

# Currency mortgages

## Calculating risk

### Taking a chance on managed currency mortgages

With the recent falls in the pounds' value having obvious effects on foreign currency mortgages, Cormac Naughten highlights the clients' need for advice in this sector

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Over the last twenty years an increasing number of high net worth and high income individuals have borrowed against their UK properties using a foreign currency mortgage. Many chose low interest currencies such as the Japanese yen or Swiss franc with current interest rates of 0.3% and 1% respectively. If it is possible to borrow at these rates against UK property, then why didn't more borrowers get involved?

#### Risks and benefits

The principal reason is the risk involved. As a currency mortgage is denominated in a currency other than sterling, should that currency appreciate against the pound then the sterling equivalent of the debt will rise accordingly. Having seen significant benefits over the previous decade, from July 2007 many currency mortgage holders have experienced significant increases in the size of their mortgages as sterling has weakened considerably against all major currencies.

For those who remember the last housing downturn, 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 borrowers 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. 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,

£1 million borrowed in yen in 1992 would have almost doubled to £1.9 million by 1995.

Whilst many who are interested in currency mortgages may initially have been attracted by lower interest rates, over the last 20 years many clients and their advisers came to feel that the key to unlocking these benefits lay in the currency fluctuations. They sought to use these very fluctuations to reduce the size of their mortgages through a professionally managed multi-currency mortgage.

#### Flexibility through switching

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. If the mortgage is switched into a currency which then weakens against the pound, this will reduce the sterling value of the mortgage without the borrower having to make the repayments themselves. Over the last 18 months this has been no easy task. For most individuals, the recent extreme volatility of the foreign exchange markets and the need for extensive monitoring has meant that managing the currency risk themselves is beyond their resources. Therefore they may have sought a specialist currency management firm. 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.

Lending banks will not tolerate loan increases beyond a certain point and may put in place a conversion limit, typically 15% above the original loan size. If this is breached, they reserve the right to convert the loan back into sterling. This would leave the client with a 15% larger loan on which they would then be paying sterling interest rates again. It is likely that before they take out a managed multi-currency mortgage, both the currency manager and the bank will wish to meet clients to assess their suitability, explain the product and ensure that they understand these risks. The entry criteria are also rigorous. As well as a minimum income of £100,000 clients typically require a minimum loan size of £500,000 with a maximum gearing level of 60%. Many lenders will not consider loans below £500,000.

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.

Multi-currency mortgages are not available from the High Street lenders. They are available from about a dozen select private banks such as HSBC, Investec and Fairbairn. Loans tend to be on a five year interest-only basis. Interest is payable monthly or quarterly in arrears at the prevailing London Interbank Offered Rate for whichever currency the loan is denominated in, plus a lender's margin typically of between 1.5% and 2%.

It is important to remember that the use of a currency manager does not remove the risk of adverse currency fluctuations. In common with many fund managers – across a variety of asset classes – currency mortgage managers have faced very challenging market conditions since the start of the current financial crisis. Sterling has recently seen its biggest percentage decline on a trade weighted basis since the ERM exit in 1992. For example, since July 2007 the yen appreciated by some 80% against the pound by mid-November 2008 and the Swiss franc by some 40%. Whilst most currency mortgage managers have outperformed single currency loans in these currencies by a considerable margin, clients of some currency managers have still seen significant increases in the size of their loans.

#### The million dollar question

The sheer extent of sterling's recent decline has captured the attention of adventurous borrowers who are prepared to take a chance. They are looking to benefit from a potential future recovery for the pound by taking out a currency mortgage – often for the first time. Whilst, as with all financial markets currently, sterling may fall further and cheap may indeed become cheaper, some professional currency mortgage managers have seen such periods before and have seen the pound recover considerable ground.

Gauging with precision exactly when this will happen is the million dollar question, but those with the resources to withstand further adverse moves and the temperament to tolerate the risks are those most likely to be well placed for the potential benefits available from sterling's recovery. But of course one should always remember that past performance is not a reliable indicator of future performance. ■