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THE POTENTIAL PINCH OF THE ROYAL COMMISSION

Nicole McMillan

Financial advisers have been knowingly charging fees to customers who died up to a decade ago. Bank employees accepted cash bribes to falsify proof of employment documents in loan applications. Banks have entirely inadequate processes in place to verify borrowers' financial information. These examples of bad behaviour on behalf of Australia's most prominent financial institutions are just the tip of the iceberg in terms of what the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has uncovered so far. Just a few months in and it is already apparent that the commission is not restoring confidence in the financial sector as was hoped by the government and the financial sector itself.

This article discusses the ever-evolving and ongoing Royal Commission. First, we explain why there were calls for the inquiry in the first place, describe the political landscape that made it unavoidable and highlight the commission's mandate. We discuss the common inherent weaknesses across the sector as a whole and discuss the extent of irresponsible behaviour on behalf of the banks. In the latter half of the feature article, we discuss the likely implications of the commission, with the most probable being tighter lending standards. The extent of the ramifications depends on how much tighter the lending standards get, but a credit crunch, trouble in the Australian property market and subdued economic growth are certainly not out of the question.

The Royal Commission

Banks behaving badly

Australia went through the global financial crisis (GFC) relatively unscathed as compared to many of its developed market peers. At the time, it was largely believed that the country's banking sector not needing to be bailed out was because of relatively sound banking regulation. However, in the years since, a series of scandals have plagued Australia's four major banks – Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac Banking Corporation (WBC). The scandals have involved a whole range of allegations, including poor financial advice given, failure to honour insurance claims, the manipulation of benchmark interest rates and the mistreatment of small business owners. Since the GFC, Australian banks have paid more than $1 billion in fines and compensation.

Mounting political pressure

In 2016, Leader of the Opposition, Bill Shorten, announced his plans for a Royal Commission into misconduct in the banking sector should the Labor Party win the 2016 federal election. Shorten came a very close second in the 2016 federal election, so he was unable to implement his proposed inquiry. Prime Minister Malcolm Turnbull did not want a Royal Commission on his watch. If it were not for a combination of calls for one within his coalition government, his one seat majority and the dual citizenship saga, he might have been able

The quote

The Royal Commission has uncovered a great deal of unsavoury conduct by the country's largest financial institutions, particularly as it relates to household and small business lending.

to wriggle his way out of one. Similarly, Australia's big banks were initially wholly opposed to an inquiry, knowing full well that past errors and episodes of misjudgement would be put on display. But the banks' realisation that the political uncertainty about a potential commission was hurting confidence in the sector caused them to change their tune, and ultimately demand the Turnbull government to call a Royal Commission.

Having been politically cornered, on 30 November 2017, Turnbull begrudgingly announced that the government would be establishing a 'regrettable but necessary' Royal Commission into the alleged misconduct of Australia's banks and other financial institutions.

The mandate

Royal Commissions are a type of public inquiry and are appointed by the government to provide advice or to investigate a particular issue. They differ from other types of inquiries because they have a broader investigatory power, and they have the power to summons witnesses to appear before them as well as to produce documents and any other material pieces of evidence.

Per the terms of reference, this Royal Commission must inquire into a variety of matters, including the nature, extent and effect of the misconduct by financial services entities, as well as if any conduct, practice, behaviour or business activity on behalf of these entities falls below community standards and expectations. The commission will also be targeting the superannuation and insurance industries.

In December, Kenneth Hayne, a former Justice of the High Court of Australia, was appointed to lead the commission. Hayne is required to deliver an interim report to the government no later than 30 September 2018, and a final report by 1 February 2019.

Extent of the irresponsibility

To date, the Royal Commission has uncovered a great deal of unsavoury conduct by the country's largest financial institutions, particularly as it relates to household and small business lending. In this section, we discuss the magnitude of the issues, which leads into the discussion about why these issues are so concerning.

Household Expenditure Measure

The Household Expenditure Measure (HEM) is a living expenses estimation tool widely used by the country's banks. The tool estimates living expenses for different types of households, including single and couple households with and without children. Lifestyle is also classified across four categories: Student, Basic, Moderate and Lavish. While borrowers are expected to provide an estimate for their living expenses, they are incentivised to provide an underestimation. Thus, banks use the HEM to ensure that a minimum level of living expense is used.

