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01 March 2023

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NPL Markets Credit Risk Monitor

United Kingdom March 2023

Overview

NPL Markets regularly publishes forecasts for non-performing loans for many countries in Europe, the Americas and Asia. In December, the Daily Telegraph wrote on the back of the cost-of-living crisis "Get ready for the weirdest recession in history" in which we were quoted predicting a doubling of non-performing loans for the United Kingdom to 2% in the next year based on forecast scenarios from the World Economic Outlook published by the IMF. In October, the IMF predicted positive real GDP growth for the UK in 2023 which in their recent January update was reduced downwards to -0.6% and hence would make a material increase in UK NPLs more likely. In this note we review some recent data of credit risk indicators beyond the NPL ratio.

The main observations are as follows. While there is a clear expectation for increased credit risk, the actual indicators available thus far have not yet shown a substantial deterioration in loan performance. Interest rates on residential mortgages have come off the heights reached after the mini-budget last year, but are still at a 10-year high. More that 75% of mortgage borrowers will face an interest reset in the next two years increasing the pressure on household finances that are already stretched from the cost of living crisis. Loan defaults on SME loans guaranteed by the government under a COVID-19 scheme are still on the rise and vary widely by originator.

Credit Risk Indicators on the NPL Markets Platform

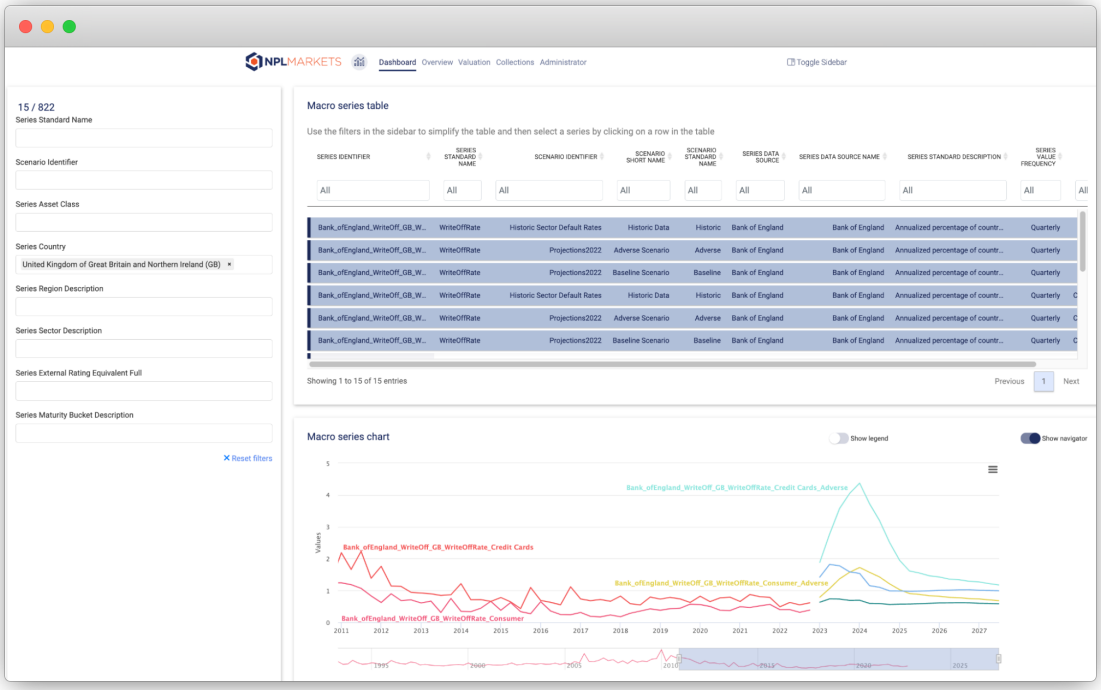

Figure 1: NPL Markets data application for macroeconomic benchmark data. Source: NPLM.

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In February 2023, NPL Markets released a new application on its online marketplace and analytics platform to allow users to query macroeconomic data, lending rates and credit risk indicators such as default rates, write off rates, NPL ratios as well as bank risk parameters and securitisation performance data. The time series and vintage data allow users interested in loan valuation, risk modelling or loan trading to explore recent market developments for pricing and benchmarking and generate reports automatically similar to this country summary. As an example, Figure 1 shows the write off rates reported by the Bank of England for consumer loans and credit cards together with the NPL Markets stress test projections based on the 2022 Bank of England baseline and adverse scenarios (see the data annex for more detail).

Recently, we summarised the developments of credit risk indicators and lending rates in Mexico in our first country monitor report[1] and for Asia[2]. We update our NPL projections[3] for many countries twice a year based on the projections of the IMF World Economic Outlook.

United Kingdom Credit Data Update

This report reviews recent development for the United Kingdom. As the Economist newspaper pointed out in a recent lead article, the UK and the global economy overall is still suffering from the effects of the war in Ukraine, with the West still trying to cool down inflation as interest rates continue to climb. The rising costs of finance, energy and food have pushed some countries like Pakistan or Sri Lanka to the edge of bankruptcy. According to the Economist, in the first quarter of 2021, policy rates in a sample of 58 rich and emerging economies stood at an average of 2.6% which increased to 7.1% by the final quarter of 2022.

The cost of living has been increasing across the UK since early 2021 and is the subject of much public debate. The annual rate of inflation reached 11.1% in October 2022, a 41-year high, before easing to 10.7% in November and 10.5% in December and 10.1% in January 2023. High inflation is expected to persist throughout 2023 and will peter out by mid 2024 according to forecasts from the Bank of England (Figure 2). High inflation affects the affordability of goods and services for households. A House of Commons Library Briefing[4] showed that low-income households are most affected by rising prices as they are more affected by high food and energy prices.

In response to higher inflation, the Bank of England's Monetary Policy Committee raised interest rates from an all time low of 0.1% at ten consecutive policy meetings since December 2021 to 4% in early February 2023.

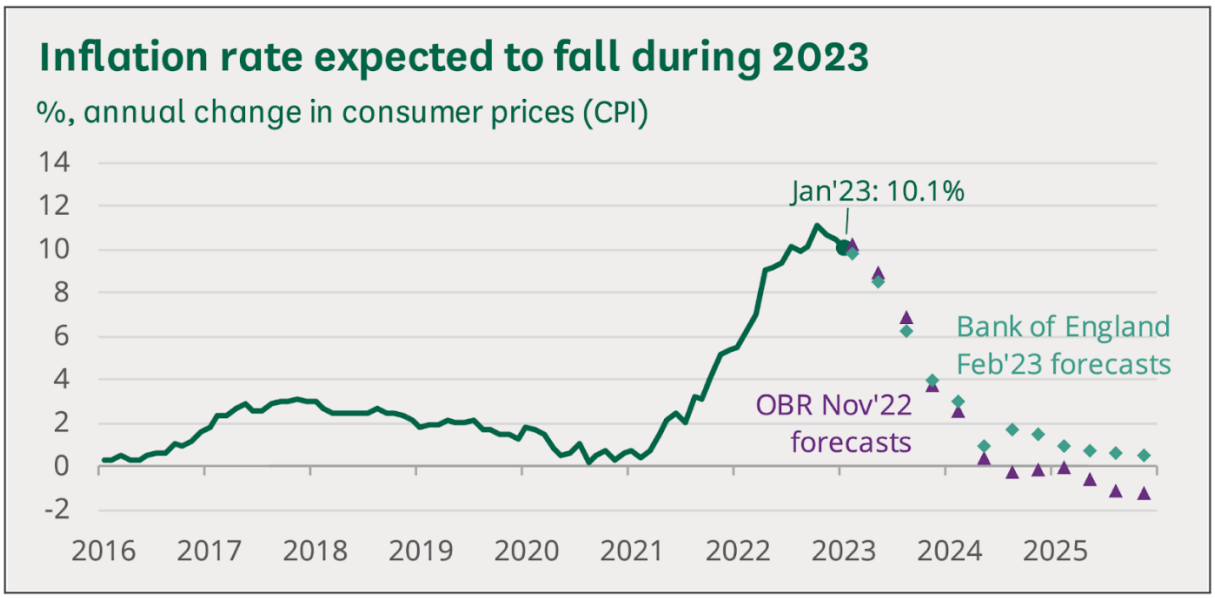

Figure 2: Annual change in consumer prices for the UK. Source: House of Commons Library Briefing.

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According to the Briefing, some households are increasing debt and falling behind on bills. 10% of workers had missed at least one bill payment during this time and 24% of workers in the bottom income fifth were behind on at least one bill.

Rising interest rates means higher borrowing costs on mortgages and other loans. Even before the disastrous mini budget which increased borrowing rates sharply, there were large upward moves in interest rates since August 2021, when average two-year fixed mortgage interest rates were around 1.2%. Mortgage providers have raised the interest rates on the mortgages they offer with average rates having increased to 5.8% for two-year and 5.6% for five-year fixes in early January.

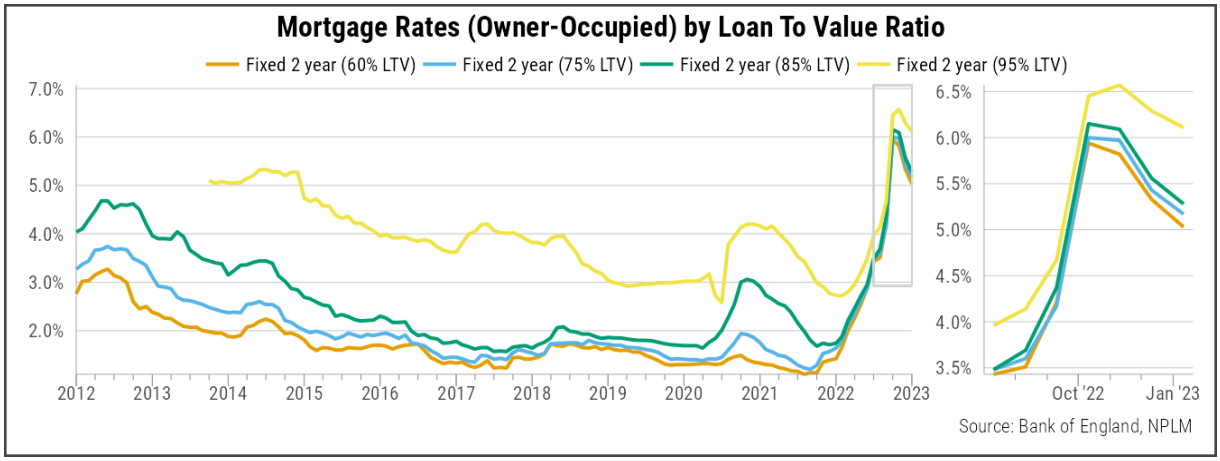

Figure 3: Owner-occupied mortgage rates by LTV. Source: Bank of England.

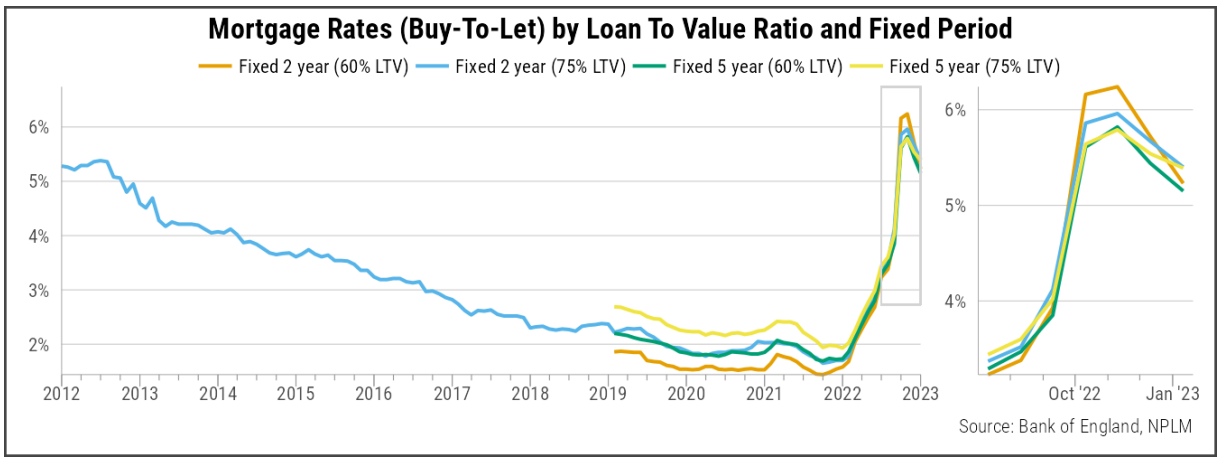

Figure 4: Buy-to-let mortgage rates by LTV. Source: Bank of England.

Approximately two million households will come off their fixed rates by the end of 2023 and will need to remortgage at higher – sometimes much higher – rates than they are currently paying. Using data from the European DataWarehouse (EDW) the rating agency DBRS estimates that for the owner-occupied segment, about 77% of mortgages will see their interest rates reset in the next two years. For borrowers in the three lowest income bands, this number is 85%. Borrowers at the lower income bands pay a higher interest rate on their mortgages. Overall, DBRS expects asset performance to deteriorate based on the gloomy economic outlook, and borrowers' ability to refinance will depend on how high the interest rates rise. A sharp increase in rates could leave many borrowers unable to refinance given their resulting high debt-to-income ratios. Even a moderate increase in interest rates can materially challenge affordability for the lowest income earners, leading to a relative increase in their mortgage payments. Anti-poverty campaigners warned that sharply increasing mortgage interest rates and double-digit inflation means many low and middle income families are likely to find their loans are unaffordable.

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Interestingly, the expected higher arrears in loan payments are not yet observable in the latest available mortgage performance data. We examined recent arrears until year end 2022 for large UK mortgage master trusts using EDW data and found only moderate increases in early stage arrears. The data from UK credit card and auto loan securitisations paint a broadly similar picture. Credit card ABS showed a 60-180 days' delinquency rate remaining stable over the last quarter at 0.7% but the annual charge-off rate rose modestly by 0.2 percentage points to 2.9%. European credit cards also showed a modest deterioration. Figure 5 shows the recent performance of the large Penarth credit card master trust from Lloyds Bank.

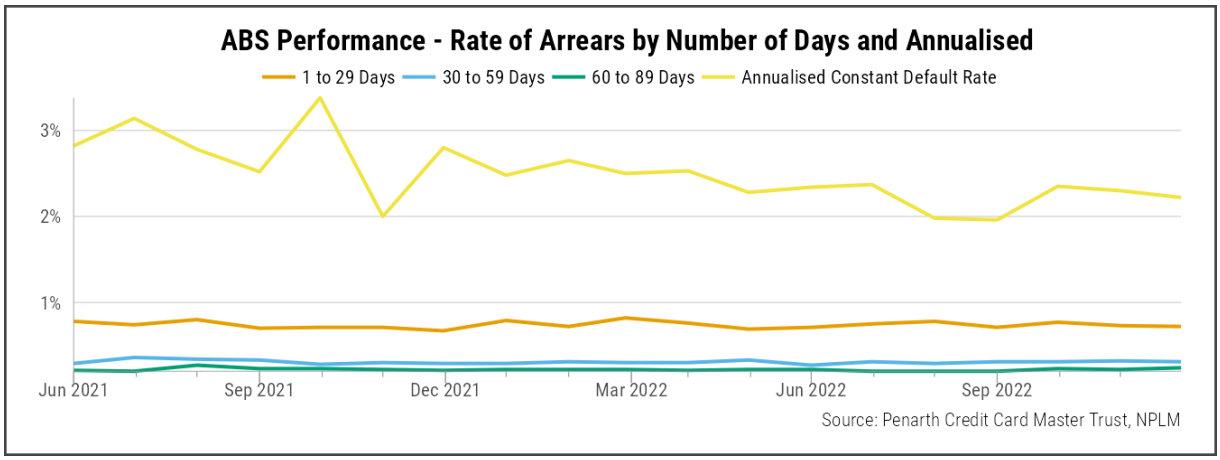

Figure 5: ABS performance - arrears annualised and by number of days. Source: Penarth Credit Card Master Trust.

For auto loans on a year-to-Q4 2022 basis, early-stage delinquencies doubled on average across UK and European portfolios starting from very low historical levels. Increases in delinquencies are more evident for non-captive originators and non-bank lenders that adopt a risk-based pricing strategy and tend to target obligors with weaker credit profiles. The performance of household loans is expected to deteriorate further, especially for portfolios comprising vulnerable or near-prime borrowers as a slower labour market together with inflation and higher interest rates squeeze household disposable income.

In January the Bank of England said in the quarterly credit condition survey for 2022 Q4 that Britain's lenders were expecting a steep rise in the number of customers who cannot pay their monthly mortgage bills during the first quarter of 2023. Default rates on secured loans to households were unchanged in Q4, and were expected to increase in Q1. Losses given default on secured loans were unchanged in Q4, and were expected to increase in Q1. The default rates for total unsecured lending increased in Q4, and was expected to increase in Q1. The default rates on loans to corporates increased for small businesses, slightly increased for medium businesses, and was unchanged for large businesses in Q4. These were expected to increase for businesses of all sizes in Q1.

Lenders reported that overall spreads on secured lending to households widened in Q4, and were expected to widen slightly further in Q1. Lenders reported that spreads on corporate lending to small and large businesses widened in Q4, but remained unchanged for medium-sized businesses.

United Kingdom Business Loan Performance Update

As borne out by the latest Bank of England survey, higher inflation and higher lending rates are expected to increase the risk of default for businesses. Last week the insolvency service for England and Wales reported 1,671 registered company insolvencies in January 2023 which was 7% higher than in the same month in the previous year, and 11% higher than the number registered three years previously (pre-pandemic). While the UK saw a doubling of insolvencies during 2021 the numbers for 2022 have been rather stable (Figure 6).

