



GenworthSM
Financial



REVIEW AND SITUATIONAL ANALYSIS OF THE UK MORTGAGE MARKET

Contents

*Review of the
Development of
UK Covered Bond
Market* 2

*Questions & Answers
With Steve Hilton,
Head of
Administration,
Cheshire Building
Society* 9

*Overview of
European Mortgage
Market* 11

Welcome to the fourth issue of Genworth Financial's UK bulletin – the periodic publication that focuses on topical issues affecting the UK residential mortgage market.

This edition includes a review of the development of the UK **structured covered bond** market and how the UK has responded to developments in continental Europe. It considers key trends in the market, a regulatory perspective and a timeline of forthcoming legislative activity.

We are always interested in **first time buyer trends** and the particular needs of this segment. Steve Hilton, who is responsible for mortgage lending policies at the Cheshire Building Society, gives his opinion on the key issues for first time buyers and how lenders can serve this segment.

In our last issue we began to provide an overview of key statistics on the **European mortgage market**. In this edition, we provide a snap shot of the key European countries based on data for 2005.

ABOUT GENWORTH FINANCIAL

Genworth Financial is a leading insurance holding company, serving the lifestyle protection, retirement income, investment and mortgage insurance needs of more than 15 million customers, with operations in 24 countries, including the US, Canada, Australia, Japan, Mexico, New Zealand, the UK, and 17 other European countries. For more information visit <http://www.genworth.com>.

In Europe, Genworth is a major provider of mortgage insurance, which enables access to home ownership and of payment protection insurance, which helps consumers meet financial commitments if they are unable to work.

Tammy Richardson
Managing Director, UK & Ireland
Genworth Financial
Mortgage Insurance Limited

REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET



The FSA has recently announced its intention to consult on whether the UK Covered Bonds market would benefit from EU compliant legislation. Subject to a positive response by the industry, new legislation would be implemented on 1st January 2007, in line with the UK's implementation of the Capital Requirements Directive (CRD).

In this article we consider the development of the European Covered Bond Market, in particular focusing on how the UK market has grown despite the lack of legislation and the potential benefits of introducing legislation that meets the requirements contained in the 1988 Undertakings for Collective Investments in Transferable Securities (UCITS) Directive, and consequently, those prescribed in the CRD.

Development of a Pan-European Covered Bond Market

Covered bonds are secured debt obligations, issued on the basis of a legislative framework against a ring-fenced pool of assets, the so-called Cover Pool. In most legislation, cover pools may consist of either low Loan-to-Value mortgage loans or loans to the Public sector. The regional scope of eligible assets varies from domestic only, to EU, G7 or even OECD. In the event of the default of the issuing bank, investors have a first claim against the cover pool. High quality collateral, strict rules for the issuing banks regarding lending policy and other risks potentially affecting covered bond investors as well as a tight and special supervision means the instrument is highly rated. The vast majority of covered bonds are AAA-rated, and enable issuers to obtain a strong rating improvement by de-linking from

their own counterparty rating, whilst retaining assets on balance sheet and issuing in their own name.

The European Covered Bond Market has experienced vibrant growth over the past decade. Whilst the product dates back to origins in Germany and Denmark in the 18th and 19th centuries, the internationalisation of the covered bond market was sparked by the creation of the so-called Jumbo-Market for Pfandbriefe¹ in 1995, and the internationalisation of its investor base in the following years. The "Jumbo" concept increased liquidity (i.e. the availability of prices with a tight-bid offer spread for a guaranteed minimum ticket size) to investors by granting a minimum transaction size per issue, committed market-making by a dealer group and other standardised features of the bonds offered (e.g. fixed coupon only, specific conditions for any increases of an outstanding bond, etc). For many fixed income investors, covered bonds serve as an alternative option to Government bonds, at a higher yield.

National regulators, legislators and issuers all over Europe aimed for a level playing field with German Pfandbrief issuers in the years following the inception of the Jumbo market. The new Jumbos provided German issuers with a substantial funding advantage due to the privileged risk weight of 10% for Pfandbriefe in the majority of European countries under the EU Solvency Directive.² The privileged status of the instrument for institutional and bank investors³ and the attractive trading and liquidity features triggered overweighting the sector by institutions.

1 German Covered Bonds

2 11.2 Solvency II

3 UCTIS Article 22(4), <http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/consleg/1985/L/01985L0611-20050413-en.pdf#page=23>

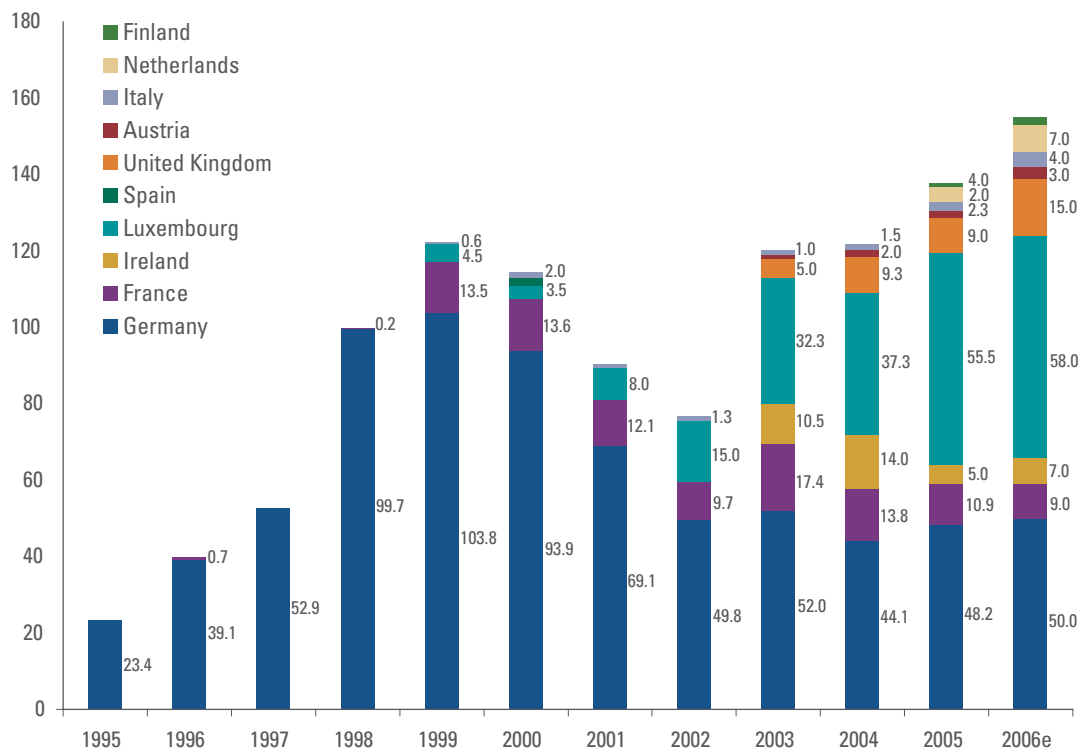
REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET (CONTINUED)

The 10% risk weight versus the 20% Basel I risk weight for senior bank bonds, the UCITS privilege, plus the liquidity features of the instrument provided by committed trading banks, the so-called market makers, led to a substantial funding cost advantage for covered bond issuers compared to other sources, in particular senior unsecured funding, but also AAA-RMBS tranches.

Since 1999, when France created a brand new legislation and with it the French Covered Bonds (Obligations Foncières), and Spain started reviving and issuing under its

longstanding Cédulas Hipotecarias legislation, the market grew at an extraordinary pace all over Europe. Spain is the largest issuing country of Mortgage Covered Bonds since 2005, having started from zero issuance around five years earlier (see graph below). The current outstanding volume amounts to EUR 1.6 TRN⁴ from 13 EU countries. The market can be expected to see continued healthy growth with the addition of new covered bond legislation in the UK but also due to the expected new offsprings from Italy and Portugal expected in the course of this year.⁵

A FURTHER YEAR OF RECORD SUPPLY IN EUROPEAN JUMBO COVERED BONDS



Source: HVB Covered Bond Research

⁴ This number comprises issuance in Mortgage Covered Bonds as well as so called Public Covered Bonds, which are backed by lending to Governments, regions and municipalities or assets carrying a guarantee from Governments or public authorities.

