**SUBMISSION 9**

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Mr Andrew McGowan
Inquiry Secretary
House Standing Committee on Economics
Finance and Public Administration
Parliament House
CANBERRA ACT 2601

Email: Andrew.mcgowan@reps@aph.gov.au

Dear Mr McGowan,

## Inquiry into Home Loan Lending Practices and Processes

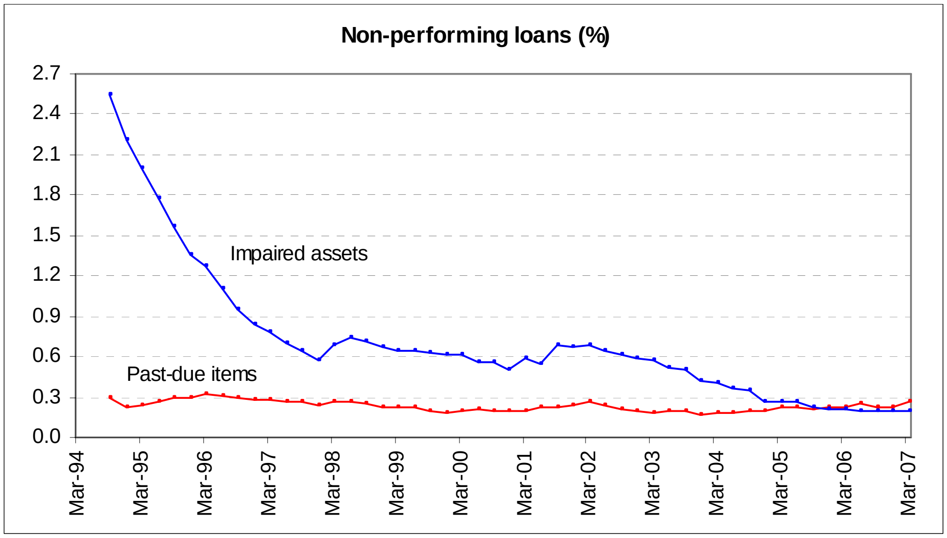
Thank you for your recent correspondence inviting the Australian Bankers' Association to participate in the Committee's roundtable on 10 August 2007 as part of the Committee's inquiry into home lending practices.

As requested we are pleased to provide answers to the four questions posed in your correspondence and look forward to talking to these answers on 10 August.

### 1. To what extent have credit standards declined in Australia in recent years? Market share of non-conforming lenders; increase in low-doc products across the board.

When compared with credit growth data, it can be seen that banks have maintained sound asset quality even during those periods where housing loan books have been growing solidly.

The Reserve Bank of Australia (RBA) classifies banks' non-performing loans (90+days) into the two main components being *impaired assets* and *past-due items*. As a percentage of total assets, impaired assets are at record low levels, between 0.19% and 0.21% of total assets since December 2005. Past due items continue a long-term trend at slightly below 0.3% of total assets even though there has been some volatility both upward and downward in this series over the past year, ranging from 0.22% to 0.26% of total assets. Overall, the RBA data are indicative of the strong and stable quality of bank loan books.

