

Why current arrears and repossession data may flatter to deceive

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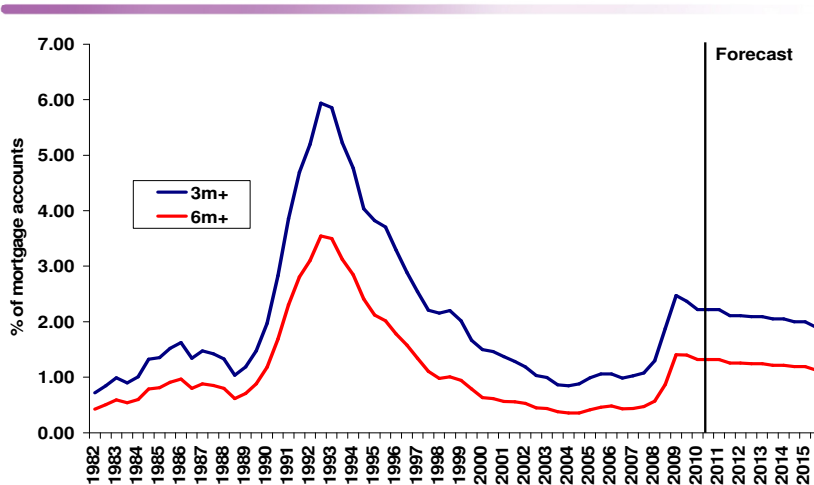
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In recent months commentators have begun to become more optimistic about UK economic prospects. The often cited purchasing manager surveys and signs of improvement in consumer confidence are frequently stated as reasons to be optimistic about the prospects for the UK housing and mortgage market. Arrears and repossessions seem to have peaked at lower levels than generally expected 12 months ago and considerably lower than the record highs seen in the early 1990's.

It is the data on arrears and possessions I would like to look at in a little more detail. The chart below shows the three month plus and six month plus arrears back to the early 1980's.

Arrears ease..... but slow run off to follow....



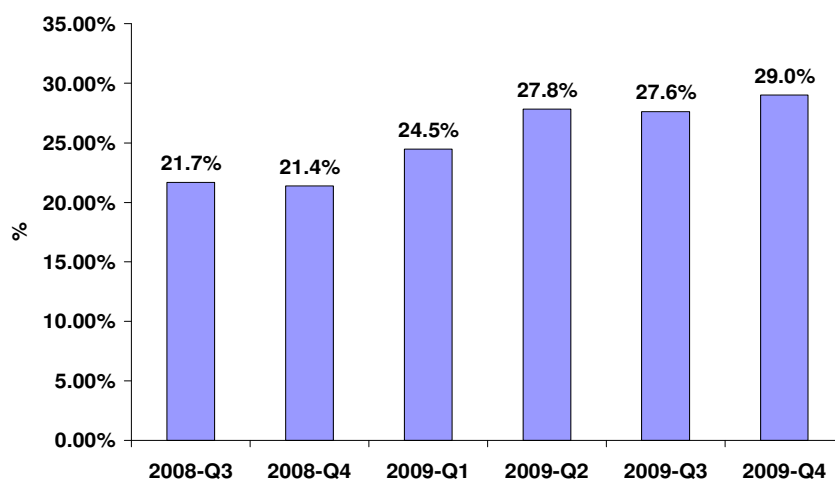
Source : CML , Hometrack

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The chart clearly shows the record peak in three month plus arrears when this reached around 6% of all accounts in 1992 compared to a current level of 2.2% (2.5% in the middle of 2009). The Basel II type definition for arrears over six months is currently 1.2% compared to a peak of 3.5% in the early 1990's. Many analysts have seen this improving position as a bellwether for better times in the mortgage market. I have some serious concerns about this assessment for several reasons.

Firstly, the economic recovery is far from certain and any recovery is likely to be fairly weak given the big structural problems we face such as the public sector deficit and bank funding difficulties. Secondly, interest rates have been at record lows for some time and although spreads on all personal credit including mortgages have widened considerably, in historic terms retail customer interest rates remain low. Thirdly lenders have chosen and have been encouraged to adopt generous forbearance policies in the current downturn. The level of arrangements put in place for customers in early arrears has risen sharply in the last two years as lenders try to help customers stay in their homes. The chart below shows that according to the FSA over 29% of arrears cases now have a formal arrangement in place compared to 22% in the middle of 2008. Mortgage lenders have also become more flexible as their own expectations for house prices and the market have become more positive.

Mortgage forbearance on the increase.....



Note: % of arrears cases with formal arrangements in place
Source : FSA, Hometrack



Fourthly, the contagion effect from commercial lending performance does not appear to have been fully discounted. The experience of the early 1990's tells us that failure in the commercial lending market and in small business lending quickly spills over into the prime mortgage and other credit markets. The level of forbearance in the commercial lending market has been even greater than in residential mortgages. Over 20% of commercial property loans are currently in breach of covenant and in excess of 10% are actually in default.

In summary, much of the analysis on asset performance is based on the central assumption that the economy growth slowly returns to trend, unemployment has peaked and that house prices will rise from here on. As I outlined last month, higher interest rates in 2011 or indeed excessive fiscal tightening will quickly challenge these assumptions. How would lenders respond to a wobble in the house price recovery, what if unemployment rises further from current levels once the public spending cuts begin to feed through? It is far too early to be planning on a sharp improvement in the mortgage market as higher interest rates and tighter fiscal policy will not really fully affect the market until 2011.

Higher arrears and repossessions are going to be with us for some time yet. New lending standards are considerably tighter than they were two years ago and this will change only gradually as lenders and customers will need to cope with higher customer interest rates and a far from certain economic picture. The knife edge economic decisions facing the Chancellor make a modest double dip in the economy a strong possibility. As we all know the economic lags in the system are long and variable making precise policy decisions has never been more difficult than now. This applies equally to lenders as it does to the government.

GPS

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