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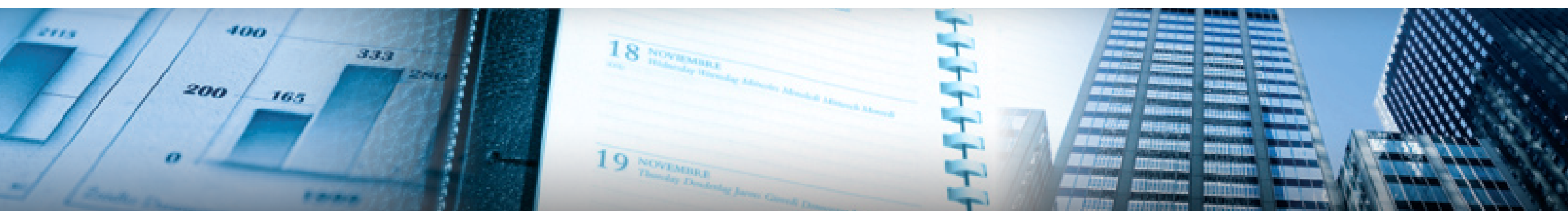

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CML leads lender response on UK regulatory reform

By Michael Coogan, Director General, Council of Mortgage Lenders

Our response at the end of January to the Financial Services Authority's (FSA) mortgage market review was the culmination of many months of consultation with members. Although the FSA only published its formal review in October last year, we had launched in the preceding spring a process of detailed discussion with members on what we believed should emerge from the inevitable process of regulatory reform, following the global financial crisis.

Let me say at the outset that the FSA's mortgage market review is an impressive document. We welcome the reform agenda and agree in principle with many of the regulator's proposals. The FSA has already made good progress by becoming a more intrusive regulator, scrutinising more closely outlying firms and products, and moving the UK financial services market on to a more stable footing.

In our view, however, it is crucial that further mortgage market reform is based on comprehensive analysis and an agreed understanding of the causes of consumer detriment. We accept that there is a case for the FSA's current plans to strengthen the rules on arrears. And for its proposals to extend its approved persons regime to cover mortgage advisers, who have been the source of some of the past problems in the market.

Beyond that, however, it is questionable whether we need further changes to the mortgage conduct of business rules overseen by the FSA. If the existing rules are used properly, the regulator already has the tools to ensure responsible lending and borrowing.

In its review document, the FSA accepts that the mortgage market has worked well for the vast majority of UK borrowers. It bases its case for further intervention on a need to address the "major economic distress" experienced by a minority of customers. Crucially, however, the proposed reforms do not address some of the main causes of consumer detriment – borrowing from numerous sources of

credit as well as a mortgage, ill-timed property purchases based on investment expectations rather than housing need, and unanticipated changes in personal or financial circumstances in the current economic downturn.

We must also not forget that the cumulative effect of a series of reforms already under way on capital and liquidity will have a major impact on the mortgage market in the UK and across Europe. So far, however, there has been little work to analyse or quantify the impact in the UK of these wider reforms. In our view, it is essential to complete this work before deciding on further reform affecting how lenders run their businesses and the nature of their relationship with customers.

We must also not forget that in the FSA's paper the cost-benefit analysis used to justify a number of its proposals is based on a market that has recovered, and not the malfunctioning and uncompetitive one that persists in the UK today. We must therefore make sure that regulatory reform is based on a proper understanding of markets as they are – and that it serves to promote their recovery, and not undermine their future prospects.

The FSA has taken a hard line on income verification for every borrower. In doing so, however, it has failed to acknowledge fundamental differences between self-certified loans – where customers declare, but do not prove, their income – and a fast-tracking process applied by lenders to mortgage applications where the risk profile is low enough not to require income verification in all cases.

Customers with an existing relationship with the lender and a good credit record, for example, as well as those seeking low loan-to-value mortgages represent a different risk profile to new, unknown borrowers with little experience of using credit. We therefore believe there is a case for fast-tracking as a process to be allowed to continue, with appropriate safeguards, and that it would be a backward step to require paper-based income verification in every case.

