Recent Developments in Low-deposit Loans[1]

The stock of mortgage debt outstanding has risen at an average annual rate of 16 per cent over the past decade. As has been well documented, the main reason for this increase is the shift to a low interest rate environment: households can now borrow much more than in the past while still satisfying lenders' requirements that repayments not exceed a certain proportion of income. This increase in household borrowing has boosted demand for property and underpinned the strong growth in property prices.

Also contributing to these trends, to some extent, has been the introduction of a range of new loan products that have eased the effective constraint imposed by lenders' limits on repayments relative to income and facilitated a reduction in the required deposit for the purchase of a given property. Two, by now well-known, examples of the latter are mortgage insurance and deposit bonds. This article focuses on two further means of easing borrowers' deposit constraints that have received attention in recent months: high loan-to-valuation ratio (LVR) loans; and vendor finance. A number of intermediaries offer loans that directly allow very high LVRs – in some circumstances in excess of 100 per cent of the value of the property. Vendor financing allows borrowers to circumvent traditional LVR (and repayment) limits by deferring the transfer of legal ownership to the borrower until all repayments have been made.

Financial Constraints

Typically, the amount that intermediaries have been prepared to lend for housing has been constrained by one or both of the following:

- scheduled repayments should not exceed some fixed share of the borrower's income – the repayment-to-income, or serviceability, constraint; and
- the loan should not exceed a certain proportion, most commonly 80 per cent, of the property's purchase price – the LVR constraint.

Mortgage interest rates have averaged 7 per cent over the past five years, compared with an average of 15 per cent over the second half of the 1980s. For a given level of income and repayments-to-income constraint, such a fall means the initial loan size can be almost double what it otherwise could have been.

In addition, financial innovation has further enhanced debt serviceability by providing much greater flexibility than in the past. For example, loans can be split according to the nature of the interest rate charged or according to the purpose of the loan. Alternatively, an investor can take out an interest-only loan, thereby front-loading the tax deductibility of repayments. Other innovations include flexible

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repayment schedules, redraw facilities and offset accounts. These products allow borrowers to manage a temporary loss of loan serviceability, access previous repayments in excess of required payments and/or provide a tax-efficient form of saving.

This broad range of options has allowed borrowers to choose a structure that best suits their personal circumstances and, in general, to reduce the *effective* burden of a given repayments-to-income ratio.[2] In some cases, lenders will recognise this benefit and allow a higher than standard repayments-to-income ratio. Conceptually, such a relaxation should not necessarily result in an easing of the LVR constraint: the repayment-to-income ratio should be the key determinant of the likelihood of default, while the LVR is important in limiting the lender's loss in the event that a borrower does default. In practice, however, lenders observe a close relationship between the LVR and likelihood of default, which gives them some incentive to ease LVR constraints as borrowers' repayments capacity strengthens. In addition, lenders are cognisant of the fact that rapidly rising property prices, *if* sustained, limit the lenders' loss were default to occur after a year or two.

High LVR Loans

Until a couple of years ago, mortgage insurance was the main way by which borrowers could take out loans with higher LVRs than allowed in the past. Typically, lenders are willing to advance somewhat in excess of 80 per cent of the property's value if the borrower takes out mortgage insurance, though the maximum permissible LVR usually declines as the loan size increases.[3] Mortgage insurers, in turn, are usually willing to offer coverage for loans with LVRs up to 97 or 100 per cent, though more stringent conditions apply.

More recently, deposit bonds have allowed borrowers to increase their gearing by removing the need for the purchaser of a property to pay a deposit at the time contracts are exchanged. Instead, the purchaser pays the bond's issuer (usually an insurance company) a fee in return for a guarantee that an amount equivalent to the deposit will be paid at settlement should the purchaser be unable to do so.

Most recently, a range of new lending products has further increased households' access to mortgage finance by reducing the required deposit well below 20 per cent and often to zero. While low-deposit products were first introduced by specialist mortgage originators, a range of banks, building societies and mortgage originators now offer loans with a maximum LVR of between 97 and 106 per cent of the purchase price of a home. While some institutions have been offering low-deposit loans for several years, most of the products currently available have been introduced in the past six months.

Most lenders are only willing to make very high LVR loans if they believe the chance of loss is particularly small. Most financiers, therefore, differentiate high LVR loans from other loans in three main ways:

- restrictions on the nature of the property;
- more stringent credit worthiness criteria; and
- higher interest rates and/or loan fees.

