



Fixing the Crunch

Steps toward a remedy for the mortgage market's credit crunch

**A white paper prepared by the
Association of Mortgage Intermediaries**

Foreword

The current travails of the UK mortgage market have their roots buried deep in the American sub-prime debacle. However, the scenario being played out in today's market has come about through a confluence of events which, individually, would have caused an industry problem, but which collectively, have gone beyond the ability of the industry to control – or remedy.

The language used to describe the current turmoil helps explain some of its causes. The problem was first, rightly, described as a “credit crunch”. Reflecting the American problems, banks were troubled by the composition of the Mortgage Backed Securities (MBS) they had bought, saw the rot setting in, and lost confidence that the paper they were holding was indeed of the asset quality they had thought. Lenders tightened criteria – many rediscovering that the art of mortgage lending was not about lending money to borrowers but was actually in ensuring it would be paid back.

The second stage was the liquidity crisis. Some central bankers, particularly the Federal Reserve and European Central Bank, recognised that the market was grinding to a halt, and correctly identified the solution was extra funds. Liquidity was pumped into the market and central banks relaxed their lending criteria against which banks could access this extra liquidity. The Bank of England was not such a willing participant in this exercise, worrying more about moral hazard (and being subjected to the tortuous Northern Rock nationalisation debate).

We now find ourselves in the third, and most systemically damaging stage: the confidence collapse. Banks have lost confidence in each others ability to repay loans and are hoarding the liquidity they can access (partly, in order to rebuild their capital positions, and partly to meet regulatory concerns).

AMI's analysis is that the market has lost the power to heal itself. Market participants have insufficient power to address the underlying fault lines – and running through the sub-strata is a thread of commercial advantage being played out as some institutions seek to remodel the market for their own benefit. What the market cannot solve, public policy must, if consumers are not to be the main losers. The UK mortgage market is worth over £1trillion, gross lending in 2007 was £362billion and there are 11 million borrowers.

This white paper advances a set of possible steps towards addressing the current market issues. AMI has always seen its role as coming up with solutions, fixing problems, and by proposing policy, helping those who must make the most difficult decisions. The alternatives set out in this paper are “green shoots” – we look to build a coalition of the willing across industry, regulation and public policy to nurture them into “sturdy oaks”.

Chris Cummings
Director General

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Executive Summary

About AMI

The Association of Mortgage Intermediaries (AMI) is the trade body for the mortgage advice community. Established 5 years ago, AMI represents over 80% of all professional mortgage brokers. A not-for-profit, non-commercial trade body, AMI's role is to contribute to the development of public policy, legislation and regulation that will have an impact on the mortgage market. By presenting the views of mortgage intermediaries to those with influence over the market, AMI hopes to improve the business environment for its members – and hence the mortgage buying public as the majority of mortgages are now distributed by intermediaries.

Why a white paper now?

This white paper has been produced to set out the causes of the credit crunch as seen by the mortgage intermediary community, establish what the impact of the current turmoil will be (on firms and, more importantly, on current and future borrowers), and provide a series of nascent solutions to the market's problems. Economic historians will be better placed to examine the events that led up to the current environment better than those who are caught in its daily travails. However, unless a course out of the storm is plotted, the market will cling to its wreckage in the passing hope that it will blow itself out and calmer seas will return. AMI is not in the business of "wait and see". The UK mortgage market is too valuable for the economy, for firms, and for consumers to be left to chance.

At the heart of AMI's proposals is the desire to see a market which is more fluid than today's, properly values risk, facilitates lending to those who require it and can repay it, and which does so at a rate which is economic for market participants. The central requirements then, are liquidity and trust.

Four interventions

This paper contains four market interventions (it would be too generous, perhaps, to call them "solutions"). We see them as "green shoots" that, if properly nurtured could develop into the "sturdy oaks" that could underpin a market recovery. If, with closer examination, they were to wither but be replaced by others that were better rooted, this outcome would be welcome. It is the result, not the start, which is important... the fact of starting now, today, is the essential act.

There is no order of preference for the options explored within this paper. Indeed, it may be that only the combination of approaches will provide the trigger for the return of a proper functioning market.

The first of the options identified is to attract new sources of capital to the market. The fundamentals of the UK mortgage market are robust, today's issue is one more of confidence than liquidity. If new sources of capital could be accessed, one of the constraints could be lifted: we propose a joint approach be made to a carefully vetted selection of sovereign wealth funds with the idea of attracting investment in the UK mortgage market.

Option two considers the role of the Bank of England in providing additional liquidity and relaxing its criteria for bank borrowing.

Option three seeks to address the need for market confidence through the rapid creation of a new "gold standard" for Mortgage Backed Securities (MBS), which would contain an asset mix drawn from a mixture of securities. This, if it came about on a given date, would provide a "point of singularity"

which the market could build from. In addition to giving certainty about the future, the market would be able to re-price history. If there were assets which were not tradable, we see a role for the National Debt Office or Bank of England in managing them.

The final option we consider is for a re-engagement of those who used to buy MBS' before the vogue for them was established. Pension funds and life offices were the largest investors in these assets but falling margins and worries over credit quality led to a loss of appetite. Regulatory comments have dampened any emerging interest in MBS' from these traditional sources.

A snapshot of today's trading conditions

The intermediary view of lending

UK lending institutions have been compared to a three-legged stool in that there are three distinct business types:

- traditional building societies (whose lending was predominantly financed by retail deposits)
- "specialist lenders" who were newer, predominantly funded from the wholesale funding markets and built their businesses on securitizations
- large, normally high street, lenders (who have been able to operate a mixed-economy of lending funded from retail deposits, wholesale funds, and by accessing European or American funding lines)

It is recognised that the credit crisis hit the middle tier first and has caused them to contract or close. Lending in excess of 11% of all gross advances in 2007, this lending group brought competition and innovation to the market. The tide is now turning against smaller building societies – whilst the final tier of the largest lenders are weathering the storm.

Since 8 August 2007, the secondary market for traded mortgage backed securities has been closed. A handful of private deals have been traded since this date with the vast majority of new lending staying on the originator's balance sheet.

To compound this backlog some previously hedged lending that required refinancing has been brought back onto balance sheet rather than being traded again. There are estimates floating around that this backlog has now reached £270bn. Those lenders who have retail deposit taking operations have entered into a price war with each other and this will see retail investors enjoying rates well in excess of Bank of England base rate. LIBOR rates have stayed at about a 0.25% to 0.5% premium to its traditional level reflecting the reticence of banks to lend to one another.

In an attempt to manage their balance sheet capacity lenders have either been withdrawing from the market entirely from certain types of asset class (sub prime, 100%+ LTV and buy to let) or increasing their pricing and tightening their lending criteria (mainly around LTV as this has the best risk mitigating impact) thereby improving the quality of the lending on their balance sheets.

As the front end origination departments have witnessed a collapse of activity due to these restricted lending practices many lenders have been laying off staff in recent months. This would indicate that there is not an expectation that volume lending will recommence any time soon.

Some of the UK's largest mortgage lenders have publicly stated that they are not looking for market share but are looking to put margin back into their businesses. They are also separately reporting that their market share is increasing and they are taking on extra staff to cope with the increased demand. To compound their competitive advantage many of the larger players that are seeing both increased margin and share also have the ability to raise funds from the ECB.

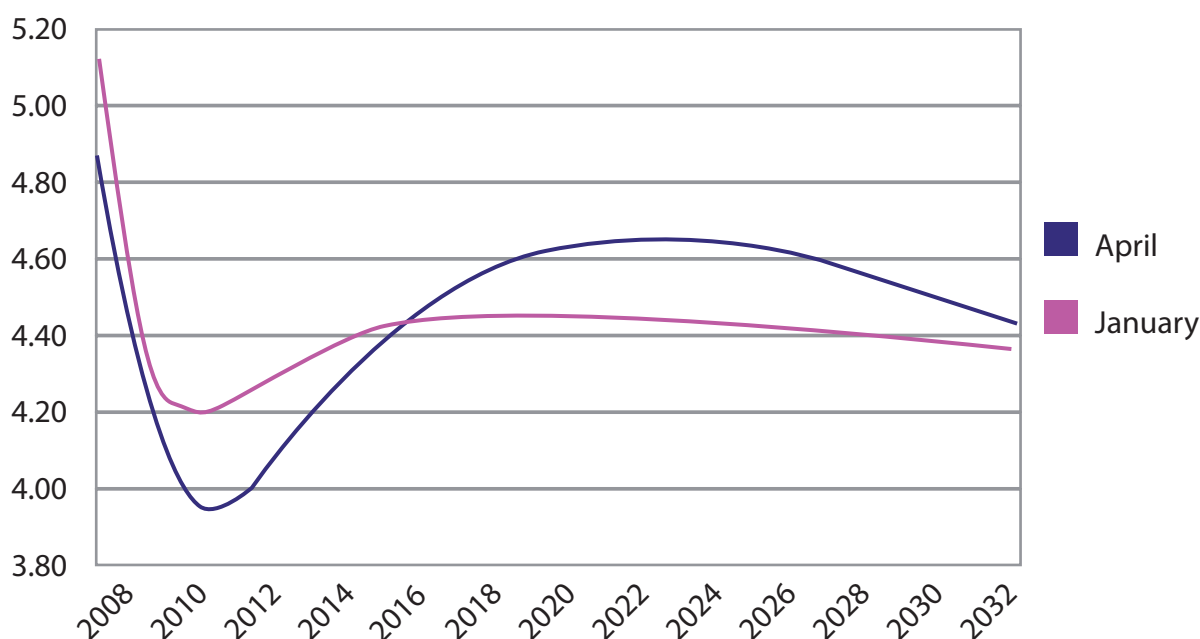
The intermediary view of the market impact

The upheaval in the mortgage market is unprecedented in recent times and is following a very unusual pattern.

