21 December 2004

NCP Inquiry
Productivity Commission
PO Box 80
Belconnen, ACT, 2616

By email: ncp@pc.gov.au

Dear Sirs/Madams

Submission #2 to the Productivity Commission's Public Inquiry on the "Review of National Competition Policy Arrangements"

The PC states that National Competition Policy *"reforms focus on improving the delivery of economic infrastructure services"*. The financial system represents an essential economic infrastructure service, perhaps the most important of all; vital in promoting growth in investment and productivity. Indeed, a strong and efficient financial system is a fundamental cornerstone of advanced economies.

The Terms of Reference for this Inquiry direct the PC to report on, among other things, *"areas offering opportunities for significant gains to the Australian economy… where there is clear evidence of potential gains, in particular where clear gains are possible for Australia's competitiveness, in the efficiency of domestic markets or for Australian consumers"*.

If the Australian financial system is not fulfilling a role in efficiently providing finance to Australia's business sector, then this could adversely affect investment, productivity and economic growth. Moreover, it is possible that past and current practices within the Australian financial system will adversely affect the availability and/or the cost of finance to the business sector in the future.

Both the OECD and the IMF have stated the need for consideration of policy responses in countries where housing prices and household debts are high (refer below).

In view of the important role that the financial system plays in promoting productivity and investment, the PC should investigate whether government policies and institutions promote an efficient and stable financial system, in a way that promotes (rather than takes away from) growth in the economy. **This area should be considered by the Inquiry on National Competition Policy.** To neglect this vital area of the economy would mean that National Competition Policy may be considered to be a very selective and narrow area of policy, or that the finance sector is "too hard". If a lack of appropriate regulation and supervision of the financial sector was to accentuate any economic downturn in Australia, it could also contribute toward a cynicism of NCP, the result of which may be an erosion of this important area of policy.

1. The availability and cost of credit to Australian businesses

Growth in credit made available by deposit taking institutions to the business sector has been slow relative to growth in the economy and relative to credit made available to households, as the following illustrates.

Real Growth in Credit, by Sector (Credit deflated by CPI Index)			
Year end June	Business	Housing	Other Personal
1979-84	8.0%	2.8%	7.6%
1984-89	14.1%	8.1%	12.3%
1989-1994	-3.1%	13.0%	-4.6%
1994-1999	7.3%	11.0%	8.7%
1999-2004	2.5%	14.1%	6.0%
1989-2004	2.1%	12.7%	3.2%
Source: Based on RBA data			

It should be noted that business credit includes loans to financial and insurance corporations, loans for investment, and loans to assist finance construction of residential buildings and infrastructure.

A number of factors affect the rate of growth in credit extended to the business sector (both in the past and in the future), including:

- The cost of credit for business is relatively high (i.e. compared with the cost of home loans). Based on RBA data, between June 1994 and June 2004, the interest rate on small business overdrafts fell from 9.30% to 8.85% (down 0.45% overall) and the large business indicator rate fell from 9.00% to 8.85% (down 0.15%), while the bank home loan standard variable rate fell from 8.75% to 7.05% (down 1.7%). Moreover, banks introduced basic home loans in the mid-1990s, which offered a rate which was 0.5% less than the standard variable rate in June 2004.

  The banks now offer a preferential interest rate for business overdrafts secured against residential property. In April 1996, the interest rate on these loans was 1.35% higher than the rate on a standard bank home loan (and 2.9% higher than on a basic home loan). By June 2004, the interest rate on overdrafts secured against residential property was 0.90% higher than the rate on a standard bank home loan (and 1.45% higher than on a basic home loan).

  Total fees on business loans have not fallen at the same rate as they did on home loans. Businesses are often charged fees on undrawn credit facilities, while home loan borrowers are not.

- Strong growth in housing credit can divert the focus from business lending, thus reducing the availability of credit to the business sector. Moreover, housing commitments (i.e. contracted but undrawn limits) may also impact on the ability to grow business credit.

In addition, the growth in housing credit has been too fast to be financed by Australians. This has meant that Australian financial institutions have borrowed in overseas markets to fund the growth in housing credit. The resulting growth in Australia's overseas debt may increase the cost of debt for the Australian non-financial business sector.

