

Improving Accessibility and Flexibility of Mortgage Lending for Australians

A Report for the Prime Minister's
Home Ownership Task Force

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Executive Summary

Australians' success at purchasing their own homes and quickly building home equity is widely acknowledged. With the national psyche so bound up with property ownership as its leading barometer of status and financial well-being, issues of home ownership are clearly central to consumers, the Nation's political landscape, its Government and its mortgage lenders.

This report comprises a pro bono contribution to the work of the Prime Minister's Home Ownership Task Force by Booz Allen Hamilton, a global leader in strategic management consulting with extensive experience assisting in improving performance for commercial and government enterprises.

This report is designed to dovetail with two other current documents prepared by the Task Force:

- A. *Policy Options for Housing for Low Income Households* – in which Gans and King consider the delivery of low-income housing assistance, with particular reference to the public market; and
- B. *Demand and Supply Side Approaches to Reducing the Costs of Home Ownership* – in which Caplin and Joye investigate innovations associated with relaxing the all-or-nothing constraint (demand-side), and regulatory restrictions that artificially inhibit the elasticity of supply

This report recognises that while Government and lenders have made great strides in the past decade, there remain significant opportunities to address the problems continuing to encumber the housing finance market. The report attempts to comprehensively identify and summarily evaluate those opportunities.

The issues and opportunities identified have been compiled through analysis of Australian and overseas mortgage industries, including those of the UK, US, Canada, France, Scandinavia, Singapore and South Africa; interviews with industry stakeholders; the application of Booz Allen Hamilton intellectual capital; and Task Force Survey responses.

The ideas contained within this report are designed to help address some of the major inhibitors to the accessibility of home ownership and home-wealth flexibility in Australia, including:

- Barriers that limit alignment of credit policies of local lenders with global best practices

- Barriers created by the average Australian's lack of understanding of the options available to them to reduce the costs of their mortgage or optimally diversify their wealth
- Barriers created by the requirement to pay Lender's Mortgage Insurance (LMI) in advance to cover the lender against loss on all purchases where the loan-to-value ratio is greater than 80 per cent
- Barriers created by the limited availability of 'reverse' or 'equity-release' mortgages, enabling those with equity in their properties to supplement retirement incomes

The report attempts to comprehensively identify issues facing prospective and current owners by home ownership life-stage, including those saving for a home; those building property equity; those diversifying their wealth away from the primary residence; those consolidating their wealth ahead of retirement; and those choosing to access or transfer property wealth during retirement.

The major emphasis; however, is concentrated on the first and last of these life-stage segments, and therefore the ideas generated in this study focus principally on issues of 'entry' and 'exit' - addressing opportunities concerning initial access to the housing market, while increasing flexibility for asset diversification in retirement for those with accumulated property wealth.

Focusing on idea-generation, this report first identifies a broad range of opportunities.

These include:

For aspiring first-home owners

- Creating 'parental-pledge' products that enable earlier entry to the housing market for young people through innovations that facilitate permanent or temporary intergenerational wealth transfer
- Developing 'home super' products that provide tax incentives on savings that are quarantined for deposits on first homes
- Reducing costs to lenders and consumers by optimising the application of LMI, either by accelerating implementation of the standardised regulatory capital provisions of the Basel II Accord, or by providing more options to home-purchasers - such as paying a premium only for the period where the loan-to-value ratio exceeds 80 per cent
- Developing products that allow certain consumers to borrow up to 100 per cent or more of the property value

- Improving and/or harmonising stamp duty discounts for first-time home buyers to the levels already provided by some Australian state governments
- Cutting entry costs by creating products that enable third parties to take a stake in the property in exchange for either a lower deposit or reduced interest

For those in ownership, building equity

- Enabling less sophisticated borrowers to take advantage of opportunities to accelerate repayments, reduce interest and lower repayment costs by mandating that simple education programs and personal budgeting tools be provided at the point of loan origination
- Creating more perfectly competitive and transparent safeguards for customers by requiring brokers to create statements justifying their selection decisions on the customer's behalf

For those building and diversifying property wealth to prepare for retirement

- Educating consumers to encourage uptake of investments which offer increased diversification benefit and which compare favourably with accelerated mortgage repayments
- Stimulating investment diversification strategies by enhancing the tax treatment of investments that are quarantined for retirement in order to close the return-gap between such investments and accelerated mortgage repayments

For those who have retired and may wish to access or transfer their property wealth

- Developing next-generation 'reverse' (equity release) mortgages that improve accessibility and eliminate the potentially distortional nature of means-testing which may encourage consumer behaviour against asset liquidation

The above opportunities comprise a subset of a longer list of ideas and opportunities generated by this study. This report contains a comprehensive list of those ideas, articulated by life-stage segment, along with a preliminary qualitative assessment of those given higher priority in order to assess their stakeholder impact and ease of implementation.

It should be noted that the ideas in this report represent demand-side stimulus which must be mitigated by supply-side initiatives in order to avoid inflationary pressure. Such supply side initiatives are proposed by Caplin and Joye.

These ideas have been contributed on a pro bono basis and have been made available for interested parties to implement as they see fit. Our wish is that many will be taken up and implemented by lenders, distributors and policy-makers.

Some ideas will clearly require further industry debate. Our hope is that the Government will seize the initiative by instigating the appropriate exploratory processes to evaluate ideas that may result in substantive, lasting and beneficial policy changes.

We hope that this report will contribute to elevating debate on these issues, one in which Booz Allen Hamilton is keen to play its part.

Acknowledgements

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The authors take full responsibility for any omissions and errors. Please direct all questions and comments to David Moloney (moloney_david@bah.com)

Approach

This report has been developed through the personal, pro bono efforts of David Moloney and Alastair Bor of Booz Allen Hamilton. Accordingly, the approach is designed to maximise outcomes from a modest and largely qualitative effort.

The approach has been structured as follows:

1. Developing a better understanding of the issues being addressed to identify potential solutions by:
 - a. Segmenting the problem by major home ownership life-stages
 - b. Understanding the key inhibitors and enablers of property accessibility and financial flexibility, as well as building an inventory of relevant ideas based on Task Force Survey responses, the contribution of Booz Allen Hamilton's intellectual capital, industry interviews and public information sources
2. Preparing an initial qualitative assessment of each potential solution for each major stakeholder group, including current and potential home owners, state and national authorities, lenders and distributors
3. Developing potential 'next steps' for each opportunity outlined by this qualitative examination
4. Producing a prioritisation of potential enhancements by highlighting potential areas of focus over the short, medium and long term

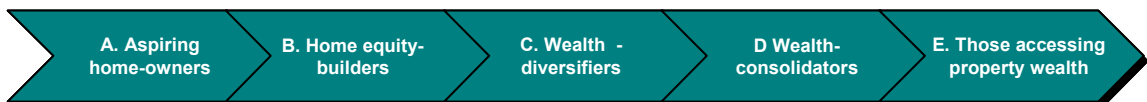
1 Understanding the Issues

1.a Segmenting the problem by major home ownership life-stages

The needs of individuals relating to property ownership will vary according to their particular situation; however, for the purposes of simplification, five broad categories of need can be identified.

Figure 1

Australian Home Ownership Life Stages



A. Aspiring home-owners: Those aspiring to own their primary residence

This segment is the primary focus of this report. The distinction is that these individuals do not yet own their primary residence, although they may or may not have begun to accumulate assets, which may include investment or other property.

B. Home equity-builders: Those who own their primary residence and are building home equity

This segment represents those who have their non-retirement assets invested almost exclusively in their primary residence. This may be because they have only recently purchased a home and have a relatively high debt-to-equity ratio, or because they have applied any potential savings to early mortgage debt-repayment.

C. Wealth-diversifiers: Those building and diversifying property wealth to prepare for retirement

This segment represents those owner-occupiers who have begun to diversify their asset base away from their primary residence. This

diversification may have taken many forms - from simple savings facilities to direct equities, managed funds, additional properties, or even assets such as vintage wine.

D. Wealth-consolidators: Those consolidating wealth (property and other) to prepare for retirement

This segment represents those owner-occupiers undertaking a housing-related restructuring of assets for retirement. Such restructuring may take many forms, such as downsizing the primary residence to create a more sustainable cost of living, or an inter-generational wealth transfer to optimise means-tested pension assets.

E. Those accessing property wealth: Retirees who may wish to access or transfer their property wealth

This segment comprises owner-occupiers who either wish to access their property wealth to supplement their pensions, or to begin transferring their wealth to other family members prior to death. Because of Australia's relatively high level of home ownership¹, many Australians will retire with an unencumbered primary residence. While retiring Australians increasingly look to smaller properties and lower-priced regional properties at retirement, a significant proportion express a desire to stay in their existing residence.

Between all of these defined segments, there may be blurring of distinctions, or mixed motivations: few customers are likely to fit exactly into any category. It is important to note therefore that the distinctions between them are intended to be indicative, rather than absolute, and that many of the solutions proposed will apply to those in more than one segment.

1.b Inhibitors, enablers and solutions

The major inhibitors and enablers of accessibility and flexibility are most clearly demonstrated in relation to participants' positions on the home ownership life stage evolution presented above in Figure 1.

¹ Australia has a 70.1 per cent home ownership rate. Reserve Bank of Australia July 2002, "Recent Developments in Housing: Prices, Finance and Investor Attitudes", *Reserve Bank Bulletin*, RBA, Sydney

A. Aspiring home owners

This segment faces some of the most significant challenges relating to home ownership. For this group the major inhibitors can be categorised as:

- **Credit** - Insufficient creditworthiness (either through an inability to demonstrate a sufficient record of creditworthiness or through a poor credit history)
- **Serviceability** - Inability to meet loan repayments
- **Down payment/collateral** - Inability to provide minimum collateral
- **Accessibility** - Inability to find suitable property or lenders
- **Risk-aversion** - Aversion to the risks of property ownership and indebtedness
- **Education** - Lack of sufficient knowledge relating to property ownership

**Table 1: Selected Global LTV² Boundaries
Residential Housing³**

Country	Maximum with Conditions
Australia	<ul style="list-style-type: none"> • 95-97% with Lender's Mortgage Insurance (LMI)⁴ • LMI charged once at origination • LMI cost can be capitalised
Canada	<ul style="list-style-type: none"> • 85% with insurance
Denmark	<ul style="list-style-type: none"> • 100% with 'Top Financing' • 'Top Financing' is a 2nd mortgage at a higher interest rate
South Africa	<ul style="list-style-type: none"> • 100% with 'Access Bond' product (LOC) • Portion of loan above 80% at 150bp premium • 108% with entire loan at premium prices
United Kingdom	<ul style="list-style-type: none"> • Loans of 95-100% are commonly available • 6.2% of all loans are 100% loans
United States	<ul style="list-style-type: none"> • 100% are widely available and typically structured as two tranches of debt - a traditional mortgage up to as high as 97.5% with the remainder as a 2nd mortgage or personal loan.. • Loans above 100% are also available (e.g., 103% to cover closing costs)

1) Credit

As compared with other major markets and seen in Table 1 above, Australian lenders have relatively conservative credit policies when compared on the simple dimension of loan to value ratio.

² LTV means Loan To Valuation

³ Booz Allen Hamilton analysis

⁴ The St. George No Deposit Home Loan™ offers 100% lending

This conservatism is reflected in the very low loss rates reported on real estate lending in Australia⁵. Increasing credit-competitiveness, however, is evidenced in at least three recent industry developments:

- The development of ‘low-doc’ loans (that is, loans that have low client documentation requirements), which provide loans to people who are unable to substantiate a consistent income (for example, certain sub-segments of the self-employed)
- The growth of third-party brokers able to shop a loan around to the most credit-competitive lender on behalf of a customer
- The development of the ‘sub-prime’ (that is, non-conforming) lending market in Australia. These providers specialise in lending to customers who are rejected by mainstream lenders.

Prospective home buyers who find themselves very close to the lender approval limit - those sometimes referred to as ‘near-prime’ customers - can choose to build a positive credit history through the use of a savings plan, a credit card or a personal loan. They can also provide lenders with additional security in the form of payment guarantees, additional security (for example, security over another asset), or an additional risk premium. Failing this, they can use a sub-prime lender and then actively seek to refinance to a lower rate as soon as they can demonstrate good credit behaviour.

It is also common for lenders and LMI providers to modify their credit policies to reflect geographical differences in risk. Potential borrowers in certain regions may be denied a loan because of an absence of credit history data or specific loss history in their area, or to allow the lender or LMI provider to avoid risk-concentrations. Clearly, a consumer wishing to purchase in an area that suffers from one of these biases may need to shop around (where the bias is specific to one player) or explore other solutions.

Solutions proposed

- 1 Solutions proposed to address the needs of all groups within this segment, regardless of risk profile, include the revision of credit and insurance policies to reduce discrimination against deposits provided by third parties (typically Government and family), as well as the exploration of ideas to make guarantor arrangements more easily accessible.

⁵ Merrill Lynch estimates loss rates among Australian major banks to be around 0.38 per cent in 2002, which is above historic rates of around 0.20 per cent to 0.25 per cent in the period 1996-2001. Merrill Lynch November 2002, *Australian Banks* analyst report, Sydney

- 2 Within the sub- and near-prime groups, the development of industry utilities to create a 'reverse auction' ensuring these prospective home buyers receive the most competitive credit assessment. A new utility could also report on positive credit achievements by customers to help them build credit histories.
- 3 Additionally, the development of a more competitive sub-prime market that automatically promoted sub-prime customers to a lower interest rate after demonstration of good credit behaviour would assist those initially forced to use sub- or near-prime products.
- 4 One final suggestion is that enhanced credit flexibility might be offered to accommodate high debt serviceability ratios in the early stages of a loan (that is, above the 30-35 per cent level typically applied) in recognition of a rising income trajectory, such as is likely in the case of two recent graduates jointly applying for a loan.

2) Serviceability - Inability to meet loan repayments

Serviceability is the inhibitor most closely linked to affordability. Perhaps the most important recent market innovation for this segment has been the development of honeymoon - that is, 'teaser-rate' or 'value-priced' - loans.

Honeymoon loans offer significant discounts⁶ to home borrowers during the initial loan period - typically six months to two years - although some lenders strongly suggest that the borrower make payments at the reversionary rate⁷, potentially nullifying the serviceability benefit.

Value-priced loans are an attempt by some lenders to provide a basic-featured loan, often through a lower cost direct channel, at an ongoing 'value' price. These loans provide the best long-term serviceability outcome for the consumer, without the need to continually refinance from one honeymoon loan to another.

Recent AAPR legislation is designed to help consumers determine the true on-going cost (serviceability) of a loan relative to alternatives.

Another serviceability enabler that can be used when the customer is purchasing a house of solid value is the consolidation of higher-priced debt into the lower-cost mortgage loan. This option is restricted to circumstances when the property being acquired receives

⁶ At March 2003 Teaser or honeymoon rates ranged from 4.89 per cent to 5.70 per cent, EChoice

⁷ The reversionary rate refers to the post-honeymoon rate

a high valuation relative to the price being paid - that is, additional equity is immediately available. As higher loan-to-value loans attract a requirement for LMI, consumers need to be careful that they are not incurring a stiff initial penalty to do so.

Finally, some lenders now offer 'payment holidays' and flexible payment loans which facilitate lending to those with volatile income streams. Where previously a missed payment might initiate contact from the credit-recoveries unit of the lender, lenders will often now allow a set number of missed payments, and add those payments to the end of the mortgage term; alternatively, if the mortgagee has exceeded the payments required to date against the schedule, the 'excess' balance on the account may be offset against the payments missed.

Solutions proposed

Solutions proposed to assist with serviceability lie on a continuum, from⁸:

1. Temporarily reducing the required minimum repayment to an amount below the amortisation curve (thus initially growing the balance of the loan outstanding); to
2. An initial interest-only period; to
3. An interest and small principal repayment; through to
4. An extended, fully-amortising loan, of, for example, 40 years.

Additional suggestions exploit employment. Firstly, the application of Pay As You Earn (PAYE) disbursement⁹ requirements to ensure consumers resist the temptation of using income for other purposes, by sourcing mortgage payments directly from an employee pay roll. Secondly, encouragement of rate buy-down models by employers (through differentiated tax treatment or other mechanisms) which effectively provide a serviceability discount to employees benefiting from the scheme. These schemes are available in a number of large organisations in South Africa, a very small number of mining companies in Australia, and in effect were available to Australian bank employees before the introduction of Fringe Benefits Tax (FBT).

⁸ Clearly any structural solution that reduces the cost of funds to lenders will also have a serviceability impact. These could take the form of reduced capital requirements through Basel II, government subsidies or alternative funding mechanisms such as the Danish Balancing Principle.

⁹ Such disbursements would be deducted at the payroll level, thus removing the amount from a consumer's disposable income.

3) Down payment/Collateral - Inability to provide minimum collateral

Australian first-time home buyers are commonly able to apply for loans that will pay for up to 95¹⁰ per cent of the property valuation, after accounting for LMI. If the valuation is higher than the price, the new owner may be able to use some of the loan principal to capitalise some of the transaction costs or to consolidate more expensive debt into the mortgage.

For all loans with a loan-to-value ratio of above 80 per cent¹¹, consumers must also pay an insurance premium via the lender to a third party who will both protect the lender in the event of losses due to repossession and allow it to qualify for exemption from regulatory capital charges.

If LMI is required, the insurer (and, therefore, lender) will require that the 5 per cent deposit has been available for home purchase for three months.

Competition in other major mortgage markets has led to the availability of loans for first home buyers with smaller deposits. In the United Kingdom loans of up to 100 per cent are available¹². In higher-inflation economies such as South Africa, lenders will fund up to 108 per cent of the house valuation in order to capitalise all of the transaction costs associated with acquiring the property.

Australians have recently benefited from a number of new initiatives designed to reduce constraints associated with down payments:

- The Government's First Home Owner's Grant – however, a number of lenders do not count the grant as part of the deposit
- Bonus-saver deposit products which reward good savers with bonus interest
- Off-the-plan purchasing
- Loan pre-approvals
- Loan incentives from builders that reduce deposit requirements

¹⁰ This number can be exceeded, as either due to incorrect initial valuations, the use of secondary unsecured loans, or through the availability of LMI up to 97%

¹¹ Under certain circumstances the lender will waive LMI

¹² Figures from the Council of Mortgage Lenders (UK) for the third quarter 2001 show that 6.2 per cent of all loans to first-time buyers were for the full value of the property. Warwick-Ching, L 2002, "Step on to the bottom rung before the ladder is moved away", *Financial Times*, 19 January 2002

- Availability of ‘joint-title’ or ‘tenants-in-common’ arrangements, which mean the acquisition costs can be shared
- Deferral or waiving of loan-establishment and house-valuation fees by lenders
- Ability to capitalise transaction expenses where valuation allows
- Full or partial exemptions on stamp duty to first home buyers¹³

These initiatives have all undoubtedly worked together to increase lending levels by making loans more accessible to some, while accelerating entry into the housing market for others.

