
The Parliament of the Commonwealth of Australia

Home loan lending

**Inquiry into home loan lending practices and the processes used
to deal with people in financial difficulty**

House of Representatives

Standing Committee on Economics, Finance and Public Administration

September 2007
Canberra

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Chair's foreword

There have been significant changes to the practices in, and the structure of, the housing lending market over the past decade. A large number of new lenders have entered the market, generating intense competition with established lenders like banks and credit unions. At the same time, all lenders have made less use of traditional lending standards. Most lenders are now willing to lend to borrowers with little or no deposit. Lenders are also willing to permit debt servicing ratios well above the levels previously allowed.

The committee undertook this inquiry with a view to examining exactly how lending practices have changed, and what effect the changes have had. The committee also undertook to examine the mechanisms in place to ensure borrowers are treated appropriately, with a particular focus on borrowers facing financial hardship. The committee received 27 submissions and held a roundtable public hearing with 30 key industry stakeholders. This format allowed the committee to gather evidence within a short time frame.

The changes in the lending market have generally allowed more households to take on more debt. This has, of course, been supported by strong domestic and global economic conditions, which have markedly increased households' ability to service debt. Some people have argued that the new lending practices have resulted in widespread irresponsible lending. The data do not support this assertion. While loan arrears rates have increased in recent times, they remain low by international and historical standards. Data on housing repossessions have also shown an increase recently, but these data lack detail and are therefore an unreliable measure. In chapter 3 the committee recommends that the Australian Bureau of Statistics begin collecting data in this area.

There are a range of reasons why a borrower might face financial difficulty and be unable to pay their mortgage. Borrowers may be faced with an unfortunate life event such as job loss or marital break up, or may have overburdened themselves with debt due to a lack of financial literacy. Most often it is not the lenders fault, but there are certainly cases where it is. There are reportedly an increasing number

of cases where lenders and/or brokers are engaging in predatory behaviour aimed at taking advantage of vulnerable borrowers.

The regulatory framework for credit should offer consumers protection against inappropriate lending practices, and should also provide guidance on lenders' obligations to borrowers who are facing financial hardship. Evidence to the inquiry suggested that the current arrangements do not do either of these things as effectively as they could. As such, reform is needed.

The primary instrument for regulating credit is the Uniform Consumer Credit Code (UCCC). The uniformity it brings to credit regulation is certainly welcome, but the code itself has a number of inadequacies. It is not easy to resolve these inadequacies because the UCCC is a state-based code and is therefore difficult to amend. Another concern with the current regulatory framework is that there are very few controls on the conduct of mortgage brokers. Since around 2002 the states and territories have been trying to come up with a national licensing regime, but it is still not in place.

The regulation of financial products is generally a Commonwealth responsibility, except in relation to credit. This division of powers was described during the roundtable as 'illogical' and 'arbitrary'. The committee agrees with these sentiments, and therefore recommends that the Commonwealth assumes responsibility for credit regulation.

One aspect to Commonwealth regulation would be to define credit as a financial product for the purposes of the Corporations Act. This would require providers of credit products and advice to hold an Australian Financial Services licence. Licensees are subject to rules about quality of advice and disclosure, and are also required to belong to an external dispute resolution (EDR) scheme. EDR schemes appear to be an effective and low-cost mechanism for resolving consumer complaints, but the schemes' jurisdictional limits could be increased to enable more complaints to be dealt with. The committee recommends that the Banking and Financial Services Ombudsman increase the limit on cases it can consider to \$500,000 and that this amount be indexed annually. The committee also recommends that other schemes consider the appropriateness of their own limits.

The committee also examined the effects of the changed lending market from the perspective of the financial system and the macro-economy. By and large, the developments to date have caused minimal concern.

On behalf of the committee I would like to thank all of the groups that participated in this inquiry. I would also like to thank the committee members for their hardworking and bipartisan approach.

Hon Bruce Baird MP
Chair



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Membership of the committee

Chair	Hon Bruce Baird MP
Deputy Chair	Ms Sharon Bird MP
Members	Mr Steven Ciobo MP
	Dr Craig Emerson MP
	Ms Sharon Grierson MP
	Mr Michael Keenan MP
	Mr Stewart McArthur MP
	Mr Patrick Secker MP
	Hon Alex Somlyay MP
	Mr Lindsay Tanner MP

Committee secretariat

Secretary	Mr Stephen Boyd
Inquiry Secretary	Mr Andrew McGowan
Adviser	Mr John Hawkins
Administrative Officers	Ms Frances Wilson
	Ms Natasha Petrovic



Terms of reference

The committee, under its power to inquire into and report on the annual reports of government agencies, resolved to examine **home loan lending practices and the processes used to deal with people in financial difficulty**.

The annual reports used to initiate this inquiry were those of the Reserve Bank of Australia and the Australian Prudential Regulation Authority.



List of abbreviations

ABA	Australian Bankers' Association
AFS Licence	Australian Financial Services Licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ADI	Authorised Deposit-Taking Institutions
BIS	Bank of International Settlements
BFSO	Banking Financial Services Ombudsman
CCMC	Code Compliance Monitoring Committee
CBP	Code of Banking Practice
COSL	Credit Ombudsman Service Limited
EDR	External Dispute Resolution
FSU	Finance Sector Union
FSR	Financial Services Reform
GDP	Gross Domestic Product
HBOS	Halifax Bank of Scotland
LVR	Loan-to-Valuation Ratio

MFAA Mortgage and Finance Association of Australia

RBA Reserve Bank of Australia

UCCC Uniform Consumer Credit Code



List of recommendations

Mortgage defaults and repossessions

Data on repossessions

A consistent theme in submissions and at the roundtable was the need to get better information on housing repossessions. The committee believes this should occur so that public debate on housing lending can be better informed. The most obvious agency to collect national data would be the Australian Bureau of Statistics. Sources of the data could include lenders and state and territory supreme courts.

Recommendation 1

The committee recommends that the Australian Bureau of Statistics begin collecting and publishing annual data on housing repossessions. The data should be disaggregated to include, as a minimum, breakdowns by loan type, lender type, primary cause, and location (local government area or postcode).

Credit regulation and consumer protection for borrowers

Commonwealth regulation of credit

In summary, the committee is of the view that a new approach to credit regulation is needed. It will not only assist in reducing the number of predatory lenders and brokers, it will also harmonise regulation within the financial system, and make credit regulation more readily adaptable to future changes in the market.

Recommendation 2

The committee recommends that the Commonwealth Government regulate credit products and advice. This includes the regulation of mortgage brokers and non-bank lenders.

EDR scheme limits

EDR schemes appear to be an effective and low-cost mechanism for resolving consumer complaints. The schemes' jurisdictional limits could be increased to enable more complaints to be dealt with. This is particularly relevant for the Banking and Financial Services Ombudsman (BFSO) because it often deals with complaints where loans have been guaranteed by property. In this type of complaint the amount in dispute can be the entire value of the guaranteed property, which would invariably be higher than the BFSO limit of \$280,000.

Recommendation 3

The committee recommends that:

- *The board of the Banking and Financial Services Ombudsman increase its jurisdictional limit to \$500,000. This limit should be indexed annually; and*
- *Other external dispute resolution schemes consider the appropriateness of their limits.*

Introduction

- 1.1 There have been substantial changes to the practices in, and the structure of, the housing lending market over the past decade. At the same time there has been continued growth in Australian households' debt levels.
- 1.2 These developments have concerned some groups and commentators, who argue that credit is too easily available and that many Australians are overcommitted and facing financial hardship. Others are less concerned and maintain that the new lending practices are generally sound and that the increasing debt burden is more than manageable for most.
- 1.3 The committee deemed it appropriate to examine some of the issues surrounding housing lending, given its fundamental importance to the Australian community and economy.

