MOVING ON FROM THE TERM FUNDING SCHEME

A PROPOSAL FOR THE MUTUAL SECTOR

CONTENTS

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Introduction

The Bank of England Term Funding Scheme (TFS) is scheduled to expire in 2022. How will building societies find substitute finance and minimise margin compression?

Established in August 2016, the TFS provided funding at interest rates close to base rate, which was 0.25% at the time. Lenders could reflect the low cost of funds in their product pricing, bolstering the supply of credit and enhancing (or at least protecting) net interest margin.

The scheme allowed borrowing for up to 4 years and many lenders took advantage accordingly. By February 2018 when the scheme was closed, £127 billion of drawings had been made (Figure 1).

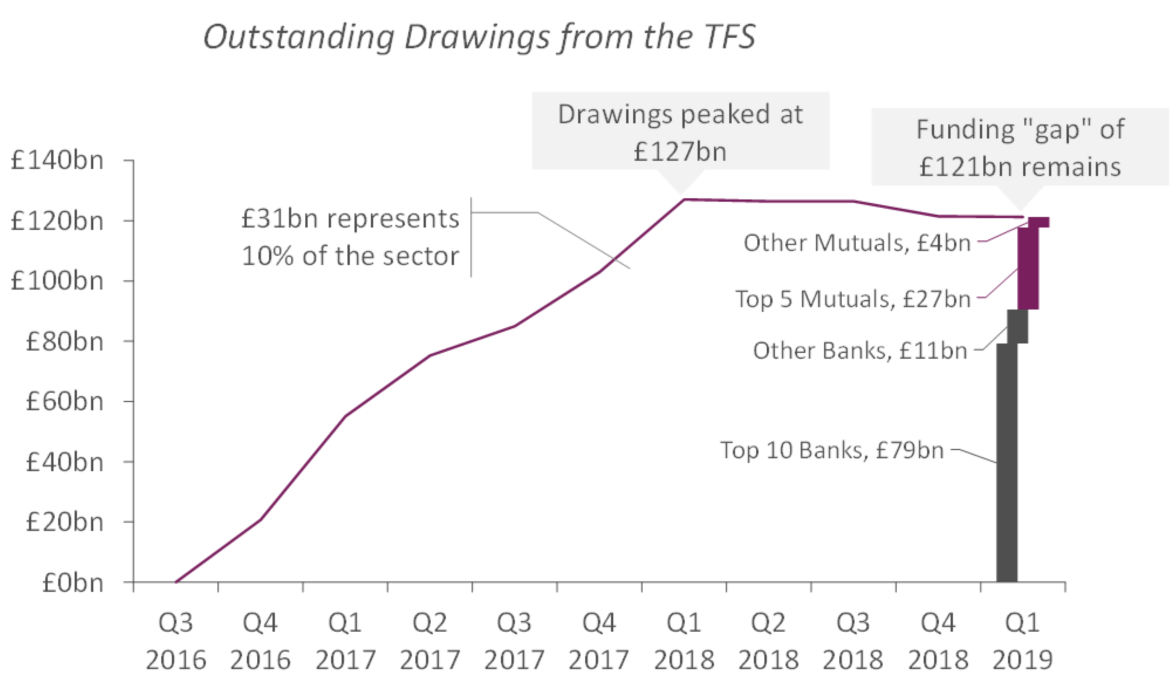
With the expiry of the first drawings rapidly approaching in September 2020 and all funds needing to be repaid by the end of Q1 2022, the hunt is on for a solution that secures the buoyancy and heritage of the mutual sector.

This paper explores the issues in more detail and proposes a potential solution for consideration.

