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Risky business?

The UK and US residential property markets share many characteristics and the trend towards reduced equity in homeownership in both nations is particularly noteworthy.

While homeownership in the US is at an all-time high, home equity is at an all-time low. That is just one element of the growing risks in today's mortgage market, where borrowers are highly leveraged and the volume of loans facing rate resets in a rising-rate environment is sobering. Highly innovative, and potentially risky, products are also common to both markets – for example, products featuring honeymoon rates and reduced documentation requirements. In short, the US could be in danger of innovating itself into danger and the UK market would do well to monitor US behaviour and its own very cautiously.

For months, Americans have been obsessed with coverage of the housing bubble. Local media coverage highlights the pitfalls, but while the bulls and the bears battle it out in the headlines, the real story – how the world of mortgage lending has changed, and how that change has dispersed risk among a number of participants who may or may not be prepared to manage it effectively – is not being told.

There are worrying developments. Second mortgages with floating rates expose more borrowers to interest-rate risk they may not fully understand, much less be able to service. Riskier loans are concentrated in geographical areas that are at highest risk of home-price declines. Because many of the new mortgage products available put less emphasis on building equity than traditional loans, Americans have lower levels of equity in their homes than ever before.

Speculation has increased as record appreciation has brought new players on to the field – many of them at once highly leveraged and inexperienced when it comes to managing investment property.

Each of these risks by themselves might be manageable. Together, however, they represent a layering of risks that is both quantitatively and qualitatively different from what we have seen before and unlikely to behave well in a more challenging economic environment characterised by slower appreciation and higher interest rates.

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