3

Options to increase competition

Introduction

3.1 Healthy competition is a key driver for the economy. Competition in the banking and non-banking sectors provides advantages to the consumer, with lower interest rates and fees, to businesses and shareholders, with considerable profits and returns, and to the economy with increased productivity and jobs.

3.2 Competition takes many forms and can be influenced by a number of wide ranging factors. In the past 20 – 30 years competition within the sector has been increased due to: financial deregulation; foreign-owned banks and non-bank lenders entering the market; securitisation; and innovations that directly benefited the customer such as phone and internet banking and mobile mortgage lenders.

3.3 This chapter examines the current state of competition and proposals set before the inquiry on how competition can be enhanced further.

Trends in the cost of funding

3.4 Financial institutions obtain funding to lend to home buyers from a range of sources including deposits, domestic and foreign capital markets and securitisation.

3.5 The RBA noted that different financial institutions obtained funding from different sources, stating:

> The five largest banks have diversified funding bases, with a little under half of total funding coming from deposits, around half from domestic and foreign capital markets, and only about 5 per cent from securitisation. The foreign-owned banks have traditionally relied less on deposits, and more heavily on domestic capital markets and offshore funding. As a group, the regional banks rely more heavily on securitisation than the other banks, although deposits still account for the largest share of their funding. Mortgage originators source essentially all of their funding from securitisation, as typically they have neither the balance-sheet size nor the capital base from which loans could be provided.[1]

3.6 The importance of deposit funding for banks has declined over time as deposit growth has not matched lending growth. Until recently the proportion of household assets deposited in bank accounts has been declining. Groups have argued that the decline in deposits could be for two reasons: reduced savings levels and increased savings in superannuation funds.

3.7 Abacus Australian Mutuals noted the decline in deposits stating:

> ADIs [Authorised Deposit Taking Institutions] are competing over a pool of deposits—as an important source of funding for home loans—that is shrinking. From a peak of more than 30 per cent of household financial assets in December 1990, deposits now account for less than 19 per cent.[2]

3.8 Resi Mortgage Corporation noted that 'relying predominantly on customer deposits for mortgage funding is a method which has become largely redundant' and that 'over the last twenty years the use of consumer credit has increased and Australian savings levels have declined.'[3]

3.9 The National Australia Bank indicated that due to an increased demand for credit, Australian banks have had to source more funding from offshore and that 'consumer deposits have been dwindling as a source of bank funding since the introduction of compulsory superannuation in 1992.'[4]

1 Reserve Bank of Australia, *Submission no. 12*, pp. 4-5.
2 Ms L Petschler, Abacus Australian Mutuals, *Transcript*, 21 August 2008, p. 4.
3 Resi Mortgage Corporation Pty Limited, *Submission no. 20*, p. 9.
4 Mr S Shaw, National Australia Bank, *Transcript*, 19 September 2008, p. 2.

3.10 The Australian Securitisation Forum (ASF) also believes that superannuation has had an effect on the level of deposits stating 'the growth of the superannuation sector has outpaced that in the deposit sector over the last decade or so, and savings that used to be directed into retail deposits and hence be a source of mortgages are now flowing more into the superannuation sector.'[5]

3.11 The cost of funding in both the domestic and foreign capital markets as well as via securitisation has increased substantially due to the credit crisis.

3.12 The RBA highlighted the difference in cost for residential mortgage-backed securities (RMBS) prior to and during the credit crisis:

> …prior to the recent turmoil, the spread on the AAA-rated tranche of residential mortgage-backed securities had fallen to around 15 basis points, compared to 34 basis points in 2000.
>
> Since August 2007, spreads on RMBS have increased markedly and issuance has been limited. Where issues have taken place, they have recently been at spreads of around 120 basis points over the bank bill rate.[6]

3.13 Collins Securities also pointed out the increased cost of securitisation within the last 12 months stating that 'the total cost of securitisation has probably increased by about 1.6 per cent [160 basis points].'[7]

3.14 It is clear overall that in recent times, financial institutions have found it increasingly difficult to access funding in wholesale markets, and where they have continued to be able to do so this has been at an increased cost.

The state of the securitisation market

3.15 Securitisation is a relatively new innovation within the mortgage market. It originally started in the United States (US) in the 1970s. Securitisation started in Australia in the mid 1980s when it became used as source of funding by state governments to finance public

5 Mr P Vernon, Australian Securitisation Forum, *Transcript*, 15 August 2008, p. 37.

6 Reserve Bank of Australia, *Submission no. 12*, pp. 3-4.

7 Mr R Emmett, Collins Securities Pty Ltd, *Transcript*, 8 August 2008, p. 35.

housing loan schemes. In the early 1990s, securitisation enabled the non-banking sector to enter the mortgage market.[8]

3.16 The Centre for Ideas and the Economy (CITE) noted the positive change that securitisation had on the mortgage market stating:

> The advent of residential mortgage-backed securities securitisation in Australia during the mid 1990s transformed the mortgage market by intensifying competition to the demonstrable benefit of households. For example, the 'spread' between the interest rates paid by borrowers and the bank bill rate fell from around 4% in 1992 to about 1.4% prior to…August 2007.[9]

3.17 In the last 12 months the securitisation market has come to a standstill because of the fallout from the US sub-prime mortgage crisis.

