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FINANCIAL SYSTEM INQUIRY

SUBMISSION BY:

MORTGAGE AND FINANCE ASSOCIATION OF AUSTRALIA

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KEY POINTS

The terms of reference which the Mortgage and Finance Association of Australia (MFAA) addresses in this Submission are those dealing with competition and funding in the Australian lending sector and regulation of that sector.

The key points of the submission are:

- Competition in the lending sector needs to be enhanced by a strong securitisation market to enable a vibrant and innovative non-bank and small lender sector

- Regulation of the sector must either be competition enhancing or, at least, competitively neutral in its impact on the various players in the lending market.

COMPETITION AND FUNDING IN THE LENDING SECTOR

It has been argued by some that competition in the lending sector does not need to be characterised by a large number of lenders and that competition can be effective even if there are only a small number of (large) participants. That might be valid if those participants in the market were providing a wide range of choice of different lending products and interest rates. But, because in the Australian lending market four institutions command 80% of the market (roughly equally divided amongst the four), there is no competitive ‘blowtorch’ which forces them to innovate and differentiate. It is also significant that they are operating in a market that is characterised by considerable inertia by borrowers in switching to a competitor[1]. That was not the case in the mid-90s through to 2007, when non-bank and smaller lenders with competitive rates and innovative products were able to take up to 42% of the market (non-bank lenders alone held over 15% at their peak in 2003).

So, in 2014, yes, there is sporadic competition between major lenders for deposits and on some selected lending products eg fixed rates and on fees and rebates etc, but this is competition at a level determined to be sufficient to maintain market share; it is not competition driven by the need to survive. It is not competition which produces systemic or ‘game changer’ innovations.

Meaningful competition which produces innovation and differentiation only occurs when survival is at stake – which was the driver of non-bank lenders when they entered, and disrupted, the industry, to the benefit of consumers, in the mid-90s. Such innovations as phone banking, internet banking, low doc lending in its original form (which subsequently was abused), re-draw products and deferred establishment fees emanated from this period,

As at the date of this submission, the Big 4 banks held around 80% of the mortgage market, a share which they have maintained effectively since the end of the GFC. The remaining smaller banks hold a 14% share while the mutuals hold a dwindling 5% and the non-banks around 2%. Table 1 demonstrates how competition in the mortgage market place has both developed and then atrophied over the past two decades.

It is significant to note that the swings in market share in the early years arose directly from the innovation and energy of the wholesale (non-bank) lenders, assisted by the

[1] Research by RFi (March 2014) shows that an average of only 1% of people change their main banking relationship per annum. This increases up to a still low 7% for home loan products. Despite the Government’s attempt to encourage ‘switching’, by banning exit fees, apart from a brief splurge in 2011, the incidence of switching is less now than what it was prior to the GFC.

tool of securitisation. The subsequent rise of the Big 4 market share during GFC occurred, not as the result of any innovation or competition by them, but because of the collapse of the securitisation market funding their non-bank competitors and two significant acquisitions.

So while securitised loans comprised over 20% of new loans transacted in the period 2002-2006, in 2013 that share is now less than 5%.

Table 1 Housing Finance Market Share

	All Banks	***Big 4***	***Other banks***	***Mutuals***	***W'sale[2] lenders***	**Refinances**
	%	**%**	**%**	**%**	**%**	%
1992	88.4			11.6		12.0
1993	90.4			9.6		13.6
1994	90.3			9.7		12.3
[3]1995	85.0			10.4	4.6	18.0
1996	83.3			11.2	5.5	23.4
1997	81.1			10.1	8.7	19.9
1998	83.2			8.8	7.9	18.7
1999	84.7			6.9	8.4	18.5
2000	79.4			6.8	13.7	23.3
2001	77.2			7.8	14.9	20.4
[4]2002	76.6	58.2	18.4	8.1	15.3	26.8
2003	76.4	58.4	18.0	7.8	15.8	29.9
2004	78.1	59.2	18.9	8.1	13.8	28.9
2005	78.7	59.7	19.0	7.3	14.0	29.9
2006	78.9	58.1	20.8	7.8	13.3	33.3
2007	84.9	64.0	20.9	6.8	8.3	27.9
2008	91.0	70.9	20.1	5.9	3.1	31.7
[5]2009	91.6	78.2	13.4	5.5	2.7	25.0
2010	89.4	78.0	11.4	7.7	2.8	29.9
2011	92.4	79.9	12.5	5.9	1.7	34.5
2012	93.8	80.0	13.8	4.9	1.3	32.4
2013	93.7	80.0	13.7	4.1	2.2	28.2

