# Housing finance in Australia

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## Overview and recent developments

The Australian housing market is characterised by a high rate of household sector ownership, of a housing stock that is largely comprised of detached houses in urban locations. The owner-occupation rate has been broadly steady for several decades. Most of the remainder of the housing stock is rented privately from small landlords (other households), typically using a real estate agent as an intermediary. Public and social housing comprise a very small proportion of the housing stock.

Government policy has tended to favour home ownership. Imputed rental income and capital gains on sale of owner-occupied property are tax-exempt, and state government land taxes only apply to the most expensive owner-occupied properties. However, interest payments on owner-occupied mortgage debt are not tax-deductible, so debt repayments are effectively made out of post-tax income. Since interest income from savings is taxed, this creates an incentive to pay down mortgage debt quickly. Accordingly, just over half of all owner-occupiers own their home outright. First-home buyers are entitled to a government grant of AUD 7,000 - roughly 2% of the average price of a first home. This was introduced in 2000 as part of the compensation package associated with the introduction of a goods and services tax (GST). Earlier schemes supporting first-home buyers had largely been abolished in the 1980s and early 1990s.

The tax system also favours leveraged direct investment in rental property. Although rental income is taxed, expenses such as interest and depreciation are deductible, and tax losses on these investments can be deducted against other income. Households can therefore accumulate unrealised capital gains while declaring tax losses. Passive investment in assets with potential for capital gains, such as equities and rental property, has become more attractive relative to income-producing assets with the change to capital gains tax arrangements in 1999. Nominal capital gains are taxed at half the taxpayer's marginal tax rate; previously, real capital gains had been taxed at the full rate. This change reduces the tax burden on capital gains that are more than double the cumulated percentage increase in consumer prices over the holding period.[2]

The market for home mortgage lending is dominated by the four large banks, with regional banks (usually former non-bank housing lenders or banks that were formerly owned by state governments), foreign banks and small non-bank institutions playing a lesser role. These institutions all generally fund their activities via a combination of deposits and borrowing in wholesale financial markets, increasingly offshore. Over the past decade, new specialist lenders have entered the mortgage market, resulting in more intensive competition and product innovation, and a sustained reduction in mortgage interest spreads over the cash rate. These "mortgage originators" have been largely responsible for the development over recent years of a substantial market for securitised mortgage debt.

The main development affecting housing markets over recent years has been the large and prolonged upswing in housing prices and households' housing debt. Annual growth in housing prices averaged more than 8% over the past decade, while household debt expanded at an average annual rate of around 14.5% over the same period. The ratio of household debt to income has therefore risen from 66%, a fairly low level compared with other developed countries, to 142%, which is at the upper end of international experience. These developments have been associated with a substantial increase in debt servicing burdens, as measured by the ratio of household interest payments to household income.

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[1] Economic Analysis Department.

[2] The tax treatment of owner-occupied housing is essentially the same as that in Canada, while the treatment of rental properties is more generous in Australia in two main ways: capital gains tax is levied at a concessional rate, and depreciation (capital cost allowance) can be deducted against other income.

Several factors contributed to this upswing. The main causal factor was the shift to a low-inflation environment. The resulting reduction in nominal interest rates allowed households to service a larger debt on any given income. Since Australian banks have typically keyed their lending decisions off repayment/income ratios rather than loan/income ratios, this has resulted in banks being willing to lend these larger sums to households. Finance for housing has also become more available, as a result of the increased competition and innovation by lenders.

Over 2004, growth in housing credit slowed significantly, and housing prices were broadly flat. These trends appear to have continued in 2005, although the flow of new lending to owner-occupiers, at least, has begun rising again.

## Detailed background

### Housing market

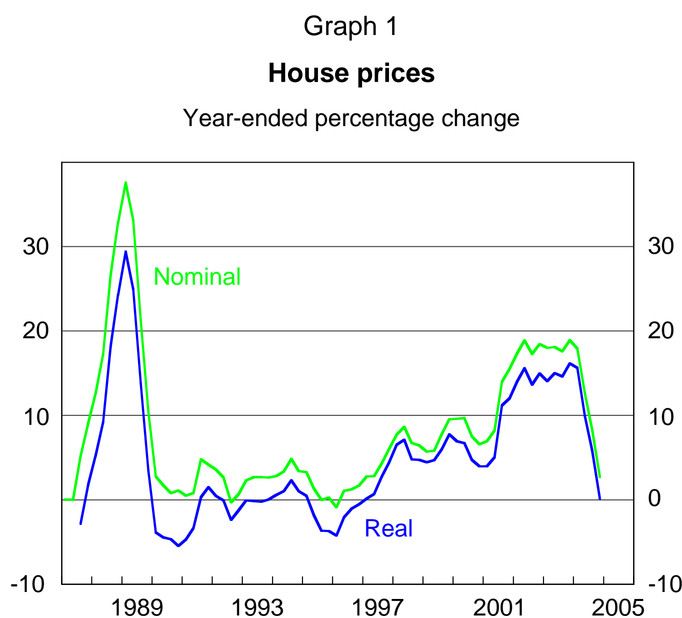
#### *Developments in prices, debt, wealth and rents*

Housing prices in Australia have increased substantially since the mid-1990s, following a slight decline in real terms in the first half of that decade (Graph 1). The median house price increased at an average annual rate of more than 8% over the decade to end-2004, with prices of apartments increasing almost as quickly.

Graph 1

**House prices**

Year-ended percentage change




Sources: ABS; RBA.

As the annual rate of price growth accelerated from the late 1990s, the Reserve Bank of Australia (RBA) became more concerned that valuations were becoming stretched and that speculative dynamics were taking on a life of their own, posing risks to the household sector and the banking system. Given that monetary policy settings in late 2002 and early 2003 were viewed as appropriate for the economy as a whole, the Bank's initial response to its concerns about housing market developments was to speak out about those concerns. The Bank did not explicitly argue that the housing market was experiencing a bubble, and noted that part of the run-up in housing prices could be explained by fundamental factors. However, in a series of RBA articles and speeches during 2002-04, it carefully detailed developments in household debt and the housing market, and expressed concerns about the risks to the household and financial sectors.

