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Key role for Bank in funding solution

- Alistair Darling's first Budget speech ultimately delivered little of real substance for mortgage and housing markets. Lenders will continue to support measures to deliver market-led solutions to mortgage funding problems. They will also work with the Treasury as it looks again at the market for low-cost home-ownership and long-term fixed-rate mortgages for niche groups of borrowers who would benefit from them.
- The problems in mortgage funding markets are well documented. Mortgage-backed securities (MBS) were originally seen as a means of spreading credit risk and gaining access to a diverse investor base. But spreading credit risk has created uncertainty about where it lies. And global investors are now rejecting markets they once embraced.
- MBS are complex, and variations in their structural features have made it difficult for investors to compare one issue with another. Another concern for investors is that it is difficult to assess the quality of mortgages backing the MBS, as experience in the USA has shown.
- In inviting lenders and investors to explore ways of addressing funding market disruption, the chancellor backed away from the idea of a 'gold standard' for MBS aired last month. We welcome that. We are not convinced that the government – or anyone acting for it – can establish a gold standard to restore confidence.
- Finding solutions to funding market problems is far from straightforward. The working group of lenders and investors announced by the chancellor represents an opportunity for the industry to explore its own preferred solutions and propose answers. We hope for early progress to strengthen funding markets – with active participation by the Bank of England.

Buy to let in a challenging environment 21 May 2008, London

This one-day seminar will look at how the ongoing turmoil in the credit markets has affected the buy-to-let market.

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Funding market conditions

In delivering his first Budget, Alistair Darling announced the setting up of a working group to help improve liquidity in the mortgage-backed securities (MBS) market. Lenders will contribute to the group, along with the Treasury, the Bank of England, the Financial Services Authority (FSA) and the investment industry. In the summer, it will report to the chancellor, who will announce proposals in the pre-Budget report in the autumn. But there could be earlier action if the group can agree credible measures for reviving the MBS market.

The problems in mortgage funding markets have been well documented. After the initial freezing of debt markets in August 2007, conditions improved in September and October only to deteriorate in the run-up to Christmas. After concerted central bank intervention, conditions initially improved but have worsened again in recent weeks, requiring yet more central bank action on the eve of the Budget.

There have been no new MBS issues in the UK since last August, and only a single publicly sold deal from any European market. There were two public UK covered bond issues in the autumn – from Nationwide and HBOS – but there has been nothing since. Banks have found it equally difficult to fund in the uncollateralised senior debt market, meaning that, for most lenders, capital markets are effectively shut across the board.

The lack of activity in funding markets is an obvious sign of stress in the financial system, although it gives little indication as to how these stresses are developing from week to week. But there are two more visible indicators of stress: the spread between the London inter-bank offer rate (libor) and index swap rates – which measures the premium banks have to pay to raise funds – and the price of credit default swaps (the cost of insuring against credit losses). These confirm that confidence has ebbed again in recent weeks.

Causes of the current situation

What lessons have we learned during this exceptional period of turbulence? It seems that some of what was previously held to be true is now much more questionable. As financial institutions came to rely increasingly on global capital markets, it was assumed that parcelling up loans and selling them in securitisations to diverse investors would spread credit risk, thereby diluting it. For issuers, the belief was that the capital markets provided access to a geographically diversified investor base that would provide protection against problems in any one region of the world.

Now, we see the other side of the coin. Rather than diluting credit risk, its spread has seemingly created more uncertainty as to where it rests. And global investors are now seen to have no commitment to any one market, walking away as easily as they once embraced new markets.

Although the trigger for the current funding crisis was the realisation that serious credit losses were emerging in the US sub-prime market, the underlying cause may be more closely linked to excessive leverage built up in the global financial system in recent years. We are now witnessing a reversal of that process – exacerbated by mark-to-market valuation, which has created a vicious circle, in which falling prices create forced sellers. That, in turn, drives prices down further.



“Finding workable solutions to the funding crisis is far from easy, not least because it is an international phenomenon”



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As we look back, it is hard not to conclude that the MBS market ended up attracting the 'wrong' kinds of investor. This is perhaps best illustrated by looking at those bond markets that are performing best through these difficult times. Those like the German Pfandbriefe or covered bond market depend mainly on a domestic investor base of cash (that is, not leveraged) investors. The reliability of domestic sources of funding is mirrored here in the UK, where the most stable funding sources have been the traditional ones of retail and wholesale deposits. In contrast, some two-thirds of the investor base in the MBS market in recent years was made up of leveraged investors of one sort or another (banks, hedge funds or structured investment vehicles). This suggests that part of the solution might be a return to more local and simple funding markets.

The government's response

The Treasury has been keen to help find solutions and two initiatives that were already underway before the funding crisis hit in August could play a positive role. The first is the statutory covered bond regime, the development of which should be encouraged by the introduction of new rules in March.

