Creating a government-sponsored enterprise for Europe – the European Mortgage Finance Agency (EMFA) Project

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GLOBAL MORTGAGE FUNDING SYSTEMS COMPARED

Since the 1980s, financial liberalisation and the growth of global capital markets have allowed business practices and whole business models to be exported, bringing different mortgage systems into direct competition for the first time in many countries.

But despite the dramatic change in the financial landscape and the ability of ideas to travel rapidly across the globe, the three main mortgage funding models that were evident at the start of the 1980s are still clearly discernable today. These systems are:

- The retail deposit funding system, which generally produces a variable rate mortgage market and 'bundled' business model, where loan origination, servicing and funding are all performed in-house by lenders (e.g. UK).
- The mortgage bond system, which generally produces a medium-term fixed rate mortgage market and bundled business model (e.g. Germany).
- The government-sponsored enterprise (GSE) and standardised secondary market, which can produce long-term fixed rate loans without prepayment penalties and an unbundled business model (e.g. US).

Table 1. Mortgage Funding Models Compared

	Rate structure	Prepayment optionality	Maturity mismatch	Credit and prepayment risk
Secondary market & GSE	Fixed and variable	Unrestricted	Matched funding	Dispersed between lenders, GSE and capital markets
Retail funding	Variable	Unrestricted	Long-term loans funded by short-term deposits	Concentrated on lending institution
Mortgage bonds	Fixed	Restricted	Matched funding	Concentrated on lending institution

Source: EMFA Project Team

Although each national mortgage market has its own unique characteristics, these three systems are the main blueprints for mortgage markets globally. And as they have started to compete, aspects of the US system (securitisation, specialisation within the value chain) have started to appear organically in traditionally retail funded markets such as the UK and Australia. In parallel, most developed countries outside Europe, such as Japan, Canada, Hong Kong and Korea, have established GSEs. Now we believe it is time for Europe to consider the merits of augmenting its traditional mortgage financing arrangements with what has become the leading mortgage funding system globally.

SHORTCOMINGS IN EUROPEAN MORTGAGE SYSTEMS

Why should Europe consider establishing a GSE? We believe that the answer to this question lies in the weaknesses of Europe's existing mortgage systems. The key deficiencies are: the fragmented nature of European mortgage markets, the lack of a funding infrastructure to support flexible long-term fixed rate loans, the lack of transparency within the value chain as current funding regimes favour the bundled business model and the lack of a standardised mechanism for lenders to get loans off their balance sheets. All of these are issues that a GSE could play a key role in addressing.

Shortcomings at a Pan-European Level

There is no EU mortgage market but instead 25 national markets, each with their own distinct characteristics. The differences cover all aspects of the market including funding mechanisms, the type of institutions making loans, the type of mortgage products available, the mortgage pricing structure, the ancillary products sold with mortgages, distribution mechanisms, the house buying process, the legal and regulatory environment, consumer protection rules and fiscal arrangements. These differences in turn give rise to variations in a range of market data, some examples of which are shown in Table 2.

The fragmented nature of European mortgage markets, and in particular the lack of a standardised European secondary mortgage market (something Americans take for granted), gives rise to a series of inefficiencies. As a result, Europe as a whole suffers from a number of specific shortcomings:

1. Fragmented national mortgage markets, preventing operational economies of scale from being realised.
2. Fragmented funding structures, making European mortgages less attractive to global investors.
3. Lack of an effective way for banks to get loans off-balance sheet in a standardised manner, limiting cross-border loan portfolio diversification.
4. Inefficient industry structure with duplication of costs in debt issuance and loan servicing.
5. Lack of a mechanism for smaller lenders and lenders from smaller countries to compete for funding on level terms with the larger incumbents with legacy retail deposit bases or superior access to mortgage bond markets, limiting competition.
6. Lack of availability to consumers of mortgages with the interest rate set for the full term without redemption penalties, except in Denmark.

These shortcomings have not been a source of great concern to the industry to date because mortgage markets have always been national and the prospect of a truly European market has seemed like a distant dream. But they should be a concern to policymakers and with the march of globalisation, the relative disadvantage this fragmented structure imposes on Europe will become increasingly apparent.

Shortcomings of Individual National Mortgage Markets

As well as the inefficiencies that arise from the fragmented structure of European markets, there are also a number of shortcomings in the way national mortgage

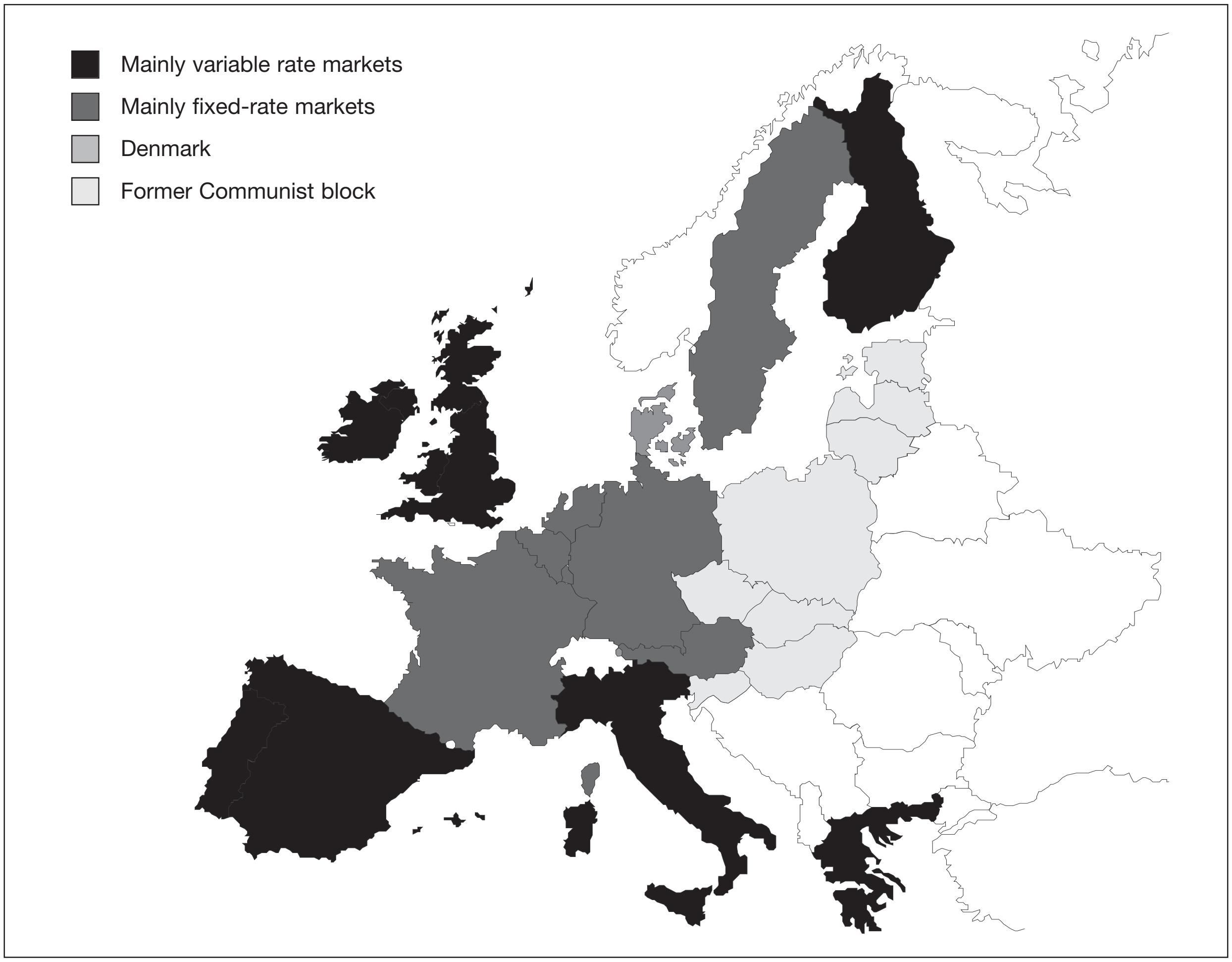
Table 2. Differences in EU Mortgage Market Characteristics

			New loans		
	Tax relief on mortgage debt*	% of households in owner-occupation	Average loan-to-value ratio	% of loans that are fixed rate	% of loans distributed through branches
Austria	No	50%	N/A	58%	71%
Belgium	Yes	65%	N/A	62%	74%
Denmark	Yes	51%	80%	90%	85%
Finland	Yes	61%	75-80%	15%	100%
France	No	54%	67%	94%	91%
Germany	No	41%	67%	88%	89%
Greece	Yes - FTB	78%	47%	3%	100%
Ireland	Yes	80%	74%	61%**	89%
Italy	Yes - limited	77%	50%	43%	88%
Luxembourg	Yes	72%	N/A	N/A	N/A
Netherlands	Yes	52%	72%	87%	42%
Portugal	Yes	66%	74%	3%	74%
Spain	Yes - limited	78%	70%	8%	84%
Sweden	Yes	60%	N/A	50%	90%
United Kingdom	No	68%	69%	45%**	54%

* Owner-occupied mortgage debt
** mostly 1-2 years fixed
FTB = first-time buyer

Source: Various

Figure 1. European Mortgage Models



markets work, which have affected consumers and attracted the attention of policymakers. Given the diversity of European mortgage markets, it is unsurprising that these shortcomings vary from country to country. However, broadly speaking countries can be divided into four categories that define their mortgage systems and the corresponding weaknesses they exhibit. Figure 1 shows the countries of the EU, divided into these groups.

