



Positioning Paper

Mortgage default in Australia: nature, causes and social and economic impacts

authored by

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CONTENTS

CONTENTS	II
LIST OF FIGURES	IV
LIST OF TABLES	V
ACRONYMS	VI
GLOSSARY	VIII
EXECUTIVE SUMMARY	1
1 INTRODUCTION	19
1.1 Context	19
1.2 Research questions	21
1.3 Method	22
1.4 Structure of positioning paper	24
2 TRENDS, TRIGGERS AND CAUSES OF MORTGAGE DEFAULT	25
2.1 Trends	25
2.1.1 Trends according to totals and averages data	26
2.1.2 Trends according to disaggregated data	32
2.2 Drivers	35
2.2.1 Inability to service debt from the start: bad judgment through to fraud	36
2.2.2 Shocks: unemployment, illness, disability and divorce	39
2.2.3 Rising interest rates	40
2.2.4 Lack of alternatives: falling house prices and rising rents	41
3 THE EFFECTS OF MORTGAGE DEFAULT	44
3.1 Processes of dealing with defaults	44
3.2 Impacts	45
3.3 Preliminary interviews	48
3.3.1 Types of borrowers and homes	48
3.3.2 Causes of default	49
3.3.3 Managing financial difficulties	50
4 THE BIG PICTURE: MORTGAGE DEFAULT AND THE MACRO-ECONOMY	52
4.1 Unfolding of the 'subprime crisis'	52
4.2 The threat of systemic risk	61
4.2.1 Act I — Prelude	61
4.2.2 Act II — Black September	64
4.2.3 Act III — Even blacker October-November	66
4.3 Prospects for the macro economy	68
4.4 The situation in Australia	70
4.5 Conclusion	72
5 POLICIES TO MINIMISE AND MANAGE MORTGAGE DEFAULT	73
5.1 Current reforms and reform agenda	73
5.2 Lenders' practices	77
5.2.1 Government guaranteed mortgage-backed securities	77

5.2.2	Debt servicing capacity	78
5.2.3	House valuation.....	78
5.2.4	Lenders' responses to borrowers requesting hardship variations	79
5.2.5	Regulating non-ADIs	80
5.2.6	External dispute resolution	81
5.2.7	Bonuses based on lending performance.....	81
5.2.8	Tightening regulation of 'low-doc' and 'no-doc' lending.....	81
5.2.9	Mortgage lenders insurance — a double-edged sword?.....	82
5.2.10	'Business' and other 'special' loans.....	82
5.2.11	Predatory lenders	83
5.3	Borrowers' behaviour	83
5.3.1	Refinancing	84
5.3.2	Superannuation	85
5.3.3	Functional financial literacy	85
5.3.4	Financial counsellors.....	86
5.3.5	Credit register	88
5.4	Housing policy context.....	89
5.4.1	Purchasing a home is the 'best' alternative.....	89
5.4.2	Defaulting landlords.....	89
5.4.3	Mortgage relief assistance	91
5.4.4	Evictions	92
5.4.5	Insurance.....	92
5.5	Improving data, monitoring and analysis	93
	APPENDIX: HOME REPOSSESSION DUE TO MORTGAGE DEFAULTS — PROCEEDINGS IN THE NSW SUPREME COURT.....	95
	REFERENCES	99

LIST OF FIGURES

Figure 1: Number of applications for claims of possession (1990/2001–2007)	5
Figure 2: Comparison of housing loans in arrears, by state	6
Figure 3: Regional comparison of NSW housing loans in arrears	6
Figure 4: Mortgagor Stress-O-Meter: severely stressed, by segment	7
Figure 5: Number of applications for claims of possession (1990/2001–2007)	25
Figure 6: Household debt levels relative to net income	26
Figure 7: Interest payments by households — on mortgages, consumer goods and investment housing.....	27
Figure 8: Housing as a proportion of total household debt and debts:asset ratio	28
Figure 9: Rising debt service ratios on household debt (2002–2006).....	29
Figure 10: Proportion of loans 90+ days in arrears, by number and value	29
Figure 11: Arrears 90+ days by kind of loan, per cent of outstandings.....	30
Figure 12: Loans 30+ days in arrears by loan originator.....	30
Figure 13: Comparison of housing loans in arrears, by state	31
Figure 14: Regional comparison of NSW housing loans in arrears	31
Figure 15: Mortgagor Stress-O-Meter: severely stressed, by segment	34
Figure 16: Median house prices.....	43
Figure 17: US mortgage delinquencies by vintage year	55
Figure 18: House price changes in US and Europe — per cent per annum.....	56
Figure 19: Structured credit issues: Europe and US.....	57
Figure 20: Structured credit products: CDOs and CDO-squareds.....	59

LIST OF TABLES

Table 1: Fitch Ratings 'Top 10 worst performing post codes'*	11
Table 2: Proposals to minimise and ameliorate mortgage default	16
Table 3: Addressing the key research questions	23
Table 4: Fitch Ratings 'Top 10 worst performing post codes'*	47
Table 5: Estimates of US financial sector losses, March 2008 (\$USbillion)	62
Table 6: Proposals to minimise and ameliorate mortgage default	76
Table 7: NSW tenants' liabilities, if landlord defaults, and reform proposals	90

ACRONYMS

ABC	Australian Broadcasting Commission
ABS	Australian Bureau of Statistics
ABSs	asset-backed securities
ARM	adjustable-rate mortgage
ACCC	Australian Competition and Consumer Commission
ACT	Australian Capital Territory
ADI	Authorised Deposit-taking Institution
AHURI	Australian Housing and Urban Research Institute Ltd
ANU	Australian National University
ANZ	Australia New Zealand (Bank)
APRA	Australian Prudential Regulation Authority
ASF	Australian Securitisation Forum
ASIC	Australian Securities and Investments Commission
BFSO	Banking and Financial Services Ombudsman
CCC	Consumer Credit Code
CDO	collateralised debt obligation
CDS	credit default swap
CALC	Consumer Action Law Centre (Victoria)
CCLC	Consumer Credit Legal Centre (of NSW)
CEO	Chief Executive Officer
CLO	collateralised loan obligation
CMBS	commercial mortgage-backed securities
COAG	Council of Australian Governments
CSHA	Commonwealth–State Housing Agreement
EDR	external dispute resolution (service/agency)
EU	European Union
FDIC	Federal Deposit Insurance Corporation
GSE	government sponsored enterprise
HIA	Housing Industry Association (Australia)
HILDA	Housing, Income and Labour Dynamics in Australia (Survey)
HOLC	Home Owners' Loan Corporation
IMF	International Monetary Fund
LMI	lenders mortgage insurer
LVR	loan-to-value (of asset) ratio
MBS	mortgage-backed security

NAB	National Australia Bank
NACLC	National Association of Community Legal Centres
NRAS	National Rental Affordability Scheme
NSW	New South Wales
Non-ADI	Non-Authorised Deposit-taking Institution
OFT	Office of Fair Trading (NSW)
OECD	Organisation for Economic Co-operation and Development
RBA	Reserve Bank of Australia
SIV	special investment vehicle
SPV	special purpose vehicle
TARP	Troubled Assets Relief Program
UCCC	Uniform Consumer Credit Code
UK	United Kingdom
UWS	University of Western Sydney
US	United States

GLOSSARY

Alt-A MORTGAGE	Though of higher quality than subprime mortgages, Alt-A mortgages are considered lower credit quality than prime mortgages due to one or more non-standard features related to the borrower, property or loan.
ADJUSTABLE RATE MORTGAGE (ARM)	A mortgage loan with a variable interest rate.
CHARGE OFF	When the lender writes off a debt that cannot be collected due to bankruptcy or default by the borrower.
COLLATERALISED DEBT OBLIGATIONS	CDOs are bonds derived from (secured by, in this case) mortgage-backed securities.
CREDIT DEFAULT SWAPS	CDSs entail the seller (usually a bank) promising (for a fee) to take over a subsequently defaulting asset from the buyer at its face value and thus, in that eventuality, 'booking' the loss on its balance sheet.
HOUSING STRESS	When households have insufficient disposable income to purchase other necessities once housing costs are met.
LOAN-TO-VALUE RATIO	Ratio of original loan principal to the value of the dwelling at the time of purchase.
(RE)POSSESSION	Legal process through which the mortgage lender acquires ownership of the property (dwelling) typically when the borrower has defaulted.
LOW-DOC LOAN	A mortgage loan requiring limited evidence of the borrower's capacity to meet loan repayments.
MORTGAGE ARREARS	Mortgage repayments outstanding.
MORTGAGE-BACKED SECURITIES (MBS)	Bonds deriving their income flow from and secured against a 'pool' of individual mortgage loans.

MORTGAGE DEFAULT	Chronic incapacity to meet mortgage repayments, often leading to sale or repossession of the dwelling.
MORTGAGEE	The mortgage lender.
MORTGAGOR	The mortgage borrower.
NON-PERFORMING LOAN	A mortgage loan in arrears.
SPECIAL PURPOSE VEHICLE (SPV)	An 'off-balance sheet' entity holding particular assets, in this case residential mortgage-backed securities, also referred to as a Special Investment Vehicle (SIV).
SUBPRIME CRISIS	The escalation of mortgage defaults in the United States in 2007–2008 and the flow-on effects on financial markets and real economies worldwide.
SUBPRIME MORTGAGE	A mortgage loan typically made originally to borrowers with weakened credit histories, such as payment delinquencies and bankruptcies; reduced repayment capacity as measured by credit scores or debt-to-income ratios; and/or incomplete credit histories.

EXECUTIVE SUMMARY

Context

The Australian housing system has undergone major structural change in the past 20 years. Continuing population growth, falling average household size, strong economic growth and rising average incomes have underpinned buoyant demand for housing focused on metropolitan areas, smaller provincial cities, natural resource centres and tourist regions. Increasing income and wealth inequalities have changed patterns of access to housing by location, tenure and quality. The growth in two-income households has also impacted negatively on the access and affordability of housing for single lower income households. At the institutional level, deregulation of Australia's financial system, starting in the late 1970s, gathering pace in the 1980s and culminating in the 1990s with the explosive growth of the secondary mortgage market, has resulted in a quantum leap in mortgage debt and helped drive a pronounced housing boom in the 1996 to 2007 period (Berry & Dalton 2004; Berry forthcoming).

Some of the consequences flowing from these developments include:

- declining home ownership rates among younger households and, hence, increasing intergenerational inequality
- declining housing affordability for many households in the lower half of the income distribution (Yates & Milligan 2007)
- increasing residential spatial polarisation on age and income grounds (Wood et al. 2007)
- an increasing spatial mismatch between housing opportunities and urban labour market restructuring (Berry 2006a)
- increasing potential macroeconomic volatility driven by booming housing markets (Berry 2006b; forthcoming)
- increasing mortgage and other debt, raising the risk of escalating mortgage defaults.

This project focuses on the last point above — the pattern, cause and impacts of mortgage default in Australia in recent times and the implications for policy responses in the immediate to medium-term future — while also considering issues related to the penultimate point.

The aim of this positioning paper is to outline the scope of the research and discuss the key issues and secondary data pertaining to the phenomenon of mortgage default in Australia. The primary data and policy directions presented here are for indicative purposes only. The main data, analysis and conclusions will be presented in detail in the forthcoming final report.

An earlier Australian study by Berry et al. (1999) found that mortgage arrears and defaults rose sharply in both the late 1980s and the late 1990s, albeit from a low base. The main drivers appeared to be:

- loss of employment and long-term unemployment
- small business failure
- personal relationship breakdown

- high indebtedness and financial over-commitment
- sudden loss of income resulting from losing or changing jobs, loss of overtime, one household member withdrawing from the labour market due to illness or pregnancy.

With respect to mortgage arrears, the study found that younger households (age cohorts below 45–54) were most likely to be in arrears. This is the group in which home purchase is likely to be recent and loan-to-value ratios highest. Households with dependent children were also most likely to be in arrears, as were purchasers of newly constructed houses. Interestingly, higher income households with managerial and professional workers were more likely than lower income unskilled and semi-skilled workers to be in arrears. In the case of defaults, the study found the same key factors to be significant — high indebtedness (i.e. high loan-to-value ratio), age (young), households with dependent children and higher than average incomes.

As Chapter 2 details, mortgage arrears and defaults have again begun to rise over the past few years. The past decade has witnessed a massive growth in housing-related debt, volatile flows of investment into the housing sector and further innovations in lending and other financial markets. It is not clear whether regulators and policy makers have kept pace with market-driven developments in this field.

In May 2007, the House of Representatives directed its Standing Committee on Economics, Finance and Public Administration to establish an inquiry into home lending practices and the treatment of mortgagors (borrowers) under severe financial stress. The committee presented its report in September 2007 (House of Representatives 2007), concluding that over the last decade lenders had relaxed their lending standards in terms of the range of acceptable borrower profiles and the size of loans for home purchase, renovation and extension, and for non-housing-related purposes. The range of mortgage lenders and products had expanded substantially, with increasingly aggressive lending by poorly regulated non-bank entities, i.e. non-ADIs (non-Authorised Deposit-taking Institutions) that are not regulated by the Australian Prudential Regulation Authority (APRA). The role of financial brokers engaged in facilitating mortgage loans, refinancing and debt consolidation has also grown rapidly since the 1990s.

Although the inquiry found no compelling evidence of widespread abuse or irresponsible lending, concern was expressed about the seemingly increasing incidence of predatory activities by fringe lenders and brokers aimed at vulnerable borrowers. Concern was also directed at the inadequate quality and coverage of available data on mortgage loan arrears and defaults.

Research questions

The Berry et al. (1999) study, noted above, was based on a quantitative analysis of lending institution data and summary data published by the key mortgage insurance firms. Conversely, this project will draw on primary data from:

- Supreme Court files held in New South Wales (NSW) and Victoria
- semi-structured interviews with defaulters and experts
- a large survey of defendants to claims of possession of their homes by lenders
- surveys and focus groups conducted by Fujitsu Consulting
- experts' submissions and testimonies to three key government inquiries (2007–2008).

The project will answer the following key questions:

1. What are the key triggers and causes of mortgage default in Australia in 2008?
2. What are the consequences of default for affected households — in terms of financial impacts, future borrowing capacity, physical and psychological health, intra-household relations, and the impacts of mobility?
3. What policy interventions — financial, educational, counselling, reporting, regulation — could reduce the incidence and negative impacts of mortgage defaults?
4. What are the broader risks to the Australian housing system and economy posed by the current global mortgage default climate?

In short, this project seeks to explore the various impacts of mortgage stress on vulnerable households and to place the phenomenon of mortgage default within a broader social and economic context. This approach is used suggest relevant and practical ways for policy makers to reduce the incidence and negative consequences emerging from mortgage default.

Method

The project comprises several overlapping stages:

- A literature review of relevant studies and reports since the Berry et al. (1999) study, which identifies trends in mortgage defaults in Australia and other advanced economies and summarises findings of the factors behind the trends.
- An analysis of the macroeconomic context and impacts of rising defaults which focuses on the liquidity constraints in financial markets and the broader risks of economic recession. This analysis will draw on and extend earlier research by Berry (2006a; forthcoming), extensive research by the Reserve Bank of Australia (RBA), and recent and continuing debate in the financial media in the context of current developments in US and global financial markets.
- An analysis of recent Supreme Court records of mortgagor repossessions in NSW and Victoria. The researchers have gained permission from the chief justices in both courts to send letters to approximately 4000 mortgagors who have been subject to Supreme Court claims of possession on their property during 2008, inviting them to respond to a written survey and asking them if they are prepared to participate in an in-depth interview. We expect to generate a sample of approximately 300 survey respondents, making up any shortfall through distributing surveys through financial counsellors and state agencies (who have already agreed to cooperate). Ten interviews and some survey trials, both with defaulters, and comments from experts informed the development of the survey, which includes over 30 questions. Replied paid envelopes will be included with the invitation letter and each survey participant who is interviewed receives a \$75 gift voucher. The survey seeks to identify key factors leading to or triggering default and canvasses certain post-default financial, familial, social and housing accommodation impacts. The results of the survey will assist the researchers in developing typologies of mortgage defaulters and default impacts for comparison with other findings through triangulation.
- In total, approximately 30 in-depth face-to-face interviews will be undertaken in order to: (i) test and further develop the typologies; (ii) document key case studies in depth; and (iii) probe for insights into effective policy interventions to reduce the

risk and negative impacts of mortgage default. Thus, the intensive interviews will seek to clarify and detail trends apparent in an analysis of the completed questionnaires and will be used in triangulating with data collected by government agencies and industry bodies such as APRA, ABS, ASIC, Fujitsu Consulting & JP Morgan, and the RBA. In order to demonstrate some of the key impacts and difficulties being experienced by households in mortgage distress and to inform later stages of the study, ten preliminary interviews were carried out with respondents recruited through a network of financial counsellors in suburban Melbourne.

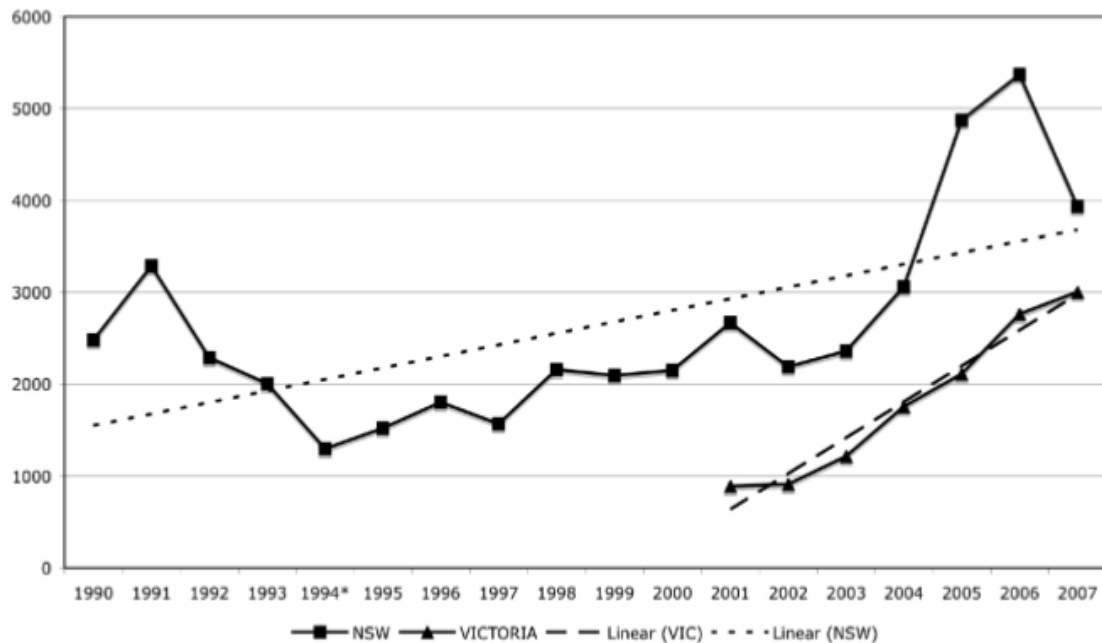
- We have secured an agreement with Martin North (CEO of Fujitsu Consulting) to draw on their primary research data into the incidence and impacts of mortgage default in Australia. This includes drawing on Fujitsu's regular survey of mortgagors, which has involved 26,000 respondents, with a panel of 2000 followed over a three-year period. It provides unique access to data on home sales instigated by mortgage stress and the threat of repossession, and problems associated with 'predation'. We have added questions on illness and depression to two Fujitsu surveys (with approximately 900 respondents) and expect to be involved in two focus groups canvassing issues involving the impacts of default. Martin North will provide several detailed scenarios of the development and sources as well as impacts of financial stress in different kinds of households for real (but anonymous) households as well as postcodes for data on mortgage stress during October 2008 in Melbourne and Sydney, which will be presented spatially in our final report.
- Interviews with key actors in the legal and community sectors include the Consumer Credit Legal Centre (CCLC) in NSW, the Consumer Action Law Centre (CALC) in Victoria, and financial counsellors at Broadmeadows UnitingCare. These interviews will reveal insights, which will be integrated into survey and defaulter interviews, and provide a range of views on the appropriateness of policy directions and other proposals to address mortgage default issues.
- The House of Representatives (2007) Inquiry into Home Lending Practices and the Processes Used to Deal with People in Financial Difficulty, the House of Representatives (2008) Standing Committee on Economics Inquiry into Competition in the Banking and Non-banking Sectors and the Senate Select Committee on Housing Affordability in Australia (2008) have yielded hundreds of written submissions and hundreds of pages of transcripts of testimonies in the associated hearings. This material is of particular use in revealing key issues, debates and proposals for improving the management of risk and policies appropriate to address factors likely to precipitate or exaggerate default and its attendant social damage.

Summary of initial findings

Trends

The number of mortgagors experiencing (re)possession of their homes has risen significantly in NSW and Victoria since the mid-1990s. The annual number in NSW peaked at above 5000 in 2006.

Figure 1: Number of applications for claims of possession (1990/2001–2007)

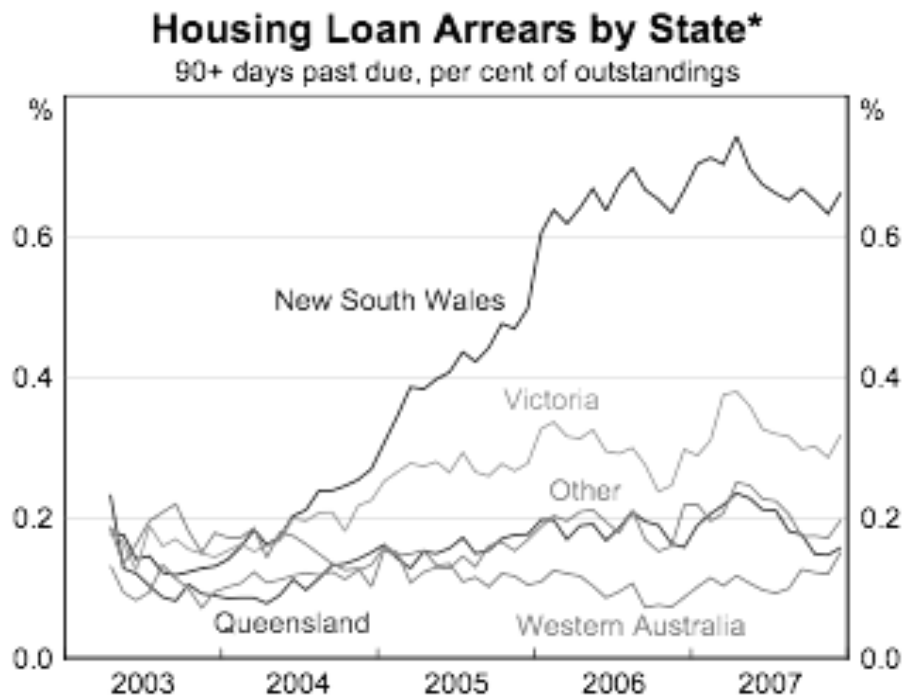


Source: Personal communications with Supreme Court of NSW and Supreme Court of Victoria

Data published by the Reserve Bank of Australia (RBA 2008a) presents a similar picture — i.e. rising mortgage delinquencies from a very small base. In particular, by the end of 2007, seven per cent of ‘non-conforming’ securitised loans were in arrears by 90 days or more, as opposed to around one per cent of prime ‘low doc’ loans and less than 0.5 per cent of ‘full doc’ loans. Wizard–Fujitsu (2007) found that by January 2008, three per cent of loans provided by mortgage originators were 30+ days in arrears (and rising), compared to less than one per cent of loans provided by the large banks (relatively stable over the past four years). Our initial analysis of the plaintiffs in just over 3000 possession cases listed in the Victorian Supreme Court during 2007 shows that almost one in three were brought by just two non-ADIs and more than one in every five was due to a claim application from one of Australia’s ‘big four’ banks. By 2007, low-doc loans accounted for around 10 per cent of all new lending by ADIs, with around half of all ADIs active in low-doc lending (House of Representatives 2007: 4).

The figures below (Figures 2 and 3) illustrate the spatial differences in the incidence of arrears. NSW and Victoria show the highest rates, while within NSW, the region of western Sydney has been particularly adversely impacted.

Figure 2: Comparison of housing loans in arrears, by state



• Prime securitised loans

Source: ABS; Perpetual; RBA

Source: Reproduced from RBA (2008a: 50, Graph 45)

Figure 3: Regional comparison of NSW housing loans in arrears



• Prime securitised loans

••Blacktown, Canterbury-Bankstown, Fairfield-Liverpool, and Central Western Inner Western, Outer South Western and Outer Western Sydney regions.

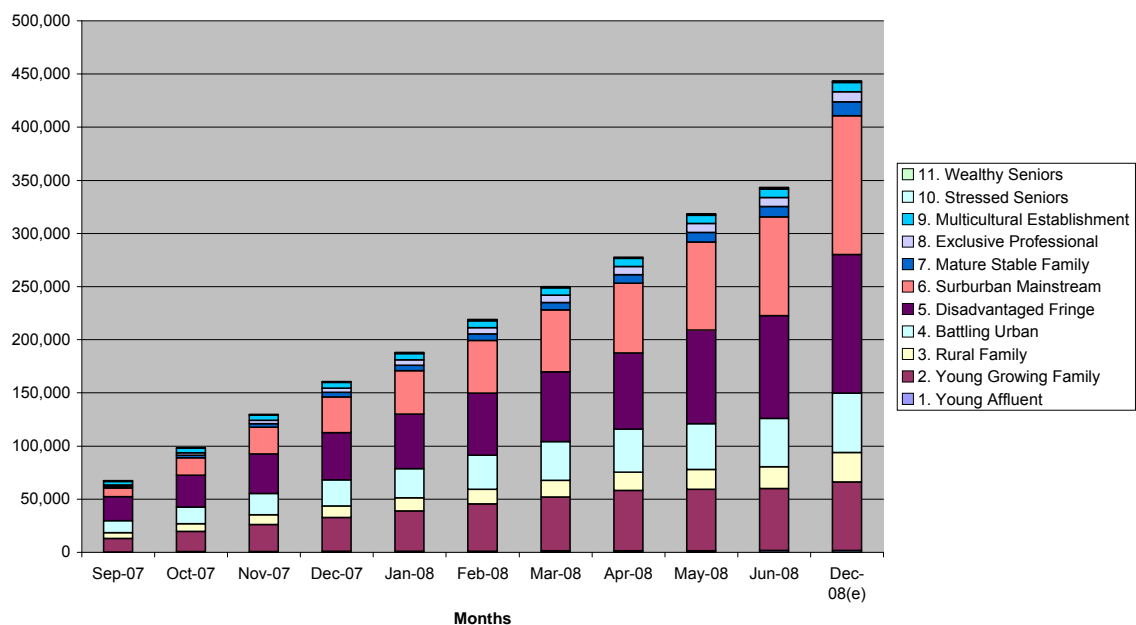
Source: ABS; Perpetual; RBA

Source: Reproduced from RBA (2008a: 51, Graph 46)

The RBA has consistently maintained that increases in home mortgage defaults have come from a very low base and are very unlikely to threaten the financial system. Bank studies carried out earlier in the decade suggested that the sharp rise in household indebtedness from the mid-1990s onwards posed a low risk for the economy as a whole. These studies found that increasing housing debt was taken on by 'financially unconstrained households' — i.e. borrowers who were not experiencing difficulties in meeting mortgage repayments and other financial commitments. Berry (2006a), however, argues that the conclusions of these studies are problematic and open to alternative interpretations. More importantly, developments over the last few years — and, in particular, during 2008 — undermine confidence in the generally benign conclusions of these earlier RBA studies. Keen (2008) also contests the RBA's analysis using their data to support arguments which highlight the risks endemic to any financial system once high levels of lending have occurred, including to unconventional borrowers, during periods of strong growth. Keen stresses the greater risks associated with current levels of household indebtedness — higher than at any other time in Australia's history — in a downturn. Complacency and confidence, he argues, characterise periods of growth while the results of financial risk-taking typically break out rapidly and culminate in a serious downturn. These current and recent developments are discussed in detail in Chapter 4.

Financial institutions such as Citibank (2006), Macquarie Mortgages (2007), Fitch Ratings (2007b; 2008b), and Fujitsu Consulting and JP Morgan (2007; 2008) have surveyed and analysed Australian householders' home-loan borrowing and repayment activities for the last few years. Fujitsu Consulting (2008) draws on a research database of 26,000 Australian households, including a 2000 strong reference group that the firm has trailed for three years. As at 28 June 2008, it estimated that 783,000 households were experiencing some degree of financial stress associated with mortgage repayments, categorising 318,000 of them as in 'severe stress' (quoted in Weekes 2008). Fujitsu has formulated a 'Stress-O-Meter' that categorises mortgagors into stereotypical more-or-less self-explanatory cohorts, to identify the most stressed.

Figure 4: Mortgagor Stress-O-Meter: severely stressed, by segment



Source: Personal communication with Fujitsu Consulting, 16 July 2008

The figure above indicates those segments suffering most stress over a time series that includes forward estimates through to the end of 2008. Currently, young growing families, those on the disadvantaged fringe, and suburban mainstream households are the most affected segments.¹

Trends highlighted by other sources include consistent reports from financial counsellors that their services are being requested at levels far beyond their capacity to supply, that the kinds of clients they are seeing are broader in income and class background than in previous decades, and that certain lenders are making it particularly difficult for borrowers of good faith to renegotiate the terms of their loans. In the roundtable called for the House of Representatives 2007 inquiry (Official Committee Hansard 2007: 11) Karen Cox, coordinator of the CCLC (NSW) reported that:

Not only in the last six years has the demand on our service gone through the roof but we were facing a situation last year where we were taking a third of the calls that were coming through; we just could not keep up with the number of people trying to contact us. Home loans as a problem have actually increased significantly. When I was first there a call about a home loan was relatively rare. It was credit cards, motor vehicle loans and personal loans, and home loans were down here. Home loans are now second. They are not a lot ahead of personal loans and motor vehicle loans, but there has been a significant increase in a very short time. Of those people who call us, around about 48 per cent are from non-ADI lenders.

Non-ADI lenders are more frequently responsible for refinancing struggling borrowers. For some years legal and financial advisers have reported serial refinancing on poor, even extortionate, terms. Clearly, levels of refinancing can indicate how many stressed borrowers are trying to alleviate intolerable debt repayments. The Australian Finance Group, which claims to be the largest wholesaler of mortgages in Australia (<http://www.afgonline.com.au/>), has reported that by February 2008 around two of every five mortgages were for refinancing existing loans, 'an all-time high' (Your Mortgage 2008: 16). These statistics are supported by estimates made by Fujitsu Consulting and JP Morgan (2008: 14) that owner-occupier refinancing has risen to account for over three in ten home loans by early 2008 whereas in 2000 refinancing accounted for less than one in five loans. Indeed ASIC (2008a: 2) has based some research on suggestions by Fujitsu Consulting and JP Morgan that 'the average Australian mortgage is terminated or refinanced within approximately three years'.

Drivers

Default generally results from a complex interplay of personal, economic and social circumstances. According to the literature, four clusters of characteristics and explanations or 'drivers' typify scenarios of mortgage default in Australia today:

- an inability to service the mortgage more or less from the time it is contracted
- an income-related shock from which the borrower does not recover a capacity to fully service the home loan
- increasing interest rates and higher house prices

¹ The formula used for the Fujitsu Consulting (2008) Stress-O-Meter is calculated by:

(Propensity to default x number of defaults) + (forced sales) + (average arrears months x affordability x reprioritised spending).

- falling house prices and sales volumes and rising rents, meaning that it is hard to avoid default by selling the home, repaying the debt, and moving into the private rental market.

Currently another characteristic is that the incidence of default is not only rising but also likely to be more severe in its consequences for defaulters — if not for the broader financial system — than when borrowing criteria were more conservative, LVR ratios were lower, and work environments were more stable and secure.

We conducted an initial review of 23 files for claims of possession lodged in the Victorian Supreme Court in 2007 in order to illustrate some of the factors noted above. In nine of those cases the default had occurred within one year of contracting the loan. In one of those nine cases no payments had been made at all and in another only one payment had been made. Only four of the cases had had their mortgage for more than a year and a half. Around a third of these loans were low-doc, had higher than average interest rates charged even before default interest rates were applied, or were 'interest-only' loans (i.e. in the initial instance, for 5–15 years, mortgagors are obliged to pay interest only, no amortisation). According to RBA–APRA (2007: 5), interest-only loans accounted for around 10 per cent of all housing loans in 2003 but, by 2005, had risen to 30 per cent of all new housing loans, around half of those were extended to owner occupiers (the rest to investors).

In May 2008, we also conducted interviews with 10 mortgagors who had encountered severe difficulties in repayments, defaulted, and some had subsequently lost their home. The main purpose of these in-depth, qualitative, semi-structured and confidential interviews was to inform the content of the survey to be distributed to 4000 defendants of applications for claims of possession lodged in the supreme courts of NSW and Victoria in late 2008 (see Method section above). The participants were recruited through a network of financial counsellors, mainly from suburban Melbourne and interviewed face-to-face by both a male and a female interviewer; two were from regional (rural) areas and were conducted by one interviewer over the telephone. Interpreters were used in two cases.

Consistent with findings from secondary sources, two types of events or processes stood out as causes of mortgage payment difficulties here: firstly, changes to, or loss of, paid employment; secondly, and closely connected, were other life events, such as illness (including depression), disability and discrimination in the workplace. Exogenous shocks to the finely balanced financial arrangements of low-income households meant that they had extreme difficulty with, or could not meet, their mortgage payments.

Impacts

The most serious adverse effects on the lives of home purchasers tend to arise when they fall behind on their mortgage payments. Each state and territory has its own processes for dealing with legal possession of houses where borrowers are in mortgage default. However, there are certain commonalities: in order to apply for a legal claim to possession, lenders are obliged to have notified the borrower that they are in default so they have a chance to make amends; the borrower must be notified once a claim for possession is made by the lender and given a month to respond, otherwise the lender can ask for a default judgment in their favour; any tenants in the contested property must be notified that they will be obliged to vacate the property within a few weeks; in the case of a default judgment (the normal course of events) or a successful hearing against the defendant (the defaulter), the sheriff will be instructed to oversee an eviction.

Under the Uniform Consumer Credit Code (UCCC), most mortgagors have a right to ask a lender to relax repayment obligations for a short period of time due to an unexpected circumstance (such as illness or unemployment) and to appeal in court if this request is rejected. However, often this is costly. In the roundtable called by the 2007 House of Representatives inquiry, Raj Venga (Credit Ombudsman's Service) pointed out that even these external dispute resolution (EDR) organisations do not necessarily have the resources to go to court and under current legislation UCCC non-members cannot be brought to task (Official Committee Hansard 2007: 49).

In short, the borrower at risk of dispossession generally relies on the lender's cooperation to resolve the impasse. Once a claim to possession is successful, stays can be requested to allow for a timely exit of the property, but delays are usually granted for only a few days. Access to superannuation funds can be applied for to remedy the situation, but the lender might well proceed and a home might be repossessed before a defendant has the chance to exhaust possibilities for addressing their plight. During 2006, APRA allowed 13,871 early access to super funds, totaling \$135 million for reasons including avoiding foreclosure on their homes, a higher number than in 2005 when 10,459 accessed \$77 million this way (Khadem 2007).

At any point in this process of seeking possession — due to the failure of the borrower to keep to the terms and conditions of a loan contract for which the home is offered as security — the lender and borrower might agree to settle the matter another way. Typically, the borrower will seek to refinance the loan with the lender or (more likely) with another lender, or the borrower will sell, or promise to arrange to sell, the property. Each jurisdiction has distinct procedures but most allow for a year or so for any suspended claim to be reactivated.

Several important points need to be made about these default procedures in Australia. Firstly, under Australian law, the home is security for a loan under 'all-monies' contracts, so the negligent borrower cannot simply hand back the house keys to get rid of their debt as pertains in many states of the United States (US) today. This is especially relevant where the value of a house has fallen below the cost of repaying the loan. In Australia the borrower wears this risk. Secondly, the number of defaults is not a sufficient indicator of the performance of borrowers in managing their loans or of their capacity to pay. There is a high incidence of forced sales, mainly due to their joint advantages for mortgagee as well as mortgagor, and of 'serial refinancing' that often involves equity stripping. Thirdly, sometimes homes are repossessed as security for a business loan or as part of a bankruptcy procedure. Not all claims for possession involve homes — some are investment or commercial properties. Fourthly, many defaulters have neither the financial nor emotional resources to seek timely legal assistance and useful financial advice.

The impacts of mortgage default on a household are economic, social and emotional. The Wesley Mission (2006; 2007: 3) argues that the impacts of broader financial stress in Australian households — impacts such as relationship breakdown, conflicts, alcohol and drug abuse, domestic violence and gambling — imply annual costs of over \$70 billion in terms of health, community and policing services. Default threatens an impoverishing process incurring all kinds of costs to settle the troublesome debt and might involve bankruptcy or carrying debts forward. Finding new accommodation involves more costs, takes up valuable time and means upheaval for the whole household. Tenants in investment properties face the same situation. In both Victoria and NSW, tenants are prejudiced against and face a serious predicament if the house they are renting is subject to legal action (Tenants' Union of NSW 2007).

As already mentioned, default is more prevalent in certain regions than in others. The table below shows the level of arrears in the worst-performing ten postcodes across Australia; in every one, more than one monthly repayment has been missed in one in every 20 mortgages. These ten postcodes are located in five regions, three of them more or less adjacent. Also the percentage of those in arrears in these areas increased in every case over the first quarter of 2008.

Table 1: Fitch Ratings 'Top 10 worst performing post codes'*

<i>Rank</i>	<i>Suburb state and postcode region</i>	<i>Loans 30+ days in arrears (%) * 31 March 2008</i>	<i>Loans 30+ days in arrears (%) * 30 September 2007</i>
1	Wetherill Park NSW 2164	6.7	4.9
	Fairfield–Liverpool	4.05	3.21
2	Helensvale Qld 4212	6.4	4.4
	Gold Coast West	2.24	1.49
3	St Mary's NSW 2760	6.3	4.3
	Outer Western Sydney	3.49	2.67
4	Kurrajong NSW 2758	6.1	4.0
	Fairfield–Liverpool	4.05	3.21
5	Guildford NSW 2162	6.0	5.7
	Fairfield–Liverpool	4.05	3.21
6	Punchbowl NSW 2196	5.3	4.6
	Canterbury–Bankstown	3.24	2.60
7	Lake Illawarra NSW 2528	5.2	2.7
	Wollongong	3.5	2.25
8	Greenacre NSW 2190	5.2	4.6
	Canterbury–Bankstown	3.24	2.60
9	Rooty Hill NSW 2766	5.1	2.2
	Outer Western Sydney	3.49	2.67
10	Fairfield NSW 2165	5.0	4.0
	Fairfield–Liverpool	4.05	3.21

* Based on figures relating to the value of loans and a sample of around one million securitised residential mortgages with the proportion based on both totals and disaggregates by postcode

Source: Drawn from figures in Fitch Ratings (2008a: 5, 6)

Moreover, house prices drop further precisely in those high default areas if forced sales are prevalent and where there is the greatest need to realise quickly the value of their housing assets. Depressed house prices in certain areas become a serious social and community-based concern impacting on grossly more mortgagors than those who go into default. At the same time, depressed home prices make all households in those regions more vulnerable to default because they are less likely to make a satisfactory voluntary sale at a reasonable price.

The most recent Fitch report of September 2008 (Fitch Ratings 2008b) charts an increasing upward trend in mortgage delinquencies, measured by the percentage of outstanding mortgages in arrears by more than 30 days. The report's main conclusions were as follows:

March and September 2008. This is still low by international standards but does show a continued upward trend that has resulted in the rate increasing by 50 per cent over the ten months to September. The 90+ arrears rate rose from 0.73 per cent to 0.97 per cent over the same period.

The arrears rates continued to be highest in NSW (2.59%) and lowest in Western Australia; nine of the ten worst-performing postcodes, and 19 of the worst 20, are in NSW. However, rates generally increased throughout Australia.

The worst-performing regions continued to be in southern and south-western Sydney, where rates were three times as high as on Sydney's Lower North Shore. However, delinquencies in the former high-risk region seem to have stabilised somewhat. Regions outside Sydney, to the north (Newcastle) and south (Wollongong) now figure in the worst-performing ten postcodes.

The international context

Increasing mortgage stress and rising defaults is not an isolated Australian outcome. Indeed, to date, these problems have been less severe in Australia than elsewhere in the developed world, particularly the United States, where the 'subprime mortgage crisis' has sparked global unrest and contraction in financial markets.

In a July 2007 special report — 'House Prices and Household Debt: Where are the Risks?' — Fitch Ratings (2007a) evaluated 16 advanced economies with respect to the degree of overvaluation in national housing markets and over-indebtedness in the household sector. Australia appears in the first three countries with respect to adverse household balance sheet exposure (overindebtedness), tenth in terms of house price overvaluation and sixth in the overall risk ranking. Interestingly, in light of subsequent developments, the US ranked down the list at around tenth, although the report points out that data limitations had probably underestimated overall debt-servicing ratios in the US.

The Fitch report summarised the situation in mid-2007 as follows:

While a number of long-term fundamental factors have driven up real house prices and household indebtedness over the last decade or so — including declining real interest rates, credit market deregulation and macroeconomic stability — there is also evidence of house price overvaluation in many countries. The rise in household debt (and, in some countries, debt service) and shifts in the composition of assets towards illiquid housing have left households more exposed to shocks to income, house prices and interest rates. (Fitch Ratings 2007a: 1)

Later in 2007, the US subprime mortgage crisis erupted, eventually leading to the demise of one of the world's largest investment banks, Bear Sterns. The general 'credit crunch' that sparked a sharp drop in liquidity in global financial markets through 2008 — that, in turn threatened to throw the major economies into recession — was triggered by the continuing rise in mortgage defaults by 'subprime' borrowers in the US housing market. During the preceding years of housing boom, borrowers took up millions of mortgage loans that would not normally qualify for such loans, due to poor credit histories, low incomes and inadequate asset backing. These traditional credit-rating criteria were largely relaxed as new mortgage products and intermediaries emerged in a climate of house price inflation and buoyant expectations as to future housing prices (Shiller 2008). Subprime loans were originated by a plethora of mortgage brokers and non-bank institutions, 'bundled up' through the process of securitisation and on-sold as mortgage-backed securities to investors like pension and

mutual funds and to special investment vehicles, many of them established by the commercial banks themselves. Many of the investment vehicles financed their purchase of the bonds by issuing short-term commercial paper. Specialist 'monoline' bond insurers insured the bonds against default on the basis of credit ratings issued by the established ratings agencies. This removed the original loans and their direct risk from bank balance sheets and was intended to allocate risk to those able to manage it most efficiently.

The system seemed to be working well when housing prices and the US economy remained strong. Unfortunately, it quickly unravelled once the housing market went into decline, as it did in early 2008. It was not possible to see where the risks were held nor whether they had, in fact, been properly priced. In fact, the suspicion gathered to the point of certainty that the risk on subprime loans had been badly underpriced. Securitisation separated information about borrowers held by the loan originators from those exposed to the risk of actual default — i.e. investors in mortgage-backed securities and commercial paper. The banks relied on the originators to vet borrowers, but the originators, having taken their commissions, passed on responsibility for continuing mortgage repayments to investors who were unaware of the real repayment capacities over time of the collection of borrowers standing behind the bonds. The banks had also passed on responsibility to their own off-balance sheet and other investment vehicles, having taken their commissions.

Perverse incentives had become entrenched all along the line. The primary motive of originators was to write new loans by offering a range of instruments designed to attract non-traditional borrowers who aspired to home ownership. Low interest 'honeymoon' rates with 'reset' clauses enticed low-income borrowers to take on large loans that became unsustainable once the higher interest rates took effect or when borrower incomes fell/ceased or both. Banks had little incentive to check credit worthiness since the risk was quickly passed onto investors and, in any event, the securities were insured. However, it eventually emerged that many of the products like 'collateralised debt obligations' had been structured in such a way as to bundle in securities of vastly different investment grades but in a manner that met the triple-A standards of the ratings agencies using their established ratings methods.

In the latter half of 2007, ratings agencies began downgrading mortgage-backed securities and bond insurers in anticipation of escalating defaults through 2008 when the bulk of the interest rate 'reset' arrangements take effect. Finally, because of the particular features of US mortgage lending, borrowers who get into financial difficulties have a limited incentive to continue meeting their repayments. In most states, mortgage loans are only secured against the value of the mortgaged dwelling. As noted above, unlike the case in Australia, where an 'all monies' regime rules and mortgage lenders can seek repayment of the housing loan from the borrowers' total assets, US lenders cannot recover any shortfall in the mortgage debt after the house has been repossessed and sold. Once repayments become unsustainable or falling house prices signal negative equity in the dwelling, purchasers have an economic incentive to default — i.e. to trigger the default option implicit in their mortgage contract.

Once financial market perceptions factor in the likelihood of escalating mortgage defaults, a self-fulfilling chain effect is unleashed. Liquidity dries up. No one is sure who holds mortgage-backed securities likely to go into default. The cunningly crafted financial instruments turn out to be non-transparent 'black boxes'. These markets close down. Investors holding these assets can't sell but often have to refinance the short-term loans taken out to buy them. They are caught holding short-term liabilities and long-term assets — like banks but without the capital adequacy backing and

regulatory support that banks enjoy. Investors who can't refinance are wound up, heightening perceptions of crisis and intensifying liquidity constraints. Banks that have self-insured their investment vehicles have to re-price risk, write down the value of the loans and take them back onto their balance sheets, reducing their capacity to lend for other purposes. Major US banks, like Merrill Lynch and Citibank group, have each written off dollar losses in excess of \$US5 billion. Swiss bank UBS had announced mortgage-related losses of more than \$US13 billion by the end of 2007. At the same time, inter-bank lending dries up as banks are unclear as to which counterparties are carrying the greatest burden of restructuring debt in this way. Liquidity constraints and financial restructuring is then expressed in a general credit tightening with sharply rising interest rates and reduced lending, which can significantly reduce real investment and aggregate demand in the macro-economy, precisely when that consumer and investor confidence has fallen. As housing and equity prices fall, negative wealth effects reduce aggregate consumption, reinforcing the forces leading to a general recession.

Although this process started in the US, the impacts have been global. European and Australian banks and non-bank intermediaries have participated strongly in the US mortgage-backed securities market. In the United Kingdom (UK), the Bank of England and Treasury have had to bail out the Northern Rock bank (Britain's fifth largest mortgage lender) at a potential cost of tens, possibly hundreds, of billions of pounds, in order to forestall the country's first 'bank run' in more than a century.

The global nature of the crisis was explicitly acknowledged in December 2007 when the central banks of the US, UK, European Union, Canada and Switzerland collectively injected £50 billion to help restore liquidity to financial markets.

The developments in the first half of 2008 turned out to be merely the first act in an as yet uncompleted performance. September 2008 witnessed a literally unprecedented unfolding of a linked series of financial crises and responses. The US Government was forced to bail out the two large government-sponsored enterprises — Fannie Mae and Freddie Mac — together holding about 40 per cent of the outstanding mortgage backed securities in the country. The major investment bank, Lehman Brothers, went bankrupt. Another giant investment bank, Merrill Lynch, was saved from the same fate by being taken over by the Bank of America, with an explicit guarantee by the Federal Reserve. The largest insurance company in the world, AIG, was also saved from bankruptcy by securing a \$US40 billion loan from the same source, the only time the Federal Reserve has lent to a non-bank institution.

In short, by mid-September 2008, the world faced the prospect of what commentators variously called 'a category four financial crisis', 'a financial meltdown' and 'the great panic of 2008'. The resulting severe credit crunch would with certainty lead to a severe recession if not worse in the real economies of the major countries. On 19 September the US Government finally announced that it intended to step in and organise a 'comprehensive attack' on the problem at its source — by buying up the (mainly real estate related) bad assets of financial institutions and allowing those institutions to re-build their balance sheets. The vehicle for this intervention is to be similar to the Resolution Trust Corporation set up in 1989 to deal with the fallout from the savings-and-loans crisis (the mass failure of the US building society sector). After a failed attempt, the US Congress passed legislation — TARP, the 'Troubled Assets Relief Program' — appropriating \$700 billion to fund this buyout, in addition to the \$300 billion already committed to saving the GSEs and helping mortgagors. It is not clear whether this amount will be sufficient for the purpose at hand.

If September was bad, October and November were even worse. During these months the main stock markets, including Australia's, lost around 30 per cent of their

total value, so that by early December 2008 the total value of equities had fallen by over 50 per cent on the preceding year. Housing prices were down by 15–20 per cent in the UK and the US. By December, 13 banks had failed in the US. Major banks have been effectively nationalised, in full or in part, in Germany, Belgium, the UK and Iceland. Bank deposits had been guaranteed by governments in most OECD countries, including Australia. The two remaining big investment banks, Morgan Stanley and Goldman Sachs, turned themselves into deposit-taking institutions in order to benefit from federal government guarantees. The British, German and French governments provided emergency funding to encourage banks to lend to each other and other borrowers. The central banks continued to aggressively cut interest rates.

It became clear by the final quarter of 2008 that the 15-country Eurozone, the United States and Japan were already in recession. The Australian economy officially grew by a mere 0.1 per cent in the September quarter. National governments are aggressively using fiscal policy to stave off further decline in the real economy. The incoming Obama administration is promising to implement a \$US500–700 billion fiscal stimulation package in an attempt to create 2.5 million new jobs. The possibility that continued buoyant growth of China and India would cushion the adverse macro-economic effects on Australia appears low. Both of these large emerging economies are faltering, along with other Asian economies, increasing the likelihood of a global economic recession in 2009. Consequently, the Australian Government has also begun to implement expansionary fiscal policy. What began as a housing, and especially mortgage market, crisis in the US has thus ramified into an economic problem of global proportions.

Policy issues and directions

The current problematic developments in mortgage finance and its flow-on effects have stimulated considerable debate on appropriate policy responses to the increasing complexities of mortgage lending, and more diverse kinds of lending, in order to relieve stress for vulnerable households and to reduce the risks of serious failure within financial markets and the real economy. With respect to mortgage lending in Australia, a number of policy interventions have been proposed through the House of Representatives (2007: xv–xvi) inquiry, which made three main recommendations, namely that:

1. The Australian Bureau of Statistics (ABS) collect data on mortgage-driven repossessions, indicating the kinds of loans and lenders involved, the location of the dwellings and the 'primary cause' of default. It was not clear from the inquiry's report as to how the 'primary' cause was to be identified, an important omission in relation to mortgage stress, where in many cases multiple factors are likely to be implicated.
2. The Australian Government regulates all housing credit products and advice, including the activities of mortgage brokers and non-bank lenders. This raises challenges in the case of non-incorporated non-bank lenders who currently fall outside the corporations powers of the Constitution.
3. Existing external disputes resolution schemes revise upwards their current jurisdictional financial limits in the wake of the recent housing boom, since many loans are secured by residential property, and, in particular, the Banking and Financial Services Ombudsman increase its loan limit from \$280,000 to \$500,000, annually indexed.

Following the change of government at the October 2007 federal election, the Treasury prepared a Green Paper, Financial Services and Credit Reform (Australian

Government, The Treasury 2008), which advocated federal control of credit, most of all home mortgages, mainly in order to overcome several deficiencies of the current system that had already been identified in the 2007 House of Representatives inquiry. The Green Paper advanced a national agenda to: address any gaps in consumer credit regulation; provide for licensing of credit providers, with the relevant conduct requirements in place; require coverage by dispute resolution schemes for consumers; and bring consistent regulation across the country (Australian Government, The Treasury 2008: 9).

It also indicated plans to bring mortgages under uniform legislation subjecting mortgage brokers, non-ADI and ADI lenders to nationally consistent licensing, conduct and advice. Such proposals have been well received and are almost a foregone conclusion.

The House of Representatives inquiry made the following points:

- mortgage brokers have a vested interest in selling loans and, therefore, encouraging quantitatively more borrowing as well as refinancing
- brokers generally have no (or little) responsibility for the borrowers' repayment performance and so have little incentive to assess debt-serving capacity
- brokers are not necessarily well qualified
- brokers have grown in number to account for processing three out of every four loans (House of Representatives 2007: 36pp; Mendelson 2007: 2).

The first two points suggest the risk of significant moral hazard in the mortgage broking industry, evident in the emergence of the subprime crisis as it unfolded, especially in the US (see Chapter 4). Draft legislation regulating the mortgage broking industry is in train. The proposed reforms cover regulation of brokers in terms of qualifications, responsibilities to borrowers and lenders — especially with respect to proving debt servicing capacity (evidence of income etc.), transparency of activities and reasonable fee structures. However, such legislation will not be enacted until 2009 or 2010.

The following table summarises proposals for policy measures considered worthy of serious attention and evaluation by government. Most have evolved in public debates and documents, but some result from the analysis in this paper. Policy measures can be broadly divided into two categories: preventative and relief or restorative. The former seek to reduce the risk of mortgage defaults, the latter address means to deal with the problems caused by defaults. These measures are listed as possible directions. No particular interventions are advocated at this stage of the research. A number of the measures summarised in the table are discussed in detail in Chapter 5 and by Shiller (2008) in his book, *The Subprime Solution*.

Table 2: Proposals to minimise and ameliorate mortgage default

<i>STRUCTURAL ACTORS/PROCESSES — TOPICS TO ADDRESS</i>	<i>PREVENTATIVE MEASURES</i>	<i>RELIEF MEASURES (RESTORATIVE)</i>
<p><i>Lenders' practices</i></p> <p>Establishing a balance between conservative and irresponsible lending.</p> <p>Models, indicators and/or formulae for defining and assessing hardship and debt-servicing capacity of</p>	<p>Regulate mortgage brokers.</p> <p>Stricter criteria for lending based on debt-servicing capacity, not asset value, restricting the size of loans (LVR), and aspects of eligibility relating to income.</p>	<p>Expand and enhance APRA-approved external dispute resolution (EDR) services as well as the powers of EDRs to discipline lenders.</p> <p>Ensure repossession cannot occur while independent</p>

<p>mortgagors that are commonly accepted by the financial industry, government regulating agencies, in legal forums and by financial advisers.</p> <p>Embedding clear and widely accepted practices of response to hardship (variations) due to both individual circumstance and wider economic impacts.</p> <p>Planned response by government to economic downturn, diminishing credit and increasing vulnerability of specific households to falling house prices, reduced income or higher interest rates.</p>	<p>Make lenders, and their agents/brokers, more responsible for confirming debt-servicing capacity of borrowers — eradicating no-doc and minimising or redefining low-doc loans.</p> <p>Require open, plain English, and detailed information on all loan products and services — perhaps through ASIC and the Understanding Money website.</p> <p>Improve reporting as well as regulation of non-ADIs and provide borrowers with lists of regulated borrowers, all demanded to be members of APRA-approved external dispute resolution organisations.</p>	<p>appeals (EDR) over rejected hardship claims or other matters of serious and legitimate dispute are in process.</p> <p>Enhance government reporting and advisory powers of the Banking and Financial Services Ombudsman and other EDRs or establish a specific home mortgage ombudsman with special powers.</p> <p>Regulatory agencies, such as OFT and APRA, continue reviewing products and services as well as market demand and awareness.</p> <p>Monitor national, state-by-state and regional developments in terms of default and house prices for timely introduction of government relief to householders.</p>
<p><i>Borrowers' behaviour</i></p> <p>How to best inform borrowers more and more effectively about responsible borrowing and options to minimise the risk of default, repossession of a home and high financial losses due to problems with repayments.</p> <p>Improving borrowers' skills and knowledge about the dangers of certain lending practices and products.</p> <p>Improving borrowers' knowledge of and enhancing the support and relief systems available to those in financial distress.</p>	<p>Improve secondary and tertiary education on financial management of home mortgages.</p> <p>Free, easily accessible and independent financial advice when a home loan is applied for.</p> <p>Publicise responsibilities of a mortgage and default more — e.g. build a narrative around a great Australian nightmare.</p>	<p>Free, easily accessible, and independent financial advice if in arrears.</p> <p>Revise and expand eligibility for mortgage relief assistance — providing uniform national coverage, redefining hardship and taking into account temporary emergency measures during downturns.</p> <p>Identify and publicise through the popular media those lenders taking most court actions, borrower types, and loan kinds most prone to default.</p> <p>Improve public credit reporting.</p>
<p><i>Housing context</i></p> <p>Ensuring households have a range of options for accommodation that are affordable and accessible where they need to work.</p> <p>Private and public tenants' rights to secure long term housing at a manageable cost.</p> <p>Access to temporary housing</p>	<p>Improve terms, conditions and supply of housing accommodation options that compete with owner-occupation, e.g. enhance public and private tenants' rights, expand social housing, etc.</p>	<p>Implement guidelines and rights to temporary housing assistance for defaulters.</p> <p>Enhance tenants' rights when the house they are leasing is subject to a claim of possession and later when it is repossessed. Appropriate reforms include sufficient</p>

for evicted households and tenants of leased properties where the mortgagee is threatening to take, or has taken, possession.	notice to vacate, the claim of possession providing sufficient reason to break a lease, and compensation for costs associated with moving.
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1 INTRODUCTION

1.1 Context

The Australian housing system has undergone major structural change in the past 20 years. Continuing population growth, falling average household size, strong economic growth and rising average incomes have underpinned buoyant demand for housing focused on metropolitan areas, smaller provincial cities, natural resource centres and tourist regions. Increasing income and wealth inequalities have changed patterns of access to housing by location, tenure and quality. The growth in two-income households has also impacted negatively on the access and affordability of housing for single lower income households. At the institutional level, deregulation of Australia's financial system, starting in the late 1970s, gathering pace in the 1980s and culminating in the 1990s with the explosive growth of the secondary mortgage market, has resulted in a quantum leap in mortgage debt and helped drive a pronounced housing boom in the period since 1996 (Berry & Dalton 2004; Berry forthcoming).

Two (among many) key consequences have flowed from these developments:

- increasing potential macroeconomic volatility driven by booming housing markets (Berry 2006b)
- increasing mortgage and other debt, raising the risk of escalating mortgage defaults.

This project focuses on these developments — the pattern, cause and impacts of mortgage default in Australia in recent times, the linkages with the overall economy and the implications for policy responses in the immediate to medium-term future.

The aim of this positioning paper is to outline the scope of the research and discuss the key issues and secondary data pertaining to the phenomenon of mortgage default in Australia. The primary data and policy directions presented here are for indicative purposes only. The main data, analysis and conclusions will be presented in detail in the forthcoming final report.

An earlier Australian study by Berry et al. (1999) found that mortgage arrears and defaults rose sharply in both the late 1980s and the late 1990s, albeit from a very low base. The main drivers appeared to be:

- loss of employment and long term unemployment
- small business failure
- personal relationship breakdown
- high indebtedness and financial over-commitment
- sudden loss of income resulting from losing or changing jobs, loss of overtime, one household member withdrawing from the labour market due to illness or pregnancy.

With respect to mortgage arrears, the study found that younger households (age cohorts below 45–54) were most likely to be in arrears. This is the group in which home purchase is likely to be recent and loan-to-value ratios highest. Households with dependent children were also most likely to be in arrears, as were purchasers of newly constructed houses. Interestingly, higher income households with managerial and professional workers were more likely than lower income unskilled and semi-skilled workers to be in arrears. In the case of defaults, the study found the same key

factors to be significant — high indebtedness (i.e. high loan-to-value ratio), age (young), households with dependent children and higher than average incomes.

As Chapter 2 details, mortgage arrears and defaults have again begun to rise over the past few years. The past decade has witnessed a massive growth in housing-related debt, volatile flows of investment into the housing sector and further innovations in lending and other financial markets. It is not clear whether regulators and policy makers have kept pace with market-driven developments in this field.

In May 2007, the House of Representatives directed its Standing Committee on Economics, Finance and Public Administration to establish an inquiry into home lending practices and the treatment of mortgagors (borrowers) under severe financial stress. The committee presented its report in September 2007 (House of Representatives 2007), concluding that over the last decade lenders had relaxed their lending standards in terms of the range of acceptable borrower profiles and the size of loans for home purchase, renovation and extension, and for non-housing-related purposes. The range of mortgage lenders and products had expanded substantially, with increasingly aggressive lending by poorly regulated non-bank entities, i.e. non-ADIs (non-Authorised Deposit-taking Institutions) that are not regulated by the Australian Prudential Regulation Authority (APRA). The role of financial brokers engaged in facilitating mortgage loans, refinancing and debt consolidation has also grown rapidly since the 1990s.

Although the inquiry found no compelling evidence of widespread abuse or irresponsible lending, concern was expressed about the seemingly increasing incidence of predatory activities by fringe lenders and brokers aimed at vulnerable borrowers. Concern was also directed at the inadequate quality and coverage of available data on mortgage loan arrears and defaults.

Increasing mortgage stress and rising defaults is not an isolated Australian outcome. Indeed, to date, these problems have been less severe in Australia than elsewhere in the developed world, particularly the United States (US) where the 'subprime mortgage crisis' has sparked global unrest and contraction in financial markets.

In a July 2007 special report — 'House Prices and Household Debt: Where are the Risks?' — Fitch Ratings (2007a) evaluated 16 advanced economies with respect to the degree of overvaluation in national housing markets and over-indebtedness in the household sector. Australia appears in the first three countries with respect to adverse household balance sheet exposure (over-indebtedness), tenth in terms of house price overvaluation, and sixth in the overall risk ranking. Interestingly, in light of subsequent developments, the US ranks down the list at around tenth, although the report points out that data limitations have probably underestimated overall debt service ratios in the US.

The general 'credit crunch' that sparked a sharp drop in liquidity in global financial markets through 2008 — that, in turn, threatened to throw the major economies into recession — was triggered by the continuing rise in mortgage defaults by 'subprime' borrowers in the US housing market. During the preceding years of housing boom borrowers took up millions of mortgage loans that would not normally qualify for such loans, due to poor credit histories, low incomes and inadequate asset backing. These traditional credit-rationing criteria were largely relaxed as new mortgage products and intermediaries emerged in a climate of current house price inflation and buoyant expectations as to future housing prices. Subprime loans were originated by a plethora of mortgage brokers and non-bank institutions, 'bundled up' through the process of securitisation and on-sold as mortgage-backed securities to investors like pension and mutual funds and to special investment vehicles, many of them

established by the commercial banks themselves. Many of the investment vehicles financed their purchase of the bonds by issuing short-term commercial paper. Specialist 'monoline' bond insurers insured the bonds against default on the basis of credit ratings issued by the established ratings agencies. The system seemed to be working well when housing prices and the US economy remained strong.

Unfortunately, it quickly unraveled once the housing market went into decline. It was not possible to see where the risks were held nor whether they had, in fact, been properly priced. In fact, the suspicion gathered to the point of certainty that the risk on subprime loans had been badly under-priced. Securitisation separated information about borrowers held by the loan originators from those exposed to the risk of actual default — i.e. investors in mortgage-backed securities and commercial paper. The banks relied on the originators to vet borrowers but the originators, having taken their commissions, passed on responsibility for continuing mortgage repayments to investors who were unaware of the real repayment capacities over time of the collection of borrowers standing behind the bonds. The banks had also passed on responsibility to their own off-balance sheet and other investment vehicles, having taken their commissions. Perverse incentives had become entrenched all along the line.

In the latter half of 2007, ratings agencies began downgrading mortgage backed securities and bond insurers in anticipation of escalating defaults through 2008 when the bulk of the interest rate 'reset' arrangements took effect. This process accelerated massively through 2008, with severe impacts on the economies of the developed nations, as discussed in detail in Chapter 4. Although this process started in the US, the impacts have been global.

1.2 Research questions

The Berry et al. (1999) study, noted above, was based on a quantitative analysis of lending institution data and summary data published by the key mortgage insurance firms. Conversely, this project will draw on primary data from:

- Supreme Court files held in NSW and Victoria
- semi-structured interviews with defaulters and experts
- a large survey of defendants to claims of possession of their homes by lenders
- surveys and focus groups conducted by Fujitsu Consulting (Martin North)
- experts' submissions and testimonies to three key government inquiries (2007–2008).

The project will answer the following key questions:

1. What are the key triggers and causes of mortgage default in Australia in 2008?
2. What are the consequences of default for affected households — in terms of financial impacts, future borrowing capacity, physical and psychological health, intra-household relations, and the impacts of mobility?
3. What policy interventions — financial, educational, counselling, reporting, regulation — could reduce the incidence and negative impacts of mortgage defaults?
4. What are the broader risks to the Australian housing system and economy posed by the current global mortgage default climate?

In short, this project seeks to explore the various impacts of mortgage stress on vulnerable households and to place the phenomenon of mortgage default within a

broader social and economic context. This approach is used to suggest relevant and practical ways for policy makers to reduce the incidence and negative consequences emerging from mortgage default.

1.3 Method

The project comprises several overlapping stages:

- A literature review of relevant studies and reports since the Berry et al. (1999) study that identifies trends in mortgage defaults in Australia and other advanced economies and summarises findings of the factors behind the trends.
- An analysis of the macroeconomic context and impacts of rising defaults; i.e. focusing on liquidity constraints in financial markets and the broader risks of economic recession. This analysis will draw on and extend earlier research by Berry (2006, forthcoming), extensive research by the Reserve Bank of Australia (RBA) and recent and continuing debate in the financial media in the context of current developments in US financial markets.
- An analysis of recent Supreme Court records of mortgagor repossessions in NSW and Victoria. The researchers have gained permission from the chief justices in both courts to send letters to approximately 4000 mortgagors who have been subject to Supreme Court claims of possession on their property during 2008, inviting them to respond to a written survey and asking them if they are prepared to participate in an in-depth interview. We expect to generate a sample of approximately 300 survey respondents, making up any shortfall through distributing surveys through financial counsellors and state agencies (who have already agreed to cooperate). Ten interviews and some survey trials, both with defaulters, and comments from experts informed the development of the survey, which includes over 30 questions. Replied paid envelopes will be included with the invitation letter and each survey participant who is interviewed receives a \$75 gift voucher. The survey seeks to identify key factors leading to or triggering default and canvasses certain post-default financial, familial, social and housing accommodation impacts. The results of the survey will assist the researchers in developing typologies of mortgage defaulters and default impacts for comparison with other findings through triangulation.
- In total, approximately 30 in-depth face-to-face interviews will be undertaken in order to: (i) test and further develop the typologies; (ii) document key case studies in depth; and (iii) probe for insights into effective policy interventions to reduce the risk and negative impacts of mortgage default. Thus, the intensive interviews will seek to clarify and detail trends apparent in an analysis of the completed surveys and will be used in triangulating with data collected by government agencies and industry bodies such as APRA, ABS, ASIC, Fujitsu Consulting & JP Morgan, and the RBA. In order to demonstrate some of the key impacts and difficulties being experienced by households in mortgage distress and to inform later stages of the study, 10 preliminary interviews were carried out with respondents recruited through a network of financial counsellors in suburban Melbourne.
- We have secured an agreement with Martin North (CEO of Fujitsu Consulting) to draw on their primary research data into the incidence and impacts of mortgage default in Australia. This includes drawing on Fujitsu's regular survey of mortgagors, which has involved 26,000 respondents, with a panel of 2000 followed over a three-year period. This provides unique access to data on home sales instigated by mortgage stress and the threat of repossession, and problems associated with 'predation'. We have added questions on illness and depression to two Fujitsu surveys (with approximately 900 respondents) and expect to be involved in two focus groups canvassing issues involving the impacts of default.

Martin North will provide several detailed scenarios of the development and sources as well as impacts of financial stress in different kinds of households for real (but anonymous) households as well as postcodes for data on mortgage stress during October 2008 in Melbourne and Sydney, which will be presented spatially in our final report.

- Interviews with key actors in the legal and community sectors include the CCLC, CALC, and financial counsellors at Broadmeadows UnitingCare. These interviews will reveal insights, which will be integrated into survey and defaulter interviews, and provide a range of views on the appropriateness of policy directions and other proposals to address mortgage default issues.
- The House of Representatives (2007) Inquiry into Home Lending Practices and the Processes Used to Deal with People in Financial Difficulty, the House of Representatives (2008) Standing Committee on Economics Inquiry into Competition in the Banking and Non-banking Sectors and the Senate Select Committee on Housing Affordability in Australia (2008) have yielded hundreds of written submissions and hundreds of pages of transcripts of testimonies in the associated hearings. This material is of particular use in revealing key issues, debates and proposals for improving the management of risk and policies appropriate to address factors likely to precipitate or exaggerate default and its attendant social damage.

Table 3 below summarises the data sources and methods used to address each of the four research questions.

Table 3: Addressing the key research questions

<i>Research question</i>	<i>Data sources</i>	<i>Methodology (including data sources)</i>
<p>Research question 1 What are the key triggers and causes of mortgage default in Australia in 2007?</p>	Literature review; court records; key organisation records; household surveys; household interviews; key actor interviews.	Analysis of household survey responses; qualitative analysis of household and key actor interviews; Fujitsu data.
<p>Research question 2 What are the consequences of default for affected households — in terms of financial impacts, future borrowing capacity, physical and psychological health, intra-household relations, and the impacts of mobility?</p>	Literature review; court records; key organisation records; household surveys; household interviews; key actor interviews.	Analysis of survey responses; qualitative analysis of household and key actor interviews; Fujitsu data.
<p>Research question 3 What policy interventions — financial, educational, counselling, reporting, regulation — could reduce the incidence and negative impacts of mortgage defaults?</p>	Literature review; key actor interviews.	Analysis of secondary literature; analysis of key actor interviews.
<p>Research question 4 What are the broader risks to the Australian housing system and economy posed by the current global mortgage default climate?</p>	Literature review	Analysis of secondary literature.

1.4 Structure of positioning paper

The remainder of the paper is divided into the following four chapters.

Chapter 2 presents recent data on trends in mortgage arrears and defaults in Australia and examines (in a preliminary way) the range of likely factors responsible for the trends identified (Research question 1).

Chapter 3 summarises the processes by which defaults and possessions are addressed in this country and discusses the impacts on the lives of households experiencing difficulties in meeting their mortgage repayments (Research question 2). The final section of Chapter 3 discusses the results of the ten preliminary interviews carried out, in order to provide an initial 'feel' for the terrain.

Chapter 4 addresses 'the big picture', looking in detail at the unfolding of the subprime mortgage crisis; examining the potential for systemic risk in the global banking system; further exploring the possible negative impacts of financial sector failure on the real economies of the developed countries; and focusing discussion on Australia's prospects in this difficult global climate (Research question 3). This chapter demonstrates the ways in which mortgage market failure ramifies through to the broader economy, raising the real possibility of a global economic recession sparked by financial contagion.

Finally, Chapter 5 concentrates on the implications of these developments and risks for policy, both at the level of relieving stress for vulnerable households and reducing the risks of serious failure within financial markets and the real economy (Research question 4).

It should be stressed that the aim of this positioning paper is to outline the scope of the research and discuss the key issues and secondary data pertaining to the phenomenon of mortgage default in Australia. The primary data and policy directions presented here are indicative only. The main data, analysis and conclusions will be presented in detail in the forthcoming final report.

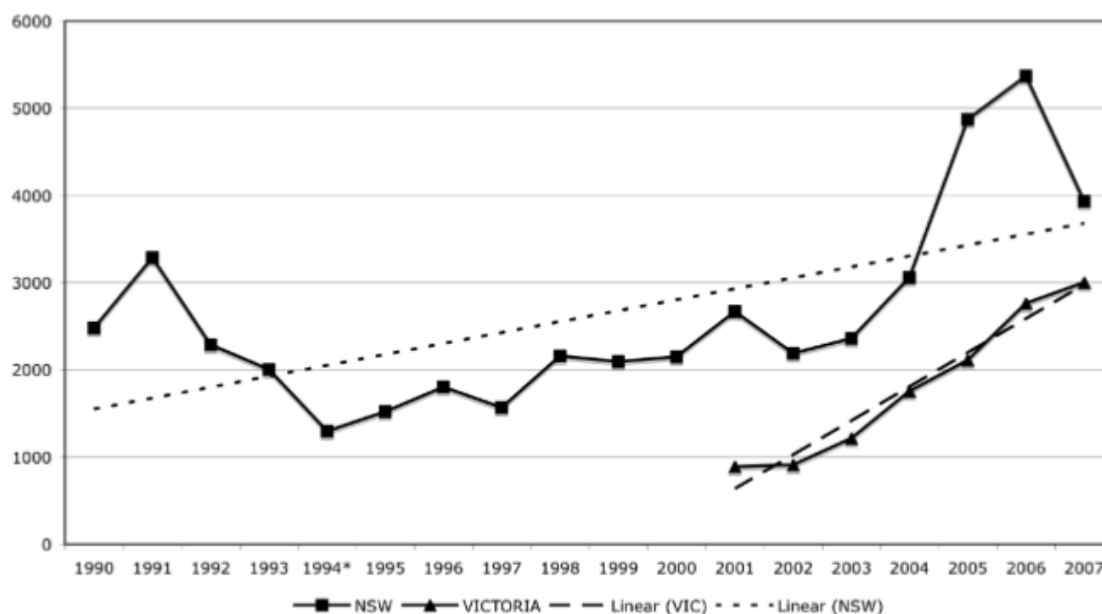
2 TRENDS, TRIGGERS AND CAUSES OF MORTGAGE DEFAULT

This chapter surveys recent trends in home mortgage defaults and identifies drivers for the rising number of defaults. The first section draws heavily on data published by the Reserve Bank of Australia (RBA), supplemented by financial sector intelligence published by key private organisations. The aim is to outline the recent trends in mortgage arrears and defaults, as best we can. Clearly, however, this picture will be incomplete as each data source has its limitations.

2.1 Trends

By 2007, the RBA was reporting that it was closely monitoring indicators that the level of mortgage default was rising, albeit from a small base. The main indicators used by the RBA — the number of applications for claims of possession lodged in the relevant state and territory courts and arrears levels as reported to the Australian Prudential Regulation Authority (APRA) — are of limited use. Data on defaults indicated by the number of writs of possession made by the NSW and Victorian Supreme Courts (see Figure 5) overstates the incidence of evictions, because an unknown number of applications by lenders do not proceed (RBA 2007a: 55; Consumer Law Centre of the ACT & ANU Centre for Commercial Law 2007: 19, 21) and some do not involve homes. Some of these claims are suspended due to refinancing yet are ultimately repossessed, involving equity stripping. At the same time, default figures exclude a much larger number of households who avoid default or repossession by voluntary or forced sales of their home. This data, not all of which could be traced through real estate agents or lenders, is not rigorously collected.

Figure 5: Number of applications for claims of possession (1990/2001–2007)



Source: Personal communications with Supreme Court of NSW and Supreme Court of Victoria

As mentioned in Chapter 1, in reference to recommendations by the House of Representatives (2007) inquiry into home lending, data on defaults and quasi-defaults is poor. The RBA cautions against drawing too many conclusions about the level of impending repossessions from the number of loans 90+ days in arrears. In the case of

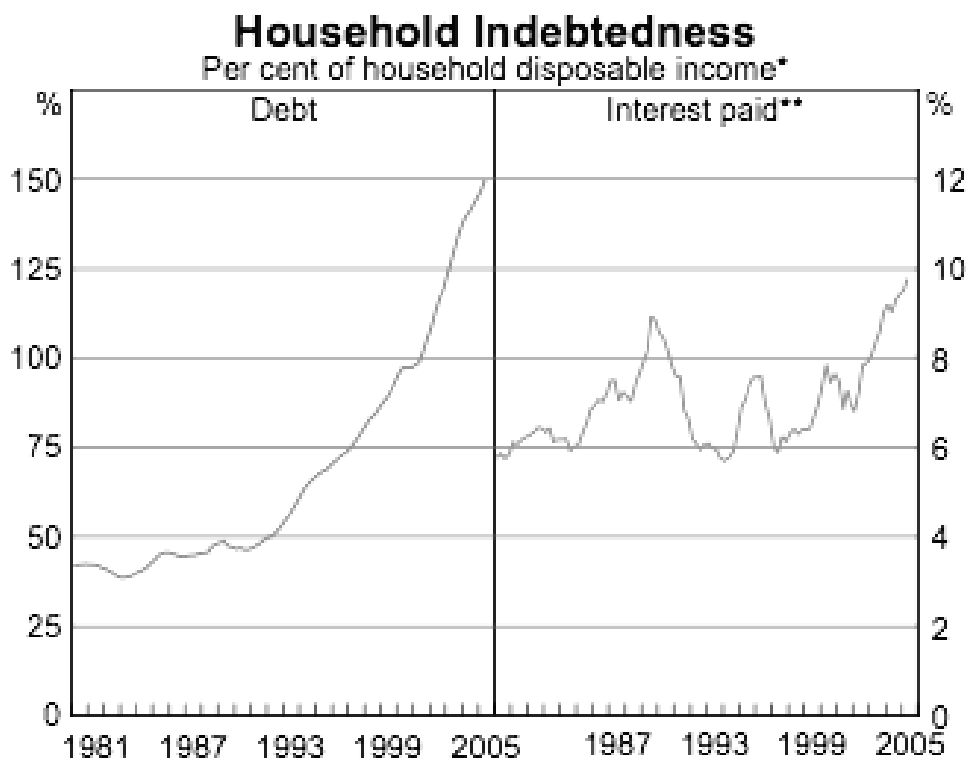
self-employed and small businesses, it is industry wisdom that many are caused by liquidity problems not absolute inability to pay and thus 'self-cure'. These observations, however, have not been tested in a downturn characterised by a high level of business failures. APRA arrears figures neither include all home lenders nor all mortgage products. Taking into account such limitations, the RBA analyses such indicators on defaults over time, between products, and regions in order to determine trends.

2.1.1 Trends according to totals and averages data

By 2008, the RBA was acknowledging that higher interest rates, falling house prices, higher household indebtedness and the economic downturn would result in more defaults and repossessions. Several graphs in the RBA Financial Stability Review for March 2008 show increasing levels of defaults, especially for 'low-doc' and 'no-doc' loans, and in certain geographic areas, such as the western suburbs of Sydney. So-called low-doc loans rely on borrowers' self-certifying stated income and 'no-doc' loans require no income-related documentation at all.

The graph on the left of Figure 6 (debt) shows that the indebtedness of the whole household sector has more than trebled, from less than one-half of annual disposable income in the early 1980s to one and a half by the mid-2000s. Also Figure 6 (right) shows that interest payments have fluctuated but are higher now than at any other time during the same period. Indeed, Figure 7 indicates that owner-occupiers are paying double the proportion of disposable income on interest payments in 2007 compared with 1980.

Figure 6: Household debt levels relative to net income



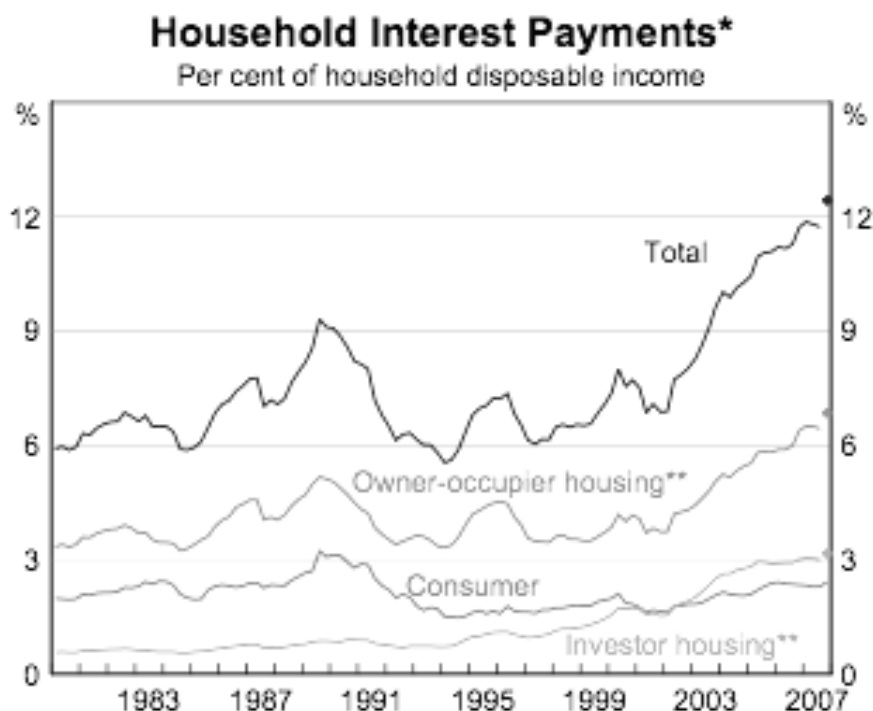
• Household sector excludes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.

••Includes the imputed financial intermediation service charge.

Sources: ABS: RBA

Source: RBA (2005 11: — Graph 14)

Figure 7: Interest payments by households — on mortgages, consumer goods and investment housing



• Includes the imputed financial intermediation service charge; income is after tax and before the deduction of interest payments. Other than for consumer interest payments, December quarter 2007 figures are RBA estimates.

••Based on share of housing credit.

Sources: ABS; RBA

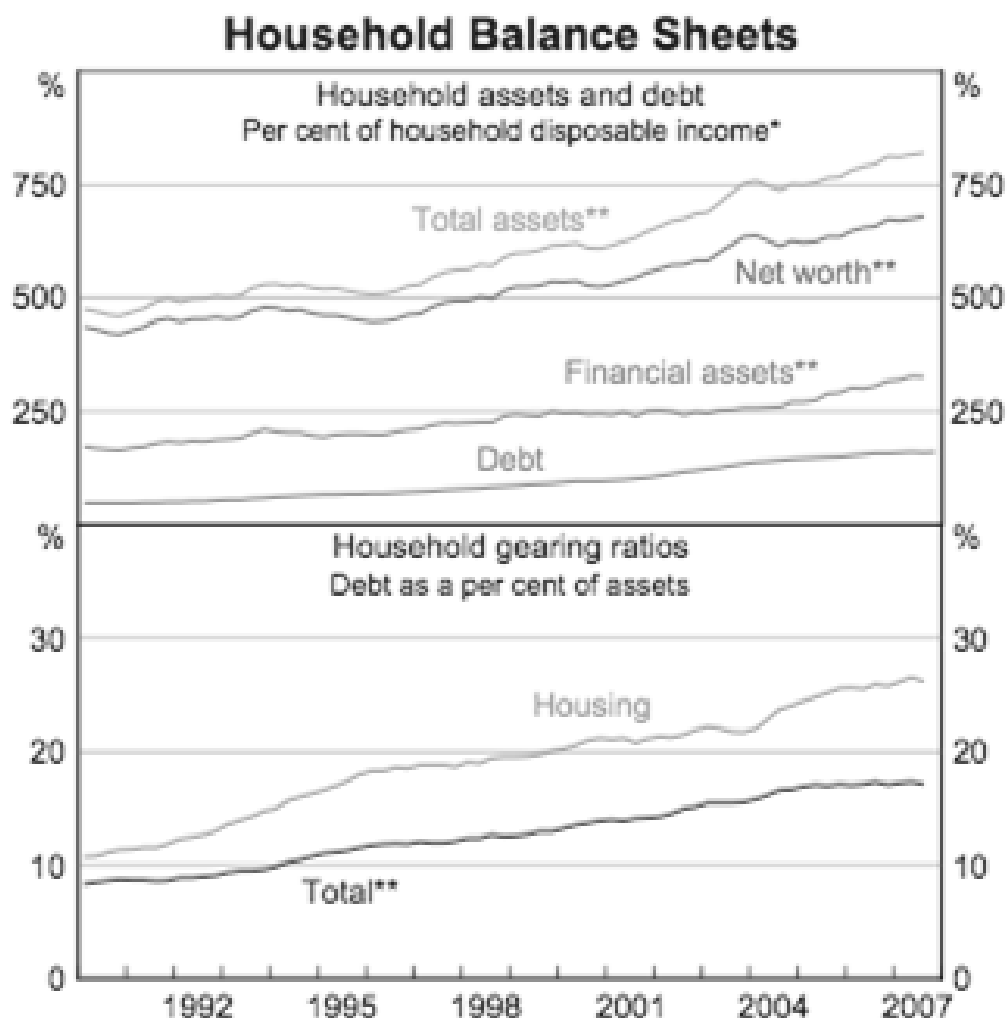
Source: Reproduced from RBA (2008a: 53 — Graph 51)

Figure 8 shows that since 1990 housing indebtedness has risen at a disproportionately higher level than non-housing household debt. This is significant especially given the rising use of credit cards and other consumer credit. Figure 9 shows the average debt servicing ratio (debt repayments: disposable income) rising — while 55 per cent of mortgagors had a debt servicing ratio under 20 per cent in 2002, in 2006 the same proportion of borrowers had a debt servicing ratio of over 10 per cent and less than 30 per cent. Also, while around 20 per cent of mortgagors had a debt servicing ratio of over 30 per cent in 2002, by 2006 that proportion had grown by half again, to around 30 per cent. Volume 7 of Fujitsu Consulting & JP Morgan (2008) reported that loan to value ratios have risen to 36 per cent, meaning that an interest rate rise of 0.25 per cent translates to an increase in the shared burden on all mortgagors of \$A1.75bn — ‘\$A924bn x 76% x 0.25% = \$A1.75bn’.

The RBA refers to increasing household indebtedness in terms of a preparedness of households to take on more debt, stressing that rising mortgage default levels over the last few years are still low compared with overseas and historically. However, averages and totals hide important characteristics related to the kinds of loans and borrowers that account for substantial proportions of defaults. The proportion of ‘prime loans’ in arrears 90+ days is represented in Figure 10. Figure 11 shows that non-conforming loans and, to a lesser extent, low-doc loans, account for most of the loans outstanding. Figure 12 identifies the number of loans by source (kind of lender) indicating that most defaults arise with loans from lenders who use mortgage brokers. Nevertheless, our initial analysis of the plaintiffs in just over 3000 cases listed in the

Victorian Supreme Court during 2007 shows that almost one in three were brought by just two non-ADIs and more than one in every five was due to a claim application from one of Australia's 'big four' banks. Indeed, by 2007, low-doc loans accounted for around 10 per cent of all new lending by ADIs, with around half of all ADIs active in low-doc lending (House of Representatives 2007: 4).

Figure 8: Housing as a proportion of total household debt and debts:asset ratio



• Income is after tax and before the deduction of interest payments; includes income of unincorporated enterprises in all ratios except for household debt to income.

••Includes financial assets of unincorporated enterprises.

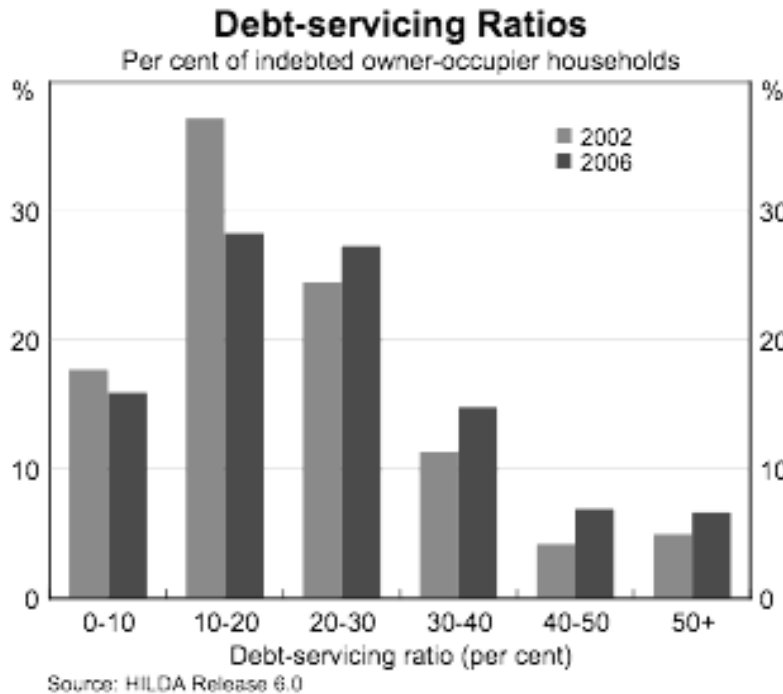
Sources: ABS: RBA

Source: Reproduced from RBA (2008a: 48 — Graph 41)

Figure 13 disaggregates the total number of loans in arrears by state to show that NSW and Victoria account for the greatest shares. Figure 14 shows further spatial polarisation within NSW. Regional hotspots are discussed further below, drawing on other data, which also categorise mortgagors by segments related to income and other social characteristics. It suffices here to point out that more detailed studies suggest that a significant minority of borrowers have made choices within a narrow set of parameters without sufficient calculation with respect to the implications of interest rates rising, as they have (until early 2008). Even as greater indebtedness has been

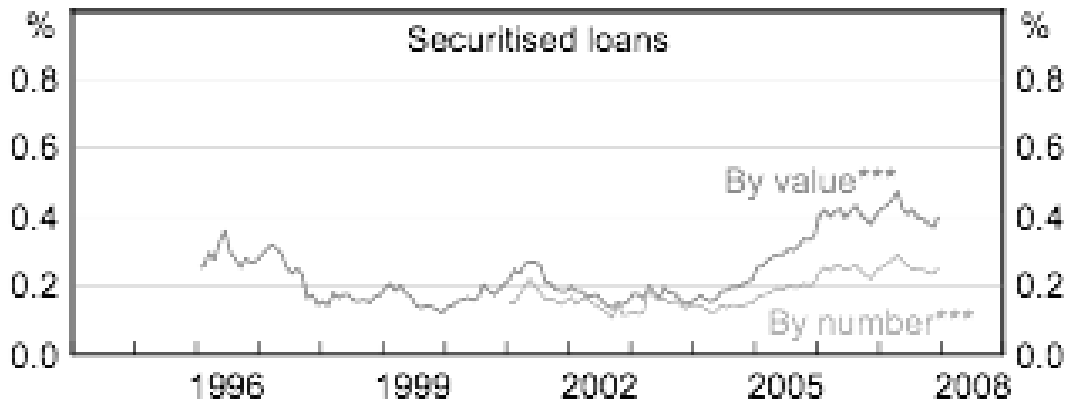
matched by rising asset values, a home is not like another asset that can be dispensed with when cash is needed, and only involves loss of money. A home has a definite and specific use-value for the mortgagor and the rest of the household. Housing will be a cost whichever form it takes, tenancy rental or mortgage payments.

Figure 9: Rising debt service ratios on household debt (2002–2006)



Source: Reproduced from RBA (2008a: 54 — Graph 53)

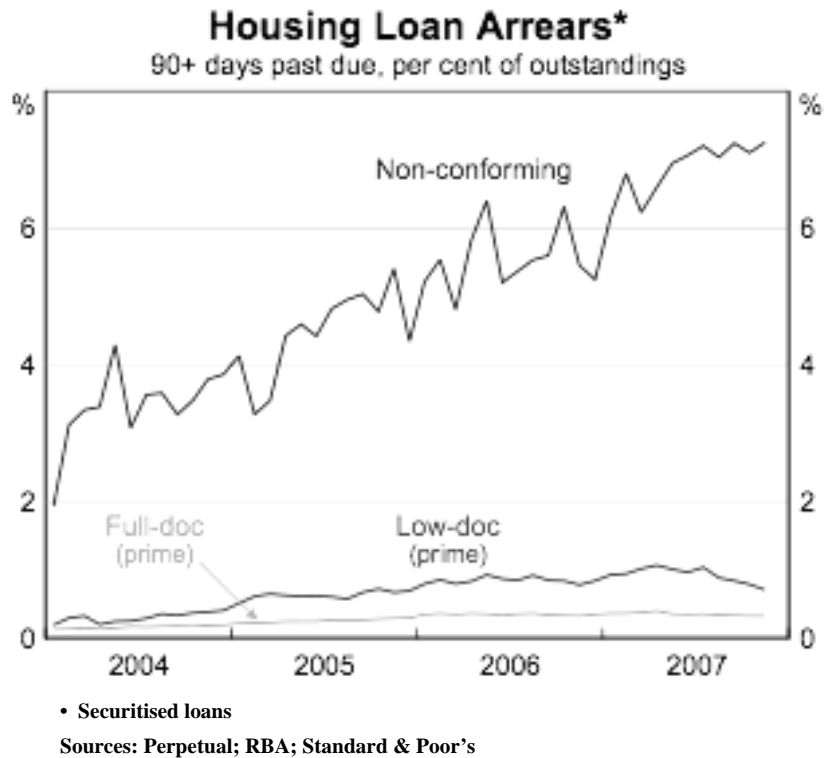
Figure 10: Proportion of loans 90+ days in arrears, by number and value



- Loans that are 90+ days past due but otherwise well secured by collateral
 - Includes 'impaired' loans that are in arrears and not well secured by collateral
 - Prime loans securitised by all lenders, 90+ days past due
- Sources: APRA; Perpetual; RBA; Standard & Poor's

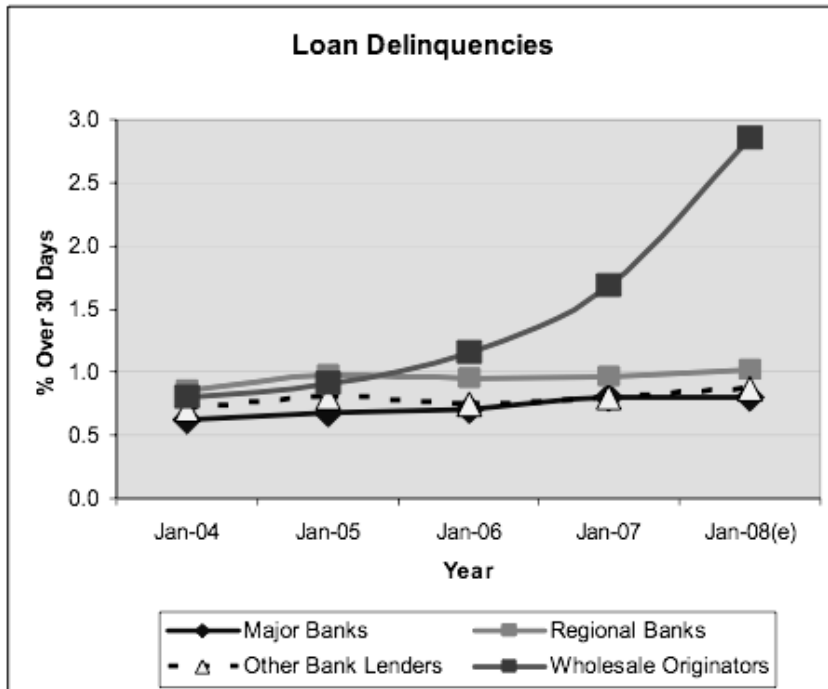
Source: Reproduced from RBA (2008a: 49, extract from Graph 42)

Figure 11: Arrears 90+ days by kind of loan, per cent of outstandings



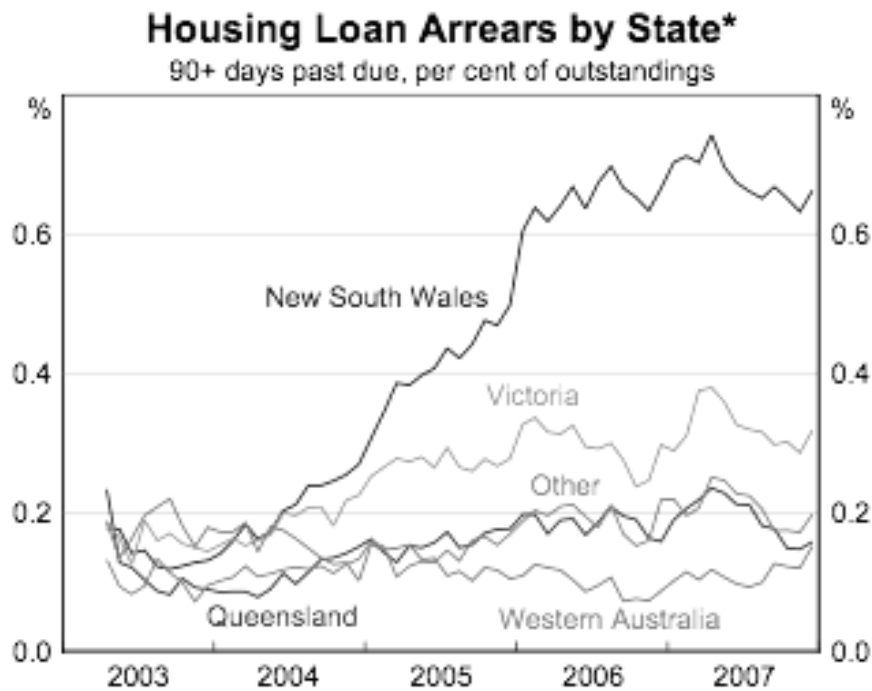
Source: Reproduced from RBA (2008a: 49, Graph 43) — on 'outstandings' refer to Figure 10

Figure 12: Loans 30+ days in arrears by loan originator



Source: Wizard-Fujitsu 2007: 11

Figure 13: Comparison of housing loans in arrears, by state



• Prime securitised loans

Sources: ABS; Perpetual; RBA

Source: Reproduced from RBA (2008a: 50, Graph 45)

Figure 14: Regional comparison of NSW housing loans in arrears



• Prime securitised loans

••Blacktown, Canterbury-Bankstown, Fairfield-Liverpool, and Central Western, Inner Western, Outer South Western and Outer Western Sydney regions

Sources: ABS; Perpetual; RBA

Source: Reproduced from RBA (2008a: 51, Graph 46)

The RBA has consistently maintained that increases in home mortgage defaults have come from a very low base and are very unlikely to threaten the financial system. Two Bank studies published in 2003 suggested that the sharp rise in household indebtedness from the mid-1990s onwards posed a low risk for the economy as a whole. La Cava and Simon (2003), using data from the ABS Household Expenditure Surveys and the Household, Income and Labour Dynamics in Australia (HILDA) Survey for 2001, found that increasing housing debt between 1998 and 2001 mainly was taken on by 'financially unconstrained households' — i.e. borrowers who were not experiencing difficulties in meeting mortgage repayments and other financial commitments. Ellis et al. (2003), also drawing on HILDA (2006) data, concluded that leverage rates (ratio of housing debt to housing value) was highest among households in mid-life with high incomes. These households tend to be those best able to bear high debt burdens. They also argued that leverage is highest in areas that are least vulnerable to house price 'reversals' — i.e. the outer suburbs of large cities and non-metropolitan regions that had experienced relatively small house price inflation over the preceding decade. Berry (2006a), however, argues that the conclusions of these two studies are problematic and open to alternative interpretations. More importantly, developments over the last seven years — and, in particular, during 2008 — undermine confidence in the generally benign conclusions of these 2003 studies.

For example, Professor Steve Keen (2008) — from the University of Western Sydney (UWS) — contests the RBA's analysis using their data to support arguments which highlight the risks endemic to any financial system once high levels of lending have occurred, including to unconventional borrowers, during periods of strong growth. Keen stresses the greater risks associated with current levels of household indebtedness — higher than at any other time in Australia's history — in a downturn. Complacency and confidence characterise periods of growth while the results of financial risk-taking typically break out rapidly and crescendo in a serious downturn. These current and recent developments are discussed further in Chapter 4.

From this perspective, and given the limitations of the data on which the RBA analysis depends and its narrow concern for broad systemic financial health, it is important to refer to current industry research that uses more disaggregated indicators of 'mortgage stress' to assess householders' capacities to service their home loans. The uneven impacts of excessive lending or economic downturn by social segment and region are significant for formulating housing policy. However, to repeat, all current data sources on mortgage defaults have limitations and biases and, consequently, must be qualified. As the recent parliamentary inquiry (House of Representatives, 2007) concluded, we are far from having an accurate and complete picture of this phenomenon.

2.1.2 Trends according to disaggregated data

Financial institutions such as Citibank (2006), Macquarie Mortgages (2007), Fitch Ratings (2007b; 2008b), and Fujitsu Consulting and JP Morgan (2007; 2008) have surveyed and analysed Australian householders' home loan borrowing and repayment activities for the last few years. Fujitsu Consulting and JP Morgan produce a six-monthly Australian Mortgage Industry review and Fitch Ratings publishes a quarterly report on arrears and defaults by postcode. Fujitsu Consulting (2008: 4, 16) draws on a research database of 26,000 Australian households, including a 2000 strong reference group that the firm has trailed for three years. Fujitsu Consulting (2008: 4) surveys households regularly asking them if they are in arrears, are thinking of selling (or have sold) their home to pay back their mortgage, and have refinanced or renegotiated the terms of mortgage repayments.

Reviewing the contemporary situation for borrowers, Fujitsu Consulting & JP Morgan (2007; 2008) stress that both the average size of loans and interest charges have increased over the last five years while disposable income has risen at only a third of the rate of housing price rises. Given this conglomeration of adverse factors, especially the remarkable rises in both home loan to value ratios and debt servicing ratios, they focus on monitoring and managing risks. Such sources have raised specific concerns over lending practices in the recent period. These practices are likely to affect certain more vulnerable sectors a lot more than the average or well-off mortgagor.

Fujitsu Consulting and J P Morgan (2007) cite Mortgage Choice data showing that, for a couple on a joint annual income of \$65,000, nine lenders would sign them up for loans ranging from \$263,585–\$378,999, all implying calculations based on the household's non-housing spending at the level of the Henderson Poverty Line, to conclude that:

lenders have altered their assessment of a borrower's capacity to repay from 'one third for the taxman, one third for the bank, and one third for yourself' to 'borrowers will alter their consumption patterns to retain home ownership in times of hardship'. (Fujitsu Consulting & JP Morgan 2007: 27)

In the Fujitsu Consulting & JP Morgan (2008) indicated that:

Overall over 700,000 households will be experiencing some degree of mortgage stress by June 2008, a four-fold increase from last year. Whilst a significant proportion are exhibiting mild stress (no significant risk of default, but households have re-prioritized and curtailed spending to pay the mortgage), around 300,000 are experiencing severe stress which could lead to forced sales, missed repayments and foreclosure. The current interest rate environment and rising costs of living are exacerbating the situation, and creating for the first time the risk of 'Affluent Stress'.

Indeed, on 29 June 2008, Martin North (Fujitsu Consulting) estimated that 783,000 households were experiencing some degree of financial stress associated with mortgage repayments, categorising 318,000 of them as in 'severe stress' (Weekes 2008). North has formulated a Stress-O-Meter, which categorises mortgagors into stereotypical more-or-less self-explanatory cohorts, to identify the most stressed:

1. young affluent
2. young growing family
3. rural family
4. battling urban
5. disadvantaged fringe
6. suburban mainstream
7. mature stable family
8. exclusive professional
9. multicultural establishment
10. stressed seniors
11. wealthy seniors.

(Fujitsu Consulting & JP Morgan 2008: 20)

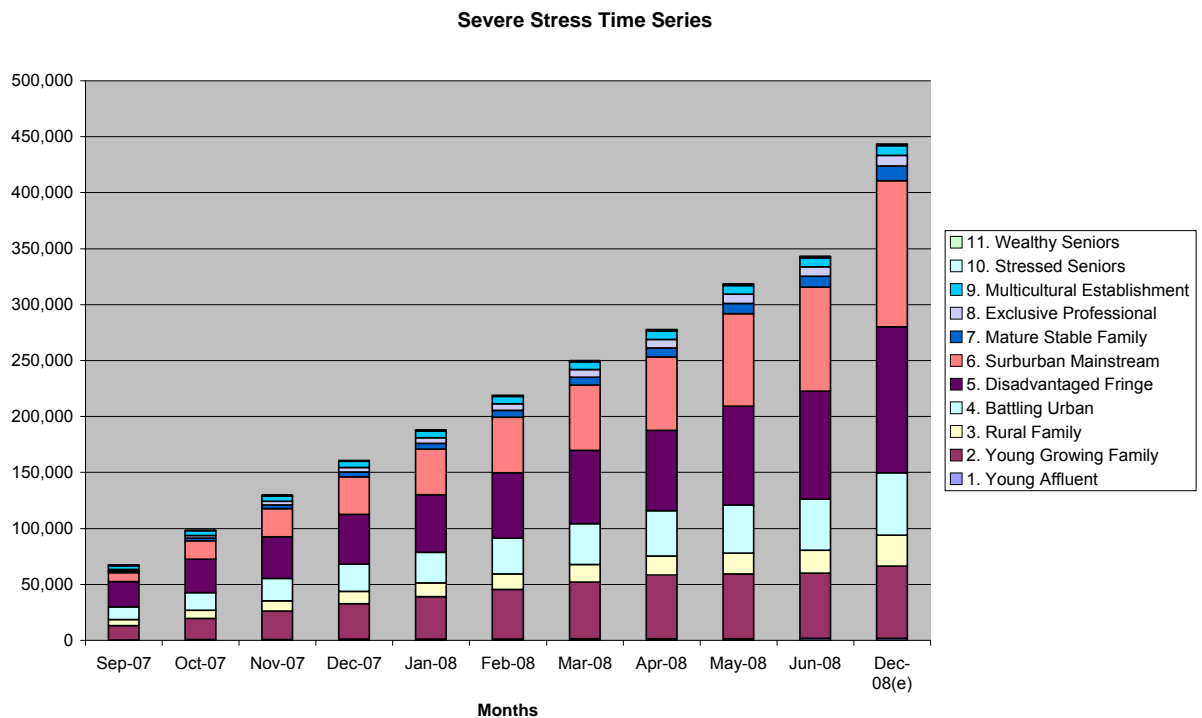
Figure 15 indicates those segments suffering most stress over a time series which includes forward estimates through to the end of 2008. Currently, young growing families, those on the disadvantaged fringe, and suburban mainstream households are the most affected segments.

The formula used for the Fujitsu Consulting (2008) Stress-O-Meter reads:

$(\text{Propensity to default} \times \text{number of defaults}) + (\text{forced sales}) + (\text{average arrears months} \times \text{affordability} \times \text{reprioritised spending})$

The data on defaults, forced sales and so on, is based on the households surveyed rather than official data on which the RBA depends, which has failings already discussed, and is from sources such as the Supreme Court Possession Lists, the Australian Bureau of Statistics (ABS), and APRA. The Fujitsu data has limitations too. It is drawn from a reasonably sized representative sample of households, but relies on self-reporting not only of behaviour, but also of perceptions, and there are weaknesses (restrictions) endemic to any survey format. On the latter, the findings on causes of mortgage stress is a case in point — narrowing responses to a single cause unduly simplifies a picture that seems more complex, synergistic, and multi-factorial in everyday life.

Figure 15: Mortgagor Stress-O-Meter: severely stressed, by segment



Source: Personal communication with Fujitsu Consulting, 16 July 2008.

Trends highlighted by other sources include consistent reports from financial counsellors that their services are being requested at levels far beyond their capacity to supply, that the kinds of clients they are seeing are broader in income and class background than in previous decades, and that certain lenders are making it particularly difficult for borrowers of good faith to renegotiate the terms of their loans.

In the roundtable called for the House of Representatives 2007 inquiry (Official Committee Hansard 2007: 11) Karen Cox, coordinator of the Consumer Credit Legal Centre (CCLC) of New South Wales (NSW) reported that:

Not only in the last six years has the demand on our service gone through the roof but we were facing a situation last year where we were taking a third of the calls that were coming through; we just could not keep up with the number of people trying to contact us. Home loans as a problem have actually increased significantly. When I was first there a call about a home loan was relatively rare. It was credit cards, motor vehicle loans and personal loans, and home loans were down here. Home loans are now second. They are not a lot ahead of personal loans and motor vehicle loans, but there has been a significant increase in a very short time. Of those people who call us, around about 48 per cent are from non-ADI lenders.

Non-ADI sources of loans are more frequently responsible for refinancing to struggling borrowers. For some years legal and financial advisers have reported serial refinancing on poor, even extortionate, terms. Clearly levels of refinancing can indicate how many stressed borrowers are trying to alleviate intolerable debt repayments. The Australian Finance Group, which claims to be the largest wholesaler of mortgages in Australia (<http://www.afgonline.com.au/>), has reported that by February 2008 around two of every five mortgages were for refinancing existing loans, 'an all-time high' (Your Mortgage 2008: 16). These statistics are supported by estimates made by Fujitsu Consulting and JP Morgan (2008: 14) that owner-occupier refinancing has risen to account for over three in ten home loans by early 2008 whereas, in 2000, refinancing accounted for less than one in five loan approvals. Indeed ASIC (2008a: 2) has based some research on suggestions by Fujitsu Consulting and JP Morgan that 'the average Australian mortgage is terminated or refinanced within approximately three years'.

RBA data provides useful, even if limited, indicators for temporal and geographic comparisons and retrospective analyses. Industry tools, such as the Mortgage Stress-O-Meter, can be more useful in disaggregating data by social segments and to monitor current trends. (While the RBA refers to HILDA data disaggregated by social segment, HILDA findings are delayed compared with the results of financial sector surveys, released straight away.) Yet surveys, which generally rely on self-reporting, perceptions and narrowly restrictive question-answer formats have distinct failings as evidence and indicators. Even so, data produced by sources such as Fujitsu Consulting have the potential to inform housing policy-making which aims at addressing specific and immediate challenges such as growing default-related evictions that place pressure on the private rental stock, public and emergency housing, or increase homelessness. The need for this kind of data flow to inform an adequate emergency response system was made clear earlier this year when the NSW Government tried to address NSW mortgagors' stress through channelling funds into the NSW Mortgage Assistance Scheme which, despite the politicians' media releases to the contrary, is restricted from helping borrowers stressed only by interest rate rises. Such issues are taken up in the discussion of policy implications in Chapter 5.

2.2 Drivers

Sources, such as the Consumer Law Centre of the ACT and the ANU Centre for Commercial Law (2007), indicate that default is only attributable to a single cause in a minority of cases. Default generally results from a complex interplay of personal, economic and social circumstances. According to such literature, four clusters of

characteristics and explanations or 'drivers' typify scenarios of mortgage default in Australia today:

- an inability to service the mortgage more or less from the time it is contracted
- an income-related shock from which the borrower does not recover a capacity to fully service the home loan
- increasing interest rates and higher house prices
- falling house prices and sales volumes and rising rents mean that it is hard to avoid default by selling the home, repaying the debt, and moving into the private rental market.

One further characteristic of the current period is that the incidence of default is not only rising but also likely to be more severe in its consequences for defaulters — if not for the broader financial system — than when borrowing criteria was more conservative, LTV ratios were lower and work environments were more stable and secure.

The high incidence of borrowers defaulting soon after they contracted their loan was evident in our initial analysis of 23 files in the Supreme Court of Victoria — files activated during 2007 when applications for claims of possession were made by the lenders. The quickly revealed incapacity to service loans successfully applied for and contracted needs explanation. Transcripts of hearings in the Supreme Court of NSW and interviews with financial counsellors and defaulters (for further detail see 3.3, below) indicate some reasons, ranging from bad judgment by borrowers and lenders to higher interest rates on loans that have been refinanced or are in default. A shock, such as unemployment, illness or divorce, which impacts on income and diminish borrowers' capacity to service their debt, is also a cause for going into arrears and default. Finally, the lack of alternative strategies to trying to blindly struggle through also typifies other borrowers who default. When house prices are stable or rising, mortgagors can resolve their difficulties relatively successfully through voluntary or forced sales of their homes, realising enough from a quick sale to satisfy the lender and get out of debt. When, however, homes are slower to sell and only realise low prices in many places, while moving into a rental market can cost as much or more than repayments on a conventional modest home loan, borrowers' difficulties intensify and persist.

2.2.1 Inability to service debt from the start: bad judgment through to fraud

Why would a borrower take out a loan that they could not service? In the last decade ignorance, poor judgment and wishful thinking by borrowers have met aggressive lending spurred on by mortgage brokers competing for business without responsibility for arrears and defaults. Thus there are 'push' and 'pull' factors at work.

In only 19 cases of our review of just 23 files for claims of possession lodged in the Victorian Supreme Court in 2007 did we find sufficient details to determine the amount of time taken to default on the loan in question. In almost half (9) of those 19 cases the default had occurred within one year of contracting the loan. In one of those nine cases no payments had been made at all, and in another only one payment had been made. Only four of the 19 cases had had their mortgage for more than a year and a half. However, in cases where it seems that there is an inability to service a loan from the start, the loan might have been a refinancing. Around a third of these loans were low-doc, had higher than average interest rates charged even before default interest rates were applied, or were 'interest-only' loans (i.e. in the initial instance, for 5–15 years, mortgagors are only obliged to pay interest, no amortisation). According to RBA–APRA (2007: 5), interest-only loans accounted for around 10 per cent of all

housing loans in 2003 but, by 2005, had risen to 30 per cent of all new housing loans, around half of those extended to owner occupiers (the rest to investors).

First-home mortgagors are facing tougher terms. The HIA–Commonwealth Bank Housing Affordability Index (HIA Economics Group Housing 2007), which assesses the affordability of an average first home for an average first-home owner by taking into account interest payments and house prices, has fallen from 176.7 in December 1984, with repayments to income calculated as 17.1 per cent, to 97.9 (the lowest on record) in December 2006 when repayments to income had risen to 30.1 per cent. By the end of 2007, this affordability index had broken a new record low of 92.8 (HIA–Commonwealth Bank 2008).

The inquiry into home lending conducted by the House of Representatives (2007) was called mainly because of politicians' concerns that relaxed mortgage lending practices were allowing, even causing, higher levels of household indebtedness with attendant risks to vulnerable social segments, and even the stability of the financial system. New kinds of products, such as low-doc loans, no-doc loans, reverse mortgages and loans with high loan to value ratios (including greater than 100%), have introduced new dangers, both because of their risky nature and by making funds available to borrowers previously considered bad risks (likely to default). For instance, by definition, taking on a loan with a high loan to value ratio suggests that, at least initially, a borrower will have little by way of a reserve to address any unexpected event likely to absorb their income and jeopardise their capacity to pay. Also, it is clear from Figure 11 that the arrears records of low-doc and no-doc loans is poor, though the financial industry and RBA have consistently argued that many of these 'self-cure' or 'self-resolve'.

Another area of concern raised in the inquiry involved the ubiquitous use of credit cards. Certainly over-use of consumer credit is a burden on other household debt and can jeopardise financial stability, especially when an unpaid debt is repaid by rolling the burden into a refinanced (larger) home loan. Preliminary findings from an Australia Institute survey and focus groups on household debt (Fear & O'Brien 2008), suggested that Australians feel they are too freely encouraged to go into debt, take on more credit cards and consumer credit, and that this is particularly dangerous for vulnerable people (young, old and low-income, struggling households). However, preliminary reading suggests that, except for a small minority, borrowers tend mainly to over-use credit once challenged by, say, a growing incapacity to keep up with home mortgage repayments. In short, use of credit cards is a strategy in juggling timings of housing loan payments. Most borrowers are aware of the great risk to their financial security of failing to make mortgage payments and will use whatever resources are at hand to cover them.

Even before this inquiry there were moves by the states — through the Council of Australian Governments (COAG) — to regulate mortgage brokers and make them more responsible for subsequent delinquencies (NSW Office of Fair Trading 2007: 1). Australia Equity Research argues that brokers are very influential in persuading customers to refinance Fujitsu Consulting & JP Morgan (2008). The 2007 inquiry also stressed the logic of national regulation of mortgage products and services as bodies such as ASIC (2008a; 2008b; 2007) and the Consumer Action Law Centre (CALC 2007: 18–19) of Victoria researched risks involved with specific loans and lending practices and considered ways to curb them. Current processes are likely to eventuate in mortgage broker regulation across Australia in 2010 and the federal government assuming responsibility for standardising and tightening regulation on mortgage products and services as well (Australian Government, The Treasury, 2008).

Initial responses to the new competitive lending environment stressed the importance of functional financial literacy (ANZ 2005a; ANZ 2005b; ASIC 2004; HIA 2007; Understanding money website), i.e. improving the knowledge and skills of borrowers, to both understand the implications of a mortgage and manage their finances. Thus, government agencies, financial counsellors, consumer advocates and philanthropic organisations distribute pamphlets and provide fact sheets on managing debt on the Internet as well as providing credit and debt help-lines which include advice on mortgage and default-related issues — for example, see the CCLC of NSW website. This information is designed to enable borrowers to consider carefully whether they can afford to take on a mortgage and, if they do, to either avoid damaging their capacity to pay or take measures to withdraw from the loan by refinancing on more comfortable terms or by selling their home.

Government and non-government third parties have sought to intervene in debates raising concerns over mortgage default by stressing the rights and responsibilities of both borrowers and lenders. Government is moving to provide a stronger legal framework to protect borrowers from unscrupulous practices, say through ensuring recourse to external dispute resolution (EDR). However, borrowers still have little more than the ability to plea, on the basis of temporary hardship, to alter the terms and conditions of their loans, whether through the lender, legal system or government mortgage assistance relief. Lenders can be resistant to changing the terms of contracts, which is why borrowers have the right to appeal rejections of their applications to vary the conditions of their mortgages. However, court judges will only insist on lenders accepting alternative terms if the hardship is strictly temporary and the borrower is almost certain to keep to their new arrangement. Lenders are not required to bear major changes as a result of unexpected shocks in borrowers' lives. These are similar criteria for eligibility for interest-free grants under mortgage relief schemes, established under the Commonwealth State Housing Agreement, which are neither comprehensive nor substantial in their coverage.

Studies, such as one conducted by ASIC (2008b), have shown disturbing levels of 'serial refinancing' by mortgagors moving from moderate mortgage stress through to severe stress and involving equity stripping. ASIC (2008b: 4) found that:

borrowers had a strong attachment to their home and were centrally motivated by a desire to avoid its sale. This meant they were predisposed to ignore options that, while financially more rational, would involve its sale.

In contradistinction to advertising surrounding refinancing, such scenarios are more likely to involve exorbitant interest rates, excessive fees and deliberate equity stripping by unscrupulous brokers and lenders. Indeed today many advisers suggest that borrowers experiencing difficulties must seriously consider selling their home or restructuring their finances rather than refinancing their household debt.

Certain cases of serial financing fall into the 'predatory lending' category, which Wizard–Fujitsu (2007: 4) defines as lenders persuading borrowers to take up 'unfair or inappropriate loan terms and conditions'. Wizard–Fujitsu (2007: 7) suggest that while one in every 200 borrowers has been victim to predatory lending, two out of every 100 borrowers from their 'disadvantaged fringe' segment experience predation, but 'exclusive professionals' are unlikely to be preyed upon or succumb ever.

Analysts, such as Prushka (in Weekes 2008), reveal that fraud, gambling and drug addiction account for a certain proportion of defaults and inherited or transmitted debts. Obviously whole households are especially vulnerable when one member uses income that should be reserved for debt servicing to drink, take drugs or gamble instead. Thus, there can be hidden reasons why a household's debt servicing capacity

is impaired from the start. In cases where a guarantor is involved there are complications too (Howell 2004).

Case study: Impaired debt servicing capacity and asset stripping

If I may just talk about a recent case that the ombudsman dealt with it might be illustrative of the kind of problems we are facing. Here we have a situation of a husband and wife living in New South Wales. They have four kids and one on the way. They are Centrelink recipients. They have reasonable equity in the house, which was excellent.

They wanted some extra money to do some renovations, essentially to convert the garage into another bedroom for the child, and to register the car. They were also in arrears with their lender, which was a bit unfortunate. They saw an ad in the papers. The broker attended the premises. They signed a declaration saying that the loan was for business purposes. I do not know how that could ever have been the case. There was no verification of income. They were initially offered a no-repayment period, interest-free, as it were. It is not interest-free. It is just that for six months you do not pay interest; it is just capitalised. That is always very enticing to people in those circumstances. The lender is a well-known fringe lender who is still in operation. There was no LMI in this loan. It was only a 12-month loan. You have to ask yourself the question how you can ever repay the loan in 12 months. The idea, of course, is that there is some sort of self-curing, or whatever, where things work out and you refinance with a less fringe lender. I do not know if it works in reality. They did provide a declaration that they could meet the repayments. My view is that if someone is desperate enough they will sign anything. The effect of the new loan was that the repayments were twice those of the previous loan. The broker commissions were over \$13,000. I cannot really remember, but I think the loan was for \$185,000 or something like that. The legal fees were over \$7,000 and there were other fees and charges. And they were all loaded up onto the loan, that is, they became part of the loan.

In many of these cases there is almost an expectation that these people are not even expected to meet the first repayment. It was quite absurd. They went away from the non-repayment grace period. When the first payment was due they defaulted and they were sold up. The fact is that the equity was reduced by some 30-odd per cent. We issued a determination awarding compensation to the consumers, to the borrowers, against the broker because the lender was not a member of our EDR scheme. But that determination is still outstanding. We have not succeeded in getting the broker to pay that sum and he has indicated that he will not pay it. The only option we have is to take him to court, which is an expensive option if we were to do it for every single non-compliant member. And we cannot touch the lender.

Source: Raj Venga (Credit Ombudsman's Service) to the roundtable called by the 2007 House of Representatives inquiry (Official Committee Hansard 2007: 48–49).

2.2.2 Shocks: unemployment, illness, disability and divorce

Another category of defaulters have taken on a mortgage that seemed well within their means at the time they contracted the loan, then experienced an unexpected external event that seriously diminished their capacity to pay and, sooner or later, they realised that their difficulties in keeping up with their mortgage repayments were intransigent. In two disturbing cases Pentland (2007) found that repossession resulted from relatively trivial loans and from loans generated by government agencies' payment mistakes.

In the new lending regime (as in the period 1997–2007), where it was easier to borrow larger sums of money, there is a higher sensitivity to such shocks as illness, unemployment and divorce. It is easier to get into trouble more quickly. The sheer size of home loans as well as cyclical factors like rising interest rates exaggerates any difficulties too. The shocks identified not only interrupt the regular repayment potential of borrowers but are often accompanied by uncertainties that make it very difficult to consider how to address or restructure loan commitments.

With the prognosis of a serious illness, the future success of treatment or management is often uncertain. Serious illness impacts on employment options. Will I get better quickly and be able to resume my old job? Will I have to work part-time? Will I need to go onto disability benefits and never have a regular income again? (See further discussion in 3.3.) The future uncertainty greatly complicates responses to addressing immediate and direct financial constraints.

Divorce often involves a period of protracted separation — Jain (2007) suggests around three years — before final denouement. On one side at least there might be a question of whether it is just a temporary separation. Uncertainty arises as a result of relationship conflicts — ‘I might lose you but I’m damned if I’m going to lose the house too!’ One party might deliberately fail to fulfil their share of the mortgage repayments.

Even unemployment, which seems straightforward in comparison to illness or an accident, is generally of an uncertain duration. It might make the job seeker consider relocation or taking on a job with a lower income or added expenses. All these decisions will impact on the ability of the income earner to service their debts in the mid-term to long-term, not just the short-term. In as much as new circumstances are less favourable, they might be viewed as temporary, though another opportunity might not arise for some time. Meanwhile, a decision needs to be made about the appropriate level of mortgage repayments or even the sale of the home.

In the new employment regime, with a precarious work environment for over a decade and where less secure employment is widespread, a recession means that shocks are more likely and more difficult, or at least longer, in their resolution.

According to RBA (2007b), RBA discussions with banks suggest that ‘many borrowers have substantial prepayment buffers’ — ‘around one quarter of owner-occupier borrowers are more than a year ahead of their scheduled mortgage repayments, with around one half ahead by more than a month’. In fact, one could conclude from the same evidence that at least one half of borrowers are only one payment ahead, which appears to make them vulnerable even to a strictly short-term crisis. Indeed, a survey conducted by Wesley Mission (2007: 4) in inner Sydney indicated that 40 per cent of households had no reserve in the form of either savings or mortgage redraw facilities to cover an unforeseen outgoing of \$2000.

2.2.3 Rising interest rates

A recent survey by Fujitsu Consulting (2008: 15) indicates that in mid-2008 the ‘over-riding driver’ of mortgage stress — the primary cause in 72 per cent of all cases — was the rise in interest rates. The RBA cash rate has risen 12 times in succession since 2002, accumulating to over three per cent, and lenders have made further hikes on the top of that (Weekes 2008). According to a 2005 survey by Fujitsu Consulting (2008: 14), causes for concern over the ability to make mortgage repayments were relatively evenly divided between illness (23 per cent), unemployment (22 per cent), divorce (18 per cent), ‘other personal circumstances’ (23 per cent) and rises in the rate of interest (14 per cent). By 2007, over half of those surveyed identified raised interest rates as the primary cause for their stress, halving the proportions of each and every other cause (Fujitsu Consulting 2008: 14). This does not mean that fewer

people were suffering mortgage repayment stress due to other causes, but rather that the rising interest rates had drawn more borrowers into the stressed category. Indeed ABS housing finance statistics show that by 2008 rises in interest rates — a deliberate strategy by the RBA to curb inflation — was deterring new home loan borrowing.

While nominal interest rates are not historically very high the average size of loans is comparatively higher so that, by mid-2008, the impact on repayments was the highest on record. This is where the practices of lenders and borrowers' financial management skills are paramount. Many lenders factor in a small margin of slack in assessing a borrower's debt servicing capacity to account for future rises in interest rates. However, the size of the margin varies lender to lender and sometimes it is non-existent. Two per cent has been an industry rule-of-thumb (House of Representatives 2007). Borrowers often take industry advice and have regarded such measures sufficient protection. If they have no other reserves or strategies to address rising interest rates, they are likely to be stretched.

The precipitate fall in mortgage rates following monthly cuts by the RBA in official rates, totalling three percentage points over the September to December 2008 period (see Chapter 4), will clearly reduce this cause of stress on borrowers at risk of default. However, this factor will take some time to work through housing markets and the broader economy and it is unclear as to how much damage has already been done by the previous high interest rate regime.

Regulation of mortgage credit and financial literacy and loan management courses need to focus the attention of both lenders and borrowers more on the effects of variable interest rates and the possible impacts on their capacity to pay. Given recent developments, the Australian Competition and Consumer Commission (ACCC 2008) has cautioned borrowers on taking on larger loans than they are confident of repaying, independent of the advice of lenders and advised them of the advantages of selling a home to avoid risking greater losses in the long term.

Government mortgage assistance relief schemes established in certain states and territories exclude support to those whose circumstances have been made difficult only by rises in interest rates. All these schemes are limited in the extent of assistance and have narrow criteria for eligibility — points discussed in greater detail in Chapter 5.

Fitch Ratings (2008a: 3) argues that in general the level of mortgage default in Australia depends on (un)employment, interest rates and house prices, and that rising interest rates have been the key factor recently with spatial differences explained by a disproportional drop in house prices in certain areas. Indeed, during the decade 1997–2007 house prices rose to such an extent that models produced by the International Monetary Fund (IMF 2008b: 11) indicate that around a quarter of the increases could not be supported by 'fundamentals' and might, therefore, be subject to future market correction. Still, it would seem difficult to extricate the causal and symptomatic factors here: house prices fall as more houses are put on the market due to mortgage stress.

2.2.4 Lack of alternatives: falling house prices and rising rents

When borrowers take out a loan to buy a home, the house is regarded as an asset. The normal course and ideal scenario is that the loan diminishes as house prices rise and income otherwise spent on rent services the loan. Under such circumstances, the home can be sold to enable mobility, downsizing, or even to avoid default.

This financial logic supports the cultural narrative with wider social appeals rooted in the home as a haven and base for the family unit, known as the 'great Australian

dream'. Owning a home has driven millions of borrowers to take on home loans since earlier in the twentieth century. However, if there is an economic downturn there is a risk that such dreams turn to nightmares.

In the current climate of unstable and falling house prices and rising rents, it is less likely that borrowers facing immanent default can easily forestall or avoid a claim for possession by selling and renting in the private market. This is especially so in certain cases, say where a reduced debt servicing capacity coincides with a high debt servicing ratio and there is no temporary private or public relief. Fujitsu Consulting (2008: 17) remark on the currently high cost of rental accommodation and the 'risk of negative equity in a falling market'. Figure 16 shows the massive upswing in housing prices that has both resulted from and driven the volume of lending for housing over the last decade or so. Most importantly, it shows a fall in home prices in Sydney over the last four years, which parallels the subsequent higher levels of default in this state. Indeed South West Sydney has experienced a fall in property values of around 30 per cent over the last couple of years (Fitch Ratings 2008b: 4).

Australia has a housing crisis. An undersupply of housing has contributed to artificially high prices. Inadequate public housing and high rents in the private rental market, especially where jobs are located, means that certain home owners have been pushed into home ownership rather than pulled by the 'dream', especially when home lending was being widely promoted and interest rates were comparatively low. These borrowers have been caught in a pincer movement, which means that many cannot sell their homes except at a loss. That might well mean that they cannot even cover the cost of settling their debt after sale and will bear an uncertain debt as well as having to find alternative accommodation in a costly private rental market. Thus, stressed mortgagors have few alternatives that make rationale financial sense to consider.

Perhaps the most significant insight made by Fujitsu Consulting (2008: 16–17) relates to a stereotypical scenario of steady deterioration from mild stress to default. Over the last few years this kind of scenario would take, on average, two and a half years but, by mid-2008, the decline seems shorter, around two years:

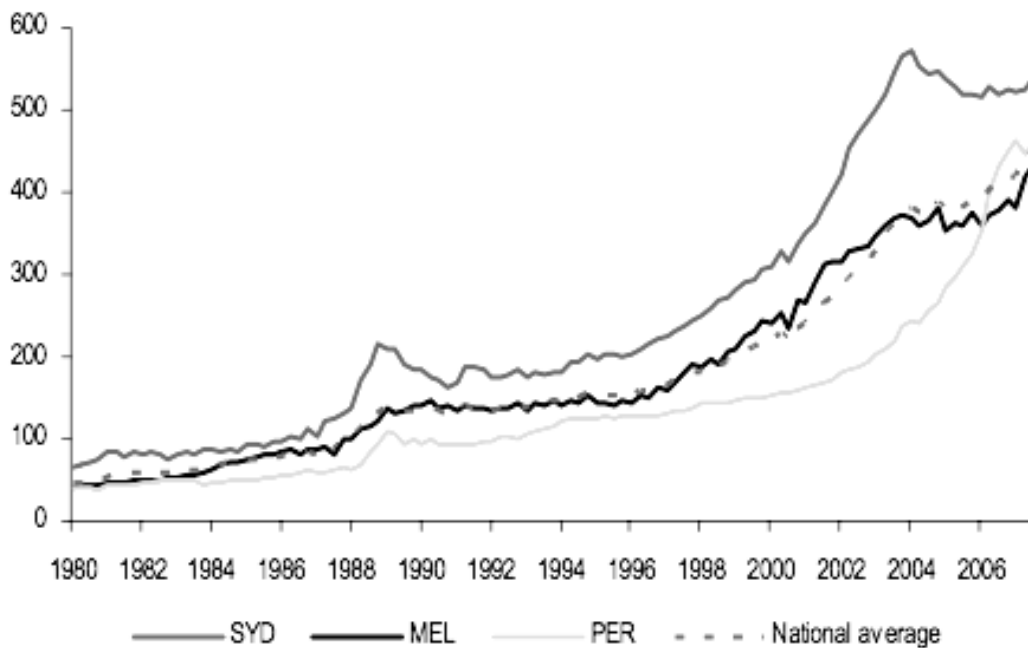
This slip into stress often commences with households initially tightening their spending ... The next step is that households start to build up debts on credit cards. In some cases, they will apply for additional cards to take advantage of low balance transfers. If the stress continues, they will often seek a refinance which liberates capital to pay down cards and reset the household budget. However, most often behaviours do not change, and the cycle is repeated again, with budget problems, leading to increased credit card utilisation. At this stage households will refinance again, often now with a provider who has broader credit policies, or an attractive refinance deal where further capital is liberated. In our research, a refinance event is more than twice as likely to lead to subsequent delinquency.

... Very often the next phase in the journey is that households start to slip behind making repayments. At this stage, either the household will refinance again, decide to sell up, or default. Default often leads to lenders encouraging a further refinance to control the situation, or more often foreclosure...

These observations are confirmed by other recent studies (Consumer Law Centre of the ACT & ANU Centre for Commercial Law 2007).

Owner-occupiers experiencing housing stress and even immanent default seem to try and struggle through their financial problems without legal or financial advice or government support. Wesley Mission (2007: 4) found that over half of the financially

Figure 16: Median house prices



Source: Real Estate Institute of Australia.

Source: Fujitsu Consulting and JP Morgan (2008: 13) using REIA data

stressed householders who they surveyed had not sought any assistance at all — ‘inaction was the most likely response to financial stress’. Many were reticent to share their problems and the most likely source of support was friends and family, who could not necessarily provide financial assistance. This situation just heightens the need to better understand the size and complexities of the difficulties experienced not only by those who default on their home loans, but also those who by good management, good luck, or accident happen to avoid default.

The next chapter shifts the focus onto the various effects of mortgage default for the households suffering or at risk of stress.

3 THE EFFECTS OF MORTGAGE DEFAULT

This chapter first summarises the current processes for dealing with mortgage arrears and defaults in Australia before discussing the main impacts on households who get into difficulties in meeting their mortgage commitments. The final section reports on a number of preliminary interviews of such households in order to illustrate some of the key points raised in Chapter 2 and Chapter 3.

3.1 Processes of dealing with defaults

There are distinct processes whereby repossession of a home due to default on a mortgage is formalised in each state and territory (see Appendix 1 for details of the process in the NSW Supreme Court). However, there are certain commonalities: in order to apply for a legal claim to possession, lenders are obliged to have notified the borrower that they are in default so they have a chance to make amends; the borrower must be notified once a claim for possession is made by the lender and is given a month to respond, otherwise the lender can ask for a default judgment in their favour; any tenants in the contested property must be notified that they will be obliged to vacate the property within a few weeks; in the case of a default judgment (the normal course of events) or a successful hearing against the defendant (the defaulter), the sheriff will be instructed to oversee an eviction.

Under the Uniform Consumer Credit Code (UCCC), most mortgagors have a right to ask a lender to relax repayment obligations for a short period of time due to an unexpected circumstance (such as illness or unemployment) and to appeal in court if this request is rejected. However, often this is costly. In the roundtable called by the 2007 House of Representatives inquiry, Raj Venga (Credit Ombudsman's Service) pointed out that even these external dispute resolution (EDR) organisations do not necessarily have the resources to go to court and under current legislation UCCC non-members cannot be brought to task (Official Committee Hansard 2007: 49).

In short, the borrower generally relies on the lender's preparedness to work with them to resolve the impasse. Westpac Assist and Genworth Hardship Solutions are examples of special units set up to deal with customers' credit repayment difficulties. Once a claim to possession is successful, stays can be requested to allow for a timely exit of the property, but delays are usually granted for only a few days. Access to superannuation funds can be applied for to remedy the situation, but the lender might well proceed and a home might be repossessed before a defendant has the chance to exhaust possibilities for addressing their plight. During 2006, APRA allowed 13,871 early access to super funds, totaling \$135 million, for reasons including avoiding foreclosure on their homes, a higher number than in 2005 when 10,459 accessed \$77 million this way (Khadem 2007).

At any point in this process of seeking possession — due to the failure of the borrower to keep to the terms and conditions of a loan contract for which the home is offered as security — the lender and borrower might agree to settle the matter another way. Typically, the borrower will seek to refinance the loan with the lender or (more likely) with another lender, or the borrower will sell, or promise to arrange for the sale of, the property. Each jurisdiction has distinct procedures, but most allow for a year or so for any suspended claim to be reactivated. Thus, while the average time for a claim to end in eviction is around 4–6 months, the courts will have many active files relating to claims for possession at any given time. This means that data on the number of defaults for a particular period or point in time is difficult to collect and must be qualified by the uncertain status and outcomes of so many active cases.

Several important points need to be made about these default procedures in Australia. Firstly, under Australian law, the home is security for a loan under ‘all-monies’ contracts, so the negligent borrower cannot simply hand back the house keys to get rid of their debt as pertains in many states of the United States (US) today. This is especially relevant where the value of a house has fallen below the cost of repaying the loan. In Australia, the borrower wears this risk. Secondly, as already mentioned, the number of defaults is not a sufficient indicator of the performance of borrowers in managing their loans or of their capacity to pay. There is a high incidence of forced sales, mainly due to their joint advantages for mortgagee as well as mortgagor, and of ‘serial refinancing’ that often involves equity stripping. Thirdly, sometimes homes are repossessed as security for a business loan or as part of a bankruptcy procedure. Not all claims for possession involve homes — some are investment or commercial properties. Fourthly, many defaulters have neither the financial nor emotional resources to seek timely legal assistance and useful financial advice.

Financial counsellors and representatives from government agencies in NSW and Victoria report that as homes are repossessed provision of temporary housing might only be 5–7 nights in a cheap local motel. Then, with a tight and expensive rental market, such clients can end up boarding or in caravan parks. (See final section of this chapter for more discussion of experiences and Chapter 5 on policy responses.)

There are few advocacy and self-help groups for borrowers. Important exceptions include the national network of state-based legal centres and certain philanthropic non-profit organisations, such as the Wesley Mission. However, there is a concerted effort under way to bring state and territory legislation related to mortgages into one national framework and, similarly, to bring mortgage brokers under national regulation so that the plethora of lenders and loan products and services can be more easily scrutinised and consumers protected (Australian Government, The Treasury 2008). ASIC (2007: 6) has been concerned with various loan products, such as reverse mortgages, and has drawn attention to borrowers’ ignorance:

- Most of the borrowers we interviewed did not fully understand how a reverse mortgage works. Of the 29 borrowers:
- 14 did not know how much the loan was likely to cost them over time;
- 6 were unaware of how compound interest works;
- 17 did not know what would happen if they breached a loan condition.

Along with the move to better understand the incidence and causes of mortgage defaults and repossessions, such developments might make it easier to prevent, support and ameliorate the whole procedure whereby borrowers default on loans and households face having their homes repossessed.

3.2 Impacts

The impacts of mortgage default on a household are economic, social and emotional. The Wesley Mission (2006; 2007: 3) argues that the impacts of broader financial stress in Australian households — such as relationship breakdown, conflicts, alcohol and drug abuse, domestic violence and gambling — imply annual costs of over \$70 billion in terms of health, community and policing services. Default threatens an impoverishing process incurring all kinds of costs to settle the troublesome debt and might involve bankruptcy or carrying debts forward. Finding new accommodation involves more costs, takes up valuable time, and means upheaval for the whole household.

Sometimes the owners vacate their homes as they struggle with making payments, leasing it to tenants who must vacate the property in a hurry and at their own expense if it is repossessed. Tenants in investment properties face the same situation. In both Victoria and NSW, tenants are prejudiced against and face serious predicament if the house they are renting is subject to legal action (Tenants' Union of NSW 2007).

Relocation might disrupt children's schooling and isolate them from familiar social circles. If the default has not arisen due to separation or divorce, it might well contribute to the breakdown of the household. The household has to deal with emotional grief and loss of self-esteem and sense of self-worth. Emotional attachments to a home make it part of a person's and a family's identity. Often, the future is raked with uncertainty too. A house is a special asset of immediate use-value, and losing a home causes more repercussions than losing shares or a business failing, though sometimes a business is supported by a home mortgage and this causes the default, complicating the household's situation further.

Besides the impacts on individual households, who often become a burden on family, friends and charitable organisations as they seek alternative accommodation, communities experiencing high levels of default suffer in several ways. As already mentioned in 2.1 Trends, default is more prevalent in certain regions than in others. Table 4 shows the level of arrears in certain areas of Australia, namely NSW and the western suburbs of Sydney. In all ten worst postcodes more than one monthly repayment has been missed in one in every 20 mortgages. These ten postcodes are located in five regions, three of them more or less adjacent. Also the percentage of those in arrears in these areas increased in every case over the first quarter of 2008.

In some of these areas there have been reports of several houses in just one street being up for sale due to the inability of their occupants to keep pace with repayments (Overton 2008). Thus, specific neighbourhoods are left very aware and fearful of default. More significantly, house prices drop further precisely in the areas where there is the greatest need to realise the value of their asset. Depressed house prices in certain areas become a serious social and community-based concern, impacting on grossly more mortgagors than those who go into default. At the same time, depressed home prices make all households in those regions more vulnerable to default because they are less likely to make a satisfactory voluntary sale at a reasonable price.

Financial counsellors and charitable organisations (Wesley Mission 2006) as well as politicians' offices in such areas report numerous requests for assistance and a growing incapacity to meet either the number or level of demand. Local businesses tend to suffer exaggerated declines in retail and other activity in such regions too. These impacts are not always separable from the general impact of a wider downturn of which increasing defaults are just one symptom, but the coincidence of factors means that often the most disadvantaged and least well off areas suffer in a variety of very obvious ways. The effect on neighbourhoods and regions is similar to those on individual borrowers and households — demoralisation, fear and impoverishment. A UWS team is due to release a detailed report on the causes and impacts of mortgage default in western Sydney, the worst affected area in all of Australia. A summary of this report will be included in our Final Report.

Table 4: Fitch Ratings 'Top 10 worst performing post codes'*

<i>Rank</i>	<i>Suburb state and postcode region</i>	<i>Loans 30+ days in arrears (%) * 31 March 2008</i>	<i>Loans 30+ days in arrears (%) * 30 September 2007</i>
1	Wetherill Park NSW 2164	6.7	4.9
	Fairfield–Liverpool	4.05	3.21
2	Helensvale Qld 4212	6.4	4.4
	Gold Coast West	2.24	1.49
3	St Mary's NSW 2760	6.3	4.3
	Outer Western Sydney	3.49	2.67
4	Kurrajong NSW 2758	6.1	4.0
	Fairfield–Liverpool	4.05	3.21
5	Guildford NSW 2162	6.0	5.7
	Fairfield–Liverpool	4.05	3.21
6	Punchbowl NSW 2196	5.3	4.6
	Canterbury–Bankstown	3.24	2.60
7	Lake Illawarra NSW 2528	5.2	2.7
	Wollongong	3.5	2.25
8	Greenacre NSW 2190	5.2	4.6
	Canterbury–Bankstown	3.24	2.60
9	Rooty Hill NSW 2766	5.1	2.2
	Outer Western Sydney	3.49	2.67
10	Fairfield NSW 2165	5.0	4.0
	Fairfield–Liverpool	4.05	3.21

* Based on figures relating to the value of loans and a sample of around one million securitised residential mortgages with the proportion based on both totals and disaggregates by postcode

Source: Drawn from figures in Fitch Ratings (2008a: 5, 6)

One of the most disturbing features about defaults is the severity of the impacts for households, local communities, and the support services they require for subsistence. Cyclical downturns are always likely to exaggerate the number of defaults suggesting, in turn, that the most adequate policy intervention would involve preparing emergency response, as well as preventative, measures. It is important to improve research tools and monitoring so as to predict how many and where casualties are most likely. Indeed the representative of LMI Genworth Financial reported in 2007 (House of Representatives 2007: 10) that they were already integrating regional ABS data into their analyses and future projections of default, noting especially that 10–12 postcodes in western and south-western Sydney had levels of unemployment around 8.0–8.5 per cent.

The Fitch Ratings top worst postcodes reports show new areas and regions jostling for places every quarter. The most recent Fitch report of September 2008 (Fitch Ratings 2008b) charts an increasing upward trend in mortgage delinquencies, measured by the percentage of outstanding mortgages in arrears by more than 30 days. The report's main conclusions were as follows:

The average national rate of 30+ days arrears rose from 1.88 per cent to 2.13 per cent between March and September 2008. This is still low by international standards but does show a continued upward trend that has resulted in the rate increasing by 50

per cent over the ten months to September. The 90+ arrears rate rose from 0.73 per cent to 0.97 per cent over the same period.

The arrears rates continued to be highest in NSW (2.59%) and lowest in Western Australia; nine of the ten worst performing postcodes, and 19 of the worst 20, are in NSW. However, rates generally increased throughout Australia.

The worst performing regions continued to be in southern and south-western Sydney, where rates were three times as high as on Sydney's Lower North Shore. However, delinquencies in the former high risk region seem to have stabilised somewhat. Regions outside Sydney, to the north (Newcastle) and south (Wollongong) now figure in the ten worst performing postcodes.

Meanwhile the Australian Mortgage Industry (Fujitsu Consulting 2008: 23) suggests that Australia is headed towards a default 'disaster':

Mortgage stress is real, and increasing in Australia. Around 13 per cent of households are in mortgage stress, of which about half are in severe stress, and are well into potential forced sales or defaults. Much of the stress is already baked in, and we expect to see continued rises in stress throughout 2008.

3.3 Preliminary interviews

In May 2008, interviews were conducted with ten mortgagors who had encountered severe difficulties in repayments, defaulted, and some had subsequently lost their home. The main purpose of these in-depth, qualitative, semi-structured and confidential interviews was to inform the content of a survey to be distributed to 4000 defendants of applications for claims of possession lodged in the supreme courts of NSW and Victoria in late 2008. The participants were recruited through a network of financial counsellors, mainly from suburban Melbourne and interviewed face-to-face by both a male and a female interviewers, but two were from regional (rural) areas and were conducted by one interviewer over the telephone. Interpreters were used in two cases. All were taped and transcribed.

As outlined in Chapter 1, following the return of the surveys, more in-depth interviews will be conducted. However, the preliminary interviews add to a stock of case studies from secondary sources. An analysis of eight of the interviews has been presented (Dalton et al. 2008) and serves as the source of much of the rest of this section. In particular, certain cases in this small sample support other observations and analyses, revealing gaps in current discussion and policies, offering insights and raising questions for further study.

3.3.1 Types of borrowers and homes

All survey participants fitted into the lowest 40 per cent of the income distribution of Australian households. With one exception, they all had experience of consistent labour market participation in such occupations as office manager, operative, factory worker, drug and alcohol worker, and hospitality facility manager. The one exception was a woman, who came to Australia as a refugee with her husband and two children, did not speak English, and had not been in paid employment. Her case involved fraud. At the point of purchase, two participants were single person households, while the other seven were with a partner in couple households. Only one interviewee had solid financial support from family — stepping in and making a substantial personal loan to the household with difficulties. Others ended up facing severe circumstances partly related to insufficient social security safety nets for families in distress.

The housing purchased (1996–2008) was modest. The cheapest and most run down was in a country town and was purchased for \$69,000. The most expensive (\$282,000) was a house purchased in another country town in 2008. The other houses in metropolitan Melbourne ranged between a house purchased for \$215,000 in 2006 and \$170,000 in 2002. All of the houses purchased were well below the median house price in their respective years of purchase. All of them reported on how easy it was to obtain housing finance with high loan to valuation ratios through mortgage brokers or directly from banks or mortgage lenders.

The initial decision to purchase a home was often made against the background of perceived disadvantages of private rental housing, which was seen as expensive and insecure. Participants put into words what statistical data has shown for some time, viz. that private rental housing in urban areas is in short supply, insecure, and expensive in high demand areas. As the participants faced mortgage foreclosure and the sale of their houses, they thought about the alternatives against the background of the housing market, especially the rental market and earlier experiences. As they faced the possibility of relinquishing their house and returning to the private rental market they expressed the same fears about uncertainty and costs.

3.3.2 Causes of default

Consistent with findings from secondary sources already discussed, two types of events or processes stand out as causes of mortgage payment difficulties. Firstly, the consequences of changes to, or loss of, paid employment. Secondly, and closely connected, are other life events, such as illness (including depression), disability and, for two participants that we interviewed, discrimination in the workplace. Exogenous shocks to the finely balanced financial arrangements of low-income households meant that they had extreme difficulty with, or could not meet, their mortgage payments.

Illness was a key issue in many cases. In one, it came after an earlier episode of financial difficulty, caused by a period of unemployment of one income earner, which was successfully managed and overcome. Then the other income earner was diagnosed with breast cancer and had to give up work, and her husband's income-earning capacity was diminished through becoming her carer. After two years completely off work she could only return to work part-time.

A disability arising from an injury at work had caused another interviewee financial distress. Conflict with workmates and his supervisors led to his being sacked from the firm where he sustained the injury and he had had no luck getting another job. He now receives a Disability Support Pension, which is not sufficient to meet his mortgage repayments as well as other living expenses. The security of his housing now rests on the outcome of a legal claim for workers compensation related to the workplace injury.

Disability undermined another interviewee's ability to meet her mortgage repayments. However, in this case, it was her son's severe disability. She purchased her house years before she became pregnant. Initially her husband had cared for the baby because she had greater earning capacity. However, his severe disability led to her deciding to provide direct care. Her husband sought to find a job, but he worked in a casual and contract-based way and his sector had suffered a downturn in activity. The resulting stress in the marital relationship led to their separation. Then she had to care for her son and live on a supporting mother's benefit while her husband provided very small maintenance payments from now regular and secure employment.

Another interviewee's difficulty in meeting mortgage payments and his decision to sell his modest house related to small business failure. The business failed because of decline in trade coupled with business loan payments secured by a mortgage on his home. He responded by going back to driving taxis, but his earnings were insufficient

to meet his mortgage repayments, provide for his family, and pay the accountant. He decided to sell the house, but the accountant 'put a caveat on the house and that is why we can't sell it'. He and his family are caught up in a struggle between the mortgage lender and the accountant over when the house will be sold and the distribution of the assets.

3.3.3 *Managing financial difficulties*

When a household gets into difficulty in meeting its mortgage payments they become engaged with the credit system in two distinct ways. Firstly, there is the management of credit card debt, and secondly there are the negotiations with mortgage providers. The use of credit cards is a ubiquitous feature of Australian society. However, for three of our eight interviewees, credit card debt was not a feature of their history of debt and mortgage repayment difficulties. Credit card debt did feature in the accounts of four others, while not being the cause of their mortgage repayment problems. Instead, they offered a means of coping when our interviewees became desperate and required funds to try and meet their commitments. Only in one case did credit card debt feature as a significant causal factor. In this case it was connected to inherited debt from a partner who died:

My [deceased] husband was a drug abuser and he spent a lot of money on drugs and that's why my card kept going up, up, up — because he had finished his own cards. Now, on my credit card, I owe about \$29,000 ... and I couldn't pay.

In short, there is little evidence of profligate purchasing of consumer items.

Nearly all those interviewed were still in negotiation with mortgage lenders primarily with the assistance of financial counsellors who had assessed their difficulties, advised them on budgeting and so on, and became their advocates with both the mortgage lenders (banks and non-bank lenders) and credit card providers. All the service providers, in particular financial counsellors we have interviewed, are severely stretched in meeting the real demand for timely and useful debt management.

There was evidence that many lenders were not good at responding to and dealing with people in trouble. One of those we interviewed reported that it took months for their lender to respond to a plea to renegotiate the loan terms due to a clear case of hardship. Meanwhile she fell further into arrears prejudicing her case and financial situation. Another had managed to gain superannuation funds to tide them over but, once successful, the lender decided to use the funds to cover a previous hardship claim instead of addressing the current situation. (To access superannuation funds, the lender must provide a letter saying the loan is in default, but these funds are not meant to be applied retrospectively.) Yet another interviewee had managed to get a real estate agent to sell her home for a reasonable price, which would have covered her debt, but the lender did not give permission for this sale to go through and now she owed the gap between what her house had realised through a mortgagee in possession sale and the original loan. Also, one interviewee who did not speak English had been implicated in a fraudulent application for a loan made on her behalf by her estranged husband and required extra levels of counsellor and legal support.

Thus, this small sample of in-depth interviews confirms some of the general points made by other analysts, especially related to the complexity of scenarios leading to and involving default, as well as indicating that those experiencing severe financial distress have few options and very little legal or financial support. The policy implications of such findings are discussed in Chapter 5.

This chapter has focused on the consequences of mortgage difficulties, as they impact the households — and to a lesser extent, immediate communities — implicated. The next chapter shifts the focus to ‘the bigger picture’ — i.e. to the implications of increasing mortgage default for the macro-economy, in the shadow of the worst international financial crisis since the Great Depression of the 1930s.

4 THE BIG PICTURE: MORTGAGE DEFAULT AND THE MACRO-ECONOMY

This chapter traces the main trajectory of the ‘subprime crisis’ in the United States (US) before looking at the potential threats posed by these developments to the stability of financial markets and the real economy in both the US and other major developed economies. The issue of how these developments and threats might impinge on Australia, briefly raised in Chapter 2, is then addressed.

4.1 Unfolding of the ‘subprime crisis’

The subprime crisis is the name for what is a historic turning point in our economy and our culture. It is, at its core, the result of a speculative bubble in the housing market that began to burst in the United States in 2006 and has now caused ruptures across many other countries in the form of financial failures and a global credit crunch (Shiller 2008: 1).

Traditionally, mortgage lenders in the US and elsewhere (generally banks) originated loans to house purchasers on a face-to-face basis. This meant that the lender generally demanded and received a range of information about the borrower, including his or her income, employment history, level of savings, credit history — particularly whether or not they had defaulted on loans in the past — allowing direct judgments to be made on the credit-worthiness of the borrower. Depending on the loan-to-value ratio (LVR) of the loan, mortgage insurance may have been required, shifting part of the risk of default from both lender and borrower to an insurer for a premium paid by either borrower or lender. Borrowers were charged appropriate fees for the credit and related assessment process, as part of the overall transaction costs. Individual dwellings were valued by certified valuers. Conservative LTVs tended to further protect the lender. As an overall consequence, mortgage default rates were low. In a real sense, all or almost all mortgage loans were ‘prime’, defined as subject to a very low probability of default.

One disadvantage for the banks, however, was that these assets were tied up in long-term loans. A disadvantage for borrowers en masse was that credit for both house purchases and other purchases was constrained by the capital adequacy or reserve requirements of the banks and the savings habits of citizens. The rapid growth of secondary mortgage markets and subsequent innovations, especially those following the wave of deregulation that has swept through global financial markets since the 1980s, has changed the face of residential mortgage lending as traditionally practiced. Increasingly, individual mortgage loans were ‘bundled’ together by investment banks and other financial intermediaries. The resulting bonds — mortgage-backed securities (MBSs), part of a larger class of asset-backed securities (ABSs) — were sold to a range of investors, notably pension and mutual funds looking to park large tranches of savings aggregated from myriad smaller investors and individual savers. The primary lender, banks, passed the loan through (sold it) to a securitisation vehicle in return for the principal and a fee. The lender could then re-lend to another mortgagor, pass that on in the secondary mortgage market, collect the fee, and so on and so on.

The explosive growth of funds under management by institutional investors seemed to provide an unending source of demand for liquid securities like MBSs (and other ABSs), as long as they were appropriately ‘rated’ by one of the long established ratings firms – notably Moody’s, Standard and Poors, and Fitch Ratings. Although the details varied among the big three ratings agencies, the basic idea was to distinguish ‘investment grade’ or prime assets from others that had a progressively higher probability of default. This was done on a sliding scale with ‘triple-A’ (AAA)

representing the lowest risk, down through a series of grades of A, B and eventually C (the latter also termed 'junk'). For example, Moody's grades bonds on a twenty-one step scale from AAA to a single C; the top ten grades are investment quality or prime. The bond rating was decisive in determining the interest (or coupon) rate that would have to be offered investors — the lower the rating, the higher the interest rate.

The ratings agencies had developed sophisticated tools for factoring in the various conditions that had been shown to bring about mortgage defaults in the past, i.e. the rating was based on a statistical analysis of a large number of past transactions and default events. MBSs could also be insured against default by specialist 'monoline' bond insurers, like PMI and MBIA, providing further comfort to investors and reducing required interest rates. The agencies also rated the bond insurers, giving investors a seemingly solid view on how likely the insurers would be in a position to pay out in the event of the insured bonds going into default. The system seemed foolproof, with risk carefully priced and allocated by efficient financial markets to those best able and willing to bear it in order to maximise the sustainable flow of investment into mortgage-financed housing purchase.

'Non-prime' and 'subprime'

Non-prime refers primarily to **subprime** and **alt-A** mortgages.

Subprime loans are typically made to borrowers that display one or more of the following characteristics at the time of origination:

weakened credit histories that include payment delinquencies and bankruptcies
reduced repayment capacity as measured by credit scores or debt-to-income ratios, or
incomplete credit histories.

Alt-A mortgages, though of higher quality than subprime mortgages, are considered lower credit quality than prime mortgages due to one or more non-standard features related to the borrower, property, or loan

Source: IMF 2008c: 4.

During the long upward swing in US housing markets, this picture certainly seemed to be accurate. Lending volumes, securitisation and housing prices followed each other up in a continuing, self-reinforcing spiral. By early 2008, the total value of housing mortgages outstanding in the US was around \$US12 trillion: more than half (\$6.8 trillion) was in the form of MBSs, in turn representing about a quarter of the total US bond market, making it bigger, for example, than the market for US Treasury bonds, with \$1.3 trillion of MBSs lending categorised as subprime (Lancaster 2008: 11). The volume of mortgage loans advanced in 2006, the high point of the subprime boom, reached a staggering \$2.5 trillion (Lowenstein 2008: 1).

But — from late 2006 — warning bells began ringing. The neat system unravelled at an increasing rate during the second half of 2007 and through 2008 as mortgage defaults escalated. Criticism focused on the role of the ratings agencies, as the comment below suggests:

Thus the agencies became the defacto watchdog over the mortgage industry. In a practical sense, it was Moody's and Standard and Poors that set the credit standards that determined which loans Wall Street could repackage and, ultimately, which borrowers would qualify. Effectively, they did the job that was expected of banks and government regulators. And today, they are a central culprit in the mortgage bust, in which the total loss has been projected at \$250 billion and possibly much more. (Lowenstein 2008: 1)

To understand how the unravelling occurred and the culpability of the agencies and other players it is necessary to see how the well-established MBS market morphed into a more complicated, opaque and uncertain investment climate in which no one really knew who was holding what risks. However, before doing this, it is salutary to outline the gathering scale and pace of the unravelling, the extent to which mortgage markets have deteriorated in recent years. The data that follows is drawn from the IMF (2008c) Global Financial Stability Report, published in April. Data relating to the dramatic developments in the last quarter of 2008 are presented later in this chapter.

Figure 17 shows that mortgage delinquencies (repayments outstanding for 60 days or longer) in the US have risen sharply for subprime loans, particularly those taken out after 2004. Loans taken out between 2000 and 2004 peaked at 15–25 per cent delinquency with respect to the amounts outstanding 3–5 years after origination. Loan delinquencies originated since then have not yet peaked. Moreover, delinquency rates among those taken out in 2006 have risen faster than those commenced in 2005, while the most recent 2007 loans are moving into delinquency more quickly again:

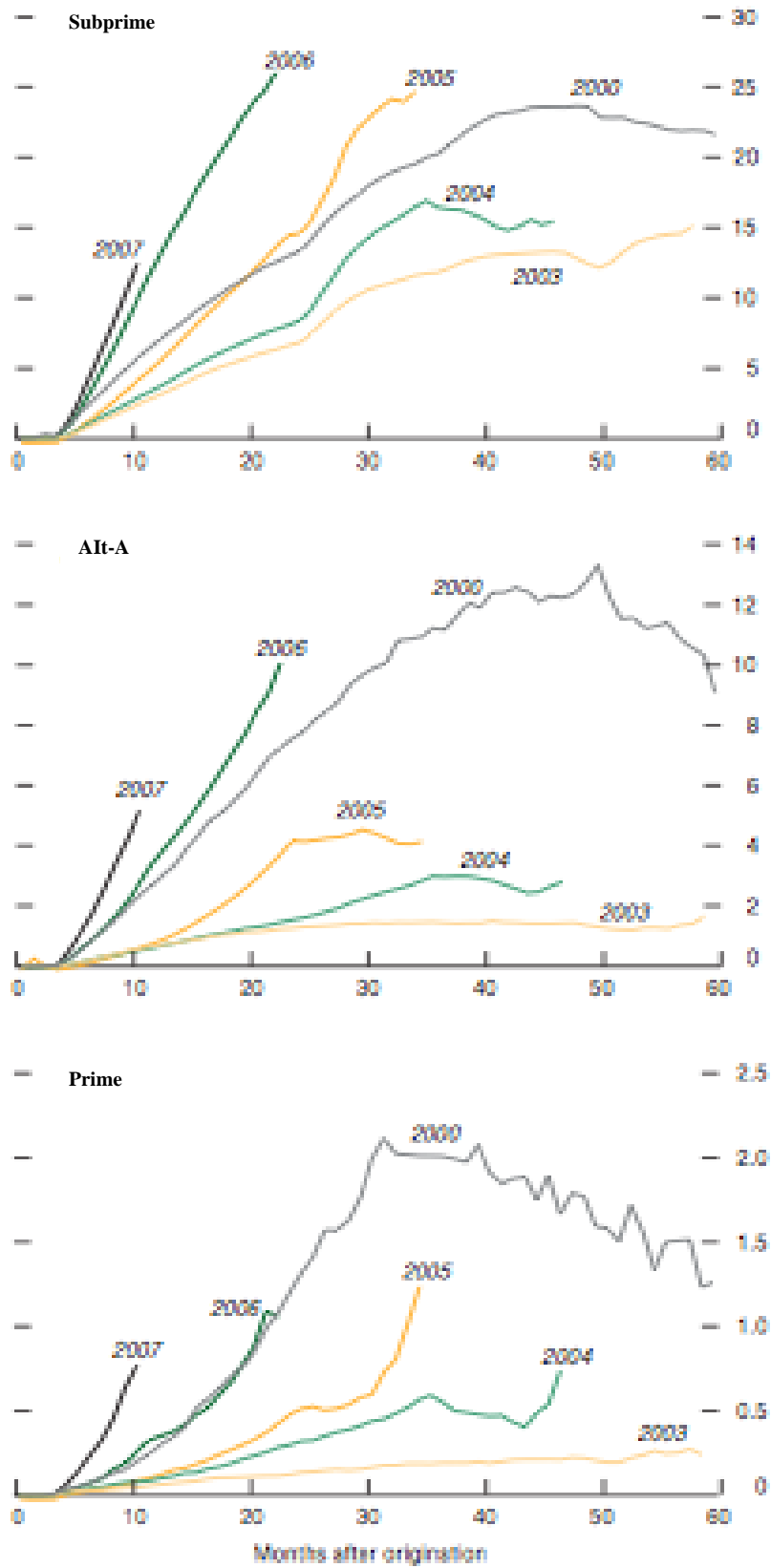
Within recent cohorts, the deterioration has been primarily associated with the least creditworthy borrowers defaulting on adjustable-rate mortgages (ARMs). (IMF 2008c: 5)

A similar pattern of delinquency is apparent for both Alt-A mortgages (see box on previous page) and prime mortgages, but at lower (and in the latter case, much lower) balances outstanding. This suggests that, although initially and substantially concentrated in the subprime market, mortgage defaults were ‘spilling over’ into other mortgage markets.

With falling house prices (see below), recent cohorts of borrowers have had a smaller equity ‘cushion’ to fall back on. Once negative equity sets in, borrowers had a growing incentive to default. The move from fixed to variable rate mortgages or ARMs has allowed, even encouraged, lenders to offer ‘teaser rates’ — i.e. low initial interest rates subsequently resetting to higher rates — a key factor in understanding the future pattern, if not the past jump, in delinquency outcomes. Thus, by the third quarter 2007, 43 per cent of foreclosures in recent mortgagor cohorts were on subprime ARMs and ‘only’ 19 per cent on prime ARMs. Foreclosures on fixed rate loans, both prime and subprime, and on mortgages insured by the Federal Housing Administration were lower (IMF 2008c: 5, fn. 7).

The IMF (2008c) report noted anecdotal evidence that the foreclosures on ARMs to late 2007 normally had been prior to interest rate re-setting, suggesting such delinquencies were the result of factors like fraud, speculation, over-extension by borrowers and weak underwriting standards. Increasingly, however, arrears, defaults, foreclosures and forced sales seemed likely to result from the wave of interest rate re-sets scheduled through 2008: \$250 billion in relation to subprime ARMs, \$82 billion in prime mortgages and \$29 billion in Alt-A mortgages. Increasing numbers of forced sales were expected to reinforce the downward slide in housing prices in the most affected regional sub-markets, threatening to fuel the downward spiral of values and defaults. Re-financing, as a way of alleviating pressure on borrowers, was expected to be increasingly difficult in the emerging climate of tighter credit and high fixed rates (IMF 2008c: 5, fn. 8).

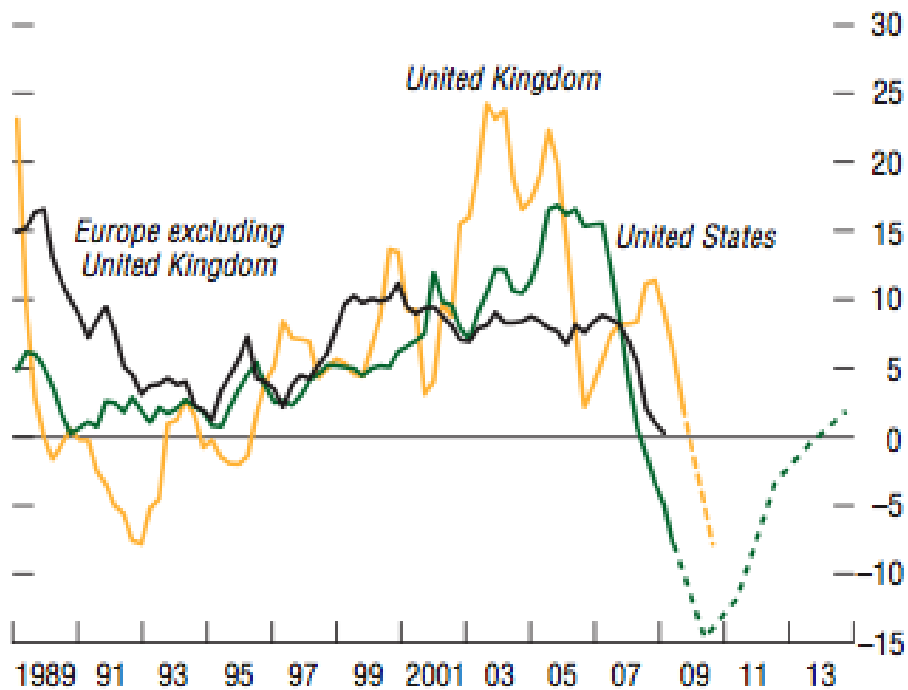
Figure 17: US mortgage delinquencies by vintage year



Source: IMF 2008c: 6 (60 day delinquencies, as a percentage of the balance)

The Case-Shiller house price index tracks repeat-sales of housing across 20 of the main metropolitan regions in the United States. In July, the index reported that median house prices across these city regions had fallen by 15.8 per cent between May 2007 and May 2008, according to Bloomberg (quoted in de la Merced 2008). Figure 18 demonstrates the extreme volatility of house prices in the US and UK. If the most recent data provided by Case-Shiller is accurate, the steep dive in US prices is likely to be even steeper than that forecast by the IMF. In the same article in the Australian Financial Review (de la Merced 2008: 16), the US Treasury Secretary, Henry Paulson, commented that '(t)he worst housing slump since the Great Depression would not end quickly'.

Figure 18: House price changes in US and Europe — per cent per annum



Sources: Standard & Poor's/Case Shiller; national authorities; and IMF staff estimates.

Note: Europe excluding the United Kingdom: unweighted average of Spain, Germany, Italy, Netherlands, Greece (from 1995), and Ireland (from 1997). Estimates are based on futures prices. Dashed lines are futures implied.

Source: IMF 2008c: 7

Returning to the question — How did it all go so wrong? — it is necessary to look at recent innovations in financial products and how the established ratings and insurance processes failed to adequately monitor, still less check, the over-extension of mortgage credit to borrowers who were likely to default. At base, too many borrowers were enabled to buy houses that they could not sustain the repayments on. In other words, loans were advanced to borrowers who would not normally have passed the credit checks of primary lenders or their brokers and insurers. This occurred largely because the brokers and lenders passed on the credit risk to purchasers of MBS, via structured finance products created by the investment banks, and so had little incentive to ensure credit worthiness of borrowers. This is a prime example of what economists term, 'moral hazard'. The new investment products — notably special

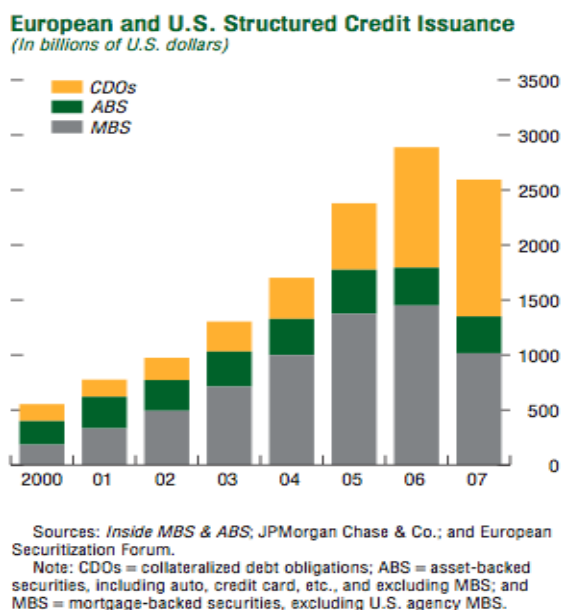
purpose vehicles (SPVs), also known as special investment vehicles (SIVs), engineered through 'structured financing' by investment banks — allowed subprime loans to back bond tranches attracting prime ratings, swelling the supply of MBS and creating its own demand in an exuberant market climate. This apparently counter-intuitive outcome worked as follows.

An SPV would be established as a legal but empty structure — i.e. having no real assets, just a pool of subprime mortgages purchased from lenders, financed by selling bonds to investors. The 'trick' was to create a ladder or hierarchy of bond classes ranging from triple-A down to Bs with each tranche sold to investors with the appropriate risk requirements. Thus, pension funds that by law could only buy triple-A did so. Investors with higher appetites for risk bought the lower rated bonds, but had to pay the higher interest rates entailed. The total interest income received from all purchasers was pooled and paid out in strict order as follows: the interest due to all triple-A bond holders ('the senior tranche') was paid out of the pool first, then that due to the next highest grade bonds paid in full, and so on down to the lowest grade debt. As long as there were no defaults, every bondholder was paid; the banks financing the SPV would also reap their not inconsiderable fees. But any defaults that did occur would be borne initially and fully by the holders of the lowest rated debt ('the equity tranche'), once a cash-buffer provided by the SPV arranger had been exhausted. Only as defaults rose would bondholders further up the chain be affected. For holders of the highest-grade debt only a financial Tsunami would disturb their payments. Lowenstein (2008: 3) provides a vivid metaphor:

[i]magine a sea-side condo beset by flooding: just as the penthouse will not get wet until the lower floors are thoroughly soaked, so the triple-A bonds would not lose a dime until the lower credits were wiped out.

Structured finance differs from standard securitisation in that the former allows investors to choose the balance of different risk classes of pooled assets they hold rather than all holding the same pro-rata share of all assets in the pool. The total issuance of structured finance products grew from \$500 billion in 2000 to just under \$3 trillion in 2006 (see Figure 19).

Figure 19: Structured credit issues: Europe and US



Source: IMF 2008c: 56

All seemed to be in order. Unfortunately, it has become clear over the past year or two that the historical default data on which the underlying bond tranche ratings were calculated did not take into account — i.e. foresee — the speculative developments (unprecedented since the Great Depression) in US residential property markets. Thus an unsustainable price boom, massive consumer debt, and a sharp downward correction (as shown in Figure 18) sparked the pattern of unexpected and under-priced delinquencies already noted.

As a result, the ratings agencies have had to progressively downgrade bond issues of many MBSs, resulting in follow-on (and increasingly anticipatory) asset write-downs by investors holding those bonds. By early 2008 the agencies had turned their attention to the bond insurers, threatening to down grade the claims-paying ability of key insurers like PMI, Radian and Republic, reinforcing the growing concerns about mis-pricing throughout the bond markets (see below for further comment on this issue). The largest insurer, MGIC, in the light of expected payouts on defaulting MBS, has indicated that it would not be profitable again until 2009 (Hamilton & Holm 2008: 14). This is a further indicator of the potential for credit problems generated in the subprime housing market to spill over to other parts of the financial system.

But the worst is yet to come. A second order or 'derivative' market quickly developed in the products of SPVs selling structured layers of MBS. So-called 'collateralised debt obligations' (CDOs) were floated and sold as bonds to investors. These were bonds backed by bonds backed by mortgages:

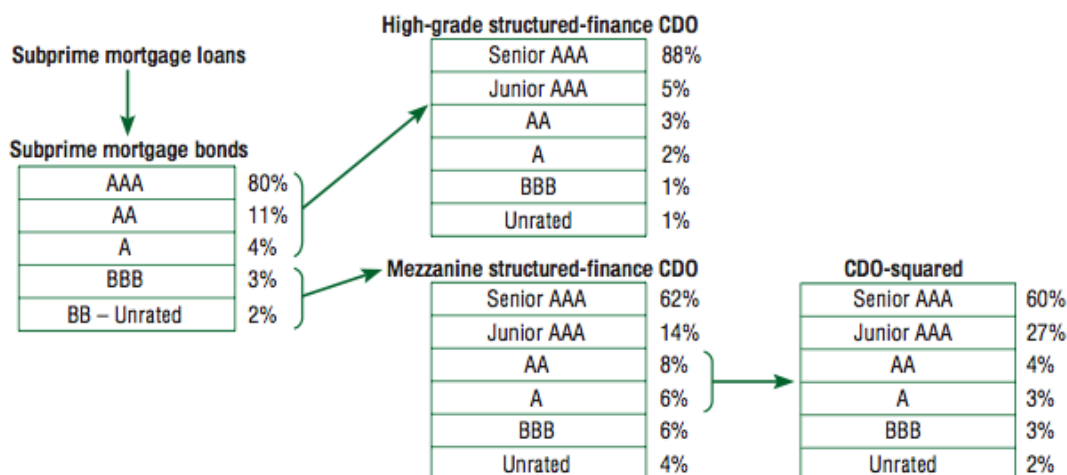
Miscalculations that were damaging at the level of [SPVs] were devastating at the C.D.O. level. Just as bad weather will cause more serious delays to travellers with multiple flights, so, if the underlying mortgage bonds were misrated, the trouble was compounded in the case of the C.D.O.s that purchased them. (Lowenstein 2008: 4).

To continue the weather analogy — it never rains but it snows. Third order derivatives were also sold — 'CDOs-squared' — which were bonds backed by bonds backed by bonds backed by mortgages, further compounding the impact of mis-pricing and rendering even more opaque the real underlying allocation of risks. Figure 20 describes the basic structure of these products with typical layering of tranches.

For the basic 'vanilla' structured product, the percentage share of each tranche was carefully calculated to fire proof the senior (triple-A) debt in light of historic default rates of subprime mortgages. For example, before the subprime crisis, it was thought that 20 per cent 'over-collateralisation' plus subordination would mean that there would always be enough money coming into the pool to fully meet the payments to the 80 per cent of triple-A bonds. Even though some of the lower rated bonds in the pool would default, the average amounts recouped on forced sales added to the priority payment to senior debt holders would fully meet the latter's payments. In effect, the investment banks were able to use the rating templates of the agencies to just get the package over the line. In the event, since delinquency rates for recent subprime mortgages (see Figure 17, above) have been running in excess of 25 per cent and falling housing prices (see Figure 19) have reduced the average amounts realised from forced sales, the triple-A bonds in structured mortgage backed vehicles appear to be riskier than comparatively rated corporate bonds. What is really a double-A (AA) or lower bond is masquerading as AAA. This emerging view of mis-rating in financial markets is further eroding investor confidence overall.

Figure 20: Structured credit products: CDOs and CDO-squareds

Matryoshka — Russian Doll: Multi-Layered Structured Credit Products



Source: IMF staff estimates.
 Note: CDO = collateralized debt obligation.

Source: IMF 2008c: 60

CDO structuring proves even more fragile and vulnerable to higher than allowed for defaults of the underlying subprime mortgages behind the repackaged MBS. BBB rated debt is effectively leveraged to AA level, but if actual losses exceed the enhancement assumed in the CDO package, the BBB-to-AA bond tranche can sustain up to 100 per cent losses (default). This further reduces confidence in the CDO's senior debt, since the floodwaters are getting uncomfortably close to their front door. CDOs-squared simply compound the risks, unsurprisingly since they appear to have arisen in part as a way of making the slower moving mezzanine CDO tranches more attractive to investors — a case of one more round of 'pass the parcel', to change the metaphor.

It has to be asked — Why did this happen? Why did Wall Street enter the housing market and transform what Lowenstein (2008: 1) called 'the sleepest corners of finance'? Structured finance had worked well in many areas. In the case of MBS derived products it appeared to allow investors to better match their risk profiles with products that offered somewhat higher returns than similarly rated non-MBS type products like corporate bonds, without taking on additional risk. The ratings agencies were simply assumed to know what they were doing. Banks could make their capital work harder without assuming direct credit risk, as they accumulated fees for passing on mortgages and providing short-term debt to fund the formation and credit enhancement of SPVs, CDOs etc. Investment banks at the centre of the web grew rich on fees and the returns on the SPVs that they held onto. Institutional investors had access to a growing pool of diversified investment products.

Nevertheless, it is clear in hindsight that very few actors saw the hundred-year flood coming, the growing volume of very risky loans that began to default at unexpectedly high rates from late 2006 onwards. Again, with hindsight, the agencies were too generous in their ratings, perhaps reflecting a basic flaw in the system, an institutionalisation of perverse incentives and conflicts of interest. Instead of providing credit ratings directly to potential investors, the agencies are paid by investment banks and other sellers to rate their products. Lowenstein (2008: 5–6) argues that

establishing ratings for structured products is essentially a collaborative process of bargaining between the banks and the agencies with both parties fully aware of the rating tools and rules. The agencies receive their fees from the banks when a deal is struck. Most deals come in large scale from a small number of banks, each successful deal carrying a large fee for the rating agency. If one of the major agencies does not rate the package to the desired level, the bank can try it with one of the other big two agencies, a practice known as 'ratings shopping'. In a situation that amounts to bilateral oligopoly, it is not clear that the interests of third parties — investors and home purchasers — will be paramount. Recent experience also appears to suggest that existing regulatory frameworks have not been effective in protecting the interests of these third parties.

An indicator of the system failures is provided by the recent spate of MBS-related bond downgrades by the main agencies. An IMF (2008a: 61) analysis of the Standard and Poors' ratings changes on residential MBS found that by February 2008, three-quarters of B and BB debt and two-thirds of BBB debt had been downgraded by one or more levels. More than 50 per cent of MBS originally rated BBB since 2005 had been graded downwards by three levels or more. 'Only' 10 per cent of AA debt had been downgraded by three or more levels, and AAA barely at all. However, 47 per cent of AAA tranches were on 'negative credit watch', suggesting that future downgrades were likely; the proportions of AA+, AA and AA- tranches in a similar situation were 57 per cent, 74 per cent and 80 per cent, respectively. This contrasted sharply with the situation in the corporate bond market where virtually no A-rated security had been downgraded by three or more levels and less than 10 per cent of any A or high B bonds had suffered any downgrading. Bond markets, however, were running well ahead of the ratings agencies; by late 2007 markets were pricing AAA MBS at spreads above BBB corporate bonds:

The multiple-notch downgrades and the severe valuation losses during the second half of 2007 and early 2008 also suggest that the credit rating agencies' key assumptions on the underlying subprime mortgage performance have been overly optimistic. It appears that the agencies underestimated the impact of the housing-cycle downturn on the speed with which subprime mortgage performance deteriorated and on the severity of potential losses... More specifically, the joint effect of house price declines and high loan-to-value ratios seems to have been underestimated, and the risk assumptions for low- and no-documentation housing loans were too low. In addition, the likelihood of early delinquencies going into foreclosure seems to have been underestimated. (IMF 2008a: 62)

Apart from the obvious losses, financial and psychological, borne by defaulting home owners, the cycle of mortgage arrears, default, foreclosure and bond down-grades is placing a heavy burden of loss on the investors who purchased the MBS-type products during the boom buoyed by the bullish market sentiment and overly optimistic ratings. The larger question is to what extent these losses will be quarantined, confined to residential MBS holders rather than spilling over to other investment classes, possibly placing at risk the entire financial system in the US and beyond. There are signs, as the next section argues, that 'systemic crisis' in this sense is a distinct possibility and one that central banks and other economic policymakers are taking very seriously.

4.2 The threat of systemic risk

4.2.1 Act I — Prelude

By early 2007 it had become clear that the US residential MBS market was in a gathering crisis. However, it was also clear that the effects of this mortgage default generated debacle would not end there. ‘Financial contagion’ describes a situation in which failures and defaults in one sector and country progressively disrupt other financial markets in one country after another, resulting in a self-reinforcing circle of declining credit — a ‘credit squeeze’ that can turn into a ‘credit crunch’ that effectively reduces liquidity to a point where real economic activity slows and, possibly, begins to decline — in short, a general global recession:

In sum, the global financial system has undoubtedly come under increasing strain since the October 2007 [IMF review], and risks to financial stability remain elevated. The systemic concerns are exacerbated by a deterioration of credit quality, a drop in valuations of structured credit products, and a lack of market liquidity accompanying a broad de-leveraging in the financial system (IMF 2008c: ix).

The IMF (2008c) review points to a number of indicators to support its conclusions, particularly with respect to the US:

- Commercial real estate markets have slowed significantly since their peak in 2005–6. Prices and mortgage borrowing are falling and securitisation has stalled. However, defaults are less likely to be a problem than in residential markets, since the rate of mortgage securitisation is much lower (25 per cent as opposed to over 80 per cent in subprime housing mortgages), less reliance on structured products and greater oversight by auditors. Even so, commercial MBS spreads (excess of bond rates over Treasury rate) have widened to ‘near-record levels’, suggesting market fears that worsening macro-economic conditions and existing debt levels or ‘over-hang’ could lead to rising future default rates in the \$3.3 trillion market.
- Consumer debt markets (\$2.5 trillion) have held up to date with relatively low ‘charge-off rates’². However, personal bankruptcies and defaults are expected to increase if the economy slows sufficiently and unemployment rises (as they have in the last quarter of 2008, see below).
- Corporate bond markets are weakening. Defaults on high-yield (low rated) bonds are up sharply in 2008. This trend is expected to continue given the high leverage taken on by the corporate sector during the long boom; the ratio of corporate debt to earnings has roughly doubled since 2003, while the ratio of earnings to interest payable has halved. The markets for high-yield debt and structured products have ‘stalled’.

Of particular concern to economic policy maker is the fact that the commercial and investment banks (until the latter ceased to exist, see below) in the US are increasingly embroiled in the credit shake-out underway. It is only gradually becoming known which banks are at risk of losses derived from the spate of SPV and related financing. In addition to the CDO exposure, some banks engaged heavily in CLOs (collateralised loan obligations — derivatives backed by commercial loans, revolving credit facilities, letters of credit, etc.), commercial paper (short-term loans and implicit guarantees to finance structured products), large lines of credit extended to hedge

² A charge-off refers to the lender writing off a debt that cannot be collected due to bankruptcy or default by the borrower.

funds, credit default swaps, and the like. Uncertainty about the level of exposure to such transactions led to widespread concern about the capacity of individual banks to meet their counter-party obligations, causing the inter-bank lending market to dry up; banks could not be sure they would be repaid. This meant that banks had to pull back on lending in order to repair and demonstrate their capital adequacy. The credit squeeze tightened and the central banks of the US and Europe collectively had to pump liquidity into world financial markets). At the same time, the banks were forced to declare and take back onto their balance sheets, as large write-downs, many of the loan products created during the boom. These depreciated bond and related assets were brought back on balance sheets in preference to being sold at fire-sale prices in deeply depressed financial markets. It is not clear at the time of writing how far this process has played out and what the final consequences will be.

In April 2008 the IMF estimated likely losses (i.e. asset write-downs, not trading losses) as summarised in Table 5. Total losses were estimated (at March 2008) to be almost one trillion dollars. Two-thirds of these losses are sheeted home to securitised real estate assets, mostly residential. Estimated losses on securitised assets are on a 'mark-to-market' basis — i.e. based on valuing the securities at the most recent prices they would fetch if traded in 'normal' volumes. Such estimates are subject to a wide variation and rapid revaluation when new information about actual losses emerges. More bearish commentators have proposed higher credit-related losses than the IMF. For example, Professor Nouriel Roubini (2008a), principal of RGE Monitor, has more recently argued that the subprime mortgage crisis is 'only the tip of the bad-loan iceberg', suggesting that total losses could reach two trillion dollars.

Table 5: Estimates of US financial sector losses, March 2008 (\$USbillion)

<i>Unsecuritised debt</i>	<i>Outstanding</i>	<i>Estimated losses</i>
Subprime mortgage	300	45
Alt-A mortgage	600	30
Prime mortgage	3800	140
Commercial real estate	2400	30
Consumer loans	1400	20
Corporate loans	3700	50
Leveraged loans	170	10
TOTAL	12,370	225
<i>Securitised debt</i>		
ABS	1100	210
ABS CDOs	400	240
Prime MBS	3800	0
CMBS	940	210
Consumer MBS	650	0
High-grade corporate	3000	0
High-yield corporate	600	30
CLOs	350	30
TOTAL	10,840	720
GRAND TOTAL	23,210	945

Source: IMF (2008a, p. 12)

Banks stand to bear about half of the losses with respect to both securitised and unsecuritised loans. Remaining losses are estimated by the IMF to be roughly evenly

spread between insurance companies, pension (superannuation) funds, government agencies and government sponsored enterprises (GSEs, notably the two major mortgage providers, Fannie Mae and Freddie Mac) and hedge funds — though the latter two categories are most at risk of facing ‘blow-out losses’.

These total losses are estimated to dwarf the US savings and loan crisis of the late 1980s and to exceed the Japanese and Asian banking crises of the 1990s, yet to be substantially lower in relation to the nation’s gross domestic product (GDP) than in the latter two cases.

Credit-related losses are not confined to the US. European banks are also heavily exposed to MBS and structured financial products and have been slower to write-down expected losses than US banks (IMF 2008c: 12–13). The ‘run’ on British bank Northern Rock in late 2007 was dramatic evidence of the global ‘over-spill’ of the subprime crisis. The effective nationalisation of Northern Rock by the UK government in February 2008 was, at the time, estimated to eventually cost taxpayers over £100 billion. However, it is not clear how accurate this estimate is in view of the extreme uncertainty about how bad actual MBS losses will be and how long it will be before market conditions allow an orderly re-sale to wary private investors. Total European bank losses are estimated at around \$120 billion, two-thirds of which are related to CDOs and SPVs (IMF 2008c: 13).

Further uncertainty in the banking system is being caused by the prospect of continuing asset downgrades due to the factor mentioned earlier — viz. the failure of guarantors like the monoline bond insurers. Uncertainty as to which financial system actors still hold undeclared non-performing assets, particularly credit default swaps (CDS)³, is further undermining confidence and constraining liquidity. The CDS market is heavily concentrated with ten market makers accounting for around 90 per cent of the \$45 trillion contracts outstanding. If one or two failed to meet their counter-party obligations, the whole market would be thrown into turmoil. Other technical weaknesses in the CDS market (e.g. lack of a centralised clearing system) also raise the risk of failures. Consequently, many banks, including those in Australia, have begun to write-down their CDS assets as the real value of the protection offered by guarantors is called into question.

As a consequence, the IMF (2008c: 18) review argued that two key measures of systemic banking failure had worsened significantly, e.g. the probability of one ‘large and complex financial institution’ defaulting on its liabilities increased from less than one per cent in early 2007 to over five per cent in early 2008, while the expected number of banks expected to default if one bank defaults rose from less than two to six.

It is worth noting that through 2007 to mid-2008, ten US banks declared bankruptcy, including the third largest failure in US history (IndyMac Bank). Other recent developments and indicators continue to suggest that systemic risk remains high — a situation explicitly acknowledged by the IMF in its July 2008 ‘Update’ (IMF 2008a). In April 2008, the third largest investment bank, Bear Stearns, faced bankruptcy until a Federal Reserve backed (i.e. effectively guaranteed) bid by JP Morgan engineered a successful take over. The share price index for US commercial banks fell by 60 per cent from January 2007 to July 2008, and by 40 per cent for European banks over the

³ A credit default swap entails the seller (usually a bank) promising (for a fee) to take over a subsequently defaulting asset from the buyer at its face value and thus, in that eventuality, ‘booking’ the loss on its balance sheet.

same period; credit default swap spreads rose from less than 10 basis points to 250 (US) and almost 100 (UK) (IMF 2008a: 5).

Finally, in July 2008, the largest two mortgage lenders in the country, GSEs Fannie Mae and Freddie Mac, together holding 40 per cent of outstanding residential MBS, successfully gained federal government support to prevent going into technical insolvency. This rescue plan empowered the US Treasury to ‘temporarily’ buy shares in the ailing GSEs and to extend short-term credit support. The US Congress subsequently passed into law provision for \$300 billion of guarantees to fund these guarantees and assist homeowners to avert foreclosures. It is not clear if this provision will be adequate to avert future crises if housing prices continue to fall and defaults to rise. Roubini (2008b), for one, argues that the final total cost to the US government to ‘bail out’ the housing market may exceed \$1 trillion. All this is in addition to the federal government guarantee on bank deposits through the Federal Deposit Insurance Corporation (FDIC) that ensures that all investors’ savings deposits are insured for the first \$100,000. The ten bank failures to date have cost the FDIC almost \$10 billion, wiping 17 per cent off its assets (the largest call on the fund since it was established in 1933) and ensuring that all US banks will be charged higher future premiums; the FDIC’s ‘problem list’ of banks rose to 90 during the first quarter of 2008 (Bloomberg, quoted in de la Merced: 12).

The banks, especially the investment banks, were under very strong pressure to sell off written down assets to raise cash to meet short-term liabilities. All banks ‘borrow long and lend short’. Investment banks are especially reliant on short and medium-term funds that need to be repaid or rolled over — and are also, typically, heavily leveraged. Thus, in March 2008, Lehman Brothers was forced to seek a heavy capital injection. In July 2008, Merrill Lynch advised that it had sold CDOs book valued at \$30.6 billion to ‘vulture capitalist’ Lone Star Funds for \$6.7 billion, a price of 22 cents in the dollar. Roubini (2008c) predicted that Merrill Lynch, Goldman Sachs, and Morgan Stanley will all be seeking buyers in the second half of 2008. Specific SPVs, mutual funds and hedge funds are even more heavily leveraged and under even greater pressure to unload declining assets at any price, further driving securities prices down and intensifying the credit squeeze.

In its July update, the IMF (2008a) points to three positive signs on the horizon. First, they suggested, emerging financial markets remain resilient and appear to be avoiding financial contagion while their underlying economies continue to grow. Second, sovereign wealth funds are continuing to inject needed equity into the banks as the latter strive to get their balance sheets in order. Third, cooperative central bank action has succeeded to a degree in slowing the decline in overall liquidity. However, banks in the developed world will continue to struggle to maintain earnings in the light of falling credit quality, as described, and de-leveraging throughout their economies. Subsequent developments suggest that the IMF’s guarded optimism proved premature, at best.

4.2.2 Act II — Black September

The developments in the first half of 2008 turned out to be merely the first act in an as yet uncompleted performance. September 2008 witnessed a literally unprecedented unfolding of a linked series of financial crises and responses. The overture was the US government bail-out of Fannie Mae and Freddie Mac, noted above. The government moved to take control of the two GSEs, replacing the management with an appointed ‘conservator’ (the Federal Housing Finance Agency) which is supposed to rationalise and sell down some of their assets in an ‘orderly fashion’. Common shareholders stand to lose all their investments, as the emphasis shifts to ensuring that bondholders are protected. Preference shareholders are also likely to lose out in

favour of repayment of any new capital provided⁴ by the US Treasury in order to shore up these organisations.

Then, on 15 September, the 158-year-old investment bank, Lehman Brothers, was forced to seek bankruptcy status under Chapter 11, following unsuccessful attempts to raise new capital, or negotiate a merger with commercial banks backed by the Federal Reserve, as Bear Sterns had achieved earlier in the year, or secure emergency finance from the government (as had the GSEs). On the same day, the even larger investment bank Merrill Lynch, agreed to a takeover by the Bank of America for the bargain price of \$50 billion, forestalling a similar fate to Lehman Brothers (Walker, 2008). These twin developments appeared to bear out (no pun intended) Roubini's dire forecast noted above. Indeed, Roubini (2008d) has more recently argued that the 'broker model' of independent investment banks is irretrievably broken and that this 'shadow banking system' is doomed. Of the two remaining independent brokers still standing in September, Morgan Stanley was actively seeking new capital, and both it and Goldman Sachs have lost more than a third of their market capitalisation following large first half year losses in 2008.

A consortium of 10 US and European banks pledged an 'insurance pool' of \$70 billion to keep the inter-bank market from stalling completely and allow short-term debt to be re-financed (Gluyas 2008). Each bank can draw up to a third of the fund against a wide range of collateral, including housing and commercial real estate assets, many of which are suspect and not acceptable as collateral for loans by the Federal Reserve. However, the latter has been forced by the sheer scale and urgency of the liquidity crisis to broaden its collateral categories somewhat, through acceptance of equities and investment grade securities.

Even more serious than the demise of Lehmans and Merrill, however, was the threat to AIG, the world's largest insurance company. AIG faced imminent credit down grading by the ratings agencies due to its massive exposure to the subprime crisis, having written contracts (credit default swaps) to protect investors in these and other risky assets. Its share price plunged 31 per cent on 12 September, having fallen by 80 per cent during 2008 overall. AIG's declining capital base increased fears that it would not be able to meet its counterparty obligations, a failure that would reverberate throughout the financial sector (de la Merced 2008). Not surprisingly, the government blinked. It announced a \$40 billion loan by the Federal Reserve, the first time an insurance company has been so favoured, as a temporary measure while the company sold assets to repair its balance sheet. This move followed an unsuccessful attempt by the central bank to encourage the commercial banks to lend to AIG. The US government and Federal Reserve clearly thought that, although the investment banks could be allowed to go under, AIG was a failure too large. This follows from AIG's larger exposure to the uncertain world of credit default swaps:

CDS contracts are very complex and this is a market reportedly worth US\$62 trillion [i.e. four times the GDP of the United States] in face amount... There is no central clearing agency and no one knows who owes what to whom. The legal precedents are very uncertain. The contracts are not always drawn so precisely. So everyone is greatly afraid of what will happen if a company as connected as Bear Sterns, or a company even larger like AIG, goes bust or into a freefall bankruptcy' (Nason 2008: 34).

⁴ Provision has been made to inject up to \$200 billion of capital into Fannie and Freddie in the form of preference stock.

The Federal Reserve's lifeline to AIG, on top of earlier commitments, all but exhausted its \$900 billion asset base. Some \$700 billion in loans had been advanced piecemeal by the central bank to mid-September without, it seems, stemming the tide of declining liquidity and injecting confidence into the system. The coordinated actions of the six major central banks to directly inject \$200 billion of liquidity into the banking system has also failed;⁵ the commercial banks are hoarding cash, uncertain of the capacity of each other to repay loans.

In short, by mid-September 2008, the world faced the prospect of what commentators variously called 'a category four financial crisis', 'a financial meltdown' and 'the great panic of 2008'. The resulting severe credit crunch would with certainty lead to a severe recession if not worse in the real economies of the major countries (see comments in 4.3, below). On 19 September, the US government finally announced that it intended to step in and organise a 'comprehensive attack' on the problem at its source — by buying up the bad assets (mainly real estate related) of financial institutions and allowing those institutions to re-build their balance sheets. The vehicle for this intervention is to be similar to the Resolution Trust Corporation set up in 1989 to deal with the fallout from the savings and loans crisis (the mass failure of the US building society sector). After a failed attempt, the US Congress passed legislation — TARP, the 'Troubled Assets Relief Program' — appropriating \$700 billion to fund this buy out, in addition to the \$300 billion already committed to saving the GSEs and helping mortgagors. It is not clear whether this amount will be sufficient for the purpose at hand.

Finally, as a short-term measure to reduce pressure on share prices and capital adequacy, the US and British governments banned 'short selling', the practice of investors, especially the hedge funds, selling shares before they bought them, speculating on a decline in price in the intervening period — a self-fulfilling process if carried out at sufficient scale. The Australian government followed suit, banning all 'naked shorts' and 'covered shorts', initially for a period of 30 days.⁶

4.2.3 Act III — *Even blacker October-November*

October 2008 may be seen in hindsight as a turning point in economic history — the month in which worldwide systemic failure of the banking system became a real possibility. During the month the main stock markets, including Australia's, lost around 30 per cent of their total value, so that by early December 2008, the total value of equities had fallen by over 50 per cent on the preceding year. Housing prices were down by between 15 and 20 per cent in the UK and US. The main developments, occurring in quick succession were:

The banks —

Waucocia, America's third largest savings and loans institution, declared bankruptcy, bringing to 13, the number of failed US banks (nine since the beginning of July).

⁵ The RBA subsequently joined a group of Scandinavian central banks in injecting a further \$30 billion into financial markets.

⁶ A naked short involves selling shares that you don't own yet, usually over the course of the day. A covered short is 'borrowing' the shares for a fee from someone who does own them, selling them, and then later buying them to give back to the original owner. The US has banned naked shorts and the UK Financial Services Authority has banned all short selling of financial institution shares until early 2009. The Australian Securities and Investment Commission lifted the ban on covered shorts in November, but may require them to be reported daily to the Australian Stock Exchange

In Belgium, Fortis was nationalised to prevent bankruptcy. The same happened to Iceland's main three banks.

In Britain, the Bradford and Bingley Bank was nationalised to forestall a similar fate to Fortis.

In the US, the two remaining investment banks — Morgan Stanley and Goldman Sachs — voluntarily converted themselves into commercial banks by becoming deposit-taking institutions, thereby qualifying for US Government guarantees.

In the UK, the largest mortgage lender, Halifax-Bank of Scotland, was forced to merge with Lloyds TAB. The national government empowered Treasury to invest up to £50 billion in bank equity and guarantee up to 250 billion pounds in new short and medium-term lending by the major banks to ensure smooth re-financing of maturing wholesale obligations. The government also underwrote £37 billion of new bank equity raising. If this guarantee is fully called on, the UK government will own 60 per cent of the Royal Bank of Scotland and 43 per cent of HBOS/Lloyds TAB. The government's investment is primarily in the form of non-voting preference shares. Conditions imposed on the banks included the power of the government to appoint non-executive directors to bank boards; requiring banks to re-start lending to businesses and home buyers and help mortgagors struggling to meet repayments; no board level bonuses; dividends not to be paid to ordinary shareholders until the government sells its preferred shares.

Germany announced €70 billion for new bank capital and €400 billion in guarantees for inter-bank lending. France followed the German lead.

The Irish government guaranteed all deposits in its banks. Germany followed and so eventually did Australia.

Other government policy interventions —

A UK-led agreement was negotiated between 15 Eurozone countries to expand bank liquidity and lending — 13-point 'tool-kit' — to re-start lending and re-capitalise banks. Liquidity was to be provided by their central banks in order to reduce short-term borrowing costs between banks and a blanket guarantee given that no bank in the zone will be allowed to fail.

The world's central banks commence a sustained policy aimed at easing liquidity. The US Federal Reserve progressively reduces official interest rates to one per cent; the Bank of England reduces its rate to two per cent; the RBA drops the official rate three full percentage points from October to December. Rates fall across Europe and Japan.

The central banks collectively provide a \$620 billion international swap reserve, of which the RBA contributes \$30 billion.

In early December, the British Prime Minister announced that home owners who lose their jobs will be able to defer mortgage interest payments for up to two years. This move came in the wake of predictions by the Council of Mortgage lenders that home repossessions in the UK would reach 45,000 in 2008, compared to 26,000 in 2007 and 8,200 in 2004 (reported in *The Age*, 5 December 2008, p. 12).

However, dramatic and far-reaching were the October-November changes in other parts of the world, the centre of contagion continued to be the United States, where the federal government struggled to develop and implement a coherent and effective response to the unraveling crisis.

TARP has proved controversial and difficult to implement, in part because of differing views as to the target for the 'bailout'. Most of the first tranche of \$350 billion has, in fact, been committed to injecting equity directly into the banks, much as was described above as occurring in the UK. This follows the line that bank de-leveraging is more effectively achieved by boosting equity rather than rescuing troubled or 'toxic' assets. It is also more likely that the final cost to government will be less when it is able to sell off its shares to private investors. If the government buys the toxic assets at too low a price from banks and other institutions then the bailout may not be sufficient to restore confidence and re-start inter-bank lending; if the government pays too much for the defaulting loans, then the cost to the taxpayer is very high and the process rewards the parties responsible for the crisis in the first place.

By early December some Members of the Congress were threatening to withhold the second tranche of the \$700 billion because they were concerned that not enough help was getting through to distressed borrowers (Hughes, 2008). It appears that this second part of the bailout will, in some manner, be tied to the requirement for lenders to mitigate foreclosure processes and more clearly demonstrate that they are expanding lending to home owners and businesses.

4.3 Prospects for the macro economy

What began as a fairly contained deterioration in portions of the US subprime market has metastasised into severe dislocations in broader credit and funding markets that now pose risks to the macro-economic outlook of the United States and globally (IMF 2008c).

Slow credit growth in a period of intensifying inflationary pressures and lax fiscal policy pose difficult problems and trade-offs for policy makers and threatens macro-economic stability in the real economy. The IMF (2008c: 32–36) has explored two scenarios — the impact on the macro-economy of a credit squeeze and of a credit crunch.

In the case of a credit squeeze, credit growth in the US economy is assumed to fall from the long-term average of 9 per cent p.a. to 4 per cent, with the decline spread evenly over three successive quarters. This roughly equates to the situation during the 1990–91 recession, but is more intense than earlier post-war recessions:

A credit squeeze might therefore feel roughly like the normal constriction of credit seen at the bottom of the business cycle in mature markets (IMF 2008a: 36)

The IMF model predicts that, in the absence of any other shocks or changes in policy settings, a credit squeeze so defined would reduce real GDP growth by 0.8 per cent, a significant impact and one continuing well into 2009.

In the case of a credit crunch, credit growth is assumed to slow to one per cent p.a., again spread over three quarters. Such a scenario could hold if liquidity constraints and credit rationing persist, forcing banks to further de-lever in order to maintain balance sheets, new capital raisings are difficult and banks restrict credit across all categories (not just on the lowest quality loans). The negative impact on GDP growth is here predicted to be a pronounced 1.4 per cent, which would see unemployment rise sharply and the demand for exports from other countries shrink, threatening other countries with an imported recession.

It is worth stressing, however, that the IMF's model — like all models — simplifies by assuming away a number of other potentially confounding factors. In the first place, its parameters are based on historic data from 1952 to 2007. Hence, the model necessarily misses the full impact of the very recent changes in financial markets and

systemic risks. If the shakeout and restriction in corporate debt markets is greater than in the past, the negative impact on aggregate demand and growth will intensify. The size of the housing wealth effect and the household debt overhang may cause consumer spending to decline and stay lower than in past recessions. Perhaps most tellingly, the fact that the crisis is centred in the banking system may result in severe dislocation for a longer than 'normal' period. Moreover, European banks and financial institutions are experiencing a parallel and linked credit crisis, which will independently impinge on their national economies reacting back in a negative fashion on US exports — prefiguring a 're-exported recession'.

One way of stating the situation would be to say that the world is again facing 'a Minsky moment'.⁷ Central banks supposedly learnt from the 1930s that if left alone, a —severe monetary shock would cause a domino effect of bank failures and a collapsing credit system, feeding into a long economic depression. In particular, it was widely believed in government and the financial system that certain institutions — notably Fannie Mae, Freddie Mac, and the large investment banks and hedge funds — could not be allowed to fail, since their failure would drag the whole system down, a financial version of Armageddon. The belief was partly — but only partly — reinforced by the government interventions in September 2008.⁸ Hence, collegial efforts by the main central banks over the past year and the aggressive intervention of the Federal Reserve in lowering official interest rates and injecting liquidity and confidence into the US financial system are aimed at forestalling such an event. Unfortunately, this not only saves the innocent, it also rewards the culprits and thereby encourages similar irresponsibility in the future. If not successful, the world will, in all likelihood, head into a 1930s-style 'Great Depression'.

Unfortunately, developments in the last quarter of 2008 (outlined above) have clearly had all the hallmarks of a fully fledged credit crunch. In the words of the Governor of the RBA: 'I do not know anyone who predicted this course of events. This should give us pause to reflect on how hard a job it is to make genuinely useful forecasts. What we have seen is truly a 'tail' outcome — the kind of outcome that the routine forecasting process never predicts. But it has occurred, it has implications, and so we must reflect on it' (Stevens 2008: 1).

Bank regulators, national legislators and international agencies like the IMF⁹ are currently debating the policy reforms necessary to deal with the outcomes of the current crisis, to minimise the problems of perverse incentives and moral hazard and to reduce the likelihood of similar recurrences.

More specifically, governments are individually and collectively acting through aggressive monetary and fiscal policy in an attempt to limit the effects of the credit crunch from reverberating through to the real economy. The November 2008 meeting of the G-20 nations pledged to avoid the 'beggar-thy-neighbour' policies that intensified the 1930s Depression. The emphasis now appears to be shifting to fiscal stimulation as slowing economies and rising unemployment are evident in the

⁷ Hyman Minsky was the economist who (following the 1932 analysis of the Great Depression by the great American economist Irving Fisher) argued that recessions were monetary phenomena sparked by a 'debt-deflation' spiral of declining liquidity, prices and spending (see Minsky 1989, Keen 2001 and Minsky's hypothesis as explained in the appendix to Keen 2007).

⁸ As noted earlier, Lehman Brothers was allowed to go into bankruptcy, Merrill Lynch forced to seek a takeover, and the remaining independent investment banks left to ponder their likely fate.

⁹ See the Funds latest Global Financial Stability Report (IMF 2008d).

developed economies. The National Bureau of Economic Research has stated that the US economy has been in recession since December 2007. The Eurozone economies are, as a group, in a technical recession — two quarters of negative growth — with the UK, Germany and Italy leading the way. Japan is officially in recession.

The situation in the United States is particularly dire. Unemployment rose by over 500,000 in November 2008. The Obama administration, on assuming office, was expected to inject a fiscal stimulus package of between \$US500–700 billion, focused on infrastructure, education and alternative energy sources. On 24 November, the current federal government stepped in to save Citigroup from bankruptcy by injecting \$US27 billion of equity in the form of preference shares at 8 per cent dividend, plus a \$US306 billion guarantee on mortgage related assets. Citigroup's total assets are \$2 trillion. The guarantee is a sliding scheme: Citigroup holds the first \$29 billion in losses; thereafter the government picks up 90 per cent of further losses; the first \$5 billion taken by TARP, the next \$10 billion by FDIC, with the Federal Reserve covering remaining losses through a non-recourse loan. The US Treasury gets \$20 billion in preference stock and the Federal Reserve and FDIC the remaining \$7 billion of stock, all paying an annual 8 per cent dividend. Citigroup has had limits placed on dividend payouts to ordinary shareholders and executive remuneration. This bailout is after an earlier \$25 billion to Citigroup from TARP. Citigroup has recently announced job cuts worldwide of 53,000, followed by a similar announcement by the Bank of America that it would shed 35,000 jobs.

Perhaps even more ominously, the three major US automobile companies have been petitioning Congress for a bailout in the form of a \$US14 billion loan. It is widely believed that failing such assistance, General Motors and Chrysler are in imminent danger of bankruptcy. On 11 December, Congress failed for a second time to agree to provide this assistance package. The Bush administration subsequently announced that it would extend \$US13 billion to GM and Chrysler, with conditions attached. It is not clear at the time of writing whether further assistance will be successful or, if it is not, what the flow on effects on unemployment will be; media speculation has nominated three million job losses as possible. The reality is that no one at this stage can be certain, since (as the RBA Governor noted, above), forecasting breaks down in 'fall tail' situations like this.

4.4 The situation in Australia

To varying degrees all major mortgage lenders in Australia were exposed to the US crisis, with degrees of exposure dependent on individual reliance on wholesale funds raised in the US, when those funds were raised, and when they had to be rolled over or refinanced. Hence, in early 2008, the main Australian lenders, including the major banks, began raising their variable mortgage interest rates on top of rises in official rates by the Reserve Bank. In this way, developments in global financial markets have quickly ramified through the Australian housing system with uncertain outcomes for the Australian economy in the immediate term. This has complicated the task of economic policy makers in Australia in the first half of 2008 attempting to deal with a strong domestic economy driven by a booming minerals export sector, a strong currency, and signs of an inflationary outbreak. It made the unexpected U-turn in policy in the last quarter of 2008, as the threat of recession strengthened and inflation faded, especially difficult to respond to.

In early 2008, ANZ Bank made provision for almost \$1 billion mostly related to bad debts stemming from the subprime crisis. Part of this provision was allocated to cover the bank's exposure to US bond insurer ACA Capital in relation to 'credit default

swaps' entered into between 2005 and 2007. More seriously, in July 2008, one of the two largest commercial banks — National Australia Bank (NAB) — informed markets that it had a \$A1.2 billion exposure to US CDOs and wrote off 90 per cent, or \$A830 million, of this stake against current earnings. This will result in the first fall in NAB profits in over 30 years. Market analysts expect that the other large Australian banks are likely to follow suit and that the NAB may still risk future provisioning against other assets held by related conduits (Moncrief 2008).

Nevertheless, compared to US and European banks, Australian banks are — as far as is currently known — not heavily exposed, directly or indirectly, to low quality loans. Thus, it is unlikely that the mortgage default, credit and systemic crises bedeviling financial markets in other advanced economies will directly spark a serious economic recession in Australia. The Australian economy continued growing strongly into 2008, fuelled by booming mineral exports. Strong demand plus supply side shocks emanating from a one-in-a-hundred-year drought and rising world oil prices have increased inflation towards 5 per cent, well above the target band set by the Reserve Bank of Australia (RBA). Consequently, the RBA has instituted six interest rate rises of 25 basis points each since early 2007, four since November of that year. Four interest rate falls since September 2008 have reflected growing RBA concern with falling commodity prices and export income and the move of virtually all the developed economies into recession, noted above.

Hence, it is still possible that Australia may 'import' a US-instituted recession. Historically, a downturn in the US economy resulted in a decline in Australia's exports, both to the US and to its major trading partners, notably Japan. In this indirect manner, a crisis generated by the American housing market could conceivably reverberate though to a sharp fall in Australia's rate of economic growth. Rising unemployment and high mortgage rates could, in turn, spark a fall in housing prices in Australia, feeding into a domestic recession, the much-feared 'hard landing'.

Against this view, the traditional close linkage of the Australian and US economies has been questioned in the context of the economic rise of China and India. The argument is that the Australian and US economies have become 'de-coupled'. If, in this alternative view, China keeps growing in near-double digit figures, Australia's resources exports will continue to boom, driving the economy at a high rate of growth and capacity utilisation which will, in turn, reinforce housing demand and values. This view is reinforced by the claim that China's growth is increasingly less driven by exports to the US and increasingly dependent on buoyant domestic demand. The key unknown is the extent to which a flagging US economy will slow Chinese growth, through reducing the current scale of Chinese exports to the US. If China's economy stalls, then Australia's exports to China will also stall. If that happens, economic growth would slow just at the time when RBA interest rate rises peak and consumers begin to feel less wealthy — both through falling housing prices and declining superannuation savings occasioned by a 'bearish' stock market.

In fact, recent signs are that both the Chinese and Australian economies have slowed sharply. The RBA (2008c), in its August monetary policy statement, clearly indicated that the next movement in official interest rates would be down, a signal interpreted by financial analysts that rates would begin falling before the end of 2008. As noted above, the RBA subsequently reduced the official rate by 300 basis points from September to December.¹⁰ The RBA forecasts that the Australian economy will grow

¹⁰ In late September, the Australian Government also announced that it would purchase \$4 billion of investment grade mortgage backed securities to be held by the Australian Office of Financial Management until the local secondary mortgage market returned to normal, again offering robust competition to the dominant primary mortgage lenders, the big four banks.

by only 2 per cent in 2008, half of that growth concentrated in the mining and agricultural sectors. Subsequent forecasts have been lower.

These fears appear to be crystallising. In his address to the Australian Business Economists' Annual Dinner, on 9 December, the RBA Governor commented:

The most striking real economic fact of the past several months is not continued US economic weakness, but that China's economy has slowed much more quickly than anyone had forecast. Our own estimates suggest that Chinese industrial production probably declined over the four months to October. Some of this might be attributable to the effects of the Olympics but surely not much. Some of it reflects the weakening in Chinese exports to major countries. But more than that seems to have been occurring. I am not sure that many economic forecasters have fully appreciated this yet. There is every chance that the rate of growth of China's GDP is currently noticeably below the 8 per cent pace that is embodied in various forecasts for 2009 (Stevens 2008: 1).

The fall in Chinese imports of raw materials from countries like Australia has followed declining industrial production and exports; imports fell by 18 per cent in the year to December 2008 (Ryan, 2008, p. 20). Australia's growth in the September quarter fell to 0.1 per cent. There is a non-trivial probability of negative growth in the fourth quarter.

Thus, it appears that the 'de-coupling' thesis proposed earlier in the year is flawed. Both the Chinese and Australian economies are locked into the global economic slowdown — albeit neither may actually go into recession. But, as the RBA Governor has stressed, economic forecasting in the recent past has proved unrewarding. Consequently, the Australian Government has joined other G-20 nations in aggressively boosting aggregate demand, particularly domestic consumption. The first tranche of expansionary fiscal policy — a \$10.4 billion program of increased social security payments targeted on age pensioners and low income families — came on stream in early December. A second commitment of \$4.2 billion almost immediately followed, comprising major infrastructure investment brought forward, increasing funding to universities and taxation benefits to business investment and cash flow requirements.

4.5 Conclusion

This chapter has outlined the contours, uncertainties and impacts of the disruption of global financial markets over the past one and a half years. Housing market failure and financial systemic risk lie at the heart of these developments. This, in turn, is raising large and as-yet unresolved policy challenges for central banks and national governments. The sharp rise in residential mortgage defaults in the US — the critical trigger — has made policy makers everywhere very aware of the importance of monitoring and minimising this phenomenon. Although mortgage defaults in Australia have not risen at anything like the US rate, they are on the rise. Australian financial markets are strongly integrated on a global scale, and Australia's economic growth is heavily dependent on the continuing prosperity of our large trading partners. For these reasons, it is important for Australian governments to better understand the trajectory and drivers of mortgage debt and default in this country. This project is an attempt to raise awareness and knowledge in this area. The final chapter of this paper presents (briefly) some of the policy questions raised; these issues will be discussed in more detail in the final report, once the primary research has been completed.

5 POLICIES TO MINIMISE AND MANAGE MORTGAGE DEFAULT

As outlined in the previous chapters, mortgage defaults in Australia have attracted increasing attention from media, government and industry over the last few years — as interest rates and mortgage-related financial stress have risen and since the US subprime (housing lending) crisis developed with associated instability in global financial markets. This chapter concentrates on policy responses to the increasing complexities of mortgage lending, and more diverse kinds of lending, to relieve stress for vulnerable households and to reduce the risks of serious failure within financial markets and the real economy.

Current plans by government to improve lenders' practices acknowledge some of the increased risks in lending for purchasing housing that have developed over the last decade, including the greater availability and variety of household credit. The first section refers to such developments, which are 'on the drawing board', and indicates the kinds of issues that remain outstanding.

The banking sector, the financial counselling sector, legal aid, charities supporting financially stressed households, and consumer advocacy organisations have all made various suggestions for interventions to minimise default, related to both lenders' practices and borrowers' behaviour. They have highlighted failings of specific kinds of loans and problems related to financial literacy, especially with more complex and complicated credit products and services, an area of interest to the Australian Securities Investment Commission (ASIC) (Fido 2008). The second and third sections below discuss the most significant existing and proposed measures relevant to lenders' practices and borrowers' behaviour.

Currently, there is a shortage of public housing, and tenants are paying increasingly higher rents for private rental often without reliable long-term tenure and with limitations on making their homes more functional and efficient. Many commentators (and almost all of households interviewed) have indicated that home ownership promises important material, emotional and economic benefits in comparison with other housing options. The fourth section below discusses the impact of broader housing issues and policy in making borrowers' behaviour and lending practices more, or less, risky.

Thus, this chapter outlines major measures currently being implemented, or planned, as well as certain others simply mooted, to prevent and manage the implications of mortgage defaults. It draws heavily on the 2007 House of Representatives Inquiry Into Home Loan Lending and other research, recommendations and activities by government agencies — such as the New South Wales (NSW) Office of Fair Trading (OFT), and ASIC — the financial industry and specialist non-profit organisations. The conclusion includes a call for more analysis based on improvements in the collection of relevant statistics.

5.1 Current reforms and reform agenda

The House of Representatives (2007) Inquiry into Home Loan Lending Practices and Processes scoped the legitimacy, level, and kinds of concerns that were widely expressed in the media and among politicians and financiers about home lending practices in Australia from late 2006. The Standing Committee on Economics, Finance and Public Administration instigated the inquiry, 10 May 2007, based on statements made in the annual reports of the Reserve Bank of Australia (RBA) and the Australian Prudential Regulatory Authority (APRA). It was a truncated inquiry, due

to the imminent federal election, but included a call for submissions from select stakeholders, a full-day round table with presentations and cross-table discussion (Official Committee Hansard 2007), and resulted in a report with three main recommendations for structural improvements relating to home mortgage lending in general and risks of, and processes related to, defaults in particular. Thus, this inquiry revealed most of the positions of the main stakeholders as well as the major challenges and different solutions to address them.

The inquiry (House of Representatives 2007: xv–xvi) concluded by making three well-evidenced and widely supported recommendations:

- to address the paucity of data on repossessions of homes, the ABS should expand its collection of data, and require more detail, from lenders and the courts
- to simplify and unify the regulation of credit, the federal government should take responsibility for credit regulation and expand it to all lenders and mortgage brokers
- to identify external dispute resolution (EDR) processes to determine whether they are effective and efficient in addressing complaints, ease the current limits on eligible cases to reflect average house prices — specifically the Banking and Financial Services Ombudsman’s limit of \$280,000 should be lifted to \$500,000.

This section is concerned more with the second and third of these recommendations — the first is discussed further in the final section, below. It suffices to point out that improved collection of sound, comprehensive and disaggregated data is critical for evidence-based policy-making, appropriate policy implementation, and the monitoring and evaluation of policies in this area.

Following the change of government at the October 2007 federal election, the Treasury prepared a Green Paper, Financial Services and Credit Reform (Australian Government, The Treasury 2008), which advocated Commonwealth control of credit, most of all home mortgages, mainly in order to overcome several deficiencies of the current system that had already been identified in the 2007 inquiry. In a talk given in April, Minister Nick Sherry (2008) outlined the major failings thus:

- regulatory gaps can be exploited by unscrupulous providers
- the level of protection for consumers may depend on where they live
- there are significant compliance costs for businesses operating in more than one jurisdiction.

The Green Paper advanced a national agenda to:

- address any gaps in consumer credit regulation
- provide for licensing of credit providers, with the relevant conduct requirements in place
- require coverage by dispute resolution schemes for consumers
- bring consistent regulation across the country.

(Australian Government, The Treasury 2008: 9)

The Green Paper indicated plans to bring mortgages under uniform national legislation subjecting mortgage brokers, non-ADI and ADI lenders subject to nationally consistent licensing, conduct and advice. Such proposals have been well received and are almost a foregone conclusion.

Meanwhile, late in 2007, the NSW Office of Fair Trading issued a National Finance Broking Scheme Consultation Package as one step in a process consolidating a long-

standing push, initially driven by the Council of Australian Governments (COAG), to implement regulation of brokers. A summary of the content of the November 2007 draft bill is contained in the March 2008 RBA Financial Stability Review (70–71), which outlines that the legislation will cover most broking activities through mandatory licensing and require transparency and greater responsibility for objectively assessing the debt servicing capacity of borrowers. Legislation based on these reforms is unlikely to take effect until later in 2009 or 2010. Still, these activities are evidence that certain moves are afoot to enact structural reforms identified as necessary by the inquiry. In the inquiry, the following points were made:

- brokers have a vested interest in selling loans and, therefore, encouraging quantitatively more borrowing as well as refinancing
- brokers generally have no (or little) responsibility for the borrowers' repayment performance and so have little incentive to assess debt serving capacity
- brokers are not necessarily well qualified
- brokers have grown in number to account for processing three out of every four loans (House of Representatives 2007: 36; Mendelson 2007: 2).

The first two points suggest the risk of significant moral hazard in the mortgage broking industry, evident in the emergence of the subprime crisis as it unfolded, especially in the US (see Chapter 4). The reforms cover regulation of brokers in terms of qualifications, responsibilities to borrowers and lenders — especially with respect to proving debt servicing capacity (evidence of income etc.), transparency of activities and reasonable fee structures.

However, while the detail associated with regulating mortgage brokers is clear, the extent to which national regulation of mortgage lending will improve the situation will depend on timely and concerted efforts to harmonise and, more particularly, discipline the lending sector. This is not an easy task because lenders are keen to avoid costs and limits associated with regulation and comprise a diffuse fragmented sector with certain segments regulated only poorly or not at all. Numerous kinds of measures are required to address current concerns, which range from improving information available on specific lending products through to more transparent and responsible lending practices, especially in relation to assessing the debt servicing capacity of borrowers and responding to changes in their income, i.e. 'hardship' variations.

In NSW, where households have been hardest hit, the state government tried to legislate against mortgagees' accepting low offers for houses that they have repossessed: 'If it can be proved a house was sold under market value, the mortgagee will be liable to pay damages' (Dart 2008).

Already ASIC is taking a greater interest in research and expanding its activities in terms of informing borrowers (Fido 2008). Besides specific research, mentioned in previous chapters, ASIC now has responsibility for the Understanding Money website, the flagship of the financial literacy program initiated by the Howard government.

Commonly acknowledged and accepted criteria, indicators and protocols with respect to debt-servicing capacity and, admittedly to a lesser extent, the definition of hardship are still forming. These are crucial to fill the void created since the '30 per cent rule' has been put aside — see Chapter 2 — and to provide commonly agreed upon, or standardised, responses to borrowers presenting with repayment difficulties.

Reforms to the financial sector are likely to be slow and will require concerted action or agreement from within the sector for their successful implementation. Other lending-related concerns raised in and outside the Parliamentary inquiry, and

suggestions for addressing them, follow. Table 6 summarises proposals for policy measures considered worthy of serious attention and evaluation by government. Most have evolved in public debates and documents, but some result from the analysis in this paper. Policy measures can be broadly divided into two categories: preventative and relief or restorative. The former seek to reduce the risk of mortgage defaults arising, the latter address means to deal with the problems caused by defaults. These measures are listed as possible directions. No particular interventions are advocated at this stage of the research. A number of the measures summarised in Table 6 and discussed in later sections are also canvassed in much greater detail by Shiller (2008).

Table 6: Proposals to minimise and ameliorate mortgage default

<i>STRUCTURAL ACTORS/PROCESSES— TOPICS TO ADDRESS</i>	<i>PREVENTATIVE MEASURES</i>	<i>RELIEF MEASURES (RESTORATIVE)</i>
<p><i>Lenders' practices</i></p> <p>Establishing a balance between conservative and irresponsible lending.</p> <p>Models, indicators and/or formulae for defining and assessing hardship and debt-servicing capacity of mortgagors that are commonly accepted by the financial industry, government regulating agencies, in legal forums and by financial advisers.</p> <p>Embedding clear and widely accepted practices of response to hardship (variations) due to both individual circumstance and wider economic impacts.</p> <p>Planned response by government to economic downturn, diminishing credit and increasing vulnerability of specific households to falling house prices, reduced income or higher interest rates.</p>	<p>Regulate mortgage brokers.</p> <p>Stricter criteria for lending based on debt-servicing capacity, not asset value, restricting the size of loans (LVR), and aspects of eligibility relating to income.</p> <p>Make lenders, and their agents/brokers, more responsible for confirming debt-servicing capacity of borrowers — eradicating no-doc and minimising or redefining low-doc loans.</p> <p>Require open, plain English, and detailed information on all loan products and services — perhaps through ASIC and the Understanding Money website.</p> <p>Improve reporting as well as regulation of non-ADIs and provide borrowers with lists of regulated borrowers, all demanded to be members of APRA-approved external dispute resolution organisations.</p>	<p>Expand and enhance APRA-approved external dispute resolution (EDR) services as well as their powers to discipline lenders.</p> <p>Ensure repossession cannot occur while independent appeals (EDR) over rejected hardship claims or other matters of serious and legitimate dispute are in process.</p> <p>Enhance government reporting and advisory powers of the Banking and Financial Services Ombudsman and other EDRs or establish a specific home mortgage ombudsman with special powers.</p> <p>Regulatory agencies, such as OFT and APRA, continue reviewing products and services as well as market demand and awareness.</p> <p>Monitor national, state-by-state and regional developments in terms of default and house prices for timely introduction of government relief to householders.</p>
<p><i>Borrowers' behaviour</i></p> <p>How to best inform borrowers more and more effectively about responsible borrowing and options to minimise the risk of default, repossession of a home and high financial losses due to problems with repayments.</p>	<p>Improve secondary and tertiary education on financial management of home mortgages.</p> <p>Free, easily accessible and independent financial advice when a home loan is applied for.</p>	<p>Free, easily accessible, and independent financial advice if in arrears.</p> <p>Revise and expand eligibility for mortgage relief assistance — providing uniform national coverage, redefining hardship and taking into</p>

<p>Improving borrowers' skills and knowledge about the dangers of certain lending practices and products.</p> <p>Improving borrowers' knowledge of and enhancing the support and relief systems available to those in financial distress.</p>	<p>Publicise responsibilities of a mortgage and default more — e.g. build a narrative around a great Australian nightmare.</p>	<p>account temporary emergency measures during downturns.</p> <p>Identify and publicise through the popular media those lenders taking most court actions, borrower types, and loan kinds most prone to default.</p> <p>Improve public credit reporting.</p>
<p>Housing context</p> <p>Ensuring households have a range of options for accommodation that are affordable and accessible where they need to work.</p> <p>Private and public tenants' rights to secure long-term housing at a manageable cost.</p> <p>Access to temporary housing for evicted households and tenants of leased properties where the mortgagee is threatening to take, or has taken, possession.</p>	<p>Improve terms, conditions and supply of housing accommodation options that compete with owner-occupation, e.g. enhance public and private tenants' rights, expand social housing, etc.</p>	<p>Implement guidelines and rights to temporary housing assistance for defaulters.</p> <p>Enhance tenants' rights when the house they are leasing is subject to a claim of possession and later when it is repossessed. Appropriate reforms include sufficient notice to vacate, the claim of possession providing sufficient reason to break a lease, and compensation for costs associated with moving.</p>

In more general terms, related to the macro-economic context addressed in chapter 4, other preventative policy measures would focus on those actions of governments and financial institutions (in particular, central banks and key financial regulatory authorities) necessary to ensure stable economic growth and high levels of employment — since, unemployment has been found to be one of the major triggers of mortgage default. Clearly, in the current climate of global financial stress, these large policy concerns are uppermost in government priorities for reasons that include but, of course, go well beyond the issue of mortgage defaults. These larger macro-economic policy responses are beyond the scope of this study. However, their salience and urgency at this time does provide a strong rationale for effective government intervention to limit the scale and impact of mortgage defaults in countries like Australia, in order to break the cumulative feedback effects of default on consumer confidence, falling aggregate demand, and rising unemployment.

5.2 Lenders' practices

This section focuses on key issues to be addressed based on lenders' practices.

5.2.1 Government guaranteed mortgage-backed securities

Recently, the Australian Securitisation Forum (ASF), which represents most home loan lenders, proposed introducing government guaranteed mortgage-backed securities (Washington 2008). The proposal was based on the Canadian model and the argument was that this would reduce the cost of raising funds by around 1.5 per cent, which would be passed onto borrowers. This ASF proposal mimics the role of the federal government's Housing Loan Insurance Commission, which had operated from 1965 (House of Representatives 2007: 18) but was taken over in the 1990s by

GE — Genworth Financial. Under this recent proposal all regulated lenders would benefit from low-cost finance raised through private investment in the government-guaranteed funding mechanism. However, given that the proposal focuses exclusively on 'prime loans over residential property with high levels of collateral' — and integrates mortgage insurance — it could be argued that such an arrangement, i.e. government guarantee, is unnecessary.

5.2.2 Debt servicing capacity

Concerns surrounding lenders' assessment of borrowers' debt servicing capacity, i.e. whether current formulae and models are reliable or appropriate, have been widely raised, along with suspicions that evidence of income provided by borrowers is not scrutinised sufficiently by the lenders or the mortgage brokers who facilitate the application process. The dominance of asset-based lending has been questioned; as the Consumer Action Law Centre (CALC) of Victoria pointed out at the 2007 inquiry, 'wealth does not actually help borrowers pay' (House of Representatives 2007: 36). Also, APRA (House of Representatives 2007: 4–5) has expressed concerns that the modeling used to estimate the debt servicing capacity of borrowers was highly variable and, in a significant proportion of cases, questionable. In the inquiry, the Genworth Financial representative pointed out that they decline around 7 per cent (350) of the thousands of applications provisionally approved by lenders that they receive weekly because, according to this lenders' mortgage insurer (LMI), the debt servicing capacity of the borrower seems inadequate (House of Representatives 2007: 24). Also they 'sometimes see the same application twice' (House of Representatives 2007: 25).

Financial counsellors, who admittedly deal with the households most likely to default, report that a culture of deceit has developed as lenders encourage (or fail to refuse) borrowers making contracts to take out loans that they can see they have no hope of repaying. This looks like a classic case of moral hazard. Thus financial counsellors, in particular, would like to see more regulation making lenders at least semi-responsible for lending, i.e. demonstrating a duty of care by being obliged to check on, or demand verification of, income sources and levels. Thus, pressure on lenders to take more responsibility for borrowers regarding income is a target for policy reform. However, the wider economic context, and especially a more precarious work environment and the long term of loans for housing, make evidence of current and immediate past income both less reliable and less relevant.

Issues surrounding an adequate estimate of debt servicing capacity can be addressed another way, by restricting debt to less than 80 per cent of a home's valuation. Indeed APRA (House of Representatives 2007: 4–5) has expressed concerns that more and more loans have been offered for over 90 per cent of the value of the property securing them, and the same concern is raised by the Australian Property Institute (see below).

5.2.3 House valuation

Valuations are another area where traditional practices have been overtaken by new practices, in this instance substantially reliant on new technologies. Once valuers would inspect a house whereas now a drive-by or desktop assessment can suffice, partly because lenders are comforted by lenders' mortgage insurance on highly leveraged loans and by valuers' general low service charges (House of Representatives 2007: 34–35, 38). However, valuation is more difficult in the current environment where the International Monetary Fund (IMF) indicates Australian residential properties are significantly overvalued, while house prices in many areas have simply stabilised in value or sustained growth even through a downturn

(Colebatch & Topsfield 2005; Mark 2008). A generalised lowering of valuation standards indicates that policies ensuring appropriate recompense, due attention to property valuations, and insistence on independence, is important in the valuation process. One policy reform might be to insist that lenders get two valuations for every home application.

In its submission to the inquiry, the professional body of valuers suggested the following policy reforms:

- Re-introduce a Loan to Valuation Ratio (LVR) such as at 80 per cent of purchase price, allowing a 20 per cent buffer (owners' equity) in times of rising interest rates, unemployment and market downturns.
- Increase the requirement for supporting documentation to ensure the borrower has the ability to make loan repayments at the current rate of interest as well as at a higher rate.
- Establish rules and guidelines (including checking procedures) covering mortgage brokers. Issues include broker-introduced deals, ability for fraud and manipulation of borrowers' financials to support the loan application.
- Require a valuation for every property purchase and refinance of residential property.

(Australian Property Institute 2007: 5)

5.2.4 Lenders' responses to borrowers requesting hardship variations

Especially given the much-publicised rising financial stress of mortgagors resulting from higher interest rates and regionally depressed housing prices, certain lenders had moved before the parliamentary inquiry to improve information on loan products and borrowing in general as well as the management of loans and borrowers in difficulties. For instance, Genworth Financial has shown a constructive role for lenders' mortgage insurers through their WorkOut program, which is conducted with borrowers, a program adapted from overseas and initially run in other countries. Of 500 cases dealt with in late 2006–July 2007 the initial success rate was 87 per cent (House of Representatives 2007: 38). By the first half of 2008, Genworth Financial had dealt with over 1000 such borrowers. Westpac has also introduced a well-advertised credit assistance unit (Westpac Assist) to help borrowers budget better and to facilitate variations in the terms of mortgages due to issues related to hardship. However, two points need to be made about the lenders' roles here. First, follow-up research is necessary to track and prove the enduring performance of such 'success stories'. Second, such efforts really only go as far as fulfilling the role expected of lenders through the Uniform Consumer Credit Code (UCCC). As indicated in the preliminary interviews conducted in May 2008 (see 3.3, above), lenders can be tardy and reluctant to respond to borrowers admitting they have repayment difficulties and requesting variations in their loan contracts. Financial counsellors claim that this is too often the case.

The federal government would need to formally assume responsibility for mortgage credit before it can more tightly regulate lending practices that might, for example, involve banks being required to pay greater attention to hardship variations (Australian Government, The Treasury 2008). Discussion in the inquiry into lending practices (House of Representatives 2007) indicated that mandatory membership of an external dispute resolution body was the most effective and cost efficient structure for ensuring that lenders do in fact respond adequately to reasonable approaches for variations in lending terms and conditions. If this is to be the main strategy, outstanding issues involve buttressing the powers of external dispute resolution bodies with respect to

both the legal processing of writs of possession — so that cases before them are not settled while the results of hardship variation appeals are pending — and the financial sector.

The Genworth Financial representative reported that, in dealing with around 5000–5500 full-doc and low-doc loan applications per week from around 250 ADI and non-ADI lenders, low-doc lending was characterised by both higher delinquency and higher self-cure rates compared with full-doc loans (House of Representatives 2007: 8–9). This result was confirmed by the ANZ Bank and the RBA (House of Representatives 2007: 17, 25). However, self-cure only means returning to a stable equilibrium for the lender, not necessarily for the borrower. As such, ‘self-cure’ incorporates practices such as:

- forced sale
- refinancing — involving 12.5–30 per cent of ANZ and Westpac mortgagors
- repayment holidays and extending the term of a loan.

(House of Representatives 2007: 32–33)

Recent estimates suggest that there are around five to ten forced sales to every repossession (Mendelson 2007) and, early in 2008, refinancing of home loans had reached around two in every five. One can only speculate how much of this refinancing is being conducted to consolidate debts or rationalise better terms for stretched borrowers.

Banks maintain that borrowers in dire straits are often encouraged by the lender to sell their home because mortgagee-in-possession sales are likely to realise 15–20 per cent less (House of Representatives 2007: 37). At the same time, certain lenders have reported ‘infinitesimally low’ (ANZ) and ‘very small’ (HBOS) losses through repossessions (House of Representatives 2007: 35). Refinancing is costly for borrowers and creates more work and income for lenders and is dealt with in more detail below. More research is required to assess how responsive lenders are to borrowers’ legitimate needs and how appropriate and successful hardship variations are in the long term for borrowers.

5.2.5 Regulating non-ADIs

The currently very lightly regulated lenders from the non-ADI (non-Authorised Deposit-taking Institutions) sector represent a clear case for regulation. Non-ADIs incorporate a dozen or so responsible institutions and a plethora of virtually unregulated and often highly dubious actors, altogether lending to about 20 per cent of the market (House of Representatives 2007: 13, 18), although in the current global financial climate this proportion is declining. The RBA has noted that while arrears were lower than in the 1990s, claims for possession were higher and that that might be explained by either problems with new loan products or enthusiasm to go to court by ‘non-traditional newer entrants’ (House of Representatives 2007: 27). A representative of the Consumer Credit Legal Centre (CCLC) of NSW reported that around half of their phone enquiries on home mortgages were arranged by non-ADIs who were much less likely than ADIs to engage in external dispute resolution (House of Representatives 2007: 11–12). Indeed, as mentioned in Chapter 2, our analysis of the plaintiffs in just over 3000 cases listed in the Victorian Supreme Court during 2007 shows that almost one in three were brought by just two non-ADIs.

The appropriate, already well-recognised policy response is to have APRA cover all non-ADIs who lend to borrowers providing their homes as security and demand that they improve their practices by conforming to standards that are regularised across

the whole financial sector, such as compulsory membership of bodies providing external dispute resolution services.

5.2.6 External dispute resolution

The UCCC neither incorporates external dispute resolution (EDR) nor extends to (reigns in) the behaviour of predatory lenders (House of Representatives 2007: 12). The representative of the Legal Aid Commission of NSW (House of Representatives 2007: 11,18) stressed not only the need for national regulation of financial brokers — which is on the government's agenda — but also compulsory membership of lenders to an independent and respectable EDR body to minimise asset stripping or asset-based lending. Similarly, ASIC (House of Representatives 2007: 12) has argued not only for national regulation of mortgage brokers but also for a compulsory external dispute resolution process with the proposal of streamlining the latter to avoid a plethora of schemes (House of Representatives 2007: 12).

External dispute resolution is not particularly broadly known nor used, partly because it only covers lending organisations that are voluntary members. Fortunately, certain professional organisations make membership of such services a condition of any firm or individual joining them. For instance, the Mortgage Finance Association of Australia supports compulsory ASIC-approved external dispute resolution membership of all lenders. However, the various bodies are also almost all creatures of the lending industry. The Banking and Financial Services Ombudsman (BFSO) is the exemplary model (House of Representatives 2007: 13).

It is clear that the powers related to external dispute resolution need to be enhanced too. The CCLC NSW has pointed to a case showing that, even when a determination was made against a mortgage broker by the Credit Ombudsman, the broker had not been brought to task; rather, the borrower was still fighting the lender in the Supreme Court (House of Representatives 2007: 21).

In short, borrowers need to be able to access external dispute resolution services when negotiations break down with their lenders. Thus, external dispute resolution systems that are well publicised, simple, uniform, inexpensive, efficient and effective need to be generalised. (See, too, relevant comments in the section on financial counsellors, below.)

5.2.7 Bonuses based on lending performance

There has been a strong reaction to the pivotal role of mortgage brokers given their reliance on 'selling' loans as a form of income, leading to what promises to be a strong reshaping of the sector and its practices in the form of their proposed regulation. However, while lenders are seen to have a more direct interest in more stringent standards in lending, the Finance Sector Union of Australia has complained that commissions based on volumes of loan 'sales' tends to lead to slack standards, arguing that better base salaries minimise this effect (House of Representatives 2007: 22). There has been well-publicised discussion suggesting that banking representatives and agents have been pressured into lowering their standards for loan applications as part of a struggle to keep and extend their share in a competitive market (Long 2008). In the inquiry, NAB and ANZ refuted any such connection with incentives (House of Representatives 2007: 23).

5.2.8 Tightening regulation of 'low-doc' and 'no-doc' lending

If standard practices on prime loans are improved so that more, and more reliable, evidence is required related to income, this means that regulation of 'low-doc' and 'no-doc' lending needs special scrutiny. APRA (House of Representatives 2007: 4–5) has expressed concerns that low-doc loans have been underpriced, that more and more

loans were being offered for over 90 per cent of the value of the property securing them, and that the modeling used to estimate the debt servicing capacity of borrowers was highly variable and, in a significant proportion of cases, questionable. APRA reported 'tightening capital rules for non-standard loans' over the last few years and has singled out certain institutions for remedial action with respect to managing credit risks (House of Representatives 2007: 5). The detail of the proposed national regulation of mortgage brokers points to a serious decline, even obliteration of low-doc and no-doc lending (NSW Office of Fair Trading 2007; Sarah 2008).

5.2.9 Mortgage lenders insurance — a double-edged sword?

Managing Director of the Housing Industry Association of Australia (HIA), Ron Silverberg (2007) criticised the recommendations from the 2007 House of Representatives inquiry for being 'mute on the role of mortgage insurance, which protects home lenders against capital loss, provides little or no protection to borrowers and is paid for by the consumer'. The Australian Property Institute has argued that lenders mortgage insurance has driven up home prices and led to diminished housing affordability (House of Representatives 2007: 34). Indeed, one of our interviewees (see 3.3, above) talked about how the lender's mortgage insurer followed her up to pay the sum they had paid out for the lenders' claim, leading to the conclusion that the borrower paid all the way round. At the same time, as mentioned above, lenders' mortgage insurers can act as a break on the worst lending practices as they filter through applications in as much as they provide a constructive service, such as Genworth Financial seems to, in assisting borrowers to address hardship.

5.2.10 'Business' and other 'special' loans

In the House of Representatives (2007: 19) inquiry, the Legal Aid Commission of NSW pointed out that where home loans are disguised as business loans they would not appear in APRA's data as defaulting households; indeed, APRA did not collect data on property repossessed as a result of being collateral for a business loan. Currently there are fewer courses of action to plead for leniency, i.e. hardship variations, when loans have been offered for business purposes. Sometimes loans are offered for business purposes when in fact they are for personal, household or domestic uses. Home-based business is an obvious grey area and it easy for lenders and borrowers to make out an application for business when in fact it is used to purchase, renovate or extend a home. However, under current legislation, the borrower is more liable for a business loan than for a home loan. Sometimes the business tag is attached to a mortgage later by way of a caveat loan. Regulation is required to close this 'loophole', which enables lenders to foreclose easily because the defendant has few avenues of defence, e.g. to argue on hardship or similar grounds. It is one aspect of calling to account fraudulent and exploitative practices.

A relatively hidden sector of home borrowing involves vendor financing ('vendors terms'), which is highly complicated and typically occurs in an organised way through a third party in rural and regional, or outlying suburban areas. Vendor financed loans have proved especially risky for borrowers, especially those who have been unaware that they might lose all monies paid to the 'vendor' if they have borrowed to lend to the 'purchaser' and then fail to keep up their repayments. Victoria has moved to amend legislation in this area to cover a range of practices considered unfair and involving products such as credit cards and reverse mortgages (Consumer Affairs Victoria 2006; 2007; 2008).

The variety of loan products and services has multiplied along with competition between lenders. Interest-only loans, which involve simply repaying interest for 5–10 years, before taking on amortisation payments as well, can be risky for borrowers

especially if the asset that is security for the loan does not gain in value over the years or the loan is large. Thus, with these, as with other kinds of special loans, it is particularly useful if borrowers have independent financial advice on the loan they are arranging — i.e. financial advice independent of lenders' advertising. Similarly, redraw facilities can be attractive but might only come at an expensive price. As household lending has increased, lines-of-credit are offered sometimes for short periods but only with security of the home. (Other traps and risks are discussed in the section on refinancing, below.)

5.2.11 Predatory lenders

Predatory lenders are estimated to account for less than one per cent of the loan market but, given that home lending involves millions of borrowers, this impacts on lots of people and disproportionately in disadvantaged and marginalised segments (House of Representatives 2007: 18–21). Research conducted in the ACT (Consumer Law Centre of the ACT & ANU Centre for Commercial Law 2007) suggests that recent repossessions have involved many more borrowers from vulnerable segments who refinance with dubious lenders (House of Representatives 2007: 19). It was acknowledged in the House of Representatives (2007: 21) inquiry that lenders to those with poor credit histories openly advertise everyday in the press and other media, with encouraging sales pitches such as 'automatic approvals'.

Protocol and practices for responsible lending need to be established and monitored. Consumer protection legislation must complement national financial services regulation, improving borrowers' behaviour and improving lenders' practices at the same time. Ways to address unscrupulous and risky lending practices include:

- improving borrowers' awareness and financial skills, as well as their access to timely and independent financial and legal advice
- ensuring that people have other housing options rather than simply being pressured into home purchasing because the alternatives are sub-standard, inconvenient, costly and limited.

These topics are covered in the next two sections of this chapter.

5.3 Borrowers' behaviour

While regulation of lending practices would seem to address many problems at source, borrowers' behaviour is an integral aspect of the financial system. Lenders are often moved to point out that they cannot force a loan, or certain terms and conditions of a loan, on a borrower. The borrower voluntarily chooses to take out a home loan and signs a contract to do so. Thus, a consumer, and consumers' rights, framework is often applied to lending. This is very useful but fails to encompass all aspects of the dynamic of lending, which is a service and involves a long-term relationship between borrower and lender. Thus, conceiving of loans as products and of lenders as involved with selling loans only covers, and to some extent contorts, the 'transaction'.

Another somewhat misleading way of referring to home loans is as 'credit', when in fact it is a relationship of debt. While it is true that lenders cannot force householders to use their home as security for debt or to borrow to purchase a new home, it is popularly thought that over the last decade lenders have advertised, promoted and pressured banking customers to take on more and more household debt in the form of credit cards and home loans to the point of irresponsibility (Fear & O'Brien 2008). Also, as lenders aggressively advertise and promote home loans, wider cultural messages and social pressures strongly support buying whatever you want right now.

The competitive nature of lending and the readiness, indeed enthusiasm, of lenders has reversed the traditional relationship of going 'cap in hand' to get a home loan. The other side of the lending 'coin' is that borrowers' behaviour can be enhanced by education on financial matters and skills associated with applying such knowledge as well as by ease of access to financial counselling. This section discusses two aspects of borrowing, refinancing and superannuation to open a wider discussion on the state of financial literacy and education in Australia, the substantial role of financial counsellors, and proposals for a credit register.

Behavioural economists have explored the many ways that people actually make financial decisions and have suggested ways of designing institutions and practices that allow for the 'biases' involved. Some of these suggestions are alluded to below.

5.3.1 Refinancing

In response to higher interest rates, the federal Treasurer has exhorted home loan borrowers to change lenders if they seemed to be unfairly hit by interest rate charges (ABC News 2008) and has tried to reduce costs, such as exit fees. ASIC (2008a) has shown that Australians' propensity to refinance — the current average length of a home loan is just three years — has had costs. Most significantly, while refinancing is advertised by lenders as a cost-saving measure (and can be) not only might refinancing be an expensive route but also it might well not solve a borrower's real problems. Financial counsellors report often advising against refinancing and, as mentioned, ASIC cautions borrowers to think carefully about refinancing. Many clients of financial counsellors are simply over-committed and most have already re-financed, which has added to their financial burden and has the affect of asset-stripping — losing more equity in their home, or owing more to lenders. Refinancing might well not address a substantial problem with repayments, especially if a major cause of difficulties is spending too much income on servicing debt. In these cases default is almost inevitable and it is better to deal with it sooner rather than later.

Asset stripping by predatory lenders seems to have been conscious and concerted. Almost half of the CCLC of NSW clients in difficulties have borrowed from non-ADI lenders. The ADI lenders, in contrast, and as noted above, are committed to engaging with customers in hardship and belong to organisations providing external dispute resolution services. However, refinancing activity that often precedes clients speaking with CCLC is characterised by a movement from the ADI to the non-ADI sector, which can hide improper lending practices by ADIs. ADI customers in arrears simply go to non-ADI and apparently 'self-cure' on ADI books but appear as bad debts in the non-ADI sector.

The incidence of inappropriate refinancing, especially when borrowers have difficulties, indicates the need for better information and advice for borrowers considering such options (Hansard 2007). Policies to address this kind of issue are discussed further below.

However, more appropriate re-financing also offers scope to assist borrowers in distress (Shiller 2008: 107–109). A government or government-sponsored agency could purchase mortgages in arrears from lenders and re-negotiate the terms of the loan with the borrower in order to make their repayments sustainable. This may entail reducing the interest rate, granting a 'repayment holiday', lengthening the term, and so on. Alternatively, such an agency could accept troubled mortgages as collateral for loans to lenders, as long as the mortgages were re-scheduled in ways that maximised the prospects of the borrower maintaining their repayments and tenure. This latter approach was, in fact, enacted in 1933 in the US with the establishment of the Home Owners' Loan Corporation (HOLC). Some current debates in the US have (as

suggested in Chapter 4) proposed re-establishing such a program as a component of a future Obama administration policy to deal with defaulting households.

5.3.2 Superannuation

According to sources such as the Consumer Law Centre of the ACT & ANU Centre for Commercial Law (2007), lenders have increasingly encouraged householders seriously in arrears to take remedial action by accessing their superannuation funds. However, accessing superannuation to clear outstanding payments is only useful for the borrower if a sudden injection of money will really overcome the underlying financial distress. In a significant proportion of cases, accessing superannuation has represented a form of 'asset stripping', delaying the inevitable, and leading to worse losses for the mortgagor than if they had simply faced default or sold their home but hung onto their superannuation savings.

The use of superannuation is complicated and fraught with problems. To make an application to APRA, supporting evidence is needed from the lender to prove that the borrower will lose their home unless they can access their superannuation. But once an application by the lender for a claim of possession is set in train, through the supreme or other formal court, it might be finalised before the defendant has successfully accessed their superannuation funds. Some lenders simply will not agree to funds being found through a superannuation payout and refuse to provide the required documentation. Thus, the superannuation route is often neither feasible nor sensible. It is clear that this process needs streamlining to take better account of borrowers' interests, and they need access to independent financial advice when seriously considering this avenue. In particular, a mandatory stay of execution of a writ of possession seems appropriate where access to superannuation has been applied for and not yet determined.

APRA only provides figures of how many people have been successful in applying for access to their superannuation funds for any number of reasons. It would be most useful if APRA were required to provide quarterly data on how many applications it has received from people asking to access their superannuation funds specifically in an attempt to resolve home loan difficulties, data on how many of these have been successful, and total, proportional and average figures for the extent of funds involved. A policy response in this area is difficult to formulate without an analysis of the extent and an understanding of the kinds of issues involved; suffice to say, that it is likely that in a certain number of cases easier access to mortgage relief assistance might be a better use of government funds than having people accessing their superannuation, which implies greater reliance on old age pensions in the future.

5.3.3 Functional financial literacy

Improving functional financial literacy was an early policy response of the previous Howard government. The Understanding Money website — see <<http://www.understandingmoney.gov.au>> — was established in 2005 to help adults. It also incorporated plans to promote basic and practical financial knowledge and skills within the school curriculum (Australian Government Financial Literacy Foundation 2008). The new Rudd government has moved responsibility for this website and associated activities from the Financial Literacy Foundation (Treasury) to ASIC, which had already been taking an increasingly pro-active role in researching and informing consumer attitudes and understanding of financial products and services, such as home loans — including through the Australian Competition and Consumer Commission website (ACCC 2008). Other organisations, such as Choice (2008), have been strong advocates of warning borrowers more about the risks of defaulting and losing a home.

Clearly functional financial literacy involves many challenges. It relies on arithmetical skills and abstract concepts being applied to further certain values related to saving and other long-term life goals. 'Functional' is the operative word here: the real difficulty for educators in this area is succeeding in applying information related to budgeting, income, spending, debt and saving to everyday life as people develop relationships, have families and encounter illness, death and unemployment. At the same time as studies show that financial literacy needs improving in Australia (ANZ 2005a, 2005b; ASIC 2003, 2004; Citibank 2006; Nelson, Berry & Dalton 2008), financial services and products have become more prolific in their variety and more complex. Financial counsellors interviewed suggest it is an ironic anomaly that people gain advice and legal support to make investments in almost all circumstances except when they take out a loan for their home, and yet problems with making payments on a home loan have the greatest potential to wreak havoc on their lives. However, it seems that almost a half of Australian investors over 50 years of age do not use such advice for other investments either (Collett 2008).

There is evidence from overseas (Bernanke 2006; Braunstein & Welch 2002; Fox et al. 2005; Hilgert & Hogarth 2003; OECD 2006) and in Australia (Consumer Affairs Victoria 2006: 235–239) that one-on-one, face-to-face and independent financial counselling at key moments when householders ask for and require guidance has a higher success rate in educating and training household borrowers in terms of functional financial literacy than programs that simply distribute informative educational material widely through the print and Internet media. While there is a concerted effort to introduce more of this kind of material into the school curriculum, attention needs to focus on the more numerous adult mortgagors who are experiencing unexpected challenges in addressing financial commitments.

5.3.4 Financial counsellors

Financial counsellors with the key organisations that consumers with debt problems are referred to mainly address the most severe and complicated cases of home mortgage default. While they deal with the worst victims of lender neglect, predation, fraud and exploitation, their services are in such demand currently that reports of their experiences and the statistics that they collect on their clients cannot reveal the real extent, nor provide reliable disaggregated data, on the experiences and impacts of home mortgage default (Moncrief 2008). Still, the high incidence of clients presenting very late in the development of repayment difficulties, the extent to which financial counsellors are forced to refer those with less advanced or complicated needs to other legal, charitable and financial services, and the substantial proportion of defendants of applications and notices of claims of possession that do not appear to mount a case, all indicate that free and accessible financial counselling would be one of the most directly effective and least costly ways of supporting financially embarrassed mortgagors through a solution that might most usefully satisfy their needs.

Defendants of a claim of possession of their home are not easily able to access legal or financial assistance unless it is provided free (Carty 2008). Services provided by organisations, such as the CCLC in NSW and the CALC in Victoria, are critical. Both provide a credit/debt telephone hotline and deal with the whole range of credit/debt difficulties, not just mortgages. Staff members are overtaxed and unable to respond to all calls. Referrals are made but — in NSW especially — there are not enough financial counsellors to cope with the number of clients presenting. Financial counselling services require more funding to respond to normal, let alone current, levels of demand. In the current period of severe mortgage stress, the level of unmet advocacy services is not only apparent in the fact that few defaulters present a

defence. Recently the CCLC had a phone call for urgent assistance from the Supreme Court of NSW Duty Registrar. Western Sydney Legal Aid has single mothers presenting too late for assistance and politicians in NSW complain about the number of households affected in their electorates that present with urgent difficulties. The principal solicitor at the CCLC, Katherine Lane, suggests that temporary funding to enhance services when defaulting becomes more common, such as the current period, should be built into government policy, on the model of emergency relief responses.

Today, automated processes mean that within a relatively short period, say 90 days, borrowers in arrears can be set on a relentless track of repossession. Unless they act fast, people lose their homes swiftly. Also, the sheer amount of a loan and high repayment rates mean that arrears accumulate into a formidable size very quickly. Government could consider providing a cooling off period for every mortgage taken on, along with two free and non-transferable independent financial advice sessions for every mortgagor, one to check the terms and conditions of the initial loan and the second to discuss any repayment difficulties that might arise. Thus mortgagors would be informed and advised on the likely burden and unfortunate consequences of failing to make repayments on their home loans as they took one out. These sessions would involve holistic financial position advice based on a financial-counselling, rather than investing, framework.

A well-advertised, easily accessed and well-funded mortgage/loan line and centres providing free independent advice to all home mortgage seekers and applicants, including those refinancing, would assist in helping would-be and new borrowers to plan and better assess the real long-term burdens of their loan. They would also be informed of the risks of defaulting. This includes not only paying inflated default interest rates once they are in arrears, but also massive court costs and legal fees. (Defaulters might be clear of repayments but, without paying accumulated costs, remain in debt.) Many borrowers do not have a sophisticated understanding of the experiential level of going into arrears, how easily it might happen and how difficult it is to address. The HIA Managing Director, Ron Silverberg (2007), responded to the recommendations from the House of Representatives (2007) inquiry in these terms: 'It is simply not enough to report on mortgage defaults after they happen, first home buyers need to get further information and advice on what they can afford to service in respect to loan repayments. They also need information on what effect an interest rate rise will have on their household budget'.

The introduction of free and easily accessible independent financial advice when borrowers take out a mortgage — and a well-publicised and enforced cooling off period of seven days when such loans have been offered — would be an extremely useful service not only for borrowers. Government might initiate such a scheme and require the mortgage-lending sector to assist in funding it. If well-used, and lenders were required to record a minimum amount of data about each case, such information could be collected by the ABS to enhance knowledge of the range of loans being offered to borrowers, including the size and indications of debt servicing capacity.

The other point in the borrowing cycle when free and easily accessible independent financial advice would be highly useful is when mortgagors have serious financial difficulties either just before or just as they are unable to make a repayment. This is when they are about to, or already have sought to, refinance through their lender or another one, are seriously considering selling their home and require sound independent advice, even advocacy, to protect their interests. Indeed this kind of locally available support might seem to be more efficient and effective in certain circumstances, and complementary to external dispute resolution. In fact such a

system would perform best as a filter, passing on the most intransigent of cases for external dispute resolution. Indeed Consumer Affairs Victoria (2006: 235–39) has reviewed the current situation to conclude that:

Financial counselling services should include early intervention counselling as well as counselling for consumers in financial crisis. (Consumer Affairs Victoria (2006: 239)

The suggestion that emphasis in financial advice and planning shift away from an exclusive restorative (after the event) focus to prevention is in line with the research findings of behavioural economists. Consumers tend to accept standard contracts and lending processes as given — i.e. they act within an established situation that ‘frames’ their decisions. Shiller (2008) proposes that new ‘boiler plate’ mortgage contracts be mandated that include clear consumer protection clauses around information disclosure, reasonable dispute resolution processes and reasonable timing. He also proposes a ‘default-option’ approach to financial planning that would require all borrowers to have access to independent professional advice before signing a mortgage contract — the adviser would be akin to a civil law notary who reads aloud to contracting parties and ensures each understands the terms and ramifications of the contract before witnessing its signing.

5.3.5 *Credit register*

Debt collection agencies, such as Veda Advantage (2007), have lobbied strongly and continuously for a credit register, i.e. lists available for lenders to scrutinise potential borrowers’ current levels of debt and credit history. Operative lists are incomplete and not always reliable. Roger Mendelson (Prushka Fast Debt Recovery agency) has expressed strong concerns about the paucity of comprehensive data — especially data spanning all aspects of household debt from mortgages through to credit cards and other forms of consumer and retail debt — as well as the need for in-depth and long-term research into causes of default other than over-commitments, such as gambling and divorce (House of Representatives 2007: 31). By mid-2008, Mendelson (in Watters 2008) indicated that this — and higher rents (Greenblat 2008) — had become a more important cause of the current wave of defaults (Weekes & Vedelago 2008).

Financial counsellors we have interviewed express cynicism towards calls for a debt/credit registry that the debt reporting agencies consistently call for. Financial counsellors believe that open industry access to such information could be used selectively, idiosyncratically, and to serve specific interests. Access to data does not mean that lenders would always use it to discourage debtors to take on home loans. A parallel can be made with gambling firms that have used registries of hardened gamblers meant for deterrence as mailing-lists to send enticing deals. The UK and US both have better debt data systems than Australia, but it has not prevented abuse of lending powers and irresponsible lending.

While financial counsellors caution on the exact use of a credit register, pointing to similar lists involving gamblers being used to target victims rather than protect them, a credit register which incorporates information about lenders and their products might make information more transparent in this area in a more even-handed fashion. Information on the latter could be drawn from the supreme courts, external dispute resolution bodies, APRA, and ASIC. Shiller (2008: 134–138) sees improved financial disclosure by lenders as an important part of the solution to mortgage default. This is especially relevant in the case of mortgage backed securities which (as Chapter 4 demonstrates) have suffered from often extreme opaqueness leading to drastic mispricing. ‘There should be more simple, standardized disclosure modes, analogous to

the standardized nutrition labeling on packages of food, that makes it easy for people to assess risks' (p. 137). More specifically:

A business conduct regulator ...could require mortgage lenders and other financial firms that interact with the general public to disclose on the internet activities that appear questionable — such as predatory lending — thus opening them up to public scrutiny' (p. 138).

5.4 Housing policy context

This section briefly points to the kinds of improvements to housing and housing-related policies and legislation that would reduce risks of mortgage default and alleviate impacts on households when repossession occurs.

5.4.1 Purchasing a home is the 'best' alternative

Currently, there are serious 'push', as well as 'pull', factors in purchasing a home. Housing affordability is the key context in which responsible home lending and borrowing practices might operate. Without reasonable alternatives, households poorly placed financially to commit to a mortgage are likely to be more attracted to embark on the risky path to home ownership. Such households with less steady, reliable and lower incomes are more likely only to obtain a loan with higher costs and more stringent conditions. If these kinds of borrowers fall into arrears and default they might well be left much worse off. If this happens to more than a very tiny minority of borrowers, the issue assumes proportions of systemic failure. The Housing Industry Association of Australia and Martin North (Fujitsu Consulting) are prominent advocates of holistic solutions to mortgage stress that take the broader housing affordability perspective into account when formulating policies to minimise mortgage default.

Potential borrowers are likely to make more thorough and sound decisions about their capacity to service a mortgage if they have viable alternatives to purchasing a home. These alternatives include secure long-term private and public housing available for rental with payments competitive with 30-year mortgage repayments for similar accommodation (similar standard, size and location). However, during 2007–2008, rents rose around 25 per cent with estimates of further two-figure hikes in the next few years (Greenblat 2008; Weekes & Vedelago 2008). The public housing sector has declined in size since the late-1990s.

Policy options include improved public housing and community housing, as well as housing developed through innovative public-private partnership arrangements (e.g. government contracts with investors prepared to limit rent and offer long-term leases), and rental subsidies; the federal government-initiated National Rental Affordability Scheme (NRAS) is a case in point. An examination and recommendations on these policies is outside the brief of this research but is an ongoing concern of several AHURI projects and continuing debate around the new National Affordable Housing Agreement. It suffices here to point out that rental shortage and high rents can be the source of pressures that make risky borrowing initially appear rational to vulnerable households.

5.4.2 Defaulting landlords

The current situation of tenants if their landlord defaults and the home they rent might be repossessed is not only directly relevant to this study but also is indicative of the limited rights and, in comparison, unfair responsibilities of tenants. It is widely acknowledged that there must be improvements made to legislation related to a tenant's situation if a landlord defaults on a housing loan and if the mortgagee takes

possession. The Commonwealth Bank and Citibank have reported that there was little difference in the performance of loans by investor-borrowers and home purchaser borrowers (House of Representatives 2007: 28).

Recently, the NSW OFT moved to reform laws on a tenant's position if a mortgagee takes possession (Tenants' Union of NSW 2007), i.e. to give tenants 30 days' notice if a mortgagee requires vacant possession in that state. Currently, a successful claim to possession automatically terminates the tenant's lease agreement. If an application for a claim to possession is pending, the tenant is put on notice to leave without knowing whether they will really need to leave or not. Meanwhile they cannot break their lease. Their invidious position is outlined in Table 7, along with proposals for reforms made by the Tenants' Union of NSW. Reform proposals drafted by the NSW OFT have been criticised (Tenants' Union of NSW 2007) because of a lack of clarity about the timing of the start date of the proposed 30-day notice to vacate and, if the mortgagee agreed to continue the tenancy, the duration of the lease. State and territory legislation is distinctive, but the NSW case is representative of broader deficiencies.

Table 7: NSW tenants' liabilities, if landlord defaults, and reform proposals

<i>Liabilities of NSW tenant if landlord defaults (2007)</i>	<i>Proposals — Tenants' Union of NSW</i>
<ul style="list-style-type: none"> → Little notice. The law provides that mortgagees are required to give a tenant 'reasonable' notice of proceedings for possession of the premises. There is no guidance in the law as to what amount of notice is 'reasonable', nor is there any consistent industry practice. → No notice. The notice requirement is toothless. The law expressly provides that possession orders made without prior notice to the tenant are still effective. → 'Special circumstances'. The law provides that the Court or the Consumer, Trader and Tenancy Tribunal may order a new tenancy between a tenant and a mortgagee. The mortgagee becomes, in effect, the landlord, which gives the tenant more certainty and time to move out. This order, however, is available in 'special circumstances' only. Most tenants do not meet this threshold. → Legal costs. If a tenant tries to intervene in the mortgagee's Supreme Court proceedings to argue 'special circumstances', they may have to pay for legal representation and, if they lose, are exposed to the risk of paying the mortgagee's legal costs. → Tenants may be liable to the landlord. In a cruel twist, if a tenant vacates premises in response to a demand from a mortgagee, and the mortgagee and the landlord subsequently settle their dispute without the mortgagee taking possession, the tenant may be liable to the landlord for abandoning the tenancy, and may be required to compensate the landlord for loss of rent and other 	<p>The reformed law should provide that upon the order for possession being made, the mortgagee has the rights and responsibilities of the landlord; it should also provide that the mortgagee may give a notice of termination and, if the tenant does not vacate in response to the notice, apply to the Tribunal for an order terminating the tenancy... where a mortgagee takes possession, the tenant should also not be bound by the fixed term... when a tenant, acting in good faith, vacates the premises in response to a notice by a mortgagee that the mortgagee intends to take possession of the premises, the tenant should not be liable to the landlord for abandonment... where a fixed term tenancy is ended early by a mortgagee, the tenant should be able to withhold two weeks rent, or a higher amount as agreed, to offset relocation expenses, and a process put in place to allow the bond to be released... there should be special provisions for the compensation of a tenant's relocation expenses... we suggest four weeks or, alternatively, that the Tribunal be able to order compensation be paid by the mortgagee from the balance of the proceeds of the sale of the premises.</p>

Source: Tenants' Union of NSW (2007)

5.4.3 *Mortgage relief assistance*

Government management of default falls into two main strategies: prevention, which implies effective regulations, and remedies to ensure responsible lending and borrowing, and restoration, i.e. efficient and socially responsible support for households with severe debt difficulties whose homes are repossessed. However, the impacts and effectiveness of legislation, regulation and policies related to mortgage default vary depending on the economic cycle, especially with respect to the state of house prices (rising or falling).

In the current economic recession, with home prices plummeting in certain areas, management of defaults assumes distinctive and more serious dimensions. When national, regional and local economies are strong, and house prices are rising, households with serious financial difficulties have a rational option of selling their home. However, once economies falter, more households are likely to experience financial stress and options related to selling homes to pay off mortgages shrink, as house prices stabilise or fall.

As outlined in Chapter 2, even though the national default rate remains comparatively low, certain regions have been seriously affected by a vicious cycle of defaults, forced sales, and falling house prices. At the House of Representatives (2007: 6) inquiry, the Chairman of PMI Mortgage Insurance had reported a very low level of claims in 2006 (0.2–0.3 per cent) compared with the early 1990s, when it was around ten times higher, yet these claims were 'fairly highly concentrated... in the south-western part of Sydney'. Six months after a header of one article read 'How the west was lost' (Saulwick 2007), television viewers were taken to a street in Kellyville where four houses had been repossessed within the last five months (Overton 2008). Subsequently, the Member for Blaxland prepared a Debt Relief Information Kit (Clare 2008) for local distribution. A holistic approach would ensure that broad and uniform measures to improve financial stability were complemented with special response plans akin to relief provided due to natural disasters, prepared in advance, to implement say when mortgagors in specific regions face overwhelming difficulties due to downswings. (In their current forms, government mortgage relief schemes do not have this purpose.)

For decades, the Commonwealth–State Housing Agreement (CSHA) has incorporated schemes that offer a very small number of households mortgage relief. However, of \$1,001,000,000 home purchase assistance to 36,122 households provided during the 2005–2006 financial year under the CSHA, only \$2,621,000 (0.26%) went to 299 households as beneficiaries of mortgage relief (AIHW 2007: 236). Typically they target mortgagors who have reasonable credit histories, but have suffered illness or unemployment and require some support till their financial position is stable again. These schemes have been run in ad hoc and intermittent ways according to state and territory proposals and implementation processes.

Given the extent of mortgage stress in NSW, the NSW Government expanded its total assistance by almost one-third under a package announced in mid-April 2008, extending the limit to mortgages up to \$350,000, those eligible to a gross annual income of \$90,000 and assistance per household to \$20,000 (NSW Department of Housing 2008). The NSW Government reported that to the \$2.6 million benefiting 638 households, it would add another \$1.4 million in loans. Although media (Carty 2008)

and the government website suggested that the scheme would help because '[t]housands of families are facing financial difficulties because of rising interest rates and rents, rising grocery prices and higher petrol costs' (NSW Department of Housing 2008), the criteria for eligibility actually preclude those simply embarrassed by rises in interest rates.

In short, mortgage assistance for home purchasers who are having trouble repaying their home loans is narrow in terms of eligibility and has not received remarkable levels of funding or publicity. The eligibility guidelines of these schemes do not include those households simply suffering because of hikes in interest rates. However, redefining and expanding such mortgage relief schemes in accordance with national and uniform policies and programs that incorporated special response plans for implementation in economic downturns and in specific areas might be a very useful way to support households at risk of default mainly because of factors outside their control. Such schemes could work closely with researchers monitoring and evaluating levels and kinds of default so that they both responded to evidence-based policy indicators and collected and passed on data to researchers.

To minimise subsequent repossession of homes, these schemes might offer, or act jointly with providers of, more free and accessible financial counselling in regions or sectors worst hit by cyclical downturns. Thus, the strength of such schemes would derive from their capacity to better inform and skill mortgagors at risk of going into arrears or default.

Professor Steve Keen (2007: 47) has suggested that one way to redress the scarcity of public housing would be for the government to buy repossessed properties and add them to the public housing stock, along the lines of a model in existence in the United Kingdom run by profitable companies. Other suggestions include ending negative gearing, taxing capital gains, and reducing stamp duty on property purchases (Keen 2007: 49–50).

5.4.4 Evictions

Currently there is strong pressure on public housing with waiting lists of several years in many regions. There is little government support available to those who, having lost their foothold in home ownership, find themselves evicted, are financially stretched and without accommodation. Typical emergency approaches involves payment for a family to stay in motel rooms for a few nights while they look for more permanent low-cost accommodation. This is often not enough time and many become temporarily homeless in overt or hidden ways. Relatives, friends, boarding houses, shelter paid for or provided by charitable organisations and caravan parks are usual half-way stopping places when available. Certainly there is no uniform policy response to this situation. Therefore, means of dealing with an increasing incidence of eviction as the private rental sector struggles to deal with burgeoning demand needs to be considered in the context of the renewed federal government emphasis on reducing homelessness in Australia.

5.4.5 Insurance

Currently, in Australia, it is the mortgage lender who is insured against borrowers defaulting, even though the latter often pays the premium as part of the initial transaction cost of taking out the mortgage. In some other countries, notably the United Kingdom, the mortgagor is explicitly protected through the insurer meeting the repayment costs for a period of time after trigger incidents, like loss of employment or illness. The Australian situation raises a 'moral hazard' in that the lender has less incentive to carefully vet loan applications — the default risk has been transferred to an insurer at the borrower's expense. A regulatory change that required lenders to

insure or self-insure against default would strengthen their incentive to better evaluate and monitor default risk. This, at least, is worth further consideration.

More far-reaching proposals have also been made in this context. Shiller (2008) has suggested two possible new markets for risk management. First, borrowers could take out home equity insurance which would pay home owners if the market value of their dwelling fell as measured by a regional average house price index. This would protect them against housing wealth losses and the emergence of negative equity, a trigger (especially in the US) for mortgage default by highly leveraged households. Moral hazard — due to the incentive for home owners to under-invest in maintaining their houses or selling them at a discount — would be avoided by tying the house value to the regional (e.g. metropolitan) average. Second, Shiller suggests that a new lending product — a ‘continuous workout mortgage’ — could be developed that automatically (say, every month or quarter) re-adjusted monthly repayments to fit changes in both the payment capacity of the borrower and conditions in housing and financial markets. Thus, for example, when the borrower’s income fell and/or when variable interest rates rose, the mortgage repayment and loan term would automatically re-set to meet a benchmark repayment to income ratio.

5.5 Improving data, monitoring and analysis

As mentioned in various places throughout this positioning paper, including at the start of this chapter, information on mortgage defaults in Australia is incomplete and lacking in important detail necessary to formulate clear evidence-based policies. Indeed, an important initial policy would be to establish a more reliable database and to integrate data-gathering tasks into all activities and institutions developed to advance policy in this area. There are no comprehensive and disaggregated data on credit and indebtedness. Indeed, to the extent that debt can always be arranged privately and unregulated activities occur, no figures will ever be comprehensive. However, Australia’s performance in this area could be greatly improved.

As recommended by the inquiry into home lending, the Australian Bureau of Statistics appears the best situated to collect and disseminate such data; much of the RBA data are already sourced from the ABS (House of Representatives 2007: 27). Keen (2007: 44) has suggested that the ABS assess the value of houses using income-imputed and liquidity-adjusted methods in addition to market valuation which, he argues, would impact on RBA analyses of risks associated with home lending.

Regulatory reform in the financial sector provides a strong opportunity to demand consistent and detailed reporting from lenders and other relevant actors in the financial sector. For instance, consultation with the Real Estate Institute of Australia might focus on ways that information on forced sales and mortgagees in possession sales could be recorded. These would never be comprehensive but, given practical and other limitations, would still provide a useful platform and reference point for assessing a range of data. Indicating the utility of finely grained and timely analysis of data, at the House of Representatives (2007: 38) inquiry the mortgage lenders insurer Genworth Financial reported more losses from defaults of loans taken out since late 2003 through to early 2005.

It is only on the basis of reliable data that strong analysis can be performed and policies evaluated. Analysis will involve identifying or developing appropriate and commonly accepted (‘objective’) principles for determining debt servicing capacity at the level of an individual borrower as well as more comprehensive and broadly acknowledged definitions of ‘hardship’ that might, for instance, even take into account adverse economic circumstances outside the control of households.

Shiller (2008) proposed six elements of what he termed a 'new information infrastructure' to reduce the risk of a recurring mortgage crisis. The first five of his suggestions have been addressed in the preceding sections. The sixth is more general. He argues that most economic actors — borrowers, lenders, regulators, financial intermediaries — operate under 'a money illusion'. They act as if money is an invariable measure of value. In fact, '[m]easuring value in pesos or dollars is like measuring length with a ruler that expands or contracts from year to year' (p. 142). Inflation — and deflation — changes the purchasing power of money. Borrowers and lenders are often unaware of the real impacts of changing asset monetary values. Shiller therefore proposes the creation of a new inflation-indexed unit — termed 'a basket', given that, like conventional CPI measures, it would reflect the value of a market basket of goods and services — in which the price of houses and other long-lived assets would be expressed. Everyone could then make informed judgments as to how the real value of their house changes over time and not be misled by focusing on changes (often volatile) in nominal values. This may contribute to reducing the speculative source of asset bubbles and their aftermath.

APPENDIX: HOME REPOSSESSION DUE TO MORTGAGE DEFAULTS — PROCEEDINGS IN THE NSW SUPREME COURT

In Australia, state and territory governments have jurisdiction over resolving disputes or settling claims associated with credit, including home mortgages. In the state of New South Wales, the Supreme Court provides for mortgagees (lenders/plaintiffs) to commence proceedings by filing a Statement of Claim for Possession of the home once the mortgagors (borrowers/defendants) are in default according to their contract. The website of the Supreme Court of NSW provides information on proceedings for plaintiffs and defendants, including occupiers, as well as templates for formal communications and guides to seeking legal and associated advice.* According to the most recent version of the court's practice notes, the principles and processes involved are designed to result in a 'just, quick, and cheap resolution'.

Warning

The mortgagee must have already informed the mortgagor that they were in default through going into arrears (or have failed to fulfill an associated obligation such as paying insurance on the property that secures the loan). The mortgagor will be given 30 days to pay the outstanding amount plus other payments due in those 30 days. The letter will refer to section 57(2)(b) of the Real Property Act (NSW) and Section 80 of the Consumer Credit Code. If the mortgagor fails to rectify the situation within 30 days, an acceleration clause means that the entire loan is payable and the mortgagee can proceed to repossess and sell the home.

Negotiation

Mortgagors struggling to repay their home loans are advised to consider renegotiating the terms and conditions of their arrangement with their lender or otherwise re-financing. Financial counsellors can advise on a range of options for each specific case. Since 1996–1997, all Australian households have been covered by a Consumer Credit Code (CCC) that includes written mortgages and allows for applications to courts and tribunals for an alteration in the interest rate, establishment or termination fees where deemed unreasonable or excessive (Bingham & Niven 1997). The CCC covers extenuating circumstances, including varying repayments to account for temporary hardship (such as unemployment and serious illness). Other industry codes of practice — the Code of Banking Practice or the Mortgage Finance Association of Australia Code of Practice, the Banking and Financial Services Ombudsman, the External Dispute Resolution Scheme — also oblige lenders to re-negotiate the terms and conditions of home loans to avoid evictions and unnecessary hardship.

Statement of claim for possession

The plaintiff's Statement of Claim for Possession must be served on the mortgagor, the defendant, and any residents (tenants) and is filed in a Possession List managed by the Possession List Judge within the Common Law Division of the NSW Supreme Court. Court orders are made on these claims, including removing them. A Default Judgement and eviction can follow if the mortgagor does not successfully defend,

make a cross-claim, or settle the claim in another way. Thus, once a claim is made in the Supreme Court a set procedure is followed.

These processes are outlined in the Supreme Court Practice Note SC CL 6 (6 November 2007) associated with Uniform Civil Procedure Rules (UCPR) Rule 45.4. A prior version of this practice note was enacted on 17 August 2005. The new version allows for:

- A shorter than otherwise is conventional Statement of Claim to be made by the plaintiff to commence proceedings. The short form aims to clarify the meaning and implications of the claim to defendants. Either claim must comply with UCPR Rule 14.15 (which includes translations in 16 languages).
- A review and investigation, involving the parties, of delays in final hearings and ADR referrals to be conducted quarterly. Matters considered are those where over nine months has elapsed since a defence or cross-claim was filed.

The notice to the defendant must include informing them of their right to file a defence within 28 days, in lieu of a judgment being obtained to possess and evict them from their property. They are advised to seek legal support and informed with regard to the legal and translating services of LawAccess NSW and the Law Society of NSW. They are notified that an undefended claim can result in a sale of the property that does not realise enough to cover the debt, in which case they will be liable for the balance, and that paying the plaintiff's fees and expenses might well be made their responsibility. (Meanwhile default interest rates will apply on the loan, which is not necessarily mentioned in this notice.)

If there is any delay in serving a Statement of Claim on the defendant/s, or the plaintiff fails to follow up with applying for a Default Judgement, they are likely to be asked for an explanatory affidavit and to appear at a Show Cause Hearing. (A plaintiff who seeks to reapply on a dismissed claim is likely to pay costs.)

It is the responsibility of the plaintiff to serve the Statement of Claim on the defendant in person. If this proves impossible, the plaintiff can file an affidavit of attempted service and apply for Substituted Service. Given the details of each case, the Registrar instructs the plaintiff and can authorise a Substituted Service, so that the order is served, say by mail (according to the order of the court). A Notice to the Occupier is also relevant where tenants reside at the property in question. Residents who are not defendants can join them by filing and serving a Notice of Motion and might even be able to gain a stay of eviction orders. The defendant is given 28 days to file a defence or negotiate a resolution of the case.

In the Statement of Claim for Possession the defendant is informed of the option of contacting the plaintiff to voluntarily surrender the property. They are advised to contact the plaintiff's collection manager or solicitor to arrange an extension of time to vacate or, if rebuffed, to apply for the same through the Duty Registrar of the Supreme Court.

Directions hearings

Defended cases proceed by way of a Directions Hearing set for around one month after the defence or cross-claim has been filed by the defendant. Parties are notified by the registry to appear or be represented by an experienced barrister or solicitor. Directions Hearings are held before the Registrar, Common Law Case Management, at 9 am each day.

Meanwhile the parties' solicitors are expected to have engaged in negotiations to clarify issues, settled on (and drafted) 'suitable interlocutory orders, directions or arrangements', proposed a timetable, and decided on the option of following alternative dispute resolution (ADR) procedures.

ADR involves a mediator, an arbitrator or a referee. ADR is preferred by the court because it is quick, easy, inexpensive and effective, allowing for solutions tailored to the specific situations and interests of parties. The court can make orders following agreements made through ADR which substitutes for and finalises court action.

At Directions Hearings the Registrar, Common Law Case Management might support a mutually agreed form of resolution or hear an application for summary disposal (according to UCPR Rule 13). Hearings always include setting a timetable. The Registrar will accept documents and hearing new points — 'pleadings', 'particulars' and 'admissions' and make judgments, orders or directions related to them. The Registrar will manage interrogations or clarify the matters in dispute. Sometimes evidence must be given on affidavit and the Registrar might give orders regarding preservation of evidence.

Where necessary, a Directions Hearing will be adjourned or involve preparing for a trial. Sometimes the Registrar removes the claim from the Possessions List and associated procedures and orders or directs the parties to another legal process or action, including ADR. Thus the parties can have voluntarily elected for ADR or might be forced by the court into ADR.

Trial

Where a trial has been deemed necessary, a Joint Statement by the parties, including clarification of points related to dispute/s and evidence must be filed at least one week before the hearing date. The Registrar, Common Law Case Management, lists hearing date for trials as they arise except when under an order for expedition has been made and agreed to by the Registrar. To be granted, applications for adjourning a trial require affidavits, strong reasons, and an unexpected situation.

The court makes a Judgement for Possession after hearing both sides. A successful plaintiff is entitled to repossess and sell the property and might have been granted costs related to the court proceedings, the sale, and the loan (default interest and fees).

Default judgments

The vast majority of cases are undefended. After 28 days has elapsed without a defence being filed, the plaintiff can apply for a Default Judgment. The defendant can file and serve a Notice of Motion to set aside this Default Judgment, which will be dealt with by the Possession List Registrar, but this action increases legal costs (which are likely to be the responsibility of the defendant).

Even if a defence has been filed, a plaintiff who thinks the defendant's case weak can serve a Notice of Motion for a Summary Judgment (to institute the orders sought), which is listed before the Possessions List Registrar and usually heard simultaneously with the substantive hearing. The court will consider the merit of the case provided by the defendant and either provide the plaintiff with a Summary Judgment or list the case for trial before a judge.

If granted a Default Judgment, a Writ of Possession is served on the Sheriff of NSW, who makes arrangements to execute repossession of the home and its contents, including evicting any residents, usually the defaulter or a tenant. The Sheriff serves the Notice to Vacate. The defendant can delay this process, but only for up to around one week, by making a stay application.

Stay applications

Stay applications made within four days of the date set for the Sheriff to execute the Writ of Possession are 'urgent'. A 'non-urgent stay application' occurs either before a date has been set or over four days before the set date for a Sheriff taking possession. The rationale for a stay application will be based on a plea for time to refinance or sell the property, a defence or claim of hardship and applications must include supporting evidence and arguments. The application to stay is made by serving on the plaintiff a Notice of Motion (and supporting Affidavit), which is listed for Hearing before the Registrar, Common Law Case Management.

Urgent applications are made to the Duty Registrar during business hours and where a stay is granted might include referral to the Registrar, Common Law Case Management. The courts are required to e-mail or fax the plaintiff and Sheriff of any 'ex-parte' stays granted and summarise the reasons. Unless there are extraordinary reasons for not doing so, a second application for a stay will not be granted unless the plaintiff agrees to appear on it, and then the Duty Registrar decides on the matter. If a plaintiff does not agree to an urgent stay, then the case will be referred to the Registrar, Common Law Case Management, and the application is then heard and decided on in an open court.

Generally the Registrar, Common Law Case Management, or Duty Registrar, deals with stay applications. They might be considered by the Duty Associate Judge say for practical reasons, or if the Duty Registrar or Registrar, Common Law Case Management, refuses a stay application or the Duty Judge or Duty Associate Judge has had prior involvement in a stay application by the applicant. However, stay applications made directly to the Duty Associate Judge or Duty Judge are directed to the Registrar, Common Law Case Management. The Duty Associate Judge decides on applications for summary disposal referred by and listed at directions hearings. The Registrar, Common Law Case Management, hears applications to set aside default judgments.

Procedural delays

After five or six months has elapsed, the court can dismiss claims that have not proceeded by way of a defence or application by the plaintiff for a default judgment, according to UCPR Rule 12.8. However, the plaintiff is notified that dismissal is imminent and can request the court not to order the dismissal. If the court decides not to dismiss the case, it might come before the Registrar, Common Law Case Management, or the Possession List Judge in a Show Cause Hearing.

* Information on procedures in the NSW Supreme Court is available at — <http://www.lawlink.nsw.gov.au>

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