ABA Submission to the Productivity Commission

for the Inquiry into First Home Ownership

27 October 2003

INTRODUCTION

The Australian Bankers' Association welcomes the opportunity to provide input into the Productivity Commission's Inquiry into First Home Ownership. ABA's member banks constitute about 70 per cent of the housing finance market in Australia.

Home ownership is an important social and economic goal in Australia. Unlike in Europe, Australians are less comfortable with rental arrangements for shelter and security, mainly because under a rental arrangement, the landlord, rather than occupant, retains the decision of entry and exit.

Housing is viewed increasingly by households as a store of retirement wealth, partly a consequence of Commonwealth Government objectives, since the 1980s, to increase the private contribution to retirement income. Recent superannuation performance reinforces this view.

The purchasing cost of a first home has been regarded by generations as the family's most significant financial commitment. The issue behind the current affordability debate is whether this commitment is now excessive and preventing households from accessing owner-occupied housing services.

ABA's submission focuses on the housing finance constraint and argues three main points:

(a) Changes in the housing finance industry and macro-economy since deregulation in the 1980s have increased the capacity of households to acquire debt to purchase housing; but

(b) Housing affordability has not improved because the increased borrowing capacity of households due to these changes has capitalised into house prices; and

(c) This suggests that any initiatives to improve housing affordability should be focussed on increasing the sensitivity of housing supply to any changes in demand. On this basis, the ABA's submission comments on proposals to improve affordability.

KEY FACTORS IMPACTING ON HOUSING FINANCE SINCE THE 1980s

The capacity of a household to borrow enough money from a bank to purchase a desired dwelling is dependent upon the borrower being able to pass two primary tests:

(a) An equity test; and

(b) An income test.

To pass the equity test, the applicant must demonstrate he/she has a sufficient loan deposit. A typical requirement for an average borrower is 20% of the purchase price. This equity indicates a savings capacity, and protects depositors' funds in the event of default.

To meet the income test, the applicant must demonstrate with documents like pay slips or tax-returns, he/she can afford the interest-repayments on the loan. A good rule of thumb used by banks is 30 per cent of the applicant's gross income - with larger commitments assessed after regard for net servicing capacity.

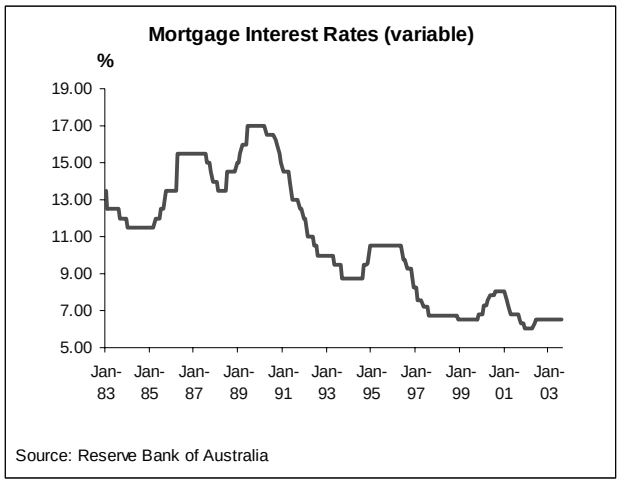
While these two primary tests have remained essentially constant over recent decades, lower interest rates, higher incomes and financial innovation have enabled households to borrow considerably more money for housing purchases.

Lower interest rates

Lower mortgage interest rates (price of housing debt) enable a borrower with any given income level to acquire more housing debt. Similarly, lower petrol prices enable car owners to buy more fuel.

Mortgage interest rates have declined dramatically since the 1980s. In the latter half of 1980s, mortgage interest rates averaged 15 per cent, compared with 7 per cent in the five years to 2003. This is a reduction of 8 percentage points, more than half.

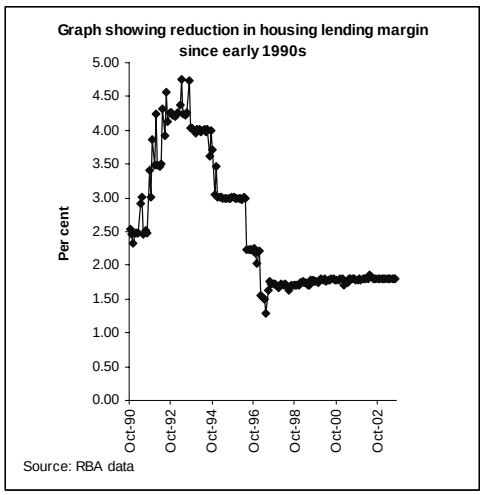
Graph 1



While low inflation is the main driver of the 8 percentage point reduction in mortgage interest rates, declining bank margins as a result of greater competition amongst lenders is also significant. Graph 2 traces this decline in

lending margins by showing the change in gap between mortgage rates and the official cash rate since the early 1990s. The margin appears stable at 1 ¾ percentage points[1] , a large reduction from around 4 percentage points in 1992. (Note – this measure does not reflect all bank lending costs).

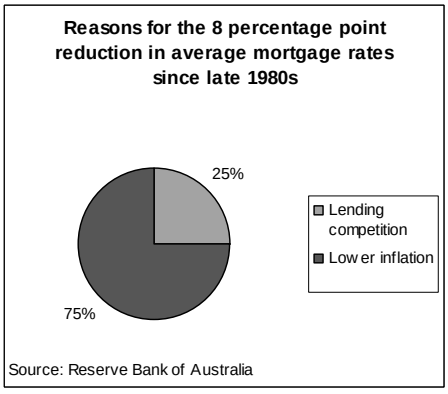
Graph 2



Another measure used to estimate lending margins is known as bank spreads. This measures the difference between what banks receive in lending interest and what they pay on deposits. This measure shows a similar story; spreads fell from 4 to around 2 ¾ percentage points in the last decade - a decline of 1 ½ percentage points or 30 per cent.

This margin decline is responsible for a significant reduction in mortgage interest rates since the 1980s. As highlighted in Graph 3, of the 8 percentage point reduction in mortgage interest rates since the 1980s, 2 percentage points (25 per cent) can be attributed to margin decline brought about through greater competition.

Graph 3



Bank fees and charges are often cited as factors offsetting the consumer savings derived by lower interest margins. Reserve Bank analysis shows that

[1] 'Banking Fees in Australia', Reserve Bank of Australia Bulletin, April 2003.

