challenger

23 July 2008

Committee Secretary
House of Representatives Standing Committee on Economics
PO Box 6021
House of Representatives
Parliament House
CANBERRA ACT 2600

email: economics.reps@aph.gov.au

Dear Sir

INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANK SECTORS SUBMISSION BY CHALLENGER MORTGAGE MANAGEMENT PTY LTD

This submission is made by Challenger Mortgage Management Pty Ltd a member of the Challenger Financial Services Group. It deals with competition between banks and non-banks in the Australian mortgage market.

Nature of Challenger loan programmes

Challenger manages the largest wholesale mortgage book in Australia with more than $20 billion of assets as at the end of 2007 and is the largest non-bank issuer of Australian residential mortgage backed securities to global capital markets.

Challenger services loans financed through warehouse trusts, with an independent party (usually Perpetual Trustees Victoria Ltd) as trustee/lender. The warehouse trusts are funded by credit facilities supplied by major Australian and international investment banks. The loans and supporting securities in the warehouse trusts are sold into securitised trusts which are funded by domestic and international institutional investors. Challenger continues to service the loans and mortgages in these securitised trusts.

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Challenger's RMBS programme provides wholesale finance so that non-bank mortgage managers can sell home loans under their own brands in competition with banks. Challenger's services include: managing credit analysis for loans originated by mortgage managers, day to day loan administration (for example, operating loan systems and issuing loan statements); and, loan recoveries action. The mortgage managers deal directly with the borrowers whose loans they originate. They arrange further advances on those loans, on the borrower's request, and are the initial point of contact and inquiry for borrowers.
Challenger Financial Services Group also includes:

- Challenger Commercial Lending Ltd which manages commercial loans for the Challenger Howard Mortgage Fund, the largest mortgage trust in Australia with $2.8 billion in mortgages under management;

- Choice Aggregation Services which offers mortgage broking aggregation services to finance brokers. Choice has $25.6 billion in mortgages under administration and more than 1,400 broker members;

- minority interests in two other entities, Professional Lenders Association Network (PLAN Australia) and Finance & Systems Technology Pty Ltd (FAST) which have interests in entities which offer mortgage broking aggregation services to finance brokers. These entities administer mortgages of $38.5 billion and $29.7 billion, and have 1,670 and 2,280 broker members respectively; and

- a minority interest in Homeloans Pty Ltd a Western Australian company which originates housing loans directly and through broker channels and currently has a book of 40,000 loans with a value of $6 billion under administration.

With this extensive wholesale finance distribution network Challenger plays a role in the provision of 1 in 5 new home loans, which makes it one of the largest non-bank mortgage providers in Australia. It has a vital interest in maintaining the competitiveness of the non-bank mortgage industry with the benefits it has delivered to Australian home buyers over the last 15 years.

Introduction

This submission is set out under the headings of the Committee's terms of reference.

It deals with the four sets of issues that have and will determine the competitiveness of the Australian mortgage market.

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1. *The rise of non-bank lending and the benefits it has brought to Australian home buyers.*

In the mid 1990's the emergence of the non-bank mortgage industry brought enormous benefits to home buyers by providing effective competition to the banks. This resulted in the cost to borrowers of mortgage finance above the benchmark RBA cash rate being reduced by more than a half over a 12 year period.

2. *Credit quality in the Australian mortgage market*

After the US sub-prime crisis the banks enjoyed a substantial increase in market share. Some senior Australian bankers spoke of this as a "flight to quality". The implication was that non-bank lending was done to lower standards and that banks could protect borrowers from the impact of the US sub-prime crisis on capital markets.

In Australia however, there had been no dramatic deterioration in the credit standards applied to mortgage lending by either banks or non-banks. Household balance sheets had generally strengthened and a very large part of the increase in household indebtedness had been taken on by those with the most capacity to repay it.

The rapid decline in market share of non-bank lenders after the US sub-prime crisis can be directly attributed to the material impairment of the debt capital markets on which they relied for long-term funding.

Because of the ability of the banks to use short term funding for long term mortgages they have had much more capacity to advance new loans but they have not been able to completely insulate borrowers from increases in the cost of those funds.

3. *Implications of the regulation of finance broking and credit for competition in the mortgage market*

The States currently have responsibility for the regulation of the provision of credit. In recent years some individual States, and the States collectively through the Ministerial Council on Consumer Affairs, developed models for the regulation of mortgage broking. Some of these individual models have already had, and if implemented the Ministerial Council model would have, a significant anti-competitive impact on non-bank mortgage lending.

At the last meeting of the Council of Australian Government in principle agreement was reached for the States to transfer their powers for the regulation of consumer credit to the Commonwealth and a process to develop an

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appropriate regulatory regime has already begun with the release of a Financial Services and Credit Reform Green Paper.

Most brokers and non-bank lenders believe that a simple and effective model for the regulation of mortgage broking to stop predatory lending, provide efficient and affordable redress for consumers and provide a mechanism for removing dishonest or incompetent operators from the industry is long overdue.

As most non-bank mortgage lending is originated through brokers, the future effectiveness of the competition between bank and non-bank lenders, which has brought so much benefit to home buyers, will crucially depend on that regulatory regime being competitively neutral between bank and non-bank lending and not unnecessarily adding to costs for consumers.

4. The impact of the US sub-prime crisis on the bank and non-bank lending models and its implications for future competition

The US sub-prime crisis has affected bank and non-bank lending models differently.

Banks have diverse sources of funding with a greater capacity to borrow short and lend long. By doing so have been able to maintain a relatively high volume of new mortgage lending, even though on a liquidity matched basis they would be lending at a loss.

Non-bank lenders capacity to use short term facilities for mortgage lending is limited to the size of their warehouses. Any large volume of term lending has to be fully matched to funding through securitisation. Securitisation markets have been effectively frozen for almost a year and the few recent Australian RMBS issues that haven't been privately placed, and any term bank issuance, have been at prices that are too high to allow the full cost of new lending to be covered at current market mortgage rates.

With consolidation in the banking sector and the impact of the US sub-prime crisis reducing the number of non-bank lenders there is a real risk that there will be a substantial lessening in competition. For the forseeable future this will result in higher mortgage costs to borrowers because of a lack of competitive pressure to drive down the spread of the banks' standard variable rate over the cash rate as the cost of funding starts to fall. This will reverse the interest rate spread benefit that the non-banks were able to provide when they became a force in Australian mortgage lending after 1994.

It is therefore important that the government consider what measures may be available to it to restore confidence and activity in the market for creditworthy Australian RMBS (residential mortgage backed securities).

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TERM OF REFERENCE:

Competition in the retail banking and non-banking sectors in Australia. Home mortgage products and linked facilities frequently offered to consumers such as credit cards and savings accounts.

(A) Recent developments in relation to products, providers and distribution channels.

Growth of the non-bank mortgage market

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. [1]

In the early 1990's a combination of financial deregulation and lower inflation substantially reduced the gap between the bank bill rate and the deposit rate allowing non-bank mortgage providers to enter the market.[2]

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 around the bill rate and undercut the banks' mortgage lending rates.[3]

In 1994 official interest rates were raised by 2.75% creating the conditions for competition between non-bank mortgage providers and the banks to intensify. The non-banks offered a significant reduction in the margin between mortgage lending rates and the official cash rate by undercutting the banks. This rapidly increased the non-banks' share of housing lending from around 2% to 8% of total approvals. To protect their market share the banks were forced to reduce their lending rates to meet this new competition from non-bank lenders.

[1] The Evolution of the Housing Loan Market in Australia, Reserve Bank of Australia Bulletin, June 1996. page 1.
[2] Ibid page 2
[3] Ibid page 3

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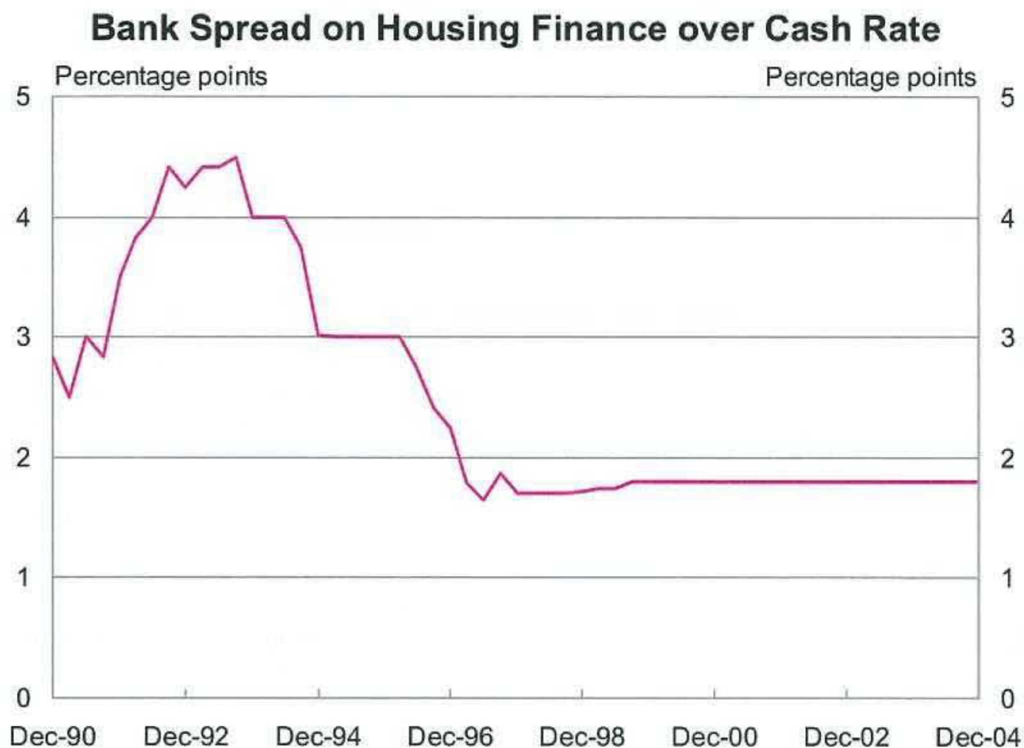

Source: Commonwealth Treasury: Ken Henry, Secretary to the Treasury, Australia's International Engagement and Reform, Address to the 2005 Economic and Social Outlook Conference, Melbourne, March 2005.

