EUROPE

The Unbundling of the European Mortgage Market

by Niamh Prendergast

With seismic changes underway at all stages of the value chain, many players are looking to specialize in just one or two chosen areas.

Historically, there has been a marked contrast between the United States and Europe in the way in which the end-to-end mortgage process has been organized. In the U.S. it is common for different entities to perform origination, servicing and funding whereas in the European Union mortgage lending banks frequently take on the whole process. As competitive pressures increase, the long predicted unbundling of the mortgage process now seems to be underway.

The recent establishments of Alltel Mortgage Solutions and Global Home Loans (GHL) are perhaps the clearest indicator of this shift. Both are committed to providing mortgage portfolio servicing on a third party basis, and need to win clients if they are to achieve the economies of scale which their parent organizations anticipate. Although United Kingdom-based, both organizations have clearly got their eyes on European expansion.

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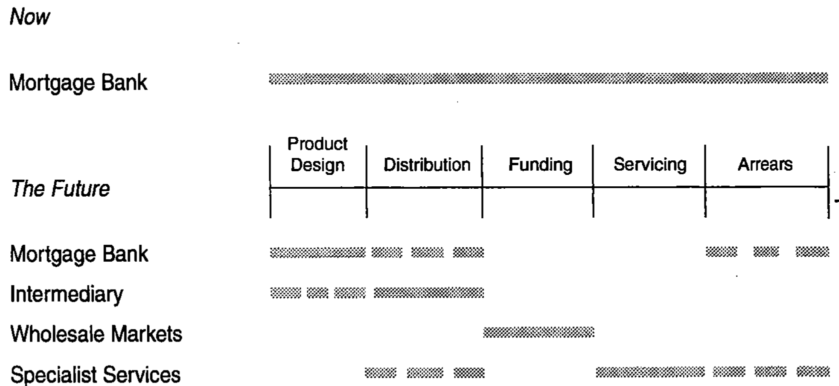
In the Netherlands, Stater BV, the Dutch subsidiary of Bouwfonds (which was recently bought by ABN Amro) already has a third-party mortgage servicing model up and running. It has opened an office in Germany and claims to be ready to move into the Spanish, French and Belgian markets.

These companies believe that an "unbundling" of the mortgage market is taking place, so that the key functions of product design, distribution, servicing and funding, which are currently all performed by mortgage banks, will be split up and performed by specialist companies. By specializing in mortgage servicing, they hope to achieve better performance in that area than the mortgage banks and hence encourage lenders to outsource. Thus, the European market may become more like that in the U.S., where alongside full service mortgage providers, specialist companies often perform only one or two of these functions.

Figure 1. How the Mortgage Market May Be Unbundled



NB: Full line indicates full involvement, dotted indicates partial.

ORIGINATION

The first stages of the mortgage process involve product design, distribution and origination. Often the three are done by the same organization, although mortgage introducers such as IFAs (Independent Financial Advisors) are a major distribution channel. Some introducers have assisted lenders at the product design stage as well as providing packaged applications.

Most recent new entrants to the market, however, have looked to take origination share and develop a competitive advantage in one or more of a number of areas:

- **Price.** To attract business, many new entrants (e.g., Standard Life, Egg) are undercutting traditional lenders significantly. Although this strategy is successful in attracting volumes, it raises questions about sustainability in the long run.

- **Distribution.** Although they are catching up, traditional lenders have been relatively slow in utilizing new distribution channels such as the Internet. Those organizations that quickly developed Internet/telephone distribution capabilities have been able to build, and are likely to continue to build, market share at the expense of traditional lenders. A recent review of Spanish banks by Merrill Lynch concluded that they stand to lose half their value if they fail to take advantage of the Internet.

- **Products.** New processing systems have encouraged innovation in product design. In particular, flexible mortgages which more aptly fit modern lifestyles, are accounting for a significantly increasing proportion of the market. In the U.K. further product design requirements are provided by the government's CAT standards, which aim to ensure that consumers can compare details of products easily. The Current Account Mortgage, introduced in the U.K. by companies such as First Active Financial, PLC and heavily promoted by Virgin, is a further innovation.