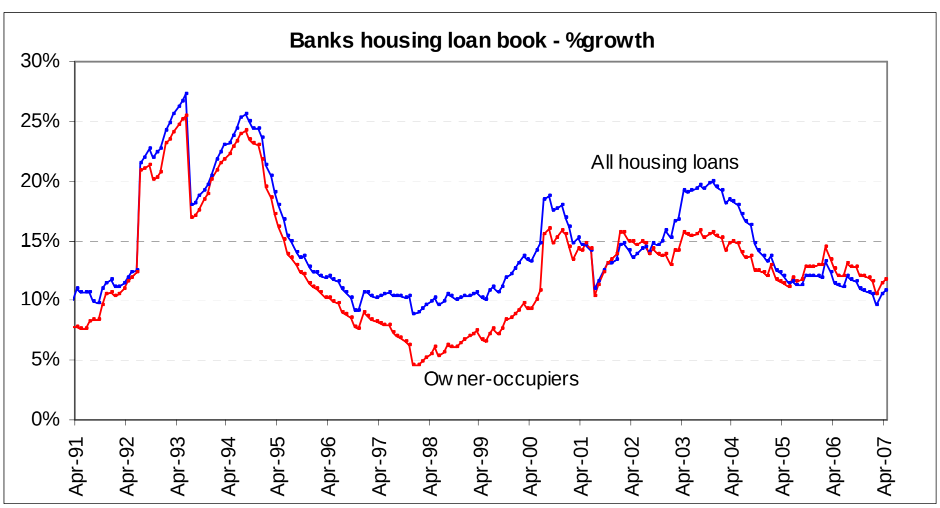



**Source: RBA Bulletin, Table B5**

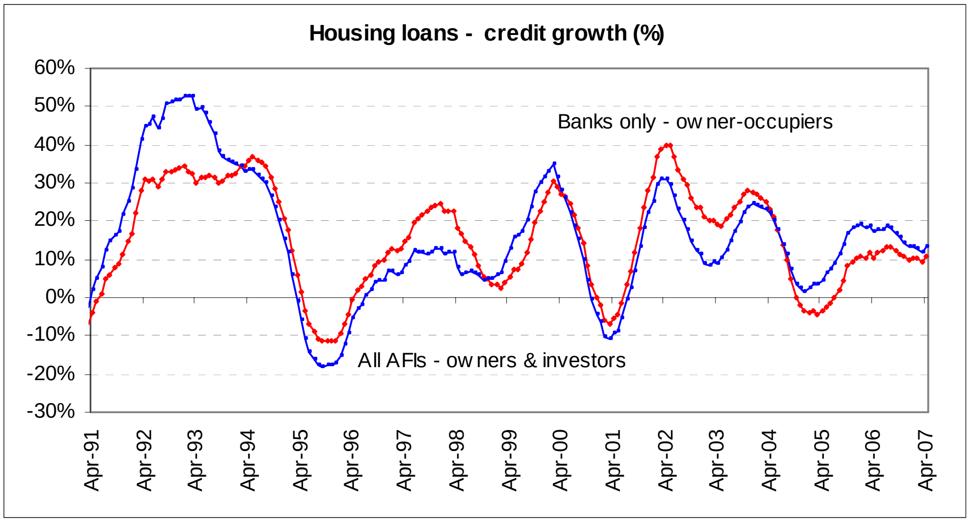
The strong quality of bank lending is also supported by various ratings agencies. The comparable measures of 90+ days arrears produced by Standard and Poor's which are based on the performance of prime residential backed mortgage securities (RMBS) shows that non-bank originators have around *four* times the rate of 90+ days delinquencies as banks. The most recent S&P data for April 2007 shows that 90+ days' arrears on prime RMBS for banks was around 0.25% while for non-bank originators this was 1.07%. For sub-prime RMBS, this rises to 6.59%. Banks in Australia do not participate in the sub-prime market.

At the end of 2006, Moody's Investor Service produced data relating to 30+ delinquencies which showed that banks RMBS performance was three times better than for other lenders, being 0.78% vs 2.18%.

RBA data show that the *growth* in the *stock* of housing loans on the books of Australian banks has moderated significantly over the past 2-3 years. The last *major* rise in the stock of housing loans – 2003 and 2004 - was largely driven by growth in loans to investors. Growth in the *stock* of loans to owner-occupiers is now running below the average longer term rate.



In terms of the growth in housing credit, it is clear that this series can be volatile. While much has been said about the peaks in growth rates since 2000, there have also been two episodes of negative growth in lending to owner-occupiers since 2000. In fact, the peak in lending growth in 2002 followed a sharp fall in growth rates in 2001. Over the past year, housing credit growth has moderated and is significantly below the 5 and 10 year average growth rate.




In its paper "*Credit Standards in Housing Lending – some further insights*" APRA states that the traditional 30% debt servicing ratio, which compares debt (and other fixed payments) to the borrower's gross income has increasingly given way to net income surplus models. These models require the borrower to have a minimum surplus of net after-tax income after taking into account debt servicing, other fixed payments and a basic level of living expenses.

APRA pointed out that the net income surplus models have their analytical attractions. They are more granular. They use after-tax rather than pre-tax income and explicitly account for living expenses and debt servicing requirements other than the housing loan. The net income surplus method is, in fact, the only method which can accommodate tax cuts. This method also allows the lender, in a systematic way, to discount income streams or add margins to living expenses and interest rates to test whether a borrower could continue to meet repayments under adverse scenarios.

