Mortgage finance:

final report and recommendations

November 2008

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ISBN 978-1-84532-514-5
PU649

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Foreword

The Rt Hon Alistair Darling MP

Chancellor of the Exchequer

Dear Chancellor,

Since HM Treasury published my interim report on 29 July, I have continued my dialogue with market commentators and participants to ensure that, in a rapidly deteriorating environment, my conclusions are as relevant as possible. As we have devoted more effort to evaluating specific proposals, so we have drawn more heavily on specialist advice from a wide range of parties. I am indeed grateful to the many individuals and organisations who have given freely their time.

I believe there is a strong case for intervention in mortgage finance markets...

Last summer, years of cheap money ended with the sudden re-pricing of risk in credit markets, an event long overdue everywhere but in the event triggered by the collapse in the US sub-prime mortgage market. The consequent contraction in banks' capital bases and lending capacity has been such that, with only short periods of mild relief, funding markets have just continued to get tighter and tighter.

Over the previous decade, the UK mortgage market had increasingly drawn in funding from outside the UK, particularly from US investors. The effective closure of the US mortgage-backed funding markets therefore had an immediate and disproportionate effect on the UK's mortgage and housing markets. This was despite the fact that credit experience in the UK is such that, even today, default on AAA mortgage-backed securities (which represent in excess of 90 per cent of mortgages funded by such securities) remains a remote prospect.

Countries have been affected very differently by the current financial turmoil. In particular, we should be careful of drawing direct parallels between the US and the UK experiences. The origins of the US crisis lay in bad debts, whereas in the UK the catalyst was the shortage of funding triggered by the US' problems. Even so, most countries now find themselves needing to take action on two fronts; firstly, the need to secure the stability of their financial systems in the face of the prolonged closure of wholesale money markets; and, secondly, the imperative of containing the impact of the severe shortage of credit on the real economy. The UK is no exception.

My interim report argued that, in the UK, the shortage of mortgage finance could well be the primary mechanism through which the consequences of turmoil in the financial sector would be transmitted to consumers and the wider economy. I also concluded that the immediate cause of such a shortage, the inability of banks to raise asset-backed funding even for structures where defaults are still regarded as remote, was the sort of market failure that might call for government intervention, perhaps even on a significant scale.

In this report I rehearse and refresh my analysis and make a clear recommendation as to the specific intervention that I believe will best ameliorate the impact of the shortage of mortgage finance on consumers and the economy in general. As is now very clear, any such intervention cannot be viewed in isolation. Recent weeks have seen the announcement of a comprehensive programme designed to preserve stability in the financial system. Accepting that these initiatives will be successful, the key challenge will then be that of containing the impact of the financial crisis on the real economy. The recent base rate cuts will relieve the pressure on borrowers, but unless and until banks get access to attractively priced sources of funding the shortage of mortgage finance will endure. It is in this context that I offer my report and recommendations on improving the flow and availability of mortgage finance in the UK.

In summary, I believe that intervention which addresses the 'closure' of mortgage-backed funding markets will bring about increased competition and improve the availability of mortgage finance to homeowners and would be homeowners. More importantly, such intervention should ensure that a cyclical correction in the housing market does not turn into something much more serious with all that would ultimately imply for the wider economy. The market turmoil we have experienced since the summer must continue to weigh heavily on confidence in the mortgage and housing markets. However, the Government's recent financial stability initiatives and the significant cuts in base rates have created the environment within which secondary intervention in mortgage finance markets can be effective.

Without intervention, the market in mortgage-backed securities won't return any time soon...

The destruction of major players (bank structured investment vehicles (SIVs) and conduits) and the reluctance of banks to take on what is now perceived as the significant market risk associated with this paper, accounts for the loss of around 60 per cent of previous demand. The perceived overhang of existing paper and increasing concerns over the health of the UK housing market have accounted for the 'money market' and 'real money' investors who were also traditional buyers, particularly those from outside the UK (the vast majority). Any return to 'normality' in this market therefore requires considerable time and a significant improvement in sentiment towards the UK housing market.

But it is the inability to refinance existing mortgage-backed funding and the continuing pressures in wholesale funding markets which is really hitting the banks' capacity to make new loans...

During the last twelve months the authorities have launched a number of initiatives designed to help banks cope with the 'closure' of wholesale money markets. By giving banks security of access to funding, the Government's recent initiatives effectively remove the immediate threat to financial stability. Even so, I still expect that mortgage lenders will have to live with little or no access to asset-backed funding through 2008 to 2010, together with having to cope with in excess of £160 billion of redemptions of existing paper over the same period.

Nor can banks rely on strong savings inflows as a source of funding...

Savings inflows have typically proved very stable and predictable, rising between 5 and 7 per cent (some excess over the interest added to balances) each year with a tendency to rise faster in times of economic uncertainty. But after a resilient first half, my discussions with the industry suggest that savings flows softened appreciably throughout the summer and into the autumn. As a result, I now expect this year's inflows to be well below those of 2007. There is little doubt that consumers' capacity to save has been under pressure for some time. Much lower base rates will be reflected in lower savings rates and this will also now exert significant downward pressure on savings inflows, although some consumers may choose to save more as they become more concerned about unemployment.

The process of re-pricing existing books of mortgages has been much more protracted than in previous cycles...

The massive growth in fixed and tracker products as a proportion of the whole (from say 10 per cent in 1990 to around 75 per cent in 2007) means that, by the end of this year, almost a year and a half after the sharp jump in funding costs, lenders will only have been able to re-price around a third of their historic book. Even then it is disproportionately the least creditworthy consumers who suffer re-pricing with all that implies for credit experience. Moreover, the fact that the most creditworthy borrowers still have good access to competitive mortgage finance, ensures that the remortgage market remains sufficiently active for there only to be a modest

slowdown in the rate at which existing mortgage-backed funding rolls off lenders' balance sheets.

...but new lending has been re-priced, particularly in the specialist and high loan-to-value (LTV) sectors where activity has collapsed with predictable consequences for housing starts

The shortage of funding and capital, together with the advent of the Basel II approach to determining capital requirements (this requires banks to hold proportionately more capital, the higher the LTV of any loan), have forced banks to concentrate on low (less than 75 per cent LTV) lending. The consequent increase in deposits has seen significant reductions in '85 per cent plus LTV' lending, traditionally the bedrock of the new build sector. As a result the number of housing starts will fall this year to a post-war low.

Competition among lenders is reducing...

The number of active lenders has fallen. Non-UK lenders have withdrawn and a number of substantial UK lenders (Northern Rock, Bradford & Bingley, the soon to be merged Abbey and Alliance & Leicester and the specialists such as Paragon) have either mothballed their activities or announced programmes to reduce the size of their mortgage books. The building society movement is effectively constrained by its dependence on savings inflows. In September, Lloyds TSB backed its acquisition of HBOS with a commitment to maintain rather than increase lending, a commitment repeated recently when the Government announced the details of its stability package. At the same time, those of the largest banks which have traditionally sought to deploy their capital and funding resources elsewhere, are unlikely to do much to plug the enormous gaps left in the market, certainly while sentiment towards the UK housing market remains poor.

To the extent that wholesale funding markets do eventually re-open, they will surely only do so for banks capable of securing an adequate spread of funding, which largely means the increasingly small number of banks with viable branch-based savings and current account businesses. In the longer term, therefore, the UK mortgage market is expected to revert to a structure where lenders fund their lending more directly from deposit gathering. As a result, 'barriers to entry' may be re-established where they were many years ago but with far fewer competitors. At some stage, this will favour shareholders rather than consumers, which may raise issues for the competition authorities; but in a matter of years rather than months.

... and perhaps not surprisingly intermediaries are under pressure

In recent years, intermediaries have been the major force for competition within the market, both in terms of extending access and achieving better value for consumers. In the face of lenders now offering cheaper deals through their branches (the reverse of what had typically been the case for many years) and the general fall in activity, intermediaries are losing share in a rapidly declining market and many will disappear.

All of which is having a serious impact on all sectors of the house building sector, including social housing...

The shortage of mortgage finance has had an immediate and severe impact on house builders, some of whom rely heavily on purchasers' ability to access higher LTV mortgage lending. They have cut their activity very quickly and there is little evidence of supply overhangs, except of flats in some city centres. My discussions with the industry suggest that capacity has fallen by between 40 and 50 per cent. In the face of extreme caution from lenders, builders have found themselves both having to cut prices faster than they are falling in the second hand market and having to help purchasers with finance. New build activity has fallen across all sectors but particularly so in smaller units in urban locations. Since building in the social housing sector is generally reliant on some form of direct or indirect cross subsidy from the private sector, activity here which has so far held up comparatively well may now fall sharply although the Government has brought forward additional funding to support the delivery of new social housing in the short-term.

But the real risk is that the shortage of mortgage finance now forces the housing market to overshoot on the downside...

As many banks (particularly traditional mortgage lenders) adjust their business models to reduce leverage and draw on more diversified sources of funding, the mortgage market is in the midst of a painful transition to a new equilibrium between supply and demand. In the meantime, we are now in the midst of a significant cyclical correction in the housing market. It is quite impossible to quantify the extent to which this downturn stems directly from the unprecedented shortage in the supply of mortgage finance. But there can be no doubt that one month's shortage in the supply of finance eventually feeds through to another's fall in demand. The real risk therefore is that the shortage in mortgage finance feeds on itself and causes the housing market to overshoot on the downside. Such a downward asset spiral would have serious consequences across all segments of the housing market and across all industries dependent on housing investment and activity. Indeed, given that the consequences of the shortage are being borne most directly by the least creditworthy borrowers, the effects would be felt most acutely in the overall number of housing starts and more specifically in lower priced housing in the least expensive localities.

In the near term even 'well capitalised' banks are unlikely to return to 'normal' lending volumes and practices...

There is no doubt that extremely well capitalised banks that are supremely confident of their access to affordably priced funding will eventually lend more freely. But it will be some time before this is the case in the UK:

- the sector is 'shell shocked' and for months to come, most banks will be focussed on strengthening their balance sheets and the internal challenges arising from all the M&A activity which has taken place, little of which has yet been executed;
- as we have seen already, the full impact of the stability package on money markets may take some time; and
- in the first instance, the expanded Special Liquidity Scheme (SLS) and the unsecured term guarantees will both be deployed primarily to achieve a secure funding base for existing assets, including refinancing maturing high grade mortgage-backed securities.

... and therefore it is very likely that new net mortgage lending will fall below zero.

Events of the last year or so have resulted in lenders accounting for the majority of the existing stock of mortgage lending, committing to a significant reduction in lending over the three years 2008 to 2010. Over the same period, the industry has to cope with in excess of £160 billion of redemptions of existing mortgage-backed securities. New savings flows are softening (now estimated at no more than £150 billion over the same three-year period) and, although now finally easing, wholesale funding pressures are still intense. Much lower base rates will help borrowers but will do little for the availability of mortgage finance. In such an environment, there are very few banks with the capacity to increase lending. Therefore, I believe that new net mortgage lending is very likely to fall below zero in 2009 (compared to around £40 billion this year and £108 billion in 2007) with only a modest recovery likely in 2010. No new net mortgage lending across a full calendar year would be unprecedented and is likely to be associated with further weakness in consumer spending and an increase in unemployment. In the housing market it is difficult to see why this would not also involve further house price falls and fewer housing starts.

...even accepting that there is no consensus on the challenges faced by the housing market.

Among market commentators there is a range of views about the outlook for the UK housing market and economy. Some are more optimistic than I am. However in this report, it is

important for me to say something about the perspective which underlines my analysis and recommendations.

The decision on intervention is clearly a matter for the Government...

It is, of course, ultimately for the Government to decide whether the shortage of mortgage finance and its potential consequences for homeowners and the economy as a whole, justify any sort of secondary intervention. Only the Government can assess the case for any such intervention in the context of the many competing demands for its financial resources.

...but in my opinion there is a strong case for further government intervention.

Credit markets are unwinding after a decade of rapid expansion and innovation sustained by persistently cheap money. Even if it were desirable, no intervention designed to ameliorate the impact of a shortage of mortgage finance should be expected to reverse the current trends in the UK housing market or return mortgaged backed funding markets to their former size. Nor would intervention remove the pressure on borrowers to reduce their indebtedness.

I believe the banking system is going through three years of major restructuring. During that time this is likely to cause pain and risk to consumers and risks accelerating the weakness in the housing market. A large injection of funding into the banking system, delivered in a way that feeds directly through into mortgage lending and real activity in the housing market, would ameliorate the economic consequences of the shortage of mortgage finance and deliver tangible benefits to consumers.

Alternatives to direct government intervention won't happen or won't take effect sufficiently quickly...

My research and analysis uncovered a number of alternatives to such direct intervention:

- greater standardisation and improved transparency of the asset-backed structures used in wholesale funding markets;
- revisions of the recently adopted ‘mark to market’ international accounting conventions; or
- new initiatives from the Bank of England specifically designed to stimulate new net mortgage lending.

Increasingly, market-led initiatives focus in particular on enhancing standardisation and transparency. But it will take time for any such initiatives to command the necessary consensus. While on their own, such steps are unlikely to drive significant new issuance of mortgage-backed securities, in the end they will undoubtedly help markets to function better. I believe that the authorities should do all they can to encourage the swift and widespread adoption of industry-led initiatives on standardisation and transparency, including those proposed by the European Securitisation Forum (ESF) and the Securities Industry and Financial Markets Association (SIFMA).

With the benefit of hindsight, some now regret the widespread application of the ‘mark to market’ accounting convention which became much more generally applicable when International Accounting Standards were adopted just three or four years ago. In practice, it has led banks to mark assets to markets with little or no liquidity, with the resultant selling pressure causing the downward asset spirals that have so undermined confidence in bank balance sheets and therefore caused inter-bank lending markets to seize up. As a result, many assets have been written down to less than their intrinsic worth. In the longer term, under this accounting convention it is now clear that banks will prove incapable of sustaining the amount of balance sheet leverage that was previously regarded as reasonable, both by bankers and regulators; a hugely important consequence foreseen by no one. Reporting to G7 Finance Ministers, the Financial Stability Forum has already highlighted the need for the International Accounting Standards Board to review aspects of fair value accounting in illiquid markets, and some

improvements have already been announced. Any review must not 'turn the clock back' in terms of transparency; but any accounting policy that causes assets to be written down below their intrinsic worth and is in turn a cause of financial instability, should surely be the subject of urgent review. Nonetheless, even if major revisions to these accounting conventions are eventually deemed necessary by policymakers, they will take years to emerge in a form that commands investor confidence.

Throughout the crisis which began last summer the Bank of England has launched various initiatives designed to ensure that UK banks have adequate access to funding. These have steadily become larger in size, longer in term and broader in terms of any collateral. No such initiatives have however been designed so as to directly stimulate or even facilitate new lending in the mortgage market, and the Bank has been clear that it does not see this as being properly within its remit.

If the Government were to favour secondary intervention in the mortgage market, injecting some sort of Government guarantee into mortgage funding markets looks like the best option...

In the course of my discussions, there has been no shortage of ideas as to how government intervention might best be shaped, including general measures to ameliorate conditions in financial markets and targeted intervention in mortgage funding markets. In considering such proposals I have focussed particularly on minimising the real burden of any government guarantees, ideally with banks retaining all their credit exposure; drawing in new funding from outside government; encouraging greater transparency and standardisation in asset-backed securities markets; and persuading traditional investors to invest so as to optimise the likelihood of eventual recovery in these markets. When judged against these criteria one proposal stood out.

My strong recommendation is that the most effective form of intervention would involve the Government auctioning its own guarantees in a form that could be attached by lenders to AAA tranches of mortgage-backed securities issued to fund their new lending. This would operate broadly as follows:

- the auctions would take place regularly with the size and timing designed to achieve an orderly market with broad distribution amongst mortgage lenders;
- the Government would specify the nature of the securities to which their guarantee could be attached (by rating and structure, for example, AAA covered bonds or AAA residential mortgage-backed securities). In order that the Government did not ultimately bear any credit risk (however remote) they would also take recourse to lenders against any losses incurred as a result of any guarantee. Ideally, no intervention should involve the Government either taking credit risk (other than to the extent covered by the banks themselves) or relieving banks of the need to have the full capital backing for their lending;
- having acquired guarantees in an open market auction, banks would have a defined period (6 months say) within which to attach them to their own new issues of mortgage-backed securities. The guarantees would attach to the mortgage-backed securities until such time as they were redeemed. For as long as the guarantees were being utilised, lenders would pay the price determined by the auction (in basis points per annum on the amount so guaranteed);
- in order to ensure that the benefit of such cheap funding fed directly through to the housing market itself, banks would only be able to attach guarantees to new lending they had made in connection with housing transactions which involved a genuine change of ownership i.e. house moves, buy to let purchases and first time purchases but not remortgages. Certain types of mortgages (a small

minority) would also be excluded; for example near '100 per cent LTV' mortgages and loans to borrowers with seriously impaired credit records;

- in order to fully address the likely shortage of mortgage finance and ensure sustained new issuance of mortgage-backed securities, the guarantees would have to be issued in significant size, say around £100 billion (subject to demand) over the two years 2009 and 2010; and
- over time, the auction price of the guarantee would fluctuate with market conditions but as confidence returned to the market it would fall, eventually to the point where in effect investors would be saying they were no longer prepared to pay for the guarantee. This would be unlikely to happen quickly, but would probably happen by the end of 2010 or earlier if sentiment towards UK housing were to improve very quickly.

Whilst not entirely without risk, this intervention would be highly likely to be profitable for the Government...

Even in today's housing market, the risk that holders of AAA mortgage-backed securities will suffer credit losses is comparatively remote. According to industry estimates, for this happen in respect of the guarantees contemplated by this report, house prices would have to fall more than twice as much as was the case in the 1989 to 1996 period. Even then, the proposal is that the Government should take the added security of secondary recourse to the banks themselves. In a market starved of confidence the proposal therefore amounts to the Government charging for access to the confidence that attaches to its credit rating.

There would be significant demand for such paper...

Both existing holders of mortgage-backed securities and new investors would be attracted to the new instruments (most probably in substantial size). They would be attracted not only by the creditworthiness of the guarantor but also by the limited market risk that would be perceived to attach to such paper (itself a function of the quality of the credit). There would inevitably be some impact on gilt issuance, but the spread over gilts at which this paper would trade and the very different structures of the securities carrying the guarantees would primarily appeal to non gilt investors, most probably those traditionally seen as buyers of residential mortgage-backed securities. In any case the rationale for intervention is entirely consistent with making 'UK plc' a more creditworthy borrower; an objective which, if achieved, would more than offset the consequences of any increase in the supply of 'government guaranteed' paper. Industry experts have validated this thinking, both on the likely demand for the paper and the limited impact on gilt issuance and pricing.

Lenders would definitely bid for the guarantees and their issuance would almost certainly result in higher net lending...

The cost of funding through these instruments would be very attractive to all banks and therefore not a source of stigma. It would be most attractive to those who are most funding constrained who would therefore make the highest bids and take the lion's share of the guarantees on offer. While a case can be made for limiting the scheme so that it would apply only to lending in certain sectors (for example, first time buyers or high LTV loans generally), I believe this would only ensure that the scheme had much less impact overall on net new mortgage lending. The direct link between the guarantee and lending associated with real housing transactions (as opposed to remortgages) would itself ensure that any increase in lending would result in much greater availability of finance in these sectors. This initiative would enable banks to use their best collateral to get long-term access to funding which was sufficiently cheap for there to be a commercially compelling case for new lending.

But intervention of this sort would not be without its difficulties...

This proposal would not be without its difficulties. The Government's recent success in launching its temporary provision of guarantees to banks refinancing short-term funding is reassuring, but the Government would still need to be satisfied that any intervention could be delivered in compliance with state aid rules.

...and the Government has its own judgement to make on the priority it should accord this intervention given the many competing demands on its financial resources taking into account short and long-term objectives

In conclusion, I have three recommendations

Firstly, and looking to the longer term, I believe that the Government should actively encourage the banking industry, both domestically and internationally, to adopt new standards of standardisation and transparency in the market in mortgage-backed securities. As and when the market recovers, this will ensure that it functions much more effectively.

Secondly, and again in the interest of the longer term health of funding markets, I also believe that the Government should encourage the International Accounting Standards Board with its review of the application of its fair value accounting principle so that without making any compromise on transparent disclosure, such an important accounting principle is no longer itself a cause of instability in the financial system.

Finally, and of more immediate import, I believe there is a strong case for the Government to intervene in mortgage finance markets with the explicit objective of containing the impact of the financial turmoil on consumers and the wider economy. My recommended intervention is the auction, during 2009 and 2010, of around £100 billion of the guarantees (to be attached to new issues of mortgage-backed securities) set out in this report. Coupled with now much lower base rates, I believe such intervention would be effective in improving the availability of mortgage finance to consumers and in directly stimulating activity in the housing market, averting the risk of a protracted fall in house prices. It would therefore be of huge benefit to the economy and the public finances whilst affording significant relief to homeowners and would-be homeowners.

James Crosby

24 November 2008

1 Introduction

1.1 In April 2008, following the publication of the Treasury's *Housing Finance Review: analysis and proposals*,[1] the Chancellor of the Exchequer asked Sir James Crosby, working closely with industry experts and practitioners, to advise on options to improve the functioning of the residential mortgage-backed securities (RMBS) and covered bond markets.

1.2 Sir James Crosby's interim analysis was published on 29 July. At that time, the report reviewed the importance of these markets for the UK mortgage market. It also highlighted the extent to which ongoing disruption in these markets had contributed, both in the UK and elsewhere, to higher funding costs for mortgage lenders, and the consequences in terms of higher prices for or reduced access to finance for many borrowers.

1.3 Securitisation markets – one of the first casualties of the global market disruption – will recover in time. When they do, however, they are likely to be different in both scale and structure to their previous incarnation. This final report to the Chancellor builds on and updates the interim analysis, and sets out Sir James' recommendations on further steps that the industry and Government could take to facilitate market adjustment.

1.4 The remainder of this section provides a short overview of the securitisation markets. Chapters 2 and 3 then assess recent global and UK market developments, while Chapter 4 reviews the current policy context, both domestic and international. Chapter 5 proposes steps that the industry could take to promote a sustainable recovery in the mortgage-backed securities markets, while Chapter 6 considers the Government's role in the adjustment process.

Mortgage-backed securities markets

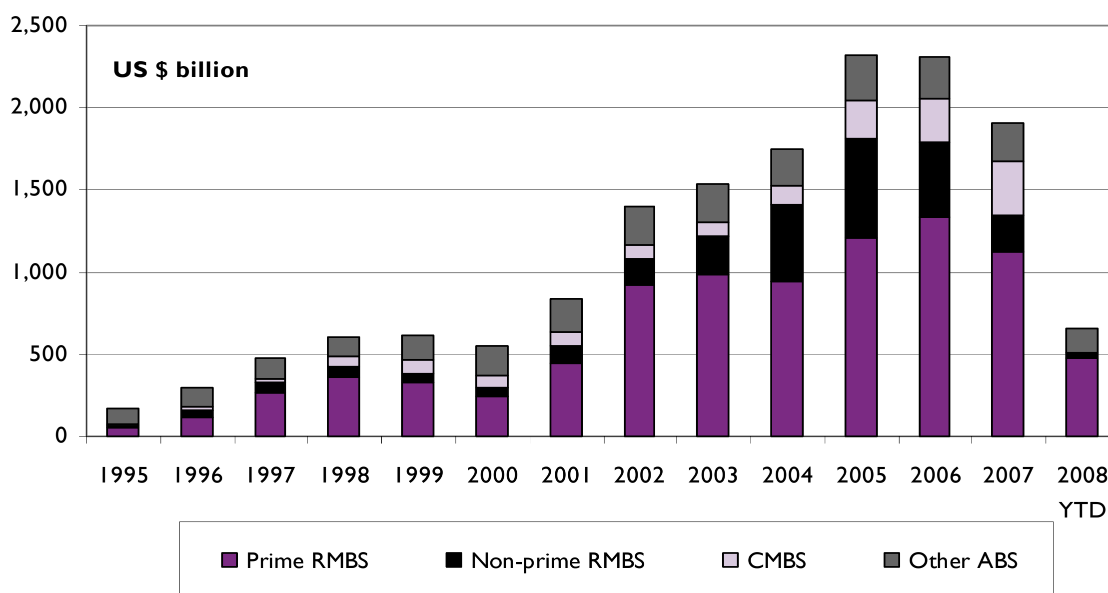
An ongoing sharp correction

1.5 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.

1.6 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.A illustrates with respect to issuance of both RMBS and commercial mortgage-backed securities (CMBS). Covered bonds also benefited, though to a lesser extent given (in a UK context) the much newer nature of the market. The increase in RMBS and covered bonds outstanding in 2006 equated to around two thirds of net mortgage lending during the year.

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

Chart 1.A: Global issuance of asset-backed securities



Notes: Public issuance only. Full-year issuance, except for 2008 which is up to and including September 2008. 'Other ABS' includes Auto, Credit Card and Student Loan ABS.
Source: Bank of England

The UK RMBS market

1.7 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.

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

1.9 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 do so at potentially less cost than would have been incurred if funded from other sources. Another attraction was that this form of funding helped break the link between issuer creditworthiness and cost of funds.

1.10 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 UK covered bond market

1.11 Recent years have also seen a relatively new arrival to the UK securitisation markets; 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. Unlike RMBS, which are secured assets, covered bonds, technically, are not secured assets but are guaranteed by the issuing special purpose vehicle; 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.

1.12 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 £56 billion in 2007 compared with RMBS outstanding of £201 billion. Covered bonds have been used to a much greater extent in several other European countries (in particular, Denmark, Spain and Germany).

International comparisons

1.13 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. Table 1.A provides a snapshot of securitisation issuance across the major European markets and the US.

Table 1.A: Comparisons of RMBS and covered bond balances outstanding (2008 Q3)

	€ billion				
	ABS[1]	CDO[2]	CMBS	RMBS	Covered Bonds[3]
Austria	0.8	-	0.2	2.3	4.1
Denmark	1.6	5.5	-	0.3	335.8
France	9.2	0.9	3.5	13.6	63.6
Germany	32.6	13.7	17.8	5.9	206.5
Ireland	-	3.3	1.6	27.3	13.6
Italy	49.7	4.2	3.8	65.4	-
Netherlands	2.7	11.5	7.6	130.5	15.7
Spain	18.4	43.3	1.5	135.2	267.0
UK	43.7	3.3	74.8	406.9	82.0
USA	1,984.0[5]		401.4[6]	4,574.0[7]	12.9
Multinational[4]	8.5	190.6	28.3	2.9	-
Other	8.9	7.7	0.1	58.2	156.3

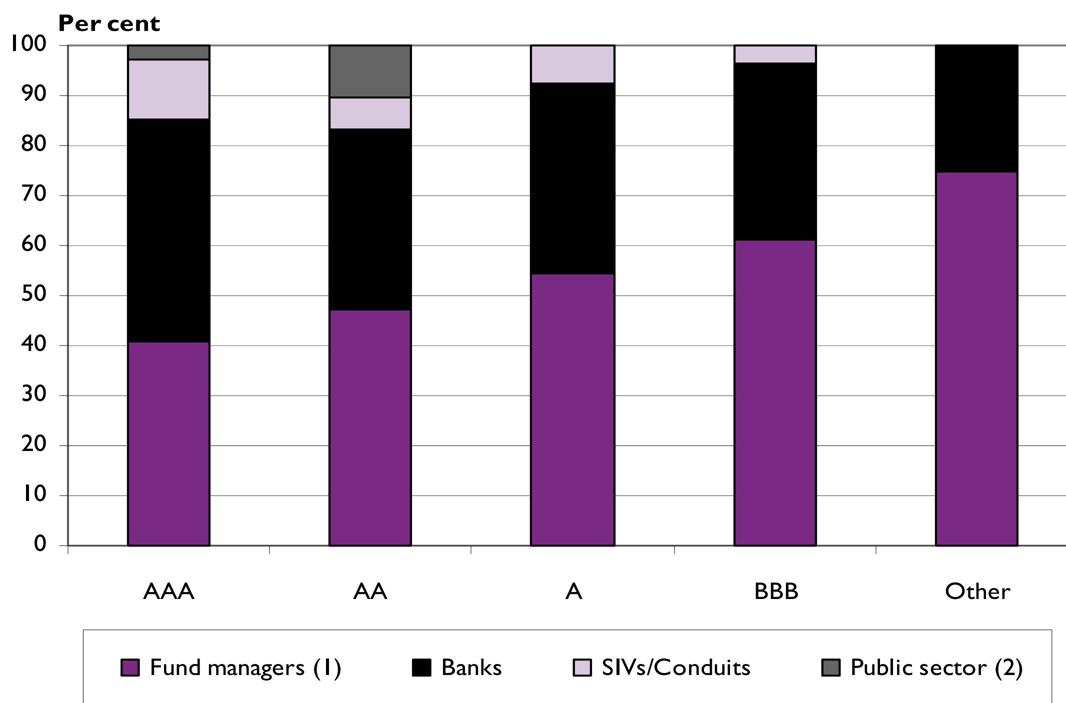
[1] *European ABS issuance includes auto, credit card, leases, loans, receivables and other.*
[2] *European collateralised debt obligations (CDO) issuance includes euro-denominated CDOs regardless of country of collateral issued after July 2007, and only CDOs confirmed by market participants to have known European collateral issued prior to this date.*
[3] *Data relates to covered bonds where the underlying asset is mortgages and 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] *US CMBS relates to non-agency CMBS.*
[7] *77 per cent of the €4,574 billion outstanding RMBS in the USA is agency RMBS.*
Sources: European Securitisation Forum and European Covered Bond Council

Issuers and investors

1.14 The main issuers of UK RMBS have historically been retail banks, with investment banks, specialist lenders and building societies accounting for smaller volumes of RMBS issuance.