Solutions proposed

The solutions we propose for the segment of aspiring first-home owners are more numerous due to the major hurdle, whether perceived or actual, of obtaining a home deposit, and include:

1. Encouraging development of ‘parental pledge’ products. That is, a product whereby lenders engineer a loan contract that allows for part or all of the deposit to be provided as a temporary loan that is returned directly to the ‘pledge provider’ (typically parents or grandparents) when sufficient equity has been accumulated. This could be refunded with or without interest directly to the pledge provider via a form of ‘automatic redraw’ facility based on loan amortisation and the additional equity realised through home appreciation.
2. Encouraging development of a UK-style ‘shared-appreciation’ mortgage (SAM). In such mortgages, the lenders or securitisers take a disproportionate upside in the property in exchange for a lower deposit, partial equity or reduced interest. (See report by Caplin and Joye, 2003.)
3. Creating a ‘Home Super’ product that provides tax incentives for savings that are quarantined, like superannuation, specifically for home ownership. Monies paid into the ‘home super’ account would earn tax-free returns but could only be used for the deposit on a first home.
4. Providing access to superannuation for the purposes of funding a first home. Variants of such a provision are currently available in Singapore, South Africa and the US.

¹³ A number of State governments, such as NSW, waive the stamp duty for some first-time home buyers; however stamp duty relief was to be phased in with the introduction of GST.

5. Creating a home ownership savings levy for young Australians that flows into a quarantined home deposit account. Options could include garnisheeing wages, substituting or supplementing existing superannuation levies, and so on. (See Caplin and Joye report for a detailed analysis.)
6. Exploring further ideas to reduce transaction costs for first-time home buyers - especially stamp duty.
7. Exploring ideas to reduce the additional cost burden to consumers from payment of LMI on purchases with a loan-to-value ratio of 80 per cent or higher. There are at least three potential solutions:
 - Improve accessibility to refunds of LMI premiums when loan-to-value ratios fall below 80 per cent before the expiry of premium cover to the lender.
 - Encourage lenders to offer a potentially lower cost alternative to consumers, such as a risk-based price premium that applies only during the period that the loan exceeds the 80 per cent threshold.
 - Explore the potential to accelerate implementation of the Basel II accord, which has the potential to reduce significantly the cost of capital applied to mortgage lending.
8. Exploring ideas to provide ready access to advice, standard legal contracts and mortgage credit to facilitate shared purchase arrangements, either as a mechanism to gain assistance from family and friends, or as a means to encourage purchase by multiple parties prepared to share residency.
9. Encouraging lenders to offer loans with a higher loan-to-valuation ratio (for example, 100 per cent) to those with deserving cases (e.g. high income trajectory, double income families)
10. Extending guaranteeing arrangements to include payment guarantee (that is, an unsupported guarantee) or security guarantee (that is, a supported guarantee), either from family, or, in extreme circumstances, government agencies.
11. Combining two or more of the current or proposed solutions, for example, combining a shared-appreciation mortgage with the First Home Owner's Grant. This would allow the Government to vary the deposit provided and to take an equity position in exchange for larger deposits.

4) Accessibility - Inability to find suitable property or lenders

This issue is typically only raised in relation to the availability of affordable housing. This issue is explored in depth by Caplin and Joye.

5) Risk-aversion - Aversion to the risks of property ownership and indebtedness

Australians enjoy one of the highest levels of home ownership in the world¹⁴. Given recent price appreciation, it is more likely that non owners are incurring risk by falling behind in personal-wealth accumulation than they are by acquiring a property and mortgage.

A key question facing non-homeowners concerned about price inflation is whether house values will depreciate immediately after buying. There is no effective remedy to market timing issues due to the indivisibility of property; that is, although a long-term investment, consumers cannot buy houses on the dollar-cost-averaging basis they might apply to direct equities. The only other solutions are the creation of retail property-hedging vehicles and shared-equity style mortgages that eliminate indivisibility (see Caplin and Joye).

An additional new concern lies in the high levels of absolute indebtedness facing new home buyers, some of whom may still be facing Higher Education Contribution Scheme (HECS) debts. Relative to the previous generation, new home buyers face much higher absolute loan amounts, which can create the perception of incurring a 'mountain of debt' which can never be repaid. However, because of lender serviceability ratios, the amount of income being applied to paying off the mortgage over a normal term has remained relatively stable at 30-35 per cent.

6) Education - Lack of sufficient knowledge relating to property ownership

Government education programs like those in support of the first homeowners grant scheme will continue to maintain or increase the proportion of home owners in Australia. This report highlights opportunities to develop a small number of additional programs targeted at specific issues.

¹⁴ Australia has a 70.1 per cent home ownership rate in comparison to the UK at 69 per cent, US at 67 per cent, Canada at 64 per cent, Sweden at 56 per cent and Germany at 43 per cent. Reserve Bank of Australia

B. Home equity-builders

Australians have been relatively successful at purchasing their own home and quickly building equity in their primary residence¹⁵.

Flexible mortgages advertised with a tag line of saving numerous years of mortgage repayments have had an enormous impact since their launch in Australia¹⁶. Australians have embraced the early mortgage repayment psyche to the extent that Australian lenders cite loan outstandings run-off as one of their most significant issues. The most obvious reason for this behaviour is the superior after-tax return available from accelerated mortgage repayment, relative to the expected return on other asset classes.

For example, assuming a mortgage interest rate of 6.5 per cent and a marginal tax rate of 49 per cent, the average mortgage-holder can obtain an effective pre-tax return of more than 12.5 per cent with effectively no risk¹⁷. Recent performance in the vast majority of non-property asset alternatives, even before adjustment for risk, further discourages diversification and encourages consolidation in the family home.

Interestingly, this strategy is yet to be embraced by consumers in comparable overseas markets, despite identical or very similar tax treatment of the primary residence and investment assets.

One hypothesis is that Australians have benefited from a public education program, effectively sponsored by lenders' mortgage marketing messages. Perhaps due to less intense competition and/or less sophisticated products, major lenders in the UK, Canada and South Africa do not offer or actively promote this strategy to their customers.

Whatever the reasons, recent cash and equity market performance will only serve to reinforce this behaviour, as evidenced by recent consumer research¹⁸. In addition, as property prices have appreciated,

¹⁵ Booz Allen Hamilton property wealth analysis 2002

¹⁶ Citibank pioneered the Line of Credit product in 1986 with the launch of its Mortgage Power product. Prior to 1986 a number of banks offered offset accounts to certain customers. Regional Banks such as The State Bank of NSW and the Hindmarsh Adelaide Building Society pioneered the first mass marketed offset products.

¹⁷ This return has no short-term risk – the extra interest will be avoided, the only identifiable risk to the consumer from this strategy is the loss of principal in the rare event that the lender be forced to repossess under a negative equity situation.

¹⁸ ING-Melbourne Institute Household Saving Report March Quarter 2003 – Proportion of households with additional new savings that intend to use this money to pay off the house mortgage has increased from 11.5 per cent in 2001 to 13.8 per

the absolute, if not net mortgage debt, relative to disposable income has increased significantly. This, along with media coverage relating to rapidly increasing consumer debt levels as a proportion of total income, may further motivate consumers to build equity in their home ahead of other investment choices.

A typical consumer may well benefit from increased income or lower expenses at some point in their mortgage life cycle. In addition, a succession of recent interest rate reductions has also encouraged many variable rate mortgage holders to increase their principal repayments by not reducing their overall monthly repayments as interest rates have fallen.

For those building equity in their existing primary residence, the inhibitors fall into three categories:

1) Inability to exceed required payment through lack of surplus cash: the 'house-poor'

The sharply increasing cost of housing¹⁹ has inevitably increased the absolute level of mortgage debt, particularly for first-time home buyers. On a relative basis, however, mortgage servicing costs as a percentage of income have held steady, due to lender credit policies which typically restrict mortgage payments to around 30-35 per cent of net disposable income²⁰.

Despite this constraint, there is a generally held view that the number of 'house-poor' Australians has increased and that this segment faces a sustained period of high debt burden. Under normal circumstances, these home owners must therefore have benefited from 'stretched' lender credit policies or have exaggerated the liquidity of their financial situation - for example, through monies borrowed from families and friends - to be experiencing serviceability difficulties. However, other factors, such as increased costs due to increased interest rates; the arrival of additional children; or reduced income through unemployment, will obviously either create an inability to exceed repayments; a need to use a 'payment holiday' facility; or to access any prior overpayments or home equity.

cent in 2003 (this number may be under-reported due to funds being placed into savings accounts with offset facilities, or by the 32.6 per cent of respondents indicating "invest in real estate as their intention")

¹⁹ Housing prices in Australia for the five years to March 2002 increased by 41.2 per cent. Reserve Bank of Australia 2002, *Recent Developments in Housing: Prices, Finance and Investor Attitudes*, Reserve Bank Bulletin, RBA, Sydney

²⁰ On occasion, lenders will over-ride this ratio, for example, those with evidence of additional expected income such as a history of annual bonuses

Irrespective of the number of Australians affected, the primary proposed solution (which is consistent with building home equity) is to facilitate both improved budgeting and payment-smoothing. Relevant initiatives range from household budgeting plans, education programs, mandating a PAYE scheme (to ensure earnings cannot be consumed), to more complex bill-smoothing functionality that consolidates all anticipated housing-related costs into a single payment aligned to income.

As an example, several Canadian lenders bundle annual property-related taxes, life insurance payments and automatic disbursements into monthly mortgage payments. More extreme solutions include the creation of US-style tax relief on mortgage interest for the primary residence, and the practice of some overseas lenders of not pursuing borrowers for missed payments until the loan-to-value ratio exceeds 80 per cent.

