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Financial Health
MONTHLY UPDATE MAY 2008

Rates go down, but rates go up! What's happening in the world?

How confusing is the world of finance? Interest rates go down and then mortgage rates go up?

The UK is rocked by 'The Credit Crunch' (the media just love a name), but how can this be when the problem is in the US? And of course, the media think the financial world is crashing down around us.

You can only really invest effectively, and sleep at night, if you have an understanding of what is happening in the world of finance and what you should do about it. Now that doesn't mean that you have to be watching the markets every minute of the day, but you need to have an overall understanding of how things work, and how they affect you.

In this month's update, we want to give you some more background to help you more fully come to grips with what's happening in the world and how it affects you (or not).

How do interest rates work?

To really understand the markets you must understand how interest rates work, because the real world is nothing like how you imagine it would be. You would think, not unreasonably, that interest rates change by the Bank of England simply announcing what the 'interest rate' is. But what is the interest rate?

The interest rate that you see in the media is the 'lender's lender rate'. This means that if a bank runs into problems, and it borrows from the Bank of England, then this is the rate that it pays - well, kind of. In practice, this has never happened as the Bank of England can do pretty much whatever it wants. In the real world, the Bank of England sets interest rates by buying or selling Treasury bonds on what is known as the 'Repo' market. The Repo market is a second-hand market for buying and selling Treasury bonds. By selling bonds on to the market, the Bank of England can increase interest rates by the impact of reducing the supply of money in circulation. Conversely, it can reduce rates by buying bonds. This may all seem very strange, but it has worked for a couple of hundred years, and the Bank of England is nothing if not traditional.

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How do rates go up when they come down?

The interest rate that you and I pay on our mortgages, and receive on our savings, is set by the bank from which you borrow or where you save. It has nothing to do with the interest rate set by the Bank of England.

The bank lending to you will look at the rate at which it could borrow money from other banks, to decide what it will charge you. As there is a huge stigma in borrowing from the Bank of England, banks would rather borrow from other banks. Most British banks, unlike their US cousins, do not need to borrow long-term money from other banks, with the exception of Northern Rock, and possibly Birmingham Midshires. Most inter-bank lending is short-term, to cover poor liquidity. For example, if you write a cheque on your Barclays account and it is deposited in a NatWest account, then Barclays will have to send NatWest that amount of money on the day the cheque clears. In the course of that day there are billions of these transactions, and there is no chance that the money that NatWest receives from Barclays will be the same that Barclays receives from NatWest customers. And so, Barclays will have to borrow from NatWest, or NatWest from Barclays, to cover the difference. Now think of this happening between all of the banks. You can see why there is so much borrowing between banks, and you can see how for this to work they must all believe that they can cover their relative debts.

All well so far, and this has worked well since the early 70s. However, as you will know from the last two updates, some imprudent lending in the US caused their systems to start seizing up, as one bank started to mistrust another (probably because it knew what its own finances were really like). As all banks are pretty much international now, this bounced across the Atlantic and made the UK banks worry.

The result of all this is that the banks, because they think there could be more risk, increase the interest rates they charge, in return for this increased risk. Certainly, as house prices have stagnated, or fallen depending who you believe, mortgage risks have increased and so interest rates increase, irrespective of what the Bank of England does with rates.

The banks, not slow to realise a trick, see this as an opportunity to make money, so at the same time that mortgage rates increase, savings rates are falling. If a bank has only £1bn on deposit and it increases mortgage rates by 0.5% and reduces savings rates by just 0.1%, they will make an extra £6,000,000! And the banks have much more than £1bn on their books.

Why isn't the Bank of England reducing rates by more?

There is another massive misunderstanding which has been caused by the media of late, and that is that the Bank of England cares about the economy. I have seen no end of 'financial journalists' over the last month asking why the Bank of England does not reduce rates by more, to stop the recession. Well, firstly, we are not in recession; the economy is certainly slowing, but it is still growing. But, secondly, the Bank of England has no responsibility for the growth of the economy. The Bank of England's sole purpose is to control inflation, and it must do that by looking in the rear-view mirror.

Inflation is a strange thing, and is affected by a hundred different factors from exchange rates to the success of the Brazilian coffee harvest. The Bank of England, however, has only one weapon to deal with inflation, and that is interest rates. It's like having a rudder on a ship, but not being able to control the engine, and certainly not having any control over the tides or the wind. What's worse is that changes in interest rates tend to affect an economy 18 months after the changes. If you think you have a hard job planning, think about those poor economists in the Monetary Policy Committee; theirs is almost impossible.

So – what should I do?

Firstly, a little common sense. Never keep more than £35,000 in any one bank (or £70,000 for joint accounts). At this level the deposit is covered by the Financial Services Compensation Scheme, so all of your money is safe.

Secondly, remember that only the Bank of England is 100% safe. For consumers this means gilts and National Savings. National Savings may pay a little less than commercial banks, but your money is absolutely safe, and you must understand that trade-off.