The result was a reduction of more than 2% in the margin on mortgage lending over the cash rate which continued unbroken from December 1996 until early this year when increases in the cost of funds, as a result of the US sub-prime crisis, forced all lenders to begin raising rates by more than the recent increases in official rates.

That reduction in mortgage rates across the banks' loan books over a period of 12 years of more than 2% is one of the major benefits to consumers of deregulation of the financial system. Instead of expensive housing finance being rationed by the banks, consumers have had a regular supply of competitive finance from a much wider range of providers.

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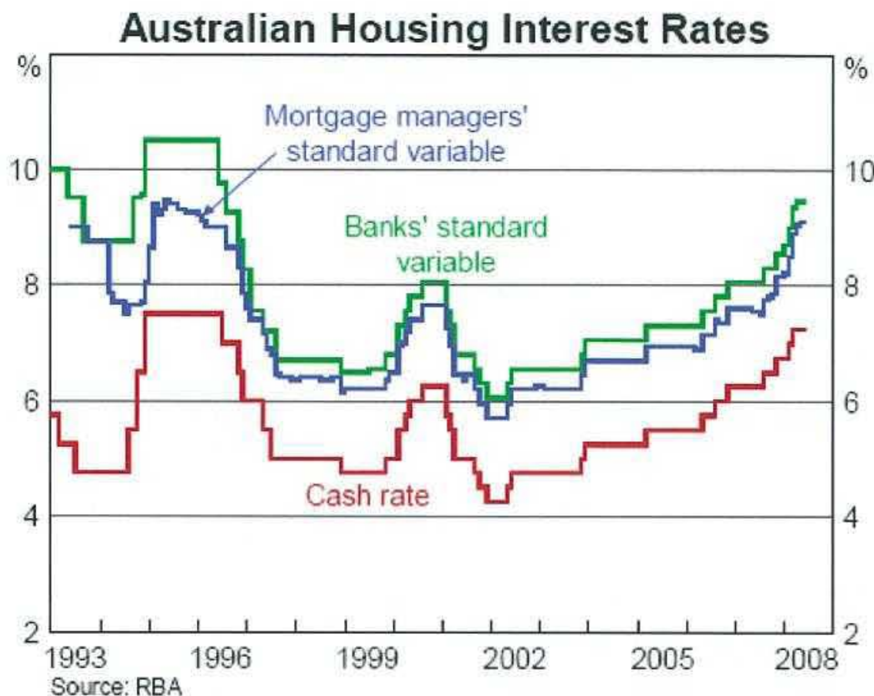

As the latest Reserve Bank statistics continue to show it is the non-bank mortgage providers lending both directly but mostly through brokers, who have consistently offered lower standard variable rates than the banks, and have been responsible for maintaining downward pressure on the spread of mortgage lending rates over the benchmark cash rate.

Non-bank mortgage providers, while only providing a minority of home loans, have had a profound effect on the interest rates paid by all home loan borrowers.

The rise of the broking industry

Another major development running parallel with the rise of non-bank lending has been the rise of the mortgage broking industry. At the same time as the banks were losing market share to non-bank lenders they were also reducing their direct retail presence. Morgan/Fujitsu estimated that the banks closed 2,000 branches between 1998 and 2004. The banks not only lost market share to the non-bank lenders, but with their diminished direct retail presence the banks themselves began to distribute through brokers.

It is now the case that when Australians buy a house or seek to refinance a housing loan there is a high probability they will use a mortgage broker. Morgan/Fujitsu analysis shows that 37% of Australia's $834 billion in housing loan outstandings as at the end of January 2007 were arranged by mortgage

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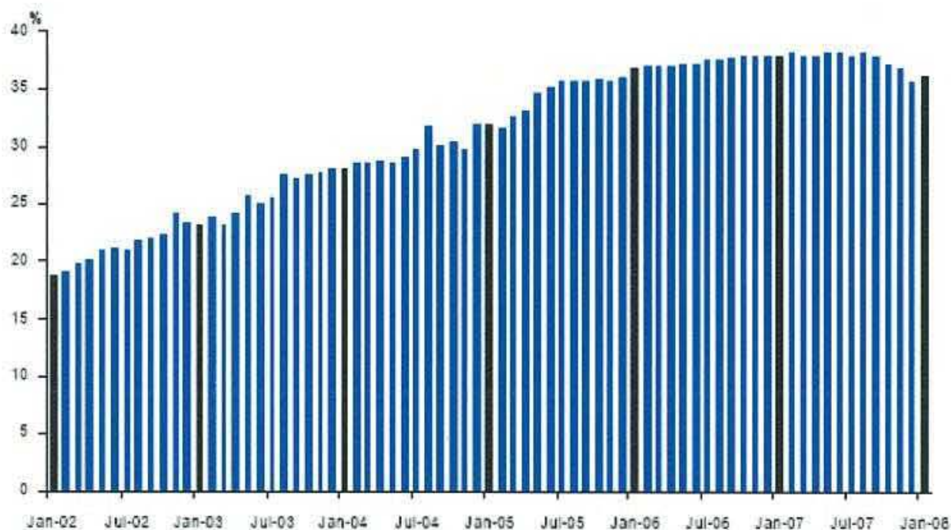
brokers.[4] Banks continue to use the broker channel but the proportion of outstandings attributable to brokers has begun to fall as a result of the post US sub-prime crisis reduction in non-bank lending.



Source: Fujitsu Consulting estimates.

Broker originated lending represents a dramatic change from the days when home buyers went cap in hand to a bank branch to beg for a mortgage. Credit was rationed and many of those fortunate enough to be given a loan were required to take a second mortgage at a higher rate.

Mortgage brokers play a major role increasing the pressure for competitive pricing by subjecting every one of the loans originated through them with either a bank or non-bank lender to independent price scrutiny and comparison with competitive products. Loans originated by a bank branch are not subjected to this process of independent comparison with the loans of the bank's competitors.

Development of low cost products by non-bank lenders

There are significant differences between the business models and cost structures of bank and non-bank lenders. Banks can be characterized as having lower average funding costs and higher fixed costs because of their deposit base and branch structure. The non-bank lending model is entirely dependent on capital markets for funding and relies on scale and the efficiency with which loans can be originated and serviced. As a result the value propositions offered to consumers by the two models differ. For example banks may leverage their

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4 Australian Mortgage Industry – Volume 5, JP Morgan Fujitsu, Australian Equity Research, 16 March 2007.

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brands and focus on value produced through cross selling while non-banks are more likely to seek the scale they require by undercutting their competitors on price.

Non-bank lenders were responsible for improving home buyers access to finance by changing the dynamics of the market from one which was volume rationed with high profit margins to one which is price cleared with low profit margins. Non-bank lenders also introduced a range of important innovations which gave more home buyers access to finance and provided them with more product choice and features that have since been copied by the banks:

- No application fee loans:
- No ongoing fee loans;
- Redraw facilities;
- On-line functionality;
- Price competitive investment loans;
- Split loans;
- Low doc loans;
- No doc loans; and
- Non-conforming loans.

TERM OF REFERENCE

(B) Current state of the retail banking and non-banking industries.

Credit standards for home lending in Australia have remained sound

The current state of the bank and non-bank mortgage sectors is determined by a number of factors:

1. The quality of credit on existing mortgage books;
2. The strength of household balance sheets and the interest cover provided by household incomes;
3. Prevailing and prospective conditions in the housing market; and
4. Current and prospective economic conditions.

The largest uncertainty today is the potential impact of the US sub-prime crisis on lenders, borrowers and general economic conditions.

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In recent years, which have included a property price bubble, and particularly since late last year when the US sub-prime crisis began to have a significant impact on conditions in Australian credit markets, the RBA has through its:[5]

- Financial Stability Review
- Monetary Policy Statements;
- Reserve Bank Bulletin;
- Speeches by the Governor and his senior officers; and
- Testimony to the House Economics Committee;

provided an increasingly detailed and accurate picture to the public, the markets and other policy makers of conditions in the Australian mortgage market.

That analysis has shown that credit standards in Australia are very different to the credit standards in the US which caused the US sub-prime crisis. While there had been a significant increase in indebtedness in recent years, Australian household balance sheets remained sound and growth in average debt levels was generally attributable to households which had the capacity to repay it.

Quality of non-bank lending

The US sub-prime crisis resulted in a focus on Australian credit standards with some commentators trying to draw analogies with non-bank lenders and low doc lending. Senior Australian bankers spoke of the banks' increase in market share which followed it as a "flight to quality". The implication was that non-bank lending had lower standards and that banks could protect borrowers from the impact of the US sub-prime crisis on capital markets.