More recently, house prices have softened. After growing at a peak rate of 19% over the year to late 2003, according to the measure published by the Australian Bureau of Statistics (ABS), prices have

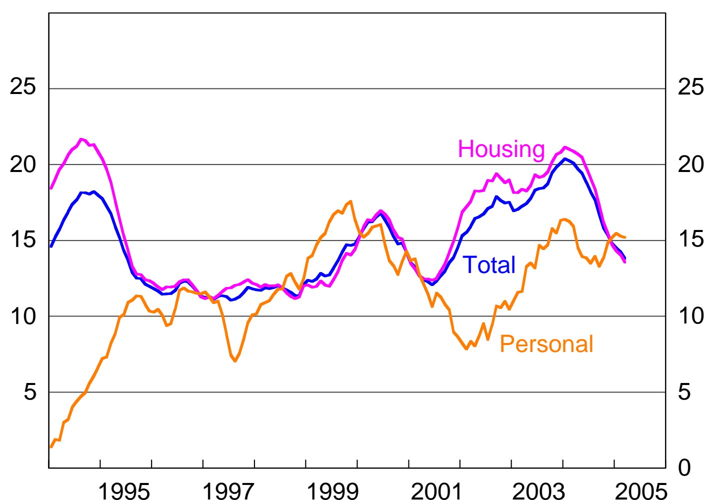
been broadly flat over 2004 and 2005. Earlier periods of strong growth in housing prices occurred in the late 1970s and late 1980s, but these were shorter and sharper than the most recent episode. The more drawn-out upswing of recent years did not involve price growth in any given year that was as strong as the peaks of the earlier cycles, but the cumulative rise was greater, especially in real terms. The recent episode also differs from these earlier price booms in that inflation in consumer prices and prices of commercial property have remained contained. The upswing also had a more broadly based geographical spread, with large price gains seen in all major capitals and a number of regional centres.

The rapid increase in housing prices in Australia was accompanied by strong growth in borrowing by the household sector. Over the decade to end-2004, household debt increased at an average annual rate in excess of 14%, driven by the housing component, which accounts for 85% of the total (Graph 2). After peaking at 21% in early 2004, year-ended housing credit growth has slowed to around 13.5%, but this is still quite a high rate. The flow of new loans as recorded by lenders' approvals started to pick up over the second half of 2004, which is consistent with the stock of credit outstanding broadly maintaining its current rate of growth.

Graph 2

**Household credit growth**[1]

Year-ended percentage change




[1] Includes securitised loans.

Source: RBA.

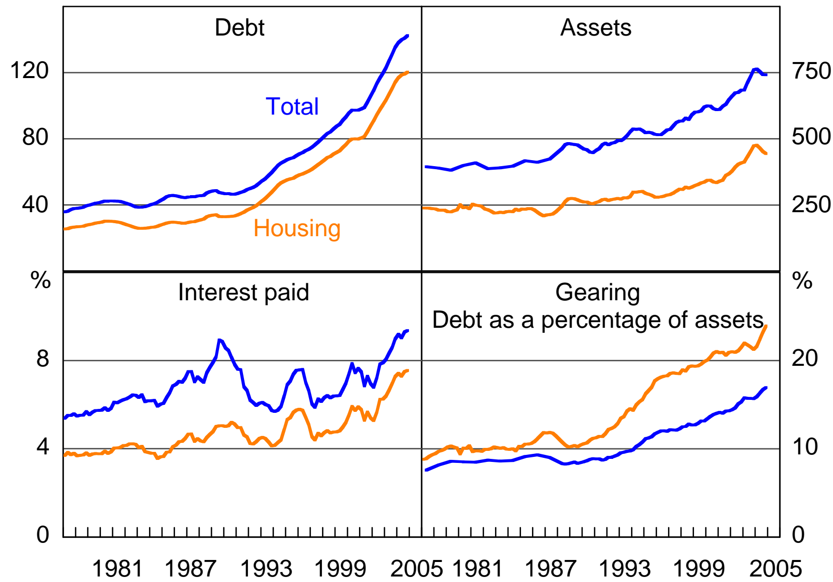
The rapid growth in debt exceeded that in income, resulting in a sharp increase in the ratio of household debt to income from around 66% in the mid-1990s to 142% at end-2004 (top left-hand panel of Graph 3). This has meant that the debt servicing ratio - the ratio of interest payments to disposable income - has also trended upwards over recent years. In the second quarter of 2005, mortgage interest costs represented around 8% of aggregate household disposable income, with the total interest costs of the household sector (ie including interest on other forms of household borrowing) equivalent to almost 10% of household income (bottom left-hand panel of Graph 3). Indicators of financial stress such as loan approvals have risen a little recently, but remain low relative to historical experience.

As a result of the rapid increase in housing prices over the past decade, the household sector's housing assets have also increased sharply, and now account for 60% of total household assets, up from 57% a decade ago. They have also increased significantly relative to household income (top right-hand panel of Graph 3). The growth in housing-related debt has been even more pronounced, however, so that the gearing ratio on housing assets has risen by more than 8 percentage points since the mid-1990s to 24% (bottom right-hand panel of Graph 3). This has also driven the increase in the gearing ratio on total household wealth. That said, household balance sheets remain in good shape, with the value of total assets six times that of household debt.

Graph 3

**Household financial indicators**

As a percentage of household disposable income



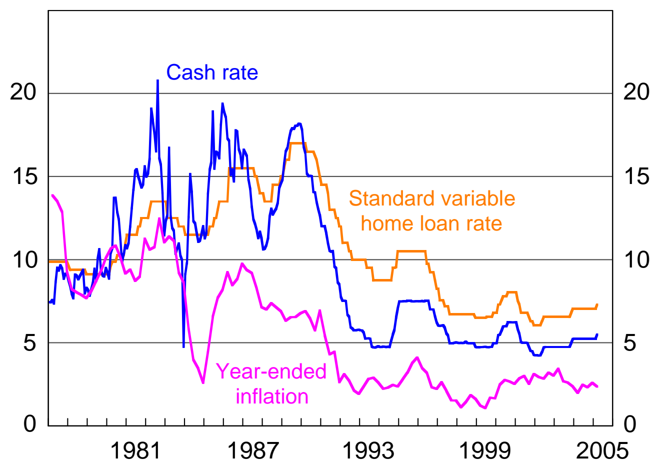

Sources: ABS; RBA.

Part of the run-up in housing debt, and thus prices, can be attributed to the disinflation and fall in nominal interest rates over the 1990s (Graph 4). Policy rates are currently averaging less than half the level prevailing in the mid--1980s. This has made it possible for households to service larger mortgages with a repayment of a given size. Borrowing capacity was further enhanced by the narrowing of spreads over the cash rate that occurred in the mid-1990s. Prior to financial deregulation, interest rates on owner-occupied mortgages were subject to a ceiling that was generally binding. As nominal policy rates came down in the early 1990s, banks allowed spreads to increase, partly in an effort to rebuild balance sheets following substantial losses on their commercial lending portfolios. Spreads subsequently narrowed in the mid-1990s as the entrance of new providers of finance increased the intensity of competition in this market.

Graph 4

**Interest rates and inflation**

In per cent




Sources: ABS; RBA.

The effect of the increase in borrowing capacity has been reinforced by an increase in the availability of finance. As already noted, new entrants to the home lending market have increased competition and reduced spreads. These so-called mortgage managers or mortgage originators fund themselves in wholesale markets, and were able to reduce costs compared with existing banks because they specialised in housing finance and lacked the higher cost structures inherent in an extensive branch network. These new institutions competed aggressively for market share and contributed to the decline in mortgage interest margins since the early 1990s. Increased competition and innovation have also brought an increase in the range of mortgage products on offer over the past decade, which further contributed to the increased availability of finance (see below).

An important distinguishing feature of the recent boom in housing prices and indebtedness was the disproportionate role played by the investor or "buy-to-let" market, where demand was unusually strong compared with the buy-to-let sector in other countries. The investor component of housing-related debt has grown much more quickly over recent years than the larger owner-occupied component, but its contribution to the slowdown over 2004 has likewise been greater. Over the period 2002-February 2005, loans for the purchase of investment properties accounted for just under 40% of new housing loans approved by financial institutions, well in excess of the share of private rental housing in the dwelling stock. Survey evidence suggests that around three quarters of owners of investment properties have debt against those properties, compared with less than half of owner-occupiers.

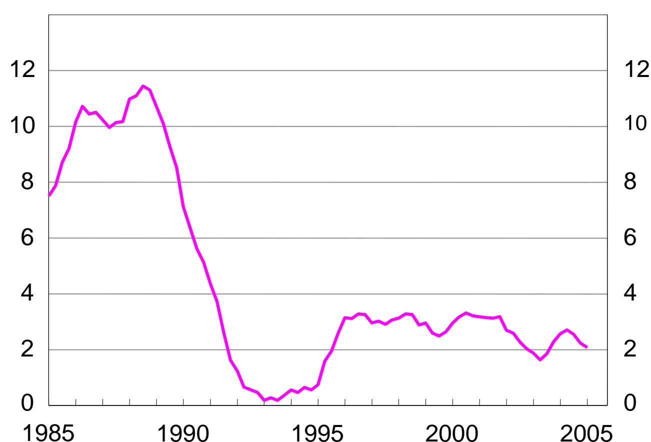
Investor loans now account for around 34% of housing debt, up from around 19% a decade ago. Much of the upsurge in demand for rental housing assets by small investors can be attributed to a desire to earn the capital gains that were expected in this asset class. This occurred in the context of a market in which finance for this purpose had become easier to obtain. Much of the new investment demand was directed towards new apartment developments, in which small investors frequently bought apartments "off the plan" before construction had begun. These new developments have contributed to a large increase in the number of dwellings in inner districts of the major cities, as well as altering the character of the dwelling stock somewhat, away from detached single-family homes.

Timely data on the ownership of the housing stock are not available, but it seems very likely that this increased demand for rental property as a leveraged investment significantly increased the supply of rental housing in some local markets. Consistent with this, rents have increased only modestly over recent years, which is in contrast to the large gains in housing prices. Over the past decade, the consumer price index measure of rents has increased at an average annual rate of 2.7%, only slightly faster than the overall rate of inflation (Graph 5).

Graph 5

**Dwelling rent**

Year-ended percentage change



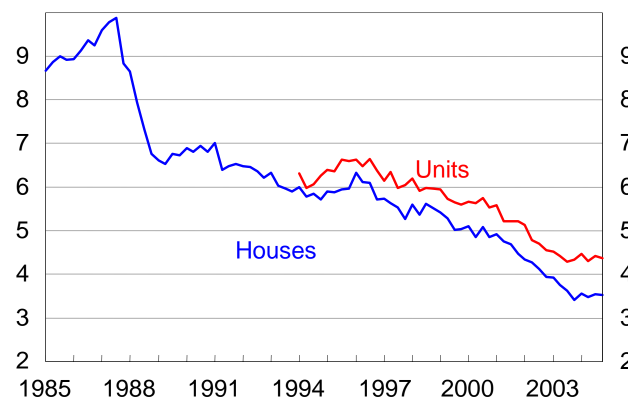

Source: ABS.

The combination of a rapid increase in housing prices and low increases in rents has meant that average rental yields have fallen to very low levels (Graph 6). Currently, gross rental yields in the

major cities are typically around 3.5% for houses and a little higher for apartments. After taking into account running and maintenance costs, net rental yields are at least a percentage point lower. In Australia, the typical yields on industrial, commercial and retail property are 8-9%. The low yields available on residential rental property largely explain the absence of institutional investors in this market, and the domination of ownership by small landlord households. Tax and survey data provide estimates of the share of households that own rent-earning property in the range of 9-13%, much higher than in many other countries, with most of these investors holding only a few properties.