SUMMARY

- The Term Funding Scheme has closed and all drawings need to be repaid by February 2022
- Substitute funding is required to protect the balance sheet and facilitate growth
- Reliance solely on retail deposits may not be viable and could impact earnings
- Access to specialist wholesale funding could prove challenging for many mutuals
- Our proposed solution provides access to covered bonds by pooling resources whilst ring-fencing risk, helping building societies protect earnings and continue to prosper

Figure 1



Source: Computershare analysis of Bank of England data

Substitution Challenges

Abstract:

Lenders who have participated in the TFS have benefited from low cost funding, which has facilitated competitiveness and helped to drive balance sheet growth. Resources now need to be dedicated to securing alternative finance as TFS maturity approaches in order to protect both the balance sheet and members' interests, with margin compression seemingly inevitable. Reliance on increased deposits may not enable complete substitution and is likely to have a notable impact on net interest income. Access to secondary markets could also prove challenging without the specialist skills necessary to structure and manage funding programmes and where sub-scale issuance may not be possible or could be an expensive alternative.

With no major funding initiatives announced by the Bank of England to extend or replace the TFS, it seems unlikely that a policy solution will be forthcoming. Selling assets to eliminate the exposure to the TFS is probably the action of last resort given the costs involved, the potential price discount to the assets to enable the sale and the implications for members, employees and the business. That only really leaves a limited array of traditional funding options for the sector to consider.

1. Retail Funding

Increasing deposits seems likely to be the most popular solution for smaller lenders. Many anticipate this will drive intense competition and result in increased rates for both savings and mortgages. Growth in net deposits will inevitably take time, require increased marketing spend and depend on a number of other uncontrollable factors, not least of which will be the relative appeal of savings to other investment options and the savings ratio in the UK.

Advances in technology also mean customers are far more promiscuous these days, particularly with instant access products, so retention could also prove much more challenging than has been experienced in the relatively benign conditions of the recent past. It seems that an approach that relies purely on substitution of the TFS with growth in deposits therefore carries risk.

When forming a view on the likely success of this strategy, one must also be considerate of the implications on the cost of funds and the net interest margin. The conundrum here appears to be whether there is likely to be sufficient growth in the savings ratio to enable substitution of the TFS with retail deposits alone and whether any increase in savings rates to compete for growth in net inflows can be passed on to mortgage customers to avoid any impact on earnings. Let's consider a worked example.

During 2018, the savings ratio in the UK averaged 4.5% and this is forecast to increase to 6.2% in 2019 and to 8.5% in 2020, a level last seen in 2014 to 2015[i]. During this period, the building society sector saw average annual growth in deposits of around £7bn per annum[ii]. On this basis, it seems there is potential for £14bn to be raised in time for the first spike in TFS repayments towards the end of 2020 and £21bn in time for the second spike towards the end of 2021, assuming normal market competitiveness and a constant share of deposit taking for the mutual sector. This still leaves a "funding gap" of around £10bn in the sector based on the £31bn of TFS still outstanding. And of course, given the scale of the drawings by the banks, the market may not retain normal characteristics and the mutual sector may find it challenging to maintain its share of inflows in the war for deposits.

