

Lending Strategy – September 2008

Is it time for a new mortgage lending model?

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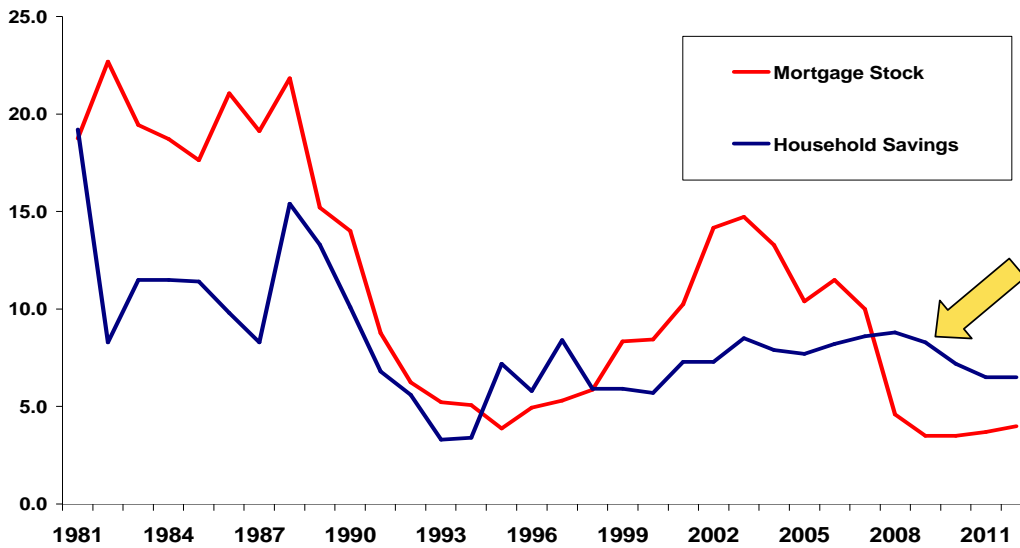
Lenders face one of the most uncertain and challenging economic environments in over 30 years. Global inflationary pressures from higher oil and food prices combined with rapidly declining confidence are pushing the UK economy towards a sharper economic downturn.

The slowdown in the mortgage market so far has been largely driven by an expectation of lower house prices and limited availability of funds to higher risk borrowers. We are now moving into a more serious and perhaps dangerous phase as the underlying economy also starts to deteriorate.

The GDP output data for the second quarter showed insipid growth of only 0.2% in the quarter compared to recent increase of 0.6-0.7% a quarter. If this wider economic slowdown is combined with a general expectation of lower house prices and higher unemployment, lenders will need to be far more innovative in making their credit and lending decisions.

As we all know rising house prices and relatively low interest rates can help disguise inappropriate or perhaps over optimistic lending and credit decisions. A period of falling house prices will quickly reveal these mistakes and this can be compounded further if accompanied by higher credit interest rates. The speed of the current adjustment in house prices has been much quicker than in the early 1990's – largely due to a dramatic change in house price expectations and lenders choosing to limit their asset growth in an attempt to limit funding difficulties.

The chart below shows how quickly the growth in mortgage balances has occurred slowing from 15% in 2003 to less than 9% in June and looks set to ease to under 4% in 2009. This has been combined with a rapid pick up in household savings growth as lenders have fallen over each other to offer very aggressive fixed rate savings deals at 6-7% to help reduce reliance on wholesale funding and to build liquidity.



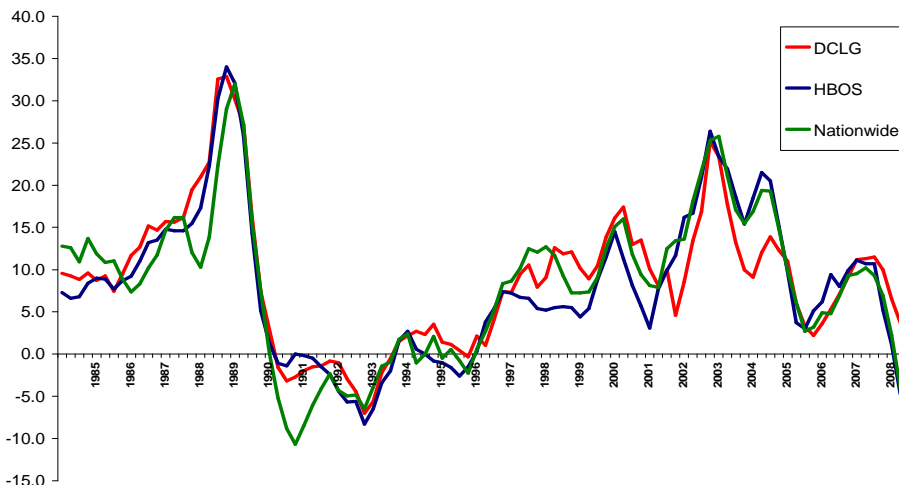
Source : Bank of England / ONS / Hometrack

The total mortgage lending data has been more mixed. Although house purchase mortgage approvals are currently 44% lower year on year, total approvals including remortgages are only around 24% down over the same period.

Limiting asset growth (mainly lending) combined with an increased emphasis on retail savings is only a short term solution to the current difficulties- hibernation is not sustainable answer. Existing cost structures could not be maintained using this approach and this will inevitably lead to more consolidation and cost reduction strategies across the industry. After all, if all you can deliver is 4% asset growth funded from existing retail customers surely a bigger more cost effective and higher rated bank can deliver much better value for customers.

The time has come for lenders to take a very close look at their lending and growth strategies for the medium term and not just focus on the safety of matching peers in the short-term.

Many lenders are soon to find out that not all 90% LTV loans are of equal risk even though their internal rating systems may treat them as equal.



Source : HBOS, Nationwide and DCLG.

In addition, assuming prime lending is safe while specialist lending is higher risk is far too simplistic. The time has come for lenders to maximise the use of the information and data they have to make lending decisions for the medium term and not just to meet short-term sales and marketing targets. Smart lending decisions based on full information on asset type and style, borrower total indebtedness, borrower occupation, flood and fraud risks are the future. Lenders need to invest now to ensure they are not left behind by well funded global players who see the attraction of the UK market in the medium term after the current house price adjustment has run its course.