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Submission in response to the

House of Representatives Standing Committee on Economics inquiry into competition in the banking and non banking sectors

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1. Executive summary

The Council of Mortgage Lenders (CML) is pleased to respond to the House of Representatives inquiry into the competitive landscape between the banking and non-banking sectors.

CML represents the interests of Australian mortgage lenders who offer non-bank loans based on prime financing. Prime non-bank lenders include: Resi, Yes Home Loans, Australian First Mortgage, First Folio, Onyx Finance, Club Finance and Wizard.

CML members support an open, transparent competitive market. Strong competition between the retail and non-bank lenders enables greater choice for working Australian families and empowers them to make decisions about whether to borrow, where to borrow, and the terms on which they borrow a home mortgage product.

During the past two decades, prime non-bank lenders have been instrumental in driving competition for the benefit of consumers. The competition this sector has introduced has resulted in lower rates, more loan features and greater flexibility for customers. None of these innovations existed in the days of the banking oligopoly. All Australians have benefited as a result.

We are deeply concerned about the way in which prime non-bank lenders have been portrayed in the wake of the subprime crisis. Our larger competitors have unfairly taken advantage of the issue in an effort to win back market share.

Prime non-bank lenders should now be referred to as mortgage managers to avoid confusion between themselves and mortgage brokers.

Mortgage managers are often unfairly positioned with all other non deposit-taking organisations as an irresponsible and insecure sector of the industry. Banks are driving this misrepresentation for commercial gain. Many consumers are making financial decisions based on inaccurate information and suffering as a result.

Prime non bank lenders must be supported to ensure Australian consumers do not return to the 'dark old days' with little choice or competition.

CML proposes three key measures to level the playing field: increased, evenly applied regulation, an agreed industry standard to restore confidence in the non-bank lending sector and a government-backed lending program to increase liquidity in the market.

2. Introduction

The Council of Mortgage Lenders (CML) is pleased to submit its view of the mortgage industry and the value competition brings to Australians wanting to buy their own homes.

The Australian financial markets are currently facing unprecedented challenges driven largely by the impact of the US subprime crisis.

The finance sector has, however, also undergone significant development in the past 20 years and this has created new opportunities and new challenges for all players and importantly, for Australian consumers.

CML represents the interests of prime non-bank lenders who together with other lenders such as banks, credit unions, building societies, subprime or non-conforming lenders, brokers and lenders of last resort comprise the mortgage lending industry.

Prime non-bank lenders, or **mortgage managers**, are non banks selling mono-line loans using prime funds – the same funds used by banks. The majority of these loans are full doc loans. It should be noted that low-doc loans are not non-conforming loans; they are means of providing parity for self-employed borrowers with employed borrowers. Banks have followed the innovation of mortgage managers in this area and now also offer low-doc loans with no additional risk margin on interest rates.

Mortgage managers should not be confused with brokers, nor non-conforming lenders who rely on subprime funds and lend to those with poor credit history or insufficient deposits.

Mortgage managers have played a critical role in the evolution of competition and consumer choice, and have in fact driven most of the positive changes in the sector. Working families in particular have welcomed an alternative to the banks and the new features and improved service initiated by the new lenders, subsequently adopted by other providers.

To ensure ongoing and healthy competition between the banks and mortgage managers, they should be treated in the same way and be governed within the same regulatory environment to ensure a level playing field.

CML proposes the development of an industry standard (applied to all lenders) or a rating system (similar to a Standard & Poor's) to reduce confusion and restore competition in the mortgage lending sector.

3. The prime non-bank lending sector (developments in relation to products, providers and distribution channels)

The emergence of the sector began in the 1990s following financial deregulation and a period of low inflation.

As new lenders gained market share, the competition intensified and the non-bank lending sector evolved and diversified within itself and created two distribution channels for consumers - the prime non-banks (mortgage managers) and mortgage brokers.

CML represents those non-banks who offer mono-line mortgages financed by prime funds. The majority are full doc loans.

CML does not represent banks, building societies, credit unions, mortgage brokers, nor non conforming lenders who rely on subprime funds or lend to the credit or deposit impaired.

While a relatively small sector of the overall lending marketing, mortgage managers punch well above their weight. Overall the non-bank lending sector, including brokers, represents 13 per cent of the mortgage market.

