Currency ebb and flow

Has the tide turned for foreign currency borrowing?

Cormac Naughten looks at the key issues surrounding currency mortgages

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To many foreigners it seems a peculiarly British trait, that just as the UK has been one of the biggest losers of the recent financial crisis so its media and population have developed a morbid fascination with how bad things are for the economy. A nation raised on self-deprecation has graduated to self-flagellation and scarcely a week passes without further opprobrium heaped on politicians and bankers - admittedly not without reason. This has now reached the point where many Brits' first reaction to bad news is to knock the country and by extension the economy. The doom-mongers focus on bad news and pay scant attention to positive news, or search high and low to find a gloomy spin. Even an escape from recession is described as an "anaemic" recovery and rising property prices pooh-poohed as a potential flash-in-the-pan.

Consequently, since 2007, sterling - a barometer of both the nation's economic health and investor sentiment towards the UK - has seen its worst decline in decades. According to some pundits this is the worst British currency "crisis" in fifty years and for others the worst since the 1930s.

Yet the sheer extent of sterling's recent decline **(see Chart 1)** has also captured the imagination of adventurous borrowers who are inclined to take chances. They view the pound's decline as closer to the end than the beginning and feel this presents a good opportunity to bet on a potential recovery for the pound by taking out a foreign currency mortgage against their UK properties. As a currency mortgage is denominated in a currency other than sterling, should that currency weaken against the pound then the sterling equivalent of the debt will fall accordingly. It also allows them 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 in sterling. For those who also feel that UK interest rates will be going up at the end of 2010 or in 2011 at a rate faster than that of many other developed economies this provides additional motivation.

Chart 1

For an adviser or banker faced with a client armed with the arguments above, what do they need to know to advise them whether this is a good idea or indeed, whether it is even possible for them?

An adviser needs to be aware of the following four issues:

1.The recent history of currency borrowing

Back in the late 1980s and early 1990s many borrowers took out currency mortgages - often with disastrous consequences. The preferred vehicles for many were inflexible single-currency loans in Japanese yen or Swiss franc, 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.

This experience led banks, advisers and clients to explore multi-currency mortgages, which allow borrowers the flexibility to switch their mortgage between different currencies such as the US dollar, Japanese yen, Swiss franc, euro and sterling. Many of them quickly realised that, for most individuals, the volatility and 24-hour nature of the foreign exchange markets and the need for extensive monitoring meant that managing currency risk themselves was beyond

> "The fastest growing economies in 2010 will be from the emerging markets, just as in 2009 and, indeed, over the last five years on average."

the scope of their resources. Therefore they sought specialist currency management firms, whose role is to seek to place the client's mortgage in currencies that are expected to weaken (or at least remain stable) against the pound, are consistent - where possible - and with an interest rate advantage.

The use of a currency manager certainly could not entirely remove the risk of adverse currency fluctuations but did much to mitigate it. As with many fund managers, currency mortgage managers faced very challenging market conditions after the onset of the financial crisis in 2007, as sterling suffered its worst currency crisis for more than a generation. At the worst in 2008/9 borrowers in yen or Swiss francs saw their loans double or increased by up to 60%+ respectively. Whilst most currency mortgage managers outperformed single currency loans in these currencies by a considerable margin, many of the clients of some currency managers still witnessed significant increases in their loans sizes.

Set against this, some professional currency mortgage managers have overcome such challenging periods before and seen the pound recover considerable ground, profiting handsomely - often outperforming single currency loans by impressive margins. The key to whether we are on the verge of entering such a period leads us to the second thing that advisers need to be aware of, namely:

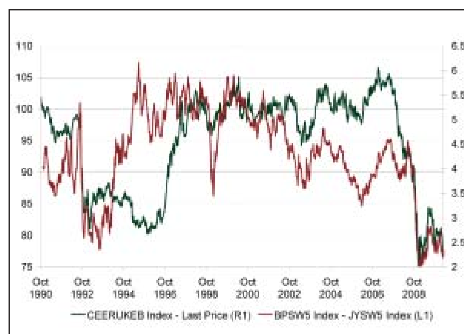
2. The outlook for sterling and UK interest rates

In the short term, sterling remains one of the world's most unloved currencies. The reasons for its woes are well known and have received much coverage. To name but a few, the threat of a hung parliament, discussion about a potential loss of the UK's AAA rating and speculation that the UK may suffer the type of debt crisis which has already hit Ireland and Greece. The reciprocal of sterling's current unpopularity and decline is that it is increasingly providing an opportunity to profit from a reversal at some point.

Sterling's performance and UK interest rates tend to have been closely correlated historically as can be seen on **chart 2**, which shows how the sterling/yen rate has tended to track five year swap rates. February survey data from Bloomberg shows an average forecast of UK base rates at 0.88% for Q4 2010 from 49 economists rising to 1.27% by Q1 2011. Whilst this is by no means a consensus opinion, most people would accept that from the current level of 0.5%, UK interest rates are likely to head upwards by the end of 2011 at the latest. When this happens, sterling is likely to benefit, particularly if UK rates go up faster than elsewhere in the G7.

If advisers think that the outlook for sterling and UK interest rates means that they feel currency borrowing should be considered by their clients in the future, they still need to ensure that lenders are prepared to accommodate them and thus must consider:

Chart 2



3. The outlook for lending

Advisers need to remember that multi-currency mortgages are not available from High Street lenders. They are only available from about a dozen select private banks such as HSBC, Bank Leumi, EFG, Investec and Fairbairn. The entry criteria for clients with private banks are rigorous and in the aftermath of a recent tightening of credit have become even more so. A minimum income of £150,000, minimum loan size of £500,000 and maximum gearing level as low as 55% are now taken as read. Some lenders will not consider loans below £1M or £2M. Others wish to have a wider relationship with the client from day one, meaning that they wish to see cash placed on deposit with them or asset management mandates awarded. For such banks their view is that credit is a scarce resource only to be granted to clients that they do significant business with already rather than just transactional lending for its own sake.

The implications of this extra stringency for advisers are that facilities may take longer to arrange than clients expect and that they need to prepare accordingly with well presented applications that evidence all the key criteria - income, assets and liabilities etc. They also need to be able to verify client suitability regarding the fourth point:

4. Client risk tolerance

The risk of loan increases, due to the adverse currency fluctuations outlined above, has meant that today lending banks will not tolerate loan increases beyond a certain point and may put in place a "conversion limit", typically 10% above the original loan size. If this is breached, they reserve the right, but not the obligation, to convert the loan back into sterling. This would leave the client with at least a 10% 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 together with their advisers 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 all clients. They tend to be popular amongst high income, financially sophisticated borrowers such as City workers, owners/directors of businesses, professionals and property investors. Whatever their occupation all multi-currency borrowers must share an appetite for risk and have the financial resources and liquid assets to able to deal with any adverse consequences without this materially affecting their standard of living or leaving them unable to meet their obligations.

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For clients that can meet these demanding criteria and who feel that the decline of sterling is indeed closer to the end than the beginning, gauging their entry point with precision is then the difficult thing. Perhaps a key point for advisers to impart is that to try and pick the very bottom is just simply an unrealistic expectation, reliant on an enormous slice of luck. It is far more likely that they will need to leave plenty of time to arrange the facility and to then accept that some adverse currency fluctuation may be inevitable before sterling experiences any ascent and even then, they must be prepared to show plenty of "intestinal fortitude".