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Introduction

Background

1.1 In the last 18 months there has been a significant upheaval within global financial markets. The US sub-prime mortgage crisis which first became evident in August 2007 has sent the cost of funding sky–rocketing.

1.2 Over the last year, both the banks and the non-banks (lenders who are not banks, building societies or credit unions) have recouped some of their funding losses by increasing their interest rates independently of the official cash rate set by the Reserve Bank of Australia (RBA).

1.3 The non-banking sector has been hit particularly hard by the economic fall out of the US sub-prime crisis. Some non-banks have been forced out of business while others have had to reduce their lending funded through securitisation. These developments have concerned some groups who argue that the decline of the non-banking sector has reduced competition and subsequently commercial interest rates have risen sharply putting substantial pressure on the average Australian household.

1.4 Others are less concerned and argue that this is a normal cyclical market event and that once the market rights itself again the non-banking sector will return and with it greater competition.

1.5 With this background in mind, on 3 June 2008 the Treasurer, the Hon Wayne Swan MP, asked the House of Representatives Standing

Committee on Economics to inquire into and report on the extent to which competition in the banking and non-banking sectors has reduced and, in particular, examine proposals that could help to increase competition and reduce fees and charges for people struggling with their mortgages.

Objective and scope

The state of competition

1.6 The rise of the non-banking sector in the early 1990's played a significant role in enhancing competition particularly in the mortgage industry. The non-bank lenders introduced innovations such as internet and phone banking and mobile lenders. This put pressure on the banks resulting in greater competition, tighter margins and lower interest rates.

1.7 The non-banking sector opened the way for 'mortgage brokers' to enter the market. Brokers acted as a 'one stop shop' for consumers by providing advice on the numerous home loans available.

1.8 Prior to the commencement of the credit crisis, the non-bank sector sourced their funds primarily from securitisation ('bundling' individual loans and selling them in financial markets).

1.9 In the last 12 months the global securitisation market has all but dried up and as a consequence the non-banking sector's market share 'has fallen from around 12 per cent in 2006 to 5 per cent.'[1]

1.10 The lack of available funding has forced some providers and brokers out of the market. Less providers within a market would normally result in a fall in competition.

1.11 There are, however, two opposing views about the current state of competition within the banking and non-banking sectors.

1.12 The Treasury, the Reserve Bank of Australia and the big four banks, Westpac, ANZ, the Commonwealth Bank and National Australia Bank, believe that competition within the sector is strong and that the non-banking sector will regain its market share when market conditions normalise again.

1 Reserve Bank of Australia, *Submission no. 12*, p. 4.

1.13 The non-banking sector, including the Mortgage and Finance Association of Australia, the Australian Securitisation Forum, and Challenger Financial Services Group, to name a few, believes that there is some uncertainty about how long it will take for the funding markets to return and that as a consequence competition will be substantially reduced.

1.14 The inquiry presented an opportunity to identify the barriers and drivers of competition within the sector and consider policies to enhance further competition and product choice for consumers.

The current state of the retail banking and non-banking industries

1.15 The Treasury noted in its submission, that 'the Australian financial system and its regulatory framework have demonstrated their effectiveness and resilience over recent months during a period of severe stress resulting from global financial market turbulence.'[2]

1.16 While that may be the case, it is clear that the number of competitors and products within the banking and non-banking sectors has reduced.

1.17 According to the October 2007 *Mortgage Star Ratings* report issued by financial services research firm CANNEX, Australia had over 150 financial institutions offering over 2,117 home loan products.[3]

1.18 The most recent report has shown that the number of home loan products has dropped significantly with 1,750 products now being offered by over 140 financial institutions. [4]

1.19 The Treasury also noted that 'bank lenders increased their market share of new home loans from 79 per cent in 2007 to 89 per cent in April 2008, largely at the expense of non-Authorised Deposit-Taking Institutions (ADI) lenders.'[5]

1.20 The recent turbulence in the global financial market and the impact this was having on the domestic home loan lending industry emphasised the need for a review of the adequacy of competition, including an assessment of how exposed our financial institutions are to the global credit squeeze.

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2 Treasury, *Submission no. 32*, p. 8.

3 CANNEX, *Mortgage Star Ratings, Report No. 20*, October 2007.

4 CANNEX, *Mortgage Star Ratings, Report No. 22*, September 2008.

5 Treasury, *Submission no. 32*, p. 9.

The impact of the credit crisis

1.21 The credit crisis has had a wide ranging effect on Australia's financial institutions. In addition, the crisis has had a social and economic impact resulting in falling shares, rising costs of funding and a fall in individual wealth and income.

1.22 The credit crisis placed funding pressures on financial institutions, and, in particular, non-bank lenders that relied entirely on access to securitisation for their funds. Collins Securities commented that:

> 12 months ago the pricing of that issue [Residential Backed Mortgage Securities] would be probably around 20 basis points into the market. That cost has now risen to around 150 basis points. So there has been almost a tenfold increase in the cost of funding.[6]

1.23 Some non-bank lenders, being unable to source any funding, have left the market; have been bought out, as is the case with RAMS Home Loans; or stopped selling new mortgages, like the Macquarie Group. Other non-bank lenders have slightly changed their focus, as is the case with Aussie Home Loans who are acting as a mortgage broker in addition to offering their own home loans. [7]

1.24 The added funding pressure also led to financial institutions raising their interest rates independently of the RBA. 'Between January and July 2008, the major banks increased their interest rates by 0.5 to 0.6 percentage points more than the increases in the RBA's cash rate.'[8]

1.25 The Treasury noted that 'to recover some of their increased funding costs…a significant number of borrowers have experienced interest rate rises of 1.5 to 1.6 percentage points over the year to July 2008, comprised of 1 percentage point due to increases in the RBA's cash rate, and 0.5 to 0.6 basis points due to independent interest rate rises by the major lenders'.[9]

1.26 Between September and November 2008, the RBA board decided to lower the official cash rate by 200 basis points.[10] In its 7 October media release, the RBA noted that 'conditions in international financial

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6 Mr J Emmett, Collins Securities Pty Ltd, *Transcript*, 8 August 2008, p. 30.

7 Mr C Joye, Centre for Ideas and the Economy, *Transcript*, 21 August 2008, p. 62.

8 Treasury, *Submission no. 32*, p. 9.

9 Treasury, *Submission no. 32*, p. 9.

10 Reserve Bank of Australia, *Media Release*, 2 September 2008, 7 October 2008 and 4 November 2008.

markets took a significant turn for the worse in September' and that 'financing is likely to be difficult around the world for some time ahead.'[11]

1.27 Fujitsu Consulting have highlighted that:

> …despite recent cash rate reductions, growing unemployment, house price falls and the global financial market difficulties will all conspire to bring more households into some degree of mortgage stress. This could reach over 1 million households by March 2009.[12]

1.28 However, 'default rates are currently still well below historical peaks in the last 10 to 15 years.'[13]

1.29 It was therefore timely that the committee examine the overall impact of the credit crisis on the sector as a whole and in particular how it has affected home owners and prospective buyers.

Chronology of events

1.30 During the course of this inquiry there has been a significant upheaval within the global financial system.

1.31 Table 1.1 below provides a brief overview of the key events that took place during the course of the inquiry, both within Australia and globally.

Table 1.1 Key events in the global financial crisis

Date (2008)	EVENT – AUSTRALIA	EVENT – INTERNATIONAL
2 June	Treasurer announces introduction of a Financial Claims Scheme for depositors and policyholders.	
3 September	Reserve Bank of Australia cuts cash rate by 0.25% to 7.00%.	
7 September		Fannie Mae and Freddie Mac are placed into conservatorship by the US Government.
14 September		Lehman Brothers files for bankruptcy.
19 September		US Treasury Secretary Henry Paulson announces US$700 billion rescue package.
26 September	Australian Government announces $4 billion investment in RMBS.	