3.18 The Rock Building Society highlighted that point stating 'the one major change that has happened in recent times is that that market is not functioning and has not been functioning effectively since August last year.'[10]

3.19 The Rock Building Society also noted that:

> Late last year…one of the international banks, Societe Generale, pulled out of the securitisation market. They were a provider of…$12 billion of warehouse funding to financial institutions in Australia….all of those financial institutions had to then go and try to find alternative warehouse funding from the major banks in Australia.[11]

3.20 CITE also noted the effective closure of the securitisation market stating, 'in Australia there have been virtually no public securitisations of AAA-rated home loans since November 2007.'[12]

3.21 The Australian Government recognised the credit crisis had affected the economy more substantially than previous indications and in particular that there was a shortfall in liquidity within the mortgage market. As a consequence, the government announced a number of

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8 A Liaw and G Eastwood, Australian Prudential Regulation Authority, *The Australian Securitisation Market, working paper 6*, October 2000.

9 Centre for Ideas and the Economy, *Submission no. 1*, pp. 3-4.

10 Mr D Lightfoot, The Rock Building Society, *Transcript*, 8 August 2008, p. 3.

11 Mr D Lightfoot, The Rock Building Society, *Transcript*, 8 August 2008, p. 3.

12 Mr C Joye, Centre for Ideas and the Economy, *Transcript*, 21 August 2008, p. 61.

initiatives designed to add both confidence and liquidity to the market.[13]

3.22 On 3 October 2008, the Treasurer announced that he had directed the Australian Office of Financial Management (AOFM) to invest $4 billion in Australian RMBS. The $4 billion in funding is allocated to both the banking and non-banking sectors.[14]

3.23 On 12 October 2008, the government also announced that the AOFM would add an additional $4 billion in funding for the purchase of RMBS for Australian non-ADI lenders. This additional $4 billion has been allocated directly to the non-banking sector (lenders who are not banks, building societies or credit unions).[15]

3.24 The additional $8 billion in funding is going to be allocated over a period of 3 years.[16]

3.25 The Prime Minister stated that the additional funds benefit Australia's mortgage market and ensure that this sector of the lending market has access to funding for its operations.[17]

Will securitisation return to its pre 2007 levels

3.26 The damage that the credit crisis has caused to the global financial system is considerable. Governments around the world have taken unprecedented steps to guarantee their banks and other financial institutions to ensure stability.

3.27 Investors, understandably, do not want to take any unnecessary risks in the current climate and are therefore extremely cautious before making any decision about re-entering the market.

3.28 The financial market is cyclical in nature. It will go up and down from time to time. However, as noted by the Treasury, 'once some normality returns to the market, this will assist in stimulating demand for RMBS and restore this funding channel.'[18]

3.29 It is uncertain at this stage of how long this particular downturn in the cycle will take.

13 Prime Minister of Australia, *Media Release*, *Global Financial Crisis*, 12 October 2008.

14 Treasurer of the Commonwealth of Australia, *Media Release*, *Treasurer Directs the AOFM to Invest in RMBS*, 3 October 2008.

15 Prime Minister of Australia, *Media Release*, *Global Financial Crisis*, 12 October 2008.

16 Prime Minister of Australia, *Media Release*, *Global Financial Crisis*, 12 October 2008.

17 Prime Minister of Australia, *Media Release*, *Global Financial Crisis*, 12 October 2008.

18 Mr J Murphy, Treasury, *Transcript*, 14 August 2008, p. 30.

3.30 It is fair to say that the unique conditions that sparked the last global financial boom are unlikely to reappear again and, as JP Morgan pointed out, 'the credit wrap of ensuring the risk has gone up so much that I do not think securitisation can ever come back to what it was before.'[19]

Does Australia need an 'AussieMac' model

3.31 A lack of access to liquidity within the mortgage market is a key theme that has been raised during the course of this inquiry. There are a number of groups that believe Australia needs an institution with the objective of providing liquidity to Australia's mortgage market over the long term.

3.32 Canada and the US have already established institutions with the objective of providing liquidity to their respective mortgage markets: the Canada Mortgage and Housing Corporation (CMHC) and the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) in the US.

3.33 CITE put forward a proposal that has a similar objective to Canada's Mortgage and Housing Corporation, Fannie Mae and Freddie Mac which they have called 'AussieMac'.[20]

How would an 'AussieMac' model work

3.34 The objective of the CITE proposal is to 'provide a minimum level of back-stop stability to the residential mortgage-backed securities market in Australia.'[21]

3.35 Under CITE's proposal, the Australian Office of Financial Management 'would guarantee the creditworthiness of an…AussieMac, thereby lending it Australia's AAA credit rating.'[22]

3.36 CITE added:

> AussieMac would be able to issue substantial volumes of very low-cost bonds into the domestic and international capital markets. The funds raised by AussieMac through issuing

19 Mr B Johnson, JP Morgan, *Transcript*, 14 August 2008, p. 25.

20 Centre for Ideas and the Economy, *Submission no. 1*, p. 6.

21 Centre for Ideas and the Economy, *Submission no. 1*, p. 1.

22 Centre for Ideas and the Economy, *Submission no. 1*, p. 8.

> these bonds could be used to acquire high-quality AAA-rated Australian home loans off the balance-sheets of lenders.[23]

3.37 CITE also noted that 'AussieMac would not be able to fund low-quality or 'sub-prime' loans: lenders would have to satisfy AussieMac's strict, pre-determined credit criteria before their loans would be eligible for acquisition.'[24]

3.38 CITE recommended that the amount of liquidity an 'AussieMac' model could supply during the course of everyday market operations be limited and that 'these constraints would be relaxed only during times of extreme illiquidity, or total market failure, when 'AussieMac' model would be able to step into the breach and act to normalise demand and supply.'[25]

3.39 Better Mortgage Management indicated that an 'AussieMac' model 'would allow non-banks to continue writing new business at rates competitive with the banks.'[26]

3.40 Others, like ANZ agreed that 'the proposal would provide additional liquidity to the market and assist those non-bank lenders reliant on securitisation'.[27]

3.41 In conclusion, however, the ANZ questioned whether this type of intervention in the market is necessary. Similarly, the CBA stated that the 'creation of an AussieMac would be premature'.[28]

The US and Canadian experience

3.42 Fannie Mae was established in 1938 towards the end of the great depression in the US. Up until 1968, Fannie Mae held a monopoly over the secondary mortgage market (the market where mortgage backed securities or bonds are sold). The US privatised Fannie Mae in 1968 and established Freddie Mac, also as a private entity, in 1970 as a direct competitor to Fannie Mae within the secondary mortgage market.

