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The Residential Mortgage (De)regulation–Innovation nexus

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Abstract

The stance of Australia's central authorities with respect to residential mortgage innovation appears different from many of our international counterparts. In this article we provide an interpretation of this policy stance, concluding that signals are arguably a more prominent feature of Australia's policy environment than many of our overseas counterparts. In addition we also observe that whilst there is a strong link between innovation and (de)regulation, a healthy degree of competition appears to be necessary if a wider-set of consumers are to have access to these innovations.

Introduction

The overall effect of mortgage product innovation has been hotly debated in recent times.[1] In some quarters it is seen as to have encouraged risky lending practices exposing economies to unacceptable levels of aggregate risk. A number of central authorities in the wake of the financial crisis have subsequently intervened in the residential mortgage market limiting the products available (for example Singapore and New Zealand[2]). Fears of impending house price bubbles and public concerns about cavalier lending practices have been cited to justify these interventions. In a recent report it was stated that 25 economies have experienced similar centrally administered interventions otherwise known as macro-prudential policy measures (IMF, 2011).

[1] See for example the US Government's Financial Crisis Inquiry http://www.gpo.gov/fdsys/pkg/GPO-FCIC/content-detail.html accessed 10/7/2013

[2] http://www.mas.gov.sg/~/media/resource/news_room/press_releases/2013/Annex%20II.pdf ; http://www.rbnz.govt.nz/financial_stability/macro-prudential_policy/5393159.html ; Accessed 16th April 2014

The approach Australian regulatory bodies have adopted seems to be different. Consider an extract of a recent speech[3] by APRA's Chairman, Wayne Byrne, in his appearance before a senate committee:

> "First, within our regulatory framework APRA generally seeks to avoid outright prohibitions on activities where possible: instead, our regulatory philosophy is to focus on institutions' setting their own appetite for risk."

This approach has remained despite the loud and regular commentary that residential properties in Australian capital cities are some of the most expensive in the world (see for example Demographia, 2014).

Recent Australian economic experience in the residential housing market differs from many of its international counterparts. In particular, there has been no significant house price correction or acceleration, at least not on the scale of countries like the US and Ireland. This leads us to ask: why is Australia different? Answers to this question are many and varied. They include reference to the institutional and legislative structure and particular features of Australia's various housing markets.[4] This article presents a review of some of the major mortgage market innovations to illustrate one dimension of this story; the (de)regulation–innovation nexus.

Australian Prudential Management

Before we identify the (de)regulation–innovation nexus it is important to observe that Australian regulators have not been lax in their approach to managing aggregate risk. For example, the RBA through its many vehicles has been very active in signaling to the market to curb any "risky lending behavior".[5] Further, although macroprudential laws forbidding particular loan features, high loan-to-value (LTV) ratios, for example have not been passed, significant changes by APRA to the National Consumer Credit Protection (NCCP) legislation have been made curtailing the lending behavior of mortgage originators.

The Australian approach is typified by the following quote by Philip Lowe, Deputy Governor of the RBA in a recent speech[6] where he discussed aggregate risk:

> "It is also important to point out that the fact that the Bank and APRA are talking about these issues does not mean that a return to the type of heavy regulation we saw in earlier decades is on the agenda. That earlier experience demonstrated all too clearly the distorting effects of such regulation as well as the ability of financial institutions to

[3] http://www.apra.gov.au/Speeches/Pages/Opening%20statement%20to%20the%20Senate%20Standing%20Committee%20on%20Economics%20October%202014.aspx Accessed 22nd October 2014
[4] See the following speech for example http://www.rba.gov.au/publications/fsr/2014/mar/pdf/0314.pdf, page 2.
[5] The following speech is just one example of the active signalling campaign the RBA has been engaged in. http://www.rba.gov.au/speeches/2012/sp-so-230212.html Accessed June 6th 2014
[6] http://www.rba.gov.au/speeches/2010/sp-ag-300310.html#f1 (accessed October 22nd 2014)

> circumvent it, including by activities outside the regulatory net. As it turns out, the financial system is very good at finding ways of getting money from the people who have it to those who want to borrow it, although perhaps less good at containing aggregate risk. All this means that we need to be realistic about what can be achieved through changes in the regulatory parameters alone. This realism, however, need not preclude consideration of modest and sensible changes within the existing prudential framework."