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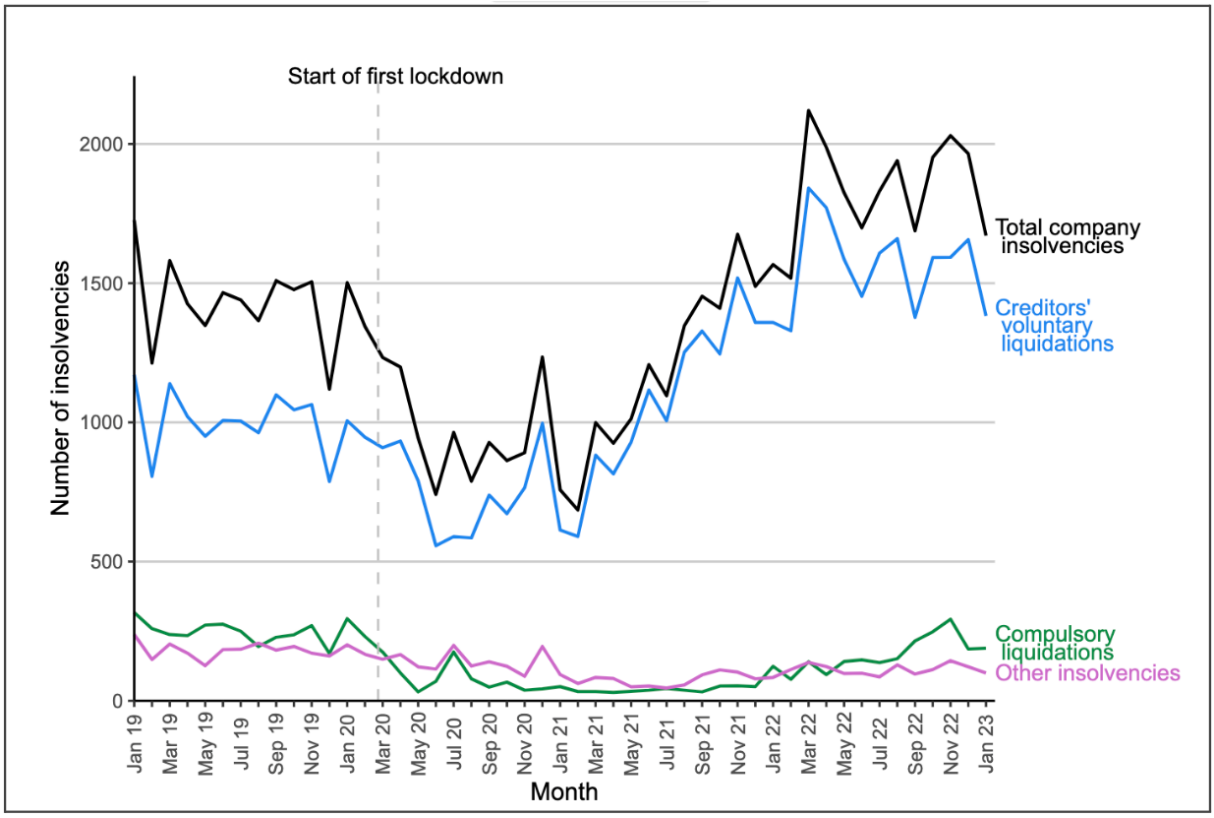

Figure 6: Business insolvencies in England & Wales. Source: Insolvency Service.

In contrast, Eurostat reported that the number of bankruptcy declarations among EU businesses increased substantially in 2022 after stable or declining bankruptcy counts in 2021. The fourth quarter of 2022 shows a plus of 26.8% compared with the previous quarter and reached the highest levels since the start of the data collection in 2015. The number of bankruptcy declarations in the EUR increased during all four quarters of 2022 (Figure 7).

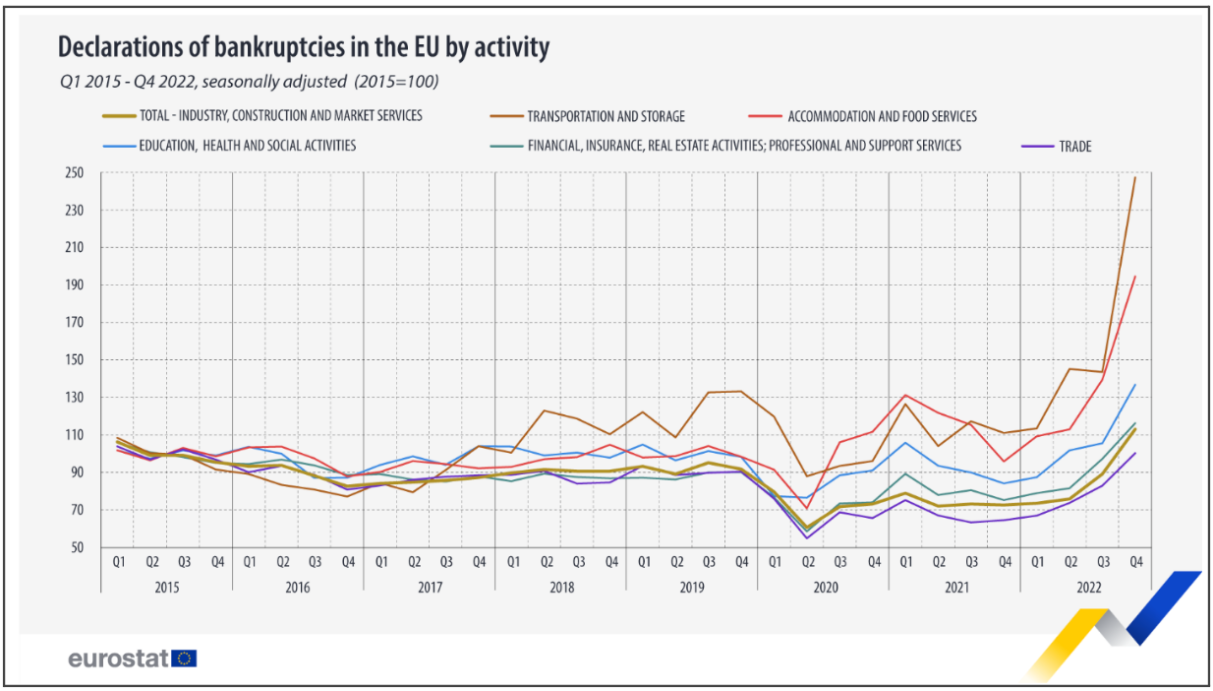

Figure 7: Business insolvencies in the EU by economic activity. Source: Eurostat.

