

Housing Mortgage Contract Design and Banking Sector Competition

Submission to: Senate Economics Committee Enquiry
"Competition within the Australian banking sector"

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1. This submission focuses upon a subset of the Committee's terms of reference, and addresses the questions of whether the current structure of housing mortgage contracts involves appropriate risk sharing between banks and customers and implications for competition in banking markets.
2. The experience of the sub-prime crisis in the USA has illustrated the importance of mortgage design for the efficient functioning of financial markets and avoidance of significant social and economic problems. This submission argues that legislation to enforce certain changes in mortgage contract design in Australia would have social and economic value.

Mortgage Contract Design in Australia:

3. Australia is relatively unique in having a standard mortgage contract which gives the lender the absolute discretion to change the interest rate on an existing mortgage whenever and to whatever the lender wishes. This is a characteristic of variable rate home loans offered by banks and other providers, and the majority of home loans are of this form (with others including fixed rate loans). Genworth Financial¹ reports that 85 per cent of new housing loans in 2009 were of this form. But there appear to be no publicly available official figures on usage of different types of mortgage to assist analysis of mortgage market developments, even though this data

¹ Genworth Financial (2009) *The Genworth Financial Mortgage Trends Report*
<http://www.genworth.com.au/lenderresourcecentre/GenworthReports/mortgagetrendsreport/2009Report/index.htm>

could be required as part of D2A returns submitted by banks and ADIs to APRA.

Recommendation 1: APRA should be required to make publicly available data on mortgage characteristics and terms from data provided by banks and ADIs.

4. Information on mortgage contract design internationally can be gathered from a number of sources.² What that indicates is that the Australian housing loan is relatively unique in allowing absolute lender discretion in changing interest rates charged on existing mortgages. More common is some form of adjustable rate mortgage in which the contract specifies that the rate charged will be adjusted at specified intervals (eg quarterly) to remain at an agreed fixed margin above some market indicator interest rate for an agreed specified period (such as 5 years). In this way, adjustments in interest rates are automatic until the end of the agreed period when terms are renegotiated (reset). Loans of different vintages (initiation dates) may involve different fixed margins above the indicator rate, depending on market conditions at the time of initiation. Also common are fixed rate mortgages in which the rate is fixed at a specified rate for some agreed period, at which time it is renegotiated (reset), or for the life of the loan. These alternative loan types can also be poorly structured and create problems (such as in the US subprime case) and ease of exit by the borrower to access alternative finance at the reset dates is critical for effective competition and fairness. Properly implemented, however, they appear superior to the current Australian contract as discussed subsequently.
5. The reason why Australian mortgage loans give banks absolute discretion to adjust interest rates on existing loans is not readily apparent. It may be that the contract arrangements evolved during the period prior to the mid 1980s when housing loan interest rates were subject to government control by way of a regulated interest rate cap. In such circumstances, borrowers faced little risk from the discretion given to banks. When deregulation of interest rates occurred, the characteristics of the mortgage contract were not reviewed to assess their compatibility with a deregulated financial sector. While there has

² See, for example, Michael Lea, *International Comparison of Mortgage Product Offerings*, Corky McMillin Center for Real Estate, San Diego State University, September 2010, http://housingamerica.org/RIHA/RIHA/Publications/74023_10122_Research_RIHA_Lea_Report.pdf and BIS (2006) *Housing finance in the global financial market*, CGFS Publications No 26, January 2006 <http://www.bis.org/publ/cgfs26.htm>

been much public debate over the years about the loan rate setting behavior of banks (e.g. speedy increases but tardy decreases in response to movements in market interest rates) it has been the disruption to relative funding costs occasioned by the GFC which has brought the deficiencies of the mortgage contract to the fore.