The Australian Prudential Regulation Authority (APRA) expects banks to use the greater of a borrower's declared living expenses and the HEM, provided that the latter has been appropriately scaled for the borrower's income. Scaling is expected given that it is assumed that a high-income household that lives a 'Lavish' lifestyle spends considerably more than a low-income household that lives a 'Lavish' lifestyle.

According to a study conducted by investment firm UBS, until the end of 2017, around 70-80% of all mortgages in Australia were underwritten using the HEM benchmark rather than using a more appropriate estimation of a borrower's actual living expenses. UBS also argues that in the vast majority of these cases, the 'Basic' lifestyle was assumed.

Up until the end of 2017, the HEM assumed the same annual living expenses for all incomes based on the classification of their lifestyle (i.e. basic versus lavish). In other words, a low-income household that lives a basic lifestyle would have the same annual living expenses as a high-income household that lives a basic lifestyle. The same relationship applies for the other classifications of lifestyle.

In Table 1, we present UBS's analysis regarding the implications of assuming the same level of basic living expenses across a range of gross incomes. The table assumes the borrower under consideration is a family of four, which has assumed 'Basic' living expenses of A$32,400. Furthermore, the borrowing limits have been calculated as the average across the big four banks given the same gross income and living expenses assumptions.

Table 1. Implications of pre-2018 HEM benchmark, assuming basic lifestyle (A$)

Gross income	HEM living expenses	Borrowing limit	Loan-to-income ratio
80,000	32,400	337,985	4.2x
100,000	32,400	484,315	4.8x
125,000	32,400	643,892	5.2x
150,000	32,400	817,340	5.4x
200,000	32,400	1,144,225	5.7x
500,000	32,400	3,141,171	6.3x

Source: UBS, Major banks

The HEM benchmark is now scaled by income level, such that those with higher incomes have higher living expenses (which makes intuitive sense given that they can afford nicer cars, eat out more, etc.). However, for loans made before this change was implemented, the assumption of the same basic lifestyle across all income levels meant that wealthier borrowers were able to take out loans up to six times the size of their annual income, regardless of whether the borrowers' lifestyle meant that they could afford the repayments or not.

Given that the majority of families who have taken out mortgages over the past several years had lifestyles considered basic, is A$32,400 a reasonable estimation for living expenses? The current old age pension for an Australian couple (who more than likely has no dependents) is A$32,385 annually. It is hard to fathom in almost all circumstances how a family of four could have living expenses that are on par with a retired couple. Children are not cheap.

Liar loans

Another issue that is consistent across all the major banks is their reliance on borrowers' stated debts and living expenses, as a result of inadequate verification systems in place. Borrowers are understandably incentivised to overestimate their incomes and underestimate their expenses when they are applying for a mortgage. UBS conducted a survey of 907 borrowers who had applied for a loan in the 12 months to August 2017. The survey found that approximately one third of its respondents had not provided factually accurate information.

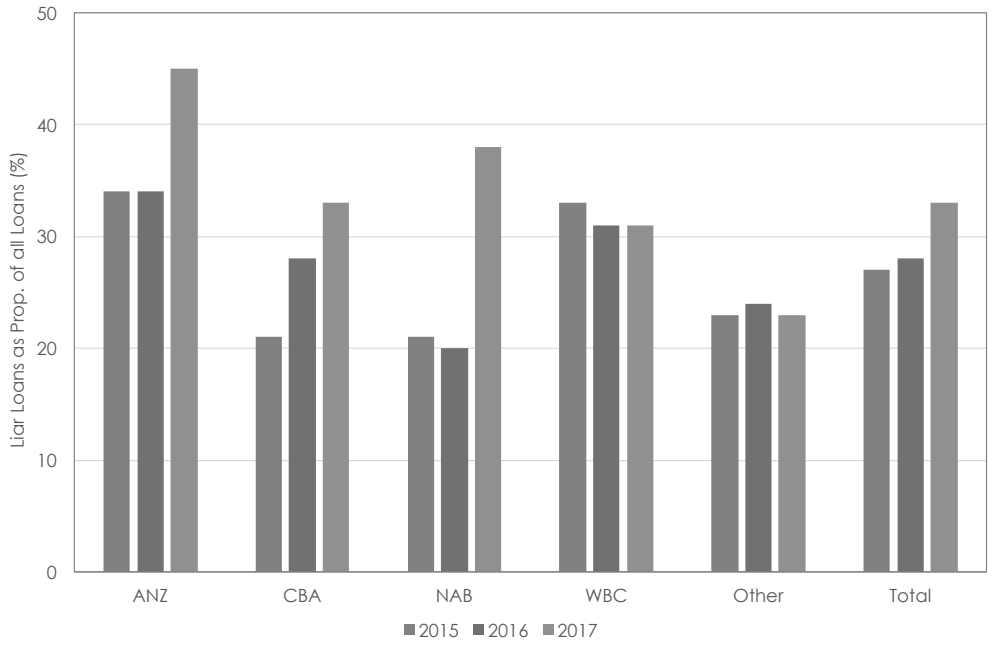
The term 'Liar Loans' was coined during the GFC and was used to describe mortgages that either had no or very little documentation associated with them. Liar loans were considered one of the main contributors to the GFC given that a substantial portion of the poor performance of the loans securitised in the mortgage-backed securities market was caused by fraudulent lending processes. The Australian financial sector is a great deal more regulated than its pre-GFC American equivalent, as noted by the fact that less than 1% of mortgages in Australia are considered to have a low level of documentation. However, given that UBS estimates that one third of those taking out mortgages stated that their application was not 'completely factual and accurate', mortgages that are not considered to have a low level of documentation could fall into the liar loan category. A high rate of liar loans is an issue across all the big Australian banks, per Figure 1.

Per UBS's estimations, the high rate of falsified information has led to as much as half a trillion dollars of factually inaccurate loans in the Australian financial system, equivalent to approximately 30% of the $1.7 trillion of housing debt that is outstanding.

The quote

The commission has shown the need for tighter lending standards, particularly as it relates to home loans … the biggest portion of lending among Australian financial institutions.

Figure 1. Proportion of liar loans of all home loans for the major banks, 2015 - 2017



Source: UBS, Whitehelm Advisers

Could the Royal Commission lead to tighter lending conditions?

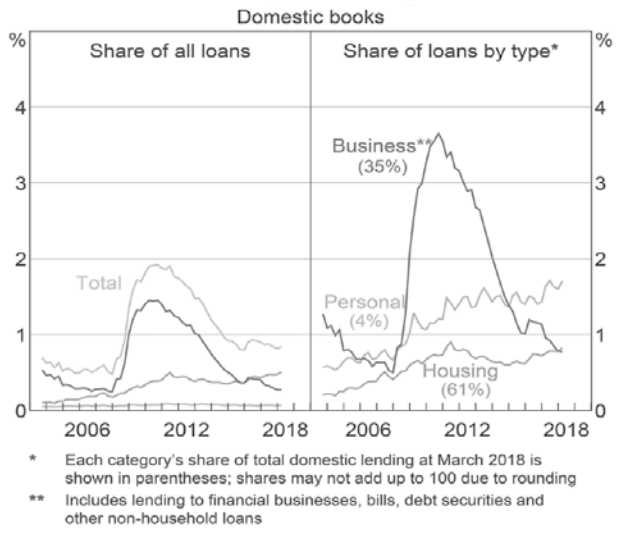
When the commission was being heavily debated ahead of its eventual announcement, many critics argued that it would be a waste of taxpayer dollars and regardless of its findings, its recommendations could fall on deaf ears. The findings of the inquiry so far have painted a far gloomier picture of the banks than was initially anticipated. What is so worrying about this? How much regulatory power does the commission wield? What, if any, are the regulatory changes that could be implemented? Finally, what political considerations are involved?

The findings so far are worrying

Opinions differ on the extent of the volume of mortgages in the Australian financial system that are based on factually inaccurate information. UBS's analyses present a worst-case scenario given that many other market analysts do not expect the problem to be as quite as extensive. Nevertheless, it is important to understand why markets, politicians and everyday Australians are worried about the revelations of the commission to date.

The lack of adequate verification systems in place to ascertain borrowers' actual financial standing is expected to have inflated the amount that homeowners should be able to borrow. In today's financial market conditions where interest rates are at all-time lows, this is a relatively minor issue because borrowers are able to keep up with their payments. Figure 2 shows the very low rate of non-performing loans across all Australian banks. The number of loans that are classified as past-due has increased somewhat over the past few years, but this primarily relates to the end of the mining boom.

Figure 2. Australian banks' non-performing loans



Source: RBA chart pack

Even without the extent of loans that are based on factually inaccurate information, an increase to interest rates is likely to cause borrowers a great deal of pain. Figure 3 shows the dramatic increase in the level of household debt, particularly over the past seven or so years, as well as the steep ascent of house prices (which typically equates to higher loan values) over the same timeframe. It is not difficult to see how even a 1% move in interest rates could be crippling for many households, but particularly for those who have been granted loans that are not suitable for their financial position.

Figure 3. Housing prices & household debt, ratios to annual disposable income

Source: RBA, ABS, Bloomberg, Whitehelm Advisers

Thus, even a marginal increase to interest rates could cause the volume of loans in arrears to rise, potentially leading to an increased level of defaults. Furthermore, a housing downturn could have a larger impact on the economy than originally anticipated. For banks, it would mean that the loss given default on their mortgage books would be larger than what they are currently planning for.

Another risk for the banks is the risk of litigation given that if interest rates go up their borrowers may suddenly realise that they were mis-sold loans that are not suitable for them. The borrowers will want to blame those they consider responsible. This will be particularly notable if house price inflation slows or turns negative. It has already been shown through the Royal Commission that banks do not have adequate systems in place to provide timely and adequate compensation to its customers. This situation could be magnified significantly if there is weakness in the property market.

Ultimately, the financial crisis found its footing because of the extent to which loans were written when they should not have been. While we do not expect that the issue in Australia is anywhere near to the same extent as it was in the US pre-GFC, it is no wonder why there have been calls for a regulatory overhaul as a result of the Royal Commission.

The Royal Commission's Powers

The *Royal Commission Act 1902* enables the commission to inquire into and report upon any matters as specified in the Terms of Reference, and can refer any suspected contraventions to the relevant regulators for enforcement. It can also provide advice, information and options to the government about a particular policy problem, which would be expected in both the interim report for this commission, due in September, or the final report due on 1 February 2019.

While the commission will not award disputes for individuals' grievances, it can refer issues to the relevant regulator to deal with accordingly. For example, the commission could send ASIC its findings on a matter, at which point ASIC could decide if it will commence enforcement proceedings. The commission helps ASIC because ASIC has to show that it has *'reason to suspect'* that an infringement may have occurred before it can initiate formal investigations. Since the commission does not face the same burden and can investigate more freely, it can refer any issues directly to ASIC.

Potential regulatory changes

Aside from any matters that the Royal Commission refers to regulatory bodies, it will also prepare a final report for the government, which includes recommendations. The government could choose to adopt any or all (or none) of such recommendations. Some of possible recommendations that could come of the commission are as per the list below.

- **Improved verification systems:** The banks could be forced to implement improved systems to ensure that accurate and factual information is being used in the processing of mortgage applications. The fine-tuning of lending standards has been and will continue to be a gradual process that is already done by the banks and enforced by APRA.
- **Potential fines:** The commission has already recommended that AMP face criminal charges for misleading the regulator. Potential penalties for a criminal breach are $210,000 per charge and $1 million for each civil breach. These fines are very minor in comparison to Australian banks' profits.
- **Changes to broker commission structures:** A recommendation from the commission could be that brokers' remuneration schemes have to change to be less reliant on the volume and value of loans written for the commissions and bonuses that brokers make. Serious conflicts of interest result from these types of commission structures.
- **End of vertical integration:** The big banks' vertically integrated wealth management systems may be forced to spin off from their parent companies because of the conflict that arises when wealth management companies are entwined with the big banks. The conflict arises when bank tellers recommend clients to bank-controlled financial advisers, who recommend them to use bank-owned platforms and invest in bank-managed products.
- **Adequate redress schemes in place:** The commission has discussed several instances in which appropriate redress schemes were not in place to ensure that any customers affected by wrongdoing were adequately compensated in a timely manner. Regulation may be put in place to ensure that banks have enough capital set aside to pay out customers in the case of a breach of policy.

