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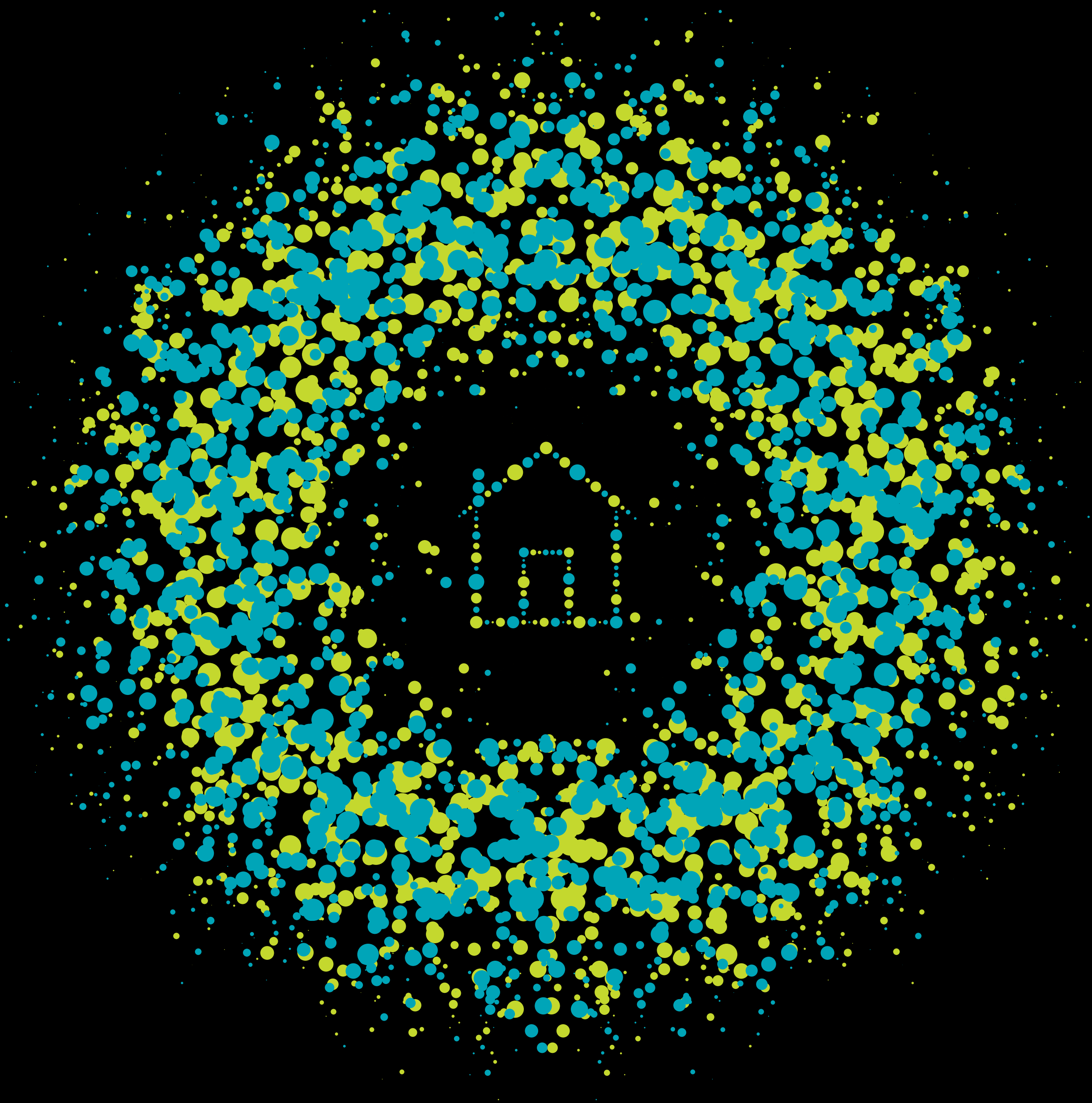


Executive summary

Extract from Australian Mortgage Report

2017

Executive summary

Back row (from left): Steve Weston, (Consultant); Kevin Nixon, Heather Baister, Graham Mott (all Deloitte); Malcolm Watkins (AFG); Mario Rehayem (Pepper Money); Scott McWilliam (Homeloans); Meg Bonighton (NAB); James Hickey (Deloitte). **Front row:** Peter Andronicos (eChoice); Louise Denver (Deloitte); Lisa Claes (CoreLogic); Jenny Wilson (Deloitte); Vimpi Juneja (BOQ)

Shifting to a year of personalised, innovative and more moderate mortgage activity dominated by availability and affordability...

