

## US Credit Crisis:

### A synopsis from PLAN Australian, Australian largest finance aggregator

Over the last couple of weeks I have had many questions on the above but today I would like to talk about the financial markets as its impact is upon us right now. Most of the questions I have received regarding the state of our financial markets ask, "What exactly happened?", and, "How did this happen?" and of course, "What's going to happen?".

I thought it may be useful to pull together and summarise some of the recent commentary on the subject and try and form a view of how we may be affected.

This problem certainly demonstrates how globally intertwined our financial markets and systems are. A problem that originates in the US through unprecedented mortgage defaults creates the collapse of mortgage origination firms and hedge funds and sends global equity markets into free fall. The upshot is that nobody wants to buy debt securities today without bigger risk margins, causing an increase to funding costs for **all** lenders including ours in Australia.

**How did this happen?** It seems that many different but related factors came together to create this disaster. A US property boom which made home ownership difficult was made easier by sub-prime lenders freely extending substantial levels of credit to people who in reality had no capability of repaying the loans.

These people may or may not have had a poor credit history but regardless, did not have capacity to repay the quantum that they borrowed. They were offered loans on low start up interest rates of 1 or 2% pa reverting to a standard rate after a couple of years.

All this was underwritten not at the rate to which the loan reverted; rather it was underwritten based on the reduced honeymoon period rate. Add to that, the loans were typically fixed rate during the honeymoon period so borrowers didn't feel the recent impacts of 16 US interest rate rises taking rates to about 7% pa, when the mortgage reaches the end of its low interest rate start-up period it "resets" at the current prevailing interest rate.

Of course at reset date these people have no way of meeting the new and higher repayment amount. The resets started to occur earlier this year and are continuing still now, in fact they will keep occurring until next year.

Apparently there were some 7 million of these loans written! To magnify this problem further, property prices have started to fall and any equity in these homes are beginning to disappear and in many cases moving into negative equity.

**Why has it affected us** in Australia when we don't have a default problem? Without going into the complexities of the capital markets, global lenders to Australian banks or non-banks have been spooked by the issues in the US and as a consequence are either demanding greater "risk" premiums in the form of higher interest or indeed not lending at all. Essentially in an environment of fear and loss it is easier and safer to park money in cash or government bonds and wait.

This phenomenon is not unique to RAMS or other non-bank lenders as all Australian banks and lenders these days securitise mortgages or raise money as corporate debt from the capital markets. Only about 20% of a bank's funding comes from their retail deposits hence all lending institutions are impacted in some form.

RAMS is an example of a local good quality Australian mortgage business that is in great shape one day and literally the next day has a serious funding problem. RAMS was

funding the majority of their loan book on a short term basis when the markets collapsed and all the investors ran for cover. RAMS now has to replace short term funding along with its new loans with a higher cost source of funds. Investors who have come out of hiding now want a higher margin for the higher perceived risk.

To illustrate this higher cost of funding Macquarie Bank earlier this month finalised the sale of a \$500 million mortgage backed debt issue of which \$485 million of AAA rated paper achieved a margin of 40 basis points or 0.40% over the 30 day swap rate, (being the rate that banks lend and borrow between each other).

Six months ago the same paper was achieving a margin of 16 to 17 basis points. This means that the cost of wholesale funding is up 0.20% to 0.25%. Similarly Westpac issued \$1B of medium term notes the other week at a spread at 0.51% versus 0.11%, the historical levels. Add to that, the 30 day swap rate has increased to 0.4% above the RBA cash rate from 0.12% which means that all mortgages, bank and non-bank, are now another 0.28% higher as well.

The current borrower rates are unsustainable as lenders are losing money.

So why haven't all institutions moved their rates yet? This is an interesting question because if we look at when the Reserve Bank lifts or lowers rates the banks are quick to pass on the interest rate rise or reduction. It is almost like there is an unwritten rule amongst them that when the Reserve Bank moves they all move uniformly and at the same rate.

Under today's situation the same law doesn't seem to apply. We have seen some banks and non-banks move but the 'Big 5' seem to be holding, presumably because each bank is concerned if they are the first to move and the others don't follow they will be competitively disadvantaged and also will be left out there alone to bear the fire of the media and the customer.

**This morning I received an email from the National Bank indicating that the first of the major banks may now be preparing to raise rates. Following is that report.**

**(Andrew Gardner)**

## **Credit crunch means interest rates will rise: NAB CEO**

Tuesday, 23 October 2007

Mike Preston

Banks will have to lift interest rates to compensate for increased costs caused by the international credit crunch, NAB chief executive John Stewart says.

In the strongest statement yet by a senior Australian bank executive on the impact of the credit crunch, Stewart told *The Australian Financial Review* that banks would have to increase the bottom line cash rate by up to 20 basis points, (0.2%)

"The price of credit has gone up and it won't be as cheap for a long time, and at some point that will be passed on," Stewart said.

The international credit crunch has caused lenders on international financial markets to become more risk averse, in turn pushing up the price they charge to lend money to banks.

And the hike is likely to come even if the Reserve Bank of Australia lifts interest rates when it next meets on November 6, Stewart says.

The comments will be seen in the context of the release of tomorrow's consumer price index (CPI) figures, which will be crucial in determining whether the RBA will lift rates when it next meets.

The market predicts that the CPI for the September quarter will come in at around 0.7%. It is thought a result any higher will prompt the RBA to raise rates.

But another factor in the RBA's deliberations will be whether the international credit crunch continues to pose any further risk to the health of the domestic and global economy.

In that context, Stewart's message – that there is more pain to come – could be designed to dampen down expectations of a rate rise in the lead up to tomorrow's CPI data.

### **Comment – Andrew Gardner**

As you will see from the following article written by the Ray White Group and drawn from **ANZ** and Australia's foremost authority on property forecasting, **BIS Shrapnel**, those that are well prepared can expect to enjoy a period of good capital growth and strong rental growth, but only if they have neutralised the effect of short term rate rises.

And, as Peter Hay highlighted at the seminar there are many patches of strong capital growth potential in and around Melbourne. To assist you to hone in on the strongest areas, why not arrange a consultation with Peter, it could be the best 60 minutes you spend this year.

I would be happy to run the ruler over your capacity to cope with any US or RBA induced rate rise and to participate in the **rare event of simultaneous capital and rental growth** in this new property cycle just give Helen a call on 03 9509 8911 to arrange a private consultation with me.

## **VARYING RESULTS AROUND THE COUNTRY**

We are certainly seeing varied results in the property markets of Australia and it would be fair to say that the Gold Coast is enjoying better results than almost anywhere else.

The mortgage belts of Western Sydney would be amongst the worst anywhere in the country, however there are similar pockets throughout Australia. Emerging factors are going to influence how we shape up over the next couple of years.

It was interesting to note that the **ANZ Bank is bullish on housing** based on the current economic fundamentals and, providing the Australian economy remains robust, the housing market will remain tight, given that the labour market is doing well and tax cuts are starting to bite.

ANZ's Ange Montalti is confident about the prospects for recovery in the residential property markets, although he does say that the recovery will be slow and steady rather than a rapid turnaround. He says, "there is a lot of pressure on rentals going forward. The rental story and the price story suggest **the housing market will be quite strong for the next couple of years, at least**".

Research by forecaster **BIS Shrapnel lends weight to the argument** for a slow recovery in residential property investments in 2008. In BIS Shrapnel's report, Residential Property Prospects, 2007 to 2010, which was released in June, property analyst Angie Zigomanis says **Brisbane will show the strongest growth** of capital city property markets. Melbourne, Adelaide and Canberra will show a modest pick-up, in line with wage increases.

Zigomanis says high employment growth will improve household confidence towards residential property investment. He also says that pent up demand for new dwellings will, over the next two years, translate into even tighter rental markets in capital cities. "This will **drive strong rental growth**, which will result in improved yields and will have a flow-through effect on **investor demand for new dwellings** and help to buoy construction levels", Zigomanis says. It is also interesting to note that BIS forecasts a relatively stable environment for interest rates.

## House prices rise except in Sydney

**Date:** October 24, 2007

**Publication:** [Sydney Morning Herald](#) ([subscribe](#))



House prices rose in all capital cities except Sydney in the past year amid favourable economic conditions, a report shows.

Mortgage insurer PMI Mortgage Insurance said its annual PMI Residential Property Overview found **house price growth accelerated in Melbourne**, Brisbane, Adelaide, Hobart and Canberra in fiscal 2006/07.

House prices also rose in Perth and Darwin, but at a much slower pace than in 2006/07.

PMI said prices rose despite two interest rate rises in the period - in August 2006 and November - showing buyer sentiment remained firm amid strong economic conditions and low unemployment.

The report found Sydney to be the only capital city with negative growth during the year, with the median house price declining marginally.

PMI Australia chief executive Ian Graham said the rise in house prices coincided with a pick-up in first home buyer and investor activity.

"Nationally, the number of first home buyers entering the residential market continued to increase over 2006/07, enticed by expanding first home buyer benefits," Mr Graham said.

"Investors have also returned to the market in greater numbers in 2006/07, **as tight vacancy rates accelerated rental growth.**

**"Nevertheless, investor activity overall remains below previous peaks and performance."**

The report said further deterioration of home affordability across all capital cities is expected to have the most influential effect on residential market conditions in 2007/08.

It said affordability would worsen if interest rates were to rise further following the rise in August 2007, with another 25 basis point rate rise widely forecast for the first quarter of 2008.

The Reserve Bank of Australia (RBA) raised interest rates by 25 basis points to 6.50 per cent in August 2007, after the period covered by the PMI report.

Despite pressure from higher interest rates, **BIS Shrapnel** managing director Rob Mellor said **strong economic conditions** in 2007/08 are expected to help to **support residential prices, and keep price growth solid in** most capital city residential markets.

"The favourable economic conditions have created strong wage growth and **record levels of net overseas migration, which should drive stronger underlying demand** at the national level, while keeping unemployment at long term low levels," he said.

#### **Comment – Andrew Gardner**

Note above, **“investor activity overall remains below previous peaks”**, this could be your opportunity to get into the market before the hordes of opportunistic investors hit the property market forcing prices up again.