RESERVE BANK OF AUSTRALIA

NOTES FOR A PANEL DISCUSSION ON EARLY WARNING SYSTEMS FOR GLOBAL FINANCIAL CRISES

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Canberra – 10 June 2011

NOTES FOR A PANEL DISCUSSION ON EARLY WARNING SYSTEMS FOR FINANCIAL CRISES

The US experience has led many observers to put more emphasis on the risks posed by households and housing markets. And understandably so: housing prices are one-third below their peak, and even more in some cities; millions of people have lost their home to foreclosure; at least 12 per cent of outstanding mortgages were three or more months behind on their payments or in foreclosure proceedings in the first quarter of this year.

In Australia, households have become more indebted over recent decades, and housing prices are high. So we need to be alert to the possibility that many households might become overstretched. Arrears rates on home loans have drifted up as interest rates have risen. But they remain fairly low overall, even compared to the *pre*-crisis experience in some other countries. The cohort that borrowed in 2004–2007 is performing a lot worse than those who took out loans before or since then. Many of the borrowers in that period were investors, and thus more prone to speculative motives than owner-occupiers. Perhaps more importantly, lending standards eased during that period; they have since tightened again, especially around income documentation. There was a surge of first-home buyers in 2008–09 in response to government incentives. These households usually have less equity in their home, so we continue to watch them closely for emerging signs of stress. But so far, they are behaving like earlier cohorts of first-home buyers. It was the buyers in the earlier boom that now seem most vulnerable.

In any case, we need to keep those potential vulnerabilities in perspective. It is very rare that households are the instigators of financial instability. We need to be mindful of the role institutional differences play. The meltdown in the US housing market was an exception to the normal dynamic for mortgage defaults. Arrears rates and defaults started to rise rapidly there *before* the economy turned down. Everywhere else, before and since, unemployment rises in tandem with large upswings in arrears. The difference seems to be the many institutional settings that are unique to the United States. These include: a segmented mortgage lending industry with a large subprime sector; the rapid non-judicial foreclosure processes; weak or incomplete financial regulation; and a household sector that is exceptionally exposed to income and other shocks. We should bear in mind the true relative risk posed by different parts of the non-financial economy. We would be doing our fellow citizens a disservice if we allowed the housing market to become the Maginot Line of financial stability analysis.

As noted in the background paper, Barrell and his co-authors found that housing prices correlate well with periods of distress. But the loan losses, and thus the damage to financial stability, are typically in loans to property developers. That has certainly been the experience in Ireland, Spain and the UK recently.

Developments in Australian Households' Borrowing Capacity: An Update

Households' potential borrowing capacity is little changed since December 2010.[1]

According to our survey of lenders' online loan calculators, is the only major bank that has reduced maximum borrowing capacity; the other major banks have left their calculators unchanged since December 2010.

recently increased its interest rate buffer, resulting in a significant reduction in borrowing capacity across all income levels.[4] For example, the maximum loan size for an individual with a gross income of $100,000 has declined by 13 per cent.

Sophie Stone
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10 June 2011

[1] For developments between March 2009 and December 2010, see Deans, C (2011), 'Developments in Australian Households' Borrowing Capacity', DM internal note.

[4] The increase in the interest rate buffer was confirmed by our mystery shopping. This interest rate buffer can be used by the banks as a broader serviceability buffer and therefore may also take into account potential increases in the cost of living.

CHANGES IN THE PROVISION OF LOW-DOC LOANS

Standards of low-doc lending tightened considerably following the onset of the financial crisis. This owes partly to a reduction in the level of competition in the market as a number of smaller and more aggressive lenders exited the market. Furthermore, there was a general reassessment of the risks involved with this type of product by both lenders and mortgage insurers. As a result, tighter regulations for low-doc lending, introduced in January 2011, appear to have had a limited effect on the industry. Nevertheless, these laws should act to curb the return of some of the riskier lending practices employed prior to the crisis.