Conduct of the inquiry

- 1.4 On 10 May 2007 the committee resolved to undertake an inquiry into *home loan lending practices and the processes used to deal with people in financial difficulty*. The committee initiated this inquiry through its power to inquire into aspects of the annual reports of agencies which stand referred to it. The annual reports used to initiate this inquiry were those of the Reserve Bank of Australia and the Australian Prudential Regulation Authority.
- 1.5 From the outset the committee determined that this would be a short term inquiry to ensure a report could be tabled before the dissolution of the 41st Parliament.

- 1.6 Given the short term nature of the inquiry, the committee did not seek public submissions, nor did it undertake an extensive public hearing program. Instead, the committee targeted key industry and government stakeholders, requesting a short submission and attendance at a roundtable public hearing. The chosen format enabled the committee to gather evidence within a short time frame.
- 1.7 The roundtable format is one that the committee has used to good effect on several occasions. It enables key stakeholders to come together to discuss and debate important issues. It also enables dialogue between government bodies and industry participants.
- 1.8 The 26 submissions received by the committee as well as the transcript of the roundtable are available on the committee's website: <http://www.aph.gov.au/house/committee/efpa/banklending/index.htm>.

Readers' guide and structure of the report

- 1.9 This report has been structured in an easy-to-read format. In discussing each issue, evidence and other relevant material is provided, followed by the committee's conclusions, and then, in some cases, a recommendation.
- 1.10 Chapter 2 of the report provides an overview of recent changes to the mortgage market in Australia. This includes the proliferation of new lenders and the changed lending practices of all lenders.
- 1.11 Chapter 3 discusses the effects of these changes. The effects are measured by looking at the data on loan arrears, house repossessions and personal bankruptcies.
- 1.12 Chapter 4 looks at why people get into trouble with their mortgages. A range of factors are discussed, including inappropriate lending, excessive consumer debt and lack of financial literacy.
- 1.13 Chapter 5 examines the regulation of credit and the protection offered to borrowers. In particular, it focuses on possible options for the reform of credit regulation.
- 1.14 Chapter 6 considers what implications changing lending practices might have for the financial system and the economy. It also considers what lessons Australian lenders and governments can learn from the troubles experienced in the US sub prime mortgage market.

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'.¹ 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'.²
- 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 1988.³ It is not surprising that

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.⁴

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.'⁵
- 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.⁶

- 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

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.⁷

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.⁸

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.⁹ The online housing loan calculators of some ADIs imply they will now permit debt servicing ratios up to around 50 per cent.¹⁰ However, the median debt servicing ratio of new loans remains much lower than this at around 21 per cent.¹¹

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

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.¹²

- 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.'¹³

- 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.¹⁴

- 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.'¹⁵

- 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.'¹⁶

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.¹⁷

- 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.¹⁸

- 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.'¹⁹

- 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.²⁰

- 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.²¹ 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.²² 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.²³ 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 2003.²⁴

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

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.²⁵

- 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.²⁶
- 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.²⁷

- 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.²⁸

- 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.

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 Debelles, 'Household debt and the macroeconomy', BIS Quarterly Review, March 2004, p. 58; G Debelles, '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.

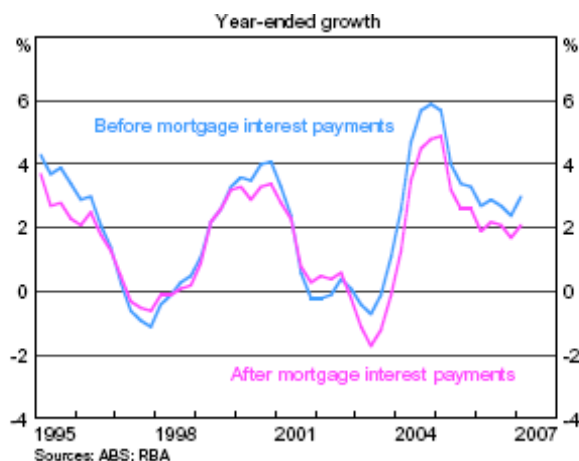
- 2.45 Competition in the lending market has provided great benefits to consumers. Interest rate margins have reduced significantly and there are a range of new and innovative products available. Some of these new products are low doc loans, interest only loans and equity withdrawal loans.
- 2.46 There 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.

Mortgage defaults and repossessions

- 3.1 It is argued that changes in the housing lending market have had both positive and negative effects. One example on the positive side is that low doc loan products have given access to affordable mortgages for the self-employed.
- 3.2 On the negative side, there has been growing concern that too many people are taking on unaffordable mortgages. It is argued that this has been facilitated by reduced lending standards on the part of financial institutions.
- 3.3 The RBA and APRA observed that most Australian households are actually in a good financial position: 'Overall, the household sector remains in sound financial shape, supported by the ongoing strength in the economy.'¹
- 3.4 This assertion is supported by data that show real disposable incomes have continued to grow strongly over the past few years, even when allowing for increased mortgage payments (see figure 3.1 below).
- 3.5 But these aggregate data conceal the fact that some households are facing financial difficulty. The RBA and APRA commented that 'there is a small proportion of borrowers whose finances are overextended.'²

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

2 RBA & APRA, *Submission no. 7*, p. 1.

Figure 3.1 Real disposable income per household (annual percent growth)

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

- 3.6 The changed lending market, together with the buoyant economic conditions, has allowed more households to take on more debt. As debt levels increase it is likely that the number of people facing financial difficulty will also increase. The RBA has recently made comments to this effect:

Expansion in the availability of credit has meant that for any given level of unemployment and interest rates, a higher share of loans could be expected to be in arrears.³

- 3.7 Recent media reports have suggested that declining lending standards have caused an increasing number of people to fall into 'mortgage stress'. However, the definition of stress that underlies this assertion—mortgage repayments of more than 30 per cent of gross income—appears to be questionable, particularly for higher income earners. Most lenders are now willing to lend well in excess of this level.

Loan arrears

- 3.8 Data on loan arrears give an indication of the number of people in 'absolute' mortgage stress—that is, the number of people who cannot make payment on their loans. Evidence to this inquiry has found agreement on two points with regard to recent loan arrears data:
- The level of loan arrears remains low by historical and international standards; and

³ RBA, *Financial Stability Review*, March 2007, p. 17.

- Notwithstanding this, there has been a steady increase in loans in arrears in recent years.

3.9 It is important to recognise that the upward trend in arrears rates does not amount to any sort of impending disaster. This point was made by Chairman elect of PMI Mortgage Insurance the Hon Nick Greiner:

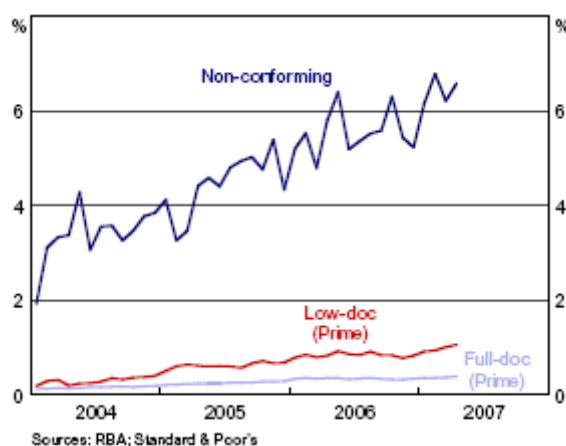
The truth is that the stress in the current mortgage market is not a crisis ... What is happening from PMI's perspective is that we are returning to a more normal loss experience.⁴

3.10 The RBA and APRA submission reported that '0.38 per cent of the value of the banks' domestic balance sheets were classified as non-performing.' They further noted that 'while this has increased since the low point in 2003, it remains lower than was typical in the past.'⁵

3.11 The figures available on securitised loans (this includes all types of lenders) show that as at April 2007, 0.47 per cent of loans were past due by 90 days or more, up from 0.16 per cent in early 2004.⁶

3.12 Arrears on securitised loans are also measured by loan type. These data show that 0.40 per cent of full doc prime loans, 1.07 per cent of low doc prime loans, and 6.5 per cent of non-conforming loans were in arrears (see figure 3.2 below).⁷

