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Members: Mr Craig Thomson (Chair), Mr Pearce (Deputy Chair), Mr Bradbury, Mr Dutton, Ms Jackson, Mr Keenan, Mr Marles, Ms Owens, Mr Turnbull and Mr Turnour

Members in attendance: Mr Bradbury, Mr Dutton, Mr Marles, Mr Craig Thomson and Mr Turnbull

Terms of reference for the inquiry:

To inquire into and report on:

Competition in the retail banking and non-banking sectors in Australia. The inquiry will pay particular attention to home mortgage products and linked facilities frequently offered to consumers such as credit cards and savings accounts.

1. The Committee will undertake a stock take of the Australian retail banking and non-banking industries, focussing on:
   a. Recent developments in relation to products, providers and distribution channels;
   b. the current state of the retail banking and non-banking industries;
   c. the likely drivers of future change and innovation in the retail banking and non-banking sectors including the continuing impact of technological developments; and
   d. comparisons with relevant international jurisdictions.

2. The Committee will also identify any barriers that may impact on competition in the retail banking and non-banking sectors, and policies to enhance further competition and product choice for consumers.
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Committee met at 9.01 am

CHAIR (Mr Craig Thomson)—I declare open this public hearing on the House of Representatives Standing Committee on Economics inquiry into competition in the banking and the non-banking sectors. To date the committee has received 43 submissions to this inquiry—submissions that have raised numerous issues that the committee is carefully considering. The committee will investigate the extent to which competition in the financial sector has reduced and, in particular, examine proposals that would help to increase competition and reduce fees and charges for people struggling with their mortgages.

Today we will hear from the Reserve Bank of Australia, Treasury, the Mortgage and Finance Association of Australia, the Australian Prudential Regulation Authority, the Council of Mortgage Lenders, Aussie Home Loans, and Mr Kevin Vierboom. I remind witnesses that although the committee does not require them to give evidence under oath, this hearing is a legal proceeding of parliament and warrants the same respect as proceedings of the house itself. The giving of false or misleading evidence is a serious matter and may be regarded as contempt of parliament.

The evidence that will be given today will be recorded by Hansard and attract parliamentary privilege. Before introducing the witnesses I remind members of the media who might be present at the hearing of the need to report the proceedings of the committee fairly and accurately.
[9.02 am]

**BATTELLINO, Mr Ric, Deputy Governor, Reserve Bank of Australia**

**LOWE, Dr Philip William, Assistant Governor, Financial System, Reserve Bank of Australia**

CHAIR—Welcome. I have already dealt with the privilege issue and the giving of evidence under oath, so I will not go through that again. You have heard what I said in relation to those issues. We have already received a written submission from the Reserve Bank. Do you have any additional submission that you wish to give us today, or do you wish to make an opening statement?

Mr Battellino—We do not have an additional submission but I might take a minute or two to highlight some of the key points that we made in our written submission and in our conclusion.

CHAIR—I have received a three-page document.

Mr Battellino—That is our proposal and that is what I was going to say.

CHAIR—For the record I might ask that that be authorised by the committee.

Mr DUTTON—So moved.

Mr MARLES—Seconded.

CHAIR—As all are in favour, I declare that carried. That document will now become part of the record.

Mr Battellino—Our written submission looked at various aspects of competition in the financial sector. One way in which to analyse the competitiveness of the financial sector is to look for any signs that we would expect to see if the sector was not competitive. For example, if the overall provision of finance into the economy was inadequate, if the cost paid by households and businesses for financial products was higher than the international norms, if the availability of new financial products in Australia was less than overseas, or if the profitability of financial intermediaries in Australia was unreasonably high.

The evidence in these key areas is quite reassuring. For example, financial intermediation in Australia has been growing at a very fast rate—on average, about twice as fast as the growth of nominal GDP. That rate is amongst the highest rates in the developed world. I do not think there can be any suggestion, therefore, that the Australian financial sector has not been able to provide sufficient access to finance by Australian households and businesses.

In the case of interest rates charged by intermediaries, we find that they have declined substantially over the past 15 years and that so far as we can tell they are in line with international norms. In the case of financial innovation, over the past 15 years we have seen a
marked increase in the range of financial products available in Australia. Again, the experience here compares quite favourably with the experience overseas. When we look at bank profitability we find that Australian banks are at the top of the international range. On the surface this could indicate a lesser degree of competition here than elsewhere. However, when we look a bit more deeply at the reasons for this we find that an important reason is that Australian banks have had an unusually low bad debt experience.

Over the past decade the bad debts of Australian banks have been about half the long-run average and about half the experience of banks overseas. This has been the result of a very strong domestic economy. It is worth noting that other Australian industries have also been very profitable over this period. If we take this into account and adjust bank profitability for this unusually low bad debt experience, we find that the profitability of Australian banks is around the middle of the international range. Overall, when we look at all the evidence that we have, we think it is reasonable to conclude that the Australian financial sector is competitive and that it stacks up quite well across a range of international benchmarks.

Some commentators have recently been concerned that financial turmoil over the past year has lessened the degree of competition. This is because the turmoil has made it harder for lenders who fund themselves in capital markets to compete. These people then go on to argue that this requires some form of government intervention in the market. In particular, there is a proposal around for the government to set up a government-guaranteed securitisation vehicle. While it is true that lenders relying on securitisation have lost market share in recent months, it has always been the case that some phases of the economic cycle favour some forms of financing more than others.

Securitisation was strongly favoured in the previous five years of low global interest rates, and the market share of securitisers increased enormously. This form of activity is now at a disadvantage. Our view is that these recent events are cyclical in nature and do not represent a permanent change to the structure of the market, in the sense that when market conditions settle we expect securitisation to pick up again. As such, we think it would be premature at this stage to embark on proposals to set up new government bodies to favour some form of financial activity. The best way for the government to promote a competitive financial sector in the long run is to ensure, first, that regulations do not unreasonably impede new entrants into the financial sector since history shows that new entrants drive competitive behaviour.

Second, the government must ensure that users of financial services have good access to information on the range and cost of services available. It is important also that this information be in a form that is easy to understand. Third, it is important that switching between financial service providers be as costless and as easy as possible. I end my opening remarks. Phil and I will be pleased to answer any questions that you might have. Thank you.

CHAIR—Thank you for that. I will start with some questions and then ask other committee members to ask you questions. In your submission you state that the level of competition and its effect in the market have been quite reassuring. From my perspective and from the perspective of the people on the Central Coast, they do not see it in quite the same light. For example, on the Central Coast we have high unemployment—almost twice the national average—and petrol costs are soaring in this high commuter base. I am talking about the Central Coast but this is
symptomatic of all outer suburban areas around Australia. They are feeling the pressure from mortgage rate increases.

People on the Central Coast who speak to me are particularly concerned about the fact that banks have increased their interest rates to a greater degree than the movements that have occurred in the Reserve Bank. I want, first, to establish your view about the banks doing that, in particular, in light of the record profits that we are seeing. Yesterday the Commonwealth Bank revealed that it had a $4.8 billion profit, so I am interested to hear your views of the history of movements over the past 12 months—movements that have been in excess of movements by the Reserve Bank. You might also have some views about banks potentially saying that they will not follow a full interest rate cut. I would like to hear what you have to say about those issues.

Mr Battellino—Obviously this has been a hotly debated topic for a while. In the normal sense, when the Reserve Bank changes the cash rate, that has an impact on the whole range of interest rates in the money and capital markets. If things are going smoothly in the markets, broadly speaking all these interest rates are moving up and down with the cash rate. We have had a fairly smooth period now for a decade or so and people have got used to the fact that when banks raise or change their interest rates basically they are moving in line with the cash rate. That is because the cash rate is acting as a proxy for the overall cost of funds to the banks. When markets move into periods of turmoil, as they have in the past 12 months or so, the relationship between the cash rate and other interest rates tends to break down to some extent.

While we have seen, for example, the cash rate rise by 100 points over the past year, many other interest rates in the money markets where the banks fund themselves have risen by much more than that because lenders have become very risk averse and they are demanding higher interest rates to lend. The banks obviously have to pay those rates and they factor all that into their cost of funds. That is what they take into account in pricing their products. On average, their cost of funds has risen by about 50 points more than the cash rate over the past year, and that, in turn, has been reflected in their lending rates. That has been the history over the past year or so. It is a break from where we had been in previous years because people had got used to the fact that lending rates just moved with the cash rate.

But the truth is that, given what has happened in the past year, it would not have been possible for the lending rates to move with the cash rate. In recent weeks there has been quite a change in market sentiment. As Phil mentioned yesterday, for example, the interest rate on bank bills, which is an important source of funding for banks, has fallen by about 50 points. That is only one source of funding, and banks have many sources of funding. When we do the calculation across all sources of funding, our estimates are that the bank cost of funds has probably fallen by 25 or 30 points at this stage. That has been quite a material change to their position. The media has been pushing the banks to give some sort of commitment.

CHAIR—I am sure it is not just the media.

Mr Battellino—Yes. People more generally have been pushing the banks to give a commitment to follow the Reserve Bank when it cuts interest rates. I think that the banks have responded to that quite cautiously, and they have been quite non-committal. My guess is that what is happening here is that the banks are saying it is unreasonable for them to give commitments when they do not know when the Reserve Bank will to move or by how much.
When I heard Ralph Norris speak yesterday I think he made quite an important point, that is, it was in the banks’ own interests to lower interest rates as much as possible for their customers. I think that was an important and quite encouraging point. I do not think we should entirely misinterpret the comments that the banks are making. I think all they are saying is that it is premature for them to give commitments when they do not know when and by how much the Reserve Bank will move.

CHAIR—I will make a number of comments and there will be some follow-up questions. Firstly, from what you are saying, in your view the cash rate situation for the banks has changed?

Mr Battellino—Yes.

CHAIR—If I understand correctly what you are saying, the banks said in the past 12 months that they needed to put up interest rates above Reserve Bank rates, but those reasons no longer exist?

Mr Battellino—Yes.

CHAIR—The Reserve Bank agrees that those conditions have changed and banks should find it easier to pass on the full amount of interest rate cuts. I take issue with your statement that it has not been possible for banks to increase their interest rate margins to the degree that they have been put up by the Reserve Bank. That is not possible in the context of trying to preserve record bank profits, which we have again seen this year. Over the past 10 years we have seen record bank profits. If the banks were increasing interest rates and not passing on interest rate cuts in order to maintain their profit margins I would agree with you. However, over the past 10 years banks have made extraordinary profits.

In hindsight, some of the issues relating to their investments have not delivered the sorts of outcomes that they want, but that should not be passed on to consumers. The banks themselves should take some hit in relation to these issues. Putting it bluntly, it is more difficult for someone struggling with a mortgage to absorb interest rate rises or not get the benefit of interest rate cuts than it would be for banks that made profits of $4.8 billion this year and that have made record profits for the past 10 years.

Mr Battellino—I do not want to be forced into a position of being a defender of the banks, but I wish to make a couple of points. Over the past year banks interest margins have, if anything, contracted a bit further. Over the past 15 years they have been coming down a lot, and in the past year they have come down a bit further. So it is not as though the banks have widened their margins over the past year; their margins have contracted, and they have continued to contract.

CHAIR—But their profit levels have continued to increase?

Mr Battellino—Their profit levels have continued to increase because the amount of activity that borrowers and lenders are undertaking is also continuing to rise quite quickly.

CHAIR—I do not think you will find a lot of sympathy in mortgage land where people are doing it tough. They look at their mortgage payments and compare them with the salaries that
are being earned by bank CEOs and the profits that are being made by banks. I am suggesting that banks have the capacity to absorb some of that within their profit levels. Obviously the Reserve Bank is not a commercial bank that is making these decisions, but surely it is something that would have been possible? I refer to your earlier comment that it was not possible for that to happen over the past 12 months.

Mr Battellino—There can be all sorts of unintended consequences. If, for example, banks had not passed on additional costs, their profits would have fallen quite sharply. I think that is the case. The question then would have been: How would that have affected their behaviour in the markets—their ability to fund themselves? In the current uncertain environment, if the banks had sharply lower profits, their cost of funds would have risen much further and they could not have gone to overseas markets to fund themselves. Their cost of funds would have gone up.

It is not clear that, in the end, interest rates to borrowers would have been any lower. Basically, it could be that the cost of funds to the banks was just pushed up. There are some advantages to the community in having stable and profitable banks. It means that they can undertake a good degree of financial intermediation. I think we have to be careful when we say that we want to squeeze down on bank profits because there could be unintended consequences for borrowers.

CHAIR—Instead of looking directly at the banks let us look at the role that has been played by the Reserve Bank. Monetary policy is very much a blunt instrument. I have spoken a bit about the Central Coast. In making the decisions that you have made over the past three years and when looking at the economy as a whole, have you taken into account the effect that interest rate rises have had on families in outer metropolitan areas? In hindsight has that been given due consideration? Do you think that the Reserve Bank has gone a bit too far with its increases in interest rates, in particular, over the past 12 months?

Mr Battellino—The short answers to those questions are, first, yes, we have taken all that into account, and, second, no, we have not gone too far. Let us go back to a bit of history. We have to go back to 2007 when I think it is very clear that inflationary pressures picked up quite noticeably under the influence of rising resource costs and very strong demand. In addition to costs going up, businesses widened their margins. In 2007 we had a very pronounced increase in inflationary pressures. If that had continued there was a danger of it causing severe difficulties for the economy in the years ahead.

The bank took the view that, consistent with the agreement it had with the government, it had to take measures to stop inflation going higher. That is why we have been tightening monetary policy. The aim of that was to slow down demand, make it harder for businesses to widen their margins, and force businesses to again start cutting their margins. That has happened; it has been very successful. We asked households to cut back on their spending, we gave them an inducement to do that by raising interest rates, and I think it is fair to say that households responded very favourably. They have been prudent and very responsible in cutting back on their spending. That is why the Reserve Bank now finds itself in a position where it is able to think about cutting interest rates. Broadly speaking, I think things have worked out in the way that we intended them to work out.
CHAIR—We fully understand the danger that inflation plays in household incomes and what people can spend. Clearly, increasing grocery prices is something that is impacting on everyone and inflation is a big driver of that. But I am referring to the inconsistent effect that a uniform interest rate rise has had on the Central Coast. I keep harping about the Central Coast as that is my electorate. It has one of the poorest household incomes in Australia.

At the moment 30 per cent of people who live on the Central Coast commute to Sydney and spend 25 per cent of their income on petrol or on tickets to travel by train. We have high unemployment and a high mortgage base. Over the past 12 months house prices have fallen and people have been caught with mortgages that in some cases exceed the value of the houses that they are paying off. You could understand that, because of what is happening on the Central Coast, people do not see the subtleties of the Reserve Bank’s strategy because it is affecting them disproportionately to people in other areas.

Mr Battellino—It is always the case that not all parts of the economy are affected uniformly. Obviously, some parts of the economy are always stronger than others. Over the past year or two people have spoken a lot about the two-speed economy. The truth is that, at the moment, the differences in economic performance between states are not unusually large. We have been very conscious that various parts of the country have been suffering more than others. You spoke about the Central Coast but the real problem areas are more in south-west Sydney.

If you look at those areas you will see that the problems there are even more severe, for example, arrears on loans and housing stress. That is a real pocket of stress. If you start to look at the reasons for that you find that it all goes back to the 2003-04 housing boom. People in those areas bought towards the peak of the market. A disproportionate amount of financial activity took place towards the peak of the housing market. It is not surprising, therefore, that those areas have been the most affected by rising interest rates. We look at all those things and, at the end of the day, we have to make a decision that is good for the country as a whole.

Overall, right across Sydney and Australia, although the level of arrears has risen—as I said earlier in some suburbs in particular it has been very severe—by historical standards it is still lower than in other periods in the past. There is a lot of talk about financial stress but, so far as we can tell when we do the measurements, I think at the moment fewer than 25,000 households across the whole of Australia are 90 days or more in arrears on their housing loans. For those 25,000 people that is a lot of pain and a lot of stress, but for the country as a whole that is a very low number.

CHAIR—I do not want to get into an argument about the measures you go through to look at that, but you can also look at the proportion that people are paying off their incomes on interest payments and mortgage repayments. Just because families have tightened their belts to ensure that they are meeting their obligations does not mean they are not doing it tough. That falls outside the sorts of figures that you are looking at. I want to move on to competition and to some of the comments that you made. I agree that competition is the key to putting downward pressure on interest rates. You referred to making it easier for new entrants to come into the market and you said that competition was the driver for those issues.

However, we are concerned that, over the past 12 months, we have seen the disappearance of the non-banking sector. Because of the cyclical nature of this industry there is a danger that it
will not be able to reappear. It is one thing for economists to say that, in the longer term or the medium term, the market will address those issues, but these organisations might not be around. A matter of some concern is that the big banks are looking at over 90 per cent of all new loans that are being taken out at the moment.

Mr Battellino—I think the market shows remarkable resilience. I am very confident that when conditions settle people will be straight back in there. When there is a buck to be made people respond very quickly. We are confident that that market will reappear when the financial conditions are appropriate. If you look at the slightly longer run period, from around 2000 to the present, you see that the share of the major banks in lending has fallen by about 10 percentage points. They have come down from 75 per cent to about 65 per cent of loans outstanding.

Mr MARLES—When was that—from when to when?

Mr Battellino—I do not have the figures off the top my head, but from around 2000 to about a year ago they went down from about 75 per cent to about 65 per cent. That share had been taken up by regional banks and by securitisers. In the past year a small proportion of that downward trend in the major banks has been reversed, so they have come back up again. If you look at a graph for the past year it shows that the banks have increased their market share. If you put it into an historical perspective you find that it is a very minor correction. If the major banks tried to abuse their position and cut back on competition I think they would find that the others would make up market share again very quickly. It is a competitive market and it does not take much for new entrants to come in.

CHAIR—Right now you could make out a case that the banks are doing pretty well. They have seen a reduction in the level of competition from non-banks; they have seen an increase in their market share; and they continue to see record profits. In the absence of ways to improve competition, they are doing disproportionately well in pretty tough economic times in their access to credit globally.

Mr Battellino—As I said, they are favoured at the moment because they have the stable funding base coming from deposits and that allows them to compete against securitisers. Because of the way that market interest rates have fallen, you will find that securitisers will be back in business quite quickly.

CHAIR—Earlier you made some comment about proposals such as Aussie Mac, increasing securitisation, and so forth. Obviously, the committee has to consider the submissions that have been made. On the face of it I understand what you are saying about that. Alternatives to that would be looking at the availability of RBA repurchase agreements that provide short-term liquidity, depending on how those agreements were reached with the non-banking sector?

Mr Battellino—Yes. There seems to be some misunderstanding about the Reserve Bank’s market operations. I think this is one of the most misunderstood things in the financial sector. The Reserve Bank is totally open on the securities that it takes on its repos operations. We are fully prepared to accept whatever amount of mortgage-backed securities anybody is willing to bring to us. The truth is, nobody wants to bring them to us. We have a repo book of about $50 billion. Less than $2 billion of that are mortgage-backed securities. It is not because we do not want to buy them; it is because nobody has ever brought any to us.
We are prepared to buy those securities on the same basis as any other security in relation to price. It is financially attractive for somebody to do that if he or she wanted to. I do not know why they do not bring that in. Some non-banks have said that they do not have access to the Reserve Bank, which is nonsense. The Reserve Bank deals with anybody in the market. In that regard we are the most liberal central bank in the world. Anybody who has some securities in the market and who can settle in the securities system can deal with the Reserve Bank.

CHAIR—That is an obvious solution to liquidity problems that non-banks have been telling us about rather than going down the government-backed securitisation route?

Mr Battellino—Yes. The truth is that these people are not bringing the securities in to us because the Reserve Bank’s operations are designed to provide short-term liquidity to financial intermediaries. These people do not want short-term liquidity; these people want long-term funding, and the Reserve Bank is not in a position to provide that. I think that is the source of the problem. But it is wrong to say that it is because the Reserve Bank does not want to do it.

Mr DUTTON—Deputy Governor, I want to ask you for a more contemporary view of your outlook over the next 12 months. I know that your colleague has reported on, and other comments have been made by board members about, the current price of money for banks. Referring to the position over the next 12 months some analysts say that there is still a lot of exposure to financial institutions in the United States of America that we do not yet know about and the impact that it will have in Australia. As I understand it, the United Kingdom is in a dire situation. What do the next 12 months hold for us in Australia?

Mr Battellino—On a global scale I think we are fortunate that things have worked out the way that they have in Australia. Our banks have been much less affected by the turmoil in the global markets. Their exposure to these United States products that have caused all these problems is very limited. I think we are in very good shape. You have seen that in the profit results that the banks have announced.

Referring to what is happening overseas, my feeling is that the worst is behind us. The write-offs that banks in America and Europe are making have lessened in recent times. No doubt there is more to come, but my feeling is that the big losses are now behind us. An encouraging thing is that banks in North America and Europe have been able to raise so much capital. Virtually every dollar they have written off they have been able to replace by new capital. I think it is very encouraging that that capital has been so readily available.

Mr DUTTON—Are you worried about any credit ratings that are taking place at the moment, either in the domestic market or in small businesses in particular in our country?

Mr Battellino—We are watching credit very closely because I think credit is a very important indicator. In recent months we have seen growth in credit slow very sharply. I think we ran through that in our statement. A couple of things are happening there. First, at the big end of town last year there was a lot of borrowing. Naturally, the banks have become much more cautious about that. You will find that lending to the more highly leveraged part of the Australian business sector has been cut back a lot. I think that really was at the initiative of the banks. I think it is fair to say that the banks have probably cut back a lot on lending to the commercial property sector because they believe that there could be some problems there.
Our understanding is that when it comes to smaller and medium businesses the banks are still very confident about that sector. If anything, they would like to expand their activities in that area. However, business people in that sector have become much more cautious because economic circumstances are somewhat uncertain, so they are delaying taking on new debts. I do not think the slowdown in that sector is driven by the banks; I think that is demand driven and it is coming from the business sector.

Mr DUTTON—I want to touch on the inflation issues to which you referred in your earlier comments and the maturing view of the RBA in relation to the next movement. If inflation stays where it is this quarter or the next quarter, will that spark a change of view within the bank? Is your suggestion of a lowering, or the possibility of a lowering, at the next meeting subject to inflation or the consumer price index coming off for that quarter?

Mr Battellino—Our view is that in the very near term, as we said in our statement, inflation could rise further. That is not unusual because in some ways inflation lags the cycle. Basically, it starts off with demand and, over time, it builds into inflation. We cannot wait to see a fall in inflation before we start cutting rates because by then it would be too late. The bank’s policy has always been to be pre-emptive in its decisions. We try to be pre-emptive when we start tightening and we are also pre-emptive when it comes to easing. As I said, we are looking for a reduction in demand. We have seen that happen. As I said, the household sectors have responded favourably by cutting back on spending and increasing their savings and that has made it a lot easier for the Reserve Bank to respond on interest rates.

Mr DUTTON—You made some comments earlier about your view of inflation in 2007. What were the published forecasts, or what was your advice on inflation, say, in the second half of the 2007 calendar year? What were your published forecasts on inflation then?

Mr Battellino—I do not have those forecasts with me but—

Mr DUTTON—Is it still within the bandwidth?

