Harbour Navigator
Prudent Response to Expensive Housing

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With 60% of Australian bank lending housing related, banks are bound inextricably to the property cycle. Unlike the worst-hit global geographies, the Australian household did not go through a period of deleveraging post-GFC, as housing credit continued to outpace income growth. With this backdrop, regulators are now doing their utmost to increase banks' resilience and the banks too are chipping in.

There is not only one Australian housing market. For example, residents of Moranbah in Queensland (who saw the median house price in their mining town soar to over $700,000 during the recent mining boom before plummeting to current median prices of $165,000) will tell you a different story from those in the plush Melbourne suburb of Toorak where prices have continued to firm over the last five years. While we see pockets of weakness and oversupply - particularly in the Brisbane and Melbourne apartment markets - more new supply remaining below underlying demand as well as ongoing low unemployment and low interest rates, act as near-term mitigants to valuation risk across the broader property portfolios banks are exposed to.

Banks will never be untethered from the fortunes of the property cycle. However, the Australian Prudential Regulation Authority (APRA) has acted to lessen the impact of property prices by enforcing the following macro-prudential controls:

- Annual growth in investor loans to remain comfortably below 10%; and
- Interest-only lending limited to 30% of new lending. Beneath that, the banks are required to have strict internal limits on interest only lending at Loan to Valuation ratios (LVRs) above 80%, and require good cause for interest-only lending above 90% (the regulator will struggle to see a good cause).

However, APRA has not yet signalled job-done. We expect continued focus on:

- Pressuring banks to put more effort into ensuring realistic projections of household expenses which they use in mortgage serviceability calculations.
- Like the RBNZ, APRA continues to investigate loan-to-income ratios.

In addition to regulatory enforced tightening, banks are now tightening internal credit standards.

Mortgage brokers play a significant role in the Australian market (see box below). Given their role, mortgage brokers are an excellent source of unfiltered insight into Australian mortgage lending standards. Conversations with mortgage brokers on Harbour's recent Australian research trip revealed that:

- Banks are increasing their documentation requirements
    - Particularly so for interest-only loans, where pricing has increased by 75-90bps.
    - Banks are applying more scrutiny to expenses and including not only basic living expenses, but also discretionary expenses.
- The difference between banks' standards is increasing. This complexity adds to a mortgage broker's value proposition.

The mortgage broker market

- In Australia, close to half of all mortgages are originated via brokers, almost double that of New Zealand.
- Brokers receive around 60-65bps of initial commission and 10-15bps of trail. This is one reason banks have higher ROEs in New Zealand than Australia.
- Some of this commission can be clawed back if the borrower repays or refinances with another bank in a specified period, typically around two years. At two years, over half of brokers' clients refinance with another mortgage provider.

What motivates mortgage brokers?

They run a business so commission will of course be a motivator. But given commissions are competitive, we found service to be a bigger driver, especially ease and consistency of a bank's application and decisioning process. Changes to service levels can therefore influence mortgage market share between the banks.

- One of the major banks is offshoring part of its credit process. This has resulted in a significant reduction in service as brokers are finding it difficult to ascertain the status of an application. This is likely to impact market share until brokers are satisfied new processes are bedded down.

It is important to put these increases in standards in an historical context, as a response to regulatory concerns over high valuations and loose standards. While new loans are of a higher quality, we are certainly not dismissing all risk, given the earlier credit binge assisted prices to the current elevated levels.

While Australia may face a 'slowly slowing' housing market as tighter lending controls continue to take the heat out of warmer parts of the market (with potential for location specific weakness), the tighter controls ultimately reduce overall financial system risk.

We can see many parallels with New Zealand: a housing market that is cooling off in hot spots, but also a banking system that has pre-emptively increased it resilience and reduced exposures to the riskiest loans.

With housing still the largest investment for many New Zealanders and Australians, a gradual cooling near term, which supports a stronger financial system, may ultimately protect the long term value of this investment.

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