It is certainly the case that different mortgage providers concentrate on different segments of the mortgage market and that each segment of the market exhibits particular credit performance characteristics, but there is no evidence in the Australian credit market of either the general deterioration in credit standards that caused the US sub-prime crisis or substantial differences in the credit standards for prime lending applied by bank and non-bank lenders.

Low doc lending is generally accessed by small business and professional borrowers who at the time they apply for a loan may not have very recent audited accounts or a tax assessment to satisfy a full doc appraisal. Instead they must provide evidence that they are in business and self certify their income. Because

[5] See particularly:

- Mr Ric Battellino Deputy Governor RBA Address to Finsia-Melbourne Centre for Financial Studies Banking and Finance Conference Melbourne - 25 September 2007.
- RBA Financial Stability Review, September 2007.
- RBA evidence to the House Economics Committee, Inquiry into Home Lending Practices and Processes Used to Deal with People in Financial Difficulty, Canberra 10 August 2007.
- RBA Bulletin, July 2007.

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many low doc borrowers receive their incomes irregularly they are more prone to short but self correcting periods of delinquency than full doc borrowers.

The banks followed non-banks into the low doc lending market and there is no evidence of any significant difference between the credit risks taken by either type of lender in this segment of the market.

RBA Estimates of the Number of Housing Loans in Australia
As at 31 March 2007

	Number of Loans Outstanding	Number of loans in arrears by 90+ days	Percent of loans in arrears by 90+ days
Prime full-doc loans	5 000 000	8 000	0.16
Prime low-doc loans	280 000	2 100	0.75
Non-conforming loans	30 000	1 700	5.65
Total	5 310 000	11 800	0.22

Source: RBA

Supplied by the RBA to members of the House Economics Committee, Inquiry into Home Lending Practices and Processes Used to Deal with People in Financial Difficulty, Canberra 10 August 2007.

The closest category of lending to sub-prime in the Australian mortgage market is the non-conforming lending segment, where the borrower may have an impaired credit history, but they are a minority even of these loans. The number of these loans in Australia is small and, if they have been properly underwritten, the borrowers are paying a sufficient premium to cover the additional risk.

Some commentators and industry players, either out of ignorance or seeking commercial advantage, encouraged borrowers to switch from non-bank mortgages to bank mortgages predicting increases in interest rates and risk as a result of the US sub-prime crisis. Borrowers who followed this advice faced the cost of discharging their existing mortgage and establishing another.

The banks claim a lower cost of funding than non banks and have used this to imply that they can and will offer cheaper loans to homebuyers than the non-

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banks can. While it is true that 15-25% of the banks' funding is obtained from short term, retail deposits at a lower cost than the funding available to non-banks, the banks have maintained as much profit margin as they can in the face of competition from non-bank mortgage providers. For the last 14 years RBA figures have consistently shown the non-banks offering lower standard variable rates than the banks.

But the sub-prime crisis did not mean that non-bank loans would be more expensive and risky for borrowers than loans from banks. As has been demonstrated by the banks' subsequent increases in rates in excess of increases in the RBA cash rate, taking that action provided no guarantee that their long term borrowing costs would be lower with a bank.

All lenders, banks and non-banks, have had to increase rates on new loans over the past year, not only to reflect the recent RBA increase in cash rates, but also to take account of the high cost of funding in wholesale markets.

US sub-prime crisis doesn't indicate a need for more regulation

As the lamentable credit standards that caused the US sub-prime crisis have not been replicated in Australia there is no justification for new regulation or controls in that area. Nor are increases in debt levels an indicator of a need for more regulation, as debt levels are not driven by lending practices, they are driven by economic and market conditions.

The early 1990's saw the end of a protracted period of high inflation. Interest rates fell, the economy entered a long period of economic expansion and asset and debt levels began to rise. This phenomena was experienced not just in Australia but across the developed world.

Australian households have increased their use of debt from about 30% of GDP in 1990 to around 100% of GDP today. This borrowing has increased effective demand for residential real estate and has been a major contributor to a doubling of house prices. Debt has increased but so has the vale of household assets.

While 10% of the rise in household credit has financed consumption, 90% has been used to acquire assets. In the past 10 years households have borrowed an additional $770 billion, of which $420 billion has been used for owner-occupied housing, $240 billion for houses to rent and $40 billion for shares.

Contrary to concerns that this build up of household debt is carried by first home buyers, the reality is that it is being driven primarily by middle-aged, and higher-income households trading up to higher quality or better located houses, buying investment properties, and taking out margin loans to buy shares. These are signs of affluence and about three quarters of the increase in owner-occupier

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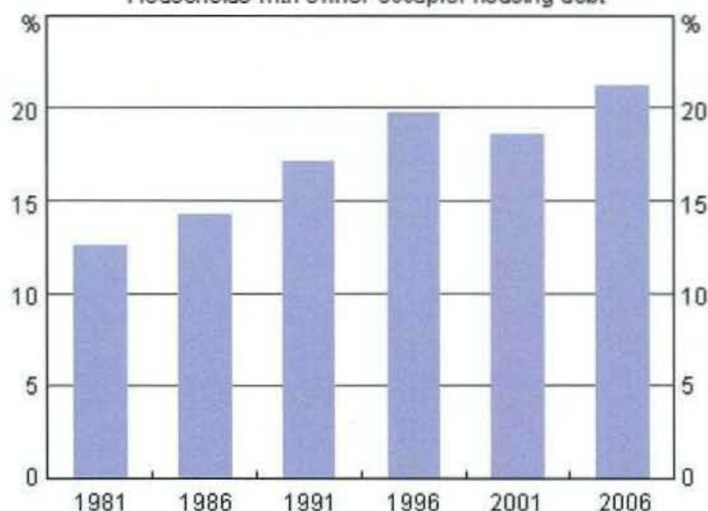
debt over the decade to 2005/06, for example, was attributable to households in the top half of the income distribution.

Despite the rise in the debt of this group of households, their debt servicing burdens remain relatively low. For those households who are in the top half of the income distribution and who have an owner-occupier housing loan, housing loan repayments currently average a little less than 20 per cent of gross income.

The average figure for households in the bottom half of the income distribution is around 30 per cent.



Aggregate gearing of the household sector has increased from 12% to 17½ % over the last decade but remains lower than in comparable countries.

Mortgage stress

Owner-occupier home buyers can face three types of mortgage stress:

1. Inability to purchase a house due either to the high price of housing and or the cost and accessibility of mortgage finance;
2. Difficulty in servicing a mortgage due either to the amount they had to borrow and/or the level of interest rates; and
3. Increased debt levels as a result of committing to other consumer debt after taking out a housing loan.

When house prices were rising rapidly the share of owner-occupier housing loan approvals going to first-home buyers declined to around 18% in early 2004, but with the slower pace of house price increases has since increased to be back

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around its long-run average share of around 25% of approvals. Many first-home buyers have low incomes and few assets and therefore experience difficulty entering the mortgage market. The fact that first-home buyers share of loan approvals had returned to around its long term average suggests that the first type of mortgage stress was not at an unusual level.

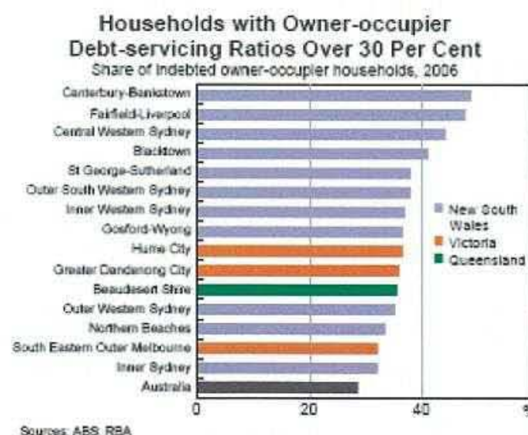
The second type of mortgage stress had returned to more manageable levels than might have generally been assumed given the significant increase in debt in recent years.

The average interest rate on outstanding housing loans was roughly the same in the June quarter 2007 as it was in mid 1997. The increase in the overall housing interest-payments ratio over the decade was mostly attributable to the increase in the ratio of housing debt to income, from 62% to 138%.

Even allowing for the increase in interest payments, real disposable income averaged across all households had grown at an average annual rate of 2% over the past decade. This means the average household had a higher absolute amount of income remaining after allowing for both inflation and interest payments than was the case a decade ago.

The resulting increase in debt-servicing commitments was reflected in an increase in the share of households with debt-servicing ratios that have historically been considered high. At the time of the 2006 Census, 29% of indebted owner-occupier households had debt-servicing ratios above 30%, compared with 23% a decade earlier.

While most of this increase was accounted for by higher-income households, the Census data shows owner-occupier debt servicing ratios above 30% are concentrated in outer metropolitan areas of Sydney, Melbourne and Brisbane. These were areas which were accessible to new entrants in the home property market during the property bubble and have since suffered downward pressure on prices.



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Default rates, which had been very low, while interest rates were at records lows and house prices were rising, have risen but only to levels around the long term average. Rising mortgage rates, due to both increases in official rates and increases in the cost of funding, are likely to have some further impact on delinquency rates for both bank and non-bank lenders. If the US sub-prime crisis causes a further deterioration in economic conditions there will be a commensurate further impact on delinquency rates.

Increases in delinquency rates as a result of deteriorating economic conditions are not an indicator of poor lending practice, since credit providers do not have the capacity to forecast which loan applicants might lose their jobs if the economy slowed. The only way to prevent such a rise in delinquency would be to deny finance and therefore home ownership to a large section of the community an overwhelming majority of whom would never feature in delinquency statistics.

