Mortgage finance: interim analysis

July 2008

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LETTER TO THE CHANCELLOR OF THE EXCHEQUER

The Rt Hon Alistair Darling MP

Chancellor of the Exchequer

Dear Chancellor,

In April of this year, you asked me to review what market-led initiatives might be necessary to improve the functioning of secondary and primary markets in UK mortgage-backed securities (Residential Mortgage Backed Securities and covered bonds), in the context of the recent and ongoing disruption in global financial markets.

Since beginning this work I have held extensive consultations with a wide range of mortgage industry experts and practitioners. I have drawn on the experience of more than 30 different organisations, including the largest UK mortgage lenders, as well as a representative range of banks, building societies, specialist lenders, investment firms, mortgage brokers and trade associations. I have also benefited from consultation with other market commentators and with international participants, and have engaged closely with the Treasury, the Bank of England and the Financial Services Authority. I am very grateful to all concerned for their time and expertise.

In the early years of this century, mortgage-backed securities markets grew very rapidly and became a very important source of funding for UK mortgage lenders. So much so that by 2006 such funding equated to around two thirds of net new mortgage lending in the UK. By the end of 2007 the total amount outstanding of UK mortgage-backed securities was £257bn as compared with total residential mortgages of £1200bn. Investors in such securities were principally attracted by their liquidity and intrinsically low risk of default and years of unprecedented innovation in financial markets and apparently rapidly increasing liquidity resulted in explosive growth in demand. The major investors were banks, their off balance sheet vehicles and money market funds. By far the greatest demand came from outside the UK.

In July 2007, when credit markets faced a sudden and significant re-pricing of risk, new issuance in these markets came to an abrupt halt. One year later, trading in the secondary markets continues to be on much wider interest rate spreads than was hitherto the case. In time these markets will stage some sort of recovery but I am firmly of the opinion that in the foreseeable future, there will be very little new issuance of UK mortgage-backed securities. Banks' off balance sheet vehicles are in decline and given the volatility experienced in the last year they themselves can no longer afford to regard mortgage-backed paper as suitable for much sought after liquidity. Equally, it will be some considerable time before money market investors from outside the UK have sufficient confidence to return to our market.

Such a major source of funding for UK mortgages will not be replaced quickly, certainly not in current market conditions. The combination of new capital adequacy rules (Basel II) and the 'mark-to-market' disciplines introduced in recent years under new International Accounting Standards will force banks to operate with less leverage in their balance sheets. Recent months have seen major capital raising exercises but significant 'mark-to-market' adjustments and increasing credit losses mean that the adjustment to lower leverage will take years rather than months.

In the meantime, banks are competing aggressively for savings but with consumers' disposable income now under such pressure from rising prices, I do not believe that this will prompt a surge in aggregate savings flows into banks. Aside from their lack of access to new asset backed funding and despite the beneficial impact of the Bank of England's Special Liquidity Scheme, banks are struggling to increase the amount or extend the maturity of their wholesale funding. Given that more than half of their existing mortgage-backed borrowings will need to be repaid over the next three years, their capacity to make new mortgage advances therefore looks severely constrained. In my opinion, such a shortage of mortgage finance will persist throughout 2008, 2009 and 2010, and I suspect that current forecasts for net new mortgage lending during this period will prove optimistic, perhaps significantly so.

Mortgage markets are adjusting to the shortage of funding. Lenders are seeking to re-price existing mortgages but this is a slow process which will take two or three years to run its course. This will itself cause an increase in defaults, which are in any case on the increase, if from historically low levels. In time however, I expect that the increase in prices will more than compensate banks for higher credit losses. In the meantime, it is hard to see why banks will increase their currently depressed appetites for risk. While there is still good availability of finance for those borrowers who offer significant security (i.e. have reliable earnings and seek to borrow 75 per cent or less of the value of their property), the availability of finance to all other consumers is considerably reduced and likely to remain so.

A number of lenders have already either withdrawn completely from the market or announced their intention to reduce their lending. So far any corporate restructuring or change of ownership amongst lenders has also resulted in significant reductions in the prospective supply of mortgage finance to consumers. Just as the squeeze is taking its toll of lending institutions so it is damaging distribution. Faced with much lower volumes and lenders switching back to distributing through their branches, mortgage intermediaries, hitherto an important source of price competition on behalf of consumers, are under intense pressure and many will disappear.

It is impossible to separate the effects of a shortage of mortgage finance from a correction in the housing market. Nor can anyone identify its effect on consumer spending with any precision. However, my discussions have identified a broad consensus that such a significant and prolonged shortage of mortgage finance must take its toll of both. That this is indeed the case is most obviously evident from the unprecedented reduction in housing starts we are likely to see this year.

Since, over time, we should expect any shortage of supply of mortgage finance to convert into a shortage of demand, I am looking with some urgency at the full range of options identified by market participants for stimulating the supply. I believe this will best be achieved through the return of significant new issuance of mortgage-backed securities, albeit not necessarily at anything approaching the rate of issuance seen in 2006 and 2007.

Everyone is clear that the UK mortgage-backed securities markets would benefit from greater transparency and standardisation and there are a number of initiatives designed to achieve the required change. While important for the underlying strength of the market, however, I doubt whether, on their own, such initiatives will do much to increase the demand for mortgage-backed securities.

Banks and their trade bodies, notably the Council of Mortgage Lenders and the European Securitisation Forum, are looking at a number of ideas to stimulate the demand for mortgage-backed securities. We will continue to engage closely with them on that work. We are also considering whether other types of action by the authorities, including the possibility of the Government guaranteeing (on commercial terms) the principal and interest on high-grade tranches of new issues of mortgage-backed securities, may still be necessary, taking into account wider Government objectives of supporting financial stability and operating in the long run interest of consumers and the economy as a whole. Much has been said about the case for launching a US-style agency but I think it unlikely that it would be right to tackle this century's problems with last century's solution. In any case it would take far too long to create any such agency.

The final phase of our work, that of evaluating the options for action and their effectiveness, will be pursued with all urgency over the summer months, working closely with interested parties and other countries facing similar challenges. We are therefore progressing in accordance with the timetable you set for our work. Even so, I should stress that I may yet recommend that the Government should not intervene in the market, on the grounds that such intervention would create more problems than it would solve.

James Crosby

29 July 2008

1 Background

Introduction

1.1 The recent period of disruption in global financial markets has had a widespread impact on businesses and consumers around the world. It has also prompted a substantive range of work at both international and UK level to respond to – and ultimately, to benefit from – the changing economic and financial situation.

1.2 In October 2007, G7 Finance Ministers asked the Financial Stability Forum (FSF) to analyse the underlying causes of recent market turbulence and propose appropriate recommendations. In April 2008 the FSF presented its report, *Enhancing Market and Institutional Resilience,* to G7 Finance Ministers, who strongly endorsed the report and committed to rapid implementation.[1]

1.3 The UK consultation document *Financial Stability and depositor protection: further consultation* published in July this year sets out in detail the actions being taken by the Treasury, the Financial Services Authority and the Bank of England to respond to the challenges of globalised financial markets.[2] It also provides an update on the steps being taken to implement the recommendations of the FSF in the UK.

1.4 Mortgage finance markets have been particularly affected by the global market disruption. This has contributed in the UK and elsewhere to higher funding costs for mortgage lenders, and higher prices for or reduced access to finance for many borrowers.

1.5 The Government is working with the mortgage industry on ways to support households during this period of market turbulence. Working with consumer groups, the industry is currently reviewing its voluntary arrangements for supporting borrowers, including steps such as strengthening links with debt advisers, providing updated debt information and proactively identifying at-risk borrowers facing repayment problems. The Government welcomes this approach and wishes to see all lenders meeting these standards. It is also important that lenders continue to fulfil their commitments under statutory regulation to treat their customers fairly and sympathetically, and only to consider repossession as a last resort.

1.6 In April 2008, following the publication of the Treasury's *Housing Finance Review: analysis and proposals*,[3] the Chancellor of the Exchequer asked Sir James Crosby to advise on options to improve the functioning of mortgage finance markets. Strengthening the efficiency of these markets will be to the benefit of consumers and the economy as a whole. This report provides some of the analysis that underpins Sir James Crosby's letter to the Chancellor, dated 29th July.

1.7 Sir James Crosby has held extensive consultations with a wide range of mortgage industry experts and practitioners, including a representative range of banks, building societies, specialist lenders, investment firms, mortgage brokers and trade associations. He has also engaged closely with the Treasury, the Bank of England and the Financial

[1] *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, Financial Stability Forum, April 2008.

[2] *Financial Stability and depositor protection: further consultation,* HM Treasury, Bank of England and FSA, July 2008, http://www.hm-treasury.gov.uk/documents/financial_services/fin_stability/financial_stability_depositor.cfm

[3] *Housing Finance Review: analysis and proposals*, HM Treasury, March 2008, http://www.hm-treasury.gov.uk/budget/budget_08/documents/bud_bud08_housing.cfm

Services Authority. He will continue to work closely with interested parties and other countries facing similar challenges over the summer months.

SECURITISATION MARKETS

1.8 Securitisation markets expanded strongly between 2000 and 2007, driven by investors' search for yield and the increasing ability of issuers to create financial products tailored to individual risk profiles. UK Residential Mortgage Backed Securities (RMBS) and, to a lesser extent (as much newer), covered bonds shared in this growth, with the increase in RMBS and covered bonds outstanding in 2006 equating to around two thirds of net mortgage lending during the year. The investor base in UK mortgage-backed securities, as elsewhere, was primarily banks, structured investment vehicles and money market funds. The majority of these investors were from overseas, with domestic investors accounting for a relatively small proportion of demand.

A period of strong growth in global markets

Strong growth in financial markets in general…

1.9 Until July 2007, the story of financial markets during the first decade of the 21st century was one of remarkable change and extraordinary growth. Financial innovation, global capital market integration, technological change and competition propelled both volumes and complexity to new highs.

1.10 To take just one example; the global foreign exchange market has seen considerable growth in recent years. Average daily turnover of the global traditional foreign exchange market rose to $3.2 trillion in April 2007, an increase of 71 per cent at current exchange rates on 2004 levels.[4]

1.11 The outstanding value of interest rate swaps and other derivatives, meanwhile, reached 11 times that of annual global GDP by end-2007. The global derivatives market grew by over 300 per cent over the course of a decade, and in 2007 alone by almost 50 per cent. Credit default swaps, which equated to 85 per cent of the size of the corporate bond market at end-2004, stood at more than five times the outstanding principle of global corporate bonds by end-2007.[5]

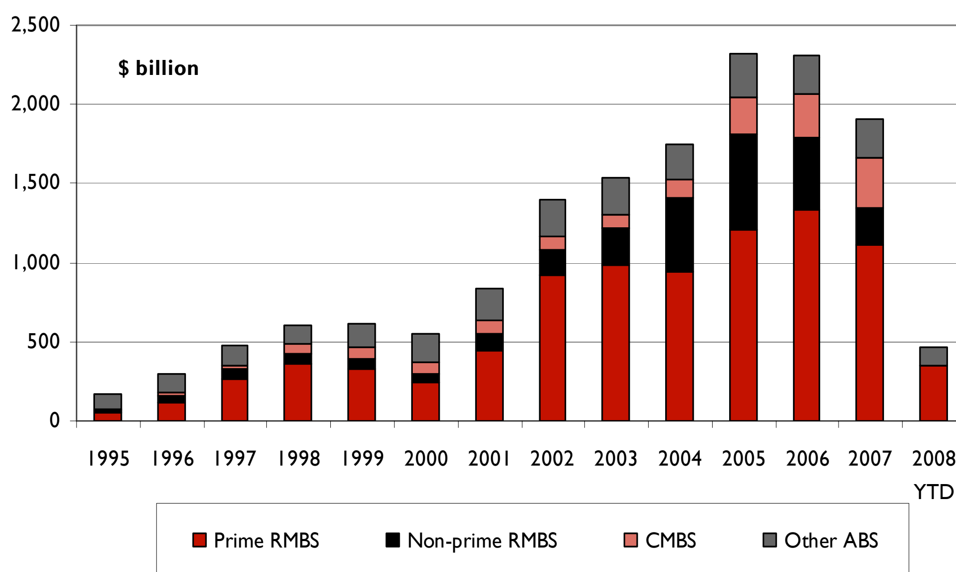
…and in securitisation in particular

1.12 Asset-backed securities (ABS) – debt securities collateralised by pools of assets, most commonly residential or commercial mortgages, credit card payments or car loans – were no exception to this global trend, as Chart 1.1 illustrates with respect to issuance of both RMBS and Commercial Mortgage Backed Securities (CMBS). ABS were particular beneficiaries of the growing ability of financial engineering to tailor products to meet individual risk preferences, and of investor appetite for yield.

[4] *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007,* Bank for International Settlements.

[5] For more examples of the pace of change in recent years, see *Financial Innovation: what have we learnt?* Nigel Jenkinson, Adrian Penalver, Nicholas Vause, Bank of England, Paper for Reserve Bank of Australia Conference on Lessons from the Financial Turmoil of 2007-2008, 14-15 July 2008.

Chart 1.1: Global issuance of asset backed securities



Notes: Full-year issuance, except for 2008 which is to 2008 Q2. 'Other ABS' includes Auto, Credit Card and Student Loan ABS.

Source: Bank of England

The UK RMBS market

1.13 RMBS involve the sale of residential mortgages to a special purpose vehicle, which then issues debt to investors. The debt is redeemed by the cash flows on the underlying pool of mortgages.

Strong expansion in recent years

1.14 Between 2000 and 2007, the total amount outstanding of UK RMBS and covered bonds rose from £13bn to £257bn, with growth in amount outstanding in 2006 alone of £78bn.

1.15 A wide range of factors drove this rapid expansion in the UK, as elsewhere. Investors bought RMBS to pick up the relatively high yield attached to what appeared to be a liquid and low risk instrument, backed by buoyant property markets. RMBS issuance also allowed lenders to diversify their funding risks, increase lending at a faster rate than their retail deposit base would have allowed (particularly important for those institutions without access to a large deposit base), and to do so at potentially at less cost than would have been incurred if funded from other sources.

1.16 The Basel I Accord, which allowed reduced regulatory capital to be held against securitised assets, also played a part in the growth of the RMBS market; so too did the growth in off-balance sheet special purpose vehicles (structured investment vehicles, or SIVs) to hold these assets, as well as issuers' increasing ability to package securities to reflect investor risk appetites.

The covered bond market

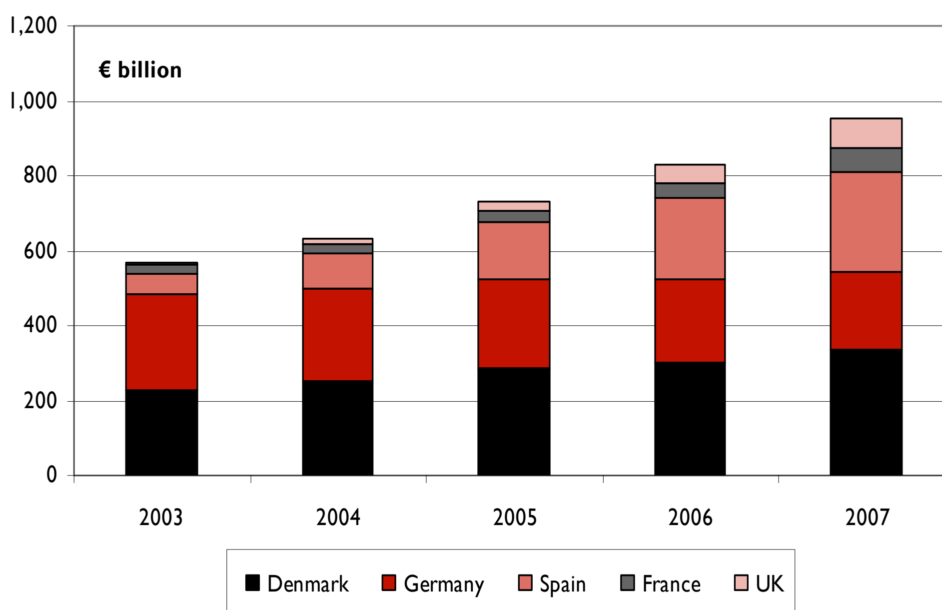
A relatively new market in the UK

1.17 Recent years have also seen a relatively new arrival to the UK securitisation markets, albeit far from 'new' in a broader European context; the covered bond. While also an asset-backed security, there are key differences from both a lender and an investor perspective between covered bonds and RMBS:

- in the case of covered bonds (but not of RMBS), the lender or special purpose vehicle is obliged, when appropriate, to make changes in the pool of assets so as to maintain its credit quality; and
- the investor in a covered bond has a dual credit claim on both the cover pool of assets and the lender, meaning that the lender bears the credit risk first, protecting the bondholder. The RMBS holder typically only has a claim on the special purpose vehicle that issued the bond and is remote from the lender.

1.18 As a relatively new market in the UK, covered bonds have been much less significant than RMBS as a means of funding mortgages. The first UK covered bond was issued in 2003, since when the total value of UK covered bonds outstanding has risen to £56bn compared with RMBS outstanding of £201bn. As is clear from Chart 1.2, covered bonds have been used to a much greater extent in several other European countries (in particular, Germany).

Chart 1.2: Covered bond balances outstanding, major European countries



Note: Data refer to covered bonds backed by mortgages.

Source: European Covered Bond Council

International comparisons

UK RMBS: a major market in Europe

1.19 The UK RMBS market is large relative to both other UK securitisation markets and other European RMBS markets (although not relative to the US). The UK accounted in 2007 for over half of all European RMBS issuance (and for a similar proportion of CMBS issuance). Table 1.1 provides a snapshot of securitisation issuance across the major European markets and the US.

Table 1.1: Comparisons of RMBS and covered bond balances outstanding (2008 Q1)

	€ billion				
	ABS[1]	CDO[2]	CMBS	RMBS	Covered Bonds[3]
Austria	0.9	0.0	0.2	2.3	4.1
Denmark	0.0	5.9	0.0	0.3	335.8
France	6.2	0.8	3.7	14.2	63.6
Germany	26.3	14.0	18.2	5.2	206.5
Ireland	0.0	2.0	0.4	14.5	13.6
Italy	47.7	4.3	3.9	47.8	0.0
Netherlands	2.8	9.1	7.2	104.7	15.7
Spain	15.2	34.2	1.7	108.6	267.0
UK	48.9	7.2	78.8	280.0	82.0
USA	1,570.8[5]		-	4,684.6[6]	12.9
Multinational[4]	7.9	165.9	28.6	2.6	-
Other	11.1	2.0	0.1	36.0	156.3

Source: European Securitisation Forum and European Covered Bond Council

[1] *European ABS issuance includes auto, credit card, leases, loans, receivables and other.*

[2] *European collateralised debt obligations (CDO) issuance includes only euro-denominated issuance regardless of the country of collateral.*

[3] *Data for covered bonds refers to balances outstanding in 2007.*

[4] *Multinational includes all deals in which assets originate from a variety of jurisdictions.*

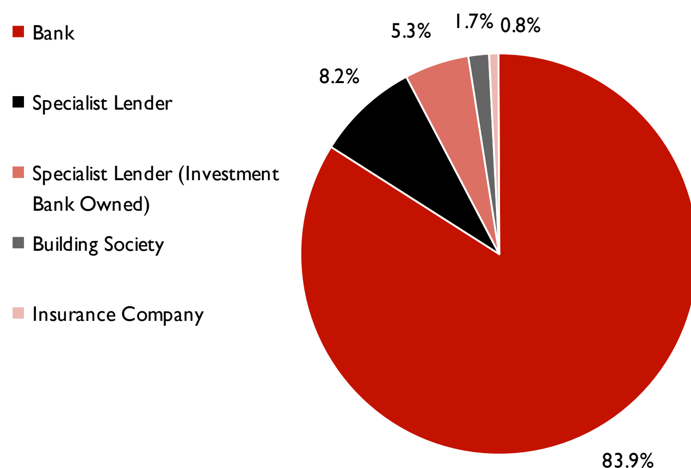
[5] *US ABS issuance includes CDOs, as well as auto, credit card, home equity, student loan, equipment leases, non-jumbo mortgage, and other.*

[6] *82 per cent of the €4,685 outstanding RMBS in the USA is agency RMBS.*

Issuers and investors

RMBS issuers... **1.20** The main issuers of UK RMBS have been retail banks, as Chart 1.3 illustrates, with investment banks, specialist lenders and building societies accounting for smaller volumes of RMBS issuance.

Chart 1.3: Issuers of UK RMBS



Notes: Balances outstanding April 2008. Numbers may not sum to 100 due to rounding.

Source: Financial Services Authority

...and investors **1.21** The investor base for UK RMBS has been relatively undiversified, comprising primarily banks and money market funds (Chart 1.4). These institutions bought RMBS for both their yield and their perceived liquidity, and also repackaged them as collateralised debt obligations (CDOs) and other instruments so as to create products with additional yield.

1.22 The middle of the decade saw very rapid growth in structured investment vehicles (SIVs) and conduits, set up by banks to buy mortgage-backed securities and other instruments, and generally funded through the issuance of commercial paper. In 2007, banks and SIVs are estimated to have bought almost 70 per cent of European RMBS. [6]

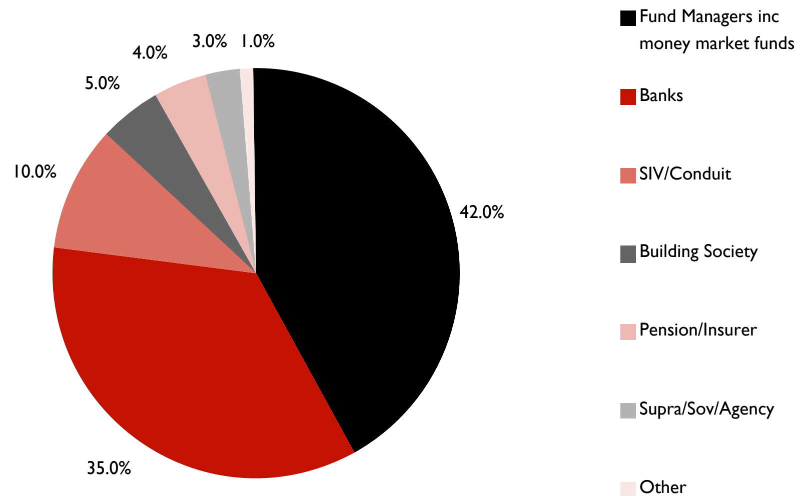
1.23 Also worth noting as a feature of the UK RMBS investor base, and shown in Chart 1.5, is the importance of overseas (and particularly US) demand. If RMBS helped fuel the recent growth in UK mortgages, it was non-UK investors who provided much of the funding. This has also been true of UK covered bonds, and contrasts with other national securitisation markets where domestic investors comprise a larger proportion of the buyer base.

