

## The financial crisis

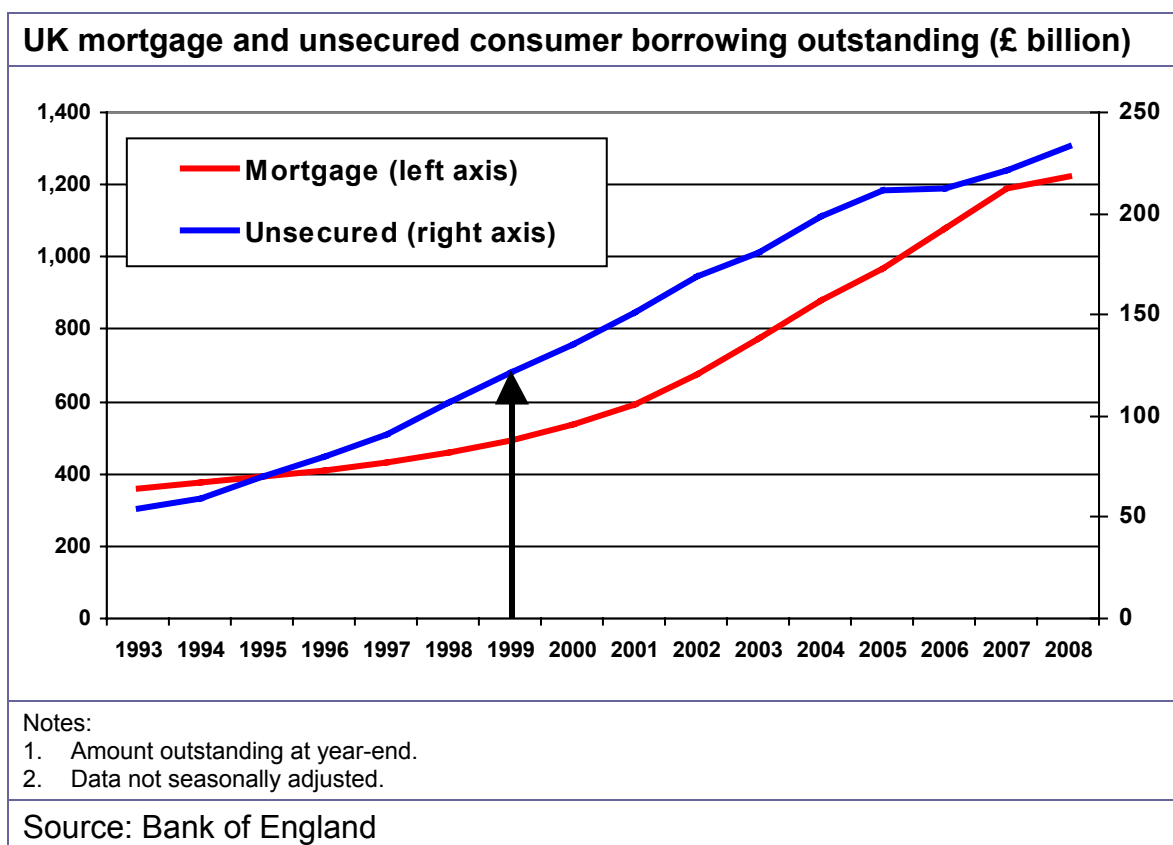
### Clouds on the horizon – an update

The financial crisis has caught almost everyone unaware with its speed and severity. But there were some warnings signs of problems ahead, not least in the implications for credit quality of the rapid growth in consumer borrowing.

Amid the complex mix of factors that lie behind the financial crisis, one particularly important factor in both the US and UK has been the high levels of consumer borrowing.

The US represents the extreme, both in the scale of sub-prime borrowing and in the extent to which the risks of that borrowing were obscured through its re-packaging as complex securities.

In the UK, there was less sub-prime borrowing and less re-packaging of consumer loans in the form of complex securities (though securitisation was a key source of funding for Northern Rock in particular and some UK banks invested in the securities backed by US consumer loans). Nonetheless, on some measures, in the years ahead of the crisis consumer borrowing grew even more quickly in the UK than in the US. And the problems arising from this rapid growth in consumer borrowing are a significant contributor to the UK's experience of the crisis.