Importantly, we also observe that the policy makers in Australia have not been concerned with "innovation" per se – rather "risky lending behaviour" which is *sometimes* manifested in the form of innovations. Guy Debelle's (Assistant Governor (Financial Markets) RBA) address[7] to a Mortgage innovation conference highlights this distinction:

> "Through the late 1990s and first half of the 2000s, there was considerable product innovation in the Australian mortgage market. Lenders sought to cater for a wider range of potential borrowers and found new ways to assess their borrowing capacity. Some of this innovation has resulted in an easing in lending standards and an increase in risk for both borrowers and lenders, but its overwhelming effect has been to widen the range of households who can access finance. Moreover, when the lending was more risky, lenders charged a larger spread on these loans to take account of the greater risk and required lower loan to valuation ratios (LVRs) for these loans."

The degree to which these concepts (aggregate risk and mortgage product innovation) are distinguished is fundamentally important. In contrast to many international counterparts the policy stance of Australian authorities seems to be that they accept there is some association between the two as well as a limit to the effectiveness of regulation.

Recognising the limitation of regulations is neither a recent nor Australian-centric phenomenon:

> "As financial systems become more complex, detailed rules and standards have become more burdensome and ineffective, if not counterproductive. If we wish to foster financial innovation, we must be careful not to impose rules that will inhibit it." Greenspan (p48, 1997)

The Australian approach to prudential management can plausibly be characterised as having a stronger emphasis on signaling when compared to similar advanced economies and that this has been complemented by an institutional regulatory approach. There seems to be an acceptance by Australian authorities that there are limits to what regulation can achieve.

Based on Australia's relative economic stability the signaling-regulatory mix appears to have been effective in managing aggregate risk. This suggests a major challenge for prudential

[7] http://www.rba.gov.au/speeches/2010/sp-ag-300310.html Accessed 21st October 2014

authorities is to maintain the integrity of the signal. Further, that any temptation to (over) regulate activity is resisted in the interest of promoting an efficient financial market.

The Policy Context

There is no global consensus as to whether policy settings should be supportive of financial innovation (as they generally are for technological innovation) or inhibitory to it (as they generally are in environmental regulation). This policy uncertainty can be attributed to two factors. One is the difference between a real and a monetary economy and the associated difficulty of translating the effects of innovation in the finance sector to the real economy (where welfare gains accrue). The second reason is the different way in which innovation happens in finance compared to other sectors. Commonly, innovation in the financial sector occurs as exogenous constraints are relaxed, whether this is due to technological or regulatory change. Merton Miller[8] in reflecting on a period of unprecedented "innovation" in financial products in the 20 years to the mid-1980's, states that:

> "Many of the financial innovations…already existed in one form or another for many years before they sprang into prominence. They were lying like seeds beneath the snow, waiting for some change in the environment to bring them to life."

In the past, changes in regulation has been motivated by goals of maintaining economic stability and maximising wealth. Gerardi *et al* (2010) argue that one of the most significant reasons for deregulating the (US) mortgage market was to cope with the challenges of high inflation. They suggest the resulting innovations served the industry well during the 1980s through to 2005. They further argue that the 2007 crash was not so much a result of the mortgage market innovations but rather that lending institutions were poorly prepared for collapsing house prices.

Interestingly, research focusing on the US and European markets concludes that market efficiency has been enhanced as a result of the recent deregulatory phase and ensuing product innovation of the markets (Gerardi *et al* (2010) and Scanlon et al (2008)). Scanlon et al (2008) further observed that whilst liberalization has been an international phenomenon, this does not mean the markets are necessarily converging, rather they appear to be evolving in parallel, governed by different region-specific legislative frameworks.

