# Inquiry into post-GFC banking sector

Senate Economics References Committee

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## Submission by Mortgage and Finance Association of Australia (MFAA)

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May 2012

# Inquiry into post –GFC banking sector

## Overview

***Notwithstanding Parliamentary Inquiries in 2008 and 2010 and the Federal Government's "A Competitive and Sustainable Banking System" reforms announced in December 2010, the Mortgage and Finance Association of Australia argues that little has occurred to competitively reform the lending landscape over that period. Arguably the banking sector has become less competitive.***

***The problem is that the hard issues have not been attacked. Any initiatives have been peripheral eg exit fee ban, mandatory key facts sheet, anti-price signaling legislation, a mutuals 'fifth pillar', while the elephant in the room, viz access to competitively priced funding for all lenders, large and small, has been largely ignored.***[1]

***In July 2007 prior to the above Inquiries, the Government reform initiatives and the GFC, the banks held 78.8% of the Australian mortgage market (Big 4 - 59.6%, other banks - 19.2%), credit unions 4.7%, Building societies 2.8% and non-bank lenders 13.7%.***[2]

***In March 2012 despite the various recommendations from the above inquiries and government legislation banks are now even more powerful in the market than they were prior to the GFC with 92.4% share (Big 4 75.6%; other banks 16.8%***[3]***) credit unions 4.6%, building societies 1.6% and non-bank lenders 1.1%.***

***Major lenders, generally, have argued that the cost of funding has made necessary either increases to interest rates 'out of cycle' with RBA cash rate movements or lesser reductions than announced by the RBA for its target cash rate.***

***On the other hand non-bank lenders have bemoaned the lack of access to sufficient quantities of keenly priced funds which would enable them to return to being a strong competitive force in the market for the benefit of borrowers.***

***If a solution can be found to provide both <u>access</u> and <u>competitive price</u>, the peripheral issues fall away. With this type of funding the mortgage market will provide competitive pricing and service levels to Australian borrowers.***

***The Australian Government, if it is serious about attacking the hard issues, must closely examine the success and characteristics of the Canadian Mortgage and Housing Corporation's securitisation programs, viz Mortgage backed Securities and Canadian Mortgage Bonds. These programs provide a proven efficient and effective template for competitively priced mortgages, whose features should be incorporated into the Australian mortgage market.***

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[1] With the exception, to a degree, of the Government's AOFM initiatives to support Residential Mortgage Backed Securities and the introduction of Covered Bonds
[2] APRA Monthly Banking Statistics and ABS Housing Finance, 5609.0
[3] If Bankwest is included with CBA the shares become - Big 4 79.5; other banks 12.9%

## Mortgage and Finance Association of Australia

The Mortgage and Finance Association of Australia (MFAA) is the key industry and professional group representing mortgage and finance brokers, mortgage managers and aggregators. It has 11,200 members operating across Australia.

### Preamble

MFAA welcomes the opportunity to participate in the Senate Economics References Committee *Inquiry into the post-GFC banking sector.*

This submission specifically addresses the following points from those outlined in the announcement of the Inquiry:

(b) the impact on relative shares of specific banking markets;
(c) the current cost of funds for lending purposes;
(e) the need for further consideration of the state of the broader finance and banking sector.

We note at the outset that an Inquiry including these general issues was conducted by the House of Representatives Economics Committee in 2008[4] and a further Inquiry by the Senate Economics Committee in 2010[5]. Many submissions to those Inquiries and their recommendations are still relevant and are referred to in this paper. In fact they are now more relevant as competition in the sector has not improved since both those Inquiries.

It is instructive to review the Report of the 2008 Inquiry. Its summary below serves as a good history of the state of competition in the lending industry. It also serves to remind all that little has changed for the better over the past four years. On the contrary, competition has continued to decline.

### The state of competition[6]

1. *The rise of the non-banking sector in the early 1990's played a significant role in enhancing competition particularly in the mortgage industry. The non-bank lenders introduced innovations such as internet and phone banking and mobile lenders. This put pressure on the banks resulting in greater competition, tighter margins and lower interest rates.*

2. *The non-banking sector opened the way for 'mortgage brokers' to enter the market. Brokers acted as a 'one stop shop' for consumers by providing advice on the numerous home loans available.*

3. *Prior to the commencement of the credit crisis, the non-bank sector sourced their funds primarily from securitisation ('bundling' individual loans and selling them in financial markets).*

4. *In the last 12 months the global securitisation market has all but dried up and as a consequence the non-banking sector's market share 'has fallen from around 12 per cent in 2006 to 5 per cent.' [now 2% - 2012]*

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[4] Inquiry Into Competition In The Banking And Non-Banking Sectors, November 2008
[5] Competition within the Australian Banking Sector, May 2011
[6] Inquiry Into Competition In The Banking And Non-Banking Sectors, November 2008, page 2

5. *The lack of available funding has forced some providers and brokers out of the market. Less providers within a market would normally result in a fall in competition.*

6. *There are, however, two opposing views about the current state of competition within the banking and non-banking sectors.*

7. *The Treasury, the Reserve Bank of Australia and the big four banks, Westpac, ANZ, the Commonwealth Bank and National Australia Bank, believe that competition within the sector is strong and that the non-banking sector will regain its market share when market conditions normalise again.*

8. *The non-banking sector, including the Mortgage and Finance Association of Australia, the Australian Securitisation Forum, and Challenger Financial Services Group, to name a few, believes that there is some uncertainty about how long it will take for the funding markets to return and that as a consequence competition will be substantially reduced.*

Clearly the belief of those in point 8 above was proven to be correct by the time of the 2010 Inquiry and is still correct in 2012.

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## THE IMPACT ON RELATIVE SHARES OF SPECIFIC BANKING MARKETS
**(Focussing on the Mortgage [Housing Finance] Market)**

### The Essence of the Problem

It is indisputable that the level of competition in the lending industry has markedly reduced just in the past few years since the commencement of the GFC.

There have been well publicised bank mergers and significant withdrawals or 'hibernations' in the non-bank sector.

The market share of banks in Housing Finance has increased from 79% in 2007 to 92% in 2012, while that of non-banks has shrunk from around 14% to 1%[7]. Credit unions and building societies have managed to maintain a market share of around 7%. Their prime funding source, member deposits, has enabled them to maintain a steady flow of funds for lending.

Much of the focus has been on interest rates alone. While rates are an important indicator of competition consumers are also interested in other loan attributes[8]. An uncompetitive market also manifests itself via poor service levels and lack of availability of product.

By January 2002 mortgage brokers had established a retail market share in the mortgage market of around 18%, which had increased to close to 40% by 2007[9]. Although that market share may have dropped a few percentage points during the GFC all indications are that it has now exceeded its 2007 share and is now 43%[10].

Consumers are much better informed because brokers are out there in the market. They are able to source the most appropriate deal for them, which if they were operating on their own they probably would not have the time or resources to do.