Introduction

Low-doc housing loans are designed mainly for the self-employed and those with irregular incomes who do not have the required income documentation to obtain a conventional full-doc mortgage.[1] Since their introduction in the late 1990s, low-doc loans have played an important role in broadening the provision of housing loans. There are greater risks for the lender, however, due to the generally lower quality of information regarding, and greater volatility in, the borrower’s income. For example, before the onset of the crisis, some lenders had started to rely on low-doc borrowers self-certifying their income, rather than using more reliable information such as a business activity statement (BAS).

Changes in low-doc lending between 2007 and 2010

Standards of low-doc lending have tightened considerably over the past couple of years. Most obviously, there was a broad reassessment of the risks associated with low-doc lending in late 2008. Most of the major banks, and at least one regional bank, increased their documentation requirements, such as requiring an ABN and/or a BAS. also ceased offering low-doc loans with a loan-to-valuation ratio (LVR) of above 60 per cent, while tightened the conditions under which these loans were made available.

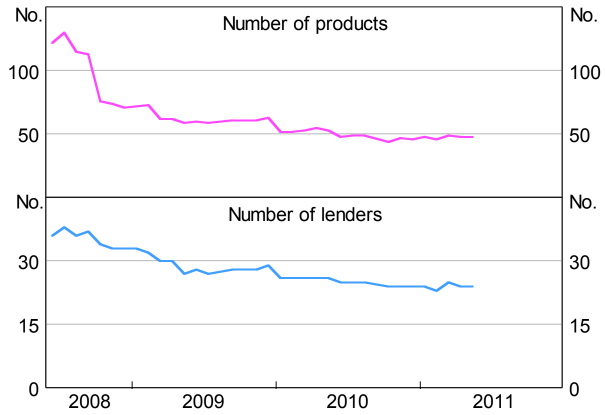
Following these changes, there was a marked fall in low-doc loans as a share of housing loan approvals (see below).

A number of smaller and arguably more aggressive lenders
were also forced to exit the market as funding pressures intensified. According to Canstar Cannex, the number of lenders offering low-doc mortgage products declined from 38 in mid 2008 to 27 a year later (Graph 1). Meanwhile, the number of available products more than halved.

[1] Typical documentation required for a full-doc loan can include a letter of employment, a payslip and a tax return.

Graph 1

Low-doc Variable-rate Mortgages

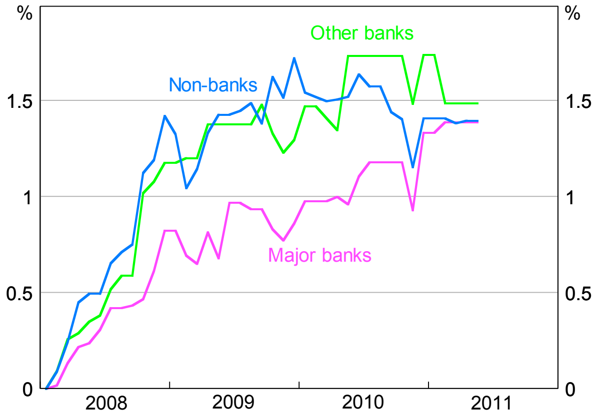


Sources: Canstar Cannex; RBA

Graph 2

Variable Indicator Rates on Low-doc Mortgages

Cumulative change in spread to cash from January 2008*



* Average of the lowest rate advertised by each lender with a loan-to-valuation ratio of 80 or below. Cumulative changes are shown, rather than levels, to alleviate some of the problems with comparison arising because some lenders advertise discounts whereas others do not. Not adjusted for changes to the sample arising from lenders exiting the market.

Sources: Canstar Cannex; RBA

Funding pressures also indirectly led to an improvement in the average quality of low-doc loans. In particular, smaller lenders – which were generally viewed as less cautious in their lending practices – experienced a larger rise in their funding costs.[5] This made it increasingly difficult for these lenders to offer competitive rates even if they were able to remain in the market (Graph 2). As a consequence, we estimate that the market share of the major banks in the low-doc market doubled from 2006 to 2008.

The incentives for borrowers to access these products also declined. In particular, the slowdown in the economy will have affected the self-employed to a greater extent than other borrowers. Furthermore, as expectations of house price growth declined, incentives to speculate on housing via potentially overstating income levels on low-doc loans arguably also fell. In combination, these factors contributed to a marked decline in the share of low-doc loan approvals from a peak of 12½ per cent in late 2008 to 6½ per cent by mid 2010.

3. Recent Developments and Outlook

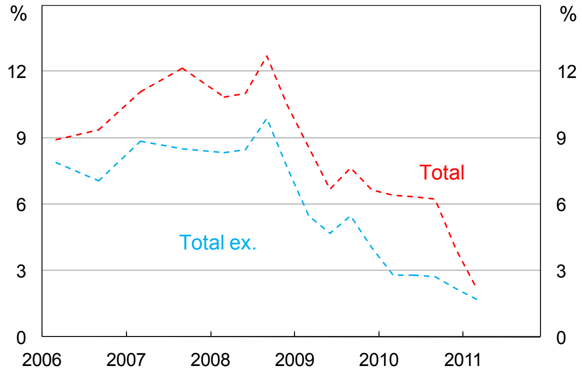
There has been a further reduction in the market share of low-doc loans in recent months. Some lenders attribute this to the recent introduction of the National Consumer Credit Protection (NCCP) legislation. These regulations have placed responsibility upon lenders and brokers – from July 2010 and January 2011 respectively – to make sure a loan is appropriate for the borrower. In particular, 'responsible lending' requirements mean that lenders have to take "reasonable steps to verify the consumer's financial situation".

Any effects on the availability of finance to the self-employed appear to have been relatively minor, with most of the recent decline in low-doc lending reflecting a procedural change in products offered by (Graph 3). had offered 'low doc loans' to borrowers with at least a 40 per cent deposit at no pricing differential to conventional mortgages. As such, many borrowers that were eligible for a full-doc loan had applied for a low-doc loan in order to reduce the administrative requirements of the application. With the introduction of the NCCP, now requires these individuals to apply for full-doc loan products.

[5] For example, smaller lenders accounted for the vast majority of products available to borrowers with weaker credit histories.

Graph 3

Low-doc Housing Loan Approvals
Share of total housing loan approvals, by value, quarterly*



* Prior to March 2008, shares are estimated based on securitisation data and company reports.

Furthermore, there has been little change in their lending standards. This follows guidance from ASIC that simply obtaining recent tax returns and/or BAS should be sufficient. Additionally, the smaller lenders have gained market share recently, suggesting that they also have not materially tightened non-price conditions (although their advertised rates have become more competitive recently). Finally, although liaison suggests that documentation requirements for broker-originated loans have been tightened recently, this was largely attributed to lenders' funding considerations.

Overall, the regulations appear to have struck a reasonable balance between allowing responsible low-doc lending to continue, while discouraging the return of high-risk lending. Nevertheless, lenders' funding considerations and some marginal effects from the NCCP mean that it is unlikely that low-doc lending will outpace the broader market over the next 12 months.

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Institutional Markets Section
Domestic Markets Department
17 June 2011

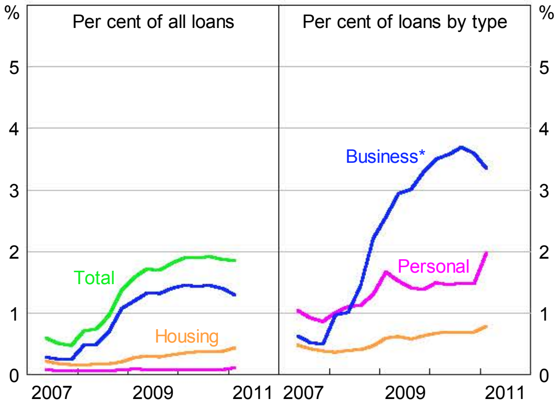
BANKS' NON-PERFORMING ASSETS – MARCH QUARTER 2011[1]

Most banks reported an increase in their domestic housing NPA ratio over the quarter.

Domestic books assets

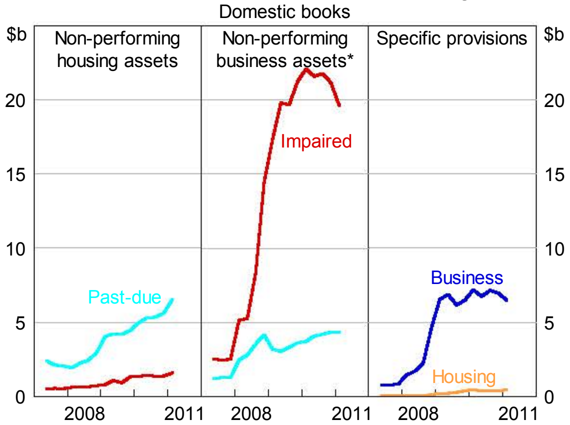
The industry NPA ratio fell for business lending over the quarter, but increased for housing and, in particular, personal lending (Graph 3, Table 1). Past-due assets account for most non-performing housing loans

Graph 3
Banks' Non-performing Domestic Assets
Domestic books



* Includes lending to financial businesses, bills and debt securities, and other non-household loans
Source: APRA

Graph 4
Banks' Domestic Asset Quality
Domestic books



* Includes lending to financial businesses, bills and debt securities, and other non-household loans
Source: APRA

Table 1: Banks' Non-performing Domestic Assets
Domestic Books

	Share by loan type* (per cent)		Share of all loans* (per cent)		Amount ($ billions)		*Memo: loan type as share of all loans* (per cent)*	
	Mar 11	Dec 10	Mar 11	Dec 10	Mar 11	Dec 10	*Mar 11*	*Dec 10*
Housing	**0.8**	**0.7**	**0.4**	**0.4**	**8.1**	**7.0**	***55***	***55***
Owner-occupier	0.8	0.7	0.3	0.3	5.7	4.8	*38*	*38*
Investor	0.8	0.7	0.1	0.1	2.4	2.2	*17*	*17*

* On-balance-sheet credit as at March 2011

Sources: APRA; RBA

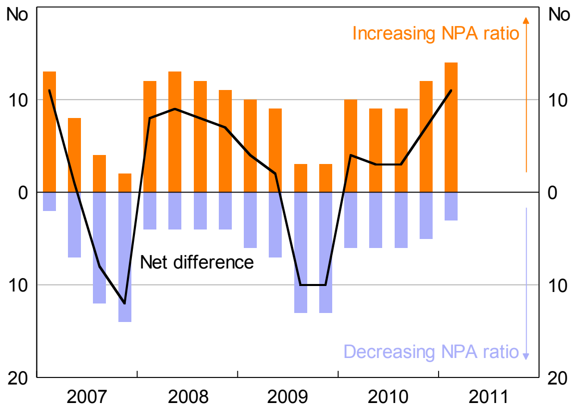
Domestic housing assets

Most banks' housing assets performed worse over the March quarter, with about 80 per cent of banks reporting an increase in their domestic housing NPA ratio (Graph 9). All bank types experienced a rise in non-performing housing loans, despite increases in loans outstanding (Graph 10). The deterioration reflected both higher impairments and past-due loans, particularly at the foreign-owned banks. Banks have indicated that they expect asset performance to deteriorate further over the June quarter due to recent natural disasters and interest rate increases.

Graph 9

Banks' Non-performing Housing Asset Ratio

Domestic books, number of banks reporting change over the quarter

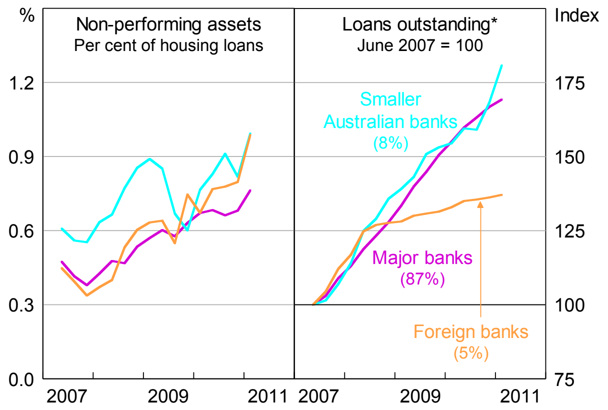


Sources: APRA; RBA

Graph 10

Banks' Domestic Housing Assets

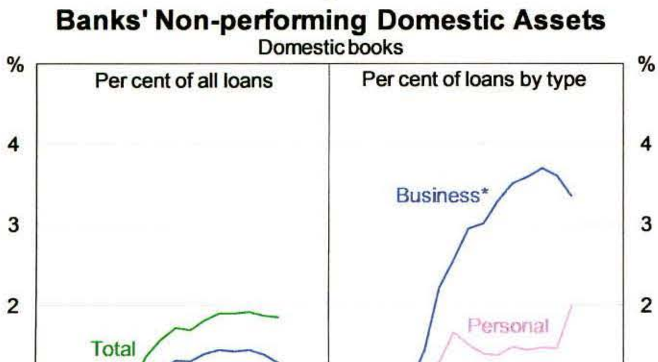
Domestic books



* Share of all banks' housing loans as at March 2011 denoted in parentheses

Source: APRA

Graph 3



* Includes lending to financial businesses, bills and debt securities, and other non-household loans

Source: APRA

From: JOHNSON, Robert
To: EDEY, Malcolm
Cc: PENDLE, Lara; ELLIS, Luci; THOMPSON, Chris; STIEHM, Susan
Subject: RE: Mortgage arrears [SEC=UNCLASSIFIED]
Date: Monday, 27 June 2011 16:18:58

A quick update now that we have a copy of the JPMorgan report. Its statements about the 2009 cohort are forward looking; the more negative take on their current performance appears to be that of the author of the AFR article.

The JPMorgan report states that the although the delinquency rate of the 2009 vintage remains below that of the 2008 and 2007 vintages, it is too early to assume that it will continue to perform better. JPMorgan's concerns about the 2009 cohort stem from its view that gearing tolerance was extended in that period, because of:

- increased approvals levels for First Home Owners;
- flat national house prices since 2009
- low interest rates during 2009 (they estimate that the interest rates on loans made during 2009 are now around the buffer levels used by the banks in their loan application assessments);
- increased average borrowing levels;
- higher levels of interest-only loans.

Given these factors, they estimate that a further 100 basis point increase in interest rates over the next 18 months would likely lead to 2009 (and 2008) loans performing more poorly than the peak arrears in loans originated in 2007. In aggregate, they estimate that the arrears rate could increase by a further 20 – 30 basis points (to a total arrears rate of 90 – 100 basis points).

The report also estimates the impact of seasoning as small (1 – 3 basis points for the major banks). It does not provide its methodology for these calculations. It uses this to argue that the recent rise in interest rates is more a reflection of the arrears rates drifting up for all cohorts than seasoning of the loans. This is broadly in line with our own work on seasoning of banks' mortgage loans, although as emphasised in my earlier email, as yet there is no evidence that loans for 2009 are performing poorly relative to other cohorts.

Thanks

Rob

From: JOHNSON, Robert
Sent: Monday, 27 June 2011 14:58
To: EDEY, Malcolm
Cc: PENDLE, Lara; ELLIS, Luci; THOMPSON, Chris; STIEHM, Susan
Subject: Mortgage arrears [SEC=UNCLASSIFIED]

Malcolm

The main thrust of the mortgage arrears discussion in the 'Trouble on the Home Front' article in the AFR is based on a report by JPMorgan. We are trying to get hold of the JPMorgan report, but in the meantime here are our thoughts on the main messages from the press report.