Don't keep too much on deposit. The whole point of holding cash on deposit is to meet liquidity, intended spending and possible emergencies. It is vary rare that someone will need more than say £50,000 on deposit. The rest should be invested, at a risk level that you are comfortable with. If you don't like risk then keep it all in gilts.

Lastly, never panic. The media's job is to sell papers and persuade people to watch their channel. Most people are attracted to bad news, and the media know this, which is why the headlines are always pointing out negative issues rather than positive. The situation is never as bad as they say, and everything goes in cycles. Be patient, don't worry and everything will turn out right.

Hedge funds not covered by FSA

At the economic and monetary affairs committee public hearing in Brussels, Dan Waters, Director of retail policy and themes, and section leader at the FSA, said that hedge funds themselves are outside the FSA's jurisdiction.

Over the last few years hedge funds have come more to the fore as investment vehicles. Unlike equity funds, a hedge fund is a collection of 'options'. These options give the fund manager the right to buy or sell in the future at set prices, whatever the market does. This means that if a fund manager thinks that the FTSE 100 will rise in the future, he can buy options to buy assets in the FTSE 100 at their price now, and thus make a profit from buying at the low price and selling immediately at the high price. Effectively it is a fund of bets!

If used correctly it can enhance gains or reduce losses. However, in practice, the fund manager seems to earn more than the investor.

This recent clarification by the FSA is bad news for those investing in hedge funds as they will not be protected by FSA regulation. For this reason alone we recommend that no investment should be made into hedge funds.

Best Savings Selection

To get the best from your deposit based savings you often need to move the money around. Use these rates to help you with your arrangements.

Top Three No Notice Accounts

Name	Contact	£1 Gross %	£500 Gross %	£1,000 Gross %
Heritable Bank	0845 607 1212	N/A	N/A	6.06
Anglo Irish Bank	0845 455 2222	6.05	6.05	6.05
Bradford & Bingley	0845 724 7247	N/A	N/A	6.00

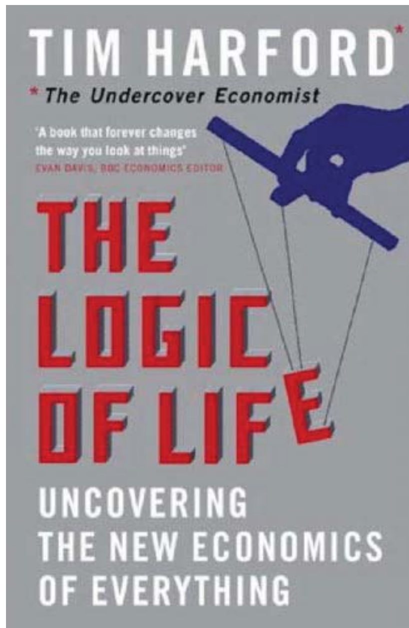
Top Three Monthly Interest Accounts

Name	Contact	£1 Gross %	£500 Gross %	£1,000 Gross %
Kaupthing Edge	www.kaupthing-edge.co.uk	N/A	N/A	6.31
Chelsea BS	0845 7446622	N/A	6.13	6.13
FirstSave	www.firstsave.co.uk	N/A	N/A	6.09 (minimum £5,000)

Top Three Cash ISA's

Name	Contact	£1 Gross %	£500 Gross %	£3,000 Gross %
National Counties BS	0845 6034876	6.26	6.26	6.26
Alliance & Leicester	www.alliance-leicester.co.uk	6.25	6.25	6.25
Market Harborough BS	01858 412250	6.10	6.10	6.10

Please check with the terms and conditions before opening any account. If in doubt consult with your financial adviser directly as the above are for information only.



Book of the month

The Logic of Life *by Tim Hareford*
(ISBN 0316027561)

This is a follow-up to his successful book, The Undercover Economist, which we recommended last year. Like his first book, The Logic of Life is a collection of essays on economic theory and how economics can work in the real world. The book is a very enjoyable and easy read and is a must for all amateur economists out there.

Clarification on Nil Rate Band

As we mentioned in previous updates, the changes to the Inheritance Tax (IHT) rules mean that the executors of a second-to-die spouse can claim any unused Nil Rate Band from the first spouse to die. This claim is made via an IHT 214 form during probate on second death.

This does not mean that you have an allowance of £624,000. It means that you have an allowance of £312,000 and can make a claim for any unused allowance, which may be up to £312,000 in this tax year. This may be semantics, but we have seen people trying to claim £624,000 when they only have an allowance of £312,000. We have also seen people who think that the allowance is now £624,000 per person, which clearly it is not.

Pre-nups up!

Research by Grant Thornton shows that the number of pre-nuptial agreements drawn up in England and Wales has increased dramatically. Their figures show an increase of 67% over the last 12 months. All very strange when you consider that pre-nuptial agreements are not enforceable under English law.

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