Mortgage and Property Report

January 2019

Welcome to the January 2019 edition of the Mortgage and Property Report. In this issue, we look at how central bank schemes have impacted mortgage lenders' funding in recent years, as well as how the end of quantitative easing has and will impact capital markets in the near term.

Key Highlights

- The Bank of England's Term Funding Scheme had a significant impact on the volume of RMBS issuances and spreads during its 18-months run
- Many specialist lenders took advantage of the scheme, changing the dynamics of their funding, which will need to be replaced by more expensive retail or wholesale funding
- Net Interest Margin compression is expected as challenger banks and specialist lenders simultaneously grapple with pricing pressure from competition and increasing funding costs

Introduction

In the last decade cheap central bank funding has been an important source of funding for many high street banks, building societies, and challenger banks in the UK, who tapped into government-sponsored schemes to replace or top up existing funding streams. These schemes were designed to encourage regulated financial institutions to increase their lending and also to pass on the historically low interest rates to borrowers by providing them with a cheap alternative to deposits, securitisation and other wholesale funding. The most important scheme for UK mortgage lenders was the Term Funding Scheme (TFS) which was introduced by the Bank of England (BoE) in August 2016 to increase lending following the UK's vote to leave the EU and the subsequent base rate cut. We previously discussed the impact it had on RMBS spreads and issuance volumes in our Spring 2018 issue. Now that the scheme has been closed for almost a year, we examine how lenders who drew funds from TFS have or are changing their funding strategies, as well as the effect it has had on funding and lending in the market more broadly.

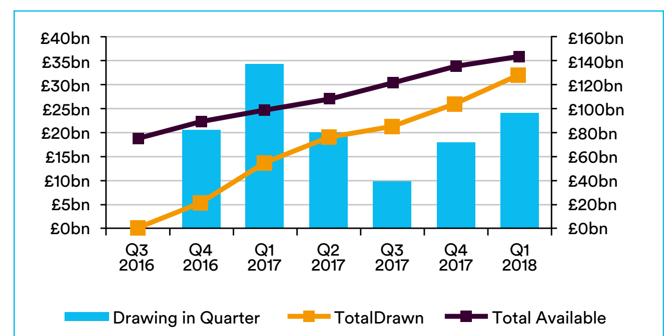
Overview and Usage of TFS

Figure 1: Term Funding Scheme

Scheme launch date	August 2016
End Date	28 February 2018
Purpose	To reinforce the transmission of Bank Rate cuts to those interest rates actually faced by households and companies
Term of Loan	4yrs
Lending Available	5% of their existing loan books (as of June 2016), as well as extra funds equal to the increase in net lending in each subsequent quarter
Number of participating banks	62 (with 5 banks accounting for over 60% of total drawings)
Total Lending	£127bn

TFS was launched to encourage eligible banks and building societies to lend to borrowers by providing them with a cost-effective source of funding. The amount of funding each lender was eligible to draw down and its cost were a measure of their existing loan book at the end of June 2016 as well as their net new lending in each subsequent quarter. The scheme proved popular and was upsized from an initial £100bn capacity to £140bn, with c. £127bn drawn when it closed at the end of February 2018 (Fig 2). High street banks accounted for most of the drawings, but challenger banks and specialist lenders also made extensive use of it, with some lenders drawing down enough to replace significant existing funding streams, particularly securitisation.

Figure 2: TFS Drawings[1]

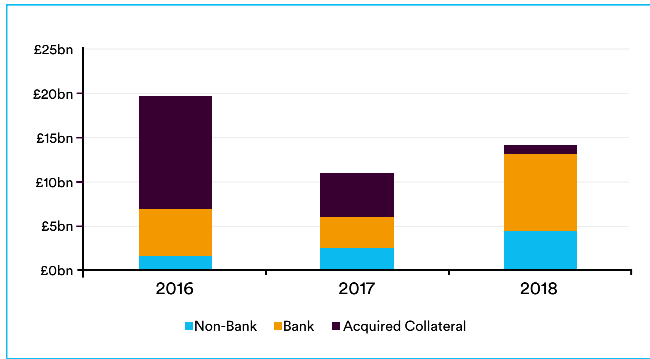


Impact on Use & Cost of RMBS Funding

The securitisation market was heavily impacted by the scheme. Immediately after the referendum vote, indicative RMBS spreads shot up – Clydesdale (the first issuer to come to market after the vote) priced a £750M securitisation in late July 2016 at 100bps over Libor, double the price of the previous Lanark deal a year earlier, demonstrating the substantial pick-up investors were demanding in the post-referendum environment. This dramatically changed with the launch of the TFS scheme a month later, which led to RMBS issuances dropping off sharply, and spreads following suit as supply dried up. TFS-eligible lenders started making increasing use of the scheme, drawing down £20bn by the end of the year. In the ensuing months, RMBS issuances were predominantly from (1) non-lenders refinancing acquired collateral (Hawksmoor, Towd Point, Dukinfield, Ripon, etc.) and from (2) specialist lenders without banking licenses (Kensington, Fleet, Vida Homeloans) who benefited indirectly from the scheme by being the only active issuers (Fig. 3 overleaf).