Since the first UK covered bond issue by HBOS in July 2003, UK issuers have faced a regulatory disadvantage compared to those from European institutions. It stems from the absence of a statutory framework for the UK market which means that UK issues do not qualify as covered bonds under the undertakings for collective investment in transferable securities (UCITS) directive. UCITS compliance provides benefits in the form of a preferential risk weighing for investors under the capital adequacy rules and higher investment limits for certain regulated classes of investor.

Before the events of last summer, the Treasury had already started work on a statutory framework for covered bonds to ensure UCITS compliance with the help of the FSA and an industry working group, to which we contributed. The new rules came into force on 6 March this year and should provide a higher degree of comfort to investors, particularly those in Europe that attach a lot of weight to the regulatory environment.

Long-term fixed-rate mortgages

The second initiative is the review into the wholesale funding of long-term fixed rate mortgages. This was first announced in July 2007, although it has yet to produce a significant outcome. In his Budget, the chancellor invited views on options for delivering more affordable long-term fixed-rate mortgages, and the lessons to be learned from international markets and institutions. The government intends to work with lenders and other stakeholders, and provide another update in the pre-Budget statement in the autumn. But the lack of any further progress suggests the Treasury has found it difficult to find solutions to the problems faced by lenders in managing – and pricing for – the risk in these mortgages.

Finding workable solutions to the funding crisis is far from easy, not least because it is an international phenomenon. Nonetheless, the Treasury has been analysing the causes and consulting with stakeholders, including investors, to find out what it is about the market that needs fixing. The message coming back is that MBS are complex, with variations in structural features that make it hard to compare one issue with another. Another key message has been that it is difficult to determine the quality of the mortgages backing the MBS as there is no standardised definition of what constitutes a prime or sub-prime loan.



“We reacted coolly to the idea of a gold standard, which risks creating the worst of both worlds”



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A 'gold' standard?

The Treasury wants to address the concerns and a perceived fear among investors of potential future credit risk. In a speech on 6 February, the chancellor aired the concept of a 'gold standard' for MBS. This was interpreted in press coverage as a kind of 'kitemark' denoting credit quality and possibly requiring bonds to conform to a uniform structure to increase standardisation.

We reacted coolly to the idea that the government – or anyone on its behalf – could establish a gold standard to restore confidence. The general feeling was that, in the absence of any concrete backing for the gold standard – such as a credit guarantee or favourable access to Bank of England support – investors would give no particular credit to an MBS that met the standard. At the same time, any MBS that was excluded – either on the grounds of the quality of mortgages backing it or because its structure did not meet a standardised requirement – could suffer a further loss of confidence because it would be seen to be inferior. Thus, the gold standard risked creating the worst of both worlds.

Sensibly, the chancellor backed away from the gold standard idea in his recent Budget announcement and instead invited lenders and investors to join a working group to explore the best way to address the current funding market dislocation. The working group is an opportunity for the industry to explore its own preferred solutions and propose answers.

Other responses

The FSA has been keen to ensure that deposit takers are equipped to weather the storm. In a recent interview on Radio 4's *Today* programme, the FSA's chief executive, Hector Sants, outlined his view of where the mortgage market was heading. It was not for the squeamish. He stated that anyone expecting a return to 'normality' in the MBS market could be disappointed. He could not see any return to what was considered normal less than 12 months ago. He suggested that lenders who had built their business model around securitisation would need to adapt to this very different outlook.

The Bank has shown some flexibility in its response. In September, it widened the range of collateral that it would accept for a money market auction designed to provide liquidity to the system, although it offered this only at a penalty rate and therefore had no takers. It went further still in December when it announced that, under open market operations, it would make available a repo facility at three-month maturity to a wide range of collateral including AAA-rated MBS without any floor to the rate at which institutions could bid for funds.

However, with market conditions deteriorating again more recently, pressure is now building for a new approach. Recent moves by the Federal Reserve to provide liquidity support to primary dealers in the MBS market, specifically to stabilise this market, illustrates the room for further imaginative thinking in the use of monetary policy. At a time when there is heightened preference for liquidity amongst banks, simply providing more central bank funds may not be the most efficient or focused way to address the problem. While the Treasury may be able to help, central bank action is still likely to be a key component of any action plan to lift the market out of its current torpor.



“Recent moves by the Federal Reserve to provide liquidity support for primary dealers in the MBS market show the potential for further imaginative thinking in the use of monetary policy”



Budget contains few concrete measures

The absence of any concrete measures to address the problems facing the mortgage-backed securities (MBS) market or to achieve the government's long-held aspiration to improve take-up of long-term fixed-rate mortgages meant that there was little of immediate substance for lenders – or home-buyers – in last week's Budget.

