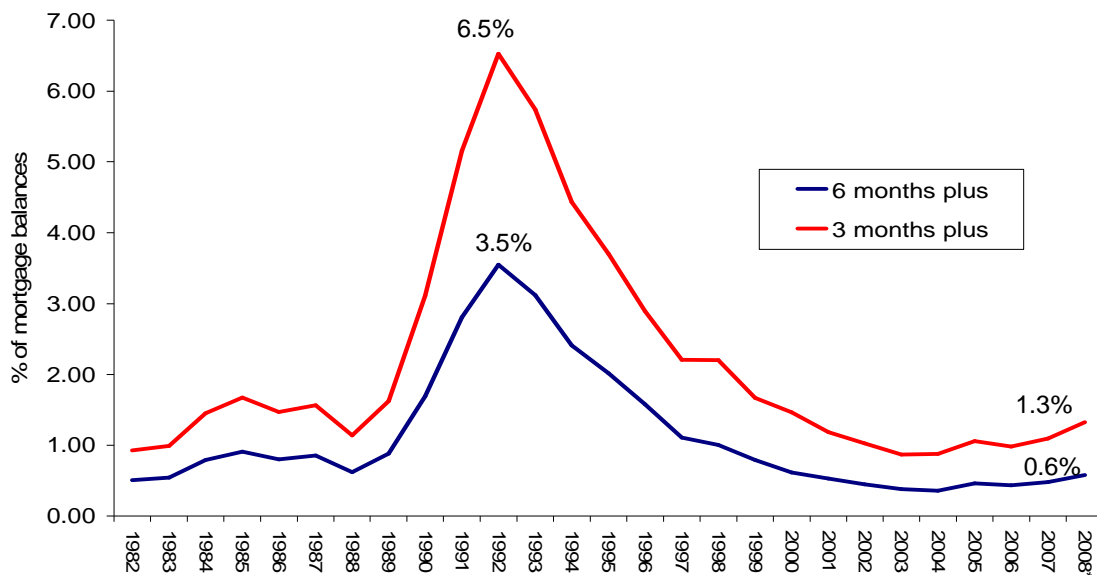
Putting arrears under the microscope?

By Gary Styles Strategy, Risk and Economics Director Hometrack

Recent arrears and possessions data obscure as much as they reveal about the underlying quality of the mortgage book in the UK. The decision by the FSA to release more detailed disaggregated data is to be warmly welcomed and if nothing else keeps the CML on its toes. For many years I have lobbied and asked for more detail on the current arrears position by sector, by product and by lender type to no great success so the recent decision by the FSA could make this a reality in the coming months.

The headline figures although useful as benchmarks hide a wide variety of performance levels across sector, region, property, lender type and even vintage of loan. It has always puzzled me that when two lenders have the same average level of arrears across their respective portfolios that this appears to make the portfolios of equal risk. In practice the diversity of performance across portfolios is equally as important as the current average level of arrears. Interestingly, arrears averages of many sub-prime portfolios bore a striking resemblance to more traditional prime lending books during the boom. The recent flight to quality or to perceived lower risk lending owes more to gut reaction than scientific investigation as industry benchmarks and histories are difficult to find.

The latest data for the first 6 months of this year showed that overall arrears remain very low with 3 month plus arrears at 1.3% of mortgage balances only 1/5th the levels seen in 1992. The Basel II definition of default (6 month plus) are only at 0.6%.



Source : CML / Hometrack

Note: 3 month plus is estimated before 1994

However, when one looks at the actual number in arrears the numbers become a little more difficult to swallow. In 2008 we estimate that around 156,000 customers will be 3 or more months in arrears and this will rise sharply in 2009 but to a level well below the 650,000 we experienced in the early 1990's.

These headline arrears numbers really do conceal a wide range of performances. The table below shows typical arrears by sector with Prime Lending remaining the dominant sector. However, the non-conforming sector has seen short-term arrears rise to over 11% (actually 30%+ in US) compared to around 2.5% in the prime sector. This has also been accompanied by a large rise in the probability of default which has reached 2% and heading higher. This has become more serious as the potential losses for these cases have risen sharply on the back of lower house prices, increased mortgage margins and increased time to sell.

