

Australian Mortgage Industry - Volume 2

Low Doc Loans - A Growing Segment



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This report is the result of a joint effort between Fujitsu Consulting and JPMorgan, focusing on developments in the Australian mortgage industry. We use the Fujitsu Mortgage Market and Yield Improvement Modelling.



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Table of Contents

Executive Summary	3
Mortgage Industry Update	6
Mortgage Broking Update.....	13
Low Doc Loan Market	19
International Comparison	26
Half An Hour with Sherman Ma (Liberty Financial)	28
Appendix	32

Executive Summary

This report is the result of a joint effort between Fujitsu Consulting and JPMorgan, focusing on developments in the Australian Mortgage Industry. We use the Fujitsu Mortgage Market and Yield Improvement Modelling. In relation to the mortgage industry generally, the key findings are:

- **The proportion of broker originated home loans continues to rise, while sales through the branch network are underperforming relative to sales through other channels** – The proportion of broker originated home loans has risen to over 35%. At the same time, each of the major banks has lost market share in branch originated home loans, with the notable exception of an increasingly aggressive NAB.
- **Banks are reinvesting in their branch networks in an effort to reclaim lost distribution** – The continued tacit support of mortgage brokers by banks is weakening the distribution strength, and ultimately the pricing power, of the banks. In response to this, banks are reinvesting in their branch networks in order to reclaim lost distribution.
- **Commission structures likely have a disproportionate impact on the growth achieved by major lenders via the broker channel** – Responses to a survey of brokers highlight the importance of both upfront and trailing commissions in determining where broker business is directed.
- **The growth of brokers has provided an opportunity for new entrants that have not previously existed in the mortgage market** – The ease of distribution through third parties precludes the need to establish an extensive branch network, thus removing the major barrier for new entrants.
- **The relative perceptions of broker and bank advice in the eyes of the consumer highlight that brokers are likely to win further market share** – Given the increasing complexity of mortgage products, the need for advice is growing. Perceptions of the relative quality of broker and bank advice indicate that brokers are likely to win further market share.
- **The disconnect between the perceptions of consumers and the action of brokers in relation to commission structures highlights a significant problem for lenders** – Only a small proportion of customers believe that commission structures influence a broker's recommendation despite the fact that commissions are the single most important factor that brokers consider when deciding which loans to recommend. This poses a significant problem for lenders in Australia.
- **One of the major banks could move to abandon the broker channel and preserve market share by handing back the commission directly to customers via lower home loan rates** – The continued tacit support of the mortgage broking channel will effectively result in the major banks losing their home loan distribution margin and only retaining their manufacturing margin. This loss of pricing power will make banks more vulnerable to margin pressure as competition intensifies. As such, a review of commission structures, profitability and home loan pricing could result in one of the major banks moving to abandon the broker channel and hand back some of the commission directly to customers by way of lower home loan rates to preserve market share.

We have also undertaken a detailed examination of the market for low documentation, or “low doc” loans. The key findings are :

- **The low doc loan market continues to grow, with over 45% originated by third party brokers** – The proportion of home loans which are classified as low doc has increased to an all time high of 10.4% of new loan approvals, up from less than 1% in June 2000. This corresponds with the growth in the broker market, which has provided an avenue for customers, who are unwilling or unable to verify their income, to access home loans that would previously not have been available to them if they had gone direct to the bank.
- **Spreads on low doc loans are falling due to increased competition, raising the question as to whether banks are adequately pricing for risk** – Historically, lenders have charged a premium for all low doc loans. However, premiums charged on “prime” low doc loans have been falling recently. Such pricing initiatives virtually ensure that prevailing premium rates on some lenders’ low doc products will disappear. This raises the question as to whether banks are adequately pricing for the higher level of risk associated with low doc loans.
- **Arrears levels are much higher for sub-prime low doc loans and could be significantly impacted by interest rate increases** – We have used the Fujitsu Mortgage Market and Yield Improvement Model to examine the relative risk profiles of standard and low doc loans. We determine that sub-prime low doc loans are over twice as likely to fall into arrears as standard loans. We estimate that arrears in excess of 180 days at the portfolio level would increase by around 50% if interest rates rose by 2%. Furthermore, the impact varies considerably within different segments, suggesting that lenders wishing to access the low doc loan market should have sophisticated sub-segment models in order to assess portfolio risk.
- **Low doc loans are a “good times” product and credit quality has not been tested in an adverse economic environment** – We highlight that the prevailing favourable economic environment with low unemployment, low interest rates and appreciating house prices likely masks any differential in the asset quality performance of low doc loans which may become more apparent in an adverse economic environment. Loss experience over the last 5 years can not be used as a reliable indicator of loss experience over the next five years if the housing market and broader economic conditions are less favourable.
- **The RBA and APRA have highlighted the higher risk of non standard home loans** – We note that the Reserve Bank of Australia (RBA) has stated that non-conforming home loans are inherently riskier than conforming loans and that the Australian Prudential Regulation Authority (APRA) has proposed higher risk weightings for non-standard loans. Furthermore, APRA has found that there have been changes to valuation methodologies in recent years that could potentially increase the risk profile of lenders.
- **The growth of low doc loans in the US and UK has been constrained by the introduction of “fast track” lending by mainstream lenders** – Low doc loans have been a feature of the US and UK home loan markets since the mid 1990s. In response to the emergence of low doc loans provided by specialist lenders, the main stream lenders introduced “fast track” lending. In contrast to low doc lending, fast track lending relies on credit scoring techniques rather than income proof, which is then only required for in specific cases, such as loans with an LVR under 75% but a high credit score.

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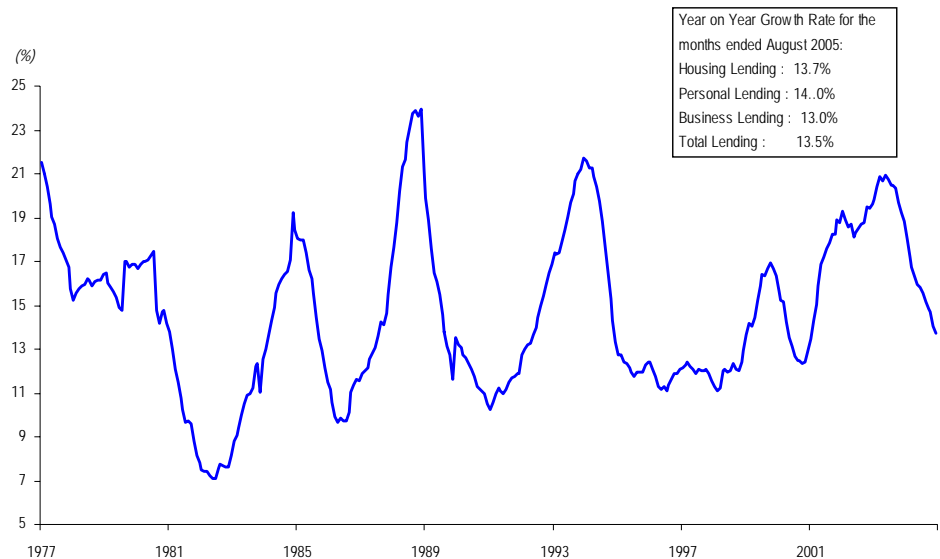
Mortgage Industry Update

Mortgage Industry Update

Growth in the Australian mortgage market has slowed in 2005 as the extended housing boom passed its peak. Nevertheless, the Australian bank housing loan portfolio was A\$681bn at the end of August 2005. We highlight recent developments as follows :

- **Home loan volume growth has fallen from a peak of 20.8% in the 12 months to February 2004 to 13.7% in the 12 months to August 2005** (refer Figure 1) – The Reserve Bank of Australia (RBA) restated its credit aggregate data at the end of August 2005 after it discovered that some securitisers had not included issuance of privately-placed residential mortgage backed securities (RMBS) in the data reported to the Australian Bureau of Statistics (ABS). This prompted significant upward revisions to the RBA credit aggregates.

Figure 1: Australian Housing Lending Growth

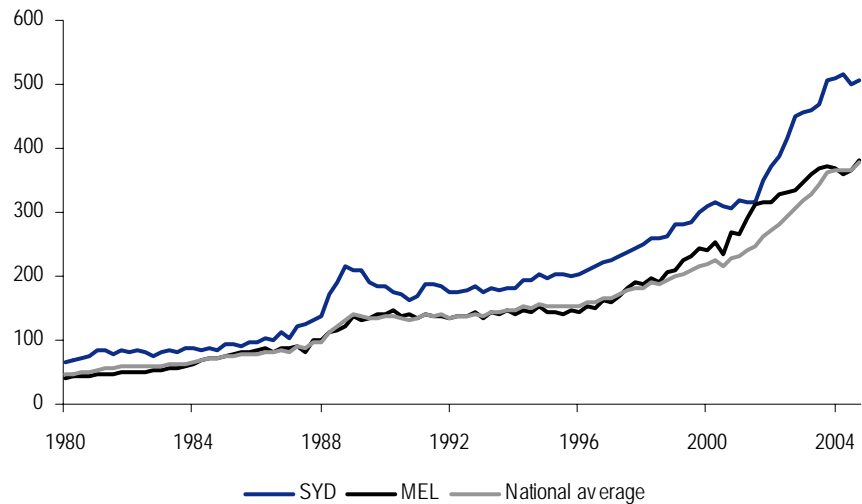


Source: RBA

- **Based on Australian Prudential Regulation Authority (APRA) statistics to the end of August 2005, NAB has experienced strong market share gains at the expense of WBC** – NAB’s market share gains can be attributed to ongoing broker penetration, increased use of “introducers” and improvements in sales of home loans to its SME customer base. On the other hand, WBC’s market share losses have been due to reduced penetration of the broker market up to March 2005 and lower productivity of its branch based sales force. Market share and growth rates based on APRA data are included in Table 4 and Table 5 respectively in the Appendix to this report.

