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Competition in the mortgage market

Introduction

2.1 In the last 20 – 30 years there has been significant economic reform within the financial sector, a key component of which has been deregulation in the 1980s.

2.2 Financial deregulation opened the door to allow both international and non-bank lenders to enter the market which has resulted in greater competition, lower interest rates and margins.

2.3 This chapter provides some background on how the mortgage market has evolved and, in particular, the effect that the credit crisis has had on competition.

The mortgage market – pre and post 1992

2.4 Up until the 1950s, competition within the mortgage market was limited to a handful of banks, building societies and life insurance companies. 'Banks faced little competitive pressure from other institutions, which had not yet begun their rapid development, and the system was not open to foreign bank entry or to offshore transactions.'[1]

1 M Edey and B Gray, Reserve Bank of Australia, *The Evolving Structure of the Australian Financial System*, October 1996, p. 4.

2.5 During the 1960s and 1970s banks had tighter regulatory requirements placed on them. This put banks at a competitive disadvantage and as a result they lost their market share 'when corresponding gains were made by non-bank financial intermediaries, particularly building societies, finance companies, merchant banks and, later, unit trusts'.[2]

2.6 Financial deregulation in the 1980s allowed banks to compete more effectively with the building societies, finance companies and merchant banks and, consequently, they regained their market share. Financial deregulation also opened the mortgage market to international competition and allowed financial institutions to access greater amounts of credit to support an increasing demand.

The rise of the non-banking sector

2.7 The non-banking sector took off in 1992 with the establishment of 'mortgage manager' Aussie Home Loans. Using securitisation as a means to obtain readily available and cheap funding, mortgage managers were able to offer lower interest rates than the existing lenders. Within 3 years, 'mortgage managers accounted for almost 10 per cent of housing loans written.'[3]

2.8 The Mortgage and Finance Association of Australia (MFAA) was of the view that the non-banking sector 'has been very much a driving force for competition in the industry over the last decade or so.'[4]

2.9 The increased competition within the sector, including a greater demand for housing, also opened the way for specialist mortgage advisors to enter the market – the mortgage broker.

2.10 There were some downsides to the increased competition. Having lost some market share, the banks closed down a number of branches, especially in regional areas, and staff lost their jobs. Fees and charges also rose dramatically after the early 1990s. The Treasury noted that 'between 1997 and 2007, banks' total fee income rose from $3.9 billion to $10.5 billion, an increase of $6.6 billion or 170 per cent.'[5]

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2 M Edey and B Gray, Reserve Bank of Australia, *The Evolving Structure of the Australian Financial System*, October 1996, p. 5.

3 M Gizycki and P Lowe, Reserve Bank of Australia, *The Australian Financial System in the 1990s*, July 2000, p. 195.

4 Mr P Naylor, Mortgage and Finance Association of Australia, *Transcript*, 14 August 2008, p. 42.

5 Treasury, *Submission no. 32*, p. 6.

2.11 The non-banking sector continued to increase its market share up until the start of the global credit crisis in August 2007. After that time, the cost of funding increased and the non-banking sector, unable to obtain competitive funding, was no longer able to compete. As a result, the non-banking sector's market share dropped by more than half.

2.12 Challenger Financial Services Group highlighted the reduction of market sharing stating that 'non-banks had a market share of 12.1 per cent prior to the subprime crisis and now have only 4½ per cent.'[6]

Product development and bank lending margins

2.13 In addition to lower interest rates, the non-banking sector was innovative offering many varied products. Some products now available include non-conforming loans, reverse mortgages, shared equity mortgages, internet and phone banking, mobile mortgage lenders, redraw facilities, offset accounts, and debit cards linked to mortgages, to name a few.

2.14 Aussie Home Loans, PMI Mortgage Insurance, Resi Mortgage Corporation, and the Australian Securitisation Forum were all of the view that the non-banking sector was at the forefront of financial product innovation.

2.15 The Reserve Bank of Australia (RBA) similarly noted that the new players in the mortgage market 'have been able to take advantage of financial innovation and improvements in technology, and have led to significant reductions in the prices of a range of financial services.'[7]

2.16 In addition to the non-banking sector, foreign-owned banks have also contributed to product innovation in the Australian market by introducing products such as high interest online savings accounts.[8]

2.17 The RBA noted that the number of financial products had increased over time indicating that 'over the past 15 years we have seen a marked increase in the range of financial products available in Australia' and that 'the experience here compares quite favourably with the experience overseas.'[9]

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6 Mr D Cox, Challenger Financial Services Group, *Transcript*, 15 August 2008, p. 75.