The third type of mortgage stress, resulting from commitments to consumer debt after taking a housing loan are not foreseeable at the time of application unless the intending borrower already has an impaired credit history. This is one of the risks lenders must accept and then manage.

TERM OF REFERENCE

(C) Likely drivers of future change and innovation in the retail banking and non-banking sectors including the continuing impact of technological developments.

Provided the government or regulators do not intervene in the market in ways which dictate product offerings, non-bank lenders will continue to develop new and innovative mortgage products and services to meet the needs of borrowers.

TERM OF REFERENCE

(D) Comparison with relevant international jurisdictions.

Causes of sub-prime crisis have no parallels with the Australian mortgage market

The sub-prime crisis is a consequence of the fragmented nature of the US mortgage industry, where those who originated mortgages had no continuing material interest in the ongoing performance of the loan. This resulted in loose lending standards which were followed by falling property prices in a large part of the US housing market.

Unlike Australia where floating rate loans are the norm and lenders have recourse to the borrowers' assets in the event of default, US mortgages are

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usually fixed rate and the loans non-recourse, which means that, if they default, borrowers can only lose their equity in the house and not their other assets.

In the US sub-prime market, these features were coupled with discounted or low start interest rates that did not reflect the credit risk, loose credit standards (the so called "ninja" or no income, no job, no assets loans) and incentives to borrow which in combination encouraged and permitted excessive risk taking by home buyers, many of whom would not otherwise have been able to obtain a loan. All of the risks were on-sold into the capital markets so individual decisions to provide credit were sales driven and did not reflect proper risk management.

These sub-prime loans became a significant part of the US mortgage market. In 2006 some 40% of all originations were either sub-prime or categorised one rung higher as Alt-A. The characteristics of these loans included high loan-to-valuation ratios, often over 90% with a second loan on top of that, meaning that many homebuyers had no equity in their homes. Sub-prime loans frequently started at a teaser rate which in many cases would reset with payments increasing by 25% to 50%.

With house prices falling in significant parts of the US market many of the holders of these high LVR loans have found themselves with negative equity in their homes and defaults rose sharply. With loans that had no recourse to the borrowers' other assets, many of the borrowers who could not sell their houses and recover some remaining equity simply walked away, with the term "jingle mail" being coined for the process of returning the house keys to the bank. These defaults caused heavy losses concentrated in CDO (collateralised debt obligation) securities ultimately leading to the failure of major institutions like Bear Stearns, and damaged other institutions by contagion like Northern Rock, while others like Countrywide and Indy Mac failed because of the quality of their own lending and the impact of the sub-prime crisis on US house prices.

Australia has never had a substantial sub-prime mortgage market. The closest equivalent in Australian lending are non-conforming loans, which are used by borrowers who have some history of credit impairment, but these only amount to about half of one percent of all Australian mortgages. To date the default rates on Australian non-conforming lending have been much lower than in the US both because of a better performing property market and the application of better credit standards which are driven by the underwriters retaining risk.

To date the performance of Australian prime lending has been supported by the application of appropriate credit standards, strengthening household balance sheets, and until quite recently strong economic growth and a rising real estate market.

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Barriers that may impact on competition in the retail banking and non-banking sectors, and policies to enhance further competition and product choice for consumers.

BROKER REGULATION

An efficient and competitively neutral regulatory regime is critical to maximizing benefits for consumers. At the last COAG meeting the Prime Minister obtained the agreement of the Premiers and Chief Ministers to refer to the Commonwealth their powers on regulation of credit. No decisions about the shape of that regulatory regime have been announced but the Minister for Superannuation and Corporate Law has released a Green Paper canvassing options which will determine whether or not there is a level playing field for bank and non-bank mortgage lenders.

One of the key objectives of any regulatory regime should be to enhance competition as the primary driver for maximizing the benefits flowing to consumers in terms of price, choice of product and quality of service. This is particularly important in the mortgage market where substantial benefits have been provided by non-bank lenders distributing highly competitive housing loans through mortgage brokers.

Any regulation which reduces the capacity of mortgage brokers and non-bank mortgage providers to write price competitive loans will allow the banks to rebuild their margins at the expense of borrowers. It is critical that the principle of competitive neutrality is applied to the design of any new regulatory framework so that the banks are not given an unfair advantage either by blanket exemption or unbalanced requirements as has unfortunately been the case with State regulatory regimes.

The mortgage broking regulation regime must therefore be carefully targeted at assuring the quality and integrity of mortgage broking services without substantial increases in administrative or other costs that would necessarily have to be passed on to the consumer in the form of higher fees and interest rates.

The major objectives of mortgage broking regulation should be to:

1. Provide effective consumer protection;
2. Prevent predatory lending;
3. Assure integrity and quality of service; and
4. Maintain an efficient and competitive mortgage market.

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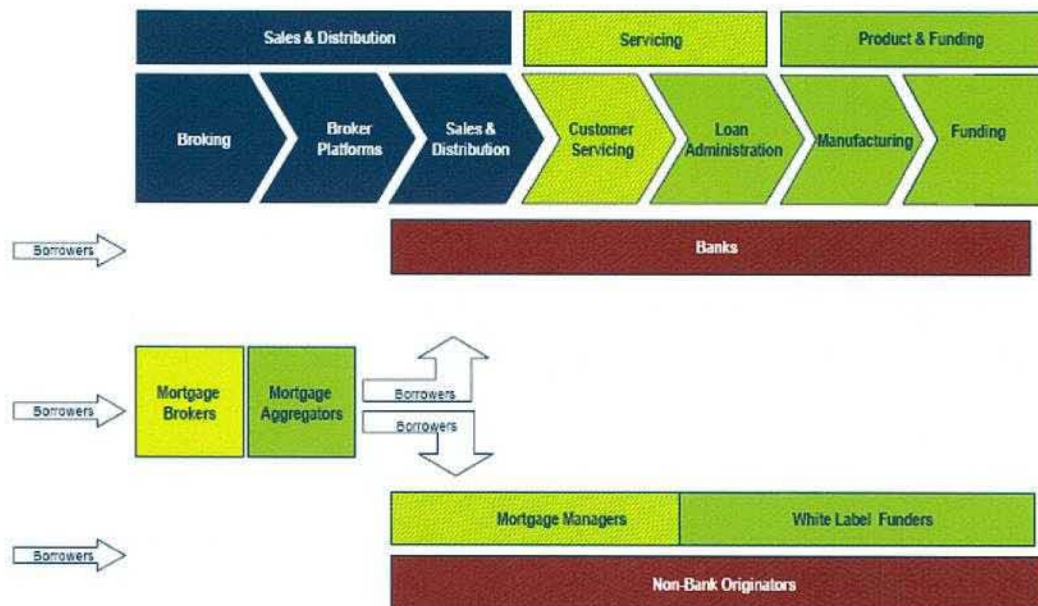
Both bank and non-bank lenders must undertake the same sets of functions to provide mortgage finance. These include; funding, product manufacture, loan administration, servicing the customer, distribution and sales. In the case of a bank they are done in house. In the case of non-bank mortgage providers they may be done by one or more entities which provide different components of the value chain.



A borrower may approach either a bank or a non-bank lender either directly or through a mortgage broker. Competitive neutrality requires that both bank and non-bank lenders be afforded the same treatment under mortgage broking regulation.

If new regulatory costs fall only on one section of the market they will interfere with its relative competitiveness and will allow the section of the market that is not subject to the new regulations to raise prices.

Borrowers from both banks and non-bank lenders will benefit from an efficient, competitively neutral mortgage broking regulation regime which provides them with appropriate consumer protection without adding unnecessary costs to non-bank lenders, brokers and ultimately borrowers.

Definition of a mortgage broker

To achieve an efficient and competitively neutral regulatory regime for mortgage broking it is critical to correctly define the activity which is to be regulated.

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A mortgage broker is a person holding themselves out to act on behalf of a borrower to recommend and arrange a suitable housing loan from an appropriate panel of lenders.

Mortgage brokers arrange loans for borrowers from both bank and non-bank mortgage providers. In both cases the activity of the mortgage broker should be subject to the same regulation.

A bank or non-bank mortgage provider selling one or a range of its own branded loans is not a mortgage broker, because it is not acting on behalf of the borrower, it is selling its own products.

A bank selling its own branded mortgages through a branch or mobile representative, or a non-bank lender, selling only its own branded mortgages, are acting on behalf of the lender not the borrower. They should be required to formally advise the loan applicant before they commence the sales process that they are acting for the lender and not the borrower, and that they are not able to provide independent advice that the loan is the best loan for the borrower from a range of competing products.

There is a risk of mis-selling where the representative of a bank or non-bank lender who is selling mortgages direct to borrowers receives a commission or incentive payment. If such a representative's remuneration is in full or part commission or incentive based, then the nature and amount of those commissions and incentives should be required to be disclosed to the loan applicant at the outset of the sales process.

Quality of existing mortgage brokers

There has been an assumption amongst State regulators that mortgage brokers need to be heavily regulated because they are providing a lower quality service than the banks. This is erroneous for two reasons:

1. The banks aren't providing an important part of the service provided by mortgage brokers they are not making independent comparisons between competing products and then recommending an appropriate product to the borrower.
2. There is no evidence of a lower standard of skill amongst brokers. In fact many mortgage brokers were once bank employees or managers of one of the 2,000 branches closed by the major banks.