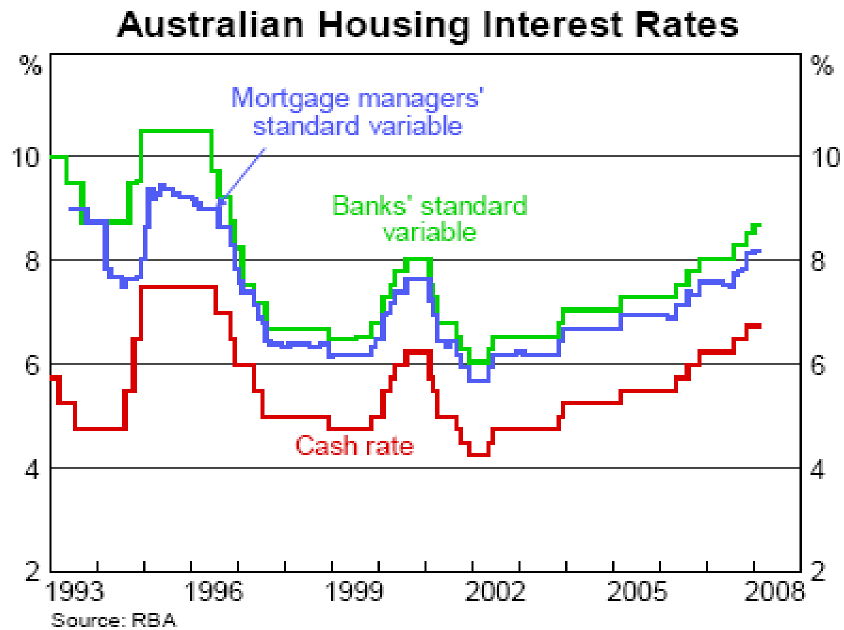
Mortgage managers include: Resi, Yes Home Loans, Australian First Mortgage, First Folio, Onyx Finance, Club Finance and Wizard.

Mortgage managers have driven significant, positive industry innovations that benefit Australian consumers.

These innovations include introducing:

- No fees and charges
- Lower pricing and lower average standard variable lending rates than banks (see graph on following page)
- Multiple monthly payment options (regular and lump sum to discharge debt more quickly)
- Linking transactional capabilities, including cheque books, credit cards and ATM cards to a mortgage account, creating an everyday working account or 'lifestyle product' out of a debt product)
- Mortgage accounts payable by via ATMs and internet
- Split loans - enabling customers to separate elements of their loan into tax deductable components. This is now common practice in banks
- Investment loans without a risk loading on the interest rate
- Making home loan products far more accessible. This in turn has encouraged small business operators to access equity in their homes to grow their businesses. (Previously they would apply for bank overdrafts at higher interest rates)
- Introducing the broker distribution channel which has given consumers greater choice. Prior to this initiative banks refused to deal with brokers, limiting choice for consumers

The mortgage manager sector has been responsible for reducing the margins on mortgage lending rates over the benchmark cash rate.



For the last 13 years official Reserve Bank figures have consistently shown mortgage managers offering cheaper mortgage finance than banks.

As a result of the product initiatives introduced to the Australian market, mortgage managers have, by default, created careers and jobs for Australians and made investment property mortgage loans popular among Australia's greatest economic contributor, small business.

4. The current state of the industry

The Australian financial markets are facing unprecedented challenges driven largely by the impact of the US subprime crisis.

This crisis has provided the perfect storm for banks to claw back residential mortgage market share lost as a result of increased consumer choice.

> By playing on consumers' lack of understanding about the sector, banks have misrepresented all non deposit taking lenders as being less secure and more exposed to the increasing cost of wholesale funds.

Unfortunately for consumers who have been enticed to incur exit fees and refinance in the hope of maintaining lower repayments, the reality is banks also rely on wholesale funds for much of their mortgage lending, and their rates are rising just as much, if not more than, mortgage manager rates.

As a result of the combination of the banks' 'predatory' behaviour and the wholesale funding credit squeeze, Australia has seen the unfortunate backlash over the past eight months of hundreds of non-bank lenders closing their franchises and businesses altogether. For many in the non-bank lending sector the prospect of recovery is bleak should the Government not intervene quickly to regulate the environment and restimulate the sector with a funding strategy. (This is further explained in 'Drivers for Future Change' section.)

In addition to this, the flexible products mortgage managers have introduced are starting to disappear as banks reassert their dominance in the market.

Confusion of terminology among consumers

A high level of confusion and misunderstanding exists about exactly what a "non-bank" lender is. There are several reasons for this:

- 'Non-bank lender' has become a generic term for any 'mortgage lending' organisation that is not a bank, but this group varies enormously in scope and offering and is **not** a homogenous group

- Non-bank lenders have not clearly or consistently defined what they do and offer – there is therefore a proliferation of terms and in this confusion, the market has found it easiest and most convenient to label all players as one group despite their significant differences

- Almost every week in the major metro media, the term non-bank lender is misused and misrepresented. This repeated behaviour has resulted not only in confusion for borrowers, but a tarnished reputation for all 'prime' lenders (mortgage managers) that reside in this space

CML believes that if the government wants to change the fractured perceptions around mortgage lending, the timing is critical for terminology within the sector to be clearly defined and communicated. If it is not immediately obvious to the consumer it will not be for government either.