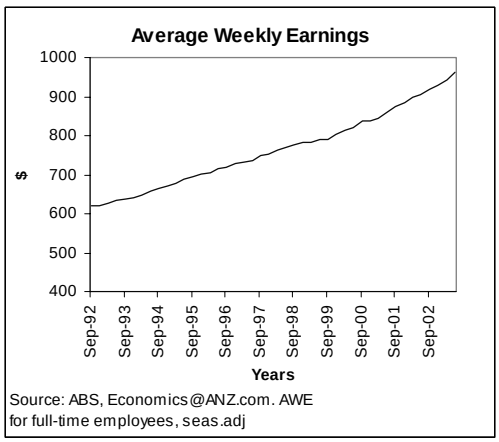
overwhelmingly, consumers are benefiting from lower interest margins, with only small offset from fee increases.

Home borrowers are particularly better off, because not only do they get the full benefits of lower interest rates, but generally they are exempted from fees and charges on transaction accounts. Most banks will charge home loan customers an application and mortgage account keeping fee, but these fees have remained stable since 1997. The Reserve Bank concludes: "*Fees on household loans, expressed as a percentage of household credit, have been almost unchanged since 1997.*"[2]

Higher incomes

Incomes have also risen strongly since the 1990s as a consequence of Australia's high level of productivity growth. The data shows that average weekly earning for full-time adults, has increased 60 percent since the early 1990s.

Graph 4



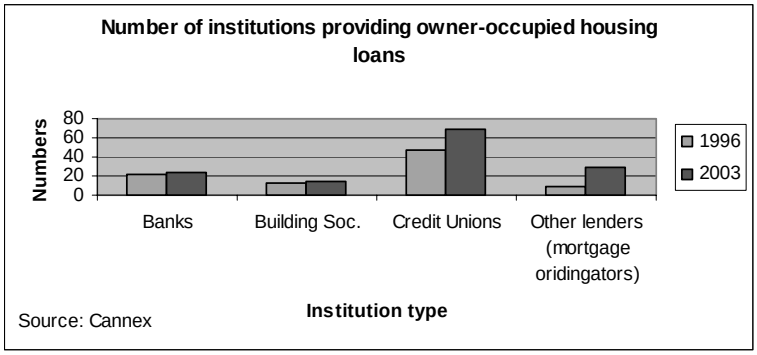
The consequence of higher incomes is that households are able to acquire a greater amount of housing debt. Assuming a fixed proportion of income available for interest repayments, and a fixed interest rate, a 60 per cent increase in income would allow the households to hold 60 per cent more housing debt.

More competitors

The number of competitors offering housing loans has nearly doubled since 1996, from 92 providers to 136 today. Graph 5 shows this increase is almost entirely driven by credit unions and mortgage lenders. Mortgage originators entered the Australian market in 1992, using securitisation to raise money for lending. Securitisation is a process of removing credit risk from the institutions' balance sheet by selling the loan interest repayments into debt markets.

[2] 'Banking Fees in Australia', Reserve Bank of Australia Bulletin, Reserve Bank of Australia, April 2003, p6.

Graph 5



Considerably more Credit Unions are also providing owner-occupier home loans. This is not being driven by an increase in the number of credit unions, but a higher proportion of them offering housing finance loans to the wider public.

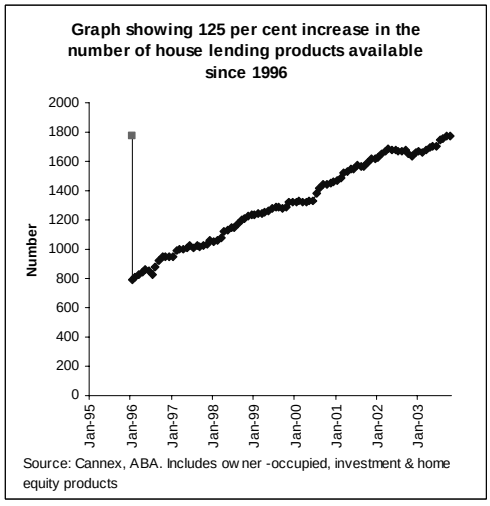
Financial innovations improving access to loans

Financial innovation, defined as the range and sophistication of financial products, increased enormously in the 1990s as a result of greater competition, customer demands and advancements in finance and information technology. With respect to mortgage lending, the innovations can be grouped by their effect on (1) assisting customers gain access to home loans; and (2) reducing the effective consumer cost of borrowing.

The innovations improving access are listed below:

- *Greater product choice.* Since 1996, the number of home loan products has increased by 125 per cent. This increase in choice of home loans means households are empowered to better find a home loan product that caters for their particular needs.

Graph 6



- *Better risk assessment practices:* Since early 1990s, spurred by substantial commercial credit losses by some institutions, banks heavily invested in improving risk management and information technologies. The practical results are that banks can more accurately assess borrowers' credit worthiness, enabling more objective (less conservative) lending policies without exposing the institution to greater credit risk. (Enhanced bank capacity to identify and manage risks is recognised in the design of the draft New Capital Accords, known as Basel II, published by the Basel Committee of the Bank of International Settlements (BIS). These accords will allow sophisticated risk management banks more autonomy in identifying and setting capital against risk.)

- *Mortgage insurance:* Mortgage insurance allows borrowers with insufficient deposit to fully meet the bank's lending criteria, to still access loans by taking out an insurance contract. This product, therefore, extends the prospect of home ownership to a greater number of people.

- *Deposit bonds:* Deposit bonds allow property buyers to delay deposit payment beyond exchange of contracts. While mainly targeted at investors, first home buyers are eligible, improving the prospect of home ownership to those reluctant (or temporarily unable) to raise a deposit up-front. Commonly, they are used for off-the-plan property purchasers where property settlement may be as long as three years from date of contract exchange, and also for short-term usage.

- *Low-documentation loans:* These loans improve accessibility for people whose careers prevent them producing normal evidence of income. Typically, these are self-employed people with uneven cash flows. Not all banks provide these loans, but they extend loan access to people who have legitimate capacity to repay loans, but can't get the normal documentation.

- *High loan/value ratio loans (e.g over 90 per cent):* For loan applicants that can demonstrate a high level of income, but who for some credible reason, do not have the normal deposit required for the loan, some banks will approve loans above the normal loan/value ratio. This practice allows these customers to bring forward their property purchase and therefore get housing access at a time more suitable to their needs.

- *Non-conforming loans:* Property buyers unable to secure bank loans on standard lending criteria because of failure in passing a bank's equity and/or income test, can apply for a loan with an institution specialising in higher-risk lending. These products are typically priced at higher rates, reflecting greater default risk.

The next section looks at innovations reducing the effective cost of lending.

Financial innovations reducing effective cost of lending

- *Interest rate differential between owner occupier and investment loans:* Since mid-1990s, banks have eliminated the differential between owner-occupied and investment housing lending rates. This is an incentive for property investment, but has also reduced lending rates for first home buyers who choose to rent and negatively gear their first home, while living in cheaper accommodation (e.g. at home with parents).