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

Chart 1.B: Pre-crisis investors in UK RMBS by rating



[1] *Includes money market mutual funds.*

[2] *Includes Supranational, Sovereign Wealth Funds and Agencies.*

Source: Bank of England

1.16 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 around 60 per cent of UK RMBS (Chart 1.B).

1.17 Also worth noting as a feature of the UK RMBS investor base, and shown in Table 1.B, 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.

Table 1.B: Investors in UK RMBS and covered bonds, by country

	Covered Bonds (percentage of global market)	RMBS (percentage of global market)
UK	12[1]	34
Ireland		6
Germany / Austria	24	5
France	15	6
Spain / Portugal	0	4
Benelux	9	5
Scandinavia	24	3
USA	1	31
Asia	3	2
Other	12	6
Total	100	100

[1] *UK and Ireland combined.*

Notes: Based on covered bonds issuance between 2006 and 2007 and RMBS issuances between 2005 and 2007. Percentages may not sum to 100 due to rounding.

Source: Merrill Lynch

1.18 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.[2]

1.19 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. As Table 1.B illustrates, around one eighth of investors in UK covered bonds have been domestic, with the rest coming primarily from elsewhere in Europe (in particular, Germany, Austria and Scandinavia).

An implosion in investor demand

1.20 Since the summer of 2007, the current low volumes and wide spreads in secondary trading attest to markets that were neither as deep nor as liquid as was perceived to be the case. The correction is part of a more general reappraisal of risk; a reaction to the mis-pricing that accompanied and fuelled the explosion in structured finance.

1.21 The scale of the recent collapse in demand reflects 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.

1.22 Bank conduits and SIVs have been particularly affected by the current market turmoil. The collapse of demand for debt issued by highly leveraged vehicles has forced banks in many circumstances to provide support to these vehicles. It is unlikely that these types of investor in mortgage-backed securities will return to securitisation markets in the future.

1.23 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.

[2] Data provided by the Financial Services Authority.

1.24 Also of concern to investors is that there is perceived to be a large number of reluctant holders of RMBS, 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.

1.25 Investors may be further deterred from buying mortgage-backed assets by fair value accounting rules, which require the valuation of illiquid assets on a short-term mark-to-market basis, if this results in assets being written down to less than their intrinsic worth.

1.26 The reliance of UK markets on overseas investors, a particular feature of the boom years, has also contributed to the subsequent downturn. US investors' concern over prospects for the US housing market may naturally influence their perception of UK mortgage-backed assets.

2 Global economic and market developments

2.1 Since the publication in July of the interim report, global economic activity has continued to slow and the financial markets – in a context of widespread deleveraging and efforts to rebuild balance sheets – have grown increasingly turbulent. This has prompted governments around the world to respond in ways and on a scale that would have seemed implausible 18 months ago.

2.2 The interim analysis noted the considerable strain on the global inter-bank funding market, and the acute level of concern over the health of financial institutions. Far from ebbing over the intervening period, those concerns have weighed ever more strongly on market sentiment, reshaping in the process the face of financial services, and of investment banking in particular.

Global economic developments

A deteriorating global backdrop

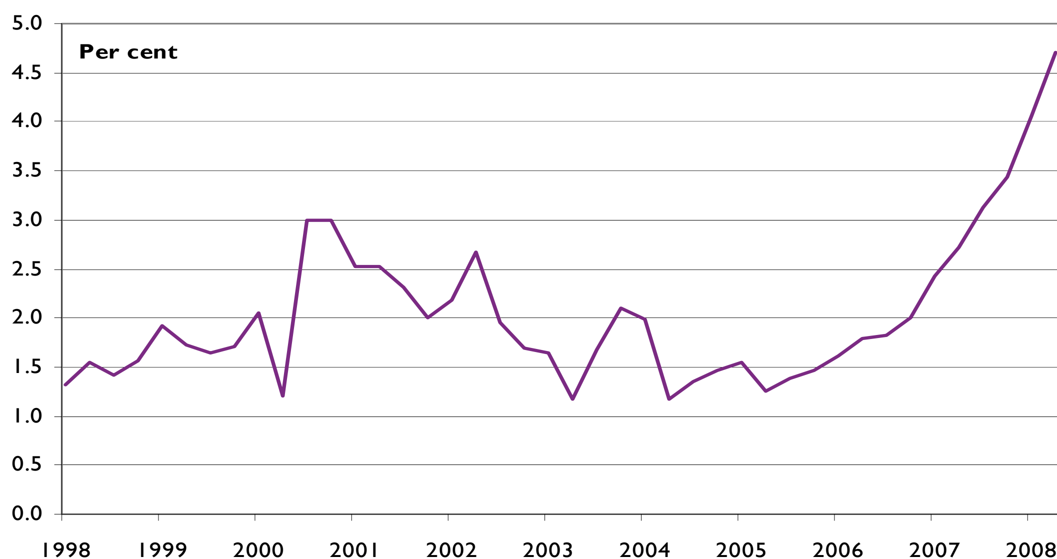
2.3 Global economic prospects have deteriorated markedly since the spring. The global credit shock, which began in summer 2007, caused credit conditions to tighten across advanced economies and growth to slow. The surge in commodity prices in the first half of 2008 lifted inflation, squeezing real incomes. The escalation of the global banking crisis weakened growth prospects further in advanced economies, and the risk of contagion to emerging markets has increased. Governments around the world have taken unprecedented actions to stem the crisis.

2.4 Against this backdrop, the IMF forecasts world growth to have slowed to 3.7 per cent in 2008 and to just 2.2 per cent in 2009. This represents a marked slowdown from the 4¾ per cent expansion in 2007, and the combination of major economic shocks and an unprecedented global policy response has generated exceptional uncertainties in forecasting economic prospects.

US sub-prime mortgages

2.5 Rising foreclosures on US sub-prime mortgages in the second half of 2007 triggered global financial disruption, and that trend in foreclosures has continued, as shown in Chart 2.A. As concerns grew over the implications for lending institutions, the impact on US financial markets spread quickly around the world.

Chart 2.A: US sub-prime mortgage foreclosure rates



Notes: US sub-prime typically refers to borrowers with low FICO scores and high loan-to-value (LTV) ratios.
Source: Bank of England

2.6 The US market appears to have been particularly vulnerable to problems. As highlighted by a recent Bank for International Settlements (BIS) special report, it is estimated that around 18 per cent of US mortgages originated in 2006 had loan-to-value (LTV) ratios of around 100 per cent. In the UK, in contrast, this type of borrower made up a small minority of the total market, less than 1.5 per cent.[1] According to the BIS report:

> "*The US housing construction sector seems to have managed to build up a substantial oversupply of housing. The United States was therefore more likely to experience a sharp fall in prices than some other countries, even before credit supply tightened. Mortgage lending standards also eased more: only in the United States was there such a rapid expansion of sub-prime, no-deposit, state-income, teaser and negative amortisation mortgage products (sometimes all of these feature in the one loan). Households were therefore more likely to fall into negative equity, and if they did, to default on their mortgages.*"[2]

2.7 Around 18 per cent of US sub-prime borrowers and 4.5 per cent of mortgage borrowers are currently behind on their payments; in the UK, less than 1.5 per cent of mortgages borrowers are currently in long-term arrears.[3]

2.8 Although the financial shock is shared across national borders, this does not mean that all the major economies face identical problems. There are significant differences between, for example, mortgage lending in the US and the UK. In the US, it is estimated that up to a quarter of all loans are 'sub' or 'near' prime; although there are no precise definitions, the UK market is generally agreed to have been much smaller. Most US sub-prime lending, unlike its UK equivalent, was at heavily discounted initial rates; the US tax system to a greater extent encourages both home ownership and high leverage on the part of borrowers; the mortgage and legal systems may have inclined lenders – in what was a very competitive marketplace – to

[1] Source: Financial Services Authority.
[2] *The housing meltdown: why did it happen in the United States*, BIS working paper No.259, September 2008.
[3] Source: Mortgage Bankers Association and Council of Mortgage Lenders.

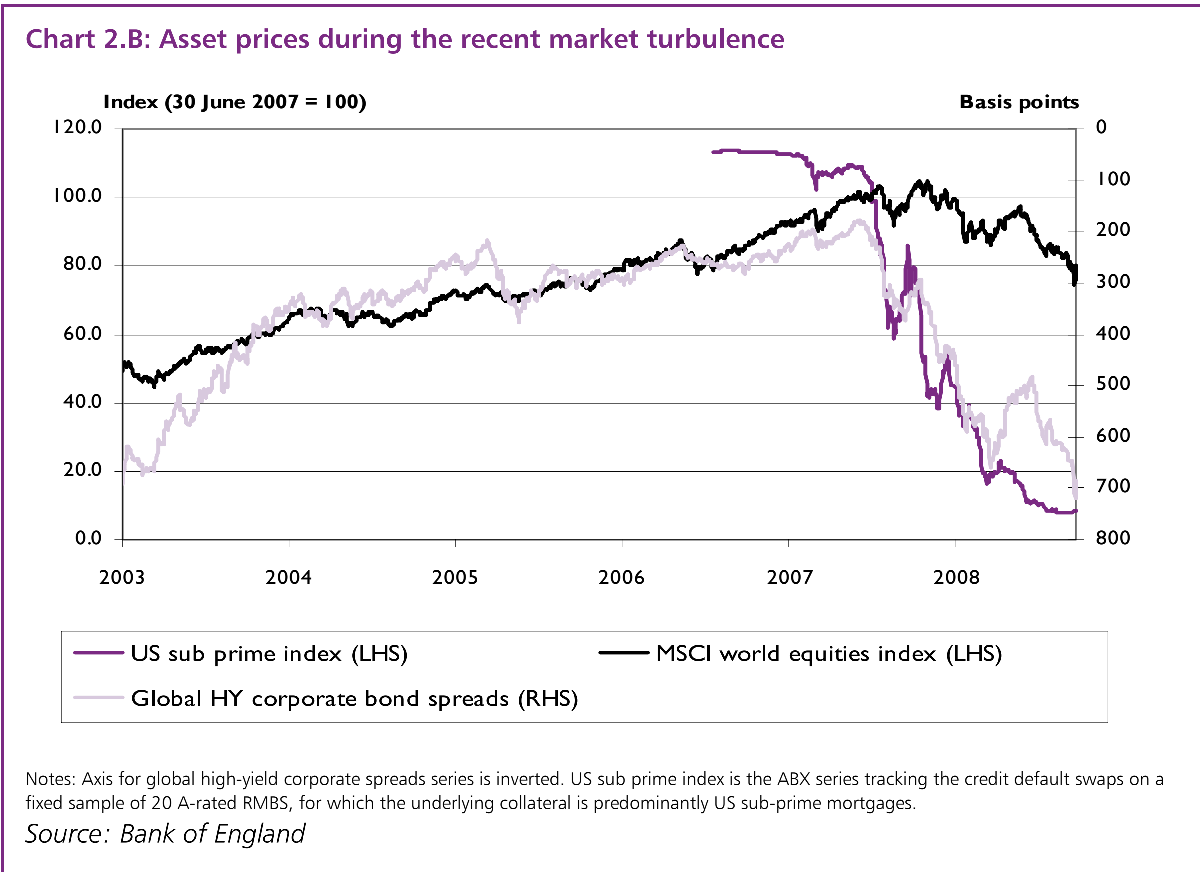
focus on collateral rather than affordability; "no-recourse lending" prevalent in the US incentivised borrowers to walk away from their debt once the equity in the property was extinguished; and the regulatory environment in the US has tended in the past to be less rigorous than the UK (though recent reforms seek to address this).

2.9 The appropriate response to a shared financial or economic problem may differ between countries. What matters is not that something is done, but that whatever is done reflects the specific economic, legal, financial, institutional and social structures of the country concerned, and is effective in that context. To the extent that this allows for effective coordination across borders, however, the impact of such intervention can clearly be magnified.

Global financial market developments

2.10 Credit markets around the world are continuing to re-price risk in the wake of the problems experienced in the US housing market (Chart 2.B). This necessary reassessment is part of a wider market adjustment following the boom in securitisation and the highly leveraged activity of the earlier part of the decade. That it is necessary does not, however, make it any the less traumatic, with the ripple effect on asset markets running from the US to Europe and around the globe.

