

1 juli 2011

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By: James Saft (June 28, 2011)

The unbelievable mercy of UK banks

What do you call an entire economy which sweeps its insolvencies under the carpet and hopes that something will turn up?

Britain.

An investigation by the Bank of England, reported in its Financial Stability Report released on Friday, found widespread evidence that banks are extending loan forbearance to weakened borrowers.

And because loans in forbearance often aren't classified as impaired, banks may be skimping on loan provisions, giving a deceptively flattering account of their capital position and health.

Forbearance, usually some form of break given to a borrower such as extending the term or making the loan interest-only, is offered to some borrowers when they miss a payment or violate part of the loan agreement.

What's surprising about the BOE's findings is how widespread the practice is, not only in residential mortgages, but in commercial real estate lending and corporate lending.

Commercial real estate, which has suffered deep and widespread declines in value, is the other shoe that never dropped for the British banking system. Perhaps this is because, as the BOE points out, around a third of all UK commercial property lending may have benefited from some form of forbearance.

The Property Industry Alliance believes that about 80 percent of all loans made for commercial real estate since 2004 may be in breach of their loan-to-value covenants. LTV covenants govern how much debt a borrower can have relative to the market value of their property and often include provisions requiring borrowers to accelerate repayment or contribute additional equity if they find themselves in breach.

"Contacts suggest that forbearance is one reason why corporate default rates in the UK have remained low relative to past recessions," according to the report, which pointed out that the corporate liquidations rate was only 0.7 percent in the first quarter, compared to a peak of 2.6 percent in the less severe recession of the early 1990s.

The bank also said that as many as 12 percent of residential mortgages may be in receipt of some form of break on their loan. An earlier investigation by the Financial Services Authority found that 63 percent of all troubled home loans have been switched onto some form of forbearance. Some 3 percent of borrowers with mortgages totaling 60 billion pounds (\$97

billion) have switched to interest-only mortgages, under which no principal is retired, since the onset of the financial crisis in 2007, according to the FSA.

So, there we have it; all significant parts of the British economy are being helped by loan repayment forbearance from a banking industry which is not sufficiently disclosing how it decides how it operates or if it is setting aside enough money for future losses.

The BOE asked the FSA to continue its investigation into residential mortgages and broaden it across UK banks' residential and commercial lending globally.

SENSIBLE OR SELF-SERVING POLICY

The BOE was at pains to stress that it is not against forbearance per se. And indeed giving troubled borrowers slack, if handled well, can improve outcomes for all parties and for the economy itself. Putting masses of borrowers into default all at once can cause a vicious cycle of forced sales and falling prices, as we have seen in the U.S.

The clear priority, then, is to force banks to be more transparent about why they offer borrowers breaks and how they decide how much to put aside against possible eventual defaults. This will protect shareholders, who might otherwise pay out billions in bonus payments to bankers only to be left holding the bag when the loans eventually go bad. It will also, of course, protect those who lend to banks and the taxpayers who ultimately backstop them.

The larger question is whether all of this forbearance is simply putting off the inevitable, and slowing sustainable recovery as it does.

Japan's example from the 1990s suggests that keeping so-called zombie borrowers alive leads to extremely poor economic outcomes. It ties up banking capital that would be better used supporting sustainably profitable businesses, as well as distorting competition throughout the economy.

There are two ways to look at this. The cynical, and quite possibly correct, way to view the mass forbearance is that, of course, this is what banks do when faced with failure, and they mostly get away with it. U.S and international banking history are littered with banks that in retrospect would have failed if they had played things straight, but lived to lend again by extending and pretending, almost often with the witting participation of their regulators. It doesn't always work out too badly.

The second way is to look at this as not only a warning about the grave risks the UK banking system faces, but an indicator of exactly how weak the economy is and will be.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund