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We Need to Prepare Ourselves for Higher Interest Rates

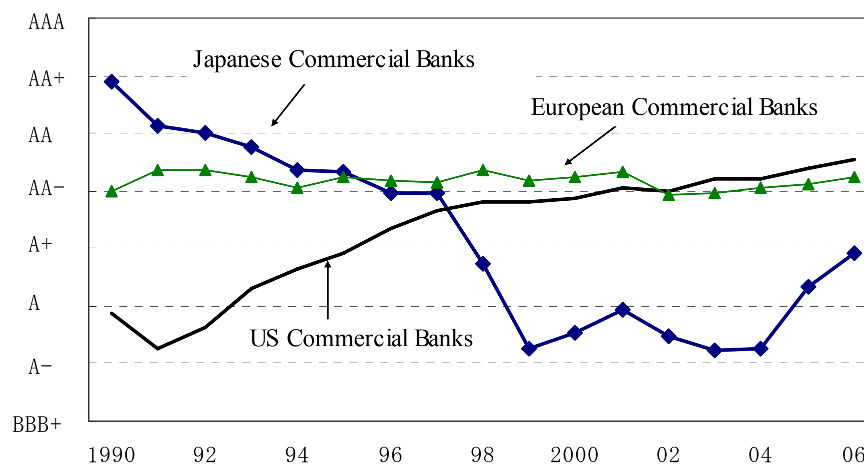
Summary

If deflation continues to be coming to an end in Japan, then interest rates are expected to rise significantly in the mid- and long-terms. In times of rising interest rates, having adjustable rate mortgages can lead to increased repayment burdens on households, and so lenders need to shoulder the responsibility of ensuring that the borrowers are well aware of this risk. The consumer loan market may shrink dramatically if market interest rates continue to rise and the interest rate ceiling is lowered. The cap on interest rates should float with market rates.

This current economic expansion -- that is now certain to outlast the postwar record of economic expansion, the Izanagi boom (57 months between November 1965 to July 1970). The BOJ lifted the zero interest rate policy, making room for future interest rate hike. Though their rises are likely to be gradual at this stage, households must be well aware of the risk of higher interest rates in the mid- to long-terms.

The net incomes of Japanese (commercial) banks in FY2005 (ending March 31, 2006) have reached record levels and the credit ratings are expected to be upgraded (Exhibit 1).

Exhibit 1. Credit Ratings of Major Banks



Notes:

1) Credit ratings by the rating agencies are transformed into numbers and then arithmetic average is taken in each country.

2) Source: S&P, Moody's, Fitch, R&I, JCR.

Though the banking sector has shown a remarkable recovery, the (lending) margins – or the difference between the funding rates for the banks and the lending rates that are charged to the borrowers – are downward-trending. There are limited opportunities for banks already cutting their expenses and loan losses to raise their profit levels Given the fact that operating expenses are increasing, profits of banks would be about to reach their peaks.

Heavier Burdens Caused by Adjustable Rate Loans

In such an environment, Japanese banks have more focused on personal loans markets. In particular, the outstanding amount of residential mortgages has been growing rapidly and helping to offset the decline in commercial loans where it is difficult to make adequate profits (Exhibit 2). On the other hand, the outstanding mortgages by the Government Housing Loan Corporation (GHLC) have been declining. That fact is at least partly due to the fact that business of the GHLC is planned to be taken over by the Independent Administrative Agency in 2007.

Exhibit 2. Loans and Discounts Outstanding by Sector of Domestically Banks

Source: Bank of Japan.

It should be noted that the majority of Japanese people choose adjustable rate mortgage loan. As home purchasers intend to own their homes, they tend to prefer loans with initially low monthly repayments. A typical example is the type of loan called the "selective fixed term rate mortgage". That has a fixed interest rate for a certain fixed period from the outset and then has a adjustable rate. However, the extremely low interest rate environment is coming to an end and there is virtually no room for interest rates to fall from now, so that the amount of repayments of "selective fixed term rate mortgage" would be larger than what (zero-interest rate addicted) people have expected.

Let us compare the typical fixed rate mortgage product "Flat 35" with the "selective fixed term rate mortgage". The Flat 35 is a mortgage product where banks subsequently sell the loans to the GHLC and the GHLC securitizes them.