- *Home equity loans:* These products extend the borrower a line-of-credit against equity in his/her property (assuming sufficient equity is maintained). They potentially lower overall borrowing costs by allowing consolidation of higher-priced (unsecured) debt.

- *Introductory (honeymoon) rates:* Banks offer introductory interest rate to compete for business. Terms are typically 6-12 months. These rates are priced significantly under the standard variable rates, saving borrowers on interest repayments for the contracted period.

- *Fixed rate loans:* All banks have products allowing borrowers to fix their home loan interest rate for a specified period, usually one, three or five years. These products emerged substantially in the early 1990s when high structural inflation ended. For home borrowers, they offer predictability in interest repayments and, therefore, greater confidence their loan will remain affordable.

- *Split rate loans:* Split loans allow the borrower to fix the rate on a specified proportion of their loan, with the difference remaining variable. As with fixed, this enables borrowers to set more predictable interest repayments.

- *Offset and redraw functions:* These facilities allow home borrowers to reduce interest repayments by maximising benefits of accumulated savings. The typical arrangement sees the borrowers' entire salary deposit into his/her home loan account. Cash flow shortage is typically overcome with a deferred payment card e.g credit card, which is cleared each month by redrawing against equity in the loan account.

- *Early repayment penalties:* Most loan products now don't penalise borrowers for faster repayment under variable rate option.

Mortgage broking

An estimated 25-30 per cent of the home loan stock has originated through mortgage brokers. Over the last decade mortgage broking has become a significant feature of the housing finance landscape. Brokers may add value for borrowers by reducing loan search costs. While concerns have been raised about standards in broking, many customer experiences are good; this point was found by the Consumer Credit Legal Centre's (CCLC) report to ASIC this year.[3]

ABA supports MIAA's [4] moves to independently regulate its members for conduct and disclosure standards with the objective of benefiting customers. While compliance cost may marginally increase service fees, customer benefits exist in ensuring brokers are subject to minimum conduct and disclosure standards. The principles of sound regulation should apply; in particular, if self-regulation is sufficient in meeting objectives, then this is preferable to legislation.

Improvement in bank efficiency

Since the early 1990s, Australian banks have considerably improved their efficiency through reducing operating expenses. This improvement has enabled banks to maintain profitability levels despite declining interest income and revenue from non-interest sources.

Graph 7 shows an impressive performance from Australian banks in reducing expenses compared with overseas counterparts.

The cost ratio for Australian banks declined from 3.0 per cent of total assets to 1.5 per cent over the decade to 2001. In other words, they halved operating costs in the decade.

By comparison, banks abroad lowered their expenses from 2.9 to 1.9 percent of total assets. The graph shows that between 1994 and 1999, Australian banks had a higher expenses compared to the international average, but in 2000 and 2001, this ratio fell considerably and is now well under the international average.

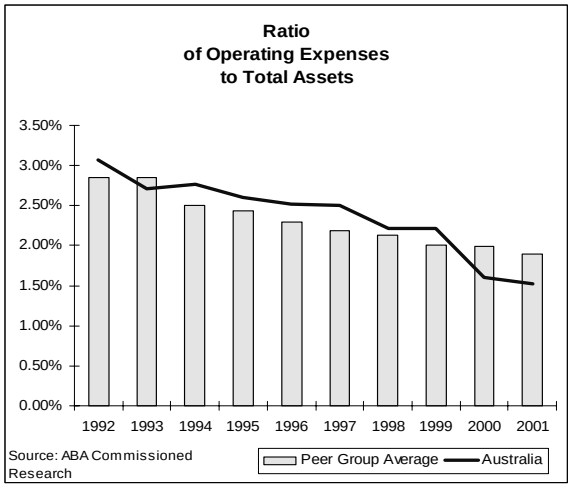
Graphs 8 and 9 highlight why banks had to cut expenses if they were to maintain profitability. Graph 8 shows the steady decline in net-interest income from 1994. For non-interest income, Graph 9 traces the decline from 1998, a trend that moved in the opposite direction to overseas bank counterparts.

The decline in non-interest income as a proportion of assets may be surprising for many because of the significant media attention given to

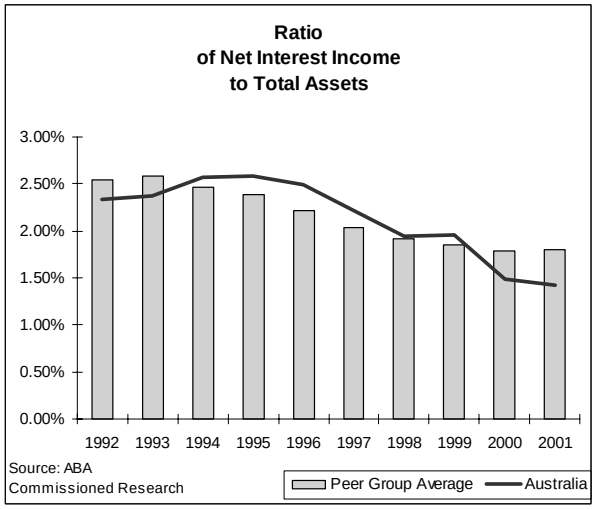
[3] Report on the Finance and Mortgage Broker Industry, Consumer Credit Legal Centre (NSW), March 2003.
[4] Mortgage Industry Association of Australia

increases in bank fees and charges. (It should be noted, however, that non-interest income includes a wider set of revenue than just bank fees and charges, but it is the largest component).

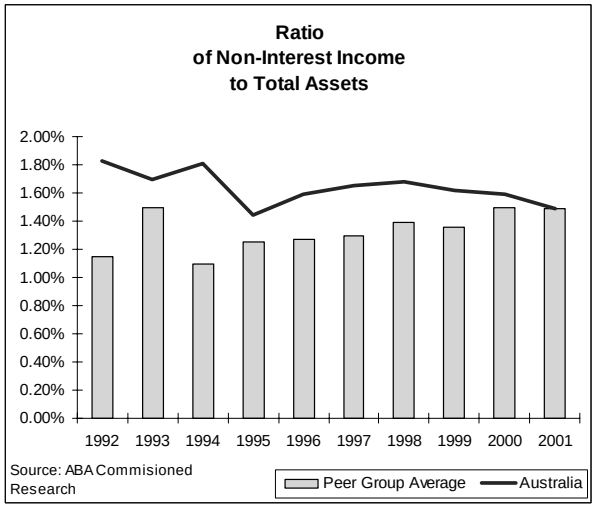
Graph 7



Graph 8



Graph 9



Refinancing and switching

Low costs for customers wanting to refinance or switch loan providers is important for market discipline and competitiveness. Evidence suggests these barriers for refinancing or switching are low.