In 2005, the Bank of England engineered a slowdown using monetary policy to classic effect – higher

base rates cooled the housing market, reduced the appetite to move house and suppressed demand for mortgages. This time things began quite normally too. The housing market began to slow before the credit crunch began, cooled in the usual way by higher base rates. But as lending markets have seized up on the back of the US sub-prime collapse, the steady succession of base rate cuts has had no effect on mortgage pricing. Variable rates are being pushed higher, and falling swap rates are not being reflected in lower fixed rates. The yield curve shows how short term rates are much lower than in January.

YIELD CURVE (Bank of England)



For example, if fixed rates had followed a more normal pattern, the decline in swap rates would mean product rates around one percentage point lower than a year ago. So while demand for new mortgages is a little lower, the massive contraction in supply is the main cause of the slowdown. People do want to move and for that they need to borrow.

This is clear when the rush of demand lenders as diverse as First Direct and Bath Building Society have seen in response to attractive product rates, and who have promptly removed product ranges to stem the flood of applications. High house prices mean people buying a home need a much bigger mortgage than the seller. This is the main reason why the average outstanding mortgage is rising faster (+6% over the last year) than house prices (+1%). Demand is certainly present, pent up by the lack of supply. Across the industry, lenders are rapidly removing products from the market and as all mortgage brokers are seeing on a daily basis, they are raising prices, toughening criteria and increasing arrangement fees (the fees lenders charge – not to be confused with “commission” or “procuration” fees which are paid to brokers).

Procuration fees for brokers are not likely to increase from higher arrangement fees, however, as competitive pressure among lenders falls, and as they seek to rebuild margin and prepare themselves for potentially higher arrears. Indeed, there are signs of lenders cutting commission rates – and reducing the attractiveness of the product ranges they make available to brokers (favouring their branch

networks). This is disappointing as the significant majority of mortgage business is intermediated and consumers have expressed a clear preference to access mortgage advice. If the availability of advice is curtailed, consumers will suffer financial detriment.

Highly capitalised lenders with good funding lines are barely any keener to increase business than those without ready access to financing. The better financed lenders will increase their market share this year, and may even continue to grow their books, although at a much slower rate than before. But this is more as a result of the contraction of activity from those less keen to lend, than due to an aggressive marketing push.

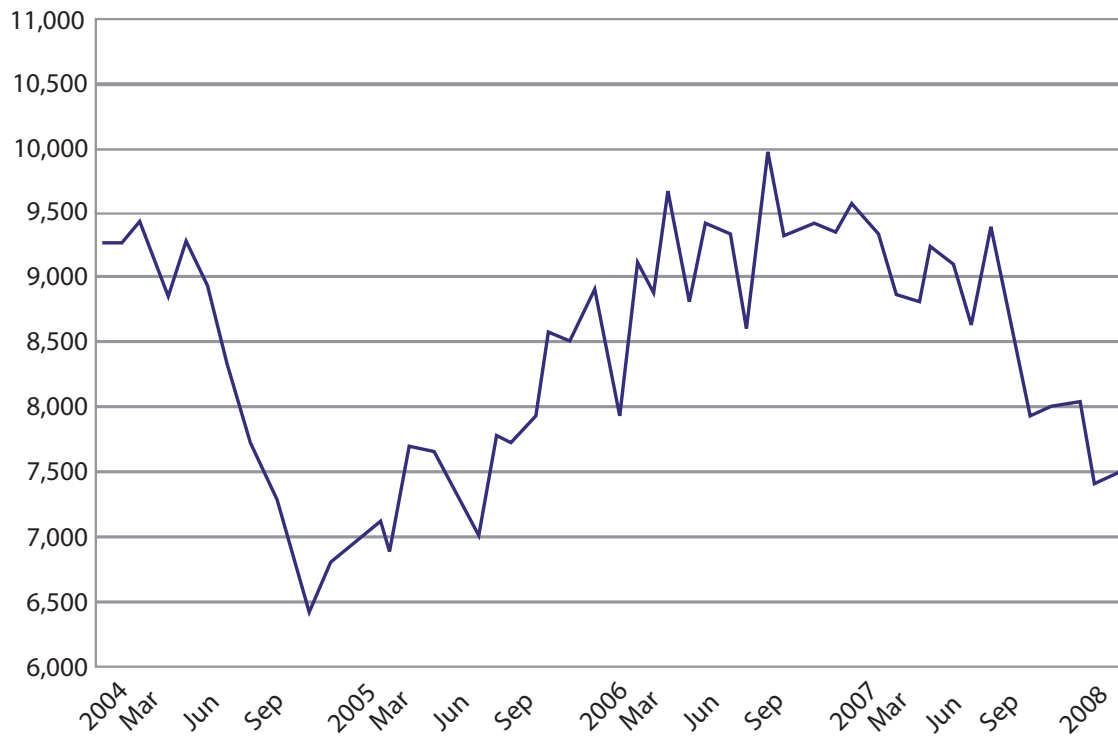
Mortgage approvals for house purchase in the first quarter ran at levels 40% below last year and are close to historic lows. Only 73,000 loans were approved in February 2008 (on a seasonally adjusted basis).

MORTGAGE APPROVALS (Bank of England)



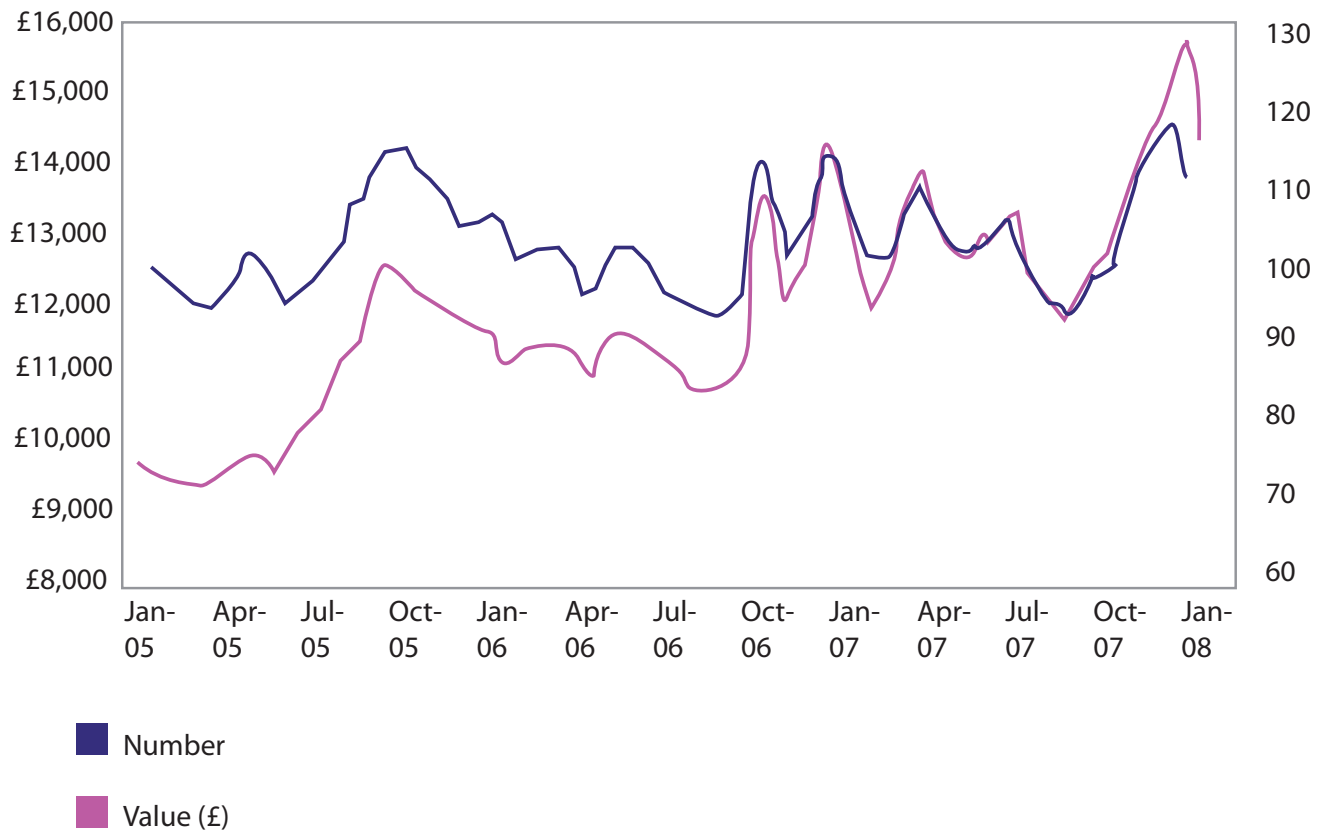
Connells Survey and Valuation's monthly research is proving itself a reliable early indicator on the trends. Up to a month ahead of the Bank of England, it shows that March has seen no significant improvement. Housing transactions are following mortgage approvals downwards. While mortgage finance remains in short supply, activity will continue at these subdued levels. In the peak year of 2006, over 1.4million mortgages were approved for house purchase. This year, we expect to see around 900,000, close to 30% below the 2007 level. Net lending is subdued in turn; February's £7.4bn was 27% below February 2006.