(De)regulation and Innovation

It is commonly accepted that the 1980s was the beginning of a major phase of financial deregulation in Australia. This deregulatory phase continued many years lasting well into the 1990s. It began with the floating of the exchange rate in 1983. In the same year it was

[8] Miller (1986)

announced that ten banks would be allowed to enter into the market (domestic and foreign owned). In the years that immediately followed there was much deregulation including the removal of all remaining controls of bank deposits and interest rate ceilings for owner-occupier loans (Williams 2009). A more comprehensive list of regulatory changes is presented in de Silva *et al* (2015).

It was not until the 1990s that competition really started to increase in the home mortgage market. This was typified by the beginning of the Commonwealth Bank privatisation in 1991 followed by the appearance of the first home loan originator *Aussie Home Loans* in 1992. By the end of 1990s the market had matured to be a highly competitive and innovative sector (Williams 2009).

To explore the (de)regulation–innovation nexus, it is necessary to have an historical account of both regulatory and innovation changes in the mortgage market. Prior to this research, no such account existed. This represented a significant challenge. Our solution was two-fold:

1. Gather as much information from secondary sources as possible.
2. Interview mortgage industry representatives from the wholesale and retail sectors and from industry bodies.

For the first part we scoured media releases from Australian central authorities, focusing mainly on the RBA and APRA reports, senate enquiries and the like. A richer form of information, however, was gathered from our interviews. We conducted semi-structured interviews until a broadly consistent picture emerged. In aggregate our interviewees had over 100 years of mortgage industry experience spanning both the retail and wholesale markets

The main innovations identified were: (1) high loan to value mortgages; (2) mortgage brokers; and (3) securitisation. Interestingly, tweaks to mortgage products including interest only and low/no doc loans did not seem to feature heavily in the interviews.

We were intrigued to discover that the majority of these “product” innovations appeared well before the beginning of the deregulatory phase. For example, one interviewee reported that the first loans to be offered with less than 25 percent deposit occurred as early as 1965. Further, the mortgage broking industry first appears in 1972 – although there is some dispute as to whether it first appeared in NSW or WA. Similarly, the first mortgage-backed security emerged in 1979, and in its initial stage it was purely a non-bank product. These accounts suggest that these innovations in the Australian market occurred prior to major episodes of deregulation (supporting Miller’s observation quoted earlier). Importantly, although the changes may have occurred prior to the major phase of deregulation, there is evidence that the two are not independent. Specifically, one interviewee recounted how they had personally advocated changes in legislation to permit innovative products to become viable.

Obviously there were many other minor innovations identified in our investigation, and which occurred throughout the 1980s and 1990s, that we have not explicitly discussed here. A more comprehensive review of these innovations is presented in (de Silva *et al*, 2015). Importantly, we observe that these innovations emerged at the time when the mortgage lending sector was experiencing intense levels of competition.

We can summarise our analysis of how mortgage product innovations emerge as follows:

- They were often introduced by fringe market operators (typically non-banks).
- At least three major innovations (LTV changes, Mortgage Broking and Secruitisation) predate the major (1980s) deregulation phase.
- The number of product innovations multiplied dramatically in the 2000s
- The period of early- to mid-2000s represents a time of heightened competition resulting from the initial changes of the deregulation phase.
- The impact of many of the early innovations did not reach their peak until the 2000s.

This summary suggests that the (de)regulation–innovation nexus is best described as inter-dependent. Further, that while deregulation may be a necessary condition of innovation, consumer accessibility to innovative products increases with competition.

Conclusion

The Australian policy/regulatory environment has a strong signaling component. The extent to which this instrument remains effective therefore depends on the clarity and the importance that market participants place on the signal.

We briefly reviewed the policy context, reporting that previous studies have concluded that market efficiency has improved as a result of this deregulatory phase. Interestingly, it was also reported that although markets have been evolving globally they have not been necessarily converging.

The Australian experience of the innovation–regulation nexus is that major mortgage innovations largely predated the deregulatory phase that begun in 1980s, and furthermore that innovation often occurred in the fringes of the markets. Yet (de)regulation and innovation are indeed linked, as we also observed that these innovative products only became available to the *general* consumer when competition increased as a result of deregulation.

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