- House price appreciation has slowed** – House prices nationally have increased 2.5% over the 12 months to June 2005 (refer Figure 2). However, a slow down in national house price appreciation is underway, with the median price increasing only 1.8% (annualised) in the June 2005 quarter after falling in the March quarter. Furthermore, house prices are actually falling in some areas, most notably in Sydney, where median house prices have fallen 3.9% in the 12 months to June 2005 and by an annualised 12.5% in the June 2005 quarter. House price appreciation has been a key driver of strong home loan growth in recent years.

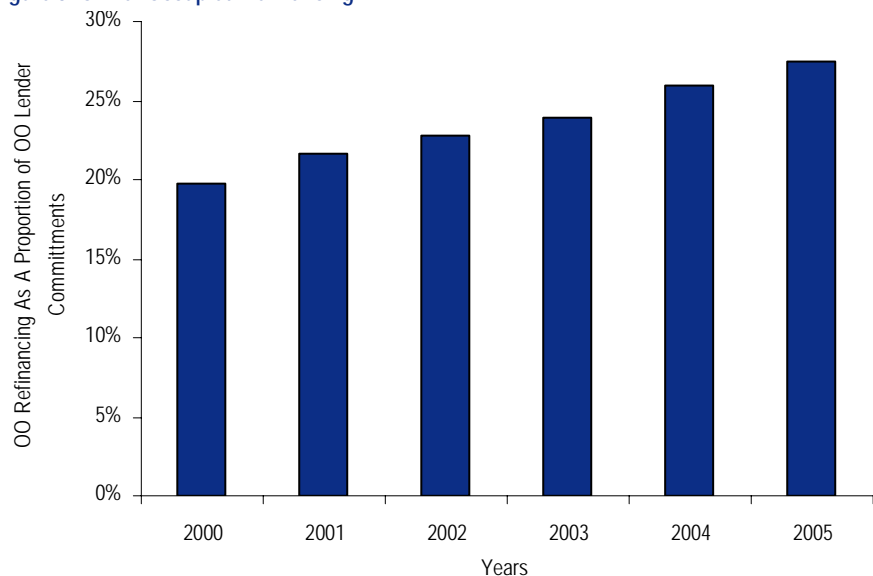
Figure 2: Median Australian House Prices



Source: Real Estate Institute of Australia

- Owner occupied financing is making up a larger share of total loans** – In the 12 months to June 2005, there has been rebalancing away from investment related lending (-4.0%) towards refinancing (+2.6%) and the churn of established dwellings (+1.8%). Refinancing as a proportion of owner occupier commitments continues to increase (Figure 3).

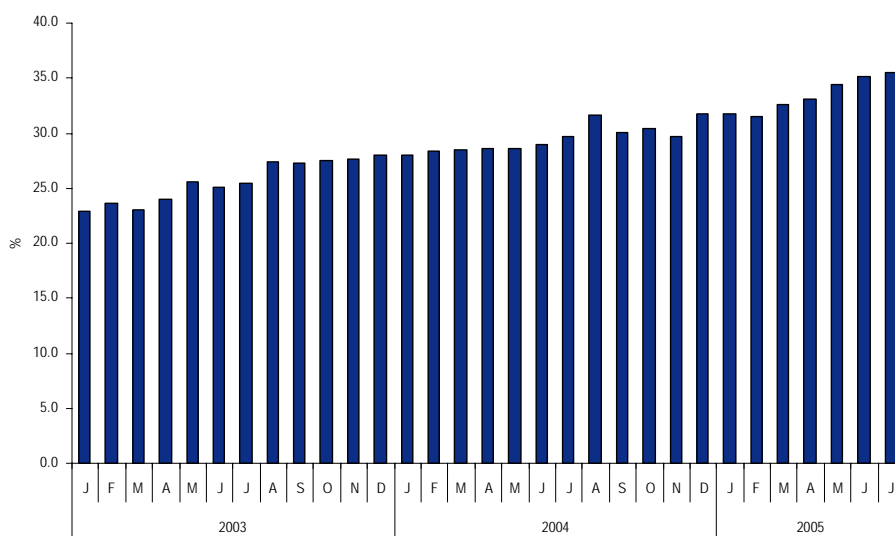
Figure 3: Owner Occupied Refinancing



Source: Fujitsu Consulting estimates

- **Mortgage market participants have reacted to slowing volume growth by offering lower rates and “attractor” packages** – Examples of the former include Wizard’s aggressive standard variable rates and WBC’s recent fixed rate offers. At the same time, examples of the latter include NAB’s “Triple Saver” package deal.
- **Generally, sales through the branch network are underperforming relative to sales through other channels** – As illustrated in Table 1, each of the major banks has lost market share in their branch networks, with the notable exception of an increasingly aggressive NAB. This market share loss continues to occur despite significant reinvestment in branch networks, particularly by CBA and ANZ, after long periods of branch closures and disinvestment.
- **The proportion of broker originated home loans continues to rise** – The proportion of broker originated home loans has risen to around 35% despite recent efforts by some banks to reinvigorate internal channels (such as ANZ and WBC) and to reduce commissions paid to brokers (such as ANZ and CBA).

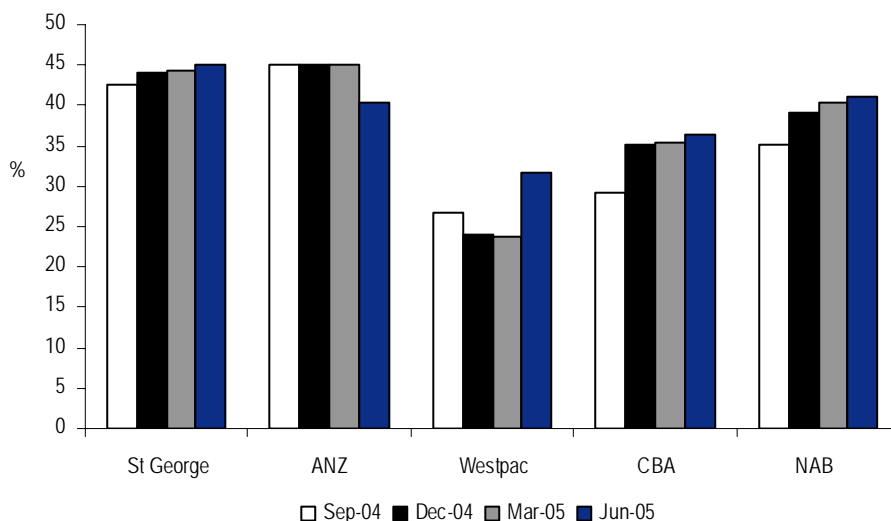
Figure 4: Broker Originated Loans as a Proportion of Total Housing Loans Outstanding



Source: Fujitsu Consulting estimates

- **Major banks’ reliance on brokers is increasing** – In the September 2005 quarter, each of the major banks with the exception of ANZ increased its reliance on third party broker originated mortgages (refer Figure 5). ANZ’s origination of new flows via brokers has dropped from 45% to 40%. While management has attributed this to increased origination through proprietary channels like its Mortgage Solutions or franchise channel, we also note that its trail commissions have been reduced. At WBC, a trend of reduced reliance on brokers has been arrested as a result of adjustments made to its approach to brokers following 1H05 market share losses and the downwards repricing of broker commission rates by ANZ and CBA in March and April respectively. Nevertheless, WBC’s reliance on brokers for new home loan originations remains below its peers.

Figure 5: New Broker Originated Housing Loans By Lender



Source: Fujitsu Consulting estimates

- **Brokers are capturing a larger share of refinancing than other channels** – The Reserve Bank of Australia (RBA) recently highlighted in its September 2004 Financial Stability Report that the current commission structures exacerbate this trend because of the importance of upfront commissions.
- **Back book repricing is continuing** – We continue to observe loans of several years duration being replaced by new loans of shorter duration at lower margins. As illustrated in Figure 6, we estimate that the spread on a new discounted home loan originated via a broker is 0.65%, 0.36% lower than a new discounted home loan originated via the branch network, which in turn is 0.70% lower than the spread on loans historically written without a discount via the branch network. We estimate that the peak of the back book repricing effect will be experienced within the next 18 months, assuming interest rates do not rise significantly.
- **Banks are reinvesting in their branch networks in order to reclaim lost distribution** – The massive reduction in branch numbers and labour shedding undertaken by the banks in the late 1990s has resulted in banks increasingly outsourcing incremental home loan origination to third party mortgage brokers. While the high housing spreads allowed banks to maintain profitability, spreads are falling in response to competition, with the impact being absorbed by lenders rather than brokers. The continued tacit support of mortgage brokers by banks is weakening the distribution strength, and ultimately the pricing power, of the banks. In response to this, banks are reinvesting in their branch networks in order to reclaim lost distribution.

