SPECTRUM ASSET MANAGEMENT

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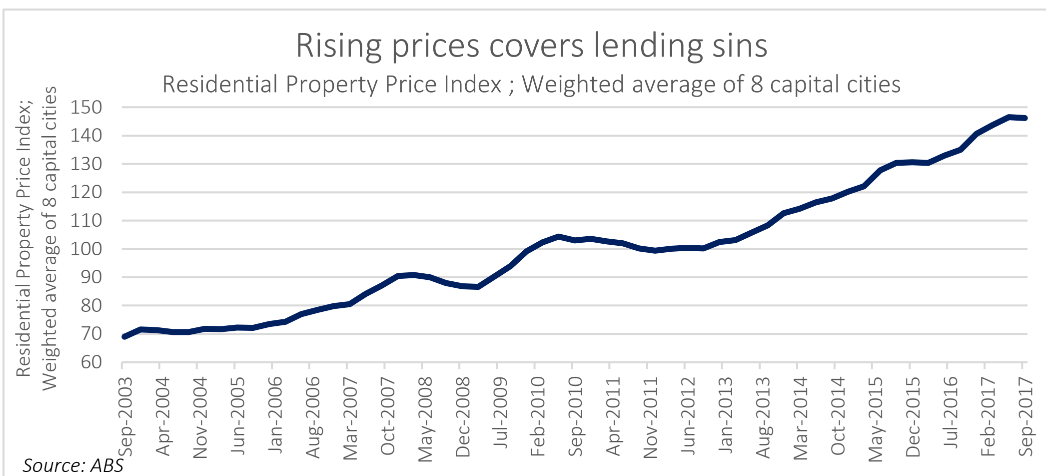
Spectrum Insights

Can the interest only bomb be defused?

Interest only mortgages boomed in the U.S. in the 1920s. What followed was the Great Depression. They re-emerged Stateside in the early 2000s. What followed was the GFC and the Great Recession. In Australia interest only loans account for around 35% of the system's mortgages. But Australia is different right? Lenders may have better security. The borrowers, though, are similar and some could face challenges when they are called to repay the principal on these loans. In Spectrum's view, the Australian residential property market is a large debt-fueled financial bomb. This bomb will not necessarily explode. To diffuse the situation requires APRA to up the ante on banks de-risking and hope the market backdrop remains benign. Else, the faint tic toc sound at present could get somewhat louder.

And the property party goes on

Interest only loans and those which are negatively geared are made when the borrower is confident of capital gains. These loans are granted at low interest rates due to the lender's confidence that the risk of loss is low. Both parties largely got it right in Australia for the best part of the last 25 years.



In finance, history influences expectations. The more recent the event, the stronger the influence. The longer the pattern, the greater investors' confidence of its continuation.

The long lasting buoyant residential property market in Australia has driven, what we see as, undue confidence from borrowers, lenders and regulators in recent years. The large use of interest only mortgages is perhaps the best indicator of blue sky group think from property market players.

The insanity of widespread interest only

In conservative banking times, a loan is supposedly only granted when you could prove no need for it. Now it appears almost anyone in Australia can get a loan to purchase property - even if you agree you can't pay back the principal from your current cashflows.

Two factors compound our concern. A study by ASIC found in Dec 2014 that interest only loans were larger than principle and interest loans – hence suggesting the easier the repayment terms the more that was borrowed. It is also found the majority of interest only mortgages came via brokers. Given our concern for the overall quality of broker-originated loans this may compound the risk - Australian banks flaunting history.

We acknowledge that, given the local tax system, there are times when an interest only loan to *some* borrowers makes sense and can be prudent lending. But to have it as a third of a bank's loan portfolio in this form is effectively a large bet on ever rising house prices.

What could go wrong?

At the end of the interest only period, borrowers face four key paths: repay the loan from other sources, get an extension, switch to a principal and interest (P&I) mortgage or sell the property to finance the loan repayment.

