

## Housing lending in Australia

- 2.1 The Reserve Bank of Australia (RBA) has referred to 'the general lowering of credit standards that has occurred since the mid 1990s'.<sup>1</sup> Similarly, the Australian Prudential Regulation Authority (APRA) has referred to lenders having 'been willing to move out the risk spectrum by loosening their credit standards'.<sup>2</sup>
- 2.2 There are two causes for this: an increased proportion of housing lending occurring outside of traditional lenders such as banks; and (not unrelated) a change to credit standards within the banking system itself. These have played out within the context of an increased demand for housing credit.

### A new landscape for housing lending

#### Increased demand for housing lending

- 2.3 Australians have become wealthier. Private sector wealth per person was around \$350,000 in 2006. In 'real terms', this is about double the average wealth in 1998 and about three times that in 1988.<sup>3</sup> It is not surprising that

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1 RBA, *Financial Stability Review*, March 2007, p. 17.

2 J Laker, *Credit standards in housing lending - some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 1.

3 These estimates are taken from Treasury, 'Australian net private sector wealth', *Economic Roundup*, Summer 2007. The growth estimates are expressed in 'real terms'; the nominal figures for wealth have been divided by the household consumption deflator. The measure therefore expresses wealth in terms of the quantity of consumer goods and services that could be purchased with it. For some purposes, it could be argued that a deflator including prices of assets such as houses would be more relevant.

this has led to an increased demand for housing credit. A lengthy period of low inflation and falling unemployment has also given households greater confidence to take on more debt.

- 2.4 Lower interest rates have increased the size of a loan which an average household can service. For example, the repayments on a 30-year mortgage of \$100,000 at an interest rate of 14 per cent are \$1,185 per month. When interest rates are instead 7 per cent, the same repayment can service a loan of \$178,000. Increases in incomes have further increased households' repayment capacity.
- 2.5 House prices have risen sharply, up over 50 per cent in the past five years. The rise in house prices has been both a cause and effect of the strong growth in housing credit.

### **New entrants and increased competition in housing lending**

- 2.6 The increased demand for housing credit has provided fertile ground for new entrants to the housing lending industry. As with many areas dominated for a long time by a small number of providers, there was also a perception that the existing players may not have been operating as efficiently as possible.
- 2.7 The commencement of new lenders in the Australian market followed investigations of the operations of non-bank housing lenders in the United States. The new lenders initially raised wholesale funds (reassuring providers that the use of mortgage insurance limited risks) and lent at rates below those charged by the banks, while providing better service such as coming to customers' homes at times convenient to them. The early focus was on individual investors, who banks were typically charging an additional 1 per cent above the standard housing rate, which was not justified by the additional risk involved.
- 2.8 Raising funds through securitisation ('bundling' individual loans and selling them in financial markets) became prevalent in the mid 1990s. At this time non-bank lenders started to focus on owner-occupier borrowers. Some of the more prominent early non-bank lenders included Aussie, Wizard and RAMS. These new lenders do not raise retail deposits and are therefore not regulated by APRA.
- 2.9 The 1990s and early 2000s were a particularly propitious time for new entrants. The spread of internet access made it easier for customers to compare offers and reduced the competitive advantage of the traditional banks' extensive branch networks. Markets for securitised loans had also become more liquid around this time and spreads over bank bill rates narrowed.

- 2.10 The proliferation of new housing lenders led to the emergence of 'mortgage brokers' earlier this decade. Brokers help households compare the hundreds of home loan products and choose the best value one with the features they want.
- 2.11 All lenders have made increased use of brokers to originate loans, rather than the traditional practice of lending to established customers. Prior to deregulation, banks would typically require customers to demonstrate a track record of saving with the bank before being granted a housing loan.
- 2.12 The emergence of mortgage brokers appears to have been particularly important for some of the smaller lenders that do not have extensive networks or the capacity to undertake widespread marketing. Brokers are now involved in about 30 per cent of new loan transactions.<sup>4</sup>