Recent research by the Australian Prudential Regulation Authority (APRA) concluded that there is considerable churning of home loan providers.

> *"…around 42 per cent of housing loans are less than one year old and 77 per cent are less than three years old. This is a natural consequence of the recent acceleration in the growth in housing credit. It is also an indication of considerable loan refinancing or churning, either directly or via mortgage brokers, often in response to "honeymoon" interest rates offered on new housing loans."* [5]

Property investors more active – do they pose a problem for first home buyers?

Property investor activity has been identified as an indicator that the property market is in a speculative bubble situation.

Property investors have clearly increased activity in recent years. ABS data shows that 45 per cent of new loan approvals are for investment housing.[6] Investors now account for around 30 per cent[7] of housing loan debt, up from 18per cent in 1992.

One of the main cyclical factors influencing property investment is the poor performance of the stock market in recent years. In two years to June 2003, the Standard and Poor's/Australian Stock Exchange Accumulation 200 Index fell by over 6 per cent.[8] In the same period, average house prices increased from $240,000 to $319,000 – an increase of 32 per cent.

Increased property investment benefits renters (Reserve Bank estimates the housing rental yield fell from 5.5 per cent in March 1994 to 3.4 per cent in June 2003), but may disadvantage first home buyers in the short term by increasing demand and therefore raising housing prices, particularly where housing supply is sticky. However, medium to long-term, prices should adjust to fundamental not cyclical or transient factors. Already, for example,

[5] 'The Resilience of Housing Loan Portfolios – APRA's "Stress Test" Results', Address by APRA's Chairman, John F Laker, to Securities Institute of Australia, Rydges Jamison Hotel, Sydney, 9 October 2003.

[6] It should be noted that ABS loan approval figures over-estimate intended investment in housing, because one buyer may be approved for a loan by more than one institution, and the figures are not adjusted for this double counting.

[7] 'Household Debt: What the Data Show', Reserve Bank of Australia Bulletin, March 2003, p.1.

[8] First Home Ownership – Issues Paper, Productivity Commission, September 2003, p.14

there is evidence that prices for inner-city Melbourne and Sydney apartments are falling in nominal terms.

Increased asset price volatility is also cited as a consequence of higher investor property ownership, because investors will trade property on the basis of financial return expectations, whereas owner-occupiers buy houses for reasons other than just economic return.

For first home buyers, greater volatility should not *prima facie* be a concern because, by definition, volatility provides good buying opportunities as well as less good; prices will ebb and flow more, similar in nature to the stock market. (Greater volatility may have economic consequences, however.)

Housing lending standards – have they declined in recent years?

Strong housing credit growth over recent years prompted concerns that lending standards by banks, building societies, credit unions and mortgage originators were less than prudent. In response to these concerns, the Australian Prudential Regulation Authority (APRA) initiated a major data collection exercise with banks, building societies and credit unions (not mortgage originators) to "Stress Test" the soundness of housing lending portfolios.

Results of APRA's program were publicly released in a speech by Chairman John Laker on 9th October 2003 in Sydney. APRA's specific aim was to satisfy itself banks could withstand a 30 per cent housing price correction and large increases in mortgage defaults, without breaching capital adequacy requirements.

The findings are attached as Appendix 1 to this submission, but the summary position outlined by APRA's Chairman is:

> *"Broadly speaking, the results are reassuring. They demonstrate that the ADI[9] sector – even though heavily exposed to Australia's very buoyant housing market at present – remains well capitalised and could withstand a substantial housing market correction, if one were to eventuate, without putting depositors at undue risk"*

Most importantly, the APRA research did not find any evidence of systemic problems in bank housing lending portfolios, indicating that credit policies generally across the industry have been effective and prudent in controlling risk. For the housing borrower, this means that banks are not making loans whereby the risks of financial loss by the borrower are excessive or inappropriate.

[9] ADI stands for 'Authorised Deposit Taking Institution', they constitute banks, building societies and credit unions.

Other issues

Investment seminars: Investment seminars characterised by aggressive and/or misleading property marketing have no place in Australia's real estate market. ABA believes property investment advisers should be subjected to the Financial Services Reform Act (FSRA). This legislation sets out standards for conduct and disclosure. All banks are covered by this legislation.

Regulation of mortgage originators: Mortgage originators compete with banks in housing lending. This competition benefits home buyers. Mortgage origination uses securitisation to finance loans, a process whereby credit is raised in capital markets, not through deposits. Banks also use securitisation, but unlike mortgage originators, banks are subjected to prudential regulation because they also take deposits. There is a case for subjecting mortgage originators to closer supervision of mortgage lending practices, particularly if evidence emerges of lax standards.

Vendor financing: The Reserve Bank has identified Vendor Financing, a contractual arrangement whereby the property purchaser occupies, but does not get full ownership of a house, until he/she fully pays off the vendor's loan. Except for in South Australia, this activity is unregulated and is potentially financially damaging to those that use it.[10]

POLICY IMPLICATIONS OF THE CHANGES IN HOUSING FINANCE

The previous section demonstrates the significant number of influences impacting on the housing finance market. These changes taken as a whole, represent a significant increase in the capacity of households to access and reduce the effective cost of borrowing.

The fact that housing affordability has not improved in that period has a strong policy implication. It suggests that increasing purchasing power of households by giving them more money, or increasing their capacity to borrow, will result in higher prices not better affordability.

Capitalisation of house prices

Despite lower interest rates, rising incomes and financial innovation since the early 1990s, housing affordability in Australia has not improved. The reason, of course, is that house price increases have offset the increased borrowing capacity of households.

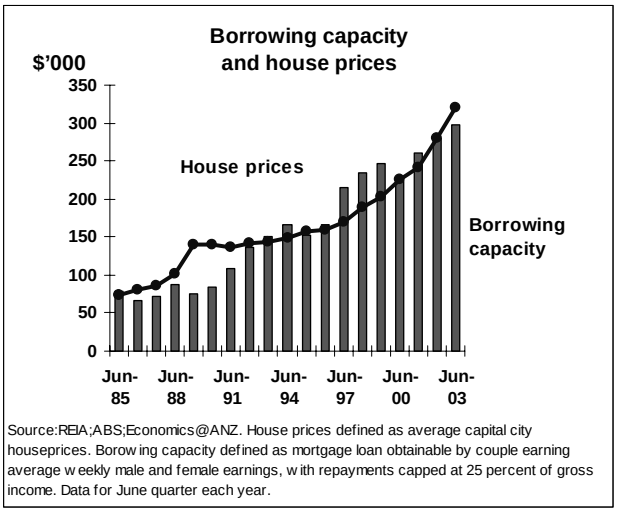
This story is emphasised in Graph 10. It shows a close correlation between average borrowing capacity of households and average house prices. As

[10] 'Recent Developments in Low-deposit Loans', Reserve Bank of Australia Bulletin, Reserve Bank of Australia, October 2003.

average borrowing capacity increases, the graph shows average house prices increasing at a similar rate.