Graph 6

**Residential property rental yields**




Source: REIA.

***To what extent is the housing sector influenced by government and regulation?***

Government policy has generally tended to encourage both home ownership and investment in residential rental property. In the past, state and federal government schemes supported home ownership amongst lower-income households through subsidised loan schemes and direct grants. Most of these initiatives had been abolished or had faded away by the mid-1990s, although quasi-corporate initiatives remain in some smaller states. Similarly, most government-owned banks were privatised in the 1980s and 1990s.

A First Home Owners Grant (FHOG) was introduced in July 2000. Under it, first-home buyers are paid AUD 7,000 as an offset to the introduction of the GST. A further AUD 7,000 was paid under the Commonwealth Additional Grant (CAG) to first-home buyers that entered into a contract to build a new dwelling between March and December 2001, with this amount being reduced to AUD 3,000 for contracts entered into between January and June 2002. The temporary nature of the CAG was designed to partly offset the large fall in construction activity after changes to the tax system in 2000. While the additional purchasing power arising from the grants has, at the margin, added to the upward pressure on house prices, the impact has been relatively small and cannot explain the large overall gains in house prices since the mid-1990s.

The Australian tax system treats owner-occupied housing as a consumption good: capital gains on such properties are exempt from capital gains tax, while mortgage interest is not tax-deductible. Owner-occupied housing is also exempt from land tax in most cases, and is not included in the assets test component of the eligibility tests for government pensions and other welfare payments.[3] In contrast, rental properties are treated as investment goods, with rental income and capital gains both being taxable, and costs such as mortgage interest being tax-deductible. Both cash costs, such as mortgage interest payments and insurance, and non-cash depreciation expenses can be deducted

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[3] In Australia, the government age pension is a safety net benefit that is both means-tested and assets-tested. It is indexed to average wages but not dependent on the individual's own earnings history. Contribution to private pension funds is compulsory for most employees as well as being tax-favoured.

against other income such as wage income ("negative gearing"). In 1999, capital gains tax was reformed to be calculated on nominal gains at half the normal marginal rate, rather than the previous system of full-rate taxation of real gains adjusted for CPI inflation.

Sales of both owner-occupied and residential properties are subject to transactions taxes (stamp duties) levied by state governments on buyers. First-home buyers generally receive exemptions for properties below a certain price threshold, although these have recently had to be increased as the strong rise in housing prices had essentially eliminated the stock of housing priced below these thresholds in some cities. In New South Wales, vendors of non-owner-occupied property were for a time subject to an additional transactions tax, introduced in 2004 but abolished in 2005.

Publicly owned social housing represents only around 5% of the housing stock, according to the 2001 Census. Access to this form of housing is usually restricted to low-income households in receipt of welfare payments, and the waiting lists are long. Low-income households in the private rental market are in some circumstances eligible for rental subsidy payments.

State governments are also involved in regulating the relationships between tenants and landlords. Rents themselves are not regulated, but each state generally has enabling legislation and one or more statutory authorities to enforce it. Regulated matters include allowable grounds for eviction, landlords' access to the property, and the terms that must be specified in the tenancy agreement (which usually must be in writing). Rental bonds are payable at the start of the tenancy, which in most states are lodged into a trust fund managed by the regulator or other independent third party. This regulatory environment - together with the absence of rent controls - provides landlords with a degree of control over the property and comfort that undesirable tenants can be removed. This may have been one factor that has made ownership of rental property more attractive to small investors than it is perceived in some jurisdictions overseas.

### *How efficient are the transfer and enforcement of ownership and collateral rights?*

Purchase and sale of residential property are generally given effect by an exchange of contracts and payment of a deposit (usually 10%). The contract will specify the date at which final settlement occurs, at which time the remainder of the consideration and title to the property change hands; this is usually one to three months after the contract is signed. The registry function of ensuring correct identification of the title holder rests with state government agencies (land titles offices). Sale contracts generally take a standard form consistent with state-level property law and agreed practices as specified by real estate or legal associations. It is not at all common for property transactions to include takeover of the previous owner's mortgage; this is usually paid out from the proceeds of sale. In addition to the stamp duties mentioned above, other costs of property sales include agents' fees (typically around 2% of the sale price), legal fees, and the costs of inspection and title searches.

In some instances, the swiftness and efficiency of the sale process is enhanced by the use of open outcry auctions rather than privately negotiated treaties. Vendors can choose which sales method to use; auctions are more common in older, more expensive suburbs in the large cities. They are also more common in rising markets where vendors want to allow for the possibility that they will receive an unexpectedly high price.

The legal system in Australia is generally supportive of property ownership and collateral rights. Borrowers remain personally liable for mortgage debt in the event of a default, so that lenders can both foreclose on collateral properties as well as being able to use bankruptcy proceedings in order to cover any residual deficiency via recourse to other assets. As noted above, state government legislation regulates the relationship between landlords and tenants, including the ability of landlords to obtain judgments against and to evict tenants in rent arrears. Authority to evict usually requires a judgment from the specialist tenancy tribunal in that state, and is effected by court-appointed bailiffs or the police. Special expedited procedures apply when violence or property damage by the tenant is involved.

### *What is the structure of housing tenure?*

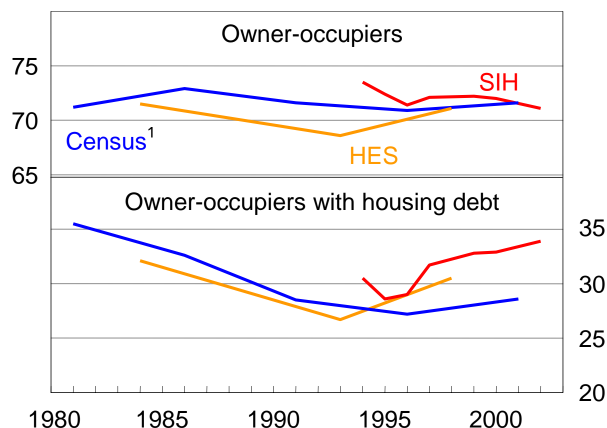
Australia's owner-occupation rate has been broadly steady at around 70% for around a quarter of a century (Graph 7). Census data suggest that just under 30% of households - a little below half of all homeowners - are paying off a mortgage on the property they live in; this proportion has been basically unchanged over the past decade. However, household survey data give slightly contrasting results; the 2002/03 Survey of Income and Housing (SIH) suggested that the proportion of households

with owner-occupied housing-secured debt increased by around 5 percentage points from the mid-1990s to 34%. Part of the difference may reflect the inclusion of second mortgages and home equity loans in the definition of debt used in the surveys.