Source: ABS Housing Finance 5609.0

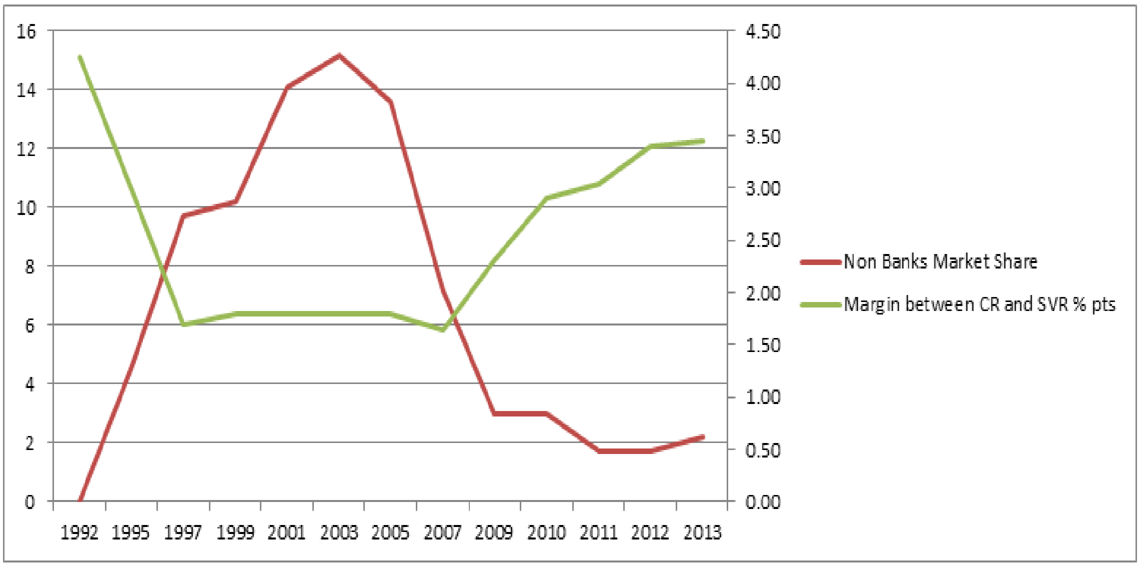
It was argued by the Government that the banning of exit fees in 2011 would stimulate competition by encouraging borrowers to 'walk across the street' but the reality is that apart from a short burst of activity around the time of the introduction of the ban, the level of refinancing now in 2014 is lower than what it was pre-GFC. As Table 1 shows the real drivers of refinancing were the entrance of non-bank lenders, the introduction of deferred establishment fees and the growth of the broker channel in the 90s.

A good measure of the effectiveness of competition is an analysis of the market share of wholesale (non-bank) lenders plotted against the gap or margin between the cash rate and the average standard variable rate. Table 2 shows there is clearly a direct inverse relationship between the two.

[2] 'Wholesale lenders' is the term for 'securitised lenders' by ABS. They are more commonly known as 'non-bank lenders'
[3] Wholesale lenders stats only collected by ABS from 1995
[4] Banking stats separated from2002
[5] St George and Bankwest acquired by Westpac and CBA late 2008

It is noted that a period of discounting occurred in 2011 – 2013 and it could be argued that the 'margin' is exaggerated as the real 'margin' is less, once discounts are applied. However discounting of a not dissimilar scale took place in the period 2003 – 2007 so MFAA would argue the comparison is still broadly valid. If discounts were applied the margin in 2013 would be around 2.60 while the real margin in 2005 would have been around 1.30.