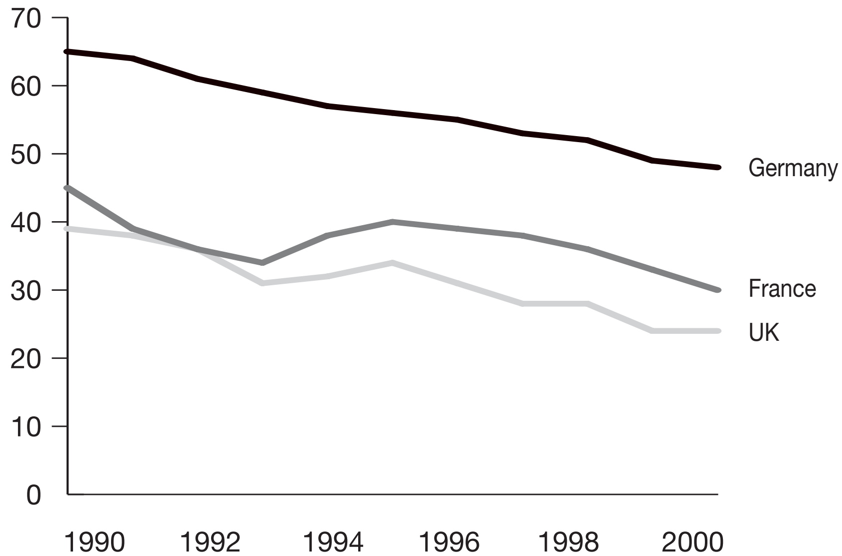
The first group is those countries that have traditionally relied on variable rate sources of funding. Despite advances in capital market funding solutions, these countries continue to have predominantly variable rate mortgage markets, with product gaps amongst longer-term fixed rate products, leaving most borrowers exposed to the full effects of interest rate shocks.

This is a potential source of instability and a particular problem for countries that have joined the euro, as they have lost the ability to control short-term interest rates. So concerned was the UK Treasury about the impact this could have on economic stability if the UK joined the euro, that last year it commissioned Professor David Miles to undertake a study into how the UK could stimulate a long-term fixed rate mortgage market.

Moreover, as Figure 2 illustrates, deposits are a declining element of household savings in advanced economies, as people switch to longer-term savings vehicles, raising the possibility of shortages in deposit volumes in the future.

The second group of countries are those that have traditionally relied on medium-term and longer-term fixed rate mortgage funding, usually on the back of a mortgage bond market. Here borrowers are insulated from interest rate shocks, at least in the medium term, and the system is not dependent on retail deposits. However, borrowers in these markets have traditionally been locked into their loans

Figure 2. Deposits as a % of Households' Total Financial Assets



Source: Datamonitor

with redemption penalties (although in France these penalties are capped by law). While the existence of redemption penalties is not perceived as a serious problem, there is a growing appetite for choice in these markets.

The third group are the eight new member states of central Europe. These countries share a common historical background in that all emerged from Communism after the fall of the Soviet block. Their transition to market economies has been far from easy and their financial sectors remain extremely under-developed. For this group the problem is how to attract private capital to fund mortgages when their mortgage markets are so small and undeveloped that individually they lack the potential liquidity that capital market investors require.

Finally, Denmark deserves its own category. Although it uses a mortgage bond funding system, it exhibits striking similarities to the US system in:

- The availability of mortgages with the interest rate set for the whole term, without prepayment penalties.
- The matching principle, where capital repayments from the borrower are passed onto the investor, mirroring the US pass-through security.
- A standardised route for lenders to access the capital market.

The most significant differences between the Danish and US systems are that:

- unlike mortgage-backed securities (MBS), which can be either on- or off-balance sheet, Danish mortgage bonds, like those elsewhere, are always on the balance sheet of the lending institution.
- The confidence required to support a standardised issuing platform derives from the legal framework in Denmark (believed by some analysts to amount to an implicit government guarantee) while in the US it comes from the GSEs' quasi-government status.

The Danes are rightfully proud of their system, which is consumer-friendly and avoids the shortcomings of other European markets explained above. As such, Denmark could be thought of as a European role model. But for other countries to adopt the Danish system would require them to abandon their own mortgage bond legislation, something which would be highly disruptive. A pratical alternative to deliver the benefits of the Danish system would be through a European GSE.

THE EUROPEAN MORTGAGE FINANCE AGENCY (EMFA) PROJECT

The European Mortgage Finance Agency (EMFA) Project commenced in early 2001, as a collaboration, initially between Abbey National (Britain's second largest mortgage lender), Credit Agricole (France's largest mortgage lender), HypoVereinsbank (Germany's largest mortgage lender) and BBVA (Spain's largest mortgage lender), to develop a blueprint for a European GSE to be put to the European Union to seek governmental support.

The proposal advocates the establishment of a public/private partnership institution in Europe to establish a standardised secondary mortgage market across the EU. The public and private sectors would focus on the roles they perform best. The private sector would set up and run EMFA, providing the equity capital to establish the institution and support its balance sheet.

The role of the public sector would be to provide a degree of support that would enable EMFA to attain a AAA credit rating and the status of a supra-national body as well as bestowing on EMFA the corporate governance structure that would ensure it furthered public policy objectives. This would be achieved through an EU legal charter for EMFA. EMFA would not have a guarantee from the EU or member states. The justification for EU government backing is that EMFA is designed to pursue key public policy objectives (integrating EU mortgage markets, reducing imbalances in the monetary transmission mechanism, increasing consumer choice and so on).

Proposed Operations of EMFA

EMFA would have two main lines of business, credit risk management and interest rate risk management.

Credit Risk Management

The core function of EMFA would be to create a standardised secondary mortgage market across Europe through the EMFA mortgage-backed security (MBS). This MBS would carry a guarantee of timely payment to investors from EMFA. Each MBS pool would be single country and usually single lender. Each MBS issue would be EMFA labelled with a standardised prospectus.