Figure 3.2 Securitised housing loan arrears (90+ days past due, per cent of outstanding)



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

4 Hon N Greiner, PMI Mortgage Insurance, *Transcript of evidence*, 10 August 2007, p. 7.

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

6 RBA & APRA, *Submission no. 7*, p. 1.

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

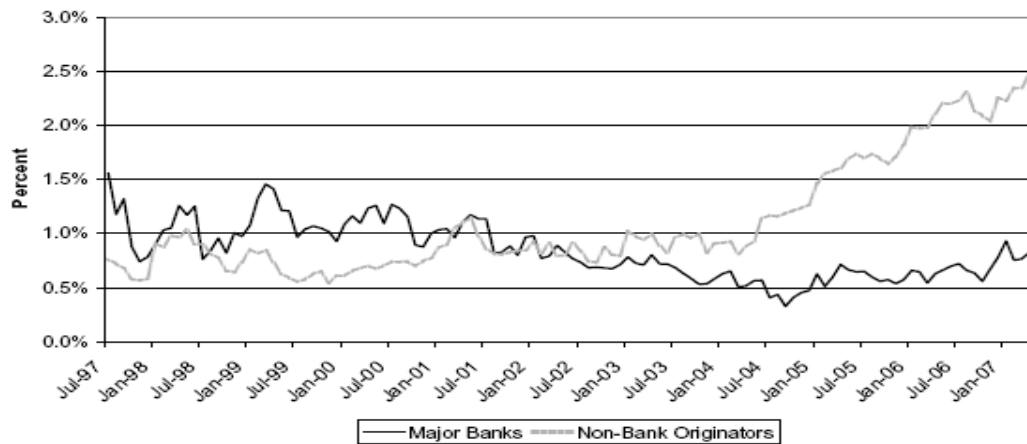
- 3.13 It is clear from these figures that riskier loan products – in particular non-conforming loans – have considerably higher arrears rates. This point was made by John Broadbent of the RBA during the roundtable. However, Mr Broadbent also noted that ‘even on riskier loans ... the vast majority of borrowers are servicing their mortgages.’⁸
- 3.14 Mortgage insurer Genworth Financial reported that while low doc loan products do have higher arrears rates, this is not necessarily because borrowers are facing financial difficulty:
- The higher arrears reflect the nature of the ultimate borrower of a low doc loan, who is typically self-employed and or a non-PAYG employee. This employment status typically results in the borrower having lumpy cash flow and a fluctuating ability to service the loan, particularly compared to a PAYG employee under a standard full documentation loan ... This increased arrears has not translated into double the rate of claims when compared to an equivalent standard loan, as the arrears will more frequently ‘cure’ for a low doc loan than for a standard full documentation loan.⁹
- 3.15 Peter Hall, Chairman of Genworth, made further comments in this regard during the roundtable:
- We have been insuring these loans for eight years and we can categorically say the performance of these low doc loans has been impeccable and, in actual fact, have exceeded any expectations of what we thought would happen at day one.¹⁰
- 3.16 ANZ Bank’s submission cites figures comparing arrears rates for bank and non-bank originators. These figures show that non-bank originators have loan arrears more than three times that of banks (see figure 3.3).

8 Mr J Broadbent, RBA, *Transcript of evidence*, 10 August 2007, p. 26.

9 Genworth Financial, *Submission no. 6*, p. 5.

10 Mr P Hall, Genworth Financial, *Transcript of evidence*, p. 9.

Figure 3.3 Australian prime securitised loans, bank and non-bank originators (30+ days past due, per cent of outstanding)

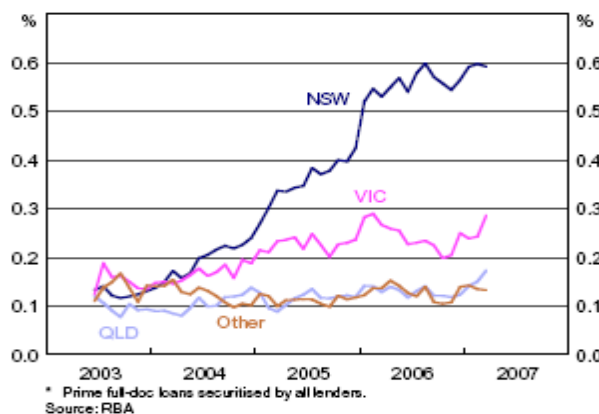


Source: Standard and Poor's RMBS SPIN

Source ANZ Bank, Submission no. 12, p. 5.

3.17 As might be expected there are substantial differences in arrears rates across the country. Arrears in New South Wales – where economic growth has been slower and house price growth has been negative in some areas – are considerably above other states (see figure 3.4 below).

Figure 3.4 Housing loan arrears by state (90+ days past due, per cent of outstanding)



Source RBA & APRA, Submission no. 7, p. 7.

Repossession

3.18 When a mortgage is in default for an extended period a lender may choose to foreclose and seek repossession of the property. Figures on court applications for repossession give some indication as to how often this

occurs. The RBA and APRA reported that court applications have risen in recent times:

In New South Wales and Victoria, the number of applications increased by around 50 per cent in 2005 compared with the previous year, and by about 10 per cent in 2006. Some more recent data are available for Victoria, and these suggest that there has not been a further increase in the number of applications in 2007.¹¹

- 3.19 However, the usefulness of these figures in determining the extent of mortgage stress is questionable. The Australian Bankers Association (ABA), among others, made this point:

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 ... 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 ... 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.¹²

- 3.20 Care Financial Counselling Service and the Consumer Credit Law Centre argued that the collection of repossession data could be improved to provide more useful insights:

Information from the various state and territory Supreme Courts regarding mortgage foreclosure activity is already collected. It is not however coordinated, or easy to access. Further, it is not broken down into categories of loan type or lender, which can make it difficult to identify the source of apparent trends.¹³

- 3.21 These sentiments were echoed by the ABA who states 'more detailed information from the Courts should be available to better inform the public debate on this matter.'¹⁴ These sentiments were also echoed during the roundtable.

- 3.22 The Finance Sector Union argued that the obligation should be on lenders to provide detailed figures on repossessions:

11 RBA & APRA, *Submission no. 7*, p. 1.

12 ABA, *Submission no. 9*, p. 4.

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

14 ABA, *Submission no. 9*, p. 7.

One possibility could be to require all lending institutions to report the number of repossessions and foreclosures each year to increase transparency in this area and encourage a public commitment to minimising such events.¹⁵

- 3.23 David Wakeley of Virgin Money made similar comments to the roundtable:

Virgin is an absolute supporter of strong data and surely we would want this data to be published by a lender. That is absolutely what we have to have. It is a wall of shame that actually goes back to the lenders who are not acting responsibly because at the end of the day this is all about consumers and it is about lenders who are lending to consumers in a way that is not responsible.¹⁶

Bankruptcies

- 3.24 Data are also available on personal administrations (mainly bankruptcies and personal debt agreements). While these figures have increased recently, with New South Wales once again showing an above average rise, the RBA and APRA warn that this is not an accurate indicator of mortgage difficulty:

Caution needs to be exercised in interpreting these trends given that a reasonable large proportion of personal administrations probably relate to personal credit problems rather mortgages directly.¹⁷

Committee conclusions

- 3.25 The level of loan arrears has increased in recent times but remains low by international and historical standards. The increased availability of credit for housing has not, at this stage, resulted in substantial increases in mortgage defaults.
- 3.26 Arrears on low doc and non-conforming loans are higher than full doc loans, reflecting the increased risk involved in such products. Evidence suggests that while low doc loans have a higher arrears rate, these arrears

15 Finance Sector Union, *Submission no. 17*, p. 4.

16 Mr D Wakeley, Virgin Money, *Transcript of evidence*, 10 August 2007, p. 46.

17 RBA & APRA, *Submission no. 7*, p. 8.

are more likely to self-cure. This is indicative of the lumpy cash flow of the holders of these loans, who are primarily self-employed.