Moving on from the Term Funding Scheme

A PROPOSAL FOR THE MUTUAL SECTOR

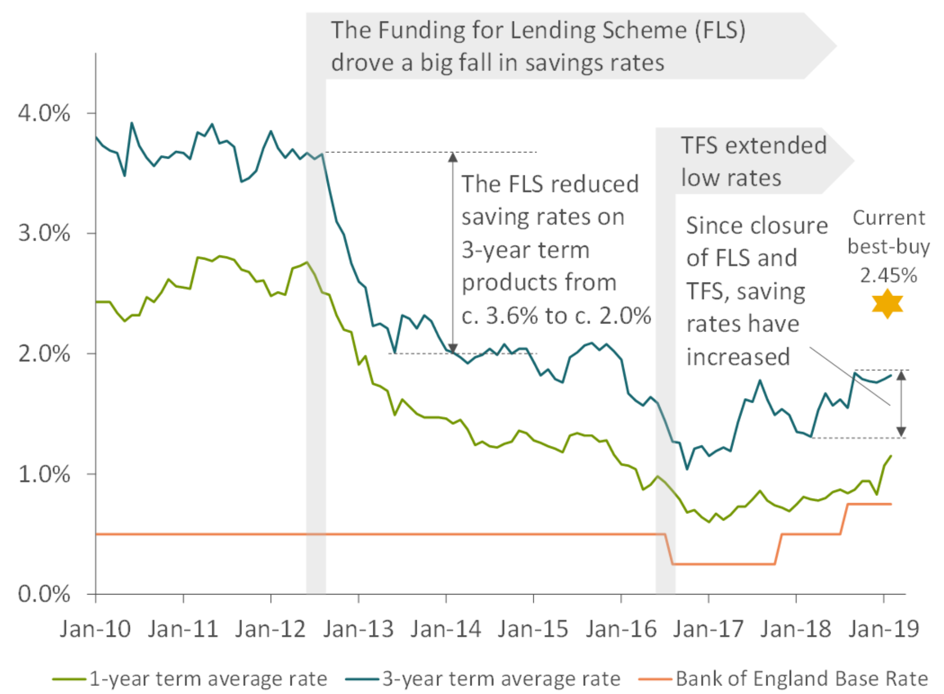
Turning now to the implications on the cost of funds and net interest income. Passing on the full uplift in savings rates to mortgage customers is likely to be challenging. In the wake of recent base rate increases and the growing expectation of further rises, many mortgage customers have selected fixed rate products and there has been a notable shift toward 5-year initial terms. This constrains the ability of lenders to pass on the higher cost of funds to existing customers, save for the population on Standard Variable Rate (SVR) products, which given the current mortgage prisoner debate and the heightened focus on SVR may prove testing to justify.

It seems likely therefore that the majority of the difference would need to be recovered through the pricing of products to new customers. On examination of historic savings rates, the impact of the Funding for Lending Scheme (FLS) and the TFS is clear (Figure 2).

One would think it reasonable to assume savings rates would revert towards pre-FLS levels as TFS maturity looms. All other things being equal, this would be an increase of around 180 basis points from current average.

Figure 2

Changes in average 1-year and 3-year saving rates



Source: Computershare analysis of Bank of England data

With a 5-year fixed rate mortgage at 50% loan-to-value currently priced at around 2.7% by the sector[iii], this would need to increase to 4.5% to maintain net interest income. However, when considering competition from lenders utilising funding from the secondary markets, it is important to understand if this rate would be competitive in order to sustain the balance sheet and drive future growth.

Reversion of spreads of prime AAA rated RMBS to pre-FLS levels would see an increase in the cost of funds of around 90 basis points[iv].

Non-deposit taking lenders are currently pricing 5-year fixed rate mortgages at 50% loan-to-value at around 3.4%[v], so this would need to increase to 4.3% to maintain margin – 20 basis points less than the deposit funded equivalent (assuming no change in reference rates for both). So to remain competitive without pushing the risk curve, societies would need to price below this level, say at 4%. On this basis, net interest income on new lending would be impacted by around 50 basis points, assuming there is no impact of competition for savings (i.e. saving rates simply revert to pre-FLS levels) and that there is a 40 basis point compression in the current 70 basis point spread between mortgages funded by deposit takers versus mortgages funded by non-deposit takers.

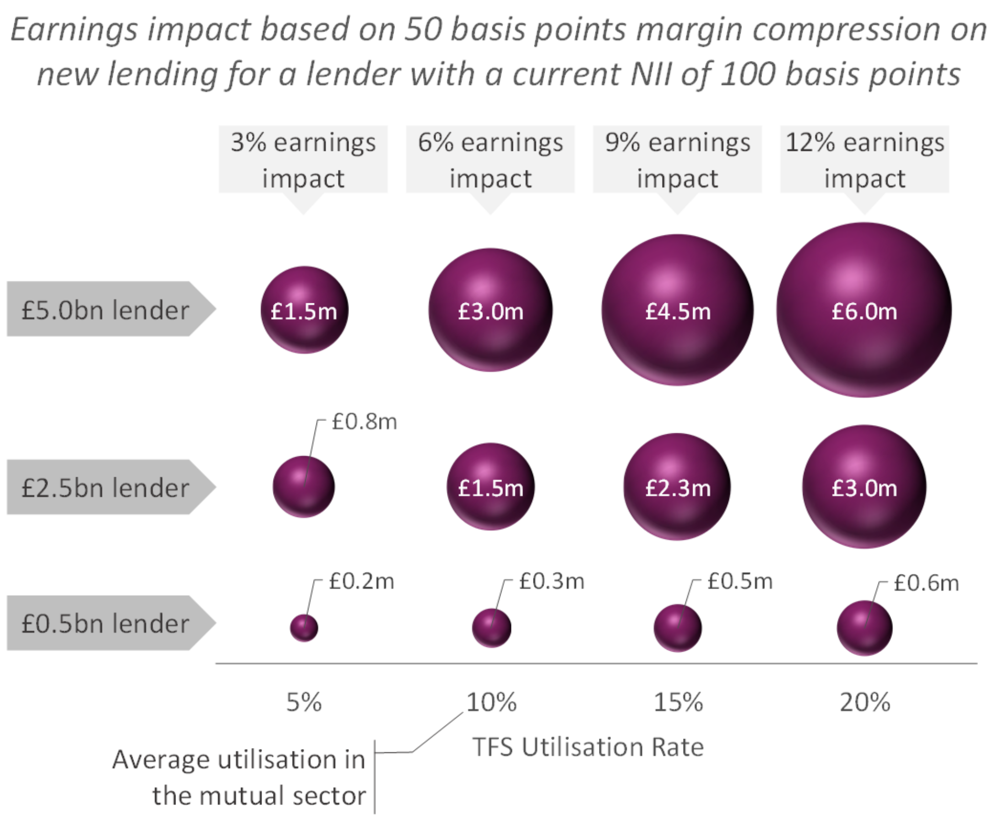
Considering a lender with a current net interest income of 100 basis points, the potential earnings impact of TFS substitution with deposits is represented below (Figure 3).

Implications for earnings will clearly depend on the level of reliance a lender has on the TFS but a deposit growth strategy seems to indicate the impact is likely to be material.

Furthermore, even lenders with no TFS funding are likely to see margin compression simply through competition to retain deposits and in order to deliver growth.

So taking into account both the potential for insufficient savings to fully substitute the TFS and the impact of this approach on earnings, it appears deposits alone are unlikely to cut the mustard and could well prove to be a high risk strategy.