3.43 Fannie and Freddie do not supply home loans directly to consumers. They ensure that financial institutions have enough funds to lend to

23 Centre for Ideas and the Economy, *Submission no. 1*, p. 8.
24 Centre for Ideas and the Economy, *Submission no. 1*, p. 8.
25 Centre for Ideas and the Economy, *Submission no. 1*, p. 8.
26 Better Mortgage Management Pty Ltd, *Submission no. 6*, p. 2.
27 ANZ, *Submission no. 28*, p. 8.
28 Commonwealth Bank of Australia, *Submission no. 27*, p. 3.

home buyers. They do this by purchasing mortgages from a lender. The purchase of a mortgage by Fannie or Freddie enables the lender to make new loans for other customers to borrow. The mortgages are packaged into mortgage backed securities which are then sold to investors. This in turn provides Fannie and Freddie the funds to purchase more mortgages.

3.44 The sub-prime mortgage crisis in the US put both Fannie and Freddie under substantial financial pressure as they were unable to raise any new funds to purchase mortgages. An inability to raise the necessary capital to continue operations put both institutions' long term viability in doubt.

3.45 The US Government determined that the collapse of either institution would cause significant damage to the secondary mortgage market both within the US and internationally and adversely affect the economy as a whole.

3.46 In order to prevent a possible collapse, the US Government placed Fannie and Freddie under their control on 7 September 2008. The US Government gave responsibility for managing the operations of Freddie and Fannie to the Federal Housing Finance Agency (FHFA).

3.47 The other proposed international model, CMHC, was created in 1946 to house returning war veterans and to administer Canada's housing programs.

3.48 The CMHC has a similar objective to Fannie Mae and Freddie Mac, in that it ensures that financial institutions have enough funds to lend to home buyers. However, unlike its counterpart agencies in the US, the CMHC also provides mortgage loan insurance; funding for housing, renovations and repairs; financial consultants; and undertakes research and analysis on the Canadian housing market and housing technologies.

3.49 Canada's mortgage market appears to be healthy in comparison with the US. However, the cost of credit has also risen as Canada's banks have been unwilling to provide funding. In order to add extra liquidity to the market, the Canadian Government has added an additional C$25 billion in insured mortgage pools which will be purchased by the CMHC.

Conclusions

3.50 The committee believes that the 'AussieMac' proposal is not a suitable model for the Australian context.

3.51 The committee supports the move by the government to have the Australian Office of Financial Management (AOFM) allow both ADIs and non-ADIs to purchase $8 billion in RMBS over the next 3 years.[29]

3.52 The committee believes that the actions taken by the government are positive steps toward adding additional liquidity within the market.

3.53 Recent difficulties in the RMBS market, as a consequence of the global financial crisis, have made it difficult for some mortgage providers to actively compete in the mortgage market. As a result, the committee welcomes the government's initiatives to invest $8 billion of RMBS in order to support recovery in the RMBS market.

Recommendation 1

3.54 **The committee recommends that the government continue to monitor the state of the Residential Mortgage-Backed Securities market and review the adequacy of the current level of investment in light of future market developments.**

Reserve Bank of Australia's repurchase agreements

3.55 The committee received evidence on a number of other proposals designed to add short term liquidity to the market including the RBA's repurchase agreements.

3.56 The RBA carries out its open market operations primarily using repurchase agreements (repos) and outright transactions in short-dated government securities. When the RBA purchases securities under repo, it provides cash in return to the counterparty, for a specified term and at a price determined by competitive tender. The securities provide the collateral for the loan, so that in the event that the counterparty is unable to repay the loan, the securities may be

29 Prime Minister of Australia, *Media Release*, 12 October 2008.

sold into the market to recoup the loan proceeds. Because the Bank needs to manage system cash on a day-to-day basis to ensure the cash rate remains at the target, in normal circumstances, repos are for relatively short terms (up to around three months).

3.57 Since the onset of the financial turbulence, term money markets have, on occasions, become quite dysfunctional. In order to alleviate some of these problems, the Bank has sought to extend the term of its repo operations and expand the range of securities that it is willing to accept in its repo operations. Repos are now routinely undertaken for terms of up to one year, and the range of collateral accepted by the Bank extends to virtually any domestic security that has a high credit rating.

The extent of their usage and effectiveness

3.58 From the evidence received, it appears as though there is some confusion between groups as to whether they are able to apply for RBA repos.

