Mortgage market integration and the US sub-prime crisis: a German perspective

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The US sub-prime mortgage crisis surfaced at a moment when the European Commission was going to close its internal impact assessment regarding measures to be proposed in the Mortgage White Paper which is scheduled for publication at the end of the year.

The European mortgage industry is currently evaluating the potential impact which the sub-prime crisis might have on the content of the White Paper, all the more given that industry experts were advising the Commission that the integration of European mortgage markets should primarily be driven by further developing mortgage funding and secondary mortgage markets.

Obviously, globalisation of businesses can have not only beneficial, but also risky or downside effects. The consequences of US sub-prime borrowers' defaults on international and European capital markets were less obvious. Suddenly, the robustness and sustainability of the financial system are at stake. While the US crisis did not yet materialise in a credit crisis, it produced a serious liquidity crisis in the US and European capital markets. Liquidity and investor confidence are fundamental prerequisites for an efficient mortgage funding market which is conceived as a major driver for further market integration in Europe.

The US crisis was the result of different effects occurring simultaneously. Low income borrowers were granted variable rate loans, also called 'teaser loans', without equity and capital redemption or even without interest payment during the first year etc... When the beginning of capital redemption and interest payment coincides with raising interest rates, the default risk of sub-prime borrowers materialises.

What could be the lesson for the European Commission? Some conservative features of European mortgage markets might regain value. A number of macro-economic models applied by research institutes to value mortgage markets against theoretical benchmarks might be reconsidered and certain statements about a pretended low level of completeness of national mortgage markets and product diversity be reviewed. The question of the widespread provision of equity release mortgages might be up for debate once again.

Unsurprisingly, largely fixed-term rate mortgage markets emerge as examples of stability in a troubled market environment. Long-term fixed-rate borrowers can relax because they are not concerned by capital market volatilities, risk premiums and raising interest rates. They are protected by stability.

The same applies to the funding market. The sub-prime crisis led to a sudden disruption of the Collateralised Debt Obligations (CDO) and Mortgage Backed Securities (MBS) markets. Securitisation of mortgage assets is providing added value to capital markets as one of its main purpose is risk diversification. But recent stress scenarios did reveal weaknesses of the MBS market in a number of respects.

As mortgage originators sell mortgage risk off their balance sheets, risk sensitivity might be less developed. Risk transparency is suffering, because investors in MBS are generally not disclosing their investments and bank investors might locate MBS assets in special conduits outside their balance sheets. As there is no secondary market for structured finance products, missing transparency in combination with complex products can easily provoke mistrust and thereby a breakdown of market liquidity. This 'poisoned cocktail' generated the present liquidity crisis.

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In contrast, Covered Bond issuing institutions keep mortgage assets on balance over a longer term. Risk sensitivity is well developed because mortgage defaults directly impact on banks' profit and loss accounts. Eligible assets are generally regulated by law establishing high quality standards (LTV limits, special banking supervision etc.). Risk transparency, standardisation and well performing secondary Covered Bond markets meet investors' expectations. In the Jumbo market segment, market makers are committed to quote bid-offer spreads in order to ensure the liquidity of the secondary market. Although Covered Bond spreads recently widened, the security of Covered Bonds, risk transparency and a sustained secondary market prevented the market from malfunction.

We expect a new risk-adjusted pricing of mortgage assets and structured finance products. The principle of funding long-term mortgages through long-term funding instruments like Covered Bonds might revive. There is urgency to restore investors' confidence in capital market products. Security, high quality and risk transparency are key requirements to achieve this. Complex and sophisticated structures which make it difficult to assess risk and on which investor decisions are primarily rating based, might suffer.

The European Commission should let markets consolidate. In such a context, regulatory initiatives could be counterproductive. Meanwhile, consumers will appreciate fixed-rate mortgages and financial stability, both turning out to be most reliable pillars of consumer protection. Covered Bonds are operating in favour of this objective. **MFG**