Figure 3



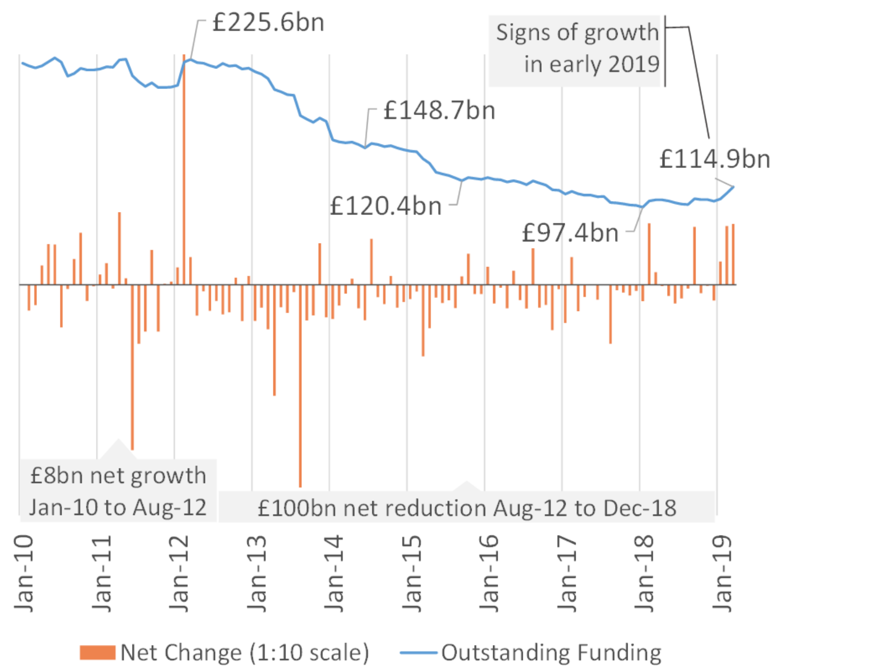
Source: Computershare analysis

2. Wholesale Funding

Wholesale funding markets were also heavily affected by the FLS and the TFS. Both issuance and outstanding funding suffered a nose dive as a result of the quantitative easing programmes, as can be seen by the evolution of covered bonds over the last decade (Figure 4). RMBS markets have followed similar patterns, with issuance dropping from £82.7bn in 2012 to an average of £15.7bn a year since 2012[vi].

Figure 4

Covered bond funding on residential properties in the UK



Source: Computershare analysis of Bank of England data

The secondary markets are expected to be buoyed by the maturity of the TFS, which is likely to see spreads widen towards pre FLS levels as noted earlier. On the expectation that the increase in spreads is likely to be less than the increase in the savings rates (circa 90 basis points c.f. circa 180 basis points), we fully expect lenders to use a blend of retail and wholesale funding to resolve the TFS substitution issue.

However, access to wholesale funding markets requires three key pre-requisites: firstly, treasury and risk management competence to structure and manage the funding programmes; secondly, the scale to enable access to finance at a cost of funds that supports competitiveness in the mortgage market; and finally, capital to deploy to establish and manage the structures. For many smaller societies, these pre-requisites are likely to be out of reach.

Then there is the added challenge of investor expectations. Investors seek lenders who regularly access the securitisation market; who have a track record that enables investors to have a sound understanding of the lender and their assets; and who have the wherewithal to honour their obligations to the securitisation, such as the embedded call options in the deals.

These additional constraints could preclude the small to mid-sized societies from accessing the securitisation markets.

On this basis, whilst the secondary market may well give the answer for those who are able to participate in it, for many mutuals it is unlikely to provide the substitute for the TFS they need. And with the deposit approach also seemingly expensive and risky, this may leave a sub-section of the sector a little stranded and without a clear, deliverable solution in play.