The 2017 predictions from a roundtable of leading Australian financial services mortgage heads and lending experts are for an increasingly personalised but more subdued mortgage market that is still bedding down 2016's macro-policy changes. The market will be impacted by housing availability and affordability, and is expected to continue to be buffeted by international decisions.

The categories include

- Market forces
- Regulation
- House prices
- Profitability
- Funding
- Innovation
- Digital
- Consumers
- Regionals
- Brokers.

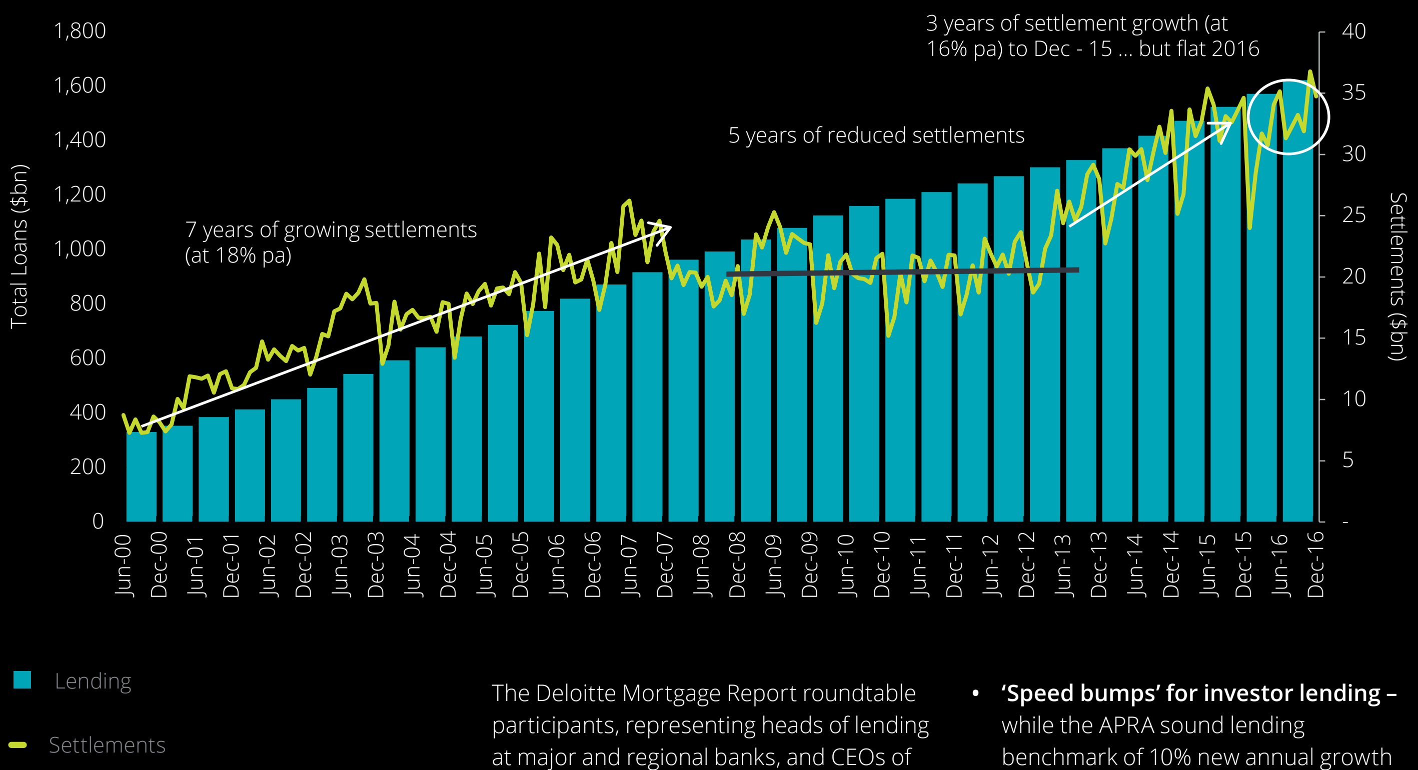
Mortgages 2017:
Finding focus in a complex market

In an insightful look at what is necessary to find focus in a complex market **James Hickey,** Deloitte Financial Service Partner analyses the Australian mortgage market and summarises much of the thinking in this year's Australian Mortgage Report.

