



Mind the Gap

It goes without saying that the past 2 years or so have been the most tumultuous in the financial markets since the 1930's. An interesting side effect is the current significant gap between the official UK Base Rate and the rate at which bank customers are able to borrow money.

For several years the margin that was applied to borrowing by banks was very slim. Historically, you could apply for a 25 year mortgage with a Loan To Value ratio of between 80 - 90% and could reasonably expect to be charged an interest rate of Base Rate plus 1%. Credit was freely available and banks could borrow money cheaply in the wholesale money markets. However, with the benefit of hindsight, it is clear that credit risks were mis-priced.

As we now understand, the competition between banks to provide cheap credit was a cause of the credit bubble. Eventually, like all bubbles, this one also burst.

The repercussions are well documented and there were a couple of events that stand out as turning points. The first was the demise of the financial giant Bear Stearns. Generally, the financial markets took this in their stride but a new awareness of risk was obvious. This was highlighted by an increase in the cost of borrowing and the London Interbank Offered Rate (LIBOR - the market benchmark for interest rates) rose dramatically.

The second significant event was the collapse of Lehman Brothers in September 2008, following which the financial markets became even more distressed. Lending in the wholesale money markets froze as banks became afraid to lend to one another. This was the credit bubble bursting.

With the collapse of credit came a downturn in consumer confidence. Lower profits forced businesses into cost saving measures with employees paying the ultimate price and suffering redundancy. With fewer people in employment, consumer spending slowed further and drove the global economy into recession. Until, that is, the world's governments started pumping billions into the financial system.

Major countries embarked on Quantitative Easing (QE) programmes. The theory was that if enough money was available the banks would start lending again, thereby freeing

up the credit markets. If credit was more easily available, then the consumer would start spending again.

The theory sounds great. However, during the past 12 months bank balance sheets have generally been eroded due to continuing credit write downs and are now in need of repair. One way of doing this is to increase lending margins.

This is only part of the story and a report published recently by the International Monetary Fund highlighted that the lending capacity of the banks in the US, UK and Eurozone will shrink further in 2010. The reason for this is two-fold. Firstly, it wasn't just the balance sheets of the banks that suffered. Household balance sheets are also being repaired with individuals preferring to pay off existing debt rather than increasing it. Secondly, much tougher capital requirements will be levied against the banks by the authorities in an attempt to prevent this situation from happening again.

Ultimately a global economy built on debt has proved to be unsustainable. Lending has been re-priced and even with official Base Rates at an all time low of 0.5%, customers are not likely to see the full benefit. In short, this price gap is here to stay, not just for mortgages but for any type of credit. The era of cheap money has come to an end and it may not be such a bad thing.

MeesPierson (C.I.) Limited is proud of its prudent lending policies and would be delighted to discuss your mortgage requirements. Our experienced credit team will be happy to illustrate our highly competitive mortgage packages.

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