Proposal for Consideration

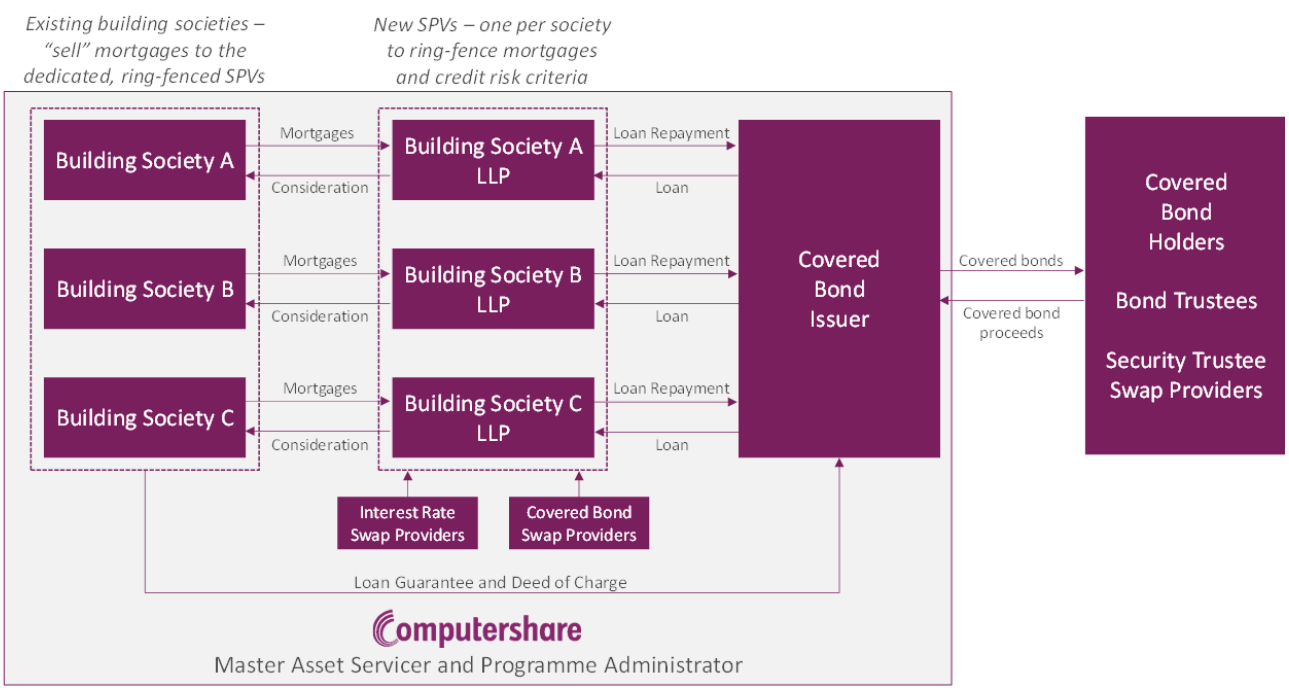
Abstract:

In order to maintain the vibrancy of the mutual sector, a solution to the TFS cliff edge is an important priority. Our proposal is designed for small and mid-sized societies to support their funding needs, both for TFS replacement and to facilitate sustainable growth as the war for deposits materialises. The scheme provides easy, low-cost access to the covered bonds market by pooling resources, whilst ring-fencing risk. With Computershare administering both the scheme and the mortgages, participants will also benefit from reduced operating costs and capital expenditure; ongoing technology investment to facilitate competition in a digital age; and maintenance of compliance in an increasingly challenging regime, enabling increased focus on the customer proposition.

An overview of our proposed model is depicted below:

Figure 5

Proposed structure of a covered bond programme to help resolve the TFS funding gap



From the perspective of each building society participating in the scheme, the programme would be very similar to the covered bond programmes used widely across the mutual and banking sector as loans would be purchased by an LLP exclusive to that building society.

Where our proposed programme starts to differ is that there will be a single issuer which will use the combined scale to reduce funding costs.

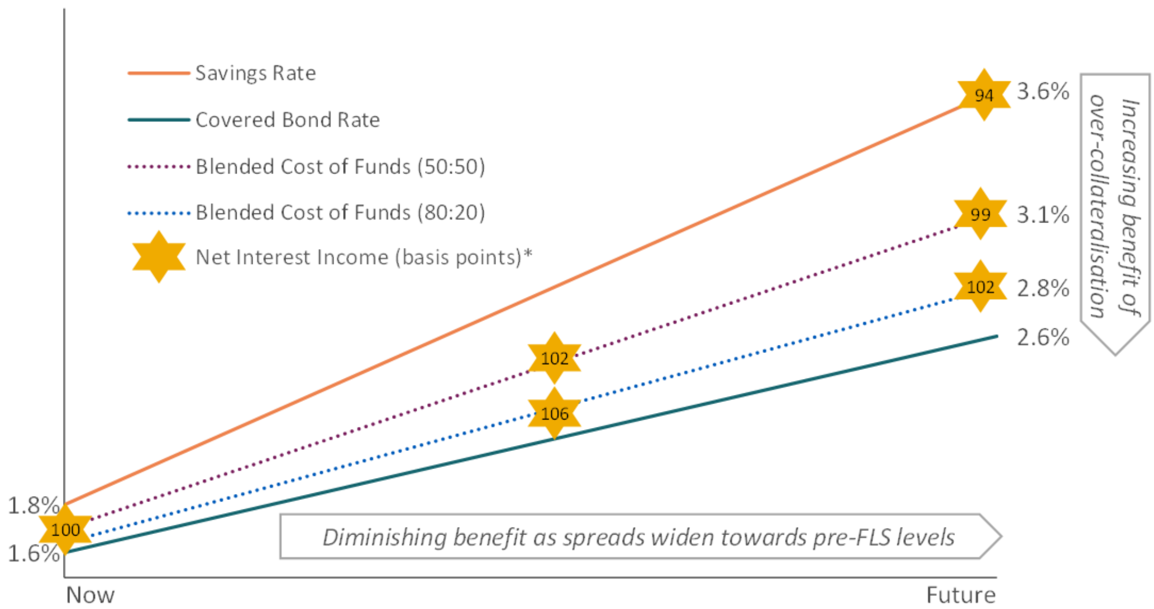
The scheme will operate as follows:

