

SUBMISSION 19

Credit
Ombudsman
Service

Inquiry into competition in the banking and
non-banking sectors

HHouse Standing Committee on Economics

Submission By

Credit Ombudsman Service Limited

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SUBMISSION

Inquiry into competition in the banking and non-banking sectors

1. Our Organisation

COSL is an external dispute resolution (EDR) scheme approved by the Australian Securities and Investments Commission (ASIC).

As a condition of ASIC's approval, COSL is required to meet the stringent conditions prescribed by ASIC's Regulatory Guide 139.

COSL is a not-for-profit company. It is required to be impartial, accessible and independent, as well as absolutely free of charge to consumers. It provides consumers with an alternative to legal proceedings for resolving disputes with its members.

The key objects of COSL are to:

- (a) act as the primary complaints resolution body for the credit industry; and
- (b) ensure the timely, efficient and effective resolution of complaints against members, having regard to the criteria of relevant legal requirements, recognised industry Codes of Practice, good practice in the credit industry, and fairness in all circumstances.

Importantly, COSL is able to award compensation in an amount of up to \$250,000 for loss. It is also able to make orders compelling a member to do or refrain from doing specified acts.

COSL's membership comprises mainly mortgage brokers, but also mortgage originators, non-bank lenders, aggregators and mortgage managers.

The overwhelming majority of mortgage brokers in Australia are either members of COSL or loan writers for whom COSL members have assumed responsibility.

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Importantly, about 36% of all home loans written in Australia are written by members of COSL or their loan writers.

COSL's membership now stands at about 8,500 members, and covers about 16,000 loan writers. COSL's strategic aim is to expand its coverage in the credit industry and so provide more consumers with further access to an EDR process.

An estimated 75% of loan writers who would not otherwise be covered by an ASIC-approved EDR scheme are covered by COSL, and this benefits consumers enormously.

About 95% of enquiries and complaints received by COSL are resolved by non-adjudicative means, that is, by conciliation, although the Credit Ombudsman does exercise his power to make Determinations, the terms of which are then published on its website.¹

Like all ASIC RG139 approved schemes, Determinations made by the Credit Ombudsman bind members but not consumers. COSL's services are funded by a combination of membership fees and complaint fees paid by its members. It is free for consumers and is controlled by a Board with equal representation from industry and consumer organisations and an independent chair.

2. This submission

Given the nature its membership, COSL is in a unique position to comment on the state of competition in the banking and, in particular, the non-authorized deposit taking institution (non-ADI)² sectors.

It is trite to say that competition is vital and beneficial to consumers in any the regulatory framework within which financial institutions operate.

¹ www.creditombudsman.com.au

² The reference to "non-ADI" lenders is preferred in this submission over "non-bank lenders", as the former excludes building societies and credit unions which are non-banks but still ADIs

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There have been substantial changes to the housing lending market in Australia over the last 10 to 15 years. This has included a huge increase in the number of lenders in the market and a consequent increase in competition.³

It is COSL's contention that the growth in market share for non-ADI lender and intermediary sectors during the 1990's and up until 2006 not only contributed to increasing competition in the overall sector, but also produced positive outcomes for consumers, including downward pressure on interest rates and other charges, product innovation and more consumer choice.

It is estimated that around one third of all home mortgage mortgages in Australia are written by brokers.⁴

About half of all first home loans by number and by value are now sourced through intermediaries.⁵ As discussed above, 75% of these are COSL members.

COSL is particularly concerned at the pressure being placed on:

- non-ADI lenders; and
- intermediaries such as mortgage and finance brokers.

Recent developments, particularly the so-called "credit squeeze", have reversed this trend and reinforced the dominance of the banks⁶, who still, for reasons of their own, use intermediaries. COSL submits that while there is little the Australian government can do about some of the underlying causes of these trends, it can respond by:

- ensuring that regulation of the sector impacts equally on both banks and non-ADI lenders;
- keeping the cost of regulation down so as to facilitate smaller non-ADI participants in the market;

³ Inquiry Into Home Loan Lending Practices And Processes, paragraph 2.44

⁴ APRA *Insight* Issue One 2008, p 19

⁵ APRA *Insight* Issue One 2008, p 23

⁶ See *Australian Financial Review* 2 July 2008 p 54

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- encouraging industry self-regulation and co-regulation at relatively uniform high levels of consumer protection so that these mechanisms do not artificially differentiate the market in favour of banks; and
- considering how it might provide confidence in the investor community in relation to mortgage backed securities⁷.

3. The salutary effect on the market of non-ADI lenders and intermediaries

The Reserve Bank of Australia (RBA) has acknowledged the salutary effect that increased competition by specialist mortgage lenders and the role of mortgage brokers has had on the housing loan market:

“More recently, the emergence of mortgage brokers, who act as intermediaries between lenders and borrowers and make it easier for borrowers to compare the costs and features of different loans, has heightened competition between lenders.”⁸

Further, the entry into the market of specialist mortgage lenders or “originators”, most of whom are members of COSL, “boosted competition in the mid-1990s.”⁹

The “big four” banks,¹⁰ of course, did continue to dominate the market for owner-occupied home lending by authorised deposit taking institutions (ADIs). Until quite recently, they had 86% of that market with “other banks” taking 10% and credit unions and building societies representing less than 5%.¹¹

Non-ADI lenders, the specialist mortgage lenders or “originators”, made up almost 15% of the overall home loan market. It would seem that most of this growth came at the expense of the big four banks, as their share of the overall home lending market was approaching 70%.

⁷ The Senate Select Committee on Housing Affordability in Australia recommended that Treasury examine whether an “AussieMac” initiative would be beneficial to the Australian market

⁸ RBA and APRA *Joint Submission to the Inquiry into Home Lending Practices and Processes*, August 2007, pp 1-2

⁹ RBA and APRA *Joint Submission to the Inquiry into Home Lending Practices and Processes*, August 2007, p 1

¹⁰ or “complex” banks as they are sometimes described by APRA

¹¹ APRA *Insight* Issue One 2008, p 18

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The effect, however, of increased competition, cannot be assessed, necessarily, simply by the size of the market share of the non-ADI lenders or, in particular, by the “big four” banks. Neoclassical economic theory has long since identified and explained the effects of ‘marginal’ inputs at the fringes of markets on the behaviour of competitors and consumers within such markets.¹²

Thus, the RBA concludes that interest rate margins have been reduced as a direct result of increased competition and, further:

“Competition has also led to various product innovations, many of which were first introduced by non-mainstream lenders but which are now widely available.”¹³

Also, the Productivity Commission states that:

“...greater competition among housing lenders (including the advent of mortgage originators and brokers) has made it much easier to obtain loans, and has contributed to lower interest costs by reducing lending margins.”¹⁴

Price and product innovation are not the only areas where the non-ADI lenders and mortgage brokers have contributed, in positive ways, to consumer participation in the home lending market. For instance, as the Productivity Commission points out about mortgage brokers:

“They have made it easier for consumers to undertake price comparisons, and their advertising campaigns have raised consumer awareness about financing costs and the different sorts of home loan products available in the market. They have also assisted new lenders (such as mortgage originators) to enter the market by providing marketing and support services.”¹⁵

¹² William Novshek and Hugo Sonnenschein *The Journal of Political Economy*, Vol. 87, No. 6 (Dec., 1979), pp. 1368-1376 at p 1369

¹³ RBA and APRA *Joint Submission to the Inquiry into Home Lending Practices and Processes*, August 2007, at p 2

¹⁴ Productivity Commission *First Report into Home Ownership* (2004) p xvii

¹⁵ Productivity Commission *First Report into Home Ownership* (2004) p 49

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Ironically, it is some of the same pro-competitive features of the non-ADI lenders and the mortgage brokers which make them vulnerable to market and regulatory forces in the current environment.

4. The “Credit Squeeze” and its anti-competitive effects

As discussed above, the recent credit squeeze impacts more heavily on non-ADI lenders than on the banks and the other smaller ADI’s in the home lending market. Largely, this is a function of the source of funds for non-ADI lenders being securities-based products as opposed to the banks who, still, can rely on their own deposits as part of a mixed portfolio of funds.

Initially, of course, in the early 1990s, this presented an opportunity for non-ADI lenders as the banks were still largely bound by the lending policies of an earlier, more regulated environment. Further, as inflation fell, the gap between the bank bill interest rate and the deposit rate narrowed and non- ADI lenders, willing to operate on lower margins, could enter the home loan market on a competitive basis. The growth of that market share has been discussed above.

Access to the securities-based bill markets, which are the prime source of funds for the non-ADI lenders, has become very difficult as a result of the US sub-prime crisis. Those funds which are available are much more expensive. The result has been a dramatic turnaround in the historic growth of non-ADI home loan lending with the banks as the “big winners.” The latest data from the Australian Bureau of Statistics puts the big four banks’ share of home loan lending up to almost 90%, the largest share in more than 13 years.¹⁶

The effect of the credit squeeze on the non-ADI lenders is well known and commented on in the popular press, as discussed above.¹⁷ It also, however, has a flow-on effect for mortgage brokers. One of their competitive advantages, as opposed to the consumer directly dealing with the banks, is the identification of choices in the market. A reduction in those choices reduces the usefulness of the broker’s service.

¹⁶ ABS Home Finance Statistics April 2008, Release 5690.0 Tables 2 and 3

¹⁷ See *Australian Financial Review* 2 July 2008 p 54

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Of course, as often as not, brokers channel borrowers to banks. One third of all home loan borrowers used a broker or other intermediary¹⁸ and banks originate more than two thirds of all home loans so, it follows, at least a third of bank home loans come through brokers. At least one major broker with multiple loan writers throughout Australia reports that it writes almost 70% of its loans for banks.¹⁹

A reduction in the number of non-ADI options for brokers to provide to borrowers will reduce their effectiveness and their usefulness to consumers. They will simply become another conduit for customers to the big four banks without value adding to the competitiveness of the market.

5. Differential regulation and self-regulation

Consumer credit, whether provided by banks or non-banks²⁰, is uniformly regulated by the *Consumer Credit Code* and has been so since 1996.²¹ It is trite to say that the documentary disclosure and conduct requirements of the Code are a greater relative impost on smaller credit providers than on the large big four banks. It is much easier for larger organisations to comply.

Yet, there are no exemptions or reductions in regulation for any credit provider, no matter what their size. This is the most obvious factor in the unfair advantage of the banks in credit regulation. It is not the only one.

Many classes of transaction however, such as personal investment credit and small business lending, even if secured by owner-occupied home mortgages, as they often are, are not covered by the *Consumer Credit Code*.²²

¹⁸ APRA *Insight* Issue One 2008, p 19

¹⁹ Loan Market Group, June 2008, at www.lendingcentral.com

²⁰ that is, non-ADI lenders, building societies and credit unions

²¹ The uniform *Consumer Credit Code Acts* being largely adopted by the States in 1994 with a two year "tooling up" period.

²² *Consumer Credit Code* sections 6 and 11

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Initially, it was banks which led the way in self-regulation of their industry. The establishment of the Australian Banking Industry Ombudsman in 1991 (later known as the Banking and Financial Services Ombudsman (BFSO) and now the Financial Ombudsman Service (FOS)), substantially predates similar schemes for non-ADI lenders and brokers. Similarly, the Code of Banking Practice was one of the first of its kind in Australia. Interestingly, the genesis of that Banking Code was marked by initial industry resistance, pressure from government and, ultimately, the “side-stepping” of a Task Force commissioned to draft the Banking Code by the Australian Bankers’ Association releasing its own version in November of 1993.²³

Not surprisingly, the consumer movement was not happy²⁴ yet the Code remained unaltered until a review by RT Viney (a former member of the Credit Tribunal of Victoria) in 2001, who concluded, amongst other things that it:

- was not seriously supported by industry;
- had not succeeded in improving bank/customer relationships;
- had been largely irrelevant to both banks and customers.²⁵

After this review, the new version of the Code, released in August 2003 and, amended again, in May 2004 was, from a consumer perspective, a “substantial improvement.”²⁶

Mortgage brokers and the mortgage originators, as an industry, did not adopt a Code of Practice, in the modern sense of the word, until the Mortgage and Finance Association of Australia (‘MFAA’) released a Code of Practice in 2003 and updated it in 2005 and, again, in November 2007. By that time the perceptions of industry, regulators and the consumer movement on what could be achieved through such Codes had changed dramatically. Expectations of industry codes and dispute resolution were much higher.

²³ See Tyree, *A Banking Law in Australia* 5th ed, Butterworths (2005) p 355

²⁴ “Banking Code Hijacked” *Sydney Morning Herald* 4 November 1993

²⁵ Viney, RT “Reviewing the Code of Banking Practice in the New Environment” 18th Annual Banking Law and Practice Conference, Sydney, June 2001.

²⁶ Tyree, *A Banking Law in Australia* 5th ed, Butterworths (2005) p 355

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On several key points, for instance, the MFAA Code of Practice for the non-ADI sector (which applies to both brokers and originators) can be considered more onerous on its members than the Banking Code of Banking Practice.²⁷

For instance, on the vexed question of appropriateness of lending and issues of “capacity to pay”, the MFAA Code requires its members to have a “genuine and reasonable belief” as to the appropriate finance being recommended to the consumer.²⁸ This is clearly a higher standard than the more minimalist and legalistic “diligent and prudent banker” formulation in the Banking Code.²⁹

COSL, the preferred external dispute resolution scheme for the vast majority of mortgage brokers and mortgage originators in Australia, has taken far more progressive positions on several issues than the former BFSO, now the FOS. These have been praised by leading consumer advocacy groups.³⁰ COSL does and is prepared to look at whether fees and charges imposed by a lender amount to a penalty at common law or are unconscionable under section 72(l) of the *Consumer Credit Code*.

COSL also takes the view that it is entitled to consider a complaint from a consumer that a lender has not given effect to section 66 of the *Consumer Credit Code* which deals with financial hardship. Again, this benefits consumers enormously, particularly at a time of rising interest rates and evidence of mortgage stress.

Both these positions have been eschewed by the BFSO as being either “commercial considerations” or “policy matters.” While COSL does not resile from these positions, for which it has large industry support, it recognises that they represent imposts on industry which, if not uniformly applied to the entire sector, will give the banks an anti-competitive and anti-consumer advantage.

²⁷ The Credit Union Code of Practice has not been amended since its adoption in the early 90's despite a critical review completed in 1996. Building societies no longer subscribe to their industry code. However, a draft Mutuals Code of Practice for credit unions and mutual building societies is being developed and is expected to become effective in June 2009.

²⁸ MFAA Code, Clause 9

²⁹ Clause 25.1

³⁰ e.g. Consumer Law Centre of the ACT, Submission to Productivity Commission Review of Australia's Consumer Policy Framework.

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As to proposed legislative regulation of the finance broking industry, the Ministerial Council for Consumer Affairs (MCCA) entrusts management of consumer credit matters to the Uniform Consumer Credit Code Management Committee (UCCMC). UCCMC assigned drafting of national finance broking legislation to the NSW Office of Fair Trading. They produced a draft Bill in November of 2007.

The draft Bill provides, among other things, that:

- (a) a broker must be licensed and:
 - (i) undergo probity checks;
 - (ii) meet prescribed educational qualifications or skills;
 - (iii) join an approved EDR scheme; and
 - (iv) hold professional indemnity insurance;
- (b) a representative of a broker must also join an approved EDR scheme;
- (c) the licensed broker is liable for the conduct of their representative as if the conduct were its own (draft clause 28(1))
- (d) a broker must have a reasonable basis for any recommendation. Specifically, clause 33 specifies that:

"...it is the broker who is responsible for ascertaining the consumer's credit needs and for determining whether the consumer has the capacity to repay a loan that satisfies those needs."

The Draft Finance Broking Bill also addresses conflict of interest issues, including that brokers disclose: the names of the credit providers through which they can access credit; all costs that the consumer will be liable for; and commissions received from lenders.

The Bill also covers small business operators, so as to prevent brokers restructuring their activities to avoid regulation, (although business credit would be subject to different requirements that more closely reflected business needs).

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Clearly, the Draft Finance Broking Bill represents significant advances for consumers in their dealings with financial intermediaries in credit. The Productivity Commission referred favourably to its provisions and called for a national licensing scheme for finance brokers as well as credit providers.³¹

COSL supports all these measures, and, indeed, the transfer of all credit regulation, including mortgages, and brokers to the Commonwealth. However, the substantial imposts which the Draft Bill represents on mortgage brokers put them at a competitive disadvantage compared with banks.

Once again, the question of the appropriateness of finance is crucial here. The Draft Bill places substantial obligations on finance brokers to determine the consumer's capacity to pay. The consequences of failing to do so can be actions against the broker for damages and possible suspension of their licence.

Banks, when dealing with loans not regulated by the *Consumer Credit Code*, have only to face the "prudent and diligent banker" test when making the decision to lend, a decision which the relevant industry ombudsman, FOS has said is largely a matter of "commercial judgement."³²

COSL submits that any relative decline in the market share of the mortgage market for mortgage broker initiated loans and mortgage originator initiated loans will reduce, in relative terms, the access of consumers to more progressive industry regulation and dispute resolution. In short, they will have fewer choices and then fewer rights.

6. Responsible lending

There is considerable variation among lenders in how much they will lend, as noted by APRA's John Laker:

³¹ Productivity Commission, Review of Australia's Consumer Policy Framework (2008) vol 2, pp 451- 453

³² BFSO Bulletin 46, June 2005, p 8

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“The most aggressive ADI will typically be willing to lend more than twice as much as the most conservative.”³³

Anecdotal evidence suggests that most ADIs and non-ADI lenders have tightened their credit policies in recent months.

In terms of responsible lending, the vast majority of non-ADI operatives who are members of COSL conduct business and provide credit in an appropriate way. Indeed, COSL's records indicate that only 7% of the complaints it received from 1 January 2008 to 30 June 2008 alleged inappropriate lending by non-ADI lenders or brokers (including brokers who acted for ADI lenders). We define inappropriate lending as involving either “churning”³⁴ or lending where the borrower has no capacity to repay.

It should be remembered that there are non-ADI lenders and brokers who operate at the fringe and who are not members of COSL (or any other EDR scheme). These operators, not surprisingly, are usually associated with improper and predatory lending practices.

7. Some myths demolished

There are some myths surrounding the mortgage market which are not supported by an examination of the statistical facts.

Myth: “Non-ADI lenders are responsible for low-doc and no-doc loans”

The truth is that banks sell the vast majority of these products. Among ADI lenders, APRA says that low doc housing lending makes up about 10% of the market and:

³³ J Laker, Credit standards in housing lending – some further insights, Address to Institute of Chartered Accountants in Australia, 20 June 2007, p. 5

³⁴ “Churning” refers to refinance situations where the incorrect loan product is sold; where there is no benefit in refinancing; or where the borrower is in the same or no better position

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“Low-doc lending was almost exclusively the domain of the banks - it accounted for about 10 per cent of loan approvals of complex banks, (the big four) 8 per cent for other banks but only 1 per cent for CUBS (credit unions and building societies).”³⁵

Myth: “Non-bank lending is much more likely to be in arrears”

As at March 2007, 0.38% of the value of housing loans on the bank’s domestic balance sheets were “non-performing” and the comparable figures for the building societies and credit unions were “slightly higher”, according to APRA and the RBA.³⁶

Of securitised, as opposed to traditional bank deposit backed, loans (regardless of lender), at April 2007, 0.47 % were in arrears. Remember, banks as well as non-ADI lenders, are doing this kind of lending.

Myth: “Broker organised loans are much more likely to be in arrears”

Although COSL could not identify a specific statistic on this point, given that more than one third of all bank loans are transacted through brokers and only 0.38% of bank home loans are in arrears, this is most unlikely.

Myth: “Non-performing loans lead to repossessions”

According to APRA and the RBA:

“The bulk of loans that go into arrears eventually get back on track, often with the lender’s assistance. Even in those cases where the borrower is unable to remedy the arrears, it is more common for the loan to be refinanced with another lender (often a non-conforming lender) or for the property to be voluntarily sold, than for than for the lender to seek repossession.”³⁷

³⁵ APRA *Insight* Issue One 2008, p 21

³⁶ Joint Submission by RBA – APRA to the Inquiry into Home Lending Practices and Processes August, 2007, p 6

³⁷ Joint Submission by RBA – APRA to the Inquiry into Home Lending Practices and Processes August, 2007, p 8

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Myth: “More loans are in arrears than ever before”

In absolute value terms, the arrears rates for housing loans, while increasing, are still less than those in 1995-1996.³⁸

8. Conclusion

Of course, there is little the Inquiry can do about the market conditions that have led to the current credit squeeze.

The Inquiry can, however, in COSL’s submission, take note of the unequal and anti-competitive effects the squeeze has on the non-ADI providers of mortgages to Australian families.

Many Australian families would not have home loans and, therefore, homes but for the deregulation of the home loan market initiated by the Hawke-Keating government, and continued through the Wallis Report, which allowed for the growth in the non-ADI home loan lending sector.

The participation of the non-ADI home lenders in the market have made mortgage finance and home ownership more accessible even when the loans were ultimately advanced, on more competitive terms, by the established big four banks. That is how competition works.

COSL asks that the Inquiry bear this in mind when considering:

- new regulation of the sector;
- the transfer of credit regulation to the Commonwealth; and
- further consolidation of the mortgage market.

³⁸ Joint Submission by RBA – APRA to the Inquiry into Home Lending Practices and Processes August, 2007, p 9