APRA stated that net income surplus models can in principle allow a higher level of borrowing than the debt servicing ratio method for borrowers with the same characteristics. What is critical in these models is the estimate of living expenses - an unrealistically low estimate would artificially inflate borrowing capacity and would be tantamount to a lowering of credit standards.

APRA's review confirmed that the net income surplus model is the most common debt serviceability test used by ADIs. Ninety per cent of the ADIs reviewed use this model. APRA calculated the median debt-servicing ratio as 21% for the 85,000 new housing loans approved in of September 2006, while also stating that over a quarter of new loans were provided at ratios above 30%. It is assumed that the greater proportion of these loan approvals would have been made under a net income surplus model.

### Low doc lending

Low-Doc lending has grown to around 5% of outstanding balances over the last five years and around 10% of flows. For banks, it is estimated that low-doc lending accounts for around 3%-4% of the total loan book.

APRA has introduced a number of restrictions on low doc lending for banks. An ADI must verify critical application data including verifying income documentation and employment details in order to benefit from the 50% risk weighting of mortgages with an LVR of up to 80%. If the documentation is not available (ie a low doc loan) the LVR on the loan must be 60% or the loan must be 100% mortgage insured.

It is also important to note that bank approval of a loan with 80% LVR or above does not guarantee that the loan is approved. The mortgage insurer will apply an additional assessment process to gauge the credit risk.

## 2. Have declining credit standards caused an increase in the number of loans in arrears and the number of repossessions? Lack of accurate data on repossessions; 'agreed' sales hiding true rate of defaults.

Given a lack of disaggregated data from the various Supreme Courts relating to *applications for repossession of land,* it is difficult to make detailed comments about repossession activity and its causes. Additionally, it is important to remember that these data are raw data and are not adjusted for volume. That is, under normal circumstances, the number of loans on issue over time would be expected to grow; hence, it would follow that the raw number of applications for repossession activity may rise. As a percentage or ratio of all loans for property, of course, it would be preferable that this ratio remains very low over time or more desirably, fall.

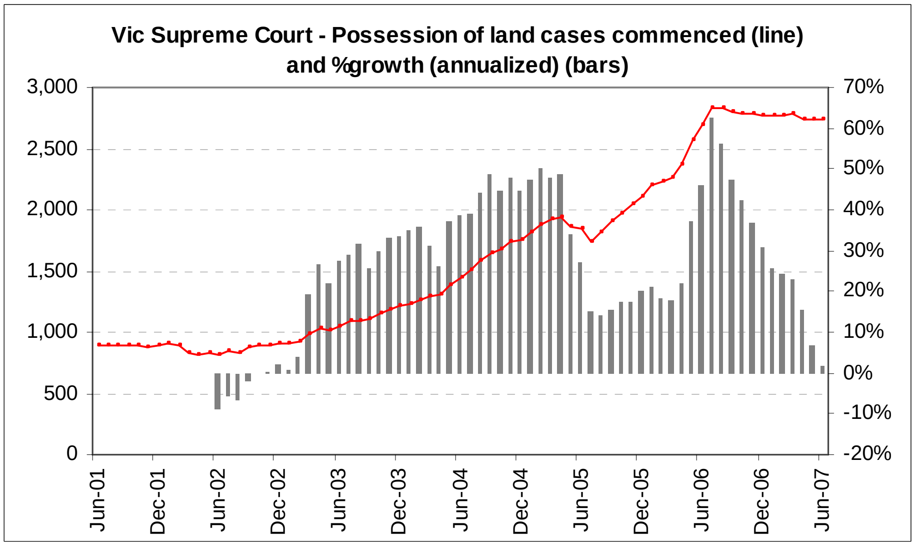
Applications for repossession relate to a variety of real property and include family homes, investment properties, vacant land, holiday homes, properties owned commercially and other land. In some jurisdictions the percentage of repossession applications relating to investment housing or speculative activity may have been as high as 40% in recent times.

