



RESEARCH NOTE

Number 51, 25 June 1996
ISSN 1323-5664

Mortgage Originators: New Financial Stars

At last, the traditional lenders in the housing loan market are facing strong competition from low-priced rivals. Such lending has been dominated by banks (with smaller contributions from building societies and credit unions) and has been very profitable for them. Funds have been largely raised from vast, low-cost household deposits. Strong demand for housing (based upon widespread aspirations to "own your own castle" and expectations of capital gains through house price appreciation) and a quite concentrated, uncompetitive market structure have both put upward pressure on home loan rates charged. Home lending has also been a safe, secure activity for these lenders. Loan default rates have been quite low and house price appreciation minimises the lender's risk of capital loss after repossession.

High profits attract new competitors if barriers to entry are not insuperably high. Until recently, it seems that barriers to new residential lenders have indeed been prohibitively high. New lenders need both a source of funds at reasonable cost and a way of contacting and engaging house mortgage borrowers. Traditional lenders rely on both their vast base of cheap deposits and their extensive branch systems to engage and service such borrowers. Aspiring rivals have been deterred by the problems and

costs of acquiring such commercial prerequisites.

But new suppliers of home lending have largely overcome these barriers. The dramatic expansion of mortgage originators in residential lending (such as Aussie Home Loans, its ally PUMA and RAMS) has attracted much attention. Their funds have been raised very largely from professional investors at reasonable cost. The use of extensive advertising and mobile loan assessment staff, who go to the clients' residence at times to suit the client, have allowed these new lenders to overcome the marketing advantages of the branch system. Indeed, the branch system seems to have become something of a disadvantage for traditional lenders since it entails higher administrative/overhead costs. Many banks have reduced their branch numbers in recent years for this very reason. Operating costs for the new mortgage lenders seem to be much lower, thus allowing them to set their loan interest rates a notch lower.

The data on interest rates for residential loans highlights these changes. In April 1996 the average standard indicator interest rate charged by banks on variable housing loans (where the rate varies as financial conditions change) was 10.50 % while for the mortgage originators/managers it was 9.0%. Indeed, this

differential of 1.5 percentage points was higher than the differential in June 1994 of 1.05 percentage pointsⁱ. Consequently, there has been a large flow of borrowers away from the banks. For example, it is estimated that between June 1994 and December 1995 the banks' share of new secured housing finance commitments dropped by about 6 percentage points (from about 91% to about 85%), albeit from a high baseⁱⁱ.

The mortgage originators have enjoyed spectacular growth in their loan volumes. For example, in the year to June 1995 the number of mortgages under the management of Aussie Home Loans increased from 356,000 to 1,352,000ⁱⁱⁱ. After incurring some losses in its initial years of operation, Aussie Home Loans is now extremely profitable, earning a rate of return on shareholders' equity of 214% in 1994-95^{iv}. Similar results are expected for 1995-96. However, the banks are fighting back with "no frills" cut-price loan packages and some seem set to launch their own mortgage originator subsidiaries. Many banks have recently cut their standard variable housing loan interest rates below 10%.

The mortgage originators/managers operate using a financial process called "securitisation". Once loans are made, they are bundled together into trusts and units (i.e.

securities) in those trusts are sold off, largely to professional investors. Interest payments on the housing loans are thus converted, after subtraction of operating costs and fees, into interest payments for the investors. Unlike a bank, the home loans do not generally stay on the balance sheet of these mortgage providers, who often continue to manage the mortgages (for a fee). This allows these providers (in contrast to banks) to specialise in their strength in credit risk assessment without the direct legal burden of continuing responsibility for the loans (and the borrowings which finance them). The efficiencies of this process seem sufficiently large that the majority of home loans could, at some time in the future, be funded and managed in this way. This prospect poses a formidable challenge to traditional banking.

Demand for such securities has grown substantially in recent years. This higher demand has allowed the mortgage originators/ managers to raise substantial volumes of funds from professional capital markets at a cost low enough to challenge the traditional housing lenders. A large portion of such funds has been raised within Australia. This seems to be bound up with the recent growth in superannuation. The rapid increase in superannuation fund contributions has, in turn, increased the

appetite of superannuation funds managers for securitised residential loans, especially since the latter are relatively safe (i.e. low default rates and low risk of capital loss). This is an unexpected benefit of the development of compulsory superannuation. As well, some funds have been raised through better access to overseas capital markets.

The appropriate regulation of the mortgage originators/ managers is now beginning to be discussed. There are some striking differences in regulatory burdens between the traditional and new housing loan providers. For example, Australian banks are required to have shareholder capital of at least 8% of their (risk weighted) assets; similar requirements are made of building societies and credit unions. Such regulations tend to push up loan interest rates; the mortgage originators/ managers are not subject to them.

This might seem a blatant case of regulatory divergence creating an "unlevel playing field" between competitors. However, the Reserve Bank of Australia (RBA) argues that these minimum capital requirements for banks exist to protect the bank deposits of ordinary Australians who may know very little about financial risk or what their own bank has been doing (if very risky loans are made and the borrowers default, then bank

shareholders can bear the costs rather than depositors). Since the mortgage originators/ managers rely on professional capital markets, where risk is routinely accepted and risk assessment is sophisticated, the RBA concludes that it would not be sensible to impose the same regulatory burdens on these new housing lenders. However, the banks argue for some lightening of their other regulatory burdens (especially the controls on mergers and takeovers) in order to achieve "fairer competition". The recently announced Wallis Financial System Inquiry will be examining such issues.

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ⁱ Reserve Bank of Australia Bulletin, May 1996: Table F.4.
ⁱⁱ KPMG, *Financial Institutions Survey* 1996: 7.
ⁱⁱⁱ Ibid, 1996: 77.
^{iv} Ibid, 1996: 77.