1.24 The investor base in UK RMBS included a large proportion of SIVs and bank conduits. As noted later in the report, these investors are unlikely to rejoin the market in the future. Money market funds, meanwhile, which featured prominently in the

[6] Data from Merrill Lynch.

overseas investor base, have – along with other types of investors – withdrawn from the market for a wide range of reasons, among them a considerably reduced appetite for mortgage-backed bonds in the wake of the US sub-prime problems.

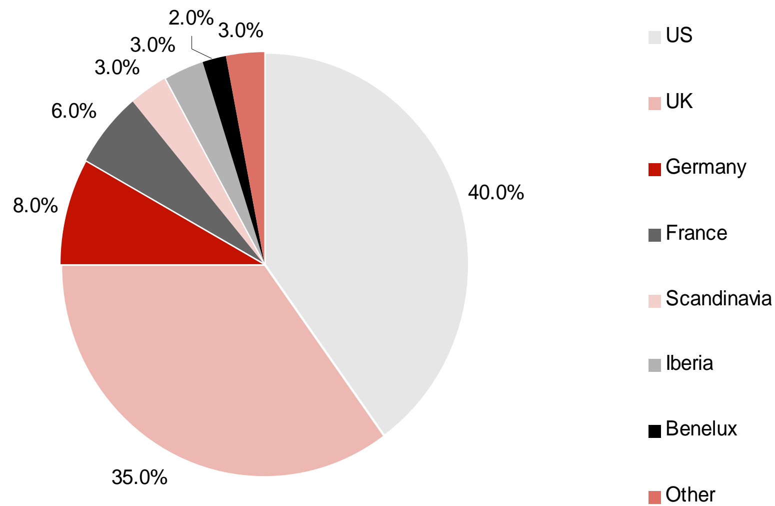
Chart 1.4: Investors in UK RMBS, by institution type



Notes: Based on UK public and prime RMBS transactions greater than £1bn between 2004 and 2006. Numbers may not sum to 100 due to rounding.

Source: JPMorgan

Chart 1.5: Investors in UK RMBS, by country



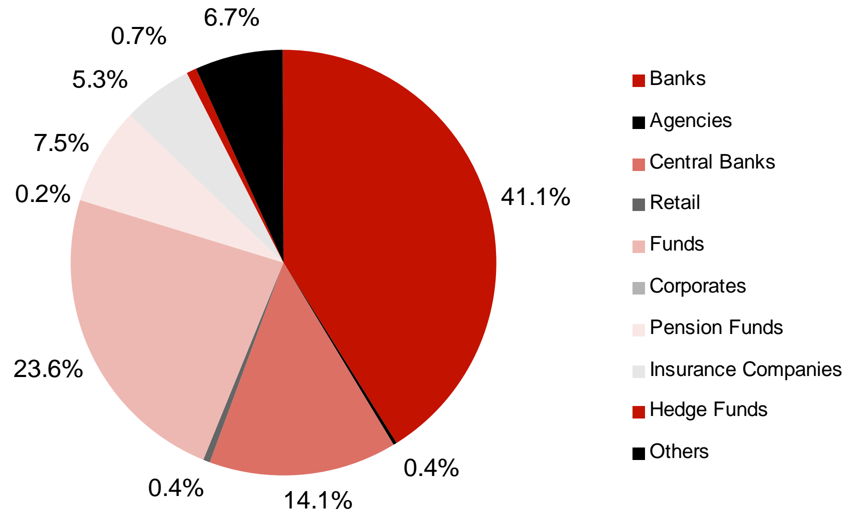
Notes: Based on UK public and prime RMBS transactions greater than £1bn between 2004 and 2006 . Numbers may not sum to 100 due to rounding.

Source: JPMorgan

Covered bond issuers... **1.25** Within the nascent UK covered bond market, debt has been issued primarily by retail banks (responsible for almost two thirds of issuance to April 2008), and some building societies.

...and investors **1.26** The investor base, meanwhile, has been banks and money market funds, as well as a range of investors interested in lower risk products, including central banks and pension and insurance companies (Chart 1.6). As Chart 1.7 illustrates, around a quarter of investors in UK covered bonds have been domestic, with the rest coming primarily from elsewhere in Europe (in particular, Germany and Austria). An investor base that includes a large proportion of overseas investors brings valuable diversification benefits. It also, however, entails a risk that investor perceptions and demand may be affected by factors not directly related to market fundamentals; weakness in the US housing market, for example, might affect US investor demand for, and confidence in, mortgage-backed securities in non-US markets.

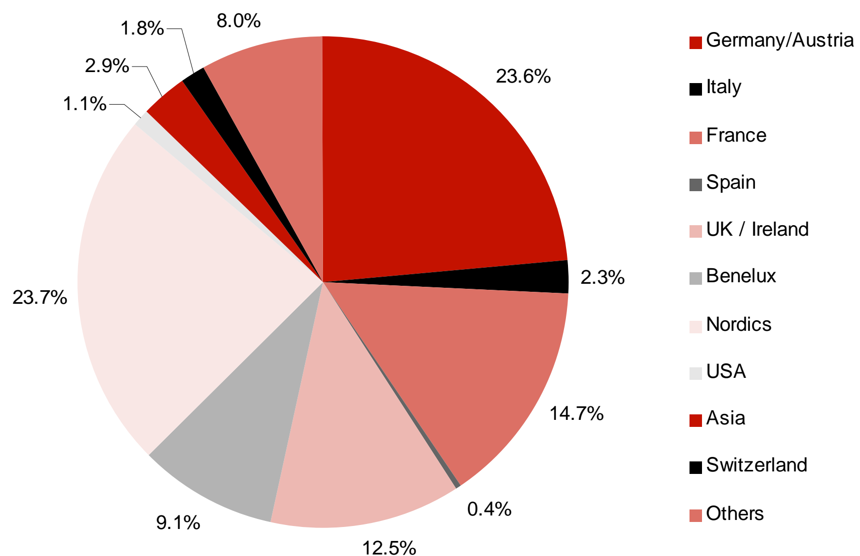
Chart 1.6: Investors in UK covered bonds, by institution type



Notes: Issuance between 2006 and 2007. Numbers may not sum to 100 due to rounding.

Source: Merrill Lynch

Chart 1.7: Investors in UK covered bonds, by country



Notes: Issuance between 2006 and 2007. Numbers may not sum to 100 due to rounding.

Source: Merrill Lynch

2 The Global Context

2.1 Last summer, credit markets around the world began to face a sudden and significant re-pricing of risk in the wake of the problems experienced in the US housing market. This necessary reassessment is part of a wider market adjustment following a boom in securitisation and the highly leveraged activity of the earlier part of the decade. The dynamics of this adjustment process are, however, being shaped by several factors that may exacerbate its economic consequences.

2.2 This chapter sets out recent developments in the global economy and financial markets around the world, including securitisation markets, which have been particularly affected by the recent market turbulence. Chapter 3 focuses on current conditions in UK securitisation markets.

GLOBAL DEVELOPMENTS

Economic...

A deteriorating global backdrop

2.3 Prospects for the world economy have continued to deteriorate in recent months as the disruption in global financial markets has begun to feed through to real economic activity. GDP growth data for the first quarter of 2008 were stronger than expected in many advanced economies, and have remained robust in emerging markets, resulting in a slight upward revision in the average of independent forecasts for growth in 2008.

2.4 Against this, however, business and consumer survey data have continued to fall, and labour markets are showing signs of weakening. The US housing market remains depressed, with nationwide housing prices falling for the first time ever; housing activity in some other advanced economies, including the UK, has also started to decline. The most recent *Euro Area Bank Lending Survey*, for example, reported a combination of an ongoing tightening in credit standards for loans for house purchase, and falling demand for such loans in the face of deteriorating consumer confidence and housing market prospects.[1]

2.5 Recent sharp increases in inflation in a number of countries have made the economic environment even more challenging, and concerns that the current slowdown may prove to be more protracted than previously expected have been reflected in reductions in the average of independent forecasts for economic growth in 2009.

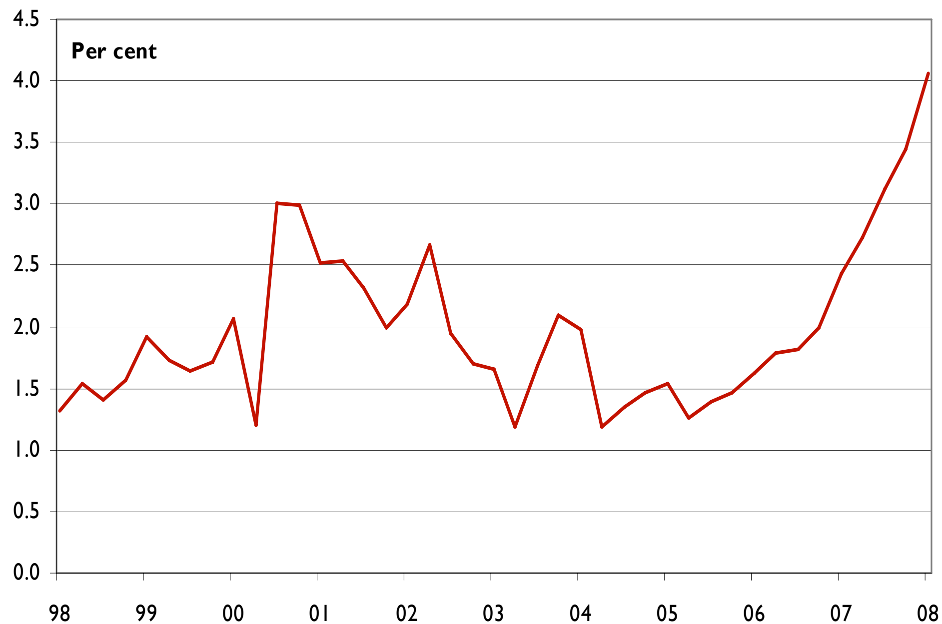
...and financial

A US trigger...

2.6 Rising delinquencies on US sub-prime mortgages in the second half of 2007 triggered global financial disruption. As shown in Chart 2.1, US sub-prime foreclosure rates began to rise sharply in 2006. Over the following year, concerns grew over the implications for lending institutions, and the impact of US financial markets rippled quickly around the world.

[1] *Euro Area Bank Lending Survey*, European Central Bank, April 2008, http://www.ecb.int/stats/pdf/blssurvey_200802.pdf

Chart 2.1: US sub-prime mortgage foreclosure rates



Source: Bank of England

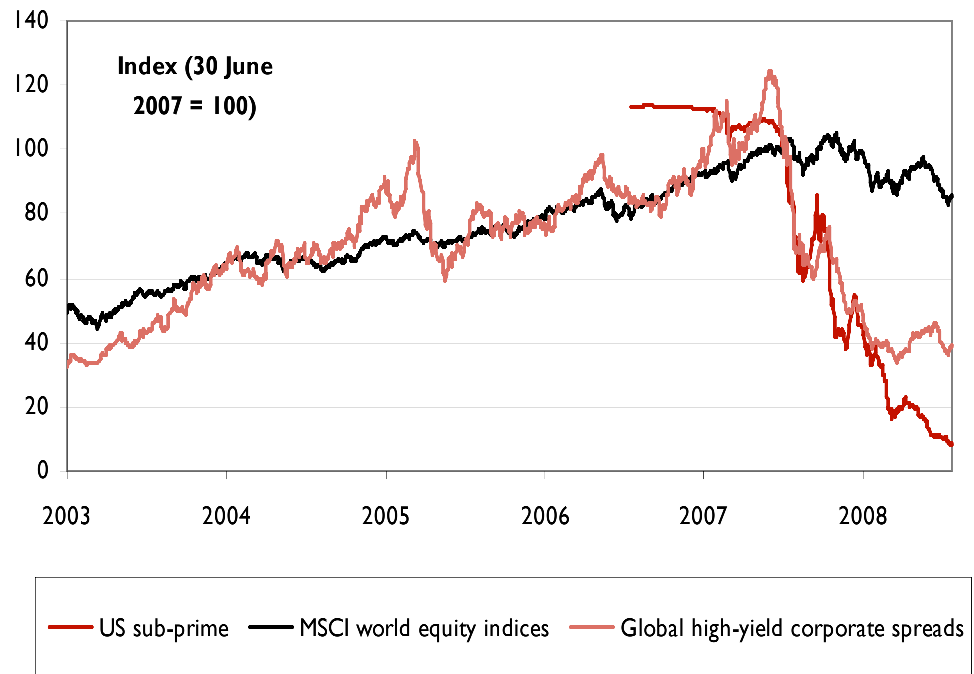
...for a global re-pricing of risk

2.7 One consequence of the sub-prime shock has been an ongoing re-pricing of risk (Chart 2.2); a correction in asset prices following a sustained period of mis-pricing, though an adjustment exacerbated by financial institutions' uncertainty about both their own capital and funding positions, and those of their counterparties. A very rapid decline in liquidity across a range of asset classes was the result.

2.8 Capital ratios of financial institutions came under pressure from a number of directions, including the impact of large write-downs on assets and capital, and the need to stand behind and provide capital backing for previously off-balance sheet SIVs and conduits.

2.9 Funding pressures, meanwhile, reflected the sudden drying-up of access to the securitisation markets (described below). The closure of this pipeline was exacerbated – in the context of a frozen commercial paper market – by the simultaneous need to provide support for SIVs and conduits.

Chart 2.2: Asset prices during the recent market turbulence (indexed to June 2007=100)



Notes: Global high-yield corporate spreads series inverted. Sub-prime series is the A-rated 2006 H2 vintage ABX.HE index.

Source: Bank of England

GLOBAL SECURITISATION MARKETS

Primary issuance

Sharp falls in issuance…

2.10 Within securitisation markets around the world, both primary issuance and secondary market volumes have fallen significantly. EU securitisation issuance in the first quarter of this year fell 69 per cent from Q1 2007; a substantial decline, albeit one from very high levels.[2]

2.11 Over the same period US issuance fell 62 per cent year-on-year. According to US market surveys conducted at the beginning of this year, US market participants expect that securitisation issuance will continue to fall over 2008.[3]

[2] Data provided by European Securitisation Forum.

[3] *American Securitization Forum 2008 Pre-Event survey*, American Securitization Forum, January 2008 http://www.americansecuritization.com/uploadedfiles/ASF2008PreEventSurvey.pdf

2.12 The constrained ability of banks to access wholesale funding markets via public placement has had an effect on both the amounts that banks are willing to lend and their lending margins. The Euro Area Bank Lending Survey referred to earlier (and conducted in April of this year) noted that banks expected that the impact of current difficulties in securitisation markets would have an increased impact on lending volumes and margins during the second quarter of 2008.[4]

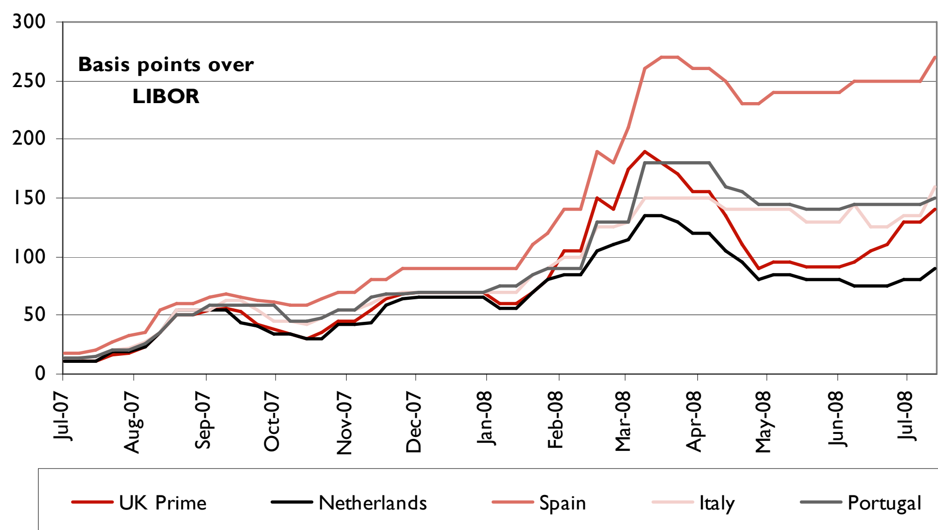
...and most retained

2.13 In Europe, most of the new issuance of recent months has been structured and retained as a means of accessing liquidity via the central bank. Market estimates suggest that 95-98 per cent of Euro area RMBS issuance over the year to date has been retained for use in repurchase operations with the European Central Bank.[5]

Secondary markets

2.14 As Chart 2.3 demonstrates, RMBS across Europe have traded at very high credit spreads since last summer's market turbulence. These spreads reflect pricing in secondary markets in the absence of primary market trading.

Chart 2.3: International comparisons of AAA-rated RMBS spreads

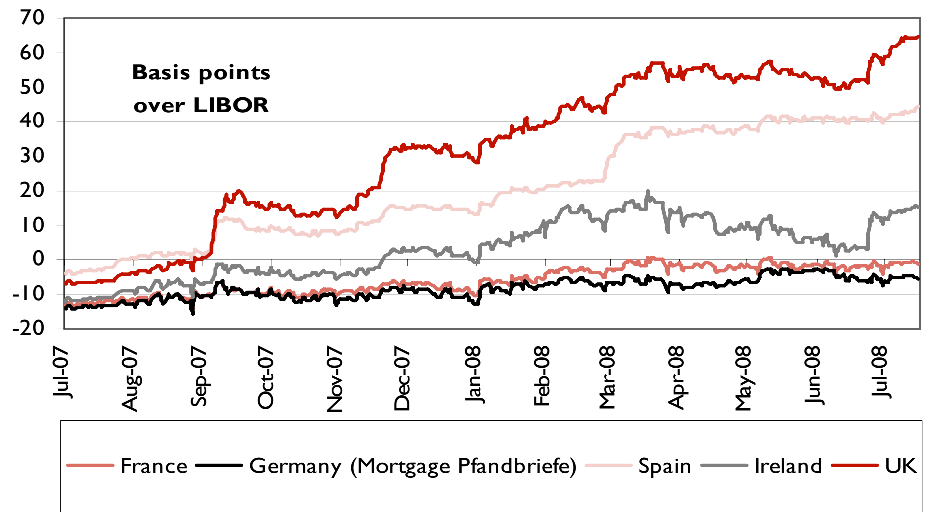


Source: UBS

[4] *Euro Area Bank Lending Survey*, European Central Bank, April 2008, http://www.ecb.int/stats/pdf/blssurvey_200802.pdf.

[5] UBS and Deutsche Bank estimates.

Chart 2.4: International comparisons of covered bond spreads



Source: Deutsche Bank

2.15 As is clear from Charts 2.3 and 2.4, UK securitisation markets have been strongly affected by recent global developments. Chapter 3 explores current conditions in the UK RMBS and covered bond markets in more detail.

3 CURRENT UK MARKET CONDITIONS

3.1 With the largest RMBS market outside the US, the UK inevitably shared in the global collapse in securitisation activity outlined in Chapter 2. New issuance of UK RMBS fell steeply through the second half of 2007 and has remained at very low levels in 2008.

3.2 While the trigger behind the global market downturn may have been rising delinquencies on US sub-prime mortgages, the correction is part of a general reappraisal of risk following the sustained period of mis-pricing that accompanied and fuelled the explosion in structured finance. That such a correction is necessary is clear. The question is whether the dynamics of the adjustment process are being shaped by market factors that are exacerbating its economic consequences, and whether – if so – those factors can be addressed.

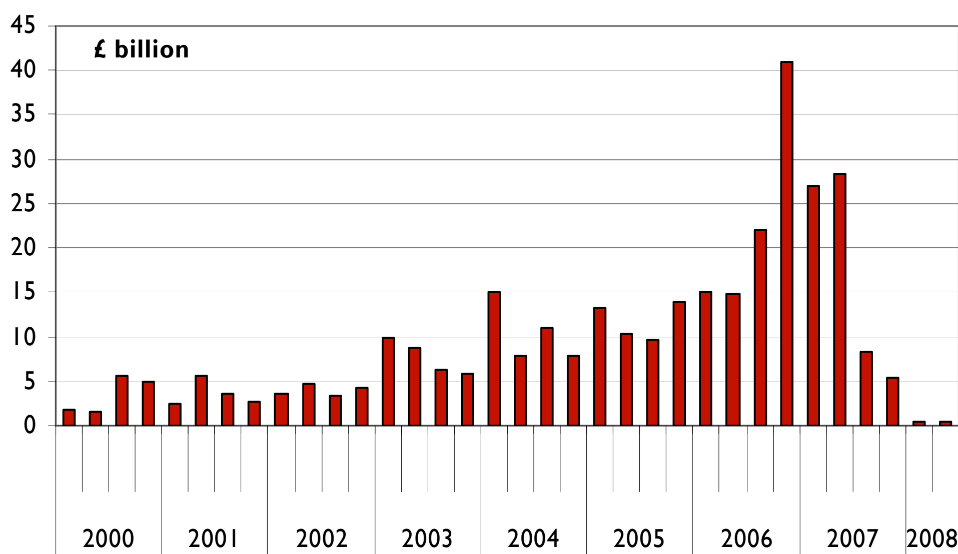
3.3 This Chapter describes current conditions in the UK RMBS market. Chapters 4 and 5 respectively then consider the implications of a closed securitisation market, and proposals for facilitating the adjustment process that may strengthen market efficiency and benefit consumers.