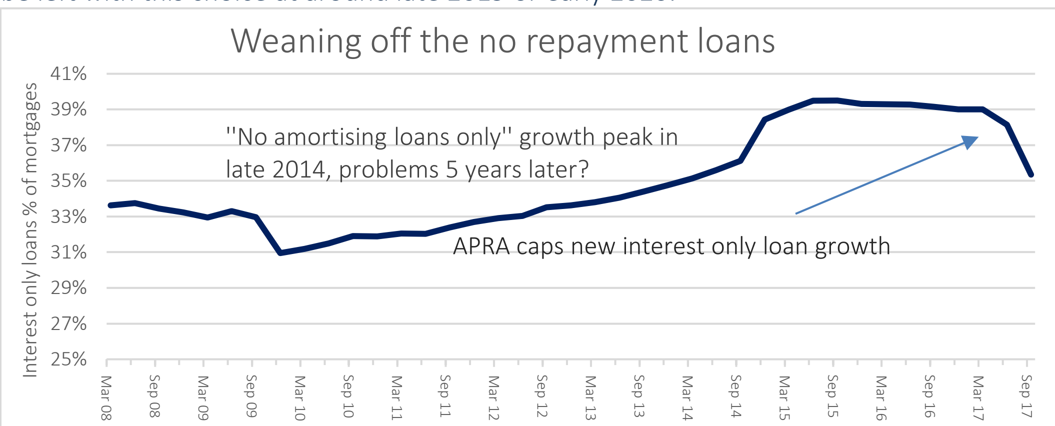
Given APRA's moves of late[1] we suspect banks will be reluctant to rollover all interest only loans. A move to a P&I loan will cause a huge jump in monthly payments. We fear it may be too high for many.

For example, in the box below we outline a scenario of a $500,000 interest only loan. By moving to a P&I loan, the monthly repayments for a 30 year loan jump 43%, for a 15 year loan it doubles and for a 10 year loan it triples.

Type of loan	Term	Interest rate	Mortgage	Monthly servicing	Annual	Increase from on interest only loan
Interest only	5 years	4%	$ 500,000	$ 1,667	$ 20,000	
P&I	30 years	4%	$ 500,000	$ 2,387	$ 28,644	43%
P&I	15 years	4%	$ 500,000	$ 3,698	$ 44,381	122%
P&I	10 years	4%	$ 500,000	$ 5,062	$ 60,747	204%

Sources: Spectrum, Your Mortgage

Presuming the bulk of the interest only loans are for 5 years, it suggests that many will be left with this choice at around late 2019 or early 2020.



Source: APRA

If the price of the property has risen, then no problem. Sell and reap the rewards. If not, the borrower better hope they have the capacity to up their monthly payments or have a bank that will rollover the interest only loans. Else the risk of financial strain on the borrower jumps. Forced selling may follow. If enough forced selling occurs, supply could swamp demand. The concern is that it kicks off a negative circularity and a fall in property prices becomes more pronounced.

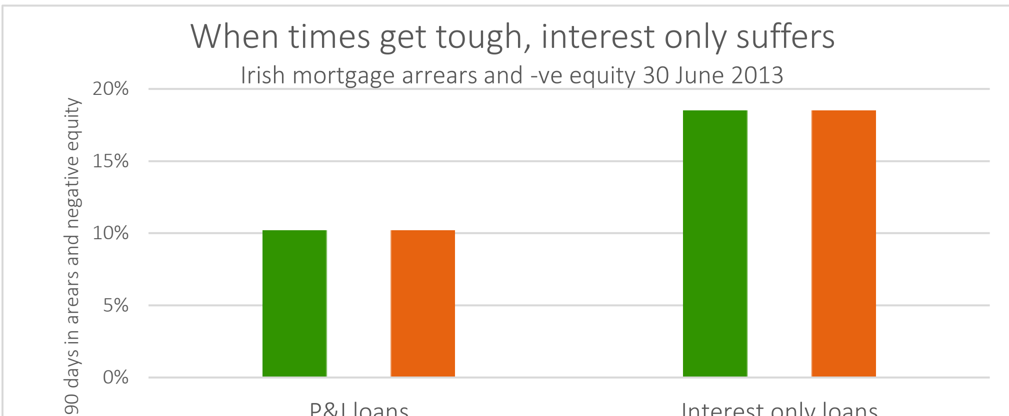
Lessons elsewhere ignored

If the scenario described above sounds like something you have heard before, it may be adjustable rate mortgages in the U.S. Many mortgages were granted on "teaser" rates to attract price-sensitive borrowers. And when the teaser rates stopped, many found they could not meet their repayments. And then came the GFC!

The similarities with Australia now and the U.S pre-GFC are clear from an academic recap of the GFC "...real estate seemed the only safe bet to many Americans, especially since interest rates were unusually low. At the same time, lenders became more and more creative, and enticed new and increasingly less creditworthy home buyers into the market with exotic mortgages, such as *'interest-only'* loans"[2].

And it's just not the U.S experience that worries us.

