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Causes of mortgage defaults and repossessions

4.1 The RBA estimates that there are 5.3 million housing loans outstanding in Australia. Of these, it estimates 11,800, or 0.22 per cent, are in arrears by more than 90 days. On the positive side these data demonstrate that there is just a tiny fraction of households not paying their mortgage. However, looked at another way, the data reveal that at least 11,800 households might be facing some degree of financial hardship. There are a range of possible causes for this, which will be discussed in detail below.

Inappropriate lending

4.2 As a starting point, it is important to recognise that the vast majority of lenders—both ADIs and non-ADIs—conduct business and provide credit in an appropriate way.

4.3 It is widely acknowledged that ADIs, in particular, are not involved in inappropriate lending practices. Heidi Richards of APRA stated:

> That is not something we see in our ADIs and we do quite extensive on-site visits of their lending practices.[1]

4.4 And the majority of non-ADIs also operate in a responsible way. Phil Naylor of the Mortgage and Finance Association of Australia (MFAA)

1 Ms H Richards, APRA, *Transcript of evidence*, 10 August 2007, p. 5.

voiced concern that the terms 'non-banks' and 'non-ADIs' are often used in a pejorative manner.[2] Mr Naylor also stated:

> Non-bank lenders, the ones who are operating appropriately in the general mortgage market, are operating no differently to ADIs.[3]

4.5 The 'appropriateness' of a loan is highly subjective and dependent on the calculations and assumptions that underlie it. As noted in chapter 2, there are considerable differences, even within the ADI sector, as to how much a lender will lend. In fact, APRA has reported that the most aggressive ADI will lend up to twice as much as the most conservative.

4.6 The same is undoubtedly true within the non-ADI sector—there are lenders who are willing to take on more risk than others by lending greater amounts. The judgement on the appropriateness of a loan varies from institution to institution.

4.7 There are, however, cases where lending has clearly been inappropriate. These loans occur within a small segment of the non-ADI sector that preys on vulnerable people through the practice of 'predatory lending'. This practice involves lenders providing loans to borrowers with no capacity to repay. The lenders charge excessive fees and commissions to establish the loan, and foreclose on the mortgage at the first sign of default. The borrower is either forced to refinance with another lender or to sell their home. In both cases the predatory lender will have stripped a significant proportion of the equity the borrower previously held.

4.8 The Credit Ombudsman Service's submission outlined what it sees in the marketplace:

> [We have] observed a disturbing trend among some lenders, normally fringe lenders, to refinance home loans in circumstances where the borrower has no capacity to repay the loan. These lenders rely solely on the value of the security, not the borrower's ability to meet the repayments. The borrower is invariably in default of their existing loan and is at risk of losing their home.[4]

4.9 Consumer groups report that they receive a large number of complaints from people with non-conforming, predatory-type loans.[5] They also report that non-conforming loan products:

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2 Mr P Naylor, Mortgage and Finance Association of Australia, *Transcript of evidence,* 10 August 2007, p. 8.

3 Mr P Naylor, Mortgage and Finance Association of Australia, *Transcript of evidence,* 10 August 2007, p. 14.

4 Credit Ombudsman Service, *Submission no. 18,* p. 2.

5 Care Financial Counselling Service & the Consumer Credit Legal Centre, *Submission no. 4*, p. 3.

> Are being marketed and sold in many cases where these products are grossly inappropriate for the borrower, for example 'low-doc' loans being sold to low-income, employed (or even unemployed) consumers.[6]

4.10 In addition to stripping a borrower's equity in their home, predatory lenders can also diminish a borrower's superannuation. APRA is required to release a person's superannuation if the applicant can demonstrate that they face mortgage foreclosure. The RBA and APRA submission reported that applications to withdraw super have increased significantly in recent times:

> In 2006, APRA approved 13,871 applications in total for the release of $135 million, compared with 10,459 applications for the release of $77 million the previous year.[7]