Brokers are an integral part of the competitive mix in the industry but their value to the consumer and the competitive forces is enhanced when there is a wide choice of lenders and credit products. See the comments from the Chair of the 2008 Inquiry:

> *"**CHAIR**—Would you agree with me that for that downward pressure to continue from brokers there needs to be enough variety in products, product lenders and ability and ease to move between those product lenders; that is, that that downward pressure is a result of competition?*
> ***Mr Naylor**—Absolutely."*[11]

The CBA MFAA Home Finance[12] research carried out on a six monthly basis by *brandmanagement* consistently demonstrates the powerful proposition offered by mortgage brokers to consumers. The most recent survey (May 2012) showed the following 'benefits of using a broker' as indicated by consumer respondents:

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[7] ABS Housing Finance, 5609.0

[8] CBA MFAA Home Finance Index, May 2012, p40 showed that 51.8% of consumer respondents selected interest rates as the most important factor to consider when selecting a mortgage product, indicating that almost half of borrowers regard a range of factors other than interest rates more important than rates.

[9] Source: Fujitsu Consulting Estimates, 2007

[10] Source: Australian Mortgage Industry Vol 15,Fujitsu/JP Morgan, March 2012 (NB Research carried by the independent research group *comparator* for the March Quarter 2012, showed that the top 17 broker aggregator groups alone transacted 42% of the total mortgage market)

[11] Inquiry Into Competition In The Banking And Non-Banking Sectors, November 2008, page 46

[12] CBA MFAA Home Finance Index, May 2012

| | |
|---|---|
| ‘They do all the leg work for you’ | 78.6% |
| They have a wider loan range’ | 76.6% |
| ‘Convenience’ | 74.2% |

Any non competitive measures which inhibit their viability will have a negative effect on the competitive forces impacting consumers.

Competition (when it works in this industry) is multi-dimensional. Non-banks, credit unions and building societies (mutuals) compete with banks both at origination, product, and retail levels while mutuals and brokers and some mortgage managers provide competition at the retail level.

In its 2008 Submission MFAA commented:

> *‘The Australian lending industry has shown over the past few decades that it has operated most competitively and in the consumers’ interest when banks have been subject to competition at the origination and retail level by non-banks/mortgage managers and at the retail level by brokers competing with branch lending.’*

In the period just prior to the GFC (viz early 2007) there was a sufficient critical mass of non-bank lenders, credit unions and building societies, applying competitive pressure on pricing, service levels and differentiated product ranges to suggest Australian borrowers could enjoy reasonable competition in all those facets.

Table 1 shows the relative market shares in the mortgage industry since 1992 and Table 2 and graph (Fig 1) demonstrates the impact of the market share of non-bank lenders on interest rates (using the difference between the RBA cash rates and the average standard variable rate as a measure)

### Table 1 Housing Finance Market Share – Finance Approvals*

| As at October | Banks % | Bld Soc and Credit Unions % | Non Banks** % |
|---|---|---|---|
| 1992 | 89.8 | 10.2 | - |
| 1995 | 85.7 | 9.8 | 4.5 |
| 1997 | 81.6 | 8.0 | 9.7 |
| 1999 | 83.2 | 7.2 | 10.2 |
| 2001 | 77.6 | 8.3 | 14.1 |
| 2003 | 76.9 (58.8)+ | 7.8 | 15.2 |
| 2005 | 79.5 (60.3)+ | 6.9 | 13.6 |
| 2007 | 84.8 (64.0)+ | 7.4 | 7.2 |
| 2009 | 91.4 (81.5)+ | 5.6 | 3.0 |
| 2010 | 89.2 (73.5)+ | 7.7 | 3.0 |
| 2011 (March) | 91.5 (75.7)+ | 7.4 | 1.2 |
| 2011 (April) | 92.0 (76.3)+ | 7.0 | 1.0 |
| 2011 (November) | 91.7 (76.0+) | 5.9 | 1.8 |
| 2012 (March) | 91.5 (75.6)+ | 6.5 | 1.1 |

*Source ABS Housing Finance 5609.0: APRA *Monthly Banking Statistics.*
+ Figures in parenthesis represent the share of the Big 4. The upsurge in 2009 resulted from the First Home Buyers Boost (Oct ’08 to Dec ’09)
** refers to securitised funding. Because of the lack of access to securitised funds some non-bank lenders/mortgage managers now access wholesale funding from banks, which is accounted for in the banks market share.
Table prepared by Mortgage and Finance Association of Australia, May 2012

**Table 2 Non-Bank Market Share and Difference between Cash Rate and Average Standard Variable Rates**

| | Average Standard Variable Rate (SVR) % | Cash Rate (CR) % | Margin between CR and SVR % pts | Non-Banks Market Share % |
|---|---|---|---|---|
| As at October 1992 | 10.00 | 5.75 | 4.25 | 0 |
| 1995 | 10.50 | 7.50 | 3.00 | 4.5 |
| 1997 | 6.70 | 5.00 | 1.70 | 9.7 |
| 1999 | 6.55 | 4.75 | 1.80 | 10.2 |
| 2001 | 6.30 | 4.50 | 1.80 | 14.1 |
| 2003 | 6.55 | 4.75 | 1.80 | 15.2 |
| 2005 | 7.30 | 5.50 | 1.80 | 13.6 |
| 2007 | 8.05 | 6.50 | 1.65 | 7.2 |
| 2009 | 5.55 | 3.25 | 2.30 | 3.0 |
| 2010 | 7.40 | 4.50 | 2.90 | 3.0 |
| 2011 (March) | 7.79 | 4.75 | 3.04 | 1.2 |
| 2011 (Nov) | 7.54 | 4.50 | 3.04* | 1.8 |
| 2011 (Dec) | 7.30 | 4.25 | 3.05* | 1.7 |
| 2012 (Mar) | 7.04 | 3.75 | 3.29* | 1.1 |

Source: ABS Housing Finance 5609.0: RBA Statistics: Table prepared by Mortgage and Finance Association of Australia, April 2012

* It is noted that a period of discounting occurred in 2011 and early 2012 and it could be argued that the 'margin' is exaggerated as the real 'margin' is less, once discounts are applied. However Fig 2 shows that 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 March 2012 would be around 2.59 while the real margin in 2005 would have been around 1.30.

**Fig 1**

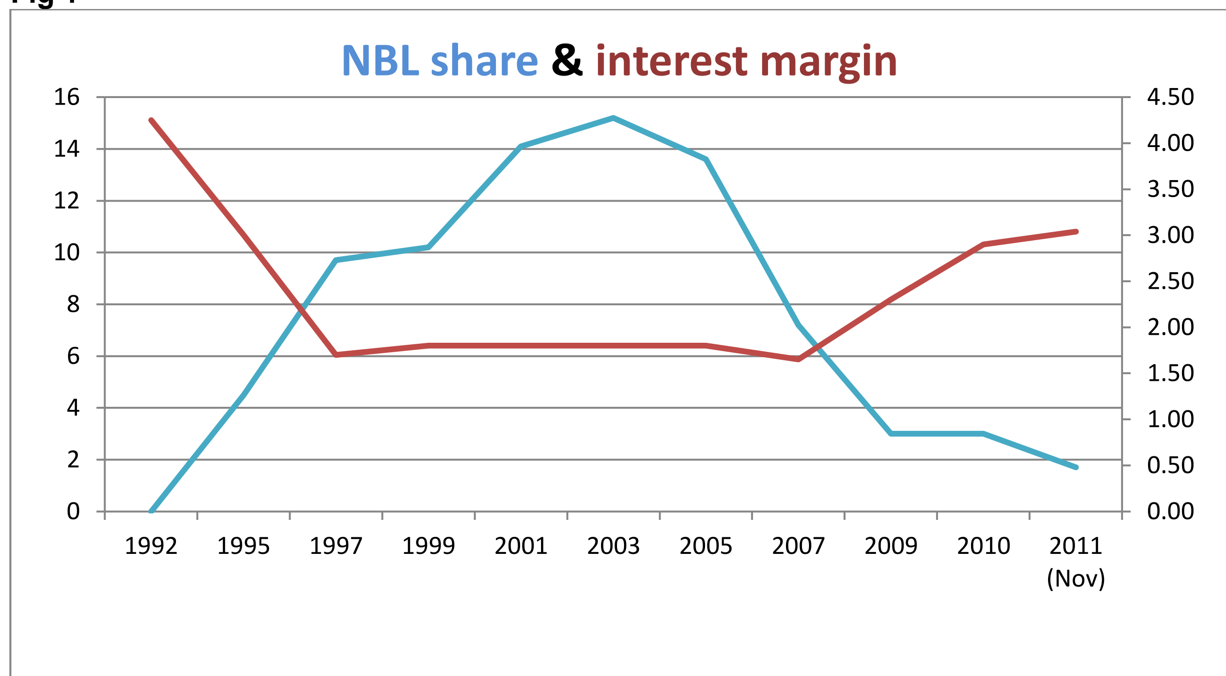
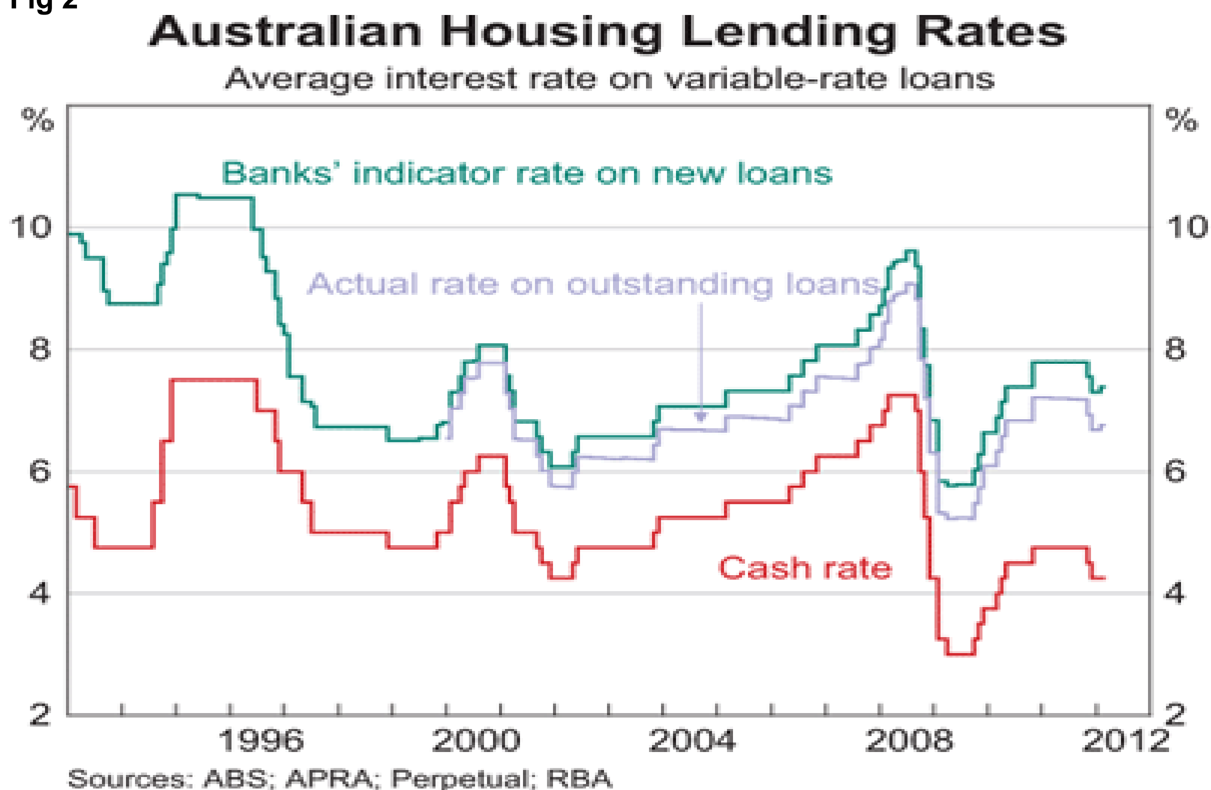


Fig 2




For those conditions of competition to be replicated in 2012 the Australian Housing Finance market share would need to approach a position where non-banks held around 10-15% and credit unions and building societies at least maintained their 7%. Such dynamics would provide the platform for a competitive lending industry in Australia.

It is instructive to review the following comments by witnesses appearing before the 2008 House of Representatives Economics Committee Inquiry:

***Mr Ric BATTELLINO, Deputy Governor, Reserve Bank of Australia***

> *— I think the non-banks drive down the margins....*
> *Our general view is that when conditions settle down and the cost of funds in the money markets returns to a more normal level, that downward pressure and competition from the non-banks will reappear.*[13]

***Mr Phil NAYLOR, Chief Executive Officer, Mortgage and Finance Association of Australia***

> *— I heard some of the previous speakers say that the market will sort it out. The market did not sort it out in 1994. It took a shock to the market by new players coming in. If the market had been left to itself with the existing players, nothing would have changed. Our concern is that we are looking at possibly a back-to-the-future scenario, winding the clock back to 1994 or pre-1994 when non-bankers and brokers were not in the market and the remaining players did not have anything forcing or persuading them to change the way they operated, whether it be in their pricing, their range of services or products.*
> *Like some other submissions, ours talks about the Canadian mortgage bond system, and the Aussie Mac system. We do not have a strong view*

[13] Inquiry into Competition in the Banking and Non-Banking sectors, Transcript 14 August 2008, page 14

*or a strong proprietary knowledge or ownership of any of those things. But we think that unless there is some dynamic that comes into the market that enables continued liquidity, competition as we know it will disappear and we will face that back-to-the-future scenario.*[14]

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*As I said before, at the best the non-banks had 15 per cent of the market. That was demonstrably effective in changing the competitive dynamics of the industry. Now they have about 6 per cent. I would certainly argue that they lost a lot of their competitive potency. Whether they would regain it at 10 per cent, 11 per cent or 9 per cent, I am not sure. <u>I am not sure what the figure is, but I think at the moment quite a few of them have gone or are inactive. I agree that we do not want to get precious about the right figure of market share, but at the moment it is probably too small to have much effect. The likelihood is that if this is left to run it will get less rather than more. There is nothing we can see in the cycle or environment at the moment that says suddenly non-banks will reverse their market share upwards. That means that there is not the competitive dynamic that was there before.</u>*[15]

It is clear that the suggestions that the cycle or market would sort things out have not borne fruit. MFAA's concerns that the competitive potency of non-banks would weaken further is demonstrated by that sector dropping to as low as 1% market share in Housing Finance approvals in April 2011. It has recovered very slightly to a still miniscule 1.1% in March 2012 (see Table 1).