We also agree that lenders, not intermediaries, should ultimately be responsible for assessing the affordability of a mortgage. More generally, we need greater clarity over the respective responsibilities of lenders and intermediaries, which will come under the spotlight even more if the FSA's proposals are implemented as drafted. We therefore favour the idea that in future all intermediary sales of mortgages should be based on advice, not just the provision of information with the borrower taking responsibility for choosing the mortgage.

We also need to address the problem of irrational borrowing by some consumers. We have therefore suggested that there is a need to consider more general money advice for higher risk borrowers before they commit to buying a home – either to live in or as an investment – or to taking out a mortgage.

But while we have criticisms of the review document, let me make it clear that we are not arguing for the status quo. There is a need for change – at the right time. At this stage, however, the market has largely corrected itself, and there will be no return to some of the past excesses in the UK in the foreseeable future. So there is no need to rush to reform.

What we need at this stage therefore is comprehensive analysis of the market and careful scrutiny of any proposals for reform. And that analysis must take into account not only the impact of proposed prudential and European reform but the significant changes already implemented by the FSA itself:

- Having identified many of the failings in its report on supervision of Northern Rock, the FSA has already become a more intrusive regulator, pursuing an aggressive retail agenda.
- It has embarked on a substantial programme to enhance its supervisory role, which should improve market understanding and awareness of potential problems.
- It has installed a conduct risk division. That will help give firms a better understanding of regulatory priorities, enabling them to support the FSA's work more effectively.
- The FSA has strengthened stress-testing requirements for firms, and will reinforce them in future if necessary. Firms that cannot meet the requirements will be made to hold more capital, and ultimately face the threat of closure if they cannot manage risk properly.
- It has introduced more rigorous processes for approving senior management. We welcome this, as long as we do not simply drive people out of the financial services industry and into sectors where there is less personal scrutiny.
- The regulatory scope has already been widened to encompass potential sources of consumer detriment like sale-and-leaseback firms, which buy properties as an alternative to possession. And there are proposals in the pipeline for the FSA to regulate second-charge lending and the purchase by new firms of already existing mortgage books – we agree with this direction of travel.

We support the FSA's determination that the mistakes of the past are not repeated. We are therefore ready to reinforce the considerable progress that has already been made – with support for the right sort of measures in the future.

But the next steps are crucial. We must avoid regulation that reinforces unnecessarily a market in which mortgages in the UK are limited to the privileged few – those who have parental support, never lose their jobs and have only the most conventional financial needs. Regulatory reform must take us towards a more stable market, but also one that helps restore confidence and delivers the wider benefits for consumers of competition and choice.

And, of course, like other countries in Europe, we await with interest the proposals for cross-European intervention in national markets. The Commission is – and needs to continue to be – cautious, for the experiences of customers and the potential for consumer detriment are different in different national markets. So, where the UK has a problem, we believe the answer is – and should remain – in the hands of the UK authorities.

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EMF publishes Study on Non-Performing Loans

By Susan Yavari, Head of Economic Affairs, EMF

Arrears and repossessions are two among a number of useful indicators monitoring mortgage lending activity. They are important from a social point of view given that if arrears result in a repossession borrowers stand to lose their homes and in as much as banks' potentially higher credit losses increase the cost of capital, and the availability of mortgage credit to the consumer.

It is with this sobering thought that the EMF undertook to examine the performance of mortgage loans in Europe in a period of financial crisis. The results have been very revealing. They show that while an end to the housing boom in Europe has given way in some markets to increases in arrears and repossessions, they are by no means comparable to those experienced in the United States. In fact, of the 10 countries surveyed, 5 showed stable rates of arrears and repossessions since 2005, showing no marked increases up to and including 2008 (some countries' data covered up to Q3 2009).

The second set of countries showed increases, but which taken from the very low levels prevalent at the peak of the housing cycle, (reaching zero in some cases) are still relatively low. Of these the UK actually adjusted its forecast for arrears in 2009 downwards, reflecting better conditions for borrowers' ability to repay than initially forecast. Two countries out of the sample of 10 were especially under pressure, coming off a period of high growth in house prices and housing supply combined with rapidly rising unemployment and negative GDP growth. But even these showed an arrears rate which still did not reach a third of the levels experienced in the US (9.8% of total residential loans were delinquent in Q3 2009 according to Federal Reserve statistics).

Of course, this should not be an invitation to complacency. It is, however, evidence of responsible lending behaviour by lenders in Europe, and furthermore testifies to the impact of industry and government initiatives to assist borrowers in financial difficulty. These initiatives and programmes were recently compiled in a report sent to the European Commission (see Mortgage Info January 2010).

In addition, the EMF Study on Non-Performing Loans 2010 looks beyond the raw data to reveal significant dependencies between loan performance and macroeconomic conditions. With some market data dating back to the early 1990s, it was easy to observe that high mortgage interest rates and high unemployment were accompanied by higher rates of defaults. This was true for the UK, Spain and Denmark where arrears in the early 1990s were twice and sometimes three times larger than the levels recorded now in the aftermath of a global credit crisis. One defining aspect of today's mortgage markets is the historically low level of mortgage interest rates, a direct result of the expansionary monetary policy pursued by the ECB and national central banks. This is in contrast to the high level of rates prevalent in the early 1990s. For instance for the BoE policy rate there was a gap of 13 percentage points between 1990 and Q2 2009 rates.

Though quarterly data for Q3 2009 appears to show a general stabilisation of trends in housing and mortgage markets, borrowers and lenders could still see an increase in defaults and repossessions if central banks embark on tighter monetary policy. Historical data and common sense would also suggest that a continued rise in unemployment will ultimately be reflected in higher arrears and repossessions.

Another aim of the Study was to arrive at cross-country comparisons for the markets surveyed. But this rapidly became an exercise in frustration. The different legal frameworks underpinning mortgage markets and the different definitions and methods for calculating arrears, doubtful loans and repossessions quickly ruled out a straight comparison. By way of illustration, in some Member States loans are considered doubtful if the borrower fails to make a payment after one month, in other Member States a doubtful loan arises only after 3 and sometimes 6 months. Arrears ratios should also be examined in context: some represent the number of mortgage loans in default as a percentage of total number of mortgage loans outstanding, while another ratio looks at the value of the missed payments over total value of outstanding residential lending.

The heightened interest in Non-Performing Loans, both by policymakers and financial analysts, is unlikely to go away and points to a need for reliable data. It will certainly remain a priority for the EMF to produce timely surveys on the Non-Performing Loans sector.

The Study on Non-Performing Loans will be published in March 2010, and will be available for download on the EMF website: www.hypo.org.

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Covered Bond private placements

Johannes Rudolph, Head of Covered Bond Research, HSBC Trinkaus

There are currently around EUR 870 billion of privately placed covered bonds[1], roughly the same volume as for benchmark covered bonds. However, private placements are sometimes overlooked in analysis and statistical reports on the covered bond market, despite being the dominant type of issuance in several countries. In Austria, Germany, Hungary, Latvia, Luxembourg, Poland, Slovakia and Switzerland, they constitute more than 50% of the outstanding covered bond debt.

So what are private placements? This article explores why some investors prefer private placements, the advantages for issuers and what is meant by a 'private placement'. Firstly, it is useful to present a simplified classification scheme of the most common placement methods for covered bonds. In our opinion, there are seven major placement types:

1. Euro Benchmarks (formerly known as Jumbo covered bonds)
2. Tap issues (common in Sweden)
3. Mortgage bond series issued via auction (Denmark)
4. Bonds retained for repo business (with the central bank, other banks or the parent company)
5. Bonds sold to a pooling institution (e.g. the Spanish AyT)
6. Larger syndicated bonds without full benchmark status
7. …and finally "Private placements"

What is a Private Placement?

How can a single bond objectively be classified by a third party as a "private placement"? Identifying which bonds are private placements is not always straightforward, however, a common feature is that the bonds are either sold by only one lead manager or the issuer itself, which can be found in the bond's description. There is usually no involvement of a dealer/co-lead group or bidding via auction.

The issue size typically ranges from EUR 5 million up to EUR 500 million, while higher amounts are possible but uncommon. The feature "no exchange listing" is always a good indicator but not sufficient, as either issuer or investor can negotiate an exchange listing for a private placement. An exchange listed deal can be owned by only one investor but as bonds are separable, it can be sold and later become a liquid bond. Private placements are tradable in general, although time for execution will be longer on average than for a benchmark bond.

Exchange listed covered bond private placements, issued in Euro are ECB eligible with an own haircut category. The haircuts range from 1.5% to 15%, depending on time to maturity and coupon type[2].

There are 295 credit institutions with covered bonds outstanding, of which 104 have outstanding "benchmarks", while at least 230-240 have issued private placements at least once. Of the benchmark issuers, only 10 have not issued private placements so far, mainly because they started issuance with a benchmark bond only recently.

Benefits of Private Placements

From the issuer's point of view, smaller bonds are attractive. Issuing a EUR 1 bn benchmark bond with total liabilities of, say, EUR 4 bn unnecessarily increases the refinancing risk at the maturity point and will be costly, if liquidity has to be held ahead of the bond redemption. Issuing various smaller bonds with different maturities is often a better funding strategy. Furthermore, private placements can be sold at lower or similar interest rates compared to benchmark bonds.

However, the private placement market is demand driven, motivated by several criteria. The major drivers have typically been:

1. Favourable tax treatment for private investors, especially low-coupon German Pfandbriefe or Luxembourg Lettres de Gage in Swiss Francs. Such bonds are usually exchange listed with only minimal turnover after issuance.
2. Registered covered bonds without exchange listing (and typically without an ISIN code) are the preferred investment of several types of long-term buyers (e.g. German pension funds and insurance companies). Valued on the basis of "hold to maturity" instead of "mark-to-market", they help generate stable earnings over a long time. (See box below).

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[1] *Source:* HSBC Trinkaus. The ECBC Fact Book statistics measures private placements at EUR531bn (end of 2008), counting bonds without exchange listing only.

[2] http://www.ecb.int/pub/pdf/other/gendoc2008de.pdf

3. Floating rate placements as underlying instruments for structured credit products. In particular, Pfandbriefe, Lettres de Gage and Obligations Foncières were issued very close to the Euribor or Libor swap curve and used by structured product desks.
4. Demand for specific currencies, coupon types and callable features from reserve managers, bank treasuries, for their own investment or for selling the bonds to private investors.
5. Demand for certain maturities where no benchmarks are issued, typically either one year or maturities above fifteen years.

It should be noted that the private placement market remained open for around half of all banks in the extremely difficult period Q4 2008 and Q1 2009, when almost no benchmark bonds were sold. According to Bundesbank statistics, the average gross monthly issuance in Pfandbriefe was EUR 14.1 bn between 2003 and 2008 (see figure 1). German banks were able to issue EUR 11.9 bn per month between October 2008 and April 2009, mainly driven by stable issuance of private placements.

For a troubled issuer, covered bond private placements are often the first step back to wholesale funding. Corealcredit had to wait just three years after its near collapse in September 2005 for the first private placement while Düsseldorfer Hyp and Hypo Real Estate were able to borrow small amounts around nine months after a crisis event.

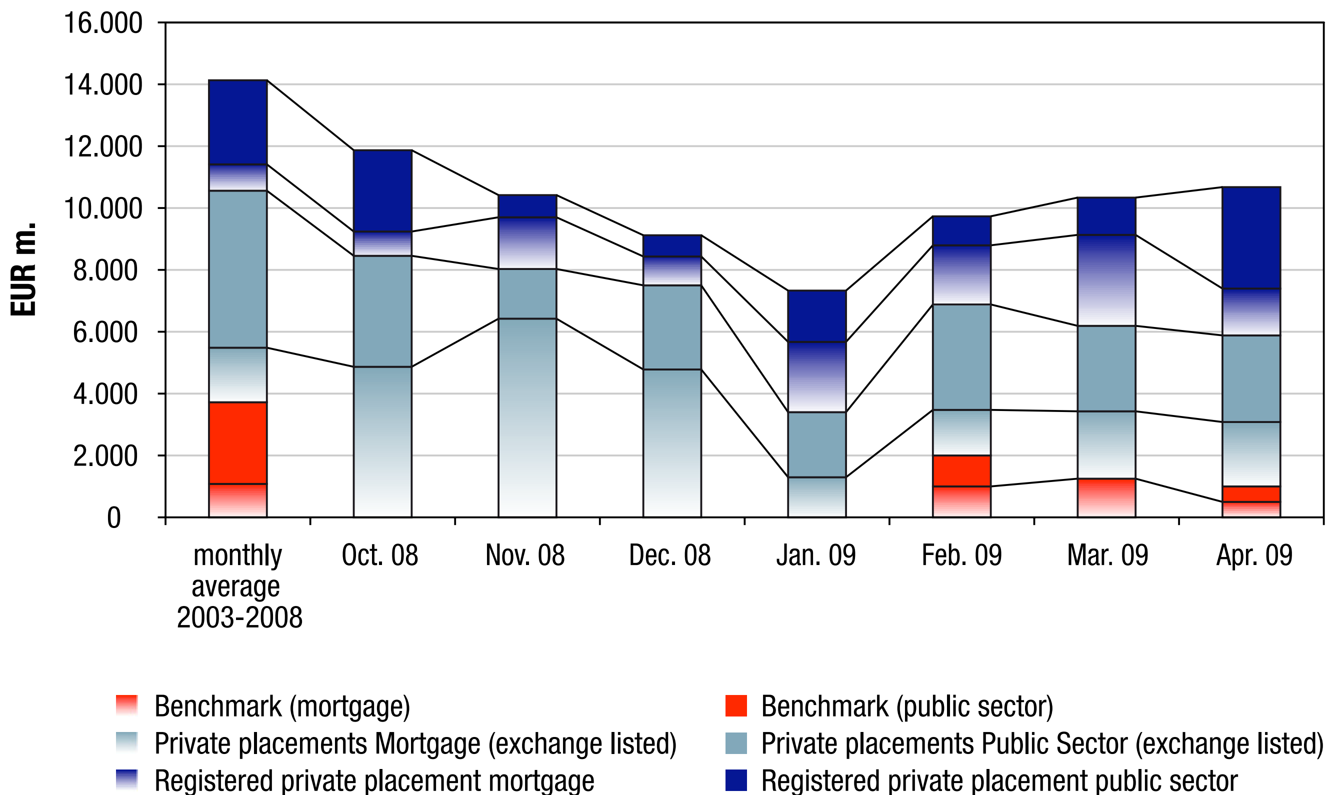
Covered bond private placements remain an important funding tool for issuers and an important investment instrument for investors.

Registered Covered Bonds

The current amount outstanding in German Namenspfandbriefe (or Registered Pfandbriefe) is EUR 272 bn, which is roughly the same size as the French covered bond market. Registered Pfandbriefe are made out to the name of the bond holder and can be transferred to another bond holder through reassignment, according to German Civil code, § 409. Payment of principal and interest are made to the person shown on a register. The register can be run by the issuer itself or another registrar.

In Denmark, France, Spain, Norway, Sweden, Luxembourg and Austria (and probably in more countries) covered bond issuers offer a similar format (for example, in Spain: «Cédulas Nominativas»). The general term is «Registered covered bond». Note, however, the term «Registered covered bond» is also sometimes used with a different meaning, e.g. the Dutch Central Bank uses this name for bonds that are registered in the Dutch covered bond supervisory register («register van gedekte obligaties»).

