

Brexit: Potential Impacts on U.K. Housing and Structured Credit

January 2019

The United Kingdom's (UK) decision to leave the European Union (EU) by referendum in June 2016 ("Brexit") has been dominating global news headlines ever since, not least due to the closeness of the vote (51.9% v 48.1% leave/remain), but also due to the fact that even now, almost three years since the referendum was first announced, the public is still largely unaware of what type of Brexit they are going to get and the resulting consequences. This elevated uncertainty initially caused risk assets with exposure to the UK to draw down significantly; however, the steady fundamental performance of the UK economy over the period and the willingness of the Bank of England (BoE) to support the economy with monetary stimulus meant that 2017 and 2018 were fairly sanguine times for such assets, and in many cases, new highs/tights were achieved. In this piece we describe the current state of play, hypothesize potential market reactions, and highlight why we think attractive trading opportunities may lie within UK RMBS bonds.

The EU was founded in 1993 as a political and economic union of certain European member states. The EU developed a system of standardized laws that apply in all member states for certain matters where members have agreed to act as one. These standardized policies aim to ensure the four freedoms of movement – the free movement of people, goods, services, and capital within EU member countries. In addition to potentially eliminating the policies intended to protect these movements, Brexit also calls for the UK to exit its obligations to the European Court of Justice as well as ceasing contributions to the European budget. Once outside of the EU, the UK would regain control of its immigration policy and negotiate its own bilateral trade deals with the EU and other global trading partners. The UK court would also revert to being the highest court in the land and EU budget payments would stop. The UK never entered the monetary union of the EU (the Euro €) so it retained its own free-floating currency throughout (Pound Sterling £).

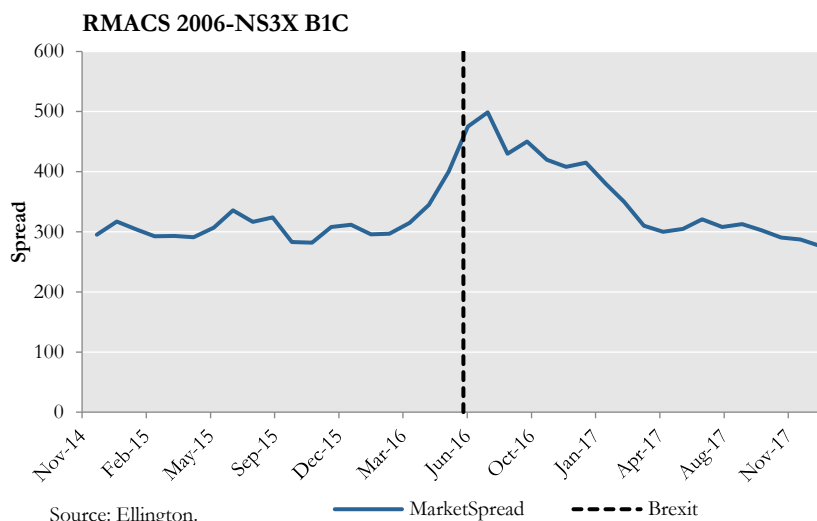
The path to implementing these changes has proven to be much more difficult than expected. In March 2017, UK Prime Minister Theresa May formally triggered "Article 50" of the Treaty of Lisbon, which forms the constitutional basis of the EU. "Article 50" gives any EU member state the right to quit unilaterally and outlines the procedure for doing so. It sets out a period of two years of negotiation designed to govern how the UK and EU will coexist once the UK is no longer a member. During this time, the UK is expected to be given a "deal" upon which UK parliament will vote to accept or reject via a "meaningful vote".

In mid-January, a "meaningful vote" on an initial deal offered by the EU failed in parliament. As details of the deal offered by the EU started to become public leading up to the vote, a general consensus of opinion formed that it was not in the best interests of the UK. The major issues with the deal were: (i) the border between Northern Ireland and Ireland needs to remain frictionless as per the 1998 peace accord; however, this was not the case in the agreement; (ii) fishing the waters around the UK would be covered by EU tariffs not governed by the UK; (iii) UK citizens currently living in the EU would be treated differently than EU citizens currently living in the UK; (iv) the UK would have to continue paying into the EU budget to the tune of £39bn in total but would effectively have no say on how those funds were spent. The EU has stayed firm in its approach that this is the only deal available and the window for negotiations is closed.

These developments leave the UK (and to some extent the rest of the world) to consider what a "hard Brexit" (i.e. leaving the EU without a deal) would look like. Given the multitude of scenarios and potential responses (both monetary and fiscal), it is very difficult to forecast how the UK economy would perform in such a scenario. The UK Government's own projections show UK GDP 10.7% lower in 15 years in a "hard Brexit" scenario compared to the scenario where the UK remains in the EU. The BoE has gone so far to warn that UK GDP would fall 8% in the twelve months after leaving the EU under these conditions.