Graph 7

**Home ownership**

Percentage of households




[1] "Fully owned" includes respondents with life tenure and "being purchased" includes rent/buy schemes.

Source: ABS.

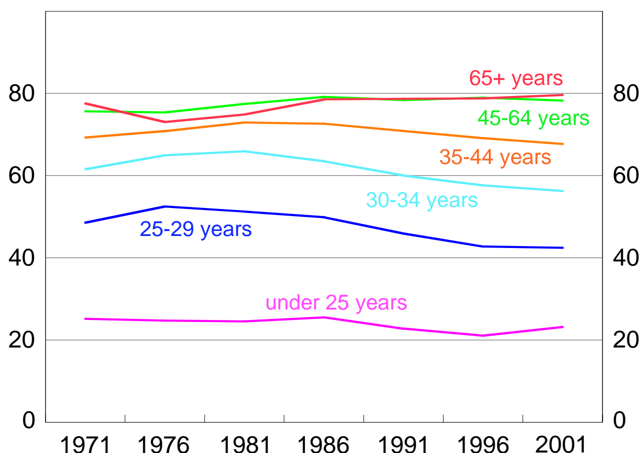
According to the Census, home ownership rates have fallen for most age groups, but particularly for the younger age groups (Graph 8). Ownership rates for households in the 25-29 and 30-34 age groups have declined by nearly 10 percentage points since the early 1980s. This development is consistent with the broadly steady ownership rate for the whole household sector because the population is ageing and older age groups have higher ownership rates.

The remaining households are primarily tenants in privately owned rental properties, although there are a few percentage points of the housing stock that are occupied rent-free (usually inherited life tenancies), public housing or employer-owned housing.

Graph 8

**Home ownership rates in Australia**

In per cent; by age of the household reference person




Source: ABS Census.

## 2. Borrowing and contract types

***What is the relative importance of fixed and floating rate borrowing?***

The bulk of housing loans in Australia - almost 80% - are floating rate loans. Most variable rate loans are benchmarked to the banks' standard variable mortgage rates, which are, in turn, de facto linked to the cash rate. Changes in monetary policy are typically passed through in full by financial intermediaries to borrowers within a few days of the change in policy rate. Many new loans have a discounted or "honeymoon" rate of interest for the first year or so of the life of the loan.

Fixed rate loans virtually disappeared from the Australian market during the high-inflation years of the 1970s and 1980s, but were reintroduced in the early 1990s, and now comprise around 20% of the market. Housing loans with fixed rates can be obtained for terms from one year to 15 years. However, the vast majority of fixed rate loans have fixed terms of less than five years, after which time they generally convert automatically to variable rate mortgages (with a total loan term of 25 years).

***In what ways has the menu of products offered to borrowers changed in recent years?***

Increased competition and appetite of financial institutions for housing loans have led to the introduction of a much wider range of loan products than was available in the 1980s. These products have given both investors and owner-occupiers considerably more flexibility, and have made finance available to those further down the credit spectrum.

Major innovations fall into three main groups:[4]

- *Those providing greater flexibility in the timing of loan repayments and in access to additional credit,* eg home equity loans (revolving lines of credit); mortgages with flexible repayment schedules and redraw facilities; offset mortgages; reverse mortgages; and interest-only loans.
- *Those widening the availability of finance to less creditworthy or credit-constrained borrowers,* eg high loan-to-valuation ratio (LVR) loans; low-documentation loans; loans to credit-impaired borrowers; shared equity loans; and vendor-financed loans.
- *Those specifically targeted at investors*, eg split-purpose loans, which enable borrowers to direct all of their repayments towards their home loan account, while the interest on their investment loan, which is tax-deductible, is capitalised.

Other innovations include deposit bonds, which are guarantees from insurance companies that the deposit will be paid at settlement, and which can be used as an alternative to paying the deposit when the sale is agreed. These facilitate the purchase of "off-the-plan" properties and avoid the need for bridging finance when construction and settlement are completed several years in the future. The emergence of mortgage brokers has widened borrower choice, and increased the degree of mortgage "churn" (refinancing).

***Is the housing market segmented?***

The housing finance market used to be segmented between owner-occupiers and investors. Banks used to apply more onerous conditions to investors than owner-occupiers and charge rates that were significantly (generally around 1 percentage point) higher. However, these interest surcharges began to disappear in the mid-1990s.

The provision of lending to credit-impaired borrowers is dominated by the specialist mortgage originators, and in particular the non-conforming lenders. These lenders also used to dominate the provision of low-documentation loans, but traditional mortgage lenders have also started offering low-doc products in recent years.

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[4] More detail is available in the RBA's "Submission to the Productivity Commission Inquiry on First Home Ownership", *RBA Occasional Paper*, no 16, November 2003.

Interest-only loans are particularly popular with investors as they enable them to make the minimum repayments on the loan and maximise the benefits of negative gearing (ie, deduction of expenses against wage or other income). Many interest-only loans eventually convert to standard principal and interest loans.

### *What is the typical maturity of a mortgage loan?*

The typical maturity of a mortgage loan is 25 years, with maturities in the range of 20 to 30 years common. Most mortgages are credit foncier-type loans with monthly or fortnightly repayments which incorporate both principal and interest. However, mortgages are often paid off ahead of schedule, with many households choosing to make excess repayments (see the section on prepayments below). Anecdotal and survey evidence suggests that many households aim to pay off their loans over a period of around 12 years.

