



Genworth®
Financial



SPOTLIGHT SERIES ISSUE 3

LOW-DOC LENDING IN AUSTRALIA

Introduction of the low-doc loan has created a unique opportunity for mortgage lenders and the self-employed borrower. Introduced to Australia in 1999, low-doc loans revolutionised mortgage lending for a key sector of the market.

Today, low-doc loans open opportunities for lenders to tap into a previously overlooked category of borrower. For self-employed workers and contractors, the introduction of low-doc loans helped many make the dream of home ownership a reality.

Low-docs vary from mainstream mortgage products only in that the borrower self-certifies their income. This self-certification is needed because the borrower does not have the up-to-date financial

information required to obtain a fully documented loan at the time they wish to borrow the funds. Other than the method to confirm income details, these loans are similar to a traditional home loan in terms of features and repayment options.

Low-doc loans service many needs, including owner-occupied or investment property requirements, home improvement, refinancing and debt consolidation.

“Rather than showing proof of income, as in a fully documented loan, a low-doc borrower self-certifies their income, which means they certify their income on which a serviceability assessment is then undertaken. This ensures that the stated income is sufficient to meet the proposed mortgage commitments.”

Low-doc performance

Low-doc lending to the self-employed market took off in Australia in the late 90s. The low-doc segment of the Australian mortgage market has grown considerably since the product's inception.

According to the Datamonitor *Low-documentation and Non-conforming Mortgage Markets in Australia 2006* report, lending commitments for low-docs were approximately A\$37.9 billion by the end of 2006, up from A\$33.7 billion in 2005 and A\$17.5 billion in 2002. This strong growth looks set to continue.

Furthermore, according to Datamonitor, 12.8% of Australians were self-employed at August 2006. This coupled with the number of contract or casual workers shows that over 39% of Australia's entire workplace are potential low-doc customers.

The non-bank sector, which introduced the low-doc product to help compete with the banking sector, has played a strong role in

the growth of the low-doc product. With banks recently seeing the benefit of this product, many now offer low-doc loans at very competitive rates.

"While the number of lenders offering low-docs is quite saturated – most banks and non-banks have a number of variants in their portfolio – the changing face of Australia's workforce will continue to drive demand," says Peter Hall, Country Executive & Director, Genworth Financial Australia and New Zealand.

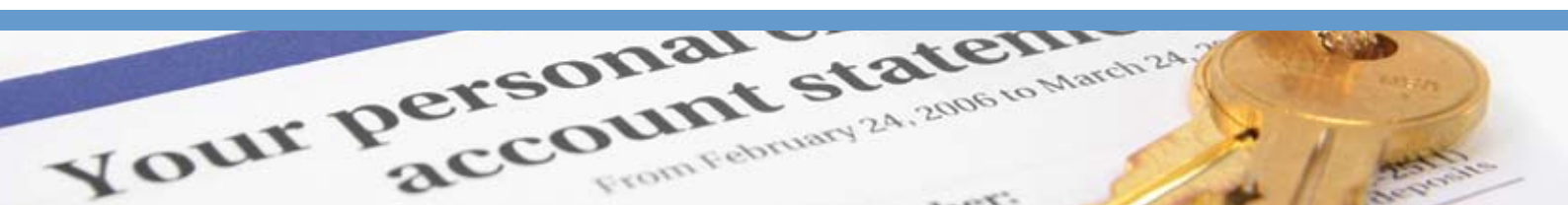
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With self-employed workers accounting for a greater number of borrowers, low-doc loans offer considerable opportunity for lenders. However, considering

the style of product and borrower – i.e. a low-doc requires less documentation – there is greater risk associated with offering loans to this group. But with proper safeguards in place, and risk offset by LMI, the opportunity for prudent lenders should continue to expand.

The low-doc product does represent increased risk for lenders and insurers, which is largely due to the ultimate nature of the type of borrower. The Australian Prudential Regulatory Authority (APRA) recognises this

and requires bank lenders and LMI providers offering this type of product to hold higher levels of capital against these loans. Consequently, providers pass on



A distinct difference

There's often confusion between prime low-doc loans and sub-prime low-doc loans.

Prime low-docs, insured by Lenders Mortgage Insurance (LMI) providers such as Genworth Financial (Genworth), are generally limited to an 80% Loan-to-Value Ratio (LVR). This means the low-doc borrower must put down at least 20% of a property's purchase price before securing a loan. Moreover, they must have a

clear credit history i.e. No credit impairment.