Mr Battellino—No, we were heading outside the bandwidth. Basically, we were always heading up. The inflation situation became quite confused. You might remember that we had two low quarters in a row of unusually low inflation. Inflation had been picking up and then, all of a sudden, we had two very low quarters of inflation. Looking back I would have to say that they were probably a false reading because inflation picked up again after that. As I said, I do not have the forecasts here that we made at that time.

Mr DUTTON—I do not understand the benefit of the figures in front of me either, but my recollection of your position in the last quarter of the 2007 calendar year is that it was still within the bandwidth and you were happy with that, which is in contrast to the comments you made a few moments ago.

Mr Battellino—Over the forecast period we always had inflation coming back to the band because, by definition, it has to. If we are not forecasting that it is back in the band we are saying that we have the wrong monetary policy. You will see that our inflation forecast and the inflation forecast of every central bank around the world is that, at the end of the forecast period, inflation will be back in the band. That has to happen.
Mr DUTTON—Some of the other central banks around the world have looked through their inflationary figures. Let us take Israel, for arguments sake. It did not have the same bullish movements that you had in interest rates, even though its inflation rate might be a bit higher than ours. Obviously it took into account energy costs and costs of living pressures. Because of where inflation is at present does the RBA have a change of position? Does it wish to take a stance that is similar to some of those other central bank authorities?

Mr Battellino—No, not at all. We set out to bring inflation back to the target range and we are confident that we are on that path. That is why we are in a position to respond to our interest rates. Most countries have now had a rise in inflation. If you look across the developed world you will see that Australia has had a bigger rise than other countries, which is not surprising because our economy has been stronger. We could not stand back, watch that happen and let the situation compound. That is why we had to respond more aggressively than other central banks. But it is still the case that over the past year or so our inflation rate has risen by more, and to a higher level, than comparable central banks. That is really the reason why our interest rates have moved differently from other central banks.

Mr DUTTON—Going back to the issue of bank profitability, do you know what proportion of a bank’s profits comes from its margins on, say, home loans or business overdrafts? Is there a breakdown of that or an industry norm that you are aware of?

Mr Battellino—No. We do not break down those figures. I do not think you could do that from publicly available data because you do not know how much a bank’s costs are for each product. We could do some estimates of the overall interest income that banks made from different financial products, but that would not be an indication of profits because we do not know what their costs in providing various services are.

Mr DUTTON—It seems to me that the comments a number of people have made relating to banks’ profits are difficult to establish. They might well be justified or they might not. Without a better understanding—which is what I thought you might have—of what these movements mean to the banks, it is difficult to establish.

Mr Battellino—we look, for example, at the overall interest margins that the banks are charging on housing loans, or at the margins banks are charging on business loans. When we look at those we see that they are in line with international standards. Basically, our banks are charging, on average, around 100 points above the bank bill yield for a housing loan. Similar banks that have similar mortgage markets to ours do the same thing overseas. Nothing unusual is happening here in that regard.

Mr DUTTON—Let us say, for arguments sake, that you moved rates down by 25 basis points at the next meeting. What would be the consequences if banks did not follow? Let us say that at the meeting after that rates came down by another quarter and banks again did not follow. What would be the consequences of that?

Mr Battellino—The consequences of that would be—
Mr DUTTON—Their negative impact on households and business would be obvious and we would all be aware of and sympathetic to that impact. However, what does that mean to you as a bank?

Mr Battellino—Let me start with the commercial banks. If the banks went down that route I think they would quickly find that the securitisers would be back in business. As the Reserve Bank is cutting the cash rate the cost of funds to securitisers is falling very quickly. They would be undercutting the banks. The competitive pressures would stop banks from behaving like that. At the end of the day the Reserve Bank takes into account all the moves by the banks in setting its rates—in determining how to set the cash rate. In the past year we took into account the fact that the banks make independent adjustments in their housing rates when we set the cash rate. On the way down, when we are setting the cash rate we similarly take into account how the banks are responding. At the end of the day the important thing for us is not the cash rate but the level of interest rates that borrowers are facing. We usually operate on the cash rate because that is a proxy for general trends in the markets. If, for some reason, that was not the case, we would respond in the way in which we adjusted the cash rate.

Mr DUTTON—In the absence of those non-banking institutions—the ones that would otherwise securitise—if the market does not improve for them over the next 12 months, they could not package up and that continued to be the case, and essentially they were absent from the market, at least in any sizeable way, how would you change the advice that you have just given?

Mr Battellino—I do not think that is a reasonable assumption. Basically, at the moment the average mortgage interest rate, after discounting, is nine per cent—the indicator rates are around 9.6 per cent or 9.7 per cent—the banks are offering 60 or 70 points of discount and a new borrower would get around nine per cent. If you look at the cost of securitisation at the moment you would find that it is right on nine per cent. Typically, if you go back through time, you will also find that the cost of securitisation was around 50 or 60 points below the mortgage rate. Basically, that was the profit margin for the securitisers. From the middle of last year and into the first part of this year we found that the cost of securitisation rose well above the mortgage rate. Effectively, securitisers could not raise money and lend it at a profit, so they had to stop.

Mr DUTTON—Yes.

Mr Battellino—In recent times the cost has fallen back to the mortgage rate. At the moment they are at break-even. Any further reduction in their cost of funds in the market, which would follow from the Reserve Bank cutting rates, would start to make them profitable. All the apparatus that led to the previous boom in securitisation is still there, and it would reappear very quickly if those margins widened out.

Mr DUTTON—What is the difference in the cost of funding to an organisation with a credit rating such as Westpac, for arguments sake, to, say, St George, or Aussie Home Loans? What would a change to a credit rating lower on the scale mean to their cost of funding?

Mr Battellino—The important thing there, because of the way in which mortgage-backed securities are structured, is that basically it does not matter whether they are coming from Westpac, Aussie Home Loans, RAMS, or whatever. Basically, they are all structured and are
similar products. Underneath they are basically the same mortgages, they are structured as triple-A products, and they all get the same interest rate in the market.

Mr DUTTON—If I was Westpac and I was going into the money market to raise capital, I would be raising capital at a cheaper price than St George, for arguments sake.

Mr Battellino—Oh yes. Are you saying that the bank raises its own bonds rather than mortgage-backed securities?

Mr DUTTON—Yes.

Mr Battellino—I do not have those figures with me to show how much one notch on a credit rating is worth. Phil, do you know what it would be?

Dr Lowe—I think roughly below 10 basis points. It would depend upon the size of the issue and the term for which they were doing it. At the short end basically they would pay the same as the larger banks, and as you go up the term structure they would pay a bit more.

Mr DUTTON—Right.

Mr MARLES—Deputy Governor, the electorate from which I come from is based on Geelong. It is obvious that people in Geelong are very anxious about housing costs and the cost of repaying a mortgage. There is an anxiety about the level of competitiveness amongst the banks. That is really what I would like to question you on—an issue about which my other colleagues have questioned you. I pick up on a question that Mr Dutton asked, which I thought was a good one. I would like to follow that line about whether there is any information, or at least the ability to get information, about the breakdown of bank profits and the contribution that margins are making to those profits. Is there any ability to look at or to estimate the relative contribution to bank profits of margins verses fees, and has that been done?

Mr Battellino—Oh yes. We can definitely do that. From the accounts that the banks publish we know what the interest income is and what the non-interest income is. That is definitely available.

Mr MARLES—Has that research been done?

Mr Battellino—Oh yes, and the banks have published that in the past. Basically, both of those have been growing reasonably strongly and that is because we are seeing very strong demand for credit. The number of loans keeps rising quite quickly and the average spread that the banks are charging on that is coming down. Similarly on fees, you will remember if you go back 10 years or a bit more, there was a lot of concern that the banks were increasing fees in response to cuts in interest margins. In recent years the growth in fee income has also slowed back to quite normal levels. Basically, unit fees across a whole range of products have again been falling.

Mr MARLES—Earlier you made international comparisons between the margin rates. I think you said that they compared favourably to banks overseas?

Mr Battellino—Yes.
Mr MARLES—Do you say the same thing about fees at the moment?

Mr Battellino—I think so. We have looked at that a few times. It is hard to get comparable data. So far as we can tell, there is no evidence about our fees here. People find particular fees on particular products that look out of line, and I have no doubt that there are some of those. But across the broad spectrum of fee income I think those things are broadly okay. When people look at our banks I think they find in the mortgages, for example, that by international standards we have relatively high exit fees on mortgages but we have very low entry fees. That is just the way in which banks price things here. There are advantages and disadvantages in both systems.

Mr MARLES—Referring to non-bank lenders, you said earlier in your evidence that, putting aside the past six months, since 2000 the relative market share of non-bank lenders basically has increased?

Mr Battellino—Yes.

Mr MARLES—Somewhere in your submission you made the point that the margins that the banks were charging had also decreased over that same period. The question I then ask is: Do you think that non-bank lenders over that period played a positive role in putting competitiveness into the home-lending market?

Mr Battellino—Definitely, yes. Through that period they have been able to leverage off that. The cost of funds in international markets was very low and global interest rates were extraordinarily low. They were able to leverage off that and package up products to sell to Australian households. There was an intense form of competition.

Mr MARLES—I might have misheard you or misunderstood you, but it seems to me that you are saying that the drop off of non-bank lenders in the past six months has not had an adverse impact on competition in the home lending market, or have I got that wrong?

Mr Battellino—We have seen the major banks increase their market share—you might say that that is a sign of a lack of competition—but have we seen the banks widen their margins on housing products? I do not think there is anything significant there. Broadly speaking, I think that they raise their interest rates in line with their cost of funds. I do not think you could say that there has been a marked reduction in competition at the moment, no.

Mr MARLES—I guess that is why I am finding it hard to reconcile. On the one hand you are painting a picture that shows that non-bank lenders have made a very positive contribution to competition as they have increased their market share but, on the other hand, you are not then saying that when the market share has been reduced there has been a corresponding lack of competition.

Mr Battellino—I think the non-banks drive down the margins. We went through a period where the margins were compressed. I have no doubt that competition from non-banks was an important source of margin compression. In recent times margins have not been going down as much. Over the past year there has been a slight reduction in bank interest margins but we have not seen the downward pressure that we saw in earlier periods. Is that because margins have reached some equilibrium and they cannot really go below that, or is it because non-banks have
disappeared and that has allowed that to happen? I do not know. Our general view 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.

**Mr MARLES**—Are you at least then painting a picture of risk? If the current depressed state of the non-bank lending share of the market continues there is a risk of reducing competition, in an ongoing sense, within the home loan market?

**Mr Battellino**—Yes, but it is something that is self-equilibrating. If the banks take advantage of that and widen their margins it immediately opens up the avenue for the non-banks to come back.

**Mr MARLES**—You commented earlier that you thought the last six months was a slight blip. I do not want to put words into your mouth, but I think ‘a relatively small correction’ might have been the more accurate phrase that you used.

**Mr Battellino**—Yes.

**Mr MARLES**—I am quoting figures from the Mortgage and Finance Association of Australia, which I put on the table. It is saying that, over the past 12 months, the bank sector market share increase has gone from roughly 79.5 per cent to 88.5 per cent. Do those figures sound right to you?

**Mr Battellino**—Yes.

**Mr MARLES**—That paints a picture that shows that the non-bank lending share of the market has almost halved in the past 12 months. That is more than a small correction, is it not?

**Mr Battellino**—They are talking there about the flow of loan approvals. That has adjusted more quickly. In the past year or so it has been very difficult for any non-bank lender to undertake securitisation, which is not surprising. The important question is: Will they come back once conditions settle? For the government the question is: Is a structural change happening in the markets here that the government needs to address, or is it just the normal workings of markets and at some point it is favourable to fund yourself in money markets and at other times it is favourable to fund yourself in deposits?

**Mr MARLES**—Sure.

**Mr Battellino**—If those cycles even out I think it would be wrong for the government to try to intervene to smooth out all those cycles between competitors.

**Mr MARLES**—You raised one question that presents itself to the government. Another question that I think the government has a right to get its head around is whether or not the banks are taking advantage of this situation.

**Mr Battellino**—Sure.

**Mr MARLES**—That is really where this line of questioning is heading.
Mr Battellino—Yes. At this stage I do not think there is any evidence of that.

Mr MARLES—All right. I wanted to ask you about switching because that is another important part of competition. In all the commentary about the subprime crisis in the United States and securitisation in Australia, one of the points that has been made is that the quality of Australian mortgages is good relative to the United States.

Mr Battellino—Yes.

Mr MARLES—It still seems as though there has been an impact on the desire to invest in Australian mortgages. Do you wish to comment on that at all?

Mr Battellino—Yes. Unfortunately, the problems that the United States has had in its mortgage market have infected the whole world. There has been a negative contagion that has affected everything. No doubt there are problems in the United States mortgage market and that has affected mortgage markets everywhere. In that respect investors have behaved irrationally. Australian mortgage securities remain extremely safe. Investors have not lost any money on those securities, yet they are very reluctant to buy them. That is just a fact of market psychology. Basically, investors go through a phase of euphoria and they go through a phase of fear, and that is what we are in at the moment.

Mr MARLES—Let me finish by asking a question about switching. Referring to the question of competition, there is a sense amongst my constituents in Geelong that competition is reduced by virtue of being able to make an ongoing choice. There is a perception that you are locked into a product for a long period. You made the point in your submission that that dulls competition. Do you have any suggestions about how that might be improved?

Mr Battellino—Phil, you have been working a lot on this. Would you like to respond?

Dr Lowe—All the consumer research shows that people find it quite difficult to switch bank accounts, both transaction accounts and mortgage accounts, and you can understand why. A lot of hassle factors are involved in doing that. An initiative is under way in relation to the transaction level account. By November this year you will be able to go to your bank and ask it to give you a list of all direct credits and all direct debits to that account. You will then be able to take that list to the new institution and say, ‘Could you please help me redirect all these direct credits and debits?’ Research has identified that issue—the difficulty of redirecting all these automatic linkages.

I think that difficulty has reduced competition at the margin, so there is this initiative, which I think will make a substantial difference. It will make it easier for people. The existing institution and the new institution will have agreed, as a set of protocols, to make it easier for people to move. There is an underlying difficulty of changing transaction accounts. I think that will help switch institutions.

Mr MARLES—Do you think that the practice of deterring establishment fees and then, in a sense, from the bank’s point of view, recouping that by a higher fee structure at the back end of the loan, makes it more difficult to switch?
Dr Lowe—As Ric said a moment ago, on international standards we have quite low loan establishment fees and we have relatively high exit fees. If you reduced the exit fees I do not think it would be unreasonable to assume that the entrance fees would rise. Ultimately, banks have to cover the cost of establishing the loan, doing the credit assessment at origination and doing the legal work.

In Australia they say to the borrower, ‘At the beginning of the loan we will not charge you for those costs, but if you leave us within a short period we will recoup those costs.’ If for some reason they were not able to do that, I do not think it is unreasonable that they would increase the loan establishment fees, which you would then have to pay if you went to the new borrower. I do not think that there is an issue here because you will either pay it at the beginning or you will pay it at the end. If you switch and you cannot pay it at the end, you will pay it at the beginning for the new lender. I do not really see that as a major issue. If you take the sum of the loan establishment fees and the exit fees, you find that, broadly speaking, they are in line with what we see overseas.

Mr MARLES—If you weight the fees at the back end presumably it creates a disincentive. Perhaps the point is to create a disincentive to get out of a loan.

Dr Lowe—If you had lower exit fees I think you would have higher loan establishment fees.

Mr MARLES—Sure.

Dr Lowe—That would create a disincentive to switch as well, because you might not pay anything at the end; however, when you went to the new lender you would have to pay the $1,000 that you would previously have paid to the old lender. I do not think it would change the fundamental incentives that consumers face when switching loans, unless you thought that we could have a regime in which we had lower exit fees, and no increase in loan establishment fees. I do not think that is the reality of the marketplace.

Mr MARLES—No that is something that the banks would face. Is it more transparent and fairer to have an even spread of these throughout the entirety of the loan? Would that help switching or would it help to promote switching?

Dr Lowe—No, I do not think it would. I think that the banks or the lenders would increase the loan establishment fees, as you see in the United Kingdom. They have quite high loan establishment fees and quite low exit fees.

CHAIR—I have two more questions just to finish off. I apologise for keeping you here a little longer than we expected. I want to follow on what Richard Marles said. BankWest, in its submission, made a point about deferred establishment fees. If there are upfront fees there is competitive pressure when people are thinking about taking out a loan, whereas if it is deferred and you are out looking for a loan it is not something that is foremost in your mind because it is not the cost that you would be going into when taking out that loan.
Therefore, there is pressure on you when you want to switch rather than getting into the market itself. BankWest’s argument was that if establishment fees were upfront and were not able to be deferred, there would be a greater emphasis on competitiveness in relation to those fees. However, that would be absent when they were deferred. Would you like to make any comments? Is there anything additional to what you have just said to Richard Marles about that? Is that a possible scenario that could exist?

Dr Lowe—It is certainly possible, but as a borrower, when you are taking out a new loan, presumably you are looking at the whole set of terms and conditions that apply to that loan. You might be right: the loan establishment fee might attract more attention than the loan exit fee. But, as a borrower, one has a responsibility to look at the whole structure of the product that is being offered.

CHAIR—That might be so. However, when most people in the ordinary world are looking at getting a loan they want to know how much it will cost them to get into a house, and that is it. When they are looking at competition when they want to switch that is when they think about deferred establishment fees. BankWest’s argument was that, if you make consumers think about the upfront costs immediately, you are starting to put some competitive pressure on that aspect.

Dr Lowe—I think that argument has some merit. The other observation that I would make here is that if you stay with a lender for a reasonable number of years you do not pay the establishment fee.

CHAIR—Yes, that is right.

Dr Lowe—If we had higher loan establishment fees every borrower would pay those at origination. In the current regime you pay only a modest loan establishment fee. If you stay with the bank you do not get charged any extra. In a model in which you have higher loan establishment fees, every borrower would pay those, and obviously not everyone would be happy with that.

Mr Battellino—It is also worth noting that a lot of refinancing goes on. It is not as though people are locked into their loans. Twenty-five per cent to 30 per cent of loan approvals are refinancings and 10 per cent of all loans outstanding are refinanced every year. That is a big number. A lot of switching is going on. When you look at the range of bank interest rates you find that they are all very concentrated around a very narrow range. That is because of the threat of a customer moving.

Mr DUTTON—Following on the comments made by my colleagues and the Assistant Governor, for arguments sake, over the next five-year period, how do you propose non-bankers will regain their market share?

Mr Battellino—in the mortgage market?

Mr DUTTON—Yes. How would they regain the share that they have lost over the last period and presumably over the next shorter period? How will they be regaining market share?
Mr Battellino—There are two issues there. First, they do not necessarily have to regain market share. Just a threat of them gaining their market share is what you need to keep competition going. That market share will reappear if conditions in debt markets become favourable to securitisation. In some ways you could say that the five years up to last year were a very unusual period. Risk in financial markets was being rated or priced at very low levels. Everybody was saying, ‘This risk is too underpriced.’

Maybe that was an aberration. Maybe they should not aspire to go back there because that was a bubble and they should not have been there. Maybe those conditions will reappear. If those conditions reappear then, no doubt, securitisations will take advantage of it. I do not think we should necessarily set that very unusual period as being some sort of benchmark. The important thing is that there is the threat of competition from new players. Some new financial interest might come up. Some person might find a new way to fund mortgages. The important thing is to keep all those options open, and that is what keeps the competition going.

CHAIR—Thank you for your attendance here today; it is greatly appreciated. You will be given a copy of the transcript of your evidence so that you can make any corrections to it. Thank you again for your attendance here today.

Mr Battellino—Thank you. It has been a pleasure.

Proceedings suspended from 10.07 am to 10.18 am
JOHNSON, Mr Brian, Bank Analyst, JP Morgan

CHAIR—Welcome. Although the committee does not require you to give evidence on oath I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the respective houses. You have not made a submission. We have not asked you for that; we have asked you here today to talk to you about your expertise in this area. Would you like to make an opening statement to this inquiry?

Mr Johnson—Yes, certainly. With regard to competition, the ability of banks and non-banks to compete comes down to the operating environment in which they are functioning. We consistently hear statements that the global crunch is over, but if we take into account a number of indicators we find that it might not be so. For example, if we were to take out the expectation of interest rate cuts, the cash 90-day bank bill rate in Australia is still very steep, which is very adverse. The cost of five-year money for banks is also very adverse. We are starting to see asset values fall, particularly in the commercial property segment, which is seen at the beginning of the loan loss cycle.

Globally, the great securitisation pass-the-parcel game is over, with securitised assets heading back onto bank balance sheets and requiring them to raise capital. To date many people thought that the Australian banks were immune from this because they do not have any subprime direct exposure, although it is interesting to note that ANZ and NAB probably had a bit more than they initially thought. The majority of the incremental funding of Australian banks comes from overseas—from the markets that are worst impacted. The other point I would like to make relates to this whole idea of competition. The products of most financial services are very generic in nature and are easy to replicate. That means that when you head into periods where the operating environment is favourable they all appear to compete very aggressively on their pricing, which is good.

At the end of the day what differentiates players are their underwriting standards. During boom times you will see a lot of easy credit available. When that is withdrawn it exaggerates the asset cycle. That is what has happened with the subprime cycle. In Australia there can be very little doubt that the household indebtedness is much higher than it has been in the past. We now see non-banks scaling back their operations—that certainly seems to be happening—and there is a risk that a whole lot of credit will be difficult to refinance. I make another general point about competition. Everyone tends to focus on and obsess about housing loans. Even though banks have been aggressively pricing up their housing loan rates, certainly in the variable arena, they have been competing very aggressively in the fixed rate space.

With regard to retail deposit rates, it is a great time to have cash. I think everyone tends to obsess about the housing rate but they do not think about what is happening with retail deposit rates. There has been a big swing towards fixed rate lending in this country where the margin is substantially lower. Apart from that, those are the comments that I wanted to make at the outset.

CHAIR—I wish to ask you a few questions and after that other committee members will ask you questions. Some of the submissions that we have received, in particular, from the non-banking sector, asked us to look at securitisation, for example, a Canadian model, or an Aussie
Mac version of a Fannie Mae-type situation. People want the federal government to play that role and to assume some of that risk. Do you have any comments to make about today’s proposals?

Mr Johnson—Yes, I do. Let us take, for example, the currency markets. What has been happening with the United States version of the Fannie Mae and Freddie Mac? There is a perception that we could reach a point where the government might even guarantee their debt. Whether or not that is real, periodically it has caused the United States dollar to weaken. The risk does not go away because it is being funded by the government. If you go back long enough you find that a long time ago this is why the government set up the Commonwealth Bank of Australia, and subsequently it was floated.

The markets will remain where they are. The idea of the taxpayer funding it does not mean that the risk disappears; it just ends up in a different place. Another point to note is the massive size of the potential funding requirement that we are talking about. Some organisations in the United States have had a deliberate strategy of facilitating easy credit for more troubled households. Aggregate debt is of the order of about $6 trillion, whereas the fed’s entire balance sheet is about $1 trillion.

The idea of the government guaranteeing those liabilities is not really effective. I would suggest—and you will certainly hear this from interested parties—that, at the end of the day, it comes down to the government providing the funding. The shareholders get the upside but the government does not. I cannot help thinking that that sounds a little flawed.

CHAIR—Historically, Fannie Mae and other initiatives were United States depression initiatives rather than twenty-first century initiatives. Is that your understanding?