2) Inefficient management of the personal balance sheet

Consumers can typically optimise their personal balance sheets in at least three ways:

- By *consolidating all assets* into an account with sweeping, offsetting or line-of-equity facilities
- By consolidating all debts into the lowest-cost loan (typically a mortgage)²¹
- By diversification

The first two options are described below. See the next section for a discussion of diversification. Strategies which require further leverage are explored as part of the next life-stage segment.

1. Consolidation of assets

Many mortgage-holders have assets other than the primary residence, which, if in the form of cash²², could provide netting and offsetting benefits.

²¹ ING-Melbourne Institute Household Saving Report March Quarter 2003 – Proportion of households with a mortgage and another form of debt is 71% (note this may include no interest incurring debts such as a credit card which is paid in full each month)

²² ING-Melbourne Institute Household Saving Report March Quarter 2003 – Proportion of households with savings in deposits with bank-like institutions is 55.2%

This class of mortgage product, launched in 1986 by Citibank in Australia, provides the ability to effectively reduce the principal balance of the mortgage by the amount of the offsetting cash assets. To obtain this benefit, lenders typically require the opening of an offset account which is used for day-to-day depositing and withdrawal of offset funds. Consumers can optimise their personal balance sheet by ensuring that all available non-primary residence assets are channelled into the offset facility (many are now packaged with frequent-transaction capabilities).

Netting or offsetting advantages, however, come at some cost, in particular:

- Loss of diversification advantages. Assets are restricted to cash, and return diversification is nullified due to the offsetting feature.
- Consumers can consider an offset balance to be a form of readily-accessible savings and be more tempted to use the money for consumption purposes
- The product is sometimes charged at a premium to discount mortgages. Splitting the mortgage and having only a fraction of the mortgage utilise this feature can mitigate the premium price of such a facility.

The second option is a 'line-of-equity' mortgage. This mortgage type provides consumers with a maximum line of credit and allows them limitless deposits, and withdrawals, back up to their current limit amount. If consumers use this line of equity to deposit all of their income and savings, then the net effect for the consumer is the same as offsetting.

The key differences to the offset product are:

- Reinforcement of the debt balance. That is, no positive balance is achieved from the offset feature
- Possible perception that no obvious headway is being made against the large debt number
- Ability to withdraw back up to the limit, which in effect provides a credit card-like facility, can tempt consumers to use equity for consumption, to stay at their limit, or to increase their limit through reappraisals of their property

Interestingly, this first difference is turned into a positive by the mortgage broker industry, which commonly structures a mortgage with a quarantined line of equity component to avoid the feature price premium applying to the whole mortgage, and then creating a personalised debt reduction (equity-building plan) around eliminating the debt in the line of equity component within a year or two.

Solutions for maximising the use of offsetting, netting and sweeping largely relate to education programs that explain usage benefits and calculate the break-even point and the optimal percentage of loan allocated to this feature.

One other proposed solution is the exploitation of offsetting funds from another source. Barclays' OpenPlan²³ product contains a facility whereby funds provided from any other source, typically family members, can be used to provide offset benefits.

2. Secured property lending

Secured property lending has the lowest risk and therefore the lowest price of the major lending products. Consumers who are paying interest on other debt types such as credit cards and unsecured personal loans are therefore typically better off consolidating their debt under the mortgage.

Exceptions to this include:

- Transaction costs being too high - for example, home loan top-up or limit increase fees being greater than interest saved.
- Personal loans used to ensure that a short payment plan is adhered to.
- The consumer being unlikely to close off other account or reduce credit card limit, effectively just adding to outstanding debt

Not surprisingly, mortgage lenders encourage consumers to consolidate these forms of debt if they are sourced from competitors, or the consumer is struggling with repayments and this approach reduces the lender's overall credit risk.

Solutions proposed

Solutions proposed for debt-optimisation involve the implementation of public education programs, such as the debt counsellor programs in South Africa, and the creation of a 'white credit' utility (debt register) which might allow mortgage lenders to make solicitations to those customers with unutilised property equity who may be holding debt at higher prices elsewhere.

²³ Barclays Bank plc, London, England

3) Inefficient use of available funds - for example, paying above the lowest market price

The range of publicised rates for prime real estate lending in Australia as at 26th March 2003 was 4.89 per cent to 6.60 per cent²⁴.

The lowest rates are typically offered as part of a teaser or honeymoon rate offer. These loans are characterised by a period of very low interest charges, followed by the automatic transition of the product to a more expensive fully featured loan when the discount period expires. Consumers can optimise their long-run mortgage interest costs, either by continually refinancing from one competitor teaser rate product to another (providing they do not have exit fees when the discount period expires), or by financing a loan which is the lowest priced for the features from which they can derive an economic benefit - that is, splitting the loan to have a small component acting with an offset or line-of-equity facility where this feature incurs a price premium.

Many enablers are present to facilitate efficient use of funds; including the required publication of a standard interest rate (AAPR); the ready availability of internet-pricing tools, and the growing mortgage broker channel. These all serve to eliminate much of the transaction cost for consumers who switch to a lower-cost lender.

Solutions proposed

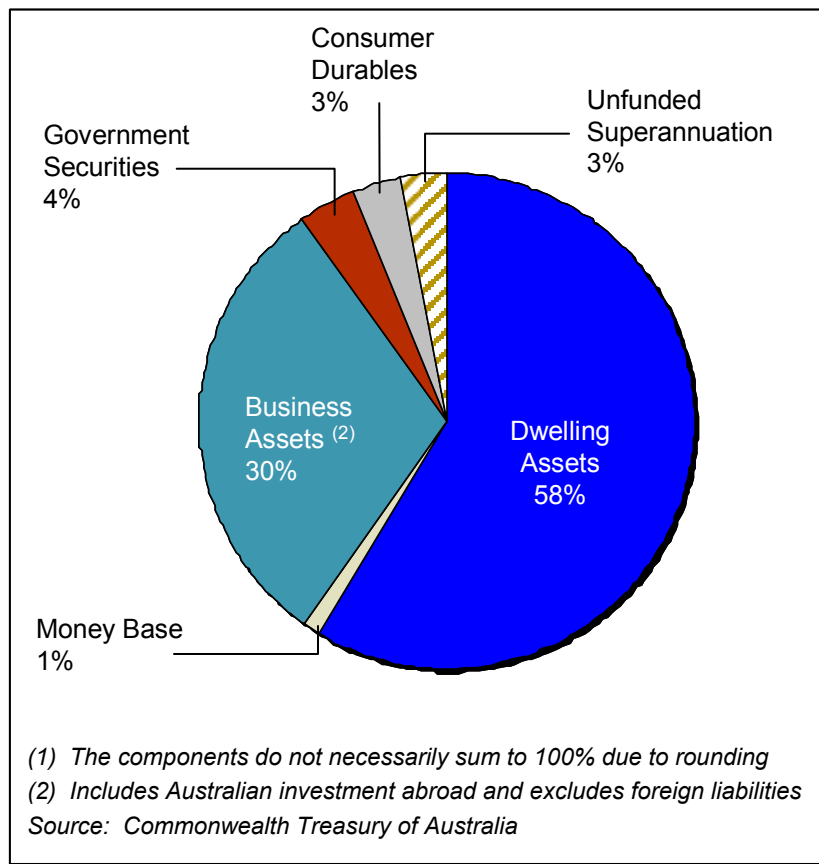
Solutions proposed for debt-optimisation involve firstly, public education programs to encourage consumers to be more active in seeking a better deal and secondly, the regulation of mortgage brokers to ensure they are accountable for a documented recommendation that ensures the best priced loan for the features their customer's need²⁵.

²⁴ Cannex Australia & EChoice, rates quoted for teaser/honeymoon and standard variable mortgages

²⁵ A The UK Financial Services Authority has proposed that brokers consider what type of loan is suitable and which product best meets the consumers needs and circumstances: A Report to ASIC on the finance and broker industry by the Consumer Credit Legal Centre (NSW) Inc, March 2003

C. Wealth-diversifiers

Figure 2
Composition of Australian Net Private Sector Wealth by Asset Type⁽¹⁾



Australians are among the most ‘real estate-overweight’ investors in the world.

Figure 2 indicates that as much as 58 per cent of the Australian private sector consumer investment wallet is real estate-based²⁶. Moreover, for a majority of Australians, the primary residence completely dominates their investment portfolio.

²⁶ Commonwealth Treasury of Australia Summer 2003, *Economic Roundup*, AGPS, Canberra

While this has insulated the average Australian from the recent equity roller coaster experienced by their UK and US peers, it has also implied that the average middle-income Australian is under-diversified and likely to use extra disposable income for either accelerated mortgage repayment or consumption. The options available to Australians seeking to diversify generally come in two flavours, which may be combined: diversion of surplus savings or surplus mortgage payments to another asset or asset class; or leverage of property equity into another asset class.

1) Diversion of surplus savings or surplus mortgage payments to another asset or asset class

The previous section highlighted the strong incentives for Australians to funnel their surplus savings into accelerated mortgage repayments. As indicated, mortgage-offset facilities provide the double benefit of accelerating mortgage repayment through offsetting of principal and providing a limited form of diversification through a relatively flexible access to a cash-based asset (performance diversification is nullified by the offset feature).

Rationally, consumers will invest into other assets for diversification and return benefits. Tax incentives such as lower marginal rates for investments in the name of lower income-producing spouses and lower contribution rates for additional superannuation payments further encourage this behaviour. Nevertheless Australians, relative to their global peers, appear to have:

- A general lack of awareness of their extreme portfolio position - that is, with the majority of non-pension assets tied up in the primary residence
- An expectation of poor expected relative returns available from other investment classes²⁷
- A focus on accelerated debt reduction rather than optimisation of leverage throughout the income-producing years
- A perception that an unencumbered primary residence coupled with a superannuation plan will be sufficient to provide for retirement needs

Actions that promote awareness of the benefits of investment diversification should be encouraged and include Government-sponsored diversification-benefit education programs and portfolio analysis tools, such as simple personal balance sheet calculators

²⁷ ING-Melbourne Institute Household Saving Report March Quarter 2003

provided as part of the mortgage origination process or as part of subsequent financial needs analysis.

Recent and predicted near-term relative returns will continue to compound the diversification problem. Solutions that may address this fall into two categories:

1. More transparent understanding of available returns

Consumers may be largely unaware of existing tax concessions that serve to reduce the relative return gap between accelerated mortgage repayment and other investment choices. For example, tax concessions that promote additional superannuation payments, especially those on behalf of non-working spouses, may produce better long-term returns than accelerated mortgage repayments. This is primarily an educational challenge in which the Government may choose to play a role in resolving.

2. Government tax incentives

The Government may choose to create a policy that enhances the tax treatment for diversification strategies. This may apply to assets that are quarantined for retirement (that is, an extension to existing policy) or for assets that are quarantined for accelerated mortgage repayment with the justification being that the house will very likely be an asset available at retirement time.

Interestingly, while this second option benefits from diversification only until the house balance is paid; it does create a form of endowment mortgage that, in a less legitimate guise, was broadly embraced by UK consumers²⁸.

The dual issues of a widespread accelerated mortgage-repayment psyche and the general aversion to debt are also addressed by the above solutions. However, they are unlikely to address these factors in a way that optimises long-term gains to consumers, because the average consumer does not gain from the advantages of leverage throughout their income-producing years. While much of the wealth in the Australian wallet is attributable to leveraged property, consumers are typically under-leveraged in their middle-to-later income-producing years²⁹.

²⁸ In 2000 endowment mortgages were widely held in the UK, with 57% of all mortgages held being linked to an endowment policy. Mori Financial Services, *The Annual Finance Survey 2002*, conducted for The Council of Mortgage Lenders (UK), London

²⁹ Booz Allen Hamilton analysis

The only area where Australians have demonstrated real progress in leveraging into another asset class outside of their own home is in residential investment property. At over 30 per cent of the total Australian mortgage book³⁰, this is the highest level of such investment among our major global peers. Purchasing of an investment property currently has a number of major advantages to consumers and is clearly the dominant current investment strategy:

- It promotes significant leverage (much higher than is available through other asset classes), maximising long-term returns
- It creates at least some diversification. Typically, an investment property is in another street, suburb or state. However, returns are likely to correlate with those on the existing primary residence much more so than an investment in another asset class
- It quarantines excess income into the creation of a wealth asset, reducing pre-retirement consumption
- It provides for negative gearing of costs associated with the investment property, in particular, allowing consumers to convert their investment mortgage to interest-only payments and divert surplus funds to accelerated mortgage repayment of the primary residence. (Note that tax treatment of split loan arrangements which allow for compounding of interest on the investment mortgage are a more aggressive option, and such arrangements are currently the topic of a challenge in the High Court. Clearly, resolving this as quickly as possible will be in the industry's interests).

Recently sustained, and in some cases rapid, property asset appreciation in the vast majority of Australia has further reinforced this investment strategy for many consumers³¹. The level of sophistication and competition in this space is evidenced by the fact that Australians benefit from investment loan funding at the same cost and loan-to-valuation rates as primary residence funding, which is unusual in overseas markets. However, as a source of diversification this strategy has some limitations, most notably, its performance correlation to the existing portfolio, and its reliance on the failure of the opportunities identified in this report - that is sustained demand for rental properties from those that are currently unable or unwilling to purchase.

³⁰ Reserve Bank of Australia 2003, *Bulletin*, Reserve Bank, Sydney

³¹ Part of this appreciation may be explained by capital investment to upgrade houses – as home renovations are a popular pastime in Australia

Solutions proposed

Obvious solutions suggested include:

1. Maximisation of taxation benefits from negative gearing, either by:
 - Ensuring that any principal repayments are directed into the mortgage on the primary residence - that is, investment loans for other assets are interest-only and principal contributions are redirected to the primary residence mortgage
 - Eliminating any remaining uncertainty around the use of split loans to allow deductibility of compounded interest
2. Government education and lender marketing strategies which inform Australians about sensible levels of leverage and diversification

2) Leveraging of property equity into another asset class

More aggressive diversification redeploys existing primary residence equity into other assets. This immediately creates a more diversified (and often leveraged and negatively-gearred) portfolio.

As equity-access loans are readily available in Australia, solutions are limited to tactics that promote leverage and diversification strategies earlier in the life cycle.

This may include, for example, promoting the use of blanket mortgages that are designed to encourage earlier diversification into investment property through cross-referencing the underlying securities (to allow higher average loan-to-value ratios and or easier credit access), and the development of line of credit investment mortgages that automatically promote optimum leverage and diversification as loan to value ratios allow³².

D. Wealth-consolidators

Few issues have been reported for this segment. At this life-stage, those with assets other than the owner-occupied home have ready access to a significant amount of retirement savings advice and product solutions.

³² This option may be difficult to sell as recent short term equity market performance has meant that home owners that have recently pursued this form of leveraged diversification strategy are typically showing negative returns

E. Those accessing property wealth

This segment is often referred to as the ‘house-rich, cash-poor’. They have paid off their primary residence during their employment years and now typically wish to remain living in the property. Retirement lifestyle expectations, however, may not be met purely from retirement income and therefore they seek to release equity from their home as a mechanism to supplement their income. Current research indicates that up to 71 per cent of Australian retirees will have insufficient income to support themselves at retirement - 38 per cent recognise the gap between actual income and their desired standard of living, and 33 per cent are deluded on their ability to bridge this gap³³. Many are homeowners who have the potential to close their retirement funding gap by accessing their property equity.

Alternatively, a lump sum withdrawal may be seen as a way to help their children or grandchildren enter the housing market either through a gift or application of a pledge-style loan contract as described earlier.

A mortgage product type generally known as a ‘reverse’ or ‘equity release’ mortgage has been developed to meet the needs of this segment. This product provides an equity-release facility (like a line-of-equity mortgage) for people without an income - that is, debt repayment is expected through the sale of the property, either when a pre-agreed debt-to-equity threshold is met, or when the owner decides to sell, or when the property is sold following the owner’s death.

These products are commonly available from specialist lenders in the UK, US, Canada and Australia, but are not currently available from the big four Australian banks.

This may be explained by the following:

- Lenders have not made money (or do not expect to make money) from such products because of poor take-up. This may be due to consumer concerns over whether they will have enough money left as a reserve either for bequests or for late-life expenses, such as health care costs and funerals; alternatively, it may be because of actual or perceived concerns that turning property equity into an income stream can adversely affect pension entitlements.
- Lenders have incurred credit losses due to early lump-sum withdrawals from the facility, whether for consumption or for

³³ ANOP Research Services, 2001, Report on *Community Attitudes to Saving for Retirement*, prepared for The Association of Superannuation Funds of Australia (ASFA), Sydney

annuity-style products, which results in significant interest accrual and compounding early in the life of the loan, destroying available equity. Credit losses can be further increased by the inability or unwillingness of an older inhabitant to fully maintain the property.

- Lenders have incurred brand damage as a result of the heirs to this housing equity claiming that the bank did not act in the true interests of the owner.
- Lenders are concerned about possible legal issues. The Uniform Consumer Credit Code (UCCC) and general law allows credit providers to call up a loan facility at any time. If a borrower's ability to repay a loan from salaried earnings stops with retirement then lenders could call up the loan. However, unless there is a default, most lenders wouldn't invoke the law simply because a borrower has left the workforce. Nonetheless, the law doesn't protect borrowers whose only means of repaying the loan is the sale of the asset³⁴.

St. George Bank and the Police and Nurses Credit Society (PNCS) of Western Australia recently launched a reverse-mortgage product³⁵. This move, along with increasing focus on Australia's ageing population, will undoubtedly stimulate the Big Four to actively explore similar product options for their customers.

Without a reverse mortgage the only solution widely available to this segment is the disposal of property, often in conjunction with the purchase of a cheaper home. This strategy incurs two sets of transaction costs, which can often consume a significant proportion of the equity that was to be released from the downgrade. Current pension means-testing may encourage consumer behaviour against liquidating assets.

An alternative strategy is a sale-and-lease-back arrangement, whereby the property is sold and the equity released is used to make rental payments to the new owner. Variants of this approach are used in the rural community as a way to allow farmers to transition to retirement as renter operators, or to facilitate staged ownership transition to children. This approach is rarely applied to residential housing in Australia for at least two reasons: the lack of experience in Australia of long-term residential leases; and the inherent risk taken on by the

³⁴ Denovan, J. 2003, "Structured reverse mortgages should be promptly assessed", *Australian Banking & Finance*, February 17th 2003, First Charlton Communication, North Sydney

³⁵ St. George's reverse mortgage is called the Seniors Access Home Loan (launched in December 2002), the Police and Nurses Credit Society's reverse mortgage is called the Easy Living Access Loan

retiree that the monies made available by the sale may be insufficient to fund all required rental payments, and the risk taken on by the purchaser that increasing life expectancies may significantly delay expected ownership.

