

The outlook for mortgage funding markets in the UK in 2010 - 2015

Report by the Council of Mortgage Lenders

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Executive Summary

- This paper is written for an audience that is familiar with UK mortgage funding markets at a technical level. It is aimed specifically at policymakers and others in a position to influence the debate on how these markets might evolve and how government can positively influence their development.
- This report examines the outlook for UK mortgage funding over the next six years, in the wake of the unprecedented turmoil in global capital markets and large scale government support for banks seen since summer 2007.
- The loss of investor confidence in wholesale debt markets since 2007 has left a £300bn gap in deposit takers' funding that has had to be filled temporarily by government funds through the special liquidity scheme (SLS) and credit guarantee scheme (CGS). These schemes expire in 2011 - 2012 and 2012 - 2014 respectively, leaving a major uncertainty overhanging the mortgage market as to how lenders will be able to refinance this £300bn.
- Retail deposits will not be sufficient to fill the gap, so the return of functioning private sector wholesale funding markets will need to play a role. But, for wholesale investors to return, they will need to be confident that the legacy issues left in the wake of the financial crisis are manageable, and above all that mortgage lenders and financial services markets will be profitable on a sustainable basis going forward.
- Even with wholesale markets functioning again, it is very unlikely that lenders will be able to repay government funds in full on the current timetable of the SLS and CGS, suggesting that an extension of the period of government support will be required.
- The closure of wholesale funding markets, coupled with government support being focused almost exclusively on larger deposit takers, has led to a dramatic reduction in competition in the UK mortgage market.
- Regulatory changes risk reinforcing the adverse side-effects of the emergency response to the crisis. The deluge of proposed regulatory reforms we have already seen internationally and in the UK risks creating a patchwork of changes that do not sum to a coherent whole, and do not provide market participants with the clarity that they need to plan for the future. Cumulatively, we face a real risk of a series of unintended consequences.
- UK policy measures have focused on bank capital and liquidity, and on tightening mortgage market regulation. Policy has been informed by a narrative that sees securitisation, wholesale funded lenders, and non-conforming mortgage credit as problematic because of the events in the US. Yet in the UK, residential mortgage backed securities (RMBS) and wholesale funded lenders have both performed comparatively well, despite an absence of government support. If this policy stance remains unchanged, the result will be a long term reduction in choice for consumers in the mortgage market.
- If there was one outstanding cause of the crisis in UK banking, it was not insufficient capital or poor quality mortgage lending in the UK, but the vulnerability of our banks' funding structure. Yet policymakers have focused on bank capital and liquidity, and even on fixing a mortgage market that was not the cause of the crisis. At the same time, policymakers have not yet identified or developed a sustainable funding model for the UK mortgage market going forward.
- The focus of government support on retail deposits, and senior unsecured bonds from banks and larger building societies, and the failure to provide meaningful support to the RMBS and covered bond markets, is seriously distorting the competitive landscape. It is creating a moral hazard where depositors and senior unsecured bondholders may feel they have no need to understand the risks they are running, because they will be supported by government.
- Ironically, given the lack of government support for RMBS and covered bonds, these funding instruments have demonstrated their effectiveness during the financial crisis. They allow non-AAA rated institutions to issue the AAA rated securities that the Bank of England (BoE) demands

as collateral for deposit takers seeking to access the SLS. It is difficult to reconcile the BoE's negative attitude to RMBS with its demand for AAA securities, given that banks can only satisfy this requirement by creating retained RMBS or covered bonds.

- We conclude that the government needs a clear strategy for putting mortgage funding markets in the UK back on a sustainable footing, with minimum possible distortion from future government intervention or ongoing support. This requires government support measures and the regulatory system to be much more even in their impact on retail deposits, senior unsecured bonds, RMBS and covered bonds, and more even between different types of financial institution – banks, building societies and non-deposit takers.
- To establish a clear strategy for the revival of UK funding markets, we believe that the Treasury should devote resources to a collaborative exercise drawing on industry knowledge in an expert group. With the termination of the SLS and CGS coming up, the Treasury has every incentive to demonstrate that a robust long term solution will be put in place.

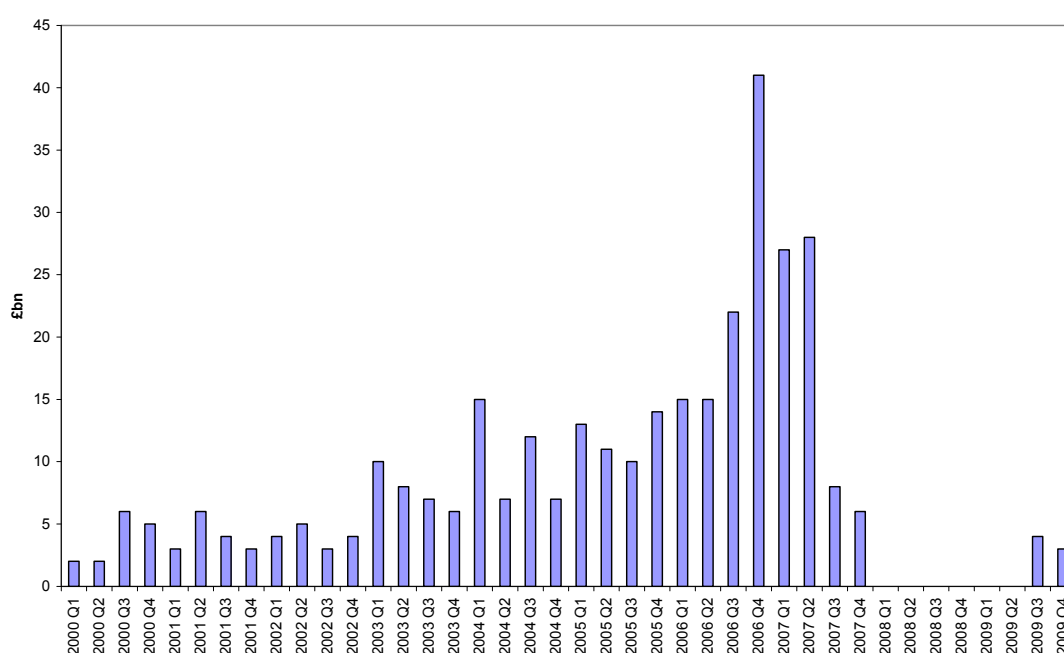
1. The shift to wholesale funding from the 1980s until 2007

1. Wholesale funding became a significant feature of the mortgage market after deregulation in the 1980s, as it allowed banks and specialist lenders who tapped wholesale funding sources to enter the market.

2. But, it was not until the end of the 1990s that wholesale funding became substantially more important when the largest mortgage lenders launched residential mortgage backed securities (RMBS) programmes.

3. This was followed in 2003 by the introduction of covered bonds in the UK. As Chart 1 shows, the large lenders' move into RMBS fed substantial growth in total public issuance in the 2000s, with a peak being reached in H2 2006 and H1 2007.

Chart 1 – Public issuance of RMBS in the UK (quarterly)



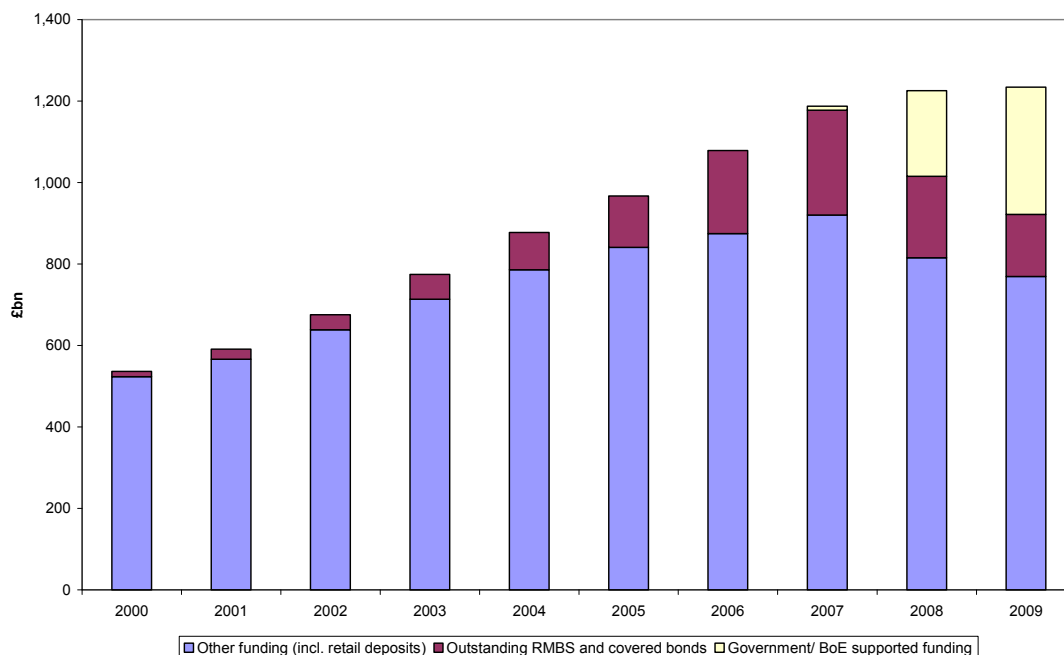
Source: Treasury report: Mortgage finance: final report and recommendations

4. Between 2000 and 2007 the total amount of outstanding RMBS and covered bonds rose from £13bn to £257bn. This took them from funding 2.5% of the UK mortgage stock to 21.5%. Chart 2 shows this graphically, with RMBS and covered bonds represented by the purple area, while other private sector sources (retail deposits and other wholesale funds) are shown in blue.

5. This period of rapid growth in wholesale funding was driven by the exceptional strength of the mortgage market and other lending segments (aided by the strength of global investor demand), which outstripped the ability of retail deposit balances to keep up. Total outstanding mortgage debt rose from £495bn at the end of 1999 to £1,187bn by the end of 2007, a compound growth rate of 11.6% pa.

6. This compared with an increase in retail deposits from £558bn to £1,070bn – this gain of £512bn was £180bn short of the growth in mortgage debt, suggesting that the rise of wholesale funding was not just a choice made by lenders, but was driven by an underlying shortfall in UK cash savings. Today, the retail savings market cannot on its own cater for the level of mortgage borrowing demand in the UK.

Chart 2 – The funding of UK mortgage debt



Source: Various

7. To the extent that this disparity between the growth of lending and deposits had been the result of changes in the way people saved, with relatively more money flowing into institutional investments such as pension funds and proportionately less into personal cash savings, it could be considered sustainable.

8. But the majority of the wholesale money raised, perhaps as much as 70%, actually came not from UK savers but from abroad, mirroring Britain's current account deficit and reflecting our low savings rate.

9. This suggests that the growth in wholesale funding was in part the consequence of an ultimately unsustainable growth of UK consumer indebtedness, fuelled by excessive investment flows from other countries, ultimately fed by excess global liquidity that resulted from high savings rates in some developing economies.

2. The vulnerabilities implicit in the shift to wholesale funding

(a) The UK's structural vulnerabilities

10. Prior to the financial crisis, there was little or no appreciation of the potential vulnerabilities of this new funding system, with a general assumption that, as long as UK mortgage assets were sound, wholesale funding would be forthcoming. But, the way wholesale funding developed in the UK gave rise to specific vulnerabilities that have been less evident in other countries with large wholesale funding markets because of important structural differences:

(i) Vulnerability to periodic systemic losses of investor confidence

11. Wholesale funding markets have periodically shut in the past, as seen during the emerging market crisis of 1997 - 1998, though never for as extended a period as in 2007 - 2009. But, during these episodes, investor fear has usually driven a flight to quality. Despite most bonds suffering, bonds that are considered especially "safe" often benefited from investors' heightened concerns about risk

12. Most notably, this has acted to support the US agency market (RMBS and other bonds issued by Fannie Mae and Freddie Mac which fund the majority of prime US mortgages) because these were

considered to carry an implicit US government guarantee (and indeed the US government did come to the aid of Fannie Mae and Freddie Mac in 2008). But, such a flight to quality has also supported covered bond markets in Europe that have built a reputation for being ultra-safe. They are considered by many investors to benefit from implicit government support, because of their importance within the financial system and in delivering credit to the real economy.

13. The UK RMBS and covered bond markets have never had such implied support. When the government took control of Northern Rock in 2007, it guaranteed the senior unsecured bonds while failing to give any support to the RMBS and initially also the covered bond programme.

14. This sent out an important message, not lost on investors, that RMBS and covered bonds were, in terms of UK government backstop, inferior to senior unsecured bonds issued by banks and building societies.

15. This can be contrasted with the actions of the European Central Bank (ECB) which, in deciding to buy covered bonds in May 2009, sent out a strong signal of support for this market.

16. Furthermore, the UK government took the decision to focus support on large depository institutions, with the small building societies and specialist, non-deposit taking lenders excluded from all government measures. Again, an important signal was sent about where investors could expect to see the limits of government support.

17. This could be contrasted with actions in other countries, most notably the US, which has supported asset backed securities (ABS) markets through the Term Asset Backed Securities Loan Facility (TALF) and Federal Reserve and Treasury purchases of Fannie Mae and Freddie Mac RMBS.

18. The ECB and Fed took these actions because the systemic importance of, respectively, the covered bond and ABS markets, to their financial systems made their continuing functioning vital to re-establishing stability and underpinning recovery. The lesson is clear. Once a financing system or instrument becomes vital to the stability of the financial system as a whole, and to the wider economy, governments will have little choice but to provide tangible support when needed.

19. RMBS and covered bonds have not reached this level of importance in the UK, where retail deposits remain vital to the funding of our banks and, in particular, our mortgage market. They are followed in systemic importance by senior unsecured bank bonds, because the failure to repay investors in these bonds would trigger a bank insolvency.

20. Thus, it was no surprise that the Chancellor gave an assurance to the public, after the run on Northern Rock, early on in the crisis, that all retail deposits would be safe regardless of the limits set under the financial service compensation scheme (FSCS). Nor was it a surprise that the CGS was applied to senior unsecured bank bonds while its equivalent for the RMBS market, the ABS guarantee scheme, which was based on a proposal from the final report on mortgage finance written for the Treasury by Sir James Crosby, came later and on terms making it unattractive relative to the CGS. Thus, while the CGS has provided guarantees on £134bn of unsecured bank bonds, the ABS guarantee scheme has seen no usage.