FIG. 1 Gross Pfandbrief issuance during crisis months



NEWS IN BRIEF

EMF publishes Updated Position on Foreclosure Prevention

The EMF has now published an updated position on foreclosure prevention, which provides an overview on key examples of existing legislation and best practice at national level, and shows a high degree of existing protection mechanisms for consumers, not only by way of national procedural law, but also by way of (continually increasing) lender forbearance.

The paper is supported by crucial arrears and foreclosure data on a number of Member States, which demonstrate that although some markets are seeing an increase in arrears and foreclosures rates, these remain exceptionally low in absolute terms, and still far lower than those witnessed during the last housing recession.

The paper also shows that although the growth in rates in some countries appears large, this is the expected effect of coming out of a period of unusually low arrears and foreclosures due to the housing boom. The position can be accessed via http://www.hypo.org/Content/default.asp?PageID=433.

Update on CRD 3 discussion at the European Parliament

The proposal (commonly referred to as CRD 3), to further amend the CRD as regards financial institutions' remuneration policies, changes to the trading book and additional capital requirements to complex securitisation, is currently under discussion at the European Parliament (EP). In autumn 2009, the Council reached a common position on the Commission's text and put forward significant amendments, especially with regards to the extension of the calculation of Basel I floors. In response to the Council's position, the EMF together with the EBIC, produced a new position paper addressed to the rapporteur of the file at the EP, Mrs Arlene McCarthy from the Socialists and Democrats Party (S&D). The publication of the draft Report, first expected by mid-January, has now been postponed to the end of February 2010. According to the provisional timetable, the ECON Committee should vote on the file by the end of April with a view to having a plenary vote by June 2010.

During the first exchange of views on the file at the ECON, MEPs generally appeared uncertain on the direction to take. Some argued that due to the fact that Basel II rules will soon be reviewed and more importantly, that a cumulative impact-assessment on the proposed changes will be carried out by both the Basel Committee and the Commission, it would be worthwhile to wait until the next round (CRD 4) before further increasing capital requirements. The EMF, together with the wider banking industry believes that this is a key element to be taken into consideration. At a time when countries like the US still have to implement Basel II rules as well as regulation on the above mentioned fields, it is vital for EU banks to guarantee an international level-playing field.

Commissioner Barnier calls for the cleaning up of financial markets

Commissioner Barnier has presented first orientation guidelines for an ambitious programme to clean up financial markets in his speech to the Ecofin Council on 16 February 2010. Commissioner Barnier, however, also warned that it was premature to set out a precise DG MARKT agenda or finalised work programme for the coming years at this stage, as the College of Commissioners had not yet had its first formal meeting.

Nevertheless he revealed some of the underlying assumptions on which his strategy would be built, notably the insight that the crisis was not over yet and would have long-term effects on growth, and that despite being a global phenomenon, it had not had the same effects in all parts of the world – a stance which had been taken by the EMF since the onset of the crisis. Finally, he reinforced an earlier message by DG MARKT's services that the Internal Market will remain a long-term strategy for the Commission, even in times of crisis when "it is not always easy to see its tangible benefits".

In terms of concrete priority areas, Commissioner Barnier also reconfirmed DG MARKT's commitment to better regulation, and highlighted the importance of an effective supervisory system, of closing regulatory loopholes, establishing common rules at an international level, improving risk management, internal control of financial institutions, and the prevention and management of future crises.

Financial Supervision package in Parliament

In September 2009, the Commission published a set of proposals to strengthen financial supervision in Europe. This included the creation of three new supervisory authorities (ESAs) to replace the Lamfalussy Committees on Banking, Insurance and Securities. On the macro-prudential level, there was the creation of a European Systemic Risk Board (ESRB) to detect risks to the financial system.

The legislative package is now making fairly good time winding its way through the European Parliament and Council. The European Parliament's rapporteur on the creation of the European Banking Authority (EBA) published his report on 10 February, leaving open the possibility for further amendments by other Members of the European Parliament (MEPs). The EBA is primarily designed to ensure that a single rulebook is applied throughout the EU (i.e. a single set of technical standards), and to resolve cases of disagreement between national supervisors.

Under the proposed framework, the EBA and the Commission would be in a position to draft technical standards. This is not problematic were it not for the fact that the oversight and right of veto of the European Council and the European Parliament could be severely diminished. If new technical standards become subject to 'implementing acts', this is what will happen. It is also

important that public consultation is duly carried out before the introduction of new technical standards. This issue is further confused by the fact that it is not clear whether the ability to draft technical standards would apply only to secondary legislation (level 2 and level 3 under the Lamfalussy procedure) or also at a more political level, amending framework directives.

The financial supervision package was discussed at the 23 February meeting of the ECON Committee in the Parliament. A report on the 'Omnibus Directive', which amends key banking directives to reflect the new powers of the EBA has yet to be published.

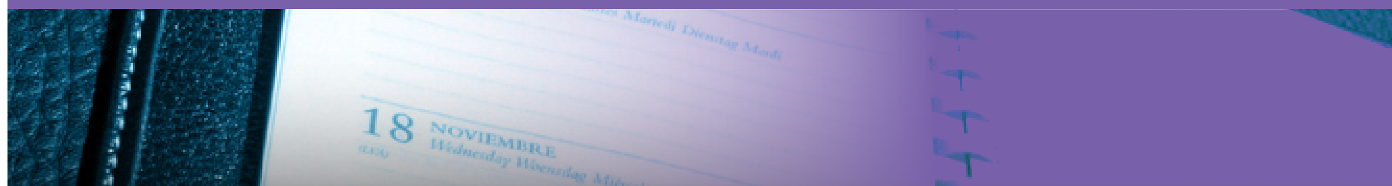
Flurry of activity in IMCO on Consumer Rights Directive

The hotly debated COM Proposal for a Directive on Consumer Rights has been top of IMCO's agenda since the beginning of the year. At the end of January, in addition to a 4th exchange of views in IMCO, the Committee also held a video conference with the French National Assembly and organised a Hearing with the Spanish Presidency's Secretary General for Social Policy and Consumer Protection, Francisco Moza Zapatero. Most recently, on 23 February 2010, IMCO held a Hearing with national parliaments. A recurrent theme throughout all of these discussions is that the current COM Proposal lacks clarity and precision and that the full harmonisation approach favoured by DG SANCO at the time would result in a reduction in the level of consumer protection in some EU Member States. Targeted full harmonisation would appear to be the preferred way forward of a majority of MEPs, including the rapporteur, MEP Andreas Schwab. This approach would appear to be shared by the Spanish Presidency, which has advocated «mixed» rather than the «maximum» harmonisation suggested by the European Commission. Very significantly, during the Hearing with national parliaments, representatives for Commissioner Viviane Reding, who had previously stated that she would maintain the full harmonisation approach, indicated that the COM is now considering targeted harmonisation. What the focus of this harmonisation will be remains to be seen.

New booklet on the Danish mortgage model

Realkreditraadet, an association of Danish Mortgage Banks, has released a publication entitled «The traditional Danish mortgage model». The booklet explains the basic principles of the Danish mortgage model, describes recent changes to Danish Covered Bond legislation and highlights why the Danish mortgage system was barely affected by the financial crisis. The booklet can be downloaded here.

http://www.realkreditraadet.dk/Current_issues.aspx?M=News&PID=973&NewsID=366



AGENDA

MARCH

12/03	EMF Legal Affairs Committee, Brussels
18-19/03	EMF Executive Committee, Brussels
25/03	ECBC Steering Committee, Amsterdam
26/03	ECBC Plenary Meeting, Amsterdam

APRIL

20/04	IBF Mortgage Conference: Delivering a sustainable mortgage market, Dublin
23/04	EMF Valuation Committee, Rome
26/04	8th Annual European Financial Services Conference: A New Deal between Finance & Society – Restoring Confidence and Responding to Public Concerns, Brussels