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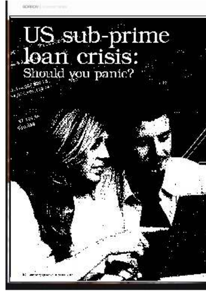

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US sub-prime loan crisis:

Should you panic?

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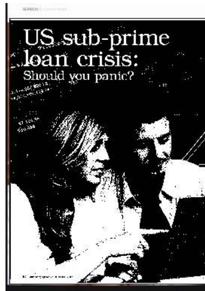

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The recent volatility in the global stock markets fuelled by the fallout of the US sub-prime lending sector has made many Aussie investors and homeowners nervous. But as *Nick Yates* reports, the future is not as gloomy as doomsayers are predicting

The sub-prime mortgage crisis in the US shouldn't cripple Aussie homeowners, as some doom-mongers are predicting, although homeowners should be prepared for more expensive home loans across the board.

Many institutions have been burnt with heavy losses because they put money into high-risk, high-yielding investment vehicles, such as hedge funds, that created returns by providing capital to US lenders who have behaved irresponsibly.

The resultant freeze on credit in the American capital markets has meant that Australian lenders are having difficulty financing their loans with the cheap money they were able to access before the crisis, and now have to increase the interest rates on home loans to cover the extra cost.

What exactly happened in the US?

These irresponsible lenders were selling loans to sub-prime (credit-impaired) borrowers at a high interest rate, but assessing them for affordability on a much lower rate.

Peter Hall, CEO of mortgage insurer Genworth, says the incorrect use of adjustable (variable) rate mortgages (ARMs) is to blame.

"With the ARM loan, the sub-prime lender offers a discount or honeymoon period below the standard variable rate for a limited period of time – maybe a year. The loan is priced at an interest rate of, say, 9–10% because of their credit rating, but the borrower is given an initial rate of maybe 5%. They're also assessed for their ability to meet repayments at 5%. When the rate reverts to the higher level after a year it becomes unaffordable and the borrower defaults."

Hall says Australian credit-impaired lenders are much more responsible and don't make such short-sighted decisions; therefore, the same crisis is unlikely to occur here.

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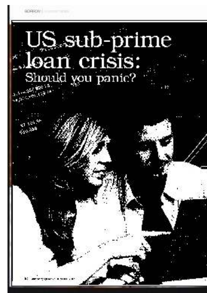

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How will Australians be affected?

The real issue concerns Australian non-bank lenders who sourced a high proportion of their funds from investors via securitisation (issuing bonds) and with short-term debt in the US commercial paper market.

Lenders such as RAMS Home Loans have raised money in the US market in this way to fund Australian home loans. These investors and debt providers, who initially supplied funds with few questions asked, at a cheap rate, have been spooked by the problems in the US housing market and are freezing the flow of capital, or else asking for a much higher return. This means that Australian borrowers will be asked to pay higher interest rates on their loans, to fund the higher cost of credit.

RAMS recently tried to secure credit of A$6bn in short-term debt from the US market in order to fund its home loans and was rejected by a nervous market.

Peter James, CEO of Mortgage Ezy, believes the days of ultra-cheap finance are over, but that the future is nowhere near as bad as predicted, saying a rise in borrower interest rates of 0.25% is significantly over-exaggerated.

"It's going to be a temporary problem; however, I do believe that the cost of funding has to rise. As with anything of a cyclical nature, we had a really good thing, but there was no margin for error, no margin for the adverse situation that naturally occurred," says James. "The appetite for residential mortgage-backed securities (RMBS) bond issues has been high and the cost of securitising has been decreasing year-on-year, especially during the last 24 months."

What if you have a loan with a bank?

Banks are less affected than non-banks because they have a deposit base which they use to fund home loans, plus they have access to more areas of the capital and debt markets than the non-bank lenders. This means they are more easily able to get the funding they need at the prices they want and so don't have extra cost to pass on to you – the homeowner – in the form of rate rises.