Solutions proposed

There are two proposed solutions to these issues in Australia³⁶:

1. Exploration of mechanisms to increase availability and usage of reverse mortgages including:
 - Reduction of brand damage potential through private/public sector co-operation on the development of a reverse mortgage contract that better educates and protects the interests of all parties involved in a reverse mortgage, including potential heirs
 - Actions by lenders to ensure products sold are engineered to prevent users from drawing down too much equity early in their retirement. For example, a product might only allow a set withdrawal amount on a monthly basis to close an income gap; alternatively, funds may be released for use as a 'pledge' to fund a deposit for their children or grandchildren that will ultimately be repaid.

Unfortunately, these remedies may conspire to restrict the profit potential to lenders from selling these products. They therefore need to ensure profitability through long loan lives, utilisation of credit lines, or by the design of fees, fee deferral or clawback³⁷ provisions that ensure that reverse mortgages are ultimately profitable.

2. Exploration of the French sale and lifetime lease-back model³⁸, under which retirees can sell their property to an investor for a life annuity and the right to occupy for life. In this model, the life annuity can represent either the whole price of the property or part of it. If calculated on part of it, the buyer pays an initial amount called the bouquet and the life annuity is calculated on the balance. The life annuity ends with the death of the tenant. The annuity is calculated using three elements:
 - The value of the property

³⁶ In addition to the Shared Appreciation Mortgage mentioned earlier

³⁷ Clawback provisions reimburse lenders for benefits (e.g. discounts, fee waivers) given away to customers who close their accounts prematurely

³⁸ "Vente en viager", Lease for Life

- The tenant's age, which gives an indication of their life expectancy
- The rate of inflation that would normally be used for renting an equivalent property

This solution is available, but not prevalent, in France, probably because of the moral hazard created by the asymmetric incentives between the investor and landlord.

2 Qualitative Assessment

This section provides a further description and likely stakeholder response to each of the potential solutions that are qualitatively deemed to have a more significant benefit for Australians.³⁹

A. Aspiring home owners

Credit-accessibility model

[A1] Perhaps the most powerful means of improving credit accessibility for new homeowners is a mortgage broker-utility model, such as those used in the Canadian market.

Under this model, all customer applications are simultaneously lodged with the major providers through an electronic feed, each of which in turn responds with its offer. While this solution requires that a customer uses a broker to originate their loans, one would expect a spill-over of credit competitiveness to other originating channels.

Such a solution would benefit consumers by creating a reverse auction, effectively transferring negotiation power from lender to applicant. The solution is, however, less helpful to lenders, who would incur additional costs from fees to the utility and the likely reduced conversion rate from this channel. They would also incur a 'winners curse' whenever under-pricing customers. However, they may also benefit from a modestly larger market size as additional customers are attracted or accepted into the 'prime' market.

Presently, for a broker, or a customer directly, transaction costs associated with submitting loan application to multiple lenders are still high. Applicants currently need to complete multiple lengthy application forms and pay several application fees. However, recent competitive initiatives have seen the provision of electronic links between the major broking houses and lenders, and the discounting or waiving of application fees.

Accelerated adoption of the LIXI⁴⁰ interchange standard and more sophisticated credit comparison tools will lead to more competitive credit for applicants.

³⁹ Each potential solution is denoted with a [Xn] index to facilitate cross-referencing. The 'X' refers to the life stages (A through E) while the 'n' is a sequence number

Credit-worthiness model

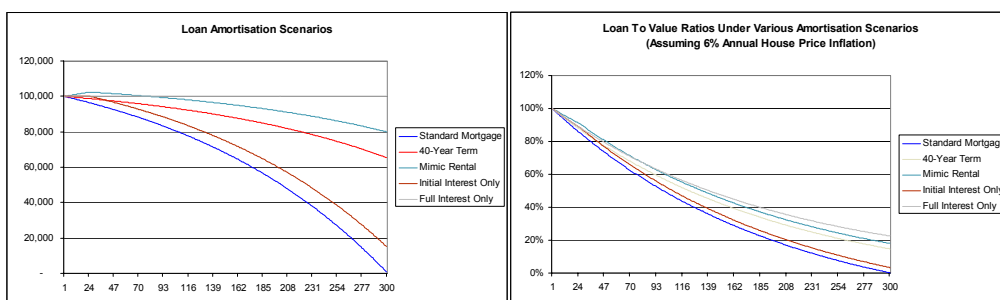
[A2] Under existing privacy legislation, credit reporting in Australia is restricted to negative, or ‘black’, reporting related to delinquencies or other derogatory information. Positive credit reporting is used in the United States and Canada and ensures that customers with good debt-servicing records can obtain a mortgage more easily.

Clearly a balance needs to be struck between privacy needs, and the efficiency of the lending system. However, an industry-wide ‘white credit utility’ which reports on positive credit to assist in the building of a credit history would ensure that more deserving prospective home owners would have access to a mortgage. Recording of a customer’s information in the ‘white credit utility’ could be made on an opt-in basis.

Serviceability model

[A3] The major solution to serviceability is more flexible lending terms that effectively align servicing capacity to incomes. This would entail a combination of the suggested payment-reduction levers, from paying less than required interest for a few years, to interest-free terms, ‘balloon’ payments, or 40-year terms. Alternatively, increased payment levers which allow applicants able to demonstrate a rising income trajectory (for example, recent graduates) to borrow at levels approaching a 40 per cent serviceability ratio, would allow such candidates into the market earlier.

Alternative repayment regimes can alleviate borrower cash-flow difficulties without dramatically affecting LTV ratios



Repayment Regime	Description
▶ Standard Mortgage	▶ 300-month standard Principal + Interest mortgage
▶ 40-Year Term	▶ Payments calculated on a 480-month repayment basis
▶ Mimic Rental	▶ Low payments equivalent to rental payments (equivalent to interest-only + low principal)
▶ Initial Interest Only	▶ Interest-only for initial “honeymoon” period followed by standard repayment trajectory
▶ Full Interest Only	▶ No principal repayment

⁴⁰ The Lending Industry XML Initiative (LIXI). See <http://www.lixi.org.au>

Presently, responsible lending regulations and lender policies constrain terms to ensure that the loan is paid off. This solution would require a revision to these regulations and policies to temporarily delay this requirement during the very initial term of the loan.

Down payment models

There are seven priority solutions to the down payment issue.

1. Parental Pledge

[A4] Parental Pledge products can be created that involve a new loan contract which returns directly to the pledge provider (typically parents or grandparents) the original pledge amount, plus foregone interest incentives through an automatic redraw facility based on amortisation and additional equity made available through home appreciation.

This solution has the added advantage of providing a tool that parents can use to encourage and facilitate earlier entry to the housing market, and a tool young people can use to ask their parents for help in a fair and relatively modest way.

Somewhat coincidentally, a variant of this inter-generational wealth-leveraging concept was very recently launched in the Irish home loan market. It would be an attractive addition to a lender's product portfolio and requires little implementation effort.

2. Home Super

[A5] A Home Super product could provide tax incentives for savings which, like superannuation, are quarantined for home ownership - that is, monies put into a mortgage saver account would earn tax-free returns and could only be used for first-home ownership deposit.

This solution provides for an additional or potential substitute subsidy to the First Home Owner's Grant for those actively saving for a home loan. The advantage for consumers and governments is that the product encourages earlier and faster saving for a property. The solution could be established with a number of non-mutually exclusive design variants.

- Inflows could be optional
- Inflows could be compulsory for a certain age group
- Inflows could be bound by minimums or maximums.
- Inflows could be made from pre-tax income (for example, US IRA)
- The government could provide 'bonus interest' on the monies in addition to reduced or tax-free status

Using this principle, the monies could be directed into any savings account designated for this purpose, or quarantined into a national fund that could further serve as a low-cost source of mortgage monies for the most deserving first-home owners.

Alternatively, the scheme could be implemented on top of existing superannuation schemes through the use of an additional levy and/or ability to withdraw a component of existing monies for the purpose of funding a first home. A version of this solution has been in place in Singapore for 39 years and has been credited with contributing to home ownership levels of 90-plus per cent in that country⁴¹.

Criticism relating to the introduction of an additional subsidy could be avoided through means testing. Lenders would likely respond warmly to the proposal, since it would provide more evidence of serviceability capacity and provide more 'hurt money', strengthening the buyer's emotional bond to the purchased property. If established through the banking system, regulation, set-up costs, high yields and relatively short product life spans may limit profitability from these accounts; however, customers could proactively be offered a mortgage, increasing the likelihood of a profitable relationship for the bank and the lender.

Another potential criticism is the impact on those saving to start a small business. If a levy is applied, this could result in reduced entrepreneurial activity in the economy, suggesting that any scheme might need to allow for funds to be used for a first home or a first new business.

3. Reducing LMI

Lender's Mortgage Insurance is a cost borne by consumers that serves two principal purposes:

- It protects lenders from losses due to repossession, in particular those more significant losses that might arise from a structural shock created by simultaneous house price deflation and reduced loan serviceability
- It allows lenders to reduce their capital provisioning for the loan

Under the 1988 Basel Accord, loans with a loan-to-value ratio of 80 per cent or above are subject to a 100 per cent risk weighting, requiring an 8 per cent capital reserve. This risk weighting is reduced to 50 per cent when the loan-to-value ratio is below 80 per cent or when LMI is purchased by the borrower. As LMI premiums typically represent 1-2 per cent of the loan amount, there is a significant

⁴¹ Carnegie, G. & Dixon D. 1991, *Saving for the Future: A Comparative Study of 'Savings Policies' in Singapore and Australia*, Australian Commission for the Future Ltd, Canberra

incentive for consumers to borrow below 80 per cent of the property price. However, for consumers unable to save the 20 per cent deposit, or secure monies from other sources, the premium needs to be paid either up front, or through capitalisation as principal in the new mortgage.