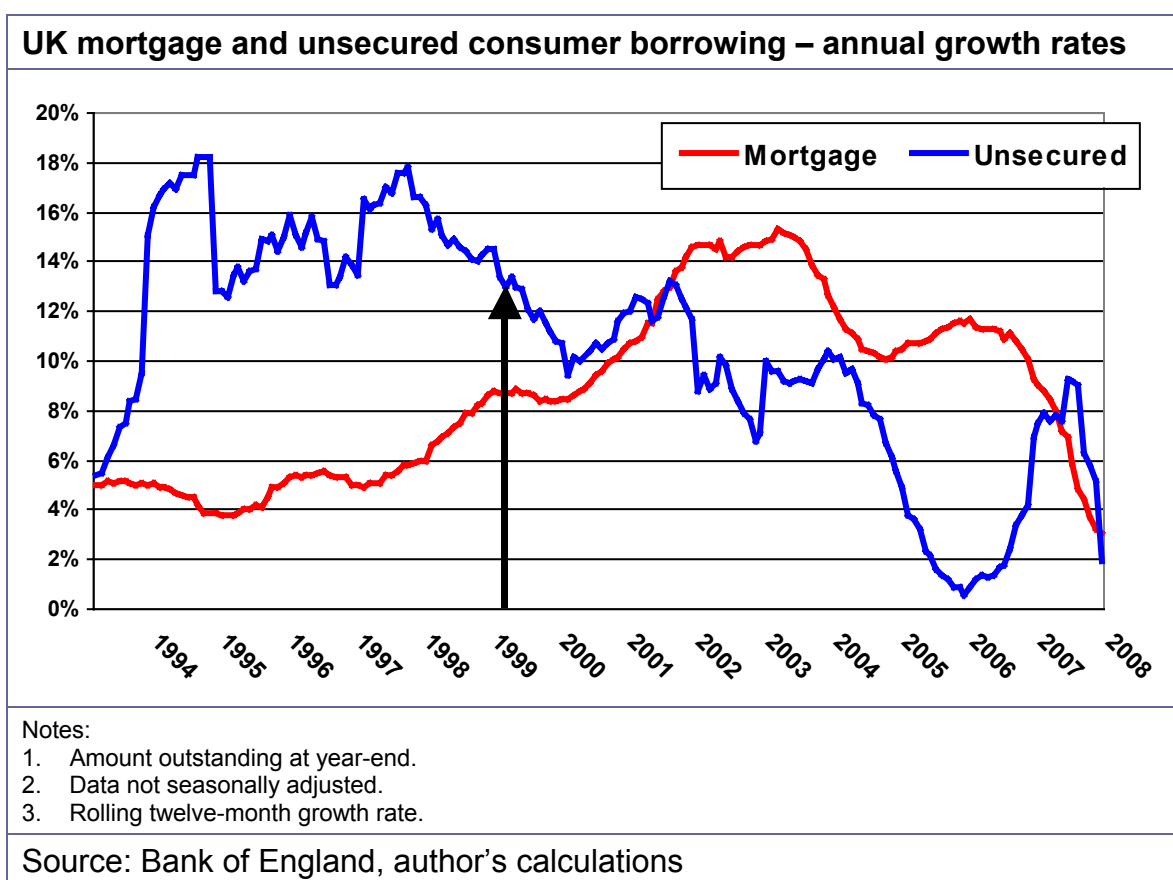
Sorting through some old files recently, I stumbled across a short article entitled *Clouds on the Horizon?* that I wrote for a UK trade journal in late 1999. The article, reproduced at the end of this bulletin, warns of the dangers from the rapid growth in consumer borrowing.

Re-reading the article, what strikes me (apart from its woeful timing) is not that it was particularly prophetic. The real lesson is that much of what it said is so glaringly obvious. And yet many banks (and non-bank finance companies) seemed oblivious to, or unconvinced of the risks. Their lending

to consumers continued to grow rapidly, with outstanding loans in 1999 now looking distinctly modest compared with the levels reached by 2006-07.