At present, the following terms are all used when referring to the range of lending roles operating outside the banks:

- Non-bank lender
- Prime non-bank lender
- Non-conforming lender
- Fringe lenders
- Lenders of last resort
- Sub-prime lender
- Low-doc/no-doc lender
- Mortgage manager
- Mortgage broker
- Mortgage aggregator
- Mortgage originator
- Mortgage intermediary
- Finance broker

It has been in banks' interests to maintain and enhance market confusion and lack of understanding about non-bank lenders to help attract customers back to what they have positioned as the "safe" and "more affordable" option of banks.

Subtle and not-so-subtle advertising and marketing by the banks has implied that loans from non-banks are unsafe. Misleading claims have to date gone unchallenged. At least one bank has used the term publicly "flight to safety" when encouraging borrowers to refinance to their bank.

Consumers are now confused and vulnerable

Many consumers have responded to unfair fear mongering from the banks and have incurred unnecessary financial costs by discharging nonbank mortgages early in the false hope of greater security and lower rates.

Unfortunately for these consumers, these decisions have not only posed greater financial burdens in the short term but if history is any guide they are likely to result in higher repayments long term as well.

This fear mongering has also threatened the existence of a sector of lenders that are critical for maintaining choice, competition and fair deals for consumers – mortgage managers.

Three harmful myths have emerged

Regardless of intent, a number of myths have developed about the operations of non-bank lenders.

- Lending standards and defaults: There is a perception that prime non-bank lenders have less strict lending standards than banks. This is a massive generalisation. While the absence of a national register for mortgage defaults means it is difficult to accurately analyse and examine data to provide a clear and robust picture of the market, research shows that the ratio of non-performing housing loans to total housing loans on banks' balance sheets at 30 June 2007 was identical to the 90 day arrears rate on securitised prime housing loans. Both stood at 0.41 per cent, suggesting mortgage defaults are equally represented by both sectors.

  It is also worth noting that there is significant discrepancy with reported figures of defaults as banks are often the original source of the loan where repayment difficulties begin before borrowers subsequently refinance with an alternative lender to increase the flexibility and timeframe for their repayment options. Australian home loan lenders know from experience that they must be able to prove they had good reason to believe a borrower could comfortably meet the repayment obligations on a mortgage from current known income sources. If a lender cannot demonstrate this, Australian courts can reopen the loan contract and reduce the borrower's obligations. These consumer protection laws are very well developed and provide effective protection for mortgage borrowers.

- Exit fees: It has been claimed that Australian early termination fees are high compared to the UK and US and that non deposit taking institutions charge the highest fees. It is important to note that all lenders over the course of a loan need to recover core costs through a combination of interest, ongoing fees or discharge fees. Most banks recoup these costs (and more) by charging significant ongoing mortgage management fees. Mortgage managers however charge minimal if any ongoing fees but recover additional costs if lenders discharge their loan within the first four to five years. In the majority of cases mortgage managers' customers pay less over the life of their loan. It is also important to note however that the interest in discharge fees coincides with the banks consumer scaremongering encouraging borrowers to leave non-bank lenders. Discharge fees are not an issue for borrowers unless they discharge. Most consumers do not need to discharge but in recent times some have, driven by fear based on suggestion and innuendo, not fact.

- Business purpose declarations: It has been claimed that these have been used to avoid Uniform Consumer Credit Code (UCCC). UCCC governs credit transactions in Australia and promotes a single standard coverage for all Australians. Credit providers, including banks, building societies, credit unions, finance companies businesses are required by law to tell consumers their rights and obligations in any credit arrangement. It is extremely unusual for these declarations to be falsely made (by banks and non-banks). The business declaration facility provides a critical service to many small business customers who alternatively would have to use higher cost overdrafts to fund business expansion.

5. Preserving and enhancing competition

The health of the mortgage market has major implications for consumers and a competitive market is rightly regarded as the most effective mechanism for driving down fees and charges and improving customer service.

Since deregulation, mortgage managers have been instrumental in helping Australia develop what is widely regarded as one of the most sophisticated mortgage markets in the world.

There are however significant differences between the business models and cost structures of bank and non-bank lenders. Banks have lower average funding costs and higher fixed costs because of their deposit base and branch structure. The non-bank lending model is mainly dependent on capital markets for funding and relies on the efficiency of service providers to competitively originate and service loans. The value propositions offered to consumers by the two models can therefore differ: banks may leverage their brands and focus on value produced by cross selling while non-banks are more likely to seek scale by undercutting their competitors on price and providing higher levels of features and service.

Competition has delivered innovation, choice and reduced costs to consumers

Mortgage managers have introduced a number of product innovations, such as no-application fees and have created competition so that better loan flexibility was introduced. Multiple monthly payment ability, daily interest calculation and redraw facilities, were just some of the features that borrowers enjoy as standard today because of this competition.

The following benefits (in addition to the innovations mortgage managers have brought to market, see page 4) have flowed from consumer demand for choice and increased competition within the mortgage sector:

- Provision of choice and emergence of brokers developed as non bank lenders entered the market. Banks had previously only offered products directly
- Mortgage managers have helped drive consumer education. Before our existence consumers were unaware that choice was available and were locked into higher cost mortgages from banks often unwilling to negotiate
- Mortgage managers have helped facilitate a more transparent decision making process assisting consumers to understand what is required to obtain mortgage credit and have also helped remove the artificial barrier between domestic and investment mortgages – thus encouraging greater investment and helping to build our strong economy
- Success of mortgage managers has helped banks understand the importance of customer service and relationships and we have recently seen a refocus on branches to re-balance the trend towards reliance on technology and brokers

Barriers impacting competition

Competition in recent years has begun to decline and the mortgage managers are already under attack by the major banks. The impact will be the non-bank lending market will lose its

level playing field and ultimately cease to exist. Competition and choice will be reduced, costs will go up and the financial pressures faced by working families will increase. This will have wide ranging and long term implications for the economy and is contrary to Australia's culture of 'a fair go for everyone'.

The barriers currently hindering competition, and which will ultimately kill a sector that has to date brought choice and financing options to working families and business owners are listed below:

- **Credit crunch** – the cost of and access to wholesale funding is squeezing mortgage managers out. The current system offers banks greater opportunity to access funds through the Reserve Bank's window. Non-banks do not have this option. Regulation is required if for the mortgage manager sector to survive
- **Government regulation** – if regulation is introduced that gives one sector an advantage over another (such as the regime proposed in the recent Financial Services and Credit Reform Green Paper), then the benefits introduced to Australians to date will disappear and a return to the 'dark old days' with little choice or competition will occur. Mortgage managers also need regulation to protect them from the current 'predatory' behaviour of banks and wholesale funders.
- **Debt stress** - consumer credit and expenditure is on the rise placing pressure on net household income, which in turn has reduced consumers' capacity to buy a home. As this continues, consumers are forced to use their mortgage funds to pay their household debts and 'live beyond their means'. In this environment, mortgage defaults will continue and in turn eventually dry up the non-bank lending market
- **Dominance of banks** – because of their size, marketing clout and diverse business models, banks can afford to keep the pressure on their smaller competitors. If regulation is not put into place quickly, Australia is likely to see the end of the mortgage manager and mortgage broker sectors.

6. Drivers for change, enhanced competition and innovation

To drive the industry to change, CML suggests three key changes should take place:

1. Increase regulation
2. Develop an industry standard
3. Introduce a government funding program.

Increase regulation

As self-regulation has clearly failed the sector, CML calls for increased regulation to ensure a level playing field and ensure continued competition and choice for Australian consumers.

CML supports the move towards one national regulatory framework to regulate all consumer credit, including mortgages.

It is CML's belief that current consumer debt issues will be rectified if the federal government assumes responsibility for all forms of consumer credit. Without comprehensive checks and balances for all credit, combined with improved financial education, consumers will continue to "live beyond their means" and seek to use any mortgage equity (which has the lowest rates of interest) to manage personal debts. In this environment, mortgage defaults will continue.

To stop the banks from eventually squeezing out the non-banks, balance needs to be restored by way of regulation that governs all players. A true level playing field and competition will only be provided by consistent regulation between the two. If this is sanctioned then Australians will continue to enjoy the benefits competition has brought to the home loan industry.

CML recommends a new two-tier system of regulation for mortgage lenders. The two tiers would be defined by whether an organisation offers just one lender's products, or a range - making them mono-line or multiple line mortgage lenders. Banks and mortgage managers (prime non bank lenders) would be tier one and mortgage brokers would be tier two.