- It is possible that some companies, entrepreneurs and potential entrepreneurs may now or in the future minimise or avoid investing in a business because they are concerned about the sustainability of current levels of household borrowing and spending, and the potential ramifications that an adjustment could have on the economy at a future time. The Australian Financial Review reports: "The housing downturn will be a concern for quite a few companies in 2005" (AFR, "Don't discount last-minute downgrades", 21/12/04).

- A rise in housing property values may have assisted some businesses to increase their overdraft facility limits (which are usually "at-call" facilities) secured against housing assets. However, any fall in housing values could adversely affect the availability of such limits.

- Excessive credit expansions, which we have seen in housing credit, can create inflationary pressures (in turn, causing a rise in interest rates). The OECD has expressed concerns about price stability in Australia and states: *"A further gradual tightening of monetary policy is projected for 2005, which should bring the cash rate closer to a neutral level of 5.5 to six per cent"* (OECD Economic Outlook).

- Growth in the business sector as a result of government privatisations, outsourcing, and private-public partnerships, which represent new sources of demand for business credit.

- The sale of property by businesses to property trusts, which may have different gearing levels.

- Credit provided by deposit taking institutions rose as a proportion of total debt of private non-financial corporations, from 47.7% in June 1995 to 51.7% in June 2000, before falling to 49.8% in June 2003. Non-financial corporations' debt securities have increased significantly in the last ten years, from about $39 billion in June 1994 (of which $27.3 billion was issued off shore) to $93.4 billion in June 2004 (of which $57 million was issued offshore).

- Taxation considerations. A decline in the company tax rate can reduce the attractiveness of debt to business. The dividend imputation regime may promote equity versus debt. Thin capitalisation rules can motivate a reduction in the level of debt owing. The taxation regime can affect investment incentives, and therefore borrowing levels.

- Listed equity market capital raisings and private equity capital raisings. The Australian Bureau of Statistics data indicates that non-financial (trading) corporations lifted their equity liabilities from less than 40% of their total liabilities at the end of the 1980s to 61.1% by June 2001, before reducing this to 59.4% in the September quarter of 2004. The reduction in debt gearing during the 1990s was partly due to privatisation activity which enabled former publicly owned trading corporations to access equity markets.

- Low R&D in Australia may have reduced investment opportunities.

- Lower prices for plant and equipment. Investment in equipment, plant and machinery grew at an average nominal rate of 3 per cent in the eight years to 2003-04. However, due to a decline in the unit prices of such plant and equipment, growth averaged 8.3 per cent in real terms over the same period; a very strong rate of growth.

- More efficient management of working capital. For example, the introduction just-in-time inventory and supply chain management practices assisted some businesses to reduce inventory levels (and associated financing requirements).

However, these last two trends should have provided more opportunities for expansion and profitable growth in the business sector, which may ordinarily promote growth in borrowing.

2. Questions and potential implications associated with slow growth in business credit

There are a number of questions that arise from the historical slow rate of growth in business credit, including:

- Has the availability or cost of business credit affected decisions whether to start-up a new business and has it affected decisions on whether to leverage growth opportunities?

- Has the lending-fuelled housing boom diverted some capital (and borrowings) and entrepreneurial activity away from some business sectors and toward the housing sector? It is highly likely that those who have been attracted to investing in housing may have, in the absence of that investment, pursued other business interests (and would have borrowed for this purpose).

- Has a change in the structure of the economy contributed to a decline in the demand for business credit? For example, if the service sectors of the economy grow faster than the goods sectors, and the service sectors have a lower borrowing requirement (relative to the goods sectors), then that could reduce demand for business credit.

- Have more proprietors of businesses borrowed in their own name for on-lending to their business (i.e. to avail low interest rates on household borrowings)? If so, that may partly explain slow growth in business credit.

- Has the recent increase in corporate profits reduced corporate borrowing requirements (although there has been an increase in dividend payout ratios)? The recent boom in economy-wide household consumption expenditures (aided by household credit growth) has bolstered profits, which may have reduced borrowing requirements.