Mortgage Contracts and Interest Rate Risk Sharing

6. At the current time, there is much debate about Australian banks increasing housing loan interest rates by more than Reserve Bank changes in the cash rate. Figure 1 illustrates how the margin was roughly constant at 180 basis points prior to the onset of the Global Financial Crisis and had increased to 290 basis points in October 2010. Underpinning this debate is the fact that there have been significant changes in bank funding costs, relative to the cash rate, such that these need to be reflected in loan interest rates if bank profitability is to be maintained. Regardless of whether bank profitability is too high or not, the question of whether both existing and new borrowers should bear the burden of such funding cost changes, or whether this should impinge upon bank profits is an important one.
7. Changing the form of mortgage contracts would defuse much of that current debate, and would work to allocate interest rate funding risk more appropriately between bank customers and shareholders (and management). Why don't banks themselves introduce adjustable rate loans and get rid of the political opprobrium the current situation involves? The reason is straightforward - the current mortgage structure makes their risk management job (for which bank executives are paid large salaries) much, much, easier. As well as movements in general market interest rates being passed onto the home borrower, for them to bear this risk, banks are also able to pass on the consequences and risks of any errors they make in their funding and interest rate risk management choices. A bank which is funding housing loans in a way which subsequently becomes relatively expensive can simply increase the rate it charges to existing borrowers. Or a bank which had its credit rating downgraded and faced higher funding costs could pass that onto both existing and new borrowers, rather than it impinging directly on shareholder profits. (Of course the bank's reprieve would only be temporary – since the higher loan rates would affect its ability to compete for new

borrowers – but being able to shift part of the burden to existing borrowers is to the advantage of bank management and shareholders).

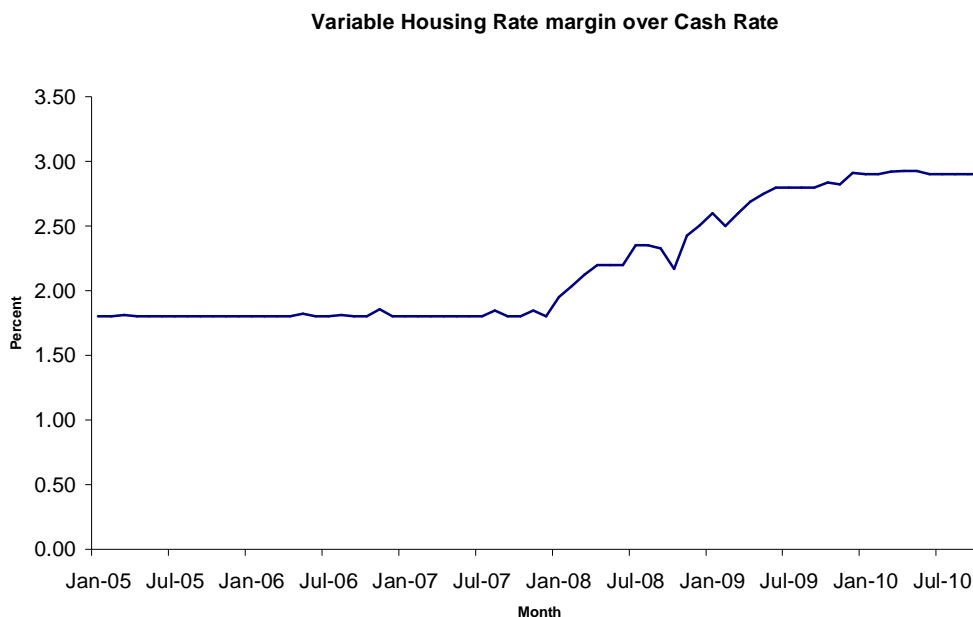


FIGURE 1: Housing Mortgage Rates and the Cash Rate

Source: RBA Statistical Tables.

8. While such funding (or interest rate risk management) errors will affect the bank's ability to compete for new borrowers, existing borrowers have limited ability to avoid wearing the resulting costs. Paying out an existing loan to shift to another lender is a costly exercise, and less appealing if all that is on offer is more of the same from a limited number of major players. Creating arrangements which make it easy for borrowers to transfer to another lender are an important part of reform.
9. The problems with the current mortgage design arise because the discretion afforded to banks enables them to spread future increases in the cost of funding over both existing and new borrowers. For example, consider a situation where a bank suddenly faces a 100 basis point increase, over and above a market indicator rate such as the cash rate or bank bill swap rate, in the cost of new funds. This could arise because the bank's credit rating has been downgraded or might be a more general increase in credit risk premia demanded in financial markets.
10. The immediate effect on the bank's average cost of funds is very small, because much of its current funding will have been previously locked in with

maturity dates sometime in the future. But as the existing funding matures and must be replaced, or if the bank wishes to expand the size of its balance sheet, the higher cost of marginal funding will gradually increase the average cost. This, in effect, is what has happened over the GFC, and the gradual increase in the spread in Figure 1 since early 2008 can be viewed as partly reflecting the gradual increase in average funding costs from earlier increases in new (marginal) funding costs.