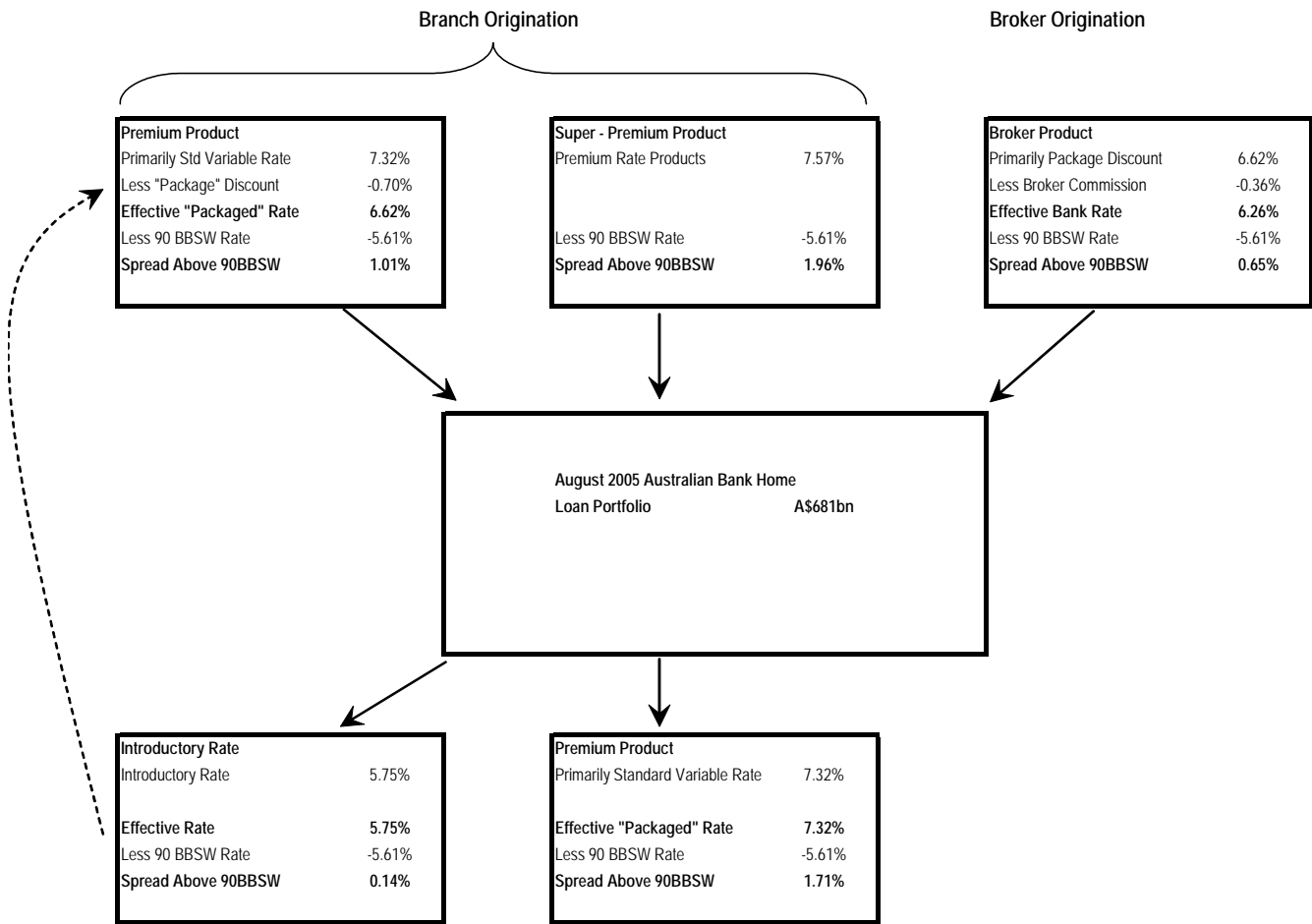
Table 1: Australian Bank Housing Loan Market Share – Branch Originated vs Broker Originated

	ANZ			CBA			
	1H04	2H04	1H05	1H04	2H04	1H05	2H05
Outstanding Loans							
On Balance Sheet	67.745	71.499	76.417	97.7	104.8	115.3	119.1
Securitised Home Loans	1.066	2.272	1.921	5.3	7.6	6.4	10.8
Gross Home Loans	68.8	73.8	78.3	103.0	112.4	121.7	129.9
<i>Balance Of Which Originated by</i>							
Branches	59%	58%	57%	87%	84%	81%	79%
Mortgage Brokers / Wholesale	41%	42%	43%	13%	16%	19%	21%
Total	100%	100%	100%	100%	100%	100%	100%
System Home Loans (Incl Sec'n)	562.135	600.865	634.367	539.774	584.298	619.180	651.941
Gross Home Loan Marketshare	12.24%	12.28%	12.35%	19.08%	19.24%	19.66%	19.93%
<i>Balance Of Which Originated by</i>							
Branches	7.22%	7.12%	7.04%	16.60%	16.16%	15.92%	15.74%
Mortgage Brokers	5.02%	5.16%	5.31%	2.48%	3.08%	3.73%	4.18%

	NAB			WBC		
	1H04	2H04	1H05	1H04	2H04	1H05
Outstanding Loans						
On Balance Sheet	89.3	94.0	100.5	85.197	89.449	90.695
Securitised Home Loans	0.5	2.8	2.3	2.65	2.3	3.8
Gross Home Loans	89.8	96.8	102.8	87.8	91.7	94.5
<i>Balance Of Which Originated by</i>						
Branches	85%	85%	85%	77%	75%	74%
Mortgage Brokers	15%	15%	15%	23%	25%	26%
Total	100%	100%	100%	100%	100%	100%
System Home Loans (Incl Sec'n)	562.135	600.865	634.367	562.135	600.865	634.367
Gross Home Loan Marketshare	15.97%	16.12%	16.20%	15.63%	15.27%	14.90%
<i>Balance Of Which Originated by</i>						
Branches	13.57%	13.70%	13.77%	12.03%	11.45%	11.02%
Mortgage Brokers	2.40%	2.42%	2.43%	3.59%	3.82%	3.87%

Source: Company, JPMorgan estimates

Figure 6: Australian Housing Loan Portfolio Back Book Repricing



Source: Company, JPMorgan estimates

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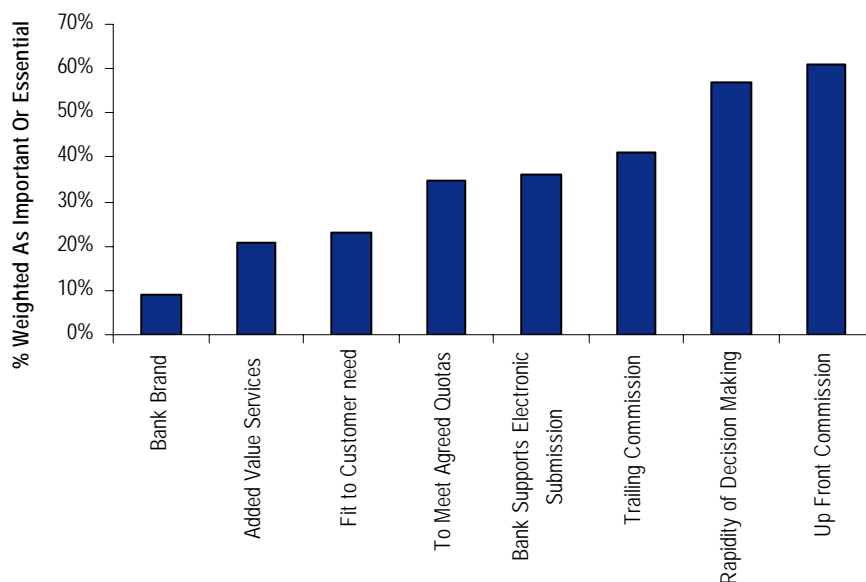
Mortgage Broking Update

Mortgage Broking Update

In Volume 1 of the Australian Mortgage Industry Report (refer February 25, 2005), we noted that the mortgage broking industry has grown rapidly in the last ten years as a result of a perceived need for third party advice relating to a significant increase in the number and complexity of home loan products. We concluded that different brokers deliver very different profit outcomes for lenders and that each of the major lenders have developed different strategies relating to mortgage broking. With these conclusions in mind, we have examined the decision making behaviour of brokers and customers.

We have conducted structured interviews with a sample of 290 different mortgage brokers from various sections of the industry to identify the key criteria used to select a particular lender. The weighted importance of the various decision criteria are illustrated in Figure 7. This highlights that the most important criteria identified by brokers included commission structures (with “upfront commission” viewed as more important than “trailing commission”) and “rapidity of decision making”. On the other hand, “fit to customer need” did not rank high in terms of importance. In our view, this does not necessarily indicate that mortgage brokers do not take account of customer needs, but instead reflects the fact that brokers assume mortgage products meet customer needs given that there is very little product differentiation across the market. Further, “bank brand” and the ability to provide “value added services” are not viewed as important.

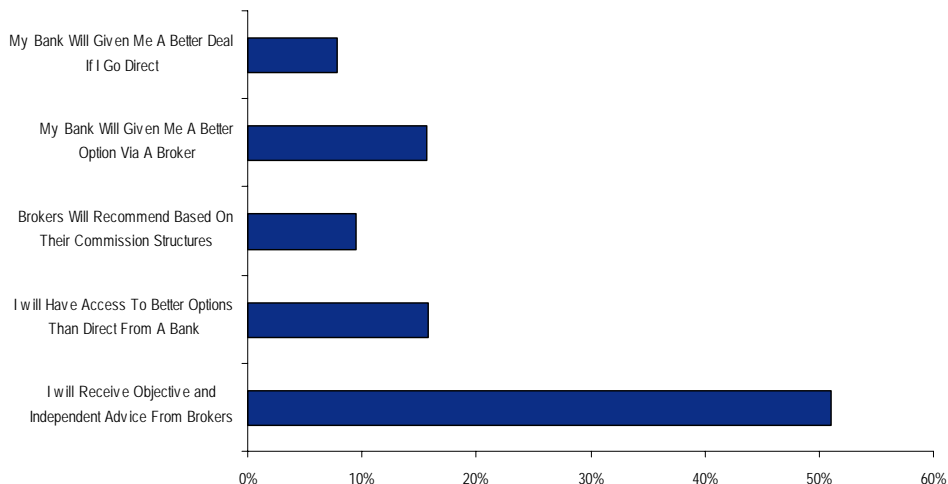
Figure 7: Broker Decision Criteria – Weighted Importance



Source: Fujitsu Consulting estimates

We also surveyed 540 customers to determine their perception of mortgage brokers. As illustrated in Figure 8 below, brokers appear to be gaining the mindshare of the customers at the expense of the banks. Over half of all mortgage customers surveyed believe that they will receive “objective and independent advice” from brokers while less than 10% believed that they will be “given a better deal” if they deal directly with the bank. At the same time, less than 10% of customers were aware that the commission structure might influence a broker’s recommendation.

Figure 8: Customer Perceptions of Mortgage Brokers



Source: Fujitsu Consulting estimates

In light of the above responses from brokers and customers, we note the following in relation to the mortgage market at the current time :

- **Commission structures likely have a disproportionate impact on the growth achieved by major lenders via the broker channel** – Responses from brokers highlight the importance of both upfront and trailing commissions in determining where broker business is directed. As such, commission structures likely have a disproportionate impact on the growth achieved by major lenders via the broker channel. To support this view, we highlight that until recently both ANZ and CBA paid higher trailing commissions than the other major banks. ANZ announced in December 2004 that it would be reducing trailing commissions by 5bp effective March 1, 2005, while CBA announced a similar reduction to be implemented progressively from April 2005. We highlight that based on APRA data, ANZ achieved annualised growth in housing loans of 13.2% in the 6 months to February 2005, above the system growth rate of 13.0%. However, in the 6 months to August 2005, its annualised growth rate fell to 10.6%, which was well below the system growth rate of 13.2%. Similarly, CBA achieved annualised growth of 14.8% in the 6 months to March 2005, significantly above the system growth rates of 13.2%. However, in the 6 months to August 2005, its annualised growth rate fell to 11.6%, which was below system. The experience of ANZ and CBA suggests that their growth rates were impacted by changes in the commissions paid to brokers.
- **The assumption by brokers that all lenders provide products which fit the customers' needs reinforces our view that mortgages are commodity products** – Bank executives have for a long time identified their mortgage product set as an area of competitive advantage. However, the speed with which product innovation can be replicated ensures that no such advantage is sustainable. As a result, mortgages are essentially commodity products, a view which is reinforced by the lack of importance placed by brokers on product features as a source of differentiation.

- **Major banks can no longer rely on brand to sell mortgages** – While major bank brand awareness is high, it no longer provides a competitive advantage in selling home loans.
- **The growth of brokers has provided an opportunity for new entrants that have not previously existed in the mortgage market** – The Australian financial sector was deregulated in 1985 and banking licences were issued to 16 foreign banks. These new entrants initially focused on the corporate market and made little impact on the housing market share of the major banks. This reflected the fact that home loans were typically sold via branches and it meant new entrants (including regional banks, foreign banks and other financial institutions) faced a significant disadvantage. However, the closure of large numbers of branches, the emergence of mortgage brokers and the increasing complexity of home loan products has ensured that an extensive branch network is no longer a prerequisite for a lender to distribute mortgages. The best example of this is ADB, which has almost doubled its national market share of approvals from 2.1% to 3.9% in the 2 years to FY05. It distributes over 80% of its housing loans via third party mortgage managers and brokers. Furthermore, we expect that foreign players will continue to target the Australian mortgage market due to the high rates of return relative to overseas markets and the ease of distribution through third parties, which precludes the need to establish an extensive branch network. For instance, GE increased its exposure to the Australian market by acquiring Australian Financial Investments Group (AFIG) in 2004 and HBoS owned BankWest is increasing its focus on the east coast mortgage market.

We also make the following comments in relation to likely developments in the mortgage market :

- **The relative perceptions of broker and bank advice in the eyes of the consumer highlight that brokers are likely to win further market share** – Brokers appear to be gaining the mindshare of the customers at the expense of the banks. We estimate that brokers now account for around 35% of total home loans outstanding, up from around 30% just 12 months ago (refer Figure 4). This compares with around 60% in the USA and 65% in the UK. Given the increasing complexity of mortgage products, the need for advice will remain. Perceptions of the relative quality of that advice indicate that brokers are likely to win further market share.
- **The disconnect between the perceptions of consumers and the action of brokers in relation to commission structures highlights a significant problem for lenders in Australia** – Only a small proportion of customers believe that broker commission structures influence a broker's recommendation despite the fact commission structures are the single most important factor that brokers consider when deciding which loans to recommend. We believe that while consumers believe that they get better advice from brokers and are not worried about the level of commissions paid to brokers, there will be little pressure on mortgage brokers to accept lower commissions despite the fact that mortgage brokers in Australia receive a higher commission than brokers in other parts of the world largely (refer Table 2). This poses a significant problem for lenders in Australia because they will continue to give up the distribution margin which is likely to become an increasing proportion of the total margin on a home loan as the combination of slowing housing loan growth and increased competition puts downward pressure on total mortgage margins.

- **If banks allow recent developments to continue, they will lose their home loan distribution margin and only retain their manufacturing margin, which will ultimately see them losing their pricing power** – As detailed in Figure 6, we estimate that mortgage brokers are presently taking up to 35% of the economic value created on a housing loan. They account for an estimated 35% of the A\$681bn total system home loan book at August 2005. Based on the estimated 36bp pa broker commission charge, this equates to A\$858m in broker commissions, or 4.1% of the forecast pre tax profitability of the five Australian major banks. More importantly, if the banks allow recent developments to continue and brokers increase their market share to the 60% share they have in the US, notional FY05E broker commissions would amount to A\$1,471m, which equates to 7.1% of the forecast pre tax profitability of the five Australian major banks. The continued tacit support of the mortgage broking channel will effectively result in the major banks losing their home loan distribution margin and only retaining their manufacturing margin. This loss of pricing power will make banks more vulnerable to margin pressure as competition intensifies. This represents a significant threat to shareholder value creation.
- **Growing mortgage broker penetration increases the chance that one of the major banks could move to abandon the broker channel and preserve market share by handing back the commission directly to customers via lower home loan rates** – To date, all of the Australian banks have commented that they will not engage in irrational pricing of housing loan products. However, based on the factors noted above, we highlight that growing mortgage broker penetration is potentially significantly shareholder value destructive over the long term as banks give away an increasing proportion of the home loan distribution margin. A review of commission structures, profitability and home loan pricing could result in one of the major banks moving to abandon the broker channel and hand back some of the commission directly to customers by way of lower home loan rates to preserve market share. Depending on the relative proportion of historic “back book” loans originated through proprietary channels, the short term profit consequences would likely be negative but may be justified in light of the alternative loss of pricing power and margin over the long term.
- **Increased regulation of the mortgage broking industry could be a catalyst to drive down commissions paid to brokers and could provide an opportunity for banks to recapture distribution margin and pricing power** – The mortgage broking industry remains outside the jurisdiction of the Australian Prudential Regulation Authority (APRA). However, regulatory oversight is likely to increase. In December 2004, the NSW Office of Fair Trading published a regulatory impact statement discussion document entitled “National Finance Broking Regulation” which sets out possible regulatory approaches and proposals for a national regime relating to finance and mortgage broking. At the current time, some market participants are advocating regulatory oversight while others propose self regulation. While the outcomes are still uncertain, we believe that the establishment of market entry criteria and the disclosure of commissions are likely to be cornerstones of any regulation. The disclosure of commissions could provide a catalyst to drive down commissions paid to brokers. More importantly, it could provide an opportunity for banks to recapture the mindshare of the customer if their relative perceptions of brokers and banks change as a result of the disclosure of commissions. Such an outcome could see banks winning back some of the distribution margin and retaining some pricing power.