The overwhelming majority of mortgage brokers are well qualified to perform this important role in the mortgage industry and do so with skill, diligence and care. It is important to them that the industry is properly regulated, that borrowers are properly protected, and that unscrupulous or incompetent operators are removed from the industry.

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State proposal for a national regulatory regime

The previous federal government declined requests from the States to regulate the broking industry and the States began the process of themselves developing a national mortgage broking regulatory regime. The first step was the preparation in 2004 of a discussion paper and draft regulatory impact statement on a national model of finance broking regulation by the NSW Office of Fair Trading for the Ministerial Council on Consumer Affairs. This contained 50 proposals and "additional proposals" for national regulation.

Some of these proposals and "additional proposals" were misguided and in some significant cases counterproductive for advancing the interests of homebuyers, but have still found their way into the draft legislation approved by the Ministerial Council. This suggests a flawed process with inadequate attention to industry experts and commercial input. The Productivity Commission noted in its draft report on the Review of Australia's Consumer Policy Framework that responsibility for this work had fallen on one officer within the NSW Office of Fair Trading.

A significant note of caution therefore needs to be raised about the statement in the Green Paper that "This work will assist in the development of Commonwealth regulation in this area". While many submissions have been made by the industry, subsequent consultation seems to have been limited mainly to government agencies. The Commonwealth should conduct a full consultation process on any legislation and regulations it decides to introduce. It is worth highlighting some of the major deficiencies that remain in the draft legislation released by the Ministerial Council on Consumer Affairs.

Requirement for brokers to determine capacity to pay

The draft State legislation requires brokers to determine the borrower's capacity to pay using third party sources of information prior to submitting a loan application. That is properly the role of the lender not the broker. The US sub-prime crisis has demonstrated the folly of lenders not being responsible for credit assessment.

Whilst some brokers may have previous experience in loan underwriting and all would have a general understanding of credit capacity, they are not equipped and resourced for this role. Brokers should be required to collect information from borrowers on their capacity to service a debt by interviewing the consumer and using any documentation the consumer has provided.

A finance broker is responsible for not misleading borrowers or credit providers. Disciplinary measures should be available against a broker who submits an application or proposal which they know or should have reasonably suspected

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contains information which is incorrect, or if a broker withholds information which is material to the lender's decision to approve an application.

The proposed requirements represent an expensive duplication of the process which is undertaken by the lender who has responsibility for approving credit and those extra costs will inevitably be passed on to the borrower.

The other defect of requiring brokers to determine capacity to repay is that borrowers will no longer be able to access low doc and no doc products via brokers as by definition brokers will not be able to independently determine capacity to pay with these types of loans.

This is anti-competitive as under the draft legislation bank branch staff and mobile lenders would not face the same restrictions. Non-bank lenders who rely on the broker distribution channel would be excluded from this section of the market and this would result in a reduction in the range of low doc and no doc products available to borrowers. Borrowers would be denied access to the services of a broker in arranging these types of loans.

Stay of Enforcement against lender

One of the least practical proposals advanced in the States' draft legislation is provision for a borrower who is in dispute with their broker to obtain a stay of enforcement against the lender while action proceeds, if there is a reasonable prospect of "saving the home."

This has a number of serious defects:

1. The lender is not a party to the dispute and the stay of enforcement interferes with the rights of the lender.
2. Lenders' mortgage insurers may refuse to cover this risk which will result in some otherwise eligible borrowers not being able to obtain a mortgage.
3. Any uncertainty as to a lender's ability to realise on its security will have implications for capital markets, with the probable result that loans that are subject to such a provision would not be able to be securitised.
4. If lenders' mortgage insurers were willing to insure for these risks LMI premiums which are paid by borrowers, in most cases first home buyers, would rise.
5. The stay of enforcement is likely to result in a reduction in the borrower's remaining equity in the home due to the protracted nature of such disputes and the fact that interest would continue to accrue. A faster remedy could be achieved by access to an EDR (external dispute resolution) scheme to consider complaints against mortgage brokers.
6. The increased risk to the security of mortgages, which in adverse economic conditions would be very significant, would result in funders

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requiring a substantial additional risk premium to be placed on mortgage interest rates.

Unnecessary documentation requirements

The draft State legislation would substantially increase the amount of documentation that must be produced by a broker. The extra documentation will be expensive to produce and is likely to provide little of value to borrowers.

Brokers will not wish to bear the extra compliance costs particularly since banks recently reduced their commissions to brokers by about 30%. They are likely to pass the costs on to borrowers. It is important not to repeat the mistakes with financial services regulation that have added so much to costs that they have priced many of the people who most need it out of the market for financial planning advice.

Defects with existing State based regulation of mortgage broking

WA is the only Australian jurisdiction that requires finance brokers and, subject to some exemptions, each entity in the chain between the borrower applying and settling a loan, to be licensed to conduct a finance broking business.

The WA model is a response to an investment scheme scandal in that State in which many retirees were duped into lending for risky property developments with inadequate security. The victims were providers of poor investment loans, not borrowers. The legislative response bears no relation to the proper regulation of mortgage brokers arranging loans for homebuyers from major bank and non-bank lenders, with WA regulating the entire non-bank mortgage industry, not just brokers.

This is effectively State based financial services regulation. The law imposes significant obligations on non-bank lenders and mortgage managers whilst exempting banks from similar obligations. So, the WA law places non-bank lenders and brokers at a competitive disadvantage.

The Queensland model, on the other hand, is light handed applying a code of conduct. It does not require brokers, non-bank lenders or mortgage managers to be licensed. The Queensland code is explicitly a transitional arrangement introduced early this year because that government believed that a State based national regime was years away.

The ACT requires finance brokers to be registered in order to broker loans regulated by ACT consumer credit law. ACT registered finance brokers must disclose certain information to borrowers in respect of the regulated consumer credit they broker. There is scope for disciplinary proceedings against ACT registered brokers.

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NSW and Victoria regulate finance broker disclosure of information to consumer credit borrowers. Other States and Territories continue to have no specific arrangements to regulate mortgage broking.

Regime needs to be federal

Even small differences in State regulatory regimes, which may be intended to protect State based providers from competition, impede efficient delivery on a national scale. This hurts consumers because it adds to their costs.

The mortgage industry is a national industry and requires a single, efficient and effective set of regulatory arrangements to protect consumers and assure integrity and confidence in the market.

The Federal Government is best placed to provide those arrangements and ensure that competition maximises the benefits to borrowers in terms of the quality of service they receive, and the range of products, features, rates and fees they can choose between.

The Federal Government is also best placed to deal with the types of malpractice that led to the WA mortgage broking scandal. National financial services regulation has an objective of ensuring proper disclosure of risks to protect small and unsophisticated investors who might otherwise be persuaded by unscrupulous or negligent operators to place their life savings in highly speculative investments.

The Productivity Commission has drawn attention to the difficulties in amending the Uniform Consumer Credit Code (UCCC), by revealing that any legislative project to amend it will take between 3 and 5 years. If Australia is to have efficient regulation of the provision of credit, which can be updated in a timely way to deal with changes in market conditions or practices, the UCCC will need to be moved into the federal jurisdiction.

One of the difficulties with attempts thus far by the States to regulate broking is that they have not been confined to regulating the practice of broking and have also sought to introduce new provisions to apply to brokers, which if they had any real merit would have been better placed in general consumer credit law. The Green Paper process presents an opportunity to separate these two sets of issues. If this occurs it will provide a more competitively neutral regulatory regime.

Any new requirements for regulation of equity release products, reverse mortgages or special provisions to deal with refinancing can then be dealt with separately and apply equally to all intermediaries.

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An effective national mortgage broking regulation regime

National mortgage broking regulation should be established under Commonwealth law and administered by ASIC.

Mortgage brokers should be registered and required to:

1. Have appropriate training and experience (a Certificate IV in mortgage broking or equivalent);
2. Maintain adequate professional indemnity insurance (say a minimum of $1 million, increasing with the size of the business);
3. Hold membership of an alternative dispute resolution process accredited by ASIC; and
4. Be a fit and proper person to conduct a broking business (for example not be bankrupt or have a conviction for dishonesty).

These arrangements will provide a framework which will allow proper enforcement, including through disciplinary action, against brokers for acts of incompetence, negligence, recklessness or dishonesty.

Registration rather than licensing would maintain a clear distinction between broking and financial advice. This would avoid any implication of automatically transferring to the new credit regulation regime the cost and complexity problems of FSR (Financial Services Regulation), particularly in relation to the obligation to provide and document full advice.

The requirements for membership of an alternative dispute resolution process and for adequate professional indemnity insurance will ensure that in the event of malpractice consumers have access to processes for resolving their grievances which are affordable, and that will provide redress.

In conducting their business mortgage brokers should be required to sign a mortgage broking contract with the borrower containing:

1. The broker's obligation to act in the interests of the borrower;
2. The requirements for the type of loan being sought;
3. The remuneration of the broker; and
4. Disclosure of any relationship or other matter which could be construed as a conflict of interest.

Brokers should be required to have a reasonable basis for their loan recommendations. Where a loan does not meet the specification set out in the mortgage broking contract the broker should be required to provide the borrower with further documentation setting out the basis for recommending the loan and the reasons why they have not recommended a loan that conforms with that specified in the broking contract.

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Where the recommended loan conforms to the specifications set out in the mortgage broking contract the broker should record the basis of the particular recommendation.