Table 2 – Non-banks share and Cash Rate – Standard Variable Rate gap



The other significant external factor driving competition in the industry has been the establishment and growth of the broker channel. From a standing start in the late 80s/early 90s the broker channel has expanded such that in 2014, 47.3% of all mortgage loans are introduced by mortgage brokers.[6]

The impact of the broker channel is demonstrated by Table 3, which shows that even in a market in which borrowers are reluctant to change 27% of loans are introduced to smaller lenders compared with only 13% if borrowers deal directly with the lender.

Table 3 – Impact of Mortgage Brokers on Competition

2013	Non broker loans	Broker loans	All loans
Big 4	87%	73%	80%
Other lenders	13%	27%	20%

Source: *comparator –Broker Market Share statistics, Dec Qtr 2013*

The Missing factor

It is abundantly clear that the missing factor that was evident in the market pre GFC is securitisation. This vehicle for funding collapsed in all markets globally except in Canada where it was successfully maintained as the result of Canadian government guaranteed mortgage-backed-securities and Canadian Mortgage Bonds, a system which has operated successfully in various forms since 1987.

[6] Independent researcher *comparator* December Quarter 2013

The result in Canada (as Table 4 shows) is a healthy competitive market in which smaller lenders hold 25% of the mortgage market, which is sufficient critical mass to influence product development and interest rates. While Canadian statistics do not show ‘flow’ or new loan statistics, MFAA understands that, because of the continuing impact of securitisation, the flow profile of loans is similar to the ‘outstanding’ profile.

Table 4

Funding profile	Canada	Australia	
Deposits	58.9%	60%	
Securitisation	28.3%	5%	
Other	12.8%	35%	
Share of loans	**Canada**	**Australia**	
	Outstanding	*Outstanding*	*New*
Banks	74.9%	88.4%	*93.8%*
Other lenders	10.4%	8.3%	*1.7%*
Mutuals	14.6%	3.3%	*4.5%*

Source: Canadian Mortgage and Housing Corporation and Australian Bureau of Statistics

This program produces about 30% of all mortgage funding in Canada. So that while Australia relies on the volatile global markets for around 35+% of its mortgage funding, Canada is able to access a much less expensive and certain funding source.

And while the Canadian system can boast that its securitisation program produces the second most cost-effective source of mortgage funds after retail deposits, Australian major lenders regularly point to the volatility and expensiveness of the wholesale global markers as hurdles to more competitive rates.

The CMHC reports that the spread on Mortgage-backed securities is around 70bps and Canadian Mortgage Bonds around 30bps[7] just above the cost of deposits, while the spread on Australian lenders’ wholesale funding is around 100 bps[8], indicating, prima facie, that lower rates can be driven under a strong securitisation program.

The *Canadian Mortgage Observer 2013,* published by Canadian Mortgage and Housing Corporation notes:

> *“(these) programs have been facilitating large and small Canadian lenders’ access to funding in good and bad times, thereby fostering competition and promoting system stability. Investors are afforded the opportunity to invest in high quality, government-guaranteed securities backed by insured mortgages. (They) carry CMHC’s guarantee for timely*

[7] CMHC, Canadian Housing Observer, 2013
[8] The Australian Mortgage Report 2014, Deloitte,p28

payment of principal and interest to investors. This guarantee acts as a credit enhancement to lower the cost of funding. CMHC charges a fee for the provision of the guarantee."

The Canadian Government had never been called on the exercise its guarantee. The guarantee is not a guarantee to prop up a failing company but a guarantee on a nationwide program to bring about a more competitive industry for consumers' benefit.

Australian critics of these programs in Australia have suggested they put the taxpayer at risk, or that they fall into the same category as the failed US Freddie Mac and Fannie Mae programs.