21. The government provided support where it felt it needed to, which was understandable during a crisis. But, as the crisis subsides, it has the opportunity to take a more strategic view by providing support more evenly amongst different funding mechanisms. Unfortunately, this opportunity has not yet been seized despite examples from abroad, such as the Australian RMBS purchase facility designed to support new RMBS issuance, which has helped that market recover.

22. Instead, the UK has stayed with a system of direct support through the CGS, even though support through a collateralised funding scheme such as the ABS guarantee scheme would have provided more comfort to taxpayers, since the government would have received a priority claim on the mortgage pools backing the bonds.

23. The result of this lack of UK government support for the RMBS and covered bond markets has been a distortion of competition in funding markets. This has disadvantaged these instruments

relative to retail deposits and senior unsecured bonds, and made them more vulnerable to future shocks in the UK than equivalent markets overseas.

24. While US and German mortgage consumers should continue to benefit from a reliable stream of funds, funded respectively through the agency RMBS and covered bond markets, UK consumers will remain vulnerable to interruptions in the flow of funds of the kind we have seen in the last two years.

25. The focus of support on retail deposits and senior unsecured bonds is also distorting the competitive landscape as it is disadvantaging lenders that rely on wholesale sources such as RMBS.

(ii) Vulnerability to systemic cross-border losses of investor confidence

26. Cross border investors have a tendency to retrench back to their home countries in times of severe stress. Consequently, UK lenders' dependence on overseas investors, with around 70% of RMBS and covered bonds sold to foreign based institutions, has been shown to have been a particular weakness, although issuers had, reasonably, believed that tapping foreign investment funds would provide diversification.

27. This weakness has not been shared by other major mortgage markets to the same extent. Both Germany and the US have large domestic institutional buyer bases funding mortgages, through the covered bond market in Germany and the agency market in the US. This has left them less vulnerable to the cross border investment retrenchment seen during the financial crisis.

(iii) Vulnerability to crises affecting leveraged investors

28. The overwhelming majority of demand for floating rate bonds (whether they are RMBS, covered bonds or senior unsecured bonds issued by lenders) has traditionally come from leveraged investors (banks, hedge funds using leverage, structured investment vehicles - SIVs - and conduits). This is because most long term cash investors such as pension funds need dependable income streams and floating rate bonds do not provide these. But, for leveraged investors whose cost of funds is linked to Libor, floating rate securities are ideal as they provide a matching Libor linked income stream.

29. The UK was again more vulnerable here, because most UK RMBS have been floating rate to match the interest rate profile of most UK mortgages. As a result, the overwhelming majority of investors, some 75%, were leveraged, and as much as 50% of investor demand came from banks.

30. By contrast, in the US and most continental European markets such as Germany, long term fixed rate mortgages predominate so securities funding those mortgages also typically are fixed rate, making them more attractive to unleveraged investors such as pension funds.

31. Typically, demand from leveraged investors is quite cyclical, rising and falling with the credit cycle, while demand from unleveraged investors such as pension funds tends to be more stable over time, reflecting the more stable profile of pension saving. And leveraged investors are always potentially vulnerable to systemic losses of confidence that undermine their ability to refinance.

32. This created another vulnerability for the UK mortgage market as it came to rely increasingly on wholesale funding, that was not mirrored in key overseas markets to the same extent. Clearly, the implications of this vulnerability were not recognised by lenders or UK regulators at that time.

(b) The consequences of our structural vulnerabilities

33. None of the three vulnerabilities outlined above has been resolved. This suggests it may be quite hard for the government to remove its c£300bn of funding support in the short term and that, if and when it does, the financial system will still remain vulnerable to future shocks in the absence of structural changes.

34. Moreover, as the financial crisis has demonstrated, this vulnerability is independent of the credit performance of the underlying loans and, to a large extent, also of the strength of the lenders operating in the market.

35. The investor hiatus in new RMBS and covered bond issues was regardless of the quality of the mortgage assets, or even the lender behind the transaction. The closure of these primary issuance markets was absolute and indiscriminate.

36. This has important policy ramifications. It suggests that the FSA's focus to date on bank capital and liquidity and on tightening mortgage regulation, culminating in the publication of the mortgage market review (MMR) discussion paper in October 2009, does not address the most significant weakness in the UK banking system – that is the structure of funding markets.

37. This is a significant shortcoming in the tripartite response to the financial crisis, as it was not poor quality residential mortgage lending that made UK banks vulnerable in the crisis, nor even in the first instance their capital or liquidity position. Rather, it was their inability to refinance in wholesale markets that forced the government to come to their aid. A major gap in the policy response has been the lack of progress towards answering the question how to ensure that our funding system is less vulnerable to future interruption.

3. Impact of the financial crisis

38. The vulnerabilities of the global financial system became all too apparent from the summer of 2007 when wholesale funding markets suddenly seized up. This proved to be the first sign of a financial crisis that necessitated unprecedented government support across the globe. The range of measures introduced by central banks and governments has been extraordinary. In the UK these have been:

Bank of England:

- Special liquidity scheme (SLS)
- Asset purchase facility
- Enhanced access to the discount window
- Quantitative easing

Treasury:

- Credit guarantee scheme (CGS)
- Asset backed securities (ABS) guarantee scheme
- Asset protection scheme
- Equity injections in banks
- Promise to depositors that their money is safe

39. As if these measures were not enough, the financial system and the wider economy have also benefitted from an unprecedented loosening of both fiscal and monetary policy, with the budget deficit heading to over 12% of GDP in this financial year and Bank rate cut to an all time low of 0.5%.

40. Of those measures above which are designed directly to support wholesale funding, by far the most important have been the SLS and the CGS, and both of these are explicitly time limited. The BoE's SLS was launched in April 2008 and ran until January 2009. The BoE has released details of the scheme's usage which shows that £287bn of collateral (mostly RMBS and covered bonds) was pledged to support £185bn of funding provided to the banks.

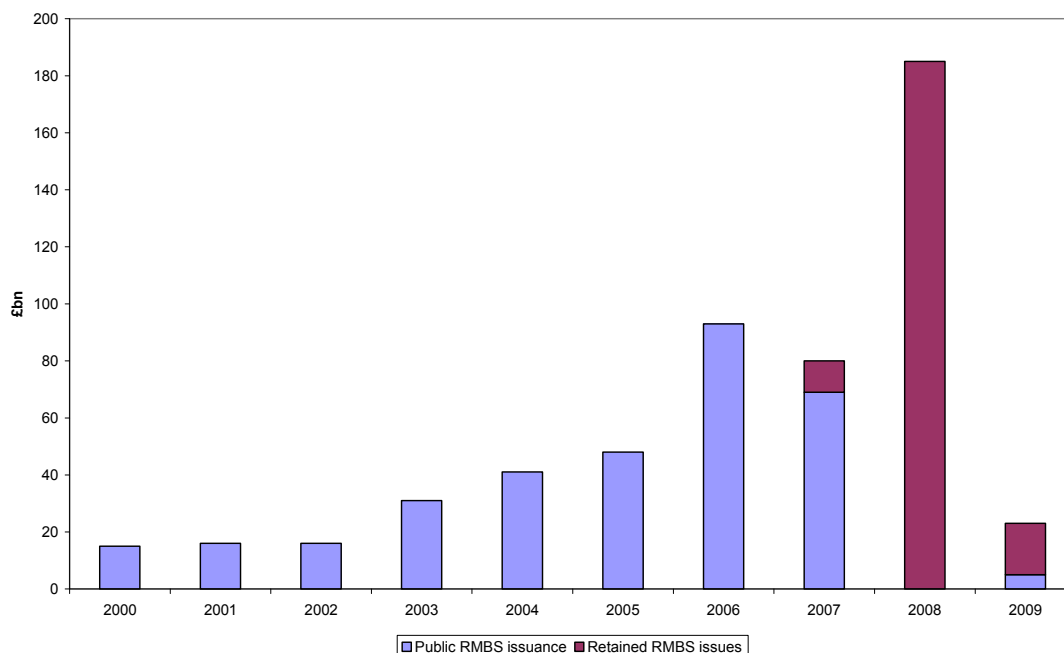
41. Ironically, while the financial crisis closed primary issuance markets, it led lenders to create record volumes of new RMBS and covered bonds, which were retained on balance sheet and used as collateral to access central bank repo facilities, in particular the SLS.

42. Chart 3 shows the dramatic impact of this on the level of RMBS 'issuance' (there was also a spike in retained covered bond issuance, including through a number of new programmes set up by

building societies specifically to access the SLS). 2008 saw a record overall RMBS issuance of over £180bn, almost all destined to support the SLS and other collateralised loans from the central bank.

43. The BoE has been quite vocal in its criticism of securitisation in the wake of the US sub-prime mortgage crisis. Yet, ironically, its requirement that lenders must post AAA rated collateral to access the SLS has driven record levels of retained RMBS issuance, as the tranching in RMBS enables issuers to create AAA rated securities. This should illustrate to the BoE and the government the value of RMBS as a funding instrument.

Chart 3 – Publicly issued and retain RMBS volumes



Source: Bank of England

44. The SLS is set to terminate over the course of 2011 and January 2012 requiring banks to repay £185bn. The further requirement to refinance £134bn of funds raised under the CGS over 2012 - 2014 can only make banks' task that much harder.

45. Even if lenders can refinance the SLS, cost will be an issue. The SLS was priced at the equivalent of 3 month Libor even though it is a 3 year facility. So banks are likely to face a significant rise in funding costs if they can replace the SLS with privately raised funds, whether these are retail or wholesale.

46. The requirement to repay these two schemes at set future dates has created serious uncertainty for the banks in receipt of the funds. These banks do not know with any certainty how they will be able to fund their existing balance sheets beyond 2011, let alone fund any net new lending to customers. Furthermore, the use of these schemes is very concentrated amongst a small number of banks.

47. On top of the requirement to refinance the SLS and CGS, some £53bn of existing master trust RMBS and covered bonds become repayable in 2010, following a similar level of redemptions in 2009. Lenders would thus have to issue £53bn of bonds in 2010 just to stand still in these markets.

48. Moreover, since these bonds were sold in the pre-crisis period, they carry very low spreads, so even if they can be refinanced without government support, the cost again is likely to be significantly higher than lenders have been paying. For example, Lloyds' 2009 RMBS issue was priced at 3 month Libor + 185bp while Barclays covered bond was mid swaps + 60bp (equivalent to Libor + 60bp). These deals are respectively about 160bp and 60bp above the spreads lenders were paying in these instruments before the financial crisis.

4. The current condition of funding markets

49. The measures of support outlined above have helped to stabilise the financial system, and have even allowed confidence to rise to the point where banks have resumed RMBS and covered bond issuance without direct government support, with four deals launched in the second half of 2009 as shown in Table 1.

Table 1 - Recent RMBS and covered bond issues without government support

	Type of issue	Rating	Spread	Amount raised
Lloyds Banking Group	RMBS	AAA only	Libor +185bp	£4bn
Nationwide Building Society	RMBS	AAA only	Libor +145bp	£3.5bn
Barclays	covered bond	AAA	Swaps +60bp	€2bn
Abbey/Santander	covered bond	AAA	Swaps +65bp	€1.75bn

Source: Various

50. The speed with which these markets have recovered has surprised many commentators. However, it is widely believed that potential aggregate investor demand is quite limited, with many investors who previously bought UK RMBS or covered bonds either now defunct, as in the case of some leveraged investors such as SIVs, or no longer purchasing UK mortgage securities.

51. Despite these concerns, the recovery in markets has encouraged the government to start to consider how it might reduce its financial exposure, so there has been much talk about “exit strategies”.

52. At the same time, European Commission competition rulings have ordered a partial break-up of the organisations that have received government equity injections. These are also the banks which have been most dependent on government funding support, opening up the possibility that part of the government’s exit strategy from funding may be achieved by selling loan books to new entrants to the UK mortgage market who have the credit standing to refinance these commitments without support.

53. For example, the sale of mortgage assets to a highly rated foreign bank or UK retailer might facilitate a relatively smooth refinancing of large chunks of government supported funding. But, sale to a new entrant without a strong credit rating would not offer the same refinancing opportunities. And sale to an entrant seeking to fund the assets with retail deposits will heighten competition in the retail deposit market still further, potentially threatening the profitability of some existing lenders.

54. These considerations are likely to influence the government’s preferences when deciding which organisations are permitted to take advantage of this opportunity to expand and limit the field of potential bidders.

5. The outlook for 2010-15 – finding a route back to normality

(a) Prerequisites for a return of wholesale investors

55. The outlook for the next few years is clouded in uncertainty given the government’s desire to exit from its huge funding support, the pressure for major regulatory changes and the fragility of sentiment in the financial system and wider economy.

56. One way of approaching the question of what is likely to happen is to ask ‘what are the prerequisites for the return of confidence on a scale that allows wholesale debt markets to return to something like normality, allowing the government to start to exit its funding support, and how likely are these prerequisites to be met?’

57. Aside from the requirement that government support is not withdrawn too rapidly, the three main prerequisites we see as necessary for a return of institutional debt investors are:

- That the macro-economy and property market have stabilised.

- Confidence that the legacy issues associated with pre-crisis lending are not going to undermine future financial stability.
- Lenders with sustainable future profitability.

58. We consider each in turn:

(i) Outlook for the macro-economy and housing market

59. Recent data show that most of the leading economies have now pulled out of recession and economic indicators in the UK have been significantly more positive in recent months. There is also growing evidence of a recovery in the UK housing market, most notably shown by surprisingly strong house price figures over the past 9 months (see Chart 4).

Chart 4 – UK house prices during 2009



60. So on the surface, this precondition for a return of investor confidence seems to be increasingly in place, supported by the sense that the financial crisis is behind us and that the fall in house prices in 2007 - 2008 was a sufficient adjustment to provide some comfort that over-valuation is now less of a concern.

61. But, investor sentiment is fragile. Fear of a double dip remains, centred on the need for fiscal retrenchment, the possible impact of a normalising of interest rates on over-indebted consumers, and a sense that house prices remain at excessive levels relative to incomes.

62. And investor sentiment will be vulnerable to further shocks, not least because the economic imbalances that many commentators believe were the underlying cause of the financial crisis have not disappeared. Concerns seem to centre on the risk that new asset price bubbles are forming, sparked by low interest rates, and that fiscal deficits are so large in some countries that they could provoke a loss of investor confidence in countries/currencies. This is clearly not the ideal background for re-establishing healthy wholesale funding markets.

(ii) Mortgage market legacy issues

63. Legacy issues in the UK mortgage market take several forms:

- (a) There is the issue of pre-crisis lending to individuals whose credit standing is now too poor to allow them to qualify for a mortgage in today's stricter underwriting environment. This may be either because they were already impaired credit borrowers when they took out their

loans, or because they have subsequently seen a deterioration in their credit score or financial status.

There has been quite a lot of attention paid to the difficulties this has created for the affected consumers who are 'stranded' on their existing deal. But, given that most impaired credit loans have interest rates linked either to 3 month Libor or Bank rate, most borrowers will have benefitted from large reductions in their monthly payments. Even if they could qualify for a mortgage, it is likely to be more expensive than their existing reversionary rate.

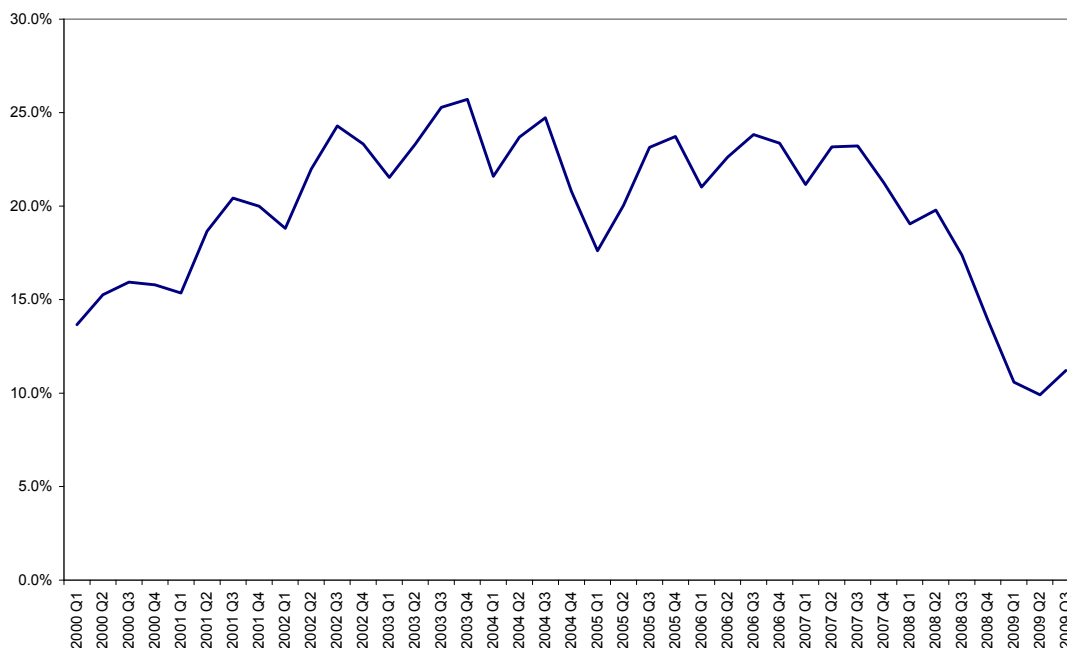
Less attention has been paid to the impact on lenders who now have a cohort of inert customers who are paying interest rates that do not compensate for their risk profile.

(b) Reductions in house prices, coupled with lenders reducing their maximum LTVs, has pushed a significant number of borrowers into a position where they do not have the equity to remortgage. Again, the focus has been on the borrower, but for lenders this has created a cohort of customers with limited ability to remortgage away, who constitute relatively high risks, many of whom are on rates pegged at extremely thin spreads over Bank rate.

(c) The low rate tracker mortgage products offered to borrowers in the pre-crisis period have created a legacy issue of their own. In contrast to the 'can't moves' of (a) and (b) above, these customers could remortgage but have an incentive not to move their loan. These borrowers are unprofitable for the lender, not because of concerns about their credit quality but simply because they are locked into borrowing costs that are often below those of the lenders themselves.

64. From a lender perspective, the above cohorts of borrowers are all unprofitable on a risk adjusted basis, and are likely to exhibit low redemption rates, suggesting the drag they will exert on lender profitability could be drawn out. As Chart 5 illustrates, these legacy issues, together with the reduction in housing transactions, are already having a dramatic effect on mortgage redemption rates, with the average life of a mortgage going from around 4 years in mid 2007 to 10 years by Q2 2009.

Chart 5 – Mortgage repayment rate



Source: CML

(iii) The outlook for lender profitability

65. Arguably the most vital precondition for lenders to be able to raise funds under their own name in the wholesale markets (through a senior unsecured or covered bond) is that they are sustainably profitable.

66. An analogous requirement exists in the RMBS market, but here it is specific to the mortgages backing the bonds. The yield on the mortgages being funded by the RMBS must be high enough to cover funding costs. If this condition is not met, the lender will have to provide additional cash flow to support the transaction. It may chose to do this for strategic reasons, as Lloyds has shown in re-opening the UK RMBS market, but that cannot be sustainable indefinitely.

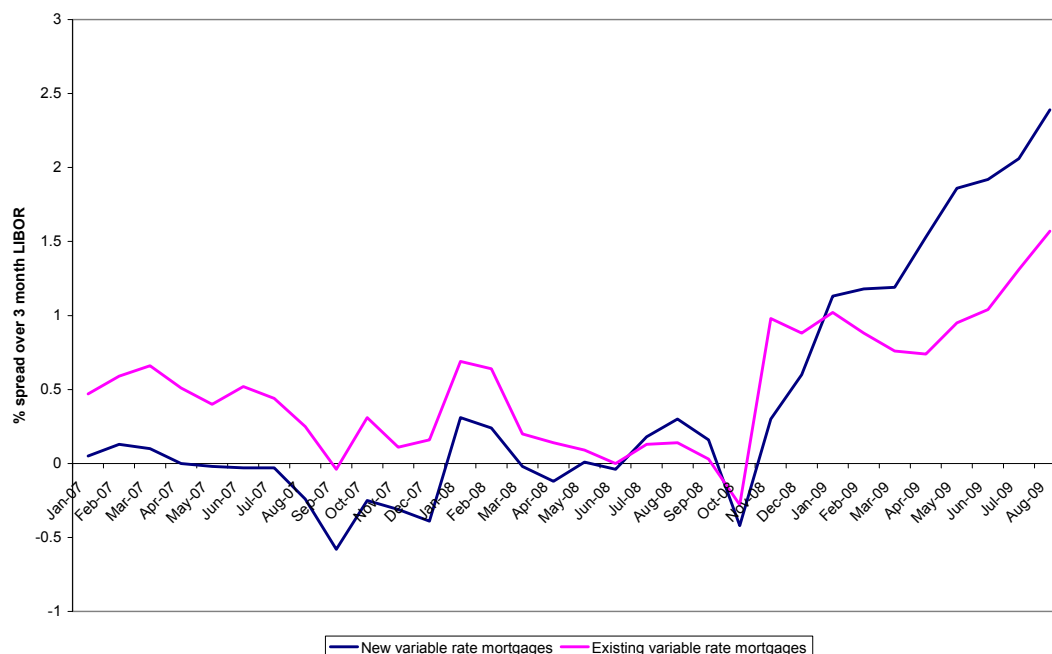
67. Has lender profitability been restored?

68. Lending rates have been rising relative to Libor across a range of banking markets, but it is unclear whether this has resulted in any gain in lender profitability, because lenders' funding costs have also been rising relative to Libor. And they face higher regulatory capital and liquidity requirements.

69. BoE data show that the average interest rate on new variable rate mortgage deals has indeed climbed significantly relative to 3 month Libor, as shown by the blue line in Chart 6, and reached 2.39% by August 2009, having been negative as recently as 2008.

70. Even for existing borrowers, shown in the pink line, there has been an increase in the spread over 3 month Libor despite the large number of borrowers locked into Bank rate trackers.

Chart 6 – Spreads over 3 month Libor on new and existing mortgages



Source: Bank of England

71. This reflects two phenomena. Firstly, most lenders have discretion not to reduce their standard variable rates (SVRs) in line with Bank rate, and have kept their SVRs at levels that provide a good spread over 3 month Libor now that Libor has come broadly back into line with Bank rate.

72. Secondly, there is a constant flow of borrowers going from discounted introductory rates to higher reversionary rates. In a normal market, this would be expected to be broadly offset by borrowers remortgaging off the reversionary rate on to another discounted rate, either with a different lender or via an offer from their existing lender.

73. But, the rise in spreads on new mortgage deals since the financial crisis started has greatly reduced the incentive to remortgage, so on average fewer and fewer customers are on introductory rates as they move on to reversionary rates and stay there.

74. It seems that the rise in mortgage spreads over Libor is not yet sufficient to attract investors who are prepared to fund mortgages on a stand alone basis (i.e. through the RMBS market). For example, in Lloyds' recent RMBS deal investors received 3 month Libor plus 185bp for AAA paper with a put option to investors which amounts to a claim on Lloyds itself. The industry average spread for all lenders on the existing mortgage book would, at some 160bp over Libor, be unable to cover a funding cost of this level.

75. Even on new mortgage business, where the average spread over Libor across the industry is some 240bp, this is still only some 55bp above the AAA funding cost. If you consider the cost of funding a mortgage portfolio entirely through the RMBS market, thus taking account of the probable cost of the lower rated RMBS notes, the all-in cost might well eat up the entire spread over Libor on new loans.

76. A conclusion you could draw, based on the price the securitisation market would demand to fully fund a mortgage portfolio, is that UK mortgages are currently barely profitable, as the rise in mortgage rates compared to Libor has not caught up with the extra return RMBS investors now demand.

77. Retail deposit rates have also been at an unprecedented premium to Bank rate or Libor as deposit takers that are starved of wholesale funds compete for retail money as a substitute. This has meant that retail funded lenders have found it equally difficult to generate a profit from mortgages.

78. Only covered bond funding seems currently to offer lenders a decent spread on their mortgage lending, given that Barclays' covered bond was issued at 60bp over mid swaps, but the volume of funds raised has been modest. So, at present, it does not seem that underlying lender mortgage profitability has improved very much.

79. Looking ahead, unless Libor rises relative to Bank rate, the lack of mortgage churn should drive a further rise in average spreads on existing mortgages as customers move to reversionary rates. Also, most lenders have discretion to raise SVR relative to Libor, although such a move can provoke an adverse media reaction as was seen with Skipton Building Society's decision to remove the cap on its SVR mortgage in the current exceptional circumstances.

80. But, lenders' average cost of wholesale funds is also likely to rise further as bonds issued before the financial crisis at tight spreads gradually redeem and need to be refinanced at today's higher spreads. 2011 could be a particularly difficult year as SLS funds, which are effectively priced at 3 month Libor, will have to be replaced. This could further heighten competition for both wholesale and retail funds.

81. So, it is also not clear that further increases in mortgage profitability are in the pipeline, particularly against a background of elevated arrears and repossessions. Moreover, lenders remain vulnerable to further spikes in Libor, which would reduce spreads on tracker rate products and SVRs.

82. However, investor sentiment has been volatile and further reductions in the spreads they demand in the senior unsecured, RMBS and covered bond markets could boost lender profitability if they are not passed on to consumers in lower mortgage rates.

(iv) Wider banking markets

83. These potential investor concerns are mirrored in other lending markets, for example with commercial property lending and lending to corporate buyouts. The concern about loans made at the top of the commercial property market is an obvious example.

84. For the more diversified banks, these issues can be as or more important than those of residential mortgage lending, but the principles are the same. Investors will want to know that lenders can sustain profits going forward and overcome issues associated with 'legacy' loans.

(v) Concluding thoughts on the return of investor confidence

85. Given the scale of the global financial shock of 2007 - 2009, the recovery in conditions in the financial system has been heartening. Investor sentiment has been underpinned by an improving economic outlook, and while it is accepted that legacy issues will have to be worked through over time, it is also widely felt that lenders can remain profitable overall despite the pressures from higher funding costs outlined above. The central concern will be with the refinancing of £300bn of government support, and re-opening competition across more lenders.

86. But, more strategically, policymakers now have a unique opportunity to bolster the architecture of funding markets and ensure that collateralised instruments such as RMBS and covered bonds are put on a more level playing field with retail deposits and senior unsecured bonds. This could take a number of different forms. By indicating greater support for the UK RMBS and covered bond markets, the government can bolster investor confidence, thereby decreasing lender funding costs and potentially speeding up the time frame over which government can withdraw its funding.

(b) The scale of funding markets going forward

87. Even if these prerequisites are met, and investors become comfortable with investing in UK mortgage funding instruments again, it cannot be assumed that these markets will return to their previous size. A number of factors will limit the capacity of the market to absorb new issuance.

88. One is the disappearance of leveraged vehicles that bought RMBS, such as SIVs and conduits, using short term wholesale funds. This model is unlikely to reappear for the time being while hedge funds' use of leverage is likely to be restricted by greater caution on the part of the banks that provide the debt.

89. And perhaps more seriously, banks themselves may have a permanently lower appetite to invest in RMBS and covered bonds because these were bought in part as treasury assets for their safety and liquidity but have proven to be potentially much less liquid at times of stress than previous thought.

90. In addition, the new liquidity rules in the UK (that may be replicated in other countries) will require banks and building societies to hold government bonds in their liquidity portfolios rather than other highly rated instruments, which will further reduce bank investment in RMBS and covered bonds. Where banks have bond trading portfolios, they will also be faced with significantly higher regulatory capital requirements, which might be expected to curtail the size of these portfolios.

91. New investor groups will need to be found to fill the gap left by the diminished role of leverage investors. One hope is that pension funds and similar cash investment funds can be attracted by the higher spreads on offer. Now that Libor is not much above 0.5%, these funds' traditional aversion to floating rate paper may also be less of a problem for two reasons.

