SUBMISSION 4

INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANKING SECTORS

SUBMISSION BY THE

MORTGAGE AND FINANCE ASSOCIATION

OF AUSTRALIA

MORTGAGE AND FINANCE ASSOCIATION OF AUSTRALIA (MFAA)

The MFAA is an association focused on the representation of, and maintaining professional standards for, mortgage and finance intermediaries, viz mortgage brokers, finance brokers, mortgage management businesses and non bank lenders. Its membership includes also ADI lending institutions which distribute their products via intermediaries, and businesses which provide support services to the mortgage and finance sector.

As at June 2008 its membership profile is:

Individual members (ie loan writers)	10038	72.7%
Broking firms	3355	24.3%
Aggregator/Franchisor groups	73	0.5%
Total loan writers/broking firms/aggregators	**13466**	**97.5%**
Mortgage managers – dealing directly with public – not dealing directly with public	189 35	1.4% 0.3%
Total intermediaries	**13690**	**99.1%**
Lenders/Funders	40	0.3%
Support Services	84	0.6%
Total	**13814**	**100.0%**

MFAA estimates that its broker members account for between 75-80% of brokers in Australia.

MFAA members (in addition to any legislation) are bound by the MFAA Code of Practice and are liable to be sanctioned for breaches of that Code or other inappropriate conduct, under the association's Disciplinary Rules.

Focus of Submission

The focus of the MFAA submission is to ensure that Australia maintains the most competitive lending industry with the objective of all players in the industry operating to better serve the interests of consumers.

An Overview of the Modern History of the Australian Mortgage Lending Industry

The modern history of the Australian mortgage lending industry can be said to have had its genesis in the deregulation of the financial system in the early 1980s.

From that event a number of cause-and-effects flowed:

Non banks (mortgage managers) entered the mortgage market with interest rates well below those being offered by banks and eventually established a market share of about 15%.

Banks reduced their interest rates in order to compete and commenced internal operational reviews, which resulted in some 2000 branches being closed and many mortgage lending officers/bank managers being retrenched. Entrepreneurial and consumer centric operators sensed the pent up demand of consumers for nimble businesses which could best represent their borrowing interests. Thus ‘mortgage brokers’ as we now know them, established themselves.

Smaller lenders with limited branch infrastructures started using brokers to distribute their products in order to compete with non bank lenders and the larger banks, utilising a willing and competent workforce made available by bank retrenchments.

The so-called ‘boom’ of the late 90s and the early part of this decade, with massive interest by consumers in borrowing or refinancing (because of favourable finance and economic conditions), and a vast array of new mortgage products on the market, provided a perfect environment for consumers to realise the benefits of dealing with a broker.

The larger banks, one by one, then joined in establishing third party (broker) sales operations. By January 2002 mortgage brokers had established a retail market share in the mortgage market of around18%, which had increased to close to 40% by 2007[1].

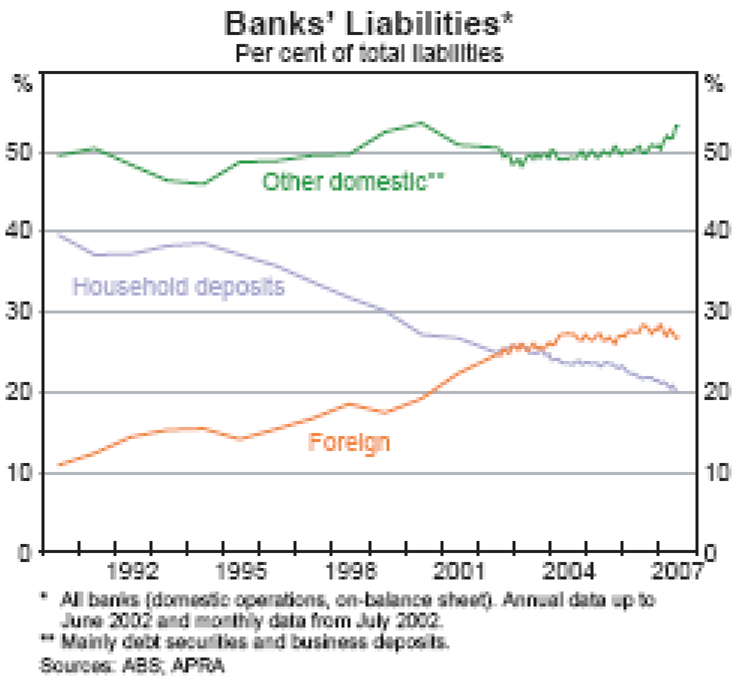
[1] Source: Fujitsu Consulting Estimates