Slow growth in credit extended to the business sector has resulted in business' share of credit falling from over 55 per cent in June 1980 to less than 37 per cent in June 2004 (see table). This has resulted in debt leverage being further removed from the source of productive income (i.e. the business sector, which provides employment to the household sector). During tough times businesses can cut staff or sell-off assets, to help meet debt commitments. If economic activity and business sales slow, businesses will usually act to protect profitability by cutting costs (including employment costs), which can leave households with little or no income to service debts. Other households may rein in their spending due to higher risks of income losses, such as from employment termination. This, in turn, causes a more severe contraction in household spending which can create a vicious circle effect.

Percentage of Total Credit (including securitisations)			
June	Business	Housing	Other Personal
1980	55.3%	31.2%	13.6%
1985	59.3%	25.8%	14.9%
1990	63.6%	23.3%	13.1%
1995	49.4%	39.7%	10.9%
2000	45.6%	43.7%	10.7%
2004	36.5%	53.6%	9.9%
2004 (October)	36.4%	53.6%	9.9%
Source: RBA			

The Age newspaper stated in an Editorial *"In recent years the banks have lent 80 per cent of their money to households, and only 20 percent to finance the growth of Australian business. Their goal now must be to restore the balance, and do it by making their core business to find Australian companies with the potential to be world-competitive, and to finance them to make that potential a reality"* ("Banks on notice: Keep your standards", The Age, 22/11/04, page 12).

But lenders still appear to have an overwhelming focus on the housing loan market. The Australian Financial Review stated that *"the Australian mortgage market was expected to produce growth of 16 per cent in 2005 and 14 per cent in 2006"* (AFR 11/11/04).

Prudential incentives, such as lower capital requirements, can increase the profitability of home loans, relative to other loans. The taxation regime provides incentives for housing investors. The family home is exempt from the pension asset test. Superannuation, which is taxed at concessionary rates, is available for debt servicing.

Policy makers should focus more on the incentives that are generating unproductive behavior. This would help in an effort to develop policies providing incentives for behavior that promotes sustainable economic growth. In the long term, that would mean more loans for business.

3. Australian households are highly geared

In Australia, *"Debt service burdens of households are now at record levels"* (speech, "Australian Banking System – Building on Strength", 10/11/04). This has occurred at a time when interest rates are relatively low.

In the last ten years, the ratio housing and household debt to household income in Australia has moved from being low by international standards to being high.

John Laker, Chairman of APRA, has pointed out that *"credit growth, in turn, fueled substantial and widespread rises in residential property prices"* (speech, "Australian Banking System – Building on Strength", 10/11/04). This could imply that weaker credit growth, which the Reserve Bank hopes will eventuate, could adversely affect housing values.

In addition to high gearing, many of Australia's household borrowers are exposed in other ways. Australian housing market is focused on adjustable rate mortgages and this will magnify the negative effects associated with any increase in interest rates. Fixed-rate mortgages, where interest rates can be fixed for up to 10 years, are also available, although borrowers who chose a fixed rate mortgage usually selected relatively short-terms. Only 21% of the Commonwealth Bank's home loan balances were fixed rate loans as of June 30, 2004. The IMF has stated that *"it appears that countries with predominantly fixed-rate mortgages have better behaved housing prices and fewer negative spillover effects on their economies"* (World Economic Outlook, "Three Policy Issues", Chapter 2, September 2004).

The IMF stated recently: *"In some cases, notably Australia, Ireland, Spain, and the United Kingdom, (housing) prices have risen by 50 per cent or more since 1997 – increases that are difficult to explain in terms of economic fundamentals alone, including record-low interest rates"* (World Economic Outlook, "Three Policy Issues", Chapter 2, September 2004).

4. The dangers of a highly leveraged household sector

A highly leveraged household sector can accentuate any economic downturn. The availability of credit to business could be severely curtailed in such a downturn. The IMF has found:

> *"To qualify as a bust, a housing price contraction had to exceed 14 percent, compared with 37 percent for equities…Housing price crashes differ from equity price busts also in three other dimensions. First the price corrections during housing price busts averaged 30 percent, reflecting lower volatility in housing prices and the lower liquidity in housing markets. Second, housing price crashes lasted about four years, about 1 ½ years longer than equity price busts. Third, the association between booms and busts was stronger than for equity prices.*
>
> *Real private consumption, real private fixed capital formation in machinery and equipment, and real private investment in construction all experienced larger and faster falls in their growth rates during housing price busts.*
>
> *Housing price busts were associated with stronger and faster adverse effects on the banking system than equity busts… all major banking crises in industrial countries during the post war period coincided with housing price busts."* (IMF, World Economic Outlook, April 2003, Chapter 2, "When Bubbles Burst").