92. Firstly, the spread over Libor is a much larger proportion of the total coupon now, so paper which pays a good spread over Libor will look attractive in this interest rate environment. And, second, Libor is close to its practical floor of 0%, meaning that although the paper is floating rate, it effectively offers the investor a collar (the coupon is almost guaranteed not to fall by more than 0.5%).

93. It is unclear how large a contribution these cash investors can make, but market experts seem to agree that they cannot fully replace the gap left by the reduced presence of leveraged investors, at least in the short-to-medium term.

94. Thus, although there is enormous uncertainty as to how large investor demand might be, the gross volume of issuance is unlikely to be anything like as high as in the 2000 - 2007 period over the next 5 years. This, together with the slow expected growth of retail deposits, points to an on-going need for government support beyond the time limits currently in place.

(c) Options for closing the funding gap

95. How will the funding gap be closed as the SLS and CGS terminate? Here we consider the possible ways in which this can take place.

(i) Roll-over of government support mechanisms

96. The most straightforward solution to the refinancing risk associated with the end of the SLS and CGS is for the government to accept that private sector sources will not be sufficient, and commit to rolling over these schemes, or at least replacing them with another scheme that fulfils the same function. The discount window, which was introduced in 2008 to provide deposit takers with access to cash in exchange for a wide range of securities, could be the vehicle to replace the SLS.

97. Set up as the new permanent mechanism for providing liquidity insurance, the duration of its funding was extended on an emergency basis from 3 months to 1 year soon after its launch. It would be a possible candidate for an SLS substitution.

(ii) Extend quantitative easing

98. An alternative for the government would be to expand quantitative easing to the point where new commercial deposits could fully replace the quantum of SLS and CGS funds. However, this may be an unattractive solution, because there is no mechanism by which the government can ensure that these deposits are placed with the institutions that face refinancing risk, so the risk of further instability in particular institutions would remain a concern.

(iii) Replace with funds raised privately

99. The scale of funds provided through the SLS and CGS is such that it is difficult to see how unsupported markets can refinance them. Net RMBS and covered bond issuance in the strong market conditions of 2000 - 2007 was £35bn pa while retail deposit growth in 2008 was £49bn. This implies a shortfall in 2011 alone of at least £100bn. While the government should take steps to encourage the revival of private sector wholesale funding, it should be under no illusion that these markets alone can provide a rapid solution.

(iv) Shrink balance sheets

100. If government funding support is not extended in sufficient volume, and capital markets are unable to make up the shortfall, lenders that are dependent on government funding will be faced with the option of either trying to compete more aggressively for a largely fixed pool of retail deposits or shrinking their assets.

101. Lenders can shrink their loan assets by curtailing new lending as existing loans redeem. This process has already been evident in the corporate debt market, where for example the total outstanding balance of bank and building society lending to the manufacturing sector has been shrinking since Q4 2008. But, in aggregate, lenders can only shrink their balance sheets if the end borrower reduces indebtedness or finds substitute forms of debt.

102. Many companies can tap the capital markets themselves and the reduction in bank lending to corporates has been driven by a switch from bank borrowing to bond issuance by some companies. Companies can also pay off debt through restructuring or asset sales.

103. But, for ordinary mortgage borrowers, there is no practical option of directly accessing the capital markets or selling assets, so if lenders' aggregate balance sheet capacity were to shrink, the only practical mechanism would be for borrowers to repay debt by saving. This would be a painful process where credit supply would need to be restricted until outstanding household mortgage debt had shrunk sufficiently.

104. Since households' ability to repay debt is constrained by their lack of access to alternative sources of debt, the strain is likely to fall disproportionately on those seeking new loans. This suggests a scenario where existing borrowers gradually pay down their debts while new loans are in

very short supply, limiting the ability of potential first time buyers to enter the market, or families to trade up as circumstances dictate, much as we have seen since 2007.

(d) The balancing act ahead

105. The conclusion must be that some extension of government support is almost certain to be needed from 2011. The later government leaves an announcement of an extension, the more it risks creating uncertainty for lenders, which runs the risk of either provoking more financial instability as investors become nervous or reducing lenders' willingness to extend new credit.

106. But, the government will face a difficult balancing act. If support is withdrawn too quickly, credit conditions will tighten unnecessarily but, if government is too slow in withdrawing funds, it runs the risks of delaying the re-emergence of functioning markets by providing lenders with an easier option not to issue.

107. However, the Treasury and BoE can control the withdrawal of their support not only through its quantum but also through the price charged and, in the case of repo facilities provided by the BoE, through the haircuts it sets. So the government should be able to limit the risk of dependence on its schemes without risking a renewed under supply of credit.

6. Impact of regulatory changes

(a) The impending surge in regulation

108. Now that the emergency support of late 2008 has helped to stabilise the financial system, regulators have started to turn their attention to the need for reforms to ensure that the financial system is less vulnerable to future shocks.

109. The CML supports efforts to determine what regulatory changes are required to ensure that the financial system is more robust going forward. But, while there is a broad consensus that regulatory reform is required, there is also growing concern. In an effort to be seen to be responding, governments and regulators are rushing to conclusions about the shape of reforms required without sufficient analysis or co-ordination of national, European and global proposals.

110. The deluge of proposed reforms we have already seen risks creating a patchwork of changes that do not sum to a coherent whole, and do not provide market participants with the clarity that they need to plan for the future. Cumulatively, there is a real risk of a series of unintended consequences.

111. There is also concern that we will see 'regulatory layering', where the combined effect of changes to make the system safer is an overkill of controls on a number of fronts. There is a particular concern in the UK, where regulators have chosen to lead the international debate, and even initiated unilateral action in key areas like bank liquidity requirements and changes to mortgage market regulation. This is despite assurances that the authorities understand the need for a co-ordinated international response.

112. European and international regulatory discussions have been progressing on a range of issues. In September 2009, the European Commission adopted a legislative package to create a European System of Financial Supervisors (ESFS) with three new European supervisory authorities including a European Banking Authority (EBA), to work with national supervisors. In December, the Committee of European Banking Supervisors (CEBS) published its guidelines on liquidity buffers. The European Commission has also put in place regulatory oversight of credit rating agencies.

113. Other regulatory changes under discussion in the EU include a leverage ratio for banks, which has been a long standing feature of US regulation. This would require deposit takers to hold a minimum level of equity capital relative to gross assets, regardless of the riskiness of those assets, to sit alongside the Basel framework. Another proposal under discussion is dynamic provisioning, the use of provisioning to build counter-cyclical capital buffers, which has worked successfully in Spain.

114. However good these proposals might be in isolation, the sheer number of changes and the uncertainty of how they might interact in practice, mean the cumulative impact is bound to raise lenders' concerns and dampen their appetite to lend.

(b) Impact of enhanced liquidity and capital requirements

115. Perhaps most importantly of all the pan-national discussions have been those around changes to the Basel framework and the capital requirements directive (CRD), which implements Basel in the EU. Some of the key proposals relate directly to funding, such as the 5% retention requirement on securitisations, and these are discussed below, but the wider cumulative impact will be to increase significantly the amount of capital deposit takers have to hold.

116. UK deposit takers already face higher capital requirements (through for example tougher stress testing), and an impending new liquidity regime, which will come into effect in 2010, in anticipation of which lenders are already raising liquidity levels.

117. At the same time, the transitional capital floors that were designed to prevent banks from releasing too much regulatory capital in the early years of the Basel 2 regime are to be kept in place for the time being. This is ahead of further expected changes to the Basel 2 framework and the capital requirements directive (CRD) that are bound to impose higher capital requirements internationally.

118. The FSA is also considering the case for requiring non-deposit takers to hold more capital than the current regulatory requirement of the higher of £100,000 or 1% of total assets.

119. Once the move to higher levels of capital and liquidity is complete, the role of banks and building societies in intermediating savings and borrowings ought to be safer, but will also be less efficient. For a given level of return on equity, a higher margin will have to be extracted between the average rate paid to savers/investors and the rate charged to borrowers. A larger proportion of funds raised will need to be kept in low yielding government bonds to meet enhanced liquidity requirements, while the higher level of capital required will also necessitate higher margins.

120. But, the transitional period presents additional concerns. As lenders increase capital ratios, or build up liquid funds, their ability to lend is temporarily constrained. The quicker the transitional period to higher capital and liquidity, the greater the constraint will be on lending. And to require banks to make the transition during a downturn risks exacerbating that downturn, while to do so at a time when funding is in short supply also risks further constraining banks' and building societies' ability to lend.

121. Moreover, the new liquidity regime may pose particular difficulties for the RMBS and covered bond markets, because many banks and building societies have previously invested a proportion of their treasury funds in these instruments.

122. The switch to investing in government debt will reduce future demand for other bonds. If banks are expected to sell securities they already have and reinvest the proceeds in gilts, it could soften prices in the secondary RMBS and covered bond markets. This could in turn undermine the ability of lenders to issue new bonds in these markets.

123. While nobody is suggesting that regulators should not insist on higher capital and liquidity requirements, greater thought needs to be given to the timing and the impact on funding markets.

(c) FSA mortgage market review (MMR)

124. Another key response to the financial crisis in the UK has been the re-examination of the UK mortgage market. Here, the FSA has concluded that the vast majority of borrowers have been well served by competition in the mortgage market and not suffered detriment. However, at the same time, it believes that the UK mortgage market has been a source of instability and cause of economic distress for some consumers. This analysis has culminated in the FSA MMR paper published in October 2009, on which the CML has responded separately.

125. The focus on the mortgage market seems to emanate from the perception that this category of lending was at the heart of the financial crisis. For example, in the Turner Review it says “the rapid extension of mortgage credit was a key factor in the origins of the financial crisis in the US, UK and several other countries”.

126. We feel that the FSA has been unduly influenced by the well documented events in the US. By contrast, the UK mortgage market has performed well with arrears rates that are a fraction of those in the US, and well below those of the last recession. Although we would accept that there is room for improvement in our mortgage market, it is important to be proportionate in response and remember that it was the closure of wholesale funding markets that was the source of the financial crisis in the UK rather than overall credit standards in the UK mortgage market.

127. Where serious losses have occurred in the UK mortgage market, they have been specific to particular lenders rather than market wide, with fraud playing a significant role in some cases, which raises a question mark as to the appropriateness and proportionality of the substantial market wide reforms the FSA is putting forward.

(d) More intrusive supervision

128. The FSA has also indicated that it intends to adopt a more intrusive supervisory stance, with a focus on assessing the robustness of lenders’ business models. Under this new approach, the FSA reserves the right to set permissions for new firms, and vary the permissions of existing firms based on its assessment of their business models and their systems and controls.

129. This approach should allow the FSA more flexibility to differentiate those lenders that have adopted poor lending practices or unsustainable business models, from others with some similarities but more robust business models or processes.

130. If the FSA uses this approach to target the kind of outliers we have seen, it should support a more robust market for all. However, it will require the FSA to make the right judgements, and not be overly prescriptive with firms simply because they serve niche, potentially higher risk, markets.

131. If the FSA is too prescriptive, it will risk injecting a greater degree of uncertainty for mortgage lenders and potentially deter the future investment needed to revive competition.

132. Building societies face their own new regulatory regime through the proposed FSA specialist Building Societies’ Sourcebook. This lays out a much more prescriptive approach, limiting building societies’ freedom of operation, as the FSA will have to be satisfied that a society has the systems and controls in place before allowing them more control over their treasury management and lending.

133. Again, there is inevitably a degree of judgement required by the FSA as to whether a society is competent in its management approach, creating a degree of uncertainty for societies, which will act as a deterrent to societies that want to expand or diversify their lending in the future.

(e) Regulatory changes specific to funding markets

134. A key part of the regulatory response of the European Commission has been through changes to the CRD. These cover a range of issues, including for example capital for trading books. But, some of the most important changes are focused explicitly on addressing perceived shortcomings in funding markets. The most prominent is the requirement that CRD firms must obtain confirmation from the originator or arranger in a securitisation transaction that at least 5% of the risk exposure has been retained.

135. This measure was a direct response to the perceived risk in the version of the originate and distribute business model where lenders securitise loans and sell all of their interest in them. European regulators have viewed lenders’ lack of ‘skin in the game’ as one of the key causes of the US sub-prime crisis. And the FSA has rightly been concerned about the same issue as applied to sellers of whole loan portfolios, where again there is no skin in the game unless the seller has an on-going interest in the loans through, for example, a profit sharing agreement.

136. CRD firms will also be required to hold more capital against any re-securitisation exposures they hold.

137. We believe the EU was right to focus changes on re-securitisation and securitisation where the originator retains no on-going interest.

138. However, the model of securitisation where the originator retains both the excess spread and a first loss exposure, does impose greater discipline on the lender and in fact was the dominant model in the UK and Europe. However, it could be adversely affected by the 5% retention requirement, since a typical retained first loss has been more like 2%, although the market itself may impose higher requirements in the future.

139. Moreover, securitisation where the originator retains an on-going interest in the loans, still seems to have suffered reputational 'collateral' damage, for example in the differential attitude of the ECB to European securitisations compared to covered bonds. The ECB recently tightened the eligibility criteria for ABS used as collateral to access its repo facility, while announcing a €60bn covered bond purchase programme.

140. Another perceived shortcoming of the securitisation market was a lack of transparency and standardisation. Here the European Council of Finance Ministers' (ECOFIN) and European Commission was keen to see action, asking the European Securitisation Forum (ESF) to set out a list of requirements for issuers that would ensure that the European securitisation market offered better disclosure and conformed to standardised terms.

141. In response, the ESF has produced ten industry initiatives to increase transparency in the European securitisation markets, which aims to raise standards of disclosure and increase standardisation. The CML supports this major initiative, which can only build confidence. But we would suggest that RMBS is already one of the most transparent funding instruments and that transparency has not been at the root of the problems afflicting the RMBS market in 2007 - 2009.

(f) Concluding thoughts on regulation

142. The UK regulatory response to the financial crisis so far has been to seek higher capital and liquidity buffers in banks and building societies, while moving to a more interventionist approach to supervision with a clamp down on what is perceived to be high risk lending in the UK mortgage market.