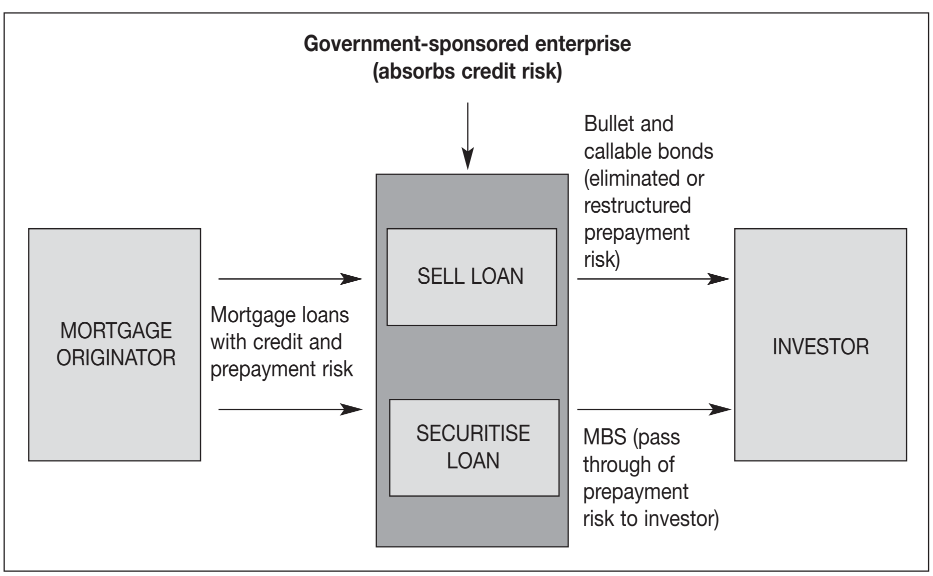
To understand the benefit of the EMFA-labelled MBS, it is worth first explaining how the current ‘private labelled’ European MBS market works. First, a lender must identify the pool of loans they wish to securitise and have them rated by a rating agency. Based primarily on the credit quality of the loans, the rating agency will determine the appropriate ratings for the MBS issued to back the pool – typically this might be 90% AAA, 5% AA, 3-4% BBB with a 1-2% subordinated loan from the lender to provide an extra buffer against future losses for the MBS investors.

Bankruptcy remoteness must be achieved, usually through the sale of the assets or their cash flows to a separate legal entity called a special purpose vehicle (SPV), where they are held on behalf of the investors. Typically, an investment bank would issue a prospectus for the lender and sell the MBS to investors.

The lender, known as the issuer, continues to service the loans but now does so on behalf of the SPV under an explicit contract, although the borrower sees no difference in the administration of their mortgage. All excess cash flows after the MBS investors are paid flow back to the issuer, but given the uncertainty as to whether payments due from borrowers will always be met immediately, the SPV generally carries a cash float. The investor carries both the prepayment risk (the risk that borrowers repay capital ahead of schedule) and the credit risk beyond that borne by the issuer through its subordinated capital in the SPV.

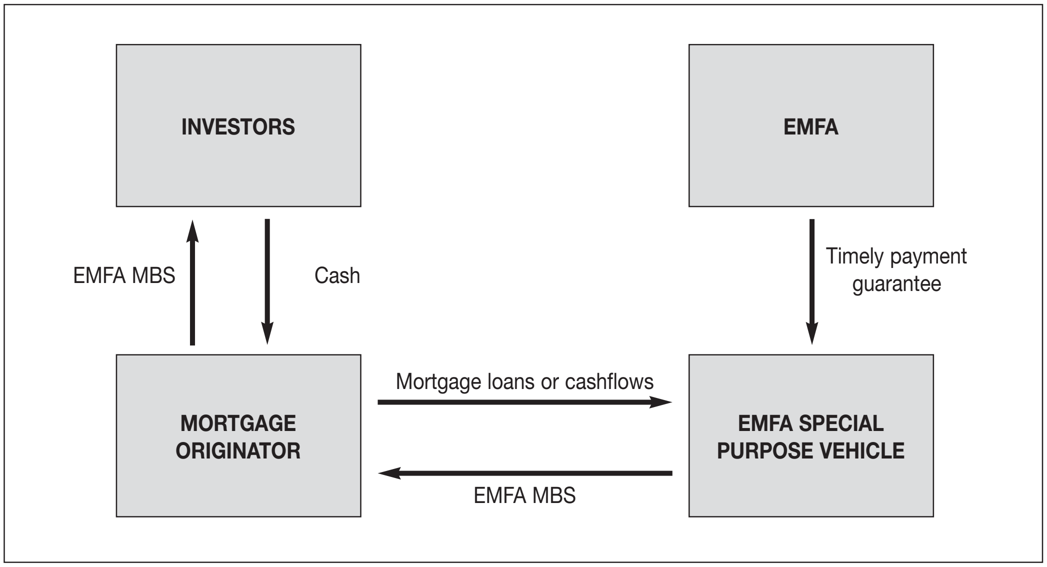
With an EMFA-labelled MBS transaction, the lender would identify the pool in the same way but instead of having it rated by a rating agency, they would approach EMFA, which would establish an SPV that would issue EMFA-labelled MBS with a guarantee of timely payment to investors from EMFA. For this service EMFA would charge a

Figure 3. Role of a GSE



Source: EMFA Project Team

Figure 4. EMFA MBS Transaction



'guarantee' fee, which would vary based on the credit quality of the loans, as well as lender servicing quality and loan volume.