In addition, refinancing makes up a large proportion of lending activity. Around one quarter of owner-occupier loan approvals are for refinancing, while the refinancing rate for investors is estimated to be around half this share.[5] Since the costs of refinancing a variable rate loan are usually relatively low, there can be fairly significant net financial benefits from refinancing. Liaison with the Australian Prudential Regulation Authority (APRA) indicates that the average age of a housing loan is between three and five years (other estimates put the average age even lower), which is consistent with the high level of refinancing activity observed.

### *What are the prepayment and/or equity withdrawal conditions?*

Floating rate mortgages typically do not have prepayment penalties, whereas loans at fixed rates tend to contain penalties for early repayment. Penalties generally take the form of fixed penalties and/or ones based on the difference between the floating and the fixed rate. Australian households typically make repayments in excess of the minimum scheduled monthly repayment. Anecdotal evidence suggests that around 70% of mortgages are being repaid ahead of schedule, although this figure varies depending on recent interest rate developments.

Redraw facilities enable households to access loan repayments that have been made in excess of the minimum repayments required by the lender. As such, they reduce the need for borrowers to maintain precautionary savings in low-interest deposit accounts and the excess repayments can offer a tax-efficient form of saving. The most flexible of loan accounts combine a home loan account, a transactions account and credit card account into the one facility. Some loans charge a fee for redraws.

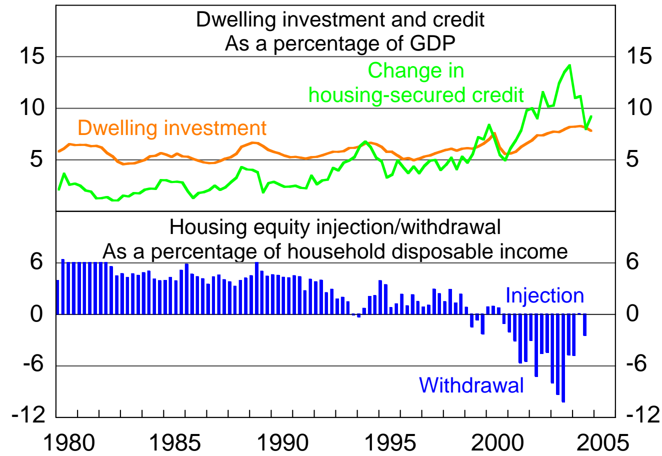
Home equity loans provide a line of credit secured by a mortgage against an existing property. The credit can be used for a range of purposes, including renovations or the purchase of an investment property. In some cases, no principal repayments are required for a number of years, provided the outstanding debt remains below an agreed limit (generally up to 80% of the value of the property). Currently, home equity-type loans account for around 12% of loans outstanding that are secured by residential property.

To some extent at least, these product innovations have enabled the withdrawal of housing equity by the household sector in aggregate. Since the end of the 1990s, households have been net withdrawers of equity from housing, despite construction being a relatively high fraction of GDP over this period. This follows an extended period in which households were net injectors of equity into housing (Graph 9).

[5] These figures relate to external refinancing only, that is, where a borrower refinances with an institution different from the original lender.

Graph 9

**Housing equity withdrawal**




Sources: ABS; Commonwealth Treasury; RBA.

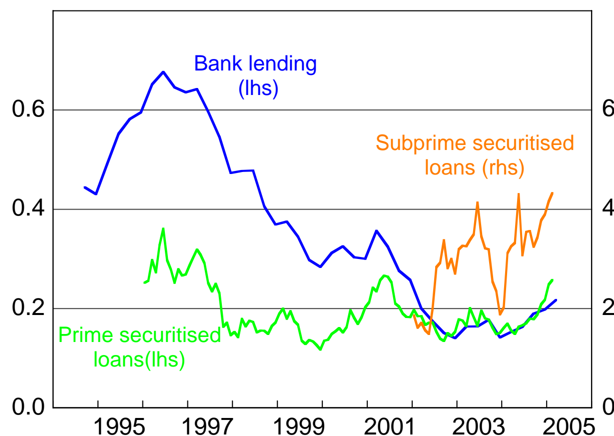
### ***What is the credit quality of borrowers?***

The credit quality of Australian households with home loans is very high. As noted above, loan arrears have risen a little lately but remain low (Graph 10). Mortgages in Australia have historically had low default rates by international standards. However, the rapid expansion in mortgage lending raises the question of whether such low default rates will be sustained, particularly if the economic environment were to become less benign. The recent surge in mortgage lending has included a high share of lending to investors, the use of new mortgage products making it easier for marginal borrowers to obtain finance, and a significant increase in debt levels relative to income. Collectively, it is likely that these factors have added to the overall riskiness of the banks' mortgage portfolios. The arrears rates on bank lending and the prime securitised market have converged over recent years. This is because the stock of securitised loans has become more similar to the total stock of mortgages as the securitisation market itself has expanded.

Graph 10

**Housing loan arrears**

Percentage of loans at least 90 days in arrears




Sources: APRA; RBA; Standard & Poor's.

Historically, investor loans have had only slightly higher average default rates than loans to owner-occupiers. It remains to be seen if this will continue to be true in the future, given the increase in the number of investor households, low rental yields and higher debt servicing burdens. The introduction of new loan products, such as low-doc and other types of non-conforming loans, has also had some effect on the overall riskiness of mortgage portfolios. Graph 10 shows that defaults on these loans are substantially above those for the conventional market. Any impact on overall default rates, however, is likely to be relatively small given that non-conforming loans in Australia account for only a small percentage of overall lending for housing.

