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Financial System Inquiry
Interim Report

Response by Mortgage and Finance Association of Australia

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Key Points

The Mortgage and Finance Association of Australia (MFAA) made a submission to the initial Inquiry and we stand by those submissions. However in this response to the Interim Report of the Inquiry we address the following points:

- Competition and the Interim Report's observation that the banking sector is competitive, albeit concentrated (2-3)

  We disagree with the observation. The GFC and government intervention have inhibited competition in the lending market.

- The residential mortgage-backed securities market (2-13)

  It is important that the Government intervenes in the RMBS market on an ongoing basis. Canada has proven it can be managed without risk to taxpayers and without the creation of moral hazard. AOFM has also provided this proof in the past few years. Its involvement in the market should be re-ignited on an ongoing basis to ensure a more competitive lending market.

- Vertical integration of mortgage brokers (2-21)

  There is no evidence that bank ownership of some mortgage broking groups is influencing individual brokers to act anti competitively and not in the consumers' interest. On the contrary, the evidence is that mortgage brokers have been influential in diffusing the concentration and facilitating competition in the mortgage lending market.

- Self-managed superannuation funds and Leverage (2-115)

  Rather than a restoration of a general prohibition of direct leverage of superannuation funds, initiatives such as the MFAA SMSF Lending accreditation, should be encouraged to ensure consumers are better protected by qualified advice from all the professionals in the SMSF process.

Competition and the Interim Report's observation that the banking sector is competitive, albeit concentrated (2-3)

The Observations seem to focus on the 'banking sector' rather than the wider 'lending sector'.

In the case of housing lending in 2007, the banking sector (including mutuals) was responsible for 85% of the lending sector, the remainder taken up by 'non-bank lenders', which competed successfully with the banks and took away significant market share and caused margins to reduce by half.

The Interim Report observes:

> *'However, competition can still be strong between players in a concentrated market. Indeed, market concentration can be a by-product of competition, if more efficient firms grow at the expense of their less efficient competitors."*[1]

While this can be true, it does not in any way reflect the dynamics of the lending market since 2007. Larger banks have grown (and the market has become more concentrated), not because they are 'more efficient' or as a by-product of competition, but because of government intervention with wholesale funding guarantees and savings guarantees and allowing mid-tier banks to be acquired by larger lenders along with the availability of securitised funding to smaller lenders shrinking dramatically. Even the Government's ill-considered decision to ban exit fees, favoured the larger banks to the disadvantage of the smaller banks and non-bank lenders.

So the premise that the current concentration in the market is a by-product of competition and the effect of more efficient firms growing at the expense of their less efficient competitors is clearly false.

MFAA continues to contend the 'lending sector' is not as competitive as it should be and that is to the disadvantage of consumers.

[1] Financial System Inquiry (FSI) - Interim Report p2-3

The residential mortgage-backed securities market (2-13)

There is no doubt that the availability of competitively-priced securitised funds enabled non-bank lenders to aggressively attack margins, service levels and, as a result, rapidly grow market share in the lending sector. The fact that their market share grew from nil to over 15% in a decade is evidence of how uncompetitive and inefficient was the banking lending sector. As highlighted in the previous section, the only things to have changed since then are the drying up of the securitisation market and government intervention. The drive (or lack of it) to compete from larger lenders has not changed; rather their aggressive and successful smaller competitors have been hamstrung.

Accordingly it is crucial that non-bank lenders and smaller lenders have access to securitised funding. Although, as the Interim Report observes, the RMBS market has started to recover, it is still a long way off where it was pre-GFC. Noting that the RBA does not expect the market will return to pre-GFC levels in the near future, there is still a need to ensure that it is fostered and continues to grow. MFAA, in its initial submission, referred to the successful impact of the Canadian approach in driving the non-bank sector and therefore providing more competition. We were also at pains to distinguish this approach from the failed USA Fannie Mae and Freddie Mac institutions. Accordingly we were dismayed in the Interim Report to see the USA models grouped with the Canadian approach as if they were the same.

The Interim Report comments that:

> *'Before recommending such interventions, the Inquiry would need to be convinced of a clear market or regulatory failure in the RMBS market. Although Government support may have been appropriate during the crisis, the recent market recovery weakens the case for further intervention. All options, to varying degrees, would create contingent liabilities for taxpayers. The options may also require the Government to intervene in the market to ensure lending standards and could potentially create moral hazard.'*

These comments ignore the reality that the Canadian system has operated since the 80s with never once there being a liability for taxpayers and in each year of the program's operation a profit has been returned to the Canadian consolidated revenue. They also ignore the fact that during the GFC, the program produced some $100b of securitised funds per year. The point about this is that it is too late to set up some sort of emergency system when a crisis hits – the infrastructure needs to be up and running smoothly, as it was in Canada.

The Australian Government did move fairly quickly (but after the event) by directing the Australian Office of Financial Management (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. *Had it been operating before the GFC it would have saved many non-bank lenders from reducing their lending or changing their business models[2]. We assert it would have enabled more aggressive*

[2] FSI Interim Report, page 2-13

competition to continue in the lending market and the concentration that has resulted would have been most likely far less.

For these reasons it is important that the Government intervenes in the RMBS market on an ongoing basis. Canada has proven it can be managed without risk to taxpayers and without the creation of moral hazard. AOFM has also provided this proof in its few years of operation. Its involvement in the market should be re-ignited on an ongoing basis to ensure a more competitive lending market.

Vertical integration of mortgage brokers (2-21)

The Interim Report asks:

- *Is vertical integration distorting the way in which mortgage brokers direct borrowers to lenders?*

MFAA would be concerned if the response to this question was proven to be 'yes'.

Implicit in the question is the assumption that ownership of a mortgage aggregation or broking group may influence the conduct of an individual mortgage broker, being a member of one of those groups, to the disadvantage of consumers.

The conduct of mortgage brokers is robustly governed by the provisions of the *National Consumer Credit Protection Act, 2009.* They are required to disclose commissions, lender panels and, in particular, <u>to ensure there is no disadvantage to clients as the result of any conflicts of interest they may have.</u> Unlike other legislation, e.g. *Corporations Act 2001* (Cth) which requires an AFSL holder to 'have in place adequate arrangements for management of conflicts of interest' e.g conflicts may be managed by disclosure, brokers under the NCCP are required to take individual responsibility to ensure there is no consumer disadvantage and not simply disclose the conflict.

Perhaps more graphical evidence that such consumer disadvantage does not appear to be occurring can be seen in the Table below.

2014	Non broker loans	Broker loans	All loans
Big 4	82%	74%	78%
Other lenders	18%	26%	22%

Source: MFAA calculations based on *comparator – Broker Market Share statistics, June Qtr 2014; APRA Monthly Banking Statistics – June 2014; ABS Housing Finance 5609.0 – June 2014.*

This shows that a consumer is less likely to be recommended a product with a Big 4 lender by a broker than if they sourced the product directly (74% v 82%).

This should be considered in light of the fact that aggregation/broking groups which are Big 4 bank owned, totally or substantially, comprise an estimated

40%[3] of mortgage brokers. If they were 'directing borrowers' to the owners of their groups it would be expected that the percentage of loans transacted by brokers with the Big 4 would be higher than that for non-broker loans. However, as the table shows, brokers play a role in diffusing the concentration in the market by recommending products from smaller lenders.

Self-managed superannuation funds and Leverage (2-115)

The Inquiry makes the observation that 'if allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.'

It seeks comments on a possible option that the previous general prohibition on direct leverage of superannuation funds on a prospective basis be restored.

The MFAA acknowledges the comment in the Interim Report (p2-117) that:

> 'Some evidence also suggests that borrowing in superannuation funds is often associated with poor financial advice … by financial advisers and accountants related to establishing an SMSF as part of a geared investment strategy.'

It was a recognition of this situation, whereby 'advisers' not expert in the area of lending were misadvising clients, that motivated the MFAA in 2012 to establish an SMSF Lending accreditation program to ensure that Credit Advisers (mortgage brokers) were properly educated in understanding the risks and pitfalls with this area of lending and in particular understanding the boundaries of their advice and the necessity to work closely with the other professionals necessary to the SMSF process (ie finance advisers, accountants, lawyers).

One of the key outcomes of this program is to develop Credit Advisers with a competency around Limited Recourse Borrowing Arrangements (LRBAs) so as to advise on the appropriateness of the lending from a credit perspective. This is a critical function in the process and one often overlooked when dealing with SMSFs in general. The professionals best placed to understand and give advice on lending are MFAA members.

With this in mind, and the interests of trustees at heart, the lending program has been developed to put the credit adviser at the start of the process. More importantly though, an Accredited SMSF Lending Specialist can determine if a trustee is likely to get approval for credit before they set up their fund, and go through the time and expense of setting these structures up, (which can save clients thousands). This also has an added benefit of ensuring that trustees are not losing existing insurances with their existing super funds before seeking a credit approval. This is a key concept of the course to ensure that Credit Advisers understand the implications, and most importantly can clearly articulate these implications to their clients. The bottom line here is that clients are protected against borrowing from their superannuation fund if that lending is inappropriate to the fund.

[3] MFAA estimate based on membership numbers

In addition to this there are considerations for cash flows of the fund, funding not only interests payments, there are also considerations for the long term viability of the fund with thought given to the payment of pensions, death benefits and insurances from the cash within the fund. We have taken the view that these considerations need to be accounted for to adhere to the 'Responsible Lending' Guidelines we have established for our industry.

At an institutional level, lenders have been diligent in creating lending products that will protect consumers while providing the flexibility for consumers to achieve what their SMSF's objectives are. The most important developments for protecting consumers that the lenders have developed to date are:

1. RG146 Financial Advice Certificate - most if not all major lenders require a Financial Adviser (or Accounting equivalent) to sign off that the lending is appropriate for the trustees

2. Minimum SMSF Fund Balance - lenders have started introducing minimum fund balances (>$150k).

3. Property type - Mortgage insurers require properties being funded with LRBA's to be at least 12-18 months old, (removing the risk for off-the-plan property sales from property spruikers)

4. Property valuations - this is not a new concept, however before any property is funded it requires a property valuation (this may be seen as double protection by lenders in covering the concerns about property spruikers)

5. Conservative lending policies - in addition to the abovementioned, lenders policies around LRBAs have a maximum lend of 80% (for residential), which is much lower than personal lending where loan to valuation ratio's (LVR's) can range up to 95%, this will help to improve the SMSF cash flows and improve liquidity within the fund

Overall, the lenders are acutely aware of the potential negative implications of LRBAs and have introduced policies to substantially reduce the risk presented to clients, and ensure that trustees have success with this lending.

With the work being undertaken by the MFAA to upskill members on LRBAs, and the proactive initiatives undertaken from lenders to ensure 'Responsible Lending' with LRBAs, the restoration of the general prohibition on direct leverage of superannuation funds is inappropriate. Rather, initiatives such as the MFAA SMSF Lending accreditation, should be encouraged to ensure consumers are better protected by qualified advice from all the professionals in the SMSF process.