## Lending standards of ADIs

- 2.13 While there have been a large number of new entrants to housing lending, the majority of housing credit is still being provided by authorised deposit-taking institutions (ADIs), such as banks, building societies and credit unions. Liberty Financial's submission stated that 'ADIs, primarily banks, still account for over 80% of all mortgage commitments in Australia.'<sup>5</sup>
- 2.14 ADIs have wanted to increase their housing credit portfolios over the past decade or so. One reason is the lower returns on some alternative assets. There has been a global trend whereby:

The low level of risk-free long-term interest rates may have induced financial intermediaries to increase mortgage lending, as an element of the global search for yield.<sup>6</sup>

- 2.15 ADIs have also responded to increased competition provided by new entrants. One way is by shaving their margins. This trend was noted by the RBA and APRA:

Interest margins (relative to the cash rate) on prime variable-rate housing loans have fallen from a peak of around 450 basis points in

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4 Mr J Broadbent, RBA, *Transcript of evidence*, 10 August 2007, p. 28.

5 Liberty Financial, *Submission no. 24*, p. 3.

6 Bank for International Settlements Committee on the Global Financial System, 'Housing finance in the global financial market', *CGFS papers*, no. 26, January 2006, p. 20. The Basel II capital rules, which more closely align capital requirements to risk, may also have increased banks' desire for housing loans; *ibid* p. 33.

1993 to an average 120 basis points at present. During the 1990s, most of the competition-induced decreases in the cost of housing finance were in the form of reductions in the margin between indicator lending rates and the cash rate. More recently, competition has manifested itself in increases in the size and availability of discounts being offered on housing loan indicator rates, rather than changes in indicator rates themselves. The average new borrower is now paying 60 basis points below the standard variable indicator rate.<sup>7</sup>

2.16 ADIs have also changed other aspects of their lending practices. This change is often touted as a 'decline' in lending standards. There are a number of aspects to the change in practices, as noted by APRA Chairman Dr John Laker:

The departures from traditional lending practices ... include:

- reliance on third parties to originate loans;
- a gradual relaxation of debt serviceability criteria;
- wider availability of higher risk mortgage products involving higher loan-to-valuation ratios or self-verification of income sources; and
- a movement towards alternative property valuation methods.<sup>8</sup>

2.17 ADIs used to impose a 'rule of thumb' that repayments not exceed 30 per cent of gross income. Now, over a quarter of new loans are being made to borrowers whose debt servicing will exceed this level.<sup>9</sup> The online housing loan calculators of some ADIs imply they will now permit debt servicing ratios up to around 50 per cent.<sup>10</sup> However, the median debt servicing ratio of new loans remains much lower than this at around 21 per cent.<sup>11</sup>

2.18 ADIs now make less use of the 30 per cent rule of thumb, and instead now typically look at what households have left over after tax, servicing of non-housing debt and an allowance for basic living expenses. This 'net income surplus' approach does have its attractions. It does seem more sensible to base calculations on after-tax rather than pre-tax incomes. The new approach no longer implicitly assumes that living expenses increase with income (although it could be argued that what households regard as a

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7 RBA & APRA, *Submission no. 7*, p. 2.

8 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 7.

9 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 2.

10 RBA & APRA, *Submission no. 7*, p. 3.

11 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 7.

minimum acceptable living standard does rise with income). The new approach lends itself better to testing adverse scenarios.

- 2.19 HBOS Australia, among others, argued that the use of the net income surplus model has actually improved, not worsened, lending standards:

We would also submit that lending standards have in fact changed for the better as lenders make use of more sophisticated models to measure affordability and serviceability of loans.<sup>12</sup>

