RESERVE BANK OF AUSTRALIA

Speech

Mortgage Arrears

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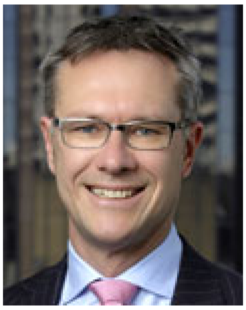
Remarks at FINSIA Signature Event: The Regulators
Sydney – 15 November 2019

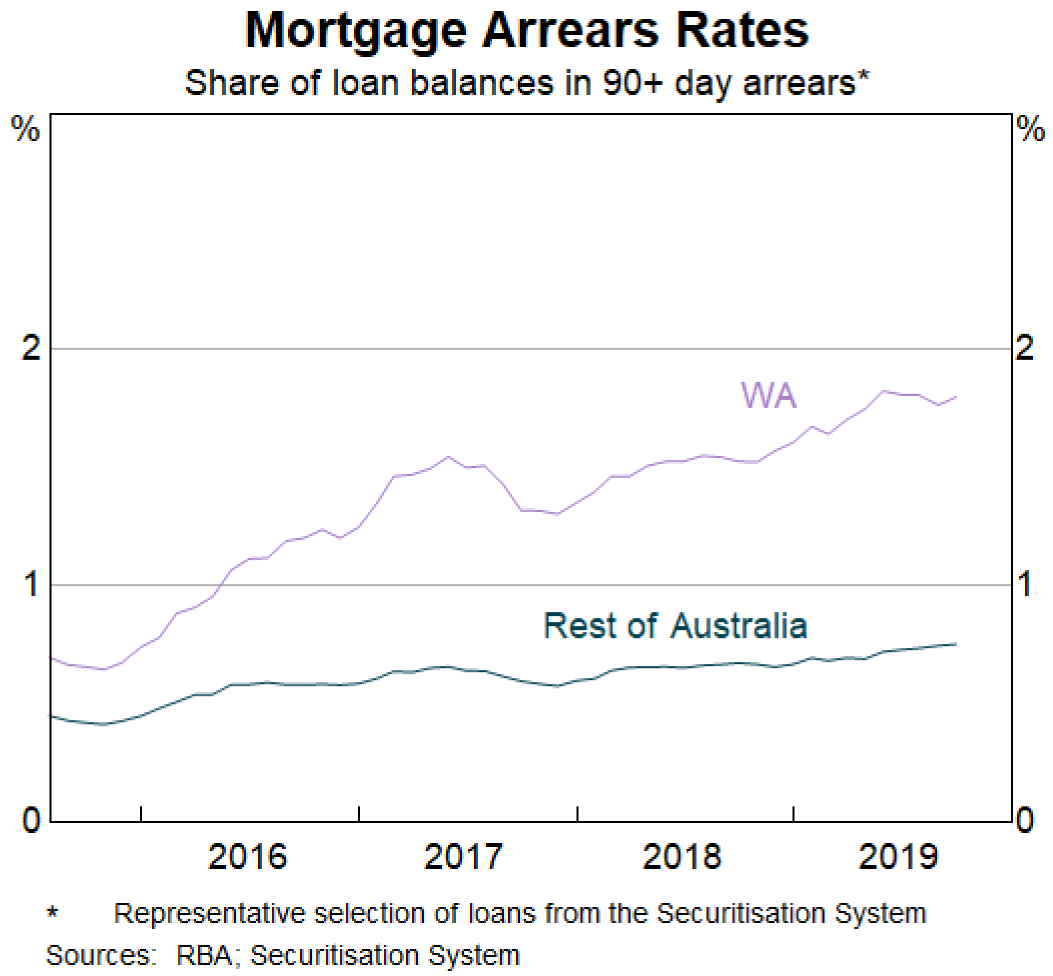


Today I am going to talk about mortgage arrears. Arrears are an important indicator of the financial health of households and so have implications for our assessment of current economic conditions and the economic outlook. They clearly are also an important indicator of the financial health of those writing mortgages, be it banks or non-banks. I will draw on material published in the October *Financial Stability Review* and a speech given by my colleague Jonathan Kearns. [1]

The mortgage arrears rate, at 1 per cent, is low by both historical and international standards. Arrears in the US peaked at around 10 per cent in the financial crisis. Non-performing loans currently pose little risk to the health of financial institutions. This is not surprising in an environment where the unemployment rate is low and interest rates have been declining. Nonetheless, the arrears rates have been increasing steadily over recent years to the highest it has been for around a decade, and so warrants some scrutiny.

