ASIC
Australian Securities & Investments Commission

Briefing on Competition and Tracker Mortgages

1. Competition in banking

1.1. ASIC supports measures to improve competition in banking and financial services.

1.1.1. We support the recommendations of the FSI in respect of competition, including the Government's announcement to have the Productivity Commission examine the state of competition in banking.

1.1.2. In addition, we support the current progress towards including consideration of competition in ASIC's mandate.

1.1.3. In respect of FSI recommendation 19, we also support the Productivity Commission's current examination of broadening access to data. ASIC has made a submission to this Inquiry, supporting greater public access to data.

1.2. An oligopoly is a market structure where a small number of firms have the large majority of market share and exercise market power.

1.2.1. Although there are competing players within the Australian banking industry, there is a high degree of concentration of market share and market power among the big four banks.

1.2.2. The FSI final report noted that although competition in Australian banking "is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time". It also noted that "concentration in retail banking creates risks to both the stability and degree of competition in the Australian financial system".

Market share and power

1.3. **Assets:** As at the June quarter 2016, there were 156 authorised deposit-taking institutions (ADIs) in operation in Australia. Assets on the balance sheets of these ADIs total $4.6 trillion, of which the big four banks hold a **77% share**.[1]

1.3.1. The FSI interim report noted that Australia’s banking market is relatively concentrated by international standards. The share of banking assets owned by the four largest banks in Australia is higher than equivalent shares in most other jurisdictions.

1.3.2. The FSI Interim report also found that concentration has increased since the global financial crisis (GFC), with the major banks’ share of total ADI assets increasing from 65.4 per cent in September 2007 to 78.5 per cent in March 2014.

[1] APRA, June 2016.

1.4. **Mortgages:** The MFAA's submission to the FSI in March 2014 noted that the Big 4 banks held around 80% of the mortgage market, a share which they have maintained effectively since the end of the GFC. The remaining smaller banks hold a 14% share while the mutuals hold a dwindling 5% and the non-banks around 2%.[2]

1.5. **Credit Cards:** The RBA's submission to the Senate Inquiry into Matters Relating to Credit Card Interest Rates stated that cards issued by the big four banks accounted for around 75% of credit card transactions in 2014-15.

1.6. **Deposits:** According to data published by APRA in August 2016, the big 4 banks hold 80% of the total value of household deposits and 77% of the value of all deposits.

Vertical integration

1.7. Vertical integration is common in the financial system, particularly in the banking and funds management industries.[3] The trend towards vertical integration between parties in the product distribution chain has continued.

1.8. **Funds management** is increasingly being bundled with a range of other financial services under the wealth management umbrella. ASIC's review of the Future of Financial Advice reform implementation found that approximately 63% of licensees sampled were affiliated with financial product issuers.

1.9. **Financial advice:** The big four banks and AMP currently account for more than half the number of financial advisers in Australia.

1.10. **Wealth management:** The four big banks, all of which have significant fund management operations, have increased their share of the wealth management industry over the past few years. We are currently doing work on vertical integration in this space which will give us a clearer picture of the extent and impact of vertical integration.

1.11. **Mortgage broking:** In the years prior to the GFC, the mortgage broking industry developed as an independent channel that facilitated distribution of home loans by smaller lenders and new players based around securitisation. In 2014, the MFAA estimated that aggregator or broking groups owned by big 4 banks (totally or substantially) are estimated to cover around 40% of mortgage brokers.

    1.11.1. Subsequently there has been vertical integration with banks buying or taking an ownership stake in a number of the major brokers. ASIC's current mortgage broker review will consider how distribution is working through this channel.

[2] Source ABS Housing Finance data.
[3] FSI final report at [529].

2. Tracker mortgages

2.1. While the introduction of tracker mortgages is a decision for the lenders themselves, ASIC would encourage lenders to offer this product. Tracker mortgages would bring a number of benefits to consumers and overcome some perceived issues in variable rate home loans currently on offer. No law reform would be required for lenders to introduce tracker loans. Whether Government would decide to mandate the offering of these products is a matter for Government.

2.2. Last week, Auswide Bank launched a rate tracker mortgage. It tracks the RBA cash rate by a margin of 2.49%, making the current interest rate 3.99%. It is available to owner-occupiers with an LVR of 80% or lower. The mortgage includes a floor rate, which means the mortgage interest rate cannot fall below 2.49%, which it would reach if the RBA cut the cash rate to zero.

Tracker mortgages internationally

2.3. A tracker rate mortgage is a type of variable rate mortgage with the interest rate fixed at a set percentage point above a benchmark rate. In some jurisdictions around the world, this is the common or only type of variable rate mortgage. Variable rate mortgages that are not tied to an underlying benchmark – that is, what we have in Australia – are less common in other jurisdictions. The structure of these loans differs across jurisdictions.

United Kingdom

2.4. Tracker rate mortgages are available for the life of a loan, but generally for a period of one to five years (two years being the most common). After the initial tracker rate period, the mortgage may revert to a fixed term or SVR or a new tracker rate.

2.5. In the UK, the interest rate tracks the Bank of England's base rate which is currently 0.25%. A 'floor rate' may apply to tracker rate mortgages which sets the minimum interest rate that can be applied.

2.6. A survey in the UK in April this year of 5,002 mortgage customers found around 1 in 10 (11%) had a tracker mortgage.[4] According to the Council of Mortgage Lenders, around 1.5 million borrowers in the UK have rate tracker mortgages.

United States (US)

2.7. In the US, the benchmark rate commonly used for tracker (or adjustable rate) mortgages is Libor. Loans often have an initial fixed term, followed by a term where the interest rate will follow the benchmark rate with a fixed margin applied. The average 5/1 (rate is fixed for five years and adjusted annually thereafter) tracker mortgage in America is currently 3.04%.[5] The terms of the loan may also specify the number of times per year the interest rate can be adjusted, commonly once a year.[6]

[4] http://www.which.co.uk/money/mortgages-and-property/guides/what-is-a-mortgage/tracker-mortgages/

[5] http://www.bankrate.com/mortgage.aspx?type=newmortgage&market=4&propertyvalue=412500&loan=330000&perc=20&prods=9&fico=740&points=Zero&cs=1

[6] For example, Bank of America ARMs are only adjusted once a year after the initial fixed period has expired https://www.bankofamerica.com/home-loans/mortgage/adjustable-rate-mortgage-loans.go

Europe

2.8. In Europe, variable rate mortgages are often based on the Euribor-rate plus a margin (e.g. Euribor + 1%).[7] Floating or variable rate mortgages tend to be more common in Europe than fixed rate.[8]

2.9. **France:** Generally variable rate mortgages are based on an index (e.g. a specific Euribor index term) plus a profit margin.[9] Currently, a 20 year tracker variable rate in France is 2.50%.[10] However, variable rate mortgages are not common in France. Over 95% of mortgages in France are granted on a fixed rate basis.

2.10. **Spain**: 96% of mortgages in Spain are variable-rate loans[11] with a margin generally set at 1 or 2 per cent above Euribor.[12] Some Spanish lenders previously included a repayment floor which set the minimum interest rate that could be charged but this practice appears to have become less common after a court ruled that some of these clauses lacked transparency.[13]

Ireland

2.11. 'Tracker' home loans are generally linked to the European Central Bank rate (ECB). Historically tracker loans made up the majority of mortgage accounts in Ireland (62% in 2011) with rates typically set about 1% above the ECB rate.[14] However, banks in Ireland have been moving away from tracker home loans as ECB rates have reduced and tracker loans have become less profitable, with concerns that some were loss makers.[15]

2.12. There is currently an interest rate gap of around 3 per cent between tracker and other variable home loans in Ireland.[16] The average rate for mortgages in Ireland for new business is 3.7% (compared to 2% across the Eurozone) with Bank of Ireland's average tracker rate around 1.1%.[17]

---

[7] http://www.euribor-rates.eu/euribor-mortgage.asp
[8] http://www.bloomberg.com/news/articles/2015-02-05/spain-s-american-style-fixed-rate-loans-break-mold
[9] http://www.francehomefinance.com/resources/bank_index_rates/
[10] http://www.frenchmortgagedirect.com/
[11] http://www.wsj.com/articles/spanish-home-buyers-helped-by-ecb-rate-cuts-1457955231.
[12] https://www.justlanded.com/english/Spain/Articles/Property/Mortgages-in-Spain; http://www.bloomberg.com/news/articles/2015-02-05/spain-s-american-style-fixed-rate-loans-break-mold. http://www.wsj.com/articles/judge-in-spain-rules-against-mortgage-floor-clauses-1460049434.
[13] http://www.wsj.com/articles/judge-in-spain-rules-against-mortgage-floor-clauses-1460049434; http://www.imsmortgages.com/spanish-mortgages/.
[14] https://www.theguardian.com/business/ireland-business-blog-with-lisa-ocarroll/2011/apr/14/irelands-dirty-little-secret-tracker-mortgages
[15] http://www.thejournal.ie/tracker-mortgages-aib-review-2-2900564-Jul2016/; http://www.consumerhelp.ie/mortage-interest-rates.
[16] http://www.independent.ie/business/personal-finance/choice/homeowners-who-lost-a-tracker-mortgage-could-soon-have-something-to-celebrate-34706988.html
[17] http://www.irishexaminer.com/business/running-out-of-excuses-not-to-cut-costly-mortgage-rates-401062.html

2.13. There appears to have been a number of scandals with banks allegedly engaging in misleading conduct to encourage consumers to leave tracker loans to switch to the more expensive variable loans, where interest rates are set at the banks discretion. The Central Bank of Ireland is currently undertaking a review across the industry into this conduct.[18]

Benefits of tracker mortgages

2.14. The main benefits of tracker mortgages are in relation to transparency, timing and comparability.

Transparency

2.15. One of the main benefits of tracker mortgages would be the increased transparency. Because the rate is linked to a benchmark rate, banks are then obliged to move in line with that benchmark rate – which is usually the cash rate. It removes the question of whether or not the bank will pass on a cut (or increase).

2.16. This can be attractive to customers who might have lost trust and confidence in the banks because of the way they have treated mortgage rates for their customers.

Timing

2.17. In the banking inquiry, concerns about the alleged the rocket and feather approach of banks were discussed. That is, when the cash rate increases, various lending rates shoot up like rockets – but when the opposite occurs they go down like feathers.

2.18. Banks can make a significant amount of money in one day by delaying passing on rate cuts.

2.19. If designed properly, tracker mortgages could potentially be a better deal for customers – and give them the certainty that when the cash rate moves, so too will their mortgage rate, and that it will be done in a timely way.

Comparability

2.20. Because of the banks discretion to move their standard variable mortgage rate, current variable loans in Australia are not easily compared. Borrowers need to make assumptions about the lenders relative propensity to move their mortgage rate in line with the cash rate.

2.21. With a tracker mortgage, rates are instantly comparable. There is a guarantee that the mortgage rate will move in line with the cash rate and in a specified time frame, such that borrowers can directly compare the rates on the market. This factor can lead to increased ease of switching for borrowers and in turn drive competition in the market, which will benefit borrowers.