- Computershare will set up the structure of the programme, including the appointment and management of the various partnerships required to facilitate the scheme.
- A new regulated entity will be established to act as the issuer on behalf of the participants.
- Set up costs will be shared amongst the participants, easing the up-front burden compared with segregated programmes.
- Each building society wishing to participate in the scheme will establish an LLP in order to purchase the mortgages from the society.
- There will be no comingling of mortgages between societies, enabling lending criteria and credit risk to be entirely ring-fenced for each society.
- The issuer will loan funds to the LLP in order to purchase the mortgages from the society, with the LLP providing the society with the matching consideration funded by the proceeds from the issuance of the covered bonds to investors.
- Each LLP over-collateralises the secured loan from the issuer to AAA level using established covered bond Asset Coverage Test (ACT) technology.
- The society guarantees the loan from the LLP to the issuer.
- Each society will also receive a membership interest in the LLP which provides the over-collateralisation and deferred consideration to return excess spread to the society.
- To enable robust and efficient operation of the scheme, Computershare will administer the mortgages in each LLP on its servicing platform as a white-labelled service for each society, providing all the necessary data, analytics and reporting to the society.

Let's examine the potential competitive advantage this scheme could achieve for a participant versus a society choosing to go it alone with a retail funding strategy. Per the earlier analysis, should wholesale spreads increase to 1.7%, then with no change in reference rates and a 50:50 wholesale to retail funding strategy, the cost of funds for this strategy would be around 3.1% compared with the savings rate reverting to 3.6%, ignoring the drag of the cost of liquidity on a retail only funding strategy. Applying the assumed mortgage pricing of 4% considered earlier, this 50 basis point advantage translates into an earnings impact of just 1% for a society with 10% FLS funding and a net interest income of 1%, compared with an earnings impact of 6% under a retail only strategy. For a lender with a £2.5bn balance sheet, this advantage equates to £1.2m in earnings per year.

Tilting the balance more towards covered bond substitution further improves the advantage, as well as providing access to new, lower cost funding to facilitate future growth. For example, an 80:20 ratio for TFS substitution could completely eradicate margin compression. This potential outcome gives those participating in the scheme enhanced flexibility, where they can blend the benefit to enhance both members' interests and to compete more effectively on pricing to drive growth. For example, mortgages could be priced at 3.5% rather than 4% and earnings impact would normalise across the two approaches.

Figure 6 *Potential competitive advantage derived from utilising covered bond funding*



* Based on a lender with 100 basis point net interest income, 10% utilisation of TFS and future average mortgage rate of 4% across all funding scenarios

Source: Computershare analysis

In order to maximise the benefit of the scheme, each participant may also wish to consider the following points:

1) Over-collateralisation: selling mortgages in excess of the TFS funding gap into the LLP will help societies minimise the cost of funds and also provides enhanced access to funding from covered bond investors to facilitate sustained growth of the balance sheet. Dilution of the dependency on the retail deposit market will help to minimise margin compression and generate better outcomes for members and customers.