The Australian mortgage market edged into 2017 with total new lending to households remaining flat over 2016. And while market participants remain confident about the fundamentals, they can see the signs of slowing growth.

Over the 12 months to December 2016, total new lending (including refinancing) was $384bn, which was the same as the 12 months to December 2015. This was the first year since 2012 when settlements did not grow over the previous annual period.

Residential Mortgage Lending
2000 to 2016



Source: Australian Mortgage Report 2017

The Deloitte Mortgage Report roundtable participants, representing heads of lending at major and regional banks, and CEOs of mortgage broker groups, collectively expect 2017 to be a year of modest (1-5%) growth in new lending. This moderating settlement growth represents:

- **'Speed bumps' for investor lending –** while the APRA sound lending benchmark of 10% new annual growth to investors certainly led to some reduction in lending to investors during 2015 and the first half of 2016, together with differentiated (higher) pricing for such lending, there was a return to stronger investor lending in the latter half of 2016

- **Tightened lending criteria –** in addition to investor lending thresholds, there was also tightening of serviceability criteria, especially around non regular and offshore income sources, and closer scrutiny of household expenditure measures in testing the capacity of borrowers to repay in times of higher rates
- **Differential pricing –** lenders began greater pricing for risk, particularly for higher Loan to Value Ratio (LVR) lending, as well as actively choosing not to participate in certain parts of the market (such as reduced lending to property developments and off the plan).

However, against this background of sound practices resulting in slowing settlement growth, lenders were also deepening discounts to existing owner occupiers who were seeking to refinance from another lender. During the latter half of 2016 major lenders were offering discounts well in excess of 120 basis points (bps) or more, from their standard variable rate to new borrowers.

Key Themes of 2017

Into 2017 there is ongoing concern over housing affordability and in particular the pace of the Sydney and Melbourne property markets, ongoing political and public scrutiny into lending and mortgage pricing practices of the banks, funding cost uncertainty placing (upwards) pressure on rates, and reviews into the distribution of mortgages, and conduct by banks in treatment of customers.

Affordability

It is important to draw a distinction between 'affordable housing' and 'housing affordability'. While the former is vitally important in assisting households of lower socio-economic standing be able to have appropriate housing, it is the latter that is often discussed around the inability of otherwise financially able households to afford property (especially in the Sydney and Melbourne property markets). See the roundtable discussion page 13.

Historically: Housing, particularly for first home buyers, has always been a challenge. Raising the deposit for a property when commencing a career and often juggling growing family commitments has always been a challenge for Australians of any generation. However, for the current situation of first home buyers representing around 13% of new lending, there are some specific issues to be considered.

Geographically: Firstly, the capital cities of Sydney and Melbourne are home to more than 8.4 million people (over 35% of the national population) and therefore are considerable centres of employment. Being coastal based cities, with central business districts towards the coastal or harbour/port regions, places considerable concentration of employment and living into limited geographical areas. These all combine to place intense pressure on available housing in and around those areas.

Property prices: With property price growth of 15.5% and 13.7% respectively in 2016 for Sydney and Melbourne - a continuing trend since 2012 - compared to a downward trend of wage price inflation of 2-3% for 2016 across all states and employment industries, there is a growing gap. This is placing greater questions around affordability for households not currently in the property market in those cities.

Regions: However, while the focus is largely on affordability for Sydney and Melbourne, and that appears to be a price vs. wage growth concern, there is more to Australia than just those markets. Across other areas, including other states and regional areas of NSW and Victoria, the affordability issue is quite different. It is not so much property prices, but rather employment and availability of jobs and certainty of income which is the concern. Therefore, addressing housing affordability is not just solving a problem for Sydney and Melbourne, it is one that needs national consideration of all the issues impacting affordability including other states and regions.

The dilemma: Indeed this shows the challenge for the Reserve Bank of Australia (RBA). Should it seek to abate housing price pressure in Sydney and Melbourne by raising official rates, and should that result in banks increasing lending rates, this may dampen growth in Sydney and Melbourne, but would also adversely impact business and investment confidence in other states and regions. Thus potentially making the affordability issue outside the capital cities worse, rather than better.

