Sub-Prime SHOCKWAVES

The sub-prime crisis in the United States unfortunately did not have a self-contained epicentre. Its effects were felt all over the world, with shockwaves hitting the Irish market.

Some borrowers, who may have no way of verifying income or who may have been previously bankrupt, often have difficulty seeking approval for a mortgage in the prime lending market. These applicants can borrow from sub-prime lenders, who will take on riskier borrowers, but at a higher cost to the borrower.

Growth of sub-prime lending in the US

Between January 2000 and July 2006, house prices grew by just over 100 per cent.

In a market of strong continuous growth, banks began to feel more comfortable about risk and began to giving more and more to sub-prime borrowers. Between 2001 and 2004, interest rates were at an all time low, (post 9-11 rates had been decreased to 1 per cent), inflation rates were also low and generally financial markets were performing well, all contributing to an elusion of a risk-free market. Banks failed to recognise or understand the risk involved in sub-prime lending. By 2006, sub-prime lending in the US represented over 20 per cent of the new lending market. Other mortgage debt also increased rapidly. This story is similar in some ways to that in Ireland where mortgage debt, albeit prime mortgage lending, increased rapidly. But unlike the Irish market, the US market was not supported by strong fundamentals, such as strong wage and employment growth.

Then the Bubble Burst

Over a very short period, between 2004 and mid-2006, US interest rates increased 17 times. For most sub-prime borrowers this came at the same time as the end of an introductory discount offering.

In fact for some borrowers, interest rates increased from 2 per cent to 8 per cent almost overnight.

In July 2006, house prices in the US began to fall. To date house prices have fallen by 15 per cent.

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Following the increase in mortgage rates – with no similar increase in salaries – sub-prime mortgages became unaffordable. Because of slowing house prices, borrowers were also unable to sell their properties in order to redeem their growth debt. And so the repossessions began.

In late 2007, one in ten homes in the city of Cleveland had been repossessed and Deutsche Bank Trust became the largest property owner in the city.

Impact on the Irish Market

As we are now operating in a global market, happenings in the US do not impact the United States market alone. During the boom period, US banks began to sell mortgages (securitisation) to investors across the globe. When repayments were no longer affordable and houses were repossessed, these investors incurred huge losses.

These losses, estimated at $1 trillion, have impacted markets worldwide as confidence in the market has been severely shaken. Liquidity has dried up, banks are now unwilling to lend to each other. Those that are lending are doing so at considerably wider margins. Northern Rock's request for help from the Bank of England was a direct result of the sub-prime crisis in the US, as was the rescue of Bear Sterns earlier this year by the US Federal Reserve.

The lack of liquidity has resulted in a significant divergence between euribor (the rate Irish lenders buy) and ECB (the rate Irish lenders sell). Similar movements have been seen globally. The crisis has also lead to volatility in investment markets.

Effect on the Mortgage Market

Irish borrowers are now paying more, as the majority of lenders have increased their standard variable and tracker rates following increases in the cost of funds.

Many lenders have also tightened credit policies, removing 100 per cent loans from their offerings.

Further increases in all lenders' variable rates and a tightening of credit policies is possible; as it is currently difficult to forecast a end to the current lack of liquidity in the market.