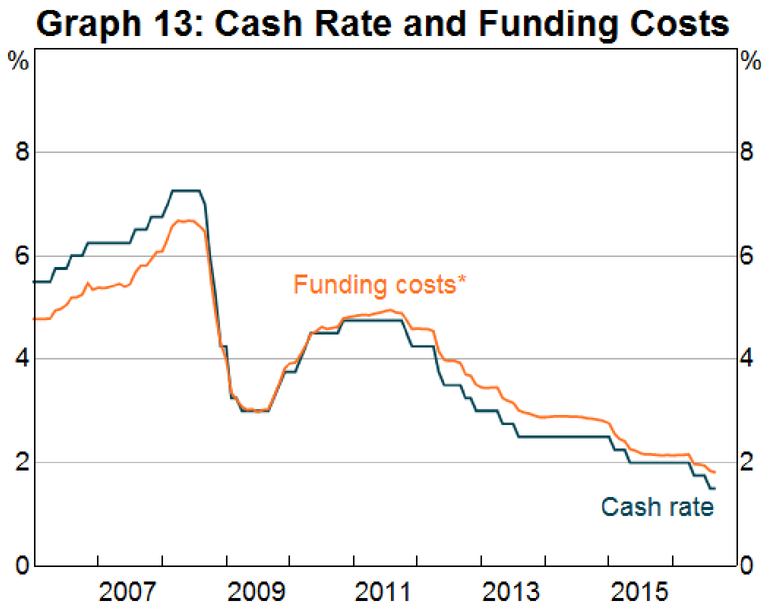
Funding of tracker mortgages

2.22. For retail home loans, the cash rate would be the most suitable benchmark to use to set the rate of tracker mortgages. Many every day Australians understand the cash rate and the process through which the RBA sets the rate (as opposed to other benchmarks such as BBSW which are not widely understood.

[18] http://www.independent.ie/business/personal-finance/choice/homeowners-who-lost-a-tracker-mortgage-could-soon-have-something-to-celebrate-34706988.html

2.23. Further to this, the funding costs of banks show a close correlation to the cash rate. This has been confirmed by the RBA. The following graph was submitted by the RBA as part of a handout to accompany their opening Statement to the House of Representatives Standing Committee on Economics, stating that "The RBA cash rate remains the main driver of bank funding costs, although the funding mix and spreads also change through time."[19]

Cash Rate and Funding Costs



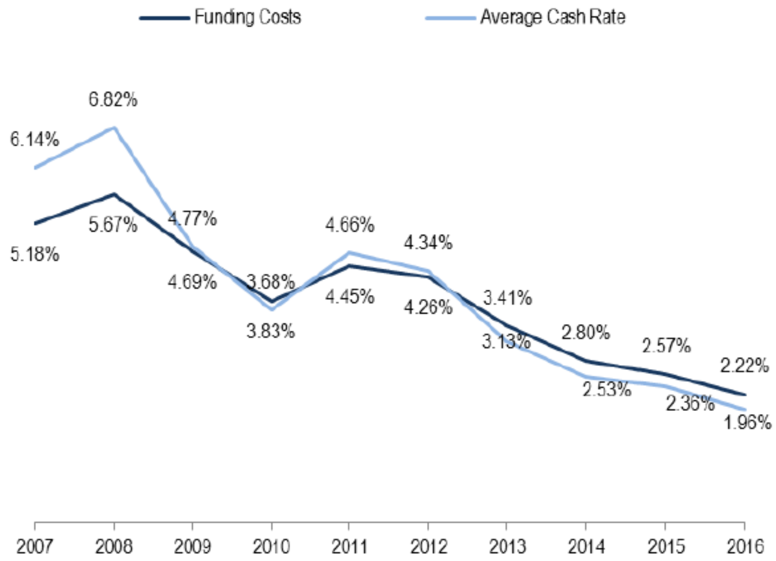
* RBA estimate

Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australia Branch

2.24. Prior to 2008, a major bank's average funding cost was well below the RBA rate. However, this has changed since, as the major banks have needed to pay higher average rates on key deposit products to attract funds as wholesale funding has become more expensive. See example below of CBA's average funding costs compared to the average cash rate.

