Box C: Non-conforming Housing Loans

Non-conforming lenders provide loans to borrowers who do not satisfy the standard lending criteria of mainstream lenders, including banks. These lenders are not authorised deposit-taking institutions and, hence, are not regulated by APRA. Their share of the 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, though this is still less than half the size of the non-conforming markets in the US and UK.

In the past, some borrowers who could not obtain housing loans from traditional lenders turned to alternative sources such as finance companies, solicitors and accountants. But in recent years, specialist lenders have emerged and are playing an increasingly important role in the non-conforming market. 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 of mortgages – to provide end borrowers with competitive interest rates.

Non-conforming loans are inherently more risky than standard home loans. In total, around two fifths of the value of non-conforming loans are to individuals with impaired credit histories.[1] Other non-conforming borrowers include those earning an irregular income, those with an erratic saving pattern or 'non-genuine' deposit, full-time property investors, new immigrants or temporary residents, and elderly borrowers. 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.

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 may have fallen into arrears on their mortgage repayments with other lenders and have subsequently refinanced with a non-conforming lender.

Reflecting the riskiness of non-conforming loans, a relatively high proportion of non-conforming borrowers are behind schedule on their loan repayments. At the 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 other securitised and banks' housing loans (Graph C1).

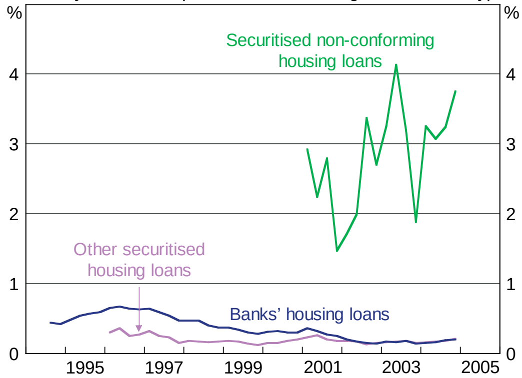
To compensate for this risk, interest rates on non-conforming loans are higher than those on more conventional housing finance. As the level of credit impairment and loan-to-valuation ratio (LVR) increase, so does the interest rate payable. Applicants who self-certify their income or

1 *Figures on the characteristics of non-conforming loans are based on those securitised since 2000 and on information provided by rating agencies. Pools consisting entirely of loans with high loan-to-valuation ratios are not included, though these are sometimes also considered to be non-conforming.*

Graph C1

Housing Loans Past Due

90+ days in arrears, per cent of outstanding loans of each type

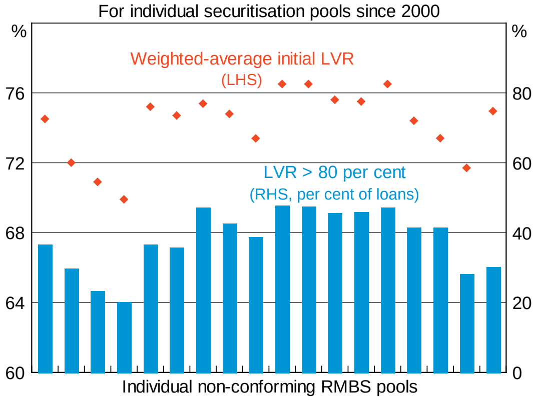


Sources: APRA; Standard & Poor's

Graph C2

Non-conforming Loan LVRs

For individual securitisation pools since 2000



Sources: Fitch; Standard & Poor's

use the loan for property investment also tend to be charged a higher rate. Typically, interest rates on non-conforming loans are between 1 and 3 percentage points above those on a standard home loan, but for higher-risk loans they can be more than 4 percentage points higher. Maximum allowable LVRs 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 per cent and 80 per cent, though a significant proportion are above 80 per cent (Graph C2).

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 borrowers exit their loans within a certain period (usually four to six years from loan origination). Further, some non-conforming lenders now reduce the interest rate payable by those borrowers who have had an unblemished repayment record for a specified 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 administration is required. The rating agencies believe that 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.