

Your mortgage and the markets

- why you pay the mortgage rate you do

The mortgage market has changed enormously during the downturn, reverting back to the familiar pattern of the last 50 years where first-time buyers invariably had to build their deposits before getting on to the property ladder and buyers with larger deposits got the premium deals.

As property prices across the UK have fallen, and aggressive competition has combined with the Bank of England's other initiatives to drive down high street interest rates, mortgage analysts have also found that many of the economic indicators which have recently governed the cost of mortgages no longer apply. For example, in the recent era of easy credit (which is roughly the decade up to the credit crunch of autumn 2007) mortgage deals closely tracked the Bank of England base rate or the wholesale market rate indicated by LIBOR (the London Inter Bank Offered Rate). Now the margins between these indicators and high street mortgage rates have widened substantially.

Some commentators have taken the lower LIBOR and lower Bank of England base rates to mean that banks are borrowing at a cheaper rate than ever before and not passing on the benefit to their customers. This analysis is wrong in both respects. What is true though is that the era of easy credit is over. A brief look at the rates the banks are offering to savers is a much better guide to the cost of funding mortgages. Nor are the banks profiteering: when they published their half-year results in August of this year, they showed that most profits were coming from investment banking activities and not from high street banking. The banks' options to source funds and the price of those funds are currently much more constrained than in the past.

In short, the banks' options to source funds are currently much more constrained and the cost of finance to the banking industry has been increasing:

- The wholesale borrowing benchmark (LIBOR) reflects the rates of the major creditworthy lenders. However some lenders will face much higher rates to reflect the increased risks that they face. Nor do LIBOR rates indicate the amount of money that is available in the wholesale market.
- Where banks borrow money from savers, they do so at rates two to three per cent higher than the Bank of England base rate (currently standing at 0.5 per cent). Banks are competing for savers' funds, pushing the cost of this funding even higher as they offer more attractive rates.
- While banks will still fund themselves using a mix of wholesale money and deposits, they are now required to finance themselves more from deposits and less from the wholesale market. As such the wholesale market rate is less important than the rates banks pay to savers when deciding, for example, on the pricing for a mortgage.
- The securitisation market, which enabled banks to convert parts of their mortgage book into attractive financial products for big investors, so providing more cash for new mortgages, has all but dried up. This is due to the knock-on uncertainty about their exposure to US subprime mortgages. The US subprime problem was one of the root causes of the worldwide credit crunch.

- British banks are now required to hold more than twice the capital than the international standards require and twice what they were holding before the credit crunch. Therefore this money cannot be used to support new lending to home buyers and to businesses.
- In the recession more people are defaulting on their mortgage payments so the lending risk has gone up.
- And the financial stability package arranged by the Government last autumn has to be paid for.

It should be remembered however that for most people mortgages from banks are cheaper than they have been for some time: the vast majority on base rate trackers and standard variable rates (SVRs) have seen their monthly payments slashed. Only those on long term fixed-rate mortgages have not yet seen similar falls, but may look forward to doing so if they are re-fixing anytime soon, or simply planning to move to their lenders' SVRs.

How the cost of your mortgage is set

The Official Bank Rate

The Official Bank Rate (to give the Bank of England base rate its proper name) has served as a peg for some mortgage loans during the past decade (those on standard variable or tracker rates). Although the Bank of England will always state that the full effects of a rate change take more than a year to feed into the economy, the habit of expectation has grown in recent years that a cut in the official bank rate will be followed immediately by a fall in the cost of mortgage offers.

Nobody borrows money for free. Nor does anybody borrow it at the current Bank of England base rate of 0.5 per cent. Borrowing from the Bank of England is normally conducted at the base rate plus another one per cent or more, depending on how the Bank of England sees the risk it is assuming.

Banks only borrow from the Bank of England in specific circumstances. Banks are more likely to borrow money from other banks in the wholesale market – which brings us to LIBOR.