While the national arrears rate is low, in some parts of the country households have found it harder to keep up with their mortgage repayments. The largest increase in housing loan arrears has occurred in Western Australia and the Northern Territory, where economic conditions have been weak and the unemployment rate has risen (Graph 1). Developments in those two regions show how arrears can evolve in adverse economic circumstances. In Western Australia the unemployment rate has risen from 4 to 6 per cent, housing prices have fallen by 20 per cent, incomes have declined and strong inward migration turned to outward migration such that population growth declined from over 3 per cent to under 1 per cent. These conditions have seen the mortgage arrears rate rise from 0.7 per cent to 1.8 per cent. This is a significant rise and associated with financial stress for a number of households. But it is still not that high given the economic circumstances.

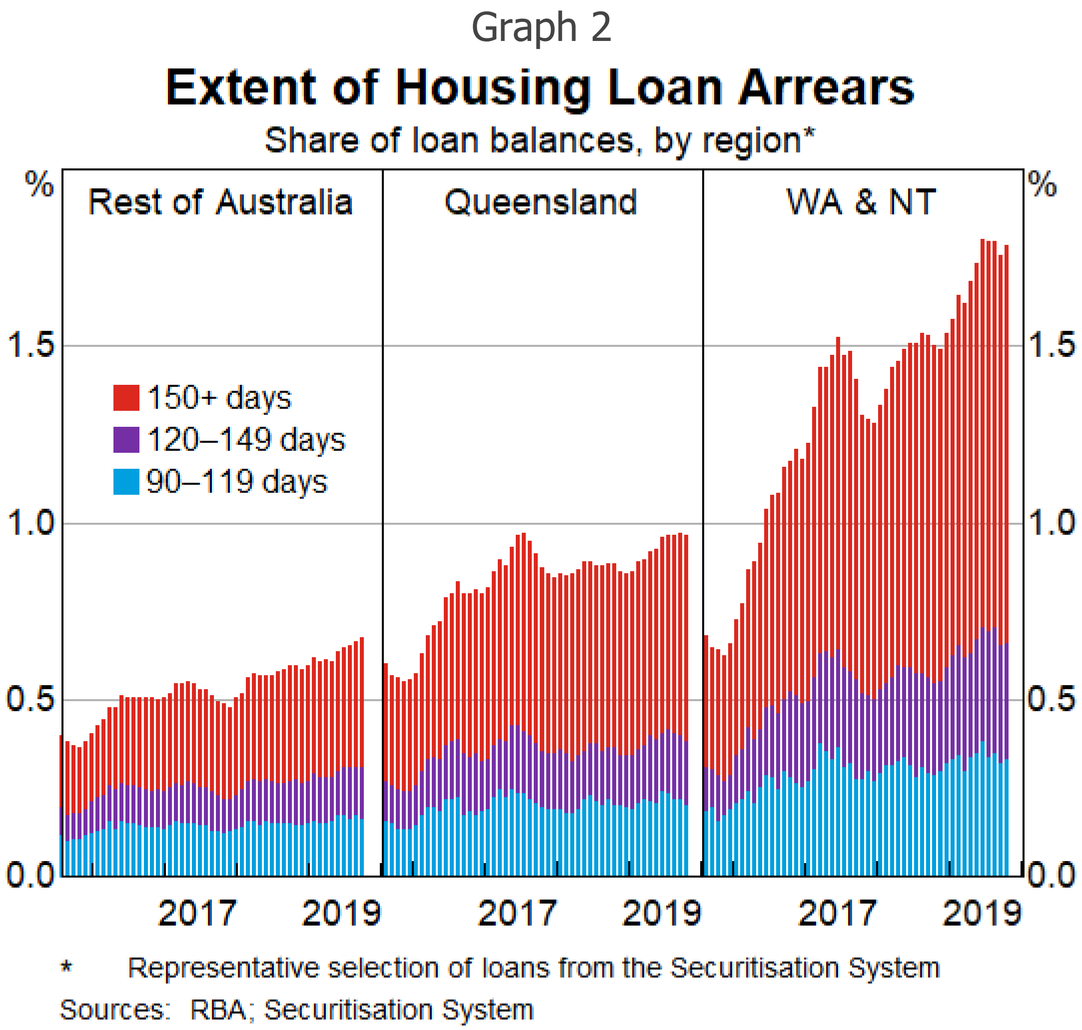
Graph 1



Borrowers can fall behind on their mortgages for a number of reasons. The vast majority of people who fall behind on their mortgages do so because of an unexpected loss of all or part of their income. Common reasons for this are the loss of a job, ill health or relationship breakdown. These occur even when economic conditions and lending standards are good. So there will always be some baseline level of mortgage arrears. Indeed, from a system-wide perspective, a mortgage arrears rate of zero would be undesirable, because it would imply that lending standards were too tight and that credit-worthy borrowers were being denied access to credit.

Widespread increases in arrears are driven by macroeconomic factors, in particular: rising unemployment rates, which lead to a widespread loss of income; rising interest rates, which create a higher regular expense for borrowers; and falling housing prices, which can make it more difficult for borrowers who are behind on their payments to get out of arrears by selling their property. Appropriate lending standards that ensure that borrowers have reasonable income and equity buffers can mitigate the impact of macroeconomic factors on arrears, while poor lending standards amplify their effect.

In all states, increases in the share of housing loans that are 90+ days in arrears have been mainly driven by loans remaining in arrears for longer rather than by more loans entering arrears (Graph 2). This suggests households are finding it harder to resolve their situation than previously and is consistent with the softer housing market conditions. This is especially so in Western Australia, where housing prices have been falling for some time. Liaison with banks suggests that more lenient forbearance and foreclosure policies have also contributed to the increase in longer-term arrears rates.



In the recent *Financial Stability Review*, we used the Bank's securitisation dataset to look at how different types of home loans have performed in Western Australia over the past few years. As might be expected, loans that were originated with higher repayments relative to income, and loans with higher starting loan-to-valuation ratios have had larger increases in arrears in Western Australia. Larger increases in arrears have been seen for self-employed borrowers, who tend to have more volatile income than salaried employees. Arrears rates for investors have also risen by more. Investors in housing in Western Australia have faced falling rental income and the highest rental vacancy rates in nearly 30 years, though this has declined more recently.

