5 October 2003

Productivity Commission
Collins Street East
Melbourne

Dear Sirs/Madams

Care should be taken when compiling a time series and making comparisons of real mortgage interest rates over the longer term. The following factors should be taken into account:

1. Inflation index used to calculate the real rate

The choice of inflation index should be appropriate and take into account the spending patterns of borrowers (i.e. households). Moreover, the RBA focuses on consumer inflation when setting official interest rates.

2. Factors to take into account when calculating nominal mortgage interest rates.

The following factors should be considered when compiling nominal mortgage interest rates over time.

(i) Nominal interest rates have in the past varied for owner occupiers and investors

Mortgage interest rates for owner occupiers and investors have converged in recent years. Borrowing and lending for housing investment is more risky than borrowing and lending for housing occupation. Hence, the convergence of interest rates may result in owner occupiers subsidizing investors.

When comparing average mortgage interest rates over the long term, the interest rate should ideally be a weighted average between interest rates on loans to owner occupiers and investors. The RBA does not publish historical investor mortgage rates, but the RBA may hold this information.

The convergence of interest rates on mortgage loans for owner occupiers and investors means that the weighted average mortgage interest rate was generally much higher in the past compared to the interest rate payable by an owner occupier on a standard mortgage loan.

(ii) Nominal interest rates should be a weighted average across all lenders

Mortgage interest rates should ideally be calculated as an average across all mortgage lenders. Players in the housing lending market have changed and, in the past, different types of lenders tended to charge varying interest rates. For example, permanent building

societies accounted for around 35% of total housing lending in 1984. Permanent building society mortgage interest rates averaged 13.45% in June 1984, while bank standard mortgage interest rates averaged 11.5% (i.e. a difference of 1.95%). Solicitors used to be a significant player in the mortgage market (and usually charged a premium).

Permanent Building Societies: share of housing credit and premium charged over bank standard variable mortgage interest rates.		
June	Share of Housing Credit	Premium over Bank Standard Mortgage Interest Rates
1970	38%*	NK
1980	40%*	2.0%*
1985	31%	1.6%
1990	13%	0.1%
1995	5%	-0.1%
2000	3%	0.1%
2003	2%	0.1%
Source: RBA and estimates (*)		

Mortgage managers emerged in the early 1990s and offered interest rates that were below bank standard mortgage rates. Competition then drove bank interest rates closer to those offered by mortgage managers.

By including all mortgage lenders, the average mortgage interest rate across all lenders will tend to be much higher than the bank standard mortgage rate prior to the mid-1980s.

(iii) Nominal interest rates should reflect an "effective rate"

In the past, mortgage lending transaction costs (such as establishment fees and monthly and annual fees) were higher than they are today and these fees tended to subsidize lower headline interest rates (i.e. the effective interest rate was much higher in the past than it is today).

Honeymoon interest rates have been offered only in more recent years.

This means that for a given headline interest rate, the effective interest rate was higher in the past than it is today.

(iv) Rationing of credit may indicate a higher effective interest rate

There used to be quantitative and qualitative controls on bank lending and this may have at times reduced supply of credit for housing and may have artificially kept interest rates down. These controls at least partly explains the significant presence of permanent building societies in the home lending market up to the 1980s.

An analogy of credit rationing could be drawn with import quotas. These quotas are included with import tariffs to arrive at an "effective" rate of import protection.

(v) Market mortgage interest rates pricing

Mortgage loan products offer the borrower more today than they did in the past. To the extent that these new services or accommodations represent additional utility to the borrower and additional costs to the lender, this may indicate that nominal interest rates have fallen by more than is apparent. For example, lenders have relaxed loan terms, offered fixed term interest rates, and extended repayment periods. Loans are advanced for a greater proportion of the value (or purchase price) of security properties. Lenders now offer other services, such as redraw facilities and loan offset accounts (which are relatively new innovations).

Indeed, since that late 1990s banks and other mortgage lenders began to offer lower interest rates for mortgage loans that offered fewer options. In August 2003, the bank interest rate for a "basic" variable interest rate mortgages was 0.55% lower than the standard variable mortgage interest rate.

Pricing of mortgage loans was driven down by a reduction in the capital weighting for loans secured by housing assets, the emergence of a housing loan asset market (i.e. securitization) and competition from new players (i.e. mortgage managers). This has contributed to lower mortgage interest rates.

Also, the ability to borrow a greater percentage of the purchase price of a property may on occasion reduce borrowers' costs (e.g. reducing the need to use higher cost credit to finance a deposit). Lenders have accrued productivity gains and have introduced new systems to evaluate credit risk and this has produced economic gains to lenders that have offset at least some of the costs of new services and accommodations.

But the costs of relaxing loan terms may not be fully reflected in pricing. A mismatch between pricing and risk is already apparent with the convergence of owner occupier and investor interest rates. Moreover, APRA has asked deposit taking institutions to perform balance sheet stress tests on the basis of various scenarios which reflect credit losses that are currently unaccounted for by lenders. If default rates were to rise above financiers current expectations, that may expose mispricing.

Also, lenders have increasingly relied on overseas borrowings to fund their Australian mortgage books and have also relied on securitization. These developments may involve additional risks, such as foreign currency risk, maturity risk and reputation risk (i.e. risks that may not be currently fully priced into interest rates).

(vi) The introduction of fixed period interest rates
Fixed interest rates are a relatively new product. Fixed rates tend to be offered at a premium above standard variable rates, and hence the introduction and take-up of these options will tend to have increased average interest rates paid by borrowers.

There may be additional factors which affect comparability of real mortgage interest rates over time.

Yours faithfully

Nigel Fitzpatrick