



Inquiry into competition within the Australian banking sector

1. Executive Summary

- FirstMac is pleased to contribute to the Senate Inquiry into competition within the Australian banking sector. FirstMac is a non-authorized deposit (non-ADI) taking institution operating as a specialised home loan lender and loan servicer.
- Following deregulation of the banking industry in the 1990s, non-ADIs have provided critical competition to the major banks. It was this competition that was largely responsible for the historic reduction in home loan margins as the major banks in particular were forced to reduce their margins in the face of eroding home loan market share.
- A continuation of the AOFM program is recommended. Key enhancements sought include an expansion of the AOFM mandate to include purchase of subordinated Notes, and the provision of pipeline funding certainty for non-ADI Issuers. It is recommended that non-ADI's be advised of their allocation in advance for a future period of 12 months.
- The persisting government guarantee of ADIs provides for an unlevel playing field both for Funds Management and for non-ADI lenders. Funds are retained predominately within the major banks largely retarding a securitisation revival. The removal or reduction of the government guarantee would be materially beneficial for securitisation.
- Over the past three years FirstMac has actively sought access to an ADI license either through establishment of a new start-up license or alternatively through strategic alliance and equity investment in an existing ADI licensed entity. Barriers to entry have curtailed our progress.

2. Who is FirstMac?

FirstMac is a non-ADI operating as a specialised home loan lender and loan servicer. The company provides loans for the purchase and refinance of residential property, catering to both the owner occupier and investor markets, including first home buyers.

Since the mid 1990s, FirstMac has played an integral part in the evolution of the home loan market into a more competitive environment, as both a direct lender to the consumer and also as a wholesale provider of loans to non-bank mortgage lenders.

FirstMac is reliant upon the issuance of Residential Mortgage Backed Securities (RMBS) in the securitisation market to source funding to enable it to continue to provide home loans in competition with the major bank lenders. FirstMac is one of the leading RMBS issuers in Australia, having issued approximately \$9 billion in RMBS both domestically and offshore since 2003.

FirstMac has participated in the Australian Office of Financial Management's (AOFM) investment support of Australian RMBS, having received \$1,400 million investment in FirstMac Issued RMBS transactions between November 2008 and October 2010.

The Group has a Standard & Poor's 'Strong' Servicer Rating, reflecting the strength of the FirstMac's fully integrated, web-enabled loan origination, underwriting and servicing platform, its long history of servicing loans, financial stability, proactive compliance culture and quality assurance framework. The rating was affirmed in December 2010.



3. The importance of non-ADIs for competition

Following deregulation of the banking industry in the 1990s, non-ADIs have provided critical competition to the major banks. It was this competition that was largely responsible for the historic reduction in home loan margins as the major banks in particular were forced to reduce their margins in the face of eroding home loan market share.

Recent media commentary has focused on the mutual sector as a source of competition. Mutuals have a place as providers of niche community or industry offerings, but they are unlikely to generate meaningful competition to major bank market dominance. This sector has existed in Australia for many decades and whilst they have continued to offer a valued and tailored service offering they did not drive competition with the major banks through the last two decades and are unlikely to do so in the future.

Rather, competition in the home loan market has been driven by the non-ADI sector. With access to securitised funding, non-ADIs such as FirstMac, have supported a proliferation of non-bank mortgage lenders, the largest of which, Aussie Home Loans, RAMS, and Wizard Home Loans, became household names. The non-ADI sector delivered meaningful competition which has had a lasting impact in the lower cost of home loans to the Australian consumer.

As a result of the financial crisis though, the non-ADI sector has been materially disadvantaged due to the dislocation of the financial markets, and the reduction in the availability of funding and the greatly increased cost of available funding that has ensued. This has seen the demise of some of the non-ADI lenders while others have been acquired by the major banks.

The non-ADI institutions have been at a huge disadvantage as they have not had access to depositor funds, did not receive the benefit of government guaranteed funding, do not have access to RBA repo arrangements, cannot access the wholesale/retail bond markets and in the current climate cannot readily implement alternate funding strategies. As such, the non-ADIs that remain in the market have been largely reliant on the AOFM investment mandate, to maintain an active presence in the home loan market.

4. Securitisation

Securitisation is the 'great leveler' in that it transfers risk from the lender to the pool of home loan assets supporting the RMBS transaction. It facilitates competition more than any other tool through allowing even unrated and unregulated issuing institutions to compete with AA rated institutions for funds. The robust trust structuring allows investors to focus and compare underlying asset security quality and performance rather than focusing solely on the issuing institution.

Australian issued RMBS has continued to perform well throughout the period of financial crisis. The operation of the Australian securitisation market has been disrupted by a global lack of liquidity rather than concerns over credit quality.

- a. Measures to support Securitisation
 - i. AOFM Program

The AOFM program has successfully implemented the Government strategy of providing medium term support for Australia's second tier lenders.

Benefit to the Government of existing scheme:-



- High quality assets rated AAA by at least two Rating Agencies
- The short Weighted Average Life (generally 3~4 years) of RMBS provides the Government with a predictable exit strategy as market conditions improve
- Improving market conditions will also allow the Government to exit its investments earlier by selling into the secondary market.
- In the short term, the scheme promotes competition and choice outside of the major banks, notwithstanding the difficult market conditions, and in the long term the scheme will be seen to have had the effect of supporting the continuation of market diversity and options which will deliver to the Australian consumer, the best outcome in respect of product offering and price.

Proposed Enhancements to the Existing Scheme:-

(i.i) Extend mandate to purchase Subordinated Notes

The AAA rating assigned to the senior RMBS tranches is achieved by the subordination of junior Notes. These Notes are typically rated AA- with the rating dependent on the underlying Mortgage Insurer's rating. There is currently only one active investor for these junior Notes and the total of available investments funds is limited. Of great concern is the ability of this investor to continue to support the non-ADI junior note issuance as well as the increasing level of junior note funding that will follow from APRA's stance on ADIs retaining subordinated Notes to their balance sheet. Failure to place subordinated Notes would result in non-ADI RMBS transactions failing in totality. It is recommended that the Government extend the AOFM Mandate to facilitate the purchase of these junior Notes. The underlying Mortgage Insurers on which the rating of the junior Notes is dependent are APRA regulated (for fully insured transactions).

Advantages

- Provides greater leveraged use of AOFM funds. The senior AAA Notes are more easily placed in the market. AOFM investment in both junior AAA and subordinated AA- Notes (roughly 5~10% of a total RMBS transaction) requires a smaller amount of tax payer funds to achieve broadly the same end result, i.e. this is more efficient than the current practice of investing in 30%~50% of a total transaction.
- Promotes RMBS Issuance by ensuring flow of funds to the tranche with the least amount of current market access
- Underlying rating dependant on APRA regulated entities

Disadvantages

- Whilst underlying mortgage insurers are APRA regulated they are not ADIs. Different capital requirements apply between Insurer's and ADIs.
- Typically a 5 year expected maturity there is risk that an Issuer may not Call a transaction at its Call Date. This may present the risk of the Note maturity being extended for up to the term of the underlying mortgages, generally between 25 and 30 years.
- Underlying rating of mortgage insurer, similar to ADIs, may be subject to ratings downgrade

(i.ii) Pipeline

Of particular relevance and benefit for the non-ADI's would be the certainty of forward pipeline mandates. Non-ADI's typically fund their new originations through short term 'warehouses' facilities that are intended to be refinanced into term RMBS within a period of 12 months. Uncertainty as to future RMBS issuance creates nervousness amongst warehouse providing banks and can lead to restricted access to funding for new originations.

It is recommended that non-ADI's be advised of their allocation in advance for a future period of up to 12 months to evidence there is an exit strategy for new origination. This certainty of future term funding would better facilitate the origination of new home loans from the perspective of both warehouse funding and product marketing. A pipeline approach (Serial



Mandate) was utilised in phase 2 of the AOFM investments however it was largely negated by greater flexibility available under the Reverse Enquiry scheme. The fundamental need for the pipeline approach remains unchanged.

