Box B: Developments in the Low-doc Loan Market

One of the fastest growing segments of the mortgage market in recent years has been 'low doc' loans. These are loans for which borrowers self-verify their income in the application process. They are designed mainly for the self-employed or those with irregular income who do not have the documentation required to obtain a conventional housing loan. But the lack of documentation also leaves them open to abuse, for example by people who are overstating their income to the lender in order to obtain a larger loan than otherwise. They may also be used by people who have understated their income for taxation purposes.[1]

The value of low-doc loan approvals has grown over the past year, even though the value of total housing loan approvals has been broadly flat. As a result, while low-doc loans are estimated to account for only around 5 per cent of all outstanding housing loans, their share has been rising. These loans are currently estimated to make up a little under 10 per cent of new loans, though the shares differ widely across lenders.

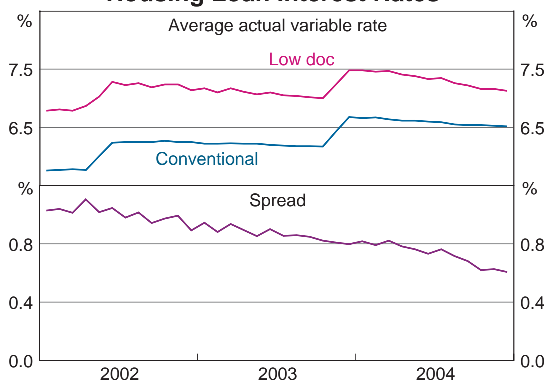
The rapid growth of the market has occurred alongside increased competition, of which the most visible sign has been an increase in the number and type of providers. Initially, low-doc loans were marketed only by specialist non-bank lenders, but in recent years mainstream lenders have also entered the market. Some smaller banks, in particular, have targeted this segment. The major banks were slower to enter the market, but they have recently begun to actively promote these products.

Aside from the self-verification, low-doc loans provided by banks are otherwise 'prime' in the sense that they are subject to banks' usual lending criteria. This contrasts with some non-bank lenders that also offer low-doc loans to borrowers with impaired credit histories or other high-risk characteristics – types of so-called 'non conforming' loans.[2]

Because of the higher risk of low-doc loans, lenders have typically charged a higher interest rate on these loans than on their conventional loans. However, as competition in the low-doc market has intensified, these spreads have been declining. Over the past three years, the difference between the average advertised interest rate on low-doc loans and standard variable interest rates on conventional home loans has fallen by around one percentage point, to very low levels. However, taking into account that the actual interest rates paid on conventional home loans are often significantly lower than the advertised standard variable interest rate, the spread between actual rates paid on low-doc and conventional loans is wider, with the available evidence suggesting it was a little over ½ of a percentage point as at the end of 2004. Nonetheless, this spread appears to have roughly halved over the past few years (Graph B1).

1 *Recent investigations by the Australian Taxation Office (ATO) have revealed that, for a significant proportion of low-doc borrowers, income declared to the lender exceeded that declared to the ATO.*

2 *See Box C in the March 2005* Financial Stability Review *for a discussion of non-conforming housing loans.*



Lenders have also increased the maximum size of low-doc loans that they are willing to provide. When low-doc loans were first introduced, the maximum allowable loan size was generally around $500 000 but these limits have since been increased, contributing to an increase in average actual loan sizes. Recent estimates based on securitised loans suggest that new low-doc loans are on average around 30 per cent larger than conventional loans.

As competition has picked up, lenders have also increased the maximum loan-to-valuation ratios (LVR) they allow on low-doc loans. While many lenders initially restricted the loan to between 60 per cent and 75 per cent of the property value, most lenders now allow borrowers to take out a loan with an LVR of 80 per cent, with some even allowing LVRs as high as 95 per cent. As a result, the average initial LVR on securitised low-doc loans has increased over the past few years, both in absolute terms and relative to LVRs on conventional loans.

The reduction in the interest-rate premium on low-doc loans, together with increases in maximum loan sizes and LVRs, raises the possibility that some lenders may not be adequately factoring in the higher risk of default of these loans. The arrears rate for securitised low-doc loans is currently around three times higher than for conventional loans. Even if estimates of the expected loss rate on low-doc loans take account of this higher arrears rate, they may still understate the risks involved because low-doc loans have only existed during the past few years of economic expansion, so their quality has not been tested during a period of weaker activity. This risk is heightened by the fact that lenders know little about the characteristics of low-doc borrowers, specifically how many have overstated their income to obtain larger loans.