We conduct a simulation of effects of rises in interest rates on the Flat 35 (whose recent average lending rate has been 3.096%) and on the selective fixed term mortgage product with fixed rates for the first five years and adjustable rate thereafter (a representative initial rate of a major bank has been 1.85%). We run a simulation for 35 year mortgages in both cases, and we assume the rates would rise only once after five years.

If we assume that the most recent adjustable rate (2.375% at a major bank) will rise to higher than 3.7%, then the total repayment amount of the Flat 35 will become less than that of the other mortgage product. If the adjustable rate will remain at low rates, then the repayment burden on the Flat 35 will become greater. However, given the current level of market rates, that scenario will unlikely take place.

The adjustable rate at any point in the future can be estimated from the expected future interest rates (IFR – the implied forward rate, derived from the current market rate) and then adding a credit risk premium. The one-year IFR, nine years from now is 2.8 - 3.0%, while the interest rate on a current one-year forward is about 0.6%, and the implied risk premium is about 1.8% (2.375% less 0.6%). Thus, the average rate on the 30-year mortgage rate in the adjustable period is estimated to be at least 4.6 to 4.8%, which is higher than the 3.096% on the Flat 35.

Greater Burdens in the Later Years with the 125% Rule

The increase in the adjustable rates is expected to result in a greater burden on the households. For adjustable rate mortgages, we calculate the repayment amounts when the interest rises just after the start of the loan, as shown in Exhibit 3. (assuming that the initial interest rate is 2% and the rate rises just one year later and that the monthly repayment amounts are revised every five years).

Exhibit 3. Estimates of Repayments of Rising Interest Rate on Adjustable Interest Rate Residential Mortgages

Amount of Loan	30 million yen	Initial Rate of Interest	2%
Term of Loan	35 years	Monthly Repayment of First 5 Years	99.4

Interest Rate from the Second Year	125% Rule	Monthly Repayment		Total Repayment Amount	Of Which Unpaid Interest
		Sixth Year	Final Payment		
2%	—	99.4	99.4	11,739	—
3%	—	118.4	118.4	18,588	—
5%	Does not apply	163.8	163.8	34,929	1,110
5%	Applies	124.2	190.2	38,384	1,285

Notes: In thousands of yen.

If the interest rates go up by 1.0% or to 3.0% in the second year and the rates remain unchanged thereafter, the monthly repayment amounts from the fifth year will be 1.2 times larger than those in the case of 2% interest rate for the whole period and if they rise by 3%, then the monthly repayment amounts from the fifth year will be 1.6 times larger.

Moreover, if the interest rates skyrocket, then the repayment amounts will be lower than the interest payment. The borrowers will find that they will not be even keeping up with interest payments. For adjustable rate loans, in order to avoid a sharp rise of monthly repayments due to hikes in interest rates, the “125% rule” is often applied. This rule ensures that when repayment amounts are revised every five year, the new repayment amount should be smaller than the current amount multiplied by 1.25. Under that rule, unpaid interests can accumulate much faster, and the burden in the later years will be much higher.

During the period of interest rate hike, household income is expected to rise in some degree, thanks to the economic expansion. But households should not be too optimistic. Many households may find that the repayments on the loan have become much greater burdens than they initially anticipated, and then they would not be able to stay current with their payments.

According to a survey conducted by the GHLC, almost 40% of respondents answered they “do not know at all” and “do not know well” the interest rules on adjustable rate loans. Such a lack of borrowers’ knowledge can be, to some extent, attributed to insufficient explanation by the lenders. In order to avoid a large number of defaults in personal mortgage loans, banks must be fully accountable to their borrowers and must also be in control of their lending activities from their risk management perspectives.

Declining Margins of Consumer Loan Companies

The consumer loan industry is at stake. The legally maximum interest rates under the Interest Rate Restriction Law are 20%, while under the Moneylending Control Law, the maximum rates of interest are 29.2% (and non-compliance can lead to criminal penalty). Consumer loan companies charge high interest rates on loans. The rates lie between the ceiling imposed under the Interest Rate Restriction Law and the ceiling of the Moneylending Control Law. The range 20%-29.2% is known as the “grey zone”. However, as there are social concerns regarding excess lending, multiple or heavy debts, and harsh collection practices, the interest rate cap under the Moneylending Control Law will be most likely to lower the maximum rates to the 20% level, which is consistent with the Interest Rate Restriction Law.

