Spectrum Asset Management

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Spectrum Insights

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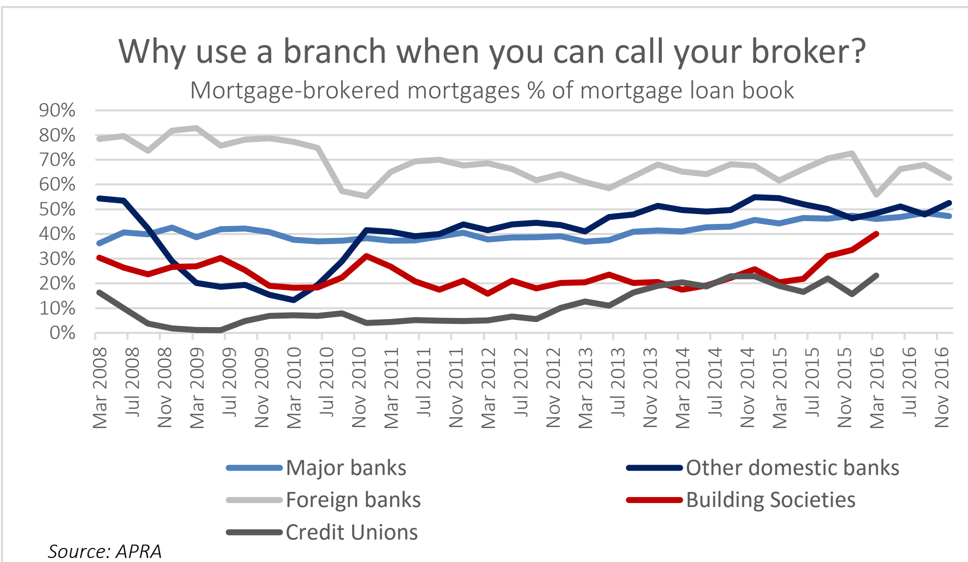
Australian banks– flaunting history

Risk management, or the lack of it, is usually the key difference between the fortunes of banks when times get tough. History books are full of evidence of what went wrong after a financial calamity. That's the easy part. The hard part is to foresee the problems. The high level of Australian household debt and interest only mortgages have received much attention of late. Spectrum sees another potential source of pain for Australian banks - the heavy reliance on mortgage brokers. Around half of the mortgage market originates from brokers. These agents can be far more financially motivated than bank branch employees to sell mortgages. The risk is, just like the pre-financial crisis in the U.S., controls and borrowers' best interests are subordinated behind brokers' financial gain. System-wide, this high reliance on brokers is a concern. At the individual bank level, it may also be a key differentiating factor in a bank's financial health should Australian mortgage losses start to rise.



Source: APRA

Why we worry about mortgage brokered loans

A mortgage broker gets paid a commission on loans written. The greater the volume, the greater the rewards. It can be a highly lucrative job.

However, what motivates a bank employee emanates from a broader range of benefits. A cornerstone of these factors is a career as a banker.

The downside for a mortgage broker, if bad loans are written, is some foregone trailing commission in the future.

However, the downside for a bank employee is job loss and potentially lost hopes of continuing in the field of banking.

The experience of the U.S.

U.S. mortgage defaults were a cornerstone of the GFC. Broker sourced mortgages made up around a third of the market. These mortgages were found to have higher default rates than branch sourced mortgages.

Research from the U.S. National Bureau of Economic Research (NBER) studied mortgage brokers' impact on U.S. mortgage lending standards before the global financial crisis. According to the study, "results point to a poor alignment of the mortgage brokers' incentives and loan quality and performance during the run-up to the subprime crisis".

Another U.S. academic paper provided some insight on why the misalignment takes place - "as brokers did not bear the ultimate costs of default, they may have had a lower incentive to screen applicants carefully"[1].