On arrears, the press report makes the following statements, based on data from Genworth:

1. Loans written in 2008 are performing worse than in previous or subsequent years
2. Loans written in 2007 and 2009 are "only marginally better"
3. Loans that are 4-6 years also have seen a jump in arrears recently

This leads the author to conclude that the deterioration in mortgage arrears is broad based and based more on a deterioration in credit quality than because of natural seasoning of the loans.

Much of this analysis is consistent with our data. Both figures provided by
and figures from on securitised mortgages suggest that at the aggregate level the 2008 cohort is the poorest performing given its level of seasoning (see Graphs 1 and 2 in attached document). In fact, figures suggest it is the poorest performing in absolute terms, consistent with the press article.

However, on point 2, we have no data that suggests that 2009 loans are only performing marginally better than those made in 2008. Both
and securitisation data suggest that loans made in 2009 have performed considerably better than those issued in previous years.

The press article's statement that loans that are 4-6 years old have also seen an increase in arrears recently is also consistent with securitisation data. However, the conclusion that the arrears trend is broad based is based on the statement that 2009 loans are also performing poorly. As mentioned above, our data shows that 2009 loans, and 2010 loans, have performed much better than loans issued in early years. This suggests that the increase in arrears that is related to asset quality, rather seasoning, is largely confined to loans made prior to the tightening of lending standards in the second half of 2008.

We are contacting another to get an understanding of how their 2009 insured loans have performed relative to earlier years. Given that our other sources all point to higher credit quality in 2009, it is unlikely that data will support the press article on this point. Once we get hold of the original JPMorgan article we will have a better understanding of whether or not the press article has quoted JPMorgan's work out of context.

If we look at the securitisation data on a state level, the credit standards story is even more compelling. For Western Australia, loans made in 2006, 2007 and 2008 are the poorest performers (Graph 3). These were loans made towards the end of the period of strong house price growth in Western Australia (Graph 4). For New South Wales, loans made in 2003, 2004 and 2005 are worst performing; these were associated with a loosening in credit standards, particularly for loans based in Western Sydney (Graph 5). For Queensland, arrears are more broad-based, reflecting more volatile house prices and weaker macroeconomic conditions (Graph 6).

Thanks

Rob

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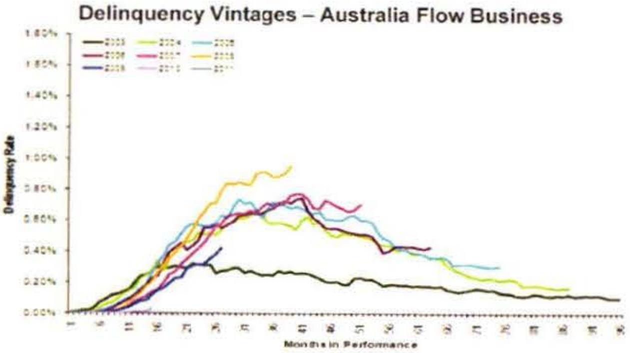
Graph 1