The chancellor remains keen on long-term fixed-rate mortgages that do not carry early repayment charges. He believes they would be particularly helpful in protecting first-time buyers and home-owners on low incomes from the potential 'shock' of having to remortgage from a short-term deal on to loan with a higher rate.

The chancellor does, however, accept that lenders have few options other than early repayment charges for managing the risks associated with long-term loans. The Treasury will now work with lenders and other stakeholders and provide an update in the pre-Budget report in the autumn. But the lack of progress suggests that it is finding it difficult to come up with an alternative to early repayment charges.

Published alongside the Budget, the Treasury's *Housing Finance Review* indicated the government's desire to encourage innovative mortgage products, including shared equity loans, interest rate protection products and house price insurance. The government is keen to work with providers from the private sector, and help remove any potential barriers to the availability of these products.

Regulation of sale-and-leaseback delayed

Lenders are disappointed that it is now unlikely that there will be any action this year to regulate sale-and-leaseback companies.

The Treasury has been conducting an internal review of sale-and-leaseback, and the Budget report said that the Office of Fair Trading will now lead a study of the market this year. It will look at the experiences of customers and then consider options to strengthen consumer protection. The study will also take into account the views of the Financial Services Authority.

However, the announcement means that any action this year is now unlikely. We are disappointed by that, as we believe that there should timely intervention to regulate the sector. Failure to introduce effective regulation could leave some borrowers in a vulnerable position. Home-owners in difficulty may be considering selling their property at a discounted value or without independent valuation of their home.

There are a range of other concerns about the operation of sale-and-leaseback, including the extent to which people agreeing to sell their home – having been assured that they will be able to stay on as tenants – enjoy real security of tenure.

- Intermediary confidence in how to set up and use management information on treating customers fairly has risen sharply, a survey of users of the tcinfo.co.uk website has found. The survey was carried out in February and shows an improvement on findings from a similar survey last September.
- Annual house price inflation in the UK declined to 8% in January, down from 8.4% in December 2007, according to the Department for Communities and Local Government. House price inflation was highest in London, where the annual rate was 13.8%.
- The outlook for the UK consumer sector has become more gloomy, according to the Nationwide consumer confidence index. Confidence levels in February were at their lowest for four years.





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news & views contacts

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Council of Mortgage Lenders

Bush House
North West Wing
Aldywch
London WC2B 4PJ
Switchboard: 0845 373 6771

Editor

Bernard Clarke
Direct line: 020 7438 8923
bernard.clarke@cml.org.uk

A full list of staff and further
information about the CML
can be found at:

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£700 million fraud claim not substantiated

We welcomed publication of the recent report by the Association of Chief Police Officers (ACPO) into criminal activity directed at the mortgage industry. The report, *Safe as Houses? Organised Mortgage Fraud in the UK*, provided a useful overview of mortgage fraud and wider financial crime. Particularly welcome was ACPO's promise of new guidance for police forces around the country on how to identify and investigate organised mortgage fraud. However, we do not believe that the report presented evidence of "confirmed mortgage fraud of around £700 million," as was claimed in the ACPO press release publicising the report.

The report contained only limited information about the extent of mortgage fraud – essentially because there is very little reliable data. A survey based on questionnaires completed by lenders and police forces – some details of which were contained in the report – is likely to have captured a wide variety of types of financial crime, including the use of mortgages for laundering money from wider criminal activity as well as attempted fraud targeted at lenders. But because both lenders and police filled in questionnaires, there is likely to have been a considerable amount of double-counting.

One estimate of fraud within the report was obtained by applying to 4,613 cases reported by CIFAS a 90% loan-to-value ratio and an average house price of £184,000. This crude calculation produced a total of £765 million, but is unlikely to bear any relationship to the real scale of fraud found in the CIFAS cases. In any case, the report itself acknowledged that 93% of the CIFAS cases were prevented.

The report itself contained nothing to substantiate the claim of "confirmed mortgage fraud of around £700 million." The report actually said: "It has been impossible to quantify the true extent of the volume and value of organised mortgage fraud."

However, we welcome the report's commitment to a better co-ordinated approach to tackling mortgage fraud. We have argued for a more holistic approach to the problem encompassing police, the Financial Services Authority (FSA), the new National Fraud Strategic Authority, and lenders and other property industry professionals.

Lenders are already contributing to the FSA's whistle-blower scheme which seeks to share information about suspected fraud by mortgage intermediaries. We have also worked to introduce more robust valuation of newly-built property to deter fraudulent loan applications.

Lenders support greater vigilance by all agencies against mortgage fraud. But it is important that policy is based upon reliable information about the scale of the problem and ways in which fraud and other criminal activity manifests itself in reality.

Overall, we believe that the ACPO report provides a useful overview of some of the causes and consequences of – and some of the potential solutions to – the problems of mortgage fraud. Many of the recommendations for lenders are, however, already incorporated into industry plans for tackling fraud.

