

# Following Fed rate action counterproductive move

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A year from now, this will be the year many will remember as when they expected another big global financial market adjustment following 'Black Monday' in 1987 and the Asian financial crisis in 1997. As with all such corrections, the adjustments have different roots and varying degrees of impact.

The United States Federal Reserve on Friday last week surprised the market by reducing the rate at which it charges banks to borrow from it - the discount rate.

However, more noticeably and much less understood, the US central bank provided additional borrowing flexibility by increasing the maturity of such loans to 30 days (normally the discount window only provides overnight loans) and expanding the types of acceptable collateral.

In my opinion, the Fed's decision 'to accept a broad range of collateral for discount window loans, including home mortgages and related assets' was a direct message to banks and investors of its willingness to shore up confidence in the structured finance markets.

While it is clear that market liquidity has temporarily dried up for several segments in the fixed income markets - asset-backed commercial paper, collateralised debt obligations, mortgage-backed securities backed by subprime mortgages, etc - the massive amounts of liquidity in the capital markets have not disappeared permanently.

Instead, the leading providers of liquidity, commercial banks and institutional investors, have backed off by not lending or investing in these sectors temporarily.

Despite the unprecedented Fed action last week, the market for new-issue collateralised debt obligations and various structured financial markets is closed for the foreseeable future.

In fact, market professionals are beginning to evaluate how creative financial engineering has allowed investment banks to arbitrage and profit handsomely by aggregating pools of low investment grade or non-investment grade-rated assets into highly rated securities.

In the months to come, the global market will turn its attention from subprime mortgages and begin bracing for the next wave of bad news - a further rise in US mortgage delinquencies/defaults not only from subprime mortgages, but also from Alt-A loans, which were made to borrowers who provided lenders with less documentation than prime borrowers, as well as prime mortgages.

The expected spike in mortgage defaults will most likely be caused by the contractual interest-rate resets from the large volume of hybrid mortgages originating in 2005 and last year.

Most of the resets will occur within the next 12 to 18 months and, on average, the monthly mortgage payment will increase 25 per cent to 35 per cent.

Similar to the Asian financial crisis in 1997, the initial impact on Hong Kong's interest rate and mortgage market has been minimal.

In addition to a rise in stock market volatility, interest rates in the interbank market - the Hong Kong interbank offered rate - have increased 0.5 per cent to 1 per cent in the past week.

The increase in interbank rates have directly affected all consumer and commercial loans which are indexed from Hibor.

In particular, the once-popular Hibor-indexed residential mortgage that was introduced by banks last year will result in mortgagors' monthly mortgage payments increasing by about 5 per cent to 10 per cent on their next interest rate reset date.

At this level, any previous interest rate advantage gained from a Hibor-based mortgage, as compared with a prime-indexed mortgage, would have evaporated.

The Fed's rationale to lower the discount rate was to 'promote the restoration of orderly conditions in financial markets' and it will only be a matter of when it decides to lower the more important federal funds rate - before or at the next Federal Open Market Committee meeting.

With the local currency linked to the US dollar, interest rates in Hong Kong are required to move in tandem.

Since 2003, the city's economy has been extremely robust as evidenced by a strong gross domestic product, declining rate of unemployment, double-digit increases in property transactions and a continuing slide in mortgage rate margins for consumers.

Therefore, it seems counterproductive for Hong Kong interest rates to follow the US by moving lower during this economic expansion which would most likely lead to asset prices overshooting on the upside again and unwanted inflation.

In fact, the city's economic expansion has been running countercyclical to that of the US for some time and there have been no recent signs of a liquidity squeeze in the local markets.

Therefore, one hopes that the existing currency regime does not also link the recent uncertain financial market conditions in the US and affect Hong Kong unnecessarily.



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