Delinquency Vintages – Australia Flow Business

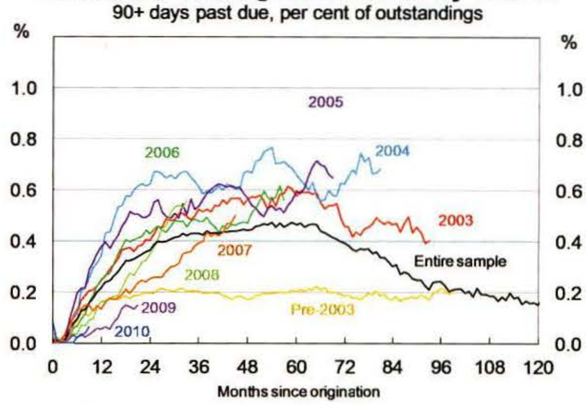


Source: Genworth

Graph 2

Securitised Housing Loan Arrears by Cohort*

90+ days past due, per cent of outstandings

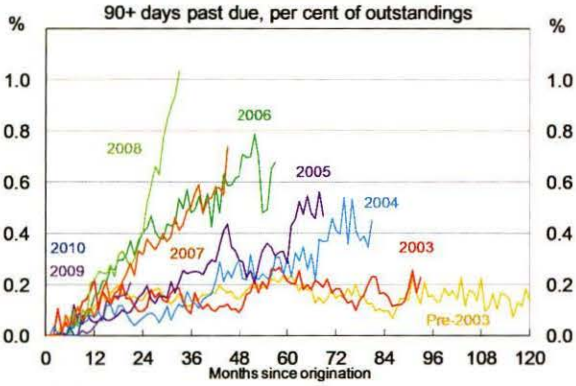


* Full-doc and low-doc loans securitised by all lenders, includes self-securitisations
Source: Perpetual

Graph 3

Securitised Housing Loan Arrears by Cohort
Western Australia*

90+ days past due, per cent of outstandings

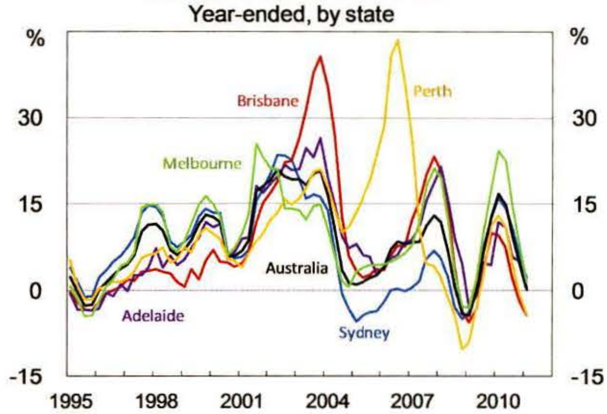


* Full-doc and low-doc loans securitised by all lenders, includes self-securitisations
Source: Perpetual

Graph 4

House Prices Growth

Year-ended, by state

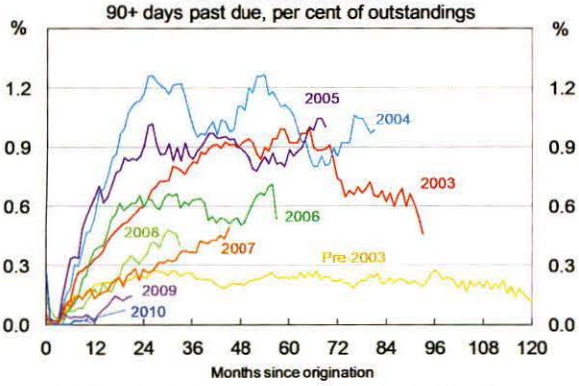


Source: APM

Graph 5

Securitised Housing Loan Arrears by Cohort
New South Wales*

90+ days past due, per cent of outstandings

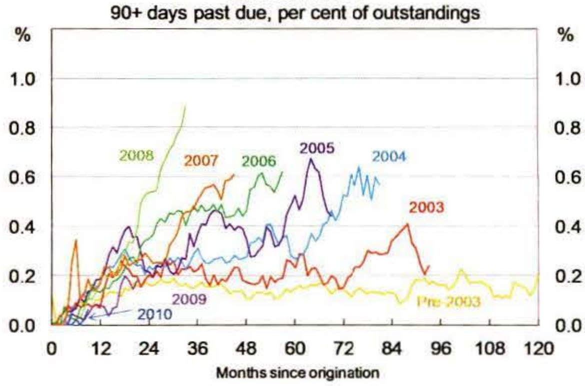


* Full-doc and low-doc loans securitised by all lenders, includes self-securitisations
Source: Perpetual

Graph 6

Securitised Housing Loan Arrears by Cohort
Queensland*

90+ days past due, per cent of outstandings



* Full-doc and low-doc loans securitised by all lenders, includes self-securitisations
Source: Perpetual