- 3.27 The level of arrears on non-conforming loans is high and is rising. This is not surprising given the profile of such borrowers, and non-conforming lenders charge much higher interest rates to cover any losses. The non-conforming market is only a fraction of the total housing lending market (about 1 per cent), so the higher arrears rates do not pose significant macro-economic concerns. Predatory lending practices are almost exclusively associated with the non-conforming sector. Higher arrears rates in this sector may also be reflective of this fact.
- 3.28 While from an aggregate perspective the level of loan arrears remains low, it must be remembered that there are an increasing number of people who are struggling to pay their mortgage. This may not cause concerns for the stability of the economy or the financial system, but it does cause great concern for the individuals involved. The following chapters will look at why people are getting into trouble, how they are treated by their lenders when this occurs, and the regulatory frameworks in place to offer consumer protection to borrowers.
- 3.29 A consistent theme in submissions and at the roundtable was the need to get better information on housing repossessions. The committee believes this should occur so that public debate on housing lending can be better informed. The most obvious agency to collect national data would be the Australian Bureau of Statistics. Sources of the data could include lenders and state and territory supreme courts.

Recommendation 1

- 3.30 **The committee recommends that the Australian Bureau of Statistics begin collecting and publishing annual data on housing repossessions. The data should be disaggregated to include, as a minimum, breakdowns by loan type, lender type, primary cause, and location (local government area or postcode).**

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:

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:

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 times that of an owner-occupied loan.¹⁵

4.22 HBOS Australia has observed similar developments:

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 led 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 unforeseen 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.

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.

Credit regulation and consumer protection for borrowers

- 5.1 Credit regulation should provide important consumer protections for all borrowers. These protections are particularly important for borrowers facing financial hardship. First and foremost credit regulation should protect borrowers from the predatory lending practices discussed in the previous chapter. It should also impose basic obligations on lenders to assist borrowers facing financial hardship.
- 5.2 Evidence to this inquiry argued that the current regulatory framework is not sufficient to discourage predatory lending practices, and could be more effective in providing guidance on lenders' obligations to borrowers. The current framework and proposals for reform are discussed below.

The current regulatory framework for credit

Regulation of financial services

- 5.3 The Financial Services Reform (FSR) regime amended the Corporations Act to introduce new practices and procedures for the finance industry. Under the FSR regime the Australian Securities and Investments Commission (ASIC) is responsible for administering licensing, disclosure and quality of advice requirements for financial products and services. One aspect to this is that providers of personal financial advice and products are required to hold an Australian Financial Services (AFS) licence.

5.4 However, as ASIC noted in its submission, 'these requirements do not apply to credit products or related services such as advice about credit products.'¹ The reason for this is that credit is not regarded as a 'financial product' for the purposes of Corporations Act.²

5.5 ASIC does have a role in the regulation of credit, albeit a limited one. The ASIC Act:

Contains provisions modelled on the consumer protection provision in the Trade Practices Act 1974 ... [which] contain prohibitions on misleading and deceptive conduct and unconscionable conduct.³

5.6 The Australasian Compliance Institute, among others, believes that non-classification of credit as a financial product is a major concern:

If we place the impact both superannuation and home lending has upon total household income it is very surprising to see how tight the restrictions are for those who provide financial planning advice versus those who provide home loans. That is, in order to provide financial services advice of a personal nature, a financial planner must be PS146 accredited, however for the average Australian, superannuation only accounts for approximately 9% of their total income. Based upon recently released research, mortgage repayments can account for between 30 to 40% of total household income, however no such training or education requirements exist for those who provide or sell mortgages.⁴

The Uniform Consumer Credit Code

5.7 Consumer credit transactions are regulated by the Uniform Consumer Credit Code (UCCC). The UCCC was enacted as template legislation in Queensland in 1994 and was subsequently adopted in the other states and territories. According to its website the UCCC:

Not only introduces standardisation, it also presents credit information in a clear and easy to understand format. Credit providers such as banks, building societies, credit unions, finance companies and businesses, must tell you what your rights and obligations are in any credit arrangement. They are required by law to truthfully disclose all relevant information about your

1 ASIC, *Submission no. 15*, p. 1.

2 ASIC, *Credit*, ASIC, Canberra, viewed 20 August 2007, <<http://www.asic.gov.au/asic/asic.nsf/byheadline/Credit+homepage?openDocument>>.

3 ASIC, *Submission no. 15*, p. 1.

4 Australasian Compliance Institute, *Submission no. 11*, p. 2.

arrangement in a written contract, including interest rates, fees, commissions and other information which in the past was often hidden.⁵

- 5.8 The UCCC attempts to offer some protections to consumers, who are able to apply for changes to their loan contract on the 'grounds of hardship and unjust transactions':

The Code recognises that it is still important to protect consumers if they get into trouble. If you lose your job or are sick, you can ask to have your contract changed so that you can better meet your repayments. Credit providers are required to be careful not to make contracts with consumers who would find it difficult to meet their repayments. A court can also order changes to a contract if it is considered unjust.⁶

- 5.9 While the uniform national approach to credit transactions is clearly desirable, there are a number of criticisms of the UCCC. Firstly, the fact that it is state-based means it is very difficult to amend. Greg Kirk of ASIC noted this during the roundtable:

The problem for the UCCC is that it was designed at a particular point in time and is very difficult to change because of the national uniform arrangements and so as new products and issues arise it has not been quick to adapt.⁷

- 5.10 There are also criticisms about the effectiveness of the UCCC's hardship and unjust transaction provisions. Care Financial Counselling Service and the Consumer Credit Legal Centre asserted the hardship provisions:

Have been a source of enormous disappointment to consumer advocacy agencies. The provisions do not impose positive obligations on credit providers to respond to requests for variation at all, let alone within reasonable timeframes or providing reasons for rejection.⁸

- 5.11 The Consumer Action Law Centre argued that the unjust transaction provisions are equally ineffective:

5 Uniform Consumer Credit Code Management Committee, 'How will the code help you', *The consumer credit code website*, viewed 30 July 2007, <<http://www.creditcode.gov.au/display.asp?file=/content/consumer.htm>>.

6 Uniform Consumer Credit Code Management Committee, 'How will the code help you', *The consumer credit code website*, viewed 30 July 2007, <<http://www.creditcode.gov.au/display.asp?file=/content/consumer.htm>>.

7 Mr G Kirk, ASIC, *Transcript of evidence*, 10 August 2007, p. 13.

8 Care Financial Counselling Service & Consumer Credit Legal Centre, *Submission no. 4*, pp. 5-6.

It is sometimes claimed that [the UCCC] places a legal obligation on lenders to assess ability to pay, and that no further legal requirement is necessary. In practice, the provision only applies when an individual makes an application to the Tribunal or Court. Lenders know that only a handful of such applications are made – and they are able to settle individual matters. As a way of encouraging responsible lending practices, the provision is worthless.⁹

5.12 It further argued:

Apart from the obligation accepted by the banks, the lack of any legal obligation to assess capacity is a serious omission to the regulation of credit in Australia.¹⁰

5.13 The Consumer Credit Legal Centre was critical of the fact that the UCCC does not apply to small businesses and individual investors:

The failure of the UCCC to afford protection to small business borrowers, and individuals borrowing for investment, is out of step with the remainder of financial services regulation. The general regulation of financial services under the *Corporations Act 2001* (Cth) includes small business and investors, as does the limited credit jurisdiction under the *ASIC Act 2001* (Cth). Important industry codes, such as the Code of Banking Practice, cover small business and investors. The forthcoming national finance broking regime will also cover small business and investment broking.¹¹

5.14 As a result of these exclusions, some fringe lenders side-step the requirements of the UCCC by requiring borrowers to complete a ‘business purpose declaration’, even when a loan is for a private purpose.¹²

EDR schemes

5.15 One of the requirements of an AFS licensee is that they must be a member of an ASIC-approved external dispute resolution (EDR) scheme.¹³ Many providers of credit products (such as banks) are holders of an AFS licence by virtue of the fact they provide a range of non-credit financial services. They are therefore required to be members of an EDR scheme.