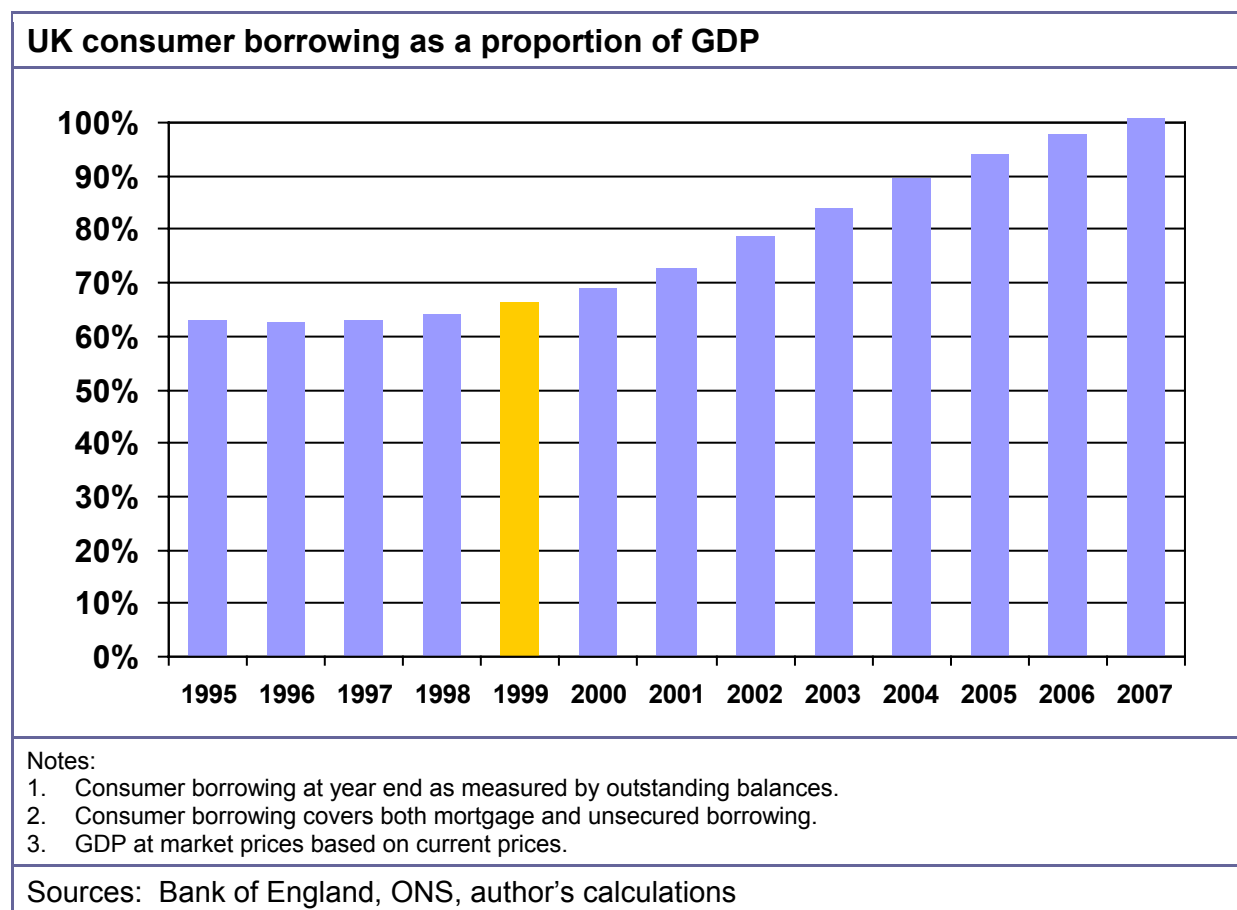
At end 1999, outstanding mortgage borrowing in the UK was just under £500bn while outstanding unsecured borrowing (consumer credit: credit cards, personal loans, overdrafts, etc) was approximately £120bn. During 2008, outstanding mortgage borrowing passed £1.2 trillion while outstanding unsecured borrowing passed £230bn.

As the 1999 article pointed out, the consumer credit market (as measured by outstanding loans) had already enjoyed five years of annual growth averaging around 15%. It continued to grow strongly over the following five years, if at a slightly lower annual rate but from what was by then a much larger base. And, as the 1999 article noted, the growth in mortgage borrowing started to accelerate during 1999. The acceleration continued in the following years, with annual growth in mortgage balances reaching 15% during 2003.



To put this growth in personal sector leverage in perspective, on a rough calculation year-end mortgage and unsecured consumer borrowing rose from approximately 66% of UK GDP in 1999 to just over 100% by 2007. Growth at this rate will almost inevitably lead to a deterioration in credit quality, whatever lenders were claiming about the quality of their risk assessment processes, then low mortgage arrears and the “fundamentals” supporting rising house prices.

Indeed, lenders ought to have anticipated the risk of problems with their mortgage books by reflecting on the sharp deterioration in unsecured loan credit quality that pre-dated the crisis. Arrears and defaults on unsecured loans first rose sharply during 2005, well before the events of 2007 and subsequent economic downturn. Bank of England statistics show that bank write-offs on credit cards and other unsecured loans to individuals jumped from £3.9 billion in 2004 to almost £5.8 billion in 2005. The jump in consumer loan write-offs, even without the prompt of an economic downturn, provided clear evidence that some UK households had over-borrowed.



Despite this, many mortgage lenders seemed oblivious to the risks, somehow convinced that house prices would remain at high levels and so continue to provide robust collateral. Yet it is now clear that UK house prices peaked in late 2007. Prices fell sharply during 2008 and by year-end were approximately 20% below their peak.

As a result, the loan-to-value (LTV) ratios of many lenders' mortgage books have risen sharply, and the spectre of negative equity re-appeared. For example, by end 2008, over 15% of the combined Lloyds/HBOS mortgage book by value had a LTV ratio of over 100%. While other banks and building societies may be less exposed to negative LTV ratios, Lloyds/HBOS is much the largest UK mortgage lender, with a book of over £350bn and a share of outstanding balances of almost 30% at end 2008.

And even if those borrowers with LTVs of more than 100% can continue to service their mortgages, rising unemployment is bound to push up mortgage arrears. The UK's Council of Mortgage Lenders is forecasting that the number of mortgages three months or more in arrears, having risen sharply during 2008, will more than double between end 2008 and end 2009.

All of which raises a raft of complex issues. These include provisioning policy for loan books where credit quality has deteriorated though losses have yet to materialise, capital adequacy rules for mortgage and other retail loans, and the taxation of residential property gains.

But the more basic point is that some old-fashioned, poor quality lending has been a major contributor to the financial crisis. Much of the focus has been on the risks hidden away in complex corporate and capital market vehicles such as SIVs and CDOs. But from a UK perspective, the risks of the rapid growth in household borrowing were there to see long before the crisis struck. And the boards and senior executives of those banks that lent most aggressively must bear some responsibility for failing to monitor and manage the associated risks more effectively.

## Clouds on the Horizon? Article for Credit Finance - November 1999

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Times are good for the consumer credit industry. The market continues to expand at levels more expected of high growth sectors such as IT. According to the latest Bank of England figures, unsecured lending to individuals grew by more than 13% in the year to September. Though the growth rate has slowed fractionally in recent months, it remains comfortably in the mid-teens.

But might the industry be storing up trouble here? The new business figures may look great, but profitability is dependent on performance during the life of the loan. Lending, like insurance, is an activity where the inherent risks sometimes turn themselves into real costs.

To appreciate the level consumer borrowing has reached, take a closer look at the numbers. The value of consumer credit outstanding has increased by an average 15% a year for the last five years. And a market growing at 15% a year doubles in size every five years. At the end of 1994, outstanding consumer credit in the UK was £56bn. By the end of September this year, it had reached £112bn. That is equivalent to almost 15% of GDP.

The numbers look particularly stark on a per capita basis. Outstandings of £112bn are equivalent to borrowing of some £1,900 for every man, woman and child in the UK. But that of course includes children and the elderly who are not in the market for credit. If we look at the credit active population of working age adults, outstandings are equivalent to a startling £3,100 per person. And that figure makes no allowance for the many people who do not borrow or borrow very little.

So far, with the economy healthy and unemployment falling, there appears to be little sign of trouble. But the pick-up in mortgage borrowing gives reasons for concern. While unsecured lending has grown in the mid-teens in recent years, secured lending has grown at a much more sedate 5-6% a year. But as the housing market picks-up, mortgage lending is accelerating with it. Net mortgage lending in the year to September 1999 already exceeds the figure for the whole of 1998. Mortgage lending in the quarter to September 99 was 57% higher than in the same quarter in 1998.

With interest rates now rising, what might the growth in mortgage borrowing do to household gearing? Indeed, there may be further pressure on household budgets as the fixed rates and discounts on new mortgages begin to expire. This is not to prophesy doom. But cautious lending practices make good business sense in current market conditions. The Chancellor's best friend Prudence may be a useful ally in the months ahead.

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