11. The gradual increase in average funding cost (relative to the market indicator rate) will be reflected in the rate charged on both existing and new loans under our current mortgage system. And with existing borrowers locked by exit costs, competition for new borrowers encourages a process whereby new borrowers are temporarily shielded from the full increase in bank marginal funding costs by the averaging effect
12. But that is only temporary. Lenders would in these circumstances be aware that over time the loan rate will have to increase relative to the cash rate as the higher marginal cost of funding on replacement funds flows through to a higher average cost of funding. Whether new borrowers during and since the GFC were (or should have been) informed by lenders that future increases in their loan interest rates above any change in the cash rate (or other market indicator rates) were likely because of such effects is a potentially explosive issue.

Reforms Required

13. One plank in a reform package is to prohibit “variable-at-the-bank’s discretion” mortgages and encourage adjustable rate mortgages where the interest rate is tied at inception to some fixed margin over a suitable market indicator rate over some medium term horizon until a “reset” date. This would leave borrowers bearing general market interest rate risk, but force banks and their shareholders to bear and manage the risk of poor funding or risk management choices.

Recommendation 2: Prohibit loan contracts which give lenders absolute discretion to change the interest rate on existing loans.

14. If such loans are prohibited, what alternative interest rate setting arrangements are possible. Ideally, the loan contract should specify some agreed mechanism by which loan rates can be subsequently adjusted based on verifiable criteria. Adjustable rate loans where the rate is specified as a fixed margin over a variable market indicator rate for some period (e.g. until a reset date 3 or 5 years from loan initiation) are one option. The interest rate charged would be adjusted at specified regular intervals (e.g. monthly or quarterly) in line with movements in the market indicator rate. An alternative would be for the interest rate to be fixed for a specified period until the reset (renegotiation) date. But more complex arrangements would also be necessary in some circumstances. In the case of business loans, for example, floating rate loans often involve a margin above an indicator rate, but where the margin may be changed if there is some observable change in the borrower's circumstances (eg credit rating downgrade, or violation of certain loan covenants). As long as the triggers for resetting of the margin are well defined and verifiable, that should not be prohibited.

Recommendation 3: Loan contracts should allow for subsequent variations in the interest rate charged as long as the conditions for such changes are well defined at the initiation of the contract and are verifiable by reference to objective information.

15. The second plank in a reform package is to require that at the reset date at the end of the agreed medium term fixed rate or fixed margin period, borrowers are able to transfer the mortgage at no cost to another lender if they wish. Critically, rather than having to discharge the mortgage, it could be transferred to a different preferred lender upon payment of the outstanding principal amount. To those of us unskilled in the legal profession, this would seem to involve no more than crossing out the name of the existing lender on the loan contract and inserting the name of the new lender. But undoubtedly lawyers can make it much more complicated! However, given that loans can be sold and futures contracts can be novated, this would not seem to be an impossible process.

16. With such a requirement in place, lenders will be forced to recoup up-front costs of mortgage origination either by up front fees or by interest rates charged over that initial medium term period. In those circumstances, they do

not suffer a loss on the mortgage at the reset date if the mortgage is transferred - other than the relationship with the customer, which gives the customer some improved bargaining power. Given the importance of wealth management business and transactions and deposit business to the banks, the balance of negotiation power would be significantly affected.

Recommendation 4: Lenders should be precluded from charging exit fees on housing loans if the loan is three years (or more) old and the customer wishes to exit at the end of a period when it is time for a reset (renegotiation) of terms.

Recommendation 5: At a loan reset date, borrowers should be able to transfer a mortgage to another lender upon payment of the outstanding principal, without the mortgage having to be discharged. If the loan is in good standing, the accepting lender should not be required to obtain a new valuation of the property involved – since that would not have been required if the loan were not being transferred.

