Submission to the

Senate Inquiry into possible links between household debt, demand for imported goods and Australia's current account deficit

14 April 2005

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1. Australian Bankers' Association

The ABA appreciates the opportunity to provide input into the Senate Economics committee into issues surrounding household debt and the current account deficit. The ABA is the industry association for Australian banks; our membership[1] is composed mainly of retail banks but also includes a number of foreign-owned banks and wholesale banks.

The ABA's submission is focussed on the terms of reference relevant to bank lending policies. It covers the following topics:

(a) Household debt – state of play;

(b) Commercial incentives in the lending market;

(c) The ABA's role in financial literacy as a means of improving customer decision-making, competition and market efficiency;

(d) The lending regulatory environment; and

(e) Competitive neutrality in the regulation of credit suppliers.

The submission concludes with some observations about the current level of loan defaults and the recently concluded examination of banks' capacity to withstand a serious deterioration in the housing market.

2. Household debt – state of play[2]

The standard approach to analyse the financial health of a small business or corporation is to analyse its assets and liabilities position – its balance sheet. A household's balance sheet also gives a good indication of its financial health. As with a business, if the assets are greater than the liabilities, the household can relieve itself of debt burdens by selling assets.

The data shows that while household liabilities (debt) are high, they are still reasonably small compared to household assets. Currently, household debt is equivalent to only 20 per cent of household assets. This ratio has been stable for a number of years, albeit, around twice the level in the 1980s, meaning households are now more highly geared. As a result, borrowers face greater risks but also greater rewards associated with that leverage.

The other commonly used indicators of household financial health are based only on the liability side of the balance sheet but can be useful information given that assets may not always be easily realised and cash flow may be important. The

[1] See the 'Members' icon on the ABA's website: www.bankers.asn.au.

[2] The data in this section is taken from various Reserve Bank Bulletin articles on household debt. They can be found at the Reserve Bank's website: www.rba.gov.au.

first such indicator is the household debt servicing ratio. This shows how much of a household's after tax income (e.g. wages and salaries) is being spent on debt interest repayments.

As of end-2004, about nine per cent of household after tax income was being used to repay interest on debt. Looking over the last twenty years, the current level is roughly equivalent to the peak reached in the late 1980s. However, the data shows a significant increase over the last three years, consistent with high growth in credit which in turn has been driven by the jump in house prices.

The other commonly used indicator is the debt-to-income ratio – this measures the stock amount of debt relative to household income. Since 1980 and late 2004, the data shows a very substantial increase in this ratio. In 1980, the ratio was around 65 per cent. Today, it is around 140 per cent. Using the benchmark of international comparison, Australia has now one of the highest ratios, whereas in the 1980s, we had one of the lowest.

There is an unresolved debate about what is 'too much' debt. This is clearly dependent on the level and composition of household assets and the household's lifestyle preferences.

The current level of housing defaults also shows that in the current economic climate, households are managing their debts well. Housing defaults are historically low despite a significant reduction in housing affordability associated with higher property prices.

It is worth noting also that households appear to be adjusting to cooling conditions in the housing sector. Consumer spending expanded just 0.4% in the December quarter 2004, a sharp slowing from the 1.2% rise in Q3. This is somewhat at odds with brisk jobs growth and historically high levels of consumer confidence. It suggests that the deflating housing market is weighing on spending, as consumers enter a period of balance sheet consolidation. Consistent with this, the rate of household dissaving has improved. The 'saving' rate was –3.7% late in 2003, but narrowed to –2.2% by the end of 2004 (in trend terms).[3]

3. Commercial incentives in the credit supply market

The Inquiry's terms of reference asks about the role of banks and other financial institutions in contributing to household debt levels.

As financial intermediaries, banks should be viewed as suppliers of credit; they do not determine the demand-side of the debt market. The demand-side constitutes those people and businesses that want credit to buy assets like houses, or goods and services. [4]

[3] ABS data

[4] Personal customers demand three sorts of debt. (a) Housing debt, accounts for around 85 per cent of all personal debt. This is then divided between housing debt for owner-occupation, and that of housing investment debt. (b) Other personal debt, for items such as boats, caravans and cars, accounts for about 10 per cent of all personal debt. (c) The third category is credit cards. This unsecured debt is typically used to smooth short-term fluctuations in income and can be used for almost any expenditure purpose.

The demand-side of the debt market is influenced by many factors; these include the price of debt (primarily determined by Reserve Bank's monetary policy), taxation incentives/disincentives (legislated by State and Federal Governments), consumer tastes, and expectations about asset price changes.

