6

Lending standards, the financial system and the economy

6.1 The changes in credit standards for housing lending were discussed in Chapter 2. As well as its impact on individual borrowers, discussed in Chapters 4 and 5, it could raise prudential concerns and have possible macroeconomic implications.

Possible prudential concerns

6.2 Even in normal times, the lowering of lending standards means that there will be a higher proportion of bad debts. This does not pose a threat to the solvency of lenders if they raise their provisions accordingly—that is, by increasing their interest rate margins. But, as noted in previous chapters, increased competition has seen lenders reduce their interest rate margins, not increase them.

6.3 A further risk arises from the long time it has now been since the last recession in 1991. ADIs have no experience of how borrowers using new products, such as loans with high debt-servicing ratios, might respond to an economic downturn.

6.4 APRA Chairman John Laker recently noted that buoyant economic conditions can actually disguise poor lending practices:

> When personal incomes are rising, unemployment is low and housing prices are steady or on the rise, it is difficult for ADI

> boards and management to distinguish prudent housing lending from poorly managed housing lending.[1]

6.5 Former RBA Governor Ian Macfarlane made similar comments to this committee in 2005:

> It is possible to come up with mathematical models to show that this lending is not very risky at all, because these mathematical models are driven by the experience of the last five, 10, 15 or something years, which have been this extraordinarily stable period in Australian history … Of course, the models assume that that will always be the case. You have to make the argument that it is not going to be like that in future.[2]

6.6 Even more uncertain is the response to an economic downturn of non-traditional lenders and markets which barely existed at the time of the last recession. The Hon Nick Greiner, Chairman elect of PMI Mortgage Insurance, made this point during the roundtable:

> If you think about the early 1990s, 1992 and 1993, most of the players that I think are probably the cause of such interest or changes and the more innovative approaches that were mentioned, in fact, did not even exist. So the truth is this is the first downturn in a cyclical sense where a lot of the non-ADI players have actually even been in existence. The lack of that experience base is an issue.[3]

6.7 These uncertainties give rise to possible prudential concerns about the solvency of lenders. The insolvency of an ADI could not only mean a loss for some depositors, but it could lead to a 'bank run', as the failure of one ADI could lead depositors to lose confidence and withdraw their money from similar ADIs, or even from all of them. This would in turn lead to adverse effects on the economy.[4]

6.8 Regulators are confident, however, that the Australian financial system is well equipped to ensure this does not occur:

1 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 3.

2 Mr I Macfarlane, *Transcript of evidence*, 12 August 2005, p. 8.

3 Hon N Greiner, PMI Mortgage Insurance, *Transcript of evidence,* 10 August 2007, p. 4.

4 The impact of various banking crises on economies is summarised in Table 6 of J Hawkins and P Turner, 'Bank restructuring in practice: an overview', in *BIS Policy Papers*, no 6, August 1999. The rest of the paper describes the causes of banking crises and the difficult task of subsequently renovating banking systems.

> Analysis by APRA and the RBA suggests that developments to date do not pose a significant risk to the stability of the Australian financial system.[5]

6.9 Strong supervision has meant that Australian ADIs have a good buffer of capital to help cope with any miscalculation of risks in the housing market. The ADI sector has been stress-tested twice in the past few years, with strong results on both occasions:

- In 2002 and 2003, APRA conducted an extensive stress test covering most ADIs in the housing market. Despite the fact that the stresses applied in this test were well beyond historical experience in Australia – including a fall of 30 per cent in property prices – no ADI would have failed as a result of this stress, although the capital bases of a small number of ADIs would have fallen below their APRA-mandated minimum.
- In 2005 and 2006, the International Monetary Fund, APRA, RBA and Treasury stress-tested the five largest Australian banks (which account for about 65 per cent of housing loans) as part of the Financial Sector Assessment Program. The exercise comprised a macroeconomic stress test involving a large fall in house prices (down 30 per cent), a marked rise in the unemployment rate (up 4 percentage points), and banks having to pay more for their funding. The stress tests confirmed the resilience of the Australian banking system; though bank profits dipped sharply, banks remained profitable and well capitalised.[6]

6.10 The insolvency of a non-ADI lender could also have adverse effects, although not to the same extent. Non-ADIs are generally smaller institutions and, importantly, they do not lend depositors money; they lend money sourced from investors all over the world.

6.11 Less is known about the robustness of the non-ADI sector because it is not supervised by APRA. But, in terms of financial system stability, the RBA are of the view that non-ADI lenders do not pose a problem:

> What we do know … is that a lot of the lending that they originate they then securitise and on-sell. So from a financial stability perspective, the actual mortgage originators do not actually represent a large threat to the system as a whole.[7]

5 RBA & APRA, *Submission no. 7,* p. 9.

6 RBA & APRA, *Submission no. 7,* p. 9.

7 Mr C Aylmer, RBA, *Transcript of evidence,* 10 August 2007, p. 61.

Possible macroeconomic implications

6.12 The changes in lending practices, and the consequent increase in Australian households' debt levels, could potentially have implications for the economy more generally.