Consumer loan companies have been highly profitable with a rapidly growing loan outstandings, while the personal lending for consumer goods and services from banks has been on the decline. The major banks have strong incentives to participate in the consumer loan business due to their high returns, and there have

been capital participation and business alliances. Examples include the alliance between Sumitomo Mitsui Banking Corporation's (SMBC's) and the consumer loan company Promise, and the Bank of Tokyo-Mitsubishi UFJ's alliance with Acom. Banks have been increasing their personal loans in this way, but there have been widespread criticism of such alliances.

Unlike corporate loans, consumers normally do not use their loans to generate profits. In addition, suppose that an individual borrows over half of their annual salary and pays close to 30% interests on it. Unless the loan has a very short term and is for bridge finance, the interest will accumulate very quickly and it is likely that the individual would not have the capacity to repay the loan. There is of course some fault of the individuals borrowing large sums without knowing their ability to repay the loans. And there is also greater criticism against the lenders: they are well aware of the borrowers' credit conditions, make large amount of high-rate loans, and use harsh collection methods.

Lowered interest rate ceiling would have huge negative impact on the consumer loan industry. The loan margins would be lowered, and the ability of the loan supply would be hampered. As the margins would shrink, consumer loan companies would not be able to lend to relatively high risk customers. Moreover, the amount of loans exceeding one-third of the borrower's salary would be generally prohibited.

Exhibit 4. Estimates of Profits and Losses of Major Consumer Finance Companies

		Expenses Reduced	Increase in Funding Rates		
			0%	3%	5%
Declining rate of Outstanding Loans	10%	No	1,597 (44.0%)	486 (13.4%)	▲ 254 (▲7.0%)
		Yes	2,051 (56.5%)	940 (25.9%)	200 (5.5%)
	40%	No	36 (1.0%)	▲ 704 (▲19.4%)	▲ 1,198 (▲33.0%)
		Yes	1,852 (51.0%)	1,112 (30.6%)	618 (17.0%)

Notes: Data of five major consumer finance companies (Takefuji, Acom, Promise, Aiful and Sanyo Shinpan). Figures in parentheses denote percentage shares over total operating profits of fiscal 2005 (363.2 billion yen). Note that the interest refund cost component of extraordinary losses is excluded. ▲ denotes negative sign.

Exhibit 4 displays estimated effects of both higher funding costs and smaller amount of loans. The estimation assumes that the average lending rate --currently 23%-- will decline to 18%, and that the amount of borrowings from the consumer loan companies will also decline as their loans decline. If their outstanding of loans

fall by 10%, then given the unchanged funding rates, their operating profit will shrink to less than half. If their funding rates rise by 5%, then they will generate operating losses.

Suppose the outstanding of loans fall by 40%, a 3% increase in their funding rates will lead to operating losses. Even under the scenario assuming a reduction in operating expenses in proportion to their decline in lending, a rise in funding rates will let consumer loan companies just barely be able to avoid losses.

Lessons from Germany and France on interest rate ceilings

The enforcement of maximum interest rates chargeable by law may have some value in resolving social problems, but it lacks economic rationality.

The problems are that this discussion concerning the interest rate ceilings takes place in the environment of extremely low interest rates and that the ceiling is expressed as a fixed nominal rate. Looking at the long-term historical interest rates in Japan, zero interest rates are very unusual. As the Japanese economy revives more and more, interest rates are expected to rise by (at least) a few percentage points.

If the interest rate ceiling is determined by the law as a fixed nominal rate, then the lenders may be unable to add an appropriate spread in some cases. The fraction of credit costs as a share of loans outstanding was about 4% until fiscal 2000 for the five major consumer finance companies but in fiscal 2005, it rose to above 7%.

If consumer loan companies will be unable to generate profits even after trimming their expenses, then they will not be able to survive. It will not be a desirable outcome for consumer loan companies to be out of business when interest rates are going to be normalized.

The interest rate ceilings should take the form of, for example, “Japanese government bond yield + a fixed spread”. This is how interest rate caps are determined in Germany and France. Though it is important to protect borrowers from a social welfare standpoint, the adjustable interest rate ceiling will be efficient or rational in economics sense.