RECENT DEVELOPMENTS

Primary issuance

3.4 The extent to which the UK has shared in the global market implosion described in Chapter 2, is evident in Chart 3.1. New issuance of UK RMBS fell steeply through the second half of 2007 and has remained at very low levels in 2008.

Chart 3.1: UK RMBS issuance



Source: Bank of England

Notes: Data includes public issuance only. Based on deals where the issuing entity is from the UK.

Retained issuance

3.5 In the UK , as in Europe, the majority of new issuance of recent months has been retained by the issuing banks. Industry estimates suggest that the bulk of UK RMBS issuance has been retained,[1] with only one prime issuance of £500m in May this year - the first public sale of new prime mortgage - backed bonds since last summer - being publicly placed. There have as yet been no indications of other banks intending to follow suit. In terms of public placements, the covered bond market remains similarly effectively closed to new issuance.

The Special Liquidity Scheme

3.6 In April this year, the Bank of England introduced its Special Liquidity Scheme (SLS). The SLS is important in providing eligible banks and building societies with liquidity in return for mortgage-backed and other securities, and in helping to increase confidence in the financial system.[2]

Secondary markets

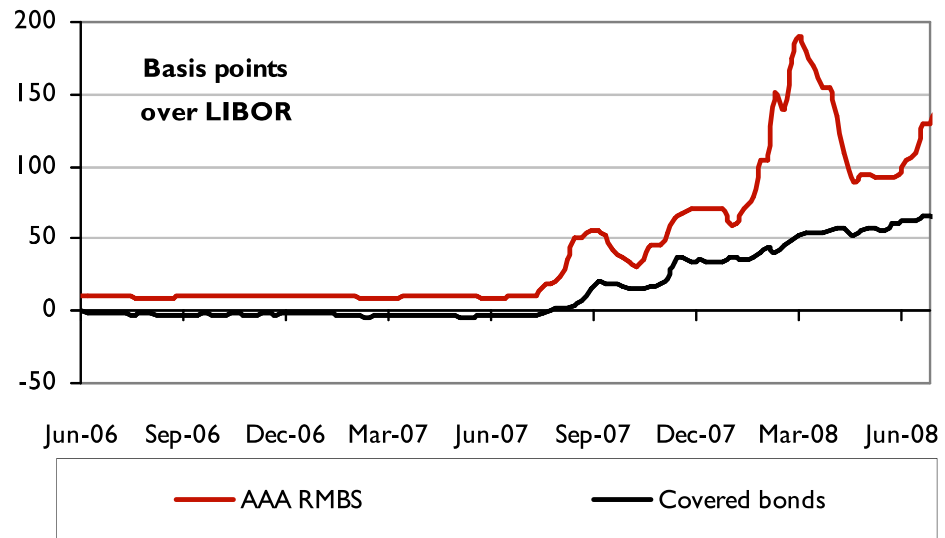
Continuing high spreads

3.7 Within thin secondary markets, UK AAA-rated mortgage-backed bonds continue to trade at very high spreads compared with a year ago (as shown by Chart 3.2). The near absence of new public issuance in these markets reflects in part the fact that, at such spreads, these instruments do not necessarily constitute economic funding tools for new mortgages.

[1] UBS estimates.

[2] Further information about the SLS can be found on the Bank of England website, http://www.bankofengland.co.uk/markets/sls/index.htm

Chart 3.2: UK AAA-rated RMBS and covered bond spreads



Source: UBS

ABSENT INVESTORS

An implosion in investor demand

3.8 The current low volumes and wide spreads in secondary markets attest to markets that were neither as deep nor as liquid as was perceived to be the case. The correction is part of a reappraisal of risk; a reaction to the mis-pricing that accompanied and fuelled the explosion in structured finance.

3.9 The scale of the recent collapse in demand, and the evaporation of market liquidity, reflect the disappearance of a substantial section of the previous investor base, and a marked reluctance to engage on the part of those investors that do remain. The result is an absence of "natural" investors in mortgage-backed bonds.

Some investors have disappeared…

3.10 The highly leveraged SIVs and conduits that played such a central role in the securitisation boom have made significant losses. Banks are unlikely to recreate new vehicles of this type quickly, and regulators, shareholders and investors are unlikely to take such a benign view of their off-balance sheet status as before.

…others are keeping to the sidelines

3.11 Banks and money market funds, meanwhile, are reluctant to buy the assets they once regarded as liquid, now that the dominant characteristic of these assets has become their lack of liquidity.

3.12 That there is perceived to be a large number of reluctant holders of RMBS is also of concern to investors, implying a potentially sizeable overhang of securities to be sold into the market as and when spreads narrow, and a risk that any price rally might be short-lived. Even where longer-term fund managers see value in current RMBS,

therefore, concerns over forced sales and hence lower prices further down the line may mean that there is little incentive to buy.

Contributing factors

Exacerbating influences

3.13 A number of features of the markets themselves – either revealed or exacerbated by the downturn – have contributed to the duration of that downturn. These include:

- a lack of transparency coupled with the complexity of some mortgage-backed products and structures. Efficient markets for risk depend on transparent information; investors too often failed to understand not only the details of highly complex products, but also the extent to which risk was inter-linked with developments in other assets and markets, as well as in the broader economy;
- an absence of standardisation, contributing to the lack of depth in the market (a factor revealed all too late as the tide of investor enthusiasm went out);
- negative perceptions about investing in mortgage backed securities, in the light of developments in the US housing market. US investors formed an important part of the investor base in UK RMBS, and their views of their domestic market may naturally influence their perception of UK fundamentals;
- concerns about the integrity of securitisation models; in particular, the US originate-to-distribute model, and the misalignment of incentives that saw the provision of sub-prime mortgages to households that were unable to repay. In the UK, lenders typically retain an economic interest in a securitisation by holding some of the first loss; but even where this is the case, this may not be well understood by investors, and the retained exposure may be hedged;
- a high level of uncertainty about the value of the collateral backing mortgage-backed bonds and about underlying economic fundamentals, making it difficult for investors to value the bonds. Concern over a deterioration in fundamentals is highlighted in ABS investor survey responses;[3]
- uncertainty about the health of financial institutions, being addressed by the significant capital raising currently underway. While these concerns persist, financial institutions will continue to be wary of engaging in transactions. The fear of potential counterparty risk makes market participants even more risk-averse and unwilling to re-enter the market;
- a lack of clarity with respect to the future approach of credit rating agencies towards structured finance, in a context where reliance on rating agencies for information had been paramount; and

[3] JPMorgan European ABS Confidence Index, June 2008

- nervousness generated by possible mark-to-market fluctuations in value. In the absence of a fully functioning market, and even where institutional investors take a long-term view and are willing to hold instruments to maturity, concerns about performance assessments made on a short term, mark-to-market basis may deter them from doing so if their clients are sensitive to recorded short term fluctuations in value. In survey data, mark-to-market volatility ranks highly among investor concerns.[4]

3.14 While the securitisation markets are likely to recover in time, these factors may, solely or in combination, intensify demand-side problems and constrain the adjustment process. The implications of an effectively closed securitisation market are considered in Chapter 4.

[4] ibid.

4 Implications of closed securitisation markets

4.1 The closure of the securitisation markets – itself, a consequence of concerns over the actual and potential losses incurred by banks on past lending – implies a higher cost of funding for UK lenders. Lenders need both to refinance the existing stock of mortgage-backed bonds as it matures, and to find alternative sources of funding for new lending.

4.2 Consumers, meanwhile, face a higher cost of borrowing and, for some sections of the market in particular, difficulties in gaining access to mortgages of the preferred type. The extent to which constraints around the supply of mortgage finance are affecting consumers may, however, be unclear in a context of falling demand due to other factors such as declining house prices, a squeeze on household budgets from higher inflation, or global economic uncertainty.

Implications for mortgage lenders

4.3 As noted in Chapter 3, the closure of the securitisation market affects UK mortgage lenders – and therefore the supply of UK mortgages – from both a capital and a funding perspective. In the absence of an open securitisation market, funding for net new mortgage lending is constrained not only by the scale of retail deposit growth and the availability of alternative sources of wholesale funding (e.g. interbank lending), but also by the competing (and priority) demand for funds as existing mortgage-backed securities mature and need to be refinanced.

Refinancing maturing securities

4.4 The amount of RMBS and covered bonds maturing in each year from 2008 to 2010 is estimated at around £40bn (Table 4.1), although this is very difficult to determine with any precision. In context, this figure would equate to around 5 per cent of the stock of UK banks' interbank liabilities at end-2007, and more than two thirds of the net new mortgage lending projected by the Council of Mortgage Lenders in 2008.

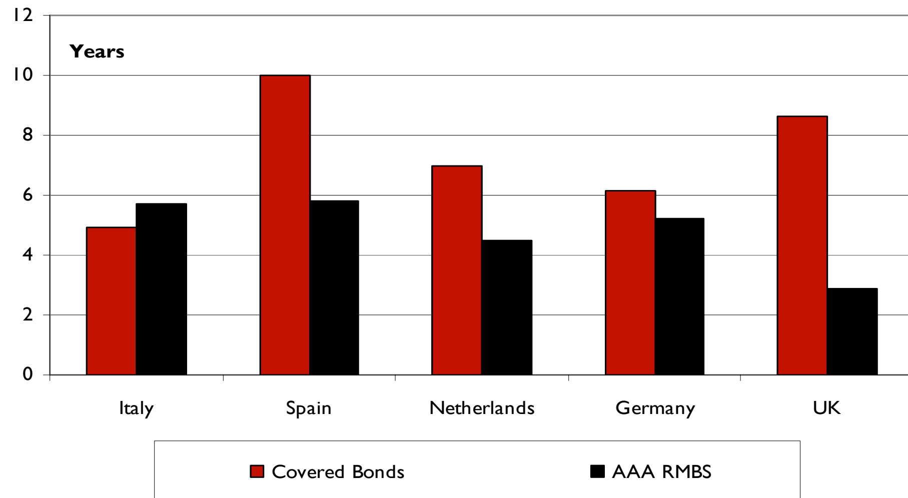
Table 4.1: Volume of maturing AAA-rated securities (£bn)

	RMBS	Covered Bonds	Total
2008	40.0	Neg.	40.0
2009	39.1	5.1	44.2
2010	35.6	5.4	41.0

Source: JPMorgan and HM Treasury calculations

4.5 The average maturity of UK AAA-rated RMBS is, as Chart 4.1 shows, considerably shorter than that of equivalent debt in other large European markets. This may be one of the reasons why the investor base for UK RMBS is relatively undiversified.

Chart 4.1: Average maturities of AAA-rated RMBS and covered bonds



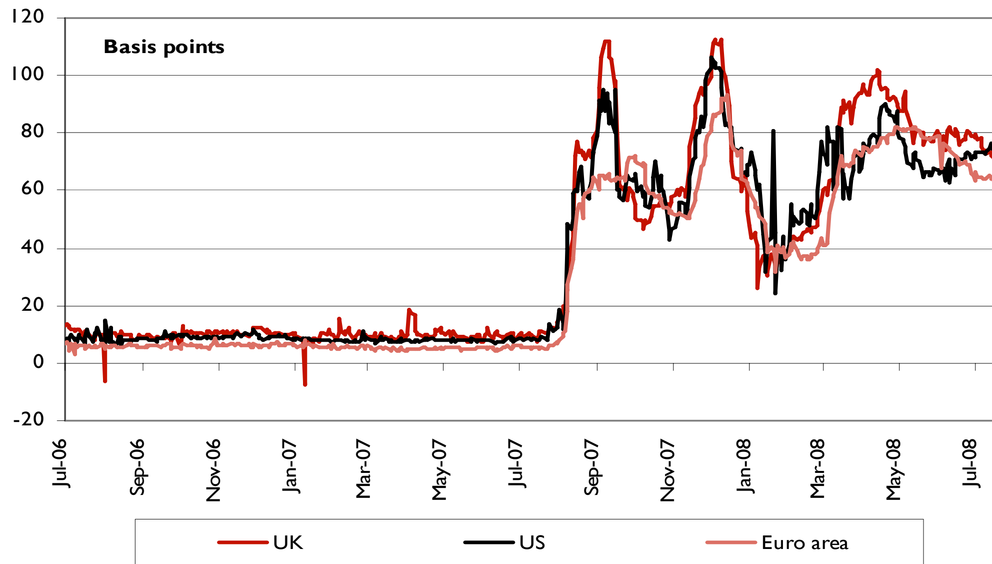
Source: Deutsche Bank and HM Treasury calculations

Other sources of wholesale funding

4.6 Given the refinancing pressure, the closure of the securitisation markets risks constraining potential growth in new lending. While maturing RMBS could be replaced by other sources of wholesale funding such as interbank funding or covered bonds, the latter are also affected by the securitisation freeze. Furthermore, the generally shorter duration of other types of wholesale funding may both reduce banks' inclination to lend against it and expose them to greater funding risk.

4.7 Interbank funding markets remain under considerable strain. LIBOR-OIS spreads widened sharply last summer in the face of acute concerns over liquidity and sub-prime related losses and remain elevated (though below their peaks in September and December). Were the closure of the securitisation market to lead to a structural increase in demand for interbank funding, this could imply that LIBOR-OIS spreads (illustrated in Chart 4.2) might remain at elevated levels for a sustained period.

Chart 4.2: 3-month LIBOR spreads over OIS rates



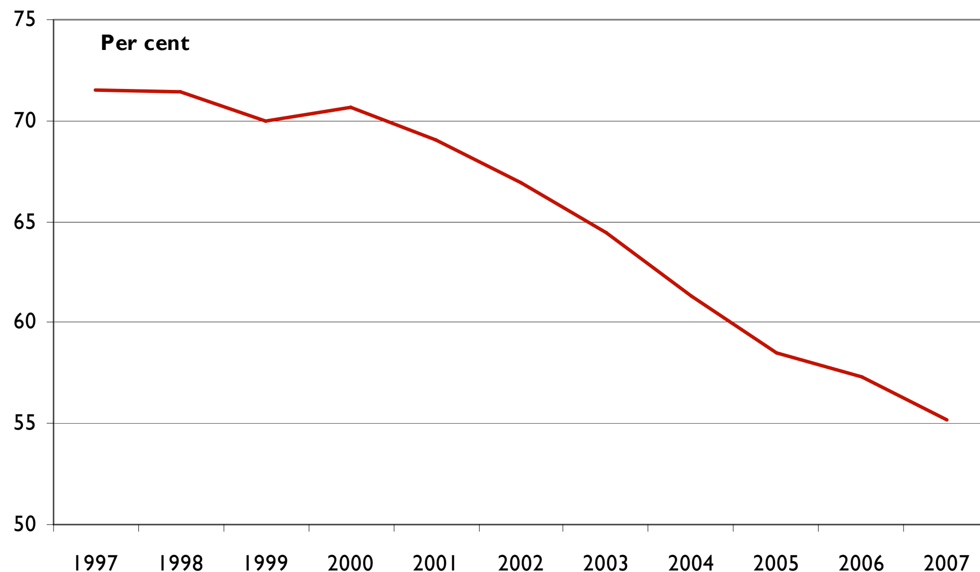
Note: 3-month LIBOR spreads over 3-month overnight indexed swap (OIS) rates.

Source: Bank of England

Customer deposits

4.8 The main alternative source of finance for new mortgage lending is UK customer deposits. As Chart 4.3 shows, customer deposits, while declining in importance in recent years, continue to represent the dominant source of funding for the UK's ten largest mortgage lenders.

Chart 4.3: Customer deposit funding as a percentage of lenders' total funding



Note: Based on sample of 10 leading UK mortgage lenders.

Source: Bank of England

4.9 While individual banks might be able to add capacity by switching away from corporate lending or by using non-UK deposits to fund UK mortgages, neither seems likely to occur to a significant extent at the level of the overall economy.

4.10 Many institutions are currently offering attractive rates to UK savers. It is, however, questionable whether this fosters an acceleration in customer deposit growth, or simply creates greater competition for existing deposits. Competition for retail savings has also meant that lenders' funding costs are rising with respect to customer deposits, thereby adding to upwards pressure on the price of mortgage borrowing.

4.11 All of the alternatives to RMBS funding are more expensive than the maturing RMBS themselves. The extent to which this affects margins on mortgage books will depend on whether and how far lenders can pass on these costs or offset them elsewhere. It is worth noting, in this context, that the high proportion of fixed-rate and tracker-rate mortgages offered in recent years means that it is taking lenders longer to re-price their mortgage books than was the case in previous interest rate cycles. This adds to the short-term pressure on financial institutions' balance sheets.

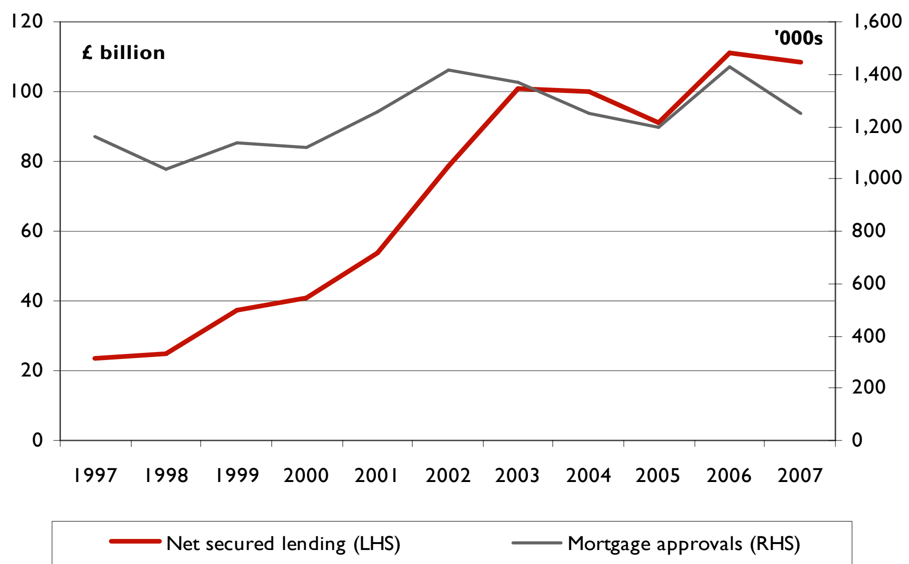
Implications for concentration

4.12 Furthermore, those lenders most dependent on the RMBS market have typically had a narrower and less diversified base than the largest UK mortgage lenders, making it harder for them to offset margin compression elsewhere. At an extreme, some of the specialist lenders have ceased new lending. Current market conditions are therefore encouraging greater concentration in the mortgage market. This raises the possibility that the wave of competition and innovation in the mortgage market that has accompanied the growth in securitisation may unwind; a trend that is reinforced by ongoing consolidation in the sector.

Mortgage lending growth

4.13 Unsurprisingly, in this context, mortgage lending growth has slowed considerably. As of May 2008, net lending secured on a residential property had reached £31bn, and is unlikely to increase markedly over the remainder of the year. This level of net lending to date in 2008 compares with £47.5bn during January-May 2007, and is significantly below the £108bn lent during 2007 as a whole (Chart 4.4). The Council of Mortgage Lenders expects net lending to decline in 2008, to £55bn.

Chart 4.4: UK net secured lending on residential property and mortgage approvals



Source: Bank of England.

IMPLICATIONS FOR MORTGAGE BORROWERS

4.14 Mortgage borrowers are not directly affected by the halt in securitisation activity. If, however, lenders are not able to access alternative sources of funding or if these alternatives are more expensive, this will clearly have implications for existing and potential borrowers in terms of both the availability and price of finance.

Demand a factor, as well as supply

4.15 The extent to which borrowers are affected by a supply constraint will, of course, depend on what is simultaneously happening to demand. Recent survey and anecdotal evidence suggest that – in a context of falling house prices, a squeeze on household budgets from higher inflation, and general economic uncertainty – demand among first time buyers, in particular, has been weakening. The Bank of England's most recent Credit Conditions Survey, for example, reported that demand for secured lending for house purchase had fallen during the second quarter of the year by more than had been expected, with demand expected to continue to fall over the coming three months.[1]

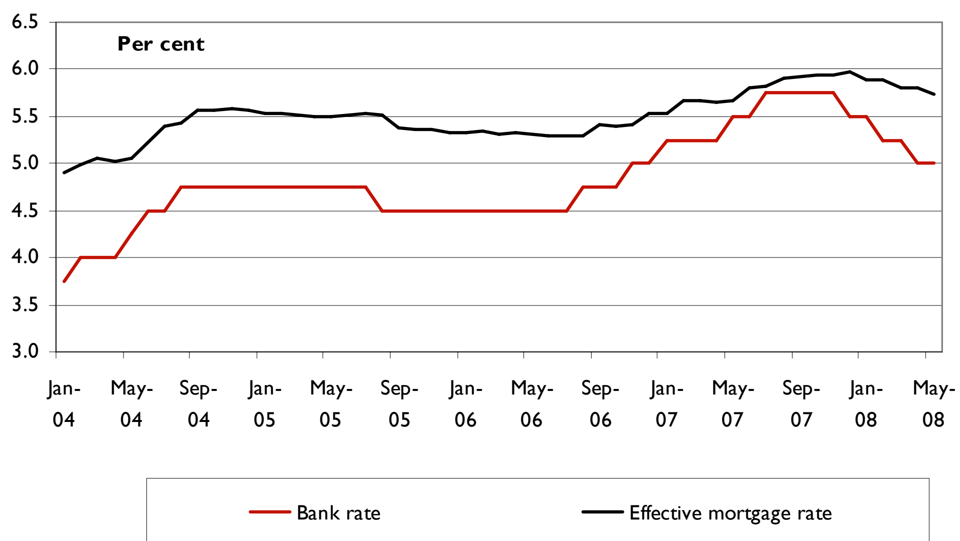
[1] *Credit Conditions Survey 2008 Q2*, Bank of England, http://www.bankofengland.co.uk/publications/other/monetary/creditconditionssurvey080703.pdf