Chart 2.B: Asset prices during the recent market turbulence



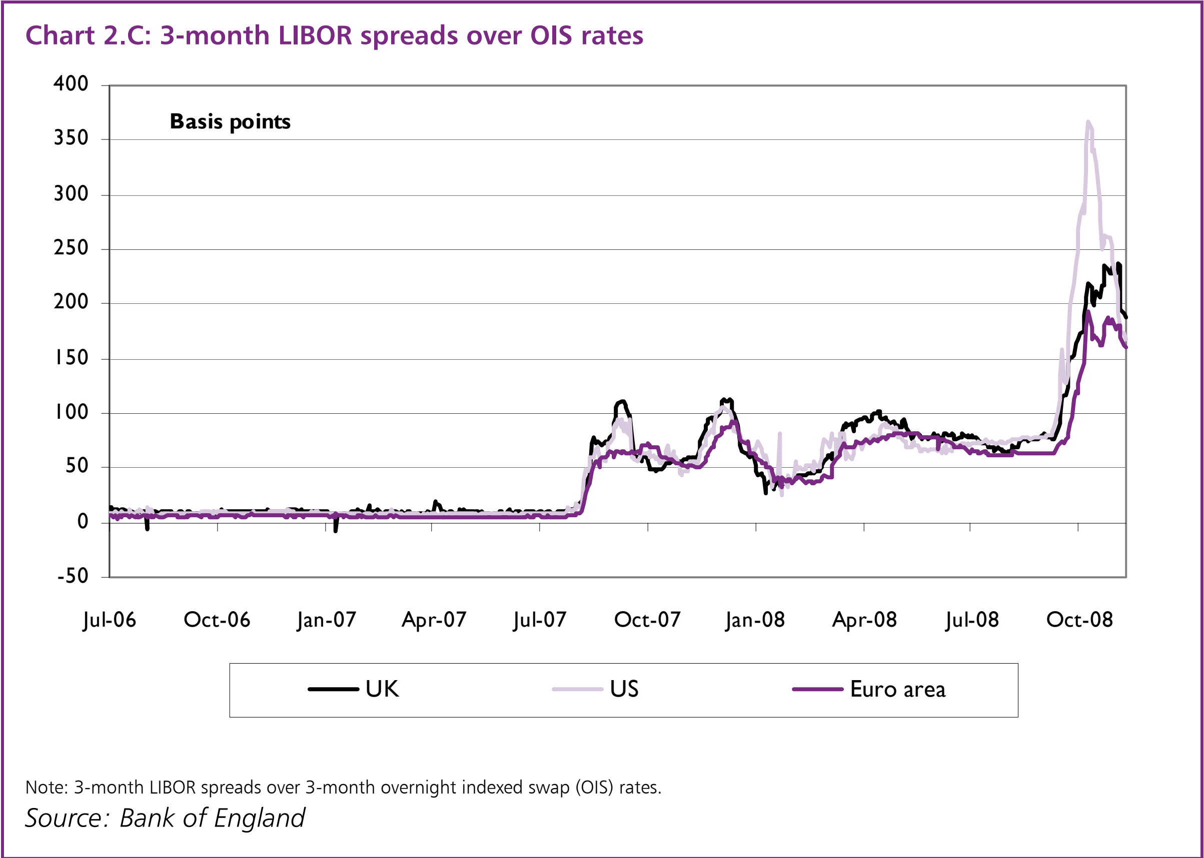
Notes: Axis for global high-yield corporate spreads series is inverted. US sub prime index is the ABX series tracking the credit default swaps on a fixed sample of 20 A-rated RMBS, for which the underlying collateral is predominantly US sub-prime mortgages.

Source: Bank of England

2.11 This risk adjustment has been complicated and exacerbated by financial institutions' uncertainty about both their own capital and funding positions and those of their counterparties. Capital ratios of financial institutions came under pressure from a number of directions, including the impact of large write-downs on assets, and the need to stand behind and provide capital backing for previously off-balance sheet structured investment vehicles (SIVs) and conduits. Funding pressures, meanwhile, reflected the sudden drying-up of access to the securitisation markets. 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.

2.12 The impact of the global reassessment of risk has been particularly evident in the interbank funding market. LIBOR-OIS spreads, which show the difference between the rate banks charge for loans relative to the market expectations of average overnight rates over the same period, and can be a useful indicator of banks willingness to lend, widened sharply last summer in the face of acute concerns over liquidity, sub-prime related losses and counterparty risk, and have continued to do so in recent months, reaching a new peak in the beginning of November (Chart 2.C).

Chart 2.C: 3-month LIBOR spreads over OIS rates



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

Source: Bank of England

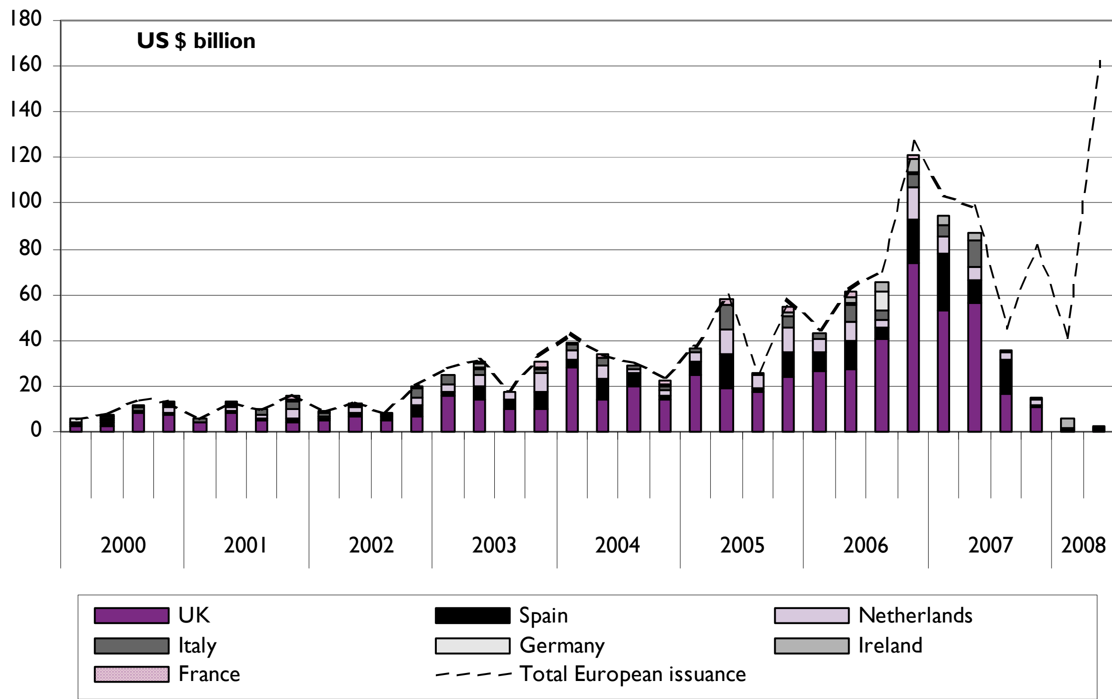
Primary issuance

2.13 Prices and volumes of structured products sold in primary and secondary markets around the world have fallen significantly under the weight of the pressures outlined above.

2.14 In Europe, securitisation issuance in the first quarter of this year was €40 billion; a fall of 69 per cent from Q1 2007. While issuance in the second quarter of this year picked up to €169.4 billion,[4] as Chart 2.D illustrates, the vast bulk of this was retained as a means of accessing liquidity via central banking facilities. Estimates suggest that in the second quarter of 2008, approximately 98 per cent of all securitisations were retained for use in repurchase operations with central banks.

[4] *Securitisation Data Report 2008 Q2,* European Securitisation Forum.

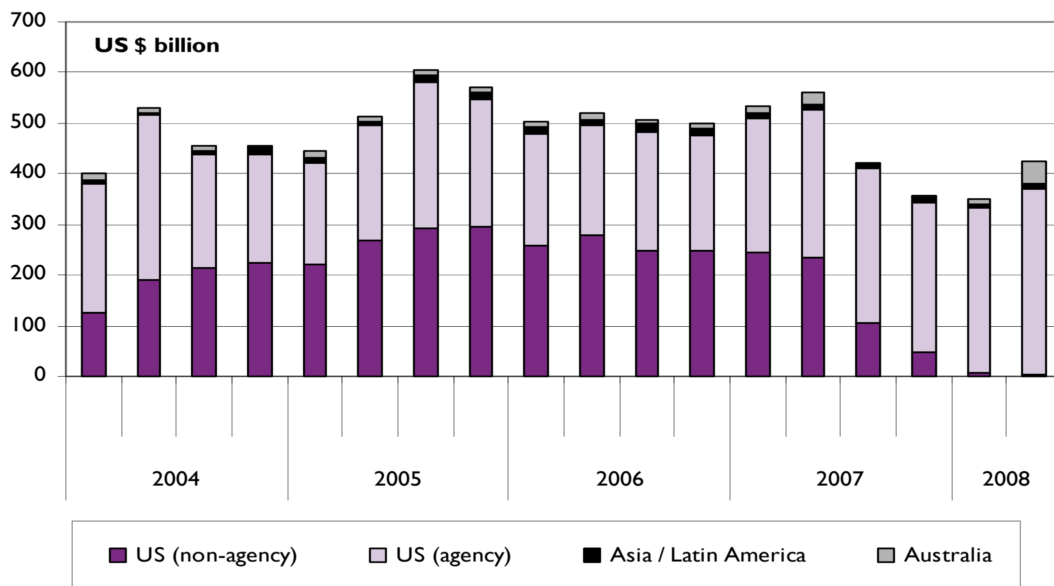
Chart 2.D: European public and total RMBS issuance



Notes: Bars include public issuances only. Dotted line shows total European issuance, which also includes issues placed as collateral with central banks.

Source: Bank of England

Chart 2.E: Non European issuance of RMBS



Source: Merrill Lynch

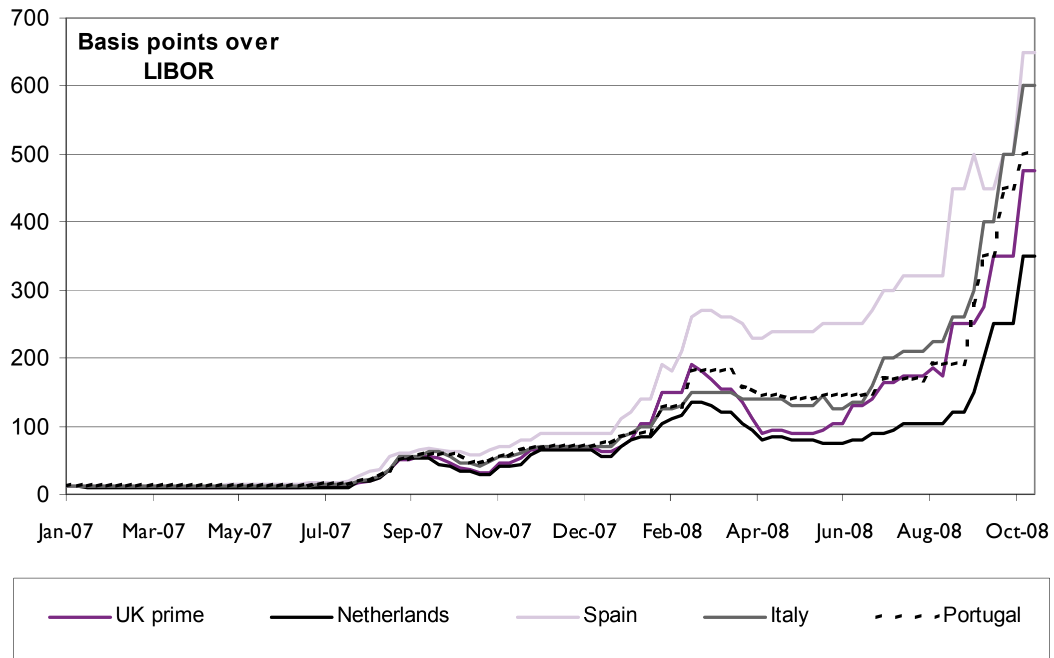
2.15 German banks remain the largest users of the ECB facilities in absolute terms, but with banks in other member states (such as Spain and Ireland) increasing their share of repo lending.

2.16 This trend of sharply declining public market activity and rising retained issuance is mirrored in the US. As shown by Chart 2.E, non-agency issuance has fallen significantly and US banks, like their European counterparts, have increasingly used mortgage-backed assets to access central bank liquidity.

Secondary markets

2.17 As Charts 2.F and 2.G demonstrate, RMBS and covered bonds across Europe have traded at very high credit spreads since last summer's market turbulence. These spreads reflect very thin pricing in secondary markets in the absence of primary market trading. As a result, under fair value accounting rules, banks are valuing assets according to short-term mark-to-market fluctuations, which, in the absence of a functioning market, may not fully reflect their intrinsic worth.

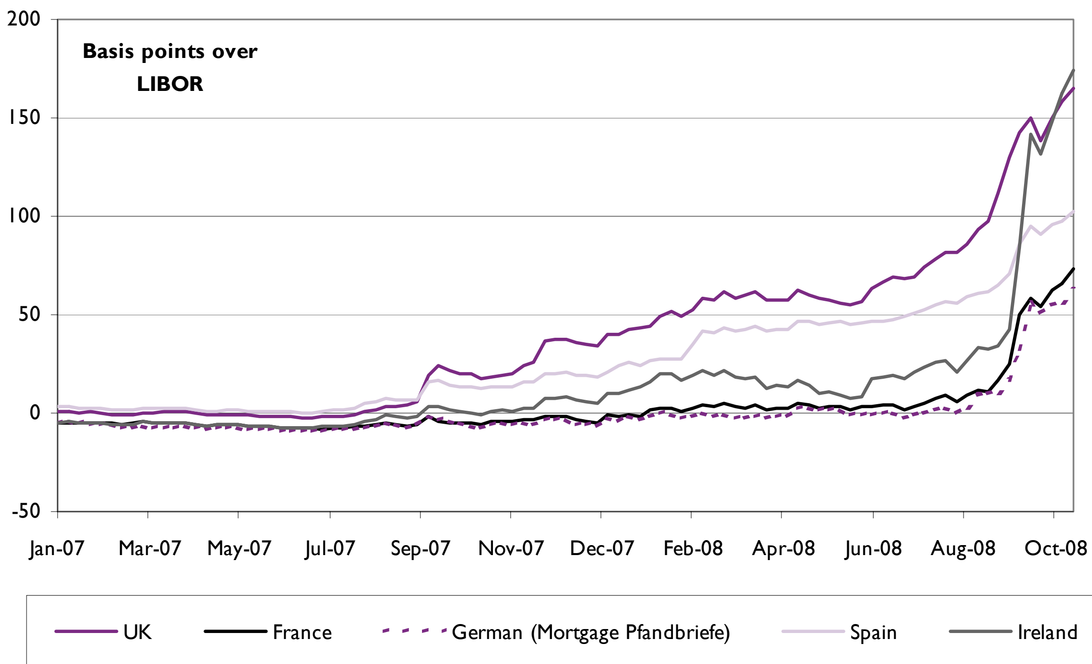
Chart 2.F: International comparisons of AAA-rated RMBS spreads



Note: Spreads are for floating rate securities with weighted average life of 5 years. For the UK spreads are given as basis points over LIBOR. For all other countries basis points over Euribor.

Source: UBS

Chart 2.G: International comparisons of covered bond spreads



Note: Spreads are given as basis points over Euribor.