3.59 CITE in its submission noted that 'non-bank lenders have never sought relief through the RBA's 'repurchase agreements' because the restrictions the RBA enforces make it next to impossible for them to do so'.[30]

3.60 Likewise, the ASF noted that 'RBA repurchase agreements - has provided short term relief but in its current form is practically inaccessible to non-banks and small financial institutions.'[31]

3.61 It was the understanding of the Credit Ombudsman Service that 'non-bank ADIs do not have exchange settlements accounts with the Reserve Bank.'[32]

3.62 The Rock Building Society also stated that they 'have not really been able to access that [repos] and I think that is a similar story for even some of the regional banks.'[33]

3.63 The RBA has stated that they are more than willing to 'accept whatever amount of mortgage-backed securities anybody is willing to bring' and that 'nobody wants to bring them to us'.[34]

30 Centre for Ideas and the Economy, *Submission no. 1*, p. 14.

31 Australian Securitisation Forum, *Submission no. 30*, p. 28.

32 Mr R Venga, The Credit Ombudsman Service Ltd, *Transcript*, 21 August 2008, p. 42.

33 Mr D Lightfoot, The Rock Building Society, *Transcript*, 8 August 2008, p. 11.

34 Mr R Battellino, Reserve Bank of Australia, *Transcript*, 14 August 2008, p. 8.

3.64 The RBA added that they have a 'repos book of about $50 billion' with 'less than $2 billion of that are mortgage-backed securities.'[35]

3.65 While groups acknowledged that the RBA repos provide short term liquidity to the market, they question its effectiveness in adding liquidity to the market long term.

3.66 The Treasury noted that 'the repo market…is only there for short-term funding needs' and 'to run a proper mortgage business, one has to have some guarantee of reasonably strong lines of funding.'[36]

3.67 The ASF noted that mortgage businesses need long term funding stating: 'wholesale funders need to have the confidence that they can have access effectively to a long-term liquidity backstop.'[37]

3.68 Genworth Financial also endorsed the changes to the repo arrangements but noted the need for a long term solution stating: 'you want to have a long-term framework in place for fundamental lending through all cycles in the housing sector.'[38]

Conclusions

3.69 The mortgage industry is not a short term business with the typical mortgage lasting up to 30 years. Repurchase agreements are available for a maximum of around one year.

3.70 As indicated by the ASF and Genworth Financial, a mortgage business requires access to long term funding. If repurchase agreements were to be used effectively in adding liquidity to the mortgage market over a longer term, the RBA would need to provide certainty of funding for a much longer period than is presently the case.

3.71 A financial institution sells their securities to the RBA for cash in order to gain extra funding.

3.72 There is also a level of risk associated with lending money. Lenders offering long-term mortgages typically need access to long-term funding, or have substantial capital bases which allow them to take on this maturity transformation risk.

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35 Mr R Battellino, Reserve Bank of Australia, *Transcript*, 14 August 2008, p. 8.

36 Mr J Murphy, Treasury, *Transcript*, 14 August 2008, p. 30.

37 Mr P Vernon, Australian Securitisation Forum Inc., *Transcript*, 15 August 2008, p. 39.

38 Mr P Hall, Genworth Financial, *Transcript*, 15 August 2008, p. 50.

3.73 JP Morgan noted that:

> There is a suggestion that the central bank can repurchase those securities and hold them indefinitely, but there is a cost. The risk does not disappear.[39]

3.74 The committee supports the steps taken by the RBA to widen the range of securities that it will accept as collateral and to lengthen the term to maturity.

3.75 The RBA repurchase agreements are an effective tool for adding short term liquidity to the market. However, there is still a concern that expanding the repurchase agreements by extending their term to maturity even further may place additional unnecessary risk on the RBA.

3.76 The committee believes that while there is merit in the proposal to make repos a long term funding option, further study on whether this will place additional risk on the RBA needs to be undertaken.

Recommendation 2

3.77 **The committee recommends that the Reserve Bank of Australia examine the appropriateness, feasibility and risks of expanding the repurchase agreements by extending their term to maturity even further and provide a public audit report within six months. The report must be made available to the committee for review.**

Australian Office of Financial Management

3.78 Another option to provide long term liquidity to the mortgage market is for the AOFM to invest in RMBS.

3.79 The AOFM is responsible for issuing government debt, managing the government's cash balances, undertaking investments of financial assets and managing resulting asset and debt portfolios.

39 Mr B Johnson, JP Morgan, *Transcript*, 14 August 2008, p. 21.

3.80 The *Financial Management and Accountability Act 1997* has given the Treasurer the power to invest public money in authorised investments. The Treasurer could direct the AOFM to invest in RMBS long term.

3.81 The AOFM noted that they could, if directed, invest in RMBS:

> The list of investments authorised by the Treasurer includes debt instruments, rated AAA or equivalent by one of the major credit rating agencies, issued by financial institutions in Australian currency…[and] it would potentially cover a high proportion of residential mortgage-backed securities issued by Australian financial institutions.[40]

3.82 The groups that provided evidence to the inquiry were, for the most part, positive that this proposal could provide liquidity to the mortgage market.

3.83 The ASF agreed that the proposal has the potential to aid competition in the long term noting some advantages:

> The advantages of the proposed AOFM initiatives are that liquidity can be provided to the market as needed, it is quick in implementation, increased return on government funds raised to provide a government benchmark, and balancing the supply and demand in the mortgage-backed securities market at a price that creates a level playing field.[41]

3.84 The Challenger Financial Services Group indicated that the AOFM investing in Australian RMBS shows investors that the government is confident that there are limited risks. This could have the wider benefit of creating confidence for both national and international investors in Australian RMBS. They stated:

> The big benefit of acquisition, as opposed to a securities lend style structure, is that I think you can engender and create that situation that we spoke of earlier and start pulling offshore investors in as well. We have examples of that ourselves showing that if you know that AOFM are investing alongside then you can garner a lot more interest.[42]

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40 Mr N Hyden, Australian Office of Financial Management, *Transcript*, 19 September 2008, pp. 32-33.

41 Australian Securitisation Forum, *Submission no. 30*, p. 24.

42 Mr B Benari, Challenger Financial Services Group, *Transcript*, 15 August 2008, p. 88.

3.85 There is always going to be an element of risk associated with any proposal. The AOFM noted that 'any investment is subject to interest rate risk.'[43]

3.86 In aiding competition within the mortgage market, the AOFM indicated that 'the size of the investment is clearly a key parameter in determining not only the risk that would be covered for the government but also the effectiveness of the intervention or the impact it would have on the mortgage lending market.'[44]

Covered Bonds

3.87 Covered Bonds were also identified as a possible additional source of liquidity.

3.88 Covered bonds work in a similar way to mortgage-backed securities in that they enable the financial institution to obtain a lower cost of funding in order to grant mortgage loans for housing. The significant difference is that covered bonds are considered to have less risk than mortgage-backed securities.

3.89 Covered bonds are issued directly by the financial institution and therefore remain on the institution's balance sheet. Bonds are covered by a group, or 'pool', of mortgage loans. If the issuing institution collapses, the bonds are 'covered' by the pool and are separated from the institution's other assets to pay back the bond holder.

3.90 The ASF provided an overview of covered bonds within its submission noting that:

> Covered bonds are a widely used funding mechanism in the U.K. and European markets. In some of those jurisdictions, there are statutory schemes that regulate the issue of covered bonds.[45]

3.91 The Treasury noted that in Europe, 15-20 per cent of mortgages are funded by covered bonds.[46] This is also in part due to the fact that

43 Mr N Hyden, Australian Office of Financial Management, *Transcript*, 19 September 2008, p. 34.

44 Mr N Hyden, Australian Office of Financial Management, *Transcript*, 19 September 2008, p. 34.

45 Australian Securitisation Forum, *Submission no. 30*, p. 20.

46 Treasury, *Submission no. 12*, p. 4.

most investments of covered bonds tend to be for periods of around 5-10 years.

3.92 The ASF also highlighted that investment in covered bonds continued to rise 'despite the dislocation in the global credit markets, with issuance up 158%' in the second quarter of 2008.[47]

3.93 The Australian Bankers' Association supported the idea of a covered bond proposal and acknowledged that they could see how the proposal could add liquidity to the market.

3.94 However, it is the Australian Prudential Regulation Authority's (APRA) view that 'covered bonds are not considered to be consistent with depositor preference provisions set out in the Banking Act and hence are prohibited.'[48]

3.95 Section 13A(3) of the *Banking Act 1959* states:

> If an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI.[49]

3.96 As indicated above, if an institution that has issued a covered bond collapses, the bond is separated from the institution's other assets. Section 13A(3) of the Banking Act effectively means that all assets of the ADI cannot be separated in the event of a collapse. APRA has therefore prohibiting the issue of covered bonds under paragraph 7 of *ADI Prudential Standard APS 120 Securitisation*.[50]

Conclusions

3.97 There is certainly merit in the proposal that ADIs be able to issue covered bonds. However, there is still some uncertainty about how covered bonds would fit within the current financial framework.

3.98 Adding covered bonds as an alternative to raising capital is not something that can be accomplished within a short period of time. Extensive studies would need to be undertaken on how covered bonds would benefit the whole banking and non-banking sector as

47 Australian Securitisation Forum, *Submission no. 30*, p. 21.

48 Australian Prudential Regulation Authority, *Letter to ADIs: Covered Bonds*, 29 April 2008.

49 This has recently been amended by the *Financial System Legislation (Financial Claims Scheme and Other Measures) Act 2008*. However, deposit liabilities still have priority over other liabilities.

50 Australian Prudential Regulation Authority, *Letter to ADIs: Covered Bonds*, 29 April 2008.

well as how both consumers who invest in covered bonds and depositors in the ADI would be protected.

3.99 If there proved to be a sizeable benefit, then the government would need to consider amending the Banking Act as well as adding an effective regulatory framework.

3.100 The committee believes that further study on how covered bonds would be regulated needs to be undertaken.

Recommendation 3

3.101 **The committee recommends that the Treasury examine the appropriateness and feasibility of allowing Australian authorised deposit-taking institutions to issue covered bonds.**

Bank of England Special Liquidity Scheme

3.102 Countries around the world are experiencing similar financial challenges due to the credit crisis. Most notably the Canadian and US experiences which have been discussed earlier in this chapter.

3.103 The United Kingdom (UK) has not been immune from the effects of the credit crisis either with the UK Government taking temporary public ownership of two banks, Northern Rock and Bradford & Bingley, and acquiring significant shareholdings in Halifax – Bank of Scotland (HBOS), Lloyds Bank and the Trustee Savings Bank (Lloyds TSB) and the Royal Bank of Scotland (RBS).[51]

3.104 The mortgage sector in the UK has had significant difficulty in obtaining access to liquidity. The Bank of England launched a 'Special Liquidity Scheme' designed to improve liquidity within the banking system and boost the confidence of the financial market.

3.105 Under the Special Liquidity Scheme, banks are able to temporarily swap mortgage-backed securities for UK Treasury Bills for a period of

51 HM Treasury, *Press Notice*, Northern Rock plc, 17 February 2008 and HM Treasury, *Press Notice*, Bradford & Bingley plc, 29 September 2008 and HM Treasury, *Statement by the Chancellor on financial markets*, 13 October 2008.

1 year, which they may renew for a total of 3 years, and the risk of losses on their loans remains with the banks.[52]

3.106 The ASF was supportive of establishing a similar Special Liquidity Scheme in Australia stating that it would be more effective than repos and that 'the advantages of such a scheme would be the certainty of availability of funding and the duration of the funding, being one to three years at the option of the borrower or the issuer.'[53]

3.107 Genworth Financial also endorsed an Australian Special Liquidity Scheme but believed that it would only provide a short term solution noting, as indicated earlier, the need for a long term framework for fundamental lending through all cycles in the housing sector.[54]

3.108 The Rock Building Society was of a similar view noting that ideally there needed to be both a long and short term solution to adding liquidity to the market. They stated:

> I would like to think that Treasury in Australia would be looking at what is happening there [the UK] as well as a very important short-term solution to the liquidity crisis…But I think it is important that we do both, that we look at what can be done in the short term…and then what is good for the long-term health of our financial system.[55]

Conclusions

3.109 The UK's financial sector is vastly different from our own. Our banking sector is considered quite robust in comparison and the Australian Government has not taken the drastic steps of putting our banks under public ownership.

3.110 The UK's Special Liquidity Scheme provided some benefit by adding liquidity to the UK market. The UK Government also appears to have mitigated the risk of taking on mortgage-backed securities to some extent by having any losses on loans remain with the banks.

3.111 As noted above, the UK Government has taken temporary public ownership of Northern Rock and Bradford & Bingley and acquired significant shareholdings in HBOS, Lloyds TSB and the RBS. It is

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52 Bank of England, *News Release*, *Special Liquidity Scheme*, 21 April 2008.

53 Mr G Medcraft, Australian Securitisation Forum, *Transcript*, 15 August 2008, p. 37.

54 Mr P Hall, Genworth Financial, *Transcript*, 15 August 2008, p. 50.

55 Mr D Lightfoot, The Rock Building Society Pty Ltd, *Transcript*, 8 August 2008, p. 6.

therefore hard to ascertain at this stage whether the scheme will add any substantial liquidity to the UK market and bolster competition.

3.112 Also, as noted previously, this type of short term solution will not provide funding for longer term mortgage lending.

The government's support package

3.113 The issue of adding liquidity to the mortgage market for the banking and non banking sectors to access funding for its operations is impacted by the government's financial support package.

3.114 On 26 September 2008, the Treasurer announced that he had directed the AOFM to purchase $4 billion in RMBS. In his media release of 26 September, the Treasurer stated:

> …due to recent extraordinary developments in international capital markets, liquidity in the primary Australian RMBS market has been reduced…This has weakened the capacity of mortgage lenders reliant on the primary RMBS market as a source of funding to compete.
>
> To reinvigorate the Australian RMBS market and support competition in mortgage lending, I will direct the AOFM to invest in AAA rated RMBS in two initial tranches of $2 billion each.[56]

3.115 By the start of October 2008, conditions in international financial markets took a significant turn for the worse with liquidity problems in the global money markets. Governments around the world introduced various packages in an attempt to stabilise their financial systems and add liquidity to the market.

3.116 The US Government offered US$250 billion of capital for its banks, and offered to guarantee directly up to US$1,400 billion of bank debt. The UK Government offered £50 billion of capital for its banks, and offered to guarantee directly up to £250 billion of bank debt. The Canadian Government offered to guarantee directly all wholesale bank debt.[57]

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56 Treasurer of the Commonwealth of Australia, *Media Release, Government Initiative to support competition in the mortgage market*, 26 September 2008.

57 Bank of England, *Financial Stability Report, Issue No. 24*, October 2008.

3.117 As a consequence of actions taken around the world, on 12 October 2008, the Prime Minister announced that the Australian Government would:

- guarantee all deposits of Australian banks, building societies and credit unions and Australian subsidiaries of foreign-owned banks;
- guarantee wholesale term funding of Australian incorporated banks and other ADIs; and
- direct the AOFM to purchase an additional $4 billion in Residential Mortgage Backed Securities from non-ADI lenders.[58]

3.118 The free guarantee on deposits up to $1 million was legislated as part of the Financial Claims Scheme (FCS). The intention of the legislation is to allow the government to make timely payments to eligible depositors and policy holders in the event of a financial institution failure.

3.119 APRA would need to declare the institution insolvent (and unlikely to return to solvency in the near future) and apply for the failed institution to be wound up. Then, the Treasurer would be able to activate the scheme and appropriate the required funds.

3.120 The scheme would be administered by APRA who, in the event of a failure of an ADI or insurer, would make payments to affected depositors or policy holders in a timely fashion and then would be substituted for individual depositors as a creditor (APRA would be given first priority as creditor in any such liquidation).

3.121 Following the insolvency process, any shortfall of funds needed to make up the payments incurred by APRA to deposit holders/insurance policyholders will be recovered through levies on either the ADI or general insurance industries (whichever industry is relevant to the insolvent company). The power to impose these levies is contained within the *Financial Claims Scheme (ADIs) Levy Act 2008* and the *Financial Claims Scheme (General Insurers) Levy Act 2008*. For this reason, the FCS is expected to amount to an eventual nil cost to government.

3.122 The financial claims scheme legislation does not contain anything pertaining to the guarantee of wholesale term funding for ADIs or for the guarantee of deposits above the $1 million threshold. To obtain the benefit for these guarantees a relevant fee must be paid to the

58 Prime Minister of Australia, *Media Release*, *Global Financial Crisis*, 12 October 2008.

government. These arrangements will be implemented through contractual arrangements. The government is currently considering whether other legislative changes are required to give effect to that aspect of the scheme.

Investigating and addressing issues of concern

3.123 Keeping the financial market stable, competitive and healthy is an ongoing concern. As has been highlighted during the course of this inquiry, markets can change dramatically within the space of a few days.

