The Mortgage-Backed Securities Market in the U.K.: Developments Over the Last Few Years

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THE EARLY U.K. MBS MARKET

The United Kingom pioneered the use of mortgage securitization in Europe with the first transaction of MBS issued in January 1985. There were clear differences from the United States market because the vast majority of mortgages were variable rate without any pre-payment penalties.

Even so, the market grew rapidly in the 1980s as centralized lenders, mainly U.S.-based, entered and the housing market boomed. When the housing market boom came at the end of the 1980s, the MBS market declined equally dramatically. During much of the 1990s specialized mortgage lenders, who depended on securitization for funds, dominated the relatively small market. However, at the end of the decade, the prime mortgage lenders entered the securitization market in search of alternative sources of financing, both in terms of financial instruments and geographic diversity of investors.

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THE CURRENT POSITION

Development of mortgage securitization in the U.K. has been significant in 2000 and 2001, even though currently MBS still account for less than 5% of total mortgage balances. Table 1 shows available statistics on residential mortgages securitized in the U.K. from 2000 to the third quarter 2001. In all cases, these are special purpose vehicles (SPVs), originated by the high-street lenders. They are large by historic standards and, unlike the 1980s, appear to be able to realize the necessary economies of scale.

The prime market has been led by three or four main lenders, and many others are now beginning to follow suit, at least to the point of undertaking a "tasting" securitization. Table 2 shows the list of U.K. prime lenders with securitization activities in 2000. In addition, there has been some £10m of securitizations by centralized lenders, which must securitize in order to fund their mortgages (Table 3).

During the last three to four years, the Abbey National has become one of the dominant names in European securitization. Its growth strategy was not so dependent on funding mortgages but on strengthening the rest of the balance sheet. They were therefore attracted by the diversification of funding argument.

Northern Rock has been very active using securitization mainly because its share of new business far outweighed its traditional share of the overall market. The Bank of Scotland has influenced the market by introducing the Master Trust Structure, which allows for repeated issuance of mortgage-backed securities from a master pool of mortgages. Their book grew very quickly because they used centralized intermediaries not built on the traditional Building Society model. The Master Trust vehicle allows the replacement of pre-paid mortgages and thus reduces cash flow risks. They also provide the framework for replication at far lower costs and generate a vehicle understood in the U.S.

SOME REASONS FOR SECURITIZATION IN THE U.K.

Most commentaries on the development of the MBS markets suggest that the three immediate reasons for securitization are:

Table 1. Residential Mortgages Securitized in U.K. (2000 to Third Quarter 2001)

Period	*Issuer and Originator*	*Number of Loans*	*Total Value of Issue*	*Discounted Yield to Investor**
Q1, 2000	Granite Mortgages for Northern Rock; Paragon Mortgage Plc. for Paragon Mortgages.	2,790	£935m	27.5 bp
Q2, 2000	Mound Financing Plc. for Bank of Scotland; . Mortgages No. 1 for Mortgages Plc; First Flexible No. 2 for First Active Financing.	5,551	£1.42 bn	26.5 bp
Q3, 2000	Auburn Securities 2 for Capital Home Loan; Holmes Financing Plc. for Abbey National; Granite Mortgages Plc for Northern Rock; and Aire Valley Finance No. 2 Plc for Bradford & Bingley Building Society.	6,956	£4.83 bn	21.8 bp
Q4, 2000	First Flexible for First Active Financing; Holmes Financing for Abbey National; Ship Shape Residential Mortgages Place for Bristol and West Plc; and Fosse Securities for Alliance & Leicester.	5,879	£3.41 bn	21.5 bp
Q1, 2001	First Flexible No. 4 for Britannic Money; Granite Mortgages Plc for RMAC-RFC; and Granite Mortgages Plc for Northern Rock.	4,122	£2.81 bn	21.7 bp
Q2, 2001	Originated Mortgage Loan for igroup; Paragon Mortgages No. 3 for Paragon Group; Residential Mortgage Securities No. 10 Plc for Kensington Mortgages Co. and Holmes Financing No. 3 for Abbey National Northern.	8,150	£5.71 bn	22 bp
Q3, 2001	Mound Financing Plc for Bank of Scotland; Preferred Residential Securities for Preferred Mortgages; RMAC Plc for GMAC-RFC; Granite Mortgages Plc for Northern Rock; Equity Release Funding Place for Norwich Union.	4,562	£4.48 bn	26.4 bp

Notes: *Denotes average discounted yield above 3 months LIBOR to investors for class A1 notes. Ratings were done by Moody's/S&P and DCR/Fitch IBCA.

Sources: Derived from ING Baring International Asset Backed Market Reviews from 2000 to Q3, 2001.