## 3. Lending and funding - who do households borrow from?

***Are traditional financial institutions lending on-balance sheet the primary source of funding? To what extent does the market rely on securitisation of loans to fixed income investors?***

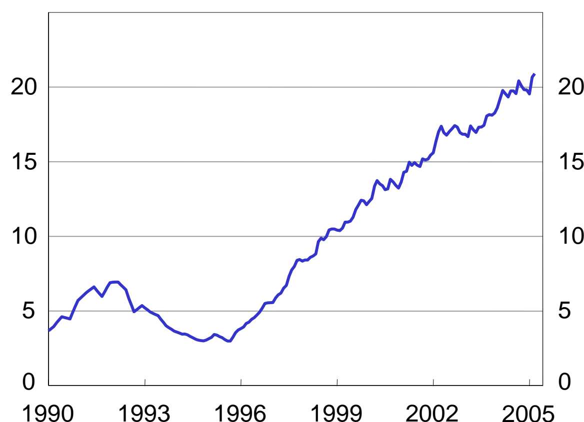
The four largest Australian banks account for over half of housing lending. Other banks - many of whom have a regional focus - have a market share of around one quarter, while credit unions and building societies (CUBS) collectively account for about 5% of the market. CUBS' share has declined since the early 1990s as a number of institutions have demutualised (the largest of these is now Australia's fifth largest bank). The remaining housing finance is provided by specialist mortgage originators. These institutions' share has increased rapidly since the mid-1990s, when the combination of deregulation and a decline in the general level of interest rates reduced the competitive advantage banks had enjoyed by being able to finance their lending through low-cost deposits. Recent years have seen the emergence of non-conforming mortgage originators that specialise in the provision of housing finance to higher-risk borrowers. However, their share of the market remains small. Publicly owned institutions do not play a significant role in housing finance.

The share of housing loans that is securitised has risen from under 5% in the mid-1990s to around 20% currently (Graph 11). Reflecting the predominantly floating rate nature of the Australian mortgage market, most residential mortgage-backed securities carry floating rates of interest. Mortgage originators fund almost all of their lending through securitisation (and account for over half of the mortgage backed securities issued). The major banks finance only a small proportion (less than 10%) of their lending through securitisation, because they are able to obtain more cost-effective forms of wholesale finance. The regional banks and CUBS - which generally have lower credit ratings, and hence higher wholesale funding costs, than the major banks - tend to securitise around one quarter of their loans.

Graph 11

**Securitised housing loans**

As a percentage of total housing loans




Source: RBA.

Table 1

**Australian entities' mortgage lending and funding - 2000-04**

| | **Gross housing lending** (in per cent) | **Share of lending that is securitised** (in per cent) | **Share of total securitisation** (in per cent) |
|---|---|---|---|
| Major banks | 56 | 7 | 16 |
| Regional banks | 24 | 25 | 24 |
| NBFIs | 6 | 22 | 5 |
| Mortgage originators | 14 | 98 | 55 |
| **Total** | **100.0** | | **100.0** |

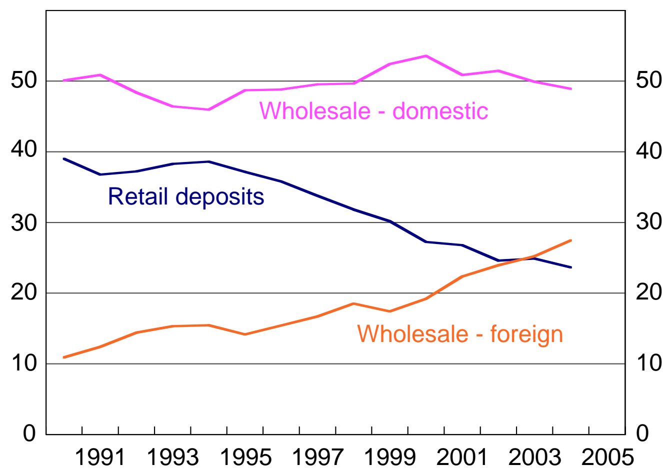
Sources: ABS; APRA; RBA.

A declining proportion of financial institutions' on-balance sheet housing lending is financed through retail deposits (Graph 12). Retail deposits currently account for less than one quarter of banks' total liabilities, while deposits from wholesale domestic counterparties have been stable at about one half of total liabilities. The funding gap - currently over 25% of total liabilities - has been filled by offshore borrowing. In addition, more than half of residential mortgage-backed securities have been issued offshore (largely in the United States, but increasingly in Europe). The vast majority of banks' foreign currency borrowing is hedged and hence does not carry exchange rate risk.

Graph 12

**Banks' liabilities**[1]

As a percentage of total liabilities




[1] All banks (domestic operations, on-balance sheet).

Source: APRA.

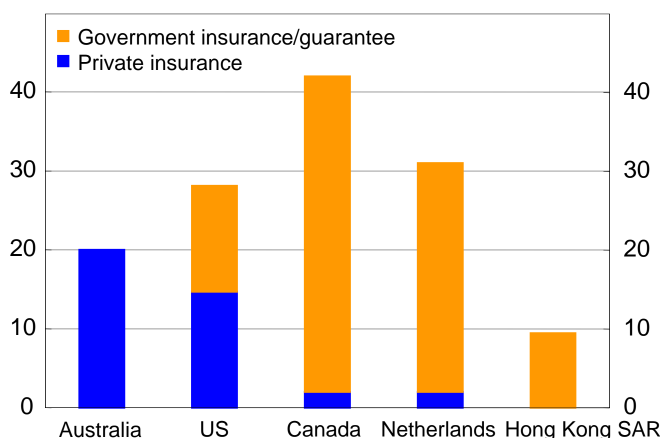
***Are there national or private insurance schemes related to mortgage contracts? Do these cover lenders and/or borrowers?***

In contrast to the experience in other countries, all mortgage insurance in Australia is provided privately, predominantly in the form of lenders' mortgage insurance (LMI).[6] APRA estimate that around 20% of banks' on-balance sheet housing loans carry mortgage insurance (Graph 13). In addition, most securitised mortgages tend to be insured. The market is dominated by two foreign-owned insurers, Genworth Financial and PMI. A third operates in run-off mode, and a small number of captive mortgage insurers also write some business, though most of these policies are ultimately reinsured through Genworth and PMI.