Uncertainty is rarely a friend of the market and uncertainty is one thing Brexit serves up in spades. During the period after the June 2016 "no" vote, many UK-centric markets exhibited extreme volatility. The GBP, FTSE 100, and listed UK housebuilders, retailers and banks all exhibited record daily and weekly moves. However, these violent drawdowns were short-lived as the BoE

stepped in with monetary stimulus to shore up investor nerves by cutting interest rates 25bps and also undertaking £70bn of quantitative easing across government (£60bn) and corporate (£10bn) bonds. As a result, investors have been overly optimistic on the Brexit issue for the majority of the post-“Article 50” era, potentially overlooking risks if a BoE-backstop does not materialize.



UK RMBS market spreads, as seen in the reference bond above, widened quickly after the initial Brexit vote but were slow to recover.

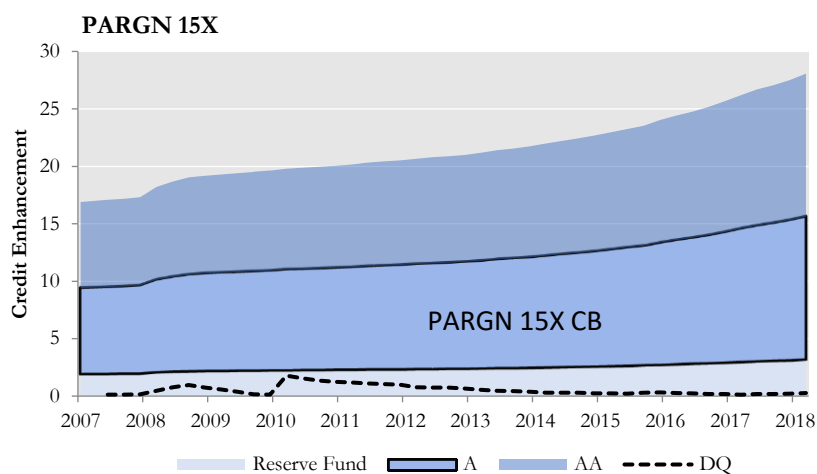
European structured credit markets, specifically UK RMBS, may present some of the most compelling areas to deploy capital if a draconian “hard Brexit” scenario does in fact come to fruition. Immediately after the initial Brexit vote, UK RMBS exhibited similar percentage drawdowns to other UK asset classes but took much longer to recover. We believe this was due to two main factors. For one, there are high barriers to entry to the UK RMBS market. Market participants must utilize models to value securities and manage risks, understand specific nuances of various deal structures, and establish trading relationships to both add and off-load risk. More importantly, in our view, the sector lacks a liquid index. Since there is no tradable RMBS index, long investors looking to de-risk are forced to sell their positions, driving cash

prices lower. Moreover, macro funds looking to gain exposure on the long side of a popular distressed theme will not go to RMBS for that exposure. Instead, they stick to more liquid indices and instruments to build their positions and exit as conditions normalize. A longer and deeper period of dislocation could see UK RMBS lag for an extended period of time as a result of these market dynamics.

The UK RMBS bond market is approximately £104 billion in size, broken down as follows:

- (i) 42% Prime – Borrowers with very clean credit history borrowing 50-70% of the value of their homes from a conservative institution such as a high street bank or building society. Very low perceived credit risk.
- (ii) 27% Non-conforming (“UKNC”) – Borrowers whose credit requires some form of manual underwriting, higher LTV, self-employed borrowers, borrowers with 2nd incomes or complex financial situations. Higher perceived risk and likely to fall outside of the lending criteria of banks. Specialist lenders originate here and fund via issuing bonds.
- (iii) 31% Buy-to-let (“BTL”) – Loans are not secured on the primary residence of the borrower. The borrower is a landlord who rents out the property and earns a yield. Borrower behavior is different due to non-recourse (in many cases) and also the fact that eviction and foreclosure is a lot simpler.

For several reasons, we believe that the UKNC and BTL sectors could exhibit some of the largest price declines without experiencing significant deterioration in fundamental performance. Due to their slow prepayment speeds, pre-crisis originated deals continue to



Tranches have structurally de-levered over time while delinquency rates for underlying borrowers have fallen.

dominate these two markets – conveniently providing over 12 years of borrower payment history, including through the 2008 financial crisis, which can be used to calibrate cash flow models. These bonds are floating rate notes, so they are buffered somewhat from increases in short-term interest rates. Given many deals pay in a sequential manner, they have been deleveraging at both the structural level (tranches become thicker and build more credit enhancement) and at the borrower level (house prices have risen back to pre-crisis peaks reducing LTV ratios while non-IO borrowers have been amortizing their debt).

These securities tend to have long spread durations though (the typical bond has a 10-year weighted-average life) and therefore exhibit a high price volatility when spreads move. In many instances these bonds have climbed back to an investment grade rating, which has sparked selling from hedge fund holders into low-risk accounts. Many times, these low-risk accounts offer daily or weekly liquidity, increasing the probability of forced selling into a falling market in times of stress. This can create the perfect storm for a prolonged period of severely depressed prices in a sector with otherwise strong fundamentals. If that does indeed happen, we believe that the sector will likely offer some of the better value within the structured credit markets.

One thing we have learned in the almost three years since the June 2016 Brexit referendum is that we do not have a crystal ball to predict the future in a situation with such long-lasting global implications where passions run extremely high on both sides of the debate. Instead, we prepare for the worst as it seems many market participants are much too complacent given the serious downside risks that are becoming more real with each passing day without a deal.

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