Implications for price, access and choice

4.16 The extent to which demand or supply factors dominate in a context of falling mortgage activity is difficult to identify and may vary over time. Funding issues may, for example, have been the primary constraint at the beginning of the year, with demand factors now becoming more evident. It is, however, clear that the lack of securitisation activity has had a number of consequences in terms of both price and access:

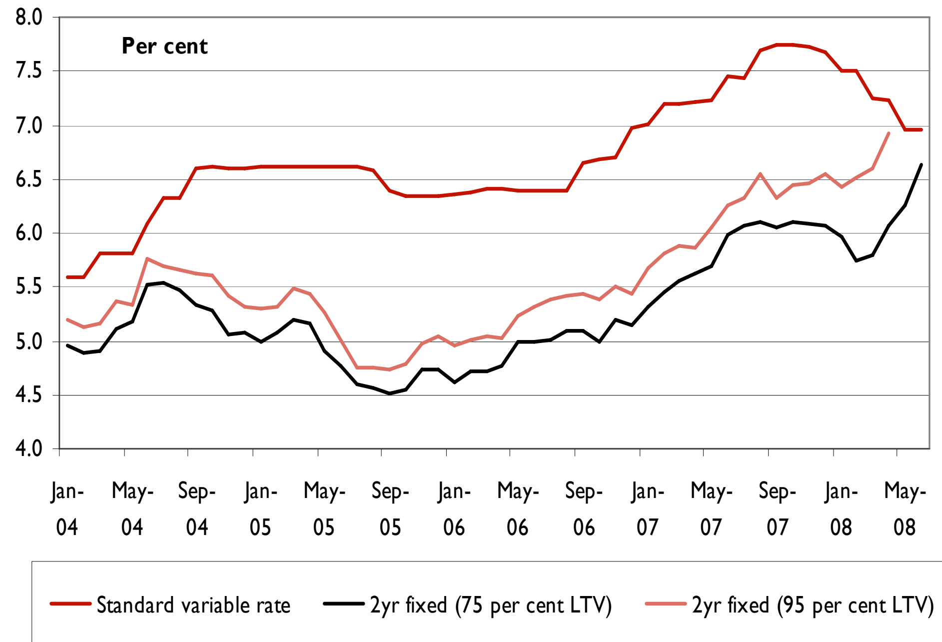
- some mortgage rates have risen substantially as a result of widening credit spreads, notwithstanding the reductions since December 2007 in the Bank Rate. Chart 4.5 illustrates the effective mortgage rate (a weighted average of all interest rates across each type of mortgage of the reporting banks) alongside the Bank Rate; Chart 4.6, developments in particular types of mortgage rate. The extent to which individual existing borrowers have experienced a payments shock will have varied considerably with the type of mortgage product. Borrowers refinancing a fixed rate two year mortgage in recent months are, for example, likely to have faced higher monthly payments; borrowers with a variable rate or tracker mortgage, in contrast, may have benefited over the first half of 2008 from lower monthly payments following successive cuts in the Bank Rate;

Chart 4.5: Bank Rate and UK effective mortgage rate



Source: Bank of England

Chart 4.6: Standard Variable Rate and 2 year fixed rates at 75 and 95 per cent loan-to-value (LTV)



Source: Bank of England

- the number of mortgage products on offer has contracted, especially for borrowers with high loan-to value ratios. The number of 2 year fixed-rate mortgages offered to buyers with a deposit of up to 5 per cent of the purchase price, for example, fell in May to the point where the Bank of England was no longer able to release data on the average mortgage rate;
- choice has been constrained in specialist sectors, and for credit-impaired individuals in particular, as a result of the operating difficulties faced by specialist lenders;
- mortgage brokers and intermediaries are also facing a challenging business environment, further reducing consumer choice and competition; and
- difficulties in refinancing existing mortgages for some borrowers may be contributing to the rising number of court orders and repossessions (albeit from a historically low base). The reduced activity of specialist lenders and intermediaries also means that households at risk of facing payments problems can no longer refinance easily elsewhere, with the result that a larger part of the poorer credit risk remains with the mainstream lenders.

4.17 This sharp reduction in mortgage lending has clearly had an influence on the housing market and on consumers. That housing transactions are down around 44 per cent compared to a year ago, and that – after rising 10 per cent in the year to July 2007 – house prices have now shown some falls, reflects at least in part the higher price and reduced availability of lending.

Long term housing fundamentals

4.18 The long-term fundamentals that underpin the housing market remain, however, strong. Employment is at a record high; interest rates have been reduced three times since December 2007; and household growth is projected to rise strongly as the population ages and expands and as more people live in single person households, which will support house prices in the long-term.

4.19 Such considerations notwithstanding, however, a sustained reduction in mortgage finance would clearly have wide implications for the UK economy. The next section of this report focuses on how the authorities and industry can work together to tackle some of the imperfections in the securitisation markets previously described.

5 OPTIONS AND PROPOSALS

5.1 Securitisation markets have, over the past year, experienced a severe shock, and are currently undergoing a necessary adjustment and re-pricing of risk. Investors, for a wide variety of reasons, are conserving funds rather than investing in mortgage-backed securities.

5.2 These markets will recover in time. When they do, however, they are likely to be different in both scale and structure to those of a year ago. This is due not only to the impact of the financial disruption itself, but also to other, not directly related, factors. The 2004 Basel II Accord, for example, established a new international standard for regulating the level of capital that banks are required to hold against financial and operational risks. The Capital Requirements Directive, which implements Basel II in European legislation and took effect on 1 January 2007, reduces the amount of capital lenders are required to hold against mortgage lending, and thereby potentially their incentive to securitise.

5.3 Against a background of considerable thinking and joint work underway at an international level on how best to respond to current problems, stakeholders have proposed a range of ideas aimed at facilitating the recovery process in these markets. Tackling the market imperfections described in previous sections of this report, including informational barriers and the lack of transparency and standardisation, will help strengthen market efficiency in the financing of mortgages, benefiting consumers. The authorities may have a role to play in coordinating and supporting industry action to address these issues.

INTERNATIONAL WORK AND RECOMMENDATIONS

5.4 There is important work underway at international level to analyse the causes of global market conditions and consider appropriate international responses. As highlighted in recent Government publications, the UK is taking a lead role in work to improve the resilience of the financial system.[1]

G7 Finance Ministers

5.5 In October 2007, G7 Finance Ministers asked the Financial Stability Forum (FSF) to analyse the underlying causes of recent market turbulence and propose appropriate recommendations. In April of this year the FSF presented its report, *Enhancing Market and Institutional Resilience,*[2] to G7 Finance Ministers, proposing action in the following five areas:

- strengthening prudential oversight of capital, liquidity and risk management;
- enhancing transparency and valuation;
- changes in the role and uses of credit ratings;
- strengthening the authorities' responsiveness to risks; and
- robust arrangements for dealing with stress in the financial system.

[1] *Financial Stability and depositor protection: further consultation,* HM Treasury, Bank of England and FSA, July 2008, http://www.hm-treasury.gov.uk/documents/financial_services/fin_stability/financial_stability_depositor.cfm

[2] *Report of the Financial Stability Forum on Enhancing market and institutional Resilience*, Financial Stability Forum, April 2008.

5.6 Many of the recommendations in the FSF report are aimed at addressing concerns about the operation of the securitisation markets. For example, three of the 67 recommendations in the FSF report relate to enhancements in financial reporting, and are being taken forward by the International Accounting Standards Board.[3] These include: accounting and disclosure standards of off-balance sheet vehicles; fair value in illiquid markets; and disclosure about methodologies and valuations.

Europe

5.7 The European Commission has set out a programme of work at EU level on the recent market disruption, including a package of changes to the Capital Requirements Directive. As part of this package, the Commission published consultations in April and June of this year that included proposals to align the incentives of lenders with those of investors and reduce credit risk transfer. The Commission's most recent proposal is to restrict the purchase by EU-regulated banks of risk transfer products where the originator or distributor did not themselves retain a net exposure of at least 10 per cent. The Commission is due to make its final proposal towards the end of September. Given the far-reaching consequences for EU markets of the suggested change, it is critical that any such proposal is supported by a full and rigorous assessment of the longer-term costs and benefits to the markets.

The US

5.8 The US President's Working Group on Financial Markets (chaired by the Secretary of the Treasury, and including also the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission), meanwhile, reported in March 2008 with a series of recommendations targeting improved market transparency and disclosure; better risk awareness and management; and stronger oversight.[4] The President's Working Group will issue a progress statement on how far these recommendations have been implemented, and whether further steps are advisable, in the fourth quarter of 2008.

5.9 This April saw the launch in the US of the Counterparty Risk Management Group III (CPRMG III). CPRMG III is co-chaired by E. Gerald Corrigan, Managing Director, Goldman, Sachs & Co., and Douglas Flint, Group Finance Director, HSBC Holdings Plc and includes a range of market participants. The group is examining risk management practices; the risks associated with complex financial instruments; the accounting rules determining whether certain classes of activity are on or off balance sheet; and the financial infrastructure supporting over-the-counter derivatives and, in particular, credit default swaps.

UK Government objectives

5.10 While there may be steps that the Government could take to facilitate the transition process, it is important that any intervention should not be directed simply at seeking a return to previous market structures or levels of activity. The authorities must also avoid creating moral hazard; there should be no reduction in the incentives on market participants to behave responsibly.

5.11 The Government wishes to see markets that are efficient, transparent and fair for all participants, so that lenders, issuers, investors and borrowers are able to understand fully the risks attached to financial transactions. It will also wish to take into

[3] *IASB response to the credit crisis*, International Accounting Standards Board, http://www.iasb.org/About+Us/About+IASB/Credit+crisis.htm

[4] *The President's Working Group on Financial Markets*, Department of the Treasury, Board of Governors of the Federal Reserve System, Securities and Exchange Commission and Commodity Futures Trading Commission, March 2008 http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf

account the implications of the current period of financial market turbulence for its wider objectives, including promoting stability in financial services markets, delivering affordable housing, and ensuring economic growth and prosperity.

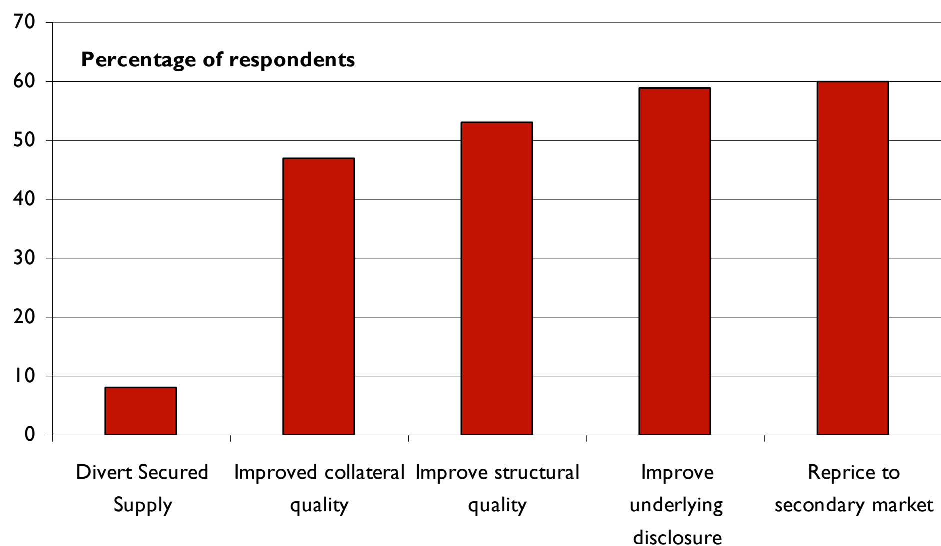
INDUSTRY PROPOSALS

5.12 The proposals put forward by market participants and other stakeholders address a wide range of issues. There has, unsurprisingly, been no consensus as to any single step (or set of steps) that would resolve the current difficulties. Some proposals have targeted ways of reducing the perceived secondary market overhang. As, however, the focus here is on delivering the greatest benefit to the economy and the consumer through new lending, the emphasis here is on primary market issuance.

