



Lending is a Risky Business

An unquestionably strong financial system is essential for a well-functioning economy and is a worthy objective for regulators. But if the regulatory environment becomes so restrictive that banks are prevented from taking on fair commercial risks associated with mortgage lending to average households, can the economy be considered 'well-functioning'?

In the years since the Global Financial Crisis (GFC), Australia's financial market and banking regulators have sought to create an 'unquestionably strong' financial system. This decade of reforms has reduced risk in the system but has come at a cost. This cost is borne by first time home buyers who are being forced out of the market, which is contributing to the decline in homeownership.

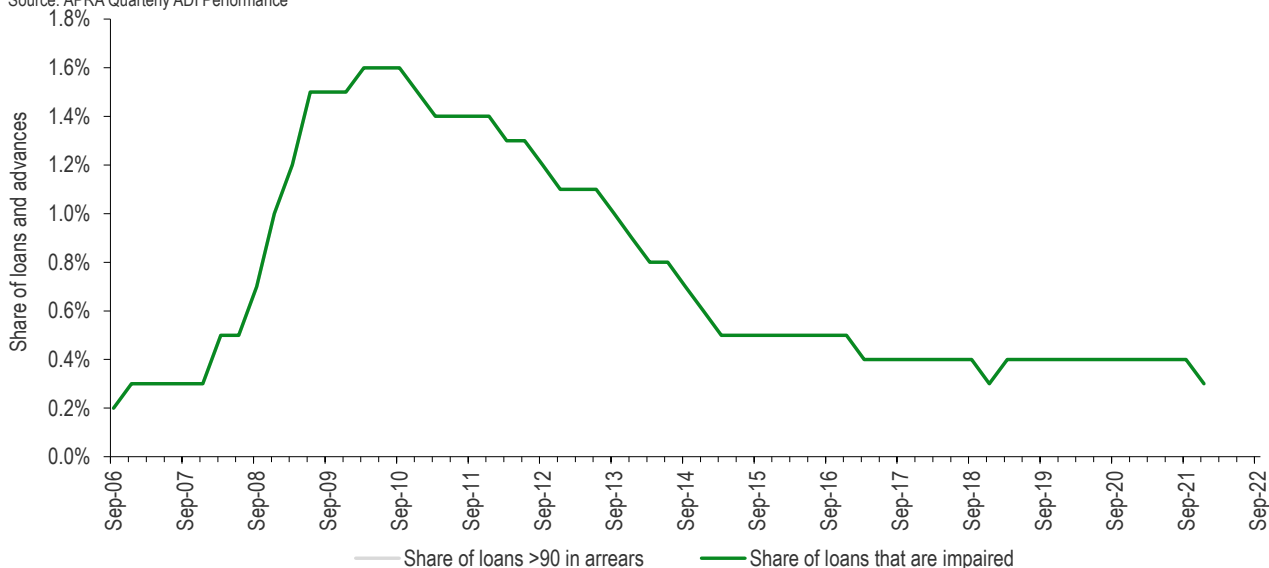
The collapse of several major financial institutions in the US and Europe during the GFC led banking regulators around the world, including Australia, to review the regulatory landscape for the banking sector. There have been substantial changes for the industry over the ensuing decade. Given that residential mortgage lending was at the epicentre of the GFC, this has been a key focus of financial system regulators.

Concerns of a financial contagion spreading to Australia led the Government to take the unprecedented action to guarantee deposits of the major banks. Since this time, Treasury and other regulatory agencies have been working to reduce the risk of residential mortgage business within the banks for fear that they may once again be required to assume the banks' risk.

It is worth noting that while the GFC led to an increase in impaired loans, the share of lending that this affected was still very small. At its worst in mid-2010, impaired loans by ADIs (authorised deposit-taking institutions) accounted for only 1.6 per cent of lending. This figure includes all forms of lending, many of which are considered much higher risk than residential mortgage lending. This was small compared with the experience of banks in other jurisdictions during the GFC.

