Higher defaults and lower collateral values will impair Irish re-performing RMBS

Sizeable cash reserves supporting Irish re-performing RMBS will adequately cover temporary collection delays and liquidity shortfalls related to payment holidays granted in the context of Covid-19. But deteriorating collateral values and an increase in defaults due to worsening macroeconomic conditions will impair the performance of securitised portfolios.

Major banks and some servicers launched aid measures at the end of March, including payment holidays and the postponement of court actions (in both cases by up to three months). Mortgage lenders have received a flood of requests for payment holidays. Within a month, the top four retail banks in Ireland have granted or are in the process of granting 45,000 mortgage payment holidays[1], which is equivalent to around 5% of total mortgages. Furthermore, Banking & Payments Federation Ireland is in discussions with the Central Bank of Ireland to offer longer payment breaks (of up to six months).

A temporary interruption in collections will have a limited impact on Irish re-performing RMBS transactions, considering their strong liquidity coverage. Cash reserves generally cover two to six years of senior expenses and interest on senior notes. This level of coverage is significantly higher than in Spanish and Italian NPL transactions rated by Scope, where reserves usually cover around one year of senior costs.

But Irish re-performing transactions will face more long-lasting effects from the Covid-19 outbreak. We anticipate that a significant correction in historically volatile Irish real estate will cause a decline in the collateral value of transactions and an increase in the propensity to default as home equity declines. We also expect delinquencies and defaults will increase following a rise in unemployment. As reported in a recent study published by Scope, the employment outlook for services in Ireland experienced its largest month-over-month declines since 2000.

[1] According to Banking & Payments Federation Ireland

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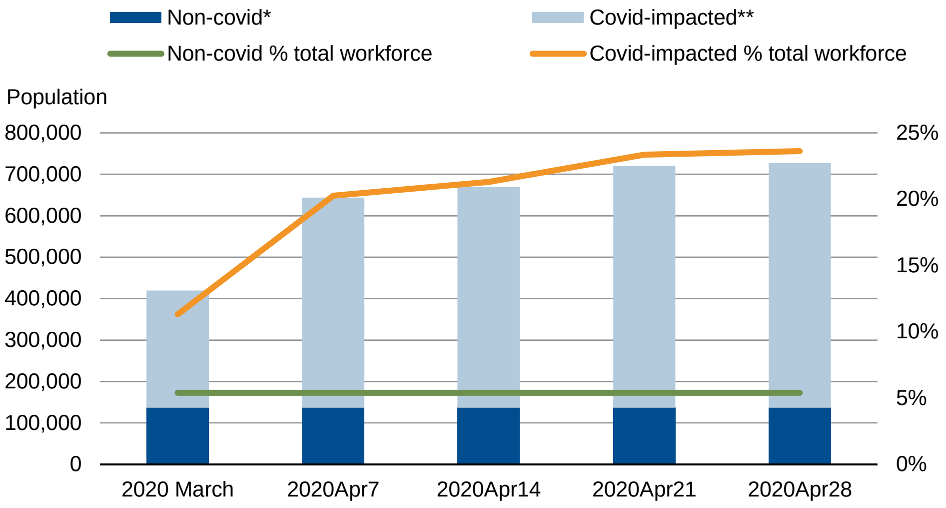
Rising default rates

Scope expects mortgage defaults to rise once State aid measures for Covid-19 are over, following a significant deterioration in job markets.

Figure 1: Ireland's unemployment



Source: Central Statistics Office, Department of Employment Affairs and Social Protection. *as of March 2020.
**People lost their jobs during Covid-19 period and received pandemic unemployment subsidies.

A large portion of Ireland's population has lost their jobs due to the Covid-19 outbreak. People receiving pandemic unemployment subsidies has reached around 24% of the total work force. This number was not reflected in the unemployment calculations as of March (5%) and has not yet stabilised.

We expect an increasing number of financially stressed corporates will translate into a further deterioration in the unemployment rate. State aid has increased liquidity support for businesses. But based on the estimates from the Central Bank of Ireland, it will not be sufficient. Lending support for corporates announced so far is around EUR 1bn (0.3 % of GDP) in Ireland. In comparison, the Central Bank of Ireland estimates liquidity needs for SMEs of between EUR 2.4bn and EUR 5.7bn, depending on the numbers of vulnerable SMEs and their non-personnel expense cuts[2].

We expect a rapid deterioration in mortgage defaults as household income significantly shrinks, especially among re-performing loans. Performance of RMBS transactions in Ireland between 2013-2018 shows that default rates of restructured loans were two to three times higher than default rates of loans that had not previously been restructured (Figure 2 and Figure 3).