NET MORTGAGE ADVANCES (£M) (CML)



Remortgaging will see more activity. The number of loans (111,000 in February) and the value (£14.4bn) are still high and look set to stay so in the short term at least.

CHART 14: REMORTGAGE ACTIVITY
(Bank of England)



The intermediary view of the future

Over the next eighteen months around 3 million borrowers will potentially be looking to refinance their home loans. The average outstanding mortgage in the UK is just over £100,000, around half the average house price. The vast majority of borrowers therefore have large amounts of equity in their homes. The key issue of course will be how easily these remortgaging borrowers will be able to shop around. Lenders will focus their business on retaining good customers, while many of those with high LTVs or impaired credit records will find themselves marooned on higher standard variable rates.

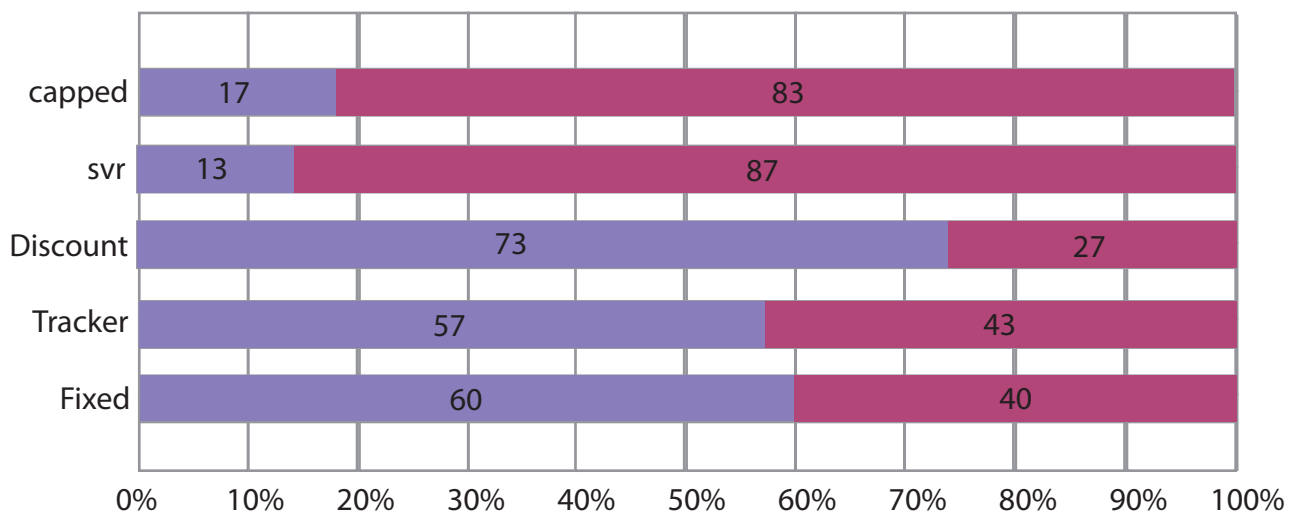
Without any UK monetary policy intervention the divide will continue to grow between those that can continue to raise funding through retail deposits and ECB funds. At best this leads to further mortgage rationing by lenders increasing price and tightening criteria and ultimately could lead to a significantly reduced provider base with an undersupply of required mortgage finance reminiscent to post war quotas with potential borrowers having no choice as to where they may invest their savings, other than the lender they wished to borrow from. This does not sit well with wider public policy desire to encourage savings, and consumer desire to maximize the return on any savings made. It also flags a concern that the Government's plans for the establishment of Personal Accounts may be undermined by the need for consumers to direct their savings into mortgage lenders.

Intermediaries scour the whole of the mortgage market to find the mortgage product that best suits the needs of their customer. Independent of lenders, it is the role of the intermediary to act as the agent of the customer, and secure a mortgage that meets the individual consumer's needs: and offer advice based on suitability and cost underpinned by excellent service.

Recent research demonstrates the value offered by intermediaries. FSA regularly publishes the findings of its review of all regulated mortgage business undertaken (this is called the Product Sales Data).

If products were being selected on a basis that put the needs of the consumer first, it might be assumed that the distribution of products would be consistent across all channel (branch based, via an intermediary etc). However, analysis of interest rate types and sales channel, shows that a majority of fixed rate sales (60%) were sold by intermediaries, and conversely 87% of standard variable rates were sold via the direct channel. Whilst there are occasions when the SVR route provides the most suitable product for a consumer, in a significant majority of cases it is probable that an alternative product would offer a better solution.