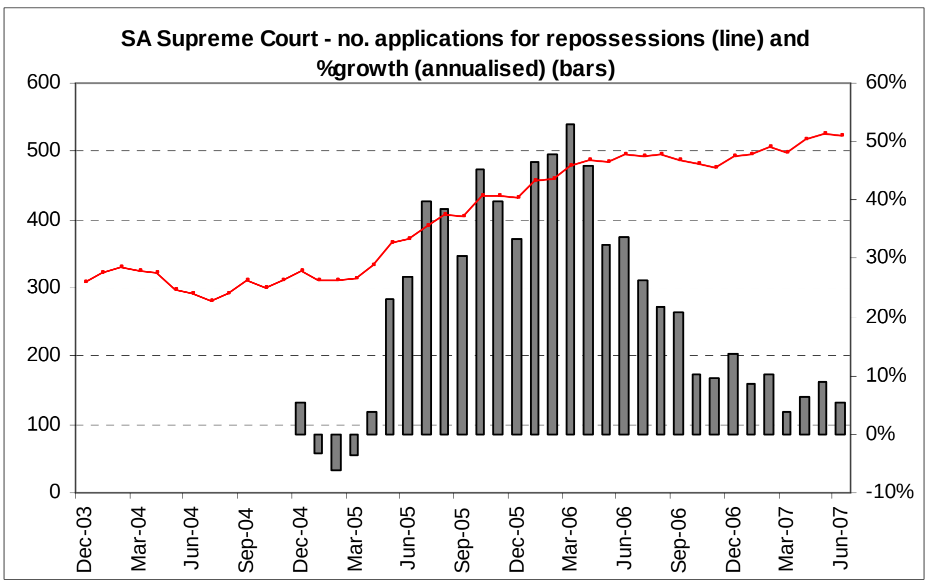
The plaintiffs who initiate repossession applications vary considerably and include all types of financial institutions (e.g. banks, building societies, credit unions, finance companies, and non-conforming lenders), businesses, trusts, solicitors, family members and other persons. Based on our analysis of data and discussions with Supreme Courts, it would be reasonable to suggest that anywhere between 65% to 80% of applications do not relate to banks, depending on the jurisdiction. For non-ADIs, the rate of repossession activity as a percentage of total loan book is expected to be several times higher than for banks.

A report by the Consumer Law Centre ACT *"They want to take our house – An investigation into house repossessions in the ACT Supreme Court"* found that 68% of actions for possession over the four years 2002–2005 were undertaken by non-bank lenders with this percentage increasing over the four years. Most notably, non-bank lenders were largely responsible for the substantial increase in the number of actions initiated during 2005.

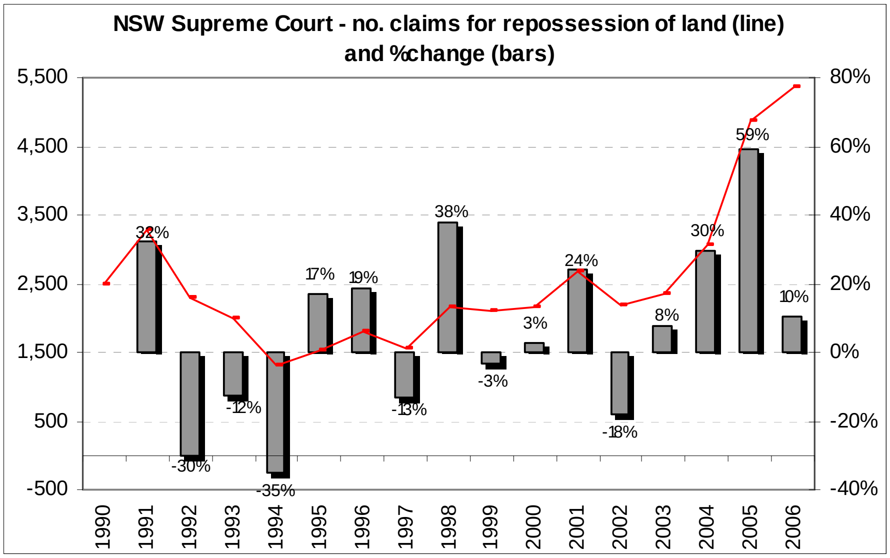
It is also important to note that an application for repossession of property does not necessarily translate into court action. Only a very small proportion of cases would result in a determination by a court hearing and consequent loss of property.

