6

The Australian House Party Has Been Glorious – But the Hangover May Be Severe: Reforms to Mitigate Some of the Risks

Gill North[1]

I. Introduction

The scope and efficacy of regulation around mortgage lending in Australia is critical, not just for the health of financial institutions and financial stability, but also for the financial position and wellbeing of Australian households. The biggest risk presently is complacency. Lending secured to residential properties (including to owner occupiers and investors) constitutes more than 65 per cent of the total lending of Australian financial institutions.[2] Hence, the exposure of the finance sector to housing markets is large, both on an historical basis and relative to other jurisdictions.[3] Similarly, levels of household debt to disposable income are now at record levels in Australia and residential property mortgage debt makes up more than 50 per cent of total household debt.[4]

---

1 Professor, Law School, Deakin University; Adjunct Associate Professor, Law School, University of Western Australia.

2 W Byres, 'Sound Lending Standards and Adequate Capital: Preconditions for Long Term Success' (Speech presented at COBA and CEO & Director Forum, 13 May 2015) 1.

3 These exposures have arisen largely because of the low default rates and high returns on residential property over the last 20 years.

4 AMP.NATSEM, *Buy Now Pay Later: Household Debt in Australia* (Income and Wealth Report, Issue 38, December 2015) 8.

Two-thirds of Australian households own a residential property, approximately half of these households have a residential property mortgage,[5] and around 35 per cent of these mortgages are to investors.[6] Accordingly, it is vital that Australians fully comprehend the nature and risks of acquiring residential property, the risks of leveraging these assets, and the regulatory protection afforded when taking on credit and receiving credit assistance. The primary lesson from the global financial crisis is that housing cycles, like all asset classes, move downwards as well as upwards, and sometimes this movement is sudden and sharp. So any assumptions by households that the purchase of residential property funded by a mortgage secured on a residential property does not involve market exposure are flawed and dangerous for the nation.

The housing party in Australia is likely to continue under existing policy settings, but like all asset cycles founded largely on credit, this party will eventually end and the subsequent hangover may be severe. The further house prices move beyond economic fundamentals and normal price trends, the more severe the likely corrections and adverse consequences, especially for highly indebted households that have minimal asset and income buffers. Policy intervention is needed to mitigate the growing exposures of households, financial institutions and the nation. Specific reforms are proposed in relation to the remuneration of mortgage intermediaries, responsible lending assessments and negative gearing concessions.

The chapter is organised into five parts. Part 2 provides essential background on the macro risks around residential housing in Australia. Part 3 summarises the existing policy settings and potential exposures. Part 4 outlines proposed reforms to mitigate possible consumer losses and hardship. Part 5 concludes.

---

5 Australian Bureau of Statistics, *Residential Property Price Indexes: Eight Capital Cities* (December 2015); Australian Prudential Regulation Authority (APRA), *Prudential Practice Guide APG 223 – Residential Mortgage Lending* (5 November 2014) 7.

6 Reserve Bank of Australia (RBA), *Financial Aggregates* (March 2016, released 29 April 2016).

II. Background

Growth in residential property prices and mortgage lending in Australia has run at well above GDP growth levels over the last two decades, at around 7 per cent per annum.[7] Moreover, the level of average household debt (including mortgage loans) to disposable income is at record levels, this ratio has almost tripled from 64 per cent in 1988 to 185 per cent in 2015, the most leveraged Australia households (the top 10 per cent) have a debt to disposable income ratio of 6 times, and the top 10 per cent of the most indebted low-income households have a debt to income ratio of 10 times with debt repayments taking 60 per cent of their disposable income.[8] Credit growth in Australia (including mortgage and other forms of credit) well above levels of economic growth and increases in household disposable income cannot continue indefinitely.[9] A major factor driving higher levels of housing-related debt in Australia has been decreasing interest rates, which have made debt repayments appear more manageable. Nonetheless, more than 25 per cent of Australian households are already in some form of financial distress or stress,[10] and should interest rates rise again these levels may escalate rapidly.

The poorly diversified portfolios of Australian lenders as a whole, combined with the highly concentrated nature of the finance sector,[11] a heavy reliance on housing construction as a driver of economic activity,[12] a concentration of household wealth in residential property,[13] and strong links between housing wealth and business and consumer confidence and spending,[14] leave Australia highly vulnerable to any significant downturn

---

7 RBA, *Monthly D2 Lending and Credit Aggregates* (March 2016, released 29 April 2016).

8 AMP.NATSEM, above n 4, 4, 13.

9 W Willits, 'Australia Vulnerable to Debt Crisis, Says Forbes', *SMH.com* (28 March 2016), www.smh.com.au/business/the-economy/australia-vulnerable-to-debt-crisis-says-forbes-20160328-gns1jn.html. M Phillips, 'The World's Debt is Alarmingly High. But is it Contagious?', *SMH.com* (25 February 2016), www.smh.com.au/business/the-economy/the-worlds-debt-is-alarmingly-high-but-is-it-contagious-20160224-gn2baj.html.

10 Digital Finance Analytics, *The Stressed Finance Landscape Data Analysis* (October 2015); AMP.NATSEM, above n 4, 15.

11 Financial Service Inquiry Interim Report (July 2014) ('Interim Report') xvii. See also S Rose and J Eyers, 'Australia's Banks Are "Too Big to Get Sick": APRA', *SMH.com* 4 April 2016, www.smh.com.au/business/banking-and-finance/australias-banks-are-too-big-to-get-sick-apra-20160403-gnwztl.html#ixzz44ndw9ZLl.

12 RBA, *Statement on Monetary Policy* (May 2016) 44.

13 Jonathan Shapiro, 'Exploring Australia's "Wealth Effect"', *The Sydney Morning Herald*, 19 November 2014. Shapiro notes that 55 per cent of gross household assets in Australia are invested in housing while 27 per cent are in shares.

14 RBA, above n 12, 28.

in the housing markets. Stress tests are carried out regularly by Australian lenders and the major banks suggest any concerns are unwarranted.[15] However, in an environment of record low interest rates and relatively stable unemployment levels in Australia, the financial positions of residential property lenders and borrowers have not yet been fully tested. The true position and exposure of individual banks, households, and the nation will only be revealed during the next financial crisis or economic recession. And, as noted in the Financial Sector Inquiry reports, adverse effects from high levels of interconnectedness across a finance sector and contagion are often underestimated.[16]

Some housing-related policy adjustments have been made over the last year, but further action is called for.

III. Policy Settings and Exposures

Australian households with a residential mortgage have various protections under law. The most important of these are the responsible lending obligations in the *National Consumer Credit Protection Act 2009* (Cth) (*NCCP*) which are intended to limit lending to amounts that borrowers can afford.[17] These provisions are supported by additional protections within the *National Credit Code* (*NCC*) in Sch 1 of the *NCCP*, including default notice requirements and hardship provisions. ASIC is responsible for administering both the *NCCP* and the *NCC*.[18]

In an industry survey in 2014, the Australian Prudential Regulation Authority (APRA) found there were wide differences in how lenders assessed the risk of a given borrower.[19] Significant factors leading to these differences included the assessments of borrower's living expenses,

15 Byres, above n 2, 2.

16 Interim Report, above n 11, 2–57; Financial System Inquiry Final Report (November 2014) 43–44, 47. See also Reserve Bank of New Zealand, *Bulletin* Vol 79, No 12 (July 2016).

17 Parts 3.1 and 3.2 of the *National Consumer Credit Protection Act 2009* (Cth) impose responsible lending obligations on all participants involved in the provision of housing credit, including licensees that provide credit assistance in relation to credit contracts and credit providers. The responsible lending obligations apply to existing consumer credit contracts when consumers apply for an increase in a credit limit, and to the provision of new credit to consumers. These obligations are intended to introduce standards of conduct to encourage prudent lending; curtail undesirable market practices, particularly where intermediaries are involved in lending; and impose sanctions for irresponsible lending and leasing.

18 *Consumer Credit and Corporations Legislation Amendment (Enhancements) Act 2012* (Cth).

19 Byres, above n 2, 3.

the treatment of 'other income sources', the discount applied to declared rental income, the size of interest rate buffers allowed, and the service period allowed for repayment of the loan principal on interest only loans.[20] In a letter to lenders, it highlighted the high growth rate of mortgage lending to investors and 'encouraged' them to limit the amount of new lending to this segment to 10 per cent per annum. It also recommended they apply an interest rate buffer of at least 2 per cent and a minimum rate of at least 7 per cent to the mortgage serviceability assessments.[21]

Further, at the end of 2014, ASIC indicated that demand for interest only loans had grown 80 per cent since 2012 and the average value of these loans was substantially higher than principal and interest home loans.[22] ASIC conducted a survey of lenders of these loans (including the big four banks) to assess their compliance with the responsible lending laws, and concluded that lending standards required lifting to meet important consumer protection laws.[23] It found that many lenders were failing to consider whether this type of loan satisfied consumer needs, particularly in the medium to longer term. Specific issues included the time period allowed for repayment of the principal of the loan, a lack of evidence about the borrower's requirements and a failure to consider the borrower's actual living expenses. ASIC also expressed concerns about the ability of borrowers to afford the loans if interest rates were to rise.[24]

There is some evidence that Australian lenders have tightened their mortgage serviceability criteria over the last year.[25] However, mortgages with a loan-to-valuation ratio (LVR) of 95 per cent are still available from mainstream lenders, and borrowers can find mortgages with LVRs above this level if parents or family members are willing to be guarantors and offer their own property as security if the original owner defaults on their loan.[26]

---

20 Ibid. 2–5.

21 APRA, 'APRA Outlines Further Steps to Reinforce Sound Residential Mortgage Lending Practices' (Media Release, 9 December 2014).

22 The Australian and Securities Investment Commission (ASIC) noted the vulnerability of these loans to credit losses.

23 ASIC, 'Lenders to Improve Standards Following Interest-Only Loan Review' (Media release 15-220MR, 20 August 2015).

24 Ibid. See also ASIC, Report 445: *Interest-Only Home Loan Review* (August 2015).

25 APRA, *Insight*, Issue One, 2016.

26 See, for example, Finder.com, '100% Home Loans: Borrow 100% of the Property Value', at www.finder.com.au/100-percent-home-loans.

Lenders naturally seek to protect their commercial position. A mortgage on residential property allows the institution to ultimately sell the property and use the proceeds to repay debts owing if the borrower defaults. Additionally, borrowers seeking a mortgage with an LVR above 80 per cent are generally required to purchase lenders mortgage insurance. These policies are used when a borrower fails to repay the mortgage and the combined proceeds from sale of the mortgaged property and other personal assets of the borrower are insufficient to cover debts owing.

Australian households are now highly exposed to the housing cycle. Many Australians may see housing as a 'safe haven' given the strong performance of house prices over the last 20 years, but this is a fallacy with potentially catastrophic consequences. Should the housing market decline sharply, some borrower households will likely fall into a negative equity position on mortgaged residential property, even though they can repay their mortgages. Some of these borrowers may be forced to sell the property while house prices remain depressed and may lose any personal equity invested. In extreme circumstances, where the sale of a residential property or shares does not cover the full extent of the mortgage or margin loan and accrued interest, individuals may be personally liable for any outstanding debts. Consequently, all consumers who purchase residential property, especially those who borrow heavily to purchase a property, should understand that this involves significant risks, including possible temporary or permanent capital losses, foreclosure, and loss of the property. Household borrowers that present with one or more of the following characteristics are most exposed: borrowings on one or more residential properties with high loan-to-valuation levels, minimal or nil net equity in the properties, and significant changes in the personal circumstances of the borrower.

IV. Proposed Reforms

The family home is the most important asset of most Australians and a mortgage on residential property is the most significant credit product in Australia; hence the need for sound housing-related policy and consumer protection are difficult to overstate. Policy reforms to mitigate possible future consumer losses and hardship are proposed across three areas: the remuneration of mortgage intermediaries, responsible lending assessments, and restrictions on negative gearing.

A. The remuneration of mortgage intermediaries

For credit assistance and advice to be trustworthy and competitive in Australia, the legal frameworks need to include remuneration structures for mortgage providers and intermediaries with appropriate incentives.[27] Close to 48 per cent of all mortgages in Australia are arranged through intermediaries, while the remainder are sought directly from credit entities that provide home loans.[28] Yet current rules concerning the remuneration received by credit providers or assisters are limited to a general disclosure obligation.[29] Under existing law, mortgage intermediaries may recommend or provide a mortgage that is most lucrative for the provider or assister, provided the recommended credit product is 'not unsuitable' and it satisfies the consumer's objectives and requirements.[30]

Notably, the customer suitability, client duties, and remuneration provisions across the credit and financial advisory schemes differ significantly. A person who provides personal financial advice to a retail client and recommends investment in a financial product using borrowed money is bound by the best interest provisions in Pt 7.7A of the *Corporations Act 2001* (Cth) and is prohibited from receiving commissions on the borrowed amount. However, reasonable consumers are unlikely to understand the legal distinction between credit and financial products, would likely assume credit products are financial in nature, and would expect mortgage brokers to recommend a mortgage product that is suitable for their needs and serves their best interests (rather than a product that is most profitable for the intermediary).

B. Responsible lending assessments

Credit providers and assisters must comply with the responsible lending provisions under the *NCCP* when consumers purchase residential properties funded by a mortgage for leasing purposes. Additional protection is also afforded under the *NCC* (including through default

27 See C Yeates, 'Mortgage Brokers to Remain in Spotlight after ASIC Review', *SMH.com*, 8 May 2016, www.smh.com.au/business/banking-and-finance/mortgage-brokers-to-remain-in-spotlight-after-asic-review-20160506-goo666.

28 APRA, *Quarterly Authorised Deposit-taking Institution Property Exposures – December 2015* (issued 23 February 2016).

29 *NCCP* s 121(2).

30 For further details, see G North, 'Regulation Governing the Provision of Credit Assistance and Financial Advice in Australia: A Consumer's Perspective' (2015) 43 *Federal Law Review* 369, 382–83.

notices and hardship provisions). These provisions are sound, but empirical evidence from APRA and ASIC suggests there are significant practical issues and additional consumer protection is required given the high levels of exposure to residential property by Australian financial institutions and households.

There is some international evidence suggesting mortgages to investors are higher risk than loans to owner occupiers.[31] However, there is no legal requirement in Australia for credit providers and assisters to adjust their assessment of a borrower's ability to repay a mortgage when it is used for investment rather than residential purposes. More critically, there is no APRA or ASIC guidance suggesting a consumer's ability or willingness to bear temporary or permanent capital losses during periods of significant house price declines and/or economic weakness should be considered by lenders, and discussed with borrowers.

The author's proposed reforms include:

- Regulatory guidance from APRA and ASIC to mortgage lenders suggesting the responsible lending assessments should be scalable and should take into account: i) the state of the economy and housing and credit markets; ii) the potential impact on borrowers should interest rates rise or the price of residential property decline; and iii) the impact on borrowers should their personal circumstances change. Lenders should allow pro-cyclical buffers depending on the levels of risk in the economy, housing and credit markets, and should consider a consumer's ability to repay a mortgage over the long term, including during periods of cyclical change.
- Mortgage lenders and intermediaries should provide: i) online warnings that interest rates may rise and housing prices may decline significantly; and ii) online sensitivity calculators that enable consumers to assess the impacts of adverse economic, housing and personal factors (including the cumulative effect of a number of changes) on the ability to repay the mortgage.

31 See Reserve Bank of New Zealand, *Summary of Submissions and Final Policy Position on the Review of the Asset Class Treatment of Residential Property Investment Loans in BS2A and BS2B* (29 May 2015).

C. Restrictions on negative gearing concessions

Some policy restrictions on the form and level of concessionary negative gearing would mitigate the increasingly significant housing and debt-related risks in Australia, would allow housing demand to moderate earlier than otherwise, and may shift capital to more productive uses. While the existing policy settings remain, many Australians will likely continue to invest (or speculate) in housing, without sufficient regard to the pending risks involved. And given tight federal budgetary constraints and high levels of personal indebtedness, our ability as a nation to respond to future adverse events will be limited.

V. Conclusion: Everybody is at the Party

APRA acknowledges the increasing proportion of lending attributable to housing over the last decade[32] and suggests that 'if all our eggs are increasingly being placed in one basket, we need to make sure the basket isn't dropped'.[33] Further, its chairman stated in 2015 that:

> the current economic environment for housing lenders is characterised by heightened levels of risk, reflecting a combination of historically low interest rates, high household debt, subdued income growth, unemployment that has drifted higher, significant house price growth, and strong competitive pressures.

Notably, though, APRA suggests that house prices and the levels of household debt are beyond its mandate.[34] The RBA is also aware of the risks but nonetheless suggests housing credit growth of 7 per cent per annum is likely to continue.[35] The Coalition Government concedes that Australia's economy is heavily reliant on housing-related activity and prefers not to dampen this activity and consumer confidence in the near term.

In the marketplace, banks are likely to continue to lend to residential property owners because the existing capital rules and returns to date encourage it. Similarly, Australians are likely to continue to invest in housing, with tax incentives to do so and a dearth of other savings

32 Ibid. 1–2, 5–6.
33 Ibid. 8.
34 Ibid. 2.
35 RBA, above n 6, 2.

opportunities that provide a reasonable return. However, the housing party in Australia will inevitably end at some point and the severity of the hangover will depend on the nature and scale of advance action taken by lawmakers and regulators. The further house prices rise above normal trend lines and economic fundamentals, the more severe the potential corrections and adverse consequences are likely to be, particularly on highly indebted households.

This text is taken from *New Directions for Law in Australia: Essays in Contemporary Law Reform*, edited by Ron Levy, Molly O'Brien, Simon Rice, Pauline Ridge and Margaret Thornton, published 2017 by ANU Press, The Australian National University, Canberra, Australia.

dx.doi.org/10.22459/NDLA.09.2017.06