Rate split by channel



Option 1: Alternative Sources of Funding

The premise

The market is currently unable to provide sufficient capital for itself, liquidity has dried up, and those banks who can access funds have been accused of “hoarding” it. The Bank of England has, to many in the industry, seemed reluctant to inject substantial liquidity into the market for fear of generating “moral hazard” and, perhaps more importantly, for worries over inflation. If new sources of capital could be found, pressure would be eased and the market could become unfrozen.

The opportunity

Traditionally, when new capital has been sought, British bankers’ eyes have looked west – to American investment banks. However, these organisations have been caught up in the credit crunch and the market has been closed. The investment banks have secured substantial capital investment from new sources: the sovereign wealth funds.

The mortgage market may have to re-adjust its gaze, not west but east in future. Undoubtedly we will experience a “Janus-like” phase where we need to look in both directions but, given the underlying strength of the UK mortgage market, attempts should be made to show-case the market as an investment prize.

The UK mortgage market is structurally robust:

- as a nation, we have an unusual affinity with property ownership,
- geographically an island, we have limited building capacity
- social trends include a high divorce rate and an ageing population – so there is demand for new properties as family fragmentation sees the need for extra homes, whilst the older generation, thanks to medical and social care advances, lives at home longer
- we have a net immigration position
- we have suffered decades of under provision in terms of house building
- as a nation, we have an affinity with debt – but a recognition that it must be repaid

In short, demand outstrips supply and will continue to do so. This creates an interesting investment paradigm.

We call for

A coalition of the willing to be assembled, under the leadership of The Department for Business, Enterprise and Regulatory Reform, to facilitate a show-case event (such as a conference or seminar), supported by meetings, other events and Ministerial support, designed to attract the sovereign wealth funds and other potential new investors.

Option 2: The role of the Bank of England

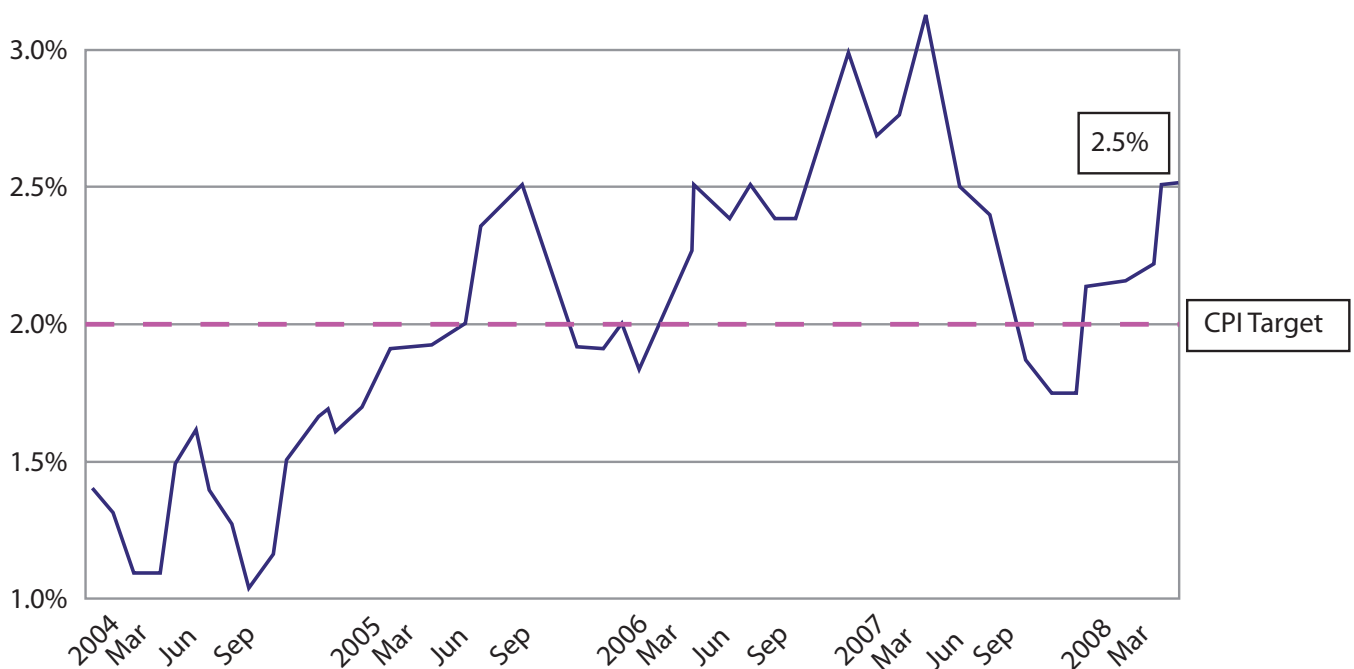
The premise

To many in the industry, it has seemed that the Bank of England has not followed its peer group (other central bankers), in moving swiftly to inject liquidity into the market – or lower its standards in terms of the collateral it has expected banks to vouch with it in return for accessing liquidity. We would like to see the Bank take a more modern approach and be open to a wider asset mix – including Mortgage Backed Securities. The Bank should press ahead swiftly with its consideration to offer extra liquidity in exchange government bonds (with a life of at least three, but ideally up to ten, years).

The opportunity

From a macroeconomic perspective, the Bank needs to stay focused on inflation; CPI is set to rise above the MPC's target and possibly even breach the letter-writing 3% barrier. Just as it paid little attention to house prices when they were rising, given that general inflation was low, so too it is hard to argue it should cut rates purely to stimulate the housing market now that inflation is too high, and rising. To widen its brief beyond an inflation target will make its job impossible to do – just like archery, you can only aim at one target at a time.

CONSUMER PRICE INFLATION (National Statistics)



But the housing market does matter because it affects confidence and as such is linked to consumer spending, particularly consumer durables (although economists disagree on the extent of the relationship). The strength of the wider economy matters, because while inflation may remain high, a slowing economy will cause inflation to slow down too, eventually.

Thus, like an archer can re-focus on a target with a greater prize, so the Bank needs to address the issues in the mortgage market urgently. More liquidity is needed, on a modernized basis, with no hint of blame attached to those banks who access it.

Further, the Bank (working with its tri-partite colleagues, in FSA and Treasury), should review the use that banks make of the liquidity they access. Hoarding should carry the condemnation that it does in any other scarcity situation. Access to new liquidity from the Bank could be turned-off for those who abuse the new system.

We call for

The Bank of England, FSA, and the recently appointed Crosby Mortgage Finance Taskforce to review the Bank's current liquidity criteria with a view to bringing it into line with other central bankers and bring into force a new tranche of government bonds to finance additional liquidity in the market.

Option 3: A new Gold Standard for MBS

The premise

What was a crisis of credit quality has now fallen into a crisis of trust. Many in the banking community have lost trust with market counterparties and are unwilling to lend funds. They have lost trust in the ratings agencies, who provided flawed analyses of MBS. A new certainty is needed for the market – but it is beyond the market’s ability to formulate it within a reasonable timescale.

A working party must establish a new Gold Standard for Mortgage Backed Securities. This, widely drawn, standard would provide a “point of singularity” upon which the market could stand, re-price risk, and rebuild confidence.

The opportunity

AMI recognises that the current liquidity squeeze is now only part of the real picture of the market’s turmoil. Of key significance is trust and market confidence. With the undermining of the role of rating agencies, so those who had relied upon them, lost confidence in the quality of assets they had bought.

The Bank of England, working in conjunction with the Treasury, FSA and the Crosby Mortgage Finance Taskforce, are ideally placed to determine (swiftly!) a new Gold Standard for the composition of MBS portfolios. (This group may also wish to set the “par” value of a book, in order to provide market certainty.) The Gold Standard should come into effect on an agreed date, so drawing a line on history.

Having an agreed Gold Standard will address the market’s confidence issue and enable historic MBS portfolios to be re-priced, at, above or below par.

Undoubtedly, there may be elements of the MBS stock that cannot be traded. In this instance, we call upon the National Debt Office, Bank of England (or other Government department) to take on and manage this debt.

We call for

Those identified above, working with practitioners and consumer representatives, to act swiftly to establish and implement the new Gold Standard.

Option 4: Traditional buyers of MBS

The premise

The trade in Mortgage Backed Securities is not a new phenomenon. It has attracted more attention in recent years partly given the scale of the market and partly the increased complexity of the engineered solutions. However, the fundamentals of the market have existed for decades.

Those who used to buy MBS' were previously such bodies as pension funds and life offices. They have not been alone in finding re-entering the market difficult due to regulatory constraints and economic pressures.

The opportunity

The traditional buyers of MBS' were pension funds and life offices who were deterred by worries over falling margin and lower credit standards. In effect, the more aggressive business models that contributed to the credit crunch drove these original players out of the market.

Lenders have also bought MBS' from those who had better distribution, or origination, abilities than they did. Lenders also bought them for portfolio management reasons, either geographic reasons (lenders with local reach would worry about being over-exposed in certain parts of the country and would buy MBS comprised of assets from other regions, for instance), or credit management (lenders may wish to better balance their Loan To Value mix through buying an MBS with a different blend to their normal business).