[19] http://www.rba.gov.au/publications/submissions/bank-fees-and-margins/handout-standing-committee-on-economics-2016-09-22/

Figure 18. CBA's average funding cost falls as the RBA cash rate falls

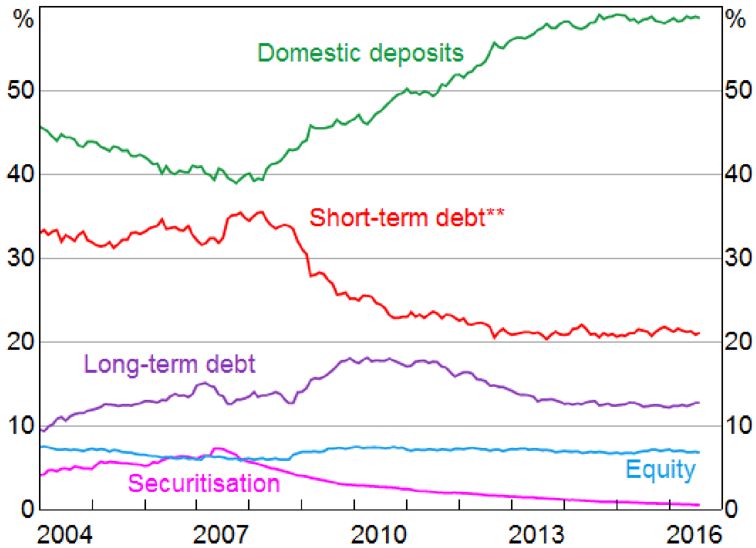


Source: CBA Company Reports, RBA, Citi Research

2.25. The following graph shows that currently almost 60% of funding for banks is through domestic deposits which are closely linked to the cash rate. Just over 20% is through short term debt and over 10% through long-term debt. For Australian banks with a more traditional retail structure, around 90% of their non-equity funding is from deposits.[20]

Graph 10: Funding Composition*

Share of total funding



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

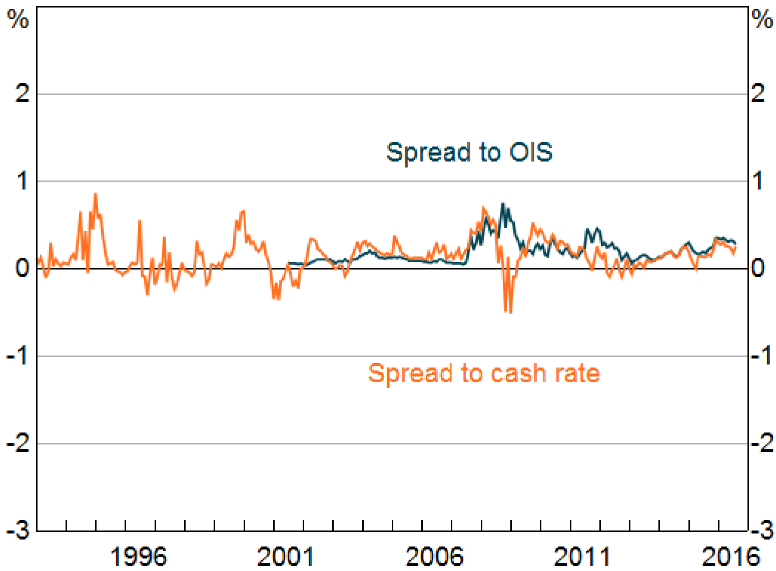
---

[20] Wilkins, Gardner, Chapman, 'Developments in Banks' Funding Costs and Lending Rates, RBA Bulletin, March Quarter, 2016.

2.26. Both short and long term debt can be swapped back to the Overnight Indexed Swaps (OIS). The cost of short-term debt relative to the cash rate shows only small variations.