⁵ In Italy, on 24 October 2005, the Ministry of Economy issued a draft regulation which, pursuant to paragraph 5 of Article 7-bis, is aimed at governing, inter alia, the asset quality of the cover pool (the Draft Regulation). Pursuant to Article 2, paragraph 1, letter (a), of the Draft Regulation, only residential mortgages up to 80 per cent loan-to-value ratio are allowed to be included as collateral. On 28 December 2005 the Bank of Italy issued a draft of the istruzioni di vigilanza in respect of covered bonds (the Draft Instructions). In Portugal the new legislation on covered bond is publicly known as the Decree-Law no. 59/2006 dated March 20, 2006 (Publication date by the Journal of the Portuguese Republic) with approval by the Government on 23rd of February 2006.

REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET (CONTINUED)

The UK Structured Covered Bond Market

In reaction to the developments in Continental Europe and the lack of legislation at the time, UK institutions created the UK structured covered bond market in 2003. This provided access to international investor demand in highly rated and liquid Euro-denominated paper. The first programme was established by HBOS, and other issuers have since followed suit. Following the UK example, Netherlands also introduced Structured Covered Bonds in 2005.

Trends – RMBS Market and Covered Bonds Market

In light of the potential changes introduced by the CRD and the reduction in the risk weight of low LTV mortgage loans (loans where the value of the property exceeds by a substantial margin the exposure),⁶ issuers have started to rethink and reshape their securitisation and funding strategies. One of the trends initiated last year was the placement of AAA-notes under securitisations only, where the issuer would retain the lower rated tranches. Such retained positions will require a lower amount of capital held against them under Basel II. RMBS thus becomes a funding tool which can compete with covered bonds for the lower LTV mortgage pools, targeting a different investor base.

Other issuers aim for maximum capital relief for outstanding and future securitisations under Basel II, and have structured programmes to achieve those goals for non-compliant outstanding securitisations; Northern Rock launched the innovative Whinstone structure, which provides capital relief on retained first loss positions from their existing securitisation programmes. Whinstone is a synthetic securitisation of the first loss pieces from the Granite master trust issuers (prior to the de-linked structure i.e. Funding 1) and from three outstanding stand-alone transactions, all of which had been retained by Northern Rock. Under the transaction Northern Rock buys protection on these first loss pieces, but will only receive payment if the losses exceed a threshold amount.



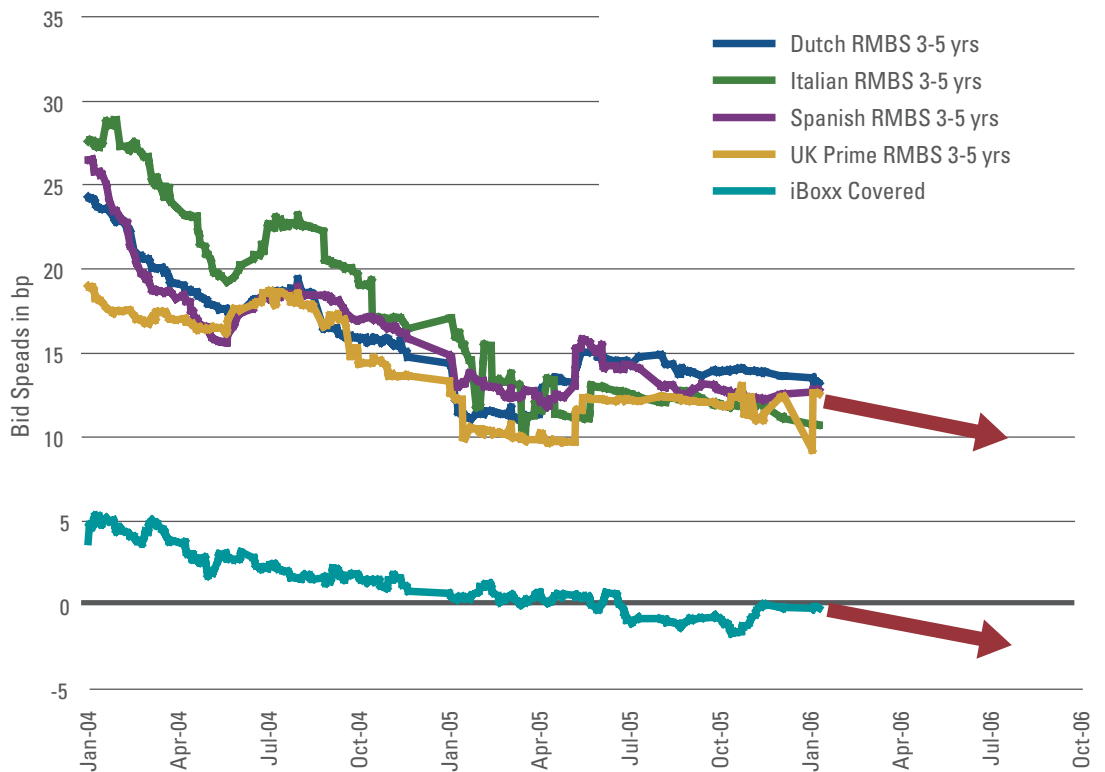
6 CRD, Annex 6. Part 1 Paragraph 45D

REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET (CONTINUED)

In anticipation of the reduced risk-weight differential between covered bonds and AAA-RMBS tranches from an investor point of view (under the IRB approach the risk weight for covered bonds is expected to be 4% for well-rated issuers, whereas AAA-RMBS will be risk-weighted starting from 7%) spreads between the two instruments declined strongly, particularly during the course of 2004. Part of this move was triggered by a general compression of credit spreads.

UK Prime RMBS, which forms the benchmark in the European RMBS market, has been trading in a relatively stable range of 10 – 15 basis points yield pick-up above covered bonds for the past 12 months. Various factors will impact spread developments between the two markets going forward, as bank investors are one category of investors in CB and RMBS transactions, and other considerations apart from risk weights influence investors' decisions. Over the short and medium term though, the favourable risk weight plus the UCITS privilege should keep covered bond yields below those of AAA-RMBS paper.

SPREADS OF COVERED BONDS AND AAA RMBS TIGHTENED



Source: HVB Covered Bond Research

REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET (CONTINUED)

Regulatory Overview

Despite the fact that UK institutions have been successfully able to issue covered bonds, UK covered bond transactions are not compliant with European legislation and therefore do not qualify for a favourable treatment under the 1988 UCITS Directive,⁷ due to the lack of specific UK covered bond legislation. The success of the market in the UK has, to date, been predicated on the enforceability of contracts and the reliability of the English common law.

However, there are benefits to having EU compliant legislation. For example, Article 22(4) of the UCITS Directive allows European investment funds to invest up to 25% of their funds in covered bonds that meet the UCITS criteria. Without UCITS recognition, the maximum investment is 5%.⁸ In order for the limit under Article 22(4) to be applicable, bonds need to be "... subject by law to special public supervision designed to protect bond-holders." Following industry consultation, and a subsequent Policy Statement⁹ the FSA chose not to implement Article 22(4) of the UCITS Directive. In addition, the 10% preferential risk weight available for covered bond transactions is not applicable in the UK as the transitional provision set out in Directive 2000/12/EC, which allowed this, was not exercised by the FSA.¹⁰ The risk weight currently applicable to UK covered bonds transactions is 20%.

The CRD has revisited the definition of covered bonds as part of the review of the capital treatment of these bonds. The definition states that covered bonds, "[are] bonds as defined in Article 22(4) of Directive 85/611/EEC [UCITS] and which are collateralised by any of the [listed] eligible assets." Annex VI, paragraph 65(d) of the CRD lists "loans secured by residential real estate ... up to the lesser of the principal amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties ..." as eligible assets.

Subject to recognition as an eligible asset, covered bonds are then assigned a risk weight on the basis of the risk weight attributed to senior unsecured exposures to the issuing credit institution. For instance, if the exposures to the credit institution receive a risk weight of 20%, the covered bond will receive a 10% risk weight.¹²

Timelines of the UK Legislation

Compliance with EU Directives would not only increase the amount a single investor can invest in a transaction, but would also open the UK market to a broader spectrum of EU covered bond investors. The higher risk weight also disadvantages UK issuers as it leads to higher yields in UK structured covered bonds versus the European core markets, and thus implies higher funding costs. In brief, UK legislation would mean access to a wider audience of European covered bonds investors and a preferential risk weight treatment for the transactions themselves.