Political considerations

The Royal Commission has obviously left the Turnbull government feeling somewhat sheepish in that it resisted the commission for so long, yet the findings have shown some poor behaviour on behalf of the country's financial institutions. However, what the government inevitably takes away from the commission is still very much up in the air. The government is not legally bound to implement any of the recommendations that arise from the commission. As we discuss in the next section, tightening lending standards has the potential to disrupt the economic and financial stability (with the potential of inducing an outright recession) that the country has been experiencing for some time, and no government will want to be the one responsible for setting this chain of actions into motion.

That said, the media and market reaction to the commission has been with a great deal of disdain, which will likely put pressure on the government to act. This could eventuate into something relatively superficial so that it appears that the government is doing something, but not enough to upset the balance. An example, while not implemented by the government, is the capital charge of $1 billion that APRA handed down to CBA as a result of a review that it undertook regarding CBA's culture which encouraged poor decision-making and complacency. While a capital charge of that size seems severe and makes for a good headline, the punishment is actually quite minor. CBA's half-year profit to end 2017 was almost $5 billion.

Implications of tighter standards

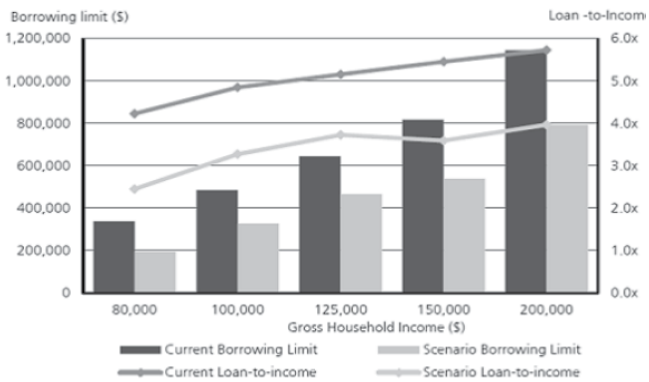
To be able to estimate the implications of tighter lending standards, it is important to understand in what ways these tighter standards would be implemented. As discussed in the previous section, there are multitudes of ways that tighter regulations could be enforced, from changing broker remuneration schemes, to enforcing the use of more realistic approximations of living expenses. However, should this occur as a result of the Royal Commission, the most likely implication will be that credit will be more difficult to come by.

Credit crunch

Since the GFC, credit growth in the housing sector has been robust, growing at an annual rate of 7-8% per year.

According to UBS, if one of the results of the Royal Commission is for banks to be required to strengthen its verification systems used to verify borrowers' financial systems, or for banks to use more realistic approximations of living expenses, it could cause housing credit growth to slow significantly. UBS estimates that banks using more realistic expectations could cause borrowing power to fall by as much as 35%: 25% in 2019 and a further 10% in 2020. This could cause loan-to-value ratios to fall dramatically. Falls of this magnitude are consistent with those seen in overseas markets during the financial crisis. The potential impact that this would have on borrowing limits and loan-to-income ratios is shown in Figure 4.

Figure 4. Effect of tighter lending standards on borrowing limits, by income level



Source: UBS

It is important to note that UBS's approximations are much more pessimistic than other analysts. That said, a more watered-down tightening of lending standards would result in implications similar in nature, but potentially less destructive in magnitude.

Implications for the property market

The appreciation of Australian house prices over the past several years has been driven by supply side and demand side factors. The country's strong economic growth, population growth and generous tax policies have all increased demand for housing, particularly in the capital cities. Construction activity not being able to keep up with demand, as well as strict regulation over land use, has choked off supply. Based on economic theory, when supply decreases (or stays the same) and demand increases, prices will go up.

On top of all of these factors, cheap credit through historically low interest rates has likely been the most dominant contributor to the house price appreciation. Not only do low interest rates make debt servicing significantly cheaper for homeowners, it also makes property a very attractive asset class for investors. Combined with the very favourable tax policies that make investing in property both feasible and appealing (negative gearing and capital gains tax discount), investors have rushed into the property market.

