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Mortgages: Time to Re-Design

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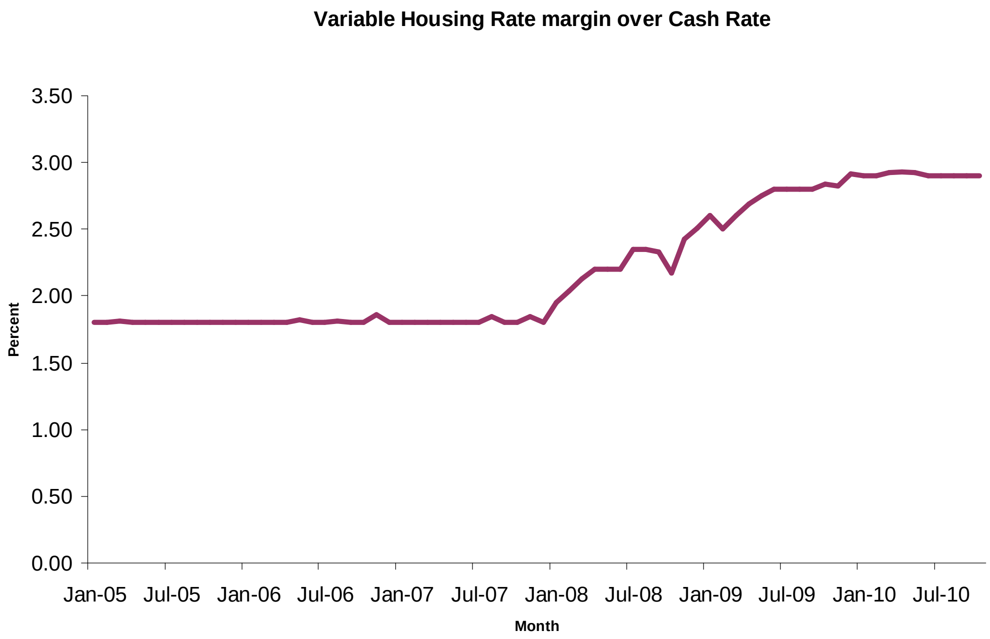
Australian housing mortgage contracts have a somewhat unique characteristic. Australian home-buyers sign a mortgage contract with banks which gives banks the right to change the loan interest rate whenever and to whatever they want.

This flexibility given to banks is of considerable value to them, but exposes borrowers to risks to which they arguably should not be exposed. If a bank faces an increase in its funding costs, this can be passed on to existing borrowers. That applies regardless of whether the increase in funding costs is something which affects all banks or only an individual bank – although competition may impose some constraints in that latter case.

At the current time, there is much debate about Australian banks increasing housing loan interest rates by more than Reserve Bank changes in the cash rate. Figure 1 illustrates how the margin was roughly constant at 180 basis points prior to the onset of the Global Financial Crisis and had increased to 290 basis points in October 2010.



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Underpinning this debate is the fact that there have been significant changes in bank funding costs, relative to the cash rate, such that these need to be reflected in loan interest rates if bank profitability is to be maintained. Regardless of whether bank profitability is too high or not, the question of whether both existing and new borrowers should bear the burden of such funding cost changes, or whether this should impinge upon bank profits is an important one.

Changing the form of mortgage contracts would defuse much of that current debate, and would work to allocate interest rate funding risk more appropriately between bank customers and shareholders (and management).

The standard variable rate mortgage loan in Australia has long had the characteristic that borrowers place themselves at the mercy of lenders with regard to future interest rates they will have to pay. Foreigners find this truly amazing, being more used to either fixed rate or adjustable (indicator linked) rate loans. If Australian borrowers are sufficiently naïve to give this power to banks, perhaps they cannot expect to be treated in any other way.

Historically, Australians acceded to such contracts because housing loan interest rates were controlled by governments, and because they had virtually no bargaining power when confronting an oligopoly of large banks. We should not go back to government interest rate controls, but governments could force banks to adopt different loan contracts which would be socially beneficial.

While there has been much innovation in Australian mortgage markets,[1]including some use of fixed rate and adjustable rate mortgages, these do not appear to have become predominant. Unfortunately, there are no publicly available official statistics which provide detailed information on the interest rate characteristics of Australian housing loans which would enable an assessment of developments in this regard.

The alternative to a "variable-at-the-bank's-discretion" floating rate loan would be a loan in which the interest rate is tied at some fixed margin (set at the outset of the loan) over a relevant indicator lending rate. In such a loan, the borrower is still exposed to movements in the general level of market interest rates, but not to other discretionary changes by the bank.

Australian banks have little incentive to introduce such loans. The current mortgage structure makes their risk management job much, easier. As well as movements in general market interest rates being passed onto the home borrower, for them to bear this risk, banks are also able to pass on the consequences and risks of any errors they make in their funding and interest rate risk management choices. A bank which is funding housing loans in a way which subsequently becomes relatively expensive, or bets the wrong way on interest rate movements, can simply increase the rate it charges to existing borrowers.

[1] See for example Guy Debelle "The State of the Mortgage Market" http://www.rba.gov.au/speeches/2010/sp-ag-300310.html

While such funding (or interest rate risk management) errors will affect the bank's ability to compete for new borrowers, existing borrowers have limited ability to avoid wearing the resulting costs. Paying out an existing loan to shift to another lender is a costly exercise, and less appealing when all that is on offer is more of the same from a limited number of major players. Also, the banks offer "special rates" to new borrowers involving discounts on the standard variable rate lasting for some number of years, which enables them to compete for new borrowers while not adversely affecting the return on existing loans.

If instead, adjustable rate mortgages (a fixed margin over an indicator rate such as the official cash rate) were adopted, the situation would be markedly different. New borrowers may face a different margin to existing borrowers because the current cost of bank funding relative to the indicator rate has changed. They could make conscious decisions about the merits of taking a loan which locks in that margin (or taking out a fixed rate loan) and banks can (if they wish) structure their funding to avoid taking on interest rate risk.

Existing borrowers would be protected from changes in interest rates other than in the indicator rate which reflects market trends. They would not be exposed to risks arising from poor funding choices or poor interest rate risk management by their bankers.

Of course, there are many details involved in structuring loans this way. It may be too risky for banks to fix the margin for very long periods (because the structure of interest rates may change), suggesting that contracts involving a fixed margin for some period (and ability to exit to another lender at the end of that period) might be appropriate. Whether the cash rate or a wholesale market rate such as the Bank Bill Swap Rate is an appropriate indicator rate is also another design issue.

But regardless of those complexities, it is clear that the current, historically inherited, internationally anomalous, mortgage design we have is creating problems. And while some of those problems affect the banks, they are unlikely to collectively give up arrangements which enable them to pass on risks to customers. Those risks should preferably fall on management and shareholders, and that could be readily achieved by government leadership to bring Australian mortgage loan contracts into line with the reality of twenty-first century financial markets.

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