- **Brand.** Building brands is key to the future success of many new entrants. Loss-leading price cutting is not sustainable in the long run and brand recognition is essential to attain wider margins on future business. The marketing expense necessary to build such a brand is prohibitive to many smaller players.

- **Application Processing.** Many traditional lenders are saddled with cumbersome legacy systems to process mortgage applications. New entrants are either outsourcing or developing state-of-the-art servicing systems themselves. Such systems can give advantages in terms of cost, speed and efficiency.

Developments in origination have not been confined to the traditional prime residential mortgage market. There have been substantial developments in mortgage lending to niche and sub-prime customer segments.

The Sub-Prime Mortgage Market

Sub-prime lending reduced markedly in the 1980s and 1990s. This was partly because many mortgage lenders adopted a policy of standardization of mortgage products to improve approval processing and servicing efficiency. It also reflected the losses suffered in the early 1990s and the understandable reluctance of lenders to risk repeating mistakes. This policy largely precluded applications from borrowers with a bad debt history or non-conforming loan applications.

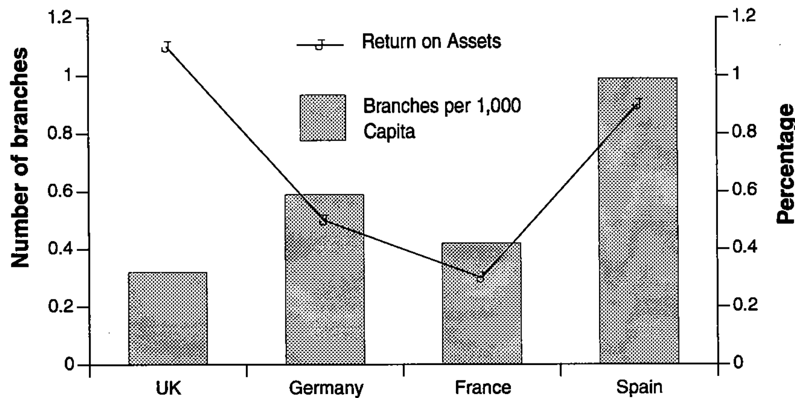
However, this trend has begun to change for a number of reasons. Firstly, as yields on investment have fallen in line with interest rates, lenders have attempted to improve returns by moving further down the credit quality curve. Secondly, lenders are now armed with better statistical information provided by credit agencies such as Experian, enabling them to more accurately assess the risk associated with lending to different individuals. This allows them to cherry-pick good quality business that might otherwise have been considered a bad risk. Many existing lenders have invested in arrears management systems which they hope will enable them to cope with arrears levels more effectively than they did in the early 1990s, while specialist sub-prime lenders are often prepared to take a more proactive approach to arrears management than has been typical in the prime mortgage market. Finally, the increased use of securitization has enabled lenders to originate non-conforming and sub-prime mortgages and then pass the risk to wholesale investors.

The Impact

The impact of new entrants and new distribution channels has perhaps been most noticeable in the U.K. Traditional lenders have been forced to rationalize their branch networks, resulting in many closures. Figure 2 on page 36 illustrates why similar rationalization may be on the cards in the rest of Europe.

Free competition and direct distribution channels make it unlikely that individual countries will completely avoid the effects of the changing mortgage origination market. There are already examples of lenders involved in cross-border selling that are more than willing to cherry-pick the local lenders' best customers. Bank of Scotland, Deutsche Bank, Deutsche Pfandbriefenbank and Belgium's Argentaspaarbank have all established a presence in the Dutch market. Bank of Scotland is also offering mortgages over the Internet in the Republic of Ireland.

Figure 2. Branch Networks and Profitability Among European Credit Institutions



Source: E.U. Commission

SERVICING

The announcement on March 7, 2000, of a joint venture agreement between the U.K.'s Bradford & Bingley Building Society and Alltel (U.S. mortgage servicing company and telecoms/information technology systems provider) is further evidence of a fundamental structural change in the U.K. mortgage market that threatens to have implications for mortgage servicing across Europe.

The joint venture, to be called Alltel Mortgage Solutions, will offer mortgage processing services to third-party lenders in the U.K. and Europe. Bradford & Bingley will be its first customer. This deal follows a similar announcement last year of a joint venture between Woolwich and Countrywide called Global Home Loans, which is now actively marketing its services in the U.K. and plans to offer services across Europe.