The government's AOFM initiative to 'kick start' the securitisation market may be the catalyst for this but even with that the non-bank market share is less than it was when the issue was raised again by MFAA in the 2010 inquiry (i.e. 3%). Although the sector is still competing on rates (see Table 3 below) it does not have sufficient access to funding to provide effective competition. An MFAA comparison of standard variable rates shows:

**Table 3**

| | Standard Variable Interest Rates |
|---|---|
| Average Major 4 Banks | 7.04% |
| Average 63 Mutuals | 6.69% |
| Average 23 Non-Bank Lenders and Mortgage Managers | 6.41% |

Source: Canstar: www.canstar.com.au
(18 May 2012)

## The Impact of the Banking Reform Package, December 2010

While the further $4b announced by AOFM for RMBS funding, is welcomed no other part of the package is of assistance to non-banks. The focus rather is one of improving the lot of mutuals (credit unions and building societies) but there has not been any material change to the 'mutuals' combined market share. The idea of a 'fifth pillar' may have been well intentioned but to date this pillar has shown no sign of appearing.

[14] Ibid, page 43
[15] Ibid, page 43

## Exit fees

The Government's ban on exit fees took affect from 1 July 2011, with consumers being exhorted to 'walk down the road' if they didn't like their existing lender. MFAA argued, unsuccessfully at the time, that this ban would have little impact on the operations of major lenders but would hurt smaller and non-bank lenders. We also expressed doubt as to whether it would bring about any material changes in the competitive structure of the industry.

An analysis of borrowers refinancing their mortgages shows:

**Table 4**

| Month | Refinances as % of total finances of established dwellings | Month | Refinances as % of total finances of established dwellings |
|---|---|---|---|
| January 2011 | 39.2% | August | 42.2% |
| February | 38.3% | September | 42.2% |
| March | 37.1% | October | 39.3% |
| April | 38.1% | November | 44.4% |
| May | 40.7% | December | 39.2% |
| June | 41.5% | January 2012 | 40.5% |
| July | 41.1% | March 2012 | 42.9% |

The average monthly refinance percentage for 2010 was around 35% so clearly there was an upsurge in refinances each month starting at the time of the government's exit fee ban intention was announced in December 2010 and coinciding with two major lenders voluntarily dropping their exit fees and a campaign by major lenders encouraging borrowers to switch. However evidence[16] suggests that there was no negative impact of refinancing on the major lenders as the market share of major lenders actually increased between October 2010 (73.5%) and March (75.7%), June (76.3%), July (76.5%), December 2011 (76%), January 2012 (75.8%) and March 2012 (75.6%)[17]. This was despite, or perhaps, because of, the publicity campaign from the government and banks encouraging borrowers to switch.

Interestingly Canstar reports that according to its customer research '*our findings …revealed that only 5% of surveyed banking customers followed the advice of industry commentators and switched their main financial institution in the last 12 months.'*[18]

This is consistent with CBA MFAA Home Finance research[19] in September 2011 which indicated 15.2% of mortgage holder respondents had refinanced in the past 12 months - an increase on January 2011 (12.2%). Of this 15.2%, only 36% reported that they changed mortgage provider, i.e 5.5% of total mortgage holders. In January 2011 36.9% reported they changed mortgage provider, i.e. 4.5% of total.

The relatively low numbers refinancing is supported by an analysis of ABS Housing Finance statistics which reveals that in the calendar year 2011 refinances by value

[16] ABS Housing Finance and APRA ADI monthly statistics show that the bank market share October 2010 was 89.2% (Big 4 73.5%) and by March 2011 it had increased to 92% (Big 4 75.7%) and has remained around 92+% (Big 4 c76%) up until the current time (March 2012)
[17] APRA Monthly Banking Statistics and ABS Housing Finance 5609.0: Oct 10-Mar 12
[18] Canstar research April 2012, www.canstarblue.com.au Compare Major Banks
[19] CBA MFAA Home Finance Index September 2011, page 93

comprised only 3.5% of the total value of mortgages outstanding as at December 2011.[20]

However of those who refinanced in the year up to September 2011 64.3%[21] said they benefited from their refinance (compared to 52.9% in May 2011) but these percentages pale compared to those registered in 2007 – 77%.[22]

Even earlier when there were far more alternatives for refinancing in December 2005 some 44% said they changed lenders and 80%[23] of those said they benefited from the change.

Of interest, the June 2006 survey revealed that while 24% refinanced in the previous 12 months, 34.6% changed lenders and of these 82.4% said they benefited from the change. However the survey comments that *"there was no significant difference in reported benefits when comparing 'switchers' to 'stayers'. Nearly all (98%) gained benefits from refinancing."*[24]

Clearly over the period 2005 to 2012, the percentage of all mortgage holders refinancing has not changed materially, but the proportion of those saying they had benefited from the refinance has dropped significantly 2012 compared with 2005 and 2006.

The ban on exit fees has brought about no improvement in industry competition and has merely reinforced the dominance of the major banks and depleted the force of the smaller and non-bank lenders.

*Clearly the solution to the lack of competition does not rest in banning exit fees.*

## The Impact of the Recommendations from the 2010 Senate Economics Committee Inquiry, May 2011

While many of the recommendations may improve the operations of banks and mutuals (ie ADIs) only one is likely to be of assistance to non-bank lenders viz

> **"13.78 The Committee recommends that Treasury develop a plan to introduce a support programme for RMBS similar to that operating in Canada in case a future deterioration in the securitisation market requires its introduction."**

Even then, this recommendation is designed to be ready, if circumstances arise. It is not intended as a permanent solution as are the recommendations applying to banks and mutuals. Furthermore there is no evidence that any progress has been made in this regard.

[20] ABS Housing Finance 5609.0, Tables 1 and 12
[21] ibid, page 99 and May 2012, page 96 (67% May 2012)
[22] Bankwest MFAA Home Finance Index May 2011, page 98
[23] MIAA/Bankwest Home Finance Survey December 2005
[24] Ibid , June 2006, page 29

## Commercial Lending

Although the thrust of this submission focuses on residential mortgage lending, advice from our members engaged in sourcing funds for commercial developments demonstrates concerns about lenders' conduct in this area.

Major Banks are continuing to take a conservative outlook on property development finance in the residential, Commercial and industrial sectors. Whilst they say they will lend to the right developer, they are taking a conservative outlook on their underwriting standards and therefore making it difficult to get funding in place. Loan to value ratios have been reduced, loan to development cost ratios have been reduced and the level of pre-sale requirements has been increased. Typically a developer may require mezzanine funding to provide the level of funding required over and above what a primary lender is prepared to provide. Banks are not in favour of any other funder taking a 2nd mortgage on the project despite not weakening the bank's position. The banks will always have a 1st mortgage with a priority in their favour to cover their exposure. This continued lack of liquidity in the property development finance sector makes it difficult for developers to obtain finance to provide the much needed supply of stock to the market and also has a ripple effect on trade related contractors and their contribution to employment and economic growth.

## THE CURRENT COST OF FUNDS FOR LENDING PURPOSES

Lending institutions, like any other business, have a responsibility to their shareholders or owners, to remain viable and to maximise returns.

In a competitive market the ability of businesses to maximise returns is tempered by the pricing actions of a number of players in the industry. Equally, the level to which businesses enhance customer service is dependent on the competitive levels of service in the market.

Clearly the 'tempering' factor is not strong currently in the Australian lending market.

In his appearance before the House of Representatives Economics Committee Inquiry in 2008, MFAA CEO Phil Naylor commented:

> *"All we are saying is that if there were more players in the market and more access to funds there would be some downward pressure on that. Not all industries have the luxury of saying, 'My costs have gone up, therefore I will put my prices up.' The world is not a cost-plus industry.*
>
> *You certainly take cognisance of your cost, but you also have to take cognisance of what your competitors are doing."*[25]

If there are insufficient competitive players in the market, their response to increased cost pressures is likely to be to pass them on, if those in the market have reason to assume other players will react similarly. It remains to be seen whether the Government's 'price signalling' legislation has any impact on this.

It is indisputable, however, that funding costs have significantly increased since pre-GFC. According to the RBA[26], the average cost of the major banks' funding is estimated to be about 120-130 basis points higher relative to the cash rate. The RBA notes that

[25] Inquiry into Competition in the Banking and Non-Banking sectors, Transcript 14 August 2008, page 44
[26] RBA Bulletin, March Quarter 2012, p41

most of the increase occurred during 2008 and early 2009 when the GFC was at its most intense, but since the middle of 2011 there has been a further increase relative to the cash rate in the order of 20-25 basis points. The RBA also comments that the increase in the funding costs of the smaller regional banks has been larger than that experienced by the major banks.

Deloitte[27], in its Australian Mortgage Report, 2012, warns that external wholesale funding costs will remain at current levels (if not increase) as global uncertainty continues. The Report also comments that strong discounting by the major lenders in the face of increasing funding costs will place pressure on bank pricing models to ensure profitability is sustainable. Ominously for competition, it indicates that smaller lenders, unable to compete on funding will find it difficult to compete profitably on price for any extended period:

> *'The funding cost dilemma is that the marginal net interest margin is circa 200 bps for the majors. In the absence of any repricing of borrower rates, reduction in borrower discounts, or easing wholesale funding costs, the current 220 bps net interest margin on most major bank back books could trend towards 200 bps over the next 12-24 months.*
>
> *In terms of smaller ADIs and non banks reliant on RMBS funding, the situation is even more challenging. Net interest margin on new lending for such groups is only around 65 bps, with net profit marginal at 10 bps. This is clearly not sustainable in the longer term for the smaller lenders.'*[28]

MFAA submits that it makes no sense for Australian borrowers and lenders to be so vulnerable to overseas funding markets when there are ample funds available in Australia, if an appropriate funding vehicle can be facilitated.

Similarly it makes no sense for Australian investors to invest in overseas bonds, when a sound bond market can be developed in Australia, providing low risk returns to investors and keenly priced funds for lending.

## THE NEED FOR FURTHER CONSIDERATION OF THE STATE OF THE BROADER FINANCE AND BANKING SECTOR

It is clear, after Inquiries in 2008 and 2010 and the government reforms in 2010 there has been no effective solution to the lack of competition and access to funding in the lending industry in Australia.

The initiative taken by the Federal Government during the 2008 Inquiry and subsequently to enable AOFM to inject $16b with a further $4b announced in the Banking Reform package in December 2010, into the securitisation market was welcomed and has been helpful. But it pales by comparison with the $300b[29] of issuances by the Canadian Mortgage and Housing Corporation over the 3 years of the GFC and another $264b over 2010 and 2011.

In the 2008 Inquiry and again in the 2010 Senate Economics Committee Inquiry, MFAA was one of several proponents of the Canadian system. Its objectives were eminently

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[27] Deloitte, Australian Mortgage Report 2012, p3

[28] Ibid, page 8

[29] Canadian Mortgage and Housing Corporation, Statistical Report R303A, Activity by Year, reports issuances of $85b in 2007, $145b in 2008 and $134b in 2009 and a further $125b in 2010 and $139b in 2011.

suited to the Australian market then and are even more appropriate now in the 2012 environment, viz:

- To create a more competitive market that would allow smaller financial institutions to provide housing finance at comparable rates to larger institutions
- To provide investors with high quality Mortgage-Backed-Securities that are secured by a government guarantee and underlying mortgage-insured property
- To lower mortgage rates to the consumer
- To strengthen the solvency of the financial system by adding another liquidity source for housing finance

Unfortunately the 2008 Inquiry's report declined to recommend the adoption of the Canadian or similar models proposed and the views of Treasury, the Reserve Bank of Australia and the big four banks, held sway, it seems largely because there was a belief that 'the non-banking sector will regain its market share when market conditions normalise again'.

Obviously market conditions have not normalised again and no one has been able to confidently predict when that will occur. It is clear that the credit markets are experiencing something which is much more sustained than a temporary glitch. That was MFAA's point in its submissions in the 2008 Inquiry.

> "The problem with cycles is that no-one knows how long they are. If we are going to sit back—and I am not suggesting the committee is—and wait to see what happens at the end of the cycle it might be too late, a lot more damage might be done. We have to assume that the environment we are in at the moment may not change for some time. If something else does not happen—and I used the phrase before—it is a back-to-the-future scenario for the industry. We do not think that is good for consumers."[30]

The Recommendation of the 2010 Inquiry[31], proposing an analysis of the Canadian system although put as a temporary measure, was a little more positive.

It may be argued that the market conditions in 2012 are the 'new normal' and this is as good as it gets. MFAA would express doubt as to whether the community would accept a market dominated by four players with 80% of the market as 'normal'. Further we would be concerned that a government would regard such a 'normal' position as good public policy.

Accordingly MFAA urges the Federal Government to consider the rationale and action of the Canadian Government when it established the National Housing Act Mortgage-backed Securities and the Canadian Mortgage Bond. This should not be seen as a knee-jerk reaction to a temporary problem but rather a permanent system to ensure there are appropriate levels of competitive funding available to all lenders, irrespective of the economic environment.

[30] Inquiry into Competition in the Banking and Non-Banking sectors, Transcript 14 August 2008, page 47
[31] 13.78 The Committee recommends that Treasury develop a plan to introduce a support programme for RMBS similar to that operating in Canada in case a future deterioration in the securitisation market requires its introduction.

Of note, in Canada, are the following statistics (with Australian equivalents) on residential mortgages outstanding:[32]

**Table 5**

| Lender | % share of balance outstanding | % share Aust. equivalent[33] |
|---|---|---|
| Life Companies | 1.4% | na |
| Banks | 55.3% | 86.1% |
| Trust and Mortgage Companies | 2.7% | 0.9% |
| Credit Unions and Caisses Populaire | 12.3% | 4.2% |
| Special Purpose Corps (Securitisation) | 1.1% | 8.8% |
| 1NHA Mortgage-backed securities | 22.2% | - |
| Pension funds | 1.2% | na |

1The banks' share of NHA MBS is around 77%% [34] (NB According to Statistics Canada, the above figures do not add to 100% due to rounding)

This would indicate the Canadian banks' total share of residential mortgage credit is around 72% (55.3% + 77% of 22%)

Again referring to outstanding mortgage balances, it is instructive to learn that of the total amount of NHA Mortgage-Backed Securities, there were 50 issuers, 14 of which were banks. The top 5 banks were responsible for 68% of the issuances. Around 14% were issued by trust companies/mortgage companies.[35]

There is a good reason for major Canadian lenders to be accessing this funding.

Pre-GFC the funding cost advantage of a Canadian Mortgage Bond versus the next cheapest alternative source of wholesale funding was 23 basis points. In early 2008, when the impact of GFC hit, the cost advantage was 105 basis points. The 2012-2016 Corporate Plan of the Canadian Mortgage and Housing Corporation reported that, on average, over the period 2006-2008, the cost of funds for the five biggest banks was 18 bps less than the cost of the next cheapest alternate source of long-term wholesale funding.[36]

The CMHC Corporate Plan also notes:

> *"CMHC has undertaken research on Australia's system of housing finance. It found that competition in Australia's mortgage sector has been reduced as a result of funding challenges experienced during the global financial crisis by smaller lenders. Consumers' borrowing costs are also higher"*[37]

CMHC comments that the NHA Mortgage-Backed Securities and Canada Mortgage Bonds programs 'allow large and small Canadian mortgage lenders to access market funding at close to sovereign AAA costs[38]. It further reports that Canada Mortgage

[32] Statistics Canada: Residential Mortgage Credit 2011 and CMHC Mortgage Lending 2011
[33] ABS Housing Statistics: Table 12 Housing Loans Outstanding (Owner Occupation and Investment) 5609.9 December 2011
[34] CMHC MBS –R-120 NHA Mortgage –Backed Securities, Volume by Issuer February 2012
[35] Ibid
[36] CMHC Corporate Plan, 2012-2016, page 92
[37] ibid
[38] CMHC explains as follows: "A 'sovereign' rating refers to the credit rating of a sovereign entity, i.e, a national government. A Credit rating is an independent evaluation of the credit worthiness of an entity. AAA is the highest rating, indicating very little risk of default. The interest costs are therefore lower for

Bonds 'are the second most cost-effective source of mortgage funding after retail deposits'.

> *They usually trade at a small spread over the Government of Canada debt of similar maturity. Prior to the global financial crisis, the 5-year CMB spread was as low as 7 basis points (bps) but climbed to over 80bp during the fall of 2008 at the height of the financial crisis, and then back to 25 bps at the end of 2010."*[39]

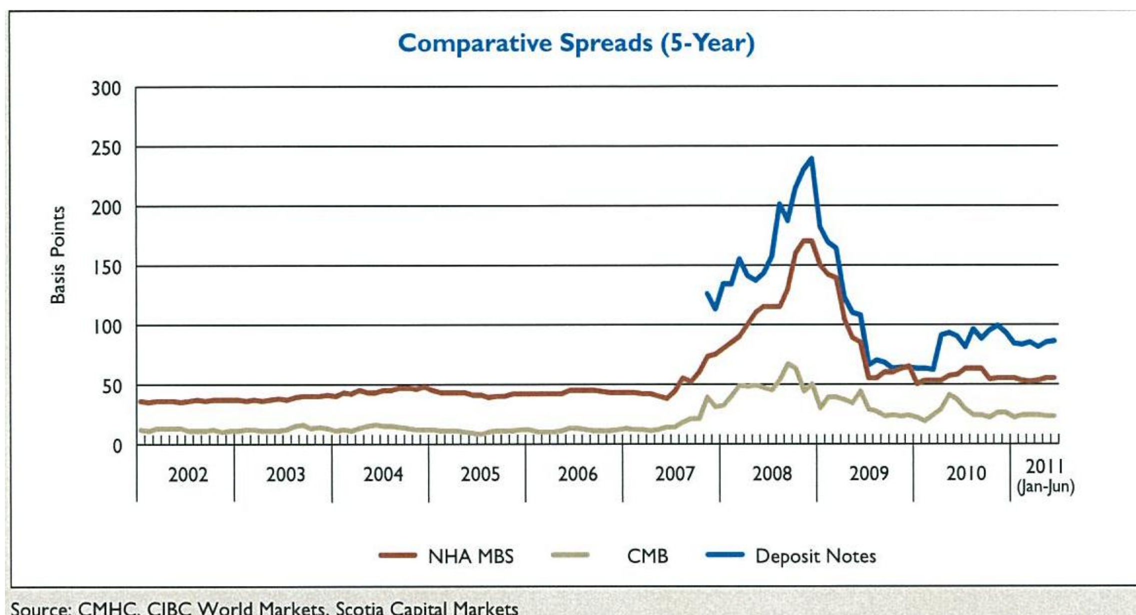
CMHC notes that over the same period major foreign-backed securities markets saw spreads rising by 250-750 bps over their respective benchmarks.

A graphical analysis of the spreads of the NHA-Mortgage-Backed Securities and the Canadian Mortgage Bonds against the Government of Canada 5 year Bond is set out in Figure 3 below showing spreads of around 50bps (NHA-Mortgage backed Securities) and around 25bps (Canadian Mortgage Bonds).

In contrast, the Australian Office of Financial Management in its 2010/11 Annual Report advises that "the margin on a AAA rated senior tranche with a weighted life of around three years improved, falling from around 130 basis points or higher over the bank bill rate at the start of the financial year, to around 100 basis points over the bank bill rate by the end of the financial year."

Advice from MFAA members participating in this funding indicates that AOFM has tended to price in line with their view of the current RMBS markets – a range of 100~165bps for seniors and 170~275 bps for AB tranches. The non-ADIs (ie non-bank lenders) have been priced about 20bps wider than where regional ADIs have been priced.

**Figure 3**




Source: CMHC, CIBC World Markets, Scotia Capital Markets

those entities achieving a AAA rating. Sovereign AAA debt therefore usually has the lowest cost of debt in a country." *(Canadian Housing Observer 2011, page 24)*

[39] CMHC: Canadian Housing Observer 2011, p26

A more detailed analysis of the impact, costs and distribution of CMHC securitisation programs is included in *Appendix A-Securitisation In Focus* (extracted from the CMHC Corporate Plan 2012-2016).

Even though the above Table 5 showing Australian equivalents is not exactly comparing 'apples with apples' it gives a reasonable picture of the differences. The Canadian mortgage market, even with five large banks, is much less concentrated than the Australian market. As with the 22.2% NHA-backed securities in Canada, the 8.8% securitisations outstanding in Australia are distributed across banks and non-banks.

As reported elsewhere in this submission the Canadian Housing and Mortgage Corporation enabled issuances of $85b in 2007, $145b in 2008, $134b in 2009, during the period of the GFC followed $125b in 2010 and $139b in 2011[40]. These provided around 25-30%[41] of the funding for residential mortgage credit over that period (27% in 2011). In Australia the amount of securitised funding made available was negligible, by comparison.