9 Consumer Action Law Centre, *Submission no. 8*, pp. 4-5.

10 Consumer Action Law Centre, *Submission no. 8*, p. 5.

11 Consumer Credit Legal Centre, *Exhibit no. 1*, p. 41.

12 Consumer Action Law Centre, *Submission no. 8*, pp. 7-8; and Credit Ombudsman Service, *Submission no. 18*, p. 3.

13 ASIC, *Submission no. 15*, p. 1.

- 5.16 There are a wide range of businesses—including non-ADI lenders and mortgage brokers—that only provide credit products and/or credit advice. Such organisations are not licensed by ASIC and are not required to be members of an EDR scheme.
- 5.17 Many non-ADI lenders and brokers voluntarily choose to join an EDR scheme, or are required to join because of membership to a professional association. EDR schemes have a range of benefits:
- provide a speedy, low-cost way to resolve complaints and reduce the risk of the costs and lengthy delays that can arise from court proceedings;
 - allow consumers to have complaints that would not be brought before a court for financial reasons, aired and resolved;
 - have the power to make a binding decision if another resolution is not achieved;
 - allow industry to improve standards and conduct;
 - promote market confidence by encouraging, prompt, fair and consistent dealing for consumers and members;
 - are an essential part of the broader consumer safety net; and
 - are an important and necessary element of a just and fair society.¹⁴
- 5.18 One of the major EDR schemes is the Banking and Financial Services Ombudsman (BFSO). The BFSO considers and seeks to resolve disputes between members of the scheme (which includes all of the major banks) and their customers.
- 5.19 Another EDR scheme is the Credit Ombudsman Service (COSL). COSL's membership includes mortgage brokers and non-ADI lenders. Members of the Mortgage and Finance Association of Australia (MFAA) are required to be members of COSL.
- 5.20 But there are many lenders and brokers that are not members of the BFSO, COSL, or any other EDR scheme. Not surprisingly, it is the lenders that are not members of EDR schemes that are usually associated with improper practices. This point was made by the Consumer Credit Legal Centre:
- Unfortunately there are many other credit providers that are not members of an EDR scheme, including a number of unscrupulous small or fringe lenders who engage in predatory lending, and when the debtor cannot pay, harassing and coercive debt collection practices.¹⁵

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

15 Consumer Credit Legal Centre, *Exhibit no. 1*, p. 44.

- 5.21 Raj Venga of COSL noted that '75 per cent of complaints that [he] receives are from non members of COSL.'¹⁶ This underlines the point that the predatory-type lenders are not members of EDR schemes, and there is no incentive for them to ever join.

Self-regulatory codes of practice

- 5.22 In addition to legislative requirements, many providers of credit products and advice also subscribe to voluntary codes of practice, usually through membership of a professional association.

- 5.23 One such code is the Code of Banking Practice (CBP), which is subscribed to by members of the Australian Bankers' Association (ABA). Under the CBP banks are required to make an assessment of a borrower's ability to service a loan before providing credit. Section 25.1 of the CBP outlines this requirement:

Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it.¹⁷

- 5.24 Section 25.2 of the CBP is particularly important to borrowers in financial difficulty. It states:

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.¹⁸

- 5.25 The Code Compliance Monitoring Committee¹⁹ (CCMC) argues that the CBP 'requires banks to provide assistance over and above their UCCC obligations.'²⁰

- 5.26 Over the past few years the BFSO and the CCMC have reported some concern with banks' compliance with section 25.2. The BFSO released bulletins 46 and 53, which highlighted 'systemic' problems with the

16 Mr R Venga, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 49.

17 ABA, *Code of Banking Practice*, May 2004, p. 12.

18 Australian Bankers Association, *Code of Banking Practice*, May 2004, p. 12.

19 The CCMC actively monitors and investigates banks' compliance with the CBP, where the BFSO only deals with specific customer complaints.

20 Code Compliance Monitoring Committee, *Submission no. 19*, p. 2.

application of this section.²¹ Both organisations are working with banks to ensure section 25.2 is implemented appropriately.

- 5.27 Credit Unions and Building Societies also have a code of practice, which is being revised at present. The new code will include detailed requirements for dealing with members in financial hardship.²²
- 5.28 Members of the MFAA, which includes non-ADI lenders and mortgage brokers, are required to comply with its code. The MFAA code is also in the process of being revised to include new provisions on dealing with consumers facing financial hardship. Raj Venga of COSL described the new provisions as 'best practice in the finance sector'.²³
- 5.29 The membership of the MFAA does encapsulate the bulk of the broking and lending sectors. But because membership is voluntary, predatory and fringe lenders are unlikely to be members.

Regulation of mortgage brokers

- 5.30 One of the concerns about the mortgage broking industry is that it is largely unregulated. This was raised with this committee by former RBA Governor Ian Macfarlane: 'There is no regulation at all of mortgage brokers, yet this is an industry that has grown up and is quite big now'.²⁴
- 5.31 As noted above, unlike superannuation or insurance, credit is not regarded as a 'financial product' for the purposes of the Corporations Act. Mortgage brokers are therefore not obliged to have an AFS licence.
- 5.32 A number of groups argued that there needs to be more control over the conduct of brokers. The Consumer Action Law Centre reported that 'there is general support from stakeholders ... that such regulation is desperately needed.'²⁵
- 5.33 ASIC noted that the state-based uniform regulation is in development:
- The Ministerial Council of Consumer Affairs is currently working to develop a uniform regulatory regime for finance brokers including licensing, minimum competence requirements and written broker agreements, including full disclosure of fees and commissions. Recommendations by brokers would be required to

21 Banking and Financial Service Ombudsman, *Exhibit nos. 6 & 7*.

22 Mr L Lawler, Abacus, *Transcript of evidence*, 10 August 2007, p. 51.

23 Mr R Venga, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 52.

24 Mr I Macfarlane, *Transcript of evidence*, 4 June 2004, p. 18.

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

meet quality standards and brokers would be required to give reasons for their recommendations, as well as to belong to an external dispute resolution scheme approved by ASIC.²⁶

Options for reform

- 5.34 There is general consensus that regulation has not kept pace with the rapidly evolving credit market. There are two specific areas where greater controls are needed: Non-ADI lenders; and mortgage brokers
- 5.35 During the roundtable two direct questions were posed to participants:
- Does anybody not think there should be regulation?²⁷
 - Is there anybody here who does not think it ought to be national regulation?²⁸
- 5.36 There were no responses to either question indicating strong support for a new or updated national regulatory framework. But there was less agreement on exactly what form the regulation should take. The options for reform are discussed below.

Commonwealth regulation of credit

- 5.37 One proposal to improve credit regulation is to make credit a 'financial product' for the purposes of the Corporations Act, thus harmonising regulation within the financial services sector.
- 5.38 The most obvious benefit of this option is that it would require providers of credit products and advice to hold an AFS licence. Licensees are required, among things, to provide advice and products appropriate to their clients. Therefore, lenders or brokers that consistently engage in predatory or dishonest conduct could have their licence revoked, and with it their ability to conduct business.
- 5.39 At this committee's most recent biannual public hearing with the RBA, Assistant Governor, Dr Philip Lowe, suggested that it's time to consider harmonising credit regulation with other financial services:

Under the Corporations Act, ASIC is responsible for the regulation of advice on financial products but not of advice on credit

26 ASIC, *Submission no. 15*, p. 3.

27 Hon B Baird MP, *Transcript of evidence*, 10 August 2007, p. 15.

28 Hon N Greiner, PMI Mortgage Insurance, *Transcript of evidence*, 10 August 2007, p. 15.

products. That is an issue that today is being left with the states; therefore this ministerial council, at the state level, has been looking at the regulation of mortgage brokers. But I think we have got to the point where the question should be discussed as to whether that should be addressed at the federal level and whether regulation of credit products or advice on credit products should be done by ASIC in a similar way that ASIC does regulation licensing of financial advice.²⁹

- 5.40 There were a number of advocates of this option at the roundtable. For example, Gordon Renouf of Choice stated:

Credit regulation needs to move national, and that is something which we did not do when the financial services reform package was brought in a good few years ago, for reasons that were convenient at the time. I think we now need to really seriously have a national debate about whether it is time to do that.