Further documentation of a loan recommendation that meets the specification set out in the mortgage broking contract would not provide additional value to the borrower and would necessarily involve significant expense to the borrower.

Mortgage brokers should not be required, and are normally not licensed, to provide borrowers with financial advice. They are required to inquire into so much of a borrower's financial affairs as is necessary for the purpose of identifying the loan product appropriate for the borrower's needs and preparing a loan application so that the lender can determine whether the borrower is credit worthy and able to service the loan sought.

Mortgage brokers have an obligation not only to borrowers but also to lenders to ensure that these inquiries are made with skill and diligence. Negligence, recklessness or dishonesty in providing information on a loan application to a lender should result in a broker being liable for disciplinary action, being sued or even being prosecuted for fraud.

In applying for a loan, borrowers also have a responsibility to make full and accurate disclosure of those matters that are relevant to their application. If they do not make full and accurate disclosure, they risk financial loss if they obtain a loan that they are not able to service.

It is unfortunately a reality that some borrowers provide false information and documentation in support of loan applications for the purposes of obtaining money under false pretences. Such persons should be liable for criminal prosecution.

Nothing in the regulatory regime should allow a borrower to transfer to a mortgage broker the borrower's responsibility for any defect in information provided to a lender.

Together these requirements will provide a proper basis for assuring integrity of the market for mortgage broking services.

The Government should adopt a more straightforward approach to regulating credit than the model in Chapter 7 of the Corporations Act. Chapter 7 was designed to protect consumers in respect of investments made by consumers. Consequently, there are significant disclosure and prudential requirements (for example, minimum capital requirements) in the Chapter which would render Chapter 7 style regulation inappropriate for brokers, mortgage managers and securitisation managers.

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Regulation and competitiveness of the market

Non-bank lenders introduced a number of product innovations, such as no-application fees and deferred establishment fees, which offer advantages to the borrowers for whom they are suited. In the case of no-application fee loans borrowers can choose either a lower opening balance or increase the total amount they can borrow. In the case of deferred establishment fees borrowers who do not switch loan providers in the early years of a loan will avoid loan establishment fees entirely and will continue to enjoy a competitive interest rate. These establishment costs are amortized by the lender over a period, typically 5 years, and not charged to borrowers at all if they maintain their loan over that period.

Any prescriptive regulation of fees will mean increased up front costs for borrowers, reduce product choice, and restrict the capacity of the industry to innovate to provide borrowers with new products which better meet their needs. Any regulation which restricts the price competitive product offerings of non-bank lenders will allow bank lenders to rebuild their margins at the expense of consumers.

In a competitive market, regulation which prescribes the fee structures of products not only reduces the range of product choices available to consumers, but may well result in one group of consumers subsidising another. For example, banning any kind of exit or early termination fee would add to the borrowing costs of those who do not switch loan products.

This potential problem of a borrower being required to pay for an option to switch loans which they may not intend to use is not mitigated for the borrower by existing State regulation of consumer credit. That regulation requires that the fees not exceed a reasonable estimate of the credit provider's loss arising from early termination or repayment, including the credit provider's average reasonable administrative costs in respect of the termination or prepayment.

Disclosure

The critical issue for borrowers is the clarity of disclosure so that they can make a judgment about the suitability of the fee structure for their circumstances.

Borrowers need to have a clear understanding of both interest rates and fee structures.

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REGULATION OF FEES

The Green Paper says at page 15 that "the Government does not intend to regulate bank fees and charges." Maintaining competitive neutrality would require that the fees charged by brokers and non-bank lenders also not be regulated.

The Green Paper also makes reference to an ASIC Review of mortgage entry and exit fees. There are a number of issues arising from that paper which need to be addressed.

General consumer advice

ASIC has produced some statistics which purport to indicate average entry and exit fees for different sectors of the mortgage market. The averages for each type of fee are simple arithmetic means of the fees listed for products offered by the 4 listed types of institution (ie. large banks, other banks, non-banks, and credit unions/building societies). The statistics do not provide useful comparisons between types of institutions for the following reasons:

1. They do not reflect the average fees actually being charged by these institutions because the averages are not weighted by the number and value of loans actually written.
2. They do not reflect the average fees being paid by borrowers because many fees are contingent on a particular borrower behaviour so the actual incidence of the fee cannot be compared. The ASIC statistics assume early termination at 2 years when the average is more like 4 years; and most importantly
3. They do not reflect the total value proposition inherent in a loan product because the analysis is conducted completely independently of the relative interest costs of the loans which is usually a larger determinant of the value proposition of the loan.

These are problems which cannot be fixed without far more detailed official statistical collections than are available today.

The other major difficulty is that while interest rate discounts may track the particular institution's standard variable rate those standard variable rates vary between institutions and can be adjusted unilaterally by the institution. Lenders will alter the value proposition of their loan products, including fee structures, relative to the products of other lenders.

Recent market conditions have demonstrated that assumptions that future rates would behave in a particular way, such as tracking movements in the cash rate, cannot necessarily be relied on. This is a risk factor inherent in the mortgage market

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which makes it difficult for regulators to provide even simple general consumer advice.

IMPLICATIONS OF THE US SUB-PRIME CRISIS FOR FUTURE COMPETITION

State of credit markets

World credit markets have effectively been frozen since August 2007 when the US sub-prime crisis crystallised. The consequences were fear among major institutions about the risk of counterparty default resulting in reluctance to participate in inter-bank lending and a severe contraction in liquidity as these institutions began to hoard cash.

RMBS (residential mortgage backed securities) lost acceptance in capital markets irrespective of the country of origin or credit quality of the collateral. Quality instruments such as high grade Australian RMBS began trading at values substantially below their economic value.

As a consequence of requirements for many institutions to mark to market under IFRS (International Financial Reporting Standards), the continuing volatility of these securities rendered them un-tradeable by most institutions because of the continuing risk of mark downs.

Until secondary markets for RMBS reopen and reach equilibrium it will not be possible to issue securities backed by new mortgage lending on any significant scale. There have been a few recent deals but they have been at rates at which it is not possible to achieve a positive return on the full cost of new lending in the mortgage market.

Investors are now requiring significantly higher risk premiums on new debt instruments. These increased risk premiums and the shortage of available credit have resulted in increased spreads (margins) over official interest rates. It is unlikely that when credit markets reopen and establish a new equilibrium that spreads will return to their previous low levels.

Effect on non-bank lenders

Non-bank lenders lend at a margin to the match funded price for pools of mortgages. Given this they have been forced to rely on their existing warehouse facilities to fund new lending. These facilities are not only finite but small relative to the annual mortgage volumes they were previously writing and successfully securitising. Faced with these higher costs to fund new lending, non-bank lenders have been forced to raise mortgage rates by more than the increases in official interest rates.

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One non-bank lender, RAMS, which had borrowed short as a cheap alternative to securitisation quickly found that it was not able to roll over its debt. It failed and was taken over by a larger entity, Westpac.

Without access to a plentiful supply of funding non-bank lenders have had to constrain new lending and with average costs rising a large number have exited the market, including ones which previously had significant scale. The remaining non-bank lenders are only able to operate at a fraction of their former capacity. As a consequence the major banks have made major inroads into the non-bank lenders' market share, predominantly funded using short term finance.

Effect on banks

Some of the regional banks were predominantly dependent on capital markets to fund their mortgage books through securitisation. The effect of the credit crisis on these institutions has been very similar to the effect on non-banks.

There has been some consolidation (takeover activity) in the banking sector (Adelaide/Bendigo, St George/Westpac) and speculation about the future ownership of other regional institutions, such as Bank West and Bank of Queensland.

There have been some large securitisation pools created by the major banks but these have been internal securitisations. They have not been taken to market and are essentially emergency facilities which could be taken directly to the RBA to obtain liquidity, for example if conditions in world credit markets deteriorated more severely.

In normal credit market conditions banks rely for their funding on a combination of long and short term securities issued to capital markets including some RMBS, their deposit base, and access to short term liquidity through inter-bank lending and the open market operations of the RBA. The credit crisis has resulted in less access to and more expensive funding through the capital and inter-bank markets, competition for available funds pushing up deposit rates, and much greater reliance on access to short term liquidity through the RBA's open market operations.

The credit crisis has forced banks to raise mortgage rates by more than the recent increases in official rates, but those increases do not reflect the full cost of long term funding from capital markets for new lending.

Effect on borrowers

The shortage of funding for mortgages has resulted in various forms of credit rationing for new borrowing. Credit standards have been tightened, which also

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reflects an emerging more uncertain economic outlook, and LVR's (loan to valuation ratios) have generally been made more restrictive.

After a long period where increases and decreases in mortgage rates have been very closely linked to upward and downward movements in the RBA cash rate, both existing and intending borrowers have been alarmed to see mortgage rate movements increase, in response to the increased cost of funding in world capital markets, in addition to the recent rises in official interest rates.

Changes in the spread over the cash rate

For the first time since 1995 when it fell below 2% the spread (margin) of the mortgage rate over the RBA cash rate has begun to rise.

Response by monetary authorities

Monetary authorities have a critical role in a credit crisis ensuring the stability of the financial system and maintaining sufficient liquidity to support economic activity.

Policy responses by monetary authorities in other countries have included dealing with failing financial institutions, cutting official interest rates, and providing direct liquidity support for the financial system through open market operations by broadening the range of counter parties they will deal with and the

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range of collateral they will take, including RMBS, and by outright purchase of securities including RMBS.

