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BoS linked to high-risk mortgages

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Bank of Scotland Private Bank, part of the state-supported Lloyds Banking Group, has been linked to one of the riskiest forms of mortgage lending – in which a manager trades different currencies with the intention of reducing the borrower's debt.

However, [these multi-currency mortgages](#) can have the opposite impact and risk increasing the size of the borrower's loan.

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BoS Private Bank is the sole lending partner of 3D Currency Management (3DCM), which launched in late 2007 and has £100m of assets under management.

3DCM takes foreign exchange positions through BoS Private Bank's treasury. Clients keep their loans in sterling – unlike borrowers with rival currency manager ECU Group (see box) – but 3DCM switches between currencies it believes will lose value against sterling. If these currencies weaken, the mortgage debt is reduced. But, if the currency that 3DCM has moved into strengthens against sterling then the client's loan will increase.

For that reason, the traders impose a stop loss of 10 per cent of the original debt. Even so, this means a £1m loan could increase to £1.1m.

Because of this stop loss, the client is not liable for any further losses over the 10 per cent. So the mortgage debt cannot rise rapidly if currency markets are rocked by a terrorist attack or natural disaster.

Similarly, ECU has a conversion limit in place with its lending partners, which include HSBC Private Bank and Citi Group – this is the level at which the bank reserves the right, but not the obligation, to convert the loan back into sterling. It is currently set at 10 per cent but has been higher in the past.

But the lending bank does not guarantee the loan will be converted back to sterling if the predetermined level is breached, according to Cormac Naughten, head of private clients at ECU.

This means that if the currency crashed through the conversion limit and the bank was not able to convert the loan to sterling due to illiquidity in the market, the client would be liable for any further losses.

"This product is for clients who are prepared to take a degree of risk and accept the potential losses," Naughten says.

Both ECU and 3DCM have achieved mixed results over the past few years. Clients with 3DCM saw their loans increase by 5 per cent last year but the group has reduced debt by 4.99 per cent in the year to date.

ECU recorded large losses last year with the size of a client's loan increasing by 10.49 per cent, excluding fees. It has decreased debt by 5.29 per cent so far this year.

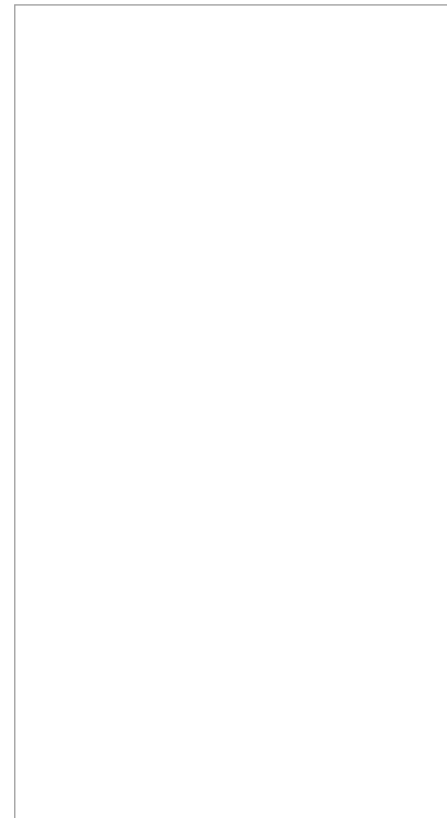
Mortgage brokers warn that these products are only suitable for wealthy, sophisticated investors. Ray Boulger of John Charcol says: "For most people, this product is entirely inappropriate. What it comes down to is you backing the judgment of the currency managers. Foreign currency loans are among the most risky type of mortgages available."

For this reason, James Laurence of 3DCM says the group stresses to clients that the product should be viewed as an investment and not just a mortgage.

"It's very much a way of having your debt managed in the same way you would manage your assets – it's risky but, really, it's not any more risky than any other investment," he explains.

The maximum loan-to-value a client can borrow is 75 per cent. A 10 per cent headroom is drawn from this total amount, leaving the maximum loan amount at 67.5 per cent. So, if a borrower's debt increases by 10 per cent, the loan will never be more than 75 per cent of the property's value.

Clients will also need to factor in fees. BoS Private Bank offers a five-year tracker mortgage charging 2 per cent over base rate. The arrangement fee is 1 per cent but there are no early repayment or exit fees. On top of this, 3DCM charges its clients an annual management charge of between 0.65 per cent and 1 per cent of the loan, as well as a 20 per cent



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performance fee.

ECU GROUP

The ECU Group has dominated the multi-currency mortgage market since its launch in 1988. Its approach differs from that of 3DCM as it actively manages debt by converting it into other currencies.

While the ECU Group has a longer track record, its results show that performance can vary significantly due to the volatility of currency trading.

The past two years – 2007 and 2008 – have seen the group end more than 10 per cent down each year. In 2007, ECU's performance was down 11.02 per cent. This meant its clients saw their debt increase by 11 per cent. The following year was also negative with the group's clients' debt rising by 10.49 per cent.

But the importance of the product as a long-term investment is emphasised by the group's performance over the last 21 years. Since November 1988, a £1m loan would have been reduced to less than £180,000 net of fees and including interest savings. In the year to date, the group has achieved a debt reduction of 5.29 per cent.

"Sterling has had its worst period since the 1930s," pointed out Cormac Naughten, head of private clients at ECU. "The key is that a client must be financially suitable. If all the client had was the property they were buying and no liquid cash, then this is not the product for them."

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