All lenders that offer very high LVR loans impose restrictions on the types of property that can be purchased. While the restrictions vary considerably across lenders, they serve a common purpose: to ensure the lender's loss

2. For a more detailed discussion of the effect of macroeconomic developments and financial innovation on financing constraints, see IJ Macfarlane, 'Do Australian Households Borrow Too Much?', Address to The Sydney Institute, 3 April 2003, and 'Innovations in the Provision of Finance for Investor Housing', RBA *Bulletin*, December 2002.
3. In part this reflects the fact that, under the capital adequacy requirements of authorised deposit-taking institutions, a residential mortgage with an LVR greater than 80 per cent must have 100 per cent mortgage insurance to qualify for concessional treatment.

is limited in the event that a borrower does default. Some lenders provide the loans exclusively to owner-occupiers while others are willing to lend to investors. A number of high LVR loans are specifically targeted at those in the process of buying newly constructed project homes, and, therefore, are made mostly to first-home buyers. Others do not lend against property that is under construction or for off-the-plan purchase. Most lenders restrict the location of acceptable properties, with some excluding inner-city areas that have seen substantial apartment building activity (such as Pyrmont in Sydney and Melbourne's Docklands), purchases in new subdivisions, or properties on large acreages or rural properties. These variations in this type of restrictions tend to reflect variations in lenders' views about prospective capital gains. One lender recently withdrew its 105 and 110 per cent LVR loans citing concerns about the potential for a slowdown in property price growth.

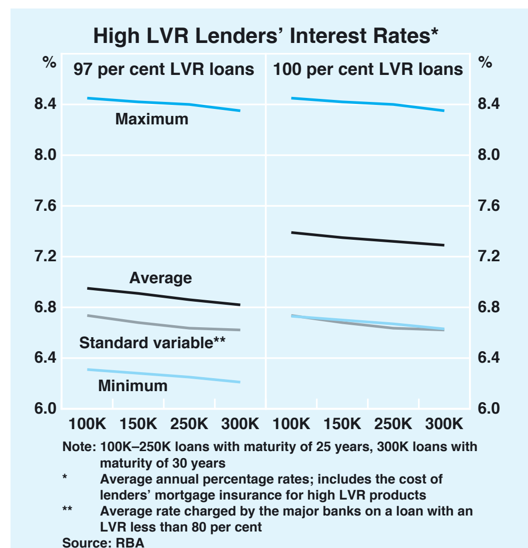
Most lenders apply more demanding credit worthiness criteria to high LVR borrowers than those taking on standard loans, often as a result of mortgage insurers' requirements. For example, some lenders impose tougher repayment-to-income ratios, set minimum acceptable income levels or do not lend to those who are self-employed. Thus it is rare for these loans to be available to those with a poor credit history. Nevertheless, a small number of lenders apply lending criteria that are considerably more flexible than those applied by mainstream lenders for standard loans, setting no minimum income or savings history requirements and lending to those with a poor credit history.

In addition, since it is relatively rare for borrowers to default in the first one or two years after taking out a loan, some lenders tailor loans so that the size of the outstanding debt is expected to fall below the property's value by the time default becomes more likely. In particular, lenders often require accelerated repayments in the first few years of the loan, which quickly bring the borrower's gearing down to more usual levels. These loans, therefore, tend to be targeted at high-income earners with low savings (perhaps because they are young and have newly entered the workforce or because they are recently divorced).

Some LVR products are subject to mortgage insurance and, as a result, borrowers must meet insurers' credit standards. A number of high LVR products, however, do not require mortgage insurance. Instead, the lender requires the borrower to pay an upfront risk fee of around 1.5 per cent of the loan's value. Other lenders require additional security in lieu of mortgage insurance. One financial institution is reported to have allowed customers to use the equity in their car as part of the security for a high LVR home loan. Such an approach would be principally designed for borrowers who wish to consolidate an existing mortgage and other outstanding debts, but are otherwise unable to meet minimum LVR requirements. Traditionally, lenders have included the value of a car in their calculation of a borrower's net assets, but have omitted it from their calculation of a deposit, owing to the rapid depreciation of motor vehicles.

A number of lenders provide loans with a 97 per cent LVR at effective interest rates (i.e. including the cost of fees and mortgage insurance) at or slightly below the effective rates charged on the major banks' standard variable home loans (Graph 1). Loans with

Graph 1



Note: 100K–250K loans with maturity of 25 years, 300K loans with maturity of 30 years
* Average annual percentage rates; includes the cost of lenders' mortgage insurance for high LVR products
** Average rate charged by the major banks on a loan with an LVR less than 80 per cent
Source: RBA

LVRs higher than this tend to carry a higher effective interest rate, with rates up to 175 basis points above the effective standard variable rate. However, some financiers do offer 100 per cent LVR loans at the standard variable rate despite the additional risk involved.

Despite rapid growth in high LVR loans of late, they remain a low proportion of outstanding loans. APRA's March 2003 survey of housing lending suggests that just 2 per cent of outstanding loans had an LVR between 95 per cent and 100 per cent at inception, while less than half a per cent of outstanding loans were made with an LVR over 100 per cent.