Given that lenders have been more-choosy about who they lend to, have been able to lend at increasingly substantial margins, and are holding their portfolios longer, the MBS' now available are of far better quality than have been around for a considerable period. Unfortunately, potential buyers have been deterred from returning to the market for three reasons:

- regulatory warnings against buying MBS
- concerns arising through the lack of a Gold Standard
- the belief that the market has not yet bottomed-out, and that even better deals will be available on MBS'

We call for

The regulatory authorities to refrain from deterring MBS potential buyers from entering the market.

Those who once viewed MBS' as part of their investment strategy to re-look at this market.

Next steps

The need for confidence

It is a well known business maxim that trust is an essential part of the market. From the Lloyds brokers, who operated under the seal of “my word is my bond”, to today’s mortgage market, without trust in the market, all is lost.

The mortgage market has been built on trust and confidence even more than any other. The “credit” that is extended to borrowers, derives from “credo” meaning “faith” or “belief” – that the loan will be repaid. Without that confidence, lending dries up and we quickly see a situation where those who have funds will not lend them, even to those with a good track record of repayment. That is why, it is AMI’s view, that the market cannot heal itself and outside intervention is needed.

The consequences of no solution

Failure to find a solution carries a heavy price.

Some consequences are easy to see, others will be the unintended consequences that will follow the market’s recovery as policy makers seek to ensure there is no repetition.

Immediately, consumers will find it harder to access suitable mortgages. FSA research found that consumers who buy direct, tend to visit between one and three lenders before making a choice. With the many thousands of mortgage products available even in these difficult times, it is unlikely that a consumer would find the most suitable product on the market. Thus, a consumer may get a product which is a poor match for their needs (or no product at all), or may end up paying far more than they should.

The job losses in the industry will continue. It is a fair analysis to suggest that thousands of jobs have been lost as a result of the credit crunch. The latest statistics suggest around 40,000 jobs will be lost in financial services – but given the disparate nature of the mortgage community, this statistic fails to account for the intermediary community’s losses. This has a personal effect on the individuals – but also robs consumers of qualified advisers just at the time when mortgage (and general debt) advice would be most needed.

Given that mortgage intermediaries also advise on how to protect mortgage loans (through income protection, critical illness cover, redundancy cover etc), those who may be in need of such protection may fail to be informed of its benefit. This is storing up a cost for the state to shoulder if the economic downturn worsens.

The European Commission has studied the mortgage market but found no compelling evidence to bring about new regulation in a hurry. An unintended consequence of this turmoil could be a sharpened desire to attempt to harmonise member states’ mortgage markets through new Directives. This is a costly, difficult and time consuming process for the industries affected and may even lead to a worsening of their positions.

But the greatest impact will always be with consumers who may find themselves restricted in the mortgages on offer, forced to deal with just the few largest players, offering less competitive mortgages, and finding that advice is far harder to come by – and probably more expensive to receive.

Why we must provoke a solution

It would be easy to talk of “global” problems, where local and national solutions are merely low-walls which will be too weak to withstand the flood. Ideally, Governments, acting in unison with their central banks, would generate a global response. National political, economic, and market conditions usually conspire against such actions.

In a report for the European Commission, the UK mortgage market was noted as the “most complete” (meaning competitive) in Europe. That is why it is for the UK to take the lead in looking for solutions. To do so with urgency, and to do so with representatives from all sides of the market: regulators, lenders, intermediaries and borrowers – under the leadership of those charged with developing public policy.

Appendix 1: AMI's work

The Association of Mortgage Intermediaries (AMI) is the trade body for the mortgage advice community. Established 5 years ago, AMI represents over 80% of all professional mortgage brokers. A not-for-profit, non-commercial trade body, AMI's role is to contribute to the development of public policy, legislation and regulation that will have an impact on the mortgage market. By presenting the views of mortgage intermediaries to those with influence over the market, AMI hopes to improve the business environment for its members – and hence the mortgage buying public as the majority of mortgages are now distributed by intermediaries.

There are c11,500 mortgage intermediary firms operating in the UK, employing 30,000 advisers. Mortgage advising and arranging are activities regulated by the Financial Services Authority (FSA). Statutory regulation came into the mortgage market on 31st October 2004, prior to this, the industry was subject to voluntary regulation by the Mortgage Code Compliance Board.

According to FSA figures, around 60% of all regulated mortgage contracts are sold by mortgage intermediaries. Given that FSA's figures do not include further advances, buy-to-let, semi-commercial, second charge and off-shore lending, our figures suggest that over 70% of all mortgage business is conducted by an intermediary on behalf of their client.

As the representative body for the sector, AMI engages with policy makers, politicians, regulators, consumer groups and the media both in Brussels and in the UK.