Table 2: International Mortgage Broking Commission Comparison

Country	Commission Structure	Degree Of Regulation	Trailing Commissions	Broker Share of New Loans
US	Brokers on sell loans from wholesale lenders, and add a mark-up that typically ranges from 0.5 to 1.5 points. 1% to 1.5% of a mortgage value is the typical total fee	Medium and increasing State level regulation in place. Accreditation provided by a number of professional bodies	Not paid	60%
UK	Mortgage brokers claim commission rates as high as 1.5pc on settlement They may also charge up to 1% of the borrowed amount for advice.	Medium and increasing. Brokers regulated by the Financial Services Authority (FSA) from October 31 2004	Not paid	65%
Canada	0.5 percent to 1.25 percent of the mortgage amount, depending on the length of the term Some charge advice fee initially	Medium and increasing State level regulation and licensing in place	Not paid	40%
Australia	Brokers typically charge 0.6% upfront and trailing commissions are around 0.25%. Many lenders have deferred establishment fees, but these are charged to borrowers, not brokers	Low but increasing	Are paid, typically 0.25% for either the duration of the loan, or a set number of years	45%

Source: Fujitsu Consulting estimates

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Low Doc Loan Market

Low Doc Loan Market

As the Australian housing loan market has grown and the mortgage industry has become more competitive in recent years, home loan products have continued to evolve. One such product is the low documentation, or “low doc” loan. Low doc loans are essentially home loan products sold to customers, who are either unable or unwilling to provide the documentation generally required by lenders to access standard mortgage products. The level of documentation required, over and above proof of identity, is determined by individual lenders within their credit policy and risk management frameworks.

It is important to note that low doc loans are not the same as “non conforming” or “sub prime” loans. Non conforming or sub prime loans are those made to customers with adverse credit, risk or other factors. Not all low doc loans are non conforming. In fact, notwithstanding the lower level of documentation required, low doc loan customers may comply with all the other criteria required for standard loans. Such low doc loans can therefore be regarded as prime loans. However, in other cases, low doc loans can be used to target customers who have some specific impairment which prevents them from accessing a standard loan. Examples include an impaired credit history, poor job security or another attribute which makes the lending proposition more risky. In these cases, the low doc loan is classed as non conforming or sub prime. There are also many other types of non conforming loans in addition to sub prime low doc loans. Examples include large or “jumbo” loans and high LVR (>100%) loans. The distinction is illustrated in Figure 9.

Figure 9: Loans By Risk Profile and Documentation Type

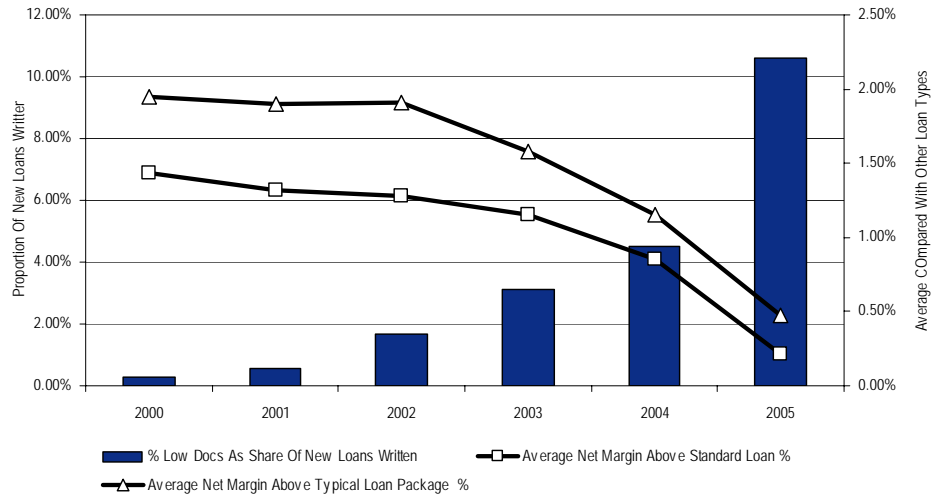
Risk Profile	Prime	Standard Loans	Prime Low Doc
	Sub Prime OR Non Conforming	Sub Prime Loans	Sub Prime Low Doc
		Standard Documentation	Low Documentation
		Documentation Type	

Source: Fujitsu Consulting

We highlight the following issues in relation to the low doc loan market :

- **Regional banks have to date been more aggressive in the low doc loan market than the major banks** – At the most recent reporting date, low doc loans comprise less than 1% of the housing portfolios of ANZ, CBA, NAB and WBC. However, the regional banks have been more aggressive. As at 1H05, “low doc” loans accounted for 4.3% of SGB’s home loan portfolio, with no deposit and seniors’ access or reverse mortgages accounting for another 2.5%. However, SGB’s Head of Retail Banking, David Gall, stated that SGB would allow its portfolio of “low doc” loans to double in size to around 8%, in line with the proportion of new loans that are low doc. Separately, ADB was one of the first banks to embrace the low doc loan market and continues to be the most exposed to this product. Low doc loans accounted for 32% of total housing loans under management at FY05, up from only 7% in FY02.
- **Other financial institutions have focused on the non-conforming market, including low doc loans** – Unlisted financial institutions have been more inclined than the major lenders to focus on the non conforming market. Notable players include Liberty Financial, Bluestone, Pepper Home Loans, HLP Mortgage, GE Money and Interstar. An interview with Sherman Ma, Managing Director of Liberty Financial, is included in a separate section of this report.
- **The low doc loan market continues to grow** – As detailed in Figure 10, the proportion of home loans which are classified as low doc has increased to an all time high of 10.4% of new loan approvals in the June 2005 quarter, up from less than 1% in June 2000.
- **Over 45% of low doc loans are originated by third party brokers** – The growth in the low doc loan market partly reflects the increasing efforts of lenders to satisfy the needs of customers. However, it also corresponds with the growth in the broker market. Over 45% of low doc loans are originated by third party brokers. We believe that brokers have provided an avenue for customers, who are unwilling or unable to verify their income, to access home loans that would previously not have been available to them if they had gone direct to the bank.
- **Spreads on low doc loans are falling due to increased competition** – Historically, lenders have charged a premium for all low doc loans. However, premiums charged on “prime” low doc loans have been falling recently. As detailed in Figure 10, the premium above the standard variable rate was close to 2.00% in 2000 but has now fallen to around 50bp. Similarly, the premium above a typical discounted loan package has fallen from almost 1.50% to around 25bp. This is a result of more aggressive pricing from lenders which were late to enter the market. For example, in March 2005 NAB launched new low doc home and business loan options for the self-employed, with a maximum LVR of 60% and no premium rate above the standard variable rate. At the time, NAB stated : *“The self-employed can now choose from a range of home loan and business loan products, once they have met the lending criteria, and not be penalised with higher interest rates or fees.”* NAB’s pricing initiative matches similar product offerings by other banks and virtually ensures that prevailing premium rates on some lenders’ low doc products will disappear. As a result of falling spreads, we expect that low doc loan portfolios will be subject to “back book repricing”.

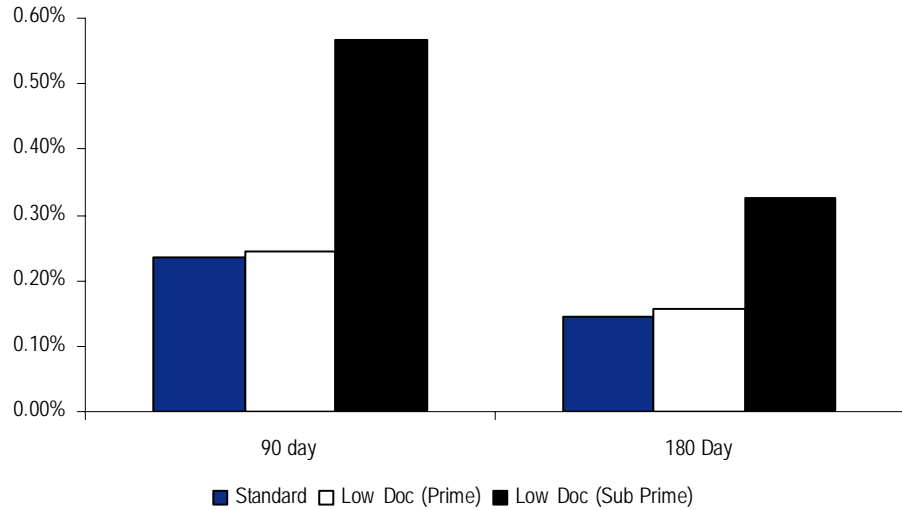
Figure 10: Australian Low Doc Loans



Source: Fujitsu Consulting estimates

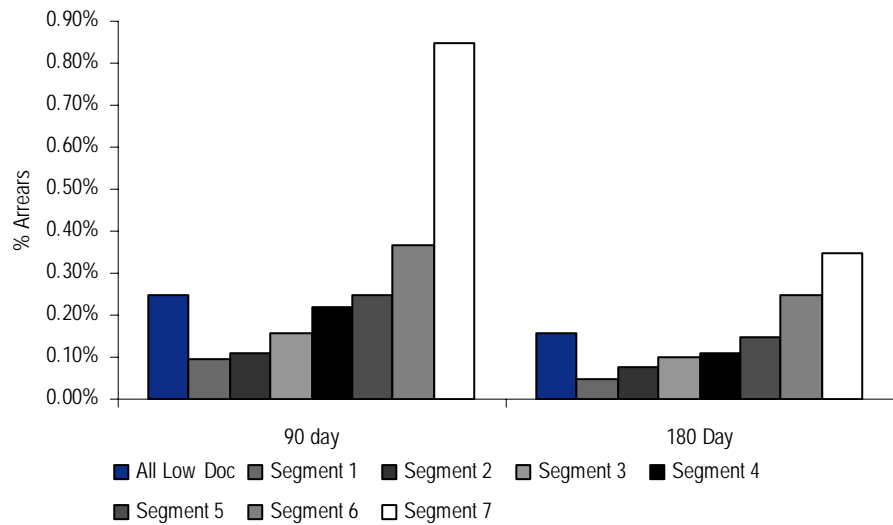
- The removal of premium prices raises the question as to whether banks are adequately pricing for risk** – In our view, a lender’s inability to independently verify the income of a potential borrower increases the risk of a loan and the lender should increase the price of such a loan accordingly. The removal of premium prices on low doc loans raises the question as to whether banks are adequately pricing for this higher level of risk.
- Arrears levels are marginally higher for prime low doc loans than for standard loans and much higher for sub-prime low doc loans** – A number of low doc loan providers have stated that the loss experience on low doc loans is not materially different from standard loans. For example, ADB stated in FY04 that its historical arrears analysis shows no difference in arrears for low doc loans versus standard loans. However, we have used the Fujitsu Mortgage Market and Yield Improvement Model to examine the relative risk profiles of standard, prime low doc and sub-prime low doc loans. We note that the risk profile for prime low doc loans is close to that of standard loans at the portfolio level, but that there are wide variations within specific sub-segments. Furthermore, we note that sub-prime low doc loans have a significantly higher risk profile. In fact, they are over twice as likely to fall into arrears. The different arrears profiles are illustrated in Figure 11 and Figure 12. However, we highlight that the prevailing favourable economic environment with low unemployment, low interest rates and appreciating house prices likely masks any differential in the asset quality performance of low doc loans which may become more apparent in an adverse economic environment.