4.11 The Finance Sector Union (FSU) is of the view that there has been, or at least there is the potential to be, an increase in inappropriate lending practices across all lenders because of the role of sales targets. Rod Masson of the union explicated this point:

> Anecdotal, statistical and documentary evidence that we have got hold of shows the ADI sector itself is engaging in HR practices that are driving what could potentially become questionable behaviours and may put us on a path to unsustainable lending practices. That is primarily a focus on sales targets.[8]

Inappropriate conduct of brokers

4.12 As the number of housing lenders has increased the role of mortgage brokers has become more important. Brokers act as an intermediary between borrowers and lenders, ostensibly trying to find the best deal for borrowers.

4.13 Again, it is important to stress that the vast majority of brokers are legitimate. However, evidence to this inquiry suggests that there are some who are not.

4.14 The MFAA noted that brokers have little effect on lending practices:

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6 Consumer Action Law Centre, *Submission no. 8,* p. 2.

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

8 Mr R Masson, Finance Sector Union, *Transcript of evidence,* 10 August 2007, pp. 22-23.

> Brokers have little to do with establishing lending practices and processes. They sell the products made available by lenders. So, if there has been a change to lending criteria, these are generally changes made by lenders.[9]

4.15 While this may be true there is a concern that lending standards tend to deteriorate when a broker is involved. The RBA and APRA, for example, stated:

> Broker-originated loans are estimated currently to account for a third of new housing loans, up from a quarter of new loans in 2003. This is a potential source of risk for lenders, as the link between borrower and lender is weaker, and brokers' incentives may be aligned more closely with the volume of loans rather than their quality. (This has been an issue in the US sub-prime market.) In addition, APRA has found that some lenders were less diligent in verifying borrower information on broker-originated loans than they were on branch-originated loans and is addressing this issue through its routine supervision process.[10]

4.16 The Consumer Action Law Centre also reported problems with mortgage brokers:

> In almost all of the cases we take on relating to mortgage financing, a broker was involved in setting up the loan, and in many (possibly the majority) of these cases the broker has been involved in some level of dishonesty.[11]

4.17 During the roundtable Grant Warner of the Australian Property Institute detailed questionable broker behaviour in relation to property valuations:

> We have had a number of issues with some brokers whereby they will shop around from valuer to valuer until they get someone to give them the right price for whatever the right amount of money is.[12]

4.18 Carolyn Bond of the Consumer Action Law Centre described that brokers' livelihood is based on selling loans, which does not meet well with the provision of appropriate advice:

9 Mortgage and Finance Association of Australia, *Submission no. 2,* p. 1.

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

11 Consumer Action Law Centre, *Submission no. 8,* p. 4.

12 Mr G Warner, Australian Property Institute, *Transcript of evidence,* 10 August 2007, p. 35.

> Brokers are often giving advice to people who are in trouble with their mortgage and the broker only makes a fee if they actually recommend refinancing.[13]

Unsecured consumer debt

4.19 There is often an assumption that mortgage defaults and repossessions are the fault of the lender or broker. However, in many cases the *borrowers* are at fault. Borrowers may, for example, overstate their income to obtain a low doc loan. In other cases they may overburden themselves with unsecured debt to purchase consumer items such as plasma televisions.

4.20 HBOS Australia explained that there has been a change in borrower mentality in recent decades:

> The priority of some borrowers to meet their home loan payments over all other outgoings has declined over the years. In the past, the number one goal of all borrowers was to pay their debt (mortgage) off as soon as possible and the main priority was the family home. Over the past 15 or so years that has changed. Where, previously, borrowers were willing to forgo luxuries such as 'brown goods' (TV's and stereos etc) until they could afford them, people are now much more willing to seek credit from a variety of sources including interest free store credit and this has contributed to an increase in the overall level of individual and household debt.[14]

4.21 The accumulation of personal debt often leads people to default on mortgage payments, or alternatively to consolidate debts by refinancing their mortgage. Genworth Financial outlined that refinanced home loans are much more likely to fall into default:

> [We have] witnessed a significant difference between the probability of default for an owner-occupied loan and a loan that has been refinanced in an endeavour to consolidate debts, with the latter having a default rate approximately two and a half time that of an owner-occupied loan.[15]

4.22 HBOS Australia has observed similar developments:

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13 Ms C Bond, Consumer Action Law Centre, *Transcript of evidence,* 10 August 2007, p. 36.