However, banks may still increase rates, because they have been discounting their products so heavily, to compete with non-bank lenders such as RAMS, that their profit margins are very thin. If companies like RAMS are forced to increase rates, it gives the banks an opportunity to increase theirs (by a lesser amount) and still remain competitive, while earning more profits.

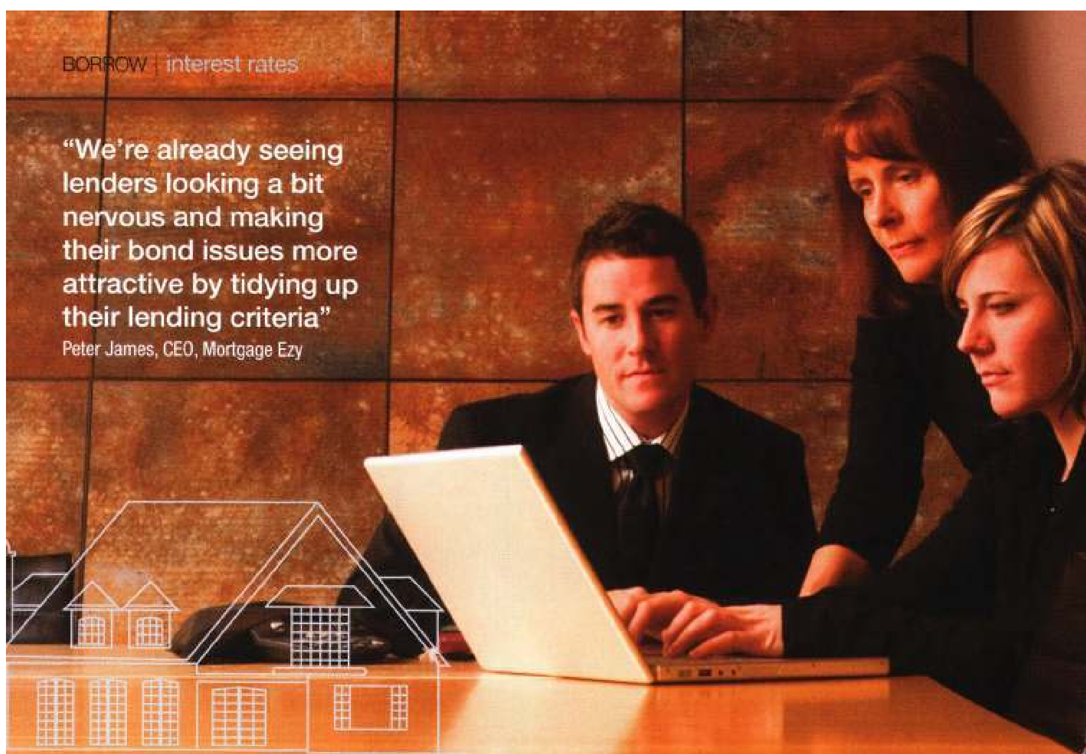
Glenn Baker, chief investment officer, ING DIRECT, says: "Banks have a deposit base for a start. They also have other parts of the capital markets to go to. That could be the medium-term note market, bank bill market or certificate of deposit market.

"They sell those debt instruments into the market based on their bank rating. The investors are buying bank risk directly, as opposed to a mortgage-backed security that might include low-doc or no-doc loans and where everything depends on the borrower making repayments, to get your money back. Currently, all forms of debt are being priced at a higher spread (cost), but the banks are less affected."

Baker adds that individual banks would need to decide whether to hold prices and grow market share or increase interest rates on loans to build profit margins up from the current low level: "A bank like ours is keen to grow our mortgage business and we want to stay as competitive as possible, but if the cost of money is higher, that may need to be reflected in the loan marketplace."

Non-banks and the credit-impaired

Some reports suggest that the banks will attempt to take advantage of



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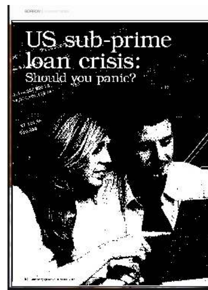

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the crisis for the non-bank lenders by promoting themselves as a safe alternative for borrowers.