3.124 The Consumer Action Law Centre (CALC) noted that the UK has established a specific body, the Competition Commission, that has powers to investigate and address issues on concern within the marketplace. They stated:

> …in the UK the competition regulators have general 'market studies' and 'market investigations' functions and powers that are simply not available in Australia. These powers have given the UK regulators the ability to address problems within various markets, including the UK retail banking and non banking sectors.[59]

3.125 If the UK Competition Commission's investigations determine that competition in a market could be limited or damaged, they have the power to undertake a range of actions including:

- publishing information to help consumers;
- encouraging firms to take voluntary action or adopt a code of practice;
- making recommendations to the government or other regulators;
- taking enforcement action for breaches of consumer or competition law;
- making a market investigation reference to the Competition Commission; or
- deciding that no further action is warranted.[60]

59 Consumer Action Law Centre, *Submission no. 35*, p. 16.

60 Consumer Action Law Centre, *Submission no. 35*, p. 16.

3.126 The CALC was also of the view that neither the Australian Competition and Consumer Commission (ACCC) nor the Australian Securities and Investments Commission (ASIC) had the power to investigate and address issues on concern within the marketplace. CALC stated:

> …the Australian Competition and Consumer Commission and ASIC are unable to undertake these important studies and investigations where market problems and their solutions are not immediately obvious.[61]

3.127 The ACCC is an independent statutory authority that administers the *Trade Practices Act 1974* and other acts. The ACCC's primary responsibility is to ensure that individuals and businesses comply with the Commonwealth's competition, fair trading and consumer protection laws.[62]

3.128 The ACCC noted that that they were somewhat limited in making comments on competition as they do not undertake extensive market reports which could be undertaken in the UK by the Office of Fair Trading (OFT), stating:

> With mergers and most of our work internally, we look at that transaction and compare it with what exists now as opposed to what we think the overall state of a market is relative to a model of perfect competition, or whatever. It just makes it a little difficult sometimes to make bold statements such as, 'This is extremely competitive,' or, 'This is very competitive,' or whatever, unless you do a full-blown market report. As some of you would know, the OFT in the United Kingdom does a lot of those. They are probably the world's leader in terms of market reports, and they are a different beast, if you like, than a lot of what we do.[63]

3.129 The ACCC also noted that they are interested in competition 'but it is only of interest if it comes across our desk in terms of a merger, an acquisition, an enforcement issue or a compliance issue.'[64]

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61 Consumer Action Law Centre, *Submission no. 35*, p. 18.

62 Australian Competition and Consumer Commission, 'What we do', viewed on 30 October 2008, <http://www.accc.gov.au/content/index.phtml/itemId/54137>

63 Mr M Pearson, Australian Competition and Consumer Commission, *Transcript*, 19 September 2008, p. 24.

64 Mr M Pearson, Australian Competition and Consumer Commission, *Transcript*, 19 September 2008, p. 28.

3.130 ASIC is Australia's corporate, markets and financial services regulator and administers the *Australian Securities and Investments Commission Act 2001*. ASIC's role is to monitor the marketplace for breaches of the ASIC Act and taking enforcement action where appropriate; contributing to policy debates and the development of self-regulatory initiatives; and contributing to consumer education efforts.[65]

3.131 ASIC acknowledged that they did not have a role in assessing competition stating:

> …the ACCC has a role in competition. Obviously mergers or anticompetitive practices of one sort or another in that sector, just like any other sector, would be within their purview, but the consumer protection aspect of financial services is with us.[66]

Conclusions

3.132 Both the ACCC and ASIC are constrained by their respective Acts which do not provide them with the power to independently investigate and report on issues of concern that relate to competition within the marketplace.

3.133 The *Trade Practices Act 1974* already contains a broad range of investigation and enforcement powers in relation to suspected breaches of the Act including, mechanisms to monitor competition in particular industries, and substantial penalties for breaches of the competition provisions. There are also a range of general consumer protection powers.

3.134 Some concerns were raised with the committee regarding whether the current mechanisms were adequate to monitor the state of competition within the banking and non-banking sectors.

Recommendation 4

3.135 **The committee recommends that the government review the current adequacy of the *Trade Practices Act 1974* to provide the Australian Competition and Consumer Commission the powers to investigate and**

65 Australian Securities and Investments Commission, 'Our role', viewed on 30 October 2008, < http://www.asic.gov.au/asic/asic.nsf/byheadline/Our+role?openDocument>

66 Mr J Cooper, Australian Securities and Investments Commission, *Transcript*, 19 September 2008, p. 76.

address issues of concern in markets and regulated sectors.

Positive credit reporting

3.136 Some groups have indicated that there is not a level playing field as Australia's four largest banks hold a distinct competitive advantage in being able to assess the potential risk of a customer and that 'their large existing customer base gives them broad insight into a consumer's ability to make repayments.'[67]

3.137 Currently financial institutions assess a customer's capacity to pay by looking at their credit report. Credit reports contain information on credit applications, credit defaults (overdue payments of 60 days or more), serious credit infringements and whether the individual has filed for bankruptcy. This is called a 'negative credit reporting model'.

3.138 The Treasury noted that the current negative reporting model may 'represent a barrier to competition as they prevent new entrants and smaller existing lenders from obtaining comprehensive information on a prospective customer's ability to service a loan' and that only a 'customer's existing lender…has access to the borrower's repayment history'.[68]

3.139 GE Money noted the difficulties associated with assessing a customer's credit worthiness stating 'GE and many other non-bank lenders are currently at a competitive disadvantage vis a vis the banks with respect to our ability to assess an applicant's capacity and willingness to service debt.'[69]

3.140 Banks in particular, who have more comprehensive client databases, can theoretically make a better judgement about a customer's capacity to pay.