- To source funds for lenders with no alternative.
- To respond to regulation for issuers subject to relevant regulatory controls – notably with respect to capital-to-asset ratios—who may use securitization to balance the portfolios.
- As a means of diversification for issuers, which can generate a lower overall cost of funding even if, of themselves, MBS are not the cheapest option.

More practically it is suggested that the growth in U.K. housing transactions in the last few years has made securitization desirable, as it did in the late 1980s. At the present time house prices are rising at almost unprecedented rates—in part as a result of structural changes in interest and inflation rates and partly related to the lack of alternative investments in the wake of stock market volatility. These pressures are unlikely to be maintained and indeed some downward adjustment is likely—which will be associated with lower transaction levels. If the housing market was the only reason for the growth in MBS over the last few years we would expect to see a decline in securitization once the market stabilizes.

Not surprisingly, the actuality is far more complex and requires careful interpretation. In the 2000s the prime lenders are the major players in securitization. But securitization is the main source of funds particularly for institutions involved in the sub-prime market. General Motors Acceptance Corporation (GMAC) has been the most important major centralized lender operating in the prime market but Egg and other net-based lenders have also played important role as centralised lenders.

With respect to response to regulation, the evidence shows that none of the high street lenders in the U.K. are in any need of fund-

Table 2. U.K. Prime Lenders with Securitization Activities (2000)

Originators	*Volume(£)*	*Transactions*
Abbey National	17,715.26	8
Northern Rock	6,147.92	4
Bank of Ireland	2,339.68	5
Bank of Scotland	2,280.11	2
Alliance and Leicester	1,335.24	1
Britannia Building Society	362.48	1

Note: The volume and number of transactions for most of above originators may have increased since 2000.

Source: Merrill Lynch, 2001

Table 3. Specialized Mortgage Lenders With Securitization Activity (2001)

Name	*Majority shareholder*	*Transactions*
Britannic Money	Britannic Plc	4 issues totalling £1.1bn
Capital Home Loans	Irish Life and Permanent	2 issues
GMAC-RFC	GMAC	8 issues totalling £2.331bn
Kensington Group Plc	UK Plc	11 issues totalling £2.439 bn
i-group	GE Capital	14 issues totalling £2.142 bn
Mortgage Express	Bradford & Bingley	2 issues
Mortgage Plc	Nikko Principal Investment Ltd	3 issues totalling £607m
Platform Home Mortgages	Britannia Building Society	5 issues totalling £1.04 bn
Southern Pacific Mortgages	Lehman Brothers	3 issues totalling £476 m
Paragon Group	Paragon Mortgage	4 issues totalling £1.2 bn

Source: Bank of Scotland (2002) Asset-Backed Fixed Income Research, March.

ing to address capital weighting issues. All have more than adequate regulatory capital. Recent trends suggest that there is little immediate pressure on the banking sector to change its balance sheet structure. As shown in Table 4, the banking sector is more than adequately capitalized, with Tier 1 capital ratios comfortably in excess of the regulatory 4%. There is thus no pressing need to economize with shareholder's funds.

In addition, most of the main prime lenders in the U.K. are not constrained by funding sources. If the securitization markets were to close to banks, most of the main prime lenders could refinance elsewhere given that they have access to appropriate capital markets. There is therefore no need for them to securitize for the purpose of funding as narrowly defined. However, there may be good reasons for doing so in the context of overall Treasury management in the sense of optimizing the portfolios.

First, the entry of Egg and others into the market gave many institutions a shock and made them think about what might happen if retail savings dried up.

Second, retail savings are anyway declining and there is a far wider range of savings alternatives available. Both of these factors suggest that there is a strong case for the diversification of funding sources.

Third, were there to be a problem it would be wise not to be doing the first securitization at that time. There is a strong case for a "taster," which ensures that knowledge is in place and the documentation and learning costs have been covered at a time when there is no immediate case for concern. Once the structure is in place, the option to securitise is available reasonably and quickly. This is the reason given by a number of the high-street lenders for their current MBS policy.

Fourth, what the bank has to manage is not the mortgage element of the portfolio but the overall portfolio. This may make it more appropriate to concentrate e.g., on corporate assets—in which case getting mortgages off-balance sheet can have some value.

In terms of costs and efficiency, again what is important is the cost of the overall portfolio. It may be sensible to raise money through MBS at the margin, even though the average costs are higher, because raising additional funds through traditional sources might increase costs over a far larger element of the portfolio. The question of the impact of the level of mortgage transactions also appears more complex. There has undoubtedly been an increase in transactions and mortgage flows in the late 1990s and 2000s. The buoyancy of the housing market clearly makes it more attractive for institu-

Table 4. U.K. Bank Profitability and Capital (1998)

Bank	*Return on equity (%)*	*BIS Tier Ratio (%)*
Abbey National	22.1	7.3
Alliance and Leicester	18.0	13.4
Bank of Scotland	22.1	6.8
Barclays	17.0	7.4
Halifax	16.3	12.2
HSBC	15.5	9.7
Lloyds TSB	30.9	8.7
NatWest	20.5	8.3
Northern Rock	19.7	8.7
Royal Bank of Scotland	28.8	6.8
Standard Chartered	18.0	8.2
Woolwich	17.5	10.9
Average	20.8	9

Source: Morgan Stanley Dean Witter Research (1999)

tions without a retail base to enter; equally the long-term trends in mortgage markets, which are towards a mature rather than a growing market, mean that high street institutions are trying to grow market share. The first adds to the extent of securitization; the second does not inherently do so. However, there may be other factors which make securitzation desirable for retail institutions—e.g., if an institution finds itself issuing a large concentration of a particular type of mortgage (e.g., buy-to-let). The general view is that the buoyancy of the market has provided an opportunity rather than making securitization a necessity.

Finally, the main reasons currently given by most issuers of MBS are diversification and learning benefits. It is a good instrument to have available; it is best to do it when an institution is not under strain; it means that later issues should be more easily assimilated, the brand will be recognized and the costs will be lower. Setting up a Master Trust further reduces future costs. If this is a correct reading of the current position when and if the market turns down, there will be some reduction in securitization but decline is unlikely to have the same impact as the early 1990s and economies of scale should still be realisable.

NEW DEVELOPMENTS IN THE U.K.

Securitization has enabled new entrants to enter the mortgage market, as it did in the 1980s. However, the scale required to compete is now far greater. The way around this has been through warehousing facilities—into which new mortgages are placed as they are issued. This approach requires a regular large-scale flow of new mortgages available for securitization. Initially, pricing involved a significant risk premium. However the issues are now carefully structured and usually made up of the lower risk paper. Moreover, there have been no defaults—even during the period of considerable negative equity in the early 1990s. Credit ratings are therefore high. The market appears to be able to accept additional tranches without reducing price—suggesting healthy demand (although there is some suggestion that prices are still "too" high given the quality of the securities).

MBS have been issued in sterling, dollars, Swiss franc and euro—or a mixture. This lowers the overall cost of the transaction as well as widens the market allowing broader diversification. The securitization instruments are reasonably readily recognized in the U.S. investment market—although the vast majority are held within the U.K. Considerable effort is being put into developing an appropriate code of practice and into greater standardization of documentation. As in the 1980s, investors see MBS in part as a substitute for gilts, which are increasingly in short supply. However the available variable rate paper is not a good substitute for fixed interest mortgage-backed securities.

The cost of funds raised through MBS is, on average, higher than funds coming through more traditional retail sources. This appears to be the case even when only interest rate and management costs are taken into account—i.e., taking no account of the high fixed costs of issuance. On the other hand, securitization is seen as having the benefit of generating funds at a relatively stable cost. This can make it a useful way of providing marginal funds—as it can be done without raising average costs overall. In addition to the prime mortgage market, there is a growing sub-prime/non-conforming mortgage market. This is almost entirely funded through securitization—as high street lenders play very little direct part. This market faces a far larger range of risk premia and credit enhancement requirements and involves sophisticated risk assessment. It appears to be very healthy—as it is in the U.S.

THE POTENTIAL FOR MBS GROWTH

The mortgage market is not a rapidly growing one in terms of underlying trends. Some of the major actors would probably like to reduce their exposure to mortgages because they want to move away from their roots rather more than has been possible so far. Levels of competition appear strong. In particular although average profits for the high street retailers are high they are derived mainly from the back book (older mortgages still on the books). Current profitability on new mortgages is estimated at around the cost of capital in their early years. On the other hand, mortgage lenders see major opportunities associated with mortgage lending, especially with respect to first-time buyers, because of the loyalty aspects, which allow them to sell customers higher profit products. They therefore are less concerned about direct measures of mortgage profitability. However, the capacity to cross-subsidize from the back book will not last forever.

The entry of direct lending/saving institutions such as Egg undoubtedly had an effect on the savings market; as has had the Ombudsman's ruling on rates to existing savers and borrowers. Margins have therefore declined as a result of upward pressure on savings rates (in a world where the underlying trend in rates is down—so it is reflected in rates not falling as far as might have been expected). Competition across mortgage providers is also strong—but the lack of a back book limits the on-line/ centralized lenders' capacity to compete. The fact that many of the larger institutions have now done some securitization means that much of the set-up costs have already been incurred. Although average costs of funding through MBS are likely to remain higher than for retail in the medium term, lower marginal costs of issuance will help to make it worthwhile to undertake further issues. On the other hand, the wide diversity of mortgage products on offer is one reason why it has proved difficult to realize all the potential benefits of securitization because of the lack of standardization. At the moment there seems little sign of significant reductions in the range of products available—which, issuers see, as led by consumer demand.