One thing that's likely to change is the ease with which credit-impaired borrowers can access debt. "We're already seeing lenders looking a bit nervous and making their bond issues more attractive by tidying up their lending criteria. That's a good thing; people shouldn't take a loan if it means they'll have to sell their property in a fire sale down the track," says James.

Firms like Wizard Home Loans have aggressively defended themselves against claims that all non-bank lenders will suffer, pointing out that they're owned and funded by AAA-rated giant General Electric and therefore have no need to securitise, while also only operating in the prime lending sector. GE Money in Australia does, however, own a securitisation vehicle in Australian Mortgage Securities (AMS) so there is some exposure.

What about interest rates?

Economists are being cagey about making predictions about interest rates, following this global credit crisis, but the general consensus seems to be that recent events may make another rate rise less likely. The Reserve Bank will wait to see what the fallout from this is before making any more moves up or down. This could be seen as good news for homeowners, as there was a possibility of another quarter percentage point rise this year, or certainly early next year if inflation didn't fall as required.

Paul Braddick, head of financial systems analysis, ANZ Bank, says it's still an open question as to whether higher mortgage rates at the banks will affect inflation and translate into a drop in the cash rate.

Shane Oliver, head of investment strategy and chief economist, AMP Capital Investors, says rates may be cut as a consequence of the sub-prime crisis.

"Our assessment remains that the current problems in financial markets and the risks they pose to the Australian economic outlook – via an increase in the cost of credit locally and a reduction in its supply and the impact on the US economy – are likely to see interest rates remain on hold for the rest of this year, with a rising possibility that they may have to be cut," says Oliver.

The Commonwealth Bank made a more conservative statement in a recent economic roundup.

It said: "We believe that there is a good chance that the Fed [Federal Reserve Bank] will cut US rates. But we see any cuts by the Fed as 'insurance' against market turmoil spreading further. Beyond the housing market, the US economy is in good shape. The turmoil may delay further increases in official rates in Australia, Europe and the UK, but economic strength and inflation risks in these economies remain, at least until there are clear signs of current financial market volatility inducing slower growth and lower inflation risks in the real economy."

Knee-jerk reaction?

The good news is that talk of a huge rise in loan rates for the Aussie public should be little more than a knee-jerk reaction. This means that once the investors understand that the nature of the Australian lending environment is unlike that in the US and see its culture of credit responsibility, they should relax their controls and increase the flow of credit again, taking the pressure off companies like RAMS Home Loans to increase interest rates on their loans.

The freeze on credit across the globe has been described as a 'virus of doubt' by some analysts, caused by the failure of credit markets to price risk. In other words, they were providing money to companies like RAMS far too cheaply for the risks associated with home loans.

James believes that investors are freezing liquidity until they can assess the scope of the fallout from the sub-prime market, but will come back albeit with a more conservative approach.

"If you're doing an issue at the moment (as a lender), you should shelve it. It doesn't matter what you pay for it, nobody wants to buy it. When people have assessed the risk, there'll be an appetite going forward but not at the margins that have sufficed in the past. They want a premium. We were living in a fantasy land before when there was no margin," says James.

The global outlook

The global reaction to the sub-prime problem is that it is an isolated case and shouldn't affect the ability of bond issuers to find buyers willing to invest in, or provide credit to, a responsible lender, therefore keeping costs to borrowers down.

This philosophy is backed up by international credit-risk agency Standard and Poor's, which says: "Lessons from the past 20 years make it clear that instability in one market can quickly spread to others and do so in unpredictable and alarming ways. These same lessons, however, also demonstrate that modern markets adjust rapidly to crises and tend to limit the damage before uncontrollable systemic disruption takes hold.

"The global markets have grown such that they're now less vulnerable to general liquidity scares triggered by isolated disruptions." ☗

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