The Canadian Housing and Mortgage Corporation notes[42] in its 2010 Annual Report:

> *'CMHC's securitisation programs guarantee the timely payment of interest and principal of National Housing Act Mortgage-Backed Securities (NHA MBS) issued by financial institutions and of Canada Mortgage Bonds (CMB issued by the Canada Housing Trust (CHT). The Corporation's securitisation programs help ensure that a steady supply of low-cost mortgage funds is available for mortgage lending and provide investors with opportunities to hold high-quality, secure investments in Canadian residential mortgages. In particular for smaller lenders NHA MBS provides a crucial source of low-cost funding, and thus enhances mortgage market competition for the benefit of Canadians seeking mortgage financing.'*
>
> *"CMHC's securitisation programs - NHA MBS and CMB - remain important pillars to the funding platforms of Canadian lenders, regardless of size, and demand for funding through CMHC's securitisation programs continues to be robust. CMHC operates its securities guarantee program on a commercial basis at no cost to the Canadian taxpayer"*

[NB The CMHC Annual Report notes that the net income of its securitisation programs was $281m in 2009 and $510m in 2010 which, as reported in the CMHC Corporate Plan 2012-2016 'help to reduce the Government's annual deficit'[43].]

As a result of the CMHC public securitisation programs, the funding profile of Canadian Lenders is quite different to Australian lenders.

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[40] Canadian Mortgage and Housing Corporation, Statistical Report R303A, Activity by Year
[41] Statistics Canada: Mortgage Loan Approvals 2007, 2008, 2009 and Canadian Housing and Mortgage Corporation, Statistical Report R303A, Activity by Year
[42] Canadian Mortgage and Housing Corporation, Annual Report 2010, pages 51 and 52
[43] CMHC Corporate Plan 2012-2016, p 23

**Table 6**

| Canada | | Australia | |
|---|---|---|---|
| Deposits | 58.9% | Deposits | 52% |
| Securitisation | 28.3% | Securitisation | 1% |
| Covered Bonds | 2.5% | Long-term debt* | 20% |
| Insurance Mortgage Purchase program (2008-2015) | 3.7% | Short-term debt | 20% |
| Other | 6.6% | Equity | 7% |

Source: CMHC: Canadian Housing Observer, 2011; RBA
* includes a small amount of recently introduced Covered Bonds by Australian Banks

An independent review of the Canadian Mortgage Bonds program carried out by KPMG in early 2008[44] (just at the start of the impact of the GFC) commented:

> '*In the current environment* (and by that they mean in the GFC impact period), *some small lenders have recently entered the prime market or have expanded their presence in this market with the funding support of the Canadian Mortgage Bond program. They can compete more on price since margins are wider and funding is reliable. Some can originate enough volume to be a challenge to the large lenders' market share. This seems to be changing the competitive dynamics, with small lenders becoming price leaders from time to time, and large lenders matching their rates.* (MFAA interposes here by reminding that this is exactly what the emerging non-bank lenders did in Australia in the 90s). *This highlights the role of the Canadian Mortgage Bond in supporting the competitiveness of the mortgage market in difficult market environments, and encouraging some pass-through of the funding cost advantage to consumers.'*

It is instructive to note that, of the 13 Western economies and banking systems considered by the KPMG review of the Canadian system in 2008, only 2 (Australia and UK) had no government involvement in the mortgage market on the rationale that the market is the best allocator of resources. (Since then as a result of GFC the UK government has had to take up ownership positions in some UK lending institutions).

We would normally agree with that rationale, provided (*and this is an important proviso)* there is an effective competitive market in operation, which we argue doesn't exist in Australia at present.

## The Objections

It is understood by MFAA the objections to a permanent solution, taking up the key features of the Canadian model, are:

- *The Government should not be involved permanently in the mortgage market and it has already flagged its intentions to wind down the AOFM involvement*

While that is a matter for government policy, it seems to result in Australia to a demonising of lenders each time they put up rates out of cycle with RBA (or fail to pass

[44] Canadian Mortgage Bonds Program Evaluation, prepared by KPMG LLP, June 2008

on the full RBA cuts). A more robust and effective public policy objective surely should be that adopted by the Canadian Government viz:

- ensure competition in the residential mortgage market and
- ensure an adequate supply of low-cost mortgage funding to financial institutions.

  - *The government should not be involved in practices which would distort the market*

This assumes, presumably, that the market is not already distorted. Clearly a market which has four dominant players and whose already dominant market share has increased by 15 percentage points[45] in less than 5 years is the epitome of a distorted market. Further the objection suffers from any real credibility when the government has previously acted in ways which have distorted the market in favour of larger lenders with the introduction of the savings guarantee and the wholesale funding guarantee. The introduction by the government of the AOFM funding restricted to smaller lenders was also a deliberate mechanism to assist smaller lenders and therefore was intended to have a market distortion (correcting) effect.

The real questions should be:

- Is the market as competitive as possible (and without any oligopolistic characteristics)?
- Are there concerns about access to, and pricing of, funding for mortgages?

If the view is, irrespective of the responses to these questions, that governments should not intervene then all we can expect in the future is a series of Inquiries such as this one and its predecessors in 2008 and 2010 which do not solve the problem, accompanied by the regular two or three day circus of criticism each time the banks do not follow RBA cash rate movements. If the government truly believes that the market should be left to its own devices then please spare us all the rhetoric each time lenders behave in a way the government does not believe appropriate.

However if the responses to these questions are ‘no’ and ‘yes’ respectively, the task should then be to identify what options are available to the government to improve the market’s competitiveness and access to funding, in the interest of borrowers.

The reality is that the Australian mortgage market has never experienced ‘real’ competition without some external intervention.

The government-actioned de-regulation of the banking system in the late 80s brought about competition from foreign banks and then Australian non-bank lenders, which assisted to spawn the development of the mortgage broking channel. Clearly these two latter developments have been the only material innovations in the mortgage market in the past 25 years. These occurred with de-regulation as the catalyst. Even the major banks’ ‘switching campaign’ in 2011 was result of the government’s announcement of intention, and ultimate action, to ban exit fees.

There are unlikely to be any significant spontaneous explosions of competitive innovation unless there is another catalyst initiated by the government. Government action to facilitate more competitive operation of the lending market is a much more productive approach than a monthly media ‘inquiry’ into its conduct.

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[45] 59.6% - July 2007; 75.0% -February 2012: APRA Monthly Banking Statistics and ABS Housing Finance, 5609.0

## Conclusion

The Australian lending industry has shown over the past few decades that it has operated most competitively and in the consumers' interest when banks have been subject to competition at the funding and retail level by non-banks/mortgage managers and mutuals and at the retail level by brokers competing with branch lending.

The lack of access to funding to the non-bank sector has reduced competition in the market, reverting the industry to almost a pre-deregulation environment.

The result of the 2008 Inquiry seemed to assume this would be a temporary position that the cycle would remedy. The 2010 Inquiry also has offered no long term solutions.

That the cycle has not remedied the market five years later should be a strong signal to all that more lasting measures are required to ensure a continuous flow of competitive funds.

We accept that it may be not as simple as just importing an overseas model into Australia but there are many similarities between the Australian and Canadian economies and banking systems, eg

- similar population 22m vs 34m,
- similar provincial/state structure,
- strong broker channels,
- 4 major banks in Australia versus 5 in Canada
- similarly sized mortgage market (Canada has $1.1 trillion in loans outstanding compared to Australia's $1.2 trillion) and, most importantly,
- both countries have a robust and prudent banking system and a strong economy which avoided the worst impacts of the GFC.