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

8 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 48.

9 Mr R Battellino, Treasury, *Transcript*, 14 August 2008, p. 3.

2.18 The increased pressure that the non-banking sector placed on banks led to the banks emulating many of the new products that were being offered. The Australian Bankers' Association (ABA) agreed that foreign banks and the non-banking sector forced the banks to 'accept reduced margins and to roll out new technology and new products, and to otherwise respond to competitive pressures.'[10]

2.19 Collins Securities noted the reduction in margins on home lending indicating that the increased competitive pressure of the non-banking sector drove margins down from about 5 per cent to about 1.5 per cent prior to the global credit crisis.[11]

2.20 The advent of the credit crisis has also placed additional pressure on lending margins for both the banking and non-banking sector. Not being able to raise any funding, most of the non-banking sector effectively ceased originating new loans.[12]

2.21 The ABA and the Commonwealth Bank have both asserted that lending margins have continued to decrease. The ABA stated that 'even though variable housing interest rates have increased in absolute terms above Reserve Bank cash rate increases, the actual margin experienced by the banks has continued to decline.'[13]

2.22 The Commonwealth Bank highlighted that its margins will continue to decrease in the current financial climate stating:

> The margins we are making on home loans now…are less than they were a year ago by nearly 10 per cent, and, if you look at the long term funding impacts as money rolls off, you will see that it will continue to decline over the next year because of the funding issue we have got.[14]

2.23 As noted by the Treasury, just after the credit crisis hit, banks independently raised their interest rates by 50 to 60 basis points more than the increases in the RBA's cash rate.[15]

10 Australian Bankers' Association, *Submission no. 26*, p. 4.
11 Mr R Emmett, Collins Securities Pty Ltd, *Transcript*, 8 August 2008, p. 28.
12 Mr M Rowland, ANZ, *Transcript*, 8 August 2008, p. 37.
13 Mr D Bell, Australian Bankers' Association, *Transcript*, 25 September 2008, p.3.
14 Mr J Sheffield, Commonwealth Bank, *Transcript*, 25 September 2008, p.5.
15 Treasury, *Submission no. 32*, p. 9.

2.24 Between September and November 2008, the RBA board decided to lower the official cash rate by 200 basis points.[16] Also during that time, the banks lowered their interest rates by at least 160 basis points.[17]

2.25 However, the banks have yet to lower their interest rates by the 50 to 60 basis points which they raised independently of the RBA's cash rate.

2.26 This could be an indication that banks are not under any competitive pressure and therefore are not lowering their margins. The MFAA noted that 'if there were more funds and therefore more players in the market there may well have been downward pressure on that [interest rates].'[18]

2.27 The alternate view, put forward by the ABA, is that bank margins have reduced due to the higher funding costs in the short and long term wholesale markets. The ABA stated:

> …the cost of short- and long-term wholesale funding, which accounts for about half of all bank funding, has spiked again. This will be putting margin pressures on the banks.[19]

2.28 According to financial services research firm, CANNEX, the number of products available to consumers in Australia currently has dropped with over 140 financial institutions offering over 1,750 products.[20]

2.29 Near the height of the non-banking sectors rise in the mortgage market, CANNEX noted that Australia had over 150 financial institutions offering over 2,300 home loan products.[21]

2.30 However, while the number of products available has dropped, the RBA indicated that 'the variety and flexibility of mortgage products offered in Australia is high by international standards.'[22]

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

17 See Table 2.1.

18 Mr P Naylor, Mortgage and Finance Association of Australia, *Transcript*, 14 August 2008, p. 44.

19 Mr D Bell, Australian Bankers' Association, *Transcript*, 25 September 2008, p. 3.

20 CANNEX Mortgage Star Ratings, Report No. 22, September 2008.

21 CANNEX Mortgage Star Ratings, Report No. 20, March 2007.

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

2.31 JP Morgan was of the view that the variety of products is limited, stating 'the products of most financial services are very generic in nature and are easy to replicate.'[23]

The US sub-prime mortgage crisis

2.32 The collapse of the sub-prime mortgage market in the United States (US) had, and continues to have, wide ranging economic effects both for the US and the global economy.

2.33 It led to the effective closure of the securitisation market and the collapse of some of the world's largest investment firms and banks and is threatening to push both the US and other major advanced economic countries into recession.

2.34 There was a combination of factors that ultimately caused the collapse which will be discussed below.

The US mortgage and housing market – what went wrong?

2.35 In 2003, the US economy was doing very well: jobs were readily available; productivity grew steadily; inflation was low; and interest rates dropped to record lows that had not been seen in 40 years. With an increased household income, consumers purchased houses which in turn stimulated the housing construction industry and housing prices increased in value.

2.36 With low interest rates and a booming economy, mortgage brokers, believing that housing prices would always increase in value, provided housing loans on behalf of banks and other lenders to customers who would not normally be granted a home loan. The RBA noted in its March 2007 Financial Stability Review (FSR) that 'sub-prime loans' are:

> …typically loans made to borrowers with impaired credit histories, which might include one or more payment defaults, a previous loan foreclosure, or bankruptcy. Because of their higher risk of default, sub-prime borrowers are charged higher interest rates than prime borrowers.[24]

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23 Mr B Johnson, JP Morgan, *Transcript*, 14 August 2008, p. 20.

24 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 23.

2.37 The RBA also noted that 'there has been rapid growth in US sub-prime lending since 2003, with these loans accounting for around one fifth of mortgage originations in 2006 and an estimated 15 per cent of all outstanding mortgages.'[25]

2.38 The lenders sold their sub-prime mortgages to aggregators (eg. investment banks). Selling mortgages allowed the lenders to raise more funds to provide additional loans to satisfy the increased demand.

2.39 The investment bank acquired mortgages from a range of lenders and then bundled them into securities to be sold to a range of wholesale investors including insurance companies, banks, pension and superannuation funds, both local and federal governments and international investors.

2.40 Investment banks raise money by selling securities like mortgage backed securities to investors. Investors get a return based on the quality of the securities. Senior tranches[26] have a low interest rate, while lower tranches have a higher interest rate and thus have a much better return for the investor because they are considered a greater risk.

2.41 The RBA also noted in its 2007 FSR that 'around three quarters of sub-prime loans made since 2003 were repackaged into residential mortgage-backed securities (RMBS) and sold to investors attracted by the higher returns on offer.'[27]

2.42 Mortgage and bond insurers provided insurance that helped the securities to obtain AAA ratings. The ratings given helped encourage the uptake of these instruments. However, there were questions raised about the credit rating agencies' role given they were paid by the investment banks whose securities they were rating.

2.43 Some financial institutions used separate entities called Special Purpose Vehicles (SPV) to take securitised assets off their balance sheets and avoid particular capital requirements.

2.44 In its March 2007 FSR the RBA highlighted that 'a combination of slower growth in house prices, rising mortgage rates, lax underwriting standards, and the expiration of introductory discount

25 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 23.

26 A tranche is a portion of one of several related securities that have different risks, rewards and/or maturities.

27 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 23.

rates on loans originated in the past few years has resulted in a sharp increase in delinquencies among sub-prime ARMs [adjustable-rate mortgages] in the United States.'[28]

2.45 The rise in interest rates put pressure on home owners that held a sub-prime loan to meet their repayments. The RBA noted:

> It has not been uncommon recently for the repayments of some sub-prime borrowers to rise by 50 per cent or more following the expiration of the introductory interest rate period.[29]

2.46 Unable to meet their repayments on a house that was now valued less than their loan, many home owners defaulted on their loan. In its March 2008 FSR, the RBA noted:

> Recent falls in house prices have also contributed to mortgage defaults as many borrowers that took out loans with little or no down payment now have negative equity. According to the S&P/Case-Shiller index, average house prices in the 20 large US cities covered by the index have fallen by about 10 per cent from their peak in mid 2006, with the pace of decline accelerating in the second half of 2007.[30]

2.47 The substantial increase in defaults on sub-prime mortgages subsequently placed many sub-prime lenders under substantial financial pressure. The RBA's March 2007 FSR noted:

> The increase in delinquencies on sub-prime loans is causing significant difficulties for many sub-prime lenders. A number have been forced to repurchase bad loans that they had earlier sold because of conditions attached to early default. Some are also facing funding pressures and are having difficulties renewing their credit lines. Reflecting this, more than 20 sub-prime lenders have shut down and, on average, the share prices of the largest sub-prime lenders in the United States have fallen by nearly 40 per cent since the start of the year.[31]

2.48 The problems in the sub-prime market eventually spilled over to the wider financial sector. The RBA highlighted that investment banks

28 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 23.

29 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 23.

30 Reserve Bank of Australia, *Financial Stability Review*, March 2008, p. 9.

31 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 24.

were particularly exposed 'to this market either through the lines of credit they have extended to sub-prime lenders, their own sub-prime lending operations or through their role as aggregators, in which they acquire sub-prime loans from originators for eventual resale as RMBS.'[32]

2.49 Investors in sub-prime residential mortgage-backed securities also experienced losses 'as a result of the increase in sub-prime delinquencies.'[33]

2.50 Credit ratings agencies eventually downgraded some of the securities and the insurance companies increased the cost of insuring against the default risk on sub-prime RMBS.

2.51 There was some uncertainty regarding which institutions had significant sub-prime exposures. This affected confidence in wholesale lending markets, with financial institutions becoming hesitant to lend to one another. These difficulties in accessing funding put pressure on some institutions' liquidity position.

2.52 This sequence of events eventually resulted in the collapse of the US sub-prime mortgage market, the closure of a few sub-prime lenders, investment banks and insurance companies[34] which prompted the US Government to:

> assist with the sale of the investment bank Bear Stearns; place the government sponsored housing enterprises, Fannie Mae and Freddie Mac, under conservatorship; and provide the world's largest insurer, American International Group, with a secured line of credit up to US$85 billion. More recently, the authorities have announced several major initiatives intended to provide a comprehensive approach to relieving systemic stress in the financial system. These initiatives include a plan to purchase up to US$700 billion of troubled assets from banks with significant operations in the United States, and insurance arrangements for short-term money market funds.[35]

32 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 24.

33 Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 24.

34 Reserve Bank of Australia, *Financial Stability Review*, September 2008, p. 3.

35 Reserve Bank of Australia, *Financial Stability Review*, September 2008, p. 3.

The global impact of the US sub-prime mortgage crisis

2.53 Within the US, the rapid expansion and collapse of the sub-prime mortgage market had wide ranging effects including:

- home owners unable to pay the mortgage lost their homes and will most likely be unable to purchase another one in the future;
- lenders found it difficult to access funding for new loans and some lost a substantial amount investing in securities which ultimately led to closures and takeovers (eg. Washington Mutual and IndyMac);
- investment banks lost a huge amount of capital, well into the billions, and also found it difficult to obtain funding which also resulted in closures and takeovers (eg. Lehman Brothers and Bear Stearns);
- some insurance companies, unable to cover their exposures to the securities, filed for bankruptcy; and
- ratings agencies' reputations, as objective assessors of risk, were severely damaged.

2.54 The collapse of the sub-prime mortgage market in the US also affected a number of international financial markets.

2.55 In particular, banks in the United Kingdom (UK) and Europe have been affected either because of significant investments in the US mortgage backed securities market, or because they have been unable to access sufficient funding in wholesale markets. Some examples include:

- UK banks Northern Rock and Bradford & Bingley, which are under temporary government ownership;
- French investment bank, BNP Paribas, which suspended three of its funds; and
- German regional bank, Sachsen Landes-bank, which was bought out.

2.56 The credit crisis has also had far reaching consequences across the global economy including:

- consumers, whose confidence has been shaken by the events, have reduced their spending;

- investors are much more risk averse than before and are also getting lower returns; and
- lenders are having difficulty accessing funding, which in turn may restrict their ability to undertake new lending.

2.57 The collapse of the sub-prime mortgage market in the US and the resulting disruptions to wholesale funding markets has ultimately led to governments around the world taking the unprecedented step of guaranteeing the stability of their respective financial institutions. Governments and central banks have also taken steps to improve access to liquidity within the market.

Competition post August 2007

2.58 Obtaining access to funding after the commencement of the credit crisis in August 2007 has been extremely difficult. Financial institutions that have a diversified funding base have been a little more protected from the current market conditions, but no institution has been totally immune from the impact of the credit crisis.

2.59 While it is true that there has been a decline in the number of players within the mortgage market, there is some disagreement as to whether this has reduced competition.

2.60 The ANZ noted that the credit crisis has had an impact but believes that competition is still strong, noting that 'intense competition on rate, service and loan features remains prevalent in the market, particularly amongst the major banks.'[36]

2.61 Westpac agrees with the ANZ's view that competition between players is still healthy, noting that 'between the organisations that are out there and competing, competition is very fierce, and we see it on a day-to-day basis.'[37]

2.62 The ABA also believes that competition is strong, especially in the areas of deposits and loans stating:

> Competition in the deposit market is currently very intense as banks and other deposit-takers compete to win deposits as a

36 ANZ, *Submission no. 28*, p. 3.

37 Mr K Lawrence, Westpac Banking Corporation, *Transcript*, 14 August 2008, p. 87.

> means of diversifying their deposit base away from reliance on international capital markets.
>
> Loan markets are similarly highly competitive, with little evidence that the relative decline – albeit temporary - of non-bank lenders in the housing mortgage market will materially increase lending margins.[38]

2.63 The RBA believes that while banks have increased their market share they 'do not think you could say that there has been a marked reduction in competition at the moment'.[39]

2.64 However, the Bank of Western Australia's (BankWest) view is that competition has decreased stating:

> We put it [a reduction in competition] down to three things. Firstly and obviously, there are the funding issues that have become clear over the last nine to 12 months. They have put a number of people with different business models out of the market. Secondly, there is consolidation. Obviously, with the merger of Westpac and St George that has taken another step up. That is causing reduced competition and, in our view, is likely to be exacerbated over the coming several years. Finally, we think there are a number of barriers to entry, in particular in terms of having ATM networks post the reform that is going to go through next year. There is also the need to have store presence in order to compete effectively. We think that concerns a significant barrier to entry.[40]

2.65 The Council of Mortgage Lenders had a similar view stating:

> …with possible consolidation in the banking sector and the impact of the US prime crisis reducing the number of non-banks, there is a serious risk that there will be substantial lessening of competition. For the foreseeable future, this will result in higher mortgage costs to the borrowers because of a lack of competitive pressure on the banks. This will reverse the interest rates spread benefit that the non-banks were able to provide when they became a force in the Australian market in the early nineties. This is very evident already with reports

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38 Australian Bankers' Association, Submission no. 26, p. 1.

39 Mr R Battellino, Reserve Bank of Australia, *Transcript*, 14 August 2008, p. 14.

40 Mr I Corfield, Bank of Western Australia Ltd, *Transcript*, 8 August 2008, pp. 49-50.

> coming out that the margins have fallen at least four basis points in the last four months.[41]

2.66 Competitive pressure has been one of the driving forces lowering margins. However, as noted above, funding pressures have now placed an additional strain on margins.

2.67 The general view from the RBA is that 'when conditions settle down and the cost of funds in the money markets returns to a more normal level, that downward pressure and competition from the non-banks will reappear.'[42]

The current state of the non-banking sector

2.68 The non-banking sector, which has primarily relied on securitisation as a means of funding, has been the hardest hit and, as noted above, there has definitely been a reduction in the amount of providers and products in the mortgage market.

2.69 There is evidence that some non-bank lenders have been bought out by their competitors, stopped selling new mortgages, or slightly changed their focus.[43]

2.70 There are currently two points of view on how the non-banking sector is managing the current financial turmoil.

2.71 Overall, representatives from the sector acknowledge that due to these funding difficulties it has been hard for them to remain in business, let alone staying competitive.

2.72 Collins Securities noted that 'at the moment, we are seeing a lot of non-bank lenders exit the market.'[44]

2.73 The MFAA were concerned that the current credit crisis would result in the non-banking sector being removed from the industry.[45]

2.74 Aussie Home Loans agreed that a number of non-bank players had been wiped out but that 'a number of players will survive—who are strong enough to do that.'[46]

41 Mr P James, Council of Mortgage Lenders, *Transcript*, 14 August 2008, p. 73.

42 Mr R Battellino, Reserve Bank of Australia, *Transcript*, 14 August 2008, p. 15.

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

44 Mr R Emmett, Collins Securities Pty Ltd, *Transcript*, 8 August 2008, p. 31.

45 Mr P Naylor, The Mortgage and Finance Association of Australia, *Transcript*, 14 August 2008, p. 43.

46 Mr J Symond, Aussie Home Loans, *Transcript*, 14 August 2008, p. 53.

2.75 The ANZ also noted that the difficulties faced by the non banking sector stating that 'non-bank lenders who relied primarily on securitisation to fund their portfolio have found, since the onset of the global credit crisis, that they have had to materially reduce their new lending.'[47]

2.76 The view from the RBA is that while the non-banking sector has lost its market share, it will regain it as soon as the financial markets normalise.[48]

2.77 The ANZ agreed with the RBA's view stating 'once these [wholesale] costs have fallen and securitisation markets reopen, we expect that these non-bank lenders will return to the securitisation market which will provide them with the funding volume to return to their previous competitive position.'[49]

2.78 Fujitsu Consulting believes that while the non-banking sector has a place in Australia 'it will probably never be as it was, and they probably will be more bit part players than they were previously.'[50]

2.79 The Treasury also notes that the exceptionally narrow spreads of recent years is unlikely to be a feature of the RMBS market for some time to come as investors are likely to demand a more sustainable level of pricing for risk.[51]

Competitiveness of the 'big four'

2.80 The Commonwealth Bank, the Westpac Banking Corporation, ANZ, and the National Australia Bank, are collectively known as the 'big four'.

2.81 While the big four have faced similar funding pressures, their diversified funding base has placed them in a better position than the non-banking sector.[52] As a result, the big four have been able to offer lower interest rates than the non-banking sector.

2.82 Collins Securities noted the lower rates offered by the banks stating:

47 Mr M Rowland, ANZ, *Transcript*, 8 August 2008, p. 37.

48 Treasury, *Submission no. 32*, p. 1.

49 ANZ, *Submission no. 28*, p. 8.

50 Mr M North, Fujitsu Consulting, *Transcript*, 15 August 2008, p. 25.

51 Treasury, *Submission no. 32*, p. 10.

52 Mr M Rowland, ANZ, *Transcript*, 8 August 2008, p. 37.

> Banks have passed on approximately 0.7 per cent of that increase over and above the Reserve Bank increases in interest rates. Most of the banks are already on the record as saying this. It is probably fair to say that new lending generated by all majors is at a rate of approximately nine per cent. The new lending rates that are occurring in the market at the moment are well below the standard variable rates that are published. Those rates are probably well below the wholesale costs that a non-bank lender can raise their funds on at the moment.[53]

2.83 As banks have been able to source funding from wholesale markets more easily, they have placed competitive pressure on their competitors. As the banks have been able to offer more competitive interest rates in the current environment, the big four have regained the market share that they lost to the non-banking sector over the past decade. From April 2007 to April 2008 the banking sector increased its share from 79.5 per cent to 88.5 per cent.[54]

2.84 While there is no doubt that the big four aggressively compete with the other players in the market, including foreign-owned banks, the credit unions, building societies and the non-banking sector, there is some uncertainty as to whether the big four are actively competing with each other.

2.85 Fujitsu Consulting noted that the big four 'are protected because they are working intrinsically together. It is not formal, but they do look at each other. They compare each other's rates and products.'[55]

2.86 This can be highlighted by the fact that when one of the four either raises or reduces their interest rates, the other three follow very closely and generally within a week.

2.87 Table 2.1 illustrates how the big four have changed their variable mortgage interest rates over the past year. With the exception of April, the big four have put out media releases announcing a change in their variable mortgage interest rates within 4 days of each other. The interest rate change is only within 7 basis points of each other at the most.

53 Mr R Emmett, Collins Securities Pty Ltd, *Transcript*, 8 August 2008, pp. 28-29.

54 Mortgage and Finance Association of Australia, *Submission no. 4*, p. 8.

55 Mr M North, Fujitsu Consulting, *Transcript*, 15 August 2008, p. 23.

Table 2.1 Comparison of the big four's variable mortgage interest rate for 2008

ANZ		CBA		WBC		NAB	
Date	*% Change*	*Date*	*% Change*	*Date*	*% Change*	*Date*	*% Change*
5/11/08	- 0.58	4/11/08	- 0.58	5/11/08	- 0.65	5/11/08	- 0.62
17/10/08	- 0.25	20/10/08	- 0.21	19/10/08	- 0.20	21/10/08	- 0.20
07/10/08	- 0.80	07/10/08	- 0.80	07/10/08	- 0.80	07/10/08	- 0.80
02/09/08	- 0.25	02/09/08	- 0.25	02/09/08	- 0.25	02/09/08	- 0.25
11/07/08	+ 0.15	11/07/08	+ 0.14	14/07/08	+ 0.15	15/07/08	+ 0.14
24/04/08	+ 0.10	04/04/08	+ 0.12	25/04/08	+ 0.10	28/04/08	+ 0.10
11/03/08	+ 0.35	10/03/08	+ 0.35	06/03/08	+ 0.29	07/03/08	+ 0.30
08/02/08	+ 0.25	06/02/08	+ 0.30	08/02/08	+ 0.29	07/02/08	+ 0.25
08/01/08	+ 0.20	09/01/08	+ 0.10	03/01/08	+ 0.12	11/01/08	+ 0.15

Sources *ANZ 2008 Media Releases, Commonwealth Bank of Australia 2008 Media Releases, Westpac Banking Corporation 2008 Media Releases, National Australia Bank 2008 Media Releases.*

2.88 However, the Treasury noted that 'it is well recognised that competition can exist in markets with a small number of major suppliers, particularly where there is a 'competitive fringe' of smaller players or where barriers to entry and exit are sufficiently low for there to be a credible threat of competition from new entrants.'[56]

The future outlook

2.89 There is evidence to suggest that, up until the recent financial turmoil, competition in the Australian mortgage market was strong and contributed to driving down margins and promoting product innovation.

2.90 Due to the credit crisis, there has been a reduction in the amount of providers in the mortgage market and, as a consequence, there appears to be a reduction in the amount of competitive pressure between players in the market.

2.91 However, given margins are being reduced by external financial pressures, most notably the cost of funding, this would indicate that there is still enough competitive pressure within the market.

2.92 Increased levels of competition will return, but with the current financial climate groups are uncertain of how long it will take and whether it will be as effective as it was prior to 2007.

56 Treasury, *Submission no. 32*, p. 3.

International comparisons

2.93 Each country has its own unique financial sector, regulation, and mortgage market. It is therefore difficult to compare Australia directly with another country.

2.94 However, the credit crisis has demonstrated the robustness and stability of Australia's financial sector.

2.95 This section looks at how Australia's banking sector is viewed globally and the strengths of our financial system.

How does Australia's market compare internationally

2.96 Both Australia's financial system and mortgage market are relatively strong and healthy in comparison with other countries. The International Monetary Fund (IMF) noted that 'house prices fell in the first half of 2008 at an annual rate of 5 per cent to 12 per cent in Canada, Denmark, Spain, New Zealand, and the United Kingdom.'[57] Australia is one of the few countries that have continued to see an increase in housing prices.

2.97 In particular, the IMF *Country Report* on Australia highlighted the strength of Australia's banking system stating:

> Australian banks have weathered the global financial turmoil reasonably well. The four large banks that account for two-thirds of bank assets continued to report strong profits through early 2008, together with adequate capital.[58]

2.98 In addition, Australia's four largest banks have been given a credit rating of AA (very high credit quality) by credit rating agency Standard & Poor's. The RBA noted that 'of the world's largest 100 banks, only a handful have higher ratings' and that 'no Australian-owned bank has had its rating downgraded since the onset of the credit turmoil.' [59]

2.99 The strong credit rating has enabled the banks to access both domestic and international capital markets. Compared with the US and UK, Australia's mortgage market continues to function effectively.

57 International Monetary Fund, *World Economic Outlook, October 2008, Financial Stress, Downturns, and Recoveries,* p. 16.

58 International Monetary Fund, *IMF Country Report No. 08/312*, September 2008, p. 8.

59 Reserve Bank of Australia, *Financial Stability Review*, September 2008, p. 35.

2.100 The market is also relatively concentrated in comparison with some other countries. The Treasury noted that 'Australia's five largest banks account for the majority of market share.'[60]

2.101 The entire banking sector has consolidated to some extent since 2000 with 'the number of building societies falling from 19 to 13 between March 2000 and March 2007, and the number of credit unions from 218 to 137 over the same period.'[61]

2.102 Both the banking and non-banking sectors have made prudent decisions about international investments and home loans.[62] The sectors have had a relatively small exposure to US sub-prime assets and were therefore not as vulnerable as other countries to the credit crisis, particularly in Europe.

2.103 The RBA noted in its September 2008 Financial Stability Review that:

> US exposures account for less than 10 per cent of Australian-owned banks' total foreign claims, and typically do not arise through lending to the US household sector. While some banks have reported that they have exposures to the US sub-prime market through holdings of financial instruments, these remain small when compared to the size of these banks' balance sheets.[63]

2.104 In comparison, the Bank of Canada noted in its June Financial System Review that:

> Overall, the direct exposure of Canadian banks to the United States represents about 16 per cent of total bank assets, more than the combined exposure to any other group of foreign countries.[64]

2.105 Australia's banking and non-banking sectors have also not engaged actively in selling 'non-conforming loans' (the closest equivalent to US sub-prime loans). The RBA also noted that: 'non-conforming loans account for less than one per cent of outstanding mortgages in Australia – compared with about 12 per cent in the United States.'[65]

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60 Treasury, *Submission no. 32*, p. 3.

61 Australian Prudential Regulation Authority, *Submission no. 34*, p. 2.

62 Reserve Bank of Australia, *Financial Stability Review*, September 2008, p. 1.

63 Reserve Bank of Australia, *Financial Stability Review*, September 2008, p. 25.

64 Bank of Canada, *Financial System Review*, June 2008, p. 22.

65 Reserve Bank of Australia, *Financial Stability Review*, September 2008, pp. 24-25.

2.106 There are certainly a significant amount of Australian households that have been put under severe stress as a result of the rise in interest rates. However, compared internationally, Australia has low arrears rates on housing loans. The RBA noted: 'the overall arrears rates on housing loans has shown little change over the past year, and remains low by historical and international standards.'[66]

2.107 The 90 day arrears rate for prime housing loans for Australian banks is 0.41 per cent in contrast to the UK's prime loans which are 2.9 per cent and the US on prime loans which is just below 5 per cent and sub-prime loans which is around 21 per cent.[67] The arrears rates in Canada are also at low levels with prime loans just above 0.2 per cent and sub-prime loans at around 1.5 per cent.[68]

2.108 However, Australia's banking sector tends to have higher account keeping fees and higher administration and management fees compared with other countries.

2.109 Fujitsu Consulting indicated that Australian banks were inefficient by international standards noting that 'the average cost of a mortgage in Australia to write for the banks is around 30 per cent to 35 per cent higher than best practice in the UK or the US.'[69]

2.110 Fujitsu Consulting added that on average 'sixty per cent of loans require some reiteration between the application and writing the loan' and that 'in the UK it is five per cent.'[70]

2.111 A report prepared for the British Bankers' Association, *The Price of Banking, An international comparison*, highlighted that both the account keeping fees and administration and management fees were higher in Australia than the other countries selected for the study including Canada, the US and the UK.[71]

2.112 The report also indicated that the disclosure of information by the banks was not entirely transparent, stating:

> While most fees are disclosed by all of the Australian Banks covered in this study, the complexity of their products and charging structures is not matched by clear explanations of

66 Reserve Bank of Australia, *Financial Stability Review*, September 2008, p. 2.

67 Reserve Bank of Australia, *Financial Stability Review*, September 2008, pp. 5-6, 44.

68 Bank of Canada, *Financial System Review*, June 2008, p. 31.

69 Mr M North, Fujitsu Consulting, *Transcript*, 15 August 2008, p. 21.

70 Mr M North, Fujitsu Consulting, *Transcript*, 15 August 2008, p. 21.

71 Oxcera Consulting Ltd, *The Price of Banking: An international comparison, a report prepared for the British Bankers' Association*, November 2006.

> when certain charges apply. This was found to be the case particularly for current accounts and personal loans, where there were also several significant gaps in the availability of information on charges and interest rates.[72]

2.113 Australia also has a low switching rate compared with other countries. CHOICE noted that 'around three per cent of Australian bank customers change financial institutions annually' and 'that is about half the rate in the UK and well below the European Union average.'[73]

2.114 It is clear that while Australia's financial sector has not been as exposed to the US sub-prime mortgage crisis as other countries, the decline and increased costs in available funding has affected the market. On the whole, the Australian market is coping well in the current financial conditions.

The key strengths of the Australian financial system

2.115 It is widely considered that Australia has a strong financial system as a result of good regulation and financial institutions making prudent decisions.

2.116 The IMF *Country Report* on Australia noted the robust regulatory environment stating that 'sound macroeconomic policies and structural reforms in Australia have delivered more than 16 years of economic expansion'.[74]

2.117 The IMF also noted that 'the RBA responded promptly and fittingly to the domestic impact of the global financial market turmoil' and 'the Australian Prudential Regulation Authority (APRA) also reacted in a timely and appropriate manner.'[75]

2.118 The other key strength is that both the banking and non-banking sector have been making prudent financial decisions. As indicated above, this is evident by the low amount of non-conforming loans within the market, the limited direct exposure to the US sub-prime mortgage market, and the banks' healthy balance sheets.

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72 Oxcera Consulting Ltd, *The Price of Banking: An international comparison, a report prepared for the British Bankers' Association*, November 2006, p. 61.

73 Ms E Freeman, CHOICE, *Transcript*, 21 August 2008, p. 75.

74 International Monetary Fund, *IMF Country Report No. 08/312*, September 2008, p. 6.

75 International Monetary Fund, *IMF Country Report No. 08/312*, September 2008, p. 19.

2.119 Good management by both government and businesses have put Australia in a relatively stable financial position globally.