...

It is just illogical to have a border line within financial services which says that some of it is regulated nationally and some of it is regulated within the state.³⁰

- 5.41 Similarly, Luke Lawler of Abacus argued that credit's exclusion from the Corporations Act 'is kind of an arbitrary division; it's not really logical why credit is not there.'³¹
- 5.42 But there were concerns from several groups about simply moving credit regulation to the Corporations Act. One reason, as explained by Luke Lawler, is that 'the FSR regime is still a flawed regime.'³²
- 5.43 Raj Venga of COSL agreed that the FSR regime is not yet perfect, but argued that moving credit into it 'is superficially attractive ... because a lot of the infrastructure is already there in the act.'³³
- 5.44 There were also concerns that credit regulation has unique aspects to it that may not fit well with the existing FSR regime. As Raj Venga explained 'credit has its own bit about hardship that you will not find in other financial products'.³⁴

29 Dr P Lowe, RBA, *Transcript of evidence*, 17 August 2007, p. 17.

30 Mr G Renouf, Choice, *Transcript of evidence*, 10 August 2007, pp. 20-21.

31 Mr L Lawler, Abacus, *Transcript of evidence*, 10 August 2007, p. 51.

32 Mr L Lawler, Abacus, *Transcript of evidence*, 10 August 2007, p. 51.

33 Mr R Venga, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 51.

34 Mr R Venga, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 51.

5.45 A final concern lies in the fact that credit remains a state and territory regulated activity, and the respective governments may be reluctant to relinquish control to the Commonwealth. However, Phil Naylor of the MFAA asserted 'if the federal government wants to take it over, I do not think you will get any arguments from the states.'³⁵

5.46 The Federal Treasurer, the Hon Peter Costello, has recently indicated that the Commonwealth would be willing to take over credit regulation:

We would say to the States that if they want to refer powers to us, then we would be willing to step in and take their powers and to legislate in this area.³⁶

5.47 Summarising the case for credit regulation to move into Commonwealth responsibility, Martin Tolar of the Australasian Compliance Institute stated:

While the credit industry or the mortgage industry may not fit naturally into the financial services requirements, when you start to talk about using superannuation to try and get people out of home loan debt problems and then as I raised beforehand the issues surrounding reverse mortgages, it is very hard to artificially differentiate between financial advice around people's wealth protection and wealth growth and a mortgage and credit provision. I would argue that, while it is not perfect, let us try to find a way to try to have that continuum with regards to financial services advice around the time and type issues and then for most people, their largest financial asset, their home, and try to make it work in a fairly streamlined approach. It may mean some change and tinkering around with the financial services legislation as it is currently to try to meet that need, but let us not artificially create some new regulations.³⁷

Amend the UCCC

5.48 Another option for reform is to strengthen the UCCC. Greg Kirk of ASIC explained why the UCCC is in need of reform:

The current UCCC regime was established back in 1996 and was developed over a long period before that when a lot of the sorts of practices we are talking about today did not exist.³⁸

35 Mr P Naylor, Mortgage and Finance Association of Australia, *Transcript of evidence*, 10 August 2007, p. 56.

36 *Meet the Press*, television program, Channel Ten, Sydney, 19 August 2007.

37 Mr M Tolar, Australasian Compliance Institute, *Transcript of evidence*, 10 August 2007, p. 57.

38 Mr G Kirk, ASIC, *Transcript of evidence*, 10 August 2007, p. 13.

5.49 As outlined above, there are a range of concerns with the current UCCC regime. Broadly, these concerns are:

- The weak requirements on lenders to assess borrowers' capacity to repay;
- The lack of positive obligations imposed on lenders to assist borrowers facing financial hardship; and
- The ability for lenders to avoid the UCCC by requiring borrowers to sign business purpose declarations.

5.50 To address the first issue it is argued that the UCCC should contain explicit requirements for lenders to assess repayment capacity prior to granting a loan. John Moratelli from NSW Legal Aid argued:

What we would like to see is a regulatory framework, which I do not think the UCCC provides at the moment, in which it is made clear that lenders should not lend to people for domestic purposes where they have no reasonable prospects of repaying.³⁹

5.51 Of course, most lenders already do this as part of their standard lending practice, but it is claimed that some fringe lenders grant loans on asset value alone, knowing that the borrower has no capacity to repay and will eventually default. These loans are often low or no doc and require the borrower to self-certify that they can afford the loan.

5.52 Amending the UCCC to require lenders to assess repayment capacity would not spell the end for all low doc loans. Bona fide low doc loans still involve a fairly rigorous credit assessment. Peter Hall of Genworth Financial explained the process for genuine low doc loans:

Their financial statements or their tax returns may be dated, so what they do to complement getting a loan is they go through a self-certification process but they would be supported by all other documents relevant to the loan, a financial position statement and assets and liabilities. There would be a credit bureau check done. Maybe financial statements were provided but they were 15 months old, or 13 months old. Self-certification was a substitute for not being able to provide your payslip for the last two weeks as a PAYG borrower would have.⁴⁰

5.53 In terms of imposing positive obligations on lenders to assist borrowers facing financial hardship, Colin Neave of the BFSO suggested that it might

39 Mr J Moratelli, NSW Legal Aid, *Transcript of evidence*, 10 August 2007, p. 11.

40 Mr P Hall, Genworth Financial, *Transcript of evidence*, 10 August 2007, p. 9.

be useful to amend the UCCC to insert a requirement similar to that imposed by section 25.2 of the Code of Banking Practice.⁴¹

- 5.54 Raj Venga of COSL argued that section 25.2 is not explicit enough for the non-ADI sector:

Our industry is one that has not fully developed. It is still very immature and we need a lot more guidance. I look at the banking code and its clause 25.2, which is a few lines. It might work for that industry. In our industry I think it has to be a lot more comprehensive.⁴²

- 5.55 The final issue—lenders’ ability to avoid the UCCC by requiring borrowers to complete a false loan purpose declaration—is a concern for many. Among the concerned parties is John Moratelli of New South Wales Legal Aid, who argued that this loophole needs to be removed:

I would like to see the business purpose loophole in the UCCC closed so people cannot describe loans that are for personal use as business loans and avoid the UCCC.⁴³

- 5.56 The solution to this problem is to amend the UCCC so it applies to investors and small businesses. Not only would this stop lenders’ avoidance, it would also bring the UCCC into line with other important financial services regulation, which also applies to investment and small business loans.