Nonetheless, there were some exceptions. High street lenders who issued RMBS during the scheme included Lloyds, Principality Building Society, Santander and Yorkshire Building Society, though in many cases large portions of the deals were retained.

Fig 3: Placed RMBS Issuances by Issuer Type



Two lenders also issued RMBS and subsequently paid back some of their TFS drawings – the only ones to do so. Clydesdale issued a £750M deal from its Lanark shelf in June 2017, having utilised c. 80% of its allowance. Similarly, Virgin Money, who had also utilised c. 80% of its available allowance by mid-2017 raised £786M in September. The 2 lenders have since become part of the same group and TFS accounts for c.11% of their total funding.[2]

Fig 4: Usage of TFS by a Selection of Lenders with Banking Licence

Lender	Placed RMBS 3yrs to Aug-16 (£M)	Placed RMBS during scheme (£M)	Placed RMBS since scheme end (£M)	Mortgage Lending in 2017	Total TFS Drawdown (£M)	Drawdown as % of Available Funds[3]
Aldermore	330	0	325	£1.4Bn	1,671	81%
CCFS	1,037	834	655	£2.4Bn	1,148	39%
Clydesdale	2,558	1,245	552	£5.9Bn	2,250[1]	63%[1]
OSB	273*	0	0	£1.5Bn	1,500	69%
Paragon	2,126	0	439	£1.6Bn	944	95%
TSB	1,093	0	0	£7.0Bn	6,470	99%
Virgin Money	3,095	786	778	£8.4Bn	7,137[2]	86%[2]
Yorkshire BS	300	600	300	£7.8 Bn	2,900	96%

(1) Includes £750M which was subsequently repaid in Q3 2017
(2) Includes £300M which was subsequently repaid in Q4 2017
(3) Calculated based on BoE published TFS Lending and Drawings Data

Non-bank specialist lenders like Kensington and more recent entrants like Fleet and Vida Homeloans took advantage of the dearth of supply to issue attractively-priced deals as spreads were driven to levels not seen in a decade (Fig. 5). Inevitably, when the scheme closed in early 2018, issuances from TFS-eligible lenders picked up again and specialists and challengers who had been mostly absent re-emerged (Fig. 6). By Q3 2018, spreads started to steadily rise as supply increased. The higher cost of RMBS funding combined with increasing Brexit uncertainty led the market to cool again as the year ended. The impact on the future of the securitisation market remains to be seen as pressure mounts from multiple sides – on one hand non-bank lenders and lenders who need to replace TFS are reliant on RMBS for funding, on the other hand the immediate uncertainty around Brexit and the volatility this creates make for difficult market conditions, which may drive the cost of wholesale funding so high in the short term that lenders who can will turn to other retail funding sources.

Fig 5: UK Senior RMBS Spreads[3]

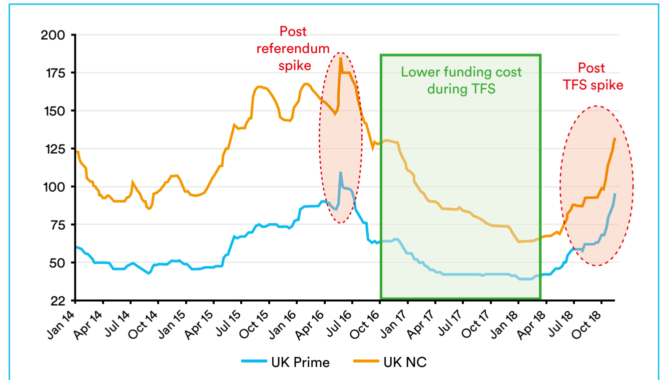
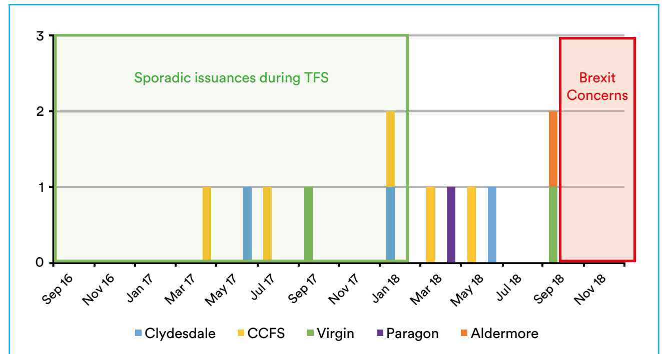