Non-bank mortgage lenders benefit to consumers by providing the banks with effective competition

Before deregulation of the financial system in the early 1980s the only practical source of finance for Australian homebuyers was the banks and to a much lesser extent building societies and credit unions. After years of saving a large deposit for a house homebuyers went cap in hand to the bank, and even then the bank might require they take out two mortgages, the second at a higher interest rate. Many people whose income was low, irregular or who had any kind of impaired credit history simply couldn't get a loan, which was an inequitable situation.

Deregulation changed all that with access to mortgage finance becoming easier and on more favourable terms. Competition and innovation have increased the amount of finance available, reduced its cost relative to the RBA cash rate, provided a greater range of product choice including for those with low and irregular income or an impaired credit history, and provided high LVR loans without second mortgages. This has put home ownership within the reach of many more Australians who would previously have been unable to obtain a loan, and has provided people with access to capital in their properties to pursue investment opportunities and create wealth for retirement. This came about mainly as a result of non-banks entering the market, not as a result of competition between existing banks.

Banks have always had a substantial competitive advantage in housing lending because bank deposits give them a lower average cost of funds than is available to non-bank lenders. In the early 1990s nearly 40% of the banks' liabilities were in the form of household deposits. This has now fallen to about 20%.



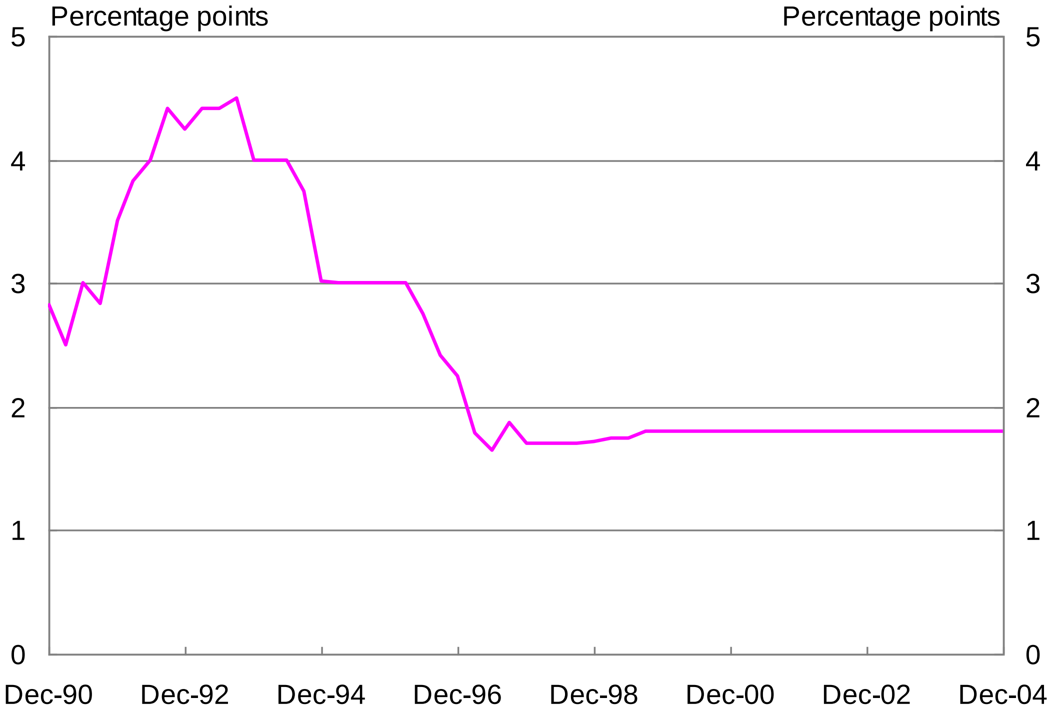
Prior to 1990 the margin between the mortgage rate and the bank bill rate was often negative so there was little or no room for housing lending on any scale by anyone other than banks, building societies and credit unions. In the early 1990's a combination of deregulation and lower inflation substantially reduced the gap between the bill rate and the deposit rate allowing a new class of lenders, the mortgage managers, to enter the market.