Compulsory EDR membership

- 5.57 This is a reform option that received almost universal support in submissions and during the roundtable. The MFAA, for example, argued:

The MFAA considers that consumers will be assisted if all lenders of UCCC regulated lending must be members of an ASIC approved dispute resolution scheme. This would ensure the borrowers from the non-ADI sector would have recourse to have their complaints heard for free.⁴⁴

- 5.58 Similarly, COSL argued:

It is vital that all credit providers and financial intermediaries are required to join an independent industry-based consumer dispute

41 Banking and Financial Service Ombudsman, *Submission no. 5*, p. 8.

42 Mr R Venga, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 52.

43 Mr J Moratelli, NSW Legal Aid, *Transcript of evidence*, 10 August 2007, p. 78.

44 Mortgage and Finance Association of Australia, *Submission no. 2*, p. 4.

resolution scheme to address many of the access to justice issues facing consumers.⁴⁵

- 5.59 The lone voice against compulsory EDR membership was Ron Hardaker of the Australian Finance Conference, who stated: 'Our position on EDR is that it should be voluntary'.⁴⁶
- 5.60 If credit regulation were brought under the Corporations Act then providers of credit products and advice would be required to hold an AFS licence. Licensees are required to be a member of an EDR scheme.
- 5.61 Even if credit regulation remains separate from the Corporations Act, compulsory EDR scheme membership is still a reform option. One possibility would be for the states to amend the UCCC to require EDR membership for UCCC-regulated lenders.
- 5.62 Because EDR membership is voluntary at present, there is not a strong obligation on a rogue member to comply with an EDR scheme's findings against them. An EDR scheme has two possible recourses against a member refusing to comply with a finding. The first is to take legal action against the member for breach of contract. As Raj Venga of COSL told the roundtable this 'is an expensive option if we were to do that for every non-compliant member.'⁴⁷
- 5.63 The other recourse is to expel the member from the scheme. Expulsion has little effect at present because lenders do not have to be members of an EDR scheme. But if EDR membership was compulsory, expulsion from a scheme would have serious consequences.
- 5.64 Another issue with the current operation of EDR schemes are their jurisdictional limits. The BFSO, for example, only has jurisdiction in complaints where the amount in dispute is below \$280,000. COSL's scheme limit is \$250,000.
- 5.65 The limit applies to the amount in dispute, not the total amount of the loan. In the vast majority of cases disputes are well below the limit, but the BFSO sees a few cases where the limit is surpassed. This almost exclusively occurs when a property has been used to guarantee a loan that is being used for the purpose of establishing or expanding a small business. In these cases the whole value of the guaranteed property can be in dispute, which can be much more than \$280,000. The BFSO can look into claims

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

46 Mr R Hardaker, Australian Finance Conference, *Transcript of evidence*, 10 August 2007, p. 55.

47 Mr R Venga, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 49.

above \$280,000 but only if the member involved in the claim approves them to do so. COSL has not yet seen disputes of this nature.

- 5.66 Scheme limits are set by each scheme. ASIC grants approval for schemes to operate but only has a limited role in setting jurisdictional limits. ASIC's guidelines on approving an EDR scheme state:

A scheme's coverage should be sufficient to deal with:

(a) the majority of consumer complaints in the relevant industry (or industries) and the whole of each complaint; and

(b) consumer complaints involving monetary amounts up to a specified maximum that is consistent with the nature, extent and value of consumer transactions in the relevant industry or industries.⁴⁸

Regulation of mortgage brokers

- 5.67 Mortgage broker regulation is something that has been mooted for sometime, but has not yet eventuated. Recent reports suggest that the states are close to agreement on a regulatory regime. As noted above, the proposed uniform regime is likely to include licensing, minimum competence requirements, and written broker agreements. Brokers would also be required to be members of an EDR scheme.
- 5.68 There was unanimous agreement during the roundtable that greater controls over the conduct of brokers are needed, but there was less agreement on exactly how these controls should be implemented.
- 5.69 If credit regulation was moved to ASIC and the Corporations Act, as many people think it should be, there would be no need for separate, state-based broker regulation. Brokers would be required to hold an AFS license and to comply with the requirements of that licence.
- 5.70 But if credit regulation remains a state responsibility then separate broker regulation is needed. As was pointed out by Phil Naylor of the MFAA 'if the federal government ... does not do something about it, the states will do it.'⁴⁹

48 ASIC, *Regulatory guide 139: Approval of external complaints resolutions schemes*, ASIC, Canberra, July 1999.

49 Mr P Naylor, Credit Ombudsman Service, *Transcript of evidence*, 10 August 2007, p. 76.

Committee conclusions

- 5.71 Credit regulation has failed to keep pace with the rapidly evolving and growing credit market. The current regulatory framework is ineffective in dealing with the new practices that have emerged.
- 5.72 Most financial services and products are regulated by the Commonwealth Government. One aspect to this is that under the Corporations Act ASIC is responsible for administering licensing, disclosure and quality of advice requirements. ASIC's responsibilities do not extend to credit products and services.
- 5.73 The Uniform Consumer Credit Code is the primary instrument for regulating credit in Australia. It is a uniform national code that was developed by the states and territories in the early 1990s in an attempt to introduce standardisation. The uniformity it brings is certainly welcome, but the code itself has a number of inadequacies.
- 5.74 The fact that the UCCC is state-based means it is very hard to change. This is probably the major reason it has been unable to adapt as the market has changed and predatory practices have become more prevalent. According to consumer advocates, problems with the UCCC itself include the lack of positive obligations on lenders to assist people facing financial hardship, and the lack of explicit requirements on lenders to only provide credit to people who can afford it. Also, because it does not apply to investment and small business loans, fringe lenders can avoid the UCCC's requirements by forcing consumers to complete a false declaration about the loan's purpose.
- 5.75 Other problems with credit's current regulatory framework include the fact that external dispute resolution scheme membership is voluntary for some credit providers, and that there are very few controls on the conduct of mortgage brokers.
- 5.76 There are a number of possible regulatory responses to remedy these concerns. The UCCC could be amended to strengthen some of its provisions, to include investment and small business loans, and to make EDR scheme membership compulsory. But, as already discussed, amendment is an inherently difficult task and is likely to take an extended period of time.
- 5.77 In terms of the conduct of brokers, the states are very close to releasing a draft bill to introduce uniform national regulation. This is certainly a welcome development, but, much to the frustration of the broking industry and consumer advocates, it has taken a long time to come to

fruition. If the regime needs to be amended in the future this would presumably involve another drawn out process.

- 5.78 The committee is of the view that a more sensible approach to reform would be to harmonise regulation within the financial sector by shifting responsibility for credit regulation to the Commonwealth Government. This would remove the arbitrary and illogical division of powers that currently exists, where all financial products and services are regulated by the Commonwealth, except credit.
- 5.79 Credit should be defined as a financial product for the purposes of the Corporations Act. Providers of credit products and services would then be subject to rules about quality of advice and disclosure, and would be required to hold an AFS licence. This would include *all* lenders and *all* mortgage brokers. Predatory lenders and brokers providing inappropriate loans or advice would be subject to sanctions from ASIC and may face the loss of their AFS licence.
- 5.80 AFS licensees are also *required* to be a member of an EDR scheme. The fact that EDR scheme membership is a mandatory condition of an AFS licence gives schemes more power when making a determination against a member. If a member fails to comply with a determination then they may be expelled from the scheme, which could jeopardise their AFS licence.
- 5.81 EDR schemes appear to be an effective and low-cost mechanism for resolving consumer complaints. The schemes' jurisdictional limits could be increased to enable more complaints to be dealt with. This is particularly relevant for the Banking and Financial Services Ombudsman because it often deals with complaints where loans have been guaranteed by property. In this type of complaint the amount in dispute can be the entire value of the guaranteed property, which would invariably be higher than the BFSO limit of \$280,000.
- 5.82 The committee is aware that transferring credit to a Commonwealth responsibility is not as simple as just defining credit as a financial product under the Corporations Act. As pointed out in evidence, there are aspects of credit products that are different to other financial services. Further, there are aspects of the UCCC that are important and not covered by any current federal legislation. An example of this is the UCCC's hardship provisions. The architects of the new arrangements would need to consider what legislation other than the Corporations Act needs to be amended, and whether there is a need for new legislation.
- 5.83 Another issue is whether or not the states and territories are willing to allow the Commonwealth to take over credit regulation. Anecdotal evidence to this inquiry suggests they would be. The Treasurer has

recently indicated that the Commonwealth would be willing to legislate in this area.

- 5.84 In summary, the committee is of the view that this new approach to credit regulation is needed. It will not only assist in reducing the number of predatory lenders and brokers, it will also harmonise regulation within the financial system, and make credit regulation more readily adaptable to future changes in the market.