As a result, house prices are not determined just by the supply and demand for housing, they are also determined by the supply and demand of credit. With less credit available, potential homebuyers cannot afford the same price points on housing and therefore prices are likely to fall accordingly. An alternative way of thinking about this concept is that house prices are determined by where supply and demand meet through time. Housing demand can be funded by either equity (physical cash) or debt. If the availability of debt reduces by as much as UBS is expecting, the debt must be replaced by equity or by seeing a reduction in demand. In this case, a reduction in demand is akin to a fall in the price that a purchaser is able or willing to pay.

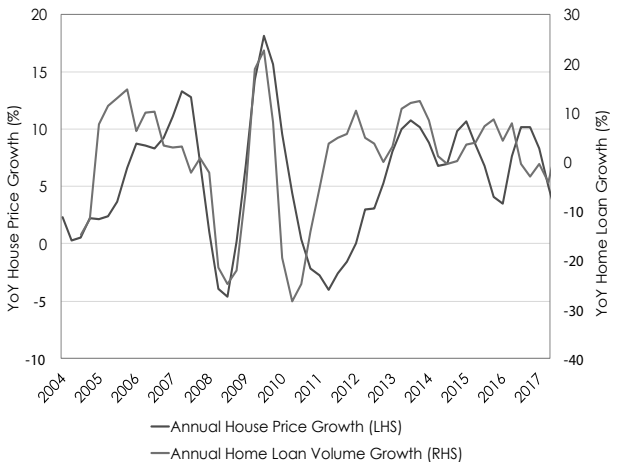
Figure 5 shows the historical relationship between credit growth and house prices, dating back to 2004. House price growth has closely tracked home loan growth.

We have already started to see cooling housing prices in the capital cities that have seen such rapid price growth. In part, this has been caused by housing supply catching up with demand (there can be a several year lag from approval to completion). But the tightening credit conditions as a result of APRA's regulations surrounding loans made to investors rather than owner-occupiers and interest-only loans, has also caused house price growth to slow.

However, should credit conditions tighten further, it is difficult to ascertain the extent to which house prices could fall. This is largely because there is no reasonable precedent in Australia for a sizeable property market correction. Even during the financial crisis, house prices only fell an average 8%. We say only because it was a relatively small drop compared to the house price falls experienced overseas. Given that the RBA cut rates by 4.25% following the GFC, the property market was quickly reflated. With the cash rate at only 1.50%, the RBA does not have much firepower to reflate a property market if we were to see a dramatic fall in prices.

If banks are required to use more appropriate and precise approximations for borrowers' living expenses, it could lead to other perverse outcomes for the property market. Presently, prospective homebuyers can secure pre-approval for a home loan from many different financial institutions. The information required to gain pre-approval differs drastically by institution. Some lenders provide online approvals in a matter of minutes, while others need all of the financial standing details that are required for the more formal loan approval process. The lenders that provide the quick approvals often use the HEM benchmark as the estimate for living expenses, so should it be regulated that banks cannot rely as heavily on such benchmarks, lenders will be less able to provide pre-approvals. If these regulations are implemented, we expect to see the upstream impacts come through first, these being an increase in the amount of homes on the market, an increase in the number of days it takes to sell, and a fall in clearance rates at auctions. From here, the downstream effects would become evident through falling prices. Additionally, if the rigour required to process loans is increased because of the extra due diligence required, processing times for mortgages will increase dramatically.

Figure 5. Relationship between credit growth and house prices



Note: Home loan growth is advanced by two quarters.