Nonetheless, such loans warrant attention. While APRA estimates that a loan with an LVR between 76 per cent and 80 per cent has, on average, a 1 per cent chance of default, the chance of default for a loan with an LVR above 100 per cent is around 3 per cent. Also, only about 0.7 per cent of all securitised loans, but 2 per cent of high LVR loans, provided by specialist mortgage originators have payments between 30 and 90 days 'past due' (i.e., the borrower is between 30 and 90 days late in making a required payment). It is important to note that the current extent of problems, while low, is occurring against a backdrop of sustained and strong growth in household incomes.

Vendor Finance

Vendor finance is not a recent innovation, with records of transactions dating back to 1915. Because many of these transactions have taken place between individuals, it is difficult to gauge these loans' popularity over time. Recently, however, the emergence of high-profile advocates of vendor finance has spurred growth in its use, encouraging individuals to opt for vendor financing and leading to the creation of new companies that specialise in the provision of these loans. Some reports suggest that up to 300 new vendor financiers have emerged over the past three years.

A typical vendor finance arrangement consists of a financier, an owner – commonly referred to as a 'wrapper' – and a purchaser. The wrapper buys a property using a standard mortgage from the financier, usually a mainstream lender, and on-sells the property to the purchaser using an instalment sales contract. Under such a contract, the wrapper provides a loan to the purchaser but retains legal title to the property until the loan is fully repaid or refinanced. To protect the purchaser, the loan contract contains a caveat that prevents the wrapper from selling the property against the purchaser's wishes, except in the event of default. Although the purchasers are not the legal owner of the property, the contract entitles them to renovate it and stipulates that they must pay for insurance, rates and repair.

Vendor finance is targeted at those who are unable to obtain finance from traditional lenders because they do not have a deposit, have a poor credit rating, and/or earn income in ways that do not meet traditional lenders' criteria for income reliability. Such 'non-conforming' borrowers include the self-employed and contract and seasonal workers. Most vendor finance is provided to owner-occupiers, but some financiers lend to investors. The prospect of eventual access to the mainstream mortgage market is the primary incentive for borrowers to opt for vendor financing. Vendor finance enables borrowers to access housing finance that they could not otherwise obtain and offers them the opportunity to establish their repayment history.

These benefits, however, can come at a substantial cost. In short, vendor financing usually carries a higher interest rate, an added debt on top of the property's purchase price and may be punitively expensive if the borrower defaults.

To reflect the purchaser's relatively high risk of default, wrappers charge an interest rate that is typically between 2 and $2^1/_2$ percentage

points higher than the standard mortgage rate.[4] The wrapper will also typically require the purchaser to gradually repay a principal amount that is somewhat higher than the property's purchase price. This additional amount can be as much as a quarter of the property's price and means that the purchaser's borrowings carry an effective LVR well above 100 per cent. In this way, vendor financing provides the wrapper with an interest income and a likely capital gain.

Loans available from vendor financing companies are typically available for terms of between 25 and 30 years, consistent with the terms offered on standard mortgages. Vendor finance companies tend to encourage borrowers to refinance their loans with mainstream lenders after they have acquired sufficient equity in their home (most likely due to rising property prices) and have demonstrated adequate repayment behaviour. Some wrappers encourage purchasers to do this within two years. Although this practice curtails the wrapper's interest income, it enables the wrapper to realise a significant capital gain over a relatively short period of time.

It is particularly difficult to determine the outstanding amount of vendor finance debt. Although it is likely to be very small, anecdotal evidence suggests that default rates are quite high, with up to 10 per cent of borrowers defaulting. In the event of default, the purchaser is often afforded little protection under the instalment sales contract. If the purchaser defaults, the mortgage wrapper can repossess the house, while retaining any repayments made, because the property's title is not transferred to the purchaser until the loan is fully repaid. Purchasers who have spent money on renovations are likely to suffer even greater losses.

Vendor finance is legal in all Australian states except South Australia but remains largely unregulated. Although the Uniform Consumer Credit Code may apply to large-scale 'wrappers', it is doubtful that small-scale operators, particularly individuals, are subject to any regulation. In some circumstances vendor finance can expose potentially vulnerable home-buyers to a considerable degree of risk.

Conclusion

The rapid growth in high LVR loans and vendor financing largely reflects an economic environment of low interest rates, rapidly rising property prices and prolonged growth in household incomes. Were the economic environment to become less favourable – in particular, were there to be a rise in unemployment – such loans would be particularly likely to see increased defaults. As noted above, however, high LVR loans and vendor financing remain a very small share of total housing loans. As a result, even a sharp upturn in defaults on such loans would not pose significant concerns about the stability of the financial system. But in the case of vendor financing in particular, these loans may place a significant proportion of already vulnerable borrowers in a very difficult situation. ✰

4. A number of banks now provide 'low documentation' mortgages to people with poor credit records. However, the borrowers do provide a deposit – the maximum LVR is usually 75–80 per cent. As a result the interest rate charged, at around 60–80 basis points above the standard variable mortgage rate, is considerably less than that charged by vendor financiers.