2) Servicing: further to Computershare servicing the LLP mortgages for each participant and on the evidence of servicing performance and clear cost benchmarking analysis, a broader outsource relationship would enable participants to decommission expensive legacy technology; reduce technology and operational spend; remove the burden and expense of maintaining regulatory compliance; move to a consumption-based variable cost model; and benefit from the future investment in the platform, particularly in the development of digital solutions designed to enhance the customer experience and support top-line growth.

We believe there are compelling reasons for the sector to come together to help resolve the TFS cliff edge and that a solution that leverages combined scale and class-leading servicing can deliver great benefit for building societies and the communities they serve.

We are open to discussions on our proposal and would welcome working with a group of societies to help form the solution. With spreads widening in the market, we hope to progress this initiative at pace to allow participants to secure the lowest possible cost of funds before spreads revert to pre-FLS levels.

Concluding Thoughts

We see a vibrant mutual sector as an important part of UK society, not only to promote competition and stability in the market but also to serve the needs of communities who often have increasingly complex financial circumstances and require diverse or flexible products.

The TFS helped to provide building societies with the affordable funding to do this but its closure means substitute finance from other sources is now necessary. Faced with strict capital requirements and high entry costs, mutuals utilising the TFS would appear to have a tough challenge to overcome.

Our analysis suggests that lenders will have to substitute the TFS with a blend of retail and wholesale funding.

Whilst margin compression seems inevitable, there are opportunities to minimise the impact by thinking strategically about the options available and by working together across the sector to enable access to wholesale markets for small and mid-sized building societies.

Those that elect to participate in a viable alternative to a pure-retail play are likely to deliver competitive advantage through a combination of lower cost of funds and operational efficiency, securing future growth opportunities more readily than those who don't.

Our proposed solution provides the sector with a mechanism that delivers benefit for consumers, for members and for society.

Andrew Freeley
Chief Commercial Officer, Computershare Loan Services

Andrew leads Computershare's commercial division in its loan services business and is responsible for strategy; business and proposition development; and marketing. With 20 years' experience in financial services and having worked previously for UK Asset Resolution, Old Mutual and Ernst & Young, he has experience of working with a range of major institutions with respect to funding, investment, M&A, capital markets and banking.

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[i] www.tradingeconomics.com, Office of National Statistics
[ii] BSA and Bank of England
[iii] Money Saving Expert, May 2019
[iv] Institutional Investment Advisors Limited, Prime RMBS October 2012
[v] Money Saving Expert, May 2019
[vi] www.structuredcreditinvestor.com

Founded in 1978, Computershare is a global leader in financial administration, renowned for its expertise in high integrity data management, high volume transaction processing and reconciliations, payments and stakeholder engagement. Many of the world's leading organisations use us to streamline and maximise the value of relationships with their investors, employees, creditors and customers. We are represented in all major financial markets and have over 12,000 employees worldwide.

Computershare Loan Services is a leading international third-party mortgage service provider. We currently administer over £100 billion of assets globally and support over a million customers through the lifecycle of their loans. We apply our expertise, experience and advanced technology to provide insight and a variety of mortgage services, including loan administration and the management of large volumes of complex data, to help mortgage lenders and investors optimise the performance of their portfolios within a highly regulated environment.

With our scale, experience, capability and breadth of clients across building societies, banks, insurers, funds and investment banks, we have long-standing and deep industry expertise. Our extensive capital markets experience and our partnerships with many of the leading global banks and investment firms enables us to bring unique, high quality solutions to the market. Our clients employ a range of funding strategies including retail savings, asset-backed securities and debt securities across their portfolios and we provide tailored servicing solutions to enable the best return on those strategies. We are also the largest provider of standby servicing for residential mortgage-backed securities in the UK.

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