Graph 13

**Mortgage insurance in selected countries**[1]

Share of total mortgages outstanding by value; in per cent




[1] Reference periods are 2002 for Australia and Canada, 1999 for the United States and 2003 for Hong Kong SAR and the Netherlands.

Sources: APRA; F Den Breejen, P Neuteboom, M Elsinga and J Conijn, *Government guarantees in the rental and owner-occupier sector: an international comparison 2004*, report by RIGO Research and Consultancy and OTB Research Institute commissioned by the Foundation Homeownership Guarantee Fund, 2004; D Liu, *Exporting mortgage insurance beyond the United States*, PMI Private Insurance Co, 2000, available at http://www.pmigroup.com/pmieurope/media/pmi_dliuhfi0006.pdf.

In Australia, in order to qualify for the concessional 50% risk weight applied to standard-policy housing loans for capital adequacy purposes, the loans must either have an LVR less than 80% or be covered by mortgage insurance. Accordingly, authorised deposit-taking institutions (ADIs) typically seek mortgage insurance if the LVR exceeds 80%. For low-doc loans, those with an LVR above 60% must be mortgage-insured to qualify for concessional risk weighting.

LMI has been offered in Australia since at least 1965, when the government-owned Housing Loans Insurance Corporation and US insurer MGIC began operations (the latter withdrew in the 1980s). Nowadays, the relatively high use of LMI is partly explained by the prudential requirements outlined above and the significant use of mortgage securitisation - where mortgage insurance is a ready means to achieve an investment grade credit rating. In addition, Australia's personal bankruptcy laws

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[6] A very small part of the lenders' mortgage insurance coverage in Australia may still be backed by the government. While the Housing Loans Insurance Corporation - previously Australia's public LMI provider - was sold to GE in 1997, liabilities on policies issued up to 12 December 1998 are retained by the government.

encourage the supply of LMI as both lenders and lenders' mortgage insurers can seize any assets of a defaulting borrower, not just the secured property, reducing the risk of loss to lenders' mortgage insurers.

From the borrowers' perspective, the take-up of insurance for mortgage contracts has been very limited. There is little evidence of mortgage payment protection insurance in Australia, although the major banks will often offer such products to their customers.

### *Are there special regulations/laws regarding funding practices?*

Banks operating in Australia as branches of foreign banks are prohibited from accepting deposits from Australian residents below AUD 250,000. APRA have also determined that banks should not be allowed to issue "covered" bonds (similar to Pfandbriefe). Otherwise, no specific restrictions are placed on banks' sources of funding.

The mortgage broking industry has grown significantly over the past decade and is estimated to now account for about 30% of new total housing loan originations. There is currently some state-based regulation that covers mortgage broking, including licensing/registration and contract disclosure requirements; however, there are inconsistencies in these state regulations, and this has led to moves to create a uniform national regulation. Issues of concern have included the disclosure of lender commissions, unprofessional conduct by fringe brokers, and the need for a simple dispute mechanism.

### *How have lending institutions' risk management practices evolved?*

Following significant losses in the late 1980s and early 1990s, Australia's largest banks embarked on a gradual adoption of strong quantitative risk management procedures. Anecdotal evidence suggests that the adoption of these practices placed them at the forefront of international trends. Australia's four largest banks (accounting for around 70% of total system assets) are expected to adopt the advanced internal ratings-based approach to risk weighting when Basel II is implemented in Australia.

## 4. Regulation

### *What is the nature of borrower protection? Do lenders have access to exercise their rights in default?*

Australian creditors' claims against a defaulting borrower extend beyond mortgaged assets. In the case of default on a housing loan, for example, the mortgagee has the right to initiate bankruptcy proceedings to claim assets in addition to the mortgaged property in order to settle any outstanding obligation. As noted above, this power also extends to lenders' mortgage insurers.

### *How sophisticated is the operational infrastructure with respect to credit risk assessments, accounting servicing and administration?*

Australian credit risk assessments are limited to negative credit reporting. In other words, Australian creditors have no legal right to independently gather information about loan applicants, beyond past instances where those applicants have made late payments, defaulted on a credit obligation or made multiple enquiries for loans. Some countries (the United States for example) allow creditors to gain a much wider array of information about their applicants independently, including their liabilities to other creditors. In terms of accounting infrastructure, Australia was one of the first countries to adopt the new international accounting standards on 1 January 2005.

## 5. International links

### *How important are foreign investors?*

Foreign banks in Australia account for 20% of total banking system assets. At present, there are 37 foreign banks operating in Australia. Ten operate as subsidiaries of foreign banks and 27 are branches. Subsidiary banks account for around 38% of foreign banks' share of banking system assets. Foreign investors are also increasingly important as a market for mortgage-backed securities originated domestically.

### *What are the main activities of foreign financial institutions?*

Some foreign banks operating as subsidiaries have been able to establish a significant retail presence by circumventing branch networks with internet-based banking services. While their market share remains quite small, foreign banks have increased their share of retail business in recent years. Some banks operate as branches and as such are restricted from taking deposits below AUD 250,000 from Australian residents, so their operations tend to concentrate on corporate and institutional banking services.

### *To what extent are Australian financial institutions active in foreign markets?*

Around 27% of Australian banks' assets are held offshore (Table 2). In particular, Australian banks (basically the four majors) currently own around 85% of the New Zealand banking system's assets. Australian banks have only relatively small exposures to emerging market economies.

Table 2

**Australian banks' overseas lending - 2004**

All banks; percentage of total assets

| | |
|---|---|
| New Zealand | 11.0 |
| United Kingdom | 7.0 |
| Non-UK Europe | 3.8 |
| United States | 2.4 |
| Non-Japan Asia | 1.9 |
| Other | 0.9 |
| Japan | 0.3 |
| Total | 27.3 |

Source: APRA.

### *How active are (international) rating agencies in the market?*

All Australian-owned banks are rated by at least one of the major international rating agencies (Moody's, Standard & Poor's and Fitch). Australia also has an extremely active asset-backed securities market. All Australian asset-backed securities carry a rating from an international rating agency. S&P also rate the service providers that administer loans on behalf of the mortgage originators.