6.13 The Australian economy will experience a downturn at some point in the future. This was acknowledged by former RBA Governor MacFarlane: 'Things will change. That is not a mathematical argument; that is just an argument based on history.'[8]

6.14 When the economy does slow, Australians' increased debt levels may have implications. APRA Chairman John Laker has noted that although loan arrears rates have only been edging up in recent times 'this trend could deteriorate markedly if the economic climate were to sour.'[9]

6.15 Some believe increased household debt will exacerbate any future downturn. An RBA economist, then with the Bank of International Settlements (BIS), wrote:

> Greater household indebtedness and higher debt service levels will heighten the sensitivity of households to a rise in unemployment, amplifying the effect of a negative shock to the economy. Households with debt will find it more difficult to maintain their mortgage payments through a period of unemployment, and hence will be more likely to default. This has the potential to increase the incidence of distressed selling, the likelihood of a downward spiral in house prices and the incidence of negative equity (where the value of the house falls below the outstanding mortgage).[10]

6.16 Former RBA Governor Macfarlane outlined how even a housing downturn that was not severe enough to lead to a 'financial crisis' (which he defined as 'bank failures, bank runs') could affect the economy through its impact on people who have leveraged highly to buy investment properties:

> A lot of people who thought they were going to get rich suddenly discover that not only are they not going to get rich but they have this asset which is costing a lot of money to service and is not going up in price; rather, it is going down, and it is hard to find

8 Mr I Macfarlane, *Transcript of evidence*, 12 August 2005, p. 8.

9 J Laker, *Credit standards in housing lending – some further insights*, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 3.

10 G Debelle, 'Household debt and the macroeconomy', *BIS Quarterly Review*, March 2004, p. 57.

> tenants. For people like that, their behaviour will change. They will be much less inclined to spend than they were before.[11]

6.17 Associate Professor Steve Keen believes that reduced lending standards and increased household debt will not exacerbate an economic downturn, but instead *cause* a downturn. Associate Professor Keen asserted:

> At some point the ratio of debt to GDP must at least stabilise, and that when it does, the economy will go into recession—unless a substantial external stimulus counteracts the depressing impact of a debt correction.[12]

6.18 These conclusions were rejected by the RBA during the roundtable. John Broadbent of the RBA stated:

> To look at only one side of the balance sheet … the liabilities, is somewhat alarmist. You need to actually look at assets. What you see is household assets, or household debt, have continued to rise
>
> …
>
> Debt to household disposable income is about 150 per cent. Household assets to household disposable income is about 800 per cent.[13]

6.19 Chris Aylmer of the RBA stated that household net wealth is now about 640 per cent of disposable income, compared with 400 per cent in the mid 1990s. He also stated:

> A slowdown in credit growth does not necessarily lead to a marked slowing in consumption and an economic downturn.[14]

6.20 Summarising the current situation Mr Aylmer asserted:

> A bigger household balance sheet in and of itself is not necessarily a concern but it does warrant being watched closely.[15]

6.21 At this committee's most recent biannual public hearing with the RBA, the Governor, Glenn Stevens, also commented the state of household finances:

> Household assets are still rising. Debts are rising too but I think that is manageable for most people. By all indications, confidence is high, incomes are growing well and, contrary to what we sometimes read in the papers about servicing debt and so on, the

11 Mr I Macfarlane, *Transcript of evidence*, 4 June 2004, p. 15.
12 Associate Professor S Keen, *Submission no. 1,* pp. 6-7.
13 Mr J Broadbent, RBA, *Transcript of evidence,* 10 August 2007, p. 30.
14 Mr C Aylmer, RBA, *Transcript of evidence,* 10 August 2007, p. 61.
15 Mr C Aylmer, RBA, *Transcript of evidence,* 10 August 2007, p. 61.

> evidence from the lenders—and they are the people with an interest to know—is that the proportion of loans where there is a real struggle going on has gone up a bit but remains very low. I think that, on the whole, households are in good shape. That is not to deny that there are pockets where there is genuine distress. There are; but, at present at least, as distressing as those pockets are, I do not think that they are macroeconomically significant.[16]

Developments in the United States sub-prime market

6.22 The deterioration in US housing credit quality through trouble in the sub-prime mortgage market has received a huge amount of attention recently. The RBA summarised these developments in its latest *Financial Stability Review*:

> A combination of slower growth in house prices, rising mortgage rates, lax underwriting standards, and the expiration of introductory discount rates on loans originated in the past few years has resulted in a sharp increase in delinquencies among sub-prime mortgages in the United States.[17]

6.23 The turmoil in the sub-prime market has had adverse effects on financial markets all over the world. At the biannual RBA hearing Governor Stevens explained some of the effects:

> Because this type of lending was via securitised structures sold into global capital markets, losses have been coming to light right around the world. In most cases, the losses are embarrassing rather than fatal for the institutions concerned. The exceptions have been where particular funds invested mainly or solely in these types of risky assets, and especially where leverage was involved. Several hedge funds have borne large losses, including some in Australia. All of this created a climate in July and early August in which investors retreated and pricing of risk started to return to levels that could be regarded as more reasonable, based on historical experience. A number of capital raisings that had sought to take advantage of the earlier very generous terms were postponed. Volatility in financial markets increased, share prices declined

16 Mr G Stevens, RBA, *Transcript of evidence,* 17 August 2007, p. 31.

17 Reserve Bank of Australia, 'Box A: Developments in the US sub-prime mortgage market', *Financial Stability Review*, March 2007, p. 23.

