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Thomas Choi: What new home lending rules mean for investors

By Perpetual Asset Management

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APRA's tighter lending rules are good news for income investors, improving mortgage quality ahead of next year's potential rate rises. THOMAS CHOI explains.

- APRA imposing new debt-to-income limits
- Tighter lending standards improve mortgage performance
- Find out about Perpetual's Credit and Fixed Income capabilities

New lending restrictions designed to cool Australia's hot housing market should improve the quality of residential mortgage-backed securities, making them more attractive to investors seeking defensive income, says Perpetual's Thomas Choi.

The Australian Prudential Regulation Authority has announced its first ever debt-to-income limits on lending, restricting borrowers with total debts exceeding six times their income to 20 per cent of new mortgages.

The move is a pre-emptive measure aimed at maintaining stability in housing lending that should make credit markets safer by reducing mortgage arrears.

"This is the first time APRA has announced this form of macroprudential measure," says Choi, a senior portfolio manager in Perpetual's Credit & Fixed Income team.

"They have noticed a significant pick up in high debt-to-income borrowing by investors in particular.

"This is designed as a guardrail – not a hand brake – but it means that the proportion of higher risk lending is going to be constrained."

Choi says similar macroprudential measures in Australia and overseas in the past led to stronger resilience among borrowers and reduced rates of people falling behind on their mortgages.

That's good news for investors in residential mortgage-backed securities.

RMBS investments form part of the Perpetual Credit Income Trust (ASX:PCI) and other Perpetual credit and fixed-income funds.

Rising home prices

Australian house prices are rising at a 12 per cent annualised pace across every capital city and most regional areas. The strongest gains are in the middle market and lower quartile price ranges.

Higher prices are driving larger loans, with loan commitments among investors rising 13.6 per cent in the September quarter and 17.6 per cent by value – the fastest annual pace since 2015. Investors now account for 41 per cent of all lending.

Choi says lending restrictions should slow the strong growth in house prices.

“The European Central Bank conducted a study across seven countries that implemented loan-to-income limits. They found credit growth and house price growth were weaker for three years – but markets then saw stronger growth due to greater borrower resilience.”

Better credit quality

Choi says APRA has a track record of acting when housing markets get too heated – and previous intervention markedly improved credit quality for investors.

In 2014, APRA capped annual growth in investor mortgages at 10 per cent, while in 2017, it limited interest-only loans to 30 per cent of new lending.

“When we looked at the vintages of mortgages that were written post the implementation of those measures, we found a difference in arrears of almost a third – that’s a significant improvement in the resilience of these borrowers,” says Choi.

He says the regulator’s choice of a debt-to-income limit reflects Australia’s unusually high rate of multiple property ownership.

“Most other countries use loan-to-income limits, which only capture the new loan,” he says.

“Debt-to-income captures everything a borrower owes. It’s a stricter measure.”

RMBS portfolio benefit

Loans complying with the new guidelines will gradually flow into RMBS portfolios over the coming years as borrowers refinance, sell or pay down loans and new mortgages enter the pool as older ones exit.

“We analyse the pools very closely on an ongoing basis,” says Choi.

“Every month, our portfolio’s exposure to these vintages is constantly evolving.

“When we’re shown a mortgage pool with a concentration of post-measure vintages, we may be a bit more aggressive on the bid. Conversely, if it’s something with less of the vintages we like, we may say no or bid just a little bit wider to compensate for that.”

Choi says the current macro-economic environment remains benign for investors in RMBS, with arrears low and employment conditions solid.

But with almost a full rate hike priced in by September next year, greater resilience matters.

“It’s good that we’re getting these measures now,” says Choi. “While not constraining right now, the measure still helps contain exposure to higher-risk borrowers in mortgage pools - and that’s positive for investors.”

About Thomas Choi and Perpetual's Credit and Fixed Income team

Thomas is a senior portfolio manager with Perpetual's respected Credit & Fixed Income team.

He focuses on the management of the treasury portfolios.

Thomas has more than 20 years of investing experience and has worked with us since 2010. He has a Bachelor of Economics from Sydney University and is a Chartered Financial Analyst.

Perpetual offers a range of cash, credit and fixed-income solutions. We are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about Perpetual's Credit and Fixed Income capabilities

Want to find out more? Contact a Perpetual account manager

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