Contrary to other countries like Spain or Italy, the UK does not have a large public securitisation market for loans to small and medium size enterprises (SME). Hence, to track the performance of SME loans in the UK one needs to look at other data sources. The Bank of England publishes write-off rates for loans to non-financial corporations which has recently been at an all time low (Figure 15 in the Annex) and the most recent data do not show any material increase in write-offs.

On February 7th, the UK government published its 2022 year-end performance data of the COVID-19 government guarantee schemes. A total of GBP 77bn was originally drawn under the different programs, 4.4bn have been paid out by the British Business Bank as guarantor to the lenders and 1.16bn have been flagged by the lenders as suspected fraud (Table 1).

Furthest life event reached	Number of facilities	% number of facilities	Outstanding balance (£m)	Final amount (£m)
On Schedule	1,117,053	68.28%	38,089.70	-
Arrears	108,734	6.65%	3,233.93	-
Defaulted	34,756	2.12%	1,210.05	-
Claimed	56,369	3.45%	1,836.32	-
Settled	132,093	8.07%	-	4,375.05
Fully Repaid	186,879	11.42%	-	14,540.71
Grand Total	**1,635,884**	**100%**	**44,369.99**	**18,915.76**

Table 1: Current balances relating to all COVID-19 guarantee schemes i.e. BBLS, CBILS, CLBILS. (Source: gov.uk)

The credit performance of COVID-19 loans varies widely for different originators as can be seen in Figure 8 with most major lenders showing current loans in distress (arrears, default or claims paid) of less than 20%. The performance overall is better than originally feared during the height of the COVID-19 pandemic, but clearly much worse than for the corporate lending market overall. We did not find time series data on the COVID-19 loan performance for the market overall. Figure 9 shows several CBILS UK COVID-19 loan portfolios tracked on the NPL Markets platform. Again, the performance differs widely by originators and the default curves (defaulted loans as percentage of origination amount) are still on the rise. As the government points out, it is still relatively early in the life of the COVID-19 schemes, and therefore it is too soon to conclude the assessment of the scheme's performance.

To conclude, while some credit performance indicators like auto loan arrears and COVID-19 SME loans show increasing arrears and defaults, the widely expected increase in UK non-performing loans has not yet materialised with asset classes such as residential mortgages and corporate loans overall still showing historically low levels of defaults and losses.

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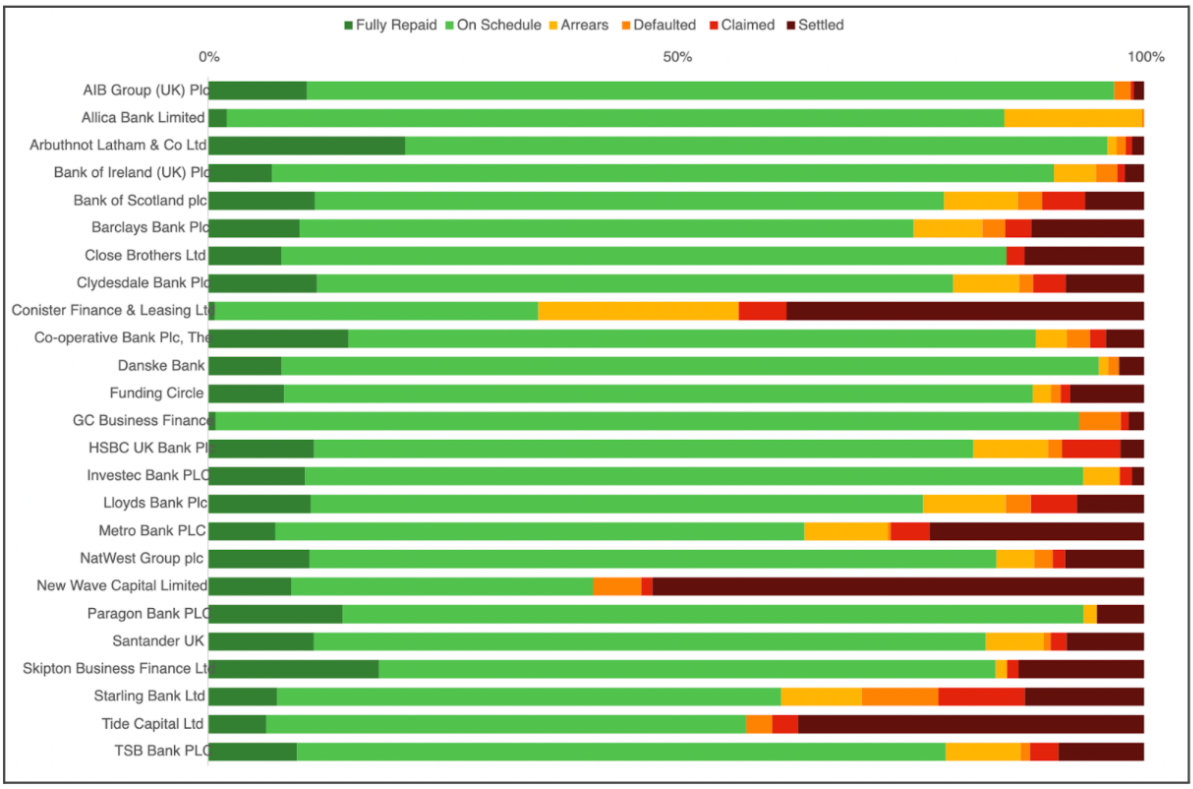

Figure 8: Furthest life event reached by number of loans for different lenders of the Bounce Back Loan Scheme (BBLS). Source: gov.uk.[5]

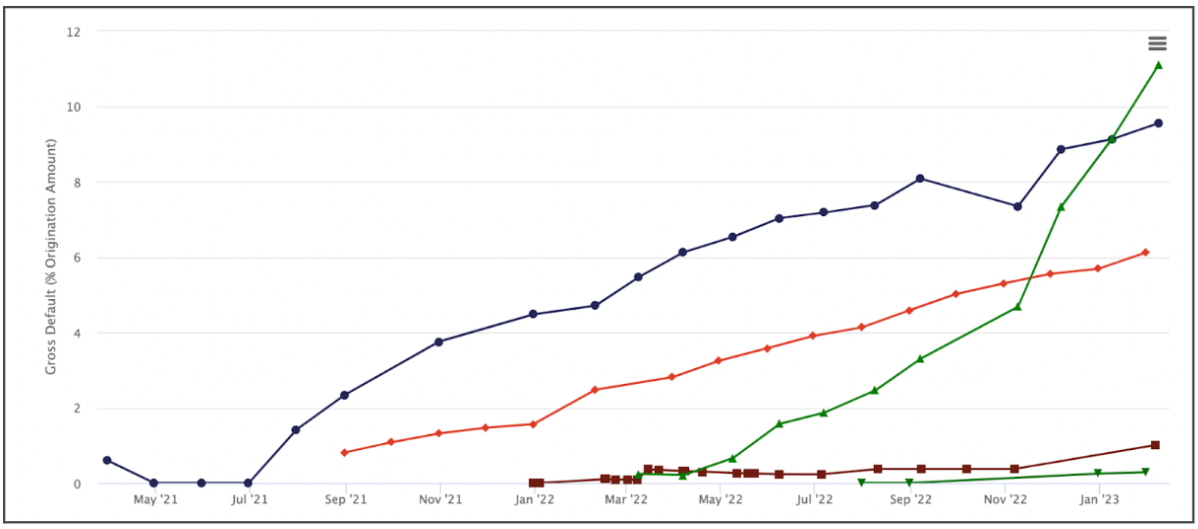

Figure 9: Percentage of defaulted CBILS loans in portfolios of selected originators. Source: NPL Markets.

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United Kingdom Macroeconomic Conditions and Scenarios

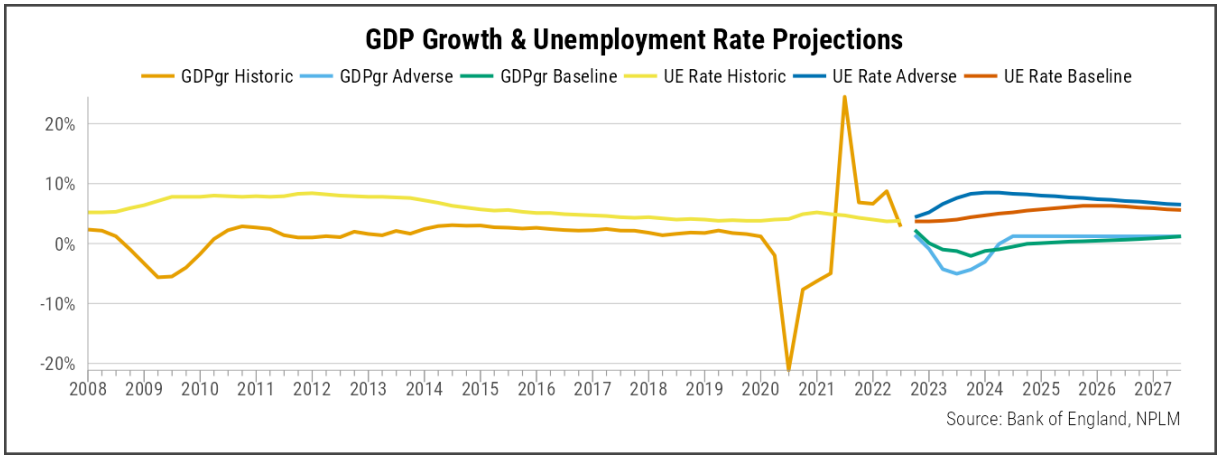

Figure 10: GDP & UE growth projections. Baseline and adverse scenarios are taken from the 2022 Bank of England stress test.

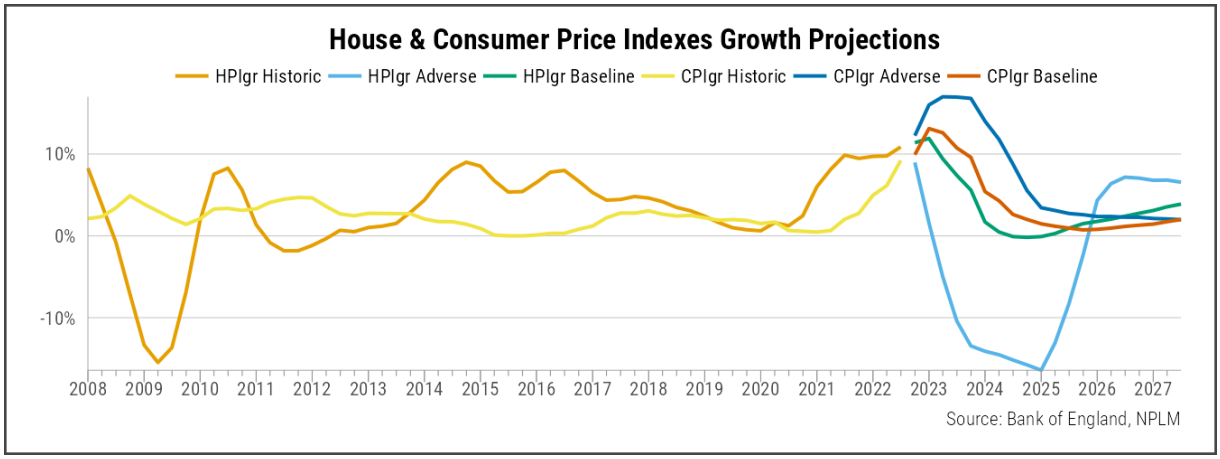

Figure 11: HPI & CPI growth projections. Baseline and adverse scenarios are taken from the 2022 Bank of England stress test.