Aussie Liar Loans

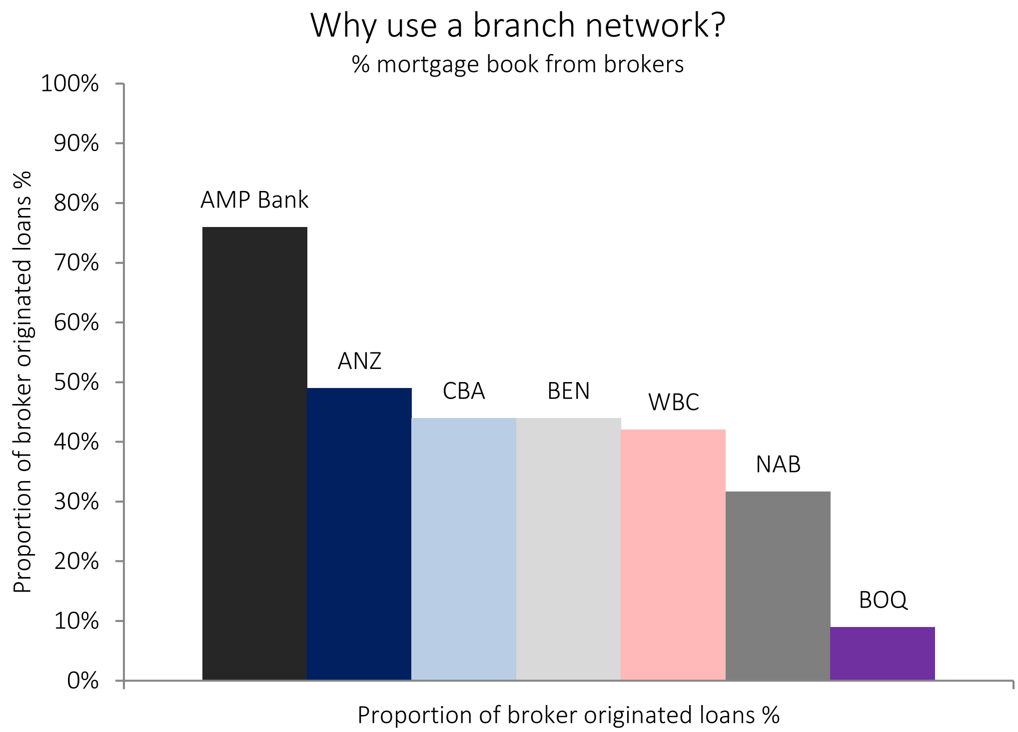
Part of the problem in the U.S. were the infamous pre-GFC "liar loans". Potential borrowers fibbed on matters such as income or assets owned. In Australia, the Banking and Finance Consumers Support Association claims that there are many mortgage applications with forged signatures on loan documents and overstated income and assets.

Press reports from a 2016 UBS study in Australia also noted 28% of mortgagors claimed to have factually inaccurate applications. The ratio rose to 32% for those using brokers. What is worse is that the study found 41% of those who lied in their applications did so at the encouragement of their brokers!

Of course, many brokers are honest and we suspect the bulk of the borrowers using them are creditworthy. Banks, however, are leveraged around 15 times. It takes just a small amount of mortgage losses to make a big dent on profits.

Red flags?

Banks will have differing standards for vetting mortgage applications from brokers. Some will be highly effective with mortgages. Unfortunately, only when there is a downturn will the broker-linked mortgage controls be properly tested. The greater the reliance on brokers, the greater the importance of the vetting process of broker-directed mortgages.



Sources: banks: AMP 1H16, ANZ FY16, BEN Dec 16, BoQ, 1H17, CBA Dec 16, NAB Sep 16, , WBC Sep 16

This time is different?

Banks strenuously defend the soundness of their underwriting policies and controls. They always do. They did in the U.S. before the 2008-9 Global Financial Crisis and in Asia before the 1997 Asian financial crisis. Some did have good controls. The weak lending standards of others were exposed only after economic conditions weakened.

Residential property lending conditions have improved in Australia for most of the last twenty five years. Interest rates fell, jobs remained abundant, the population continued to expand and home prices kept rising. This resulted in a loan loss rate for lenders nearing zero. In short, the environment for lending could not have been any better. The worry is sooner or later lending conditions will get worse.

Perhaps, this time is different in Australia. The global history of banking problems, though, suggests that after a prolonged period of loss-free lending, credit controls tend to ease well past levels that are proven to be prudent. Spectrum fears this time is <u>not</u> different for Australia and its home lenders.

What is different in Australia?

Australian laws give far more protection to home lenders than in the U.S. Here, borrowers are personally liable for loans. Even after repossession of a property a bank can chase the borrower for repayment until the debt is extinguished or the borrower declared bankrupt. In the U.S., the recourse tends to be restricted to the property linked to the loan.

This difference in laws impacts on the relative propensity of a borrower to repay the loan. This makes a mortgage relatively safer in Australia - all things being equal. The laws, however, do not impact on the ability to pay. If borrowing conditions deteriorate sharply, many will not be able to service their mortgages. Home repossessions will accelerate. This will also occur just when demand is likely to be falling. Hence, this would expose banks to increasing loan losses.

History lessons ignored

We worry Australian banks may have too wholeheartedly embraced the mantra that "Australia is different" when referring to the housing market. Sure, it is not the same as the U.S. but that does not mean lending for homes is nearly risk free. As Winston Churchill said, "*Those who fail to learn from history are doomed to repeat it*". We fear that the extensive use of mortgage brokers and embellished loan applications will cause financial pain among lenders when borrowing conditions in Australia deteriorate. At Spectrum, should we foresee mortgage stress rising, we will look to further scale back our underweight position in Australian banks.

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Notes:

1. Keys, Mukherjee, Seru, and Vig, 2008

Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in A$ corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information and how to invest please go to our website http://spectruminvest.com.auor contact your mFund brokerhttp://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities