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Title: **It's crunch time**
Feature: **Feature focus**
Date: **1 February 2008**

After the banks tightened their belts and restricted mortgage lending, the protection industry braced itself for a downturn in business. Yet as Peter Carvill points out, the opposite appears to be happening – for now.

On 21 May 2004 at the Financial Services Roundtable Annual Policy Meeting in Chicago, the late Edward M Gramlich, the then-governor of the US Federal Reserve Board, outlined his fears about the increasing fashion for sub-prime lending that was, at that time, accounting for 10% of all the new mortgages in the US. "It has been associated," he said, "with higher levels of delinquency, foreclosure and, in some cases, abusive lending."

Gramlich, who died in September 2007, had every reason to be wary of what he termed "lending that involves elevated credit risk". Just over two years after his speech in Illinois, the sub-prime market in the US collapsed as over a hundred sub-prime lenders failed or filed for bankruptcy. By the time of the crash, the proportion of sub-prime loans in the US market had more than doubled in three years to 20% of all new mortgages in the market.

The fallout was swiftly felt on UK shores as Northern Rock very publicly shuddered to a near halt when it was forced to go to the Bank of England for an emergency loan so it could continue to run its business. Amid scenes of a very British panic, the bank's customers began queuing outside the bank to withdraw their savings, fearing that the bank's imminent collapse would cause them to lose their hard-earned money.

Globally, one financial institution after another began to suffer the effects. The US financial services company Citigroup reported sub-prime losses of $18bn (£9.17bn), and the Switzerland-based UBS revealed a $13.5bn loss through its sub-prime investments while Morgan Stanley and Merrill Lynch saw similar losses of $9.4bn and $8bn, respectively. Closer to home, the Royal Bank of Scotland saw $2.6bn evaporate.

Deflecting fate

The outlook for the US housing market is currently far from positive, with the US Congress' Joint Economic Committee predicting two million foreclosures on sub-prime property by the end of 2008. In an attempt to deflect this fate or, at the least, soften its blow, the US government formed partnerships across all levels of the mortgage sector to form Hope Now in October 2007, an alliance to aid homeowners who may be unable to pay their mortgages.

Uncertainty in the global financial markets has already started to affect the prices of UK homes as house prices experienced their first decrease in value in years and institutions become more wary of approving mortgages. According to a survey from the Nationwide building society, the price of the average UK home fell by 0.8% in November of last year, and dropped a further 0.5% the following month. In addition, the British Bankers Association revealed that the number of approved mortgages for home purchase in November 2007 was 43.5% lower than it had been a year previously.

RATE RISES

In response to the increasing fears of an imminent UK recession, the Bank of England reversed its increase in the interest rate of June 2007, reducing it by 0.25% to 5.5% in December last year. In the protection industry, disquiet has been building as it has become widely recognised that it may take some time before the UK economy returns to a state of relative normality. The Confederation of British Industry's quarterly financial services survey revealed that 80% of life insurance firms believe that it will take more than six months to return to normal markets. Among general insurers, that figure rose to 100%.

"What has effectively happened is that lenders are rationing funds by changing criteria and raising prices," says Ray Boulger, senior technical manager at John Charcol. "They're driving up prices to restrict the business they get. That's not across the board but some have problems where they can't lend too much."

Yet with the rush of cash being effectively restricted, sales of protection seem, bizarrely, to be increasing. According to figures from the Association of British Insurers, the numbers of new income protection and critical illness (CI) policies being sold rose significantly through the first three quarters of 2007. The number of income protection policies sold in 2007 ranged from 43,000 to 44,000 per quarter, a marked increase on the average quarterly figures of 32,500 and 34,750 for 2005 and 2006, respectively. In comparison, sales of stand-alone CI products rose from quarterly averages of 14,750 and 16,000 in 2005 and 2006 to 26,000, 24,000 and 18,000 over the first nine months of 2007.

That sales have risen is little surprise to Richard Verdin, sales and marketing director for Direct Life and Pension Services. "The housing market was having a negative effect on the protection market because mortgage brokers didn't have time to fully explore protection with their customers. Consequently, what we have seen is growth in the protection market that is counter-intuitive to what you would think. Now mortgage brokers are not having so many customers, it stands to reason that they are spending more time with them. The opportunity is there to provide a holistic or tailored package, and that generates more revenue than just putting out more life insurance."

However, Verdin warns that the protection market should expect to see an eventual downturn in business in the near future as the credit crunch begins to further push the housing market and, consequently, brokers into a corner. "It still means that the protection industry is in a fine balance as it means there will be less mortgage brokers, and that will have a negative effect. Right now though, we are seeing a reduction in mortgage income, which is translating to a rise in protection income."

Mark Jones, protection products and actuarial manager at Friends Provident, believes that not only will the reluctance of banks cause the housing market to lose speed and possibly even reduce in the coming months, but that consumer confidence will also play a big part. "It's likely to cause a reduction in housing transactions as people lose confidence. They're not going to move or are going to wait as they don't want to see their biggest asset losing value. I anticipate that the market is likely to initially be flat or down."

Verdin's view that the global reduction in credit flow could lead to a temporary boost in protection sales is endorsed by a handful of figures within the industry, including David Hollingworth, head of communications at London & Country. "It's certainly focused the mind, and advisers will be thinking about advising their clients on protection," he says. "It's going to be important that brokers are making the most of each and every client. It may spur brokers on to pay more attention and give more advice on protection, which would be a good thing."

However, Hollingworth says there could be negative consequences for the protection industry in the event of a recession, and comments that if interest rates are increased and mortgages become more expensive as a result, protection policies will probably be the first to be sacrificed. "Obviously, mortgages are one of the points where people start taking out protection. If people are facing higher mortgage payments, that may have an impact on protection products. People at the end of fixed-rate deals can still get a good arrangement but they're not going to get what they've had. One of the dangers is that you have people having to deal with increased payments, and they may be tempted to cancel on an existing protection policy."

Peter Chadborn, principal at CBK, agrees and says the importance of being adequately protected needs to be put across to consumers, who may be ignorant of what could happen if the worst does occur after they decided to forgo or reduce a protection policy. "It depends on how people view their protection. If we are talking to a first-time buyer and they are trying to understand all these new expenses, they'll tend to include protection in the same budget."

Going through a recession may make things much more difficult for customers, IFAs and providers alike, especially if the Bank of England does as widely predicted and is forced to declare another hike in the interest rate in May. "If people have to stretch themselves to get the mortgage they wanted, there may be less money in the pot for protection issues," Chadborn says. "It comes down to how consumers value their protection. If they've bought into the concept, they shouldn't be cancelling policies, but if they are looking to cut costs and not much value was put on the need for the protection when it was taken out, then they will easily discard it." n

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