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Cutting debt by switching currencies?

Cormac Naughten examines how borrowers could reduce their mortgage by switching between major currencies

When most people think of switching mortgages, they mean changing from one lender's product to another in search of a more competitive interest rate. But over the last 18 years an increasing number of financially sophisticated borrowers have placed their mortgages into a currency debt management programme whereby the mortgage itself is switched between the world's major currencies.

The currency debt manager's aim is to reduce the loan just as an asset manager seeks to manage investments to increase assets. "If you have your assets professionally managed, then why not your liabilities too? After all a pound is a pound, whether it has a plus or minus sign in front of it." So says Michael Petley, chief investment officer and founder of ECU Group, the UK's largest currency mortgage manager.

So how does it work? A multi-currency mortgage is arranged with one of the dozen private banks that provide these facilities. If the borrower already has a mortgage then this will be refinanced to one of the panel lenders. The appointed currency manager then switches the loan from currency to currency on a discretionary basis. On average over the last five years ECU has made 15 switches per annum. The manager is using the world's largest financial market – foreign exchange (FX) – to manage the mortgage. Some \$1.9 trillion is traded daily in FX – a volume which dwarfs that of equity and bond markets combined.

Three main potential benefits

If the mortgage is switched into a currency that weakens against the pound, this will reduce the sterling value of the mortgage without borrowers having to make the repayments themselves.

For example, if you convert a £1 mil-



lion mortgage into US dollars when each pound = \$1.80, this gives you a \$1.8 million mortgage. If the pound strengthens so it is now worth \$2, and you convert your dollar mortgage back into sterling, your mortgage would now be reduced to £900,000.

Secondly, it allows UK borrowers to borrow in a currency other than sterling with interest charged at the prevailing rate for that currency rather than UK rates. Interest payments are then made in sterling. Over the past 20 years the cost of servicing loans denominated in most of the world's major currencies has been less than it would have been in sterling. For example, low interest currencies such as the Japanese yen or Swiss franc currently have interest rates of 0.5 and 2.5 per cent respectively.

Thirdly, the product has been highly tax-efficient for UK taxpayers. For an individual or trustee borrowing against their main residence, buy-to-let or commercial property, neither the loan reduction nor the interest savings have been liable to capital gains tax. Figures from ECU show that they have reduced a client's mortgage by some

40 per cent over the last ten years through currency fluctuations alone – a benefit amplified by the tax treatment of the product.

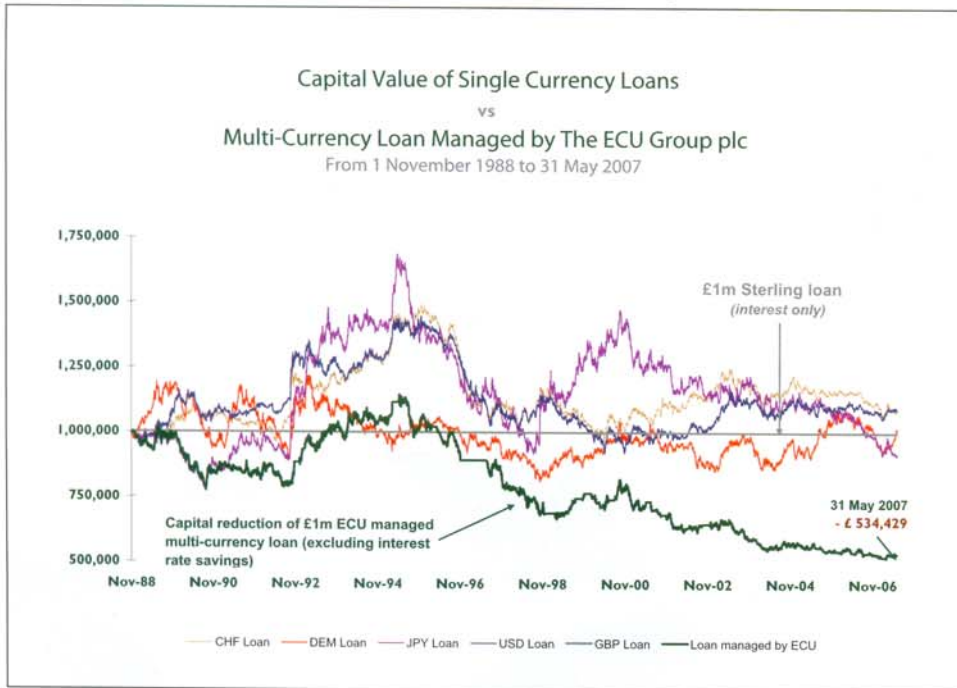
Perils of single-currency loans

For those with longer memories this may all sound familiar. Many people took out currency mortgages in the late 1980s and early 1990s – some with disastrous consequences. The preferred vehicles for many were single-currency loans in Japanese yen or Swiss francs, as they seemed to offer a low interest rate compared to the then double-digit rates in the UK.

