

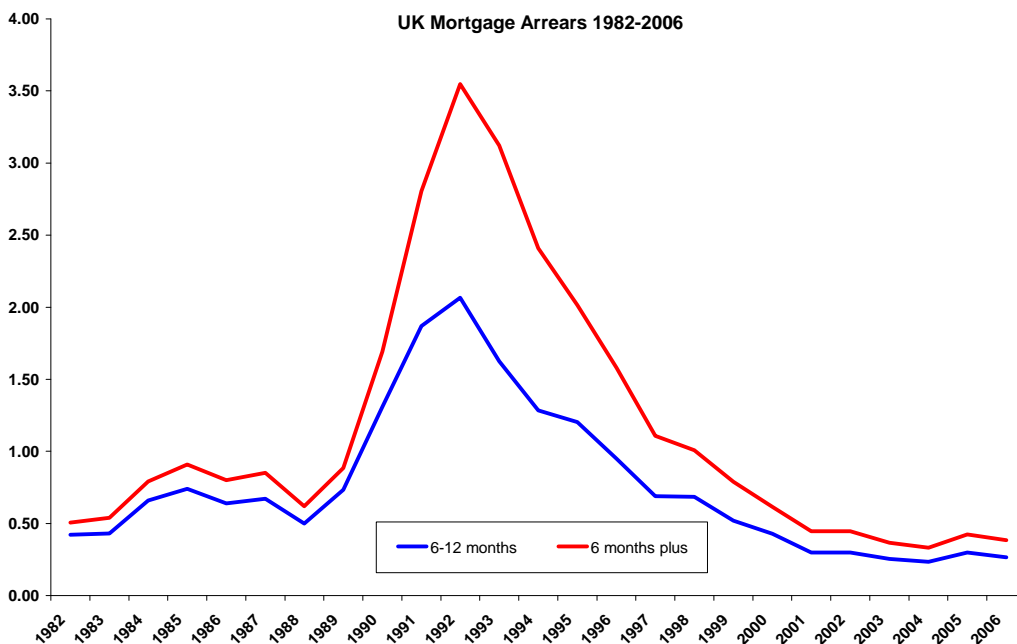
## Lending Strategy – 01 April 2007

### Why lenders should look deeper into the published arrears and possessions data?

By Gary Styles Strategy, Risk and Economics Director Hometrack

Recent mortgage arrears and possession figures have given confidence to many lenders and commentators that the underlying asset quality position remains broadly steady. Mortgage arrears over three months have fallen from 0.97% of all mortgages at the end of 2005 to 0.89% at the end of last year. Similarly on a Basel II definition of six months plus the overall percentage has fallen from 0.42% to 0.38% over the same period.

The chart below shows the performance of arrears between 1982 and 2006 with the distinctive peak in the early 1990's. The deteriorating economic conditions of the late 1980's were very slow to feed through to arrears and there is strong evidence that this effect will be more pronounced in the next economic downturn.



Borrowers struggling to meet mortgage payments can conceal their problems for many months or possibly years by choosing to fall behind on other credit payments or household bills while maintaining their mortgage payments. In addition in the current market, borrowers have far more choice as to how they manage their finances and have much greater access to more flexible mortgage lenders who are keen to provide a service to customers with credit problems. These borrowers can refinance or consolidate existing debt and continue without any real deterioration in overall arrears. The absence of this essential mortgage tier in the market would inevitably lead to substantially higher arrears than shown in the aggregated figures. For this reason direct comparison with the developments in the late 1980s should be treated with extreme care made worse by the complete absence of mortgage tax relief and the lack of mortgage payment insurance today.

Many of the credit problems the UK face are well concealed but there are plenty of signs of deterioration if you are only willing to look a little closer. The number of water customers receiving warning letters about non-payment reached 8.3 million last year - a rise of 40% on 2005. The number of County Court Judgements ordering the repayment of outstanding debt rose by over 18% in 2006. Personal insolvencies and Individual Voluntary Arrangements (IVAs) grew at a rate of over 50% and 100% respectively last year.

The FSA has made very clear in recent months that it would like lenders to take a close look at their stress testing (scenario planning) and ensure that they are able to cope with any significant downturn and the corresponding deterioration in arrears and defaults. - see below.