- 2.20 The new method typically allows a person to borrow more than would be the case under the 30 per cent rule of thumb. This is not a concern of itself; however, there are fears that some lenders are applying the new approach imprudently. For example, they may use unrealistically low estimate of living expenses, thus overstating borrowing capacity. An APRA study found that many lenders were 'using estimates of living expenses below the Henderson poverty line or were not regularly updating their estimates.'<sup>13</sup>
- 2.21 In deciding how much to lend to a household, ADIs allow for the effect of a possible rise in interest rates on repayment capacity. The maximum interest rate rise considered varies from bank to bank but averages two per cent.<sup>14</sup>
- 2.22 There is considerable variation among lenders in how much they will lend, as noted by APRA's John Laker: 'The most aggressive ADI will typically be willing to lend more than twice as much as the most conservative.'<sup>15</sup>
- 2.23 ADIs have also increased loan-to-valuation ratios (LVR). They are making an increasing proportion of loans to customers with little or no deposit, and the availability of such loans is being more widely advertised. Increasingly, the interest rates on these loans are little or no higher than for standard loans.
- 2.24 While the number of high LVR loans has increased markedly, ADIs 'almost always pass off the risk in these loans to mortgage insurers.'<sup>16</sup>

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12 HBOS Australia, *Submission 3*, p. 1.

13 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 4.

14 The RBA's cash target rate fell by 2 per cent between its August 2000 peak and its December 2001 trough and has since increased by 2.25 per cent with many market commentators expecting a further rise.

15 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 5.

16 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 7.

- 2.25 Property valuation techniques have become less rigorous. The RBA and APRA commented on the new techniques:

Traditionally, valuations were based on a full external and internal inspection of the property. But an APRA survey of approximately 100 lenders in December 2004 found that around one third of the valuations requested by lenders were based on only an external inspection, or were conducted off site using information from the contract of sale, valuer general records, or desk-based electronic methods.<sup>17</sup>

- 2.26 Competition from non-bank lenders has also led ADIs to introduce 'low doc' loans, which do not require as rigorous proof of creditworthiness. The RBA has commented:

These loans involve a large element of self-verification in the application process and are designed mainly for the self-employed or those with irregular incomes who do not have the documentation required to obtain a conventional mortgage.<sup>18</sup>

- 2.27 When first introduced, low doc borrowers had to pay significantly more than the standard variable rate, as would be expected given they are likely to be riskier. However, they are now paying *less* than the indicator rate and only around 45 basis points more than the average rate actually being paid by 'full doc' borrowers. They now account for about a tenth of new loans.

- 2.28 This worries some commentators who believe that a borrower willing to pay more interest to avoid giving details about their financial affairs is very likely to be a significantly poorer credit risk. The RBA and APRA noted that low doc loans 'may be more open to abuse by some who overstate their income to obtain a larger loan.'<sup>19</sup>

- 2.29 Former RBA Governor Ian Macfarlane raised similar concerns with this committee:

These are lenders who will lend to people who cannot or will not tell them what their income is, which is an interesting concept when you think about that one hard enough. These people are prepared to pay a percentage point or more in order not to say what their income is.<sup>20</sup>

- 2.30 Another development in recent years has been the introduction of 'interest only' loans, under which no repayments of principal are required for the
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17 RBA & APRA, *Submission no. 7*, p. 6.

18 RBA, *Financial Stability Review*, March 2007, p. 34.

19 RBA & APRA, *Submission no. 7*, p. 4.

20 Mr I Macfarlane, *Transcript of evidence*, 4 June 2004, p. 17.

first 10-15 years. These are mostly extended to investors, but are also used for around 15 per cent of new owner-occupier loans.<sup>21</sup> Whereas a normal mortgage loan becomes less risky for the lender over time as the principal is gradually repaid, interest only loans retain their initial risk.

- 2.31 Housing loans to investors have grown significantly faster than loans to owner-occupiers for most of the past decade (although not since mid 2005). Notwithstanding that investors tend to be wealthier than owner-occupiers, they may be more likely to default than owner-occupiers, as they are not 'losing the roof over their heads' and tenants may be less likely to maintain the property in good condition than owners.
- 2.32 While not strictly 'housing lending', it is worth noting that over the past decade households have borrowed against the stock of housing to fund non-housing spending (mostly consumption or purchase of other assets). That is, particularly over 2001 to 2003, they have withdrawn equity in the housing stock, whereas in previous decades they built it up.<sup>22</sup> This has been facilitated by relatively new products such as home-equity loans.
- 2.33 The pressures to lower credit standards may actually increase if higher interest rates slow the demand for housing loans, but ADIs want to continue to grow their portfolios rapidly.<sup>23</sup> The Reserve Bank has commented:

More recently, it appears that many lenders have attempted to maintain strong growth in their mortgage portfolios at the same time as the demand for housing finance has moderated from its peak in 2003.<sup>24</sup>

## Lending standards of non-ADIs

- 2.34 As outlined above, lenders like Aussie, Wizard and RAMS are not ADIs because they do not raise funds from retail deposits—that is, they do not operate in the same way as a traditional bank. These non-ADI lenders are

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21 Data refer to 2005. RBA, 'Box B: Interest-only housing loans', *Financial Stability Review*, September 2006, p. 42.

22 RBA, 'Survey on housing equity withdrawal and injection', *RBA Bulletin*, October 2005.

23 This appears to have happened in the US recently. S Braunstein, Federal Reserve System, told the US House Committee on Financial Services that 'some lenders may have lowered their underwriting standards in the face of reduced borrower demand for credit'; 27 March 2007, p. 4.

24 RBA, *Financial Stability Review*, March 2007, p. 33.

therefore not supervised by APRA and, as a result, less detail is known about their operations.

- 2.35 There are a large number of non-ADI lenders and the products and services they offer vary considerably. Some of these lenders compete in the mainstream home loan market, offering prime and low-doc loan products utilising similar lending practices to ADIs.
- 2.36 Other non-ADI lenders offer 'non-conforming loans' to customers who would be denied loans by mainstream lenders. These customers typically have poor credit or payment histories.
- 2.37 The number of non-conforming loans has increased in recent times – from 0.5 per cent of approvals in 2000 to 2 per cent in 2006. In 2005 the RBA reported that the majority of non-conforming loans were made to individuals refinancing other debts:

A significant proportion, around 60 per cent, of the value of non-conforming loans involve the refinancing or consolidation of other debt(s). Some of these are to borrowers who use their housing loans to consolidate numerous personal and credit card debts, while other borrowers have fallen into arrears on their mortgage repayments with other lenders and have subsequently refinanced with a non-conforming lender.<sup>25</sup>

- 2.38 Lending to people with poor credit histories is clearly a risky business. Losses on non-conforming loans are significantly higher than for prime loans, at around 30 basis points in 2006. Lenders protect themselves against this risk by charging higher interest rates and imposing harsher fees and conditions. The average interest margin on a non-conforming loan is 290 basis points which compares to around 120 basis points for a standard loan.<sup>26</sup>
- 2.39 A small number of lenders in the non-conforming sector are associated with inappropriate or 'predatory' lending. These practices, and possible strategies to eliminate them, are discussed in later chapters.

## **International comparison of housing lending**

- 2.40 The changes to lending practices noted above have been common in other countries. A recent report by the Bank of International Settlements (BIS) Committee on the Global Financial System noted:
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25 RBA, 'Box C: Non-conforming loans', *Financial Stability Review*, March 2005, p. 33.

26 RBA & APRA, *Submission no. 7*, pp. 2 & 10.



Common developments include increased loan-to-value ratios, a reduction of credit restrictions, a wider array of loan contracts offered to borrowers, and a move towards greater reliance on capital market funding via securitisation of housing loans. Together, these developments have made borrowing cheaper and more readily available, which has allowed new categories of households to enter the housing market. In particular, sub-prime lending has increased significantly in countries where it is allowed. ... In many countries housing debt per capita and house prices have reached new all-time highs ... Lower interest rates have played an important role in leading households to assume more debt.<sup>27</sup>

- 2.41 The BIS Committee went on to warn that households were assuming 'more and increasingly complex risk' and that:

The strong growth in subprime lending might also be a potential source of risk if credit defaults turn out to be larger than expected.<sup>28</sup>

- 2.42 The study points to some aspects where the Australian experience differs from the average advanced economy. Australia has gone from having one of the lowest housing debt/income ratios in the mid 1980s to one of the highest now. Over the same period, it has gone from a typical debt-servicing ratio and household debt/assets ratio to now having the highest ratios of the 13 economies studied (although, as table 2.1 shows, unlike many other countries there has been no significant increase in home ownership rates in Australia). Real house prices have more than doubled over the past two decades in Australia, a larger rise than in most advanced economies. This has occurred despite Australia having comparatively high (since 2003 the highest) mortgage interest rates.