Impaired and Past Due Loans of Australian ADIs

Source: APRA Quarterly ADI Performance



Despite the resilience of the Australian financial system during the GFC, the Financial System Inquiry in 2014 provided a number of recommendations to further minimise the risk to the government's balance sheet in the event of another crisis.

Since the Financial System Inquiry the government and regulators have adopted a 'belt and braces' approach designed to ensure that the banking sector is 'unquestionably strong', meaning they have enough capital reserves to withstand any conceivable financial or economic shock and that there are rules in place to prevent excessive risk taking.

You're in good hands

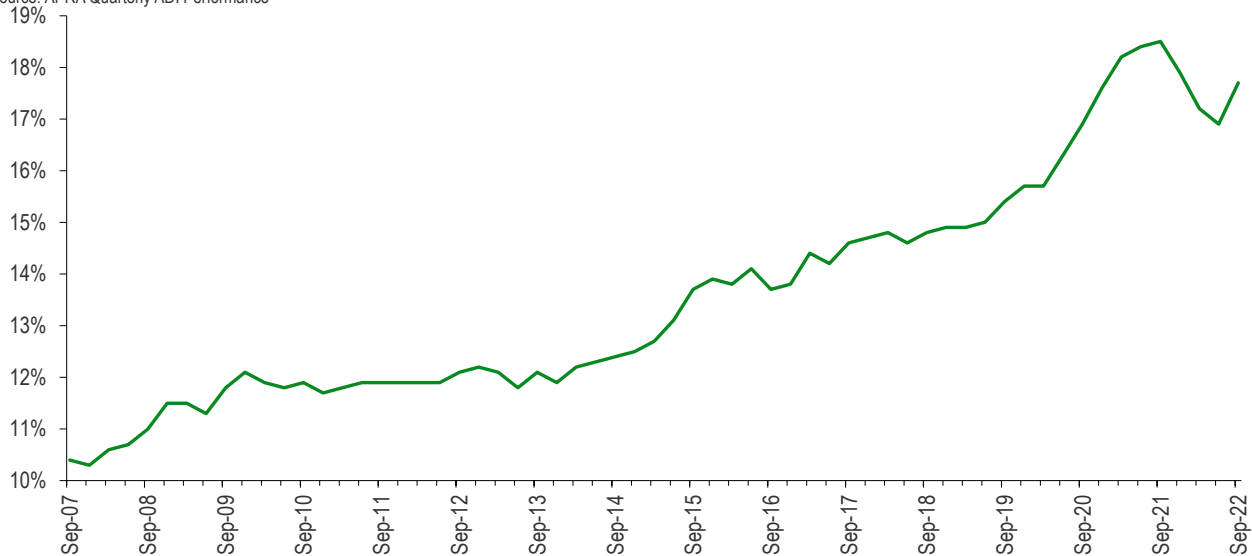


The riskiness of a bank's loan portfolio dictates the amount of capital the bank must hold – a riskier portfolio of assets requires a bank to hold more capital in reserve. Recent changes imposed by the Australian Prudential Regulatory Authority (APRA) mean that lending in segments of the market that are perceived to be risky required banks to hold more capital in reserve than they had in the past, thereby increasing the cost of lending.

Since 2008, ADIs have increased their capital as a share of total risk-weighted assets from around 10.5 per cent to as high as 18.5 per cent.

Ratio of ADI Capital to Risk Weighted Assets

Source: APRA Quarterly ADI Performance



Residential mortgages were also deemed to be riskier than they had been considered prior to the GFC. This meant that mortgage lending became more capital intensive and lenders priced-in the additional costs through higher borrowing costs. This was more significant for riskier types of loans, such as interest-only loans, loans to investors, loans with high loan to value ratios and loans in riskier geographic areas.

Just in case this wasn't enough, APRA reviewed its Prudential Practice Guide for Residential Mortgage Lending in 2014, 2016 and 2019. Compared with the pre-2014 guide, the guidelines in the 2019 edition were considerably more stringent. The most recent additional constraints were the Basel IV regulations that came into effect on 1 January 2023.

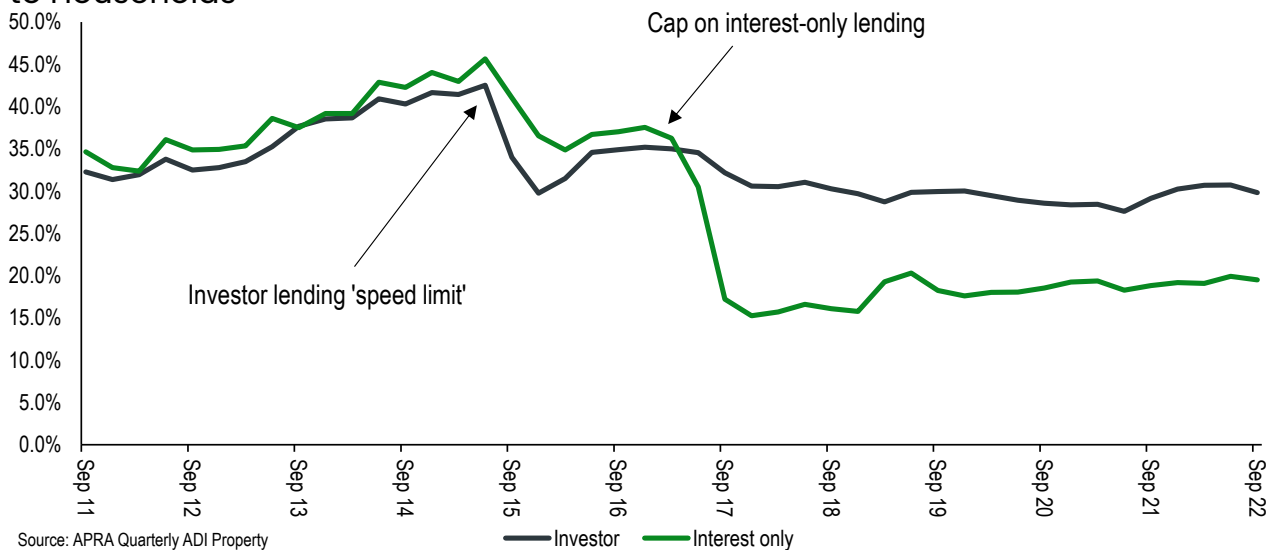
Banks must now apply much greater scrutiny on the income and living expenses of applicants; there are tighter criteria for assessing loan serviceability buffers; lenders are required to discount non-salary income (such as rental income, bonuses, overtime etc.) when establishing an applicant's income; there are more restrictive criteria for assessing applications for interest-only loans; and guidelines were added for mortgage lending to self-managed super funds.

Implementation of structural reforms and the tightening of lending guidelines were already underway when the housing market began to heat up. Despite progress on these reforms, between 2014 and 2017 lending in some riskier segments of mortgage lending (i.e. investor lending and interest-only lending) was growing faster than with what regulators were comfortable.

On top of this list of restrictions, APRA then implemented a series of counter-cyclical regulatory interventions to slow lending at the peak of the housing market. The interventions included a 10 per cent per annum 'speed-limit' on investor credit growth and a cap on interest-only lending. The speed limit on investor lending growth was withdrawn by April 2018, and the cap on interest-only lending was removed in January 2019.



Counter-cyclical Regulatory Interventions in Mortgage Lending to Households

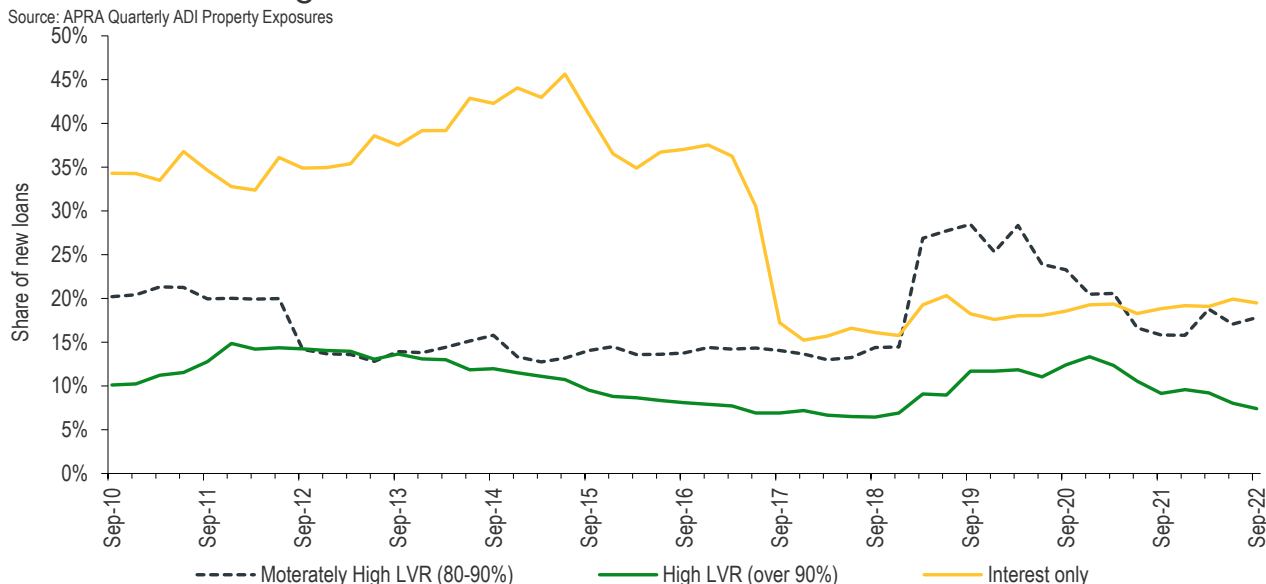


The combined impact of a decade of tightening lending restrictions means that it is considerably more difficult for many home buyers to obtain housing finance than it was prior to 2014.

Banks continue to assert that they are open for business and the RBA echoes this sentiment, noting that there is strong competition for borrowers of high quality. This is great news for 'high quality' borrowers – those with high verifiable incomes and a large asset base against which loans can be secured. But many aspiring homeowners don't satisfy the new narrow criteria of a 'high quality' borrower.

Lending to home buyers with a loan to valuation ratio (LVR) of over 90 per cent (i.e. a deposit of less than 10 per cent of the property value) exceeded 20 per cent of new lending in 2009 but now accounts for just 7 per cent of new loans. The high point in 2009 coincides with the boom in first home buyer activity in response to the GFC stimulus measures. The ability to access finance with a high LVR was a factor that assisted many first home buyers enter the market. This is no longer an option for most. In addition, lending to buyers with an LVR between 10 and 20 per cent dropped from 20 per cent of new lending to 15 per cent of new lending.

Residential Lending to Households



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These reforms over the past decade in residential mortgage lending have been successful in creating an ‘unquestionably strong’ financial system. Lenders have increased their capitalisation, they have cut back lending on terms that are perceived to be high risk and they managed to implement temporary measures to lean against a property boom.

The problem is that in the pursuit of this ‘unquestionably strong’ financial system, the regulatory squeeze has forced the banking sector to eliminate much of the flexibility in the mortgage market that made home ownership accessible for households of variable credit quality.

Add to this the effect on interest rates from the steepest RBA tightening cycle in a generation, and the less affluent end of the financial spectrum is at a serious disadvantage heading out of the pandemic.

Ensuring that home ownership remains an attainable aspiration for Australian households is an equally important objective to financial system strength.

The regulatory system is in place to ensure that the financial system serves the needs of the Australian people. Australians expect the financial system to facilitate home ownership for all, not just those who regulators consider ‘worthy’. An overly restrictive lending system risks creating inequitable outcomes.

The tighter regulatory guidelines for mortgage lending have excluded many aspiring homeowners from the market. Fortunately, governments have recognised the adverse impact on first home buyers and established policies to support their entry to the market. First home buyer schemes, shared equity and stamp duty concessions exist in many jurisdictions.

These schemes support some first home buyers but many are still confronted with these barriers when attempting to secure finance.

Having an “unquestionably strong” financial system is essential to the future of the building industry, but home ownership must remain an attainable goal for all Australian households.