Most Aussie Loans Exposed as Foul

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A few weeks ago, I warned about a **black swan for UK investors**. Bloomberg is on to the story too now, so it's no longer a surprise package:

> *A survey by* [UBS] *of 907 Australians who took out a mortgage in the last 12 months found only 67 percent stated their application was "completely factual and accurate," down from 72 percent the previous year. The most common inaccuracies were overstating income and understating living expenses, the survey found.*

Investment bank UBS calculates that Australian banks are sitting on half a trillion Aussie dollars of liars' loans, over 300 billion pounds' worth. That's more than the market capitalisation of the big four banks which dominate lending in the country.

But this is only a third of the story

Based on my PhD research, mortgage brokers and banks manipulate a lot of loan applications after the applicant signs off on them (so unknown to the borrower). They literally stick in a "1" in a different colour pen to turn $50,000 of income into $150,000. Even if the scrutinisers at the bank pick up on the problem, they often don't speak English well enough to make a fuss. And there's no reason for them to.

The most fascinating part is that, if a borrower can prove that their lenders changed the loan application form after it was signed, they can cancel their loan and keep their home. The bank has to write off the debt, booking the entire loss.

All this is of course impossible, if you ask regulators. They have very tight restrictions on lending (which are irrelevant if they are not applied by banks, or applied on incorrect information). But one newspaper and investigative TV show at a time is exposing the truth.

Here's what they all miss: while house prices keep going up, none of this need be a problem. Anyone in default can simply sell their home and walk away with a huge amount of cash after paying off the mortgage.

Unfortunately, there are pockets of **Australia with falling house prices**. And that's what exposed the liars' loans in the US.

With Aussie banks importing a big proportion of their funds from Europe, you need to keep an eye on this one. It poses a risk to banking worldwide.

Not that local banks don't have their own problems too.

How the volatility crunch hides risk

Mark Whitehouse made an excellent point in his Bloomberg column which you need to understand. Especially if you own financial shares or are thinking of buying them.

Measures of risk in the financial system are not the same sort of risk that we think about day to day.

In markets, **volatility** is a key factor in calculating risk. For example, trading desks still use the value at risk (VaR) model mandated by regulators even though the financial crisis exposed it as useless.

This model uses recent levels of volatility to calculate how much prices on an exchange might move in a day. Given that and the investment positions you hold, you can calculate your VaR and see if you're in compliance with the regulations.

The idea is to create a bell curve of how much you might lose if things go against you. Banks must be able to weather, say, a once in a lifetime crash, but not a once in a millennia event. The "once in a lifetime" bit is calculated based on volatility recently – it gives you the bell curve of possible market moves and their probabilities.

But in a market ruled by central bankers, volatility is hitting extreme lows. Which means the perception of risk is calculated to be low. Traders can make bigger bets within the rules given the bell curve includes smaller moves for a given probability. If they don't make those bets, their returns will fall. We've seen trading revenue slump at the major banks, which complain about the lack of volatility to trade off.

But the low level of volatility is artificial. If volatility returns to more normal levels, the perception of risk will surge. Suddenly VaR will rise and put existing positions in breach of risk management rules. Traders will have to unwind their bets, increasing volatility. It's a recipe for chaos and a nice little example of how central bank intervention raises risks and problems – unintended consequences.

Whitehouse adjusts American banks' VaRs for the fall in volatility and reaches this conclusion: "The banks' trading operations are only about 25 percent less risky than they were in 2009," instead of almost 75% less risky as they claim. Banking is a game of numbers and that enormous gap matters a lot.

Brexit momentum builds towards… something

With Britain set to leave, the EU can go about making a mess of the continent at a faster pace.

Tax harmonisation between states will lead to higher taxes. Financial market transaction taxes will hobble EU exchanges. Regulations will boom. Trade restrictions will bite. Anti-trust laws will tighten. Without Britain, so much nonsense will become possible.

Meanwhile, **Brexit** and Britain progress well. London remains the world's financial centre in the minds of surveyed professionals, losing less ground to Asia than the other major centres. Several EU states are considering keeping euro clearing in the UK. Employment and employment participation rates are extraordinarily high. The Brexit bill which adopts EU law passed another hurdle. The main opposition was on the issue of Henry VIII laws. But opposing these only when it suits you looks rather dodgy.

The best news is that our new post-EU British passports might be made on the continent. Wouldn't that be a wonderful way to demonstrate how pro-trade and committed to Europe Britain remains?

Now all we need is another technological and energy revolution on par with the invention of the steam engine. My friend Eoin Treacy has found one in the very same place the steam engine was first developed and used – Cornwall. It could turn Britain into an eco-friendly energy power, delivering vast gains for investors. Find out more here.

The only fly in the ointment of **Britain's growing independence** are the anti-democratic forces protesting in favour of remaining in the EU. Someone needs to let them know we had a referendum.

Tomorrow, our President Jean-Claude Juncker will give his state of the union speech. I can't wait.

Until next time,

Nick Hubble
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