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Brewing mortgage crisis set to upend the credit profile of the UK housing construction industry

by Raghav Mathur

- **NUS-CRI Forward PD suggests a deterioration in the credit health of UK housing construction companies as mortgage rates increase and credit extensions to homeowners decrease**
- **Stress tests suggest that an increase in mortgage rates is likely to increase the credit risk of UK-domiciled banks**

The cost-of-living crisis that is currently plaguing the United Kingdom has started to flash red in the country's domestic real estate sector. After the Bank of England (BoE) raised interest rates by 50bps in Jun-2023, one of the highest increases for the month amongst most major central banks that are beginning to slow down their monetary tightening campaigns, the UK's housing market has seen mortgage rates increase substantially. Though the signs of a mortgage crisis, which has already begun to show colors, have not affected the NUS-CRI Aggregate (median and interquartile range) 1-year Probability of Default (Agg PD) for the housing construction industry yet, the NUS-CRI Aggregate (median and interquartile range) Forward 1-year Probability of Default (Forward PD)[1] suggests that a potential decrease in new housing demand due to the resultant rise in mortgage rates, in conjunction with lower credit extended by banks to homeowners, may worsen the outlook of the UK housing construction companies' top lines, and vis-à-vis, credit profiles.

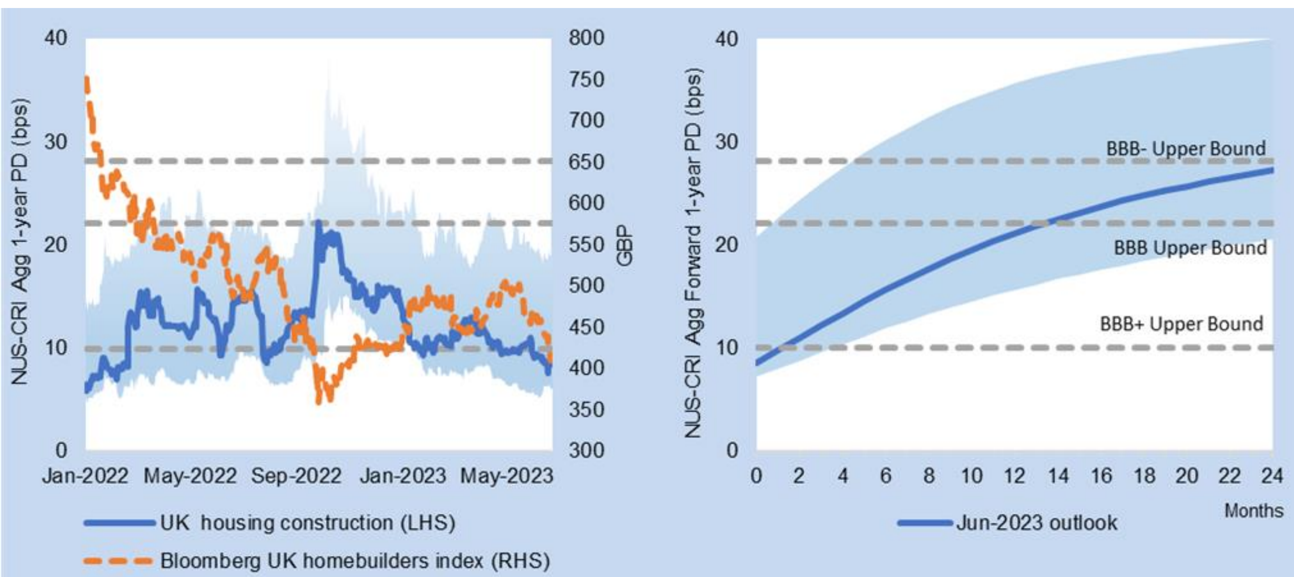

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for UK housing construction industry, with their interquartile range from Jan-2022 to Jun2023, with reference to PDiR2.0 bounds[2]; the Bloomberg UK homebuilders index from Jan-2022 to Jun-2023. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for UK housing construction, with their interquartile range as of Jun-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