Figure 11: Arrears Profiles - Standard vs Low Doc Loans



Source: Fujitsu Consulting estimates

Figure 12: Low Doc Loan Arrears by Segment

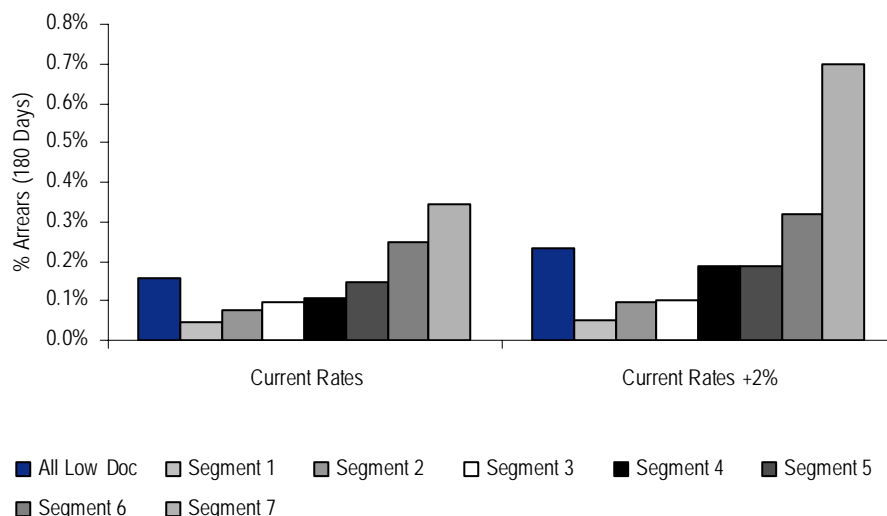


Source: Fujitsu Consulting estimates

- Interest rate increases could have a significant impact on portfolio profitability** – We have assessed the impact of an increase in interest rates on a typical set of low doc loan portfolios using the Fujitsu Mortgage Market and Yield Improvement Modelling. As illustrated in Figure 13, arrears in excess of 180 days at the portfolio level would increase by around 50% if interest rates rose by 2%. However, the impact varies considerably within different segments. Figure 14 shows the results of our scenario analysis. As rates rise, the risk obviously increases, with arrears rates accelerating rapidly as rate rises exceed 2%. Our analysis implies that lenders wishing to access the low doc loan market should have sophisticated sub-segment models in order to assess portfolio risk. A sample of segments within the low doc market is included in Table 3.

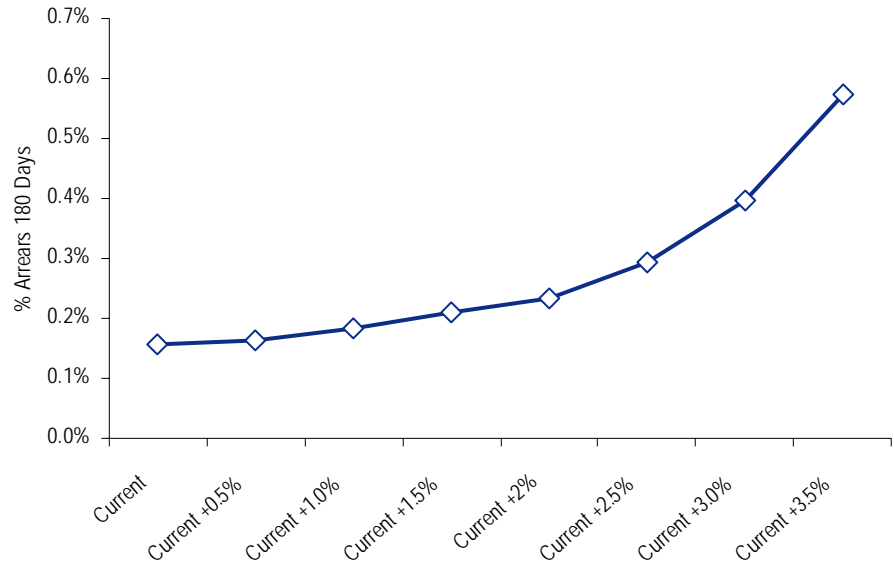
- The RBA and APRA have highlighted the higher risk of non standard home loans** – While loss experience to date on low doc loans has been low, we note that the Reserve Bank of Australia (RBA) has stated that non-conforming home loans are inherently riskier than conforming loans and that the Australian Prudential Regulation Authority (APRA) has proposed higher risk weightings for non-standard loans than for standard loans so that “*regulatory capital is more closely aligned with the relative riskiness of particular housing loans*” (refer April 2005 Discussion Paper : *Implementation of the Basel II Capital Framework : Standardised Approach to Credit Risk*).
- APRA has found that there have been changes to valuation methodologies in recent years that could potentially increase the risk profile of lenders and mortgage insurers** – In May 2005, APRA published the results from a survey of residential practices by authorised deposit taking institutions (ADIs) and lenders mortgage insurers (LMIs). The survey found that residential valuation practices have undergone a significant change in recent years. Whereas previously a full external valuation, including an internal inspection of the property, was the most common valuation technique, this is now not the case. APRA believes that alternative valuation methodologies can pose additional risks and is concerned that these new methodologies have not been tested during a period of property price declines. We believe that APRA’s survey result raise particular concerns in relation to low doc loans, which place more reliance on property values than traditional standard loans.
- Low doc loans are a “good times” product**– While losses on low doc loans have been low to date, we highlight that this loss experience coincides with the prevailing favourable economic environment with low unemployment, low interest rates and appreciating house prices. As a result, we do not believe that the credit quality of low doc loan portfolios has been tested. Loss experience over the last five years can not be used as a reliable indicator of loss experience over the next five years if the housing market and broader economic conditions are less favourable. Low doc loans are a “good times” product.

Figure 13: Impact of Interest Rate Increase on Low Doc Loan Portfolios



Source: Fujitsu Consulting estimates

Figure 14: Impact of Interest Rate Increases on Low Doc Loan Portfolios – Scenario Analysis



Source: Fujitsu Consulting estimates

Table 3: Low Doc Loan – Sample of Customer Segments

Sample Segment (subset of 30)	Profile	Typical profit Outcome (life value)	Average Duration	Risk Assessment (Compared with Portfolio)
Covert Professional	Prefers not to disclose income information, otherwise prime borrower	\$9,567	34 months	Lower
Sole Trader Artisan	Few financial resources, short trading record, sub-prime	(\$362)	8 months	Very high
Non Resident Investor	Asset Rich Visitor, sub-prime	\$4,683	28 months	High
Divorce Trauma	Post separation restart, often with stable employment, but low cash flows, sub prime	\$2,657	21 months	High
Entrepreneur	Investing in business opportunity, prime	\$5,893	26 months	Average
Risk Taking Entrepreneur	Investing in business, sub prime	(\$1,894)	6.5 months	Very high

Source: Fujitsu Consulting estimates

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11 October 2005

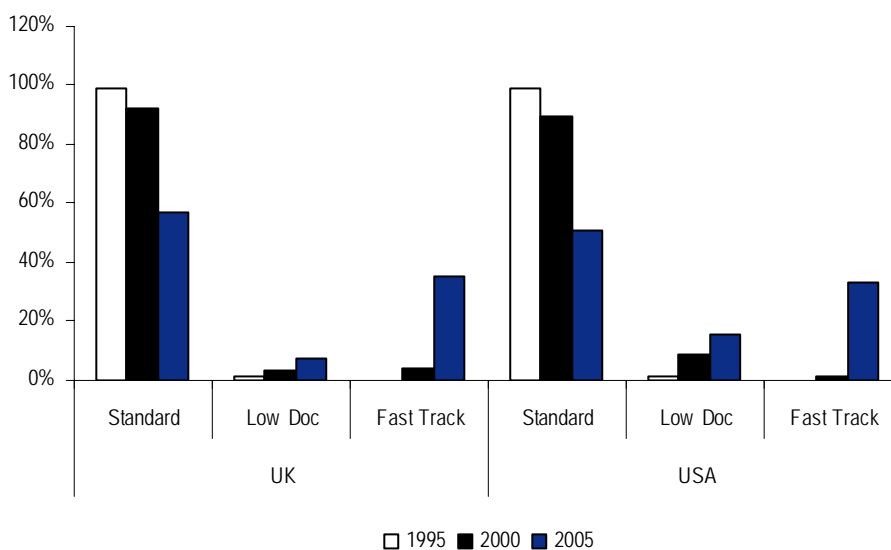
International Comparison

International Comparison

Low doc loans have been a feature of the US and UK home loan markets since the mid 1990s. In these markets, low doc loans are typically offered by specialist lenders and are characterised as loans where income proof is no more than a signed statement of income by a borrower. The low doc loan process can be applied to any loan type. In response to the emergence of low doc loans provided by specialist lenders, the main stream lenders introduced “fast track” lending. In contrast to low doc lending, fast track lending relies on credit scoring techniques rather than income proof, which is then only required for in specific cases, such as loans with an LVR under 75% but a high credit score.

