INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANKING SECTORS

SUMMARY OF SUBMISSION:

Introduction

I make this submission as co-founder and public officer of Mates Rates Mortgages, a mortgage broker that for the past several years has been delivering commonly available mortgages at substantially below retail cost from the likes of Commonwealth Bank, ING, Suncorp, Westpac Bank and more. We achieve this through the payment of monthly mortgage rebates to borrowers.

I also make this submission as a concerned individual who entered the residential mortgage industry in 2001 with the intention of creating more positive outcomes for consumers. Since that time, in addition to development of Mates Rates Mortgages, I have provided ex-gratia support to borrowers in distress, provided input to industry bodies and other Government commissions and Tribunals, developed a range of competitive initiatives and now have mortgage related articles published on a regular basis in consumer magazines aimed at improving consumer knowledge.

The terms of reference of the Inquiry into competition in the banking and non-banking sectors encompass concepts dealt with in previous submissions to the current government. These submissions are attached as Appendix 1 – Request for Government Assistance. Concepts relevant to the terms of reference of this inquiry and made in previous submissions are not repeated in this document except by reference to Appendix 1.

I regret that the broad scope of the inquiry coupled with shortened period for submissions and my own limited resources has restricted the depth and quality of my submission.

Definition and scope of submission:

As I write this submission for this enquiry, I do so with the view that a truly competitive marketplace is one that ultimately benefits the consumer in both price and quality.

With this simple thought in mind, the main facets required to achieve these outcomes are a number of accessible, unrelated lenders in the marketplace; a profitable and maintainable lender base and an informed and upwardly mobile borrower.

These core attributes are required as the number of lenders provides choice; profitable and maintainable lenders ensure sustainability; and an informed and upwardly mobile borrower rewards competitive lenders through support, whilst the borrower is also free to abandon less competitive lenders.

Although the terms of reference of this inquiry extend beyond residential mortgage products, my commentary is constrained to the mortgage finance sector as this sector has the greatest barriers to competition, the highest rate of market inertia, involves the largest levels of individual debt and has the largest level of opportunity.

I make this submission assuming that a truly competitive mortgage marketplace is the ideal outcome sought by both consumers and the inquiry and with the view that the interest of the consumer is paramount.

Bargaining Power of Consumers

Achievement of stronger consumer benefit is possible when bargaining power of consumers is higher. In the residential and investment mortgage market, borrowers bargaining power is improved when:

- There are many lenders in the industry
- Products are standardised or easily differentiated

Although there may be some debate over the number of lenders in the market place or the adequacy of that number, there is little doubt that mortgage loan products are by no means standardised. Perhaps one of the greatest challenges for borrowers is to understand the differences between various home and investment loans and to assign a financial, practical, or emotional implication to the features or characteristics of different lender solutions.

Appropriation of terminology

Lenders deliberately cloud honest comparison by appropriating common terms such as Fixed Rate or Offset to describe features with vastly different definitions or calculations. This manipulation can and often has significantly different financial and usability consequences to borrowers.

In one real life example, a borrower saved or could have lost almost $20,000 in interest in 5 years on a $410,000 home loan. This difference arose from a Lenders appropriation of the term Fixed Rate. See ‘A consumer case study’ in Appendix 1 – Request for Government Assistance, pages 4 and 5. The lender involved was ANZ via its wholly owned mortgage origination business, One Direct.

This confusion allows unscrupulous marketing practices to diffuse the perception of differentiation, which suppresses honest comparison and competition.

Recommendation – Standard form wording

Government must develop home and investment specific legislation covering standard terminology and perhaps extending to standard contract form to facilitate more simple and honest comparison of different lender products between different lenders. The objective of this legislation is to simplify differentiation on key features and provides for more informed decisions by borrowers.

Consideration should be given to defining a national set of standard, defined terms for key features, including, where applicable, the methodology or formula used to value the feature. Lenders should be prohibited from using these terms or similar in advertising, marketing, or promotion, where the feature they are attempting to describe has a non-standard definition.