A greater proportion of the workforce is now in casual employment – employees that the business sector can be easily and cheaply cut in a recession.

As this writer pointed out in a submission to the PC's First Home Affordability Inquiry, the prudential regime covering deposit taking institutions may promote housing investment relative to investment in businesses and other productive assets. This may mean that while household debt commitments rise at a rapid rate, the capacity for the economy to produce employment and wage growth may not increase at a comparable rate.

5. Other implications of the housing price-debt boom

The debt fuelled rise in housing prices has increased the cost of land, which may have increased accommodation costs for some businesses.

Higher housing prices may have placed upward pressure wages.

6. Regulation and prudential oversight of housing finance

John Laker, Chairman of APRA, has warned about slippages in basic lending practices (speech, "Australian Banking System – Building on Strength", 10/11/04).

Ian Macfarlane, Governor of the Reserve Bank has said *"there has been a step-by-step reduction in credit standards in recent years… and if present trends continue we could have one (an urgent problem) in a few years"* (speech "Monetary Policy and Financial Stability", 16/11/04).

But is this just "jawboning" and has enough emphasis been placed on putting together a timely and adequate policy response?

The Bank of International Settlements has warned about risks associated with banks under pricing loans and cautioned about the need to maintain prudent banking practices (and this warning from BIS was highlighted by the Chairman of APRA in a recent speech).

The IMF has stated that, in addition to monetary policy initiatives, *"Policy makers should also consider tightening lending requirements and strengthening surveillance of financial entities as household debt may be reaching (or may have reached already) unhealthy levels in some countries"* (World Economic Outlook, "Three Policy Issues", Chapter 2, September 2004). The IMF would appear to have Australia in its focus, because the IMF has already picked out Australia for attention in relation to housing price increases (refer above). Moreover, Australia's ratio of household debt to household income is among the highest in the advanced world, and it has grown from being relatively low to relatively high in the last 10 years (meaning that debts and gearing levels may be relatively concentrated). And further, it is widely acknowledged that credit standards in Australia have slipped.

The OECD has also pointed out that strong supervision arrangements and high prudential standards provide a means to guard against problems with finance sector balance sheets arising from property prices rising to unsustainable levels.

This writer believes that strong regulation of deposit taking institutions is of the utmost importance, particularly in the current economic and financial environment. John Laker, Chairman of APRA, has already pointed out a number of areas of concern in relation to banking practices (speech, "Australian Banking System – Building on Strength", 10/11/04). This writer previously offered his concerns about banking practice and prudential management to an abandoned Banking Inquiry by the House of Representatives, to the PC's Inquiry on First Home Ownership, as well as in numerous letters to the editor of The Australian Financial Review dating back as far as 2001.

Currently, there are a number of areas where prudential policies or directions are not consistent, do not adequately acknowledge identifiable risks, or do not prescribe the provision of adequate information. **In some cases, there are serious anomalies.** The following points illustrate:

Risk weighting for loans secured against residential property

Provided certain requirements are met, Authorised Deposit-Taking Institutions (ADIs) can provide credit facilities secured by residential property which attract a favourable risk-weighting for the purpose of calculating a risk asset balance (which is the numerator in calculating capital adequacy ratios).

Loans secured against eligible residential mortgages are risk weighted at 50%, while loans secured against investments in premises, plant and equipment and all other fixed assets are weighted at 100%. This means that Australian Deposit-Taking Institutions (ADIs) with a given level of capital can lend twice as against loan secured by residential mortgages (relative to the amount that could be lent against business premises and other business assets).

The favourable risk-weighting applied to loans secured against residential mortgage security has been based on the low levels of loan losses on home loans in the past. It is generally understood, however, that past loss experience may not translate to the actual losses that may occur in the future (and that losses on residential loans have been significant in some overseas markets during certain periods in the past).

APRA has stated that *"low losses reflect the fact that 'conventional' mortgage lending by ADIs has involved them undertaking a comprehensive assessment of the ability of the borrower to service the loan as well as ensuring that the property is appropriately valued"* APRA, "Proposed Changes to the Risk-Weighting of Residential Mortgage Lending', Discussion Paper, November 2003).

