

## So long, sub-prime

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The heady days of summer 2007 seem but a distant memory, but perhaps a more sensible approach to risk will benefit the market in the long run

Most people reflecting back on summer 2007 wish for a return to the days when mortgage market competition was intense, funding was not an issue and sub-prime borrowers were paying only 1 percentage point more than prime customers.

Fast forward to today and you have lenders pleading for more shareholders cash, 1252 sub-prime residential mortgage products available compared with 8148 a year ago and despite prime rates falling riskier borrowers are facing rates up to 2.75 per cent more than they were the same time last year.

The stark contrast between the start of 2007 and the end of 2008 is a bitter pill to swallow but surely it is vital that lessons are learnt from the events of the last 18 months.

Nick Young, director of mortgage solutions for pricing optimisation company Nomis Solutions, said the problems we are faced with today are largely down to the fact lenders were pricing high risk products far too low.

He said: "The lesson of the last year is sub-prime mortgages, and more than 100 per cent loan-to-value prime mortgages, were priced far too low in relation to their intrinsic risk.

"As a result, not only has the sub-prime retail market closed but so, effectively, has the wholesale funding market for all mortgages, sub-prime and prime. This is a direct result of a failure to price mortgage impairment risk accurately."

Helen Gee, marketing manager of Checkmate Mortgages, said while many reflect fondly on a year ago, the fact there was little between a prime and sub-prime rate meant it was always going to be unsustainable.

She said: "It is unlikely we will see the narrow price differentials of last summer again. Instead lenders will look for new and innovative ways of pricing for risk without assuming that this risk can be passed on after completion."

Lenders have learnt the hard way they should not be so blasé with their pricing strategy in the future.

Alan Harper, head of mortgages for provider of personal finance information Moneyfacts, said: "We have seen many lenders regain some appetite to lend and as a result a competitive edge has begun to re-enter the market, certainly in the prime sector.

"In sub-prime it is a different story. Rates on these products remain up to 2.75 per cent more than this time last year and it is difficult to see much changing in the near future. Certainly it is hard to foresee a pricing differential as narrow as 1 per cent for some time to come."

This seems to be the common opinion and most agree a return to such a narrow gap would be foolish.

Mikael Krohn, vice-president of provider of software solutions for the banking industry EDB Business Partners, said: "Whether we can expect to see a corresponding narrow spread between sub-prime and prime deals in the future is difficult to say.

"However, in retrospect it is plainly apparent the risk premiums had been far too low on sub-prime deals."

Having said this, Mr Krohn said the finance market was a highly competitive and dynamic market where technical innovations, changes in customer behaviours and the emergence of new competitors constantly challenge the banks' decisions.

He said: "The industry's memory has in the past proven to be short. As shown by history, there is a danger that without formalised requirements the banks, driven by competition and customer demand, might again begin to compromise on risk pricing."

Although it is still next to impossible to predict the future of this market or what will even happen in the next 12 months, there is optimism that as the wholesale market slowly opens up again, there will be a far wider spectrum of mortgage product price points emerging.

Nomis Solution's Nick Young said: "There may potentially be up to a 10 per cent spread between the highest risk sub-prime mortgages and the lowest loan-to-value prime mortgages with a complex series of graduations in between."

This said, however, Mr Young said it is possible that between specific segments price spreads will narrow.

He said: "For example the Bank of England is reporting an 86 basis point spread between the average pay rates of 95 per cent loan-to-value and 75 per cent loan-to-value two-year fixed prime mortgages.

"It is reasonable to expect this gap will close as additional risk segments are developed and more sophisticated methods for pricing risk into mortgage products become available."

So how should lenders go about ensuring they price risk into mortgage products correctly in the future?

Moneyfacts' Mr Harper said risk will remain the main factor when designing new products.

He said: "Wary of the stigma attached to bad debt provision, lenders will continue to make use of sophisticated affordability calculators to ensure their customers can afford repayments and, therefore, avoid a default situation in the first place."

Let us hope a more sensible approach will last and as competition returns to the market and consumer demand increases, banks do not go back to the old ways of compromising on risk in the chase for new business.

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