It is estimated that Australian consumers paid in excess of A\$200M in LMI premiums last year⁴². The actual cost to consumers may be much higher due to compounding interest costs.

A revised accord, known as the Basel II accord, is scheduled for full implementation in January 2007. Lenders can follow two approaches to capital allocation for the mortgage book, both of which are expected to reduce the cost of capital allocated to mortgages.

Under the 'Standardised Approach', lenders will be required to apply a 40 per cent risk weighting to mortgage loans with a loan-to-value below 80 per cent; however, in light of low mortgage book losses, this figure may be revised down further before implementation.

Under the 'Internal Ratings'-based approach, lenders will be required to set aside capital based on its historic loss levels, both credit and operational⁴³. Most lenders believe that this approach (even accounting for additional capital required for operational risks) will lead to substantial reductions in capital provision for mortgages.

As the Basel II Accord requires that total capital provisioning for the industry not be reduced by adoption of either approach, lenders can expect that capital provisioning will need to be transferred from the mortgage book to non-mortgage lending. This requirement could be interpreted as a form of cross-subsidy by mortgage borrowers to other borrowers. Clearly, any opportunity to accelerate the elimination of any such inefficiency should be investigated.

[A6] The *first* opportunity lies in acceleration of the regulatory capital provisions of the Basel II Accord. This could take many forms. For example, one might be an APRA-instigated interim prudential requirement that maintains overall system capital provisioning while allowing mortgage lenders to reduce their mortgage capital to levels mandated by the new standardised approach, and to transfer this capital to other forms of lending.

⁴² Booz Allen Hamilton Analysis

⁴³ Under Basel II, lenders can adjust their capital to actual risks through models of loss data in their own books over time. Lenders using the new Basel II methodology may be able to cut their capital levels in half (from 4% to 2% risk-weighted capital) on their residential mortgage portfolios – on certain low risk loans, lenders may even have a 0% risk weighting

This opportunity potentially creates substantial benefits to home purchasers, through pass-on of reduced capital costs in the form of reduced interest rates from lenders, and potentially the further encouragement of lenders to provide additional LMI options to consumers. It has, however, significant implementation complexity, not least in the effort required by lenders to make the necessary interim changes, while meeting the Basel II schedule.

[A7] The *second* opportunity recognises that loans that initially exceed a loan-to-value ratio of greater than 80 per cent can quickly be returned to a safer level below 80 per cent due to capital appreciation or principal reduction.

As LMI premiums are priced for the life of the loan and paid upfront (currently calculated by one leading insurer as an average of nine years), the total risk premium paid by consumers can be reduced by more efficient access to refunds by consumers, or by a pricing mechanism that readjusts the annual premium paid according to ongoing loan to valuation ratios.

Currently, refunds are only given to customers when they repay their loan in full within either one or two years, i.e. the opportunity for a refund is unavailable when the loan is paid out in full later, or when the combination of principal repayment and property appreciation reduce the LTV below 80%. This means that LMI insurers are earning premium for risks that no longer exist and are keeping capital aside that is no longer needed. As LMI is a cost that is organised by the lender and paid for by the customer, there appears insufficient incentive for lenders or LMI insurers to work together to eliminate this slack in the system. Recent developments in property valuation database technologies appears to provide a low cost way for lenders or LMI providers to monitor ongoing LTV ratios and advise the consumer when a refund is deserved.

Alternatively, as practiced in South Africa, such refunds might be simply operationalised by lenders self-insuring with a risk premium applied to that part of a loan above 80 per cent and adjusting down the risk premium based on a simple property price index adjustment, or by consumer funded re-appraisal of the property.

100 per cent-plus borrowing

[A8] Another solution with significant potential is the development of products that allow the consumer to borrow higher levels of the property value. Such products are available in several overseas markets, for example in the United Kingdom (maximum 100 per cent) and higher inflation economies such as South Africa (maximum

108 per cent⁴⁴). Though less widespread than overseas, such products are also available in Australia.⁴⁵

Deserving consumers would of course welcome the flexibility to buy a property with little or no requirement for collateral to meet transaction costs or initial deposit requirements.

Lenders would benefit from an expanded loan book but would need to develop more sophisticated credit-analysis and risk-based pricing capabilities to prevent further exposure or price for risk accordingly.

Regulators would express concerns that this form of offering would further expose lenders and consumers.

Improving stamp duty levies

[A9] The Real Estate Institute has been lobbying heavily for the abolition of stamp duty on property purchases.

Many home buyers effectively borrow extra to cover the stamp duty costs. In Melbourne, where the median cost of a house in 2002 was \$316,500, borrowers paid \$14,500 in stamp duty, which over 25 years at a 6.5 per cent interest rate can amount to an extra cost of \$29,700⁴⁶. Some state governments already offer stamp duty discounts to first-time home buyers, however this discount is not uniform across Australia, and not linked to median house prices. In Sydney, the median house price is already greater than the maximum exemption amount of A\$300k⁴⁷.

Buyer-lender shared appreciation model

[A10] The 'Shared-Appreciation Mortgage' is a product in which the lender or securitiser takes a disproportionate stake in the capital appreciation of a property in exchange for a lower deposit, partial equity or reduced interest. This enhances the first-time home buyer's ability to afford housing as they are not required to purchase the entire dwelling.

As with 'reverse-mortgage' product variants, early experience with this product has produced teething problems⁴⁸, most notably a

⁴⁴ Australia has significantly lower inflation rates to South Africa, thus 108% lending may require supported guarantees or may only be appropriate for borrowers with high income trajectories.

⁴⁵ St. George Bank has offered a No Deposit Home Loan™ since 2000.

⁴⁶ Dunlevy, M. 2002, "REI on warpath against stamp duty under GST", *The Australian*, 26 July 2002

⁴⁷ Commonwealth Bank Task Force Survey Response

⁴⁸ Source: Booz Allen interviews with Bank of Scotland

reluctance by institutions to purchase the underlying risk-return profile, and brand damage risk caused by consumers who believe they have an unfair deal as a result of faster-than-expected property price appreciation.

However, we believe that as in the case of reverse mortgages, an opportunity exists to meet the needs of particular segments with this style of product, and that lenders and institutions should explore the detailed work of Caplin and Joye in this area.

B. Home equity-builders

Competitive market forces, development of the mortgage-broking sector and lender adoption of customer advocacy initiatives as a retention tool will all conspire to resolve most of the issues in this segment. The two solutions that most deserve further attention are the provision of a budgeting tool/education programs and regulations to ensure that brokers always operate in the consumers' best interests.

Mandated personal budget tools

[B1] There is a potential need for a mandated personal budget tool to be provided as part of the loan origination process.

As the house and its mortgage is very likely to be the biggest purchase in the consumer's life, a simple budgeting tool (populated with mortgage application data), complemented by an education and debt counselling program would be of great potential benefit to consumers likely to be facing affordability issues (as are easily identifiable by 'serviceability thresholds' and family status).

This type of program is mandated as part of low-income housing lending in South Africa, and is available in Australia to some extent through the popularity of books, magazines and television programs which include self-help material related to this issue.

Regulators would likely see such programs as reinforcement of the notion that a mortgage is an advice-based product that is sold, not bought.

Third-party distributors and lenders might see this as a cost burden which has little benefit to them, especially since enhanced budgeting would likely lead to accelerated repayments and reduced earnings on outstanding interest or trail commissions.

Broker accountability

[B2] Mortgage brokers now originate more than 30 per cent of all mortgages in Australia⁴⁹. Individual brokers are typically provided with a cross-lender panel mortgage-comparison tool to help them match products to customer needs, and then provide advice to the customer about which loan to select.

Many of Australia's individual brokers are rewarded directly by lenders' commissions⁵⁰ and therefore may be prone to 'predatory lending' – recommending a loan that is not optimal for the client.

Accountability for every recommendation from brokers in the form of a statement justifying their selection for the customer would present immediate consumer benefits, ensuring that the risk from non-compliance would override lenders' incentives.

Such a change might also be welcomed by regulators, who would see brokers' compliance transformed to a more perfectly competitive model. Brokers and lenders, however, would likely not respond favourably, arguing that this would create a compliance burden that would ultimately add cost to the consumer and destroy profits.

C. Wealth-diversifiers

The two primary solutions for this segment relate to government education programs and increased tax concessions to promote continuation of wealth-creation beyond the family home.

Consumer education

[C1] Firstly, an education-based solution would need to expose the problem through better consumer understanding of how 'property-overweight' the majority of consumer asset portfolios are.

Secondly, an education-based solution would need to promote investment classes benefiting from existing tax concessions that compare favourably with accelerated mortgage repayments, and which provide diversification benefit.

If such a program was Government-funded, the distributors and manufacturers of products that benefit from existing concessions would effectively be receiving an advertising subsidy and would welcome the solution (for example, in the instance of providers of spousal superannuation schemes).

⁴⁹ Booz Allen Hamilton analysis

⁵⁰ An obvious exception are brokers operating under a Mortgage Choice franchise which receive uniform compensation regardless of the selected lender

Stakeholders associated with the residential property value chain might, with few exceptions, argue against it by saying that consumers have equal access to all asset classes and have already voted with their investment wallets (largely through accelerated mortgage repayments).

Consumers in Australia are seen to be largely unaware of the somewhat extreme portfolio position they take, and would therefore benefit from a better understanding of their position and the diversification options available to them.