14 HBOS Australia, *Submission no. 3,* p. 2.

15 Genworth Financial, *Submission no. 6,* p. 4.

> Another trend has been for borrowers to refinance unsecured debts into their mortgage, for example to pay for renovations, and this has also lead to an increase in the number of loans and possible arrears.[16]

4.23 According to consumer groups some borrowers start at the top of the lending tree with mainstream lenders and refinance their way to the bottom. Karen Cox of the Consumer Credit Legal Centre described this process:

> It works as more of a funnel and many people make their way for one reason or another from the mainstream sector, either ADI or non-ADI, down through sub-prime and often end up in predatory having refinanced several times through that process.[17]

4.24 It is argued that one of the problems for lenders is that they have no way of knowing exactly what other personal credit commitments a person has at the time of granting a mortgage. David Grafton of the Commonwealth Bank gave a lenders' perspective:

> One of the biggest difficulties that we have … is that we do not have any means of understanding what the customer's other credit commitments are at the point that we are considering granting them a loan. We simply do not know.[18]

4.25 Christopher Maclean of HBOS Australia expanded this point:

> The issue that we do have trouble with is those customers who actually do not disclose their entire level of unsecured debt. They might not have any defaults. When they have taken out that loan with us, particularly a mortgage, and they have gone off and taken a lot more unsecured debt, we have no ability to even monitor that or even to be able to act on it until it is too late.[19]

4.26 There is some discussion at present about introducing more extensive credit reporting arrangements in Australia. Nelson Yiannakou of the National Australia Bank outlined the potential benefits of these arrangements:

> What that seeks to do is disclose as a minimum the type of products, the limits and the delinquency history so that the succeeding lenders for each and every limit increase or new lend are fully informed about that customer's current obligations. In the

16 HBOS Australia, *Submission no. 3,* p. 2.

17 Ms K Cox, Consumer Credit Legal Centre, *Transcript of evidence,* 10 August 2007, p. 53.

18 Mr D Grafton, Commonwealth Bank, *Transcript of evidence,* 10 August 2007, p. 58.

19 Mr C Maclean, HBOS Australia, *Transcript of evidence,* 10 August 2007, p. 69.

> absence of such information there is the threat that those who may be marginal in their risk profile may not wish to disclose all of their debts. That is often the case with those customers who are defaulting and particularly those who eventually refinance out of the ADIs.[20]

Financial literacy

4.27 When a person takes on excessive consumer debt or gives false information to obtain a bigger loan, it may be due to a lack of financial literacy. Credit products, and in particular mortgages, can be quite complex. Many borrowers do not understand the implications of decisions about their mortgages. For example, many do not appreciate the huge difference to total repayments that a slightly higher interest rate can make.

4.28 Financial literacy is particularly important in a time where more households are taking on more debt. The Bank for International Settlements discussed this issue in early 2006:

> Given the higher level of household leverage, as well as the complexity of the risks involved in mortgage loans (particularly for the latest generation of innovative housing finance products), it is important to ensure that lenders provide sufficient guidance about risks to borrowers. This is particularly relevant in markets with a high fraction of less experienced borrowers and with new types of loans. Furthermore, it is important to enhance market transparency regarding pricing and contractual terms to help borrowers obtain loans that best fit their needs. Indeed, financial education for all households, at all stages of the life cycle, ought to be encouraged.[21]

4.29 David Wakeley of Virgin Money argued that increased financial education is imperative. He further argued that improving consumer financial literacy should be a joint task:

> I actually think there is a duty there both on the government and also on the lenders. I think that part of the regulation of the mortgage broking industry that you need to look at is in the

20 Mr N Yiannakou, National Australia Bank, *Transcript of evidence,* 10 August 2007, p. 69.

21 Bank for International Settlements Committee on the Global Financial System, 'Housing finance in the global financial market', *CGFS papers*, no. 26, January 2006, p. 34.

