Preventing a Mortgage Default Flood

"For sale by mortgagee" signs sprouting around the country is not something anyone wants to see happening. But there is a risk of that, and homeowners being evicted onto the streets, once the mortgage repayment deferrals afforded to borrowers by Australian banks cease to operate.

There is a limit to how long the deferrals can continue. The ongoing accumulation of interest works to push the amount owed upwards and eventually beyond the borrower's capacity to ultimately repay.

Innovative mortgage arrangements, involving a "debt for equity" swap could help resolve this problem for those borrowers with some equity in their house (where the loan to valuation ratio is not too high). For the remainder, the banks will need (and will no doubt try hard) to find alternative ways of avoiding the stigma of being heartless debt collectors.

How can "debt for equity swaps" help? Take, for example, a home-owner with a house valued at $600,000 and a mortgage loan outstanding of $300,000. Now long-term unemployed, as a result of the Covid crisis, they are unable to make the mortgage repayments.

They have an asset (the house) and a liability (the mortgage) with the difference ($300,000) being their equity in the house. One, undesirable, solution would be for the house to be sold, and the mortgage repaid. Yes they have $300,000 cash – but no place to live. Whether that cash (and any government benefits) will meet their lifetime rental and living expense needs is problematic. And let's not forget the emotional trauma and distress.

Instead, why not convert the debt owed to the bank into a bank equity share in the house? The borrower sacrifices some part of future capital gains on eventual sale of the house but no longer needs to make mortgage principal repayments.

What about the interest payments which would otherwise have been required? The homeowner is still enjoying the benefits of occupation of the house which is now part-owned by the bank. So some such payment may be appropriate. To see how much, consider the effect of the "debt for equity" swap on the bank.

In terms of the bank's balance sheet it has simply exchanged one asset (the loan) for another (its share of the property) of equal current value. Is the bank worse off in terms of income? There is obviously a timing difference between regular interest receipts and realization of capital gains on eventual house sale. But putting the timing difference to one side, the bank would be no worse off if its share of the expected capital gain on the property equals the mortgage interest repayments it has given up.

Unfortunately, looking ahead at likely property value appreciation, that seems unlikely – even though mortgage interest rates are very low, and likely to stay that way for some time. So it is likely that some adjustments would need to be made to offset the negative effect on the bank's income.

One possible adjustment could be for the borrower to continue to make some "interest" (essentially rental) payments to the bank – at a much lower interest rate reflecting the bank sharing in potential property appreciation. How much lower? It would depend on how much equity the bank has after the debt for equity swap.

Another possible adjustment, lowering any need for ongoing payments by the household, could be for the bank to get an equity interest greater than the debt given up. There are lots of possible variants. Clearly some regulatory oversight of arrangements being made would be warranted, and perhaps government financial support for home-owners warranted to facilitate such a scheme for those with low equity in their homes.

Such an arrangement of banks having an equity stake in properties of their customers is not a new concept. Shared Appreciation Mortgages (SAMs) are an example– although the proposal here differs considerably from those schemes.

Using a debt for equity swap mechanism to prevent a flood of foreclosures is not without its complications. APRA would need to tweak regulatory settings. ASIC would need to ensure the swap terms were fair. There are tax issues to attend to (treatment of the bank's capital gains on the property). Government financial support might be needed.

But finding a way to prevent a flood of mortgage defaults and the horrendous social consequences warrants considering innovative solutions.

Kevin Davis

Professor of Finance, The University of Melbourne

August 14, 2020