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Financial System Inquiry: Part 1 — A lending industry perspective on competition

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Background

In late 2013, the Treasurer released draft terms of reference for the Financial System Inquiry (FSI). After consultation with interested stakeholders, the Treasurer appointed an independent committee charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.[1] The intention of FSI is to establish a direction for the future of Australia's financial system, given it has been 16 years since the last financial system inquiry. In July 2014, the committee produced its Interim Report, which tackled issues relevant to credit advisers — such as the substantial regulatory reform agenda, new competitive dynamics in the banking sector and the impact of the global financial crisis (GFC). As part of consultation with the banking and finance industry, the Mortgage and Finance Association of Australia (MFAA) responded[2] specifically to express, among other matters, its disagreement with the Interim Report's observation that the banking sector is competitive, albeit concentrated.

In November 2014, the FSI's Final Report[3] was published, taking into account industry and expert responses, including from the MFAA.[4] In this article, we explore the findings of the FSI as they apply to the mortgage broking and lending industry and, in particular, hear the views of Tim Brown, Chairman of the MFAA, on the Final Report's findings in relation to competition in the banking sector.

Competition

The Interim Report observes that competition can still be strong between players in a concentrated market, stating "market concentration can be a by-product of competition, if more efficient firms grow at the expense of their less efficient competitors".[5] The Final Report concluded that that competition is generally adequate in the market, although the high concentration and increasing vertical integration in some parts of the financial system have the potential to limit the benefits of competition in the future and should be proactively monitored over time.[6] Generally, Mr Brown and the MFAA disagree with the Final Report's findings that the banking sector is competitive, albeit concentrated, and we provide below a lending market perspective on competition in the Australian financial system that may be of interest to banking and finance lawyers.

The GFC and competition

First, Mr Brown explains how the Interim Report and the Final Report both seem to incorrectly and narrowly focus on the "banking sector" rather than reference the wider "lending sector". In 2007, 85% of the residential lending market was made up of banking sector institutions (including mutual communities), with the remainder of the share going to non-bank and specialist lenders. Up until the GFC, the specialist-lending sector successfully competed with the banks and stole significant market share from them, resulting in overall lower margins in favour of customers.

While, to a certain extent, the Final Report's statement that competition can still exist in a concentrated market may be true, Mr Brown describes how this does not in any way reflect the dynamics of the lending market since 2007. In its response[7] to the Interim Report, the MFAA submitted that larger banks have grown in market share since 2007, resulting in a more concentrated lending market, not because the larger banks have been "more efficient", as the Interim Report suggests, or as a by-product of competition. Rather, the MFAA believes that there are a number of other factors that explain why larger banks have grown, including:

- the GFC;
- allowing mid-tier banks and lenders to be acquired by larger lenders without regulatory intervention;
- over-regulation, including the government's ill-considered decision to ban exit fees;
- government intervention with wholesale funding and savings guarantees; and
- the reduction (or elimination) of securitised funding to smaller lenders.

In particular, regarding the influence that the government guarantees had on competition, the Final Report noted simply that "perceptions of implicit guarantees in the banking system can distort competition by providing a funding advantage to those banks".[8] The Final Report went on to say, however, that any recommendations that increase resilience of the largest banks will reduce these perceptions over time and help contribute to restoring a more competitive environment. So far, the perceptions of the MFAA have not changed. It believes that these advantages to the larger banks and lenders throughout the GFC, to the clear disadvantage of the smaller banks and specialist lenders, played a large part in creating the lack of competition that we see today in the lending sector. On this basis, Mr Brown and the MFAA continue to contend with the FSI's findings that the current concentration of the lending market is a by-product of competition and that the reason for banks taking a larger share is their efficiency. It is Mr Brown's view that the lending sector in particular is not as competitive as it should be, and the ultimate disadvantage is to consumers.

Vertical integration of credit advisers and competition

An imbalance of regulatory cost versus share of market, coupled with the GFC, saw large banks swallow some mortgage aggregators and brokers. The FSI asks whether this vertical integration is distorting the way in which credit advisers direct borrowers to lenders.[9] Mr Brown explains how the MFAA would be concerned if the response to this question was "yes". While the MFAA believes that large banks and lenders swallowing smaller banks and lenders has created less competition in the banking sector, it strongly disagrees with the FSI's findings that vertical integration of credit advisers into larger aggregators and lenders has had the unintended effect of reducing competition. There is a big difference, according to Mr Brown. There is no evidence that bank ownership of some mortgage broking groups is influencing individual brokers to act anti-competitively and against the consumers' interests. To the contrary, Mr Brown explains that the evidence shows that credit advisers have been influential in diffusing the concentration in the market and have assisted with facilitating competition, in particular in the mortgage lending market.

The heart of the question from the FSI, according to Mr Brown, is the assumption that ownership of a mortgage aggregation or broking group may influence the conduct of an individual credit adviser, being a member of one of those groups, to the disadvantage of consumers. As the conduct of credit advisers is robustly governed by the provisions of the National Consumer Credit Protection Act 2009 (Cth) (NCCP Act), the MFAA argues against this assumption. Credit advisers are required to be licensed, to disclose commissions and the lenders on their panel, to conduct responsible lending assessments and, in particular, to ensure that there is no disadvantage to clients as the result of any conflicts of interest that may arise. Of particular interest to banking and finance lawyers like myself, Mr Brown explains how — unlike under other legislation, such as the Corporations Act 2001 (Cth), which requires an Australian financial services licence holder to "have in place adequate arrangements for management of conflicts of interest"[10] — credit advisers cannot simply manage a conflict through disclosure. Credit advisers under the NCCP Act are required to take individual responsibility to ensure that there is no consumer disadvantage as a result of a conflict.[11]

Further, MFAA statistics,[12] documented in the MFAA's response to the Interim Report, demonstrate that currently a consumer is less likely to be recommended a product with one of the big four lenders by a broker (at 74%) than if they sourced the product directly with the big four banks (at 82%). This should be considered in light of the fact that aggregators and broking groups that are now wholly owned by the big four lenders comprise an estimated 40% of all credit advisers. If credit advisers were directing borrowers to their bank holding companies in conflict with their duties to customers, according to the MFAA it should be expected that the percentage of loans transacted by brokers into the top four banks would be much higher. The MFAA continues to believe that credit advisers play a role in diffusing the concentration in the market, rather than adding to it, by recommending products from smaller lenders and ensuring genuine suitability of loan product for their customers.

The FSI did comment that stakeholders provided little evidence of differences in the quality of advice from independent, aligned or vertically integrated mortgage broking firms. However, it still sees value to the customer in making ownership and alignment more transparent.[13] The FSI has recommended that brokers should disclose their ownership structures more broadly than as the current Credit Guide rules apply, and disclosure should extend to branded documents and materials.[14] We think it is highly doubtful that the benefits to consumers in adding further disclosure requirements on brokers will outweigh the already high transitional costs to the industry of effective branding changes.

Regulation and competition

This brings us to the question of regulation and its impact on competition. In the MFAA's submission[15] in response to the Interim Report, it stated that regulation must either be competition enhancing or, at least, competitively neutral in its impact on the various players in the lending market. The consumer credit and other regulations introduced to the mortgages industry over the last five years, with their many requirements and high compliance costs, apply equally to a small credit adviser as to a large bank. Further, banning exit fees may have even had the unintended impact of reducing competition between the larger and smaller lending players. This has resulted in an inequity across the sector, with smaller credit advisers and non-bank lenders struggling to keep up with the regulatory costs that can be better absorbed by the big banks. In our view, this does not mean that small credit advisers are less efficient.

Mr Brown and the MFAA submission[16] express a desire for any new regulation to enhance competition, rather than decrease it. Mr Brown explains the MFAA's view that, before Treasury considers introducing any further regulatory reform that may impact credit advisers, it should first examine the proposed reforms to ensure that they are competitively neutral across all players in the market. The Final Report addressed this point by suggesting that a review of the state of competition should occur every three years, that reporting on how regulators balance competition against their core objectives should be improved, and that competition should be made part of the regulators' mandate.[17] Thankfully, the FSI is very conscious that unnecessary and inappropriate regulation has the potential to reduce the financial system's efficiency.

As an immediate first step, the FSI states that regulators should examine their rules and procedures to assess whether those that create inappropriate barriers to competition can be modified or removed, or whether alternative and more pro-competitive approaches can be identified. Mr Brown and the MFAA agree that this would be a good first step. In the absence of change, there is a risk that regulators and policy-makers will not place sufficient emphasis on competition when making decisions, and this could have a flow-on effect of disrupting innovation. The extent of market concentration in some parts of the system, and its potential to limit competition in the future, is a significant issue, according to Mr Brown.

Securitisation and competition

Finally, and importantly to the MFAA, is the need for a stronger securitisation market to enhance competition and enable a vibrant and innovative non-bank, specialist and small lender sector. This is something that Mr Brown, as Head of Sales & Distribution, and I, as a senior in-house lawyer, both experienced firsthand at Macquarie Bank just as the GFC began. Mr Brown explains his experience at Macquarie Mortgages when Lehman Brothers collapsed, which caused the systematic collapse of the securitisation market and the closure of warehouse facilities that many of the financial institutions were using to fund mortgage growth. The flow-on effect was the inability of many smaller institutions, including Macquarie, to fund mortgages. Had Australia had a similar system to Canada at the time, Macquarie may not have had to withdraw from the lending market, St George Bank would not currently be owned by Westpac, Bankwest may not have had to sell to Commonwealth Bank of Australia (CBA), and the founder of Aussie Home Loans, John Symond, may not have seen the need to sell to CBA to secure Aussie's future in the mortgage industry.

The substantial negative effects of having to wind back origination where funding options decreased or were completely eradicated enabled large balance sheet lenders to regain the market share they had previously forfeited to the innovative lenders. In its submission[18] in response to the Interim Report, the MFA strongly expressed that competition in the lending sector needed to be enhanced by a strong securitisation market, and also stressed the importance of government intervention in the residential mortgage-backed securities (RMBS) market on an ongoing basis. It argued that Canada has proven that this type of system can be managed without risk to taxpayers and without the creation of "moral hazard". The Australian Office of Financial Management (AOFM) has also provided this proof in the past few years. The MFAA believes that the AOFM's involvement in the market should be re-ignited on an ongoing basis to ensure a more competitive lending market.

There is no doubt that, prior to the GFC, the availability of competitively priced securitised funds enabled non-bank lenders to aggressively attack the margins of the major retail banks. It also enabled non-bank lenders to start competing on service levels. As a result of both improved margins and service to customers, the non-bank lending market share rapidly grew. The fact that the specialist lender market share went from nil to over 15% in a decade is evidence in itself of the inefficiencies and lack of competitiveness in the banking sector since the GFC.

Mr Brown submits that since 2007 the only significant changes to the lending market have been:

- the pause in the securitisation market; and
- major government intervention in the form of regulation.

The competitive drive from larger banks and financial institutions has not changed. Rather, "their aggressive and successful smaller competitors have been hamstrung", says Mr Brown. I most definitely agree, particularly having had an inside perspective on the impact that these factors have had on securitised lenders, even the most efficient. It is crucial that non-bank lenders and smaller lenders have access to securitised funding in order to enhance competition and innovation in the lending market.

As the Interim Report observes, the RMBS market has started to recover. However, the markets still have a long way to go before bouncing back to the pre-GFC level. While the Reserve Bank of Australia does not expect that the market will return to pre-GFC levels in the near future,[19] we believe that there is still a need to ensure that it is fostered and continues to grow.