143. At the same time, some European policymakers have sought to blame securitisation for the financial crisis. The cumulative impact of the regulatory response so far has been to reinforce the sharp reduction in competition seen since the start of the financial crisis, while doing little to address the structural weakness of UK mortgage funding.

144. We know that whilst lenders' capital and liquidity buffers matter, it was disruption in funding markets that was the catalyst that started the financial crisis in the UK. An inability to raise new wholesale funds necessitated the initial rescue of Northern Rock and the other banks that needed support.

145. Given the importance of funding markets, both to the continued flow of credit to consumers and to the stability of the financial system, the ongoing lack of a blueprint from policymakers on how to ensure a sustainable funding system remains a serious omission.

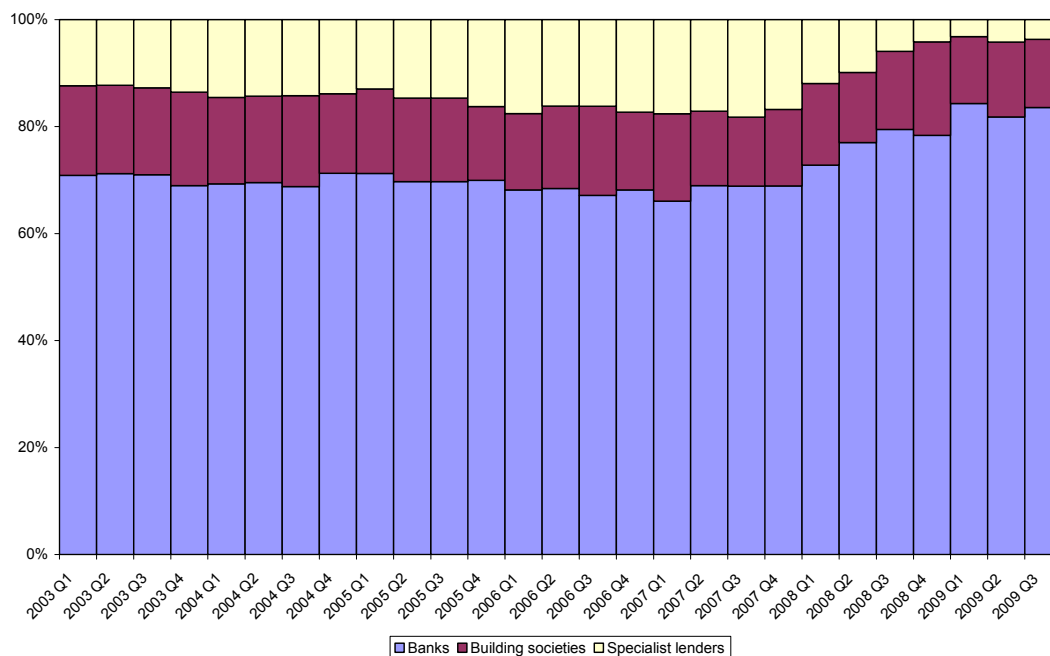
7. The competitive landscape

(a) The impact of the financial crisis

146. One major consequence of the financial crisis and the government's response to it has been the reduction in the breadth of competition in the mortgage market. No other major economy has seen a reduction on this scale.

147. There has been reduced competition across all types of lender but the impact of the crisis and, crucially, the policy response has been quite different amongst the different categories of lender. Here, we briefly look at the impact on these different lender groups and the implications of this for the wider market.

Chart 7 – Share of gross mortgage lending



Source: Council of Mortgage Lenders

(b) Banks

148. Banks have significantly increased their mortgage market share since the onset of the financial crisis, taking it from 68% in 2006 to 83% in the first three quarters of 2009 (see Chart 7). This trend has been driven by the differential impact of the freeze in wholesale funding markets and the concentration of government support on them.

149. But, despite the support, the banking sector has already undergone significant restructuring with competition reduced through the merger of Lloyds and HBOS, with Santander’s purchase of Alliance & Leicester and parts of Bradford & Bingley, and more recently through Barclay’s purchase of Standard Life Bank.

150. The banking sector now comprises three types of entity; fully nationalised (Northern Rock, Bradford & Bingley), part government owned (Lloyds Banking Group and RBS) and the remaining private sector (HSBC, Barclays, Santander). Clearly, further corporate restructuring will occur once the government sells its equity stakes because of EU competition requirements.

151. Funding is likely to be a key factor determining the shape of the restructuring, and who will be in a position to buy Northern Rock and part of the C&G mortgage book as and when they are sold.

152. Regulation is likely to reinforce the trend towards greater concentration, as the FSA appears to see size and access to a mix of funding sources as important defences for institutions against market turbulence, while seeing dependence on a single funding instrument such as RMBS as a source of risk.

153. With this heightened concern about risk on the part of the FSA, being ‘too big to fail’ appears to be a greater competitive advantage than before the crisis. However, the future direction of bank structures remains fluid, with uncertainty following President Obama’s announcements on bank reform in the US.

(c) Building societies

154. The current mix of policy and regulatory responses to the crisis have had the unintended consequence of seriously disadvantaging building societies and have compounded the impact of difficult trading conditions. This can be seen in a number of financial indicators including building societies' mortgage lending market share, which has fallen from 15% in 2006 to 13% in the first three quarters of 2009.

155. No single policy is responsible for this state of affairs but rather it has come about as a result of a combination of policies, including:

- The cut in Bank rate, which has squeezed the liability spread and reduced the endowment benefit of societies' general reserves.
- The nature and pricing of government measures to support wholesale funding (SLS, CGS and ABS guarantee scheme), which have disproportionately benefited larger banks.
- Heightened competition for retail deposits from government owned or part-owned lenders and from NS&I.
- The cost of the FSCS.
- The prospect that a more stringent approach will be taken to the regulatory capital treatment of permanent interest bearing shares (PIBS).
- The recapitalisation and asset protection schemes which have not been available to support any building societies.
- Changes in the FSA's regulatory attitude to building societies with higher liquidity and capital requirements, coupled with the planned introduction of the new sourcebook measures with lending limits.

156. While building societies have traditionally been dependent on retail deposits, in recent years the large and medium sized societies have increasingly accessed wholesale sources. This has taken the form of both senior unsecured issues and covered bonds, where the Nationwide Building Society and Yorkshire Building Society set up programmes and, since the financial crisis, many medium sized societies have joined them to access the SLS.

157. The closure of wholesale funding markets directly affected the large and medium sized societies, whilst a wider range of societies were adversely affected by the indirect impact, as lenders who could not access wholesale funds turned their attention to retail markets, heightening price competition.

158. The position of a number of medium sized societies has been further weakened by credit rating downgrades which themselves reflect in part the lower level of government support these societies have received.

159. The government has repeatedly voiced its support for the concept of mutuality, and the need for diversity amongst financial services providers. It has stated that it wants to explore how the mutual model could be used as part of the process of restructuring the financial system. But, if the current policy mix remains unchanged, the current breadth of large, medium and small building societies are not going to be able to play a full role in the recovery of lending markets. Further consolidation will occur, but it is uncertain on what scale and over what period.

(d) Non-deposit takers

160. Non-deposit takers have been particularly hard hit by the closure of wholesale funding markets because of their dependence on these markets. They have also been excluded from all government support mechanisms.

161. This has resulted in this segment being almost entirely starved of the funds needed for new lending with the result that non-deposit takers have suffered by far the largest fall in gross new lending volumes, which have gone from 17% in 2006 to 4% in the first three quarters of 2009.

162. Regulators have also expressed concern about this business model, seeing it as vulnerable because of its dependence on wholesale sources of funds and in particular on the RMBS market, and seeing it as a key source of higher risk lending.

163. In the MMR, the FSA explained that it plans to take further steps to increase regulatory control over these lenders. It stated that this could take the form of greater analysis of the acceptability of business models, possible asset limits and a consideration of whether higher capital requirements should be imposed on non-deposit taking lenders.

164. Despite the lack of funding and government support, many of the non-deposit takers continue to function, serving their existing customer base. Typically, non-deposit takers have used the pass-through structure of securitisation, where the maturity of the liabilities (funding) matches that of the assets (mortgages) and funding margins are locked in, leaving the lender without the refinancing commitments that required government to provide emergency funding support to banks.

165. A funding structure that has demonstrated its ability to withstand a wholesale market crisis of this scale ought to be of great interest to regulators seeking to limit the need for future government intervention. Yet regulators do not seem to have acknowledged the potential benefits of a system of funding which, by matching the maturity of assets and liabilities, has the potential to protect financial intermediaries and thereby the taxpayer.

(e) The future risk to competition and diversity

166. The financial crisis has had a dramatic effect on the competitive dynamic in the UK mortgage market, with the closure of wholesale funding markets all but halting the non-deposit takers' ability to originate, and creating a scramble for retail deposits that has squeezed the building societies that had relied most heavily on this funding source. But, the policy response may yet prove to have had an even more detrimental impact on competition.

167. First, government emergency support measures have been focused on the lenders that were deemed to be of systemic importance (i.e. too big to fail); the large banks. But, secondly, the subsequent response of the FSA has further disadvantaged the other competitors.

168. At a strategic level, the FSA seems to have concluded that it is safer to have a smaller number of competitors, each using diversified funding sources, than to have a larger number with a diversity of funding mechanisms, including a securitisation only model of funding. This is an illogical response given that the large diversified funded banks needed government support, while the securitisation funded specialist lenders have not.

8. The outlook for specific funding instruments

(a) RMBS

(i) A critique of securitisation

169. To many commentators and some regulators, the securitisation market was at the very heart of the financial crisis and played a pivotal role in bringing it about. The narrative they subscribe to reads something like this: 'The securitisation market allowed an 'originate and distribute' business model to develop, where the lender retained little or no interest in the on-going performance of the loans it made. As a result, these lenders were not incentivised to care about the quality of their lending, and they allowed standards to fall.

170. Moreover, there was a lack of transparency, creating an asymmetry of information between loan originator and buyer, which allowed the seller to pass off pools of poor quality loans to buyers who were unable to gauge their real quality. This meant that investors were taking much higher risks than they realised'.

171. How fair is this narrative? Well, there is an alternative way of presenting these events that is a mirror image of these arguments: 'Declining interest rates from the mid 1990s onwards encouraged investors to seek higher returns by taking higher risk in a 'search for yield'.

172. As the advanced economies continued to perform well year after year, investors became more and more relaxed about risk. At the same time, rising savings rates in emerging economies such as China was recycled into the advanced economies, increasing global liquidity and driving up demand for financial assets across the board.

173. Lenders responded to these market signals – higher investor demand, especially for higher yielding higher risk assets - as any supplier in a competitive market economy is supposed to: They increased lending to end borrowers (both consumers and firms), driving down the cost, especially for higher risk, higher yielding lending such as sub-prime.

174. By juxtaposing these two explanations of the causes behind the US sub-prime crisis, it is clear that the argument that 'originate and distribute' lenders and the securitisation market were responsible cannot be seen as a fair representation of the event.

175. As in previous upswings, perceptions of risk by market participants, including borrowers, lenders and investors, became distorted by years of benign market conditions and rising asset prices.

176. And had the US sub-prime market not existed, excess liquidity would have been recycled through some other market, just as the recycling of Middle Eastern funds in the early 1980s fuelled the over-borrowing that led to the emerging market debt crisis, with banks rather than securitisation acting as the transmission mechanism on that occasion.

(ii) Issue of transparency and asymmetry of information

177. In their critique of securitisation, regulators have focused on the issue of transparency above all others and, in the case of the European Commission, have sought industry initiatives to improve transparency under pain of harsher regulatory treatment should the industry fail to deliver.

178. Yet an assessment of the transparency of securitisation relative to other funding instruments such as unsecured bonds issued by banks or other corporates shows that the degree of transparency – the extent to which the investor can see and understand what they are investing in – is unambiguously superior with a securitisation.

179. A securitisation relies on a defined pool of assets. The level of information available to the RMBS investor varies depending on the nature of the transaction. Typically, in RMBS backed by non-conforming or sub-prime mortgages, investors receive loan-by-loan information while in UK master trust transactions, which typically contain hundreds of thousands of individual prime mortgages, aggregated pool data is provided as loan-by-loan data is of limited value over such large portfolios. But typically all deals, as a minimum, show average initial loan-to-value (LTV) ratios, loan-to-income (LTI) ratios and details about borrower type.

180. By comparison, an investor in an unsecured bank bond has much less visibility of the assets and activities of the bank they are lending money to. And the same is true with any corporate borrower, which is free to change the risk profile of its business over time, and involve itself in a range of activities, the riskiness of which is hard to judge from outside.

181. Stemming from the concern about transparency is the belief that the securitisation market suffers from an asymmetry of information between issuer and investor. The critique has it that the RMBS seller, being in possession of information that the buyer is not party to, can dupe the buyer into believing that the quality of the bonds they are investing in is higher than it really is. But again, a comparison with other markets is instructive.

182. In any financial transaction there is the potential for an asymmetry of information. The seller will invariably have better information about what they are selling than the buyer, and history is littered with examples of asymmetries of information in financial transactions that led to catastrophic losses for investors, for example with Enron.

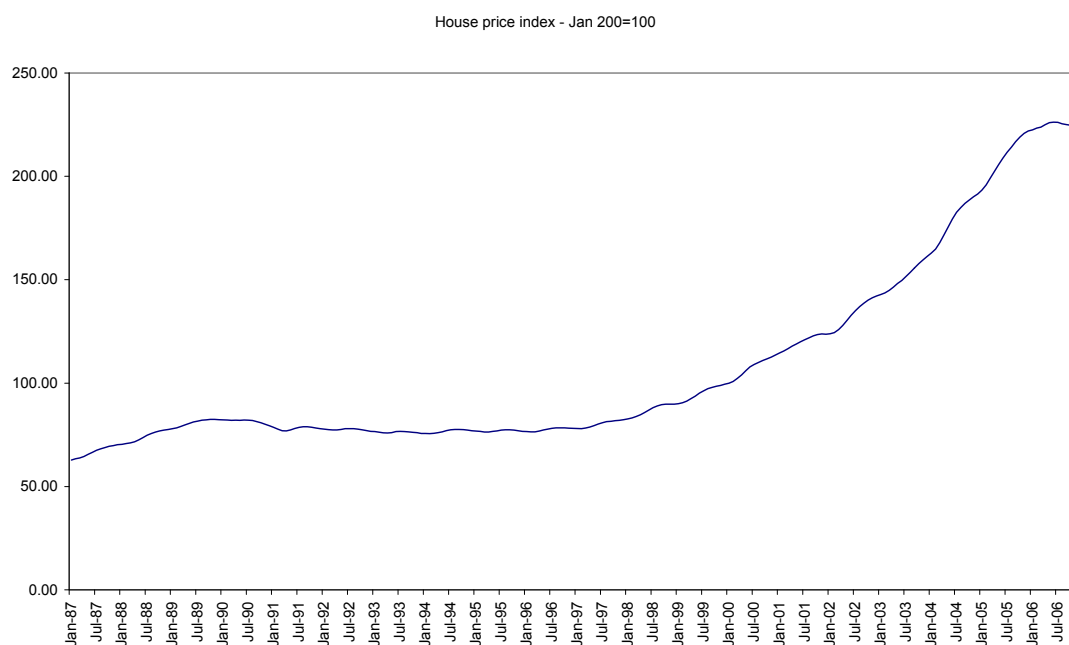
183. Moreover, any seller in a financial transaction will always want to give the best impression, whether it is a company selling its equity or bonds or a country funding its deficit.

184. But, the more transparency the investor has, the less potential there is for an asymmetry of information. And, as mentioned above, RMBS are amongst the most transparent of financial instruments.

185. Consider an investor buying US sub-prime RMBS in 2006. These investors were funding sub-prime mortgages (the term sub-prime was something of a clue as to the quality of the borrowers) secured on property values that had enjoyed extraordinary gains in the preceding 5 years as can be seen from Chart 8.

186. Were these investors the victims of lenders with hidden information on the poor quality of their lending? Or did they ignore the warning of excessive house price growth and loose lending criteria. Indeed, it is hard to argue that the lending process was in any meaningful sense secret when investors were free to see the types of business being accepted by US mortgage brokers and see the products available in the market.

Chart 8 – US house prices 1987-2006



Source: S&P Case Shiller Home Price Index

187. Furthermore, securitised mortgage portfolios are subject to significantly more transparency than portfolios on lenders' balance sheets, as the securitisation process requires external scrutiny of lending processes and standards by rating agencies and on-going reporting to investors.

188. Clearly, events in the US sub-prime market demonstrate that this additional transparency is no protection against losses when all the parties involved, including investors and rating agencies, become complacent about credit standards. But, this does not change the fact that the process offered a high degree of transparency.

189. Evidence from balance sheet lenders in the US sub-prime market also seems to demonstrate that securitising lenders were not necessarily exposed to higher loss rates. And, of course, there were earlier periods of overzealous lending in the US mortgage market, for example when savings and loan institutions (balance sheet lenders funded mainly from retail deposits), were hit with heavy credit losses from imprudent lending and subsequently required a government bailout.

(iii) The role of securitisation in the financial crisis

190. So, if securitisation suffers less from a lack of transparency and asymmetry of information than other financial instruments, why has it come to be seen as playing such an important role in the financial crisis of 2007 - 2008? Three factors played a pivotal role: The growth of leveraged buyers,

particularly banks; the repackaging of RMBS into collateralised debt obligations (CDOs); and the impact of mark-to-market accounting.

(iv) Leveraged investors

191. As a mechanism for transferring funds from savers to borrowers, the great advantage with securitisation is it allows funds to be transferred without credit and prepayment risk being concentrated on the balance sheets of leveraged financial intermediaries like banks.

192. So securitisation should have an important role to play in de-risking the financial system going forward, but only to the extent that the buyers are cash investors such as pension funds. If the buyers are themselves leveraged, securitisation will not facilitate disintermediation.

193. The RMBS investor base, particularly for UK RMBS, had become increasingly dominated by leveraged investors before the financial crisis, with some 75% of UK issuance being bought by leveraged investors, and around 50% by banks alone.

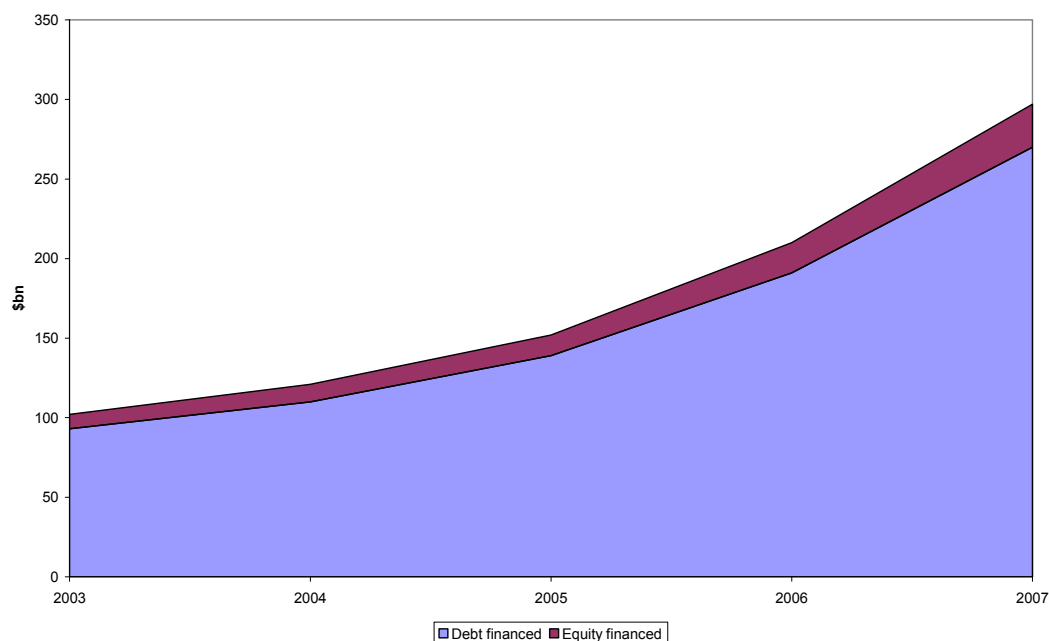
194. The intellectual case for banks buying RMBS is that the trading of these securities between lenders allows each lender to diversify its credit risk exposure so, for example, a mortgage bank in Germany could diversify away from a concentrated exposure to the German mortgage market with exposures to other markets with a low correlation of risk because, for example, they are on different economic cycles.

195. In practice, however, banks were often buying securities with higher yields to enhance profits. In the benign conditions of 2000 - 2006, AAA-rated sub-prime RMBS not only appeared to many to be low risk but, as a result, were easily sellable in secondary markets (i.e. highly liquid), making them seem appropriate as treasury assets (i.e. part of the bank's liquidity buffer). In short, banks investing in RMBS had, like other market participants, become inured of the risks involved.

196. Banks also set up SIVs to undertake leveraged investments in ABS markets outside of the regulatory net. SIV's combination of low levels of capital, maturity mismatch and exposure to mark-to-market volatility in their assets made these vehicles unstable.

197. Regulators should have been concerned with the systemic implications of SIVs given the collective size of their balance sheets (as show in Chart 9), but the full implications of this model were not apparent until the financial crisis laid bare its weaknesses.

Chart 9 – Total assets of SIVs



Source: S&P

198. So, whilst leveraged investment in ABS is not necessarily bad, it does prevent securitisation from fulfilling its primary economic function of disintermediation. It also increases the risk that a credit crisis in one lending market in one region of the world can undermine confidence in those banks dotted around the globe that may have acquired an exposure to that market, creating the risk of systemic fear unless there has been full disclosure on which banks own what.

(v) Collateralised debt obligations (CDOs)

199. The most catastrophic investor losses in the US sub-prime market have stemmed not from investments in RMBS themselves but from mortgage CDOs. These were created by investment banks that bought mezzanine RMBS tranches (e.g. BBB-rated), pooled them and issued bonds backed by them (this is why these are known as re-securitisations).

200. The economic rationale for these bonds was uncertain, since investors clearly could have bought a selection of BBB bonds themselves to diversify their exposure rather than relying on an investment bank which would require some form of remuneration.

201. The aspect of mortgage CDOs that seems to have given them value in excess of their constituent RMBS was the willingness of the credit rating agencies to accept that a pooling of BBB-rated bonds could be restructured into a bond with a top rated tranche of AAA, and the willingness of investors to believe that the AAA label on this tranche implied low risk, even though it was based on a pool of BBB-rated RMBS.

202. The CML supports the measures we have seen from the European Commission to increase the capital requirement for banks holding re-securitisations, and we believe that the poor performance of mezzanine mortgage CDOs has unreasonably tarnished the reputation of securitisation in the minds of some commentators and policymakers.

(vi) Mark-to-market

203. The trend in accounting globally in recent years has been towards mark-to-market accounting of financial assets. This is where a firm holding a financial asset must value it on its balance sheet at its then market value and reflect changes in its market value through its profit and loss account. This can be contrasted with the traditional approach in banking of valuing assets such as loans at book value less an impairment charge or provision.

204. Today, banks can still hold loans at book value less an impairment charge, but accounting standards have made it increasingly difficult for them to justify valuing debt securities such as RMBS at book value. The shift to mark-to-market accounting is much more than a technical issue and arguably led to a greater destruction of capital in the banking system in 2007 - 2008 than the sub-prime credit shock that sparked investor fears in the first place.

205. Because it was difficult to estimate projected RMBS losses, buyer interest dried up, sending market values plummeting. This in turn created forced sellers amongst some investors that depended on leverage, such as SIVs and hedge funds, as they could no longer refinance their debt because their assets had fallen so much in value, driving prices down further still. Some banks also had to start selling as they could not afford to take the risk of a further erosion of their capital through more mark-to-market RMBS losses.

206. In short, mark-to-market losses drove a vicious circle that magnified the impact of the initial credit deterioration, infecting RMBS around the globe regardless of the quality of the underlying credit. The mark-to-market losses were such that they, in turn, began to spark fears that they could deplete the capital of some banks, spreading the contagion to bank debt markets and ultimately creating a systemic panic that only governments could arrest.

207. Since securitisation is a process of parcelling up a loan or group of loans into smaller pieces, if the intention is to hold the security to maturity, the economic substance of the exposure will be the same whether it is held as a loan or as a security. So requiring banks to mark-to-market their RMBS portfolios unnecessarily created enormous additional volatility in the financial system.

(vii) Bond performance

208. Given the events in the US sub-prime securitisation market since 2007, it is important to bear in mind the extremely positive track record of performance of UK RMBS since the first deals appeared in the mid 1980s. No AAA rated UK RMBS has failed to repay in full to date. No bond issued from a master trust has failed to repay in full to date. This supports the view that the structure of securitisation is not at fault but rather that, if the quality of lending is sufficiently poor, it is inevitable that investors will lose out.

(viii) Policy response

209. There have been quite different responses to the seizure of securitisation markets in Europe and the US. In the US, the government has come to the aid of securitisation markets with the TALF and the purchase of agency RMBS by the Fed and Treasury. In Europe, the approach has been the opposite, with the European Commission looking at ways to stiffen regulation of securitisation.

210. The European response, for example in measures like the 5% retention requirement, reflects a perception that securitisation played a major role in bringing about the crisis. It has been easier for European regulators to pin the blame on the sellers and the system (securitisation) that enabled them to pass risk to buyers around the globe than to question why European depository institutions bought higher risk securities using leverage.

211. The contrast in approach between the covered bond market, with the ECB buying €60bn of bonds, and European ABS, where the ECB is tightening requirements for ABS as repo collateral, is stark.

212. In the UK, superficially the government has been more positive in its attitude to securitisation with the ABS guarantee scheme announced in January 2009. This followed on from the Chancellor's decision, announced in the 2008 budget, to commission Sir James Crosby to report on possible solutions to the hiatus in mortgage finance. However, in reality, the government's policy decisions have not aided confidence. Against the advice contained in James Crosby's report, the ABS guarantee scheme was only made available to deposit takers, who already had access to the CGS on terms that made the ABS guarantee scheme unattractive.

213. The failure to provide a guarantee on the master trusts of Northern Rock (Granite) and Bradford & Bingley (Aire Valley) also marked them apart from these lenders' senior unsecured bonds, which were guaranteed. This was despite the fact that RMBS, as collateralised bonds, would have provided the government/tax payer with security.

214. More significantly, the decision to allow these master trust programmes to enter wind down, putting the bonds into extension, undermined investor confidence. Even though the wind down was a structural feature of these programmes, designed to protect senior bondholders, its deliberate activation did not come across as a carefully considered policy action but rather was taken by investors as a vote of no confidence in master trust and RMBS.

215. There has also been a damaging difference of opinion within the tripartite authorities. The Treasury has taken a relatively positive public line, most recently in the pre-budget report on 9 December 2009 saying 'The government will explore ways of encouraging more sustainable, transparent and standardised UK mortgage backed securities...in discussion with issuers and investors, in order to establish a broader investor base and lay the foundations for stronger markets in the future.' But the BoE has adopted a negative attitude to securitisation, particularly to the master trust structure, which it sees as overly complex.