As detailed in Figure 15, fast track processes now account for around 35% of new loans in the US and UK while low doc loans account for around 8% of new loans in the UK and 16% in the US. To date, there is no evidence of adverse credit outcomes stemming from fast track or low doc lending in the US or UK. However, we highlight that the macroeconomic environment in both countries has been favourable, particularly house price appreciation.

Figure 15: International Mix – New Loans



Source: Fujitsu Consulting estimates

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Half An Hour with Sherman Ma (Liberty Financial)

Half an Hour with Sherman Ma (Liberty Financial)

Sherman Ma is Managing Director of Liberty Financial.

Can you provide a description of Liberty Financial and its position in the Australian home loan market ?

Liberty Financial is a diversified specialty financial services company operating in Australia and New Zealand. Liberty pioneered the non-conforming mortgage market in 1997 and has since issued over A\$5bn of non-conforming asset-backed securities representing about 60% of this market sector. Our product range has now expanded to include residential mortgage finance, motor vehicle finance and commercial mortgage finance.

What are the main features of a low doc loan and what distinguishes them from other non conforming loans ?

A low doc loan is generally defined by loans with reduced income verification standards. Relaxation of income verification standards varies from lender to lender. For example, reduced income verification techniques can range from 'alternative verification' to 'self-certification'. Most lenders will mitigate the risk of low doc loans by limiting the loan-to-value ratio of a loan but more aggressive lenders do not. A low doc loan is one type of non-conforming loan which generally refers to any loan that does not comply with at least one criterion of mainstream lenders.

How big is the non conforming loan market in Australia and what level of growth do you expect for the various types of the loans over the next few years ?

Estimates vary quite substantially ranging anywhere from \$6bn to \$20bn per annum in comparison to the overall mortgage market that originates over \$100bn each year. Any of these estimates would be based on a number of assumptions such as the state of the interest rates, employment and housing markets. Such estimates do suggest that growth in the non-conforming loan market will outpace the broader mortgage market.

What evidence do you see of low doc loans being used for commercial purposes rather than residential purposes ?

Just as lenders adopt different income verification standards for low doc loans, lenders also have different views on the appropriateness of low doc loans. There is a risk that low doc loans will come under greater regulatory scrutiny. Therefore, some lenders may prefer that low doc loans are available only for bona fide investment purposes rather than residential purposes. Other low doc lenders may simply require an applicant to be self-employed and disregard the purpose of the loan.

What can be learned about low doc lending from experiences offshore, particularly in the US and the UK ?

While each market is unique, generalised observations can be gleaned from the US and UK experience. Some early attempts by mainstream lenders, such as banks, to offer specialised mortgage products produced unfavourable results. The scale-driven procedures of such institutions did not adapt well to the customised requirements of specialty lending. Today, the leading providers of specialty finance continue to be smaller and more skills-based organisations. At the same time, many major lenders have instead focused on leveraging their existing franchise by pursuing higher profit opportunities in wealth management and insurance, for example.

How does Liberty manage risk in the non conforming market ?

Liberty utilises a very granular, bottom-up approach to managing a spectrum of risk across all vital aspects of the lending process. This contrasts with the actuarial, top-down approach that is required to be successful in commoditised markets where volume and efficiency are paramount. For example, behavioural patterns are an intangible but essential factor in our assessment criteria. Further, a purpose-built account servicing, loss mitigation and asset realisation platform is also required to properly manage a heterogeneous customer base.

Does technology capability provide Liberty with a competitive advantage ?

For Liberty, technology is more than a source of competitive advantage – it is a prerequisite to properly understanding and managing risks. The very nature of specialty finance requires a customised approach. Initially, a variety of third party systems were considered but such systems were found to be unsuitable. Perhaps other companies could operate without proprietary technology but it is and will continue to be a necessary and vital investment for Liberty.

What are the major changes taking place in the low doc loan market and what role are the major banks playing ?

The pursuit of greater market share which has led to an aggressive soliciting of low doc loans has produced positive and negative outcomes. For example, consumer awareness and knowledge of alternative financial solutions have certainly increased. On the other hand, anecdotal evidence of valuers being pressured and the use of desktop valuations which help applications qualify for 'low doc' treatment have become more widespread.

What are your expectations for low doc loan lending spreads ?

Some lenders price low doc loans no differently than standard, fully verified loans. However, the favourable loss experience to substantiate this pricing policy has been generated during a relatively benign environment. Spreads may need to adjust if an economic downturn occurs as low doc customers would be particularly vulnerable in such a scenario. This situation could be further exacerbated if property valuations are found to be inflated.

What regulatory changes are likely and what impact could they have ?

Finance industry specific regulation has been relatively pragmatic. There has been some discussion of regulating the broker industry but details have yet to be formed. More broadly, several macro ‘regulatory’ changes that are on the horizon may also have an impact on the industry. For example, Basel II and even the introduction of IFRS may result in lenders structuring products differently.

Do you expect any major changes in the broader home loan market in the next few years ?

The home loan market will certainly continue to evolve. A range of innovative developments have surfaced such as shared-appreciation schemes. So long as our love affair with property persists and access to capital remains readily available, there will be plenty of attempts to introduce the ‘next big thing.’

What developments do you expect in the role of brokers in the home loan market ?

In a short space of time, brokers have become a significant force in the mortgage market. The industry is characterised by innovation and a diverse range of operating models and business strategies. For example, some are developing better technological solutions while some are looking to offer a wider range of products. We expect successful brokers will continue to find ways of delivering distinguished customer benefit to expand their role in the industry.

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11 October 2005

Appendix

Table 4: Housing Loans (including Securitisation) Market Share

	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Jul-05	Aug-05
ANZ	13.4%	13.3%	13.4%	13.3%	13.3%	13.2%	13.2%	13.2%
CBA	22.3%	22.4%	22.4%	22.5%	22.5%	22.5%	22.5%	22.4%
NAB	17.2%	17.0%	16.7%	16.7%	16.8%	16.9%	16.9%	16.9%
WBC	17.3%	17.0%	16.7%	16.3%	16.1%	15.9%	15.9%	15.8%
Major Banks	70.2%	69.7%	69.2%	68.7%	68.7%	68.5%	68.5%	68.3%
ADB	2.2%	2.3%	2.3%	2.4%	2.5%	2.5%	2.5%	2.5%
BOQ	1.1%	1.1%	1.1%	1.4%	1.4%	1.4%	1.4%	1.4%
BWA	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.6%
BEN	1.1%	1.2%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%
SGB	9.3%	9.3%	9.3%	9.2%	9.2%	9.2%	9.2%	9.2%
SUN	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.2%	3.3%
Regional Banks	19.5%	19.7%	19.7%	19.9%	20.0%	20.0%	19.9%	20.1%
Other	10.4%	10.5%	11.0%	11.3%	11.4%	11.5%	11.6%	11.6%

Source: APRA.

Table 5: Housing Loans Growth Rates (Annualised)

	Sep-04	Dec-04	Mar-05	May-05	Jun-05	Jul-05	Aug-05
ANZ	16.0%	14.9%	12.6%	11.8%	11.4%	10.7%	10.2%
CBA	16.5%	15.1%	14.8%	13.4%	13.3%	12.3%	11.6%
NAB	9.7%	10.8%	14.0%	15.9%	16.6%	16.2%	15.8%
WBC	8.4%	5.6%	5.6%	6.5%	8.1%	8.4%	8.9%
Major Banks	12.6%	11.6%	11.7%	11.9%	12.3%	11.9%	11.6%
ADB	27.9%	25.3%	27.5%	30.2%	28.0%	25.8%	24.4%
BOQ	19.1%	57.7%	59.9%	63.7%	14.6%	15.1%	15.0%
BWA	16.9%	11.3%	12.0%	10.9%	11.6%	14.5%	19.0%
BEN	19.4%	13.9%	8.9%	5.9%	7.0%	6.3%	6.7%
SGB	16.6%	12.8%	11.1%	12.4%	13.1%	12.7%	13.7%
SUN	18.1%	13.4%	14.1%	14.5%	13.8%	4.1%	11.9%
Regional Banks	19.7%	22.4%	22.2%	22.9%	14.7%	13.1%	15.1%
Total	15.6%	14.7%	13.7%	13.4%	13.4%	12.6%	13.2%

Source: APRA.