The favourable risk weighting available for loans secured by residential mortgages has been set in stone since it was introduced. The risk weighting has not altered in line with any changes in perceived risks (and there is a belief among many that risks have increased in recent years). Australia's housing market has changed significantly. In Australia, there has been an increasing emphasis on loans for housing investment, which are now high both from an historical basis and a global perspective. In the last ten years, the ratio of housing and household debt to household income has moved from being low on an international basis to being high. There are now significant concerns in many quarters about housing values and household debt levels in Australia. The IMF has identified four countries, including Australia, where housing prices were difficult to explain on economic fundamentals (refer above).

The favourable risk-weighting for loans secured by residential mortgage was initially extended to home loans, but was extended to all loans secured by residential property (subject to meeting certain guidelines). New "home loan" products have been introduced – loans not contemplated at the time the favourable risk weighting was introduced (such as low doc loans). Loan to valuation ratios have increased, while acceptable levels of debt-serviceability have declined. Housing investment loans have grown in significance, as have "Low Doc" loans.

It is interesting to note that many of the "innovations" in the housing loan market are associated with a loosening of credit terms (such an increase in loan to valuation ratios, a decline in debt-service ratios, longer terms to maturity, no proof of income, no formal valuation of security, no "purpose test").

Debt serviceability
The Governor of the Reserve Bank has stated: *"There has also been an upward drift in the maximum permissible debt-servicing ratio. When once a maximum of 30 per cent of gross income was the norm, now it is possible for borrowers on above-average income to go as high as 50 per cent of gross income (and a much higher percentage of net income). The new lending models used by the banks (and provided on their websites to potential borrowers) seem to regard the bulk of income above subsistence as being available for debt-servicing"* (speech "Monetary Policy and Financial Stability", 16/11/04).

Undrawn loan limits
The available discounting of undrawn housing loan limits for the purpose of calculating a risk-weighted balance (which is included in "assets" when calculating capital adequacy ratios) is high. As a result, the amount of capital that banks (and other regulated institutions) must keep aside for undrawn housing loan limits is very low and may be too low in relation to the risk assumed.

For example, St George Bank's Capital Adequacy Statement in its 2004 annual report shows off balance sheet commitments (including undrawn limits on loans other than housing loans) total $15.8 billion, with a risk weighted balance of only $0.7 billion (i.e. only 4.4% of the value of the commitments). In the event of a downturn in the economy, some borrowers may draw down limits to meet obligations. Such obligations may include scheduled loan repayments, so that the undrawn limits could mask for a time any deterioration in credit quality. Consequently, it is possible that in any downturn, there is the potential for a lot of off-balance sheet exposures coming back on balance sheet (adversely affecting capital adequacy ratios).

At-call set-off accounts
Housing loan balances that are secured by cash deposits have a zero risk weighting (so long as there is an appropriate set-off arrangement). This allowance is carte blanche and does not take into account the term of, or the ability to access, the deposit. The risk weighting is the same whether the loan is secured by cash deposited in a term or "<u>at-call"</u> account.

A borrower usually knows when they are in trouble (i.e. before the bank will), such as resulting from imminent and actual termination of employment. Credit amounts in "at-call" set-off accounts can be drawn immediately to meet repayments (which could delay the bank's knowledge of a credit problem). So while there is a definite risk to the bank in relation to the amount secured by moneys in an at-call "set-off" account, there is no requirement for the bank to allocate capital for this amount. Take an example where there is a home loan limit of, say, $100,000 and an "at-call" set-off account with a credit amount of $90,000. The bank need only allocate capital against the net balance (i.e. $10,000). However, the borrower may have accumulated funds in the set-off account, rather than reduced the loan balance, for a reason. The borrower may need the money! Perhaps this could be to meet a tax liability or a future contractual payment. If the borrower was to suffer a decline in his/her income earning capacity in the meantime, he/she could immediately withdraw the moneys in the set-off account (and the bank would then have a net liability of $140,000 risk-weighted at 50%). In a downturn, that could potentially result in a lot of off-balance sheet exposures coming back on balance sheet.

Capital adequacy statements
There appears to be no requirement on ADIs to publicly disclose in the Capital Adequacy Statements the risk balances <u>by type of loan</u>.

Valuations of security property
APRA does not require an ADI to conduct formal valuations of residential properties in order for the ADI to receive the 50% risk weighting. The Chairman of APRA has stated that valuation has become an *"area of complacency"* and that APRA is *"seeing cases where valuations that would otherwise have been done formally are being replaced by drive-by or desk valuations"* (The Australian Financial Review, "Property valuations under scrutiny" 21/12/04).

Where the loan to "valuation" ratio does not exceed 60 per cent, the ADI is not obligated under prudential guidelines to justify the criteria used to value the security property. Furthermore, in this situation there is no requirement to ensure that a security property is a "marketable" property. This means that an ADI making a loan secured against a dodgy valuation of an unmarketable property appears to be eligible to for the 50% risk-weighting (if the loan to valuation ratio is below 60%). This situation can be contrasted with a loan secured against a formal valued business premises, which is risk weighted at 100%.

There have already been a number of reported incidents where <u>bank</u> lenders have accepted inflated valuations to assist property developers achieve above-market prices. The banks now rely more on brokers whose interests are less aligned to the lending institutions (compared with a bank employed lender).

To qualify for the concessional 50% risk-weight, the ratio of the outstanding amount of the loan to the value of the mortgaged residential property securing the loan must not exceed 80 per cent unless the loan is 100 per cent mortgage insured through an acceptable mortgage insurer. This appears to apply only at the outset of the loan, so that if there was a significant decline in property values, and the value of the secured property exceeds 80% of the loan balance, then the 50% weighting remains in place.

Under the current regime, there is incentive for ADIs to promote growth in housing loans to help prop up real estate values. This promotes lending growth and can help achieve loan to valuation ratios that attract concessional risk weightings.

Limited account taken of the age of the borrower(s)
Lenders approve and extend home loans to borrowers on the basis of today's incomes (and debt-serviceability), without taking into sufficient account the sustainability of serviceability (e.g. a 30-year loan offered to a 50 year old).

Household incomes tend to fall when people are aged in their 50s. According to the ABS Household Income and Expenditure Survey for the 1998-99 year, average incomes of households whose reference person is aged between 55 and 64 years was 36.8 per cent lower than average incomes of incomes of households whose reference person is aged between 45 and 54 years. There is an even bigger decline in average household incomes for households with a reference person moving from the 55 to 64 age group to the over 65 years age group.

Inconsistencies in loan terms and assessment

ADIs do not apply debt-service or gearing covenants to home loan borrowers, even though such covenants apply to business borrowers (it should be noted that some housing loans exceed the size of some business credits).

Credit assessment of a home loan is undertaken at the approval stage of a housing loan only (except when there is a repayment default), which could mask any slow deterioration in credit quality (in contrast, commercial loans are often reviewed annually). As discussed above, undrawn limits and set-off accounts can assist a borrower to make scheduled repayments and mask any deterioration in debt-serviceability.

This writer is aware of a person who decided to that he would quit his high paying job, take time out of the workforce, and also buy his third house. This person knew that the bank would not approve the loan he was seeking to buy the house without the income from his current job, so this person sought and gained the approval prior to his resignation. This person is currently unemployed but has his third house and a big loan limit too boot which, ironically, helps fund the scheduled repayments.

Increases in home loan limits

Housing loan limits are increased to fund the purchase of discretionary goods and services (such as a car or holiday), so that loan balances amortise over a longer period. Borrowers can have their homes revalued to access further credit.

It is ironic that many economic “experts” and commentators believe that the current housing market is overvalued on a fundamental basis by as much as 30% (and one finance sector economist has stated that on some measures it is 40% overvalued on a fundamental basis), yet banks will readily revalue a borrowers property today at current “market values” and extend additional finance on this basis (risk weighting: 50%).

Low documentation loans

The non-conforming or low documentation market offers housing loans with limited or no proof of debt-servicing required. Bank of Adelaide stated that 27% of its mortgage loan portfolio is comprised of “Lo Doc loans”. St George Bank’s 2004 annual report states: “*one of our most successful products is our innovative Low Doc Home Loan. It offers a flexible solution for customers who, although they have adequate income and assets, may not have sufficient documentation for a traditional mortgage application*”. This begs the questions: Is the product innovative because it requires no documents?