Because the banks had far larger mortgage books than the mortgage managers and wanted to maintain their traditional average margins, the mortgage managers were able to borrow at the bill rate and undercut the banks' mortgage lending rates.

In 1994 the competition between mortgage managers and banks intensified providing a major and lasting benefit to home buyers in the form of a significant reduction in the margin between mortgage lending rates and the official cash rate.

Between August and December 1994 official interest rates were increased by 2.75%. This caused many homebuyers to seek the refuge of lower interest rates in mortgage managers' products with their share of housing lending rising quickly from around 2% of total approvals to more than 8%. To protect their market share the banks, reduced their lending rates to meet the mortgage managers' competition. The result was a reduction of about 2½% in the margin on mortgage lending over the RBA cash rate.

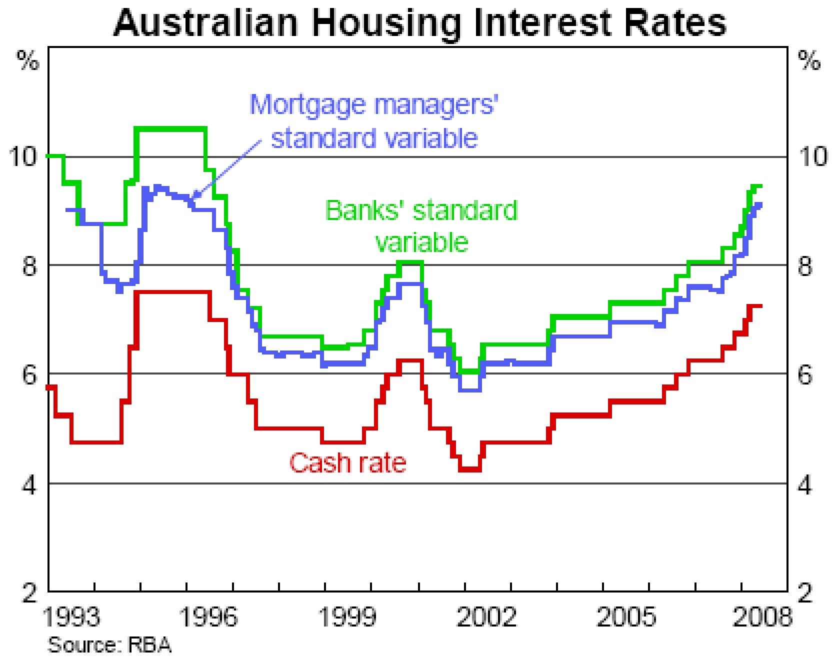
Bank Spread on Housing Finance Over Cash Rate



Source: Commonwealth Treasury: Ken Henry, Secretary to the Treasury, Australia's International Engagement and Reform, Address to the 2005 Economic and Social Outlook Conference, Melbourne, March 2005.

That represents a more than 2% reduction in mortgage rates across the banks' loan books over a period of more than a decade. This has been a considerable benefit to consumers that would neither have eventuated nor been maintained without the competitive pressure provided by non-bank lenders.

The Reserve Bank of Australia regularly publishes a graph which demonstrates that it is this competition from the non-bank mortgage industry that provides downward pressure on mortgage lending rates.



Residential mortgages held by securitisation vehicles represent less than a quarter[2] of the total residential mortgage market but there is no doubt they have had a profound effect on the competitiveness of the market.

The Role of Mortgage Brokers

The statement by the Chair of the House of Representatives Economics Committee, Mr Craig Thompson MP, in the media release announcing this Inquiry reads:

"We need to open up competition in the retail banking and non-banking sectors, demystify the number of home mortgage products available and offer a wider choice to the consumer"

This encapsulates the role of mortgage brokers and why they are so popular with Australian borrowers, transacting around 40% [3]of all residential mortgages.