Graph 9: Short-term Debt Interest Rates

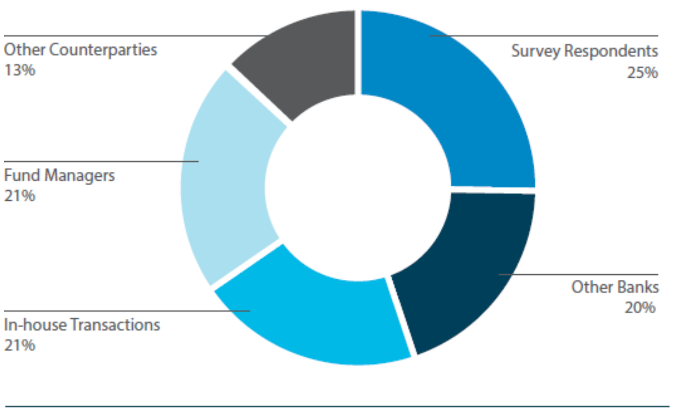
Three-month BBSW



Sources: AFMA; RBA; Tullet Prebon (Australia) Pty Ltd

2.27. The OIS has a growing market, with annual turnover being $9.6 trillion in AUD in 2014-15. This compares with the fixed and floating rate swaps in AUD which had a turnover of $7.3 trillion in 2014-15. The following diagram shows the counterparties involved.[21]

Figure 6: OIS Turnover by Counterparty



[21] 2015 Australian Financial Markets Report (AFMA), p. 34. Survey Respondents are: AGL Energy Limited, Alinta, Energy Australia, Ergon Energy Corporation Limited, ERM Power, Intergen (Australia) Pty Ltd, Origin Energy, Snowy Hydro, Westpac Banking Corporation.

2.28. Of particular interest, the market has seen the development of the BOB (Bill OIS Basis) market in terms out to 30 years. As it grows, this market will provide the basis for term OIS, and looking forward, a potential alternative interest rate for swaps.[22]

2.29. It may be technically correct, as the banks have argued, that they don't fund off the cash rate. The cost of funding for a major bank varies considerably depending on the product or debt security issued.

2.29.1. Long-term funding is the most expensive with average cost more than 100 basis points above the prevailing RBA cash rate

2.29.2. Term deposits for retail & business customers, as well as short-term wholesale funding instruments for money managers are often also above the prevailing RBA cash rate

2.29.3. Other retail and business deposit products are often well below the RBA cash rate. However, as interest rates fall, the value (profit earned) of the deposit product also declines

2.30. However, overall, the weighted average funding cost for a major bank is correlated to the prevailing RBA cash rate. This is because most debt securities and deposit products either automatically adjust or are hedged using interest rate derivatives against adverse interest rate movements.

Pricing of tracker mortgages

2.31. Rates from the UK show tracker mortgages to be competitive.

2.32. Loans which use a tracker rate for a set initial period are common, which then revert to standard variable after the initial period. For example, Barclays offers rates in the first 2 year period of 1.14-2.25% above BBBR, depending on the LVR of the loan, then reverts to standard variable.

2.33. Table 1 below illustrates some of the rates of current lifetime tracker mortgages in the UK market compared to the advertised standard variable rates (SVR). Table 2 shows the advertised SVR's for the big four banks in Australia.

Table 1: Examples of Lifetime Tracker Rates currently offered in UK

Lender	Tracker interest rate	Tracker margin above cash rate	Maximum loan-to-value	Advertised SVR offered	Margin between cash rate and SVR
HSBC	1.74%	1.49%	60%	3.69%	3.44%
HSBC	1.94%	1.69%	70%	3.69%	3.44%
HSBC	2.14%	1.89%	75%	3.69%	3.44%

[22] 2015 Australian Financial Markets Report (AFMA), p.33.

Barclays	2.29%	2.04% above BBBR*	75%	3.74% (BBBR +3.49%)*	3.49%
Santander	2.14%	1.89%	75%	4.49%	4.24%
First Direct	2.24%	1.99%	60%	3.69%	3.44%
First Direct	2.64%	2.39%	75%	3.69%	3.44%
First Direct	2.74%	2.49%	80%	3.69%	3.44%
First Direct	3.23%	2.98%	90%	3.69%	3.44%

*Barclays bank uses Barclays Bank Base Rate, which typically follows the Bank of England Bank Rate but it is not guaranteed to do so.

Table 2: SVR rates in Australia

	Advertised SVR (owner occupied)	Margin between cash rate and SVR
CBA	5.22	3.72
Westpac	5.29	3.79
NAB	5.25	3.75
ANZ	5.25	3.75

Current cash rate = 1.5%