With EMFA's payment guarantee to investors, the entire MBS tranche would be AAA-rated and there would be no requirement for the lender to provide capital. EMFA SPVs could be established in any EU jurisdiction, but each issue would use a standardised EMFA prospectus.

As with private labelled MBS, the issuer would continue to service the loan and retain any excess cash flows after payments to MBS investors and EMFA. The borrower continues to deal with the lender and need not be aware of EMFA's involvement in financing the loan.

No cash changes hands in the transaction between the lender and the EMFA SPV - the EMFA SPV simply swaps loans for EMFA MBS with the lender. The lender can then retain these MBS on its balance sheet or sell them to investors. The holder of the EMFA MBS carries any prepayment risk, but is no longer faced with a complex matrix of prepayment and credit risk, as EMFA carries the credit risk.

Interest Rate Risk Management

As well as guaranteeing MBS, EMFA could operate its own balance sheet. Generally it would seek to purchase only EMFA MBS. Its ability to buy EMFA MBS would allow EMFA to boost market liquidity. Such purchases would be funded through the issuance of EMFA callable and bullet bonds.

This business would complement credit risk management by offering investors an alternative to EMFA MBS, which carry prepayment risk, allowing investors who prefer the certainty of bullet repayments to fund European mortgages via EMFA debt. EMFA would hedge any interest rate risk between its assets (EMFA MBS) and its liabilities (EMFA debt).

EMFA Development Projects

As well as the two basic business lines, EMFA could undertake three key development projects:

Mortgage product design. EMFA could introduce standard mortgage products across the EU, that lenders could sell under their own brand alongside their traditional products. These products could parallel the US 15-year and 30-year fixed rate mortgage without redemption penalties.

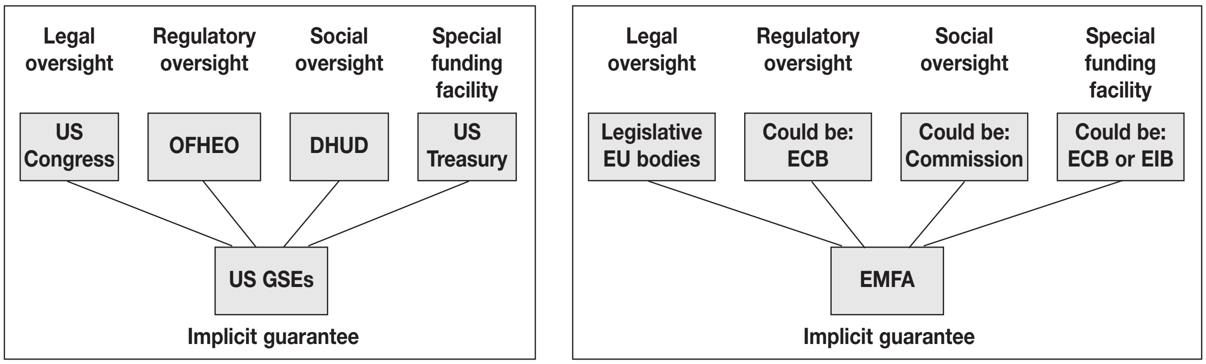
Loan servicing and documentation standardisation. In collaboration with lenders, EMFA could develop standardised systems for loan securitisation and servicing. Such standardisation could dramatically reduce industry IT development costs. A process of mortgage documentation standardisation could also be undertaken, as it has in Hong Kong by the local GSE (the Hong Kong Mortgage Corporation).

Automated loan underwriting. Ultimately, EMFA could develop a system of automated loan underwriting. This would allow the development of the concept of a 'conforming mortgage' (a loan that is known to meet the GSE's purchasing criteria), which confers considerable liquidity benefits.

The Precise Role of the EU

EMFA's role would be defined by an EU charter, broadly based on the US congressional charter governing the GSEs. The charter would ensure that EMFA remained focused on activities that

Figure 5. Components of the US GSEs' Implicit Guarantee and How EMFA Might Compare



furthered public policy objectives while ensuring that it had the links to other EU bodies that reassured investors of EMFA's special status.

The role of the charter can be described under four broad heading:

Responsibilities

- To provide a stable flow of funds to mortgage lenders across the EU through the establishment of a standardised secondary mortgage market.
- Targets for funding loans to low-income households and disadvantaged regions.
- To advocate harmonisation measures for EU mortgage markets.
- Requirement to submit annual progress report to the EU.

Special status

- EU shareholding (this would be bestowed by the lenders providing the equity capital).
- Access to special funding line from the European Investment Bank or European Central Bank.
- Special status for EMFA's debt in terms of listing requirements and investment limits for other financial or public institutions.