Source: Deutsche Bank

3 UK market developments

3.1 The freezing of securitisation markets and the global reassessment of risk has had a significant impact on the availability of funding for the UK mortgage market. The lack of access to a previously important source of wholesale funding, combined with balance sheet adjustment on the part of many lenders, has led to tighter credit criteria, reduced product choice and higher borrowing costs for some borrowers, in particular those with high loan-to-value ratios (LTVs).

3.2 A reduced supply of mortgage finance, combined with reduced demand on the part of prospective purchasers expecting further falls in house prices, has led to and in turn been fuelled by significant declines in new mortgage lending and property transactions. It has also provided the backdrop for structural consolidation within the mortgage sector (whether through merger, acquisition or exit), and an expansion of market share on the part of those institutions which have remained active.

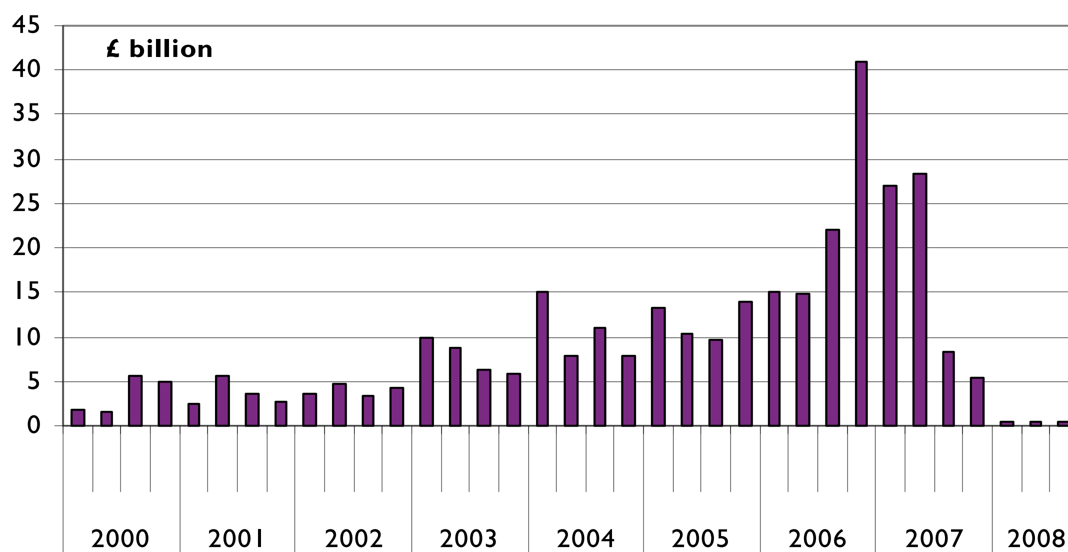
Anaemic securitisation activity

3.3 With the largest RMBS market outside the US, the UK continues to share in the global collapse in securitisation activity outlined in Chapter 2. Having fallen steeply through the second half of 2007, new issuance of publicly traded UK RMBS has remained at very low levels in 2008.

3.4 In the UK, as in Europe, the majority of new issuance of recent months has been retained by the issuing banks for use in the Bank of England's Special Liquidity Scheme. Industry estimates suggest that the bulk of UK RMBS issuance has been retained, with only three separate and very small issues in March, May and August this year being publicly placed (Chart 3.A), and no indications as yet of other banks intending to follow suit. In terms of public placements, the covered bond market is also effectively closed to new issuance.

3.5 In the absence of an open securitisation market, funding for new mortgage lending is constrained not only by the scale of retail deposit growth and the availability of alternative sources of wholesale funding but also by the competing (and priority) demand for funds as existing mortgage-backed securities mature and need to be refinanced.

Chart 3.A: UK RMBS public issuance



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

3.6 The amount of RMBS and covered bonds maturing in each year from 2008 to 2010 is estimated to be around £161.5 billion (Table 3.A), although this is very difficult to determine with any precision.

Table 3.A: Volume of maturing AAA-rated securities (£ billion)

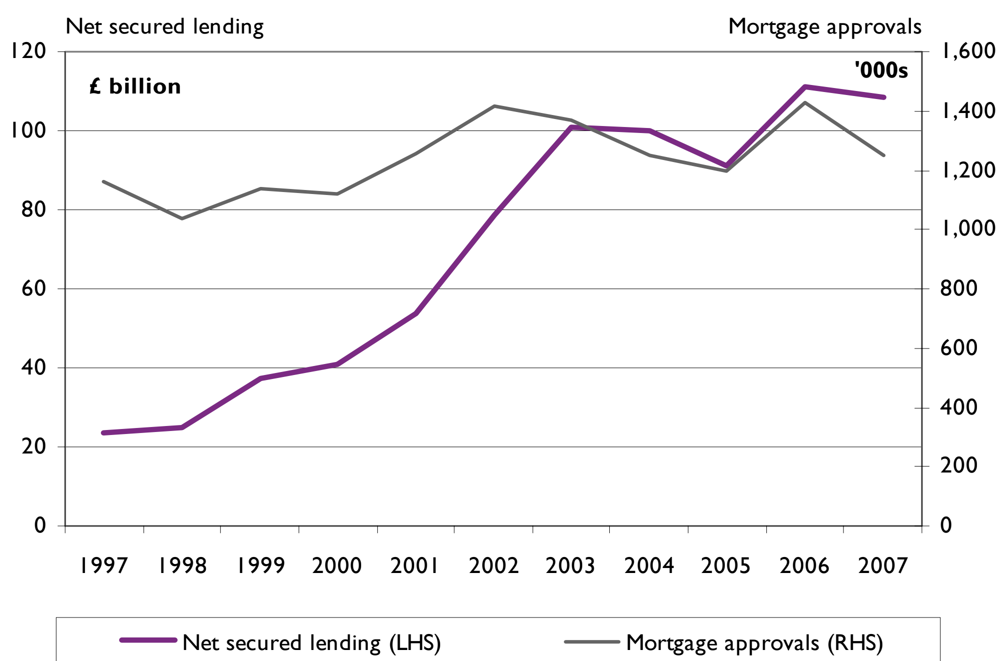
	RMBS	Covered Bonds	Total
2008	56.5	-	56.5
2009	46.4	5.1	51.6
2010	48.0	5.4	53.4

Note: - symbol indicates that the amount is negligible.
Source: UBS, JPMorgan and HM Treasury calculations

Constrained new lending

3.7 Mortgage lending growth has slowed considerably in recent months. As of September 2008, net lending secured on a residential property totalled £37.4 billion for the year to date, and appears unlikely to increase markedly over the remainder of the year. This level of net lending compares with £84.7 billion during January-September 2007, and is significantly below the £108.3 billion lent during 2007 as a whole (Chart 3.B).

Chart 3.B: UK net secured lending on residential property and mortgage approvals



Source: Bank of England

3.8 As discussed in the interim analytical report, the closure of the securitisation markets – itself, a consequence of concerns over the actual and potential losses incurred by banks on past lending – is contributing to higher funding costs 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.

Impact on consumers

3.9 The extent to which borrowers are affected by a supply constraint will, of course, depend on what is simultaneously happening to demand; supply and demand side factors are interdependent. Survey and anecdotal evidence also suggests 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 reported that demand for secured lending for house purchase had fallen sharply during the third quarter of the year by more than had been expected, with demand expected to continue to fall over the coming three months.[1] The report also highlighted the extent to which banks were further restricting lending due to their concerns over the future level of house prices.

3.10 The sharp reduction in the supply of mortgage lending has, however, clearly had an influence on the housing market and on consumers. That housing transactions are down around 50 per cent compared to a year ago, and that house prices are now falling sharply after rising 10 per cent in the year to July 2007, reflects at least in part the higher price and reduced availability of lending.

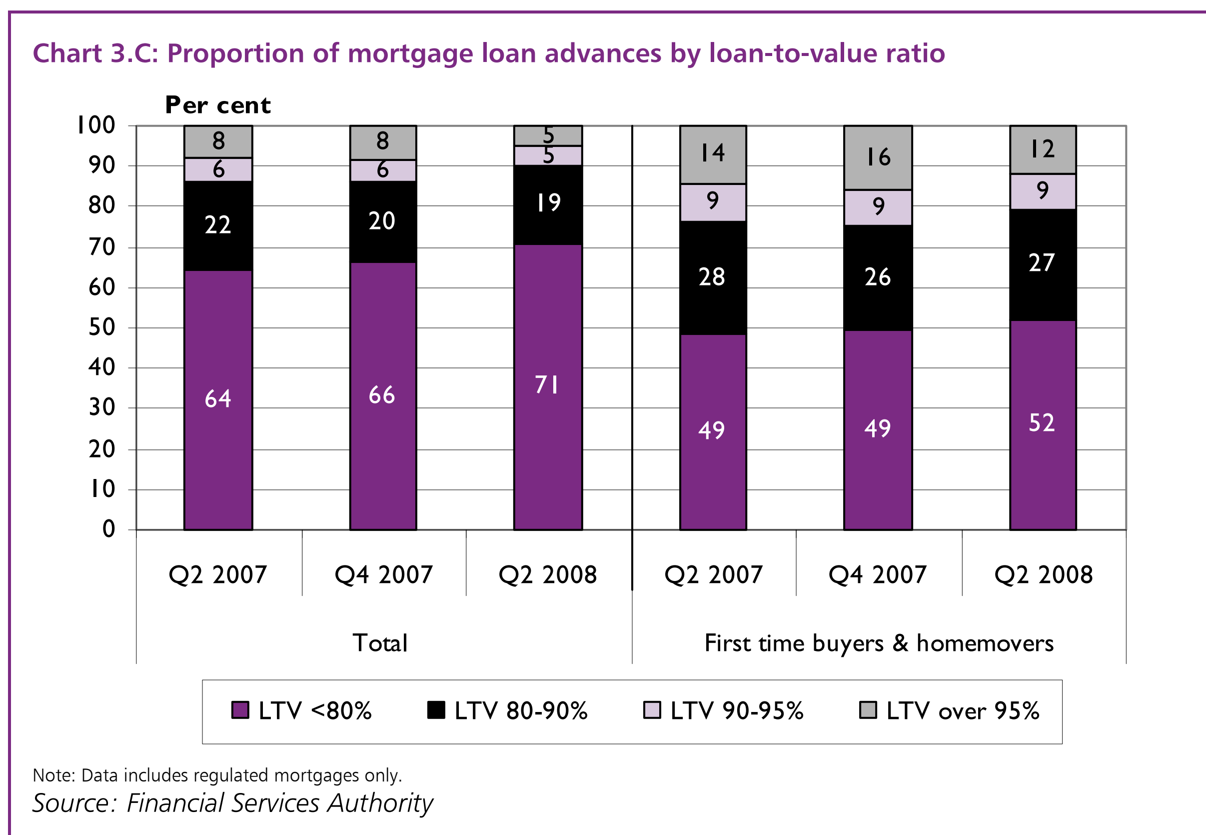
[1] *Credit Conditions Survey 2008 Q3*, Bank of England, http://www.bankofengland.co.uk/publications/other/monetary/creditconditionssurvey081002.pdf

First time buyers

3.11 Lenders are continuing to tighten lending criteria and lend primarily to low-risk borrowers. The number of mortgage products on offer has contracted, especially for borrowers with high loan-to value ratios (LTVs). The number of two- and five-year fixed-rate mortgages offered to buyers with a deposit of not more than 5 per cent of the purchase price, for example, fell in May to levels where the Bank of England was no longer able to release data on the average mortgage rate and this remains the case today.

3.12 According to recently published data, the proportion of new loans with an LTV of more than 90 per cent, fell from 14 per cent at the beginning of 2007 to 10 per cent in the second quarter of 2008 (Chart 3.C). While lenders are competing keenly for borrowers at low LTVs and with other low risk characteristics, they are generally much less willing to risk capital and funding for higher LTV mortgages. Chart 3.D illustrates that the credit availability to borrowers with high LTV ratios is reported to have fallen in recent quarters with the expectation that this deterioration would continue for the remainder of the year. Loans based on higher income multiples, and loans to borrowers with impaired credit histories, have also seen sharp falls over the last year as a result of the operating difficulties faced by specialist lenders.[2]

Chart 3.C: Proportion of mortgage loan advances by loan-to-value ratio

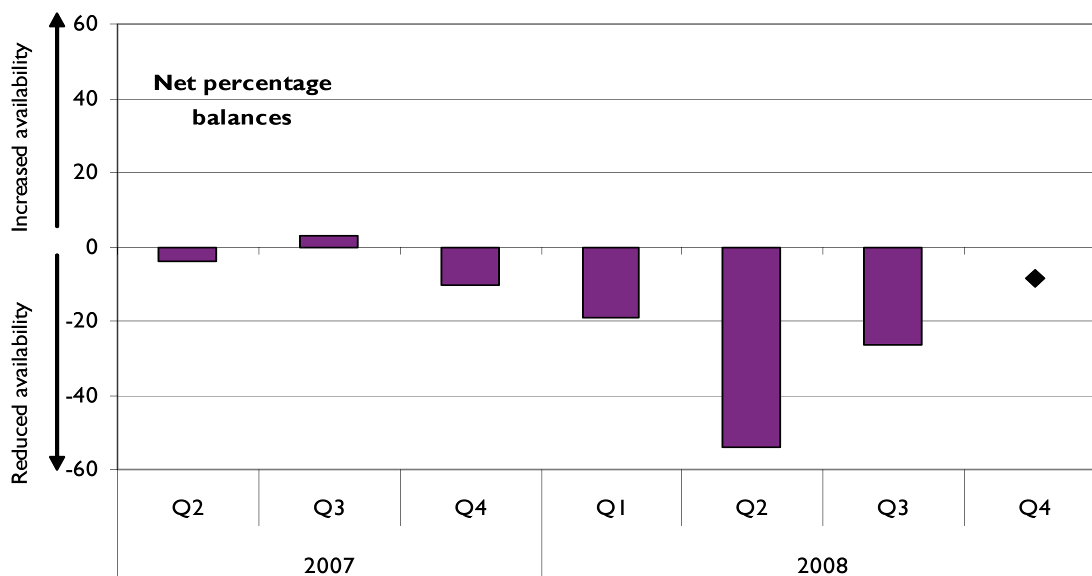


Note: Data includes regulated mortgages only.

Source: Financial Services Authority

[2] *FSA Statistics on Mortgage Lending*, Financial Services Authority, October 2008, http://www.fsa.gov.uk/pages/Doing/Regulated/Returns/IRR/statistics/index.shtml

Chart 3.D: Availability of loans to borrowers with high LTV ratios



Notes: A negative balance indicates lenders are reporting a reduction in loans available to borrowers at high LTV ratios.
Results are calculated by weighting together the survey responses of lenders when asked if they expect to make loans more available to high LTV borrowers.
The red bars show the net balance of responses for the outturn in the previous three months. The black diamond indicates expectations of availability in Q4 2008.