In Australia no failed institution has required intervention by the RBA, nor has the RBA considered it necessary to lower the official cash rate as a response to the credit crisis. Like its overseas counterparts the RBA made an early indication that it would broaden the range of its counterparties, the collateral it would deal in, and lengthen the tenors of repurchase trades. The RBA has accepted RMBS in its open market operations for repurchase on tenors of up to 363 days.

Competition between banks and non-bank

The underlying dynamics of the mortgage market are complex. It is critical to understand the underlying asset that is being funded. Mortgages are not individually funded. They are funded through large diversified pools. These will either be on a bank's balance sheet or in warehouse trusts and later, when a large enough pool exists, securitised.

This pooling process allows financial institutions to efficiently fund the assets knowing that the average performance of the pools across the industry will be similar.

A typical pool has the following characteristics:

- Underlying mortgages have a senior secured charge over the underlying property;
- Underlying mortgages have recourse to the owner of the property;
- The Pool has an average LVR of around 75%;
- The mortgages pay down on average about 20 – 25% per year;
- The mortgages have an "average life" of circa 4 years; and
- The mortgages are generally set at a margin to a standard variable rate.

Risk

There are a number of risks involved for a financial institution in funding and managing mortgages:

- Credit risk – the risk the borrower does not repay his loan and the lender has to exercise its security rights;
- Interest rate risk – if the loan has a fixed rate, the risk of interest rates changing such that the expected cost of funding the mortgage rises;
- Liquidity risk – if the loan is not funded via a liability of an equal term the risk that the cost of borrowing money throughout the term of the loan rises; and

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- Operational risk – the loan has been incorrectly sold to the customer, the loan has been incorrectly administered, or there has been some form of fraud, such that the institution suffers loss.

To have a competitive, functioning and efficient mortgage market it is important that these risks be correctly priced and for the participants to compete on their efficiency.

Correct market clearing price for a mortgage

The correct price for a mortgage is one that reflects:

- the cost to the institution of providing the mortgage and associated services, and
- an additional cost reflecting a fair return on the capital needed to cover the risks taken in providing the mortgage.

The component costs for administration, distribution and credit losses will differ between providers according to their efficiency and the type of credit risk accepted, but as an indicative example based on current market prices:

Current 3 month BBR Rate	7.75%	
Liquidity cost	1.00%	Current margin to lock in funding for expected term of 4 years
Administration cost	0.35%	Cost of approving and administering loan and managing arrears
Distribution cost	0.40%	Cost of selling mortgage via a branch or broker
Credit loss cost	0.05%	Cost of writeoffs of bad loans over time
Capital charge	0.54%	Cost of 3% capital charge (covering all forms of risk) an 18% return on equity
Return on capital	(0.24%)	Assumes 8%
Required break even	**9.85%**	
Price of mortgage	**8.95%**	**Average standard variable rate of 9.65% less discount of 0.70%**

So current new loan variable rates (inclusive of the typical discounts of 0 -0.7% on the standard variable rate) are approximately 0.90% below this.

The price of liquidity

Currently the profile of liquidity risk within the global financial system has been a central issue as those institutions that have ignored the true cost of financing have learnt to their detriment. Global risk free government yield curves are more often than not normally shaped which means the cost of longer term finance is higher than short term finance. In addition, the cost of money for riskier institutions will have an even higher cost in the long term than the short term.

As a result there is always a propensity to lend for longer terms and borrow for shorter terms at lower rates than would be required to match fund a transaction. The price of liquidity to term is the long term borrowing cost of an institution. If

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that institution decides to borrow shorter and take the risk that rates might rise in the future the institution is taking liquidity risk.

Because banks have a window to the central bank they have the ability to take more liquidity risk. Even though a bank's mortgage book may have an average life of about four years it currently would only fund a significant minority of its liability balance sheet to a term of greater than one year. As term funding costs have soared and availability of funding has dried up, banks have relied on their ability to issue short term debt or repo securities to the RBA.

It is a complex question as to how much liquidity risk an institution should take. Northern Rock, RAMS Home Loans and Countrywide were examples where liquidity risk was allowed to grow too large for the institution.

Currently mortgages are being written at non market clearing prices. Institutions doing a large amount of this lending know that if they had to match fund they would lose a significant amount of money post costs. What this means is that banks are taking liquidity risk at an out of market level which they are not required to mark to market in their books.

Taking liquidity risk in a controlled and regulated way is one of the roles of the banks in the financial system. The market is currently not discovering the cost of liquidity (which has clearly increased in global markets) because the banks can confidently fund mortgage growth via access to short term funding at lower short term rates.

Non-bank mortgage lenders are much more constrained in their ability to tolerate liquidity risk. They can only lend with any scale at prices which closely reflect the true market cost of funding their assets to the term of those assets.

In the 15 years since non-bank lenders became efficient providers in the mortgage market the margin over bank bills for AAA RMBS (3 – 5 year term) has been closely aligned to the margin over bank bills of AA major trading bank 3 – 5 year term paper.

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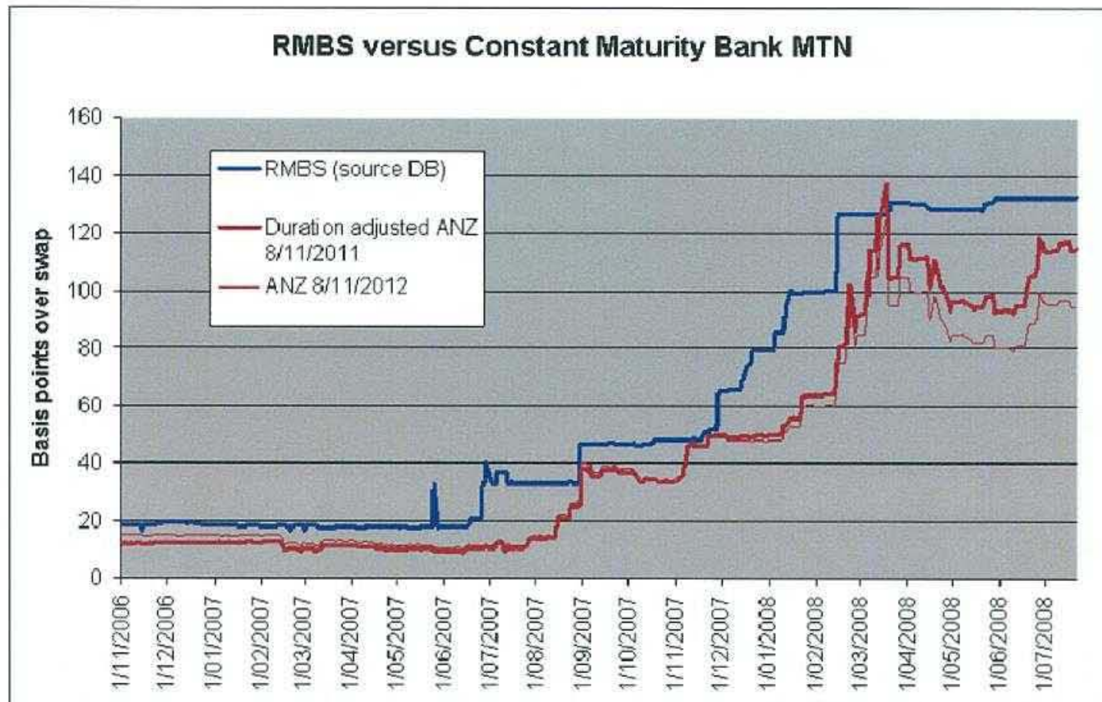

This makes sense given the similar credit quality and underlying assets backing the credit. Given this, and if the banks price term mortgage finance correctly, it will allow healthy competition in the mortgage markets as the pricing of the assets will reflect the true costs of funding them.

Access to liquidity through RBA open market operations is giving the banks a pricing advantage

As a result of the credit crisis the major banks have had to rely much more heavily on RBA open market operations to obtain the liquidity that they need to fund lending. The cost of this borrowing is determined by the bidding process which is used by the RBA to maintain the overnight cash rate as close as possible to its target rate.

As a result of the credit crisis, the RBA announced it would increase the range of collateral and counterparties which would have access to these repurchase arrangements and increase the tenors (lengths) of repurchase arrangements.
Most of the collateral used by the banks are bank bills and certificates of deposit at tenors for repurchase which are short. As a result much of the RBA's activity in financial markets involves rolling over its repo book. This is one of the ways banks are able to manage the mismatch between the duration of their assets and liabilities.

