Dire Straights for UK Financials

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At the beginning of August it was widely expected that by now the Bank of England's Monetary Policy Committee would have introduced at least one more interest rate hike to take the UK base lending rate to at least 6% per annum. It would mark a slow down in the housing market but spell a positive close to a record breaking era for the UK Banking Sector where Barclays alone were expected to announce profits of £7 billion.

However, August was an extremely pivotal month as the magnitude of the North American Credit Crunch finally came home to roost and has already forced financial institutions to write off tens of billions of dollars against Credit Rated Securities.

The problems in America started with a housing boom some years back, which prompted many Americans to stretch themselves to borrow more money to reinvest in property. The property market finally passed its peak at the back end of last year, primarily as a result of increased interest rates that were implemented by the U.S. Federal Reserve to curb inflation.

Housing, of course, is a key inflation indicator and the increase of interest rates is an extremely effective method of cooling inflation because it slows down house prices and reduces people's disposable income to cut their spending.

In this case, it is possible that the 'Fed' may have been guilty of over-cooking things a little as the US housing market is now in dire straits and many borrowers have defaulted on their mortgages. The first major UK casualty was Northern Rock; its financial stability was decimated in a matter of days by a refusal from other banks to continue to lend it money to cover its mortgage book.

Now we are also starting to see the housing market cooling in the United Kingdom it could spell big trouble for the UK Financial Sector. It is still too early to tell how big the write offs are going to be in the City but already heads are starting to roll in the board room as senior executives from Citigroup and Merrill Lynch have been given the chop following write offs of £3 billion and £4 billion respectively.

This is just the tip of the ice berg however. The problem is that any current provision for bad debt is simply a broad estimate of the damage as banks have no way of calculating how big their exposure will be.

Speculation by analysts of how big the writes-offs are likely to be are extremely varied but one of the most prominent predictions to date has been issued from Royal Bank of Scotland's chief credit strategist Bob Janjuah who said: "This credit crisis, when all is out, will see $250 billion to $500 billion of losses."

This current situation is by no means a new phenomenon as we have seen a similar pattern emerge many times in history as house prices have experienced a bull run (and then corrected to a more realistic level), and it is therefore, with some certainty that we can predict the next chapter in the tale - but how badly could this current housing slump impact upon financial markets?

Well the answer is that it could have a much greater long term impact on capital markets than we have seen in previous economic cycles as the amount of debt involved on this occasion is simply enormous and this time it is not limited to the USA, the problem is global and will impact significantly on UK Banks because of the international investment activity as well as the potential impact from similar defaults staring to occur on this side of the Atlantic.

Over the past twenty years we have seen any number of sophisticated investment vehicles come to the market and in institutional circles there are many more. In the case of property, an enormous amount of money has been invested in Mortgage Based Credit Rated Securities, which are debt instruments that have been engineered by mortgage packaging firms that pool groups of Sub-Prime (or Higher Risk) Borrowers together to lend them money that is secured against their homes. The debt instruments are then sold on to investors in the form of a bond.

These bonds will be typically rated by a rating agency and the yields on the bonds are generally only a narrow margin higher than prevailing interest rates. But as a Credit Rated Security is risk rated, it is a comparatively simple vehicle for a financial institution to borrow against and in some cases a bank or investment house may have leveraged up their investment by four or fives times to achieve a greater net return.

The downside of this process is when the assets in the bond are no longer recoverable (because of defaults and repossessions), and this is when big write offs start to occur. In the case of a Mortgage based Credit Rated Security that has been leveraged four times, the assets only need to drop by 25% for the entire value of the investment to be lost.

UK bank shares have plummeted since the credit crisis took hold but the real impact to the UK Banking sector is yet to manifest and it is highly likely to be more profound that originally feared. In February this year, HSBC were one of the first active players in the sub prime mortgage market to close their position announcing a loss of $800 Million from their mortgage book, which did little to inspire its shareholders.

Alliance & Leicester and Bradford & Bingley were most affected by the Northern Rock debacle although their own mortgage books are regarded as less speculative than some.

Lloyds TSB is thought to be largely unaffected by the US credit crunch as it has no investment banking division but with house prices now cooling in the UK it is highly likely that their exposure to mortgage debt will increase.

According to Anthony Broadbent from Sanford Bernstein, Royal Bank of Scotland could have to write off as much as £500 million and he suggests that the Barclays Capital losses could be as much as £1.6 billion.

So, is this all doom and gloom? Well for Barclays and RBS shareholders then the answer is possibly yes since their combined stock value has fallen by almost £30 billion during 2007 alone, which is of much greater significance than their estimated write-offs as a result of the credit crunch. But the write-offs will seriously compromise profits estimates for most financial institutions this year and next and it is highly likely that we have still not reached a point where share values from UK Financials represent good value.