(ix) The outlook for the UK RMBS market

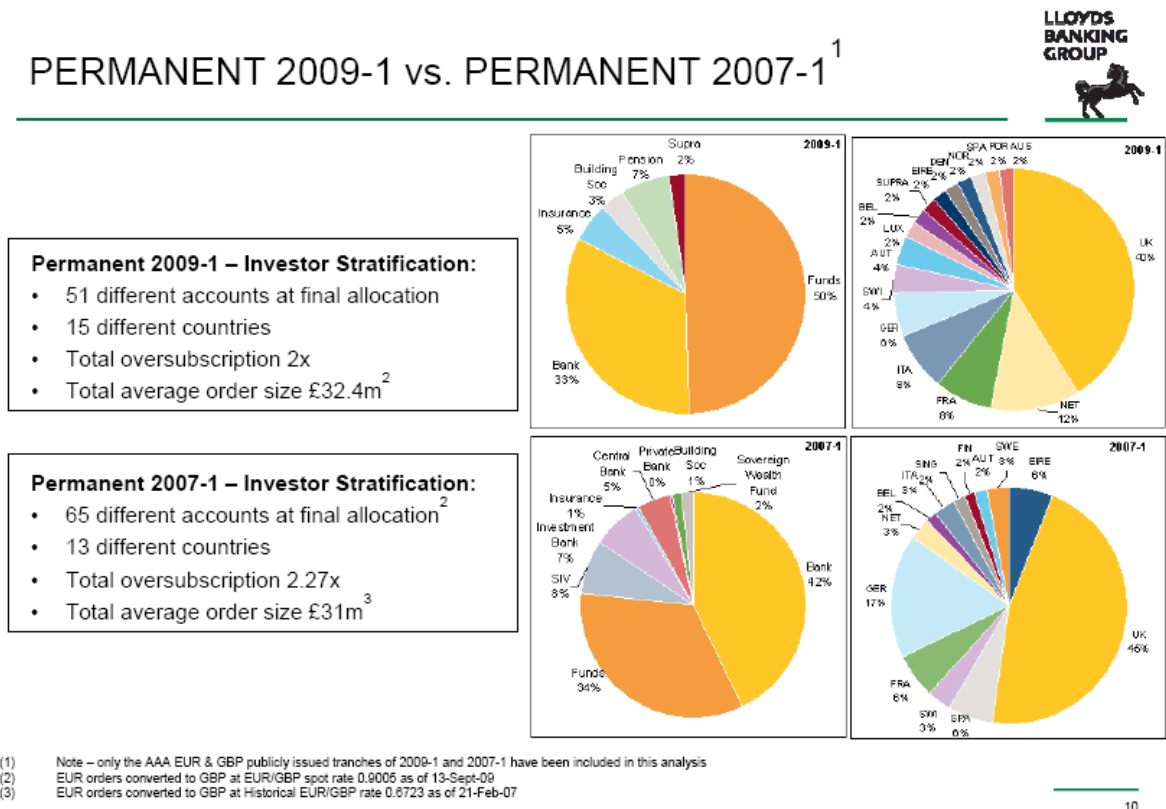
216. Since the larger UK mortgage lenders first set up RMBS programmes in the late 1990s, the market can be divided into two distinct segments; the specialist lenders relying on stand alone RMBS transactions with a pass-through structure for their funding needs and the large banks running master trust programmes as one element of a diversified funding strategy.

217. Any examination of the future prospects for the market must take account of this distinction because the drivers of these two segments are quite different.

(x) Large bank programmes

218. The large banks will issue into the RMBS market if it compares favourably with other funding sources in terms of characteristics such as price, duration and reliability. They will also value the diversity of funding it provides and the ability to access a different investor base.

Chart 10 – Details of Lloyds’ recent RMBS deal



Source: Lloyds Banking Group

219. A good test case for the UK master trust structure was the issue from Permanent master trust in September. The AAA only deal was priced at 185bp over Libor, but crucially it featured a put option to investors at 5 years. This made it more like a covered bond than a traditional RMBS from an investor standpoint, and it was supported by JP Morgan, which bought a tranche and provided repo finance against another.

220. Therefore, the deal could not be said to represent a fully fledged re-opening of the UK RMBS market, but it was an important step on the road. Interestingly, the transaction did show a welcome shift away from leveraged investors with a significant switch away from bank purchasers to funds (see Chart 10).

221. Some investors have expressed concerns about the master trust structure, and it is known that the BoE has been critical. Yet the Lloyds and Nationwide deals show that investors are voting with their feet and supporting master trust deals.

222. Again, RMBS seem to have come in for undue criticism. Investor concern with master trust stems from its revolving nature, meaning the quality of the loans can change over time. But, again, consider the comparison with a senior unsecured bond – it is certain that the nature of the business of the issuer will evolve over time and the bondholder has no real control over the risk associated with that evolution.

223. By comparison, the potential for drift in the quality of loans going into master trust structures seems an acceptable risk given the nature of the issuers and the safety features, for example with a random cross section of qualifying prime mortgages going into the pool with the rest remaining on balance sheet.

224. The other main criticism of master trust, voiced in particular by the BoE, has been its complexity. However, this complexity of structure has been designed to support a greater simplicity in the bonds issued, allowing bonds to carry set redemption dates, while protecting senior bondholders in the event that the structure has to be wound down. There is no doubt that a wider range of investors can be attracted to RMBS by offering such soft bullet bonds. Therefore, master trust fulfils an important role that should not be lost.

225. Master trusts are also an efficient way to obtain RMBS funding backed by mortgages with flexible features such as over/under payment and payment holidays (as required increasingly in the prime mortgage market). Master trusts also provide an efficient mechanism for ensuring that the risk of set-off, flexible redrawing and unenforceable loans are absorbed entirely by the sellers' interest rather than the RMBS investor.

226. One of the key reasons banks first launched master trust programmes was that under Basel 1 securitisation released regulatory capital, but under Basel 2 this capital relief is likely to disappear as the capital required for low risks assets held on balance sheet falls. Unless regulatory capital requirements are maintained at artificially high levels, for example through the extension of Basel 1 capital floors or by a universal leverage ratio, the capital benefits from securitisation are likely to be greatly diminished.

227. This is likely to produce a smaller master trust market in future, but one based more on fundamentals rather than an element of capital arbitrage, which could be seen as a positive development. However, the government support provided to senior unsecured bank creditors has also made master trust RMBS relatively less attractive to investors, which risks distorting the market.

(xi) Non-deposit taker RMBS

228. There are a number of reasons why you might expect the non-deposit taker RMBS market to recover more slowly. Most of these lenders are dependent entirely on the securitisation market for their funding, with limited balance sheets of their own. Thus, these lenders do not have the ability to encourage the market in the way that Lloyds has by issuing a new deal with a put option.

229. Secondly, they tend to operate in niche mortgage markets where credit risk is higher, and investor appetite for such risk is likely to be muted for some time to come. Thirdly, because of their lack of a balance sheet, they are dependent on warehouse funding lines from banks and re-opening such lines will not be a priority for many bank providers.

230. However, investor feedback has been supportive of the stand alone RMBS structures used by non-deposit takers. And the original business case of most of these specialist lenders, that they could cater for under-served borrower segments, is perhaps stronger today than it has ever been, given that the tightening of lending criteria has left a large number of borrowers and potential borrowers unable to access mortgage credit. And the recession will have also increased the number of borrowers with blemished credit records.

231. This combination of investor confidence in the structure and high potential mortgage margins available in niches markets currently being under-served should provide a path back for the RMBS market for non-deposit takers.

232. Warehouse providers should also be attracted back by the potential to take a substantial slice of the margin. The constraints facing the balance sheet lenders, with £300bn to be repaid in SLS and CGS funds, suggests that these lenders are unlikely to make a rapid return to higher risk segments, so the under supply of credit and high margins that currently characterise these markets looks set to remain a feature for a number of years to come.

233. However, there is considerable uncertainty about the regulatory environment that non-deposit takers will face, and a sense that the FSA may put up barriers based on the attitude expressed in the MMR which associates non-deposit takers with the problems that afflicted the US sub-prime market. It would be unfortunate if non-deposit takers were unable to pursue an otherwise sound business case by an overly cautious FSA, influenced more by events in the US than by the track record of lenders in the UK.

(xii) CML's preferred approach to restoring a healthy RMBS market

234. We believe that securitisation should play a vital role in aiding the government's withdrawal from funding support and de-risking the financial system. In looking to build a more stable securitisation market, we believe that policymakers should focus on the weaknesses outlined above as follows:

- **Building a domestic cash investor base.** Measures should be put in place to encourage cash investors, particularly domestic institutions, to become regular buyers of UK RMBS. Regulators should monitor the balance between leveraged and cash investors with an understanding that a preponderance of leveraged investors is likely to signify excess liquidity.
- **Mark-to-market accounting.** We believe that the correct accounting treatment for RMBS and other bonds backed by loans should be determined by whether the bonds are being held to maturity or being traded. Where they are being traded, mark-to-market accounting is appropriate but where they are 'buy and hold' investments they should be held at book value less an impairment charge as would a loan.
- **CDOs.** We support proposals contained in CRD 3 to require banks to hold more capital against investments in re-securitisations if proper due diligence is not undertaken.

235. But the largest single obstacle to the UK RMBS market's recovery is the extent to which other funding channels (retail deposits and senior unsecured bonds) have been seen to receive preferential government support. Redressing this imbalance should be a priority.

236. We support moves to create a more transparent and standardised RMBS market but, as we have consistently pointed out, these are not the core issues holding the market back. RMBS could benefit from more transparency but they already compare favourably to other bonds in this respect, and greater standardisation will aid investors but, again, the lack of standardisation was not at the heart of the market dislocation seen since 2007.

237. The crisis was above all driven by the excessive use of leverage by investors, which allowed the RMBS market to become the receptacle for excess global liquidity. An RMBS market with a strong presence of UK cash (unleveraged) investors should form part of a more sustainable funding market.

(b) Covered bonds

(i) The attraction of covered bonds

238. Covered bonds are an attractive funding instrument for investors, as they offer dual recourse – to the issuing lender and to a ring-fenced pool of mortgage assets, making them particularly safe. This, in turn, has made them attractive for issuers because their safety is reflected in the lower yield investors demand and the longer maturities that investors will accept.

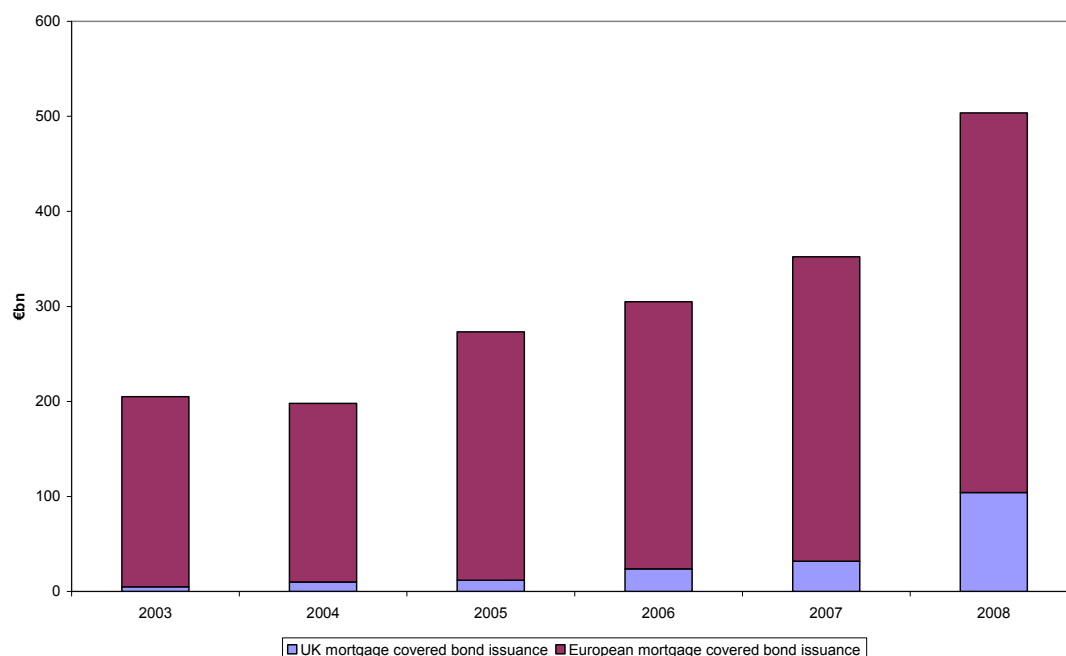
239. And because of their safety, the vast majority of covered bonds are rated AAA, making them eligible for repo facilities such as the SLS that demanded AAA-rated bonds, whilst also making them attractive collateral for private sector repo trades.

240. The European covered bond market has performed relatively well during the financial crisis compared with other wholesale funding instruments such as RMBS, reflecting the unleveraged nature of much of the investor base and the continued positive perception of the credit strength of covered bonds.

241. Primary markets did not entirely close in continental Europe, and prices in the secondary market were not struck nearly as hard as for RMBS despite disruption to market making. The strength

of issuance is shown in Chart 11, however, this does include retained deals being used to access central bank repo support.

Chart 11 - European and UK covered bond issuance including retained deals



Source: European Covered Bond Council

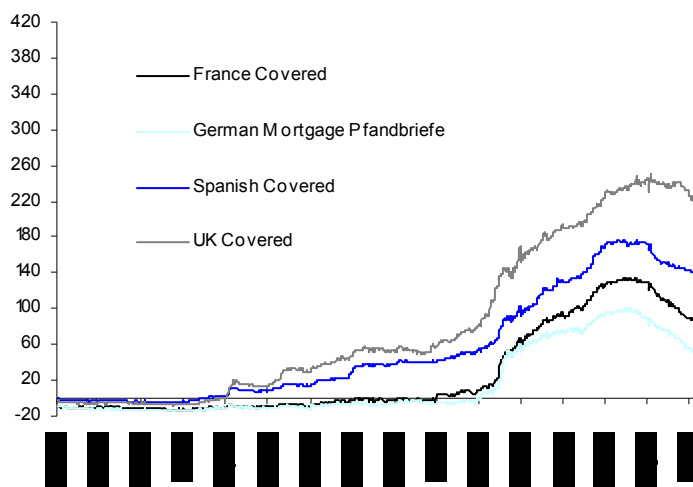
242. However, it was not until the ECB announced in May 2009 that it planned to buy €60bn of covered bonds in the market that new issuance really picked up. The ECB announcement led to a dramatic tightening of spreads in the secondary market, and a wave of new issuance on the continent. And improved conditions persuaded Barclays and Abbey to launch new issues. The pricing has been attractive with Barclays paying 60bp over the swap rate for a €2bn euro denominated 10 year floating rate bond.

(ii) Outstanding concerns of the UK covered bond market

243. UK covered bonds have consistently traded at the widest spreads of any major European market (see Chart 12), indicating that investors have considered them less attractive. One reason often cited before the introduction of statutory regulation was that UK covered bonds were based on contract law and structures, whilst most European markets had dedicated covered bonds laws that gave investors comfort that their claim over the mortgage assets was secure.