Source: ABS, RBA, CoreLogic, UBS, Whitehelm Advisers

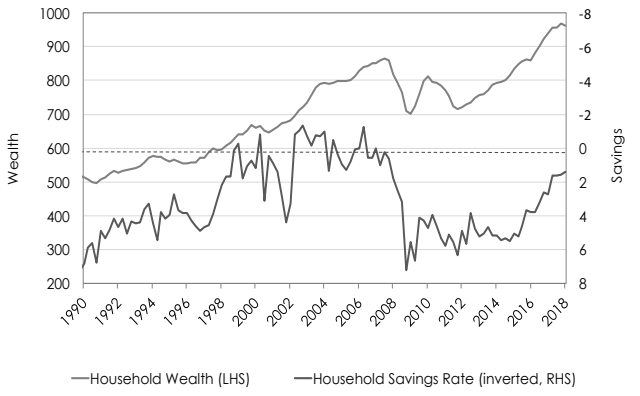
Broader economic implications

Credit growth and house prices have a much broader macroeconomic significance, due to their impact on housing and spending. Housing makes up a significant portion of household wealth, and is the single largest asset for many individuals. Changes in the value of housing can have a large impact on consumer spending due to the 'wealth effect'. The Australian Housing and Urban Research Institute estimates that every $100,000 increase in housing wealth reflects an increase in consumption of between $1,000 to $1,500 in Australia. Figure 6 illustrates the concept of the wealth effect over the past several years. As house prices have increased, so too has household wealth. The additional household wealth has caused consumer spending to increase, or the household savings rate (inverted in the figure) to fall.

The impact of falling house prices on the economy would likely be significant, particularly if combined with a severe rationing of credit. If a credit crunch is severe enough, it could result in a rise in unemployment, which magnifies the likelihood that homeowners will be

unable to repay their mortgages. If it led to a severe economic slowdown and recession, the RBA would be forced to lower the cash rate off its already historically low base.

Figure 6. Household wealth and savings rates, as a percentage of household income



Source: ABS, RBA, UBS, Whitehelm Advisers

Financial market implications

Australian banks are heavily exposed to property prices due to their large holdings of domestic mortgages. Residential property loans make up 60% of overall lending in Australia, a much higher share relative to many other countries. Mortgage lending has been a key source of profitability for the major banks, and they have benefited greatly from rising household leverage. Should the property market experience a sustained downturn, Australian banks are likely to take a significant hit. Combined with the costs that come with implementing improved compliance processes, changing remuneration schemes and improving lending standards, bank profitability will likely be impacted.

The Australian share market is a concentrated market in terms of exposure to certain key sectors, with the financial sector being the most dominant. As of mid-July, 33% of the ASX 300 Index was made up of financial sector stocks, with the big four banks alone accounting for 23% of the index. Therefore, a significant hit to the banks because of pressure in the housing market would have significant implications for investors heavily invested in the Australian share market. According to SuperRatings data, Australian super funds have typically maintained a 25-30% exposure to Australian equity.

If the financial sector was to come under pressure because of tightening lending standards and coinciding trouble in the housing market, it is unlikely that equities would be the only asset class to experience downside implications. Banks would pay lower interest rates on cash accounts, so super funds with large cash holdings would receive lower rates of return (albeit positive). Australian government bonds would likely be the star performer in this type of investment environment, notwithstanding their current low levels of return offered. Debt issued by the government rather than financial institutions would quickly become far more attractive.

Conclusion

While Australian financial institutions have experienced their fair share of scandals over recent years, it is safe to say that most market observers were not expecting the extent to which they have been dragged over hot coals thus far in the Royal Commission. Cross-examination has led to some shocking revelations, and the executives of the nation's most trusted financial institutions have been forced to accept ownership for the mistakes made by the organisations that they run.

To date, the commission has shown the need for tighter lending standards, particularly as it relates to home loans, which happens to be the biggest portion of lending among Australian financial institutions. The banks, as well as the relevant regulators, are continuing to make improvements in this space, however the commission could expedite this process. If the improvements continue to happen behind the scenes, it will likely be a relatively smooth transition, given that such improvements have been made over the past several years without the market taking much notice. However, if the government decides to accept the commission's expected recommendations, the implications will likely be far less placid. A credit crunch could be the result, which inevitably has knock-on implications for the all-important Australian property market, the broader economy and the share market.

Tighter lending standards are certainly positive for the credit market over the long term because it ensures that borrowers can afford the loans they are approved for and improves the resilience of both borrowers and subsequently the property market in times of stress, such as a rise in unemployment or a rise in interest rates. However, the journey towards improved standards is likely to be a rocky one, with a slowdown in the property market and economic growth highly likely. That said, the government is conscious of these trade-offs and will be very wary of not upsetting the state of relative balance that the Australian economy currently finds itself in. It will be navigating its own trade-off of appearing to be doing something about the findings of the commission, while ensuring that it does not do too much. Ultimately, the calling of the commission was incredibly politically divisive, and so too could be what comes after it. **FS**