Alternatively, consideration could also be given to producing standard form definitions requiring lenders to disclose how their features vary from the standard form. However this approach is likely to add to the current complexity of comparison and increase the volume of disclosure, which is already proving overwhelming to the average consumer.

Absence of reliable comparison methods

Borrowers who act on their own do not have a simple and reliable method to compare the actual cost of different options available to them. Government has attempted to alleviate this confusion by the introduction of Compulsory Comparison Rate ('CCR') legislation; however this has only served to make matters worse by introducing yet another metric to an already confused consumer.

The most significant problem with the CCR is that it is formula driven and this formula does not reflect the likely outcome for most people. The CCR's formula excludes unascertainable fees, which is open to manipulation and can increase cost substantially. The CCR also excludes unascertainable discounts and rebates, which can also affect the actual cost substantially. Table 1 demonstrates a real life example and the amortisation tables are attached as Appendix 2 – Table 1 Amortisation Tables.

Life of Loan	Total Repayments Made	**CCR 8.63**% Payout Figure	**CCR 8.94%** Payout Figure
20 Months	$46,727	$299,107	$295,380
3 Years	$84,926	$294,204	$290,736
5 years	$142,632	$285,088	$283,083
7 Years	$200,338	$275,087	$273,975

Table 1 - This table demonstrates how a comparison rate of 8.94% works out cheaper than one with a comparison rate of 8.63%. This is an apple-to-apple comparison for a $300,000 loan showing four likely life of loan durations.

CCR's are only in use in general advertising and promotion. At this point in time, an array of fees such as Lenders Mortgage Insurance which are charged and apply at different points for different lenders and loans are not known and are excluded from the CCR.

Lenders are not currently required to provide borrowers with a CCR based on the individual borrowers' circumstances even when undertaking an individual consultation, nor are they required to provide this important pricing information prior to accepting an application for finance from a borrower.

A secondary, but also important shortcoming is reliance on Comparison Rate Schedules which provide an array of different loan terms and amounts, but invariably do not reflect the real loan terms or amounts of the average borrower.

Recommendation – Borrower based Compulsory Comparison Rates

Lenders should be required to produce an individual CCR for each customers scenario whenever they are in direct contact with a borrower and responding to pricing enquiries. This CCR should be confirmed in writing and provided to the borrower at least 24 hours prior to the borrower making an application for credit.

Investigation should be undertaken into production and provision of a standard form mortgage report outlining key costs and information based on the borrowers personal situation prior to acceptance of an application for finance. See Appendix 3 – A Real Life Mortgage Report, which is currently produced individually for every prospective borrower seeking finance through Mates Rates Mortgages.

Absence of adequate advertising controls

There is a range of tricks utilised in advertising to catch the initial attention of a consumer which current legislation fails to address. Until borrowers are offered a real method to compare different mortgage options on an individual basis, they remain exposed to advertising trickery. Once borrowers are taken in by the advertisement, the overwhelming nature of comparison, the pressure of needing finance and the range of other matters that are fighting for their attention mean that most do not have the time or skill to sort through the smoke and mirrors designed to win their business. What Government has attempted to do with legislation, lenders have undone with clever advertising tactics, These include:

- Emphasising a nominal headline rate by bolding, increasing the point size or choosing high contrast colours.

- De-emphasising Compulsory Comparison Rates by reducing the point size or choosing low contrast colours.

- Making generic comparisons to non-existent products
- ‘Pushing’ disclosure outside of the frame of the advertisement or reducing the point size or choosing low contrast colours.
- Promoting generic awards commonly offered by business the lenders pay to advertise with.

Recommendation – Increase advertising controls

Controls, standards and regulations should be reviewed to reduce the opportunity for unscrupulous lenders to confuse borrowers. Consideration should also be given to reviewing the appropriateness of advertising bureaus such as CANNEX, Money Magazine and Your Mortgage Magazine from promoting ‘Best of’ awards where these bureaus do not look beyond lenders that advertise with them.