The demand-side of the debt market is the primary driver of increased household debt. Mortgage interest rates today are roughly half what they were at the beginning of the 1990s, this factor alone almost fully explains the surge in a demand for debt to buy housing. The Productivity Commission provides a good explanation of how low interest rates fuelled demand for debt for housing in its recent housing affordability report. [5]

Financial deregulation is also an important part of the household debt story. A central tenet of the financial sector deregulation achieved in Australia over the past two decades has been the removal of iniquitous credit rationing that had previously prevailed, thereby allowing policy to influence credit through demand-side factors. Based on this, banks and other credit providers will lend to customers primarily on a commercial basis. This provides an incentive for banks to ensure they lend responsibly.

Incentive to lower loan defaults

The profit motive is the strongest commercial incentive for banks to ensure their lending practices are sound. If a customer cannot repay their home loan, then the bank's profits will be affected.

This basic profit incentive manifests itself in the home loan application process. Before approving an extension of credit, such as a home loan, the bank will satisfy itself the applicant is a person who is capable of repaying the loan. For secured housing lending, this boils down to two essential tests:

(a) An income test – to determine if the person can repay the monthly interest and principle payments without substantial hardship; and

(b) An equity test – to ensure that if the person cannot make the loan repayments, the bank will have sufficient recourse to recover the funds.

Traditionally, the standard income test a bank will apply is that the monthly loan should not exceed 30 per cent of gross income. These days, banks generally have more sophisticated approaches to determining repayment capability. For loan applicants that have higher-than-average incomes, most banks will allow a higher ratio, reflecting the reality that with certain living expenses more or less fixed, higher income individuals can manage if they choose to dedicate a higher proportion of their income to debt repayments.

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[5] '…a halving of the interest rate almost doubles the mortgage potentially obtainable, as well as nearly doubling the price of a home that can be 'afforded' for a given budget or income. With double the purchasing power, existing home owners could choose to 'trade up' to an improved (bigger, nicer, better located) house, and aspiring first home owners could buy sooner. ..the cumulative response to lower finance costs was a growing demand for housing…'. Productivity Commission. 'First Home Ownership' Report, 31 March 2004, p.xvii.

To ensure conservatism in the income test, banks will generally factor in an interest rate buffer of plus one to two per cent. This means that in the event of an interest rate increase which is less than the built in factor, the borrower's repayment obligation should continue to be affordable.

The equity test again also has an historical standard. Roughly speaking, banks will require the home loan applicant to demonstrate they will have 20 per cent equity in the house they intend to buy. This means the difference between the price of the house and value of the bank loan is 20 per cent. With this buffer, the bank has financial protection against default risk.

As with the income test, the banks will allow exceptions to this standard but that will require the loan to be covered by an insurance policy (known as Lenders' Mortgage Insurance), or for the customer to demonstrate that the applicant's income is high enough and credit risk low enough to justify the extra risk for the bank.

It needs to be stressed that the equity and income tests that banks apply – the two basic constraints applied to credit applications - are commercially driven. It is in the banks' interests that credit is repaid according to the contract terms of the facility, rather than defaulted.

Box 1: ABA's financial literacy commitment

The ABA member banks have agreed to a five-year campaign to improve the financial literacy of Australia's banking customers. This is an important initiative for the industry as it demonstrates that Australian banks accept a collective responsibility for improving the capability of Australians to make sound financial decisions. Modern economic theory also stresses the importance of well informed markets for efficiency, competition and consumer protection.

Over the last twelve months, the ABA has undertaken financial literacy initiatives under the banner of its 'Broadening Financial Literacy Program'. Some highlights so far:

- Production of information booklets:
  "Smarter banking – make the most of your money"
  "Smarter banking – make credit work for you"

- Production of Web-based Fact Sheets:
  "Another day another bill to pay"
  "Bank account basics"
  "Borrowing money - obtaining and managing credit"

- Implemented the national education campaign - Protect Your Personal Information Online consisting of national print advertisements and fact sheets , launched 8 March 2005.

- The ABA Chairman's involvement on the Government's Taskforce on Consumer Education and Financial Literacy which has resulted in the establishment of a Consumer and Financial Literacy Foundation which will replace the Taskforce.

- Contributing to the work of the Consumer and Financial Literacy Foundation by having direct input into the development of their superannuation choice campaign;

- Organising and chairing (in conjunction with Reconciliation Australia), an Industry Roundtable with specific focus on the distribution of financial literacy materials, to people living in regional, rural and remote Australia. The Round Table was held 11 March 2005.

The program so far has focussed on the production of key financial literacy information, whereas the focus over the next year will be concentrated more heavily on distribution and delivery of the written information.

4. Regulations impacting on bank lending

Bank lending is also subject to Government and self-regulatory rules. This includes, the Uniform Consumer Credit Code (UCCC) administered by State Government; the self-regulatory Code of Banking Practice; capital rules imposed by APRA that affect lending; and the Banking and Financial Services Ombudsman (BFSO).[6]

Uniform Consumer Credit Code

State Governments, through the Uniform Consumer Credit Code (UCCC), require banks and other credit providers to undertake the proper disclosure and contract documentation whenever a credit facility is extended.

The UCCC imposes a legal discipline on banks to ensure that before they lend money, the bank has or could have ascertained through reasonable inquiries of the loan applicant that the applicant will be able to repay it in accordance with the terms and conditions and without substantial hardship.

Banks should have established procedures that would satisfy and clearly demonstrate this requirement. Otherwise, they will be exposed to a legal risk of having the loan contract nullified or altered by a Court, resulting in higher costs and financial loss to the bank.

Code of Banking Practice

Eleven ABA member banks, each with a retail presence, have adopted the modified May 2004 Code of Banking Practice.[7]

This Code sets standards of conduct for banks in their dealings with individual and small business customers. It is aimed at fostering a good relationship between banks and their customers by promoting sound disclosure and conduct principles. Once a bank has adopted the Code, it binds the bank contractually to the customer. If a bank breaches the Code, it has breached its legal contract with the customer.

Compliance with the Code is monitored by the independently formed Compliance Monitoring Committee (CCMC). The CCMC can conduct its own investigations; request banks to remedy breaches of the Code and in certain cases publicly name a non-compliant bank.

In respect of lending, the Code requires subscribing banks to exercise care and skill of a diligent and prudent banker in assessing the loan application. It explicitly[8] commits those banks to try to help customers overcome their financial difficulties with their bank loan by, for example, agreeing to a new repayment

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[6] Banks are also subjected to the Privacy Act, the Corporations Act, Industrial Relations laws, Financial Services Reform Act (FSRA), the Banking Act, the Electronic Funds Transfer (EFT) Code, payments systems regulations imposed by the Reserve Bank's Payment Systems Board (PSB), anti-money laundering regulations. This regulatory framework is complex and onerous and adds significantly to the cost of Australia's financial system.

[7] 'Code of Banking Practice', The Australian Bankers' Association, a copy is available from the ABA's website: www.bankers.asn.au.

[8] See clause 25.2.

schedule. These difficulties may have arisen because the borrower loses employment temporarily. The Code also requires banks to inform customers about the existence of the hardship variation provisions in the UCCC if these provisions could be relevant to the customer's situation.

Other self-regulatory initiatives

In March 2004, the ABA announced [9] four self-regulatory rules to improve current ABA member bank practices with respect to credit card lending. These initiatives were aimed at giving credit card customers more information on the risks of accepting higher debt, providing a warning about the risks associated with changes in personal circumstances, and greater convenience for a credit card user in varying the credit card's loan limit.

These changes appeared straightforward, but they require very substantial systems changes for ABA member banks. Most banks are now compliant.

Banking and Financial Services Ombudsman

Any bank customer that fails to have their dispute with a bank satisfactorily resolved, has the option to have their dispute assessed by the Banking and Financial Services Ombudsman (BFSO). The Ombudsman may make a representation to the bank on the customer's behalf, mediate a remedy and, if necessary, resolve the dispute by making a formal determination. If the customer agrees with the determination, this binds the bank to the requirements of that determination.

While this scheme is funded mainly by the banks, its constitution establishes it as a fully independent body. There is no cost to a consumer wanting to pursue a complaint. [10] (NB there can be a cost to a business which may be an individual)

Australian Prudential Regulatory Authority

Government plays a very significant role in protecting bank customers who have savings deposited in a bank. This is common around the world; all Governments undertake initiatives to ensure that when banks make a promise to repay a person's savings in the form of a deposit, then to the greatest practical extent, this promise is kept.

To this end, the Australian Prudential Regulatory Authority (APRA) - the government organisation established in 1998 - publishes a range of standards on its website, known as 'prudential standards', and it enforces these standards with strong legislated powers.

APRA has the authority to determine the level of capital the bank must hold, it can visit the premises of the banks' head office and demand to see data and information. It can force the bank to cease any activity it deems as detrimental to bank deposits.

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[9] 'Banking Industry Initiatives Target Debt', Media Release, Australian Bankers' Association, 5 March 2004, available at ABA website: www.bankers.asn.au.

[10] Further information about the Banking and Financial Services Ombudsman scheme is available from the website www.abio.org.au.

In the extreme, APRA's powers extend to the capacity for the regulator, with Federal Court approval, to take over the full board and management responsibilities of a bank that it believes is either insolvent or at risk of insolvency.

In protecting the interests of depositors, APRA is particularly focussed on bank lending because it is on the lending side of the banking ledger that traditionally the largest risks to the banks' solvency reside. The most significant risk is known as 'credit risk'. This refers to the risk that a loan will default. If a large enough proportion of a banks' stock of loans default, this will place major stress on the bank to fulfil its promises to repay the banks' depositors.

In the last 12 months, APRA has announced a number of prudential regulatory changes aimed at reducing risks in housing lending. These are briefly reviewed.

Low documentation loans (Low Docs)

In October last year, APRA increased the capital a bank must hold against loans that meet the APRA's definition of Low Doc. Low Doc refers to loans that are originated with less than the normal income-verification documentation. One means of avoiding this increased capital requirement, allowed under APRA's rules, is to have the loan fully mortgage-insured by a recognised insurer.

Capitalised expenses

In June 2004, APRA effectively increased bank capital requirements by mandating that the value of loan origination costs paid by banks to mortgage brokers and other loan originators, be deducted from their capital levels.

Lenders' Mortgage Insurance

On 14 February 2005 this year, APRA announced changes to the prudential regulation of providers of lenders' mortgage insurance (LMI). These changes are scheduled to take effect on 1 October 2005, subject to further industry consultation.

The effect of the changes is to ensure foreign-owned LMI providers operating in Australia are subjected to appropriate prudential regulation in their home country, offer no other insurance products in addition to LMI and have appropriately structured reinsurance arrangements and/or hold higher capital levels.

APRA's changes aim to ensure that if housing loan defaults increase significantly in Australia, then banks' soundness will not be compromised by LMI providers that have not properly understood and managed the potential credit risk they have been contracted to absorb.

5. Competitive neutrality

Banks are the largest providers of credit in Australia, providing roughly 85 per cent of the total amount lent to individual people and businesses. The remaining 15 per cent is provided by credit unions, building societies, and other lenders which are differentiated by the fact they don't take deposits from customers.

Banks, building societies and credit unions all face a broadly similar regulatory environment, including prudential regulations supervised by APRA. There is a class of lenders that are not subjected to APRA regulations. This group accounts for about ten per cent of all home loans. An increasing presence in the unregulated lending market is being made by non-conforming lenders – see Box 2 below.

While this class of competitor has a reasonably small market share, the way in which these competitors operate has a greater influence on the lending market than is obvious by their market share. Competition in lending means that any new initiatives by non-bank lenders that take market share will pressure banks, as major finance suppliers, to also adopt those initiatives, subject, of course, to the commercial and regulatory constraints discussed above.

Low doc loans became banking products through this process. The unregulated lenders began offering loans that did not require the borrower to provide the normal documents verifying the applicant's income. For many borrowers, this development was welcome because, even though they had sufficient income and equity to meet repayment commitments, the self-employed nature of their work meant they don't have the appropriate documentation. The products, to some extent, reflect changing workforce trends, with greater employment in part-time, contract work and micro-businesses.

Some banks responded by offering these products (not all banks do offer Loc Doc loans) and there was considerable timing differences between the banks in when they offered the product.

It was only when banks began offering Low Docs that there was any official government intervention. APRA has instituted a prudential rule that any bank issuing a Low Doc loan (under APRA's definition) will need to back that loan with twice the amount of capital as for a normal residentially-secured loan, to account for the higher risk, although there is no published evidence that ABA is aware of yet that has quantified the increased default risk of a bank issued Low Doc loan.

The existence of APRA's prudential supervision is the key differential between the regulatory environment between banks and non-regulated lenders. Non-regulated lenders do face financial market discipline on their lending practices to the extent they raise money in the capital market, for example, through mortgage-backed securities.

But, the financial markets are singularly concerned with the maximisation of profit, whereas APRA's prudential supervision is concerned with containing lending and other risks for the benefit of depositors, not shareholders.

Box2: Reserve Bank comments on non-conforming lenders

Recently, the Reserve Bank detailed the characteristic of loans issued by non-conforming lenders. The Reserve noted the following points (amongst others):

- Non-conforming lenders provide loans to borrowers who do not satisfy the standard lending criteria of mainstream lenders, including banks.
- Non-conforming lenders share of the Australian housing loan market has grown significantly in recent years, with non-conforming loans estimated to account for up to 4 per cent of the value of new housing loans in Australia.
- The major non-conforming lenders have achieved scale through large distribution networks, including the use of mortgage brokers, and have been able to use their size to obtain relatively favourable wholesale funding – largely by securitising pools or mortgages.

- Over half of all non-conforming loans are to borrowers who self-certify their income, typically with less restrictive conditions than those on banks' similar 'Low Doc' products.
- Reflecting the riskiness of non-conforming loans, a relatively high proportion of non-conforming borrowers are behind schedule on their loan repayments. At end of 2004, nearly 4 per cent of the value of securitised non-conforming loans were in arrears by at least 90 days, compared to only 0.2 per cent of both securitised and banks' housing loans.
- Typically, interest rates on non-conforming loans are between one and three percentage points above those on a standard home loan, but for higher-risk loans they can be more than four percentage points higher.
- Maximum allowable Loan to value ratios (LVR) on non-conforming loans also tend to be relatively low, particularly for the more severely credit impaired and for self-certified loans.
- The average initial LVRs on securitised non-conforming loans are usually between 70 and 80 per cent, though a significant proportion are above 80 per cent.
- The average life of non-conforming loans is much lower than that of other housing loans. This is largely because many borrowers refinance with a traditional lender, at a lower interest rate, after demonstrating an ability to service their debt. For this reason, and the fact that originating a non-conforming loan is a relatively labour intensive and costly exercise, for the lender, non-conforming lenders charge significant early repayment fees if the borrower exit their loans within a certain period.
- The features of non-conforming loans place a strong emphasis on the lender's credit underwriting and property valuation standards, and mean that close attention to loan servicing and collections is required. The ratings agencies believe these aspects of the major non-conforming lenders in Australia are sound. Nevertheless, to the extent that non-conforming borrowers are more sensitive to less favourable economic conditions, loan quality may deteriorate at a faster rate than on standard housing loans during an economic downturn.

Reference: 'Box C: Non-conforming Housing Loans', Financial Stability Review, March 2005, Reserve Bank of Australia, pp.41-42.

6. Loan defaults, stress testing and concluding comments

For individual households that get into a situation whereby they cannot repay their loan or other debts, considerable stress follows, with the ultimate risk being that the household loses its assets and bankruptcy may follow.

Currently, there are very few bank customers that are facing this scenario. Defaults are at almost record lows.[11] This outcome is a result of favourable employment conditions and low interest rates. It is also one indicator that banks are being responsible with their lending decisions. Even in favourable economic

[11] The Reserve Bank Financial Stability Review (March 2005) states: "…Australian banks have benefited from very low bad-debts expense over recent years. As at end 2004, only 0.3 per cent of banks' on-balance sheet assets were classified as 'impaired' – that is, loans that are not well covered by collateral and where either payments are 90 days or more in arrears, or there are other reasons to doubt the ability of the borrower to repay the loan. Including those assets that are in arrears, but are well secured ('past due' items), the ratio of 'distressed' assets to total assets is still only 0.5 per cent…These are exceptionally low ratios both by our own historical experience and by standards overseas…As at December 2004, only 0.2 per cent of outstanding housing loans were past due by 90 days or more…" Reserve Bank, p. 27, available at www.rba.gov.au.

circumstances, systemically poor lending by one or more banks may – at least theoretically - become apparent.

In the scenario that the economy turns downward, evidence demonstrates that banks are financially well-positioned to absorb the impact. Under the extreme assumptions of housing defaults at a dramatic 3.5 per cent and 30 per cent house price declines, APRA's 'Project Panama' stress test[12] showed that 90 per cent of Deposit Taking Institutions would not even breach their regulatory capital requirement. None of them would fail.

Of course, while a very good finding in respect of financial stability, under such an economic scenario, the impact on individual households bearing the brunt of the downturn would be severe.

7. Further Information

The ABA is available to provide follow-up information to this Inquiry. If you have any questions, please contact the ABA on (02) 8298 0450.

[12] 'The resilience of housing loan portfolios – APRA's "stress test" results', Speech to the Securities Institute of Australia, by APRA Chairman, John Laker, Thursday, 09 October 2003. Speech available on APRA web-site: www.apra.gov.au.