Australian bank hearing reveals growing danger of interest-only housing loans

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Disturbing evidence of the vulnerability of the Australian housing market and its major banks to a sudden shift in financial conditions and any rise in interest rates emerged in the hearings before a parliamentary committee last week.

Testimony given by Westpac chief executive Brian Hartzer revealed that half the bank's $400 billion of outstanding home loans consists of interest-only mortgages. The figure for other three of the "big four" of Australian banks—ANZ, NAB and CBA—is 40 percent interest-only.

In an article for *The Conversation*, reposted by the Australian ABC, University of New South Wales economics professor Richard Holden wrote that while he was not normally a fan of parliament hauling in private sector executives and asking them questions, last Wednesday's proceedings were "both useful and instructive."

"And, to be perfectly frank, terrifying," he added. Commenting on what he called the "startling level" of interest-only loans—that is, loans in which the borrower does not pay back any principal for a period up to five years—Holden noted what he called the "banal response" of the Westpac chief.

Questioned on the figure, Hartzer had told the House of Representatives standing committee on economics: "We don't lend money to people who can't pay it back. It doesn't make sense for us to do so."

But as Holden remarked: "Did it make sense for all those American mortgage lenders to lend to people on adjustable rates, low-doc loans, no-doc loans etc. before the global financial crisis?"

Holden also made a scathing comment on the testimony of the ANZ CEO, Shayne Elliott, who took the same line as his Westpac counterpart, insisting that ANZ did not lend money to people who could not repay.

Holden commented: "Recall this is the man who on ABC's 'Four Corners' said that home loans weren't risky because they were all uncorrelated risks (the chances that one loan defaults does not affect the chances of others defaulting). That is a comment that is either staggeringly stupid or completely disingenuous."

The point is that while home loan defaults may be uncorrelated, the same factors that cause one mortgagee to default—a rise in interest rates or a significant downturn in the economy causing unemployment to rise or some other factor—will impact on others in the same way.

Hartzer and Elliott "must all take us for suckers," Holden wrote. He estimated there are about $1 trillion of interest-only loans on the books of Australian banks, under conditions where, according to the Reserve Bank of Australia, about one-third of borrowers do not have a month's repayment buffer.

The crunch would come when interest rates began to rise, recalling the US mortgage meltdown when borrowers had to refinance. "When the market couldn't bear that refinancing, defaults went up," Holden wrote. "Then the collapse of US investment bank Bear Stearns, then Lehman, then Armageddon."

Holden warned that Australia's large proportion of interest-only loans, "turbo-charged" by an "out-of-control" negative-gearing regime (in which investor-borrowers can write-off interest payments against tax), "looks spookily similar."

"It's one thing for borrowers to do silly things. When it becomes dangerous is when lenders not only facilitate that stupidity, but encourage it. That seems to be happening in Australia."

Last April, the Australian Prudential Regulatory Authority (APRA) stipulated that interest-only loans should comprise only 30 percent of any bank's mortgage holdings. But Holden warned that may be "far too little, way too late."

Questioning by committee members on Westpac's compliance with the APRA stipulation centred mainly not on the level of systemic risk posed by the high proportion of interest-only loans but how the bank sought to take the most profitable route to bring down the proportion.

Rather than simply refuse new applications once the 30 percent limit on new borrowings was reached, Westpac sought to change the mix of its holdings through what Hartzer called the "pricing mechanism." The bank raised rates on interest-only loans and reduced them slightly on

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loans requiring the repayment of principal—the most beneficial approach for its bottom line.

Hartzer insisted that the changes were a response to the APRA requirement. But the committee's chair, Liberal MP David Coleman, noted: "It does appear that what you have described as a response to the regulator had, from your perspective, the happy coincidence of a meaningful increase in your earnings."

While the exchanges during the committee hearing on this question revealed the absolute concern for the banks to gouge every last cent of profit, the overriding issue is the stability of financial system as a whole given the banks' dependence on housing.

Nationals MP Kevin Hogan asked Hartzer why Westpac's "lending to housing, in relative terms to small business, has become completely skewed? Why has lending to housing taken over and dominated your lending relative to small business?"

Hartzer replied that the demand for housing was high, interest rates were falling and the price of houses was rising. This had pushed up the demand for housing lending to meet the price. He could have shortened his answer by stating simply: "Because that's where the money is."

At the same time, Holden said the bank did not constrain its lending to small business—a claim that many businesses, facing tightening financial constrictions, would no doubt dispute.

A key feature of the Australian banking system is its dependence on the flow of foreign funds to finance essentially parasitic activities, under conditions where the creation of an inflated housing market has led the International Monetary Fund and other international organisations to warn of a bubble.

In September 2008, the Australian banks were not directly affected through the purchase of "toxic assets" issued by US finance houses because they are borrowers from, rather than investors in, global markets. But after the world financial crisis broke, they were rapidly impacted because loans to fund their activities dried up virtually overnight in October. Had the situation continued, they would have suffered a major liquidity crisis and potentially bankruptcy, a breakdown averted only when the Rudd Labor government stepped in as their guarantor.

Since the 2008 crisis, the banks have lessened their dependence somewhat on volatile international short-term funding. But they still rely on the flow of money from global markets.

In January this year, a Morgan Stanley analysis found that while new regulations had forced the banks to increase their use of customers' deposits, the banks also had increased the issuance of longer-term bonds.

Last year the big four issued $148 billion in long-term debt, up from $109 billion in 2015, with a further $142 billion to be issued this year.

Low interest rates in international markets have created favourable conditions for such borrowing, but Morgan Stanley warned the situation could change. One of the key issues will be further interest rate rises by the US Fed.

On the one hand, the Reserve Bank of Australia would need to lift interest rates in order to keep funds flowing into the Australian banking and financial system. On the other, rising interest rates could impact on the interest-only loans of investors and on homebuyers whose finances have been stretched to the limit by soaring house prices.

A survey conducted by global banking giant UBS last month found that of the people who took out a home loan in 2017, only 67 percent gave a "completely and factual" account to the bank of their financial situation, down from 72 percent from last year. UBS said the survey, which involved 900 people, would tend to underestimate the level of mortgage misrepresentation because people would be reluctant to admit it, even anonymously.

UBS has estimated that about $500 billion of the $1.7 trillion of mortgages outstanding in Australia could contain misstatements about incomes, assets, existing debts and expenses.

So far the international low-interest rate regime has allowed the housing bubble to continue, with ordinary homebuyers and investors still able to meet their debts. Only a small shift, however, would rapidly bring to the surface a major social and financial crisis, reaching into the banking system itself.

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