This is a dramatic change from the days when home buyers went cap in hand to a bank to request a mortgage. It reflects both intense competition by non-bank mortgage providers since 1994 and the banks themselves increasingly operating through mortgage brokers. It is clear that not only has the mortgage broker sector significantly increased in the last 10 years, but it has done so mainly by facilitating lending by banks.

This competitive market provides substantial benefits to consumers. Not only are housing loans cheaper, relative to the benchmark RBA cash rate, but borrowers have a much wider choice of mortgage products. There is substantial competition on features, fee structures, interest rates and service levels. This presents a significant new challenge for many borrowers to find a loan with the particular features that best suit their requirements. The growth of the mortgage broking market reflects these borrowers' need for expert advice to assist them in arranging the most appropriate loan for their particular circumstances.

[2] RBA 'Lending and Credit Aggregates", April 2008
[3] Source: Fujitsu Consulting Estimates

The MFAABankWest Home Finance[4] research carried out on a six monthly basis by *brandmanagement* consistently demonstrates the powerful proposition offered by mortgage brokers to consumers. The most recent survey (Autumn 2008) showed the following 'benefits of using a broker' as indicated by consumer respondents:

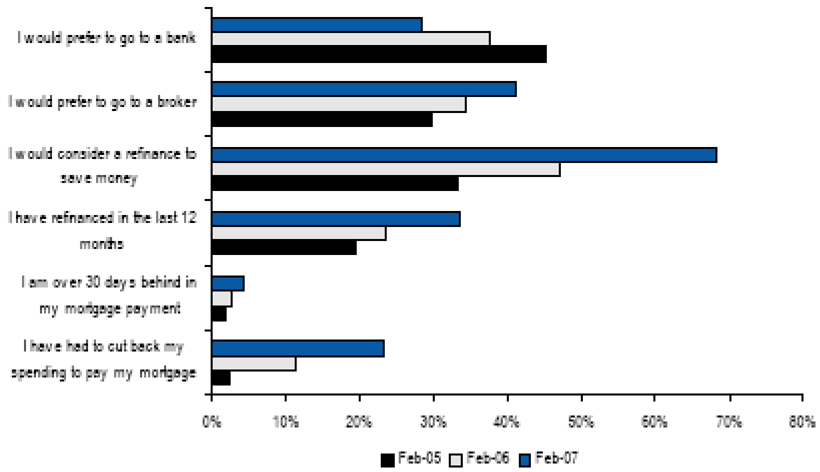
'They do all the legwork for you'	75.1%
They have a wider loan range'	72.0%
'They are experts in a range of mortgages from numerous lenders'	71.1%
'You can get the right loan for your circumstances'	63.7%

A key driver of competition in any market is access to information. Clearly brokers provide that information and representation of borrowers and accordingly are an important influence in maintaining competitive forces in the Australian lending industry.

The same survey also shows that the 'overall satisfaction with home loan source' is consistently higher for brokers than for banks. The broker figure in previous surveys has been as high as 7.9 out of 10 and the banks as low as 6.2. The most recent survey shows brokers at 7 out of 10 and banks 6.5.[5] Interestingly in the current environment, the same survey showed that significantly fewer borrowers who used a broker to arrange their mortgage were likely to say they are struggling with their loan compared to those who were comfortably meeting their repayments as opposed to those who used a bank where those who were struggling slightly exceeded those who were comfortably meeting their repayments.[6]

Research by Fujitsu[7] confirms the growing preference of consumers to deal with a broker.

Customer Attitudes



Source: Fujitsu.