	1m+	3m+	6m+	12m+	PD (6m+)
Prime	2.5	1.1	0.5	0.2	0.7
Non-Conforming	11.3	3.9	1.6	0.2	1.8
BTL	2.4*	1.1	-	-	0.7*
TOTAL	3.2	1.3	0.6	0.2	0.8
Non-Conforming as a multiple of Prime	4.5	3.5	3.2	1.0	2.6

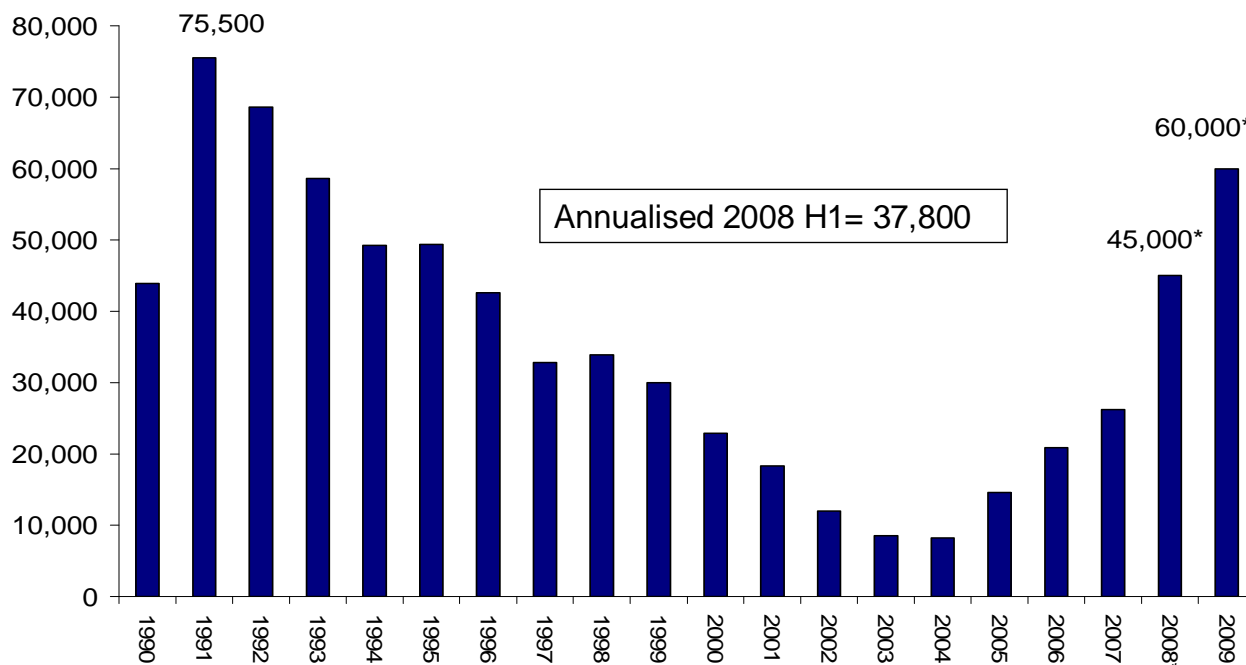
Source: Hometrack / CML

•Estimated

•PD : Probability of default

It should come as no surprise to anyone that this difference in short term arrears has translated into much higher levels of repossessions for a given average level of UK arrears as some lenders have adopted more aggressive strategies. The distribution of arrears has had a significant impact on the outlook for total repossessions.

We expect repossessions to rise sharply in 2009 without any intervention from the government reaching over 60,000 compared with little over 26,000 in 2007.



Source : CML / Hometrack

The latest data from the FSA has also highlighted that building societies and banks appear to be far less affected than specialist lenders. Arrears among securitised loans are currently nearly double the arrears level for the whole mortgage book. Although this reflects in part newer loans with higher loan-to-value ratios it also should have a major bearing on the required capital lenders should put behind such loans.

	2007 Q1	2008 Q1
Total Arrears as % of Loan Book	2.07	2.44
Total Arrears as % of Loan Book (Securitised only)	4.02	4.47
Performance of Loans in Arrears (% payments received)	45.83	45.27
Loans with an Impaired Credit History (% of Loan Book)	3.61	2.34
Industry Split for Total Arrears (Unsecuritised only)		
Bank	-	2.04
BS	-	0.56
Other	-	3.68
Total	-	1.99

Source: FSA (include some second charge lending)

As the UK mortgage market has become more complex and fragmented the need for more detailed market data and insight has increased. Relying on peer group lenders for reassurance as to the absolute risks is folly. Maintaining your relative position may look attractive in the short run but the whole industry can easily get into a systemic problem by not taking a detailed view of the problems and risks. We need a more mature and transparent approach to risk in the mortgage market with lenders adopting more cautious lending practices in the upturn and more flexible and appropriate adjustments in the downturn. Basel II risk information seems to have had a big impact on lenders attitudes in the downturn but seemed to have little or no role in the decisions made in the upturn. The devil is in the detail and much of the detail was sadly absent when it really mattered.