In other words, when a person's financial situation improves, they use this leverage to pay more for property.

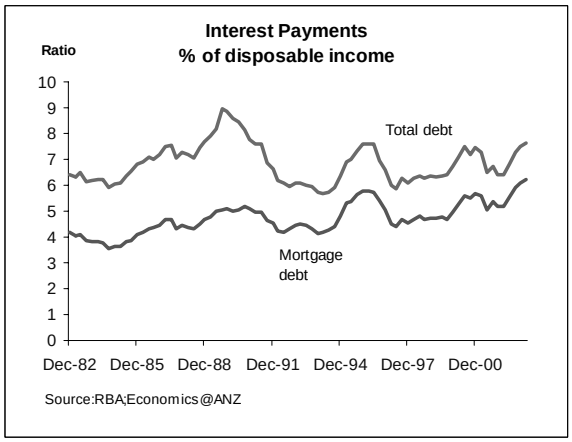
Graph 10



Source:REIA;ABS;Economics@ANZ. House prices defined as average capital city houseprices. Borowing capacity defined as mortgage loan obtainable by couple earning average weekly male and female earnings, with repayments capped at 25 percent of gross income. Data for June quarter each year.

This is also demonstrated in Graph 11, it shows that average mortgage interest repayment levels (measured against income) are roughly the same as they were in the late 1980s. The implication of this is, again, that the borrower responds to increased purchasing power by increasing his/her loan until it reaches a comfortable proportion of income.

Graph 11



Source:RBA;Economics@ANZ

The argument that improvements in effective housing demand capitalise into house prices is also supported by evidence that the proportion of Australians owning a home has not changed significantly since the 1980s.

Census data shows that up until 1991, the proportion of households with a mortgage has not increased above 30 per cent of the population [11] despite financial innovations widening access, lower interest rates and higher incomes. This indicates that households are holding more debt, rather than more households holding debt. A result consistent with the capitalisation argument.

Supply-side stickiness

The fact that increases in household borrowing capacity appear to transfer (capitalise) smoothly into higher house prices rather than widening access to housing loans, indicates that housing supply is relatively sticky compared to the demand-side.

Housing affordability is impacted by the interplay of demand and supply-side factors, as with any market for goods or services. To the extent to which housing supply responds slowly to demand will determine the impact on housing affordability. The slower the supply, the worse for first home buyers attempting to purchase a home.

The construction of new houses and the processes for developing housing suitable for building involves considerable time. The time lag is – in part – dependent upon the nature of house building, it takes around six months to fully erect a house, but it is also dependent upon State Government policies. State Governments can impact on housing supply sensitivity in two key ways:

- Planning policies; and
- Taxes and charges.

Planning policies include land release and zoning strategies. While any increase in the demand for housing will increase the price of land if that supply is fixed, State and Local Government have control over laws that can improve the speed of supply. Land availability can be increased through converting land from other uses, or by increasing the intensity of land use.

State and Local Government also have powers to influence housing development by specifying zones on building type and size apply. If, for example, a government disallowed a proposal to build an apartment building on the equivalent land of four stand-alone houses, then that represents a supply-constraint equivalent to the number of households prevented from occupying dwellings on that land. State government can also influence housing supply through infrastructure policies. It is not possible, for example, to construct urban housing without access roads, electricity and other services.

[11] 'Household Debt: What the Data Show', Reserve Bank Bulletin, Reserve Bank of Australia, March 2003.

Taxes and charges are also important factors in the housing affordability because they prevent an efficient usage of the existing housing stock. For example, Stamp Duty is payable whenever a person purchases a house. For an owner-occupier, Stamp Duty represents a significant tax on moving residence, and therefore is a barrier to more efficient utilisation of the existing housing stock.

Shared equity solution

ABA believes the key to improving housing affordability is to increase the supply-sensitivity of housing supply, rather than undertaking initiatives to increase demand. On this basis, we comment on a number of policy proposals to improve affordability.

Caplin & Joye [12] advocate a secondary housing equity finance market whereby a home buyer could secure equity to assist financing. In return, the equity provider realises his/her investment when the house is sold.

This proposal, from a theoretical financial perspective, may be sound, as it potentially improves diversification of the household's asset portfolio, by reducing domestic property exposure (Other means[13] of achieving this are: buying a cheaper form of housing e.g. unit, moving to a cheaper location, renting, or buying a house jointly with another person).

In terms of improving housing affordability, ABA is less convinced of its appeal because housing supply stickiness poses a risk that stronger household purchasing power may capitalise into higher prices. While increasing supply elasticity (as advocated by Caplin/Joye) it is unclear whether State and Local Governments will adjust planning and tax policies sufficiently to improve this sensitivity.

ABA also believes the proposal to establish a securitisation market would require the Government's balance sheet. Under the proposal, the house's occupier does not pay rent to the equity partner. Establishing a predictable portfolio cash-flow return for investors, therefore, requires a very large portfolio of equity claims.

The question is: how long would it take to build this portfolio and whose balance sheet would be used to do it? From the banks' perspective, a critical factor is how the prudential regulator (APRA) would set capital charges against banks holding domestic equity investments on their balance sheet. Our assumption is that the Australian Prudential Regulation Authority

[12] 'Volume 1: Innovative Approaches to Reducing the Costs of Home Ownership', a Report Commissioned by the Menzies Research Centre for the Prime Minister's Home Ownership Taskforce, Authors: Caplin, Joye, Butt, Glaeser, Kuczynski, June 2003. Available at www.mrcltd.org.au.

[13] ABA acknowledges that the shared equity financing proposal has the advantage over these options of allowing the owner-occupy to consume better quality housing services, and in the case of joint ownership, the Caplin/Joye proposal would be seen as superior by many because the occupier maintains all rights management and the decision of when to sell.

(APRA) would regard this equity investment as it does other equity investments, and require capital deduction for the investment's full value.

With this capital treatment, a business case for investing in these equity stakes is uncertain. However, Government can take a longer-term focus and is therefore in a better position to establish a market by originating a sufficiently sizeable portfolio for securitisation.

Housing Lifeline proposal

Melbourne University academics Joshua Gans and Stephen King propose a Higher Education Contribution Scheme (HECS) funding model to provide eligible households with a Government funded line-of-credit to maintain loan repayments or rent when in cash-flow difficulties.

From banks' perspective, this initiative reduces lending risk to customers eligible for the Government subsidy. Lending risk is then absorbed by Government, but secured against secondary mortgage on the property. Even with limited security, the extent of risk transfer to Government is potentially high (in stressed environments), but ultimately a function of terms and conditions and eligibility.