Table 6: Australian Housing Loan Product Pricing

	Variable Rate Loan	Introductory Rate Loan			Fixed Rate Loan		
		Rate	Term	Type	1yr	2yr	3yr
Adelaide Bank	7.32	5.25	6	Variable	6.75	6.75	6.69
ANZ Bank	7.32	6.00	12	Variable	6.85	6.79	6.65
Aussie Home Loans	6.67	n/a	n/a	n/a	6.93	6.93	6.99
Bank of Queensland	6.62	n/a	n/a	n/a	6.59	6.59	6.59
BankWest	7.32	6.32	12	Variable	6.75	6.75	6.75
Citibank	6.86	n/a	n/a	n/a	6.85	6.85	6.79
Commonwealth Bank	7.32	5.99	12	Variable	6.85	6.79	6.59
Homeloans Ltd	6.76	6.60	12	Variable	7.15	7.15	7.11
HomeSide Lending	7.02	6.09	12	Fixed	6.85	6.85	6.99
ING Bank	7.24	6.24	12	Variable	6.49	6.49	6.49
Macquarie Bank	7.15	n/a	n/a	n/a	7.05	7.05	6.85
Mortgage House	6.84	n/a	n/a	n/a	6.95	6.90	6.90
National Australia Bank	7.32	5.99	12	Variable	6.85	6.79	6.47
RAMS Home Loans	7.34	6.54	12	Variable	n/a	7.00	7.05
St. George Bank	7.32	6.14	12	Variable	6.85	6.79	6.59
Suncorp	7.32	6.19	12	Fixed	6.85	6.79	6.49
Westpac Banking Corporation	7.32	6.19	12	Fixed	6.85	6.79	6.49
Wizard Home Loans	6.79	n/a	n/a	n/a	n/a	6.74	6.69

Source: bankchoice.com

Table 7: Sample Australian Housing Loan Return on Equity

Official Cash Rate	5.50%			
90 BBSW	5.61%			
Standard Variable Rate	7.32%			
Professional Choice Rate	6.72%			
Home loan Approval Fee	A\$600			
Post Settlement - Servicing Cost	0.10%			
Settlement Cost	A\$300			
Cost of Credit Losses				
Tax Rate	30%			
Proprietary Channel				
Loan	A\$179,000			
Risk Weighting	50%			
Target ACE Ratio	4.75%			
Regulatory Capital Required	A\$4,251			
Debt Funding	A\$174,749			
Expected Life	3.7yrs			
Cash Flows	Year 1	Year 2	Year 3	Year 4
Cumulative Life	1.0	2.0	3.0	4.0
Life to Go	3.7	2.7	1.7	0.7
Yr Weighting Factor	1.0	1.0	1.0	0.7
Loan Approval Fee	A\$600			
Less Settlement Cost	-A\$300			
Interest Income	A\$12,029	A\$12,029	A\$12,029	A\$8,420
Interest Expense	-A\$9,795	-A\$9,795	-A\$9,795	-A\$6,856
Servicing Cost	-A\$179	-A\$179	-A\$179	-A\$125
Pretax	A\$2,355	A\$2,055	A\$2,055	A\$1,439
Tax	-A\$707	-A\$617	-A\$617	-A\$432
Total Cash Flows	A\$1,649	A\$1,439	A\$1,439	A\$1,007
Capital	A\$4,251	A\$4,251	A\$4,251	A\$2,976
Cash Flow ROE	39%	34%	34%	34%
Broker Channel (Current)				
Loan	A\$180,000			
Risk Weighting	50%			
Target ACE Ratio	4.75%			
Regulatory Capital Required	A\$4,275			
Debt Funding	A\$175,725			
Expected Life	3.7yrs			
Upfront Commission	0.65%			
Trailing Commission	0.20%			
Cash Flows	Year 1	Year 2	Year 3	Year 4
Cumulative Life	1.0	2.0	3.0	4.0
Life to Go	3.7	2.7	1.7	0.7
Yr Weighting Factor	1.0	1.0	1.0	0.7
Loan Approval Fee	A\$600			
Less Settlement Cost	-A\$300			
Upfront Commission	-A\$1,170			
Trailing Commission	-A\$360	-A\$360	-A\$360	-A\$252
Interest Income	A\$12,096	A\$12,096	A\$12,096	A\$8,467
Interest Expense	-A\$9,849	-A\$9,849	-A\$9,849	-A\$6,895
Servicing Cost	-A\$180	-A\$180	-A\$180	-A\$126
Pretax	A\$837	A\$1,707	A\$1,707	A\$1,195
Tax	-A\$251	-A\$512	-A\$512	-A\$358
Total Cash Flows	A\$586	A\$1,195	A\$1,195	A\$836
Capital	A\$4,275	A\$4,275	A\$4,275	A\$2,993
Cash Flow ROE	14%	28%	28%	28%

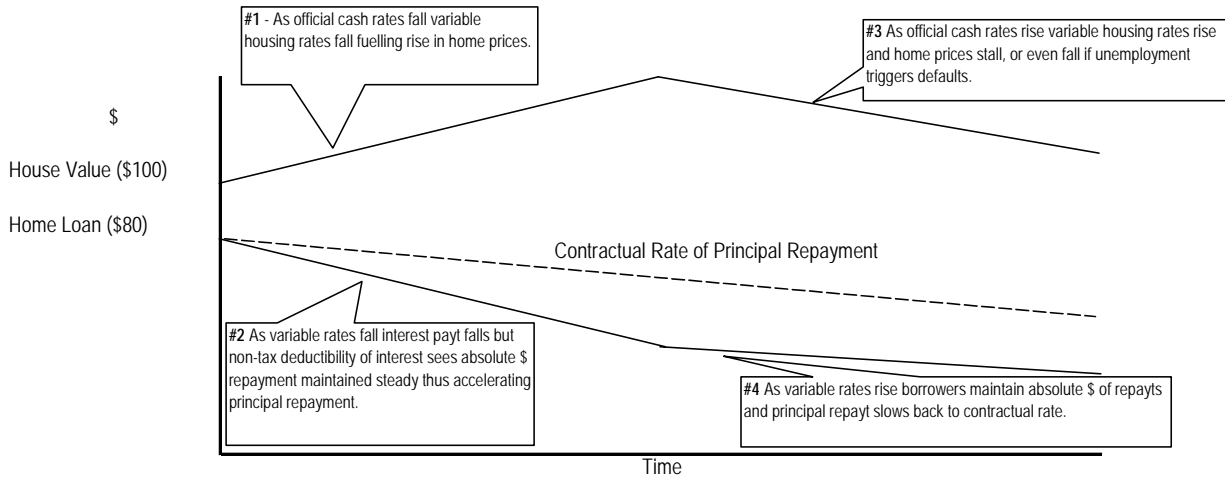
Source: JPMorgan estimates

Figure 16: Owner Occupied Home Loan Structure

Australian Home Loan

Characteristics

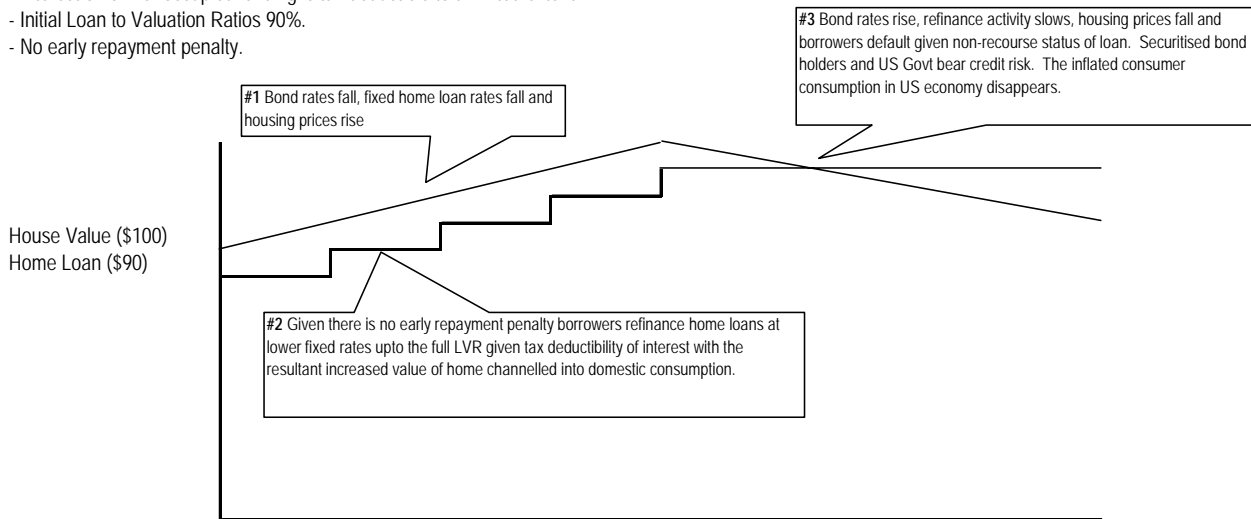
- 94% done at variable rates.
- 70% of outstanding loans are for owner occupied housing.
- All consumer credit is full recourse.
- Interest on owner occupied lending is not tax deductible.
- Home loans are typically principal and interest over 25 years.
- Initial Loan to Valuation Ratios < 80% or fully mortgage insured.



United States Home Loan

Characteristics

- Majority done at 30 year fixed rates.
- Most outstanding loans are for owner occupied housing.
- Housing lending is non-recourse.
- Interest on owner occupied lending is tax deductible to a limited extent.
- Initial Loan to Valuation Ratios 90%.
- No early repayment penalty.



Source: JPMorgan estimates

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