

# US Sub-Prime

## – How it affects UK households

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### What is the US sub-prime issue?

The term 'sub-prime' refers to borrowers with poor credit ratings. Generally, these households have a recent history of missed loan payments, repossession of assets and even bankruptcy. However, while US house prices were rising sharply and interest rates were low, mortgage companies became more willing to lend to non 'prime' borrowers. By 2006, sub-prime accounted for one in every five mortgages originated.

Sub-prime borrowing started to go wrong in 2006, when borrowers had to move from their initial low fixed rate payments and move to higher variable rates. Because interest rates had risen so much in the two year period during which their payments had been 'fixed', many borrowers found that they were no longer able to meet their new 'adjustable' monthly payments. Sub-prime mortgage holders started to fall behind with their mortgage payments, and an increasing number have already lost their homes.

### Why has it become a global problem?

The sub-prime mortgage issue has developed into a global problem for

financial markets due to 'securitisation'. This process involved the mortgage originators selling the expected cash flows from their mortgages to investment vehicles which turned these into securities. These securities relied on the cash flows coming through every month, with no missed payments or mortgage defaults. Through the process of structured finance, these securities became part of a whole chain of leverage, sometimes by up to 100 times. The negative impact of a missed mortgage payment was therefore magnified many times over.

### How might it affect UK households?

Although the problem of missed mortgage payments is occurring in the US, it has the potential to impact UK households in many ways. Six of the most important ways in which we might all be affected are outlined below.

#### 1 Impact on US Economy

Weakness in the US housing market has already caused house prices there to fall. This situation could get even worse if more sub-prime borrowers have to give up possession of their homes. Falling house prices can be expected to lower consumer confidence, and this in turn tends to

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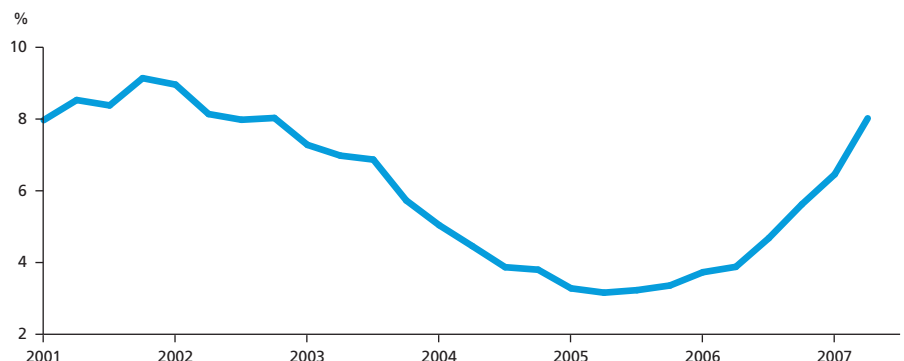
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### Sub-prime Adjustable Rate Mortgages in Foreclosure

Source: EcoWin



hit spending. Households, who have been relying on their house price rising, often feel the need to save more and cut back on discretionary spending. The US consumer is powerful, accounting for over 70% of US GDP and around 20% of world GDP, so any significant downturn in spending will have some impact on the world economy. Companies which export consumer goods and services to the US are likely to be hit hardest.

## 2 Credit Market Spreads

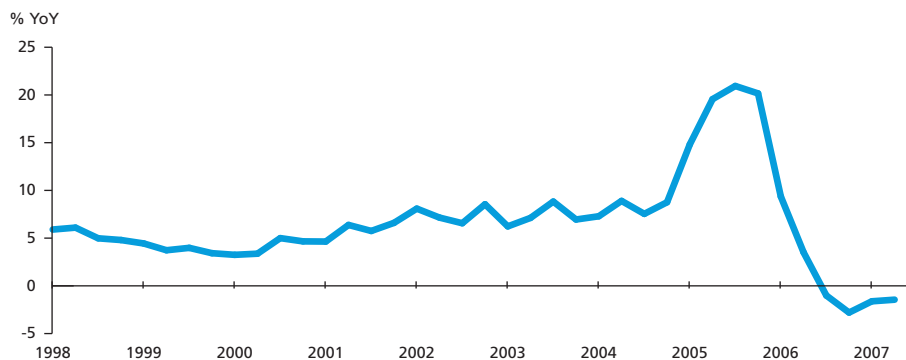
Fear and uncertainty in the financial markets have caused credit spreads to increase. This means that it now costs companies a bit more to borrow – even over the short term. Companies frequently need to use this facility to navigate through the timing of their incoming and outgoing cash flows. If this now costs more then profit margins will come under a bit more pressure. Corporate profitability is one of the key drivers of equity market performance. So far we have just had a credit squeeze, which occurs when firms can still borrow but at a higher rate of interest. More significant problems occur when companies, and households, with good credit ratings find it impossible to borrow – this is known as a ‘credit crunch’.

## 3 Household Access to Credit

Lenders have been shaken by the sub-prime crisis and are looking to minimise the risk of further defaults amongst borrowers. Lending standards are being increased as a result. UK households may, therefore, find it more difficult to secure a loan, perhaps requiring more documentation to prove income and previous credit history. Potentially, this could affect many potential borrowers, ranging from consumers requesting new credit cards, households seeking loans, first time buyers looking to secure a mortgage, and existing householders who want to mortgage their property.

## US house prices - National Association of Realtors

Source: EcoWin



## 4 UK Sub-prime

Sub-prime borrowing exists in the UK, but this is subject to more regulation than was the case in the US. However, sub-prime borrowers here are already paying the price of US defaults, as loan providers have raised interest rates on this type of loan, and some types of product are being withdrawn for new borrowers. This could make access to credit more difficult for any household with a poor credit history.

## 5 UK Reliance on Financial Services

The UK is heavily reliant on the financial services sector, which has been growing much more quickly than the economy itself. The growth in this sector has helped to create many jobs and to raise income levels for many households. If this hiccup in the global markets continues, activity, income and employment in some specific sectors of the finance industry could be affected. Merger and acquisition activity has been particularly strong in recent times, and has helped to underpin some of the good performance which we have seen in the UK's equity market. Future deals could be hit by a decline in access to low cost financing.

## 6 Property Prices

UK households have seen their property prices rise strongly over the last few years. In London, in particular, growth has been exceptionally strong, boosted by bonus payments in the financial sectors, which many recipients invested in property. If financial market activity slows, bonuses could be hit and London property prices might suffer. This could have some impact throughout the rest of the UK. The problem could be compounded if potential buyers are struggling to secure mortgages, particularly those with a high loan to value ratio or ‘interest only’ products.

## Conclusion

The final scale of the US sub-prime crisis is still unknown and the implications for financial markets may also take some time to fully unfold. We can already see many ways in which UK households could be affected but, as yet, we cannot assess how serious these effects are going to be. Hopefully, the central banks will be successful in containing this problem, and in restoring confidence to financial markets, limiting the negative impact. If central banks fail, and a credit crunch ensues, the outcome could be much more severe.