7 As amended in 2002.

8 UCITS Article 22(1).

9 CP 135, New Collective Investment Scheme Products, 2002, question 3.9 and Policy Statement 135, 2002, paragraph 3.14.

10 Miles Review, The UK Mortgage Market: Taking a Longer-Term View, Interim Report, 9th December 2003, paragraph 5.41.

11 CRD, Annex VI, part 1, paragraph 65.

12 For a full list of the applicable risk weights see Annex VI, part 1, paragraph 68(a)-(d).

REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET (CONTINUED)

The lack of covered bonds legislation in the UK has been raised as a potential issue for the industry on a number of occasions. Notably, the Miles Review¹³ identified that a key obstacle in the funding of fixed rate mortgages is the lack of specific covered bond legislation in the UK. Miles suggests¹⁴ that the lack of legislation in the UK could affect the development of a longer-term fixed rate mortgage market by restricting one potential route through which lenders could fund longer-term fixed rate mortgage lending.

The Miles Review also notes that the lack of legislation raises concerns regarding the competitiveness in the UK covered bond market driven by the potential higher cost premium associated with investment in UK covered bonds; the cost to issuers of convincing potential investors that a particular issue was a covered bond could be higher in the absence of specific covered bond legislation.¹⁵

In August 2004, the FSA issued an interim policy response on its approach to the prudential regulation of the issuance of covered bonds. This was followed by a further response to the British Bankers Association (BBA) in August 2005 after a review of the interim policy. The August 2005 response confirmed a cumulative threshold issuance of between 4% and 20% of total assets; institutions with issuance between these levels would be considered on a case-by-case basis. However, once a credit institution reaches the upper benchmark of issuance of 20% of total assets the FSA is likely to consider this to be sufficiently material to require an increase in an institutions' Individual Capital Requirement.¹⁶

To date the FSA's policy has allowed UK institutions to issue covered bonds. However, as noted above, there are concerns that the lack of legislation in the UK has had an impact on investors willingness and ability to invest in the UK covered bond market, and in addition, subjects UK covered bond investors to a higher risk weight than is applicable throughout the rest of the EU.



13 Miles Review, The UK Mortgage Market: Taking a Longer-Term View, Final Report and Recommendations, March 2004.

14 Miles Review, Final Report paragraph 7.11

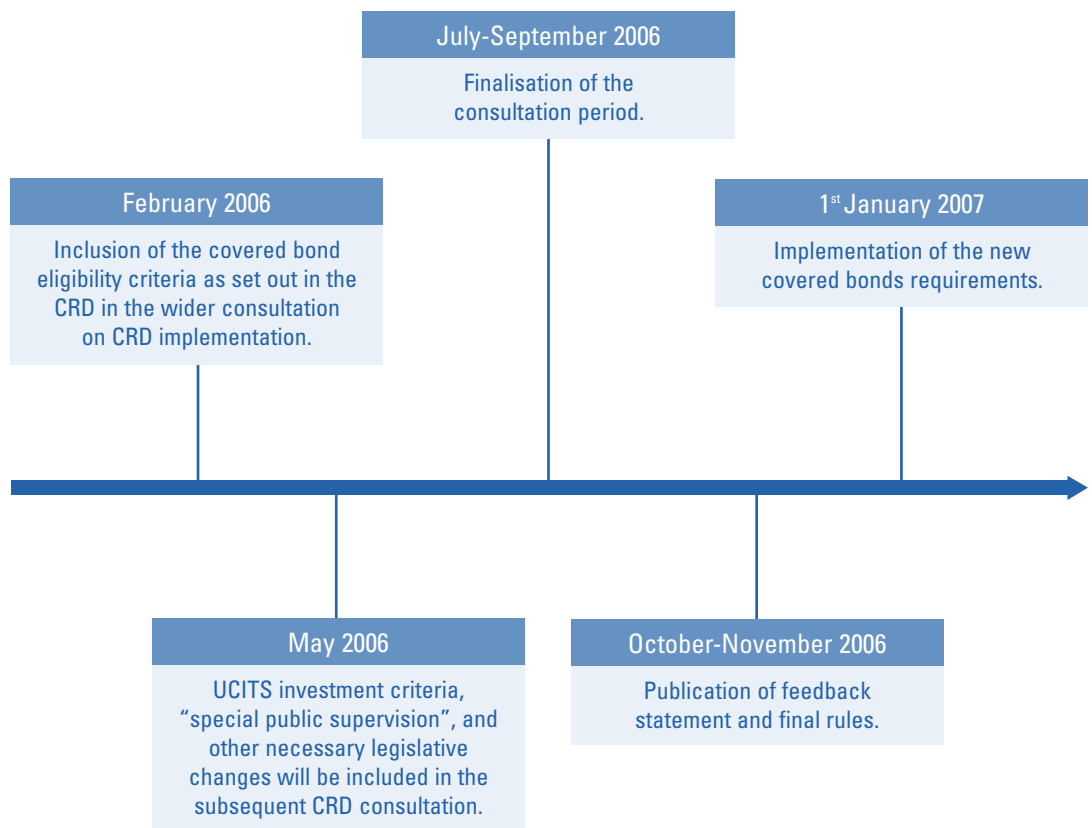
15 Miles Review, The UK Mortgage Market: Taking a Longer-Term View, Interim Report, 9th December 2003, paragraph 5.37.

16 http://www.fsa.gov.uk/pubs/international/cbsg_pslletter.pdf

REVIEW OF THE DEVELOPMENT OF UK COVERED BOND MARKET (CONTINUED)

As a result of ongoing discussions with HMT and the industry, the FSA announced in a letter to the BBA that it intends to consult with industry on the implementation of a UK covered bond regime that is compliant with EU legislation.¹⁷ Following successful implementation of a specific UK covered bonds regime, UK covered bonds transactions would become UCITS compliant and credit institutions could benefit from the preferential risk weights available under the forthcoming CRD following implementation on 1st January 2007. The diagram below outlines the FSA's planned timetable for implementation of the new requirements.

Genworth Financial will be tracking the progress of the covered bonds legislation and we will provide an update in subsequent bulletins when the structure of the proposed legislation is clear.



¹⁷ http://www.fsa.gov.uk/pubs/international/cbsg_letter.pdf

QUESTIONS & ANSWERS

with Steve Hilton, Head of Administration, Cheshire Building Society

We asked Steve Hilton, who is responsible for the mortgage lending policy at the Cheshire Building Society, about the driving forces behind first time buyer trends and the particular needs of this segment.

Q1 - It is well documented that the number of first time buyers (FTB) is falling. In your experience, what have been the main drivers of this trend?

House prices have risen to a point where FTB affordability is stretched to the limit. Many would be buyers just don't have the necessary income to qualify for the minimum loan they need. Higher prices mean higher deposits too, which causes a further obstacle for FTBs.

There also seems to be a shift of attitude from security to convenience. More young people are opting to live together before they get married and therefore are shying away from the commitment of buying a property in case the relationship breaks down. Also the flexibility associated with renting versus buying is being recognised. Young people can rent property near their work, particularly in cities and towns, which means less expenditure on travel, a better social life, potential to live in a better (or more suitable) property than they could afford to buy, and the option to move to new jobs and new areas more easily. These options are facilitated by the increased availability of rental property as the buy-to-let market has become larger.

Finally, perhaps there is less peer pressure now to get on the housing ladder as soon as possible after leaving school or college.

The result of all these factors is that the average age of FTB has increased from about 25 ten years ago to nearer 35 now.

Q2 - How do you think the needs of FTB buyers differ from other buyers in the market?

In many cases they have been renting and may not have saved a sufficient amount for a deposit and the fees associated with purchasing a house - e.g. stamp duty and legal fees.

If they are setting up home for the first time they have lots of additional expense at the outset for furniture, furnishings, white goods etc. In addition, there is more pressure now to own things like TV/ video/ DVD/ Sky/ home computers than in the past and therefore there is the temptation to over commit on finance.

As a result they usually need to borrow at a higher loan to value (LTV) than other buyers.

They need to be aware of potential changes to circumstances, which could result in financial pressures (e.g. starting a family or increasing interest rates).

QUESTIONS & ANSWERS (CONTINUED)

Q3 - What gaps do you think exist in terms of products/ services/ advice being supplied to FTB?

- Fee free products or the ability to add fees to high LTV products possibly taking the overall indebtedness above 100% LTV.
- 100% LTV schemes aimed at lower income FTB.
- Advice on the overall impact of buying/setting up home for the first time, including financial counselling.

Q4 - What initiatives have been successful for Cheshire BS in trying to stimulate the FTB market?