Third-party servicing has been an established though small part of the U.K. mortgage market for a number of years. Most of the organizations that have provided third-party servicing are subsidiaries of mortgage lenders or other related financial institutions, and a significant proportion of their total assets under management have been portfolios funded by their parents. The largest such established player is Homeloan Management Ltd. (HML), a subsidiary of Skipton Building Society.

The best of these third-party providers have demonstrated the flexibility needed to deal with a range of clients with varying requirements. Typical scenarios might include assisting a niche market entrant to achieve a speedy set-up, or managing a small portfolio purchased (or acquired in a merger or acquisition) by an existing lender to save that lender from the IT effort required to transfer the new portfolio onto its own system.

So what do these latest moves signify for the European mortgage servicing market, and what are the pressures behind them?

Pressures for Change

A number of internal and external pressures are forcing mortgage lenders to consider outsourcing as a strategic option for their processing/servicing function:

- **IT investment.** The number of new products, e.g., current account mortgages in the U.K., coming onto the market, the new functions demanded by customers and the market, e.g., securitization, is requiring increasing investment by lenders in their IT systems to compete effectively. Outsourcing mortgage processing means that they no longer need to worry about this extra investment, while the servicing specialists will have the economies of scale to maintain cutting edge technology.

- **Increasing cost pressures.** Growing competition in the mortgage industry is leading lenders to become more cost-conscious. Outsourcing allows them to measure their processing costs more accurately, and exploit the economies of scale and specialization of outsourcing companies to reduce costs.

- **Management focus.** Outsourcing non-core functions such as mortgage processing allows management to concentrate their energies on product development and sales, which are the core profit drivers of any mortgage lending business.

- **New entrants.** New entrants to the mortgage market can set up their businesses far more easily if they do not have to worry about their processing/servicing function. They can concentrate simply on product design and distribution. A recent example of this is Europeloan, which has already started offering loans in Sweden over the Internet and plans to roll out its products across the continent. Its loans are serviced by Stater.

These pressures do not, of course, apply universally across the industry. For example, in the U.K. the largest lenders often already have the economies of scale to be cost-effective servicers, and may not wish to outsource so that they do not lose strategic control of part of their business.

Although the servicing market is still dominated by originators, the move to outsourcing is set to continue to some degree. On the supply side, KPMG is aware of a number of European companies that are actively contemplating entering the mortgage servicing market, as are more players from further afield.

FUNDING

The pattern of funding of mortgages is also changing, in the U.K. at least. Traditionally, lenders have funded portfolios out of retail savings and wholesale funding—and held the mortgages on their balance sheets. There are a number of reasons why this model may not be suitable for either new entrants or incumbents going forward.

Many new entrants do not have access to retail savings and for those that do, the current relatively low margin between retail and wholesale rates make funding mortgages through retail savings an expensive option. There may also be restrictive limits on the amount of wholesale funding that markets are willing to provide. Holding mortgages on the balance sheet may not be possible given the increasing demands of capital adequacy requirements. Consequently, lenders are looking to other models to overcome these constraints.

SECURITIZATION

One alternative is to utilize origination capacity and simply sell pools of mortgages to other lenders. It would be up to the buyer to assess the credit quality of the pool, provide the necessary funding from their own sources and take the mortgages onto their balance sheet. The originator may opt to retain the servicing rights to the mortgages or sell them along with the pool. This is a common arrangement in the U.S., where smaller banks often sell pools of recently originated loans to larger banks that can then securitize in larger portfolios.

More popularly, though, in the U.K. securitization is used to package the mortgages, obtain credit ratings and ultimately fund through the wholesale investment market.

In fact, securitization in the mortgage market has its origins in the U.S. in the late 1970s and early 1980s. High inflation and interest rates in the U.S. jeopardized the existence of the thrifts (mutual mortgage lenders) that had traditionally lent long-term, fixed-rate mortgages which were funded at short-term rates. This meant that they were often committed to low interest loans which were now funded at a loss.