Sub-prime low-doc loans, currently offered by a few

"Borrowers taking out sub-prime low-doc loans typically also have some credit impairment."

lenders in Australia, are not covered by standard LMI and often have LVR's of 95%. The major difference however, is that borrowers taking out sub-prime

low-doc loans typically also have some credit impairment – which may range from a default on an existing finance commitment to a

bankruptcy against their name.

This is the essential difference between a prime low-doc and sub-prime low-doc borrower.

this requirement in their pricing, charging higher rates of interest for low-doc lending.

The perceived risk level of the low-doc sector is sometimes overstated, however. According to Hall, the product has performed in accordance with Genworth's original expectations when it began insuring low-docs.

"While the product has an arrears rate approximately double that of a comparable standard loan, this does not necessarily translate into the same proportion of increased claims," said Hall. "The higher arrears rates we see reflect the type of borrower for which the product is designed – a borrower with irregular income from month to month. As a result, we see a higher cure rate for low-doc loans compared with standard loans that fall in arrears for very different reasons."

While the lending cycle is now seeing delinquencies and mortgage defaults increasing in line with long-term trends, low-doc lending is not the predominant cause. Increasing delinquencies and defaults are occurring across all product suites, largely due to a changing market environment, particularly in NSW.

"Whilst we expect this trend to continue in the short term we are still tracking well within expectations in Australia."

Hall concurs that in some instances, borrowers seeking to conceal true earnings, or developers seeking finance, have



are not a material contributor to the current increase in mortgage

The low-doc loan is a win-win situation for borrowers and lenders. With prudent execution, lenders can expand their product offering and customer base. And for the self-employed borrower, it can mean the difference between owning a property or not.

misused the product. But based on arrears and claims data, Genworth is confident that low-doc loans

defaults and mortgagee-in-possession sales since the capped LVR mitigates the risk.

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Mixed messages

While often defined under the same name, it is clear that sub-prime low-doc loans and prime low-doc loans are different, both from a borrower and risk perspective. Recently, the current US mortgage crisis has intensified debate regarding the performance of low-doc loans in Australia.

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The recent coverage of problems arising from the US sub-prime lending situation has been intense. The magnitude of the US situation begs the question, “How could this have happened?”

Many believe the US sub-prime trouble was caused by some lenders too aggressively

seeking short-term profits in a changing market environment. This behaviour, combined with broader underwriting guidelines, and stacked risk factors such as high LVRs, credit impairment, low/no documentation, over reliance on FICO (Fair Isaac & Co scale) scores, and low ‘honeymoon’ or ‘teaser’

rates caused many loans to fall into arrears.

Whilst Australian lenders also offer ‘honeymoon’ rates, the difference is that US lenders were qualifying loans on the honeymoon rate rather than the ongoing rate, once the honeymoon period is complete.

No one factor caused the US situation, but many factors combined with a changing market environment have created a dramatic increase in defaults.

This situation is compounded by the fact that sub-prime lending accounted for as much as 20% of the total US mortgage market. In contrast, similar lending is just 1% of residential mortgage lending in Australia.

Today, many comparing the US experience with Australia are drawing conclusions about a type of product, rather than about compounding practices in a changing market environment. As a result, important points around low-doc loans have been muddled:

- First, because specialist sub-prime lenders are from the non-bank sector, it’s assumed that all non-bank lenders, have the same borrower profile.
- Second, confusion surrounds sub-prime low-doc loans and prime low-doc loans, with the belief that they are both designed for the credit-impaired borrower. While Australian borrowers can secure sub-prime low-doc loans, the majority of low-doc loans written in Australia are prime loans with a maximum LVR of 80%. They require full valuations, a borrower with a clean credit history, no second mortgage on the property and the borrower must have been self employed for a period of at least 2 years.

These requirements, unique to Australia, underline the stability of the market. The similar US low-doc product known as the Alt A loan does not have the same stringent requirements.

Australian Prime Low-Doc Loan Compared to US Alt-A Loan

	Australian Prime Low-Doc Loan	US Alt-A Loan
Type of Borrower	Self-Employed	All incl. Salaried
Maximum LVR	80%	95%
Prior Credit Defaults	Not Allowed	✓
Negative Amortisation	Not Allowed	✓
Teaser Rates	Not Allowed	✓





Low-docs emerge

The transformation from a niche lending product to a mainstream loan has been rapid for low-docs.

