Mortgage Contract Redesign – Even More Reasons

The current situation where mortgage contracts allow banks complete discretion to subsequently change the loan interest rate whenever and to whatever the bank likes (subject to copping political bullying and community angst) has some damaging consequences.

First, it exposes new borrowers to future interest rate rises, over and above those they may anticipate, and which the banks may have anticipated were on the horizon when they granted the loan. Second, it reduces the ability of securitisers to compete in the new mortgage market when there are upward shocks to interest rates, such as occurred in the Global Financial Crisis (GFC).

Altering mortgage contracts to an adjustable rate form where the interest rate is tied for some defined period to an agreed margin above some market indicator rate, or where the rate is fixed for some defined period would have benefits in both these regards.

Those benefits would be enhanced if lenders were precluded from charging exit fees at the end of that defined period (say 3 to 5 years) and it were made possible for a mortgage to be simply transferred (on repayment of outstanding principal) to another lender without having to be discharged. To a non-lawyer such as me, that seems like a relatively simple process of striking out the name of the current lender and replacing it with that of the new lender – but legal niceties probably complicate matters there.

The problems outlined above arise because the discretion afforded to banks enables them to spread future increases in the cost of funding over both existing and new borrowers. For example, consider a situation where a bank suddenly faces a 100 basis point increase, over and above a market indicator rate such as the cash rate or bank bill swap rate, in the cost of new funds. This could arise because the bank's credit rating has been downgraded or might be a more general increase in credit risk premia demanded in financial markets.

The immediate effect on the bank's average cost of funds is very small, because much of its current funding will have been locked in with maturity dates sometime in the future. But as the existing funding matures and must be replaced, or if the bank wishes to expand its balance sheet, the higher cost of marginal funding will gradually increase the average cost. This, in effect, is what has happened over the GFC.

The gradual increase in average funding cost (relative to the market indicator rate) will be reflected in the rate charged on both existing and new loans under our current mortgage system. And with existing borrowers locked by exit costs, competition encourages a process whereby new borrowers are temporarily shielded from the full increase in bank marginal funding costs by the averaging effect

But that is only temporary. Lenders would in these circumstances be aware that over time the loan rate will have to increase relative to the cash rate as the higher marginal cost of funding on replacement funds flows through to a higher average cost of funding. Whether new borrowers during and since the GFC were (or should have been) informed by lenders that future increases in their loan interest rates above any change in the cash rate (or other market indicator rates) were likely because of such effects is a potentially explosive issue.

A second problem caused by the averaging effect concerns the competitiveness of the securitisation market. Issues of mortgage backed securities must offer current market interest rates and thus interest rates on the underlying loans must reflect that marginal cost of funding.

If credit spreads increase, as in the example above and as occurred in the GFC, the competitive position of securitisers is reduced because banks increase interest rates on new loans only gradually in line with the increase in the average cost of funds. Over time, as the average adjusts to the marginal the competitive disadvantage of securitisation disappears (as is happening currently in Australian mortgage markets). Securitisers, of course, benefit when spreads move in the other direction.

The ability of banks to average funding cost changes across both existing and new borrowers increases the vulnerability of the securitisation business model to events such as the GFC, and to volatility in credit spreads. Removing the lender's absolute discretion change the interest rate on existing mortgage contracts has benefits for customers and improves risk sharing, and also would be one way to assist the securitisation industry which should be done before considering more extreme proposals involving government support and guarantees.

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