Mr Johnson—Yes, very much so. It was all about kick-starting it. That having been said, it is important to note what easy credit markets have done in the housing market. It has gone from a system where you almost had to be a regulated bank to be able to do it, to the point where effectively anyone could buy mortgages through the mortgage brokers, so you could abrogate your distribution responsibility. The flipside to that is that you could fund it through the securitisation markets and keep a bit of a residual spread for not doing very much at all. Clearly, that model is not working at the moment, which is why we are seeing the non-banks shrinking or exiting in droves.

CHAIR—An alternative to short-term liquidity issues in the market is looking at an expanding or better use of RBA repurchase agreements. What is your view? Is it possible to make available that sort of credit?

Mr Johnson—It really comes down to an acceptable risk for the central bank to take. When you think about it, just because the central bank takes on board that risk, it does not mean that the risk disappears; it means that it is just in a different spot. Ultimately, that has a lot of implications for government budgets and currency movements. What happened in the United Kingdom when the government assumed responsibility for Northern Rock? Stirling was sold down on the back of that. A lot of currency values around the world come down to the quality of the underlying assets held by the central bank.
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. Since the start of the global credit crunch in July 2007 banks globally are willing to repurchase securities of lesser quality for longer. To date the Australian central bank has not acquiesced in that sense because we have not had that bigger problem.

CHAIR—In looking at this area there is another consideration for the government. It has been argued that as the global economy adjusts and credit markets globally adjust, non-banks will be able to come back in and potentially play the sort of role that they played 10 years ago. One of the balancing factors for the government must be whether there is the capacity for those organisations to survive and to reappear. I suppose that is why there is discussion about long-term securitisation options—the Aussie Mac—or short-term provisos for repurchase agreements. Can you comment on that?

Mr Johnson—Yes. Let us go back to the situation in the United States, which is somewhat different. What you had in the United States was the availability of very easy credit for those who were not geared up to borrow. It drove housing prices really high. It is admirable that everyone loves the fact that everyone in Australia can get a home loan. However, over the past 15 years the pool of housing mortgages in Australia has grown from about $100 billion to a figure of about $970 billion. In the same period the market value of all residential houses in Australia has gone from $990 billion up to about $3.4 trillion, which means that the leverage has gone from 11 per cent to 25 per cent.

My point is that for the past 15 years in Australia you have had a combination of either rallying bonds or, alternatively, steady bonds and shrinking debt spreads, shrinking equity risk premiums and rising gearing, which has driven asset values up to incredibly high values. There is a belief that we should protect the asset value at all cost. Perhaps asset values should fall. When we let housing growth continue to grow at this rate every month more and more debt is in the hands of households—and that is variable rate debt. In a world where we have a lot of inflation that creates more and more vulnerability.

CHAIR—I understand what you are saying but I am not sure those who have taken out mortgages and who have seen the value of their properties reduce—their mortgages are now worth more than their houses—would necessarily have a lot of sympathy for the position you just put.

Mr Johnson—What concerns me is the need to preserve the growth rate in credit. Perhaps we should have a long period in which credit growth slows dramatically. In fact, that is what we are starting to see.

CHAIR—I will ask one final question before I hand over to my colleagues. The Reserve Bank referred to competition. The government has looked at initiating being able to switch between loans. Submissions that we have received referred to going beyond those loans, being able to switch to better institutions for credit cards and for ordinary day-to-day transaction accounts, and looking at the difficulties that are there. Would that play an important role in driving competition? If it does, what would you suggest? How far should we go and what things should we be looking at?
Mr Johnson—One of the things that really helps banking profitability is apathy. At the end of the day banks borrow at a low rate and lend out at a higher rate. So far as switching costs and the ease of switching are concerned, it really is not all that difficult. It is just that people might not be aware of how easy it is. Periodically banks have come out with very aggressive campaigns to capture the switching clients, to the point where they help customers transfer all their business to them.

It is not as hard as people might think. Apathy is why you do not see as much switching. That having been said, the propensity to switch has increased dramatically in recent years. The life of a home loan is now down to about four years because a lot of people switch their home loans to another borrower so that they have more opportune rates. So far as that goes it comes down to an education process to make people aware. It is not a hard thing to do.

CHAIR—Would you acknowledge that that in itself puts competitive pressure on the margins of banks and non-banks?

Mr Johnson—There is no doubt about it at all. That is definitely the case.

CHAIR—If that is made easier, presumably more pressure would be placed on those institutions in a competitive market?

Mr Johnson—Let me give you a definite example of this. If you have ever looked at the banks that periodically had problems growing their housing loan books you would have found that they invested a small number of staff in what they call a loan retention unit. Their effective efficiency or their incremental growth from retaining home loans is probably five or six times higher than you would get from having someone out there trying to sell a new loan. I think the banks are very aware of customer retention and competition and they are acting accordingly.

Mr DUTTON—Brian, thank you for your time this morning. Would you give us an overview of where you see us over the next 12 months? You might have heard the evidence of the Reserve Bank this morning. I thought it was a little more bullish in its outlook over the next 12 months. Would that be your same take? Is there already an end to the exposure to debt and bad debt that we have seen from the ANZ and the NAB? How will the market play out over the next year?

Mr Johnson—There is no doubt that the situation is very volatile and it will change literally day to day. If you have a look at the most recent data points that are coming out you will find that Westpac and St George both said that there does not seem to be any escalation in the rate at which problem loans are emerging. Have a look at the Commonwealth Bank result which came out yesterday. Once again the rate of deterioration in its second half was much better than it was during the first half. For ANZ the rate at which bad loans is coming out seems to be very elevated and it will be worse in the second half than it was in the first half. There is a slightly different story in relation to the NAB. To date the NAB is saying that, at the operating level, everything is going really well. But it has had to write down some securitised asset values.

Perhaps the bigger issue is coming back to this whole idea of asset values generally. Going back to what I was saying before, this easy credit market has driven up asset values over an extended period. We have not seen a loan loss cycle for Australian banks since 1992. Basically, that means that the profit levels we have seen, up until the beginning of this year, were very high...
because there were no loan losses. As loan losses move up even slightly it has a big impact on the earnings. To date the level of loan losses is back to where you would have seen it before the 1992 asset quality prices. There is nothing particularly dramatic there, but we will have to wait to see where it goes from this point.

There is no doubt about the fact that rising interest rates globally have not all been passed on to business borrowers. I estimate that probably only 20 per cent of business borrowers have yet to see their business rate re-priced up for the higher cost of funds that banks bear. That means there is a massive pressure point out there going forward. The next data point I favour would be the capital expenditure intention data, which is out on 28 August. If that starts to turn down, which I suspect it will, that data point will show us that everything is slowing quite dramatically.

The other wildcard here is the global commodity cycle. If you have a look at that you will see that commodity prices are certainly heading down again. Australia has certainly been a big beneficiary of that, but we will have to wait and see what that will do to the economy. We might have a sustained downturn in commodity prices.

Mr DUTTON—I want to ask you about the retail market, with a particular focus on small business, their activities and their sourcing of capital at the moment. What is the experience there and how will that market play out over the next 12 months?

Mr Johnson—If we look at the provision of debt linking to this market we find that most smaller companies borrow at a rate above the 90-day bank bill rate for a three-year to five-year duration. As I was saying just a moment ago, not all this stuff is refinanced. Basically, higher interest rates mean that when people look at the validity of their model—whatever they want to invest in—it will stress it to the point where it comes down. I think that higher interest rates will reduce the demand.

On top of that, banks are being much more diligent in their underwriting standards than we have seen previously. I think the outlook is that growth will slow dramatically. It will be harder to get debt and debt will be more expensive. That means that, if you want to borrow, the business case to borrow will be somewhat tighter than it has been historically.

Mr DUTTON—The point that I wanted to make is what is the circuit breaker? When does confidence come back into the market?

Mr Johnson—Confidence will come back into the market when we hear every bank in the world simultaneously say, ‘We are so confident that we are running down our balance sheet liquidity.’ At the moment all banks around the world are running excess levels of liquidity because they are worried about counterparting risk. That will be the circuit breaker. When banks start to lend out that excess liquidity because they are so confident that the world will be better, the cost of debt will go down and everything will flow back the other way. Unfortunately, everyone likes to make these grand pronouncements that the global credit crunch is over. We have been hearing that now for over a year. Structurally, some of these imbalances in asset values are still washing through the system, so it could be here for quite a while.
Mr DUTTON—Going back to the retail market from the home lending side, when will companies, the non-bank lenders, be packaging loans back up again? When will there be a return to normalisation for people in that market?

Mr Johnson—With the securitisation of home loans—unfortunately, we only ever realise these things in retrospect—it becomes apparent what made securitisation markets work. Globally, banks could provide very big liquidity facilities, and they are not alone. It is a promise that, if you need liquidity, they will give it to you. Globally, the banks were providing big liquidity facilities to companies to invest in these securities, but they did not have to put capital away for that. In the new capital advocacy world of Basel II that would be somewhat harder to do. Securitisation will come back, but I do not think it will ever come back at the rate at which we used to see it in June 2007. 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.

Mr DUTTON—I wish to ask a related question about the Australian economy over the next 12 months. What is your outlook on China and resource prices? What impact will that have in Australia over the next couple of years?

Mr Johnson—For a start, I do not pretend to be an economist, so this is very much a personal view. Retail consumption for the whole of the United States last year was about $9 trillion. If you add together all of China and India it would probably be about $1.5 trillion. At the moment people are suddenly realising that as the United States slows down it is not just bad news for the United States—it is bad news for the world. Basically, that is where everything is sold. That will have tremendous ramifications and we are starting to see that flow through the world.

China is a story about building capacity to supply the United States and consumers around the world. There is no doubt that the next level will involve building up domestic demand in places like China and India. However, it is a matter of whether that can replace fast enough the slowdown that we are seeing in the United States. We are at an unusual point where the capital expenditure cycle has probably inflated commodity prices. Commodity prices are starting to unwind and the currency trades associated with that are also unwinding.

Mr DUTTON—Thank you.

Mr MARLES—I want to focus on the competitive aspects of the banking verses the non-banking lending market. I think you addressed this issue in your opening statement, but I might not have fully got my head around it. It seems to me that you said two things. First, will the rates of securitisation ever return to the levels of 2007?

Mr Johnson—I am saying that I do not think the pricing can return to where it was.

Mr MARLES—Okay. In your opening statement you referred to the pass-the-parcel phenomenon. Have we seen the end of that?

Mr Johnson—Correct. Let me explain what I mean by that. A lot of these asset-backed securities—CDOs and CLOs—all seem to comprise three letters and have an ‘s’ on the end. These products were created. You took a loan or a debt risk and you then sliced and diced it to the point where one little piece had the first loss, which was probably more like an equity risk.
rather than a loan risk. You then packaged those up and they all aggregated into one product. The very best return you would ever get out of that was a great rate of return on a debt security. That is great when asset values are rising, but when asset values are falling that becomes equity. The game of packaging up these things, which creates demand for the asset and drives up the asset values, is now reversing sharply.

Mr MARLES—Does that not mean that those two phenomena work against the non-bank lenders being in the market?

Mr Johnson—Much more so. Non-banks have a disadvantage in three ways. As a rule they generally use external distribution, which means that they pay out broker commission rates to originate assets. They do not have retail deposits and they do not have strong ratings in their own right, which means that when they go to securitise, the quality of the credit wrap they buy is a big driver in the value they pay, and that cost has gone up. They are being squeezed on every side.

Mr MARLES—Perhaps the way to put it is: others who have given evidence have talked about this being a cyclical thing and that the non-bank lenders will come back once this part of the cycle has washed through. However, when I listen to you, you seem to be describing a greater degree of permanency in the situation. If that is right what are the long-term implications of competition within the lending market?

Mr Johnson—in my view it is not that things will not get better; it is just that when they get better they will not be as good as they have been.

Mr MARLES—As they were?

Mr Johnson—Yes. I keep going back to what happened generally in the world between 1996 and 2001. We had a massive rally in the bond rate, or the risk-free rate. That meant that investors needed a lower rate of return, and that drove up asset values. When the 10-year bond rate in Australia stabilised in about 2001 everyone thought there was no risk, so debt spreads contracted, equity risk premiums contracted, and gearing levels in the corporate and resource sector went up dramatically, which drove up asset values even further. Over 15 years it has conspired religiously to drive up asset values.

All I am saying is that where it settles probably will not be like the environment that we have seen for the past 15 years. It does not mean that it will always be as bad as it is now, because now we are going through a period where some of the bubble-type assets are reducing. It does not mean that it will be like this forever. I am just saying that when it all settles it is hard to think that it will be as good as what it was.

Mr MARLES—Would that have a long-term implication on the level of competitiveness in the bank verses the non-bank lending market?

Mr Johnson—That is very true. Basically, banks borrow money cheaply and they lend it out. To the extent that they are borrowing money cheaply from retail depositors, they are regulated, which creates that degree of safety. Non-banks borrow through the securitisation markets that they raise externally. It is a much more entrepreneurial-type model where you are just trimming
a little. Basically, you are arbitraging the difference between what you pay out to originate a home loan and what it costs to distribute it. It is a much more entrepreneurial financial market-type model.

Mr MARLES—Do you think that, over the past six months, banks have enjoyed a much less competitive environment?

Mr Johnson—No, I do not. If you looked at the home loan rates you would think yes, but when you look at the funding environment for banks, in particular, in retail deposits, you realise that the answer is no. Look at the Commonwealth bank result that came out yesterday. Notwithstanding all this very aggressive re-pricing of home loans up to the standard variable rate, a much higher proportion of its lending has been done at fixed rates. The yield that it earned on its home loan book relative to the average cash rate went down in the second half versus the first half.

The variable rate is the one that gets all the headlines but banks have been doing a lot of their business in the fixed rate space where the margin is demonstrably lower. You have to remember that banks have been competing very aggressively for retail deposits. Deposit rates are up quite significantly. When we talk about competition we have to think holistically about the whole thing—not just home loans and not just deposits. At various points in the cycle they will need to be competing aggressively for deposits. They are not so worried about home loans or vice versa. We are going into an environment where retail deposits are much more valuable.

CHAIR—Thank you for your appearance here today. It has been very worthwhile to this inquiry. You will be forwarded a copy of the transcript of your evidence to make any corrections that need to be made. Thank you again for appearing before the committee.

Mr Johnson—Thank you.
[10.48 am]

BULTITUDE, Ms Susan, Acting Executive Level 2, Financial System Division, Department of the Treasury

INGRAM, Ms Veronique Anne, Acting Executive Director, Markets Group, Department of the Treasury

MURPHY, Mr Jim, Executive Director, Markets Group, Department of the Treasury

WIJEYEWARDENE, Ms Kerstin, Acting General Manager, Financial System Division, Department of the Treasury

CHAIR—At this point I would like somebody to move a motion to form a subcommittee.

Mr DUTTON—I so move.

Mr MARLES—Seconded.

CHAIR—There being no objection, it is so resolved. I welcome representatives from Treasury to today's hearing. Although the committee does not require you to give evidence on oath I should advise you that these hearings are legal proceedings of the Parliament and therefore have the same standing as proceedings of the respective houses. You have given us a written submission. I am not sure whether you want to submit any additional written submissions or whether you want to go straight to an opening statement.

Mr Murphy—I will make a short opening statement. I thank the committee for the opportunity to appear before it today. Treasury's submission outlines the key features that we consider to be important in a competitive market. It also outlines our views on the state of the banking sector in light of current market turbulence, as well as initiatives that are under way to improve competition in the sector. I would like to touch on three key issues before we answer questions. The first relates to the competitive features of the Australian banking sector. Second, I would like to make some observations about bank funding costs and, finally, I would like to make some observations about competition in light of the current state of the securitisation markets.

I refer to the features of a competitive market. Notwithstanding improvements over the past 10 to 15 years, government and Treasury have concerns that remain about competition not working effectively in some parts of the banking sector. With this in mind, the government continues to pursue opportunities to improve the operation of the banking sector, including those that enhance competitive pressures or remove any remaining impediments to competition from new and existing providers. The government's switching package is a key initiative in this respect. The banking industry also has an important role to play in promoting competitive pressures, such as by supporting government policy, and through industry-led initiatives.
I refer, next, to funding costs. The current market turbulence has put the spotlight on the state of competition in Australia’s domestic market. As has been repeatedly noted by the Prime Minister and the Treasurer, Australia is weathering the turbulence well, but we are not immune to the vagaries and the turmoil in overseas markets. Higher funding costs and dislocation in the securitisation markets are two manifestations of the turbulence in Australia. The deterioration in United States subprime lending triggered a global re-pricing of risk, which has increased the funding costs of all financial institutions, including Australian lenders. Funding costs remain at elevated levels in comparison to 12 months ago.

However, we have recently seen a decline in the bank bill rate of approximately 40 basis points, resulting in a fall in the cost of raising new funds. We saw the banks increase their interest rates when funding costs went up. By the same token, we expect lenders to pass on any reductions in funding costs to their customers in a timely way. We have already seen this in some areas of fixed-rate mortgages where one major bank has reduced its interest rate for new loans. Securitisation markets have experienced limited activity and are currently experiencing a period of price adjustment.

This dislocation has impacted on lenders that previously relied heavily on securitisation for funding, and it has raised concerns about competition in mortgage lending. As our submission notes, some of the gains relating to a reduction in interest margins and market concentration, which have occurred over the past few years, have been partially unwound because of the decline in the securitisation market or the freezing of the securitisation rate. This tightening has led to calls for some form of government intervention. Some commentators have suggested that the government should establish an Aussie Mac as a mechanism that will inject equity in the market and provide a price discovery function time to severe market stress.

It appears that, for some, the Aussie Mac proposal is seen as a mechanism to address the current problems in the securitisation market. Treasury strongly disagrees with that. I note that the Treasurer has ruled out establishing a government body of this nature. While the securitisation markets are clearly under stress I want to note a couple of things. First, the total supply of finance to the Australian mortgage market has not been unduly restricted, with the major banks, as well as a number of smaller banks, credit unions and building societies meeting customer demand for housing price. While I say that, it does not address the issue of finances, but at what price? I suppose that is the key issue at the moment.

There is some activity in the Australian securitisation markets with new prime and non-conforming residential mortgage-backed securities being issued, and more issuers reportedly in the pipeline. Over $2 billion in RMBS was sold in July, but again we note that that is a start and it is nowhere near enough. What remains a concern is how soon the securitisation market will come back into full operation, or be much better placed than it is at present.

While there has been a slowing in lending growth overall with a particularly sharp decline in the lending growth of the non-authorised deposit-taking institutions and non-conforming funders—this morning you talked about non-banks but we would see them in those two categories—mortgage lending growth outside the five big banks still continues. It is not black and white if we think that with the decline of the securitisation market all business has gone back to the major big banks. Other foreign banks, credit unions and building societies have also
started to increase their market share. Again, is this good enough to address competitiveness in the banking industry?

I think we would say again on that feature of the securitisation markets that it is a start but probably much more is needed for it to bring back a truly competitive market. We think it is important to note that underlying Australia’s RMBS markets are high-quality assets. It is expected that, once some normality returns to the market, this will assist in stimulating demand for RMBS and restore this funding channel. The Reserve Bank noted that it found it hard to understand why there is not more business in the RMBS market. One can only speculate why superannuation funds are not involved in this, but they make their own decisions. In conclusion, overall we are monitoring how the current market turbulence is playing out in the domestic market.

Bank funding costs have increased dramatically over the past 12 months and that has given rise to interest rate increases above those made by the RBA. With any easing in funding costs we expect that these will be passed on to consumers in a timely way. Referring to securitisation markets, the impact of the current turbulence has been centred on a relatively small slice of the lending market, albeit a very important one. The current dislocation does not appear to have unduly restricted the supply of credit, and lending activity continues. As I pointed out previously, it is the beginnings of a return to a strongly competitive market, but it is still early days.

We continue to monitor events closely and we continuously assess the impacts of that turbulence on the dynamics of the market.

CHAIR—Thank you for that. We will now ask you some questions. I refer to the issue you raised concerning the RBA repurchase agreements. You were here earlier and you repeated the comments that were made by the Reserve Bank about them. I am interested, in particular, in the comments you made about superannuation companies and organisations, and their ability to look at that as a way of providing liquidity and credit in this area. I would like you to expand a little bit on that in anticipation that perhaps some of the answers might also address what we could be doing as a government to encourage the greater use of RBA repos, if that is a possible alternative way of providing liquidity in a liquidity dry area.

Mr Murphy—I will start with just a general comment. We have an open market and Australia has benefited considerably from the deregulation of the financial system back in the 1980s. Although the general public may criticise the profits of the banks, the banks and their non-banks through their competition have served Australian consumers reasonably well—finance is available. To their credit, the banks and the non-banks have been reasonably prudent. We do not have the subprime crisis, the poor lending that we have in overseas markets or the dislocation that we have seen in Europe. Borrowers have been prudent; they have not sought to over borrow. The providers of finance have been prudent as well. Yes, there are always exceptions in pockets, but overall things have worked quite well.

In terms of the repo market with the banks, the key point that Mr Battellino made was that while that facility is open to whoever wants to engage or trade in that market or to use that facility, it is only there for short-term funding needs. I would suggest that to run a proper mortgage business, one has to have some guarantee of reasonably strong lines of funding. It may
be there as a temporary top-up or a temporary measure. I do not see the RBA repo market as actually providing the answer.

Super funds have large pools of assets. The government does not in any way wish to or want to direct super funds as to how they should conduct their business. Obviously they are investment vehicles that are seeking to get it best return for their superannuants or members. But at the same time, super money is locked in there for a long time. You would start to see a match up between assets in super funds and mortgage lending. Obviously there is an affinity there.

Up to now, super funds have not seen the need to engage in that market, or my understanding is that if they have engaged it is only to a limited extent. If it became competitive and profitable for super funds to engage in that market, they could. What the Reserve Bank was saying this morning was that they think the Australian residential mortgage-backed securities are very good instruments. They would be happy to take them off people’s hands. That may be a very good clarification for the super funds. If the Reserve Bank is saying, that they might want to look more closely at those Australian RMBSs and start lending into the mortgage market.

**CHAIR**—There are a couple of things that flow from your comments. We have had submissions, particularly from the non-banks, about the ‘Aussie Mac’ model. I understand what you are saying in terms of that. But the argument that has been put is about a need to provide in a market where securitisation has dried up that institutional support that is there. I do not want to take you to those arguments particularly because you have made your position clear on that and we have heard various submissions about it. The counter position that has been put is that this is cyclical in nature. The Reserve Bank said today, and so have some of the big banks, that the market will readjust. That brings me back to your comments about repo arrangements and it being a temporary measure. Is that not something that the government should be considering in terms of the current climate if we accept that there is a cyclical problem at the moment, that the market will readjust and that a temporary measure that may assist in terms of providing additional liquidity in the market in the short term. Is that something that we should be examining?

**Mr Murphy**—I would say, yes. There are two things. The answer is that the market will correct itself and the market will come back. It is a cyclical matter. The government is concerned that the market is not coming back quickly enough. As the Treasurer has noted in some public comments, he is considering what actions could be taken.