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27 Bank for International Settlements Committee on the Global Financial System, 'Housing finance in the global financial market', *CGFS papers*, no. 26, January 2006, p. 1.

28 Bank for International Settlements Committee on the Global Financial System, 'Housing finance in the global financial market', *CGFS papers*, no. 26, January 2006, p. 2.

Table 2.1 International comparison of housing finance markets

	Owner-occupancy rate	% of owner-occupiers with mortgages	Usual length of contract	Average loan-to-valuation for new loans	Common type of mortgage interest rate	Home equity withdrawal	Use of mortgage-backed securities	Interest tax deductible
	2001-2004 (1980)		years	per cent				
Australia	72 (71)	45	25	60-70	Variable	Yes	Extensive	No
Belgium	71 (59)	56	20	80-100	Fixed	No	Limited	Partly
Canada	66 (62)	54	25	75-95	Fixed	Yes	Extensive	No
France	55 (47)	38	15-20	78	Fixed	No	Limited	No
Germany	42 (41)	na	20-30	60-100	Fixed	Yes	Yes	No
Italy	80 (59)	na	5-20	80	Mixed	No	No	Yes
Japan	60 (60)	na	20-30	70-80	Mixed	Limited	Limited	Yes
Korea	54 (na)	na	3-20	56	Variable	Yes	Limited	na
Netherl'ds	54 (42)	85	30	87	Fixed	Yes	Extensive	Yes
Spain	82 (73)	na	15-20	70-80	Variable	No	Limited	Partly
Sweden	61 (58)	na	30-45	80-95	Variable	Yes	Limited	Partly
Switzerl'd	35 (33)	na	15-20	<80	Variable	No	Limited	Yes
UK	69 (58)	60	25	70	Variable	Yes	Yes	No
USA	68 (65)	65	30	85	Fixed	Yes	Extensive	Yes

Sources *Bank for International Settlements Committee on the Global Financial System, 'Housing finance in the global financial market', CGFS papers, no. 26, January 2006, pp. 13, 14 and 40; G Debelle, 'Household debt and the macroeconomy', BIS Quarterly Review, March 2004, p. 58; G Debelle, 'Macroeconomic implications of rising household debt', BIS Working papers, no. 153, June 2004, p. 17.*

2.43 Australia is highlighted (along with UK, US and Canada) for the rapid growth in lending to households with poor credit histories. While Australian home loans have predominantly been at floating rates, with some increased use of fixed-rate lending more recently, in a number of other countries fixed-rate lending has been traditional and more use is being made of floating rates. Australia also stands out for the importance of individual investors in the housing market, which is attributed to favourable tax treatment, the absence of rent controls and relatively little public housing.

## Committee conclusions

2.44 There have been substantial changes to the housing lending market in Australia over the last 10 to 15 years. This has included a huge increase in the number of lenders in the market and a consequent increase in competition.

- 2.45 Competition in the lending market has provided great benefits to consumers. Interest rate margins have reduced significantly and there are a range of new and innovative products available. Some of these new products are low doc loans, interest only loans and equity withdrawal loans.
- 2.46 There has been a change in lending practices for all lenders. They now make less use of the traditional 30 per cent of gross income debt servicing ratio to determine loan affordability. Instead, they assess serviceability based on net income modelling, which allows for other debt servicing commitments and living expenses. On the whole, the net income approach appears to be a good development, provided that the underlying assumptions of living expenses, other debt commitments and possible interest rate rises are prudent.
- 2.47 An increasing number of loans are now being made with higher loan to valuation ratios, thus requiring little or no borrower equity. In making these loans lenders still make an assessment of the borrowers' capacity to repay, and very regularly require mortgage insurance to limit risks.
- 2.48 The overall change to lending practices concerns some people, who argue that credit is being provided irresponsibly. Lenders, of course, deny this and maintain that credit is only provided to people who can afford it.
- 2.49 The effects to date of the changed mortgage market and its possible future implications are discussed in the ensuing chapters.