Intensity of Rivalry

More beneficial consumer outcomes are achieved when the intensity of rivalry between competitors is higher. The intensity of rivalry between Australian lenders is reduced because:

- The appropriation of terms has reduced the degree of honest differentiation as discussed in the previous section, Bargaining Power of Consumers.
- Borrower mobility is retarded due to high switching costs, a lack of time, the complexity of a refinance transaction and the difficulty in understanding actual benefit.

High switching costs – Deferred Establishment Fees

For borrowers most affected by poor competition, the prospect of voting with their feet is not only difficult, but also costly in spite of the eradication of Mortgage Duty as a consequence of implementation of the Goods and Services Tax. In recent times there has been a great deal of focus on Deferred Establishment Fees (DEFs) charged by lenders when a borrower refinances their loan away from that lender within the first 5 years.

Lenders introduced DEFs to enable them to greatly reduce upfront charges to borrowers through the amortisation of these costs over a longer period, typically five years. This approach has simultaneously enabled them to maintain profits and lower nett interest margins, resulting in reduced interest rates to borrowers.

Recommendation: Moderate changes to Deferred Establishment Fees

Legislation regarding the illegalisation or capping of these fees should be approached with caution as Government interference on this level may result in adverse consumer outcomes. Although the popular view supports legislation of these fees, to do so will invariably lead to a downgrade in quality of credit assessment, quality of service, or a transfer of cost to another area of the loan. None of these outcomes is desirable for industry or borrowers given DEFs can be avoided or reduced by borrowers, whereas likely changes that will replace outlawed DEFs, could not. See Point 3, Appendix 1 – Request for Government Assistance, page 11.

There is however, a substantial case for clear and open disclosure of Deferred Establishment Fees and inclusion of these fees in a standard mortgage report as described earlier in Recommendation – Borrower based Compulsory Comparison Rates.

High switching costs – Lenders Mortgage Insurance

A cost which is fare more significant than Deferred Establishment Fees and which regularly retards borrower mobility is Lenders Mortgage Insurance or LMI. LMI premiums are paid by the borrower and typically represent around 1-2% of the total loan amount, whereas the DEFs are rarely more than 0.5%.

LMI serves two principal purposes:

1. It protects lenders from losses due to repossession and;

2. It allows lenders to reduce their capital provisioning for the loan.

LMI premiums are charged on a sliding scale based on loan to value ratios (LVR). Generally speaking, to avoid paying LMI, borrowers cannot exceed an LVR of 80%. However over the past decade, growth in the price of property has outpaced most consumers' ability to save a 20% deposit, resulting in increasing numbers of borrowers paying LMI.

LMI premiums are priced for the life of the loan and paid in a lump sum on the establishment of the loan. Although they are priced for the life of the loan, refunds are seldom offered. As a consequence, borrowers that have already paid LMI and who wish to refinance to another, more competitive lender, are often required to pay a new premium and do not receive any refund on premiums already paid.

Recommendation – Lenders Mortgage Insurance Review and Overhaul

A Government initiated review must be undertaken to explore manners in which the cost of Lenders Mortgage Insurance is reduced. Assuming maintenance of the current framework, borrowers should be entitled to pro rata refunds of LMI when switching between lenders before the risk rated period expires. It is indecent that Insurers retain premiums when they are no longer insuring the risk, and may even collect a new premium from the same borrower for what is substantially the same risk via a different lender.

Other models that could be considered may involve more regular risk assessment and premium charging or rebating based on a simple property price index adjustment, or by consumer funded re-appraisal of the property.

Threat of New Entrants and Recent innovation

Innovation and new entrants to an industry can raise the level of competition, thereby improving outcomes for the consumer. The threat of new entrants largely depends on the barriers to entry and key barriers to entry include

- Capital / investment requirements
- Access to distribution and supply channels
- The likelihood of retaliation from existing industry players.

Although the likelihood of new lender entrants or innovation is relatively low, the same cannot be said for the intermediary channel of mortgage origination and mortgage brokering. Many of the pro-borrower initiatives raised in this submission have already been implemented and operational for several years at Mates Rates Mortgages and cover dozens of lenders. These include:

- True apple to apple comparison of lenders
- Realistic disclosure of significant fees
- Written, individual reports including CCR calculation based on individual scenario
- Assistance in document preparation and loan co-ordination
- Subsidy of refinance costs where the lender has proven inadequate

Although these quality of advice measures are important and beyond that currently offered by either the mortgage broker industry generally or lenders directly, it should also be noted that Mates Rates Mortgages also passes 100% of ongoing or trailing commissions to assist the borrower in the repayment of their mortgage. This is a redistribution of profits which are traditionally retained by brokers or lenders directly to the borrower and result in significant savings to the borrower. Table 2 demonstrates the total interest and fee cost across the first 5 years for six sample lenders with and without this profit redistribution. These savings continue to grow throughout the life of the loan.

	ING CCR: 8.99%		**Commonwealth Bank** CCR: 9.55%	
	Direct Retail Cost	Cost via Mates Rates	Direct Retail Cost	Cost via Mates Rates
$250,000	$110,488	$106,810	$108,951	$106,745
$500,000	$220,755	$213,398	$216,052	$211,638
$750,000	$331,022	$319,987	$323,153	$316,532
	Westpac CCR: 9.60%		**BankWest** CCR: 9.16%	
	Direct Retail Cost	Cost via Mates Rates	Direct Retail Cost	Cost via Mates Rates
$250,000	$109,456	$107,259	$109,862	$106,913
$500,000	$216,937	$212,541	$218,774	$212,876
$750,000	$324,417	$317,823	$327,686	$318,838
	AMP CCR: 8.93%		**Suncorp** CCR: 9.62%	
	Direct Retail Cost	Cost via Mates Rates	Direct Retail Cost	Cost via Mates Rates
$250,000	$109,799	$106,130	$109,056	$106,848
$500,000	$219,053	$211,714	$216,537	$212,120
$750,000	$328,306	$317,297	$324,017	$317,392

Table 2 - This table demonstrates savings available to borrowers via Mates Rates Mortgages pro-customer model. These savings are generated by redistributing 100% of ongoing commissions to the borrower to assist in the repayment of their mortgage. Brokering of the mortgage by Mates Rates simplifies the mortgage application or refinance process and, unlike mortgage originators, in no way interferes with the borrowers ongoing relationship with the lender.

As can be seen from the table, the Mates Rates model delivers significant savings through the redistribution of ongoing commissions to borrowers. Unlike mortgage originators, Mates Rates Mortgages, as a mortgage broker, supplements, rather than replaces the ongoing relationship between the borrower and the lender. Products and service provided by the lender are identical to those brokered via Mates Rates, however the cost to the borrower is significantly reduced.

With support from Government, this model could be expanded across more mortgage broker businesses and stimulate a new level of competition in the mortgage market. However there are range of barriers and limitations that are stifling progress of this model and these are explained in Appendix 1 – Request for Government Assistance.

Recommendation - Develop protection and incubation measures for innovators

As identified in the Productivity Commission Review of Australia's Consumer Policy Framework, legislation to protect the consumer in the mortgage finance arena has fallen behind. It is also likely that protection through legislation will continue to either remain behind industry development or restrict competitive development in this sector. In the absence of legislation, protection and professionalisation of the mortgage broker industry has the very real potential to produce the most favourable outcomes for borrowers.

A range of incentives and protections must be considered to kick start businesses taking an interest in better consumer outcomes as well as a review and discussion on the risks associated with these businesses. Commencement of a real dialogue aimed at the implementation of pro-borrower initiatives is now well overdue.