3.141 Some groups believe that all financial institutions should be able to access a borrower's repayment history and are proposing that Australia adopt a 'positive credit reporting model'.

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67 VEDA Advantage, *Submission no. 11*, p. 7.

68 Treasury, *Submission no. 32*, p. 16.

69 GE Money Australia and New Zealand, *Submission no. 13*, p. 4.

3.142 VEDA Advantage, the main proponents of a positive credit reporting model, argued that 'a [negative] credit report really does not tell you about your capacity to repay or in fact whether you are financially stressed.'[70]

3.143 VEDA Advantage also pointed out that 'Australia, New Zealand and France are now the only three OECD nations limiting credit reports to just negative information.'[71]

3.144 The Australian Finance Conference also supported the positive credit reporting model indicating that 'it would enable our members to better manage risk and consequently make better informed lending decisions.' They also noted that 'its inclusion should see a boost in competition among financiers and lead to lower interest rate credit products for low-risk consumers.'[72]

3.145 Additionally, there is a perception that people on low incomes pose a greater credit risk. Based on a the current risk assessment process, people on low incomes are generally given a much smaller choice in credit products at a much higher interest rate.

3.146 The Brotherhood of St Laurence noted that 'Banks have developed risk assessment policies and conditions which make them inappropriate for people on low incomes.'[73]

3.147 Being on a low income does not necessarily equate to being a credit risk. The Brotherhood of St Laurence also noted that 'low-income people hold a significantly lower amount of debt than higher income people' and 'the default rate for loans to people on low incomes is actually lower than the industry average for people on higher incomes.'[74]

3.148 A positive credit reporting model may assist people who are on low incomes to obtain lower interest rate credit products.

3.149 As noted by the Treasury, the Australian Law Reform Commission (ALRC) has also examined the credit reporting system. On 30 May 2008, the ALRC delivered their final report, *For Your Information: Australian Privacy Law and Practice*, which recommended that 'there should be some expansion of the categories of personal information

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70 Mr M Strassberg, VEDA Advantage, *Transcript*, 15 August 2008, p. 4.

71 VEDA Advantage, *Submission no. 11*, p. 11.

72 Australian Finance Conference, *Submission no. 18*, p. 5.

73 Ms G Sheehan, Brotherhood of St Laurence, *Transcript*, 8 August 2008, p. 61.

74 Ms G Sheehan, Brotherhood of St Laurence, *Transcript*, 8 August 2008, p. 61.

that can be included in credit reporting information held by credit reporting agencies' including:

- the type of each current credit account opened (eg, mortgage, credit card, personal loan);
- the date on which each current credit account was opened;
- the credit limit of each current account; and
- the date on which each credit account was closed.[75]

3.150 The ALRC President, Professor David Weisbrot, recognised that the current credit reporting model had limitations stating:

> It is hard to justify the present, artificial limitations, which do not accord with standard practice in the rest of the industrial world. The recommended moderate expansion in the types of information that may be recorded on a credit file falls short of the more open US or UK regimes advocated by some credit providers, but that is because the ALRC recognises that there are competing interests at play, and we have sought to place an appropriately high premium on the privacy and security of sensitive personal information.[76]

3.151 As alluded to by the ALRC President above, adopting a positive credit reporting model has privacy implications. Veda Advantage noted the current concerns of privacy advocates stating:

> There are some privacy advocates who believe that any database of information is dangerous and a human rights breach. I think we will never satisfy those, but most consumer advocates now accept that we have got good data governance and good ways of regulating it.[77]

3.152 While undertaking an examination of the credit reporting system, the ALRC also recognised the concerns of privacy and consumer advocates noting that 'privacy and consumer advocates also argued strongly that allowing more personal information on the financial position and credit behaviour of individuals to be collected in private sector databases would pose greater risks to security and privacy.'[78]

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75 Australian Law Reform Commission, *Media Briefing Note 7, ALRC Privacy Inquiry, Reform of the credit reporting system*, 11 August 2008.

76 Australian Law Reform Commission, *Media Briefing Note 7, ALRC Privacy Inquiry, Reform of the credit reporting system*, 11 August 2008.

77 Mr C Gration, Veda Advantage, *Transcript*, 15 August 2008, p. 6.

78 Australian Law Reform Commission, *Media Briefing Note 7, ALRC Privacy Inquiry, Reform of the credit reporting system*, 11 August 2008.

Conclusions

3.153 The proposal for Australia to adopt a positive credit reporting model has advantages for both the business and the consumer.

3.154 However, there will always be some extenuating circumstances that cannot be predicted by either a negative or positive credit reporting model. This includes a significant change in an individual's life, such as illness, divorce or the loss of a job, can inhibit the individual's capacity to pay.

3.155 The committee believes that the benefits that such a model would provide to enable businesses to better assess risk outweigh any limitations. The fact is that there will always be some extenuating circumstances that any model will be unable to predict.

3.156 The committee believes that there are some privacy concerns about expanding the categories of personal information held by credit reporting agencies but notes that the ALRC has undertaken an examination of the impact on privacy and security of personal data before it made its recommendation to government.

3.157 The committee concurs with the ALRC's recommendation that there should be some expansion of the categories of personal information that can be included in credit reporting information held by credit reporting agencies.

Recommendation 5

3.158 **The committee supports the findings of the Australian Law Reform Commission's report and urges the government to implement the report's recommendations on reforming Australia's credit reporting system.**