Letter to the Chancellor of the Exchequer

The Rt Hon Alistair Darling MP

Chancellor of the Exchequer

Dear Chancellor,

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

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

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

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

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

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

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

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

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

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

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

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

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

James Crosby

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