> somewhat and a general sense of heightened uncertainty was evident.[18]

6.24 The repricing of risk has seen borrowing costs increase for some Australian lenders—particularly non-bank lenders who source funds from the US. Some lenders have increased their interest rates to reflect increased borrowing costs.

6.25 Australia has its own sub-prime market—referred to here as 'non-conforming'—but there are vast differences compared to the US. These are explained by the RBA and APRA:

- Non-conforming loans, the closest equivalent to sub-prime loans in Australia, accounted for only about 2 per cent of new loans in 2006. This was well below the 20 per cent share of sub-prime loans in total new loans approved in the United States.
- Australian non-conforming housing loans have lower LVRs than sub-prime loans in the United States. The average LVR on newly-approved Australian non-conforming loans is around 75 per cent, much lower than the average LVR of about 95 per cent on United States sub-prime loans.
- A feature of many US sub-prime loans is their use of low introductory or "teaser" interest rates for a period before the rate reverts to a much higher standard rate. Also, high-risk repayment options such as negative amortisation periods have been common. These features can expose borrowers to payment shock – a large increase in their mortgage repayments – when the initial introductory interest rate period or negative amortisation period expires. Non-conforming loans in Australia do not have these features.
- The arrears rate on non-conforming loans in Australia, at 6½ per cent, is well below the corresponding rate on sub-prime loans in the United States.[19]

6.26 Because of these factors it is generally held that the sub-prime problems in the US will not be mirrored here. This view was summarised by PMI Mortgage Insurance:

> In answering speculation about the potential knock on effect to Australia, the general view is that it could not happen here; the non-conforming (or credit impaired) market in Australia is much smaller and less aggressive than that of the US, and underwriting standards and product innovation are more conservative.[20]

---

18 Mr G Stevens, RBA, *Transcript of evidence,* 17 August 2007, p. 3.

19 RBA & APRA, *Submission no. 7,* Attachment, p. 1.

20 PMI Mortgage Insurance, *Submission no. 10,* p. 6.

6.27 Notwithstanding this, there may still be useful lessons from the US experience. The speed at which sub-prime lending expanded appears to have amplified the extent of poor lending practices. The US Federal Reserve has recently noted that:

> Because of the rapid expansion of sub-prime lending in recent years, lenders, investors and ratings agencies had limited data with which to model credit risk posed by new borrowers or novel mortgage types, and so may have underestimated the risk involved.[21]

6.28 The Federal Reserve has also recently emphasised general prudential guidelines which should be heeded by all lenders:

> Prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt ... lending standards should include well-defined underwriting parameters such as acceptable loan-to-value ratios, debt-to-income ratios and minimum acceptable credit scores.[22]

Committee conclusions

6.29 The changes to lending standards, the increase in Australian households' debt levels, and the proliferation of non-ADI lenders were examined from the perspective of the financial system and the macro-economy.

6.30 In terms of the financial system, it appears that, due to good supervision, the ADI sector is capable of coping with significant economic downturns. Less is known about the robustness of non-ADI lenders, but because of their size and structure they pose less risk to financial system stability.

6.31 Increased household debt levels could amplify future shocks to the economy. However, the RBA is less concerned about this than some commentators, and points out that while debt levels have risen sharply, so too have household assets. The net wealth of Australian households is now 640 per cent of disposable income.

6.32 The turmoil in the US sub-prime mortgage market is impacting the global economy, including Australia. One effect has been the repricing of risk to more normal levels. This has seen borrowing costs for some Australian

21 S Braunstein, Federal Reserve System, *Statement to the US House of Representatives Committee on Financial Services*, 27 March 2007, pp. 4-5.

22 S Braunstein, Federal Reserve System, *Statement to the US House of Representatives Committee on Financial Services,* 27 March 2007, pp. 7-8.

lenders increase. These increased costs may result in higher interest rates for some borrowers. Global equities markets suffered large losses in July and August, although more recently appear to have stabilised.

6.33 Australia's own sub prime lending market—termed 'non-conforming'—is vastly different to the US. As such, it is generally held that the problems experienced in the US could not materialise in Australia. But the situation in the US does highlight the importance of prudent lending practices. It also highlights the need to stamp out predatory lending practices, which were apparently widespread during the rapid growth of the sub-prime market.

Hon Bruce Baird MP
Chair
4 September 2007