Since the advent of the subprime crisis many large players have used this to make customers question their decision to borrow from non banks. By suggesting, either subtly or overtly, that non banks are less secure, consumers have become confused and have, in many cases, made bad financial decisions to refinance perfectly safe, good value mortgages. To date, this behaviour has gone unchecked. Banks, and other organisations that make claims or suggestions not based on fact, should be sanctioned by the ACCC.

Develop an industry standard

The wholesale credit squeeze, combined with the opportunistic behaviour of the banks, has led to a slump in confidence around non-bank lenders. To restore competitive balance and redress the damage, CML suggests the development of an industry-wide set of standards. These standards would allow consumers to make informed decisions about lending, rather than relying on the myths and misconceptions being bandied about by the banks and some sections of the media.

The standards could take the form of an official Australian standard or a rating. The government may even consider introducing an accreditation system for all lenders – banks and non-banks. The objective would be to provide an independent assessment of the lender's credentials so that consumers could make better informed choices. Such a measure would also benefit smaller players who risk being swept aside by the banks' marketing clout.

CML, as the representative body of mortgage managers, would be happy to work closely with government in developing and testing the standard.

Introduce a government funding program

The global financial crisis has effectively caused the 'primary' market for residential mortgage-backed securities in Australia to evaporate, and as a result severely rationed credit channelled to non-bank lenders. Australia needs a policy solution that will restore liquidity to the market. Failure to act will see the competition that emerged in the mortgage market over the past 10 years dissipate significantly.

CML proposes the federal government sponsor an enterprise, like the 'AussieMac' policy initiative to protect households and the financial system against current and future credit crisis proposed by Melbourne Business School to the Commonwealth on 26 March 2008 by Christopher R.E. Joyce and Joshua S. Gans. The program is based on the successful 'Fannie Mae' and 'Freddie Mac' model in the US:

Fannie Mae has a federal charter and operates in America's secondary mortgage market to ensure that mortgage bankers and other lenders have enough funds to lend to home buyers at low rates. Freddie Mac, one of America's biggest buyers of home mortgages, is chartered to keep money flowing to mortgage lenders in support of homeownership and rental housing.

In effect, the government would become the ''issuer' of securities for lenders, and everyone would benefit - banks, non-banks and consumers. A funding program of this nature would restore stability and long term confidence to both the primary and secondary mortgage markets and ensure that a high level of competition will continue.

7. Impact of technological developments

The mortgage manager sector was the first mover in the market to drive innovation through technology. Mortgage managers pride themselves in finding ways to enhance the customer experience and build relationships with them. Technology has helped them to achieve this, and will continue to do so in the future.

The mortgage manager sector was the first to:

- Bring mortgage transactions online
- Sell mortgages online
- Introduce value add banking products online, cheque books, credit cards
- Send automated SMS messages for reminders or offer new financing products

8. Comparing Australia to international jurisdictions

The majority of economically developed countries still operate in an old mortgage model environment. These countries include Germany, the US and Canada. In addition, they do not have a mono-line banking industry to drive competition and change.

Australia has one of the most advanced mortgage markets in the world, largely due to the innovative mortgage products and technology advances introduced by mortgage managers. Features such as redraws and direct salary crediting are unheard of in many overseas markets which still seek 30 per cent deposits from customers.

Many countries envy and seek to emulate the features of our mortgage lending market introduced by mortgage managers. Over recent years many of the best features introduced in Australia have begun rolling out overseas. For example, Macquarie Bank took the line of credit offering into ten states in the US, and the Canadian Broker Association studied our market and used it as a benchmark to push for industry and regulatory change.

9. Conclusion

Mortgage managers have driven innovation in the Australian mortgage market with consumers the clear winners. Other nations see Australia as one of the most advanced mortgage markets in the world.

However, the increased choice and flexibility introduced by these lenders is now under threat due to the wholesale credit squeeze and the banks' predatory behaviour.

These challenges are complicated by a lack of understanding of the non-bank lending sector. Mortgage managers, who are clearly differentiated from mortgage brokers, should be regulated in the same way as banks to ensure a level playing field.

Australia's giant banks are attempting to drive mortgage managers, who offer lower rates and innovative products, from the Australian market. The Council of Mortgage Lenders urges the government to move immediately to protect smaller players from anti-competitive and actively misleading behaviour. There is a demonstrated need for increased regulation and CML also supports the development of an industry standard to restore confidence in prime non-bank lenders, who have been unfairly targeted in the wake of the subprime crisis.

Further, we call on the government to introduce a funding program to ensure Australians wanting to buy their own homes have access to affordable funds.

The government must act now to address anti-competitive behaviour and ensure continued competition and choice for Australian consumers.