Why doesn't the borrower have the documents? How can St George be sure that the customer has sufficient income and assets if there is a lack of documents to prove it?

APRA allows low doc loans to have a concessional 50% risk weighting if the borrower has met contractual loan repayments continuously over the previous 36 months, or if the loan to valuation ratio is not more than 60%. This a number of questions. For example, if the borrower still cannot provide documentation of debt serviceability after three years, why then should the loan receive a concessional weighting? Such a situation must surely raise questions about the bona fides of the borrower. Is the borrower avoiding tax? Is the borrower receiving moneys from illegal activities? A borrower could use part of the proceeds of a low doc loan to meet loan repayments in the early years of the loan. As another example, why should a housing loan without assessment of debt serviceability <u>and</u> without a formal valuation (of a property that may be unmarketable) receive a 50% risk-weighting?

Mortgage Brokers
Mortgage brokers are paid commission on loan volumes sold.

Loans are often written by mortgage brokers who may not fully apply the credit standards of the lending institution. The extent of reliance on brokers for new business varies by institution, but has increased significantly. For example, 43% of St George Bank's new loans are sourced from brokers, while 26% of CBA's new home loans are originated by third parties.

APRA now requires that an ADI that outsources any part of its credit assessment process to a third party conduct due diligence of these third parties and has a formal agreement in place with the third party that specifies criteria that are to be used in approving a loan. The ADI must also have audit and monitoring procedures in place to ensure that its lending criteria are applied at all times by the third party credit assessor. This is a positive development, however APRA could be more prescriptive and specify the frequency and extent of the audits.

Some lending institutions rely on brokers to feed business in markets outside the bank's home market, where the bank may have little or no presence (and, more at issue, little understanding of the local market). For example, in June 2004, 70% of Bank of Adelaide's total loans under management were outside South Australia.

For marginal borrowers, mortgage brokers have the ability to pick a lender that has credit assessment requirements or procedures that are low.

An increasing reliance of mortgage broker business means that ADI's are increasingly losing the relationship interface with customers (which are being assumed by brokers). This helps ADIs to reduce fixed costs by reducing employee numbers. However, in the event of a significant increase in defaults ADIs may need to significantly increase employee numbers.

Public disclosure of information
APRA and the banks promote that the average life of a loan in housing portfolios is very short (approximately 7-years), which seems to be a way to ameliorate concerns about the risk of these housing loan portfolios. Yet, such analyses can be misleading because they include refinancings, and repayments on the sale of property. Moreover, these analyses ignore the dispersion of maturities around the mean. In the event of a property downturn, housing sales and refinancing activity would decline, which would tend to increase the average life of loans.

Some banks disclose (and promote) the average loan to valuation ratio that applies across their entire portfolio. For example, Bank of Adelaide's 2004 annual report states: *"The on balance sheet loan to valuation ratio across the residential portfolio was 61%, and the Bank is very comfortable with these levels"*. This rudimentary analysis and disclosure is misleading (perhaps even to the bank) because it does not account for the dispersion of ratios around the mean. Presumably, some loans have very low loan to valuation ratios, in which case Bank of Adelaide may have a significant number of loans with very high loan to valuation ratios. Moreover, current "valuations" could prove to be excessive (if values return to "fundamental" levels).

Lack of information about housing prices
The OECD has pointed out: "*in some countries, adequate information about real estate prices is lacking"*. Australia is certainly a case in point.

Securitisation
There are risks associated with securitised home loans, which may not currently be fully assessed or taken into account. For example, securitisers face reputational risks (i.e. in the event that the securitised vehicle performs badly or faces financial difficulty), which may tempt the securitiser to provide assistance to the securitisation vehicle. Securitisers often provide facilities to the securitisation vehicle such as undrawn facilities to fund drawings of undrawn loans within the vehicle, as well as derivative products (i.e. to enable the securitisation vehicle to offer fixed rate loans). Moreover, some deposit taking institutions have a significant reliance of the revenue steam coming from services provided to securitisation vehicles.

7. Recommendation

The implications of the household debt spiral and the practices of the Australian financial system have not been addressed adequately in Australian policy circles. The Inquiry on National Competition Policy should address the issue and call for an independent Inquiry.

Yours faithfully

Nigel Fitzpatrick