The debate about potential short and longer term solutions need to be broad and should account for:

- **Taxation basis –** while negative gearing is often mentioned, for many Australians that is their wealth generation vehicle. Indeed many first time buyers they choose to be first time investors rather than owner occupiers. So any changes to this need not necessarily picture all investors as the same profile. Further, the discussion of broader ongoing tax bases, such as land based tax rather than stamp duty, is also merited. However this will likely give longer term structural benefits, rather than necessarily short term ones.
- **Supply release –** while state and local governments are addressing the process of releasing and approving new supply, there is also an opportunity to encourage greater release of existing supply. This would be a supportive policy for retirees in downsizing from their properties, without adversely impacting pension eligibility. And it would give other relief from e.g. stamp duty on repurchasing for retirees.
- **Infrastructure –** to alleviate the pressure on capital city prices investing in both physical and technological infrastructure will support workers to live in areas outside the city and be employed. This is vitally important. Improving remote working and other flexible work and travel solutions, is an emerging opportunity to address the problem.

The mindset: Lastly, while home ownership is strongly embedded in the Australian mindset (and favourably supported by tax and other incentives), focussing more on the benefits of long term 'permanent tenancy' should also be encouraged. Many European countries have systems with longer leases and greater support for tenants. This has resulted in renting being an entirely acceptable norm for housing over the long term.

> The need to have only one path of housing purchase, may not be the only model for many Australians going forward.

Mortgage Pricing

With official cash rates at record lows lenders have been able to offer competitive pricing to borrowers. However, this has mostly been of benefit to recent borrowers, or those who have actively refinanced or negotiated better deals with their lenders. While standard variable rates are the often quoted headline rate for lenders, a vast majority of borrowers (especially those having financed in the past five years) will be on rates well less than the Standard Variable Rate (SVR).

This then means that lenders' will need to carefully balance their 'front book' (ie new lending rates to borrowers) and their 'back book' (ie lending rates to existing borrowers). During 2016 it was not uncommon for major lenders to offer 120bps or more, discount on the SVR for new borrowers to the lender. This is around 50bps better than the long term discounting average (of around 70bps) across the 'back book'.

It is important to lenders' profitability that they carefully balance the desire to grow market share using deep discounts, as over the long term, the current front book will become the future back book.

From an existing borrowers' perspective, it is important to be aware of where current offers are in the market. Often a good deal some years ago, may not be the best that could be achievable in the current market. See more on Page 15

Funding Costs

There was considerable focus over 2016, especially in the senate economics hearings, around the way banks price mortgages. Certainly the official cash rate set by the RBA is one measure impacting bank funding costs (primarily through deposits). However, offshore wholesale funding costs (which can comprise 40% or more of bank funding) are largely dependent on offshore events and market conditions. In 2016 there was considerable volatility in such costs, ranging from the impacts of Brexit to the United States election. We also expect such volatility and uncertainty to continue throughout 2017. See our article on Page 15

In addition, there are capital costs which lenders need to price for. These represent charges for the capital the banks must hold to remain 'unquestionably strong' and capital secure. The greater perceived risk of investor lending, different economic and employment factors, higher loan to value ratio lending, and so forth, are all risk based factors that increase capital and hence cost. We expect there to be more risk based pricing points across mortgage interest rates in 2017, reflecting more granular risk assessment by lenders of specific borrower' and loan' characteristics.

Conduct

Related to all of the above is the way in which banks deal with borrowers in a fair and equitable manner. See our article on Page 21

While a lot of the conduct spotlight throughout 2016 focussed on banks financial planning and life insurance arms, it remains that the most regular interactions with customers is through their banking activities.

James Hickey

In early 2017 the Australian Securities and Investment Commission (ASIC) released its review into mortgage brokers, and the impact of remuneration on customer outcomes.

This review identified a number of areas for both broker groups and the lenders, to improve their remuneration structures, and the transparency of their interactions with potential borrowers at point of sale when using a broker.

The Australian Bankers Authority (ABA) is also conducting a review into the sales practices of bank staff, which should cover similar aspects of the role remuneration incentives play for front line staff versus best interest for the customer.

We will see a continuing elevation of the importance of conduct improvements across lenders through 2017. While very much stating they are 'customer first', there is a level of public confidence necessary to restore between customers and financial institutions. It is important that in 2017 concrete steps are made, to show the improvements being implemented by lenders in supporting this.

I hope you find our 2017 Deloitte Australian Mortgage Report both useful and an interesting read.

James Hickey - Partner

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