**CHAIR**—There is a question in terms of super funds. Surely another issue that government should look at is your description today in terms of the role that super funds could play and your observation about the Reserve Bank’s comments. Essentially the argument you are putting forward is that the market will, when it sees the right time, for profitable reasons will look at extending and entering that particular phase of the market. But as I understand it, both the Reserve Bank and you are almost questioning why that has not occurred already. That being the case, that is the market taking a little longer to adjust than one would expect.

**Mr Murphy**—Yes.
CHAIR—Again, is that not an area that government can look at what sort of incentives we can provide to attract the market or open the market’s eyes to this particular area to help in terms of stimulating what eventually will take place in the market?

Mr Murphy—I will make some general comments on that before I say what the government should do. I think the market is actually in a state of shock and it is just coming out of it. By that I mean that the credit turbulence has really shaken institutions. Another witness said that the excess liquidity is being held by major institutions because they are concerned about their counterparty risks.

CHAIR—that was JP Morgan.

Mr Murphy—Yes. That is across the world and that is why you have this low return to normality in terms of market behaviour. We have all been softened up for the further write-downs that are occurring with the major banks and investment banks in the United States. We sort of shrug our shoulders—that is another few billion write-down. The market is getting used to it. While that is occurring, as other people have pointed out, you will still have concerns about counterparty risk and about your own solvency instability. So you have that.

We have to be talking in real time. In the last few weeks you have seen very positive developments—the bank bill rate is coming down. That means confidence is starting to come back into the market. The government is always loath to intervene. You have heard the public debate about the US Government intervening in Bear Stearns, Freddie Mac and Fannie Mae. It is a major issue. What you have seen is government—the Prime Minister and the Treasurer—talking, jawboning, seeking to encourage business to be positive. The Treasurer has been encouraging people to understand what a very sound economy we have. Australia has not really been shaken by the credit turbulence. These comments should be seen as comments to give confidence, as well as other matters, to the market so that people can move on.

As well as that talk, there has also been discussion in some circles, as I said, about super funds engaging in this market. You have heard the deputy governor of the Reserve Bank say today that the bank could also contribute to returning to normality. Previously the Reserve Bank relaxed its requirements in the middle of the credit turbulence. The only other point I would make would be that the government, as the Treasurer has noted, is still examining the matter, very much monitoring how the market returns to normality. When Treasury says it is cyclical, that is right, but the issue is how long it takes to return to normality.

CHAIR—Absolutely. I want to move on to some other areas, particularly switching, because that is a major part of what is there. From my point of view, the issue is that there are areas where the government can look at encouraging greater liquidity if we see this as a short-term issue. Because what might be cyclical and short-term for the market and the economy as a whole, I can assure you that householders with mortgages see that in a very different light with the sort of pressures they are facing. Obviously there is room there for the government to look at how it can act in terms of that.

Mr Murphy—The government is very sensitive to that and Treasury is very sensitive to the impact on households of the fluctuations in interest rates.
CHAIR—Turning to switching and some of the issues there. You make the comment in your submission that total savings to bank customers from lower interest margins have more than offset the cost of higher fees. However, it is recognised that the benefits have not necessarily been distributed equally amongst banks and so forth. In the last 10 years there has been an increase of about 170 per cent in revenue generated from bank fees and so forth. While we have had a competitive market in terms of mortgages in that period of time, we have not seen the same level of competitiveness. I know there has been some, but we have not seen the same level of competitiveness with bank fees. Would you agree?

Mr Murphy—From our examination and studies, clearly in OECD countries they have said that to try to enhance competition in banking product services you have to have appropriate switching arrangements. Also, the Reserve Bank said that stickiness of accounts is primarily through direct debits and the hassle, for want of a better word, of trying to change accounts. That is why the Treasurer announced his package. The package for which he is seeking strong cooperation from the banking industry will come into formal operation—but it has started in certain aspects—in November, is to ensure that switching can occur more easily.

I know some people can be dismissive of things like that, but customer retention is a key aspect of the business. While you have a customer you can sell them other products. We want to facilitate people being able to go to their current finance provider and say that they are unhappy. They will be switching because they are unhappy or they are going to get a better deal. You do not switch for fun and fancy. It must be a stimulus.

The Treasurer has also announced a website that resulted from work done on people understanding their accounts. It was provided by the Treasury financial literacy group.

Ms Wijeyewardene—There is a compliance hotline as well that the Australian Securities and Investments Commission administers. The Australian Securities and Investments Commission also did a review of mortgage entry and exit fees.

Mr Murphy—The Treasurer has also written to the banks with the Australian Securities and Investments Commission report in hand saying, ‘What are you going to do about this?’

CHAIR—Many of the written submissions that we have received so far and every witness who has appeared has supported switching as a way of increasing competitive pressure. I do not think there will be any opposition in terms of the philosophical approach that switching helps to increase competitive pressure. What we want to explore today is the proposal that has been put and whether that goes far enough, whether there are other initiatives that can be looked at in terms of switching to build on the announcement. To start off, for example, you were talking about direct debits. The Dutch model involves a central registry that facilitates that. The evidence that comes out of the Netherlands is that that works very effectively in terms of assisting people with switching. That is going a little further than where the Treasurer has gone at the moment. Has Treasury looked at that?

Mr Murphy—We have looked at it. At this stage I would suggest that the least-cost option to everyone is the switching package for customers and service providers. Having a centralised account numbering system or a simpler system would be a costly exercise. Whichever way you look at it, someone will have to pay for that.
CHAIR—It is essentially a one-off cost in terms of establishing and the technology that needs to change. We had a similar argument in the mobile phone industry about the transfer of mobile phone numbers. The industry said it would cost a fortune and they would not be able to do it. I know it is not a totally analogous situation, but we found that as soon as that happened there was incredible downward pressure on margins and the industry became far more competitive.

Mr Murphy—At this stage it is hard to predict. It is a significant capital expenditure.

Ms Wijeyewardene—There are probably two issues you are rising there. The first is the central registry in relation to a repository of direct debit and credit arrangements. We did look at it and the Australian Payments Clearing Association also examined that option. The reason we did not go down that path was because of the way that direct entry arrangements are held in Australia. Direct debit and credit authorities are actually held by the merchants, whether it is your gym membership or whatever. They hold those arrangements. To establish a central registry would require not just the banks to be involved, but also every merchant in Australia that holds direct credit and debit arrangements. That would be quite costly. They would have to voluntarily or compulsorily participate in this system. Potentially to do so would increase the cost of their services and increase the cost to consumers.

CHAIR—You would not have to make it compulsory because if you set up such a registry the competitive pressures would be there to participate. I accept that there would be cost with that.

Ms Wijeyewardene—Potentially. There is a question whether the merchants have an incentive to participate.

CHAIR—You would. You would be able to remove all those concerns away and it would be done once centrally.

Ms Wijeyewardene—The current switching arrangements have been very much designed to fit within Australia’s current payment system architecture. That is important. They are a significant advance on the current arrangements. Some of the banks have had arrangements in place, but the winning bank,—I guess you would call it—has maybe had a switching pack in place that assists a customer who has come into them to switch. However, this will impose obligations on the losing bank to get all the direct debit and credit arrangements for the customer. The customer then does to go to the new bank, and they are under an obligation if the customer requests to re-establish all those direct entry arrangements. That is a significant step. Once it is in place from 1 November, the obligations will be contained in what is called the bulk electronic clearing system regulations of the Australian Payments Clearing Association. Consumer complaints can be actioned through what is now the financial ombudsman service. There will be some bight to them. It is a significant advance. It is really looking to address that consumer inertia problem or the hassle that has been identified not only in Australia but also internationally.

CHAIR—I understand that and I am certainly not saying that they are not significant advances. What I am really looking at is other than initial costs, it is clearly easier if it is done through a central registry for a consumer than being provided with the information yourself and then going out and doing it yourself. That has to be balanced against the cost to the industry and
so forth. That was the reason for the question, nothing more than that. Another impediment that has been raised in terms of switching is deferred establishment and exit fees and their prevalence. Clearly for their own market reasons, BankWest made the submission that if establishment fees are not deferred when people are taking out mortgages, they are very aware of the costs and are able to make that accurate comparison of cost. However, if it is deferred to another time that is not foremost in their mind when they are buying a house and taking out a mortgage. Do you have any comment about that?

Mr Murphy—in general, and then I will be more specific. I think it was noted this morning that establishment fees can often be waived through people bargaining. The establishment fee is activated if you seek to break a contract before a certain time. Under RAMS contracts, if within two years you sought to remortgage you had to pay a penalty fee. We have to be careful. It appears that providers have used establishment and exit fees as a competitive mechanism.

CHAIR—They have used it to stop competition, have they not? Would you agree that barriers are there deliberately to make it more difficult to get out of a loan? They certainly affect the ability to switch and competitiveness?

Mr Murphy—Yes, but at the end of the day we want to get the best result for the consumer. Oftentimes regulation distorts markets and does not get the best result for the consumer. We have looked at a chart showing each of the banks’ rates and tried to work out what is more competitive and what is a better price on these mortgages. The point is whether the consumers really understand what they are getting into. You would hope when you are signing up for a mortgage, which is a substantial commitment, you really understand the fees and charges.

CHAIR—We know that is not the case; we know that a lot of people are going to say, ‘How much does it cost to get this house? Where can I get the finance for it? That is the cheapest deal for me now. Let’s get into this house and move on.’

Mr Murphy—Things have changed with generations. Some people entered into mortgages for 25 years. We know now that the majority of mortgages are turned over within five years. There is a lot of churn and a lot of refinancing. People might start to concentrate more on these particular features of mortgage products.

Mr MARLES—if the chair is not right, why do you think banks structure it in the way they do?

Mr Murphy—Some banks structure it differently. There are different arrangements.

Ms Wijeyewardene—they do have products that do not have exit fees. I think that the work that the ASIC did in this area as part of the switching package put the spotlight on exit and early termination fees. Some institutions do not charge exit fees. That suggests that putting a spotlight on it puts pressure on the banks or the institutions to actually make some movement in this area. It is not widespread, that is taken. However, if a customer moves to some institutions will provide a rebate of the exit fee or the early termination fee that they have incurred. Putting the spotlight on it then leads to some competitive pressures being put on banks to actually move in relation to these fees.
CHAIR—I understand the industry talking about the spotlight being on it and the competitive pressures. But, frankly, the consumer does not look at exit fees until they are actually looking at exiting and saying that this is not competitive—’Oh my god, I have these exit fees. I may well have been told about that at the start of the loan, but that was three or four years ago. I now do not know about it.’ The reason banks have these products is to make it more difficult to leave early. That is the reason for it and to make it more attractive, artificially, to enter into their loan at the outset. That is why you are deferring.

Ms Wijeyewardene—The point that the RBA made is that if you do not have the exit or early termination fee, it is likely that the banks will put it upfront and that, too, could act as a switching barrier.

CHAIR—Does it not put—in your words—the spotlight on that particular aspect of it? In putting the spotlight on it you then generate the competitive pressures.

Mr Murphy—It may. Those types of fees have become an issue of competition. Yes, you do not need to have people hogtied to a particular provider because of the cost of exiting. At the same time, these things will come out in the wash.

Ms Ingram—I think you are right and I take your point. The psychology is that when customers are shopping for a loan they are looking at the cost upfront. They do not envisage that they will change their loan, even within five years. As my colleague Ms Wijeyewardene has said, the ASIC report does uncover some issues. It is a matter of rather than regulating the fees but how you get the consumers to focus on that upfront. The ASIC report throws up issues around transparency and how you draw attention to those fees or explain those fees when the customers are getting into the loan. That is something that is ongoing and the minister has asked ASIC to do further work on that. It is something that we are looking at.

Ms Wijeyewardene—It might be something that we are looking at through the transfer of credit to the commonwealth—that is, disclosure arrangements and transparency. The other thing that ASIC looked at was the nomenclature—how fees are described and what is the consumers’ understanding of these fees. That will all be looked at as we move credit into the commonwealth sphere.

Ms Bultitude—You can look at these exit fees and loans and say that they are an impediment to switching and therefore may have an impact on competition. However, if you look at the overall conditions, fees, charges and features of a mortgage, CANNEX in its star ratings has done some comparisons looking at all those factors. It did a special report in which it pointed out to people that they do need to be aware of exit fees. But it also found that some products that did charge exit fees were actually better overall in their ratings compared to some that did not because of the balance of all the different features. It is not necessarily in fact that a product with an exit fee is not competitive or not a good product for consumer. You have to look at it as a package holistically as to all the different features and options that the consumer is getting into.

CHAIR—We understand that product differentiation in itself is a competitive stimulant. Switching package does not look at credit cards at all at the moment. Is that something that we should be thinking about in the longer term—the ease of switching? Obviously substantially different levels of credit are offered. We have had submissions about stores and their interest-
free, 28 per cent credit cards and those sorts of issues. Some of that is about transparency. Some work has been done in that regard and some recommendations have been made. However, should not switching and the competitive pressures that that puts on credit cards also be examined and considered in the future as well?

Mr Murphy—It could be, yes. There are various vehicles. The RBA through the Payment Assistance Board has sought to improve competitive pressures in all card systems. We have seen that over the years, as my colleagues have pointed out, the commonwealth will be taking over the regulation of credit under the Uniform Credit Code. That has come through agreement in the Council of Australian Governments. Yes, there could be more work in this area.

CHAIR—We look like we have done part but not the whole.

Mr Murphy—Yes.

CHAIR—We have not had the benefit of hearing from some of those who have made submissions. But they have stated that with the advent of compulsory superannuation a lot of savings have gone into the super area that previously would have gone into bank savings and deposits. That has caused some liquidity issues with financial organisations. A proposition has been put, particularly by the credit unions and their association, that we look at either tax breaks or some sort of incentive to make it an advantage to put money into bank or credit union deposits and that that would increase the pool of funds that are then available for mortgage lending et cetera. Has that been examined or do you have a view on that?

Mr Murphy—I would not have thought there was a need to do that or to give any preference for bank deposits in terms of tax.

CHAIR—we do it for superannuation. The argument put is why we do it for that. There are some obvious reasons why they are different as well.

Ms Ingram—Because superannuation is a mandatory savings vehicle for long-term retirement whereas term deposits are quite a different animal. That is not to say that with what we all call the Henry review that that is not something they are looking at. That was raised in terms of a financial services hub for Australia—that that could be something that would also attract investment. It is certainly on the agenda.

CHAIR—It is something this committee will be looking at because it has been squarely put before us by a number of players. That is the reason for the question.

Mr MARLES—I will go back to the switching issue. There is a new area I want to get into. However, I refer to low entry fees and deferred exit fees. You made the comment that this is a function of a competitive market and one ought to be loath to regulate it. As a disposition I think that is exactly right, although, of course, the Trade Practices Act is regulation and it is the structure of competition within the market. I do not think regulation per se is anticompetitive; it might in fact be about being pro-competitive. We have had evidence, which I think you have had the benefit of hearing today, that by international standards we have low entry fees and high exit fees. An industry structure of loans that makes it easy for people to get in and hard for people to get out—which is what that is by definition—must be anticompetitive. Does that not invite you
at least to ask the question about whether this should be something we do something about? I am surprised that in all the evidence there is almost a defence of what has occurred.

**Mr Murphy**—I am not defending it, but I think you have to look at it. If you say low entry fees and high exit fees, by nature, how many people would sign up? You are trying to judge how many people will say they deterred from switching because of the high exit fee. We had a number—

**Ms Wijeyewardene**—Thirty per cent of new lending.

**Mr Murphy**—Is what?

**Ms Wijeyewardene**—Is switching.

**Mr Murphy**—There is much more switching in the mortgage market than there is in other transaction accounts. I am not saying that your thesis or proposal is not right; I am just saying that you would have to try to work out whether the high exit fee is a real deterrent to a significant part of the market. I do not know if it is. People might say if you put it to them, ‘We would rather have a low sign-on fee than to pay at the end of the day.’

**Mr MARLES**—I might be flogging a dead horse, but I just cannot see why. There is potentially a rationale, but I have not heard anyone explain why a bank would structure in this way if it is not about trying to make it easy for people to get in and hard to get out.

**Mr Murphy**—I think they structure it to attract the business and to get your business because when you go along you say that the sign-on fee is cheap or non-existent—’I have gone to another provider and they have said there is a significant signing-on fee,’ It is a competition thing. All you can hope is that when people enter into that market and through information they really understand what they are getting into. That is all.

**Mr MARLES**—Perhaps we should go to that because that is what I am keen to talk to you about. Your submission states that ‘the working group is looking to develop short, concise and readable product disclosure documents’. You have talked about the strictness of accounts, which I think is a really good term. That resonates with me what the issue is in terms of why people do not switch or at least look at what other competitors are offering. It would seem to me that a major part of stickiness is fully understanding what is out there. They are not the easiest mathematical equations to get your head around—what a loan will cost you—particularly in the absence of some standard form comparison vehicle, if that makes sense. Can you expand a bit more on that comment and where that is going?

**Mr Murphy**—You are right, there have been various initiatives by governments to try to improve consumer understanding of financial markets. We have had the Financial Literacy Foundation, which is now part of ASIC. That was there for the past three or four years. This government is moving to try to standardise and simplify documentation that people will use when they are entering into financial transactions. The first step along the way has been this first home owners scheme. They have standardised some very simple documentation and now the government, under Minister Sherry, is looking at trying to track that across the board.
That said and done, earlier we were talking about non-bank lenders. Obviously in their heyday they have attracted business away from the majors and become the competitive fringe players. They have done it through either advertising, word of mouth or people seeing that they are a better bet than the banks. There is need for improvement and information and for the government to try to ensure that there is better information put before people. But we cannot completely discredit that people have actually in the last few years voted with their feet and shopped around.

Mr MARLES—Sure.

Mr Murphy—The best thing that you can have for a competitive market is consumer sovereignty and people shopping around. The information is terribly important, but we go back to saying that we want those fringe players in the market.

Mr MARLES—It is a really good initiative that you are doing. You are looking at standard forms.

Mr Murphy—That is what the minister has sought to do. I think they have just lost patience. It is a bit tough, but they have lost patience with financial sector providers that they cannot provide better and simpler documentation. There is a risk in that, but the government wants to start prescribing more standardised information. Hopefully then that will catch on with financial services providers.

Mr MARLES—I go back to the level of competitiveness in the market and the comment you just made about the need to have those non-bank players in the market. You heard the evidence this morning and we have been questioning the witnesses a fair bit on this. Is it your view that the reduction in the non-bank lenders in the market has given rise to a less competitive environment for the banks in the past six months?

Mr Murphy—that is hard to judge. However, over the past 10 years the competitiveness of the banking market has been particularly stimulated by the development of those fringe players. They have provided a competitive stimulus to make the banks improve the provision of their services. We saw it earlier. If you go back in time, in my view that is why we had the growth of the credit union movement. They gave much better customer service and the banks caught up and improved their services, opening times and the way people were treated. The fringe players—who emerged through the securitisation of the market such as Aussie Home Loans, Wizard and all those players—were providing what the public wanted and they were preferred to the banks. That said, the major banks will always provide the basic stability of the system and the majority of home loans.

Mr MARLES—but you have described a scenario where those non-bank lenders in a sense put competitive pressure on the banks, albeit that they do provide that stability.

Mr Murphy—Yes.

Mr MARLES—is it fair to say that that competitive pressure in the last six months has been reduced significantly?
Mr Murphy—In the past six months the four majors have increased their share of the mortgage market. But some of the other financial institutions have also improved. The foreign banks and credit unions have also lifted their percentage of the mortgage market. I would suggest that that is still nowhere near good enough in terms of what the government would like in a competitive mortgage market.

Mr MARLES—The Mortgage and Finance Association is appearing next. They say that over the past 12 months building societies and credit unions have also suffered a reduction in their share of the market.

Mr Murphy—We might be talking different figures. Change in share from 2007-08—

Mr MARLES—Yes.

Mr Murphy—We are both right or we are both wrong. We say that the credit unions are zero, zero, zero, zero.

Mr MARLES—So they are stable?

Mr Murphy—They are stable. Foreign banks have improved. I was right there.

Ms Bultitude—As a whole the credit unions have maintained their market share, but there are particular larger credit unions that have grown their lending portfolios. It is the same within the banks. There are particular banks outside the big four that have grown their market share and lending portfolios at a faster rate than the major banks. You have had different players performing more strongly than others in this time and some of them more strongly than the major banks.

Mr MARLES—I want to touch on the superannuation stuff as well. I want to ask the question and see whether we can take it a bit further. As the chair said, it seems to me that you are asking the question as to why super funds have not been more involved in this part of the market, in a sense preceding the shock that you described. In asking that question, you must have thought of some of the answers yourselves. It is a good question.

Mr Murphy—It is not preceding; it is now. Why do they not look at their balance sheets and what they are seeking to do? As my colleague pointed out, they are there to get retirement incomes for people. Here is a good investment. Why do they not move into that field?

Mr MARLES—A good question now is why they have not done in the past.

Mr Murphy—I think they are conservative and possibly they are ensuring that they get good return for their members. But as we have seen, they have had significant declines—the first negative returns have occurred. It may be that they need to be more active in considering their investment portfolios.

Mr MARLES—You said that the clarification that we have had today that you described is important in your view. Do you think that is enough to lead the super funds down this path?
Mr Murphy—I think from the government’s point of view we are hoping that we get a return to full competition in the market. From the government’s point of view I would say in the medium term that matter could be addressed. That is, if we do not see either securitisation return to what it was before or at a level which I suppose the government feels is adequate, so that lead to leads to a competitive banking market, and if superannuation did not come into market or for other reasons chose not to, it may seek to examine that in the future.

Ms Ingram—I refer to the superannuation issue and why they have not come in. They have been in the securitisation market in a limited way, but they are not there now. It is not a question of quality, although they are prudent and need to be. It is a question of liquidity and not being able to offload. They are not a liquid asset at the moment. Therefore, it is a chicken and egg situation. That is again what the government is looking at. Without liquidity, people are reluctant to go in there unless they are prepared to hang on to them for some time and punt.

Mr MARLES—I want to understand what you are saying in terms of the super funds. Are you saying that the super funds or not institutions that carry liquidity with them?

Ms Ingram—They need to carry some liquidity. It depends on the balance of each portfolio in their spread of risk. I am no expert in where they put the RMBS—whether it is considered highly liquid or capitalised for some time.

Mr MARLES—I think it is a good question that you have asked.

Mr Murphy—There is an issue there. It is a matter of whether the superannuation funds are agile enough to see there is an opportunity as the bank has pointed out.

CHAIR—Obviously the reason that the Treasurer has referred this particular inquiry to the committee is to look at those broader issues that you are both looking at, but also looking ahead at other options. Clearly competition is helped by the ability to swap between competitors. That is why the switching package is important and why we are looking at other issues around that. But equally important is to ensure that there are actually competitors there. There is the need to look at short-term, medium-term or longer-term issues. They are the two key areas we have to look at.

Thank you for your participation today. It is great to see where it is up to. It was a very valuable contribution. This is obviously recorded by Hansard. A transcript will be sent to Treasury. Please look at it and make any corrections you need to make. If there is any particular issues of a technical nature that Hansard needs to grab you about today they will do so straight away. Thank you again for your participation.

Mr Murphy—Thank you.
NAYLOR, Mr Phil, Chief Executive Officer, Mortgage and Finance Association of Australia

CHAIR—I welcome the representative from Mortgage and Finance Association of Australia to today’s hearing. While the committee does not require you to give evidence on oath, I advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the respective houses. We have received a written submission from you and your organisation. Do you wish to make any additional submission or do you want to go straight to an opening statement?

Mr Naylor—I do not have any additional submission. I think our submission is fairly self-explanatory, but I will make a brief opening statement and then open myself to questions.

CHAIR—Thank you.

Mr Naylor—Our focus is very much taking the consumer viewpoint. I think that comes out in our submission. We see this whole inquiry is really about making sure that our lending market is the most competitive possible for the benefit of consumers. In order to do that obviously there are players who provide those services and there are vested interests. We try to steer away from the vested interest issue as much as we can and focus on how the industry operates and how you make it operate in such a way that consumers can benefit better than they are now.

It is history that over the last decade or so, since the 1990s, we have seen a fairly competitive lending industry in Australia. Banks, non-banks, credit unions and building societies have all competed with each other to get borrowers to buy their mortgage product. But that level of competition did not happen by any fluke. It did not happen because one day the banks all decided to reduce their interest rates by two percentage points. It happened because new players came into the market and dynamics occurred which enabled new players to come into the market—non-bank lenders—which forced the retail interest rates to drop all of a sudden, almost overnight, and quite considerably at that point of time.

We would argue that it has been very much a driving force for competition in the industry over the last decade or so. Even though non-banks at their best have only ever got about 15 per cent of the market, that has been a large enough critical mass to drive a competitive wedge into the market and to ensure a dampening pressure on interest rates, not only on interest rates but also on services and a range of products and so forth.

The other thing that happened, as our submission says, around the same time as non-banks came in was the opening up of the mortgage broker channel. Mortgage brokers got involved. They have provided very strong competition for banks and non-banks at the bank level, at a retail level. Consumers now have the choice of going to a bank branch, a non-bank branch or dealing with a broker. In some cases, banks and non-banks obviously also use brokers for their distribution channel. But that has had an effect on providing information to consumers.
Consumers are much better informed because brokers are out there in the market. They are able to source the most appropriate deal for them, which if they were operating on their own they probably would not have the time or resources to do that. All these sorts of things are linked. The market started to free up in the 1990s—non-banks and brokers came into the mix. You had competition at a price level but also at a product range and service level.

You can argue that the subprime crisis or credit crunch—however you want characterise those events—has changed all those dynamics. Without sounding too dramatic, it is almost like a pack of cards. If you take out the card that allowed non-banks to come into the industry, you also take out competition. You take out possibly, and some people might argue this is drawing a long bow, but you take out competition and the need for banks to have brokers to be a distribution chain because they no longer need to compete with non-banks, which, for the sake of the argument, are no longer there. You could find that all those things that have been of consumer benefit—lower interest rates than would otherwise have been the case, better service and a better range of products—start to fall away.

I heard some of the previous speakers say that the market will sort it out. The market did not sort it out in 1994. It took a shock to the market by new players coming in. If the market had been left to itself with the existing players, nothing would have changed. Our concern is that we are looking at possibly a back-to-the-future scenario, winding the clock back to 1994 or pre-1994 when non-bankers and brokers were not in the market and the remaining players did not have anything forcing or persuading them to change the way they operated, whether it be in their pricing, their range of services or products.

Like some other submissions, ours talks about the Canadian mortgage bond system, and the Aussie Mac system. We do not have a strong view or a strong proprietary knowledge or ownership of any of those things. But we think that unless there is some dynamic that comes into the market that enables continued liquidity, competition as we know it will disappear and we will face that back-to-the-future scenario. I am open to questions.

CHAIR—Thank you for that. Market share in itself is not necessarily the judgement of whether there is competition in the industry. The fact that there is another option drives it. You could have a situation where non-banks are in the market but banks, in a competitive response to that, lower their interest rates, which is partly what your submission states.

Mr Naylor—Yes.

CHAIR—Therefore, they retain or, if they are able for commercial reasons to do it better, increase their margin to the area. That itself is not the definitive issue. But it is certainly an indication that the market is not as robust perhaps as it was in the past.

Mr Naylor—As I said before, at the best the non-banks had 15 per cent of the market. That was demonstrably effective in changing the competitive dynamics of the industry. Now they have about 6 per cent. I would certainly argue that they lost a lot of their competitive potency. Whether they would regain it at 10 per cent, 11 per cent or 9 per cent, I am not sure. I am not sure what the figure is, but I think at the moment quite a few of them have gone or are inactive. That means that there is not the competitive dynamic that was there before.
I agree that we do not want to get precious about the right figure of market share, but at the moment it is probably too small to have much effect. The likelihood is that if this is left to run it will get less rather than more. There is nothing we can see in the cycle or environment at the moment that says suddenly non-banks will reverse their market share upwards.

CHAIR—Intuitively one would think that that is right. You sat through some of the submissions that have been made and you heard our line of questioning.

Mr Naylor—Yes.

CHAIR—I am interested in whether you have any examples of the behaviour of the banks that shows that they are less competitive than they were, that they have changed their products because behaviour by the banks has changed to try to take advantage of the credit crunch as well. They have said, ‘This is more difficult for non-banks. Let’s try to take them out now while we can because that will decrease competition in the longer term and therefore relax the competitive pressures.’ There are two parts to that question. The first is about whether we have seen any evidence about of the bank’s products and their behaviour being less competitive and the second is whether we have seen them change their behaviour in relation to the way they operate to try to make it less competitive.

Mr Naylor—I am not aware of anything overt and I am not even suggesting that anything that has been done is malicious. All I am saying is that it is economics 101: if you reduce the number of players in the market you normally expect that competition will decrease. Although the banks have a justifiable argument in pointing to the cost of funds from overseas markets and requiring them to push their rates up higher than the RBA cash rate, if there were more funds and therefore more players in the market there may well have been downward pressure on that. At the moment, as I read in the media, banks are saying, ‘Even if the Reserve Bank does reduce the cash rate in the next month or so, we will not necessarily do the same because we still have that cost coming through.’ No-one is disputing that.

All we are saying is that if there were more players in the market and more access to funds there would be some downward pressure on that. Not all industries have the luxury of saying, ‘My costs have gone up, therefore I will put my prices up.’ The world is not a cost-plus industry. You certainly take cognisance of your cost, but you also have to take cognisance of what your competitors are doing. I think it is more that rather than suggesting anything improper is happening.

CHAIR—We have certainly been making comments to the people making submissions about the pressures that people are facing with mortgage rates increasing above and beyond the Reserve Bank rates and our constituents’ expectation that if there is a decrease it will be passed on to them. The issue you are raising leads to the question: Do you think there is still fat in the margins for financial institutions that are operating now? That has to be the logical conclusion to what you are saying. If greater competition is going to force down margins then by their very nature there is still room to move, they are higher than they need to be.

Mr Naylor—History probably answers that to some extent. Margins were quite wide before the 1990s, they came down considerably and they remained at about that level for a number of years. What happens to them now as the banks try to adjust their position based on their cost
structures and so forth? It may well be that if there is no competition, or no further competition, in the market there will be nothing stopping those margins from winding out again.

I have certainly seen evidence and other people making submissions might talk about Australian lending margins compared overseas lending margins. There has been some evidence that the margins in Australia are probably higher than in other countries. There may be lots of other reasons for that, so I would not want to rely on that alone. The point is that if you take out a critical mass in the industry that is providing competition it is natural to expect that those remaining will do their best on behalf of their shareholders to get best return they can.

CHAIR—I understand that argument and I understand the historic context. I do not think anyone has disputed that. Whether it be one of the big four, the Reserve Bank or any other submission, no-one has disputed that the advent of the non-banking sector put pressure on bank margins, which saw them being reduced as a historic fact. The issue I am interested in is whether the proposition you are putting forward about non-bank competition is about preserving those margins—you have said that if competition is taken away they may rise—or whether it is also about there being room to move those margins down even more.

Mr Naylor—I do not think we are suggesting that they are too high or too low. It is really up to lenders in the market, whether they are bank or non-bank, to decide what margins they want to operate on. Different models will operate on different margins. What we are saying from a consumer point of view is that if you take competition out of the industry it is more likely that those who are less exposed to competition will naturally widen their margins. We are trying to think of the future; we are not saying there is a massive ill to be remedied now, even though some would argue there is. We are saying that if nothing happens it will potentially get worse.

CHAIR—I understand that in the context of, for example, the Commonwealth Bank’s $4.8 billion profit announced yesterday. Do you see that there is room in terms of their margins, for example, through competition? They are obviously not going to cut their margins unless they need to because they are trying to get the best return for their shareholders. But in the context of the submission you have made regarding competition and the profits we are seeing from some players, do you think that competition of itself will help to reduce margins?

Mr Naylor—It will help to put downward pressure on interest rates. I do not have a concern about how much profit any particular lender makes. If they can make it in such a way that satisfies their shareholders, but the ultimate price they charge for their funds to the consumer is not impacted, that is fine. But that is a matter of their business model.

CHAIR—I want to ask a couple of questions about the role that brokers play and the ability to switch between financial institutions. The role that brokers play is not just for that first mortgage, is it? They also play a role in terms refinancing and assisting in finding a more suitable product to suit the individual consumer.

Mr Naylor—Whatever, it could be a lower rate, better service, better facilities or whatever. It is certainly not just first home buyers, it goes on. Brokers aspire to have an ongoing relationship with their customer. They talk with them every couple of years and reassess their mortgage and make sure it is still right for their circumstances.
CHAIR—Your evidence has been that brokers have assisted in putting that competitive edge there and putting downward pressure on interest rates because they do a lot of the work that an individual consumer probably does not have the time or ability to do.

Mr Naylor—That is correct. Not only our figures but also the Fujitsu figures show that the market share is about 40 per cent at the moment. That has grown very quickly because consumers have seen the range of products out there and, until recently, the range of lenders. No-one, unless they had a lot of time on their hands, can resource all that and make a sensible decision about what is best for them.

CHAIR—Would you agree with me that for that downward pressure to continue from brokers there needs to be enough variety in products, product lenders and ability and ease to move between those product lenders; that is, that that downward pressure is a result of competition?

Mr Naylor—Absolutely.

CHAIR—In terms of switching, you have probably heard some questions in relation to deferred establishment and exit fees. Do you have a view about their effect on competitive behaviour and the barriers to switching they may put in place?

Mr Naylor—Intuitively—and I have heard your questions—you would expect that if a consumer is confronted with that extra fee that may persuade them to do something. I am inclined to agree with what the Treasury spokesperson said. I am not sure that it does because at the time that someone enters into a loan they are certainly not thinking of what might happen in five years. That does not become an issue. It may well become an issue in five years when they are seeking to move on. But at the time they enter into the loan, I do not think the fee is really an issue.

Part of the broker’s role is to explain the exit fees as well as the entry fees to the consumer—'By the way, if you refinance within a certain period there may be other fees.' That is part of disclosure and information provided to consumers. It is true from the ABS statistics that around 30 per cent of mortgages taken out every year are refinances. Obviously people do refinance and whether or not there are fees does not seem to have a huge impact on that.

CHAIR—The only problem with that figure is that we do not know what the level would be if it were more competitive. The natural level if there were perfect competition may be 50 per cent or 60 per cent. We do not know because we are talking about how many people switch in the current environment.

Mr Naylor—that is correct. I do not know that I can add any more to that; I do not really know.

CHAIR—We have had evidence of an exit fee of $12,000 to move from a loan that was significantly higher than other mortgage products that were then being offered.

Mr Naylor—Yes.

CHAIR—Clearly that would be an impediment to someone trying to switch.
**Mr Naylor**—Unless they were getting a massive deal somewhere else, which is probably unlikely.

**CHAIR**—Yes.

**Mr MARLES**—I would like to go back to the competitive nature of the market at the moment: You have made a number of comments about that. As the chair said, everyone has conceded the improvement in competitiveness that the non-bank lenders have given to the market over the last 10 years. Did you hear all the evidence this morning?

**Mr Naylor**—No. Some of it.

**Mr MARLES**—There has been a little bit of a debate in the evidence that has been given to us about the cyclical nature of the circumstances we find ourselves in. I think I am right in saying that the Reserve Bank made an argument that at the moment we are in a particular cycle, but it will return. Someone from JP Morgan said that we are unlikely to return to a situation where non-bank lenders have the same market share that they had 18 months ago, to take a date. They are unlikely to return to that level ever again. I think is that essentially what he said. What is your view of that? Do you think we are in a cycle or do you think there is something about what is going on at the moment that might be more permanent for non-bank lenders?

**Mr Naylor**—I heard that evidence. I do not know; he is much more articulate and knowledgeable in that area than I am. The problem with cycles is that no-one knows how long they are. If we are going to sit back—and I am not suggesting the committee is—and wait to see what happens at the end of the cycle it might be too late, a lot more damage might be done. We have to assume that the environment we are in at the moment may not change for some time. If something else does not happen—and I used the phrase before—it is a back-to-the-future scenario for the industry. We do not think that is good for consumers.

**Mr MARLES**—The comment in your submission that I am trying to get at is right at the end. In the conclusion you talk about lack of access to wholesale funding reducing competition in the market and potentially wiping out the non-bank lending sector. Do you see that as a real possibility?

**Mr Naylor**—We do see that as a real possibility. That is why we have been looking around for other sources of liquidity. We have looked at the Canadian system. I know that Aussie Mac has been put up as a solution. We are not knowledgeable enough to know whether they are the right ones, but the Canadian system seems to work. I know that Treasury and the Reserve Bank seem to have a different view of that. But it seems to work from my inquiries about a counterpart organisation in Canada.

I think you mentioned before, whilst regulation is often looked at as anticompetitive, sometimes it is pro-competitive and sometimes you have to kick start things by bringing in regulations and rules to make sure that the industry is more competitive. There is the scenario about things being left to nature. If we are going to finish with the major four banks, that cannot be good for the Australian borrower.
Mr MARLES—When we put that to the RBA as an example, there was quite firm evidence coming back that that is not where nature is heading. Their point is that whatever the conditions were that lead to non-bank lenders entering the market in 1994 still exist. Why are they wrong in that?

Mr Naylor—What are they saying? I did not follow that.

Mr MARLES—Your point is that if you are wiped out it might be back to the future—I think is your term—and we might be in a pre-1994 situation. I think in your opening statement you said that this did not happen just by good luck; there was a shock in the system, which was the non-banks entering the system in 1994.

Mr Naylor—Yes.

Mr MARLES—There must have been some conditions in place which allowed non-banks to enter the market in 1994. Will they not continue to exist in the future if conditions get better?

Mr Naylor—In general, the answer is yes. If the conditions are such that the securitised market comes back and they have the same access to funds as they had before and they can retail loans at a lesser rate than the banks have been doing, that certainly will remedy the position. But what I do not know, and I do not think anyone knows, is how long it will be until that happens. Will it happen next week or will it be another 10 years before that cycle winds around? That is the problem. Consumers or borrowers do not think about long-term cycles; they think about the bills they have to pay next week. Similarly, non-bank lenders do not have massive pockets that they can sustain themselves for 10 years to be around when the cycle moves, if it does move.

Mr MARLES—Your point is not that you will not come back but how quickly you come back and the condition you come back in.

Mr Naylor—Yes. It sounds like I am pushing the barrow for non-banks, which I suppose I am, but the real beneficiary is the consumer.

Mr MARLES—in terms of competition?

Mr Naylor—Yes.

Mr MARLES—that is fair enough. You advocated for the Canadian model in your submission. Why do you think it has worked?

Mr Naylor—I do not have detailed evidence to support that other than the inquiries that we made in Canada. The Australian Securitisation Forum will be giving evidence and they will give better information on this. It has enabled other than major banks to stay in the system because they have been able to issue mortgage bonds even during the storms of the last few months. The way the system works is that the smaller lenders get first chop at the funds and they take their requirements. Whilst it is open to the whole market—even the major banks can access those funds and do access those funds—it is geared in such a way that the smaller lenders have first shot at the funds. That means that you have the continuity of those non-bank lenders remaining in the market. That has certainly happened in Canada.
Mr MARLES—But the Canadian system is capped. It is hard to imagine how you could have a system that is unlimited.

Mr Naylor—Yes.

Mr MARLES—The Reserve Bank puts the argument—I guess I am inviting you to critique this, but I am struggling to—that if there is a cap on the liquidity that the small lenders get, once they have got that there is no incentive to write any more loans because they are capped. They then described the experience in Canada where in fact the small lenders simply placed their margins and rates at the same level as the banks and effectively ended up pocketing whatever government subsidy was in that system.

Mr Naylor—I am not aware of that. It may be the case, but I am not sure. I think the difference may be that the non-banks in Australia have shown themselves, as someone said before, to be very entrepreneurial. They have a drive to make sure they do the right thing by the customers because they know that if they do not have customers they do not survive. I cannot see them pocketing the difference in an Australian environment.

Mr MARLES—But is there not then an argument that the absence of some government subsidy in the form of this is exactly why the non-bank lending sector in Australia is entrepreneurial? We would not want to encourage something different.

Mr Naylor—No. We are certainly not suggesting anyone should be getting subsidies. We are suggesting that whatever is put in place should be open to everyone, because it does not matter whether you are the largest bank in Australia or the smallest non-bank there is still a liquidity shortage. If you have a system whereby you can cover that drought, either partly or totally, you at least keep that liquidity flowing, and hopefully at a competitive rate.

Mr MARLES—But you are advocating a system in which presumably the key component is that it gives preference to the small lenders. That is how you described it.

Mr Naylor—I said that the Canadian system does that—it gives them first go. I am not necessarily saying that that is crucial. My overriding submission is that we need some form of a system that introduces liquidity into the market to cover situations like we have had over the past year where liquidity has all but dried up. We have looked at the Canadian system because it has been around for 20 years. From our perspective and our inquiries, it seems to work.

We say that is one that could be looked at. I know Aussie Mac is putting up a variant of that and there may be other people who have different ideas. But what has been clearly identified is that there is a lack of liquidity in the market and that is right across the board. But it impacts on non-bank lenders more so because they do not have deposits. I know we are going around in circles, but if they are not there, by whatever mechanism, that will have a detrimental effect on competitiveness in the market.

Mr MARLES—Okay. Did you hear evidence that the Treasury gave in relation to the superannuation funds?

Mr Naylor—Yes.
Mr MARLES—The Treasury was asked about why super funds had not invested more in Australian mortgages. Do you have a view about that?

Mr Naylor—Yes, in fact I made some unofficial inquiries with super funds a few months ago trying to ascertain whether there was an appetite for investing in mortgages. I was told that there is, providing it is a robust vehicle. Obviously they have their members’ funds to be careful of and they will not be investing in schemes or vehicles that are not solid. There is some interest there in the superannuation area to invest in the mortgage market, but it must be a very solid and very recognised. I use the term ‘government supported’ not in the sense of anything other than saying that it has some government imprimatur so that they have some comfort that they are investing in a solid fund. The short answer is that I think there is interest, providing there is a proper vehicle to invest in.

Mr MARLES—I want to finish briefly on the role of brokers. Fujitsu Consulting has said that they think that the right model which gives rise to the best advice is where brokers are receiving payments from consumers as opposed to a commission from the lender. Do you think that at the end of the day brokers are influenced by the commissions they receive? Do you think that what Fujitsu Consulting is saying is the right model?

Mr Naylor—The assertion about brokers being influenced by commissions has been around for some time. Until recently the commissions that have been available to them from lenders have been so similar that it would be hardly worth your while to recommend one rather than the other for the sake of a small difference in commission. Our members tell us the driving forces for recommending a particular lender are the service they provide and how quickly they approve the loan. Remember that the broker is operating on behalf of the borrower and the borrower is normally saying they have an auction next Saturday or they have this property they want to get really quickly. The driving force is to get a response quickly about whether or not the loan is approved. The lender who is first to approve the loan is the one that will get the business.

As to the other part of the question about whether brokers should charge fees or rely on commission, I think that game is starting to change already. I do not know whether you are aware or not, but pretty well all the major and minor lenders in Australia have changed their commission structure considerably downward. I know brokers are looking at the idea of saying to consumers, ‘We think we can add value to the process and we think that you should pay a fee for our services.’ I think that will evolve, rather than happen overnight.

One argument against it is that it militates against borrowers who are least able to pay fees. A lot of borrowers who go to brokers are people who are not in the position of having extra cash to pay fees. The danger in that potentially is that a broker who has been dealing with borrowers who are borrowing medium or small loans but who do not have any extra cash to pay fees will be disqualified from the broker process. That is something the industry will have to work through.

The other interesting thing we have—and we have been looking at this—is that where there is regulation of brokers in the market at the moment, pretty well right across Australia, you are not allowed to charge a fee until you actually provide credit. People would say that is fair enough, but the service the broker provides is to look at the borrower’s financial position, and in the case of switching or refinancing the broker’s advice might be not to switch.
Mr MARLES—Don’t.

Mr Naylor—Yes. If brokers move to a fee model, you would want to be able to say, ‘I will do a health check on your mortgage and give you advice as to whether you should or should not go, but, by the way, the fee is x number of dollars.’ That is an evolving position.

Mr MARLES—I appreciate that answer because it is an interesting area. There must be a risk that brokers ultimately feel they are responsible to the person who is paying the bills? Is that not right?

Mr Naylor—I suppose that if you look at it very theoretically that is the case. But in reality successful brokers are dealing with lots of different clients over a week and different lenders and they do not send all their business to the same lender. They send it to the lender whose has the most appropriate product for their particular client. That assertion has been made, but everything I get from our members when I talk with them is that of course they expect to be paid, so commissions are important to them because that is how they survive—they do not do it for nothing. But in reality, the defining point as to which lender gets the loan is the one who can satisfy their service requirements, which is how quickly the loan can be approved or whether it has the facilities that the particular borrower wants.

Mr MARLES—in the context of switching, I think lenders and brokers in the UK are required to provide a key facts document about the product they are recommending. Do you think there is value in that?

Mr Naylor—Yes, as long as it does not become so onerous to the provider of the document and so complicated to the receiver of the document that it is unintelligible.

CHAIR—I want to clarify a response. I refer to the liquidity shortage that you see as being part of taking away the competition because players do not have access to that—they are not in the market.

Mr Naylor—Yes.

CHAIR—The solution that you are proposing in terms of the Canadian model is based on the assumption that it may be some time before the cycle is rectified. That is a permanent solution.

Mr Naylor—Yes.

CHAIR—There are other more short-term solutions, such as repos. At this stage, given the evidence that you have heard today from the RBA that they see the conditions already changing, why would we not be looking to a more short-term solution in terms of liquidity?

Mr Naylor—Short term?

CHAIR—If at all.

Mr Naylor—Yes, short-term solutions probably will not help non-bank lenders.
CHAIR—How would that be the case if there was access to greater credit in the short term? How would that not assist?

Mr Naylor—If there was, that may well assist the situation. I am not sure of the details. I did not hear the Reserve Bank’s comments. We are also looking ahead as well because the world runs in cycles. Somewhere down the track we will probably get a cycle like this again. It is better to have the mechanism in place rather than to have another inquiry and ask what we are going to do about it.

CHAIR—But the history of, for example, Fannie Mae in the United States was that it came out of the depression. I am not sure that you are suggesting that we are about to have a 1929-style crash or something like that in the near future.

Mr Naylor—Nor am I suggesting that we should adopt the Fannie Mae model, because from what we have seen they have got themselves involved in pretty silly loans and pretty poor lending practices.

CHAIR—But whether it is a Fannie Mae or Canadian model, it involves long-term change of a permanent nature that to some degree has the government taking on a risk that it previously did not have to take on over an ongoing period. There are other solutions. If this is about keeping players in the market while the cycle comes around again, surely we are better off looking at solutions of that nature?

Mr Naylor—If those solutions are available. As I said, we put up the Canadian mortgage bond system as a possible solution because we are aware of it. If there are other solutions that achieve the same objective, you would obviously be crazy not to look at them.

CHAIR—Thank you for your contribution both in terms of the submission and in making yourself available today to be questioned.

Mr Naylor—Thank you.

CHAIR—This is obviously recorded by Hansard and you will be sent a copy of the transcript. Please look at it and correct any errors. Hansard is here today and if there are any issues they wish to raise with you about technical terms that have been used they will. Once again, thank you for your contribution.
SYMOND, Mr John, Founder and Chief Executive Officer, Aussie Home Loans

CHAIR—Welcome. Do you have any comments to make on the capacity in which you appear?

Mr Symond—I represent both myself and my organisation, Aussie Home Loans.

CHAIR—Welcome, and have a seat. Although the committee does to the require you to give evidence on oath, I advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the respective houses. We have received your written submission, which we have read through. Is there an additional submission that you would like to put to us? You may go straight to an opening statement or tender any additional documents.

Mr Symond—I would like to table my paper that was put up a year ago to both the then government and opposition entitled ‘The John Symond Paper Addressing the Housing Affordability Crisis’ dated 21 August 2007.

CHAIR—It is the wish of the committee that the document so entitled be presented by Mr Symond and be taken as evidence and included in the committee’s record as an exhibit and numbered. There being no objection, it is so ordered. Thank you for being here today. We invite you to make some opening comments. The committee will then ask you a series of questions to try to draw out some of the issues in your submission.

Mr Symond—Thank you. I would like to remind the committee, the government and bureaucrats that the competition, particularly in the home loan market, which eventually occurred over the last 10 or 15 years did not come from the banking sector. It came from outside the banking sector, and I am pleased to have played a major role.

We kicked off in 1992 when there was no non-bank industry. The industry started to grow after 1994 when we, in partnership with Macquarie Bank, introduced securitisation of home loans. It was the first time that that facility was made available to Australian consumers, thereby bypassing the banking sector, which then provided the funding for home loans. The non-bank sector grew. It probably grew too fast. There were very few rules regarding entry. Be it the majority of non-bank players, participants, originators or mortgage brokers, they have been quite ethical, but there is still a significant sector where the consumers’ interests are not always looked after. I commend the federal government’s green paper about taking over the supervision of financial services. I believe that the majority of non-bank players, in particular, support that.

In my view there has been a deterioration in competition over the last 12 months on account of the global credit crunch. It has wiped out a number of the non-bank players. A number of players will survive—who are strong enough to do that. It has given the big retail banks a fantastic opportunity to increase pricing on various products. I am concerned that we may also see a deterioration in servicing because service comes at a cost.
There have been various submissions put to government to support a funding vehicle similar to the Canadian model. Whilst I am supportive of an initiative along those lines, I am not supportive of the government supporting a full-on vehicle providing or supporting securitisation to the general public at large.

As I highlighted in my affordability paper, I believe a vehicle supported by the government will have great competitive and social benefits to Australia, in that if there were funding available at a reasonable price—not subsidised, reasonable—government and developers could better project housing needs. Today we are going through a terrible rental crisis because, quite frankly, we are not developing new housing to house first home buyers, they are staying in rental accommodation. The shortage is there and we all know that rents are going through the roof and will continue to increase. There could be a vehicle supported by government, and restricted to the demographic that most needs it—that is, first home buyers buying new housing—with a ceiling limit so that it will not finance million-dollar homes. I believe there is a case for government looking at creating a stable funding vehicle whereby local government, state government, federal government and developers can ensure that the housing requirements going forward and can be more accurately projected.

The other concern I have that is hindering competition is the inability in today’s economy particularly of young people to get into housing. It is difficult to get a deposit today with the cost of living being so high. We are fortunate that we live in a country that has an enviable standard of living for most. However, governments have been negligent in allowing the cost of housing to go through the roof. State governments pass on 100 per cent of the cost of the services for a new block of land, whereas 30 years ago it was paid out of taxes. That cost is passed that on to the developer and the developer passes that on to the first home buyer. In New South Wales, for example, purchasers pay $140,000 or $150,000 in service fees before they pay for the real cost of the land. We need reform in that regard.

My belief is that young people should be given tax breaks on their mortgage payments. Again, I target it to new housing, because I believe that new housing is absolutely critical to the fabric of our society. I believe that a home is not just a house with a roof. I believe that homes keep families and marriages together and stop kids going AWOL. I know what it is like to lose your home because in the late 1980s I went through that experience.

In February this year the federal government announced an incentive for people to save towards buying a home. That is all very good and it may help some in four or five years. But what is being done today? We had a housing affordability crisis a year ago, and on top of that we are now going through an amazing liquidity crunch that the world has never seen before. I do not see where federal or state governments are doing anything to be proactive in helping with the crisis today. I believe it will also assist competition if young people know that they can save money, and they need to save it for mortgage payments.

My proposal is not dissimilar in style to the university HECS system. For the first five years they can get up to $15,000 in tax deductibility. That would give them five years to settle into their home. One partner may stop working to start a family. In the second five years they pay half of that back. That sort of style would stimulate new housing, take pressure off rental accommodation and encourage investors to get involved in the sector. We are now going through absolute peaks and troughs where nothing is happening.
In summary, I believe competition was quite healthy up until a year ago because we had a supply of funds that was not dependent on domestic banks getting involved. That has totally shut down. I accept the Reserve Bank and government suggesting that the credit crisis will not go on forever and that the securitisation markets will reopen. Provided that happens within six or nine months, fine; but I still strongly support the style of the government-sponsored funding vehicle to give some certainty to our future new housing. However, if this credit crunch continues, it would then be absolutely necessary for government to sponsor a securitisation vehicle that can help a wider demographic than first home buyers.

I believe tax reform is needed. Aspects of capital gains on housing are probably too generous. Had we and the government known 20 years ago that asset appreciation on houses and investment properties would be so great, I do not think that the generous tax laws would have been agreed upon. I believe tax reform would be a big driver in assisting to resolve the housing affordability crisis. It also would ensure that young people can get into housing. It would mean that banks would know that there is a vehicle there and if they do not compete, they are going to lose business.

Currently we are all forced to deal with domestic banks, whether we like it or not. If, and I emphasise ‘if’, they start to gouge, that may force government to do something. But if we have no competition, that is not good, and competition will not come from within the banking sector. Global banks, big banks, are probably hurting more than global small banks. Fortunately we have, I believe, a very sound transparent banking system in Australia. However, the old rules in life—that you will get away with whatever you are allowed to get away with—may well apply going forward, and we need government not to take for granted that credit markets will open up in time and everything will be hunky-dory. I believe we have to remember: Where did competition come from? It did not come through the banking sector.

CHAIR—Thank you for those opening comments. Going to the issue of competition, almost every submission we have had, particularly from those who have come before us so far, has recognised the role that non-banks played in the early and mid-nineties in opening up competition, and particularly the role your organisation played in that. There has been no disagreement about the historic role that that competition has played. One also would think intuitively that if there are fewer players in the market, there is less competition going forward.

A couple of the key issues that this committee wants to consider are how we can keep competition at its highest level in the industry, given the historic success of making things better for consumers concerning products they received, and how we can move between the various financial institutions’ products or between financial institutions so that there is greater ease of moving between them.

You said that competition tightened up in the last 12 months. In your view, has that had an effect on the level of passing on of benefits to consumers at this stage, or are you foreshadowing that that will happen, given enough time, because there are not players there?

Mr Symond—It absolutely has had a dire impact on the non-bank players. We are fortunate that we have a loan book of $24-$25 billion. If we did not have that, we would not have an income stream. Our profitability probably would be halved over the last 12 months and before, but fortunately we have a big business in a non-bank sector and we are still very profitable. But
there are many non-banks out there who have no profitability and who will not last. When you do not have the profitability for which you budgeted, including in our case, it stops you providing different services or jumping in to do other initiatives. The impact of what has happened over the last 12 months has definitely—and it will become more transparent over the next 12 months—resulted in less competition out there for consumers, and the consumers will be funneled to the front door of bank branches. Of course, that is what the banks want.

CHAIR—We have already had some evidence in this hearing of the significant increase in banks taking up mortgages compared to the way it was even three or four years ago.

Mr Symond—Yes.

CHAIR—Has that meant that banks have been in a better position to pass on costs to consumers, in your view? Has there been less competitive pressure because of that? We have seen interest rate rises above and beyond the RBA. We have heard banks talk about perhaps not passing on the full benefit of that. In your view, if that in some way linked to the competition issue?

Mr Symond—If securitisation was still out there, the banks would be acting in a far more competitive way. There are two arguments over not passing on possible rate cuts. Clearly the global credit crisis, just as happened with oil, pushed up the cost of money significantly. I am not someone who sticks up for banks, but it is fair to say that the banks have not recovered the increasing cost of money globally. In very recent times—like, weeks—the short-term money markets in Australia have settled down, but my understanding is that that is not where the banks get the bulk of their funding from; it is from the global credit market.

One question is that the banks can show you dollars and why they have not covered. Of course the other question is a very important one, and that is the moral question. With the big four or five banks generating in excess of $20 billion a year after tax, can they afford not to increase housing rates? Banks can get away with it today because there is no competition outside of the banks themselves. I have no doubt that there will be future creep in margins, not just on home loans. While there is no competition outside the banking sector, that will continue. The longer the credit crunch goes on, the less likely it will be that there will be any competitive competition outside the domestic banking sector.

CHAIR—My electorate is on the Central Coast, which has a high proportion of young families with mortgages, and David’s electorate is in Western Sydney, so you have two people on the committee who have constituents who face daily pressures from mortgage rates in particular. One of the things that concerns us about which we are a little disturbed, and one of the things we want to consider during this inquiry, is the RBA talking about these things being cyclical and saying that things will sort themselves out in the long run. In the meantime our constituents are losing their houses, they are cutting back or they have to sell because of the perceived lack of competition that exists. Do you see your proposal in terms of a Canadian style system affecting that in the short term?

Mr Symond—It would affect it in the short term, and I would restrict it, certainly in the short term, to focus on first home buyers buying new housing. However, the longer the credit crunch goes, it may well need to be widened because it might help first home buyers buying an existing
property. But I would not go out and suggest that the government should be supporting a
securitisation funding vehicle that is open to all segments, all prices, and funding million-dollar
homes. I do not believe that is the solution.

**CHAIR**—We have had discussion with most of the people who have made submissions that if
the RBA and the big banks similar to the RBA are right, and it is cyclical and will sort itself out,
if it is relatively short term, why as a government would we not examine RBA repurchase
agreements and expanding those as a vehicle? They can be of a more limited nature than setting
something up at this stage as a more permanent change in terms of the Canadian model, given
your qualifications on it which may well go beyond the issue of competition?

**Mr Symond**—I guess I am supportive of the concept, but I do not really believe it is
necessary to commit resources capital because it will come at a cost. It may curtail expenditure
by government into other areas. I believe that by going into a full model that is open to
everybody, it will impose pressures and financial cost. I do not believe the government needs to
do that just yet. But my view would change if the credit crisis worsens and becomes more
protracted than what is being suggested by the RBA governor, government and Treasury. I do not
believe, from what I can gather, that Treasury is overly supportive of the concept as well.

**CHAIR**—We have had Treasury here today and we explored some of those options with
them. In particular we have looked at one of the other key initiatives of this inquiry that we want
to come out of that, which is not only having enough competitors in the industry but having the
ability for them to move between competitors. What is your view of making switching easier?
First of all, is it an issue? If it is an issue, do you have any views on how we can make that easier
for consumers?

**Mr Symond**—Switching is only an issue when lenders write a new loan, discount the real
cost and lose up front $1,000 or $2,000 to win over the business by giving somebody the
honeymoon interest rates they used to promote and absorb the cost of valuations, legals and all
the rest of it. That happened in the US in the eighties when they discounted both interest rates
and fees and they burnt the candle at both ends. That is when their equivalent to building
societies and others went bust. In Australia, competition got so red hot it reached the point when
some people were borrowing money who really should not have been borrowing money. To help
them along the way, there were no up-front fees, no documentation fees, no valuation fees and it
got to the stupid point of people not even needing a deposit.

Fortunately we are at the point of the cycle where we cannot in any way be compared to the
subprime of the US. One good thing that has come out of the credit crunch is that it will bring
sanity back in. I have a fundamental belief that if you have no deposit, or even 10 per cent, it is
pretty flawed if you borrow the lot. The reality is that you have to be in your forties to remember
what happened in the eighties. Young people do not have a clue because it was not on their radar
when they were teenagers. Not only can they buy a home and borrow the lot and not pay any
fees, they go to a department store and buy plasma TVs and furniture on the never-never and
think that it is on no interest payments and that there are no payments. That is absolutely a
flawed model. Hopefully some sanity will come in. My belief is that you need to have some hurt
money when you buy anything.
CHAIR—One of the discussions we have had today relating to various submissions has been about deferred establishment fees. An argument was put to us by the NatWest bank that essentially that is anti-competitive in a sense because it defers a payment, which is a disincentive for people to swap between loans, whereas if it was put up front, people would know at the time they enter into a mortgage what their costs are.

Mr Symond—Skill in the game is important, as I said. However, a lot of the deferred establishment fees are designed such that if you stay with a lender for one year, two years or three years, that deferred fee can whittle down in most cases to nil or a couple of hundred dollars. It costs a provider, whether that is Aussie Home Loans or the NAB, money to pay for documentation and valuations to establish the loan, but competition got so red hot that consumers were not paying any of that. That was the reason that deferred establishment fees came in. To make switching better, I would prefer a consumer to pay an application fee, whether it is $600 or whatever, and go into a variable home loan rate, and let them discharge whenever, with no cost. But I think a better system to enable people to switch is needed, and that would certainly support consumers.

Mr BRADBURY—Mr Symond, the evidence that has been heard by this committee is fairly consistent, but competition has deteriorated in the market since the credit crisis. It would appear that the banks seem to have us by the short and curleys in the current climate. If there were a measure or a range of policy measures that you think would have the greatest effect on increasing competition in the short term, what would that measure or those measures be?

Mr Symond—Without any doubt, funding of mortgages is what brought competition on and lowered home loan interest rates by 300 basis points. That is starting to be eroded, so the one single most significant issue is the lack of funds being available to finance home mortgages. You have to have a big balance sheet, which means you have to be a big bank—not even a small bank. The few remaining small banks out there cannot compete with the big banks. They are going to feel the pain more and more as time goes on with their cost of funds compared to the cost of funds of a big domestic bank. That is one of the reasons I believe St George is looking at merging with Westpac. St George is a pretty big bank, but its funding and cost of funds is significantly higher than the big four banks. The one single error to me obviously is where the funds come from to finance housing. Securitisation provided that, but that is slammed shut at the moment with no signs of easing up whatsoever.

Mr BRADBURY—Alternatives to securitisation to provide those funds would include—

Mr Symond—Bypassing the domestic big banks.

Mr BRADBURY—In relation to your comments about taxation and capital gains tax, what specifically were you referring to? Were you referring to main residence exemptions?

Mr Symond—Yes. I was referring to a first home buyer borrowing a mortgage and paying their interest payments, having those interest payments to a limit of $15,000 per annum as a tax deductible entity for five years, and then for the second five years they pay back 50 per cent of that benefit.
Mr BRADBURY—But you have suggested that certain taxation concessions had been overly generous in the past.

Mr Symond—I still believe that.

Mr BRADBURY—Specifically, which measures are you referring to?

Mr Symond—The real estate industry will shoot me for making these comments, but I believe that, considering past sharp price increases and being taxed at the capital gains rate, buying residential real estate has been extremely generous for those who were fortunate enough to go in and invest in second properties and rent them out. They have had a huge windfall. The government’s argument is, ‘If we cut back spending here and spend more there, and if you want us to cut back taxes here, where will it be funded from?’ I believe that the whole tax system needs to be reviewed. It may well be that some areas of capital gains may well have to be rejigged.

Mr BRADBURY—In relation to commissions for mortgage brokers, one of the submissions—and I think we are anticipating that a representative of Fujitsu Consulting will be appearing tomorrow—made a suggestion that a better approach of funding advice would be for the consumer to pay a fee for advice from the broker, rather than the lender paying commission. I have to say that in my dealings with people in my community, a number of whom have been stung by what they believe has been less than effective advice, most people out there believe that when they go to see a broker, the broker is acting in their interests and that their interests are being placed above the interests of all others. Would that type of model, by which advice is provided on a fee for service basis, be a much more transparent approach than one where effectively the broker secures their funds by way of commission when they sell the product?

Mr Symond—It would be a lot more transparent. However, the fee would have to be a very significant fee to take into account the costs of your staff, valuations, costs, legal costs on the documentation, and the cost of running an operation. Take Aussie Home Loans: we spent $1 million a month on advertising. Forget all the other infrastructure costs. It would have to be a sizeable fee. Maybe it is a fee that spreads the burden. Maybe it is a lower fee from the funders and a lower fee from consumers. I am supportive of that. However, I believe consumers have the best end of the bargain over the last number of years because someone else is picking up the tab. You can say, ‘Oh, yeah, but it is in the interest charges’, and all the rest of it, but in terms of consumers in Australia, we have had the most flexible, sophisticated mortgages in the Western World.

In the US, notwithstanding the US is in trouble, they have mortgages of 30 years that are fixed—set and forget. Here you can take a mortgage that you can split twice or three times or pay part interest only, have redraw facilities, and part fix. That costs a lot of money for your IT platform to run. Consumers have sharper and smaller margins, fantastic service—lenders go their to home and banks have picked up their game big time and have been offering similar services—and pay no application fees. In the overall scheme of things consumers have benefited from this competition remarkably—I emphasise ‘remarkably’—with right-priced home loans and no costs up front.
Anywhere in the world you pay costs up front. You cannot go to an accountant, a lawyer or a doctor without paying for a service. Yet in the mortgage world the consumer does not pay for it. You can say, ‘Oh yeah, but it comes out of interest payments.’ But why do we not pay for that when we continue to pay for it when we buy some other product; when you pay for the service, and that is it. Consumers do not pay for the service up front. On the competition and pricing side, consumers have had a good run over the last four or five years.

Mr BRADBURY—I note that you acknowledge that it would be more transparent to approach it on that basis.

Mr Symond—I would much prefer an up-front fee.

Mr BRADBURY—The question here is: To deliver a comparable service would probably require a significant up-front cost unless there were some facility to spread it?

Mr Symond—You would be talking a few thousand dollars here—$2,000 or $3,000, or a 1 per cent fee.

Mr BRADBURY—But is it not an awkward scenario that we presently face, and a confusing one for the consumer, when most people go along to speak to a broker in the belief that the broker will be providing advice to them in their best interests, which may or may not be the case? In that scenario, who does the broker owe an obligation to? Is it the consumer, or is it to the lender?

Mr Symond—It is a blurred responsibility. It might be naivety, but I honestly believe the broker believes that they are serving the best interests of the consumer first. I do honestly believe that. Our organisation invested many millions of dollars in a software system that takes the choice of a home loan away from the broker and the consumer chooses from the short list of matching customer needs to 2,000 different home loans, but we are the only ones who have got that. But, yes, it is a blurred responsibility. But I believe that the vast majority of mortgage brokers would be acting in the interests of the consumer, and I am talking here about prime home loans. I am not talking about loans that people have to pay 2 or 3 per cent in higher rates for because they are not credit worthy. I am talking about triple-A rated, prime, normal straight up and down home loans.

Mr BRADBURY—I noted that in the Council of Mortgage Lenders submission they have made a proposal that would involve greater regulation and drawing a distinction between mortgage managers and mortgage brokers. I wonder if you have any views on the appropriateness of that distinction?

Mr Symond—They are two very distinct groups. Mortgage managers are originators who are raising funds and provide funds. Mortgage brokers really are supposed to be offering consumers choice, not raising the funds themselves. You get some organisations like us where 5 or 10 per cent of our business is an origination business, but 90 per cent is that we process $1 billion a month in new home loans on a broker basis, like a big supermarket. But, technically, the service provided by a mortgage manager is totally different to that offered by a mortgage broker. A mortgage broker offers choice; a mortgage manager says, ‘A Ford is better than a Holden. I’m Ford. Have this.’ So there should be a distinction.
I am all for regulation, but not over-regulation. I think it is a combination. The healthy scenario is the combination of self-regulation plus government regulation. We have been lacking particularly in government regulation and up to recent years self-regulation. I think we are heading in the right direction. The sooner we get uniform federal regulation the better rather than the costly cumbersome exercise of complying with WA laws that are different to Queensland laws, and New South Wales is different, which impact at the end of the day on the consumer. Federal uniform legislation is a godsend, and strong self-regulation by industry players is absolutely essential if you are going to have any credibility with consumers, government and the media.

Mr BRADBURY—Finally on the issue of dislocation between movements in the official cash rate and the variable rates being charged by the banks, some people have suggested that what has occurred has led to now a permanent dislocation between movements in the interest rates that we pay compared to what the Reserve Bank is imposing at the official cash rate level. Do you have a view on whether that is a temporary matter?

Mr Symond—I have a very strong view that it should be dislocated. I have believed that for many, many years. Where in the world can you buy a stock and equity price of oil based on a price setting from six months ago or three months ago? It is a piece of cake because if you want to fix your home loan rate today, you will be quoted the fixed rates in the money market today. If you want to buy some BHP shares, you cannot say, ‘Oh, but they were trading cheaper three months ago, and I want that price.’ That is the way this country has run variable rate pricing. It is absolutely archaic, out of date and cannot work, so personally I think it is a good thing going forward. Let market forces set the rates, provided we have competition. Certainly you cannot fill up your petrol tank and say, ‘Hang on, two months ago it was 20c a litre cheaper.’ No, you have to pay today’s price.

Mr BRADBURY—What are the implications of that for monetary policy?

Mr Symond—But nowhere in the world is there a system like that. It is really what the cost of the commodity is. It is no different to currency. Look at the Aussie dollar. It is tanked. It has dropped 12 per cent in a span of days. Try to get 97c for a transfer today when 10 days ago you could have got 97c but today it is 86-point something cents. They will not talk to you. You have to pay today’s price. Money is no different. In terms of monetary policy, it is still very important with monetary policy and that has a huge bearing on the cost of money. But in terms of 30 basis points or 50, or 20, I think it is a flawed system that we have been operating on. It was designed when there was no competition and banks conformed to that. With competition, and subject to competition in the future, that is a flawed policy.

You still need monetary policy for sure because the cost of money will go up or go down, but in terms of trying to keep a variable rate that in the real world is costing a higher amount than it cost three months ago, that is totally unrealistic. Forget that banks are banks. That is asking a provider of any commodity to absorb the loss today, and that just does not work. I think that the dislocation is healthy, provided that it is not abused. Going forward, I am totally supportive of it. I am surprised it has not happened before now. It has taken a credit crunch for the dislocation to happen.
CHAIR—In conclusion, because we are conscious that we are already over time, and we thank you for remaining, there is one other question relating to competition that I want to ask you. You touched on it with the interest free periods in stores and the credit cards that are available. In terms of the government’s proposal for switching credit cards having been left aside, do you think that is an area we need to examine? Is competition in that area strong enough? You can go to many stores now and buy something, but you will end up paying 28 per cent interest.