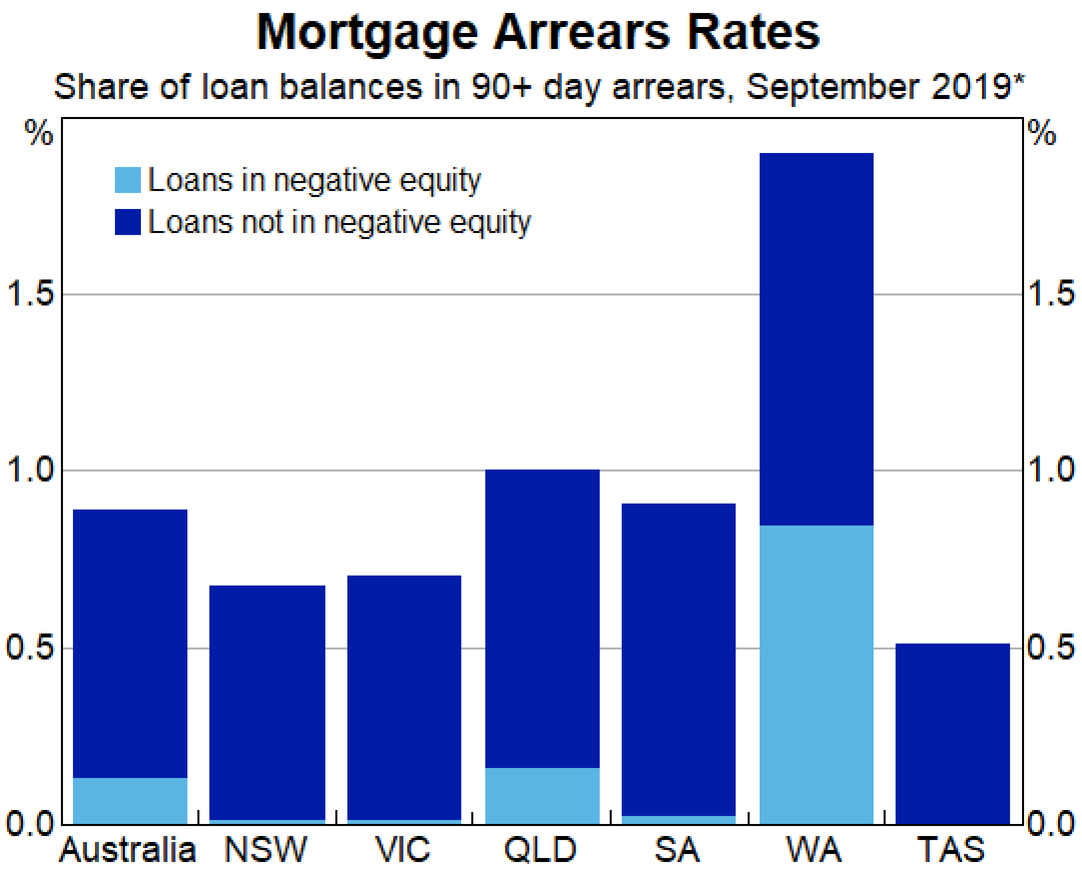
We also found that the increase in arrears for interest-only (IO) and principal and interest (P&I) loans have been similar. While IO loans have similar repayment performance to P&I loans, they are more risky for the lender as they can lead to larger losses. Since IO borrowers are not required to make principal payments, their outstanding loan balance need not decline over time. Because of this, IO loans increase the chance the loan ends up in negative equity if housing prices fall, and so expose the lender to a loss if the borrower cannot make their repayments.

In Western Australia, around half of loans that were originated on interest-only terms and are in arrears also have negative equity. This compares to around 40 per cent of P&I loans in arrears.

Moreover, IO borrowers are less likely to have buffers in the form of prepayments or balances in offset accounts. A bit more than 40 per cent of IO borrowers have no buffers of this sort at all, compared to around 20 per cent of principal and interest borrowers. [2] Some of this difference arises because IO loans tend to be newer, and so have had less time to accumulate buffers. IO loans are also more likely to be taken out by investors, who may have other liquid assets. But even controlling for these factors, a significant difference exists. That said, those IO borrowers who have buffers, generally have much larger buffers.

Nationally, around 15 per cent of loans that are in arrears are also in negative equity (Graph 3). However, this is equivalent to just 0.1 per cent of all housing loans and the risks that mortgage arrears currently pose to bank profitability are low.