It is worth noting that transferability of a mortgage at (near) zero cost is a feature of the Canadian system.³

17. Exit fees would still exist in certain circumstances. Should the customer wish to switch banks or pay out a loan prior to the reset date, there would likely be some exit fees. In the case of fixed rate loans, banks will generally have hedged interest rate risk by “matched funding” in which fixed rate funding to the same maturity date as the loan reset date has been raised.⁴ If interest rates have fallen, and the customer exits the loan, the bank is left with the fixed cost of funding which can only be reinvested at a lower interest rate. A break fee would be appropriate in those circumstances. The break fee could in fact be negative (with the bank paying the customer) if market interest rates had gone up, such that the bank could reinvest its funds at a higher interest rate than was being paid on the loan. More generally, fees would be

³ Eric Laselles, *Canadian Mortgage Market Primer*, TD Securities, June 18, 2010, p4
http://www.td.com/economics/special/el0610_cdn_mort_market.pdf

⁴ Generally this will be done at the portfolio level (including by use of derivatives) rather than at the individual loan level, but the consequences are the same.

appropriate for recoupment of any “up-front” costs which had been built into the interest rate over the initial period prior to the reset date. ASIC’s recent Regulatory Guide 220 sets out its view on defensible costs which could be included in exit costs.⁵

Deferred Establishment Fees and Competition

18. “Exit” fees are often “deferred establishment fees” (DEFs), whereby the lender has not charged the borrower up front fees for the significant costs in establishing a mortgage. It is asserted by some lenders that this practice enables such lenders to better compete with major banks in the market for new mortgages. Would the preclusion on exit fees proposed in Recommendation 4 thus reduce competition?
19. It is important to distinguish two possible polar approaches to use of DEFs. One approach is that the costs incurred for each loan are to be recouped over time from that borrower by incorporating those costs into the interest rate for that loan. If the borrower exits early the DEF reflects the unrecouped costs associated with that loan. The alternative approach is where such costs are not reflected in interest rates, but are anticipated to be recouped in aggregate from exit fees paid by that proportion of borrowers who exit early. In this case, the lender is, in effect, providing each borrower with an early exit option which requires payment of a fee. And because only a proportion of borrowers will elect to exit early, the fee charged will need to be significantly higher than the establishment costs incurred on a single loan for the lender to recoup those costs in aggregate. In practice, the use of DEFs probably involves some element of each approach, and the ASIC guidance principles will tend to inhibit the use of DEFs as part of an exit-option feature of loan contracts, by linking allowable exit fees solely to costs related to that loan.
20. If use of deferred establishment fees makes such loans attractive to particular borrowers considering entering a loan contract, it needs to be asked why they would find that characteristic valuable. In aggregate, a lender needs to recoup those costs somehow from the borrowers it deals with (and will require more if the recoupment is deferred to reflect the time value of

⁵ ASIC (2010) “Early termination fees for residential loans: Unconscionable fees and unfair contract terms”
Regulatory Guide 220, November 2010.
[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg220.pdf/\\$file/rg220.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg220.pdf/$file/rg220.pdf)

money). In that sense, the way and time at which those costs are recouped should be of little concern to a financially literate borrower who is able to understand that the total cost of the loan will be unaffected. But some borrowers may be cash-constrained and may value highly a deferral of certain fees. Of course, this is really nothing more than the lender providing an additional “implicit” loan to the borrower to cover the up-front costs which are packaged into the mortgage loan repayment arrangements. Making that implicit loan explicit by including it in the initial loan amount on which interest and repayments are calculated would thus remove the need for exit fees. This would prevent situations where borrowers misperceive the consequences of “deferral” of establishment fees. It would also make more apparent the risks in very high loan-to-value loans, which are understated if DEFs are used.

Recommendation 6: Deferral of loan establishment fees should only be achieved by explicit addition of the amount which would otherwise have been charged into the initial loan principal.

21. Precluding exit fees which reflect the exercising of an early exit option arguably reduces choice available to borrowers. Some borrowers may anticipate not exiting the loan, such that the deferred establishment fee will not be incurred. Others, may value an option to exit early which involves a significant cost to exercise. While in principle such risk sharing between customers may have value, its practical relevance is questionable, and the potential for unscrupulous lenders to set the exit fee above a “fair” price (which would be difficult for borrowers and possibly regulators to estimate) suggests that banning such arrangements does not involve significant social cost.
22. The deferred establishment fees can thus act as a very significant exit cost and lock borrowers into their current loan. Such switching costs are a significant impediment to competition.

Mortgage Design and Securitisation

23. The current structure of mortgage contracts has an indirect effect on the competitiveness of the securitisation market. Issues of mortgage backed securities must offer current market interest rates and thus interest rates on

the new loans underlying an issue must reflect that marginal cost of funding. In contrast, banks are able, under the variable-at-bank's-discretion contract to price new loans at the average cost of funds.