Our 100% LTV scheme is generating interest. In addition, the Cheshire Shared Equity scheme is also helping to stimulate the FTB market.

Q5 - What can Genworth Financial do to help you write more FTB business?

Genworth Financial is operating in more than 24 countries around the world and we will always welcome advice and input on what lenders are doing in other countries.

We would be interested in working together to develop niche schemes e.g. own shared equity scheme.

We believe that moving to affordability based underwriting instead of income multiples will help FTBs.

Q6 - What is your opinion of the Government's initiatives on shared equity schemes as a solution to the FTB problem?

It is mixed. I don't believe the proposal is financially viable for smaller lenders. It also seems to be too restrictive in the number of people who will benefit. It may, however, raise awareness of shared equity schemes that have been offered by lenders such as the Cheshire for some time.



OVERVIEW OF THE EUROPEAN MORTGAGE MARKET

Please find below a summary of the European market for end of year 2005.

	UK	Ireland	Portugal	Italy	Sweden	Germany	Spain
Mortgage debt (in \$ billion) ¹	1,712	118	97	253	180	1,371	843
Mortgage origination (in \$ billion) ²	510	25	18	65	36	102	169
Population (000's) ³	59,668	4,148	10,495	58,093	9,041	82,689	43,064
Average household size ⁴	2.27	2.96	2.69	2.05	2.06	2.05	1.81
Homeownership rate ⁵	70%	78%	75%	82%	60%	43%	83%
House price increase ⁶	5.0%	7.7%	2.3%	8.4%	11.0%	2.0%	13.9%
Consumer debt (\$ billion) ⁷	1,903	NA	105	NA	NA	1,195	706
Gross Domestic product (\$ billion) ⁸	2,146	197	168	1,672	347	2,739	1,067
Base Rate ⁹	4.5%	2.25%	2.25%	2.25%	1.5%	2.25%	2.25%

Sources: 1 National sources
 2 National sources
 3 United Nations
 4 Citigroup, "The View from the Rooftop", September 2005 (figures for 2004)
 5 Citigroup, "The View from the Rooftop", September 2005 (figures for 2004) / Genworth Financial estimates
 6 Genworth Financial estimates
 7 National sources
 8 Global Insight
 9 Bank of England, European Central Bank, Swedish Riksbank

EDITORIAL TEAM

Editor:

Anita Jani
Marketing Manager
Genworth Financial

Covered bond article writers for bulletin:

Gabriele Müller
Capital Markets Director
Genworth Financial

Anna Whittingham
Regulatory Analyst
Genworth Financial

**For further information
on any of the featured
articles please call
0207 5991514.**

RECENT AND UPCOMING GENWORTH FINANCIAL EVENTS AND ACTIVITIES

4th April 2006 – Sponsorship of Basel II/CRD: An Update, Joint CML/BSA Seminar

Seminar covered a range of issues for building societies arising out of the UK implementation of the proposed EU Capital Requirements Directive and Basel II, including a presentation by Genworth's Anna Whittingham.

12th May 2006 – Hope Into Homes Gala Dinner

Genworth Financial are proud to support Habitat for Humanity by hosting a table of key industry participants at the 'Hope Into Homes Gala Dinner'. This will take place at the Greenwich Maritime Museum.

Genworth Financial Mortgage Insurance Limited, incorporated in England and Wales. Registered No: 2624121. Registered address: 80 Strand, London, WC2R 0GR. Authorised and regulated as a general insurance company by the Financial Services Authority. Any transaction entered into by a recipient of this communication will not fall within the jurisdiction of any dispute resolution scheme or compensation scheme.

Legal Disclaimer

The information, including any financial information, contained in the bulletin is included for information only, and does not constitute an offer to sell (or the solicitation of an offer to purchase) any product or security, nor does it constitute any form of advice including investment advice. While the information contained in the bulletin has been compiled in good faith, no representation is made as to its completeness or accuracy. Genworth Financial makes no commitment, and disclaims any duty, to update or correct or to provide notice as to any error or omission in any information contained in this bulletin. Genworth Financial reserves the right to add, modify, or delete information in the bulletin at any time. In no event shall Genworth Financial be liable for any damages whatsoever (including, without limitation, damages for loss of profits, business interruption or loss of information) arising out of the use of the information contained in the bulletin, even if Genworth Financial has been advised of the possibility of such damages.