244. However, UK covered bonds continue to trade wider now that the new statutory regime is in place. This may be in part a function of the nature of the regime, which does not follow the prescriptive approach used in countries such as Germany, but rather acts as an umbrella, allowing for different structures including the existing UK structured covered bond. Or it may be simply that UK covered bonds are still relatively new and therefore less established.

Chart 12 – Spreads in major European covered bond markets



Source: European Covered Bond Council

245. It may also to some extent relate to decisions made in respect of Northern Rock's covered bond programme, which was not covered by the initial government guarantee when the government rescued Northern Rock in September 2007, while other senior bonds were.

246. Although covered bonds were brought within the guarantee in December 2007, the terms are still inferior to those for the unsecured bonds as the guarantee on the covered bonds can be removed at three months' notice, whilst the guarantee on Northern Rock's unsecured bonds is to remain in place until redemption.

247. The UK's position outside the Eurozone may also have disadvantaged UK covered bonds. This factor may have played a larger role since the start of the financial crisis as Eurozone banks have had access to repo support against eligible covered bonds and ABS collateral on better terms than those available from the BoE. And since it announced in May 2009 that it would start buying covered bonds, the ECB has demonstrated a degree of support for the market which has further bolstered the impression that Eurozone covered bonds have a degree of governmental support.

248. UK covered bond issuers were also concerned earlier in 2009 when S&P and Fitch announced reviews to their covered bond rating methodologies. Fitch focused on the risk to bondholders in the event that the issuing bank became insolvent (the so called discontinuity risk) but maintained the bonds' AAA ratings.

249. Arguably the largest concern for some UK covered bond issuers is the FSA's regulatory approach, which seeks to constrain covered bond issuance based on concerns about the detrimental impact it has on depositors, because it deprives them of recourse to the mortgages that are ring-fenced for the benefit of the covered bond holders in the event of issuer insolvency.

250. The FSA has stated that, although it will treat lenders on a case by case basis, issuance in excess of 20% of a lender's total assets would usually be expected to trigger higher capital requirements. This will be less of a concern to the more diversified lenders but for a lender where mortgages form the bulk of loan assets it could be a real constraint.

251. What the above indicates is that there are a number of issues specific to the UK covered bond market that has held it back. By contrast, pan-European concerns, led by the expiry in 2010 of the waiver that permits the use of a loss given default (LGD) rate of 11.25% in banks' regulatory capital calculation, are second order issues for our market.

(iii) Outlook for covered bonds

252. For banks and the largest building societies, covered bonds look like a highly attractive funding tool going forward, offering the cheapest funding costs, despite the cost premium to continental covered bonds, and the longest durations. This should help lenders to raise the average duration of their funding as required by the FSA under the new liquidity regime at limited additional cost.

253. And as the capital relief that was available through securitisation under Basel 1 will largely disappear under Basel 2 once the Basel 1 floors are removed, one major reason for choosing RMBS over covered bonds will largely disappear. Given these advantages, the most significant regulatory factor now holding the market back is the FSA's issuance limits, at least for undiversified mortgage lenders.

(iv) Possible policy solutions

254. We welcome the announcement in the pre-budget report on the statutory regime stating that 'government will consult in early 2010 on supplementary rules where greater clarity may be warranted'. Further improvements in the regime can only support confidence in the market.

255. We also support the ECBC's proposals for a tighter definition of a covered bond, which should further help to build the reputation of UK covered bonds as being equal to those of other leading markets.

256. But, of greater significance in our view is the potential covered bonds have to attract a stable UK cash investor base. With low risk, long maturities and mostly fixed rates of interest, covered bonds are the instrument with the best chance of attracting a stable buyer base of investors such as UK pension funds, but policymakers cannot assume that this investor base will just appear.

257. The government needs to provide the right signals of support. A temporary UK covered bond buying programme to mirror that of the ECB would be a positive step, but even less significant changes, such as getting the BoE to extend its liquidity facilities to cover pools in the event of issuer insolvency, would help sentiment.

258. We would also urge the FSA to rethink its approach to limits on the scale of covered bond issuance, and question the logic of its current stance, where firms are expected to hold more capital if covered bond issuance goes above 20% of total assets.

259. The FSA's thinking is driven by the concern that in the event of a bank insolvency, the prior claim on the mortgages supporting the covered bond will disadvantage unsecured creditors including retail depositors. But, the events of 2008 suggest that, while being theoretically correct, this argument is unlikely to be relevant in practice as, to maintain confidence in the financial system, the government will ensure that the claims of senior unsecured creditors in depositor institutions will be honoured.

260. To hold back the market with the best chance of establishing a stable UK investor base for fear of its impact on depositors is therefore, in our view, misguided.

(c) Senior unsecured bonds

261. One of the greatest anomalies in the support given by government to the financial system has been the treatment of senior unsecured debt issued by deposit takers relative to the treatment of RMBS or covered bonds.

262. Where the government has taken over stricken banks, as with Northern Rock and Bradford & Bingley, they have guaranteed the unsecured senior bondholders and other senior creditors. This has protected both short term funding instruments such as commercial paper and longer term funding instruments such as floating rate notes (FRNs). It also covers interbank exposures.

263. In contrast, covered bond holders have received less fulsome guarantees and RMBS investors have seen no guarantee. And the main government instrument for helping banks to continue

to raise funds in the wholesale markets, the CGS, required no collateral to be supplied, leaving taxpayers with an unsecured exposure to the banks that utilised the scheme.

264. Whilst this support for senior unsecured bondholders was understandable to maintain investor confidence during the crisis, the inferior treatment of collateralised instruments, which provide the taxpayer with greater protection, is surprising and risks increasing moral hazard.

265. The SLS at least recognised the importance of requiring participating lenders to provide collateral and, now that we have reached the point where confidence is rebuilding, it would seem to make sense for future schemes to require users to post collateral to minimise taxpayer risk.

(d) Retail deposits

(i) Government support for retail deposits

266. On 27 September 2007, following the run on Northern Rock, the Chancellor announced that the government would not allow retail depositors to lose money, stating that 'Should it be necessary we and the Bank of England would put in place arrangements that would guarantee all the existing deposits in the Northern Rock bank during the current instability in the financial markets'. The Treasury added that if necessary similar measures could be put into place to assist other lenders.

267. Subsequent events put these words into effect. The Chancellor ensured that all retail depositors in three Icelandic banking operations in the UK: Icesave; Heritable, a subsidiary of Landsbanki; and Kaupthing Singer and Friedlander were protected in full regardless of the ceiling on protection under the FSCS.

268. These were pragmatic steps to minimise the risk of a contagion, where depositors pull money out of other institutions in fear. And, because the government succeeded in calming nerves, the retail deposit market was a source of stability during the crisis, ensuring that its reputation amongst lenders and regulators was enhanced.

269. On the back of this apparent stability, something of a knee-jerk conclusion has emerged that 'retail funding is good, wholesale is bad' and this seems to have influenced the FSA's thinking.

270. Yet an alternative conclusion might be drawn that the retail deposit market was stabilised through blanket government support, without which the run on Northern Rock could have been repeated at other deposit takers, creating the potential for enormous volatility in savings flows. Had a similar guarantee been provided to RMBS or other wholesale investors, it would no doubt have had the same stabilising effect.

271. Retail deposits have been historically a stable source of funding as demonstrated by the long history of solidity amongst the building societies. However, the characteristics of retail funding look far from ideal for funding mortgages.

272. While a typical mortgage term is 25 years and the average life of a mortgage is currently around 10 years, the majority of retail funds are instant access or short term bonds or notice accounts, giving rise to a significant maturity mismatch.

(ii) The potential for moral hazard

273. Moreover, past financial crises demonstrate both the potential deposits have for creating instability when investor confidence is lost, and the potential for moral hazard when depository institutions know that depositors will not be liable for the losses of those institutions. The US savings and loan crisis was an example of the latter.

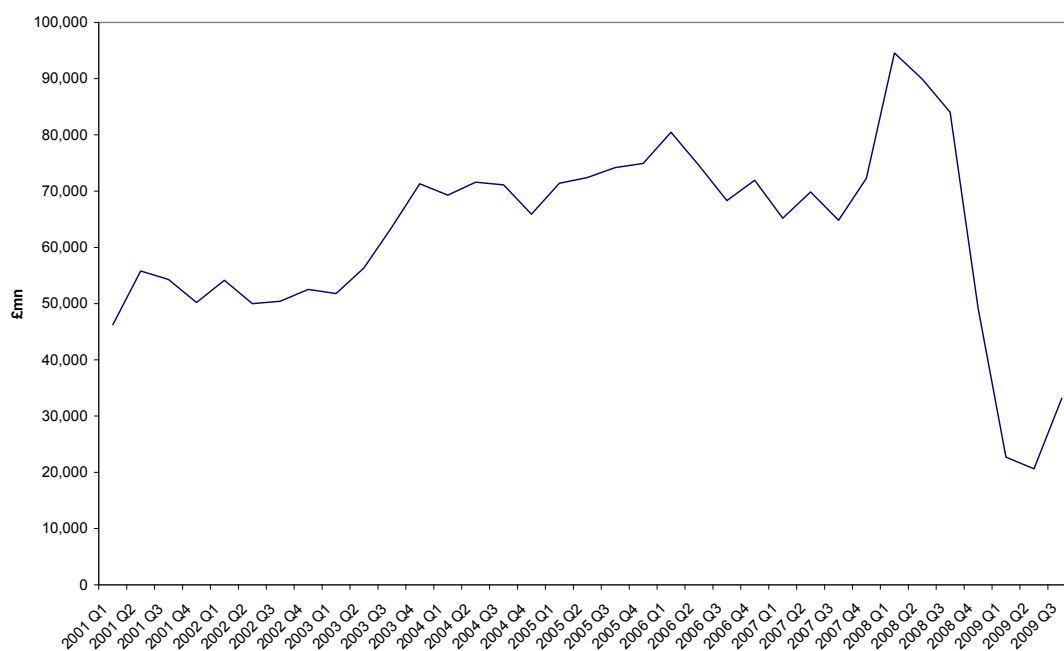
274. The potential for moral hazard is particularly acute with retail deposits because ordinary depositors cannot be expected to accurately assess the riskiness of the institution where they are putting their money. Instead, at times of stress, they will be driven by sentiment and rumour.

275. Whilst the government's support for depositors in the wake of the run at Northern Rock was crucial to restoring stability, it will have heightened moral hazard while the 'retail funding is good wholesale is bad' psychology risks encouraging more reliance on a funding source that has received blanket government support.

(iii) Insufficient size of the retail deposit base

276. The chancellor's intervention in the retail deposit market may have ensured stability but it has not led to a flight to deposits from other investments. Retail deposit balances grew by only £49bn in 2008, an increase of 4.6% compared with £72bn the previous year (7.0%). But growth has slowed further since, so that by Q3 2009 the increase in deposits over a year earlier had slowed to only £33bn (see Chart 13).

Chart 13 – Growth of retail deposits on a year earlier



Source: Bank of England

277. One reason for the slowdown in this series is that most of the growth in deposits historically has been from credited interest rather than people actually depositing new funds in banks and building societies, and with interest rates coming down the quantum of credited interest has fallen sharply.

278. If a low interest rate environment persists, as seems likely over the coming years given slowing wage growth and the need for fiscal austerity, the growth of retail deposits will remain subdued.

279. This suggests that any idea of a return to a mortgage market funded entirely from retail deposits can be dismissed as the portion of mortgage assets that are funded from wholesale or government sources has risen to over £500bn (more than 40%).

280. Even the prospect of government supported funding totalling c£300bn being replaced by retail funds seems wholly unrealistic. At current rates of growth, it would take 9½ years for deposits to fill the gap without any growth in mortgage debt, illustrating the need for wholesale funding channels to return to health.

(iv) Concluding thoughts on retail deposits

281. In conclusion, any push from government to move back to a mortgage market funded mainly from retail deposits would not only place extreme restrictions on the availability of mortgage credit, but

would also fail to protect taxpayers from having to underpin the financial system, as depositors have been seen to have received fulsome support from government during the current financial crisis.

282. Retail deposits can continue to play a vital role in funding UK mortgages as they have since the beginnings of the market, but policymakers need to be careful not to adopt a 'retail deposits are good wholesale funding is bad' approach in response to the recent crisis.

283. This applies particularly to the proposed sale of mortgage assets at the state owned or part-owned banks. If the purchasers of these assets plan to fund them from retail deposits they will heighten competition in the retail deposit market still further, threatening the profitability of some existing lenders.

9. Conclusion

284. Structural weaknesses in UK mortgage funding markets have been revealed in graphic form by the global financial crisis. After successfully intervening with emergency measures to support the financial system, not least by plugging a £300bn funding gap, the authorities have now increasingly turned their attention to reshaping the regulatory system through a raft of measures to control lender behaviour, and bank and building society capital and liquidity.

285. But, as they examine what structural changes are necessary to prevent future instability in the financial system, they should not overlook the need to address the structural weaknesses in funding markets.

286. Reasonably, the UK authorities provided the fullest support for the funding markets that matter most; retail deposits and senior unsecured bonds from the largest deposit takers. By comparison, however, there has been an absence of effective support for the RMBS and covered bond markets. This contrasts with the US and continental Europe which have respectively supported the RMBS and covered bond markets because of the vital role these markets play in the financial system in these jurisdictions.

287. The unintended adverse consequences of the UK policy response has been to create an unlevel playing field in funding, with retail deposits and senior unsecured bonds being advantaged relative to RMBS and covered bonds.

288. With strong support for these markets in other countries, the UK risks losing out in competition for global investors and indeed even amongst our own institutional investors, who might conclude that it is safer to fund mortgages abroad. Retail deposits alone cannot support the size of mortgage market we have in the UK, and a dedicated funding instrument which provides wholesale investors with a claim on mortgage assets provides an important additional market discipline.

289. The government should level the playing field by providing more tangible support for UK RMBS and covered bonds. This could take the form of temporary purchase programmes of the sort conducted by the Fed and ECB, and a change in the regulatory stance to remove barriers to the use of these funding tools. In the absence of such support, the UK may well find it difficult to re-establish RMBS and covered bond markets on a scale sufficient to plug the funding gap, leaving us with a reliance on government funding and the risk of an under supply of credit for a prolonged period.

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