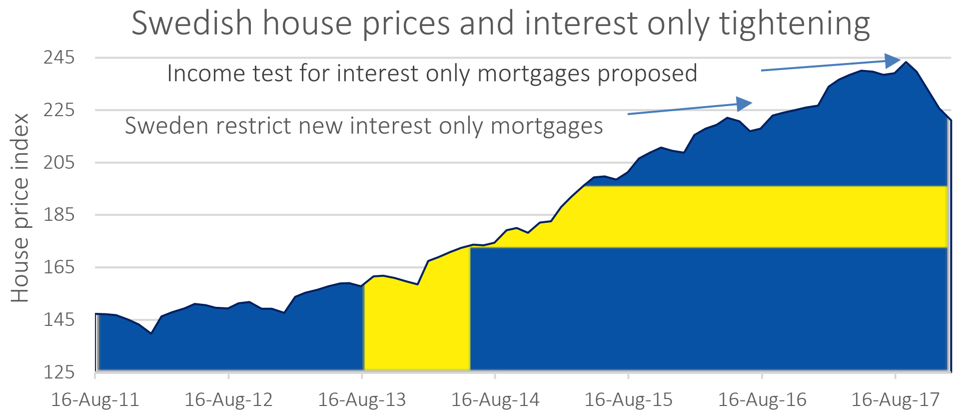
In Ireland, interest only mortgages made up just 10% of their mortgage market going into the GFC. What is interesting is several years after the worst of the country's property crash, interest only loans were far more likely to be in distress than P&I loans[3].



Sources: Central Bank of Ireland

Some regulators picked up on the risk. After the GFC, the Dutch government stopped interest only loans unless there was at least a 50% deposit paid. Singapore banned them from September 2009. In the U.K, interest only loans made a third of all mortgages in 2012. Post a regulatory review, pressure to reduce no amortizing mortgages brought this down to 20% of the market. In Canada "risky non-traditional products offered in the United States (e.g. interest-only mortgages) are either unavailable or are very limited in Canada[4]".

Sweden has kept interest only loans going. They make up around 40% of the mortgage market - a similar level to that in Australia. After several years of wrangling, new laws restricting interest only loans were finally agreed upon in 2016. The regulator has proposed further tightening in late 2017 to be enforced in March 2018. We note Swedish property prices have recently started to fall.



Sources: Nasdaq (NASDAQ OMX Valueguard-KTH Housing Index

APRA to the rescue?

In March 2017, APRA instructed the banks to limit interest only mortgages to stay below 30% of new lending. Reportedly $1.1b in loans were reclassified in 2017 alone[5]. As the graph on page 2 indicates, the scale of interest only loans is now falling. This follows APRA's clamp on investment mortgages to just 10% annual growth.

Looking forward, APRA has already signaled that house lending is a key priority. It noted it "will devote a large portion of its supervisory resources to housing over 2018 and maintain its focus on reinforcing prudent lending standards and practices". We suspect instructions of further tightening in credit standards for lenders will come.

Interest only – a danger, not a death warrant

We stress that the mere existence of widespread interest only loans is not a death warrant for our residential property market and lenders. It just puts both at elevated risk levels. APRA, though, is pushing the banks towards safer mortgage portfolios. If market conditions remain supportive, it may achieve this. We think there are no major concerns in the next six months.

Longer term should interest rates rise, employment fall, population growth stalls or foreign demand for our property slump, this risk escalates.

On these factors, rising interest rates looks likely in our opinion, as we suspect global bond yields to trend towards normalized levels. This, in turn, will put upwards pressure on mortgage rates in Australia.

In short, APRA and perhaps the banks[6] are in a race to diffuse risky past practices before market conditions change. It may win this race but we think it's prudent to manage our portfolio just in case our long lasting property boom starts to unwind.

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(1) Interest only loans limited growth to 30% of new mortgages. Growth in loans for investments limited to 10%. Proposed revisions to risk weighting for mortgages to reflect the risks of loan to value, principal and interest and owner occupiers.
(2) The Credit Crunch: A Minsky Moment: Charles J Whalen
(3) Central Bank of Ireland, Interest Only Mortgages in Ireland, Kelly, Kennedy, McIndoe-Calder Vol 1 2014
(4) Bank of Canada: The Residential Mortgage Market in Canada: A Primer
(5) The Australian, Feb 1 2018
(6) "Banks are run by executives, and executives protect themselves, and that does not always mean that banks are going to behave rationally" - Daniel Kahneman

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