

Mortgage monitor

“Experts predict one or maybe two further reductions in 2008 with some even predicting a rate of 5% by the end of 2008”

In this article Tony Taylor discusses the ‘credit crunch’ and its implications for investors.

Hello again to all existing and new readers of Jet-to-Let Magazine.

Unless you have been marooned on a desert island for the past few months, you cannot have failed to notice the huge change that has occurred within the markets during this period. The global credit crunch, the collapse of Northern Rock, the elimination of several sub-prime lenders from the UK market, large rises in oil prices, the weakening of the dollar, a stalling housing market and, surprisingly, a cut in interest rates: the list goes on. I would like to explain in simple terms what the ‘credit crunch’ is all about, and how it affects you.

It may seem strange to some people, but in the world today debt is an asset that can be packaged, bought and sold, very much like any other investment. A mortgage loan has a RETURN, i.e. the interest amount that is paid by the borrower, and this is calculated into a yield and thus gives the mortgage debt a value. The mortgage is an ASSET on the lender’s balance sheet and a LIABILITY on the borrower’s balance sheet. What happens then is that billions of pounds of mortgage debt is bundled into packages and sold on to other financial institutions around the world.

The current problems have, in the main, originated in the United States where mortgage companies have been lending ridiculous amounts of money via crazy mortgage products to people with low incomes and poor credit histories. This can work well, as long as house prices rise (to protect the lender’s asset) and customer affordability remains stable or positive. However, it doesn’t work when interest rates rise, property prices fall and people lose their employment without insurance in place.

Billions of pounds-worth of this kind of mortgage ‘asset’ is sold and traded around the globe. Some of the originators of this debt have defaulted on their mortgage payments so the return on the asset has been removed and, to add icing to the cake, many properties have fallen in value, resulting in negative equity. This means that the lenders cannot even repossess the property to recoup some of their loss.

On November 1st 2007 the Federal Reserve injected \$41 billion into the US market following its previous massive cash injection of \$47.25 billion earlier in the year. Both City Group and Merrill Lynch have recorded significant losses over the previous months leading to their CEOs being replaced.

It is not just American lenders who are affected; HSBC has lent \$178 billion to American consumers, of which \$70 billion is unsecured. Barclays has announced £1.3 billion of write-downs related to the sub-prime crisis and its share price fell by 9%. It still has nearly £4 billion of ‘high-grade’ collateralised debt obligations (CDOs), which at the time of writing were trading on the market at a FIFTH of their current value.

How does this affect us as mortgage borrowers in the UK?

Since the crisis began lenders have found it increasingly difficult to borrow money on the open market, as finance providers have been unsure of the lenders’ financial stability. This has led to lending being restricted and borrowers being analysed much more closely to assess their risk. Even now as the dust starts to settle, confidence has been severely shaken and an air of caution remains.

This leads us to Northern Rock. The company operated mainly on a system of buying in wholesale money, repackaging it into mortgage assets and then moving them into the market. Unfortunately it had significant exposure to the American sub-prime crisis and, although it had many potential customers and had innovative products, it proved vulnerable. The problem was that, although it had plenty of customers, it had a liquidity problem brought about by exposure to the American sub-prime market. The emergency loan from the Bank of England is now up to £23 billion and Northern Rock has been nationalised in all but name.

This month has seen the closure of High Street Home Loans with the loss of 60 jobs, GMAC has announced 200 redundancies, The Victoria Mortgage Company and Infinity have closed down and it looks as if Paragon Mortgages is sailing very close to the wind. I fully expect more of the smaller sub-prime

lenders to fall by the wayside as well as the majority of sub-prime packagers.

So, is this a bad thing? Obviously it is if you are one of potentially thousands of people whose job or business is affected by this problem. Leaving this aside, however, it is common sense that people who have not maintained their commitments in the past and who are on low or very volatile incomes are a higher risk for lenders. These people should rightly be regarded as higher risk, both by the professionals who arrange these mortgages and the people who actually provide the money.

A year ago it was possible to provide a client only recently discharged from bankruptcy with a 95% Self-Certification Sub-Prime mortgage at an interest rate only half a percent higher than a full status prime client. This evidently does not accurately reflect the difference in the risk profile between the two types of client. Most sub-prime loans are now somewhere between 75–85% loan-to-value and are priced up to 1.5% above the mainstream market: this should prevent clients from either going into negative equity or overstretching themselves. This is one of the few positive effects of the credit crunch.

The crisis will hopefully cause some lenders to change their strategy away from destroying value at the expense of market share. There is no doubt that things were getting out of

hand with lenders offering crazy deals with low interest rates and huge arrangement fees. This tactic of constantly pursuing better growth figures for the board and shareholders, rather than spending money on new technology and creating products that people wanted to buy, has resulted in

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this short-term outlook. Lenders will now hopefully concentrate on looking after an existing loyal client base.

Before Christmas there was an unexpected quarter of a percent drop in the Bank of England’s interest rate. A quarter of a percent will not make a huge difference to most people’s mortgage payments but it does send out an important message: that things may improve. Rate rises were implemented primarily to bring down inflation and secondly to take the heat out of the housing market; inflation is still not under control, with oil prices rocketing and the price of food going up, but house prices across the country have fallen over the past two months. The Bank of England is obviously worried that this slowdown may lead to a recession, so this small drop in interest rates creates hope that house prices will stabilise and that a recession

may be averted. Experts predict one or maybe two further reductions in 2008 with some even predicting a rate of 5% by the end of 2008.

In conclusion, the mortgage market in the UK is undergoing serious changes, just as all markets do at various points in their histories.

However, I think we will emerge from the credit crisis leaner and meaner and there will be a return to more responsible lending and in smaller volumes. The UK housing market is still very strong and is supported by a lack of supply and strength of demand.

Overseas mortgage markets have been largely unaffected by the ‘credit crunch’ as they are normally low loan-to-value products that are bought by high net worth or prime clients. It is virtually impossible to get an overseas mortgage with a bad credit history and you normally have to prove your income. Of course, this is not the case in America, where lenders are still apprehensive and the market is yet to settle – although there are still good products out there.

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