Enhanced tax rewards for investment diversification

[C2] A second priority solution is the provision of enhanced tax treatments for diversified investment strategies. These should be aimed at closing the gap between the effective pre-tax returns from accelerated mortgage repayment and the returns from other investment classes that are quarantined from retirement assets. (These may include the accelerated repayment of the mortgage on the primary residence.)

In the first instance, these benefits should apply to assets that are quarantined for retirement (that is, an extension to existing policy). However, the Government may explore the benefits of applying this to assets that are quarantined for accelerated mortgage repayment, the justification being that the primary residence will very likely be an asset available at retirement time.

Interestingly, while this second option benefits from diversification only until the house balance is paid; it does create a form of endowment mortgage that in a less legitimate guise, was broadly embraced by UK consumers.

Clearly the regressive nature of such a tax would require significant income and/or asset testing.

D. Wealth-consolidators

Opportunities to resolve issues identified for this segment are not considered to be a priority.

E. Those accessing property wealth

Reverse mortgages

[E1] Exploration of mechanisms to increase availability and usage of reverse mortgages, including:

- Elimination or reduction of any distortion (whether actual or perceived) due to means testing of pensions which might

currently discourage home owners from turning property equity into an income stream through a reverse mortgage

- Reduction of brand damage potential through private/public sector co-operation on the development of a reverse mortgage contract that better educates and protects the interests of all parties involved – including the property owner, their beneficiaries, the lender, and medical and legal advisers
- Actions by lenders to ensure:
 1. Products sold are engineered to prevent users from drawing down too much equity early in their retirement for consumption purposes. For example, a product might only allow a set withdrawal amount on a monthly basis to fill the gap between existing retirement income and a sustainable lifestyle. (One exception to this might be where the monies are used in the pledge mortgage described earlier, and will most likely be repaid)
 2. Loan contracts that either encourage or require the sale of a property when predetermined loan-to-value triggers are reached (preferably when sufficient equity remains to pursue other retirement housing purchasing options)

Removal of impediments to the supply of Reverse Mortgages would be warmly received by most stakeholders. Lenders would benefit from an ability to assist their customers at all lifecycle stages, as well as exploring a largely untapped source of demand. Governments and retired homeowners would benefit from the provision of an additional solution to the growing problem of pension funding gaps. However, traditional reverse mortgage products have enjoyed limited success in overseas markets, suggesting that Australia will have to continue its track record as an innovator in the global mortgage market to provide an effective solution.

3 Next Steps

This report has focused on the generation of a comprehensive set of opportunities to improve access to, and flexibility of, housing finance for Australians.

First and foremost it is designed to stimulate relevant stakeholders to take actions they deem to be in the mutual interests of themselves and consumers. Indeed, during the early circulation of this report, a number of senior lending executives have expressed interest in initiating projects that take advantage of some of these opportunities.

This report has been a pro bono, largely qualitative effort. Further, the selection and prioritisation of opportunities is based only on initial qualitative assessment by the authors. There may therefore be opportunities that at this point have been overlooked or incorrectly assessed.

Nonetheless, it is hoped that through the circulation of this report a complete set of ideas can be collated, and that with appropriate time and resource applied, all key stakeholders could be engaged. This might, for example, begin in the form of a Housing Summit held to initiate a process that more rigorously defines the actions needed to most fully benefit Australians.

As a starting point, the following major actions should be considered by Government, lenders and other stakeholders.

Government

- Sponsor a Housing Summit to fully and fairly explore the issues and opportunities presented by the Taskforce's three reports
- Explore regulatory changes that would reduce the burden on consumers from LMI and excess costs of capital (for example, encouragement of lender self-insurance, or acceleration of Basel II options). In addition:
 - Ensure that mortgage brokers are accountable for recommending loans that are optimal for the consumer;
 - Fully explore the benefits to home purchasers from creating a white credit utility in Australia; and
 - Ensure that regulations do not (without due cause) prevent lenders from offering the product and credit innovations suggested by the paper.

- Explore regulatory and public education changes that would provide for a personal budgeting tool and education program for first-time home buyers and those with high debt-serviceability burdens. In addition:
 - Provide education (and where necessary additional incentives) to ensure that all home owners are aware of the relative merits of funnelling surplus savings into accelerated mortgage repayment and other forms of savings such as spousal superannuation
 - Ensure that means-testing of pensions does not distort consumer incentives to use reverse mortgages to supplement income, or to use pledge mortgages to assist their family to enter the housing market
- Explore tax and savings scheme changes which would improve home accessibility, in particular, examination of a home super scheme, standardised and improved first-home owner stamp duty exemptions

Lenders

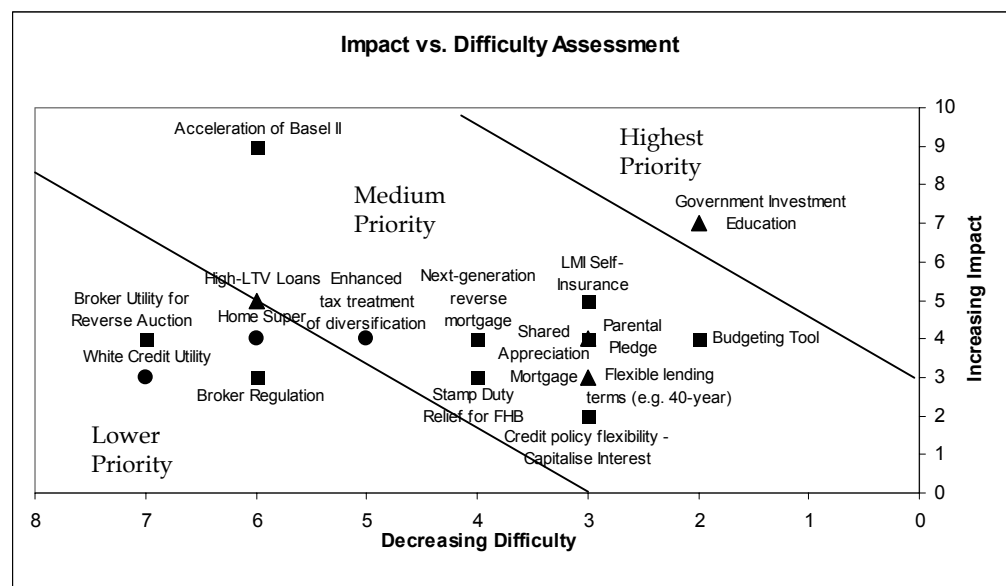
- Fully explore enhanced credit flexibility; in particular, options that include 100 per cent LTV loans, extended payment terms, initial interest only payment periods, and higher serviceability ratios to deserving candidates
- Explore new product options; in particular, the parental pledge mortgage, the enhanced reverse mortgage design proposed in this paper, and the shared appreciation mortgage model detailed by Caplin and Joye
- Explore options to ensure consumers avail themselves of LMI premium refunds, or have access to an alternative insurance product that charges them an annual fee until their loan value ratio falls to 80 per cent

Mortgage brokers

- The mortgage-broking industry body should explore how it can facilitate more competitive credit assessment through more transparent lender credit policy comparison mechanisms, or a reverse auction approach to loan approval and acceptance

4 Summary Portfolio Analysis

The following chart plots the estimated potential positive impact of priority initiatives against the likely difficulty of implementing them. Ahead of full circulation and investigation, this chart is meant only as a guide to further cross-industry prioritisation of key initiatives. Clearly, each stakeholder group will be able to construct their own analysis based on specific prioritisation factors and more detailed knowledge of benefits and costs.



▲ Short Term ■ Medium Term ● Long Term

In order to construct the impact-versus-difficulty analysis shown in the chart, we evaluated each initiative against a five-point scale of impact against each life-stage (that is, first-time home buyers, equity-builders, wealth-diversifiers, wealth-consolidators, those accessing wealth).

Impact was defined as the extent to which a particular initiative would assist a borrower to meet their life-stage needs.

We also assessed each initiative against a five-point scale of difficulty and cost-to-implement for lenders, the Government and other stakeholders (for example, third-party originators). The locus of each

point on the chart is defined by the sum of the scores on the corresponding axes.

We further segregated the initiatives into short, medium and long-term focus by assessing the level of work required in each of five areas: economic analysis, customer research, coordination of multiple parties (for example, lenders and third party originators), legislative changes and systems complexity.

The chart can be interpreted to suggest that the initiatives that would have the highest impact for the lowest cost would include:

- The Government Investment Education Program

In turn, medium-priority initiatives include:

- Acceleration of Basel II
- Enhanced tax treatment of diversification
- Next-generation reverse mortgage
- Stamp duty relief for first-time home buyers
- LMI self-insurance
- Parental Pledge products
- Shared appreciation mortgage
- Flexible lending terms (e.g. 40 years)
- Credit policy flexibility (e.g. capitalise interest)
- A budgeting tool

5 Conclusion

Australia is already seen as a major source of innovation in the mortgage lending industry, and is frequently looked to by overseas lenders as a source of best practices⁵¹. With the realisation of wealth from investment in property so clearly a goal in the minds of many Australians at all stages of the ownership life cycle, a stream of new low cost opportunities is emerging to address the remaining inhibitors to accessible and flexible mortgage lending in Australia.

The authors believe that through the exercise of prudent initiatives, the major stakeholders in the Australian mortgage lending industry can build upon the advances made over recent years, both to streamline the functioning efficiency of the housing finance market, and to realise the promise of flexible, accessible home ownership for the greater Australian public.

⁵¹ Booz Allen Hamilton Analysis

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