Graph 3



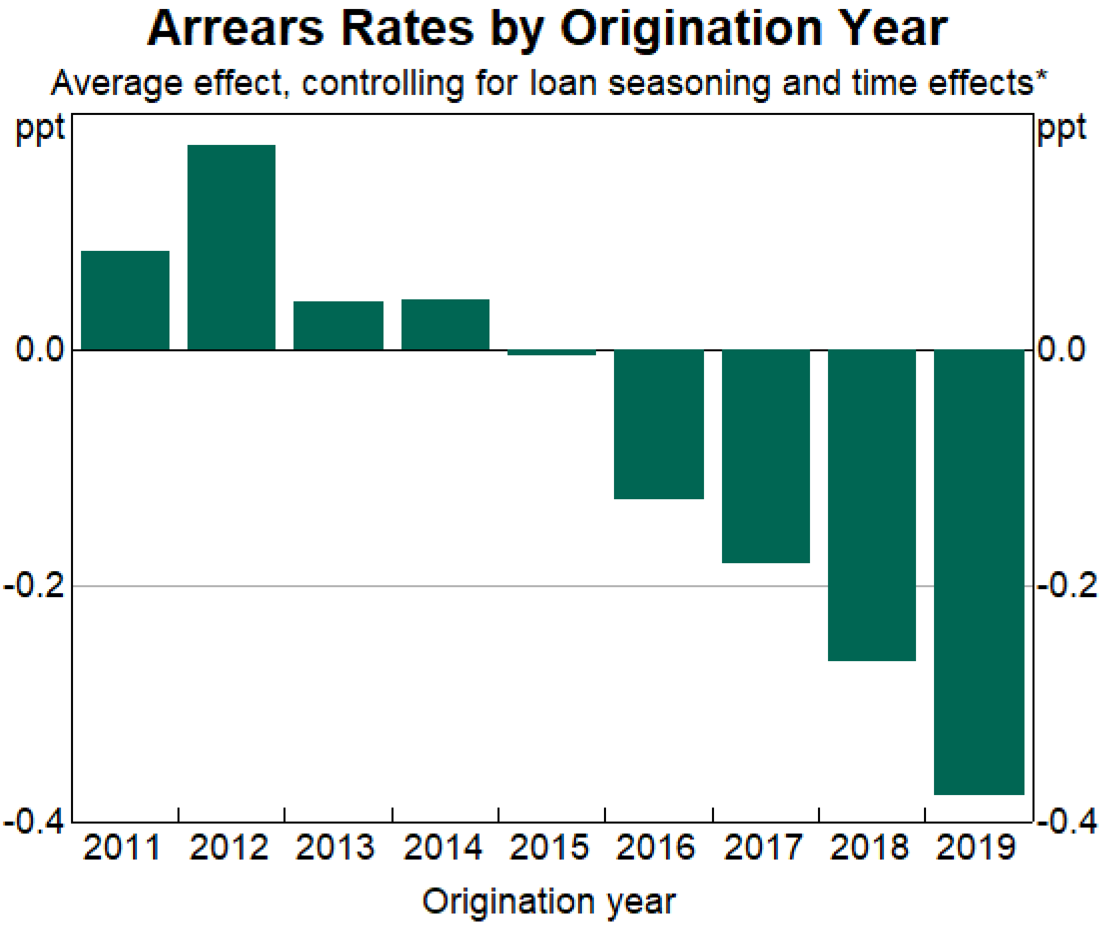
* Representative selection of loans from the Securitisation System

Sources: RBA; Securitisation System

Tighter lending standards should lead to lower arrears but this can be hard to discern in the raw data. One reason is that borrowers' circumstances tend not to change so quickly that they fall behind on their repayments soon after taking the loan out, so newer loans tend to have lower arrears rate than older loans. For example, a three-year old loan is four times more likely to go into arrears than a one-year old loan. When credit growth is higher, the share of new loans also tends to be higher, so the arrears rate tends to be lower. This is in addition to the effect on the denominator. Another issue is that macroeconomic conditions, which also affect arrears, are constantly evolving.

When we control for the age of loans and the state of the economy, we find that the more recent cohorts have lower arrears rates than earlier cohorts. Specifically, those loans originated in the past two years have an arrears rate that is almost 40 basis points lower than loans originated prior to 2014 (Graph 4). The lower arrears rates for more recent loans suggests these tighter lending standards have been effective.

Graph 4



* Coefficients from a panel regression with origination year, seasoning and time fixed effects, weighted by loan balances

Sources: RBA; Securitisation System

I trust that that has given you some perspective on the recent evolution of arrears and some of the factors behind it. The experience in Western Australia provides an insight as to how housing lending in the rest of the country may perform if there was an economic downturn. An economic downturn is definitely not our forecast. Rather, it seems unlikely that the national arrears rate will increase substantially from here. Improvements to lending standards have placed downward pressure on arrears. In addition, the recent reductions in the interest rates will reduce the interest payments of indebted households and support employment growth and housing market conditions more generally.

Endnotes

[*] Thanks to Penny Smith and Paul Ryan for their help.

[1] Kearns, J (2019), 'Understanding Rising Housing Loan Arrears', Address at the 2019 Property Leaders' Summit, Canberra, 18 June.

[2] IO borrowers may have other assets that can serve as buffer, as indeed is the case for P&I borrowers.