The most up-to-date data for repossession applications are from the Supreme Courts of Victoria and South Australia. Statistics for these two states show that the level of repossession activity has flattened or is trending downwards, while growth rates have shown sharp declines since mid-2006.




While it would be preferable to have more up-to-date data, data to the end of 2006 for NSW show that the growth rate in 2006 for repossession applications was the lowest in 3 years and may decline further in 2007.




## 3. Are borrowers in financial difficulty being treated appropriately by lenders? Obligations under CBP and/or UCCC; access to superannuation for repayments.

In an issues paper published in February 2001 the independent reviewer of the Code of Banking Practice (CBP) Richard T Viney recommended that the problem of debtors in hardship needed a positive response from banks. In its positive response to this recommendation, the ABA considered the then hardship provision in the UK Banking Code as a suitable model. It should be noted that the CBP operates as an enforceable contract between subscribing bank and its customer.

After consultation with relevant stakeholders and with member banks Clause 25.2 of the CBP was formulated as follows:

> *"With your agreement, we will try to help you overcome your financial difficulties with any credit facility you have with us. We could, for example, work with you to develop a repayment plan. If, at the time, the hardship variation provisions of the Uniform Consumer Credit Code could apply to your circumstances, we will inform you about them."*

The CBP provides that subscribing banks' compliance with the CBP must be monitored by an independent monitoring committee, the Code Compliance Monitoring Committee (CCMC). In July 2005 the CCMC established an inquiry into subscribing banks' compliance with Clause 25.2 of the CBP.

The CCMC reported that it was pleased to find that generally the banks that took part in the inquiry were committed to meeting their obligations under Clause 25.2 and had specific processes for dealing with customers in financial difficulty. Concerns raised during the course of the inquiry were addressed with banks involved.

Since 2004, the CCMC and the Banking and Financial Services Ombudsman (BFSO) have been providing guidance to banks in the form of bulletins on the application of Clause 25.2. These bulletins are evolutionary in nature providing guidance as specific issues in relation to a bank's management of customers in financial difficulty with their credit facilities arise.

Banks have been working with CCMC and BFSO and participating in forums to better understand and deal with these issues. The issue of a bank requesting a customer in financial difficulty to consider accessing their superannuation fund to service repayments has been raised.

The CCMC has formed the view that as severe financial hardship is required in order to obtain early access to superannuation funds a bank should be assisting customers to overcome such difficulties and advising customers of their right to seek a variation to their contract on the grounds of hardship, in accordance with 25.2, before making any suggestion regarding accessing superannuation funds. The CCMC believes a suggestion that superannuation funds could be accessed is clearly insufficient to meet the obligations imposed by Clause 25.2.

The CCMC also has advised banks that it is good practice for a bank to be including a reference that the uniform Consumer Credit Code (UCCC) hardship variation provisions may apply to a customer's circumstances early in the collections process, for example in initial correspondence. The CCMC has recently determined that such a reference is insufficient to meet the obligations imposed by the second limb of Clause 25.2. Rather, if the bank considers the contract is covered by the UCCC, the bank should make this clear to the customer and provide the customer with information about the provisions and how to seek a variation.

Under the CBP subscribing banks have committed to "continuously work towards improving the standards of practice and service in the banking industry". Appropriate guidance on compliance with clause 25.2 is one consideration that banks may take into account in meeting this key commitment.

In the 2005/2006 Annual Report of the CCMC, there were four determinations issued by the CCMC in relation to breaches by subscribing banks of Clause 25.2. There are 13 CBP subscribing banks.

Credit facilities of CBP subscribing banks as at April 2007 amount to around 4 million housing loans, 1 million personal loans and nearly 12 million credit card accounts.

It is clear from the ABA's response to Question 1 that banks' credit standards are sound and that under the CBP and its independent compliance monitoring arrangements banks have taken leadership in dealing with customers in financial difficulties with their credit facilities.

Further, the data provided in the ABA's response to Question 1 indicates that the majority of court applications for recovery of possession of mortgaged properties consequent upon a borrower's default are not by banks but are initiated by non-bank or non-conforming lenders. The ABA believes that more detailed information from the Courts should be available to better inform the public debate on this matter.

As far as the ABA is aware there is no comparable code of practice or standard binding non-bank financial institutions to the standards set out in the CBP and in particular clause 25.2. Banks have set standards that they believe other credit providers should follow.