Transparency and standardisation

5.13 In time, market recovery is likely to be led by simpler, more transparent and more standardised structures. Along with improved information to investors, simplicity and standardisation may help establish stronger, deeper and more liquid markets, helping investors to undertake due diligence, and encouraging a better alignment of incentives between issuers and investors. A recent investor survey shows the importance European investors place on improving underlying disclosure, alongside concerns about pricing and risk (Chart 5.1).

Chart 5.1: Investor perceptions of what ABS issuers need to do to re-open the European ABS market



Source: JPMorgan European ABS Confidence Index, June 2008

5.14 The recent proposals on transparency published by a group of European trade associations are to be welcomed as a step towards these aims.[5] Consistent with the FSF's report, the planned outputs from the ten initiatives proposed by the trade bodies include:

- improved transparency and disclosure by issuers;
- publication of periodic reports on European securitisation markets;
- more standardised reporting of transactions (working also with the American Securitization Forum);
- standardised definitions, including for example 'non-conforming RMBS'; and
- the development of investor credit assessment and valuation principles.

5.15 The aims and, in some cases, substance of these proposals are echoed in several other initiatives around the globe. Approaches intended to enhance transparency and standardisation – and therefore liquidity and market efficiency – include:

- the recommendations of the Institute of International Finance (IIF) Committee on Market Best Practices. The IIF published its final report on 17th July this year, setting out principles of conduct and market best practice for the global financial service industry (supported by the official sector) across a wide range of areas, including risk management and transparency and disclosure issues;[6]
- the American Securitization Forum's Project RESTART (Project on Residential Securitization Transparency and Reporting), focused on developing specific and detailed market standards and practices, including templates for disclosure in securitisation, and model warranties to provide assurances to investors regarding the allocation of risk;[7]
- consideration being given by the US Department of Treasury to a standardised approach for issuing covered bonds, thereby promoting a new source of mortgage funding in the US;
- the Short-Term European Paper (STEP) initiative, launched in 2006 by European trade associations and aimed at establishing common standards for the short-term paper market.[8]

Industry-led initiatives

5.16 Steps by the industry to agree common standards and definitions and to monitor these effectively could facilitate the development of a 'gold standard' for securities (or even several such standards, spanning different eligibility criteria). In a global marketplace, consistency of approach across national borders would clearly be desirable. This could, over the longer term, help promote investor confidence, extend the appeal of mortgage-backed securities and strengthen the market.

[5] *Industry Take Further Steps Toward Improving Transparency*, 2 July 2008 http://www.europeansecuritisation.com/Communications/Archive/Current/Joint%20release_transparency%20initiatives%202Jul08.pdf

[6] For more information see the Institute of International Finance website, http://www.iif.com

[7] Further information on the American Securitization Forum's Project RESTART can be found on the American Securitization Forum website http://www.americansecuritization.com/story.aspx?id=2655

[8] For more information see http://www.stepmarket.org

5.17 There is also potential for further market-led reforms to improve the financial infrastructure for mortgage-backed bonds with a view to enhancing liquidity, for example by moving from over-the-counter products to exchange trading.

5.18 Such initiatives may be important in ensuring that a stronger and more efficient market, and one therefore which is ultimately more beneficial for the consumer, emerges from the current downturn. In isolation, however, market-led initiatives are unlikely to help resuscitate markets quickly.

5.19 The Tripartite Authorities – the Treasury, the Bank of England and the Financial Services Authority (FSA) – may also have a role to play in coordinating cross-industry work.

The Bank of England

5.20 Stakeholders have proposed that the Bank of England extends its Special Liquidity Scheme to provide liquidity to eligible institutions in exchange for new issues of RMBS and covered bonds. This would guarantee liquidity to banks and building societies holding the bonds.

5.21 The aim of this proposal is to encourage new issuance of RMBS and covered bonds and therefore more mortgage lending in the UK. It is, however, necessary to take into account the extent to which the provision of liquidity would lead to an increase in the supply of new lending, if used by banks and building societies primarily to finance re-mortgaging. It is also debatable whether this sort of approach would help or prolong the transition to better functioning markets in the long term. The authorities would have to consider the extent to which intervention along these lines would expose them to significant fiscal and legal risks, and consideration would also need to be given to the consistency of this approach with the Bank of England's objectives for central bank facilities, which relate to the management of commercial bank liquidity and the achievement of the inflation target.

5.22 The Bank of England has said that it intends to announce later this year a new liquidity facility that will work in both 'normal' and 'stressed' times, as part of wider reforms of its money market operations.[9] This facility will be considered by the Bank in consultation with the Treasury and the FSA, and designed to achieve the Bank's objectives for its Official Operations in the Sterling Markets.[10]

The FSA

5.23 The FSA has a role to play in tackling regulatory distortions and building confidence in mortgage funding markets, in its capacity as regulator of the banking, building society and investment sectors.

5.24 In particular the FSA, along with the Treasury and the Bank of England, is represented on the Financial Stability Forum and is actively engaged in taking forward its recommendations. A significant element of this programme involves working collaboratively with overseas supervisory authorities, such as at the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions, the Senior Supervisors Group and the Joint Forum to craft international responses to cross-border issues.

[9] *Banking and the Bank of England*, Speech by Mervyn King to the British Bankers Association, 10 June 2008 http://www.bankofengland.co.uk/publications/speeches/2008/speech347.pdf

[10] *The Red Book,* Bank of England, January 2008, http://www.bankofengland.co.uk/markets/money/publications/redbookjan08.pdf

5.25 In December 2007 the FSA published a discussion paper[11] on liquidity requirements for banks and building societies, aimed at reviewing lessons learned from recent market turbulence in managing and regulating banks' liquidity, and setting out preliminary ideas for reform. The FSA aims to publish a follow-up consultation paper later this year, setting out proposals on sound practices for managing liquidity risk with a strong focus on stress-testing. These enhanced requirements will reflect work currently under way in the BCBS. The FSA will also give consideration, in discussion with the industry and the Bank of England, to data-based requirements, which should usefully complement proposals in relation to the sound risk management of liquidity.

A Government guarantee

5.26 Stakeholders have also proposed various Government interventions, among them a temporary Government guarantee (on commercial terms) the principle and interest on high quality mortgage-backed securities. Such initiatives are aimed at transferring credit risks from investors to the Government.

5.27 A guarantee could create new investor demand for the Government-backed bonds, reopening the way for lenders to securitise loans and potentially increasing the supply of mortgage lending. This would be likely to support increased market activity in the near term, though the extent of the impact on net new mortgage lending is less clear.

5.28 As with any such proposal, the extent to which the necessary market adjustment would be facilitated (rather than prolonged), would need to be weighed carefully. In the specific case of a guarantee, and alongside the potential benefits, the Government would also need to consider the fiscal, debt management and legal implications, and the extent to which a transfer of risk to the Government might distort incentives and create moral hazard, rather than help investors and issuers price that risk more accurately.

5.29 Guarantee models come, of course, in a variety of guises, often reflecting specific country or historical contexts. In some existing structures, the government guarantee is implicit rather than explicit; though as the recent experience of the US Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac illustrates, the markets will tend, effectively, to regard the former as equivalent to the latter. It appears unlikely that an implicit government guarantee on mortgage-backed securities would be an appropriate model for the UK to adopt.

[11] *DP 07/7 'Review of the liquidity requirements for banks and building societies*, FSA, December 2007.

Box 5.1 Fannie Mae and Freddie Mac

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) operate in the secondary mortgage market, buying conforming mortgages from lenders and issuing mortgage-backed securities.

Fannie Mae was founded in 1938 as a government agency, authorised to buy Federal Housing Association (FHA) insured mortgages and thereby replenish the supply of lending for these types of loans. In 1968, Fannie Mae became a privately owned company and its remit was broadened to allow it to buy mortgages not insured by the FHA. In 1992, regulatory responsibility for Fannie Mae was given to the newly created Office of Federal Housing Enterprise Oversight; Fannie Mae was also, at this time, given new affordable housing goals.

Freddie Mac was created in 1970 to introduce competition in the secondary mortgage market. Like Fannie Mae, Freddie Mac buys conforming mortgages and issues mortgage-backed securities. The two institutions together own or guarantee over $5 trillion of home loans, or almost half of all outstanding US mortgages.

Although they are private companies, Fannie Mae and Freddie Mac have federal charters and are Government Sponsored Enterprises (GSEs). As such, they are protected financially by the US Government (through, for example, access to a line of credit, exemption from state and local income taxes, and exemption from Securities and Exchange Commission oversight). As a result of their status, the securities issued by both have tended to be regarded by investors and market commentators as implicitly guaranteed by the US Government.

In February and March 2008, lending restrictions for both GSEs were eased to allow them to make further investments in mortgages. On 13th July, and in response to declining confidence in the two companies as a result of growing concerns about potential large-scale defaults on the mortgage-backed bonds issued, the US Treasury recommended that it be provided with additional authority for it to purchase debt and equity securities of the GSEs, and that the Federal Reserve be provided with a consultative role in developing new GSE regulations. Congress passed legislation on 26th July establishing an enhanced GSE regulatory framework that included the US Treasury's recommendations.

5.30 Any action by authorities would not of course reduce the need for the industry to re-capitalise and deliver necessary market reforms. Any action can only be effective with support of industry-led reforms.

NEXT STEPS

5.31 Sir James will continue to work closely with interested parties and other countries facing similar challenges over the summer months, and will produce his recommendations as soon as possible thereafter. Should appropriate steps be identified which would facilitate the market adjustment process and ameliorate the economic consequences, it would clearly be desirable to move forwards with these as quickly as possible.

5.32 The next phase of work will explore a range of options, drawing on the ideas summarised above and taking into account their effectiveness and value for money in both the near and longer term. The persistence of current market conditions could have significant implications for the economy. Even less desirable, however, would be

interventions that distorted these markets and prolonged any recovery process. The costs of action need to be set against those of inaction.

5.33 Any steps will need to be assessed according to the possible impacts on the markets, the extent to which they may help smooth the adjustment process, and their contribution to establishing more sustainable sources of mortgage funding in the longer term, taking into account the Government's wider objectives on financial stability and fiscal sustainability.

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