Mr Symond—Unfortunately, competition is certainly strong enough, but it is competition on how best to mislead consumers.

CHAIR—So it is issues of transparency that we need to be looking at?

Mr Symond—There are issues of transparency. If people only knew this: when they buy a plasma TV and miss one payment, even in year two, they will pay 28 per cent from day one. What consumers do not look at is that it is an emotive purchase. They do not look at the fine print. There are many billions of dollars a year in this space. I think that that area is a ticking time bomb in itself.

CHAIR—Thank you for your contribution today. It was a very serious contribution that the committee will spend a lot of time considering and going through. Today’s proceedings were recorded by Hansard. That will be sent to you, so if there are any corrections, please make them. The Hansard reporters are here and they will ask you straightaway for details that they did not get. Once again, thank you for your contribution.

Mr Symond—Thank you very much.
BYRES, Mr Wayne, Executive General Manager, Diversified Institutions Division, Australian Prudential Regulation Authority

RICHARDS, Ms Heidi, General Manager, Industry Technical Services, Australian Prudential Regulation Authority

CHAIR—Welcome. Although the committee does not require you to give evidence under oath, I should advise you that these hearings are legal proceedings of parliament and therefore have the same standing as proceedings of the respective houses. We have received your submission, which we have and which we will ask you some questions about. Are there any additional submissions you wish to put to us today in writing, or do you want to go straight to an opening statement.

Mr Byres—We have no additional submissions.

CHAIR—That being the case, we are in your hands.

Mr Byres—Thank you very much. We are pleased to have the opportunity to appear before the committee today. I thought by way of opening comments, I would draw out quickly a couple of key points form our submission. The first is obviously just to draw the committee’s attention to APRA’s responsibilities, which are set out in the APRA Act, but generally we do not have responsibility for competition policy or consumer protection beyond our core mandate.

Our responsibilities are probably best set out in simple form in the government’s Statement of Expectations, which was given to us in 2007 and said that our task is to maintain a low, but not zero, incidence of failure among regulating institutions, and not to impede efficiency or hinder competition. In our Statement of Intent in response, we fully supported that approach.

The second point I would like to draw out quickly is the limit of our regulatory responsibilities. We are responsible for licensing and supervising authorised deposit taking institutions, which are banks, building societies and credit unions. We are responsible for insurers, including lenders’ mortgage insurers, and we are responsible for superannuation funds. But that is the extent of our regulatory mandate; hence, we are not in a position to offer comments on those parts of the financial sector that we do not supervise or have any responsibility for.

With those couple of explanatory points, I would like to make a few comments about current conditions in the financial sector, particularly in the area of lending for housing as we see them. There is no doubt that the business environment for housing in Australia has deteriorated in the past year, but that comes after a very long period of robust growth. That has posed challenges for APRA to ensure that all of our regulated financial institutions remain in sound health. Pleasingly though, the funding, the profitability and the capital adequacy of the ADI sector has held up well. There are no signs at this point that the sector is facing material losses from housing lending or funding adversity.
We do not expect that we will need to make any material changes to our capital adequacy requirements for ADIs in response to the recent market turbulence. The LMI sector in Australia certainly has seen claims increase from historic low levels, but this sector too remains profitable and well capitalised. The strength of the ADI credit standards and the LMI underwriting standards in Australia stands in sharp contrast to the US subprime mortgage market where a significant number of loans has been extended on unsound terms and conditions.

As a result of that relatively health position in Australia, our view is that borrowers with sound credit records, reasonable equity and a documented ability to service a mortgage should have little, if any, difficulty in accessing housing finance from competing lenders. Many borrowers who are good credit risks but perhaps with more limited capacity to provide equity will continue to benefit from access to lenders’ mortgage insurance and will receive housing finance on that basis. That view is supported by our regular liaison with the credit officers in the ADIs who have noted that credit standards for housing lending have not been tightened outright, but there has been some reduction in lending outside internal credit policies, so a reduction in the number of policy exceptions, and obviously a heightened scrutiny of debt serviceability of their customers.

On the other hand, borrowers who have an impaired credit record, little or no equity or uncertain income sources to support a loan and who might have previously used the services of a mortgage broker or an unregulated lender are likely to find it more difficult to access housing credit, particularly at the low risk spreads charged by lenders up to the middle of 2007. That is not a local phenomenon but a reflection of the global repricing of risk that has happened in the last 12 months and the sharply reduced risk appetite of investors in the wake of the US subprime difficulties.

In that difficult global financial market environment, we have stepped up our supervisory intensity of the institutions that we regulate, particularly with respect to credit and liquidity risks. But that heightened focus on financial safety and soundness does not, in our view, compromise the efficiency or the competition in those two sectors. Those comments were all made in our submission, and with those opening remarks, we are happy to take questions.

CHAIR—In terms of ADIs, you have said the sector is strong, profitable and well capitalised. Given that analysis of the sector, consumers-mortgagors in my electorate are hearing similar comments made, but then find that description at odds with decisions banks have made when putting up interest rates above and beyond the RBA and in recent times talking about not passing on interest rates. How do you reconcile your comments with the actions that we have seen?

Mr Byres—I made the point that the profitability of the banking sector has remained sound. Partly that has to do with the fact that the banks have adjusted their pricing in response to global market conditions. The ADI sector as a whole and the banking sector in particular source a large proportion of its funding from offshore markets and needs to pay the going cost for those funds. Banks have had to pass on that increased costs to borrowers of all sorts, not just housing borrowers but borrowers of all types.

CHAIR—You have said they have to pass on those costs, but have they had to pass on the costs or have they chosen to pass on the costs because there is the issue of maintaining margins that has been the prime focus of some of the players here? They are a profitable industry. They are on a sound financial basis. We are seeing record profits, the CBA announcing its yesterday.
We have seen 10 years of record profits. There are very few industries where the costs can be entirely passed on to the consumer. Why should this industry be different to any other in terms of that?

Mr Byres—I am not sure it is in the sense that notwithstanding that a number of lenders have probably found it more difficult in the current environment, as I said in my opening remarks there is still a degree of competition, particularly for borrowers with good income, some equity and a demonstrated ability to repay a loan. The banks have sought to maintain their profitability; there is no doubt about that. That is their commercial business decision.

CHAIR—We also have seen in recent times, particularly in the last 12 months, a reduction in the proportion of the market that the non-banks have had with new lending. We have had significant evidence from most players that it was the introduction of the non-bank sector in the 1990s that brought about massive competition that put downward pressure on interest rates. Are you concerned at all about the decline or lack of competition in this industry?

Mr Byres—As I said in my opening comments, promoting competition is not an objective we have. Obviously our role is not to hinder that competition in any way with our regulatory requirements. There is no doubt that over the last decade new entrants into the industry have brought a greater competitive force to that sector, but it is part of the cycle of markets that that will come and go and in all likelihood will come back.

CHAIR—The issue with the cycle of markets is that there are real people out there with mortgages whose timing may not fit precisely with the way the cycle of markets is operating. They are areas where the government may make some changes or intervene, if it seems necessary. I also am interested in comments you might want to make in relation to superannuation funds. Earlier today we had evidence of superannuation funds’ reluctance to get into the mortgage market. There were comments made by both Treasury and I think the Reserve Bank that they could not quite understand why that was the case. Do you see that as an area of increasing potential to provide credit through superannuation funds for this sector? What would be barriers to that, if there are any?

Mr Byres—I am not sure there are particular barriers beyond a general nervousness in markets at present. As best I can tell, when we have asked people and looked at Australian prime mortgages, they are quite different to US subprime mortgages which have caused a lot of difficulty around the world. Why are people not willing to invest, particularly as yields on those have improved and prices have come down? The usual answer is simply a case of, ‘I’ll wait until I’m confident that things have hit the bottom before I am willing to invest my money. Why would I buy something today if it might be worth less tomorrow?’ There is just a general nervousness in investment markets at present. People are quite happy to sit on their hands.

Mr Turnbull—I would like to pick up on a point made by the chairman earlier. He mentioned that people buy houses and therefore take out mortgages not simply because they think houses or mortgages are cheap, but because of the time in their life; they are getting married or they have had some children or they have had more children, or whatever it is that gives them the incentive to move. Clearly a family that does that at the top of the housing market runs the very real risk of losing money when the market turns down, as markets generally do.
One of the things that has confounded policy makers for years in your area around the world is whether anything can be done to take the spikiness out of the housing market. When you see a lot of volatility in financial markets for equities, for example, that is something that investors have to take into account. No-one has any sympathy for an investor that buys any stock at the top of the market if they subsequently lose money. But because families buy houses and therefore borrow money because of the stage of their life that they have reached as opposed to what they think of the inherent value of the house relative to the market, the spikiness in housing markets has very severe implications when it turns down, as it obviously has done in many parts of the world, including in parts of Australia. Do you have any views? Is there anything that regulators, central banks, or governments, for example, can do about that, or is it something beyond the realm of policy management?

Mr Byres—I think people have talked about that relative to housing prices or more general asset price bubbles and whether the government sector somehow should be able to do something to try to dampen that volatility. There is discussion in the current environment about the extent to which regulatory requirements might be used to indirectly dampen cycles by making finance more or less expensive.

Mr Turnbull—In other words, to be leaning against the wind.

Mr Byres—Leaning against the wind is the phrase that is commonly used. In theory in one sense you could ask: What could APRA do in that space? We could raise capital requirements in times when things look like they are in a sense booming and reduce those if markets are going the other way. There are two challenges: first of all, when, how and how much you intervene and being able to pick when a market is booming and when it is not because, in effect, you are interfering in the market by doing that; and the second thing is that if we were to do that and in a sense raise capital requirements because we thought there was some broader community benefit in slowing housing finance, for example, the tools we have would tend to make it more expensive for banks to lend.

Mr Turnbull—Of course. They would put up rates.

Mr Byres—That would be the way it would work. That would get passed on. The short answer is that there is a lot of discussion and thought being put into these things, but no-one has actually come up with the magic bullet, so to speak. For all the solutions that come out, there is usually just as much, if not more, downside than there is upside.

Mr Turnbull—we have seen the brutal outcome in the United States of the consequence of very cheap money and very easy credit conditions with massive declines in housing values across America as well as huge and historical levels of defaults. I do not want to pursue that further, but other members of committee may. It is a very interesting and difficult topic. Spikiness in housing markets is a major social problem.

The second thing I wanted to ask you about was something you flagged in your submission and in what you have said, which is the very real qualitative difference between the Australian mortgage market and that of the US. We all accept or recognise that the collapse in the US residential mortgage-backed securities market, the so-called securitisation market, has infected similar markets everywhere. The window on securitisation was closed to Australian mortgages
just as much as it was to US mortgages, notwithstanding that our lending practices have been so much more prudent than those in the US, hence our banks have been more profitable and secure, et cetera.

Do you think that Australia should have done and could do more to get across to the rest of the world how different our mortgage market is? Have we failed? Have governments, regulators, and banks failed to differentiate the Australian mortgage market sufficiently? Should the securitisation window have shut so firmly on our mortgage-backed market as it did, given it is so very different to that of the US?

Mr Byres—I am reluctant to say anyone has failed to do something because I do not think anyone foresaw in any way that such a deep and liquid market could shut the way it did.

Mr Turnbull—Yes, but it did.

Mr Byres—Because of problems that existed on the other side of the world, so to speak. With hindsight, you would have to say the financial sector in total probably wishes it had done more to educate the rest of the world about the differences between our environment and our lending standards, our legal environment and the general credit quality of the Australian than it did. There is no doubt that the rest of the world did not fully appreciate those differences and probably still does not appreciate the differences between our market and others. The short answer is, yes, it would have been good had more been done. All the banks now are working hard to educate overseas investors.

One of the things that perhaps may play a small role and that will be coming in during the next few months is that, under the Basel II capital adequacy framework, there is what is termed Pillar 3, which in a sense is a set of disclosure requirements on the banks whereby they have to disclose a range of risk metrics, in a sense, of their portfolios. This is something that obviously will be applying around the world. To the extent that banks are doing more to highlight the very low levels of arrears, the very low levels of defaults, the very low levels of actual losses incurred on their housing portfolios, and investors are able to compare that with banks in other jurisdictions, that may well help. It will not necessarily resolve that issue but it may well help that issue.

Ms Richards—Another part of it was that a big part of the investor base for our RMBS were offshore-structured investment vehicles, which are just gone at this point. There is just a global kind of overhang of supply and it takes a while to work through the market.

Mr Turnbull—But realistically, our market is so incredibly different. The percentage of subprime mortgages in Australia is miniscule compared to the US. In the US now, given the collapse in housing values, there are a lot of prime mortgages that are under water.

Ms Richards—Absolutely.

Mr Turnbull—They are ones that, at the time of issuance, had a pretty conservative loan to value ratio. Do you think that governments could do more? Recognising that we are all members of parliament, is there something more that governments, or indeed parliamentarians
and committees, could do to get across internationally the difference in the quality of the Australian mortgage market and lending culture?

**Mr Byres**—Off the top of my head I cannot think of specific issues beyond just reinforcing the message that there are some fundamental differences here. In a sense that is why I think we view closure of the market as a temporary or cyclical thing rather than a permanent thing. You have to assume that even if overseas investors are sitting back and taking their time to watch the fall-out from banks around the world and wait until they feel the market has hit the bottom before they start investing back in, you would have to say over time that people will observe there is a different performance level between the prime Australian mortgage and the subprime investment that many investors have been stung with today.

**Mr Turnbull**—But going forward, your counsel to us would be that we should, given all our different capacities, we should be aiming to make clear to the rest of the world the very different characteristics of the Australian mortgage market and the different lending culture here so that we do not get tarred with the same brush in the future.

**Mr Byres**—Yes, but to the extent that the primary responsibility for that obviously rests with the lenders. As I said, there will be regulatory initiatives coming along that in some sense are coincidental, but nevertheless are very helpful, that should lead to their presenting much more information to the rest of the world and to having the opportunity to explain that information to the rest of the world.

**Mr Turnbull**—Good. Thank you.

**Mr Bradbury**—I want to asked a question in relation to lenders’ mortgage insurance. I know that the submission indicates that claims have increased from historic lows. Would you be able to give me some figures on what we are talking about—what the historic lows were and where we are now at? What is meaningful?

**Mr Byres**—I could not give them to you off the top of my head, but if I can take that on notice, we can provide you with some statistics on claims rates, loss rates, et cetera, and the time series or over time.

**Mr Bradbury**—Could you give us a broad indication? I am not trying to pin you down to an answer that you are not sure of, but could you give us a ballpark sense of the vicinity of those increases?

**Ms Richards**—I am thinking loss rates, which would be claims to losses, were running at something like 20 per cent for a long period of time, which is very, very robust. They have increased to something closer to 30 or 40 per cent, so there is still a very good buffer in there, but it has come up significantly off a very low base.

**Mr Bradbury**—And if historic lows were 20 per cent, historic highs would be, at one end of the spectrum, how high?

**Mr Byres**—Loss rates or claim rates now are probably as high as they have been since the last 15, 16 or 17 years, probably since the last serious downturn in the early nineties. But at that level
the mortgage insurers themselves are still quite sound and well capitalised. Certainly the loss rates and claim rates are higher than they have traditionally been, but they are within the bounds of tolerance, if you like, for that industry to continue to be able to operate and provide insurance as and when needed.

Mr BRADBURY—As a point of international comparison in the role of LMIs in the domestic marketplace, how do we compare with other countries? Are there any peculiarities there that mark out their presence in the marketplace in Australia compared to other countries?

Mr Byres—The only thing I would probably say is that the particular distinction here is that we are effectively dominated by two. There are essentially two large mortgage insurers which make up the vast bulk of the market. In the US, for example, there is a greater range of them. Our two main mortgage insurers obviously are subsidiaries of US parents.

Ms Richards—Mortgage insurance is also more important here in the mortgage-backed securities market than it may be in some other countries, so it is more common for an RMBS issue to be fully covered by LMI than in a lot of other countries.

Mr BRADBURY—Would you make the connection between the existence of that fact and the relative strength of our market compared to others, or the quality of the market compared to others, or not?

Mr Byres—It has probably played a role. I am not sure what level of credit I would give to it, but effectively what the LMI does is provide a second set of eyes over the credit standards of the lender. We think at least in the regulated sector the credit standards of the banks have held up quite well. For anything that has a fairly high loan to value ratio, they would tend to also seek mortgage insurance over that, so there is a second set of eyes that come in and look at that. To the extent you have that second set of eyes, they would be playing a kind of discipline on credit standards. They also would be playing that same discipline for the non-APRA regulated lenders.

Mr BRADBURY—I have a question regarding where funds are sourced by our banks. The evidence we have been picking up is that for some of the bigger players approximately between 40 or 50 per cent of their funds are from deposits. Would that be roughly about correct?

Mr Byres—That is ballpark, yes.

Mr BRADBURY—On that component, without moving into the other components of where funds might be sourced from, is there an argument for the deposits accounting for a larger proportion of the funding sources of the banks?

Ms Richards—Historically they have accounted for a higher share. Deposits relative to assets have declined for quite a few years. You might think from that that there is scope for deposits to increase.

Mr Byres—in a sense what we have seen is the lending side of the banks’ balance sheets grow faster than the capacity of the deposits to fund that growth, hence the banks have had to seek offshore funding to provide for that gap.
Mr BRADBURY—Just picking up on a point made a bit earlier about superannuation, I wonder what potentially the impact has been here of superannuation? It is often said that we are not saving all that much, but in a sense, we are, if you look at our retirement savings. But there is a bit of a disconnection here between money going into retirement savings vehicles and money being accessed by the banks for lending in the mortgage market. Do you have any thoughts on that? Is there any light you can shed on historically what has occurred there over the last decade or two, and whether or not there might be any lessons that can be learnt from that?

Ms Richards—It is hard to say what the impact was. Recently deposit growth has been very strong, which obviously has not really been related to growth in superannuation assets. Superannuation funds themselves hold a reasonable chunk of their money on deposits with banks, so to some extent it all sort of washes around. When there was a change to the superannuation regime last year, a lot of the banks saw that money coming in, not necessarily as direct deposits but as deposits through superannuation funds. It is hard to say what the overall impact is.

Mr Byres—If you look over the longer term, there is no doubt that in a sense a greater proportion of household wealth has been held in superannuation rather than someone who may have previously had their savings in term deposits with banks. Indeed, one of the trends over the last decade and a half has been that the banks have all developed quite significant wealth management operations because they could see that the way people saved was changing from bank deposit types of products or finance company debentures into superannuation products, so they have sought to move into that part of the market.

There probably is a correlation and a causation there. What is the lesson? I am not quite sure what the lesson from that is, other than that it is probably not going to change. That trend probably is not going to reverse in any long-term way. What we are seeing though in the current environment is probably that banks have not had to aggressively compete for deposits for a long time, and now there is very aggressive competing for deposits and very attractive rates available that has not been there before. But now, having seen the experience they have had and the difficulties that they are having in maintaining the growth in borrowing from offshore markets, there will be much greater emphasis now on competing for deposits.

CHAIR—Is there a role for governments? Some submissions call for tax concessions and the like to apply to deposits to increase the amount of deposits. Do you have a view on the effect that would have on the liquidity in the market?

Mr Byres—I have to say that I do not think we have a particular view one way or another on that.

Mr TURNBULL—Mr Byres, do we have you or APRA on the record on the Aussie Mac proposal? Are you familiar with it? The RBA does not like it, but I want to know what your view is.

Mr Byres—From an APRA perspective, we see it as a matter for government, not for us. Our regulated financial flock, as we see it, is still operating quite well. It is sound and generally competing against one another reasonably well. We are not advocating and we are not putting a position on Aussie Mac.
Mr Turnbull—You are agnostic.

Mr Byres—It is a matter for government to decide if you want to provide a subsidy or not.

Mr Turnbull—You are running out of time, so I will be very quick. What should this committee draw from the recent problems with Fannie and Freddie in the United States? How should that influence our views on the Aussie Mac suggestion?

Mr Byres—It shows there is considerable downside and that this sort of proposal is not a magic wand that comes cost free. It is not clear how that will all play out, but potentially there will be a cost to the US taxpayer. That is the downside of when things start to go wrong.

Chair—Thank you for your submission and your time here today. Obviously this was being reported by Hansard. A copy of the Hansard transcript will be sent to you. If there are any corrections that you need to make, please make those. Hansard reporters are here and if they have any questions, they will see you after your attendance. Thank you for your contribution.

Mr Byres—Thank you.

Ms Richards—Thank you.

Proceedings suspended from 2.56 pm to 3.14 pm
JAMES, Mr Peter, President, Council of Mortgage Lenders

REDDEN MAKATOA, Mrs Susan, Adviser, Council of Mortgage Lenders

CHAIR—I welcome the representatives of the Council of Mortgage Lenders to today’s hearing. Although the committee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the respective houses. We have your written submission. Are there any additional written submissions you would like to tender, or would you like to go straight to an opening statement?

Mr James—We will just go to a statement and open up for questions.

CHAIR—Thank you.

Mr James—Chair and members of the committee, I am here today with 32 years of hands-on experience in finance at the consumer level and as President of the Council of Mortgage Lenders. The council, or the CML, is a small very experienced group of prime non-bank lenders and they include: Australia First Mortgage, First Folio, Onyx Finance, Club Finance, Pioneer, Yes, and Resi Mortgage Corporation, of which I am the managing director. I emphasise the use of the word ‘prime’, as one of the major issues we have in the marketplace today is the lack of understanding of the different roles participants have. Some of the terms used to describe us in our industry include non-bank, mortgage manager, subprime lender and, yes, even broker.

We acknowledge that this standing committee has received upwards of 40 submissions detailing the issues relating to competition in our industry. Many of the submissions are from some of the best and brightest organisations Australia has to offer and go a long way to detailing the financial analysis of our current landscape.

We are here today with a simple message: we want to encourage an open, transparent and competitive mortgage landscape for the future to benefit all Australians. When deregulation allowed our industry to evolve in the early nineties, we created our own opportunities by delivering to all Australians a clear alternative to the standard bank home loan: We gave consumers what they had never had or been offered before. We reduced interest rates, up to 3 per cent in some cases; we organised multiple payment options, saving borrowers interest; we introduced transactional capacity capabilities attached to mortgages, such as a cheque and ATM; and we created product innovations, which developed things such as the redraw and expert loan facility. Probably the driving force behind non-bank lending sector was improved customer service.

At that time we sought no government assistance or support. We come today before you at a critical time in the evolution of our sector. Many prime non-bank lenders, those very non-banks that have provided vital competition for so long, are struggling. Today we request acknowledgement of our industry and the significant role that it has played in delivering more value through competition to the consumer. It is our desire that any outcomes from this inquiry deliver a level playing field for all participants.
For the past 12 months Australian financial markets have been facing unprecedented challenges, driven largely by the impact of the US prime crisis. Post US subprime crisis, the banks have enjoyed a substantial increase in market share, with some senior banking analysts speaking of this as a flight to quality for consumers, with the implication that non-bank lending lowers the standards, that our rates will increase above bank rates and that the banks have protected borrowers from this impact. Indeed COSL in its submission notes that the low incidence of complaints about inappropriate lending by members of non-ADIs, yet consumer perception is still misguided.