Source: Bank of England – Credit Conditions Survey Q3 2008

Existing homeowners

3.13 Those looking for high LTV mortgages are typically first time buyers, but this group may also include existing homeowners seeking to remortgage with only limited equity in their home. Such homeowners have found it difficult to obtain a mortgage on comparable terms.

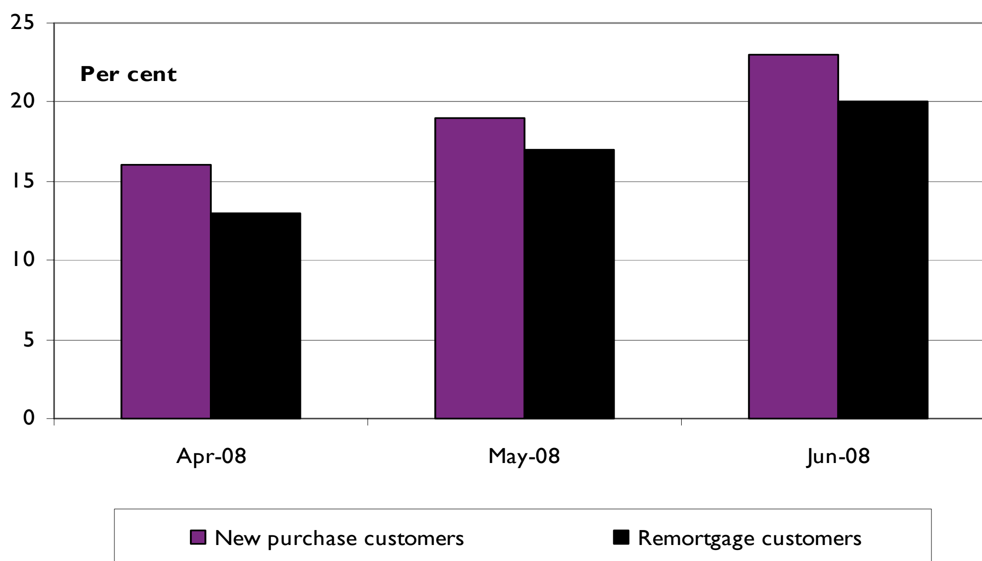
3.14 It is difficult to estimate the number of existing homeowners facing higher rates. Around 1.5 million borrowers are estimated to have taken out fixed rate mortgages in 2006 and 2007, and industry figures suggest that more than two-thirds of these borrowed at fixed rates of up to three years.[3] A small proportion of these borrowers will have had high LTVs, and some of these may face a payment shock when their fixed rates mature and they move to more expensive fixed rate deals, or onto higher standard variable rates (SVR).

3.15 Rising mortgage rates may be contributing to the current rise in the number of court orders and repossessions (albeit from a historically low base). Most homeowners, however, have considerable equity in their homes – notwithstanding recent house price falls – and are adjusting.

3.16 The reduced activity of specialist lenders and intermediaries also means that households at risk of facing payment problems can no longer refinance easily elsewhere, with the result that a larger part of the poorer credit risk remains with the mainstream lenders. The proportion of customers (whether seeking to purchase a house or remortgage) for whom mortgage intermediaries are unable to find a mortgage has been rising (Chart 3.E).

[3] Council of Mortgage Lenders estimates.

Chart 3.E: Percentage of customers that intermediaries are unable to assist



Note: Based on a sample size of approximately 220 customers.
Source: Association of Mortgage Intermediaries

3.17 Average quoted mortgage rates for fixed rates and other types of products have fallen over recent months following falls in swap rates (which reflect market expectations about future moves in interest rates). Even where rates have fallen, however borrowers may be asked to pay high upfront arrangement fees, negating some of the savings.

Near-term prospects

3.18 It is difficult to assess the prospects for the market in the short-term, though recent large-scale interventions by the Government and the Bank of England to push both capital and liquidity into the financial system will certainly help mitigate problems. Nevertheless, continuing strains in wholesale funding markets, pressure on banks to reduce their balance sheets, and the continuing need to refinance existing mortgage-backed funding, are constraining the ability of the market to make new loans.

3.19 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.

3.20 Many institutions are currently offering attractive rates to UK savers. It is, however, difficult to determine whether this fosters an acceleration in customer deposit growth, or simply creates greater competition for existing deposits. It is also difficult to estimate with any certainty the path of savings over the next one to two years. That first time buyers may now require a higher deposit to buy a house, points to increasing saving. At the same time, however, the current economic climate may make it increasingly difficult for households to save, and some savers, for example parents, may choose to run down their savings to help fund deposits for house purchases by their children. 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.

3.21 For as long as these pressures remain, most lenders will have no incentive to expand their balance sheets. Unprecedented as such a development would be, there is therefore a possibility that net mortgage lending falls to zero over the next two years. A sustained reduction in

mortgage finance on this scale would clearly have wide implications for the market and the UK economy.

Industry consolidation

3.22 Recapitalisation and structural adjustment is happening in part within firms (helped in some cases by taxpayer support through the Government's recapitalisation scheme) and in part through merger, acquisition, or exit from the market. The number of firms engaged in mortgage lending has contracted as volumes of both lending and securitisation have declined, and as balance sheets have come under pressure.

3.23 A number of lenders have announced book reduction programmes, including Northern Rock and Bradford & Bingley, which were taken into temporary public ownership earlier this year, and Alliance and Leicester, acquired by the Spanish bank Santander this summer. Current market conditions are also encouraging greater concentration in the mortgage market; September, for example, saw Nationwide's recent merger of the Cheshire and Derbyshire Building Societies, and the merger announcement of Lloyds TSB and HBOS.

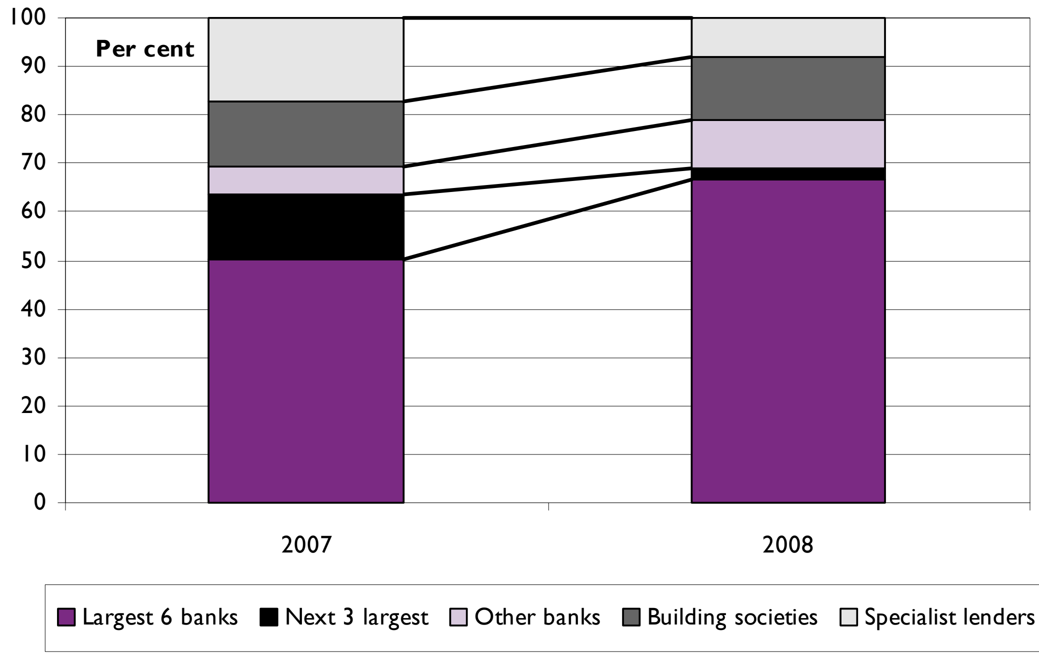
3.24 Specialist non-bank lenders have withdrawn almost entirely from the market. Whereas there were between 10 and 12 specialist lenders a year ago, industry estimates suggest that no more than three are now accepting new business.

3.25 The UK mortgage market has been recognised as one of the most competitive markets in Europe.[4] Competition is not, of course, a function solely of the number of players in a marketplace. A sector with a small number of firms may be extremely competitive and beneficial for the consumer, while one with a larger number may not be; but ongoing consolidation reflecting a narrowing of funding sources does raise a risk of reduced new entry into the sector dampening competitive pressures.

3.26 As Chart 3.F illustrates, the market share of new lending of the largest six banks stood at over 66 per cent in June 2008, from just over 50 per cent a year earlier; the same firms' share of mortgage approvals rose by a comparable amount over the same period. While the amount of new lending undertaken by these major institutions contracted in absolute terms, that of their smaller bank, building society and specialist lender competitors fell even more steeply.

[4] *Study on the Financial Integration of European mortgage markets*, Mercer Oliver Wyman, 2003.

Chart 3.F: Change in the market share of new lending



Note: Data up to June of each year.

Source: British Bankers Association

4 The policy context

4.1 Recent responses to the global financial turmoil have been a mix of national and, increasingly, coordinated approaches, with coordination evident between both central banks and governments. Actions are being taken both in the UK and internationally to stabilise markets and to enhance the stability and resilience of the financial system for the future. Given the global nature of the disruptions in financial markets, and the interconnectedness and complexity of the international financial system, it is vital for countries to coordinate their actions and to take account of the potential cross-border effects of national decisions.

Recent financial instability

4.2 September 2008 arguably marked the beginning of the most turbulent period since the beginning of the current financial turmoil. US mortgage finance agencies Fannie Mae and Freddie Mac were placed into conservatorship, as doubts increased about their solvency in the context of the ongoing housing correction.

4.3 Only a few days later, Lehman Brothers' stock tumbled sharply as concerns about its financial condition grew. This eventually led Lehman Brothers to file for bankruptcy protection. Other US investment banks came under pressure, prompting a sale of Merrill Lynch to Bank of America, and subsequently the transformation of Morgan Stanley and Goldman Sachs into deposit taking banks, allowing them access to the Federal Reserve's discount lending window. In September too, the US Federal Reserve, with the support of the US Treasury, decided to lend up to $85 billion to insurer AIG.

4.4 In the aftermath of Lehman Brothers' collapse, institutions across Europe and the US experienced severe difficulties. The global financial system came under extreme stress due to liquidity and solvency problems, as financial institutions and investors lost confidence in counterparties in general. This led to Fortis' bail out by the Netherlands, Belgium and Luxembourg, the bail out of Hypo Real Estate by the German Government and banks, and the recapitalisation of Dexia by France and Belgium. Stock markets fell rapidly, with the FTSE losing 13 per cent in September 2008 and experiencing further falls thereafter.

Stabilising markets

UK policy response

4.5 In response, the Government, Bank of England and the FSA have taken decisive action to maintain UK financial stability. The principles adopted in the UK are being adopted by Governments around the world.

4.6 At the end of September, the Government announced that Bradford & Bingley's UK and Isle of Man retail deposit business, along with its branch network, had been transferred to Abbey National plc., and that the remainder of Bradford & Bingley's business would be taken into public ownership.

4.7 After consultation with the Bank of England and the Financial Services Authority, the Government announced on 8 October that it would bring forward specific and comprehensive

measures to ensure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers, and safeguard the interests of the taxpayer. Box 4.A summarises these measures.

Box 4.A Measures to support stability in the UK financial system

In order to support stability, protect depositors and safeguard taxpayers' interests:

- the Bank of England extended its Special Liquidity Scheme (SLS) to provide liquidity in the short-term. At least £200 billion will be made available to banks under the SLS. Bank debt that is guaranteed under the Government's guarantee scheme will be eligible in all of the Bank's extended-collateral operations.
- the Government announced the establishment of a facility which will make available Tier 1 capital in appropriate form (expected to be preference shares or PIBS) to UK incorporated banks. On 13 October, following detailed discussions, the Government announced capital investments to RBS and upon successful merger, HBOS and Lloyds TSB, totalling £37 billion.
- the Government also announced a Government guarantee of senior unsecured debt instruments (Certificates of Deposit (CDs), Commercial Paper (CP), and senior unsecured bonds and notes), available to eligible banks and building societies, and aimed at restoring confidence in the inter-bank lending market. The guarantee is due to terminate on 13 April 2012. The Government expects the take-up of the guarantee to be of the order of £250 billion, and will keep this under review alongside ongoing monitoring of capital positions and lending volumes.

Enhancing the resilience of the financial system

The UK Government

4.8 On 7 October this year, following extensive consultation with the financial services industry, the Government introduced the Banking Bill into Parliament. The Bill provides a permanent framework for dealing with banks before and after they get into severe difficulties: enhancing the effectiveness of early regulatory intervention and liquidity assistance, providing the Tripartite Authorities with permanent powers to deal with failing banks, strengthening depositor protection through the Financial Services Compensation Scheme (FSCS), and formalising and strengthening the Bank of England's role in preserving financial stability.

The FSA

4.9 Last year, the FSA published a discussion paper on liquidity requirements for banks and building societies, aimed at reviewing lessons learned from recent market turbulence in managing and regulating firms' liquidity, and setting out preliminary ideas for reform.[1] The FSA aims to publish a follow-up consultation paper before the end of the year, setting out its new regime designed to strengthen the liquidity risk management standards of banks, building societies and investment firms. The new regime implements the recently agreed Basel Committee on Banking Supervision Principles for Sound Liquidity Risk Management and Supervision and proposes a new quantitative framework for liquidity regulation. In parallel the

[1] *Review of the liquidity requirements for banks and building societies*, Financial Services Authority DP07/7, December 2007. http://www.fsa.gov.uk/pubs/discussion/dp07_07.pdf

FSA is also developing new liquidity risk reporting requirements, in discussion with the Bank of England, which will be an integral part of the new liquidity regime.

4.10 On 6 October this year, the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations for reforming the UK approach to ensuring the stability of banks. Lord Turner's report will be published next year.

The Bank of England

4.11 The Bank has taken a range of steps to implement monetary policy and strengthen confidence in the banking system. In April this year, the Bank of England introduced its Special Liquidity Scheme (SLS), providing eligible banks and building societies with liquidity in return for mortgage-backed and other securities, and thereby helping to increase confidence in the financial system. [2] The SLS window is due to close on 30 January 2009.