LIBOR

LIBOR is the world's most widely used benchmark rate for short term interest rates on unsecured cash. It is sometimes referred to as the rate of interest at which banks borrow funds from each other but this is misleading on two counts: pension funds, investment funds, hedge funds and more also contribute to the money markets; and banks are seeking principally to lend to their customers rather than to each other.

BBA LIBOR (to give its full name) is owned by the British Bankers' Association but is compiled independently on our behalf by ThomsonReuters and governed by an independent committee. Although LIBOR rates are influenced by changes in central bank interest rates, they are a reflection of overall market conditions at a given time: in contrast the Official Bank Rate targets an inflation rate two years away.

Not all those banks and other institutions who borrow money for the wholesale market can do so at rates close to the LIBOR benchmark. The major banks which contribute to the benchmark are the largest and least risky. Smaller institutions may well be perceived as having a higher risk and so the cost of their borrowing is commensurately higher.

When banks need to fund longer terms (such as the two- or five-year fixed rate mortgages, for instance) they need to pay an additional premium above LIBOR.

Savers' funds and wholesale funds

Banks have always funded their lending from a mix of retail deposits (placed by individuals and companies) and wholesale funds. Retail deposits on their own can never fund all of a bank's lending, either because they are not available in the same quantity or they mature at the wrong time. Imagine a mortgage of £100,000 for 10 years: if average savings deposits were £5,000 and were held on average for five years, you would need 40 such accounts to be able to provide that single mortgage over its lifetime – and that's before adding in the cost of providing the associated banking infrastructure or the risk of a customer defaulting and not paying back the mortgage.

Raising funds from savers is considerably more expensive than raising them in the wholesale market: currently the difference might be two per cent or more. Competition for savers' funds is obliging the banks to offer ever better deals for savers, pushing up the cost even further.

Securitisation

Before the credit crunch, banks could also generate funds by creating financial instruments which they could sell as securities to institutional investors (such as pension funds and hedge funds). These instruments included bonds and other securities backed by the steady income stream from mortgages (hence the so-called asset-backed securities).

When the credit crunch hit, investment activity slumped. Investors shied away from asset-backed securities that had uncertain or much-reduced intrinsic market value. And the credit ratings of banks fell, affecting the price of these securities where they were available. The securitisation market – a major source of mortgage funds for banks – effectively closed.

Where we are now

Banks' credit ratings are stabilising thanks to increases in the amount of capital they hold, greater confidence that losses have been disclosed and, in a few cases, direct intervention by governments. The cost of short-term money in the wholesale markets has steadily fallen since governments worldwide acted in concert to support the banking system in October 2008. But new regulatory requirements for lenders are now in place, obliging them to better match their funding maturities to their lending maturities – in other words they cannot use short-term money to fund long-term lending - and longer-term borrowing remains considerably more expensive than the usually quoted three-month LIBOR rate.

Summary

In a recession money is harder to come by for banks as well as for customers. As the lessons of the credit crunch are absorbed, banks must strengthen safeguards against future downturns and their impacts. They continue to lend to responsible borrowers: banks currently approve four in five mortgage applications, a ratio that has remained steady for the past decade. However no lender can offer the unsustainable rates of the easy-credit era.

There will continue to be a significant difference between official or market rates and high street mortgage rates for the foreseeable future. The simple fact is that your mortgage rate is reflecting the banks' increased costs in obtaining appropriate funds, more than any other factor.

Further reading

BBA Bank Fact: *Your mortgage and LIBOR*

http://www.bba.org.uk/content/1/c6/01/49/45/LIBOR_mortgages_BankFact.pdf

Monetary Policy at Low Interest Rates (extract from the Bank of England's Inflation Report, February 2009):

http://www.bankofengland.co.uk/monetarypolicy/pdf/irfeb09_box.pdf

BBA LIBOR website:

<http://www.bbalibor.com>

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