Fig 6: Number of Issuances from Challenger Banks and TFS-eligible Specialist Lenders



Impact on Use & Cost of Deposit Funding

For most banks, RMBS and TFS are just a top up and added diversification to their predominantly deposit-funded businesses, and the end of the scheme has a limited bearing on their cost of funding. However, for some specialist lenders, the impact is expected to be more pronounced, as the funds drawn from the scheme represents a more significant proportion of their overall funding and they have fewer and more expensive alternatives to replace it. Lenders with more recently acquired banking licenses like Paragon and Precise (through Charter Savings Bank) rely largely on fixed term deposits which are significantly more expensive than the instant access current accounts the high street banks and some of the larger challenger banks use to fund their lending. When TFS funds were available, lenders didn't need to offer attractive savings rates, but since the scheme has closed, more competitive rates have returned, and while these are good for savers, they change the dynamics for lenders. New online deposit takers such as Marcus from Goldman Sachs may also drive rates higher for the incumbents.

For example, since acquiring a banking license in 2014, Paragon shifted from being predominantly wholesale funded (80% in 2016) to relying more heavily on deposits (c 35% of total funding in Q1 2018, and expected to increase)[4]. However, the cost of these deposits is rising – whereas in January 2017 the rate on their 2yr fixed term savings product was 140bps, by January 2019 this has hit 220bps (Figs. 7 & 8 overleaf). Instant access accounts have similarly shot up from 50bps at the beginning of 2017 to 135bps currently, more than doubling (too much of an increase to be attributable to the 25bps base rate increase). Moreover, the cheaper short term deposits only account for a quarter of their balance sheet. TFS funds accounted for 8% of total funding in Q1 2018, and as Paragon look to refinance this, both the RMBS funding they are trying to use only "tactically"[4] and the deposit funding they are embracing are becoming more expensive. As competition simultaneously puts pressure on mortgage rates, this can only lead to Net Interest Margin (NIM) compression.

Fig 7: Cost of Deposits Through Time – Instant Access[6]

Lender	Jan-17	Jul-17	Jan-18	Jul-18	Jan-19
Aldermore	75 bps	75 bps	100 bps	100 bps	125 bps
Paragon	50 bps	50 bps	50 bps	124 bps	135 bps
CCFS	50 bps	50 bps	50 bps	50 bps	130 bps
Clydesdale	5 bps	5 bps	15 bps	20 bps	25 bps
Barclays	5 bps	5 bps	20 bps	10 bps	25 bps
HSBC	5 bps	5 bps	10 bps	10 bps	20 bps

Fig 8: Cost of Deposits Through Time – 2yr Fixed[6]

Lender	Jan-17	Jul-17	Jan-18	Jul-18	Jan-19
Aldermore	120 bps	160 bps	160 bps	195 bps	195 bps
Paragon	140 bps	205 bps	205 bps	210 bps	220 bps
CCFS	150 bps	170 bps	195 bps	210 bps	225 bps
Clydesdale	70 bps	160 bps	160 bps	160 bps	160 bps
Barclays	80 bps	65 bps	80 bps	125 bps	90 bps
HSBC	65 bps	65 bps	65 bps	65 bps	80 bps

Charter Court Financial Services (CCFS) is another example. As of the end of September 2018, CCFS held a total of £4.5bn of retail deposits, which account for just over 65% of the group's total funding[5]. Most of these deposits were raised during TFS, and as deposit rates go up and fixed-term deposits mature, this source of funding will become more expensive. Meanwhile, TFS accounts for just over 15% of their total funding, and these funds will need to be repaid with a more expensive alternative. Aldermore similarly relies on deposits to fund 80% of its business, with most of the rest made up by TFS funds, thus facing a similar situation.

Outlook for 2019

As banks and building societies who took advantage of the cheap funding from the BoE start to look at repaying the TFS loans they took out (which will become due between 2020 and 2022) and funding their new lending, a more marked return to the securitisation market is expected. Whether the outcome of the Brexit negotiations supports this or creates market uncertainty that ultimately makes RMBS unattractive remains to be seen in the coming months. In any case, the increased supply in 2018 has already led to a sharp turnaround on the spread tightening of the previous 18 months. At the same time, the cost of deposits is rising, so whether lenders decide to rely on deposits, wholesale funding, or a mix of the two, funding costs are inevitably increasing. Coupled with ever increasing competition in the mortgage market, lenders' NIMs are likely to suffer.

(1) BOE Data
(2) https://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/CYBG/13682717.html
(3) JPMorgan
(4) Paragon Interim Report 2018
(5) Charter Court Financial Q3 2018 Trading Update
(6) Moneyfacts

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