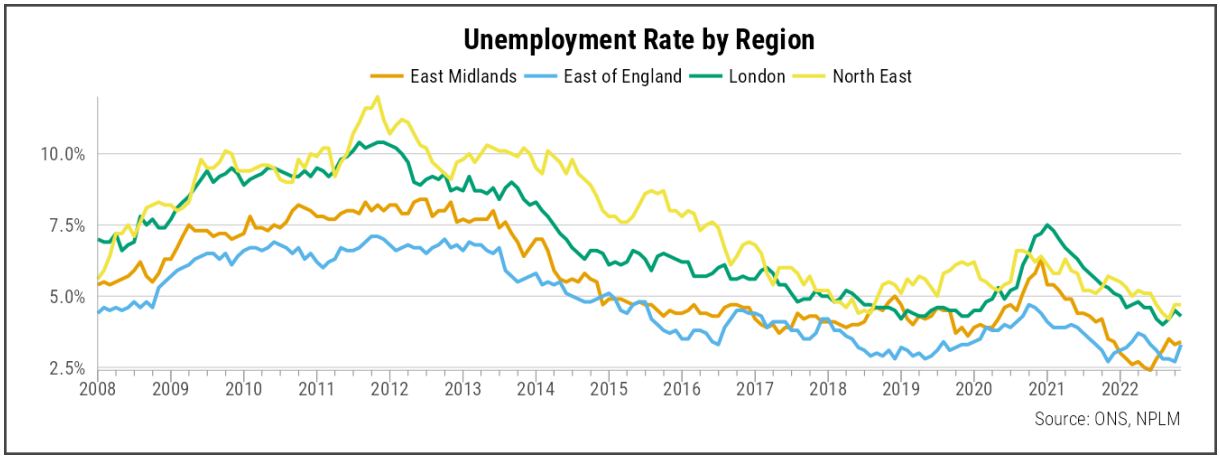

Figure 12: Unemployment rate by region.

Lending Rates

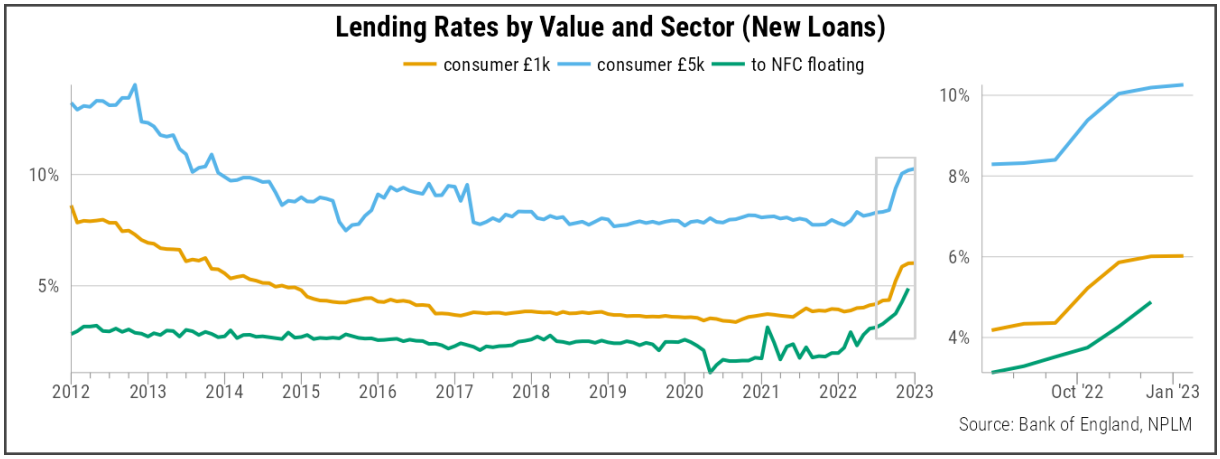

Figure 13: Lending rates by loan value and sector. Source: Bank of England.

Write-off Rates on UK Bank Loans and Stress Test Projections

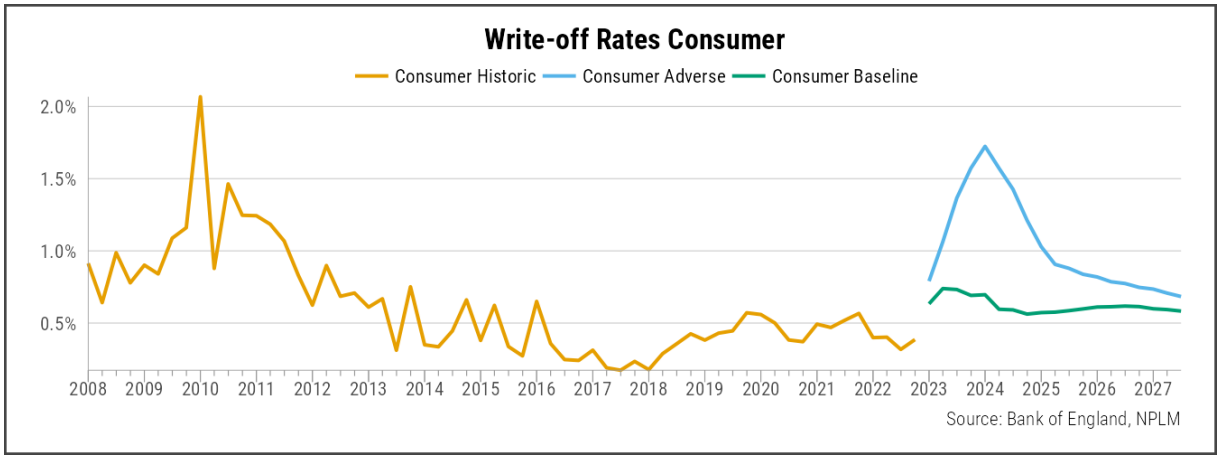

Figure 14: Write-off rates consumer. Projections by NPL Markets based on macroeconomic scenarios of the Bank of England 2022 bank stress test.