An attraction of the Housing Lifeline proposal is that it improves the capacity of households to repay their mortgage over time, without leading to increased (up front) purchasing power and therefore risk of capitalisation into prices. On this basis, ABA believes the proposal is worth examining with a net public benefit, cost/benefit analysis.

Initiatives by David Moloney and Alistair Bor (from Booz Allen & Hamilton)

David Moloney and Alistair Bor[14] recommend a range of initiatives which, as they acknowledge, increase purchasing power of home buyers and effective demand for property. As argued previously, ABA is not convinced demand-side initiatives will be effective given supply-side stickiness.

ABA agrees fully with the recommendations to improve financial literacy and assist borrowers to, for example, accelerate loan repayments, refinance loans etc. ABA is currently planning a financial literacy program covering these issues. This will supplement individual bank programmes.

ABA notes that since the author's published their recommendation for reverse mortgage products, Commonwealth Bank of Australia (CBA) has introduced such a product. St. George bank has offered this product for some time.

[14] 'Volume 3' a Report Commissioned by the Menzies Research Centre for the Prime Minister's Home Ownership Taskforce, Authors: Moloney and Bor, June 2003. Available at www.mrcltd.org.au.

CONCLUSION

In conclusion, ABA's recommendations are for the Federal and State Governments to:

(a) Ensure mortgage brokers are subjected to appropriate regulation for conduct and disclosure;

(b) Subject real estate investment advisers to the Financial Services Reform Act (FSRA) which sets down standards for conduct and disclosure.

(c) Concentrate policy remedies for first home ownership on the supply-side of the market, particularly improving State and Local Government planning processes and taxation.

(d) Take precautions in adopting policies that will increase buyers' purchasing power of properties.

(e) Consider the Gans & King proposal for financial lifeline as a means of reducing lending risk profile of low-income households, subject to a demonstration of net public benefit.

Further information

13. For further information on this submission, please contact Nicholas Hossack at the ABA on 02 8298 0408 or email: nickh@bankers.asn.au.

Appendix 1: 'The Resilience of Housing Loan Portfolios – APRA's "Stress Test" Results', Address by APRA's Chairman, John F Laker, to Securities Institute of Australia, Rydges Jamison Hotel, Sydney, 9 October 2003.

The resilience of housing loan portfolios - APRA's "stress test" results

John Laker
Thursday, 09 October 2003

Introduction

I am pleased to be speaking to you today, my first address as the new Chairman of the Australian Prudential Regulation Authority (APRA). I look forward to other opportunities to explain the important role which APRA plays in the Australian financial system and the various prudential issues with which it is dealing - always, I hope, with a positive message to impart. My thanks to the Securities Institute of Australia for hosting this gathering.

The mandate of APRA, broadly speaking, is to promote the soundness and stability of regulated financial institutions in the interests of beneficiaries, whether they be depositors, policyholders or superannuation fund members. APRA's prudential oversight is naturally focussed on individual institutions. At the same time, it must always be cognisant of the macroeconomic environment in which these institutions operate and the pressures that may arise if this environment turns adverse.

One macroeconomic development that has become the subject of increasing policy attention is the continued rapid growth of credit for housing, which has fuelled strong rises in housing prices. Over the past five years, credit for housing has grown by around 120 per cent and housing prices across Australia's capital cities by around 80 per cent on average, and more sharply in particular capitals. A growing share of this credit has been for investment housing. These developments have increased the vulnerability of Australian borrowers – particularly those with substantial exposures to inner-city apartments – to interest rate increases, housing price falls and any impairment of their ability to service loans.

The recent momentum of the housing market cannot be maintained. Credit growth must inevitably return to a more sustainable relationship with nominal GDP although, at this stage, the timing and path of the adjustment is uncharted. The risks in this outlook for economic management have been clearly articulated by the Reserve Bank of Australia and, in more shorthand form, by the International Monetary Fund recently. The risks for the Australian financial system have also been identified by the Reserve

Bank, in pursuing its financial stability objective. In its 2003 *Annual Report*, released a month ago, the Reserve Bank noted:

> "Looking ahead, the main potential source of risk to financial stability would be a substantial correction in the housing market, impacting on the balance sheets of authorised deposit-taking institutions through mortgage defaults….The concern would be a sharp jump in mortgage defaults which triggered a more substantial market correction – a scenario more likely to be associated with a deterioration in employment conditions or sharp rise in interest rates." (p14-16)

APRA has been closely monitoring the risks facing Australia's authorised deposit-taking institutions (ADIs) – that is, banks, building societies and credit unions – in these heady times in the housing market. Late last year, it voiced its concerns about the emergence of some questionable housing lending practices and it asked all ADIs to review the soundness of their lending policies. Over recent months, APRA has also been conducting a rigorous "stress test" to help it gauge the resilience of ADI housing loan portfolios in the event that there were to be a substantial housing market correction.

APRA's approach to stress testing

In developing this stress test, APRA had three main objectives:

- to satisfy itself that ADIs would be able to withstand a large increase in mortgage defaults (associated with a significant fall in housing prices and a deterioration in economic conditions), without breaching capital adequacy requirements;
- to ensure ADIs have in place processes to manage the costs and risks involved in the loan recovery process; and
- to identify and direct supervisory action towards those institutions judged to be most at risk in a housing market downturn.

As input into the stress test, APRA requested data on housing loan portfolios from those ADIs, 120 in total, with more than $20 million in housing loans outstanding. The data covered the main characteristics of housing loans - their age, the loan-to-valuation ratios (LVR) at the time the loans were originated, their size and purpose (owner-occupied or investment property) and the arrangements in place for lenders' mortgage insurance. The ADIs were also asked to supply data on resource costs involved in managing loan defaults. A sample of ADIs had, in an earlier phase of the project, provided APRA with details of their housing loan defaults.

Some interesting features about housing lending have emerged from the data. Firstly, the average age of housing loan portfolios is very young. Around 42 per cent of housing loans are less than one year old and 77 per cent are less than three years old. This is a natural consequence of the recent acceleration in the growth in housing credit. It is also an indication of considerable housing loan refinancing or churning, either directly or via mortgage brokers, often in response to "honeymoon" interest rates offered on new housing loans.

Secondly, the median LVR on new housing loans is around 70 per cent. At this level, ADIs are building in a good buffer that reduces the likelihood of loan losses if properties held as security have to be realised on default. ADIs writing new lending business at much higher LVRs would attract closer supervisory attention from APRA.