However one obvious difference is the strong non-bank sector in Canada vs the seriously weakened non-bank market in Australia.

The Canadian Government took its decision to intervene, initially by the issuance of mortgage-backed securities in 1987 and then, Canadian Mortgage Bonds in 2000, because it wanted to:

- ensure competition in the residential mortgage market and
- ensure an adequate supply of low-cost mortgage funding to financial institutions.

On the independent analysis of KPMG, it has achieved those objectives on an ongoing basis, whether in fair economic weather or foul.

Furthermore it has passed the most rigorous stress test in the past 80 years with flying colours, by coming through the GFC without missing a beat.

The Canadian model, as well as achieving those social/economic objectives, also produces a profit for the government and a competitive rate of return for investors in the program.

It should be understood that there will be no meaningful changes to competition in this industry unless there is a strong and viable non-bank sector.

History demonstrates this as does the successful Canadian model.

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# Appendix A – Securitisation in Focus

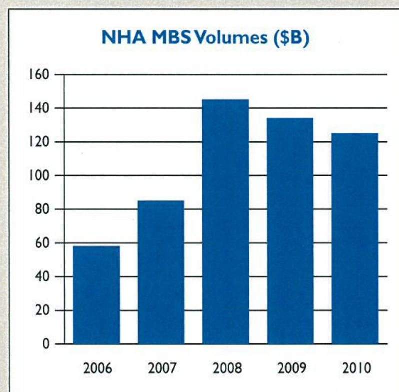


## Securitization IN FOCUS

### Providing a reliable low-cost funding framework for lenders

Since the introduction of CMHC's securitization guarantee programs, approximately $800 billion in insured residential mortgages have been securitized. Of this total, approximately 42% ($341 billion) is in the form of market NHA MBS issued by Approved Issuers for sale to investors (outside of CMB) and/or used for balance sheet management or collateral for liquidity facilities/programs. The balance is largely NHA MBS under the CMB program. This demonstrates the importance of the NHA MBS program in providing a robust framework for Approved Issuers to transform illiquid mortgage loan assets into high quality secure investments. Similarly, the CMB program plays a crucial role in further enhancing the supply of low-cost mortgage funding for program participants, particularly small institutions.

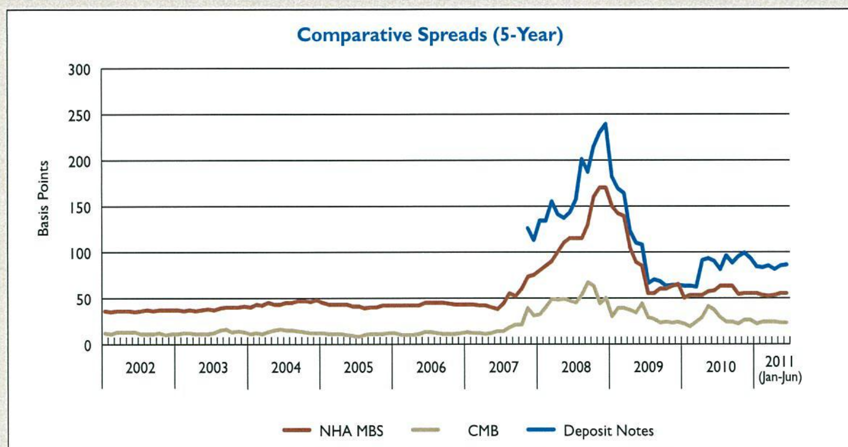
The following shows volumes from 2006 to 2010.




Source: CMHC

In 2010, excluding IMPP, approximately one quarter of outstanding mortgages were securitized under CMHC's securitization programs. The remaining three quarters were funded by lenders through other means.

The reliability and cost-effectiveness of CMHC's securitization programs were clearly demonstrated during the global financial crisis which occurred between the fall of 2007 and the spring of 2010. This is reflected in the volume of insured residential mortgages securitized and the relative spread differential between these programs and the major wholesale funding source of large financial institutions compared to the Government of Canada five-year yield.

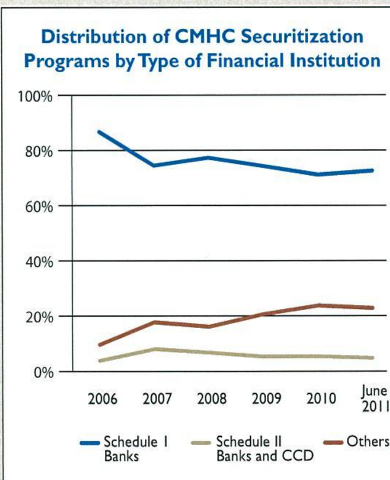


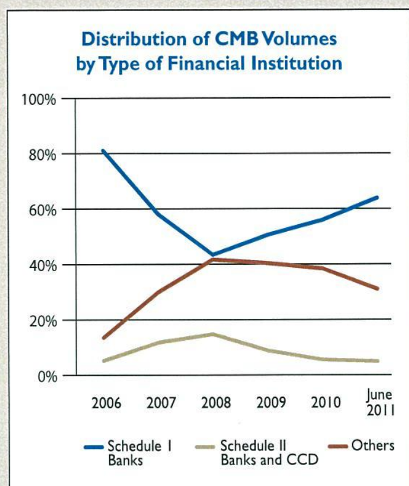

Source: CMHC, CIBC World Markets, Scotia Capital Markets

## Support for smaller lenders and competition in the mortgage market

Smaller lenders are important in maintaining a competitive Canadian mortgage market as they compete with the established larger lenders. During the recent global financial crisis, smaller lenders found it more difficult to access liquidity and funding. CMHC's securitization programs in general, and the CMB program in particular, played an important role in supporting smaller lenders during those challenging times.

Prior to the global financial crisis, smaller lenders accounted for approximately 10% of insured residential mortgages securitized though CMHC's securitization programs. With the increase in the number of smaller lenders who sought access to CMHC's programs, the participation rate increased from 10% to approximately 23% as at June 2011. Under the CMB program, the increase in the participation of smaller lenders is even more pronounced, moving from 14% in 2006 to 31% as at June 2011.






The reliability and the volume of funding that CMHC's securitization programs provide to smaller lenders ensure that they continue to play an important role in maintaining the competitiveness of the Canadian residential mortgage market.

## Meeting the mortgage needs of Canadians

CMHC has responded to the wider range of mortgage choices sought by Canadians through the introduction of NHA MBS pool types that allowed lenders to securitize new mortgage products. Expanding CMB terms and offerings to include 10-year and Floating Rate Notes also facilitated cost-effective funding to support a wider range of term structures enabling mortgage lenders to address current and emerging mortgage choices of Canadians.

## Prudent risk management

Since the inception of CMHC's securitization programs, there has never been a loss under these programs. They fulfill CMHC's objective of enhancing the supply of reliable low-cost funding for mortgage lending in Canada and the competitiveness of the mortgage industry.

Risk exposures under the timely payment guarantee are managed through robust risk mitigating practices including stringent approval criteria for program participants. Moreover, the commercial nature of CMHC's securitization programs means that they contribute to CMHC's net income and, as such, help reduce the Government's annual deficit.