Mortgage lenders, therefore, turned to the secondary markets for funding, effectively eradicating funding risk in exchange for a premium. This premium is kept to a minimum because the secondary market makers (Ginnie Mae, Fannie Mae and Freddie Mac) are either explicitly or implicitly guaranteed by the U.S. federal government (although the implicit guarantee has never been tested). Over 50% of U.S. mortgages are now securitized through these agencies or directly by mortgage originators.

Securitization has several benefits:

- Access to a vast wholesale funding market is available to all lenders that securitize.
- Lenders can utilize their origination capabilities to the full.
- Greater lending to the sub-prime and non-conforming segments of the market is facilitated with the credit risk being passed to the wholesale market.
- As margins become tighter, fee income becomes more attractive than net interest income.
- An efficient flow of information is generated to support the securitization process. Standardization of products is also encouraged to ease the complexity of that information.
- Capital efficiency is improved as assets are moved off the balance sheet.
- Competitive pricing might be improved if institutional funding rates are partly passed to consumers.
- Credit risk is substantially reduced.

Funding in the E.U.

Will the E.U. market embrace securitization in the same way as the U.S. and to some extent the U.K.? It is unlikely that the high percentage of securitization in the U.S. will be replicated in the E.U. because the E.U. does not have the equivalent government agencies to support the secondary market. Furthermore, securitization is at present dwarfed as a funding method in much of the E.U. by mortgage bonds. While there is no formal European mortgage bond definition, the different bonds issued across countries share common characteristics. Mortgage bonds are backed by asset pools and differ from typical mortgage-backed securities in a number of ways, as illustrated by considering the German pfandbriefe (see Figure 3).

The German mortgage banks are committed to expanding the international appeal of the pfandbrief and have focused on enhancing its liquidity in order to do so. The

Figure 3. Comparison of Pfandbriefe and Mortgage-Backed Securities (MBS)

	Pfandbriefe	*MBS*
Balance sheet treatment	On balance sheet	Off balance sheet
Source of principal and interest payments	Issuer's cashflow	Collateral cashflow
Collateral pool structure	Secured by a dynamic pool of assets	Secured by a pool of assets that are not generally substitutable
Rating	Loans to value of the pool ratio is kept below 60%	Rating depends on asset quality and over-collateralization or insurance
Risk weighting	10% in core countries and 20% in others	50% for non-agency issues
Principal redemption	Bullet	Amortization and prepayment of the underlying assets

Source: The Association of German Banks

measures taken include the launch of the jumbo pfandbrief in 1995, making markets in the bonds and ensuring that a continuous repo market exists.

The German model for pfandbriefe has been spreading across Europe. France, Spain, Luxembourg and Finland all have legislation in place allowing for the issuance of mortgage bonds. Ireland and Belgium are now looking to follow suit.

Issuers of mortgage bonds are unlikely to completely dismiss the securitization alternative though. Regulatory capital requirements, improving return on equity and increasing the investor base are all reasons to have a mix of funding alternatives at their disposal.

Economic Influences on E.U. Mortgage Funding

Despite recently rising interest rates, the E.U. is still in a relatively low interest rate environment. In such economies fixed-rate debt is preferred to floating-rate debt. Additionally, a feature of a low inflation environment is a sharp fall in the volatility of long-term rates especially versus short-term rates.

On the other hand, for high interest rate economies, floating-rate debt is the norm with high volatility. This high volatility has discouraged borrowers from entering into long-term debt. In the E.U., these economies are now in a low interest rate environment and the big increase in certainty and reduced volatility in long-term interest rates points to a big shift toward longer-term, fixed-rate finance, particularly for traditionally high interest rate economies such as the U.K., Spain and Italy.

The long-term savings rates from this scenario may discourage savers from placing funds in traditional savings accounts and to search other markets for better returns, e.g., the equity market. The knock-on effect is that mortgage lenders may have to look increasingly to the wholesale markets for funding. Those without adequate credit ratings or who have significant wholesale funding already in place may find the securitization market a suitable alternative source.