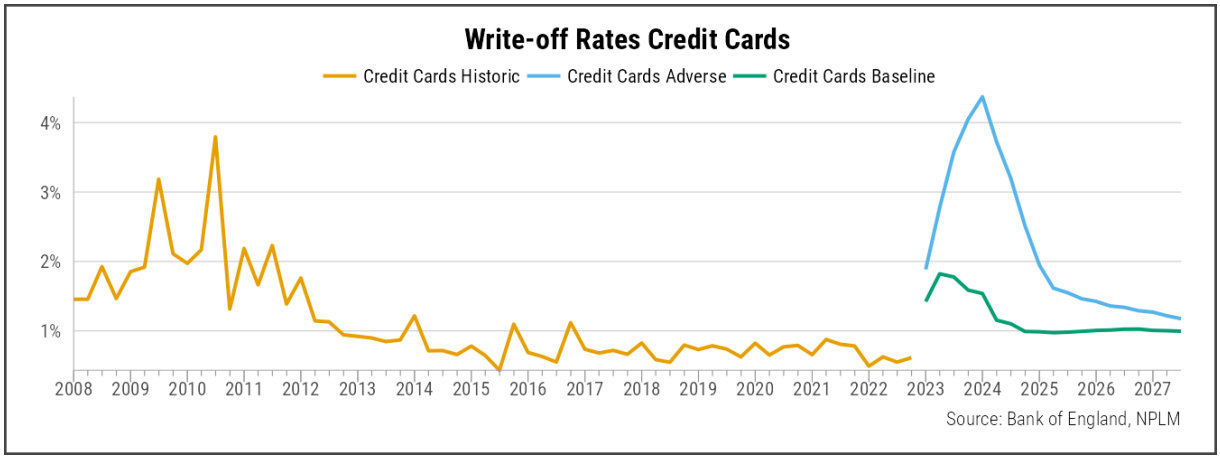

Figure 15: Write-off rates credit cards. Projections by NPL Markets based on macroeconomic scenarios of the Bank of England 2022 bank stress test.

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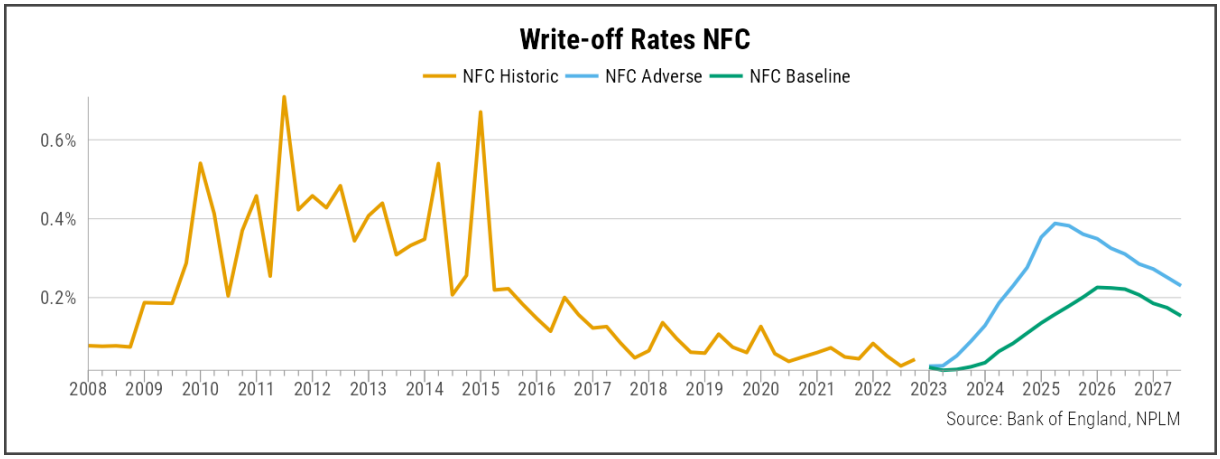

Figure 16: Write-off rates - Non-Financial Corporations. Projections by NPL Markets based on macroeconomic scenarios of the Bank of England 2022 bank stress test.

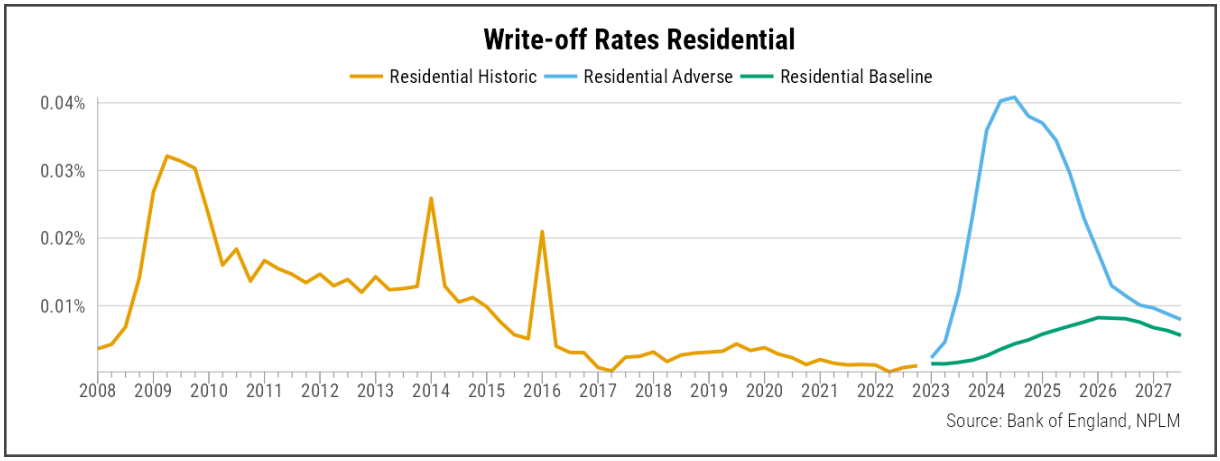

Figure 17: Write-off rates residential. Projections by NPL Markets based on macroeconomic scenarios of the Bank of England 2022 bank stress test.

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