MANSFIELD
BUILDING SOCIETY

Why understanding "swaps" are important for brokers

There is no question that we are in the midst of a turbulent time for interest rates. Recent data from Moneyfacts found that the average rate charged on a five-year fixed rate has now passed 4% - the first time it has done so since February 2013. Brokers will be only too familiar with lenders pulling and repricing products - often at relatively short notice - or in some cases, even pausing lending altogether.

On the surface, it's easy to ascribe this activity to the changes in bank base rate. After all, following years of record low base rates, we have seen a succession of increases since December, taking base rate from 0.1% to its current point of 1.75%. And as the base rate moves, so too do the rates on mortgages, right?

Not quite, it's important for brokers to recognise that this link is not so cut and dried, and that something called "swap rates" are worth our attention.

The role of swap rates

Banks and building societies use retail deposits (money invested by personal savers and businesses) to fund a large proportion of their lending – the difference between what they charge their borrowers and what they pay to their savers (and other funding sources) creates the profit margin before operating costs are taken out. This model works well whilst both borrowers and savers pay and receive a variable rate of interest i.e. if rates go up the margin is protected as borrowers will pay more, increasing the return for savers who naturally expect the rate increase to be passed on. The opposite is also true.

Naturally, if interest rates increase, banks and building societies pass on the increase to their savers but, what happens if their mortgage book comprises a significant proportion of fixed rate lending? In this scenario (*which is common in an inflationary market as borrowers naturally opt for the security of a fixed rate mortgage*) the problem is that they can't pass on the corresponding uplift to fixed rate borrowers so the profit margin gets squeezed and, the reality is, that lenders could in fact find themselves receiving less interest from borrowers than they pay to their savers.

So, to enable banks and building societies to manage this risk exposure they are obliged to take prudent measures to mitigate the risk in the form of 'swaps'.

Natural swaps can take the form of fixed rate savings products; term savings bonds for example which can be used to effectively 'lock-in' the margin, and lock-out any future interest rate movement. However, more commonly, swaps take the form of a financial transaction between the lender and a counterparty (typically a large bank) whereby the lender forfeits some of the margin in exchange for rate certainty.

There are all sorts of external factors that can influence the pricing of these swap rates, but at their heart they are driven by what financial institutions think will happen to base rate over the coming years.

Even with the base rate increases we've already seen this year and with inflation predicted to rise even higher, commentators expect there will be further hikes in order to get a handle on inflation. As a result, lenders have seen some fairly dramatic increases in swap rates recently across two, three, five and ten year terms, as the market reacts to an ever changing economic climate.

Whilst the Monetary Policy Committee (MPC) meet to set the rate at specific time periods, swap rates can be constantly changing and reacting to market confidence. Given they are driven so much by sentiment and anticipation, uncertainty around the future means that swap rates can become volatile and what was a previously a logically priced mortgage can quickly become an unsustainable option.

Base rate and swap rates

Swap rates are significantly influenced by what could happen to base rate. And it's that sentiment about what lies ahead for base rate which can then have such an impact on the interest rates your clients face when looking to purchase, remortgage or go through with a product transfer on a fixed rate.

The role for mortgage brokers

The vast majority of clients will have never heard of swap rates, let alone have any inkling of the role they play in the setting of mortgage interest rates.

Yet brokers are the front line when it comes to educating clients about both current and future product pricing availability.

Checking in with clients at a time of turmoil is not only a good retention strategy, but it also provides brokers with the opportunity to outline that product pay rates have a limited availability that can be completely unrelated to base rate. This may be the prompt some clients need in order to get on with securing a new rate and equally, brokers may be able to reassure clients about what may lie ahead.

Brokers always want to deliver the best possible experience to their clients - advisers all take their role incredibly seriously. By building up a greater understanding of what can influence lender pricing, including swap rates, brokers are better placed to deliver a more comprehensive advice service.

A common sense approach

If you've got a case on your desk that requires a common sense approach to lending then please, whether it's a first-time buyer, home mover or remortgage client, pick up the phone to our Broker Support team on 01623 676360 or visit https://www.mansfieldbs.co.uk/intermediaries/.