Many of the benefits of standardization arise from appropriate documentation and risk assessment rather than from the range of products available. Greater standardization would reduce transaction costs and make securities more easily accepted by credit rating agencies and investors alike. The same potential applies to the fixed-rate mortgage. While yield curves remain upward sloping, there is no incentive for borrowers to take on long-term fixed rate mortgages. Equally, it is difficult to issue fixed-rate securities because of the lack of an adequate bank of relevant information especially on pre-payment. However, fixed-rate securities would be a better substitute for gilts and would extend the market. They are widely thought to be beneficial in the context of membership of the single currency and in reducing the macro-economic volatility of the housing market.

One area of concern to some actors has been the lack of a repo market—i.e., the capacity for issuers to buy back—or to maintain on their balance sheet—securitized assets. It is an accepted part of the market in for example the U.S. and Spain. Enabling institutions to buy back assets provides further flexibility in building portfolios and is thought to allow further cost savings. However, at the present time there are regulatory barriers to developing an institutional repo market in the U.K. because it is seen as taking back some of the credit risk. Other concerns relate more to the more general development of the mortgage market rather than being specific to securitization. These include in particular legal questions about how the Consumer Credit Act may be applied to mortgages and the potential for enabling consumers to renegotiate fixed-rate prepayment penalties. The current environment is seen as creditor friendly—any shift towards further assistance to consumers is seen as increasing risks and costs. Similar questions arise in relation to the range of regulators that affect the mortgage market and the impact that changes in accounting practices could have on how issuers may operate. Again the Treasury is currently seen as relatively benign and responsive to concerns.

One of the particular benefits of mortgage-backed securities is seen as being that they can be issued in a number of currencies—the dollar, the euro and the Swiss franc as well as in sterling. This opens up the market to a wider range of investors and allows even broader diversification. So far, however, the vast majority of investors are U.K. based. Thus, the general picture is of a useful instrument where there are still the possibilities of cost savings to be made, but where MBS is unlikely, in current conditions, to become a cheap funding option. Where MBS is important is in providing flexibility in building efficient portfolios for both the issuers and the investors. It is, therefore, expected that the MBS market will grow in absolute and proportionate terms, but, unless there are structural changes, it will not come to dominate the system. It will remain a useful instrument, used when and where thought desirable by the institution concerned.

This position is likely to continue while the basic instrument remains the variable-rate mortgage (including short-term fixed) and government does not move to guarantee some element of the market. This contrasts with the American market, which is based almost entirely on fixed-rate securities. The view with respect to the European market was that, outside the Pfandbriefe market, if anything, mortgage issuance was moving more in the U.K. direction of short-term fixed or variable rather than towards longer-term fixed rates. Interviewees all believe "leave well alone" is the most appropriate response from government—unless external factors, such as regulatory change occurs. They felt that the legal environment was conducive to innovation; that much of the most interesting innovation was taking place in the MBS market and that competition was reasonably healthy. No estimate of potential growth was made—but given the current rate, perhaps a doubling would not be an unreasonable best guess over the next few years. Were the housing market to go into recession there would be a decline in securitization, but not a complete withdrawal.

The main structural change envisaged in the near future is Basel II, where the consultation paper has just been issued. The objective of Basel II is to improve risk evaluation and management and to ensure that regulatory and economic realities are congruent with one another. This could be expected a priori to reduce the need for securitization. MBS will not be a core element in the overall negotiations—however the changes will undoubtedly modify behavior considerably. It is also likely to modify which types of assets are securitized—shifting away from the "best assets" as is the situation at the present in the U.K. to rather poorer quality loans. This potential shift is linked to the lack of differentiation in the adequacy rules in relation to the attributes of the assets such as loan to value ratios.

CONCLUSIONS

In the U.K. MBS market both prime and sub-prime securitization markets are basically healthy and developing. A downturn in the market may slow that development but the increased flexibility arising from securitization will still be valuable. It appears however that securitization with respect to prime lending is unlikely to come to dominate the housing finance market. However, the U.K. general legal and regulatory frameworks are seen as creditor friendly, responsive and appropriate. If anything, other countries are seen to be moving towards the Anglo-Saxon model. Basel II is clearly a pivotal point for capital adequacy regulation and will affect mortgage-backed securitization both directly and indirectly.

Overall, all-in costs of securitization are still too high to make it a dominant form of funding in the prime market. This will continue to be the case while the U.K. market is structured around variable rate mortgages and based on retail institutions, which do not see themselves as capital constrained.

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