4.12 On 16 October, the Bank published a consultation paper on the development of its market operations. This proposes a range of reforms designed to improve the functioning of the existing framework, including:

- a Discount Window Facility, enabling banks to borrow gilts or, at the Bank's discretion, cash, against a wide range of eligible collateral; and
- the introduction of permanent long-term repo operations against broader classes of collateral, to be auctioned under a mechanism where counterparties bid separately and against different types of collateral.

4.13 The Discount Window Facility is designed to provide liquidity insurance to commercial banks in the event of stress. The population of eligible collateral will be broad and will be developed over time. Initially it includes highly rated UK, US and EEA asset-backed securities, backed by residential and commercial mortgages, credit cards, student loans, auto loans and certain equipment leases.

4.14 The Bank's reforms of its market operations are important in supporting the liquidity position of the banking sector. Effective liquidity management is a necessary basis for any actions by the industry or Government to improve mortgage funding market functioning.

Coordinated international action to stabilise markets

4.15 The UK has led international efforts to stabilise the global financial system. Both the US Government and the Euro Area have announced proposals based on the UK's approach. US Treasury Secretary Paulson has announced that the US will introduce a standardised equity purchase programme as part of its $700 billion financial package. The Euro Area has also committed to a similar approach: in particular, France and Germany have announced rescue packages of €880 billion, out of which up to €120 billion will be used for recapitalisation.

4.16 On 29 October the International Monetary Fund (IMF) launched a new short-term facility for emerging markets to help these markets during this period. It has reached outline agreements with Iceland, Hungary and Ukraine and is in talks with other countries.

4.17 From the beginning of the current financial turmoil, central banks around the world undertook coordinated action to help ease global monetary conditions. In the last few weeks, major central banks, including the Bank of England, the European Central Bank, and the Federal Reserve announced coordinated reductions in policy interest rates and extended their swap agreements.

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

The US

4.18 As set out in box 4.B, the rapid pace of events in US financial markets has required the US Treasury to take a wide range of actions to ensure market stability and protect the integrity of the financial system.

4.19 It is important to recognise, as set out in Chapter 2, that there are significant differences between US financial markets and other markets, including the UK. The very high delinquency rates in the US sub-prime market have not been replicated elsewhere. Furthermore, the US housing market's unique reliance on the Government Sponsored Enterprises (GSEs) has meant that policy formation has taken place within a specific regulatory and legal context and not necessarily replicated elsewhere.

Box 4.B Measures to support stability in the US financial system

- In September 2008, the Federal Housing Finance Agency was appointed as Conservator of the two main US Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac, in order to oversee the financial health of these institutions. These two institutions own or guarantee over $5 trillion of home loans, or almost half of all outstanding US mortgages. At the same time, the Treasury announced a combination of measures, including Preferred Stock Purchase Agreements to maintain the net worth of the GSEs, and a GSE Credit Facility to provide liquidity to the GSEs, backed by US Treasury funds. These measures confirmed that the US Government would explicitly guarantee these institutions if necessary, something that the market had long held to be the case.
- On 19 September, the US Treasury announced a temporary US Government guarantee programme for money market mutual funds, making up to $50 billion available from the US Exchange Stabilisation Fund.
- On 20 September, the US Treasury submitted legislation (the Troubled Assets Relief Program, TARP) to Congress requesting the authority to purchase troubled assets from financial institutions through the issue of up to $700 billion of Treasury securities. The initial proposition has substantially evolved and was signed into law on 3 October as part of the Emergency Economic Stabilization Act of 2008 (EESA 2008).
- On 14 October, the US Treasury announced that the TARP would include an equity purchase program to recapitalise banks. $250 billion (out of the $700 billion) is devoted to the bank recapitalisation plan.
- On 12 November, US Treasury Secretary Paulson proposed that the bulk of the remaining TARP funds should be deployed to strengthen the capital base of the financial system, support the asset-backed securitisation market critical to consumer finance, and increase foreclosure mitigation efforts.

Enhancing the resilience of the global financial system

4.20 Last year, 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,*[3] to G7 Finance Ministers. Many of the recommendations in the FSF report are aimed at addressing concerns about the operation of the securitisation markets. The FSF proposes action in the following five areas:

- strengthening prudential oversight of capital, liquidity and risk management – including new Basel II capital requirements for certain complex structured products, strengthened capital treatment of liquidity facilities to off-balance sheet conduits, new guidance on supervising and managing liquidity risk, and new guidance for supervisory reviews under Basel II;
- enhancing transparency and valuation – including robust risk disclosures by financial institutions; improved financial reporting standards for off-balance sheet vehicles, new guidance on valuations when markets are no longer active, and expanded information made available by financial institutions about products and the underlying collateral;
- changes in the role and uses of credit ratings – including the revised IOSCO Code of Conduct, and also taking into account the reviews by regulators of the role given to ratings in regulations and prudential frameworks;
- strengthening the authorities' responsiveness to risks – including the introduction of a college of supervisors for each of the largest global financial institutions; and
- robust arrangements for dealing with stress in the financial system – including improvements to central banks' operational frameworks and cooperation by authorities for dealing with stress.

4.21 In October 2008, the FSF presented to the G7 Finance Ministers and central bank Governors a follow-up report to its April Report, providing an update on progress in implementing the recommendations.

Europe

4.22 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 July of this year that included proposals to better align the incentives of lenders with those of investors and limit credit risk transfer with quantitative requirements.

4.23 The Commission's most recent proposal, made in October, is to restrict the purchase by EU-regulated banks of risk transfer products where the originator or distributor does not itself retain a net economic interest of at least 5 per cent. It is important that any specific proposal on retention is based on firm evidence that they will bring benefits to these markets, while avoiding unintended consequences. The Commission's proposal is currently being discussed by the European Parliament and the Council of Member States, and is due to be agreed early next year.

4.24 The Commission has also proposed new requirements on investor due diligence and originator transparency, building on the industry-led work set out in the next chapter. These requirements will, from 2011, ensure that investor credit institutions can demonstrate that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures for analysing and recording, among other things:

- the level of retention by originators;

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

- the risk characteristics of the securitisation position and the underlying exposures; and
- all the structural features of the securitisation that can materially impact the performance of the credit institution's securitisation position.

4.25 Investors will also be required to establish formal policies and procedures to monitor information on the performance of underlying exposures on an ongoing basis.

5 Industry-led reforms

5.1 Market participants generally share an expectation that securitisation markets will recover in time. They do not, however, expect this to happen quickly; and when it does, they do not expect the level of activity to return to that seen during the last few years. There is no consensus about how long the current period of adjustment will last or when the securitisation markets will reach a new equilibrium, though most parties are less than optimistic about prospects over the coming year.

5.2 The interim analysis considered a number of factors that have contributed to the downturn and may have intensified market illiquidity. This chapter focuses on what more the industry can and should be doing to address these issues and establish a sustainable investor base in mortgage-backed bonds.

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

Strengthening mortgage-backed asset markets

5.4 A number of weaknesses in the operation of mortgage-backed asset markets have been revealed or exacerbated by the current freeze in market activity, including:

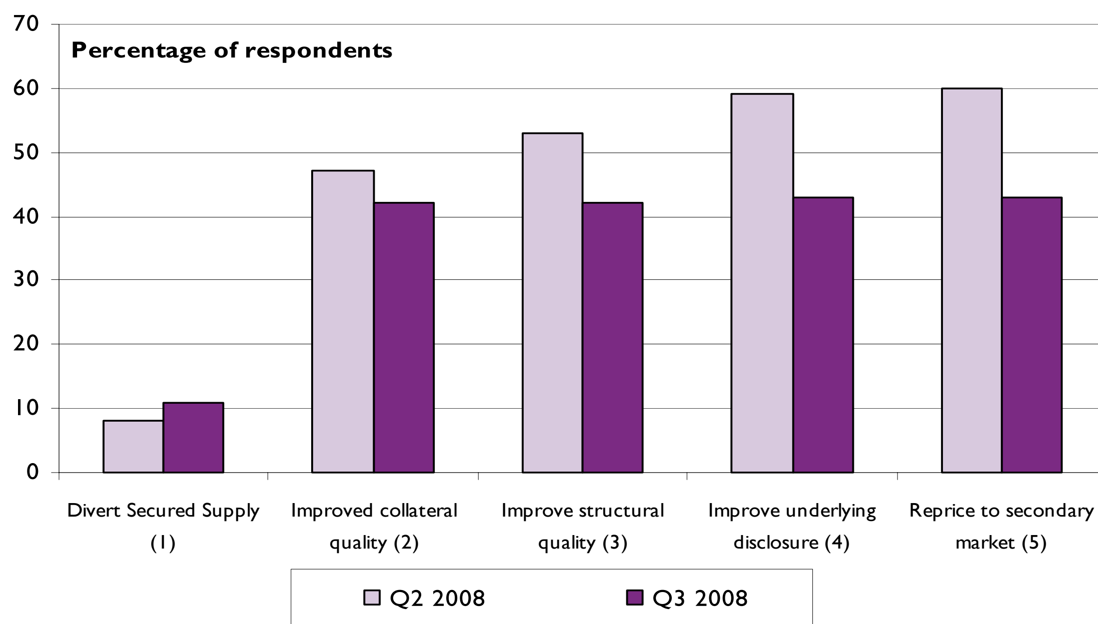
- a lack of certainty about the financial health of counterparties, which has contributed to a loss of confidence in the banking sector;
- a lack of transparency in securitised products, which has led to valuation difficulties and a loss of investor confidence in these markets;
- an absence of standardisation, which has contributed to the lack of depth in the market; and
- concerns about the integrity of securitisation models, and whether loan originators have clear incentives to monitor borrowers.

5.5 Steps to address many of these weaknesses are currently being considered by the industry, and such initiatives are to be welcomed. It is, in general, the markets that can judge how best to correct market problems without distorting behaviour or constraining innovation and competition.

Transparency

5.6 A lack of transparency, coupled with the complexity of some mortgage-backed products and structures, has meant that investors have too often failed to understand the details of their investments and the extent to which the risk they were carrying was contingent on developments in other financial markets and the broader economy. Investor surveys demonstrate the importance European investors place on improving underlying disclosure, alongside concerns about pricing and risk (Chart 5.A).

Chart 5.A: Investor perceptions of what ABS issuers need to do to re-open the European ABS Market



[1] *Directing residential mortgages into other secured markets such as covered bonds.*

[2] *Improving the quality of the residential mortgages that are used as collateral, possibly requiring they conform to certain criteria.*

[3] *Establishing requirement for higher credit enhancement levels and moving away from complex master trusts to simpler structures.*

[4] *Improving and standardising the information made available to investors.*

[5] *Issuers to price at 'market clearing' levels.*

Source: JPMorgan European ABS Confidence Index, September 2008

5.7 As set out in Chapter 4, the European Commission is considering reforms of the Capital Requirements Directive. The industry is also exploring a range of ways in which the information available to investors could be improved. A greater degree of transparency should help investors undertake due diligence and value assets effectively, avoiding previous misjudgements about credit and liquidity risks. It should also help reduce dependency on credit rating agencies and third party risk assessments, and improve investor confidence in these markets.

5.8 The recent proposals on transparency published by a group of European trade associations are to be welcomed as a first step towards these aims.[1] The planned outputs from the ten initiatives proposed by the European trade bodies include the development of issuer disclosure principles and improved access to data in order to help ongoing monitoring of performance.

5.9 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 17 July this year, setting out principles of conduct and market best practice for the global financial service industry and disclosure issues;[2]

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

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

- the American Securitization Forum's Project RESTART (Project on Residential Securitization Transparency and Reporting), focused on developing specific and detailed market standards and practices. [3]

5.10 Some market participants consulted in the course of this work have also highlighted the lack of access to a borrower's aggregated credit score (as is provided by the FICO scores, in the US) as a particular challenge in their assessing accurately the quality of an investment and its underlying mortgage pool.[4] Access to such information – deemed particularly useful by some investors – is limited to lenders and other organisations under rules established by the credit industry, and UK credit reference agencies.[5] Investors do not generally have access to this data.

5.11 In order to facilitate investor decision-making, the industry may wish to consider making credit scores available to investors in mortgage-backed assets, giving the latter an additional source of information to supplement that provided by the CRAs. Any changes should clearly not, however, be at the expense of investor due diligence, and individuals' privacy.

Risk disclosure

5.12 Financial institutions' continuing uncertainty about the financial health of their counterparties has contributed to a loss of confidence across the global banking sector. While these concerns persist, market participants will remain risk-averse and unwilling to re-enter the market.

5.13 UK banks are continuing to work with regulators, auditors and other market participants to provide robust risk disclosure and improve trust between financial institutions.

Standardisation

5.14 An absence of standardisation has contributed to lack of depth in the mortgage-backed securities market. As set out in Chapter 1, a significant proportion of investors have now either disappeared or found their leverage much reduced, or are unwilling to re-enter a market that was perceived as highly liquid but suddenly revealed itself to be quite the opposite.

5.15 The industry is taking steps to promote the standardisation of information and products and, insofar as these can be coordinated at international level, this should help to create deeper and more liquid global securitisation markets.

5.16 European trade association proposals include recommendations to standardise reporting practices and to introduce standardised terms and definitions; there are for example, no common definitions in Europe of what constitutes sub-prime or non-conforming loans, or of when a loan may be regarded as being in arrears.

5.17 The IIF's report on market best practice also includes recommendations to harmonise market definitions and structures. The ASF project RESART, meanwhile, proposes standardised templates for information disclosure, and model warranties to provide assurances to investors regarding the allocation of risk.

5.18 Efforts are also being made to coordinate such initiatives across borders, thereby driving forward reforms consistently across markets. In July this year, the ESF, SIFMA and ASF launched a global working group with the aim of introducing and implementing industry reforms to help restore confidence in securitisation markets. The formation of these groups is welcome; industry

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[3] 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

[4] The FICO score, developed by the Fair Isaac Corporation, is a three digit number used to predict a borrower's default risk, based on their credit history. The score ranges from 300 to 850, with a higher score indicating a lower default risk.

[5] The principles of reciprocity published by the Steering Committee on Reciprocity (SCOR).

action needs to be coordinated internationally if reforms are to have an impact in a global marketplace. It is important that the proposals are implemented and taken up quickly by the industry so that they have the desired effect on behaviour and on markets as soon as possible.