Unique restrictions

- EMFA's activities would be very narrowly defined around its role of supporting a standardised secondary mortgage market.
- It would not be permitted to originate loans.
- It would not be permitted to purchase loans other than residential mortgages.
- It would not be permitted to purchase loans from outside the EU and accession countries.
- EMFA would be required to have mortgage insurance from third parties in place on loans above certain predefined loan-to-value ratios, and maintain a low risk profile.

Appropriate regulatory status

- EU responsible for appointing part of the Board of Directors with additional directors appointed to represent stakeholder groups such as consumers.
- EMFA given its own supervisory framework, possibly with capital adequacy rules based on the US GSEs' leverage and stress tests.

The charter could include sunset clauses, which would remove EMFA's links with the EU at some future date, or regular reviews to ascertain whether these links were still justified. But the basic function that the charter would have to fulfil is to ensure that investors felt that EMFA was quasi-governmental and therefore safe.

Based on our analysis of the rating agencies' GSE rating methodology and meetings with the rating agencies, we believe that the elements of support outlined above should be sufficient to ensure that EMFA was assigned a AAA credit rating, as Fannie Mae and Freddie Mac have despite their lack of a government guarantee.

THE POTENTIAL BENEFITS OF A EUROPEAN GSE

Earlier this article identified three main deficiencies in the Europe mortgage arena. First, that Europe remains a fragmented series of national markets with no incentive for participants to shift to a more efficient pan-European structure. Second, that across Europe, with the exception of Denmark, the funding infrastructure that is needed to provide long-term fixed rate prepayable finance is lacking. Third, that Europe's funding systems have favoured a bundled business model, which obscures transparency within the mortgage value chain and finally, that there is no standardised mechanism for lenders to get loans off their balance sheets.

A European GSE could directly address these deficiencies, and do so by working with the lending industry, by providing lenders with a financial incentive to participate in a pan-European funding system, a marriage of public policy and private incentive. Lenders would be incentivised to use EMFA funding because it would:

- Provide a common funding instrument for mortgage loans across the EU, making European MBS more attractive to global investors.
- Provide banks with a new credit and prepayment risk, capital and liquidity management tool.
- Reduce the cost of accessing the secondary mortgage market by creating a simple, standardised MBS structure.
- Provide an efficient mechanism for lenders to get mortgages off-balance sheet through a standardised market that would allow lenders to diversify the geographic concentration of their loan books.
- Improve the efficiency of providers by promoting specialisation within the mortgage process.
- Allow all lenders to access the secondary mortgage market on equal terms with costs based primarily on the quality of the loan book rather than the name of the originating bank.
- Allow lenders to introduce mortgages with the interest rate fixed for the whole term with no early repayment penalties.
- Ensure that industry restructuring is driven by European lenders rather than having it driven from outside.

As lenders take advantage of the benefits outlined above, building up the EMFA MBS marketplace, EMFA would start to deliver a broader range of economic and social benefits as follows:

- Integrating European mortgage markets, potentially increasing operational economies of scale.
- Reducing mortgage rates for consumers through improved market liquidity and efficiency.
- Developing EU capital markets.
- Reducing imbalances in the monetary transmission mechanism by providing a uniform source of long-term fixed rate mortgage finance.
- Enhancing the stability of the financial system by providing lenders with a dependable source of finance.
- Overcoming potential future funding constraints that may occur as retail deposits decline as a proportion of household wealth.
- Providing targets for lending to low-income households and disadvantaged communities.
- Reducing variations in the level of efficiency between national mortgage markets.
- Broadening access to home-ownership and promoting fairness in the mortgage system.
- Aiding cross-border labour mobility.
- Aiding the convergence process in the new member states and accession countries.
- Creating transparent pan-EU markets in mortgage credit and prepayment risk.

Of these many potential benefits, it is worth focusing in more detail on two key ones; EMFA's ability to integrate European mortgage markets and its ability to create a stable source of long-term fixed rate funding, uniformly across the EU.

Integrating Mortgage Markets: a Key EU Policy Objective

Creating a single market in financial services is a key policy objective of the EU. A legislative framework for developing the single market, termed the Financial Services Action Plan (FSAP), was endorsed by the European Council in Lisbon in March 2000, and thereby agreed by the member states. The FSAP is a 5-year programme of measures aimed at promoting integration by breaking down barriers between national markets.

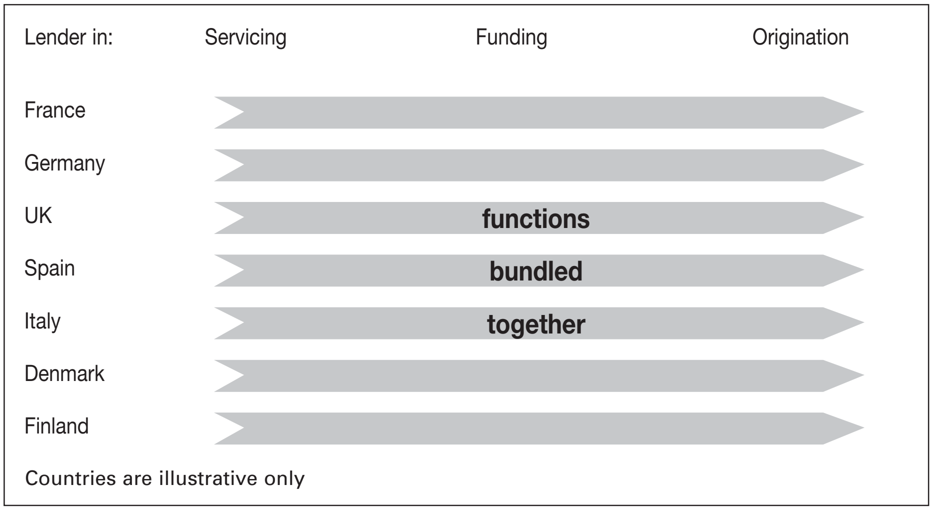
The FSAP has focused on removing barriers to cross-border trade. For example, in mortgages the Voluntary Code of Conduct on Pre-contractual Information was designed to make it easier for consumers to compare products from different member states.

But despite the fact that by April 2004, 38 of the 42 measures in the FSAP had been adopted, there is almost no sign of progress towards a single market in retail financial services. It seems that when establishing the FSAP, policymakers grossly under-estimated both the scale of harmonisation measured required and the level of consumer and producer resistance to cross-border transactions. As a result, measures such as the Code of Conduct have been of little practical purpose, because consumers are not shopping for loans across borders.

Indeed, in the mortgage market, it is clear that the barriers are so numerous and entrenched that even an extensive programme of harmonisation will not have the desired effect of stimulating cross-border trade. Just consider two of the many barriers that exist:

- court systems and the laws relating to mortgage contracts and property are nationally based. So to lend in a particular market requires in-depth knowledge of its system of mortgage and property law and forced sale procedures. This knowledge base is not readily available on a cross-border basis, making it difficult to see how lenders could offer cross-border loans cost-effectively. Moreover, in a cross-border transaction, in the event of a legal dispute, one party will have to submit itself to a foreign court, an unappealing prospect.
- The house buying process varies greatly from country to country, reflecting a range of factors including cultural ones that may not be susceptible to harmonisation.

Figure 6. Europe's Bundled Mortgage Banking Business Model



Source: EMFA Project Team

A New Approach to Integration is Required

So a new approach is needed if progress is to be made towards mortgage market integration. We believe that the key to understanding where progress can be made lies in the mortgage value chain. When mortgage lending is distilled into its three constituent functions: funding, servicing and origination, funding appears as the obvious place to start the integration process. But in Europe's current business models the functions are bundled together as shown in Figure 6.

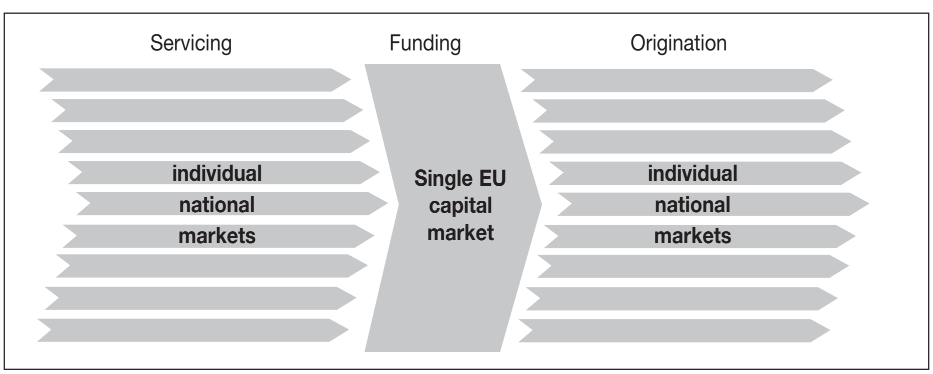
The establishment of a GSE would unbundle funding and create an integrated EU funding market (see Figure 7). And because of the potential increase in market liquidity this could bring, funding integration would have immediate economic benefits. By contrast, origination is the function most impervious to integration, so encouraging cross-border trade seems a rather unpromising approach.

The experience of the US market is a useful template. Historically the US banking market has mirrored Europe's in its geographic fragmentation. But in contrast to most other retail banking markets, in mortgages the US has developed a clearly defined national market as a direct result of the standardisation established by the GSEs through the secondary mortgage market. Yet even in the US, origination remains essentially a local business.

Creating a Stable, Uniform Source of Long-Term Mortgage Funding

One of the most universal reasons countries have given for setting up GSEs, lies in their ability to provide stable funding for the

Figure 7. How a Unified Secondary Mortgage Market Would Integrate Funding



Source: EMFA Project Team

Table 3. Existing Mortgage Funding GSEs Compared with EMFA

	Ginnie Mae, USA	Fannie Mae, USA	Freddie Mac, USA	HKMC, Hong Kong	CMHC NHA-MBS Program, Canada	Cagamas, Malaysia	EMFA
Gov't guarantee	Explicit	Implicit	Implicit	Implicit	Explicit	Implicit	Implicit sought
Ownership	US gov't	Stock market quoted	Stock market quoted	HK gov't	Canadian gov't	20% central bank, 80% private sector banks	Banks & EU Possible IPO later
Reason for establishment	Finance government insured loans and veterans' housing loans	Provide liquidity for mortgage market during banking crisis of 1930s	Promote secondary market for S&Ls	Develop HK debt market Promote home-ownership	Promote home-ownership Encourage long-term fixed rate loans	Improve lenders' liquidity Develop debt market	EU integration Improve market efficiency Social policy objectives
Inception	1938, split from Fannie Mae in 1968	1938, split from Ginnie Mae in 1968	1970	1997	1985	1986	N/A
Social policy targets	Yes	Yes	Yes	No	No	No	Yes
Funding structure	MBS only	MBS & on-balance sheet	MBS & on-balance sheet	MBS & on-balance sheet	MBS & on balance sheet	On-balance sheet only	MBS & on-balance sheet in full model
Own mortgage product	No	Yes	Yes	No	No	No	Yes
Mortgage stock share	11%	20%	17%	4%	8%	19%	N/A
Long-term senior credit rating	N/A	AAA	AAA	A+	N/A	N/A	AAA required
Financial strength rating	N/A	AA-	AA-	N/A	N/A	N/A	N/A
Jurisdictions	1	1	1	1	1	1	25

Note: Credit ratings from Standard & Poors. Ginnie Mae not rated but carries the full faith of US government. Special Administrative Region of Hong Kong has A+ long-term credit rating.

Source: Various

mortgage market. More specifically, in the US the GSEs have made available the long-term fixed rate loan without redemption penalties. This product has proven remarkably popular with consumers, yet this type of product is available in only a handful of countries (US, Japan, Denmark). Why? Well, it is extremely difficult for lenders to fund these loans through their own balance sheets and hedge the prepayment risk. So where there is no mechanism for passing these risks directly to investors in an efficient manner (i.e. via a standardised secondary market), lenders have shunned such loans.

The benefits of such a funding source in Europe would come both at a pan-continental level, because the liquidity of a European market would far exceed anything national markets could offer, and at a national level. For example, in countries that have not possessed a funding system capable of providing long-term fixed rate loans, a GSE could enable lenders to fill this gap, improving consumer choice.

The new member states of central Europe would probably be the greatest beneficiaries of a pan-EU GSE. At present their small size and lower government credit rating are holding back development by denying them access to global capital on the same terms as other EU states. For example, at present if you take two pools of loans with identical expected credit and prepayment characteristics, one in Poland and one in Germany, the German pool will fund more cheaply. This is both unfair to the Polish borrower (they suffer higher mortgage rates not because they are riskier borrowers but because they live in a country which accesses global capital on less favourable terms) and contrary to the concept of a properly functioning internal market. EMFA could eliminate such anomalies by allowing investors to assess mortgage pools on their performance rather than country of origin.

EMFA: A UNIQUELY EUROPEAN INSTITUTION

Table 3 compares some of the more prominent mortgage funding GSEs around the world. Although all share the common role of ensuring a stable flow of funds to the primary mortgage market and an element of government support, as Table 3 illustrates, their characteristics vary substantially to suit local market conditions and policymakers' preferences.

In seeking to establish a GSE for Europe, it is vital to create a blueprint that is suited to the needs of the European marketplace, and that draws on the experience of all GSEs. It is also vital that we understand the weaknesses of overseas GSEs so that we do not repeat them in Europe. In particular, we should be clear about the causes of recent problems at Freddie Mac in the US, which has a corporate governance structure that has allowed it to become too focused on shareholder returns and the management of its earnings.

Firstly, we envisage an institution that is much more tightly focused on the pursuit of public policy objectives than the US GSEs and much more closely monitored with regard to how well it is fulfilling its public policy objectives. This can be achieved by establishing the right corporate governance structure from the start.

Secondly, we envisage a stakeholder institution, run for the benefit of all interested parties (consumers, lenders, equity investors, debt investors, the EU and the member states) with a corporate governance structure designed to ensure a balance of priorities between these groups, including board representation for each.

Finally, by having the equity provided by the mortgage lending industry itself, the potential for conflict between the interests of shareholders and customers (the lenders) should be minimised. EMFA must be focused on providing the best possible service to lenders and working with lenders to realise benefits for the marketplace as a whole.

PROGRESS WITH THE EMFA PROJECT

The EMFA Project was taken public in November 2003 with the support of five major European mortgage lenders; Credit Agricole of France, BBVA of Spain, BCP of Portugal, Northern Rock of the UK and Irish Life & Permanent. This followed a period of 2 years when the blueprint was developed by a team of banks, which earlier had included Abbey National and HypoVereinsbank.

Despite these heavyweight backers, the industry reaction was decidedly mixed. The European Mortgage Federation (EMF) responded with a press release arguing against implicit public guarantees. It was somewhat surprising that the prospect of cheaper, more stable funding for lenders was not better received by the trade body. However, a number of other lenders have privately expressed support while taking a more cautious public line following the EMF's negative response.

However, it is member state governments that will ultimately decide EMFA's future. We are now in discussions with a number of governments, who have provided positive feedback on the proposal and are currently evaluating it in getter depth. Meanwhile, the European Commission is taking a neutral stance ahead of any member state decisions. With a new European Parliament elected in June and a new European Commission in November we believe there is everything to play for.