Thirdly, around one-fifth of housing loans are covered by lenders' mortgage insurance, mainly loans with LVRs of 80 per cent and higher. For ADIs, this protection is sensible from a risk management perspective and it enables them to take advantage of the concessional risk-weight applied to housing loans for capital adequacy purposes. As I discuss later, however, reliance on mortgage insurance does place the onus on ADIs to have reliable systems for tracking insured loans and satisfying the requirements of the mortgage insurers.

Finally, the benign credit environment over recent years can be contrasted with earlier experience, which has shown a close correlation between periods of rapid increases in housing credit and subsequent credit losses. Graph 1 matches the increase in housing credit for a given year with defaults on loans originated in that year. Up until the mid-1990s, increased credit growth was associated with increased loan defaults, two or three years later. Since the mid-1990s, housing loan default rates have been remarkably low, even by Australia's excellent standards. Given the typical lags, it is too early to chart the results for lending from 2001 onwards but ADI housing loan default rates over this period have remained very low.

Graph 1

Housing Credit Growth and Housing Loan Defaults

Over the past seven years, it would seem, housing loan default rates have become uncoupled from growth in housing credit. The likely explanation is that the rapid increase in housing prices over

the period has enabled any troubled borrowers to exit the market without incurring losses. The decoupling might continue for a time whilever the belief persists – on the part of both borrowers and lenders – that housing prices can continue to rise without respite. When reality inevitably intrudes, however, the earlier linkages between housing credit growth and loan defaults might reassert themselves. This is not a prediction on APRA's part, but it is the kind of "worst case" scenario which has motivated our stress test of ADI loan portfolios.

APRA's stress test model

Let me turn now to the stress test itself. APRA's stress test model is a microeconomic model, which estimates housing loan default rates and losses based on the characteristics of individual loans – in particular, the LVR at origination and the age of the loan. The model does not attempt to forecast or simulate the future path of any of the macroeconomic factors that could affect house prices and default rates and losses. As a result, the APRA stress test does not model the potential causes of a housing price correction, and this is quite deliberate. Rather, it focuses on the impact that a potential correction could have on the capital position of ADIs.

The stress to which ADI housing loan portfolios have been subjected is a 30 per cent real reduction in housing prices over a one-year period and a substantial increase in mortgage defaults. Remember, these are assumptions, not predictions. At first glance, the assumption on housing prices appears a severe one. However, in the late 1980s/early 1990s, other countries have experienced peak-to-trough falls in real property prices of greater than 25 per cent, including the United Kingdom, Finland, Norway and Sweden. Sharper falls have been observed more recently in some South-east Asian capitals. APRA's assumption corresponds to a situation where property prices return to around mid-2001 levels, which could not be called a draconian result.

In APRA's stress test, the impact of a housing price correction of this magnitude on housing loan portfolios depends on three key considerations:

- the probability that a loan will default;
- the extent of losses if loans do default (loss-given-default); and
- any mortgage insurance recoveries that may be available.

Probability of default

For any given loan, the probability of default is a function of its LVR, age, size and type (owner-occupied or investment). In general,

high LVR loans are more likely than low LVR loans to default since the borrowers tend to have a higher proportion of their incomes committed to debt servicing, and a lower equity buffer to withstand a fall in housing prices.

The relationship between the probability of default and age of a loan tends to be non-linear. Default rates are low in the year after the loan was originated because borrowers under stress are often able to access other forms of credit or sell assets to maintain repayments for a short period. Similarly, borrowers that have been making loan repayments beyond four years have generally passed the most difficult debt servicing period, and are less likely to default. Such borrowers will have built up their equity in the property concerned due to a combination of the historical experience of rising housing prices and loan repayments (often ahead of schedule). Borrowers in the middle years (two to four years since origination) tend to have the highest default rates under normal market conditions.

Based on the housing loan default data provided, the APRA model assumes that, for a given LVR and loan age, larger loans are likely to have a higher debt servicing burden than smaller loans and therefore a higher probability of default. Moreover, larger loans are more likely to be secured against properties with a higher luxury component and/or in geographical areas that have experienced the greatest price appreciation. Such loans, in turn, are likely to be more vulnerable to market corrections.

Finally, and also based on the default data provided, the APRA model assumes that investment loans are likely to be more at risk of default than loans for owner-occupation. Some may challenge this assumption, but the underlying reasoning is that owner-occupiers are likely to place more importance on retaining their primary place of residence. Moreover, investment loans often have a speculative element and face the additional risk of rental vacancies.

The APRA stress test has a range of default rates, depending mainly on the LVR and age of loans, which are calibrated to an median probability of default on a housing loan portfolio of five per cent. Based on the data provided to APRA, this equates to a probability of default on housing loans for ADIs as a group of around 3.5 per cent. How tough is this scenario? The answer is that it is tough, judged against Australian experience over the past twenty years, when housing loan default rates – measured by claims under mortgage insurance arrangements – have averaged only around 0.12 per cent a year. At the same time, it is not out of line with experience in Queensland in the mid 1980s and Victoria in the early 1990s, when

default rates reached five to six per cent (on an underwriting year basis). Episodes of housing market stress in the United Kingdom and some regions of the United States over that same period generated higher default rates.

Loss-given-default

Losses on defaulted loans arise mainly because of a shortfall between the proceeds from the sale of property held as security and the amount of the loan outstanding. Losses can also increase significantly because of legal costs, real estate agent fees, marketing expenses and other costs involved in the collections process.

In the APRA model, the loss-given-default is determined by the LVR and age of loans. The higher the LVR, the lower the security coverage is likely to be in the event of default and hence the higher the potential losses. The younger the loan, the higher are debt levels likely to be and the less likely that security against such loans would have benefited from housing price appreciation. Hence, loss-given-default is expected to decline as the age of a loan increases.

APRA has calculated loss-given-default ratios based on historical data supplied by the mortgage insurance industry in Australia and data provided by a major international mortgage insurer to the Basel Committee on Banking Supervision. In APRA's stress test, the average loss-given-default equates to around 25 per cent.

Mortgage insurance recoveries

As I noted earlier, around one-fifth of ADI housing loans are covered by lenders' mortgage insurance. Where defaulted loans have such insurance, the ultimate loss to an ADI will depend on the level of mortgage insurance coverage held, and on the payout ratio.

Modelling the determinants of payout ratios is a difficult task, hampered by the lack of available data. Based on APRA's analysis, payout ratios in a stress scenario are likely to be determined by two general factors. One is whether the insurance was written directly by the mortgage insurer or by the ADI under "open policy", where ADI staff manage the insurance origination process. The other factor is the age of the loan.

Payout ratios are likely to be lower for open policy contracts because the mortgage insurer's terms and conditions are less likely to have been followed precisely. Payout ratios are likely to be higher for older loans. If a loan defaults shortly after origination, it is more likely that an error has been made in the origination

process and that mortgage insurance policies have not been followed correctly. This would require some adjustment to the claim made by the lender. Loans that default well after origination, however, are more likely to be the result of changes in the borrower's circumstances rather than poor loan origination procedures, in which case no claims adjustment is likely to be required.

