SUBMISSION 10

Competition in Australia's Financial Marketplace

Competition in Australia's financial marketplace is under severe threat as a result of the global liquidity crisis. The reason for this is that the financial institutions that have provided competition in Australia have been very reliant on securitisation of loans to fund their business expansion and the securitisation market has not been operating in Australia since August 2007. The reason why securitisation has been so important to these institutions is that they cannot access the capital markets at a similar price level to the major banks, whereas the pricing in the securitisation market has reflected the quality of the underlying assets in the pools and this has been similar for large and small financial institutions. In other words the securitisation market enabled smaller financial institutions to compete more effectively. When the financial marketplace was dominated by major banks, prior to the development of the securitisation market, bank margins were approximately 4%. Those margins have now dropped to approximately 2%.

The reason why the securitisation market has not been functioning in Australia since August 2007 is because the global liquidity crisis, triggered by the sub prime crisis in the US, led to the demise of the structured investment vehicles (SIV) overseas and because SIVs were the major purchasers of securitised loans internationally. There is no sign of a recovery of SIVs in the short to medium term. Without the participation of SIVs in the securitisation market, the major purchasers will be major banks, which are benefiting from the current state of the securitisation market.

The benefits of supporting competition in the Australian financial marketplace include:

- Lower housing loan interest rates
- Lower fees and charges
- Greater contribution to regional communities, which are heavily supported by regional building societies and credit unions
- Greater customer satisfaction as the smaller financial institutions provide a more personal banking experience. This is particularly appreciated by older customers
- The natural strengthening of the market provided by diversity

Another issue that needs to be considered in this discussion is that the advent of compulsory superannuation in Australia has withdrawn a significant amount of money that was previously deposited in financial institutions and was used for funding housing loans. Those funds are now invested overseas by Australian funds managers. Securitisation filled the void left by this significant transfer of funds from the housing market and enabled financial institutions of all sizes to provide funding for housing at very competitive rates. Now that securitisation is not operating effectively there is a significant reduction in funds available for housing and this is evident in the marketplace.

The financial institutions that have survived the liquidity crisis in Australia to date have already demonstrated their strength and viability but the smaller financial institutions are under continued funding pressure and many have either had to withdraw from housing lending or significantly reduce their lending activities. This funding pressure will only increase as existing securitisation trusts reach their “clean up” call options, when issuers are expected to find the funds to pay out those trusts.

The reduction in housing lending from smaller financial institutions recently has enabled the major banks to regain market share and regain control over pricing in the housing loan market. It has also led to significant pressure being placed on mortgage brokers, who enhanced competition in the Australian marketplace and managed to achieve approximately 45% share of all housing loans sold in Australia. This share demonstrated the value they were providing to customers in finding the most competitive housing loan.

I can demonstrate the problem with the current market prices with the following example:

	%
Standard variable housing loan interest rate	9.47
Discounts offered to housing loan customers from standard	(0.70)
Cost of origination through mortgage brokers	(0.40)
Cost of other origination and loan servicing costs	(0.20)
Net interest rate	**8.17**
BBSW interest rate	7.54
Difference	**0.63**

(The difference shown above is the calculated margin above BBSW that can be paid to break even.)

Currently the margin above BBSW for AAA rated securitised loans is about 1.2% to 1.4%. At such a margin a financial institution would make a loss of 0.57% to 0.77% on all broker loans in the pool of assets sold. The loss on non broker loans would be 0.17% to 0.37%.

Since the start of the liquidity crisis the cost of warehouse funding has increased from 25 to 30 basis points over BBSW to 120 to 140 basis points over BBSW. This increase can't be absorbed by any financial institution that relies on securitisation for funding and has to be passed on to borrowers. The greater the reliance on securitisation the greater the cost and therefore the greater the risk of not being able to compete in the market as the costs have to be passed on to borrowers. It should be noted that the warehouses are provided by major banks in Australia and through the pricing of the warehouses they are able to force smaller financial institutions to be uncompetitive.

Many smaller financial institutions are also facing the need to perform a term issue within the next 6 months because they have reached the capacity in their warehouses, or they need to pay out older trusts as they fall due, or they will be forced to by the providers of the warehouse. If these financial institutions are forced to undertake a term issue at current prices they will suffer a loss on the assets sold for the following 5 years, being the average term of trusts. This provides a 5 year disadvantage for smaller financial institutions which are forced to do this. This disadvantage is a significant risk to some well respected financial institutions that have supported the Australian marketplace and particularly regional Australia for 50 to 100 years.

An opportunity does exist to overcome the current financial turmoil and enable competition to thrive in Australia. That opportunity is to establish a government agency to enter the Australian securitisation marketplace and provide long term liquidity support at virtually no risk to the government. The Australian Securitisation Forum is proposing a model similar to one used in Canada, which was introduced to encourage competition in the Canadian marketplace and has been very successful. It is a model that has already been tried and tested and achieved the main aim of supporting competition.

The model that is being proposed by the ASF is being resisted in Australia by major banks, as it was in Canada, because without the introduction of such a model they can control pricing and competition in the Australian financial marketplace.

Since the start of the liquidity crisis, the RBA and APRA have been monitoring the market and the impacts on all financial institutions very closely. Unfortunately, however, any proactive steps taken by the RBA (eg the expansion of the types of securities that are eligible for repurchase) have only been of value to the major banks. It is natural and appropriate for their focus to be on the major financial institutions, however, some interaction with smaller financial institutions may at least provide a different perspective.

Some people have recently suggested that there are early signs of the securitisation market returning and that eventually it will return without intervention. The market may recover without any assistance but the questions remain: how long will it take? what level will the pricing return to if the major buyers of securitised loans in Australia are major banks? and what damage will have been done to the competitive capabilities of regional financial institutions for many years?

A view that the market may be recovering is at odds with very recent reports from the UK that they are now facing the biggest housing crisis since the great depression. My concern is that Australia is often some months behind developments overseas and we may see a similar crisis in Australia if we do nothing. There are already signs of a significant slowdown in our housing market and each month it is getting worse.

This issue is all about competition and whether the regulators and government in Australia are willing to support competition in Australia, particularly regional Australia, or whether they are prepared to allow the major financial institutions to dictate pricing and competition in the Australian financial market.

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