As a currency mortgage is denominated in a currency other than sterling, should that currency appreciate against the pound the sterling equivalent of the debt will rise accordingly. Unfortunately, when sterling famously exited the European exchange rate mechanism (ERM) on Black Wednesday in 1992, borrowers saw the pound weaken considerably against other currencies, causing the sterling equivalent of their mortgages to increase dramatically. For example, a million pounds

Multi-currency mortgages

Chart 1 – The multi-currency approach has outperformed single currencies



borrowed in yen in 1992 would have almost doubled to £1.9 million by 1995. Clearly having a mortgage locked into a single foreign currency is a very high-risk strategy.

Multi-currency v single-currency

Whilst many who are interested in currency mortgages are initially attracted by lower interest rates, over the last 20 years more astute clients have seen that the key to unlocking these benefits lies in the currency fluctuations. They have then used these very fluctuations to reduce the size of their mortgages through a professionally managed multi-currency mortgage.

A multi-currency mortgage allows

borrowers the flexibility to switch their mortgage between different currencies such as the US dollar, Japanese yen, Swiss franc, euro and sterling rather than being stuck in just one currency. The outperformance of single-currency loans by a professionally managed multi-currency mortgage can be seen in Chart 1.

This outperformance is hardly surprising. For most individuals, the volatility of the foreign exchange markets and the need for extensive monitoring have meant that managing the currency risk themselves extends beyond their resources. Therefore they often employ a specialist currency management firm. Indeed, many

lenders will not provide a multi-currency mortgage unless an approved manager is in place. The currency mortgage manager's role is to seek to place the client's mortgage in currencies that are expected to weaken against (or at least remain stable against) the pound, consistent – where possible – with an interest rate advantage.

The approach of today's leading players in currency debt management mirrors that of leading hedge funds. They blend fundamental and technical analysis, underpinned by market intelligence provided by investment committees comprising some of the industry's most highly acclaimed economists and analysts. Over the last two decades trading systems have been developed in conjunction with the lending banks and the leading foreign exchange market-makers that allow managers to use a range of 24-hour risk-management tools for entering and exiting currency positions.

ECU Group

Formed in 1988, ECU Group is the UK's largest and longest-established currency mortgage manager with some £800 million of mortgages under management. It is an independent firm having held a management buyout in 2003 from ED&F Man Holdings, the City trading house which was part of the hedge fund giant Man Group until 2000.

For ECU clients the combined benefits of its programme would have allowed borrowers to pay off in full the interest-only loans they took out in the late 1980s without making a single capital repayment (see Chart 2).

With results like these why then is both ECU and the managed currency mortgage concept so relatively unknown? Partly this is due to the way that the product has been marketed. It was initially dubbed "The best kept secret in the City" in the late 1980s and since then most clients have come via word-of-mouth introductions from a select band of intermediaries, lenders and referrals from existing clients. It has developed via subtle profile building – relying on its performance rather than mass-market campaigns.

It is also because the lenders themselves are very selective.

Lenders, criteria and costs

Multi-currency mortgages are not available from the high street lenders. They are only available from about a dozen select private banks such as HSBC,

Executive Summary

- The multi-currency mortgage market in the UK private client sector is estimated to be worth at least £1 billion.
- An appointed currency manager uses the world's largest financial market – foreign exchange (FX) – to manage the mortgage. Some \$1.9 trillion is traded daily in FX – a volume which dwarfs that of equity and bond markets combined.
- The currency mortgage manager's role is to place the client's mortgage in currencies that are expected to weaken against (or at least remain stable against) the pound, consistent with an interest rate advantage.
- Currency fluctuations can reduce the size of a professionally managed multi-currency mortgage but it is a very high-risk strategy.
- The approach of currency debt managers mirrors that of leading hedge funds. They blend fundamental and technical analysis, underpinned by market intelligence. Trading systems allow managers to use a range of 24-hour risk management tools for entering and exiting currency positions.
- Loans are usually interest-only, have numerous fees and are charged at 1 to 2 per cent above LIBOR for whichever currency the loan is denominated in.

Investec, Citigroup, Kaupthing Singer & Friedlander and Kleinwort Benson. Loans tend to be offered on a five-year interest-only basis. Interest is payable monthly or quarterly in arrears at the prevailing London Interbank Offered Rate (LIBOR) for whichever currency the loan is denominated in plus a lender's margin of 1-2 per cent.

The entry criteria are rigorous. As well as a minimum income of £100,000 clients require a minimum loan size of £250,000 with a maximum gearing level of 70 per cent. Many lenders will not consider loans below £500,000 or £1 million. Moreover, as currency mortgages are often large (£1 million plus) lenders tend to follow traditional underwriting practices with no online decisions or automated valuation models.

The private banks will generally charge clients a 0.5 per cent arrangement fee which is split with the introducing broker. In addition clients will need to pay legal and valuation fees – including the bank's legal fees. Currency managers will typically charge an annual management fee (AMC) of 1 per cent of the value of the mortgage and a performance fee of 20 per cent of the profit made for the client. They also often pay intermediaries a share of the AMC once the loan has been under management for a specified time.

Risks and client suitability

The key part of advising a client on a

managed currency mortgage is ensuring that they understand that the use of a currency manager does not remove all the risks. Lenders put in place a "conversion limit", typically 15 per cent above the original loan size to limit the risk faced by the borrower. If this is breached they reserve the right to convert the loan back into sterling. This would leave the client with a 15 per cent larger loan on which they would then be paying sterling interest rates again. It is likely that both the currency manager and the bank will wish to meet the client to assess their suitability, explain the product and ensure that they understand these risks.

For this reason, multi-currency mortgages will not be suitable for everyone. They tend to be popular amongst high-income, financially sophisticated borrowers such as City workers, owners/directors of businesses, professionals and property investors. For lenders looking to attract more of this type of client, the ability to provide managed currency mortgages offers an opportunity to benefit from a stream of high-quality client referrals – particularly when the currency manager is successful.

Market growth and drivers

Although information is scarce, the multi-currency mortgage market in the UK private client sector is estimated to be at least £1 billion. The private client debt under management at ECU alone

is growing annually at a rate of between £300-400 million. This amount has steadily increased for each of the last five years. There have been several drivers. Firstly, as UK house prices have soared buyers have been forced to borrow more and more to finance their properties. This pressure has been greatest at the top end of the market. According to a June 2007 report by the *Financial Times*, "A wall of Middle Eastern and Russian money has helped push the price of a top-end house in London up 46 per cent in the past two years." Even for high earning investment bankers and professionals this has meant exploring more adventurous means of funding in order to gain an 'edge'. This is why the average ECU-managed mortgage is over £1 million.

As more than a million Britons now own a home abroad, awareness of foreign interest rates has increased together with the appreciation that UK rates are higher than in many other parts of the world. With UK interest rates hitting 5.75 per cent and some market commentators suggesting that they will hit 6 per cent by year end, more borrowers are now considering a foreign currency mortgage for their UK properties.

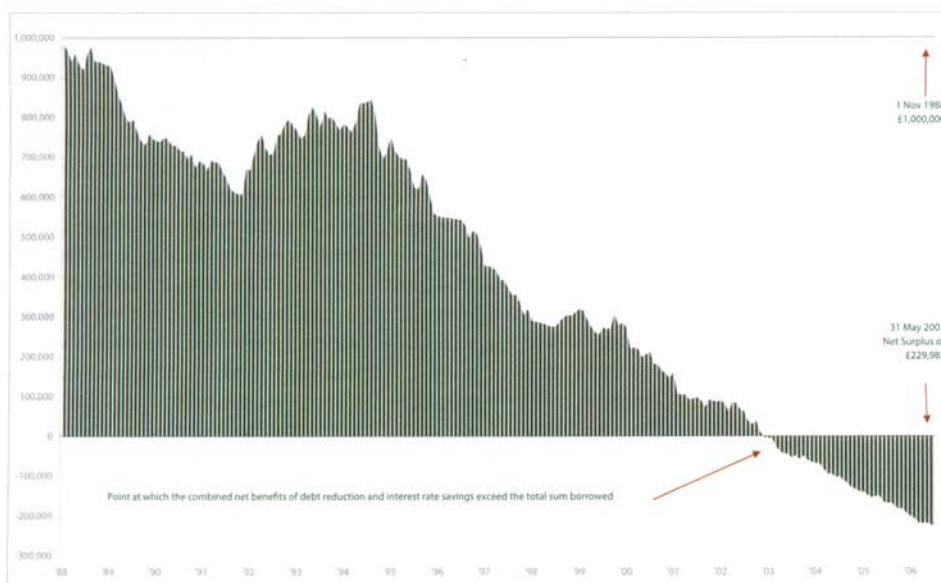
While multi-currency mortgages are currently a tiny percentage of the overall UK lending market this niche could increase dramatically to include the corporate sector. ABN Amro has created a protection product to underwrite corporate clients' potential trading losses on loans above £25 million, and ECU has seen a large number of enquiries from firms in a variety of industries from marine to commercial property.

Such clients have a realistic appreciation of the product. They realise that far from being able to sit back and watch their mortgages disappear, currency borrowers must face significant risks. But for those who have been prepared to do so, the benefits have been considerable. The key to unlocking these benefits lies in finding the right currency manager. Conscientious borrowers should do their due diligence carefully observing the rule that reputation in the market place is vital. The two most important qualifications are a long-term track record and the quality of the foreign exchange professionals involved in managing the firm. Failure to heed this advice could mean a painful experience for both borrower and lender.

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Cormac Naughten is director and head of private clients at the ECU Group

Chart 2 – Net performance of a £1m ECU-managed multi-currency mortgage



The above chart states net performance, in both capital and interest rate terms, of a £1m multi-currency loan managed by the ECU Group plc (interest being charged at 1.75 per cent above the weekly closing seven-day inter-bank cost of funds applicable to the currency/currencies borrowed) using the sterling seven-day LIBOR rate (plus 1.75 per cent spread) as a benchmark for calculating interest rate savings.