Drawing on overseas experience, the APRA stress test allows for the possibility that claims under mortgage insurance policies will be subject to greater adjustment in the event of a substantial housing market correction, particularly where this is preceded by a surge in new housing lending.

The stress test results

Drawing these various elements together, the APRA stress test model involves determining a common set of assumptions about the probability of default and losses-given-default on ADI housing loan portfolios, in the face of a "shock" of a substantial housing market correction. These assumptions were then applied to the actual housing loan portfolio of each ADI, taking into account the LVR, age, size and purpose of its loans and its mortgage insurance arrangements. By applying a common set of assumptions in this way, APRA has prepared an easily comparable projection of defaults, losses and resultant impact on each ADI's capital position.

The key results of the stress test, for the ADI sector as a whole, are worth emphasising.

Firstly, ADIs as a group enjoy strong capital positions today and this strength – though reduced – would not be materially affected under the stress scenario modelled by APRA.

Secondly, the estimated default rate for ADIs as a group would be around 3.5 per cent. This default rate leads to a loss rate of around one per cent of the value of housing loan portfolios for ADIs as a group, equivalent to around 66 basis points of current regulatory capital ratios.

Thirdly, over 90 per cent of ADIs would survive such losses, taken on their own, without breaching minimum regulatory capital requirements. For a small number of ADIs, the losses, again taken on their own, would not be covered by surplus capital, but the breaches of minimum capital requirements would not be large. No ADI would fail or come uncomfortably close to failing under the stress scenario.

Finally, ADIs as a group would have net claims on lenders' mortgage insurers of a little below 3 per cent of current capital, a modest exposure in the context of ADI capital positions overall.

These results are, as I mentioned, averages for the ADI sector and there is obviously variation across institutions. Those institutions with older, lower LVR loans mainly for owner-occupiers would be expected to perform better in the stress test, and generally did so.

Broadly speaking, the results are reassuring. They demonstrate that the ADI sector – even though heavily exposed to Australia's very buoyant housing market at present – remains well capitalised and could withstand a substantial housing market correction, if one were to eventuate, without putting depositors at undue risk.

It could be argued, of course, that the impact of a housing market correction should not be assessed in isolation. Such a correction would create pressures on the household sector, and on economic conditions more generally, that could threaten the quality of other ADI lending and other profit sources. The APRA stress test makes no allowance for this, but we acknowledge that a significant increase in loan default rates would be associated with a deterioration in economic conditions. On the other hand, the stress test has not factored in any ADI response to signs that the credit environment was becoming tougher. If conditions were to turn, ADIs would be taking steps to bolster their capital positions in anticipation.

Lessons learned

Having completed the stress test, APRA's supervisors are following up on the results with individual institutions. We are providing ADIs with an analysis of their performance, including benchmarking to relevant peer groups to help ADIs understand where they sit in the industry.

APRA's stress test has drawn attention to some particular issues in ADI housing lending, which APRA will be taking up with the institutions concerned. One issue is the quality of management information systems. Some institutions required a number of attempts to provide accurate data to APRA; this was particularly the case for institutions that have been through mergers, and had to collect consistent data across the organisation. More surprisingly, many ADIs – both large and small – are not keeping vital information such as LVRs, loan purpose or insurance status in an electronically accessible format.

Over the past year, APRA has been emphasising the importance of investment in risk management systems, in which information

systems play a crucial part. We acknowledge the constant pressure on ADI boards and management for earnings increases, but these increases should not be achieved through short-term cost cutting measures that "hollow out" risk management capacity.

A second issue concerns mortgage insurance. The stress test results showed that the net exposure of the ADI sector to mortgage insurers is only a modest proportion of ADI capital. For some individual ADIs, however, the ability to claim effectively on their mortgage insurance policies has a material effect on the profitability of their housing lending activities. Such an exposure requires considerable attention to detail by the ADI. A mortgage insurance policy is not a guarantee. Just as with any other insurance policy, the holder must justify a claim, and an ADI engaging in poor underwriting, loan management or collection processes may well find that its mortgage insurance claims require adjustment or, in the worst case, are denied. This is not a reflection on the capacity or willingness of mortgage insurers to pay claims; APRA supervises these institutions closely and acknowledges their commercial imperatives. It is a simple statement of the operational risk facing ADIs that find themselves unable to claim properly.

A third issue concerns the ability of ADIs to handle any significant housing market correction from a management and resourcing viewpoint. We are asking ADIs to discuss with us their management plans for dealing with an increase in problem loans and loan defaults.

Summing up

APRA has subjected ADI housing loans portfolios to the "what if" scenario of a housing market correction – involving a substantial fall in housing prices and rise in loan defaults – that is far worse than Australia's experience over the past twenty years and beyond. In that sense, the assumptions underlying the stress test could be viewed as conservative and searching. However, the assumptions are not out of line with the experience of other industrial countries in the 1980s and 1990s and, though we would not wish to have this experience visited on our shores, the assumptions could not be called unreasonable.

The core finding is that a substantial housing market correction, if one were to eventuate, would not of itself be cause for undue alarm as far as the strength and stability of Australia's ADI sector is concerned. This finding gives considerable comfort that the ADI sector remains able to protect depositor safety over the medium to longer-term. For a few institutions, nonetheless, APRA has identified specific improvements that are required to risk

management policies and capital positions, and APRA will be working with these institutions to achieve improvements. Where necessary, APRA would raise minimum capital ratios for ADIs whose housing lending practices are not up to the mark.

The conclusions from APRA's stress test fully support the view of the Reserve Bank in its 2003 *Annual Report*. Having identified a substantial housing market correction as the main potential source of risk to financial stability in Australia, the Reserve Bank offered the assessment that the increase in lending to households "… does not pose a significant danger of a financial crisis, such as occurred in the early 1990s after the build-up in corporate debt". The Reserve Bank's assessment was based on its readings of a range of aggregate financial soundness indicators and its understanding of ADI risk management procedures, while APRA's conclusions are drawn from data on the characteristics of housing loan portfolios of individual ADIs. The two approaches obviously complement each other.

In our view, the stress test has been a highly worthwhile exercise. It has helped APRA and industry participants alike to gain a fuller understanding of the risks in housing loan portfolios in Australia. We also believe it will sharpen the focus of ADI boards and management on these risks, and provide a counterweight to the current exuberance in housing credit growth and housing prices. The housing cycle will inevitably turn at some point. For this reason – and notwithstanding the positive results for the ADI sector as a whole – APRA's message to individual ADI boards and management is "Proceed with Caution".