> education area and to use mystery shopping to ensure that the education does take place in the sales process.[22]

4.30 The Australian Government has taken up this task since 2005 with the introduction of the Financial Literacy Foundation. The foundation has developed an easy-to-use website and handbook as part of its *Understanding Money* campaign. The foundation has also worked with primary and secondary schools, as well as directly with workplaces.

Life events

4.31 Another common cause of mortgage difficulty is an unfortunate and unforseen life event. The MFAA argued that in *most* cases a life event is to blame:

> The reason for a borrower defaulting on their loan cannot be generalised as relating to interest rate increases or inappropriate lending. Most often, the reason is an unforeseen event in the borrower's life or business.[23]

4.32 There are a range of unforeseeable circumstances that may affect a borrower’s ability to make mortgage payments, such as job loss, permanent injury or the death of a family member.

4.33 Peter Hall of Genworth Financial noted that unemployment rates are above average in the areas where defaults are the highest:

> There are certain elements of south-west Sydney and western Sydney where you have got maybe an aggregation of say 10 or 12 postcodes where unemployment is actually running at eight or 8½ per cent … That is obviously flowing through to stress in people making their financial commitments.[24]

Committee conclusions

4.34 Lenders and brokers are very often blamed when a person falls into mortgage default. There are certainly some cases—probably an increasing number—where the lender and/or broker is at fault.

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22 Mr D Wakeley, Virgin Money, *Transcript of evidence,* 10 August 2007, p. 76.

23 Mortgage and Finance Association of Australia, *Submission no. 2,* p. 3.

24 Mr P Hall, Genworth Financial, *Transcript of evidence,* 10 August 2007, p. 10.

4.35 The practice of predatory lending is disturbing. Credit's regulatory framework should protect borrowers against such practices, but it does not appear to be doing so at present. The regulation of credit and consumer protection for borrowers is the subject of the next chapter.

4.36 There is no universal consensus on what constitutes an 'appropriate' loan. Different institutions—both ADIs and non-ADIs—are willing to take on different levels of risk. One lender's appropriate lending practices will be different to the next. While there are big differences between the most aggressive and least aggressive lenders, given that the RBA estimates only 0.22 per cent of loans are in arrears, it is fair to say that in the vast majority of cases 'appropriate' lending practices have been undertaken.

4.37 Not discounting the incidence of predatory lending, in most cases of mortgage default it is likely that the lender was *not* at fault. Unfortunate events like job loss, marital breakdown and family deaths do occur. These events have a material effect on a person's ability to make mortgage repayments.

4.38 Another important, perhaps underplayed, factor is unsecured consumer debt. People have an increasing propensity to take on debt to purchase expensive consumer items. If not paid in a timely manner, some of these forms of debt involve large fees and penalty interest rates. Where a person seeks to consolidate unsecured debt into their mortgage, evidence suggests that mortgage defaults become far more likely.

4.39 Some lenders have argued that the problem of excessive consumer debt could in part be addressed by introducing positive credit reporting. This would give lenders more detailed and accurate information with which to assess potential borrowers' creditworthiness. However, there are a range of privacy concerns surrounding positive credit reporting. The committee notes that the Australian Law Reform Commission is currently reviewing credit reporting arrangements as part of its broader review of the Privacy Act. The commission is due to report by 31 March 2008.

4.40 It is apparent that some consumers do not fully understand the implications of their decisions when taking on excessive debt. The government's establishment of the Financial Literacy Foundation appears to be a good step in improving consumer financial literacy.