Ten years ago, home ownership for the self-employed was a difficult proposition.

In the past, self-employed borrowers had to provide at least two years personal tax returns, in-depth P&L statements, and an accountant's letter supporting their financial position.

"Mortgage brokers were instrumental in taking low-doc lending into the mainstream,"

The emergence of non-bank lending changed how self-employed borrowers were viewed. These lenders looked at a borrower's overall ability to service a loan, rather than simply ticking off a documentation checklist.

This new approach to credit assessment coincided with the rapid rise of the Australian mortgage broking industry, creating the perfect channel for non-bank lenders to distribute the new product to the self-employed market.

"Mortgage brokers were instrumental in taking low-doc

lending into the mainstream," says Hall. "Through lenders' education of the market via advertising, marketing and product training, brokers helped find real solutions to self-employed borrowers' needs."

While low-doc loans offer a degree of risk compared with fully documented mortgages, Hall believes closer analysis shows self-employed borrowers represent

a stable and attractive market.

"There is a higher delinquency rate for low-doc loans – often out to 90 days – but this does not necessarily follow through to a default," he says. "Moreover, the LVR on prime low-doc loans is capped at 80%."

Hall points to how owning and building equity in property has helped self-employed borrowers grow their businesses as a motivator for keeping up with mortgage repayments.

"Delinquency is largely due to the nature of borrowers' employment and resulting

irregularity of income, which will always be a factor of low-doc lending."

The role of lenders mortgage insurance

Since 1999, Genworth has insured over 200,000 prime low-doc loans, enabling lenders to offset the related risk. Unlike in the US, most of these loan types carry mortgage insurance.

"LMI has helped the market responsibly offer this product to borrowers."

LMI has helped the market responsibly offer this product to borrowers. LMI has also meant that, the insurer supports the ultimate risk in the event of default. As a result, neither the lender nor the economy is over exposed.

The right loan for the right situation

Genworth sees three key indicators that suggest whether a borrower is suited to a low-doc loan, and whether they have the necessary paperwork and capabilities to meet their mortgage commitments.

1) Does the borrower have demonstrated cash flow? That means tax returns, financial statements and a self-certification that accurately reflects their financial position, or the income

they receive. It's also important to determine if their position as a contractor or self-employed worker compares with someone in an equivalent position as a PAYG employee. For instance, a sole-operating electrician earning A\$300K per annum should ring alarm bells.

2) Do the borrower's assets and liabilities reflect their self-certification? Does the actual nature of their self-employment

look suspicious? If they've gone from an office administration worker to a specialised self-employed contractor, something isn't right. If it looks too good to be true – it probably is.

3) Does the borrower's credit bureau look right? Is anything out of order? Don't just look at defaults and judgements. Examine their past applications for credit and their approval success.



Up close and personal – profile of a low-doc borrower

Greg Watson runs his own carpentry business on Sydney's Northern Beaches. With the birth of his first daughter last year, Greg chose to spend more time with his family, rather than working 12-13 hour days.

For Greg, the trade-off is a significant reduction in regular income compared to his previous take-home wages. His regular contract with a building and maintenance firm was lost because he could not commit to working Monday through Saturday. Instead,

he chose to pick up smaller short-term contracts.

While paid more by the hour on short-term contracts, Greg's work is now less frequent, meaning his income ebbs and flows.

While comfortable to meet the repayments on a mortgage – as well as all his other living expenses – Greg is unable to secure a traditional mortgage loan because he can't show regular income. As a self-employed worker he does not meet the lender's credit criteria.

Keen to move his family into a home of their own, a broker, recommended to Greg by a friend, suggested that he consider a low-doc loan.

As a self-employed low-doc borrower, though unable to provide regular PAYG payslips, Greg can

self-certify his income, which means he guarantees his capacity to manage his mortgage debt.

Along with his business' tax return from the year prior, plus his ability to prove his business had operated for more than two years through documenting the date he received an ABN, Greg secured a A\$320,000 mortgage. When added to the A\$80,000 deposit (20%) he saved over the previous two years, he purchased a three-bedroom semi for A\$400,000.

The repayments on his low-doc loan only differs by about A\$23 dollars per month compared to a traditional mortgage, a price Greg says he's willing to pay considering the additional time he's now able to spend with family.

Future of low-docs

Whilst the Australian lending environment has been performing differently in comparison to the US, recent events in the US sub-prime market has meant that the cost of funding via the capital markets for many lenders is increasing.