Today, some 12 months post subprime, prime non-bank lenders are still trading and delivering standard variable rates at lower than the major four banks, but under difficulties. Competition in the mortgage marketplace is being eroded. What can be done to effect change? We support the move towards one national regulatory framework to regulate all consumer credit, including mortgages. We note that both the ABA and the MFAA, as do most of the submissions before you, support this initiative. Consumer confidence in non-bank lending is low.

To restore competitive balance and redress the damage, we suggest the development of an industry-wide set of standards. These standards would allow consumers to make informed decisions about lending, rather than relying on myths and misconceptions. Some examples are: standardised industry-wide information packs, education programs, dovetailing with national regulation and endorsement of a stamp of approval for all lenders, indicating they meet appropriate criteria to restore borrower confidence, the introduction of a government funding program—not to rescue the non-bank sector but to ensure that liquidity is never affected when credit is tight, and that a level playing field still exists, relieving the burden on consumers.

In summary, 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 coming out that the margins have fallen at least four basis points in the last four months.

Working families need a quality alternative to a banking system. Without this, we face a return to the dark old days. Consumers need a choice. The CML remains committed to delivering choice and real savings to the Australian consumer. Our presence here today is evidence of that commitment.

CHAIR—Thank you for that. You spoke in your submission about the role played by non-banks in the early nineties in competition. That has pretty much been acknowledged by most submissions that have been written or made in evidence before the committee. You made a statement that you are still offering mortgages at rates lower than the major banks, but that competition has eroded. How do you explain that competition has eroded if your product is more than competitive with the banks?

Mr James—In a couple of ways. First of all, there is a perception that the non-bank lenders are unsafe. This happened just on a year ago when the credit crisis came to the surface. All of a sudden there was a perfect storm. You had RAMS floating and imploding eight weeks later
because they were the first ones to be noted as having short-term borrowings in the US market. Of course there was a great build-up by the banks of the fear factor: Is your mortgage safe? I can give you an example. You could have walked into a National Bank in September when all the tellers were wearing T-shirts showing, ‘Is your lender safe?’ It was the perfect environment in which they could capitalise and take back market share, which they did.

CHAIR—How is that different from the non-bank sector with its publicity saying, ‘Do banks care?’, and similar sorts of things. Is that just a marketing issue, or are you saying that there has been behaviour by the banks that goes beyond that? If so, can you give us some other examples of how that has happened?

Mr James—There is no real behaviour as such. It is a competitive market and we will play in that space, as we have for the last 20 years. It is very hard challenging somebody that (a) has bottomless pockets and (b) is such a big force in the marketplace: Having said that, we have done a very, very good job up until now. The factor is that for many years we created all the advantages to the consumer and we came in with better pricing. What happened after that, which would have been in the late nineties, the banks who traditionally would not pay fees to brokers started to pay commissions and up-fronts to the broker network, and drove the business to themselves. Again, that was competitive, but they were willing to take a percentage hit at that time to recapture the customer.

CHAIR—Because the banks are not saying that that is the situation at all. The ANZ Bank told us directly that it has never made loans on any sort of loss basis and that is not the way they have operated. If there is some evidence of that, obviously we would be interested to hear it. But is the situation you are in really a result of your members having had more difficulty because of liquidity drying up and that that is the key issue in your being able to offer competitive products, as you had been five years ago, for example?

Mr James—We have always had a market competitiveness of around 60 or 70 basis points. If I could just take you back to the start of that question, you said that banks will say to you that they are not losing on their transactions. Right at this moment the cost of a loan at bank bill rate currently is 7.34. What is the cost of the funds on top of that? Substantially these days everyone is paying between 85 and 110 points. If you add to that 25 basis points which they pay on the trailer and if you amortise a 0.7 or a 0.5, which it is now on the up-front fee, the cost of that loan is somewhere close to 9 per cent. If they are delivering rates at 8.8, as they do—their standard variable rate is 9.65, but everyone discounts at the moment—you could probably get a loan from a bank at 8.8. Add to that their cost of operations, and I suspect that most loans at the moment are under water.

If you go back four months ago, the base rate of funds was 8.16. When the bank bills were 8.16, that was the highest they reached and thence they started to come back. If you add the same principles on 8.6, you are not even close at 9.65 in covering your costs. But they do have fees, which we traditionally do not.

CHAIR—What has been put to us both by the big banks and by the Reserve Bank today is that the issue of the drying of the securitisation market is a cyclical event, and one that the Reserve Bank is in the process of changing already. Why should we, as policy makers, be
looking to any sort of policy initiative that interferes with the market, particularly if they are right and the market is adjusting itself at the moment? One, comment on that, and two—

**Mr James**—Why should you?

**CHAIR**—Yes.

**Mr James**—As a government, you do not really need too much in the way of cycles. Every time there is a cycle, there is an impact on the consumer. Earlier I heard the Chair talk about his constituents in the Central Coast. Cycles usually last six or seven years; that is the normal cycle. This last cycle has gone for 11 years where we have had good growth and good funding supply for 11 years. Why is that? It is because there has been a substantial amount of money in our economy, which has been able to fuel the growth. All of a sudden, a hiccup happens in the US and all the investors stop their lending to have a look at exactly what the impact has been, and the very basic supply and demand factors have come into play. When there is no supply, demand goes up and price follows. That is what has happened.

What a government should have is instruments in place to offset the shortage in liquidity at any time. You spoke many times about the Canadian model. Earlier I heard many of the presenters talk about the Canadian model. That is one. You spoke about superannuation issues and why superannuation schemes are not funding. My direct answer to why they are not funding is purely price. They do not make enough return on a loan. Everyone has skirted around the issue, but superannuation funds are not buying our bonds, which are triple-A rated and excellent quality as the RBA has stated, because they can make more money elsewhere, so they do.

If a government can put instruments in place when it sees a change in the liquidity cycle and makes some adjustments accordingly, you will still get your cycles. Yes, it is a cyclic market, but hopefully the degree of difficulty, the degree of damage, can be restored to some level that is a bit more reasonable.

**CHAIR**—While you have proposed and say you support an Aussie Mac style of policy initiative, what you are saying now is that it is not necessarily that; there could be a number of ways that we could do this, such as RBA repurchase agreements.

**Mr James**—Repurchase agreements for all—setting a set of standards, RBA repurchase, some implementation with superannuation, an Aussie Mac structure. But the key to what you do is to do it equally and effectively for everybody. If you do it just for the banks, the competition is gone.

**CHAIR**—Why would we consider an Aussie Mac proposal? On one front, it is a permanent solution to something that the market should correct—and we are really looking at a temporary intervention perhaps. Why should we look at a permanent model for those reasons, particularly when you consider the difficulties of Fannie Mae and Freddie Mac in the United States and the historical fact that they were born out of the Depression rather than in the modern global financial economy that we are in currently? Why would we even consider exposing the government to any sort of risk associated with that model?
Mr James—First of all, in relation to Freddie Mac and Fannie Mae, yes, they came out in 1928. They have been serving the community for over 80 years. The glitch that they have had, which is a major one and has caused problems, is because the common rules of lending or, in the investors’ case, the quality of the bonds that they were buying were prepared in not the normal circumstances. There was deceit in the structure. People are going to jail over the things that happened overseas. If you say that Freddie Mac and Fannie Mae did not work, I suggest that we have a look at the 80-year history and not just isolate it to the last six months. It has worked extremely well. It is those types of initiatives that give you that length of time that gives an economy the change to grow and prosper.

CHAIR—One of the key things with which every member of the committee agrees is that the greater the competition that exists, the more pressure there is on margins, and the consumer is better off in terms of that.

Mr James—Yes.

CHAIR—Do you have any fears? If the government does nothing to the market at the moment, takes the advice of some of the submissions and stands back to wait for the market to adjust, what are the long-term consequences that you foresee for consumers in this industry?

Mr James—My personal view first and foremost is that the market will come back. We are starting to see it already, albeit in small amounts and slowly, slowly. Earlier there was a suggestion of an education program in respect to overseas investors understanding the quality of Australian bonds. The quality of Australian bonds far outweighs anything that is out there at the moment, and they do not care just at the moment. At the moment it is a case of sit back and look. When that starts to turn, we will see that securitisation funding vehicle coming back to us. Some people say it will be six months and others say it will be 12 months. It is really going back to supply and demand. The investors cannot hold onto their funds forever and not put them on government Treasury bonds. They have to invest it in better-earning vehicles, and Australian RMBS are as good as you will get.

The irony is that today I can go out and issue a subprime RMBS, get it out there fully subscribed and pay 200 or 250 points above because my pool of funds has the margins in there because of its subprime nature, but I cannot get out of prime RMBS issue. Investors still want their higher earnings (a) because they are not sure of the risk leverage of those bonds at the moment and are still waiting to see the market settle down and (b) they are trying to recoup the losses that they have incurred. They are not going to sit there and just cop billions of dollars.

We were paying a year ago 20 basis points above the costs of funds for prime, 17-21 points, 25 points for subprime. The last issue was 87 for prime, 200 points for subprime. Somebody out there on very good quality paper is making four times what they were making before, so it will not take them very long before they recoup some of these losses that have been written off in the market place. I add that the effect of all this if we do not do anything will be borne by the consumer. If these sort of things keep happening, the price keeps going up, and the consumer is the end payer of anything we do wrongly.

CHAIR—Do you see that already there has been an effect on the consumer with the decrease in competition? Are the banks not forced to have their margins perhaps as narrow as they need to
have them at the margin, or are you forecasting that that is more likely to happen if action is not taken?

Mr James—When we came into the marketplace in the early nineties, there was a 4 per cent spread in home loans. Today the best spread is about 1.8 to 2 per cent. The ANZ’s latest report showed that they have crept up to 2.25. The banks already have announced that they will not be locked into the Reserve Bank. In as much as I agree with John Symond’s comments on the connection between the two, if you do not have the competition in there, that margin will just keep going up.

CHAIR—My final question relates to having a competitive sector. It is not just about having enough competitors in it, but being able to move between competitors adds to the competitive pressures that exist. What are your views on the switching package that so far has been announced? Are there any areas that you think this committee could recommend should go further to make switching easier?

Mr James—You can make switching as easy as you like, and it would be a very hard. A previous speaker this morning said that the problem you have is the apathy of the consumer. They need to have a program associated with any legislation that you put through to make switching easier so that they understand that they can, and they can ask the questions. From my person viewpoint, my company was Mortgagee of the Year four years in a row from 1999 to 2003—the best mortgagee, according to CANNEX. Why were we not inundated with applications? It was because people were paying more brokerage somewhere else in the introductions and banks were doing their job on PR.

It is not a matter of making the switch easier; I support that, and I think you must do that. It is hell at the moment if you want to discharge a loan from a bank. There are so many connections within that mortgage on overdrafts you cannot even get payouts in a reasonable time to be able to do the deal. Any process you put in place to make the process easy opens up competition. Your next step is to make sure that the consumer understands that this process is there, is there for them, and they should activate it and make it happen for them. I am a true proponent of competition. The more you are able to create, the better the consumer will benefit from it.

CHAIR—We have finished reasonably early.

Mr James—Amazing!

CHAIR—Thank you for your contribution. It is a valuable one. Hansard has reported what has been said. You will be sent a copy of that transcript. If there are any corrections to that, please let us know. Thank you for your contribution.

Mr James—Thank you.

Mrs Redden Makatoa—Thank you.
VIERBOOM, Mr Kevin William, Private capacity

CHAIR—Welcome.

Mr Vierboom—I have made a written submission to the committee, but I wish to hand up something further.

CHAIR—We will come to that and give you that opportunity in a second. First of all I must point out that while the committee does not require you to give evidence on oath, I should advise you that these hearings are legal proceedings of the parliament and therefore have the same standing as proceedings of the respective houses. At this stage, it would be appropriate for you to hand up your additional submission.

It is the wish of this committee that the document entitled ‘Additional Notes to the House of Representatives Standing Committee on Economics’, which has been presented, be taken as evidence and included in the committee’s records as an exhibit. If there are no objections from anyone, I so order. That is now an exhibit in these proceedings. I invite you to make some opening remarks in the context of your submission, and then there will be the opportunity for the committee to ask you questions in relation to the submission.

Mr Vierboom—I begin what I have to say by dealing with mortgage lenders insurance. Currently when a marginal consumer goes to a bank for a loan and they exceed the loan’s valuation ratio in relation to property, they are asked to take out mortgage lender’s insurance by the lender. Unfortunately the consumer does not have a legal interest in the policy. The party with the legal interest is the bank, so the consumer is asked to meet the very substantial amount of money in relation to a loan in which they have no legal interest. If they elect to bail out of the loan at a later point in time, they may or they may not get a full or partial refund of some of the premium, and the banker has had the privilege of no risk whatsoever in relation to the loan because he has farmed out the risk.

To my mind, it seems that we should be changing the law in relation to insurance so that the consumer has a legal interest and receives a certificate of insurance associated with the loan. The consumer could then roll over the loan to other banking institutions and get more competitive rates, and we would start to get a more competitive situation happening in the banking sector that way. That is one of the most important reforms that needs to flow from something of this nature.

I believe that there is currently an incredible lack of competition among the banks for home loans. I believe that is evidenced by the fact that the banking sector could put up its rates independently of the RBA and get away with it. In my additional notes, I have drawn attention to the fact that banks currently are seeking to buy credit card debt, which is unsecured, at rates which are far lower than current home loan rates, which are secured. I have given you a printout of offers that are available currently today on the Internet to transfer a credit card.
It is incredible to think in a liquidity crisis that banks could be thinking about buying out unsecured debt on these terribly favourable terms. In my additional notes, I also have given you a summary of just how much extra the average consumer has been asked to pay at 0.5 per cent more, which the banks have given people, on two different loan scenarios. You will note that in the case of a person with a $250,000 mortgage, they have been asked to meet approximately an extra $26,000. In the case of a person with a $500,000 mortgage, which I am sorry to say is not unusual today, over 30 years the banks have helped themselves to an extra $65,000. That is somewhat of an outrageous thing for bankers to just get away with on the basis that they say, ‘Look, we’ve got a liquidity crisis’, but the other branch of the same bank, if you please, is offering to buy out credit card debts at 3.9 per cent.

Firstly, I put it to the committee that that is an outrageous position. Secondly, until we get some real competition in the market, I see superannuation funds as being the best source of real competition because it is a very large bowl of Australian savings, and that should start to be used to introduce real competition in the marketplace here. In my view superannuation funds should be offering to lend money to non-bank lenders on terms provided by the Reserve Bank. There has to be some measure of regulation in this to protect people’s life savings.

Unfortunately the banks have said to us, ‘We’ll go overseas. We’ll invest in all of these ridgey-didgey loans’, to use a better expression, and now they have come back and said, ‘We want you consumers here to pay for our stupidity’—which is a rather remarkable position—’and we’re going to use our market muscle against the Australian consumer.’ It is quite incredible that we have sat on our hands and let that happen.

Finally, to get some real competition in the marketplace as far as banking is concerned, the consumer should be able to buy a specified number of transactions. Part of the problem at the moment is that consumers are met with so many different packages, it is not clear exactly what they do and do not understand. But if each bank has to put up a statement to the effect that 0 to 50 transactions will cost X number of dollars, whether it is Internet, EFTPOS or something else like cheque, people will be able to see on a competitive basis what they are able to buy. That concludes what I would like to say to start with.

CHAIR—Thank you for that. In relation to your last comments about regulating the cost and number of transactions, will that not possibly have the exactly opposite effect on competition? Is not one of the competitive factors driving this industry the fact that there is and can be product differentiation that suits different people in different circumstances? If you make everything the same, where is the competition?

Mr Vierboom—I do not pretend to suggest that everything should be the same. ANZ should be obliged to put up a figure and the Commonwealth should be obliged to put up a figure. One might say that for 50 transactions, it is $5, and the other one might say it is $8. The consumer will be able to see readily what the cost is.

CHAIR—Do they not do that already? What you are asking for is transparency in costs.

Mr Vierboom—Transparency in how costs operate in the banking system in clear documents that can be viewed by the average person on less than a page, basically, so that they can say,
‘Look, it’s quite easy. I can see what the real situation is very quickly.’ Bankers like complex products because they are out to confuse people.

CHAIR—Of course that is the balance that needs to struck between full disclosure and presenting a document that is so big that people are not going to read through it.

Mr Vierboom—Exactly.

CHAIR—In relation to your comments on accessing superannuation funds, this morning there was discussion with the Reserve Bank about that. The indication from the Reserve Bank is that they were surprised that superannuation funds had not at any stage moved into the mortgage market. Given that there is no impediment against their doing so at the moment, that would tend to indicate that either, as someone else said, they are not going to make money out of it and are getting a better level of return from something else, or is there a role that government can play to encourage that money to be available? If there is, do you have any views on what that role would be?

Mr Vierboom—Firstly, the banks have made a lot of money out of home loans over the years. One of the reasons that superannuation funds will not go into home loans is because it is very difficult to get an effective vehicle to do that if you are a superannuation fund. However, if superannuation funds were required to back the likes of, say, RAMS or other marginal or boutique lenders and have certain amounts of money available to them, that would tend to overcome it.

CHAIR—But you are not suggesting that we regulate as to which business opportunities are going to be provided with money?

Mr Vierboom—No. I am suggester rather that it would be more appropriate to say that superannuation funds should have a percentage of their total investment onshore in investments here, such as in home loans or in other forms of business loans in the Australian community. The real lesson to be learned from the subprime crisis is that banana republics and other things that have been invested in overseas have not proved to be very good investments in the long run. It would be much safer for people’s retirement savings for it to be invested onshore here.

Mr TURNBULL—Mr Vierboom, do you seriously suggest that the government should be telling superannuation funds how to allocate their assets?

Mr Vierboom—No, I am not seriously suggesting that. I am suggesting that they should be asked to put a reasonable portion of their money into home loans and things like that to get a bit of competition here.

Mr TURNBULL—How much of your assets do you have in home loans?

Mr Vierboom—Well, I have most of mine invested on the other side of the ledger, Mr Turnbull.

Mr TURNBULL—That is right. So you are a borrower, not a lender.
Mr Vierboom—That unfortunately is the position, Mr Turnbull.

Mr TURNBULL—Yes, but I am just saying: How would you take it? Let us say you were a lender rather than a borrower. Would you really appreciate it if the government told you to whom and what type of loans you should be making?

Mr Vierboom—I do know that I would say to whom. More aptly it would be terms put out by the Reserve Bank as reasonable lending criteria associated with it—criteria that are independent and encouraged people to get real competition in the current market. As I see it, one of the reasons the banks have been able to increase interest rates is because there is a lack of competition. We can talk about other areas where there are funds, et cetera, which previously had been provided overseas to this country, but the reality is that those funds and those areas are extraordinarily tight and bankers have done nothing else but capitalise on the market. It seems to me that you have to take advantage of what is here to get competition going.

Mr TURNBULL—But a fundamental element of competition is freedom of choice, is it not?

Mr Vierboom—Well, yes, but at the moment there is only a very qualified form of choice, I would have thought.

Mr TURNBULL—What you are proposing is that superannuation funds should not have freedom of choice. The government should tell them where to put their money.

Mr Vierboom—I am saying that perhaps there should be core investment criteria onshore here to some extent.

Mr TURNBULL—But you are saying the government should tell superannuation funds where to put their money, okay?

Mr Vierboom—to some extent, that is probably reasonable.

Mr TURNBULL—It is certainly not something I could agree with. You see, Mr Vierboom, the difficulty that you run up against here is that the trustees of superannuation funds have to manage those funds in the best interests of their investors. The minute governments start telling them where to put their money, they have lost their ability to manage their funds in accordance with their fiduciary obligations.

Mr Vierboom—Equally a lot of the trustees currently might have a little bit of accounting to do for the losses from the stock market this year. Perhaps it would have been a far more reasonable and more prudent package to have had some investment in property and some in the stock market. The proof of the pudding is a little bit in the eating.

Mr TURNBULL—Okay.

Mr BRADBURY—In your submission, your suggested reform is:

I would like to see legislation to make the insurance policy transferable between banks provided the amount of the loan amount is not increased.
Mr Vierboom—That is correct.

Mr BRADBURY—From what you have said today, it seems to me that you are suggesting something that goes beyond that in the sense that the insurance is provided for the consumer as opposed to the lender. Is that what you are suggesting?

Mr Vierboom—No. As it stands at the moment under the current law, it is the lender who is insured. If we take a simple example of a $300,000 mortgage to a banker, and the consumer goes on for two or three years, but then wants to swap over to another bank and it is a 30-year loan. If the person transfer the same amount of money over to the next bank, and it might be $285,000 or something of that nature after three years, the person should be able to receive the benefit of the balance of the insurance they have already paid for—in other words, for the other 27 years or whatever it might be under the term of the loan—in the form of a certificate of insurance that goes to the next bank. After all, they have paid for the insurance. At the moment, they have no legal interest in something for which they are paying very dearly, and something which, I might add, is added to the principal of the loan and adds a lot more in terms of costs at the end of it.

Mr BRADBURY—Because in that scenario the new lender presumably needs to ensure the borrowings.

Mr Vierboom—But if there is already a certificate of insurance that comes with the loan—

Mr BRADBURY—But frequently people refinance for greater amounts or to buy a second home.

Mr Vierboom—That might be the case, but then any additional insurance should only be to the extent that it would have to be topped up. If they increase the amount of money that is being borrowed to $350,000 and there has been a top-up, the payout figure was $285,000, so the top-up figure was $65,000, the person should only pay the additional mortgage lender’s insurance on the $65,000. Under the current rules, the banker pockets a great amount of money.

Mr BRADBURY—If I was owning my first home and paid mortgage insurance, for the benefit of the lender, and I then decided to buy my second home so I refinanced and discharged the mortgage on the first loan, how would that scenario be any different under your proposal? Presumably the insurance already has been covered for the course of that first loan, and presumably the new lender also will be requiring the consumer to take out on their behalf a new policy of insurance. Effectively there would be no difference in that scenario, would there?

Mr Vierboom—Sorry, are you saying if you got a payout from your first?

Mr BRADBURY—You have discharged your mortgage.

Mr Vierboom—How have you discharged your mortgage? If one bank has bought it out.

Mr BRADBURY—You have borrowed the funds from the subsequent bank to discharge your mortgage.
Mr Vierboom—So you have discharged your mortgage there, and your lender has had the benefit of the insurance policy for the period of time that you have had the mortgage. Then, if they have not given you a refund, you have paid for X number of years of insurance for a loan that they walked away with, scot-free basically, because they are insured, you are not.

Mr BRADBURY—Whereas you are saying that should be carried across to the—

Mr Vierboom—To the new bank. It is the insurance company that is taking the risk and the bank is acting as little more than an intermediary and collecting the money from the consumer.

CHAIR—Thank you for your submission. That was great. You will be sent a copy of the transcript of today’s hearing. Read through it carefully and if there are any errors or corrections that need to be made, please make those and get them back to us. The Hansard reporters are here and if they need to ask you about anything, they will do so. Thanks again for your submission.

Mr Vierboom—Thank you.

Resolved (on motion by Mr Bradbury):

That this committee authorises publication, including publication on the parliamentary database, of the transcript of the evidence given before it at public hearing this day.

Committee adjourned at 3.59 pm