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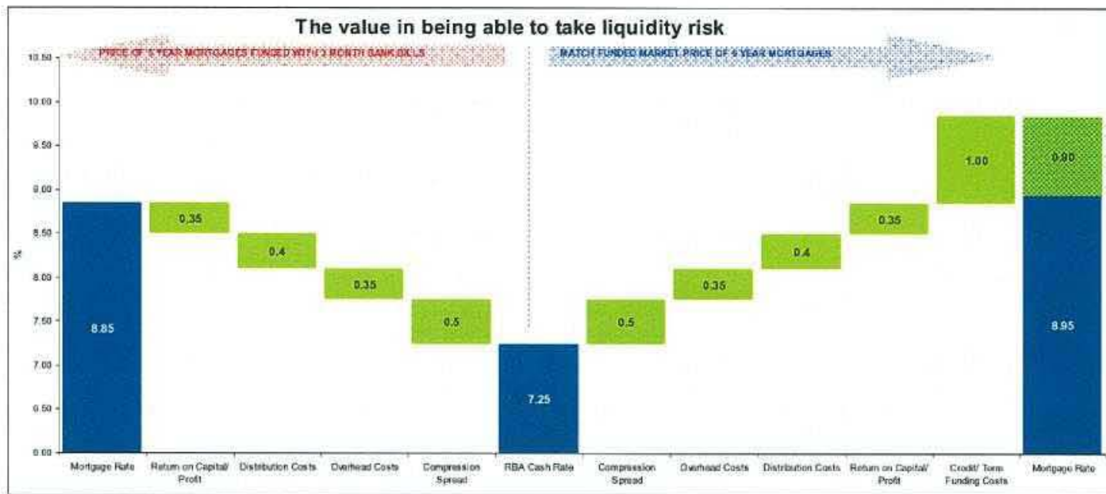
Extensive use of the RBA's repurchase arrangements therefore gives the banks two advantages relative to their non-bank competitors:

1. Access to liquidity; and
2. A pricing advantage.



Banks also provide the warehouses for non-banks, but the pricing now charged for these warehouses does not reflect the price at which the banks are originating mortgages on their own books, which also makes non-banks less competitive.

As a result of the freeze in credit markets, most primary issues of RMBS have been by way of private placements. The recent issues that have gone to market are still at spreads above the level at which it is possible to break even on the full long term costs of a new loan at current mortgage rates.

PRIMARY ISSUES OF AAA RMBS TO CAPITAL MARKETS (EXCLUDING PRIVATE PLACEMENTS)

Date	Issuer	Value ($m)	BBSW	Spread (bps)
28-05-08	Citibank	500	7.9900	145
17-06-08	Macquarie	270	8.0850	180*
03-07-08	Members Equ	448	7.9700	120
08-07-08	Macquarie	300	7.9200	110

Australian Asset Backed Weekly, Macquarie Research Debt Markets, Macquarie Bank
* a 100% low doc deal

The cost of this term funding of fully priced RMBS can be compared with the price of liquidity obtained on a short term basis from the RBA using equivalent securities as collateral.

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RBA DOMESTIC MARKET OPERATIONS
RMBS REPURCHASE AGREEMENTS

Date	Term (days)	Value Dealt ($m)	Weighted Average Rate (%)	BBSW	Spread (bps)
10-10-07	14	20	6.630	6.7300	-10
15-11-07	85	100	6.930	7.1367	-21
22-11-07	85	200	6.930	7.1700	-24
22-11-07	140	200	7.040	7.2500	-21
23-11-07	96	100	6.930	7.1650	-24
28-11-07	44	100	6.870	6.9200	-5
28-11-07	187	100	7.070	7.3717	-30
04-12-07	56	20	6.950	7.1483	-20
14-02-08	95	500	7.450	7.6433	-19
25-02-08	71	200	7.450	7.5967	-15
18-04-08	343	200	7.820	7.9800	-16
18-04-08	349	120	7.990	7.9800	1
21-04-08	22	100	7.450	7.5967	-15
21-04-08	346	80	7.780	7.9467	-17
21-04-08	353	600	7.850	7.9467	-10
07-05-08	365	150	7.750	7.9383	-19
20-05-08	77	400	7.380	7.8267	-45
27-05-08	17	150	7.280	7.8717	-59
29-05-08	15	120	7.280	8.0000	-72
06-06-08	39	200	7.420	8.0467	-63
10-06-08	184	100	7.680	8.1500	-47
20-06-08	7	100	7.300	8.0267	-73

Westpac and RBA

To the extent that the Future Fund has also found bank paper a more attractive short term repository for the cash transferred to it from government surpluses than leaving it on deposit with the RBA at the cash rate, the banks are also enjoying the benefit of another source of short term funding during the credit crisis.

The Future Fund's role is to invest Australian government assets for the long term. Its Board of Guardians is charged with making its own investment decisions. More can be done to convince the Future Fund portfolio managers that Australian AAA RMBS is an exceptional low risk investment opportunity at the current time.

In May the Treasurer announced that the AOFM would issue additional CGS (Commonwealth Government Securities) to support the effective operation of the Australian financial system. On July 22 the AOFM indicated that the proceeds of

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this new issuance would be invested in Australian dollar denominated debt securities issued by Australian, State and Territory government guaranteed entities and AAA rated sovereigns, supranationals and financial institutions.

The AOFM also announced that it will invest some of the Australian Government's short term cash balances in A1+ and A1 rated bank accepted bills and certificates of deposit issued by ADI's (banks), and A1+ rated asset backed commercial paper. This will provide the banks with a further source of short term funding.

While the RBA's expanded open market operations, the Future Fund's investments with the banks, and AOFM's prospective investments in bank ABCP (asset backed commercial paper) are for good public policy purposes and are not undertaken with the intention of giving the banks a competitive advantage in the mortgage market, they are having that effect. There is no argument for denying banks access to these facilities. However the government needs to also consider any indirect negative effects these operations are having on competition and whether a policy response is appropriate to provide for the maintenance of a competitive mortgage market in the face of the current credit crisis induced consolidation.

Possible policy responses

A range of policy responses have been canvassed by various market participants and their representative organisations, as well as academics. Some of these involve agency models which would facilitate long term intervention in the mortgage market. The government would have to consider whether these models would introduce distortions, unintended consequences and limit future innovation, as well as requiring the government and taxpayers to assume some risk.

It is important to recognise that, while the credit crisis has been severely affecting the functioning of capital markets for almost a year and it remains uncertain when they will begin to function efficiently to allocate funding, the problem is an immediate one and long term structural interventions cannot address it in any meaningful timeframe.

The most desirable solution would be to restore confidence in the secondary market for RMBS backed by creditworthy Australian assets issued by both quality bank and non-bank lenders. That is a prerequisite for non-bank lenders being able to do a sufficient volume of new securitisation issues to ensure a viable competitive market into the future.

There has been some recovery in the RMBS market with issues of new securities into the market in recent months, but these are not yet priced sufficiently tightly to allow a significant volume of fully priced new lending. With the recent setbacks in

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the US markets due to emerging problems in some major institutions the recovery may not come quickly enough by itself to maintain a critical mass of competitive non-bank lenders and regional banks.

It is not safe to assume that even if the credit crisis continued for long enough to reduce the number of non-bank lenders below a critical mass that they will quickly re-emerge when capital markets begin to function efficiently. The rapid rise of non-bank mortgage lending in the 1990's owed a great deal to a specific set of market conditions. At that time the retail banking system had little competition and the incumbents were charging excessive margins to retail customers to restore capital levels post the corporate and property lending mistakes of the late 1980's.

Effective competition from non-bank lenders in the Australian mortgage market now requires sufficient scale to compete with the largest financial institutions in the country. Any company re-entering the market would require a substantial amount of capital to do so and face significant financial and competitive barriers.

There would be no necessity to create any new agency as there are several institutions available to the government which could provide some fully priced long term liquidity for non-bank lenders. Any or all of the RBA, Future Fund and AOFM could purchase creditworthy Australian RMBS because it currently represents an exceptional asset, in terms of risk and return, in which to invest.

Such transactions, entered into on a competitive basis, could be effected rapidly. They would send a signal to the primary and secondary markets. Any such program could be terminated or unwound when secondary markets reopen.

An RBA paper[6] presented to its annual conference in July 2008 discussed the mechanisms for the public provision of liquidity, including:

- Central bank open market operations; and
- Outright purchase of assets.

The paper also discussed options to assist failing institutions. However that is not relevant to this discussion since non-bank lenders are not, because of their matched term funding which is structured to a AAA level, experiencing any crisis in their capacity to fund their existing liabilities. In present market conditions, if non-bank lenders are unable to obtain additional liquidity and make new mortgage loans at break even they will simply and profitably allow their existing books to run-off.

At some point, if the securitisation market does not reopen they may decide that the costs of maintaining the infrastructure to write new loans are too high and

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Jonathon Kearns and Philip Lowe, Promoting Liquidity: Why and How? RBA Conference, Sydney 14 – 15 July 2008.

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close that part of the business. Many have already done so and that will result in a substantial lessening of future competition.

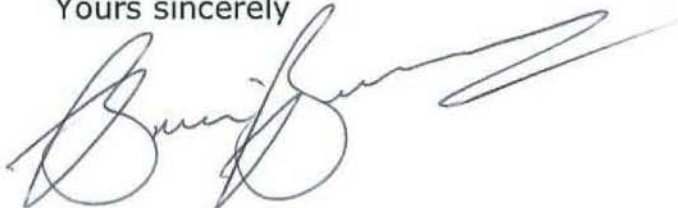
In their paper Kearns and Lowe set out three circumstances where they believe there would be a strong case to consider intervention:

1. The lack of liquidity, or misalignment in prices, was likely to have first-order adverse effects on the macro-economy;
2. The lack of liquidity, or misalignment in prices, was the result of some clear market failure, and was not likely to be rectified in a timely way; and
3. Any intervention was not likely to materially distort the pricing of similar assets or affect the structure of the market in normal times.

Kearns and Lowe specifically nominated mortgaged-backed securities as an example of a high quality bond that is suitable for purchase in such an intervention.

Challenger hopes that this submission assists the Committee in its deliberations. We would appreciate the opportunity to appear before the Committee at any hearing and will provide any other information or assistance which the Committee may require. In the first instance you should contact our Head of Government Relations, David Cox, (telephone: 02 9994 7256 and email: dcox@challenger.com.au).

Yours sincerely



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