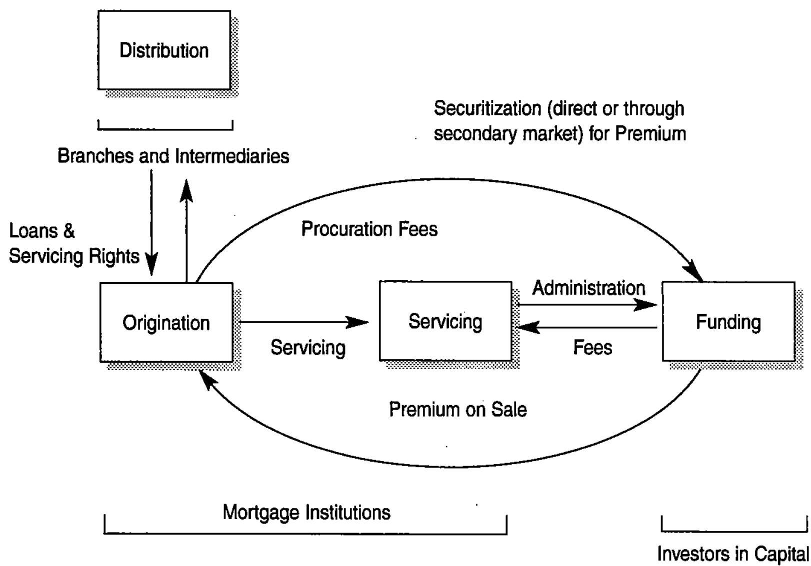
COMPARISONS TO THE U.S. MARKET

Some market observers predicted that the advent of the Euro would herald a rapid shift toward the U.S. mortgage market model in Europe. They would currently argue that the advent of major third-party servicing operations like Stater and Global Home Loans suggests that this trend is now establishing itself.

However, the U.S. market has developed in a quite different way from the mortgage market in Europe. A fundamental difference is the role of U.S. government agencies supporting the secondary markets in mortgage-backed securities to counter the problems caused by thrifts in the 1980s, as described above. There is little reason to believe that this scenario will be replicated in Europe.

Figure 4 illustrates a typical U.S. mortgage process. A large mortgage institution originates loans or purchases them from intermediaries. It then securitizes the loans in a pool to the capital markets. However, the right to service the loan pool is retained by the mortgage lender so that although it is then servicing under a commercial contract for a third party (the capital market

Figure 4. Typical U.S. Arrangement



investors), it is on a portfolio for which it was the originator.

The "servicing rights" retained by the mortgage institution on securization have an inherent value, giving the institution an ongoing income stream from the transaction in the form of payments from the investors to the servicer. In practice, servicing activity is concentrated in a small number of large institutions, which are typically also the largest originating mortgage institutions. Servicing rights are tradable and there is a considerable market for them reflecting the activity in correspondent lending (smaller institutions originating and then selling through loans to larger institutions) and portfolio sales.

Third-party servicers, administering loans which they have neither originated nor bought, are no more common in the U.S. than in the U.K. They make up only around 5% of the market, little higher than in the U.K. historic average excluding GHL and Alltel. In part the low take-up of "pure" third-party servicing in the U.S. may be due to the size of the market, which has enabled a number of players to achieve economies of scale. The market in servicing rights helps institutions to match portfolios under management to the optimal capacity of their operations.

CONCLUSION

The arrangement of processes in the U.S. model is primarily driven by the prevalence of securitization. In Europe, the lack of government-backed organizations promoting this approach, and the popularity of mortgage bonds, is likely to prevent securitization from becoming such a dominant funding method.

In terms of mortgage servicing, the European market is likely to develop differently from that apparent in the U.S. The ambitions of Stater, Alltel, GHL and others to specialize in genuine third-party servicing represents a distinct departure from the U.S. model. As we have seen, the proportion of U.K. mortgages serviced by third parties is already greater than that in the U.S., if Alltel and GHL are included. The trend is likely to spread across the E.U., where in countries like Germany, the servicing of other retail financial products such as savings accounts by third parties is relatively common.

Mortgage distribution is likely to grow as a specialization as organizations capitalize on their existing customer relationships outside of the mortgage sector, or on their ability to take advantage of emerging distribution channels. Distributors may play the familiar role of mortgage introducer or could follow the smaller U.S. banks in originating loans for speedy sell-on to larger lenders.