By Laurence Neville

Can the UK Restore its Bulldog *reputation*?

The UK's mortgage market was a proud beast, responsible for more than half of Europe's mortgage bond volume. Now, after the Northern Rock fiasco, it's moribund. The Bank of England governor has finally stepped in with some aid, and the UK Prime Minister is pushing for better lending standards. Both could help. But it will take time.

There was a collective sigh of relief in UK and European markets in April. The Bank of England (BoE), after months on the sidelines, finally stepped in with some substantive help for the moribund UK mortgage-backed securities (MBS) market. In a scheme with some similarities to the three already launched in the U.S. by the Federal Reserve, the UK central bank announced it would inject at least £50 billion ($100 billion) into the UK banking system using what it has dubbed the Special Liquidity Scheme, or SLS.

It was something of an about-turn for Mervyn King, the bank's governor. He had allowed MBS to be added to its little-used three-month funding program in December. And while the BoE has cut interest rates, it has only done so by three-quarters of a percentage point to 5% since December — it is constrained by its sole remit to focus on inflation. And in what often appeared to be a near-textbook example of rejecting taking action on the grounds of moral hazard, he had largely stuck to the line that the Bank of England should oversee the markets and not put itself in the thick of things unless emergency action was required.

This one's not quite so hungry right now Getty

His record on that score is hardly enviable, though. That said, the fiasco at Northern Rock was hardly the UK's finest hour — executives, shareholders, the UK Treasury and the Financial Services Authority (FSA) all gave an underwhelming performance in the aftermath of the run on the UK mortgage lender and top-10 European asset-backed issuer and its eventual nationalization.

But now King, by launching the SLS, is admitting that the fallout from the UK's first major bank collapse in a generation is worse then he expected. Some of the country's remaining banks are scrambling to raise capital — admittedly Royal Bank of Scotland's £12 billion rights issue came just after the SLS announcement, and HBOS' £4 billion a week later, but rumors had been circulating for some time.

And the mortgage bond market is moribund. Spreads on triple-A UK MBS in the secondary market have jumped out to almost 200 basis points over benchmarks, from 10bp before the crisis. Yet no one expects these tranches to come under much actual credit stress. Standard & Poor's reckons it would take a 15% annual drop in house prices as well as foreclosures on 90% of home loans in the pools for them to default.

Meanwhile, issuance of publicly placed sterling-currency MBS plunged from £66 billion in the first seven months of last year to just £3 billion between August and February this year, according to Citigroup. That hurts the rest of Europe — UK residential mortgage bonds constituted just over half the volume for the entire continent in the last two years, according to the European Securitisation Forum.

There are still some private placements, and some UK deals are being done in euros and used for repo with the European

Central Bank. But that doesn't help the underlying mortgage lending market, which has dropped by a third this year, according to the British Bankers' Association.

It all smacks of the makings of a broader crisis that could render moral hazard fears moot. But King has not caved in completely. The scheme will allow banks to swap triple-A-rated residential MBS created before 2008 and credit card securitizations denominated in sterling, euros and dollars for nine-month government bonds. The offer is open for the next six months and any arrangement between the BoE and a bank entering a swap will last a year, although it can be renewed annually for as long as three years.

But crucially, the commercial banks retain the risk. First, the haircuts applied to any swap are harsher than the Fed's: depending on the collateral, the BoE will hand over government paper that's worth between 78% and 88% of the market value of the asset-backed collateral it receives. In fact, it's lopping off an extra five percentage for banks' own MBS deals. And the haircuts can be increased if asset prices fall sharply. The Fed, by contrast, pays between 80% and 98%.

The program has won praise from observers. Lehman Brothers' European structured finance analysts, led by David Covey, think the size, breadth and terms of the program are promising. "It should help make bank security portfolios much more liquid than they have been since last July," they wrote in a report on the SLS.

The initial size of the SLS may not eliminate all the liquidity concerns of UK banks and it only applies to true sales rather than synthetic securitizations. But Lehman's team reckons a £35 billion overhang in the UK mortgage market has developed since the securitization markets shut down last summer, which makes the initial size substantial. Thus, wrote Covey and his team, "the program seems well structured to achieve its stated goal of easing current liquidity strains among UK banks and building societies."

That's certainly the hope at the BoE. Swapping hard-to-value bonds for assets that are beyond reproach ought to revitalize the interbank market and, in theory, residential mortgage lending shouldn't be frozen by a liquidity-driven lack of funding.

From the City to Westminster

However, while that's the stated goal, the political aim for UK Prime Minister Gordon Brown is to rehabilitate the mortgage lending market. The SLS may help do that, although it is specifically designed not to be a dumping ground for new paper: only securities held on balance sheets at the end of last year and securities issued from loans held at that time can be given as collateral. But it is far from clear that banks will use the opportunity granted by the plan to take on more mortgage assets in a falling property market. Instead, banks may simply use the SLS to reinforce their balance sheets. And judging by action taken by Abbey, the SLS hasn't made new mortgages cheaper yet: the UK mortgage lender, owned by Spanish bank Santander, raised rates on some of its loans on the same day the BoE announced its scheme.

Prime Minister Brown has taken other steps, though. At the beginning of March, the UK government announced plans for a gold standard kitemark: residential mortgages would be officially graded and the least risky given a stamp of approval. That, so goes the thinking, should give MBS investors more comfort about the collateral behind the deals and provide a benchmark for collateral comparisons. But, explains a research piece by Lehman Brothers: "While the plan has some merit, it would do little by itself to address the challenges keeping the UK RMBS shut."

The plan aims to question documentation and reporting requirements and the suitability of existing issuance structures, and push for full and regular disclosure of the quality of the underlying assets. Other than those broad aims, little is known. Nor will anything happen soon. A Mortgage Finance Working Group, comprised of lenders, investors, the Treasury, the Bank of England and the FSA has been set up to study the plan. It won't present its final report until October.

Many welcome the good intentions of the gold standard scheme, but are somewhat skeptical. "As someone recently pointed out, it's hard to accept that politicians – who only recently believed that Granite [Northern Rock's securitization vehicle] was a secret tax avoidance scheme – should be in a position to tell the industry what a good mortgage is," says Richard Curtis, head of European ABS and structured products bond syndicate at WestLB in London.

Others, while believing that, in principle, the idea of a gold standard for mortgage bonds would work, note that financial markets have a habit of paying lip service to such reforms only when it suits them. "The problem is that financial markets have a tendency to develop outside regulatory markets," says Fabrice Susini, European head of securitization at BNP Paribas. "For example, the savings and loans intervention in the U.S. was effective and the industry participated fully but, as we have seen, the mortgage market migrated to a new model outside that regulated environment."

Birgit Specht, managing director in Citi Securitized Products Strategy, points out that a gold standard scheme for mortgage bonds won't fix existing problems. "Leverage and loan-to-values (LTVs) will come down in a downturn, as they always do, but the trouble is that it's always too late," she says. "Last year's 95% LTVs are now likely in excess of 100% because of asset value falls and a gold standard can't fix that. The problem is always going to be with existing, rather than new, deals."

But as Lehman Brothers analysts note, it's not credit concerns that are keeping investors from UK: "Rather, the primary problems they face are abnormally high price volatility and abnormally low liquidity."

The BoE swap facility may help with that. But there's no guarantee it can also help establish a floor for house prices. Until that happens, all thoughts and plans for a more effective mortgage lending and financing market are on hold.

Additional reporting by Antony Currie