Unfortunately, the MFAA's submission regarding the successful impact of the Canadian approach in driving the non-bank sector and providing more competition was largely disregarded by the FSI — which, according to the MFAA, incorrectly grouped the Canadian model with the US model approach as though they were one and the same. This ignored the reality that the Canadian system has operated since the 1940s and never once has there been a liability for taxpayers. In each year, a profit has been returned to the Canadian consolidated revenue. We believe that the infrastructure should be created in Australia now, not as a crisis strategy but as a long-term solution. It seems that the FSI would require a "clear market or regulatory failure in the RMBS market"[20] before it could consider intervening. The MFAA, Mr Brown and I (along with many others in the banking and finance industry) believe that this would be too late.

The MFAA acknowledges that the Australian government did move fairly quickly (albeit after the event) by directing the AOFM to purchase RMBS securities to support the market. Through the rigour of its operations, it caused no liability to the taxpayer and, like the Canadian program, produced a profit for the government. We believe that had it been operating before the GFC, it would have saved many non-bank lenders from reducing their lending or changing their business models. For these reasons, the MFAA believes that it is important that the government intervenes in the RMBS market by reigniting the involvement of the AOFM on an ongoing basis to ensure a more competitive lending market.

Summary comments

The MFAA expressed disappointment at many of the findings and recommendations of the FSI specific to the question of competition in the banking sector. In particular and relevant mostly to the lending sector, the MFAA does not believe that the major banks have been "more efficient" than their smaller counterparts, causing a more concentrated and less competitive market. In contrast, Mr Brown and the MFAA maintain that the major banks have received advantage over the smaller lenders since the GFC, including government bank guarantees, over-regulation causing an imbalance, and lack of steady securitisation funding. While many of the MFAA's suggestions to the FSI regarding competition were dismissed, we hope that, at the very least, some of the recommendations of the FSI, including an assessment of the impact that over-regulation has had on competition, may result in the return of innovation and enhanced competition in the lending market in the future.

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About the author
Leonie Chapman's *experience extends to banking and finance, consumer credit and mortgage lending, contract negotiation, trade practices and fair trading legislation, intellectual property and trade marks, and corporate and financial services. After completing her Bachelor of Laws and Bachelor of Commerce in 2002, Leonie went on to work both in private practice and as senior in-house lawyer supporting a specialist lender, and then for six years with Macquarie Bank Ltd. Having achieved a Master of Laws in 2009 specialising in banking and finance law, Leonie's main focus now as Principal of LAWYAL Solicitors is on regulation and compliance for banking and financial institutions.*

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Tim Brown *is the Chairman of the Mortgage and Finance Association of Australia (MFAA). He has worked in the banking and finance industry for over 30 years and has held senior management positions in organisations such as Macquarie Bank, LJ Hooker, Suncorp, Aussie Home Loans and AVCO Finance (now GE Capital). Tim's industry experience has seen him successfully establish and own LJ Hooker Home Loans as a master franchise which was acquired by LJ Hooker in 2003. Tim is currently the CEO of Vow Financial, Australia's sixth largest mortgage aggregator. He has an MBA and also completed a Diploma in Mortgage Lending and Business Management and a Diploma in Financial Planning.*

Footnotes

1. Financial System Inquiry *Interim Report* July 2014 p xi.

2. Mortgage and Finance Association of Australia, submission in response to the Financial System Inquiry, March 2014.
3. Financial System Inquiry *Final Report* November 2014.
4. Above, n 2.
5. Above, n 1, pp 2–3.
6. Above, n 3, p xvi.
7. Mortgage and Finance Association of Australia, response to the Interim Report, August 2014.
8. Above, n 3, p 19.
9. Above, n 3, p 255.
10. Corporations Act 2001 (Cth), s 912(1)(aa).
11. National Consumer Credit Protection Act 2009 (Cth), s 47(1)(b).
12. Source: MFAA calculations based on Comparator, Broker Market Share statistics, June Quarter 2014; APRA Monthly Banking Statistics, June 2014; ABS Housing Finance 5609.0, June 2014.
13. Above, n 3, p 272.
14. Above, n 3, Recommendation 40, p 271.
15. Above, n 2.
16. Above, n 2.
17. Above, n 3, Recommendation 40, p 254.
18. Above, n 2.
19. Above, n 1, p xviii.
20. Above, n 1, pp 2–15.

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