Recommendation 2

- 5.85 **The committee recommends that the Commonwealth Government regulate credit products and advice. This includes the regulation of mortgage brokers and non-bank lenders.**

Recommendation 3

- 5.86 **The committee recommends that:**
- **The board of the Banking and Financial Services Ombudsman increase its jurisdictional limit to \$500,000. This limit should be indexed annually; and**
 - **Other external dispute resolution schemes consider the appropriateness of their limits.**

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 Debelles, '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

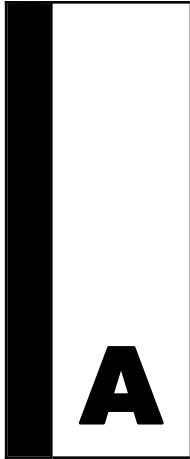
21 S Braunstein, Federal Reserve System, *Statement to the US House of Representatives Committee on Financial Services*, 27 March 2007, pp. 4-5.

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.

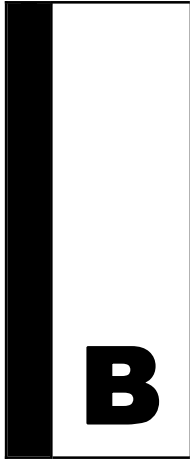
Hon Bruce Baird MP
Chair
4 September 2007



Appendix A – Submissions

No.	Provided by
1	Associate Professor Steve Keen
2	Mortgage and Finance Association of Australia
3	HBOS Australia
4	Care Financial Counselling Service and Consumer Credit Legal Centre
5	Banking and Financial Services Ombudsman
6	Genworth Financial
7	Reserve Bank of Australia
8	Consumer Action Law Centre
9	Australian Bankers' Association
9.1	Australian Bankers' Association (supplementary)
10	PMI Mortgage Insurance
11	Australasian Compliance Institute
12	ANZ Bank
13	Abacus Australian Mutuals
14	Prushka
15	Australian Securities and Investments Commission
16	Australian Property Institute

17	Finance Sector Union
18	Credit Ombudsman Service
19	Code Compliance Monitoring Committee
20	Finance Brokers Association of Australia
21	Financial and Consumer Rights Council
22	Legal Aid New South Wales
23	Wesley Mission
24	Liberty Financial
25	Housing Industry Association
26	GE Capital Finance

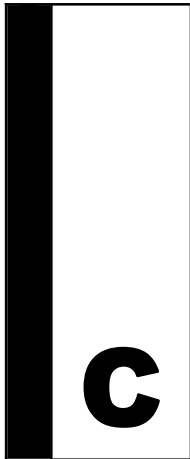


Appendix B – Exhibits

No	Description
1	<p>Presented by Care Financial Counselling Service and Consumer Credit Legal Centre</p> <p><i>Consumer Credit Legal Centre, Submission to the Productivity Commission's Review of the Consumer Protection Framework, June 2007</i></p> <p>(Related to Submission No. 4)</p>
2	<p>Presented by Care Financial Counselling Service and Consumer Credit Legal Centre</p> <p><i>David Tennant, Lo Doc Loans - increased market access for lower income consumers, or the potential catalyst for a consumer credit meltdown?</i></p> <p>(Related to Submission No. 4)</p>
3	<p>Presented by Care Financial Counselling Service and Consumer Credit Legal Centre</p> <p><i>Amy Kilpatrick, They want to take our house: An investigation into house repossessions in the ACT Supreme Court</i></p> <p>(Related to Submission No. 4)</p>

- 4 Presented by Banking and Financial Services Ombudsman
Philip Field, "Recent" changes to hardship and financial difficulty
(Related to Submission No. 5)
- 5 Presented by Banking and Financial Services Ombudsman
Case Note, Permanent Custodians v Upston: Broadening the scope for reasonable grounds of hardship
(Related to Submission No. 5)
- 6 Presented by Banking and Financial Services Ombudsman
Banking and Financial Services Ombudsman, Bulletin 46, June 2005
(Related to Submission No. 5)
- 7 Presented by Banking and Financial Services Ombudsman
Banking and Financial Services Ombudsman, Bulletin 53, March 2007
(Related to Submission No. 5)
- 8 Presented by Genworth Financial
Genworth Financial, The Genworth Financial mortgage trends report, June 2007
(Related to Submission No. 6)
- 9 Presented by Genworth Financial
Genworth Financial, Managing fraud in the mortgage market, Spotlight series, Issue 2
(Related to Submission No. 6)

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- 10 Presented by Genworth Financial
Genworth Financial, Minimum verification policy
(Related to Submission No. 6)
- 11 Presented by Code Compliance Monitoring Committee
Code Compliance Monitoring Committee, Bulletin no 7, May 2007
(Related to Submission No. 19)
- 12 Presented by Code Compliance Monitoring Committee
Code Compliance Monitoring Committee, Inquiry into bank compliance with clause 25.2 of the code, December 2005
(Related to Submission No. 19)
- 13 Presented by Code Compliance Monitoring Committee
Code Compliance Monitoring Committee, 2006-07 Annual Report
(Related to Submission No. 19)
- 14 Presented by Mr Paul Castley
P Castley, Valuation default clauses: Everybody beware, 2006
(Not related to a submission)



Appendix C – Roundtable participants

Friday, 10 August 2007 - Canberra

Abacus Australian Mutuals

Mr Luke Lawler, Senior Adviser, Policy and Public Affairs

ANZ Bank

Mr Michael Rowland, Managing Director, Mortgages

Australasian Compliance Institute

Mr Martin Tolar, Chief Executive Officer

Australian Bankers' Association

Mr David Bell, Chief Executive Officer

Australian Finance Conference

Mr Ron Hardaker, Executive Director

Australian Property Institute

Mr Grant Warner, National Director

Australian Prudential Regulation Authority

Mr Tom Karp, Executive General Manager, Supervisory Support

Ms Heidi Richards, General Manager, Industry and Technical Services

Australian Securities and Investment Commission

Mr Greg Kirk, Director, Compliance and Campaigns, Consumer Protection

Banking and Financial Services Ombudsman

Mr Colin Neave, Ombudsman

Bendigo Bank

Mr Robert Makeham, Manager - Mortgage Help Centre

Mr Ken Turner, Senior Manager - Origination

Choice

Mr Gordon Renouf, General Manager, Policy & Campaigns

Citibank

Mr Nicholas Cowell, Director, Retail Bank

Code Compliance Monitoring Committee

Ms Kirsten Trott, Chief Executive Officer

Commonwealth Bank of Australia

Mr Michael Cant, Executive General Manager

Mr David Grafton, Executive General Manager

Consumer Action Law Centre

Ms Carolyn Bond, Co-Chief Executive Officer

Consumer Credit Legal Centre

Ms Karen Cox, Coordinator

Credit Ombudsman Service

Mr Raj Venga, Chief Executive Officer and Ombudsman

Finance Brokers Association of Australia

Mr John Mulcair, National Treasurer

Finance Sector Union

Mr Rod Masson, Manager Policy & Communications

Genworth Financial

Mr Peter Hall, Country Executive & Director

HBOS Australia

Mr Christopher Maclean, Head of Retail Risk

Legal Aid New South Wales

Mr John Moratelli, Acting Regional Program Coordinator (Civil Law)

Mortgage and Finance Association of Australia

Mr Phil Naylor, Chief Executive Officer

National Australia Bank

Mr Nelson Yiannakou, Head of Mortgage Credit Intelligence

PMI Mortgage Insurance

Hon Nick Greiner, Chairman

Mr Scott Powell, Principal, New Business Ventures

Prushka

Mr Roger Mendelson, Chief Executive Officer

Reserve Bank of Australia

Mr Chris Aylmer, Deputy Head, Financial Stability Department

Mr John Broadbent, Head of Domestic Markets

University of Western Sydney

Associate Professor Steve Keen, Schools of Economics and Finance

Virgin Money Australia

Mr David Wakeley, Chief Executive Officer

Wesley Mission

Ms Elizabeth Orr, General Manager, Operations

Westpac

Mr David Malcolm, General Manager, Consumer Risk