24. For example, consider a situation where a bank suddenly faces a 100 basis point increase, over and above a market indicator rate such as the cash rate or bank bill swap rate, in the cost of new funds. The immediate effect on the bank's average cost of funds is very small, because much of its current funding will have been locked in with maturity dates sometime in the future. But as the existing funding matures and must be replaced, or if the bank wishes to expand its balance sheet, the higher cost of marginal funding will gradually increase the average cost. This, in effect, is what has happened over the GFC. The gradual increase in average funding cost (relative to the market indicator rate) will be reflected in the rate charged on both existing and new loans under our current mortgage system. And with existing borrowers unlikely to switch (particularly where other lenders are behaving similarly due to having similar funding experiences), competition encourages a process whereby new borrowers are temporarily shielded from the full increase in bank marginal funding costs by the averaging effect
25. If credit spreads increase, as in the example above and as occurred in the GFC, the competitive position of securitisers is reduced because banks increase interest rates on new loans only gradually in line with the increase in the average cost of funds. Over time, as the average adjusts to the marginal cost the competitive disadvantage of securitisation disappears (as is happening gradually at the current time in Australian mortgage markets). Securitisers, of course, benefit when spreads move in the other direction.
26. The ability of banks to average funding cost changes across both existing and new borrowers thus increases the vulnerability of the securitisation business model's competitive ability to events such as the GFC, and to volatility in credit spreads. Removing the lender's absolute discretion to change the interest rate on existing mortgage contracts would thus also assist the securitisation industry in remaining competitive in the new mortgage market during times of disruption.

Volatility of Mortgage Loan Rates

27. Because both existing and new variable rate borrowers are charged the same interest rate under the current system, there tends to be a “smoothing” of the initial rates paid by new borrowers. Moving to an adjustable rate mortgage would mean that while both old and new borrowers were affected equally by movements in the market indicator rate, shifts in the lender’s funding cost relative to that benchmark would impinge only on new borrowers rather than existing borrowers. In practice, this could mean some greater volatility of new mortgage loan rates due to variability over time in the margin charged over the indicator rate on new loans. Conversely, there would be less volatility in interest rates on established mortgages.
28. While this “decoupling” of interest rate margins on old and new loans and the volatility consequences would have been significant in the GFC it is likely to be of less importance in more normal times. But even in the GFC, the decoupling would have merit, by signaling to intending borrowers the margin they are required to pay over a number of years. In contrast, under the current system, new borrowers entered loan contracts where the initial margin was an understatement of the future margin the borrower was likely to face as bank average funding costs caught up with higher marginal cost.

Prudential Concerns

29. Redesigning mortgage loan contracts with effects upon risk sharing and banking market competition is likely to raise a number of prudential concerns. One prudential concern would be that banks would bear, rather than pass onto existing borrowers, the risks of any funding or risk management errors. During the GFC, the ability of Australian banks to pass on to existing loan customers the higher funding costs undoubtedly contributed to their relatively good performance. But, arguably, their knowledge that they could do so may have influenced their willingness to take on funding positions which exposed them to those risks. Changing loan contract design and risk sharing could be expected to affect bank funding decisions.
30. APRA will also no doubt worry about “adverse selection” problems arising from changes which make it easier for a customer’s loan to be transferred to another lender. Banks, naturally, will exert less effort in trying to prevent loss of poorer quality loans, leading to a potential outcome where those are taken over by other banks with inadequate due diligence procedures, and a consequent weakening of their balance sheets. In practice, however, this is

not likely to be a major issue in the case of housing mortgage loans. Borrower loan repayments and credit standing can be verified from account statements and credit bureaus, income data can be obtained, and property price movements can be observed to assess likely security value.

Conclusion

31. Australian mortgage contracts warrant review to remove the variable-at-the-lender's-discretion characteristic. This enables lenders to pass onto borrowers certain interest rate risks which the lenders are better suited to manage, arise from their funding choices, and the consequences of which should impact upon shareholder profits rather than borrowers. Contracts in which interest rate changes after inception, and prior to some agreed reset (renegotiation) date, are only possible in response to observable, verifiable, events are more common elsewhere, and have merit. But it is also crucial for competition and equity that at the rest (renegotiation) date, borrowers are able to transfer a mortgage to another lender at minimal cost. The recommendations given above are one way of achieving improved risk sharing and competition in housing mortgage markets in Australia.

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