11 Reserve Bank of Australia, *Media Release*, 7 October 2008.

12 Fujitsu Consulting, *Press Release, Mortgage Stress Worst Ever By March*, 23 October 2008.

13 Mr C Joye, Rismark International, *Transcript*, 21 August 2008, p. 61.

29 September		Bradford and Bingley mortgage book nationalised by the UK Government.
29 September		Paulson's rescue package defeated in US House of Representatives.
3 October		Paulson's rescue package passed and signed into law.
6 October		The US Federal Reserve announces it will provide $US900 billion in short-term cash loans to banks.
8 October		The IMF releases its revised forecast for the global economy, which anticipates a major global downturn.
8 October	Reserve Bank of Australia cuts cash rate by 1.00% to 6.00%.	
8 October		The UK announces a guarantee of new short and medium term debt issuance and a facility to provide for new capital to UK banks and building societies.
6–10 October	The All Ordinaries lost 16.1 per cent (closing at 3,939.50 on 10 October down from an opening of 4,697.80 on 6 October).	Major downturn in the world's stock markets. The US Dow Jones lost 22.1 per cent, its worst week on record.
11–12 October		Meetings of the G7 and G20 in Washington agree to urgent and unprecedented coordinated action to address the credit crisis, including the strengthening of depositor protection and measures to assist financial institutions to raise new funds.
12 October	Australian Prime Minister Kevin Rudd announces Australian Government guarantees on deposits and wholesale funding. Also announces additional $4 billion investment in RMBS.	
13 October	Australian Prime Minister Kevin Rudd announces $10.4 billion in economic stimulus package.	
14 October		The US announces it will use the $700 billion available from the Emergency Economic Stabilization Act to inject $250 billion into US banks in return for non-voting equity.
17 October	Financial Claims Scheme legislation receives Royal Assent.	
23 October		The Canadian government announced a voluntary guarantee facility (for six months) on the wholesale term borrowing of federally regulated deposit-taking institutions of up to C$218 billion ($A263 billion).
24 October	Treasurer announces further details of Government guarantee arrangements, including $1 million deposit guarantee threshold.	
5 November	Reserve Bank of Australia cuts cash rate by 0.75% to 5.25%.	

1.32 The inquiry has been taken over to some extent by further financial shocks to global financial markets. Governments around the world responded with unprecedented steps to bolster financial stability both domestically and globally.

1.33 Initially, the committee's inquiry was focussed on the current state of competition within the banking and non-banking sectors, and in particular home mortgage products. As the global financial turmoil unfolded, the focus quickly changed to the overall stability of the financial sector.

The mortgage market and other financial services

1.34 The terms of reference called on the committee to pay particular attention to home mortgage products and linked facilities frequently offered to consumers such as credit cards and savings accounts.

1.35 The majority of evidence focused on the adequacy of competition with home mortgage products.

1.36 In addition, concerns were raised about credit cards, including unsolicited pre-approved credit offers, and the need to increase the ease with which customers can switch between providers.

Conduct of the inquiry

1.37 The inquiry was advertised nationally on 5 June 2008 and subsequently received 58 submissions from a broad cross section of interested parties.

1.38 Between August and October 2008 the committee held a total of 6 public hearings in Canberra, Sydney and Melbourne.

1.39 A list of submissions, exhibits and public hearing witnesses can be found at appendices A, B and C respectively.

1.40 Submissions received and transcripts of hearings can be found at the committee's website: www.aph.gov.au/economics

1.41 Mr Adrian Russell, Department of the Treasury, assisted the committee by undertaking a technical edit of the report.

Reader guide and structure of the report

1.42 This report has been structured in an easy-to-read format. In discussing each issue, evidence and other relevant material is provided, followed by the committee's conclusions, and then, in some cases, a recommendation.

1.43 Chapter 2 of the report provides an overview of Australia's mortgage market prior to and after the rise of the non-bank lending sector; the effects of the credit crisis on competition; and how Australia's mortgage market sits within the global financial marketplace.

1.44 Chapter 3 looks at various options designed to increase competition including adding additional long term liquidity to the market, the benefits of a positive credit reporting model and investigating and addressing issues of concern in the future.

1.45 Chapter 4 examines the banks switching regime including the current barriers to switching and the Australian account switching facilitation package.

1.46 Chapter 5 considers ways in which consumers can be empowered to make educated financial decisions and protect themselves from fringe predatory lenders.