As seen in Figure 1a above, the median PD for UK housing construction companies is well under the BBB- threshold for investment-grade companies when proxied by PDiR2.0. The improvement in the industry's credit profile from Sep-2022 can largely be attributed to the impact of the "mini-budget" set forth by then Prime Minister Liz Truss. The supportive budgetary policies presented in the mini-budget, such as changes to stamp duty that favored new home sales and boosted property demand, saw a rally in the equities market for housing

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

construction companies, with the Bloomberg UK homebuilders index rising close to 34% between Sep-2022 and Jan-2023 (see Figure 1a). However, the Forward PD in Figure 1b suggests that the industry, especially its most vulnerable members (those in the upper quartile of the sample), is susceptible to rapid deterioration in its credit profile over the next twelve months.

The rising interest rate environment has led to worries that the increasing new mortgage costs, and existing mortgage refinancing costs, are likely to hamper the demand for new homes. As seen in Figure 2a, the average mortgage costs have risen by close to 2.5 percentage points for both the 2-year and 5-year horizons. Though a drop in overall construction demand is yet to materialize in the markets as shown by the Agg (median) PD of the industry trending marginally downwards since Jan-2023, sentiments pertaining to a potential drop in new residential demand affecting new housing output have already picked up steam. Although the S&P Global / CIPS UK construction PMI index increased at the fastest pace over three months in May-2023 to 51.6, the recovery in industry outlook is divergent between the three composite sub-industries (housing activity, commercial activity[3], and civil engineering), with housing activity recording the steepest decline to 42.7 (see Figure 2a) in output since the initial stages of the COVID-19 pandemic in May-2020.

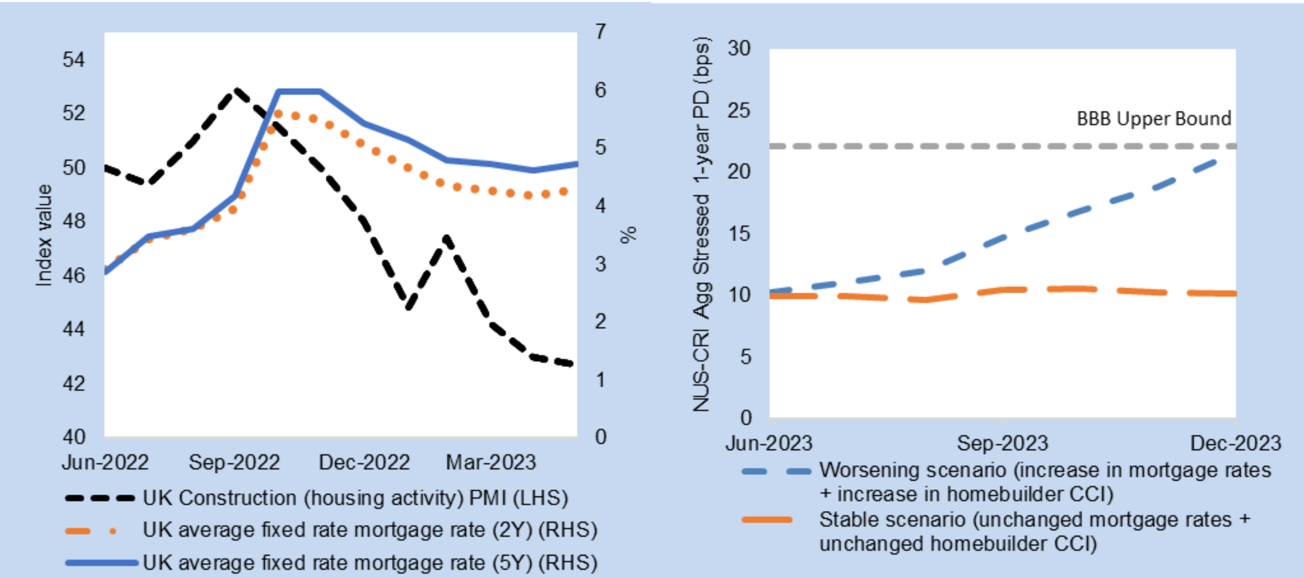

Figure 2a (LHS): Index value for the UK Construction (housing activity) PMI, the 2Y and 5Y UK average fixed rate mortgage rate. Figure 2b (RHS): Stressed NUS-CRI Agg (median) 1-year PD for UK banks for the worsening and stable scenarios. *Source: Bloomberg, S&P, BuDA v3.5.1*