Advantages

- Facilitates the origination of new home loans with certainty of future term funding
- Promotes access to short term funding facilities due to certainty provided to facility provider

Disadvantages

- Commits AOFM to forward funding reducing flexibility to adapt to changing market conditions if required

ii. Funds Management Industry

Competition for funds is equally as important as competition for lending. The funds management industry previously provided competition to the major banks deposit funding base. A material amount of funds raised by the funds management industry was invested in RMBS. Non-ADI issuers such as FirstMac relied heavily on managed funds as their core investor base. The introduction of the government guarantee of ADI resulted in large outflow of funds from fund managers to major bank deposits. This resulted in the demise of traditional RMBS investors and the second tier lenders who relied on their investment.

(ii.i) *End or at least reduce the Government Guarantee of ADIs.*

The persisting government guarantee of ADIs provides for an unlevel playing field both for Funds Management and for non-ADI lenders. Funds are retained predominately within the major banks largely retarding a securitisation revival. The removal or reduction of the government guarantee would be materially beneficial for securitisation.

(ii.ii) *Fund Management Mandates*

As an alternative to AOFM purchase of subordinated Notes, funds could be allocated to selected fund managers with a mandate to invest in subordinated RMBS tranches. This would provide the additional benefit of boosting fund management institutions that have suffered recently from increased redemptions.

Advantages

- Provides boost for Fund Management Industry
- Promotes RMBS Issuance by increasing flow of funds to the tranche with the least amount of current market access

Disadvantages

- Potentially more cumbersome to manage
- Direct investment of funds in other than AAA rated securities (Subordinated Notes typically rated AA-)

iii. Guarantee of Senior RMBS Notes

There has been some discussion amongst the second tier industry as to the potential for a guarantee of senior RMBS Notes. Whilst we would welcome such an initiative this is not FirstMac's preferred option. The current difficulties with placing the senior RMBS Notes is due to a general lack of funding and liquidity and is not related to credit quality which remains undoubted.

Advantages

- Level playing field for bond issuance in the marketplace



Disadvantages

- Does not replace the general lack of funding available for pass through instruments (bullet bond Issuance such as that of the bank senior debt is non-amortising and attracts wider categories of investors).
- Higher overall funding costs due to combination of guarantee fee and market differentiation of 'Government guaranteed' Issues
- Further distortion of free markets in addition to the distortions already arising from the ADI guarantee

5. Covered Bonds

There has been some discussion amongst the ADI industry and media as to the potential benefits that may arise from the introduction of Covered bonds. This may facilitate fund raising opportunities for the larger ADIs. This may be a positive for the broader industry generally given greater fund flow however is unlikely to provide any discernable benefit to non-ADIs.

6. Bank Licensing – Barriers to Entry

Over the past three years FirstMac has actively sought access to an ADI license either through establishment of a new start-up license or alternatively through strategic alliance and equity investment in an existing ADI licensed entity.

A significant barrier to entry has been the ownership of FirstMac Group which is 100% held by private family interests. Legislation prevents an individual from owning greater than 15% of an ADI. It is understood that this requirement is in place to facilitate capital raising if required by that ADI. This appears inconsistent with the licensing of Mutual's which by their membership design have numerous owners but limited capital raising capability. In contrast FirstMac Group has limited owners but far greater capital raising capacity.

Whilst taking a 15% equity stake in an existing ADI is an alternative the Group would anticipate regulatory complications, namely related party transactions and a deemed over reliance by the ADI on a single party, in providing product distribution and funding for that ADI partner.

It is telling that, aside from limited foreign entrants, no new banking licenses have been granted in Australia for a decade. This may be due to the primary regulatory objective of banking stability which would likely preference a consolidation to fewer banking licenses rather than expansion. Facilitating competition is not a regulatory objective.