The facts are that the programs have provided a continuing revenue[9] each year since 1987 to the Canadian Government which has assisted CMHC in funding public housing projects and more recently has enabled retirement home funding. Unlike the disastrous US programs which crashed during the GFC and are still under government 'conservatorship', the rigorous, well managed and regulated Canadian programs produced $100b of securitised funds each year during the GFC. In 2013 $146b was produced. Even though the Canadian government has limited its involvement this year to $120b to encourage the private securitisation market, this is light years ahead of the Australian securitisation market at present.

MFAA has appeared before a number of Senate Committee and other Parliamentary Inquiries since 2008 in which we have advocated the Australian Government analysing the benefits of the Canadian system. On most occasions the reports of these committees have made favourable recommendations regarding the Canadian system but there appears to have been no action. Yet it was demonstrated in Australia, in the 10 years up to 2007, that a strong and viable securitisation market creates an environment in which lending competition and product innovation thrives.

At the very least it should be a strong recommendation from this Inquiry that all than can be done to encourage and enhance Australia's revitalising securitisation market should be done and that any regulatory hurdles or roadblocks should be dismantled.

Whether or not a Canadian-type system is adopted, the Canadian experience and Australia's pre-GFC experience demonstrate that a pre-requisite for a more competitive market is a thriving securitisation market.

MFAA argues that the drivers of game-changer or systemic innovation in the lending sector over the past two decades have been: non-bank lenders (including innovations such as deferred establishment fees), securitisation (facilitated by lenders mortgage insurance) and mortgage brokers. On the other hand the following events had a negative effect on competition: GFC, deposit and wholesale funding guarantees, the slump in securitisation, bank mergers and the exit fee ban (which banned one of the drivers of competition – deferred establishment fees).

The past two decades demonstrate that the drivers of innovation were external disruptors to the lending sector. This pattern would indicate any future innovation is likely to come from operators currently external to the sector.

[9] CMHC Quarterly Finance, Sept 2013, shows that the annual net revenue from the securitisation programs to be around $200m pa over the past few years. CMHC also receives considerable net revenue from its mortgage insurance operation which, along with securitisation revenue, is used to fund its other activities.

REGULATION

MFAA was one of the strongest proponents of the National Consumer Credit Protection Act which became effective in 2010. The idea that borrowers should only be exposed to 'responsible lending' was definitely worthy of being enshrined in legislation. However the resultant Act and regulations, plus various ASIC Regulatory Guides have produced hundreds of pages of details which effectively seek to micro manage each business in the credit sector.

This creates compliance concerns, costs and time pressures for those businesses. While this Inquiry is not the forum to raise 'micro' issues, some examples of the impact on mortgage brokers are:

- The requirement to produce three documents for consumers – Credit Guide, Credit Quote and Credit Proposal, when prior to the NCCP, state regulation combined the information in all three in a single Finance Broking Contract which worked well

- The requirement for mortgage brokers to conduct a preliminary assessment of all potential borrowers before recommending finance when the lender has to carry out their own assessment before deciding to lend, particularly when brokers do not have access to all the information available to lenders (eg credit reports)

In the above cases, the regulations referred to demonstrate no benefit to the consumer and simply add to compliance time and costs.

CONCLUSION

In general MFAA subscribes to the principle that governments should not intervene in markets unless it can be demonstrated that that there is an imbalance in competition which regulatory measures would correct. Under this principle, the Canadian government introduced its mortgage-backed-securities regime in the 1980s and it is still operating successfully in 2014.

Further, before being introduced, regulatory proposals should be examined to ensure they are competitively neutral across all players in the market (except in situations like the above where a market imbalance is identified). Examples of regulatory intervention which discriminate against or negatively impact competitively on some players – deposit guarantee, wholesale funding guarantee, some Base III requirements on smaller lenders and the ban on deferred establishment fees.

MFAA submits that the competition principles governing regulation in the lending sector through which all proposed regulation should be filtered should be that:

- regulation should only be introduced:

  - If it enhances competition or
  - It is competitively neutral

- regulation should be principles based rather than attempt to micro-manage business.