The impact of the ongoing mortgage crisis may also trickle down into the UK's banking sector. Stress in the domestic housing market is likely to reduce the amount of credit extended by banks to mitigate an uptick in non-performing assets, especially in the, albeit unlikely, scenario where homeowners mass default on mortgage interest payments. In order to shield households from the increased burden of higher mortgage payments, the UK's Chancellor of the Exchequer, Jeremey Hunt, has struck a deal with domestic banks to delay the repossession of homes in the case of borrower default, while temporarily lengthening mortgage terms without impacting borrowers credit ratings. The deal offers homeowners some much-needed reprieve for mortgage payments as households tapped into their savings at a record pace in May-2023 to meet their repayment obligations.

To measure the impact of a widespread mortgage crisis, stress tests can be conducted to measure the potential impact on UK-domiciled banks. As seen in Figure 2b, using the NUS-CRI Bottom-Up Default Analysis Toolkit (BuDA v3.5.1[4]), UK banks could see their credit profiles worsen should mortgage rates continue to increase by 10bps MoM till Dec-2023, while concurrently, the credit profile of publicly listed housing construction companies worsens. Compared to the unlikely 'stable' scenario where the BoE does not continue the tightening campaign and mortgage rates and homebuilders' CCI do not rise further until the end of the year, the impact on banks remains relatively muted.

Suffice it to say that the cost-of-living crisis is likely to translate to an uptick in the median PD of the housing construction companies, as well as the domestic banking sector should default rates increase. With the median PD of the industry being close to the lower quartile, the distribution of PDs of entities in the housing construction

[3] As of May-2023, rising demand among corporate clients saw an increase in new construction orders at the fastest pace since Apr-2022.
[4] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of the National University of Singapore (NUS) and the International Monetary Fund (IMF).

industry is likely to be skewed, potentially signaling that the worsening macroeconomic environment is likely to cause a disproportionate impact on vulnerable homebuilders that may have weaker fundamentals, as suggested by the Forward PD in Figure 1b. As such, the realized impact of a continued tightening campaign by the BoE that results in even higher mortgage rates may lead to heightened credit risk for the UK's housing and banking sector, as a mortgage crisis potentially evolves into widespread financial distress.

Credit News

Global funds have another window to buy Asia's favorite bonds

Jul 03. International investors in Asia have preferred South Korean bonds this year, with recent price reductions viewed as possible buying opportunities. Due to worries that inflation will affect interest rates, the yield has risen for three months in a row. However, consumer prices have eased in June for a fifth month, indicating the Bank of Korea may soften its stance at its mid-July review. In the most recent quarter, the yield on the three-year bond increased by 40 basis points, and the swaps market is pricing in no rate reduction in the following six months. Global investors have been building positions in Korean debt, with purchases accelerating in May and June, with USD 37bn invested year-to-date, making it the highest in Asia. (Bloomberg)

China's factory, service sectors stumble as economic malaise broadens

Jun 30. In June, manufacturing activity in China decreased for a third consecutive month, and other sectors also saw worsening weakness. According to official surveys, although the second-largest economy in the world expanded more quickly than anticipated in the first quarter, mostly as a result of a robust post-COVID rebound in consumption, the second quarter has seen officials battle to maintain the same. Since China abandoned severe COVID limits in the latter part of last year, the services sector activity for June registered its lowest reading. Indicating a slowdown in service sector activity and construction, the official manufacturing purchasing managers' index (PMI) increased to 49.0 while the non-manufacturing PMI decreased to 53.2. (Reuters)

Gilts lose out in global bond market rally

Jul 01. In the first half of 2023, UK government bonds, known as gilts, have performed poorly compared to other major bond markets. Investors anticipate that the Bank of England will raise interest rates to address high inflation, leading to this underperformance. The ICE Bank of America index indicates that UK government bonds have fallen by 3.7 percent during this period, while other bond markets have seen positive returns due to easing inflation pressures and the expectation of rate hikes reaching their peak in other countries. Wages and inflation data in the UK have consistently surpassed market and economist expectations, with UK headline inflation at 8.7 percent compared to 6.1 percent in the Eurozone and 4 percent in the US. As a result, market expectations now point to UK interest rates rising from 5 percent to approximately 6.25 percent by year-end. (FT)

Sweden's debt-laden landlords are veering closer to forced sales

Jul 03. Sweden's landlords are facing increasing pressure to sell properties in order to raise cash as USD 17bn in debt is set to mature over the next 18 months. With limited access to bond and equity markets, selling properties has become one of the few remaining options for real estate companies. However, a rush to raise cash could result in significant discounts in Sweden's already struggling property market. This may trigger a domino effect that affects valuations across the industry and exacerbates funding gaps. The Swedish central bank has expressed concerns that a large-scale sell-off by landlords could pose a threat to the country's financial stability. (Bloomberg)

Leveraged-loan logjam eases after banks unload tens of billions of debt

Jul 03. Banks have sold off billions worth of leveraged-buyout debt, which had been causing disruptions in their lending operations. This development signals a return to normalcy for banks. Traditionally, banks provide high-risk loans to support private-equity buyouts and then transfer the debt to investors. However, when interest rates rose last year, investors grew wary of purchasing billions of dollars of debt associated with deals like the USD 44bn acquisition of Twitter. Consequently, banks held approximately USD 80bn of this debt on their balance sheets, reluctant to sell at significant losses. This situation constrained their ability to issue new loans and impacted their profits. According to research from Morgan Stanley, banks have managed to reduce their exposure to such debt by over half since May 2022, bringing it down to USD 35 bn. Although it may take time to eliminate the remaining backlog, bankers affirm that making new loans is now easier compared to last year. (WSJ)

Big banks stay cautious as stress doesn't end with a test (WSJ)

Bank of America nurses USD 100bn paper loss after big bet in bond market (FT)

Retail bond investors chase corporate issues (FT)

Regulatory Updates

Central bank chiefs warn interest rates will keep rising

Jun 29. Top central bank leaders, including those from the US Federal Reserve, the European Central Bank (ECB), and the Bank of England, have indicated their readiness to raise interest rates further and maintain a high level. At a conference in Sintra, Portugal, they cautioned that tight labor markets continue to exert upward pressure on wages and prices. Despite concerns raised by some economists about the potential for rate increases to trigger a recession or financial crisis, the central bank chiefs stressed that additional measures might be necessary to bring inflation closer to their target of around 2 percent. Investors anticipate that the Federal Reserve, ECB, and Bank of England will raise their policy rates a few more times in the coming months, citing resilient economic growth, tight labor markets, and rapid wage increases as contributing factors. (FT)

China central bank vows to stabilize yuan as slide deepens

Jun 30. China's central bank, the People's Bank of China (PBOC), has announced its commitment to stabilizing the nation's currency as it approached its lowest level in 15 years. The PBOC stated that it would implement comprehensive measures to stabilize expectations and prevent large fluctuations in the currency. In its quarterly monetary policy report, the central bank also pledged increased support for the broader economy, noting that domestic demand is still relatively weak. This commitment follows the release of data showing a contraction in manufacturing activity and a lack of momentum in other sectors, further confirming the assessment that domestic demand is not robust. (Bloomberg)

FCA warns banks over 'greenwashing' in sustainable loans (FT)

Study shows 130 countries exploring central bank digital currencies (Reuters)

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