The CBP as reviewed in 2003/4 is highly regarded by consumer protection regulators and consumer advocates as an effective code that sets standards of good banking practice. A further review of the CBP is in progress.

## 4. Are declining credit standards likely to have any long-term implications for the Australian financial system? Lessons from the current situation in the United States.

### Financial system stability - RBA

In its September 2006 Financial Stability Review the RBA commented that there had been a broad-based easing of credit standards which allowed borrowers to take out loans with repayments as a share of gross income well above the 30% maximum that commonly prevailed until the mid 1990s. Since then the income surplus model has been used to determine debt servicing capability. Member banks suggest that these models allow for a more rigorous assessment of debt servicing capacity and more effectively account for differences in household composition. The 30% debt servicing rule resulted in a more 'blunt' approach to debt servicing. Income surplus models build in more detailed analytics within the loan assessment process.

The RBA added that while some borrowers have taken full advantage of this greater borrowing capacity, most have not. The share of *average disposable income* required for principal and interest payments on the average new owner-occupier housing loan is currently (2006) just under 27.7% (or about 21% of *gross income*). The RBA noted that this average undoubtedly conceals considerable variation across households.

While some new borrowers have debt-servicing burdens higher than was the case historically, much of the increase in the aggregate servicing burden reflects the greater number of households with debt, either for investor or owner-occupier purposes. Nonetheless, the increase in the aggregate servicing ratio does mean that the financial position of the household sector is more sensitive to changes in the economic and financial climate than was the case a decade ago.

Aggregate indicators of stress in household finances, however, continue to show a reasonably healthy overall picture.

### Stress testing the loan book - APRA

In response to concerns that lending standards were less than prudent, 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 this exercise 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. In summary, the summary position outlined by APRA's Chairman was:

> *"Broadly speaking, the results are reassuring. They demonstrate that the ADI sector - even thought 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 mean that banks are not making loans whereby the risks of financial loss by the borrower are excessive or inappropriate.

### US lending

The US mortgage market is different to that in Australia in terms of lending products, asset quality and market composition. One major difference is the uptake of sub-prime lending. For Australia, sub-prime loans made up just over 1% of lending in 2006 as opposed to US where this is as high as 36%. In fact, approvals for sub-prime lending in the US accelerated rapidly, from 4% of loan approvals in 2003 to 17% in 2006. As such, it is important to note that the difficulties being experienced in the US are, at this stage, confined to the sub-prime market. In Australia, banks do not play a role in the sub-prime market whereas in the US, banks do.

Additionally, those products which are causing significant problems in the US sub-prime market such as adjustable rate mortgages (ARMs) and second lien loans are rare in Australia. During 2004 and 2005 house price appreciation in the US was strong. Originators became less concerned with affordability allowing borrowers with weaker repayment serviceability to get mortgages. Many loans were written with features dependent on strong house price appreciation. Many new loans were non-prime where borrowers had higher credit risk either due to high LVR's, low docs or poor credit history. Subdued house prices meant that a large number of loans written in 2004 and 2005 had negative equity and could not be refinanced. This led to borrowers having to pay the higher fallback rate which was unaffordable. As a result, credit quality in the sub-prime market has been deteriorating since 2004 with delinquencies rising from 10% in 2003 to 13% in 2006.

Delinquency rates in Australia are 1.2% on prime loans compared with 2.5% in the US 2.5%. For sub-prime and low-doc lending, delinquencies are at 2% in Australia and 12.6% in the US. Delinquency rates for ARMs in the US have been affected by monetary policy tightening by the Federal Reserve. That is, after the initial two-year honeymoon period borrowers were hit with a substantial increase in interest rates.

Another important difference between the Australian and US housing markets is that 75% of securitised sub-prime mortgages written in the US in 2005 had a fixed rate. The vast majority of low doc and sub-prime mortgage lending in Australia are at variable rates, minimising the potential for similar delayed interest rate shocks.

Mortgage funders in the US also have a far higher threshold for credit risk than lenders in Australia. Numerous new non-traditional mortgage products, facilitated by positive credit reporting, have enabled many mortgage lenders to expand into riskier markets.

Yours sincerely

David Bell

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**David Bell**