As a result, lenders will look to increase the interest rates they charge on these products, not

A\$58.4 billion by 2011, up from an estimated A\$52.9 billion in 2010 and A\$47.7 billion in 2009.

Looking at the entire period, this is a compounded growth rate of 9.6%, compared to the estimated growth of the entire mortgage market during this same period of 6.4%.

What is the future of the low-doc sector? Several trends may emerge

- While Genworth limits the low-doc mortgages it insures to 80% LVR, other market sectors may start to offer low-doc loans at higher LVRs.
- The number of lenders offering low-docs will plateau. However, borrower pickup will increase due to greater education of the market and the changing face of Australian employment.

While the sector continues to grow, Genworth's recommendations to further underpin low-doc lending include:

- Adopt minimum verification standards so that all parties engage in satisfactory procedures to ensure the quality of borrowers and the loan advanced.
- Put processes in place to ensure that all parties are satisfied that the borrower has the capacity to repay the loan.

“The market is expected to reach A\$58.4 billion by 2011.”

necessarily due to increased risk associated with them, but rather as a result of the increased cost of funding.

“As events in the US sub-prime market continue to play out, we do expect to see this negative speculation continue in the capital markets in relation to the Australian mortgage market in the short term.” Hall says “However, we expect to see this subside and confidence restored in the medium term.”

As more and more self-employed borrowers look for solutions to assist with their needs and competition continues for low-doc business, the future for this market looks bright.

Potential key developments over the next 12 –18 months – such as capital markets funding, broker legislation, anti-money laundering legislation, which Genworth supports – may impact how lenders offer low-doc loans. However, the consensus is that a growing self-employed population will continue to increase the need for low-doc lending.

By late 2006, low-doc lending is estimated to account for up to 16.1% (A\$37.9 billion) of total housing lending commitments in Australia, up from 15.9% in 2005 and 16.2% in 2004.

These figures, detailed in the Datamonitor report, are supported with longer-term forecasts, which show how quickly this sector is expanding.

The market is expected to reach

according to Genworth:

- As the cost to obtain funding from the capital markets continues, the price for low-doc loans may increase. Demand for the product by self employed borrowers will continue to drive product growth.
- Product features will continue to become more similar to standard mortgages, with little differentiation except the process in which low-doc borrowers self-certify their income.

Low-docs in numbers

54 – average LVR percentage for low-doc loans, compared to the 67 per cent for traditional loans

385 – number of different low-doc loans offered by banks, credit unions, building societies and non-bank lenders to Australian borrowers

80 – maximum LVR on a low-doc loan Genworth is willing to insure

98 – the approximate percentage of low-doc loans on Genworth's books where the

principal person is a self-employed borrower

82 – percentage of jobseekers that told online recruitment website SEEK that they are interested in owning their own business at some stage in their career, highlighting the market potential for low-docs

30 – maximum loan term for a low-doc loan insured by Genworth

8 – the number of years Genworth has been insuring low-doc loans

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About Genworth Financial

Genworth Financial is a leading provider of Lenders Mortgage Insurance (LMI) and credit enhancement product solutions in Australia and New Zealand. Together with our customers, our aim is to make home ownership more accessible to borrowers through the provision of LMI solutions.

When you choose Genworth Financial you choose a team focused on delivering the highest levels of personalised service, whose keen ability to understand your market drives our willingness to take a commercial approach. Our success is founded on our total commitment to understanding our customers' business needs. We have developed a culture of accepting challenges and turning them into solutions that create value for our customers.

The Genworth Financial name is associated with financial strength and integrity throughout the world. Together with our predecessor business, we have insured over A\$250 billion of residential mortgages since 1965. We offer a wide range of LMI product solutions, as well as VAL Central, an online valuation workflow management system.

Rating Company	Genworth Financial Rating
Standards & Poor's	"AA" (Very Strong)
Moody's	"Aa2" (Excellent)
Fitch	"AA" (Very Strong)

Genworth Financial Internationally

Internationally, Genworth Financial, Inc. is a leading financial security company with strong and expanding global operations. With a presence in more than 25 countries, we serve more than 15 million customers. We provide innovative products that position us as leaders in growing market segments, including life and long term care insurance, individual and group annuities and investment products, managed money, payment protection insurance and Lenders Mortgage Insurance.

We invite you to learn more about us at:

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