## Recent Statements from the FSA on Scenarios

**“Stress Testing and scenario analysis enable firms to assess and mitigate risks that face them. It is important firms use this period of relative stability to identify risks that could arise in less benign times. Our work shows that many firms still need to do more work to develop their stress testing and to use more challenging scenarios”**

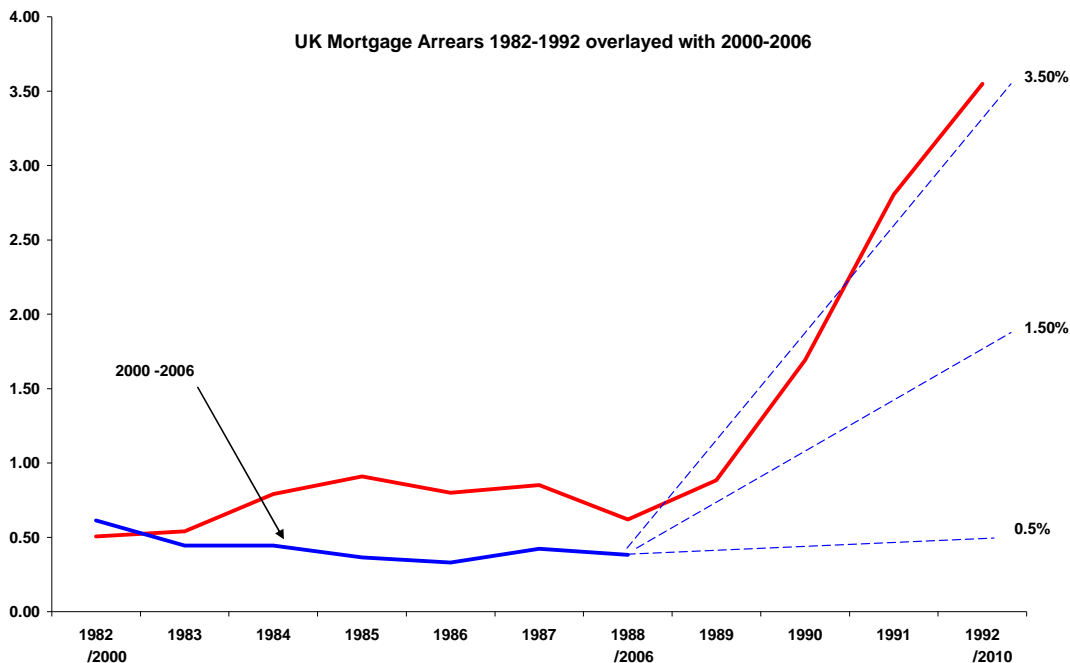
**“ The range and magnitude of significant downside risks appear to be growing, and there is an increasing risk that the operating environment could become more demanding for firms and consumers”**

**“ Some firms could be underestimating the probability of severe events. Firms should not overestimate their ability to take action in an effective and timely manner”**

FSA – January 2007

## So what is a sensible arrears assumption or scenario for lenders to use?

This is of course a difficult problem made worse by the changing behaviours and features of the mortgage market. However, the chart below shows the path of arrears between 1982 and 1992 (in red) combined with an overlay of the recent performance until 2006 (in blue).



As you can see between 1982 and 1988 six month plus arrears moved in a relatively tight range and it was not until 1990 that serious arrears really started to pick up and then by 1992 arrears had risen 6 fold in four years. The speed and size of this deterioration caught most lenders unprepared and they struggled to manage the situation from a credit and operational perspective. This management challenge of dealing with a 6 fold increase in arrears is immense and as the FSA has highlighted, lenders should not overestimate their ability to take action.

If we look at the performance of arrears from 2000 and 2006 shown by the blue line we can see arrears have moved in a very narrow range of 0.4-0.6%. However, the underlying position may well have deteriorated far more than we think given all the reasons explained above. A relatively small economic or market shock could have a very pronounced impact on arrears over the next 3-4 years. Many lenders will be planning on the continuation of the status quo and assume serious arrears will hover around 0.4-0.5% of all mortgages.

The stress test recommended by the FSA is to look at a return to the conditions of 1991/92 and the corresponding 7 fold increase from current levels. If we were to see arrears rise to 3.5% this would mean over 400,000 households would have serious arrears compared to 45,000 today. A more sensible planning assumption is to consider a rise to say around 1.5% over the next 4 years perhaps caused by a wider global slump combined with a withdrawal of some mortgage lending from the bottom end of the market. If arrears reach 1.5% this would result in around 175,000 households with serious arrears and the possibility of a very large rise in possessions.

Forecasting based on recent performance and a continuation to the status quo is always dangerous. Stepping back and revisiting the conventional assumptions must make sense given the growing downside risks facing the conventional view of the market.