[4] MFAABankWest Home Finance Index, Autumn 2008
[5] ibid
[6] Ibid, The survey allocated borrowers into two groups: 1 those comfortably meeting repayments and 2 those who were struggling to meet repayments or had been late in payments from time to time or who were in arrears. 26.1% of those who were struggling sourced their loan from a broker (49.3% from a bank) while 35.2% of those who were comfortably meeting repayments had a broker loan (47.7% from a bank)
[7] Australian Mortgage Industry – Vol 5, March 2007

Impediments to Competition

Access to funds

The US sub-prime crisis, while largely irrelevant to Australian lending practices and environment, has had a significant impact on the lending industry because of the reliance (particularly by non bank lenders) on securitised funding and global capital markets. Thus the lynch pin which enabled the mortgage manager/non bank lender sector to flourish in Australia has been (temporarily) withdrawn.

Accordingly the banking sector has responded to pressure (to the extent that it is reliant on the global markets for funds) to increase interest rates, but it is, to a far less extent feeling any downward pressure from non bank competitive forces, because of the non bank sector's overwhelming reliance on global market funding.

That has seen the non bank (wholesale lenders) market share of owner occupied housing finance fall to 5.5% in April 2008, whereas in April 2007 it was 13.5%[8]. Over the same period the bank sector increased its share from 79.5% to 88.5% while building societies and credit unions have dropped from 7% to 6%.

The non bank share was just under 13% as late as August 2007 and fell to 6.5% by December. So having lost 60% of its market share in a matter of months has removed its, until then, significant potency as a seriously competitive force from the lending market.

Will the global markets realign with reality and more realistically price the very low risk Australian securitised mortgage market? More particularly can they be relied on to provide a level of certainty in the supply of competitively priced funds?

Or does the government have a role 'to open up competition in the retail banking and non-banking sectors'.

While there is strength in the argument that governments should stay out of the market place and resist 'picking favourites', there is a greater strength in the view that government should consider a mechanism which would avoid consumers being impacted unnecessarily by droughts in the capital markets, as they have been in Australia over the past few months.

After all this Inquiry is all about opening up the market to benefit the consumer – any initiatives suggested during the course of the Inquiry should be assessed as to their benefit to the consumer.

To that end MFAA supports and recommends for the Committee's consideration the adoption of a scheme in the nature of the Canadian Mortgage Bonds program. The Australian Securitisation Forum (ASF) has produced a detailed paper[9] on this (which MFAA supports).

The Canadian scheme (National Housing Act Mortgage-backed Securities) was introduced in 1985 in response to rising mortgage costs. The program has four main aims:

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[8] ABS Housing Finance, April 2008, Cat no 5609.0

[9] The Australian mortgage-backed securities market. Is an enhanced model needed to lower mortgage rates? ASF Discussion Paper April 2008

- To create a more competitive market that would allow smaller financial institutions to provide housing finance at comparable rates to larger institutions
- To provide investors with high quality Mortgage-Backed-Securities that are secured by a government guarantee and underlying mortgage-insured property
- To lower mortgage rates to the consumer
- To strengthen the solvency of the financial system by adding another liquidity source for housing finance

<u>Regulation</u>

The Federal Government has recently issued (June 2008) a Green Paper on *Financial Services and Credit Reform.*[10]

MFAA's response to the Green Paper in summary is:

- We support federal regulation of all credit (as opposed to the existing state based regulatory regime)
- We strongly oppose credit regulation being squeezed into the financial services product dominated FSRA regime.

Regulation, inappropriately applied, can strangle the life out of a viable and consumer supported industry sector.

A broking sector which is overburdened by unnecessary or inappropriate regulation is not in the best interests of consumers. The future regulatory regime of the credit sector (and, in particular, brokers) must reflect the risk profile of the products and services provided and not be grouped in on a one-size-fits-all approach with financial products and services.

Conclusion

The Australian lending industry has shown over the past few decades that it has operated most competitively and in the consumers' interest when banks have been subject to competition at the origination and retail level by non-banks/mortgage managers and at the retail level by brokers competing with branch lending.

The lack of access to wholesale funding has reduced competition in the market and potentially could wipe out non bank lending, reverting the industry to a pre- deregulation environment. Because of the cause and effects linkage that occurred after deregulation (referred to earlier in this submission), that may have serious repercussions for competition in both origination and distribution of mortgage products and will not be in the best interests of consumers.

[10] *Financial Services and Credit Reform – Improving, Simplifying and Standardising Financial Services and Credit Regulation GREEN PAPER June 2008*