A **yen** for financing

*Yen-denominated mortgages have proven an attractive source of low-cost housing funding over the past 10 years. **David Rowe** asks if these products are an accident waiting to happen*

Japan has struggled for more than a decade with a stagnating economy and persistent fears of deflation. To counter this malaise, the Bank of Japan has kept yen interest rates at or near zero for most of this period. This has presented a tempting opportunity, not just for experienced traders booking leveraged yen carry trades, but for many humbler folks as well.

A web search on yen mortgages turns up references as far back as 1996. In the years since then, borrowing in yen to finance a house, either in the US or UK, has proven to be a profitable move. While such borrowers do not get a zero interest rate, they may get rates that are as little as a quarter to a third of those in their home currency. Most of these foreign currency mortgages have been arranged for high-net-worth individuals, and many have been professionally managed to switch in and out of yen. Still, there is a lingering concern that some borrowers may have undertaken such loans to cut their borrowing costs with limited understanding of the potential risks.

A profitable but harrowing ride

Tracking the performance of the yen over the 10 years to December 2006 shows that the currency has depreciated by 2.5% against the dollar and by more than 15% against sterling. Therefore, the value of a yen mortgage taken out at the end of 1996 has actually shrunk in terms of US dollar or UK sterling, on top of carrying a much lower interest rate than would have applied to domestic borrowing. As the graph (right) shows, however, it has been a rather harrowing ride along the way.

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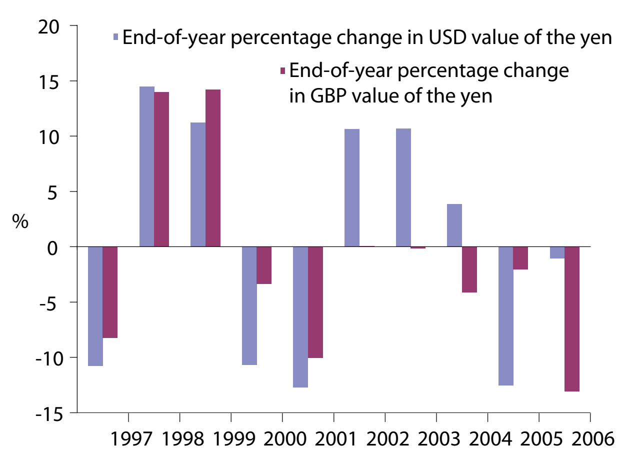
After declining substantially against both the dollar and sterling in 1997, the yen rallied at double-digit rates over the next two years before giving back most of this gain in 2000 and 2001. It gained versus the dollar between 2002 and 2004, before giving back about half of that gain in 2005. Sterling-based borrowers did better in these years, with the yen fairly stable against the pound between 2002 and 2003, before falling modestly in 2004 and 2005 and substantially in 2006.

Lurking danger?

Economist John Kenneth Galbraith once quipped: "In some quarters, financial genius is a rising market and a short memory." When any strategy works for a prolonged period of time, it is easy to become complacent and lose sight of the inherent risks involved. The interest rate advantage of yen mortgages has been so significant that none of the periodic yen rallies over the past 10 years would have been sufficient to offset it. (The biggest year-on-year rally in the yen over this period was almost 35% against sterling in the 12 months to August 1999.) Of course, some of these rallies would have temporarily eroded most or all of a homeowner's equity if allowed to run their course, depending on the initial loan-to-value ratio.

With emerging problems in the subprime loan market, one must wonder whether some aggressive lenders have put relatively unsophisticated borrowers into yen mortgages. To date, such loans would have worked out well for all concerned, assuming no need to sell the underlying property at an awkward time along the way. On the other hand, if Japan returns to a more normal economic environment, this could produce serious problems. Yen interest rates could start to rise simultaneously with a strengthening yen exchange rate. If this was combined with falling domestic housing prices, it would constitute a nearly perfect storm of losses on all three aspects of such loans. Let's hope this is just an idle scenario of an old risk manager's hyperactive imagination. ■

1 Annual year-end percentage change in yen value



Source: OANDA.com