2 Central Bank of Ireland, SME liquidity needs during the COVID-19 shock, McGeever, McQuinn, Myers Vol. 2020, No. 2, April 2020

Figure 2: (Re)default likelihood in a year per loan to value bucket

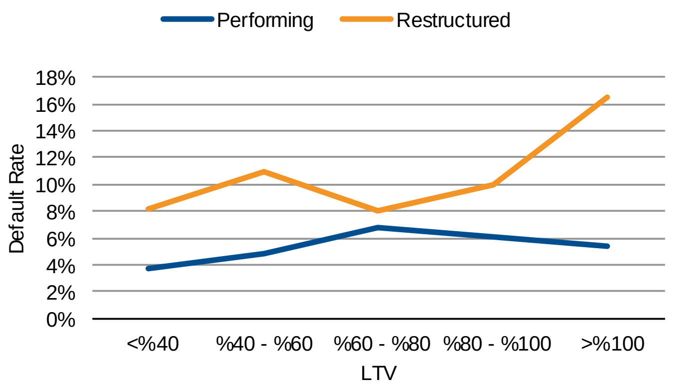
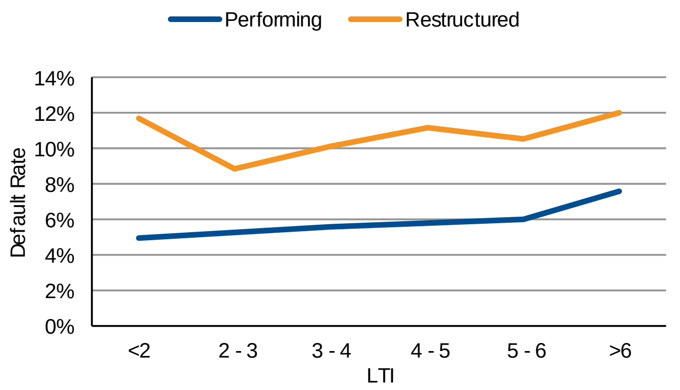


Figure 3: (Re)default likelihood in a year per loan to income bucket



Source: European DataWarehouse and Scope.
Sample includes public Ireland RMBS transactions, with more than 177,000 loans and across 2013-2018.

Property price readjustments will also increase default risk. Restructured loans with negative equity defaulted roughly twice as frequently as those with low LTVs (Figure 2).

However, we believe adequate loan security and good historical payment levels of Irish re-performing RMBS transactions will mitigate the increased credit risks.

The weighted average loan-to-value (LTV) of securitised Irish re-performing pools (60%-65%) is significantly lower than LTV levels of non-performing loan (NPL) transactions in other jurisdictions. The proportion of loans with negative equity is also limited, typically less than 10% of the pool, reflecting positive portfolio selection at closing. By contrast, an average of 35%-70% of loans in Italian NPL transactions rated by Scope contain LTVs of over 100%. Low LTVs incentivise debtors to avoid defaults and also serve as a cushion for recovery rates in the event of adverse movements in property values.

Good repayment track records have contributed to a deleveraging of loans since closing. Ireland’s restructured pools has shown a strong improvement in payment rates in recent years. Scope data shows that payment rates on re-performing loans exceeded 80%, from around 50% in 2013, mainly due to significant loan restructuring and an improvement in macroeconomic conditions.

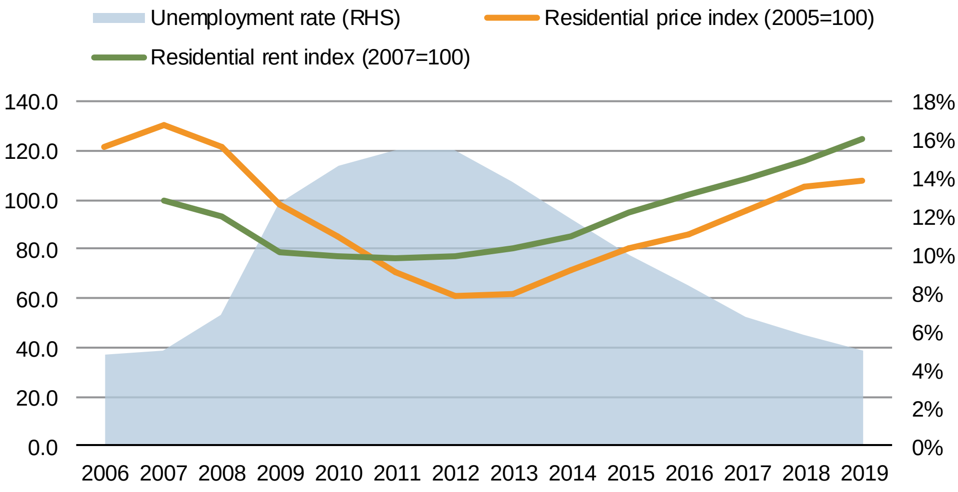
Housing price re-adjustment

We expect a significant correction in the real estate market mainly triggered by a spike in unemployment, as well as by domestic rental controls that put downward pressure on real estate prices.

Ireland’s property market is highly correlated to unemployment (Figure 4). We expect a spike in unemployment rates will impair affordability, translating into a significant property price decrease driven by lower demand.

In addition, the Irish property market has been historically volatile, with sharp price corrections. Figure 4 shows a maximum annual drop of 20% and a top-to bottom drop of 50%.

Figure 4: Ireland's property prices



Source: Banking & Payments Federation Ireland, Central Statistics Office Ireland

Continuing policy controls on rental levels, especially in Dublin, will put additional pressure on property values. Residential rents have strongly increased in the past few years and current rental levels are 10% higher than the historic peak. As Dublin became one of the highest rented residential markets, the government issued a series of rental increase caps in 2018 and 2019. These measures did not succeed, however, so we expect government will introduce further controls.

Recovery values from property disposals will be negatively affected as property prices fall. However, we expect the number of foreclosures on mortgages on primary dwellings will remain limited after Covid-19, as this recovery strategy has been increasingly subject to legal constraints.

Scope expects the increase in defaults will drive another wave of restructuring, increasing recovery timings. We also expect new debt haircuts will decrease lifetime recovery inflows of Irish re-performing loan transactions.

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