Improving the integrity of securitisations

5.19 Recent events have raised question marks among investors as to the integrity of securitisation models; in particular, the originate-to-distribute model characteristic of the US, where a misalignment of incentives saw the provision of sub-prime mortgages to households that were unable to repay. The UK model has been very different, with lenders typically retaining an economic interest in a securitisation by holding some of the first loss. Even where lenders buy financial instruments to hedge against credit risks, they will still retain some of the risk associated with underlying loans. The UK securitisation model may not be well understood by investors.

5.20 Alongside work by the European Commission, the industry is also considering ways of improving the understanding of retained exposures. A recent credit ratings agency consultation, for example, proposed that firms disclose specific information on retained equity risk, including whether the firm retains an equity piece or has obtained credit protection (e.g. via credit default swaps or any other instrument), and the size of any retained exposure.[6] Improved disclosure along these lines may help to reassure investors about risk transfer.

RMBS best practice

5.21 The UK industry should build on the steps described above to develop RMBS best practice. This should be done in discussion with investors and in concert with international industry groups, so that investors are able to access clear and comprehensible information, thereby improving market efficiency. Best practice could include some of the following elements:

- enhanced initial and ongoing information about the performance of the underlying collateral, in order to strengthen investor decision-making;
- standardised terms and definitions in the provision of all information, to help build more liquid markets;
- the provision of aggregated credit reference agency ratings;
- the provision of information about retained equity shares; and
- independent verification that the information reported to investors conforms to these standards.

5.22 Issuers might also wish to consider agreeing eligibility criteria for underlying mortgage collateral, in order to reduce credit risk for investors and improve transparency and clarity (see Chapter 6).

5.23 The UK industry should be able to promote issuance that conforms to these standards both in the UK and overseas, to the benefit of both investors and the UK RMBS market.

5.24 As the market moves towards greater transparency and standardisation of definitions and practices, there is also potential for further industry reforms to improve the financial infrastructure for mortgage-backed bonds and enhance liquidity. This might include, for example, a move from over-the-counter products to exchange trading.

[6] Fitch Rating, Exposure Draft: Retaining Equity Piece Risk Enhancing Transparency 24 June 2008.

Covered bonds

5.25 The UK Government has already introduced legislation that should help encourage the development of the UK covered bond market. The UK Covered Bond Regulations entered into force on 6 March 2008 and will enable UK covered bonds to meet the requirements of the Undertakings for Collective Investment in Transferable Securities (UCITS) directive. The FSA announced the initial list of issuers to be added to the UK Regulated Covered Bond Register on 11 November 2008.

5.26 The legislative framework should help encourage investor confidence in UK regulated covered bonds, as the regulations set out eligibility criteria for the assets that may be included in the cover pool. The FSA is also required, as the regulator, to have regard to the reputation of the UK regulated covered bond sector when assessing applications for authorisation and in its supervision of the regime.

5.27 On 28 July, the US Treasury launched Best Practices for Residential Covered Bonds,[7] with a view to encouraging the development of the US covered bond market as an additional, complementary funding source for residential mortgages. This sets out eligibility criteria for the underlying collateral. It also includes the Federal Deposit Insurance Corporation's (FDIC) Final Covered Bond Policy Statement, which clarifies the actions that FDIC will take during an insolvency or receivership of covered bonds.

5.28 A coordinated industry initiative could help support the development of the UK market, promoting UK covered bonds in a similar way to that in which the Association of German Pfandbrief Banks (vdp) promotes the Pfandbrief brand. UK issuers should be encouraged to establish a similar organisation with a view to communicating the benefits to investors of bonds issued under the UK regime.

[7] *Best Practices for Residential Covered Bonds*, United States Department of the Treasury, July 2008, http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf

6 Government interventions

6.1 While the trigger behind the global market downturn was rising delinquencies on US sub-prime mortgages, the ongoing 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. At the same time, the sector is deleveraging and changing its funding models to reduce reliance on wholesale funding sources. That such a correction is necessary is clear. The question explored in this chapter is whether there is anything further the Government can and should do to reduce its impacts on the individual and the economy.

6.2 While the persistence of current market conditions could have significant implications, interventions intended to alleviate these effects, but which distorted markets and prolonged the recovery process, would clearly be undesirable. Any action must to be assessed in terms of the extent to which it helps facilitate and smooth the market adjustment process. Also important is that such action should contribute 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. The costs (and benefits) of action must be set against those not only of alternative interventions, but also of inaction.

6.3 As set out in the interim report, Sir James Crosby has consulted widely with market participants, industry experts and interested parties. In the course of consultations, stakeholders have proposed a range of Government interventions. These include reform of the Basel II capital requirements; reform of fair valuation or mark-to-market accounting rules; and a Government guarantee for mortgage-backed securities.

Basel II capital requirements

6.4 Under the 2004 Basel II framework, banks are required to maintain minimum capital levels proportionate to the risks they run. In Europe, Basel II is implemented through the Capital Requirements Directive (CRD), which came into force on 1 January 2008. Basel II and the CRD are more comprehensive and risk sensitive than the original 1988 Basel Accord, incorporating operational risk measurement in the calculation of minimum capital requirements and building on firms' own risk management practices.

6.5 There is increasing focus internationally on whether the financial system is excessively pro-cyclical – fluctuating with the economy and potentially amplifying business cycles. Concerns have also been raised that aspects of the current regulatory framework may increase the inherent pro-cyclicality in the financial system.

6.6 These questions are rightly being considered at the international level. The Financial Stability Forum (FSF) has initiated a programme of work to look at these issues, and a working group has also been set up by the European Council. The UK authorities participate in these groups.

Mark-to-market accounting

6.7 In the absence of a fully functioning market, and even where institutional investors are willing to invest on a buy and hold basis, concerns about short-term mark-to-market fluctuations may deter them from doing so if their clients are sensitive to such changes.

6.8 Some parties have raised concerns about whether the application of fair value accounting rules, by valuing assets at market prices in distressed and illiquid markets, is amplifying current difficulties in markets and may prolong the current period of adjustment.

6.9 The International Accounting Standards Board (IASB) has responded to current market conditions by updating its guidance on valuation in distressed markets and ensuring alignment of its standards with US GAAP, permitting the reclassification and revaluation of certain assets where the initial classification was not appropriate. The FSF and accounting standard setters continue to examine other issues arising from the application of fair value accounting standards. Relevant issues should be addressed quickly, with full understanding of the impact of proposed changes.

A Government guarantee

6.10 As set out earlier in this report, the lack of liquidity in wholesale funding markets has significant adverse consequences for borrowers and the UK mortgage market. Although these markets will recover in time, it is unlikely that they will recover quickly. In the meantime, this implies a continuation of tight credit conditions and a shortfall in mortgage finance. A sustained reduction in mortgage finance would have serious consequences for the UK economy.

6.11 One response could be for the Government to intervene directly in the securitisation markets by guaranteeing the interest and principal on mortgage-backed bonds. Such a guarantee would transfer credit risk from lenders and investors to the Government. The rationale for doing so would be to tackle some of the weaknesses in the operation of the markets, set out in the interim report. In particular, it could quickly re-establish confidence in the market, overcoming concerns about the performance of underlying collateral and the financial health of the issuing institutions.

6.12 By providing a guarantee, the Government would be using the existing market structure to channel funding to the banking sector, providing lenders with the means to undertake new mortgage lending. This approach would complement the different types of funding provided both by the Bank's Special Liquidity Scheme (which allows banks temporarily to remove the overhang of existing assets from their balance sheets, in order to improve their short-term liquidity positions), and by the Credit Guarantee Scheme, which supports unsecured lending and is facilitating the return of liquidity to the inter-bank lending market.

6.13 Guarantee models, as the interim report described, come in a variety of guises, often reflecting specific country or historical contexts. In some existing structures, the government guarantee is implicit rather than explicit. As the recent experience of the US Government Sponsored Enterprises Fannie Mae and Freddie Mac illustrates, however, the markets will tend to regard the former as effectively equivalent to the latter. The interim report concluded that an implicit government guarantee on mortgage-backed securities would be inappropriate in a UK context.

6.14 The remainder of this section sets out how an explicit Government guarantee could be structured in order to support mortgage lending. Any such proposal would, of course, need to be consistent with the Government's broader objectives of macroeconomic and financial stability and prudent financial management.

6.15 Box 6.A sets out a model for a Government guarantee of interest and principal on mortgage-backed securities. The key elements of this model have been developed in consultation with a range of market participants in the course of preparing this report.

Box 6.A: Government guarantee proposal

- The Government would guarantee the timely payment of scheduled principal and interest of both residential mortgage-backed securities and covered bonds, eligible under the scheme. Participating institutions would be required to pay fees at commercial rates.
- The guarantee would be restricted to assets where the underlying collateral is sterling denominated loans to owners of UK residential property, secured by first charge, and originated after a specified date.
- The guarantee would be restricted to assets backed by mortgages used for the purchase of residential property, and not for re-financing existing mortgages.
- The guarantee would be available to banks, building societies and specialist lenders.
- The guarantee would only be available for assets rated by at least two Credit Rating Agencies as AAA/Aaa, and which would be senior in ranking to all other tranches in the securitisations.
- The guarantee would only be available for assets backed by 'prime' mortgages. This could exclude high loan to value lending, for example, 95 per cent, loans to borrowers with impaired credit histories, Individual Voluntary Agreements (IVAs) or bankruptcy orders, and second charge loans.
- Participating institutions would have to abide by high standards of disclosure and reporting, consistent with the recent proposals of European trade associations (see Chapter 5).
- The originating firms would be liable to reimburse the Government for any and all claims under the guarantee.

Protecting the taxpayer

6.16 Guarantees work by transferring credit risk from investors to another party – in this case, the Government. This model, however, aims to minimise the risks to Government in two ways:

- the choice of eligibility criteria, i.e. AAA/Aaa. To date, no UK AAA rated RMBS has ever suffered a downgrade or a credit default.[1] According to industry estimates, AAA rated RMBS would only default if house prices fell by more than twice as much in the 1989-96 period; and

- offering recourse to the lender in the event of the guarantee being called. By requiring the lender to make good any shortfall, credit risk would remain with the lender, who under normal circumstances should be in a position to meet it. The Government would only be exposed in the event of a double default, i.e. on both the paper and the issuer.

Size of the guarantee

6.17 In order to create sufficient investor demand and generate confidence among both investors and issuers, and taking into account the redemption calendar of existing mortgage-backed securities, the guarantee should total around £100 billion over a two year period.

[1] This excludes a tiny number of cases from the very small percentage of RMBS which used insurance from AAA counterparties to obtain their rating and which were downgraded due to a downgrade of the insurer.

Allocating the guarantee

6.18 Allocation of the guarantee should be through an auction process, allowing the Government to receive fees at commercial rates, and ensuring price competition between originators for the guarantees. Lenders which had successfully bid for guarantees would then either originate qualifying mortgages to underpin the securities to which the guarantee would attach, or select mortgages originated after whatever date was specified in the eligibility criteria.

Investors

6.19 A wide variety of securities structures could be adopted in order to attract different types of investor. These structures might include securities denominated in different currencies, aimed at covered bond investors; pass-through securities, which would be expected to appeal to traditional RMBS investors; and short-dated (under 13 months) securities, which might attract, for example, US money market investors.

Potential benefits

6.20 A guarantee would potentially bring benefits for investors, lenders and consumers. It would cover any shortfall in payments to investors, and provide certainty about future cash flows. This certainty would create investor demand for Government-backed bonds.

6.21 For lenders, a guarantee would reopen the way to securitising their lending, thereby reducing the cost of funding mortgages and potentially increasing the supply of new mortgage lending. Reopening the market would be of particular benefit to those specialist lenders which, without a deposit base, are entirely reliant on wholesale market funding.

6.22 To encourage banks to extend lending for house purchase, thereby benefiting consumers, the guarantee could be attached only to securities backed by mortgages given for new housing transactions (i.e. not for remortgaging).

Operational considerations and risks

6.23 Any intervention to mitigate the impact on the real economy of financial market adjustment, needs to be considered in the light of whether it facilitates or prolongs that adjustment process. In the case of a guarantee, the Government would also wish to consider the extent to which the transfer of risk might leave market participants with less incentive to assess and price that risk accurately. The recourse provision incorporated in the model – meaning that issuers remain exposed to potential loss – should help mitigate against this. The Government would wish to be satisfied that both investors and issuers would have every incentive to undertake due diligence on, and take responsibility for, their transactions.

6.24 More broadly, the Government would also wish to satisfy itself as to the effectiveness of a guarantee in supporting new mortgage lending. It would also need to take into account the fiscal, debt management and legal implications.

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

Recommendations

6.26 That the Government should:

- encourage the industry to adopt new standards of transparency and standardisation in the mortgage-backed securities markets, which will help to ensure that these markets function more effectively in the long term;

- encourage international dialogue on the application of fair value accounting without compromising the principle of transparent disclosure; and
- subject to practical considerations to be resolved, guarantee the interest and principal, at a commercial rate, on residential mortgage-backed securities or covered bonds backed by new mortgage lending.

A Consultation list

A.1 Sir James Crosby and his team have engaged with around fifty stakeholders involved in different aspects of mortgage finance through a series of one-to-one meetings and informal discussions. In addition, a number of organisations and individuals submitted their views in writing.

A.2 Sir James Crosby is very grateful to all those who made contributions. The following list provides an indication of the breadth of discussions, with apologies to those that may have been inadvertently omitted. Thanks are due to:

Abbey

Association of Independent Financial Advisers (AIFA)

Association of Mortgage Intermediaries (AMI)

Bank of England

Barclays

BlackRock Investment Management

Bovis Homes

Bradford & Bingley

Britannia Building Society

British Bankers Association

Building Societies Association

Capital Economics

Citigroup Global Markets

Council of Mortgage Lenders

Coventry Building Society

Credit Suisse Asset Management

Crest Nicholson

Deutsche Bank

European Commission

European Securitisation Forum

Fidelity Investments International

Financial Services Authority

Genworth Financial

Goldman Sachs

GMAC-RFC

HBOS

Home Builders Federation

Homefunding

Homeloan Management Limited (HML)

HSBC Bank

Intermediary Mortgage Lenders Association (IMLA)

International Capital Markets Association (ICMA)

International Monetary Fund

Investment Management Association (IMA)

JPMorgan

Kensington

Legal & General

Lloyds TSB Group

Merrill Lynch

Moody's

Morgan Stanley

Nationwide Building Society

NYSE Euronext

Oxford Economics

Paragon Mortgages

Royal Bank of Scotland

Securities Industry and Financial Markets Association (SIFMA)

Spanish Ministry of Economy and Finance

Taylor Wimpey

UBS Investment Bank

US Department of the Treasury

ISBN 978-1-84532-514-5