FINANCIAL SYSTEM INQUIRY**Error! Bookmark not defined.**

SUBMISSION

by

AUSTRALIAN HOME LOANS LIMITED

September, 1996

PREFACE

Australian Home Loans Limited congratulates the Commonwealth Government on its initiative in undertaking this inquiry into the financial system. Contrary to some, we regard the Inquiry as an opportunity for commencing major changes to existing arrangements which have the potential to open up the Australian capital market and reduce the cost of capital. We are certainly keen to avail ourselves of the many potential opportunities which exist and we are anxious to see the reduction in regulation and levelling of the playing field that would allow that to occur.

We make this submission on the understanding that there will be an opportunity to lodge a supplementary submission after the Inquiry has circulated an issues paper in November.

Australian Home Loans Limited wishes to acknowledge the assistance provided in preparing this submission by Mr Des Moore, Director, The Institute for Private Enterprise and Ms Jane McGinnes, Corpec Pty Ltd. Mr Moore, whose twenty-eight years' experience in the Commonwealth Treasury included a period as both head of the Financial Institutions Division and as Deputy Secretary with responsibility for that Division, has provided valuable input into the economic and policy aspects of the submission. Ms McGinnes, whose experience has included three years as Chief Economist at the Australian Bankers' Association, has provided important insights into the workings of the capital market and the role of the banks.

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EXECUTIVE SUMMARY

INTRODUCTION

- As both a mortgage manager and a mortgage originator, Aussie Home Loans (AHL) has been a leading innovator in the home mortgage market and is potentially an innovator in other markets. The future regulatory framework for the capital market is thus of major importance to AHL.

- Unlike the Campbell Committee, the general direction which this Inquiry should take is less obvious. In that sense, the Inquiry's task is the more difficult and requires more deliberation.

- Regulation of the securitised home loan market should not be increased and should be reduced for financial service providers (FSPs) generally.

- FSPs should be regulated more as "normal" companies.

- FSPs should, however, be required to publish more information more frequently. This would provide a better basis for prudential regulation and help overcome the present problem of misleading market information.

- Regulatory authorities should also be required to publish frequent assessments of individual FSPs against stated benchmarks.

- More onus should be placed on investors and borrowers to decide on the relative merits of FSPs in an environment which is both more informed and more competitive.

- The privileged position of the banks in the financial system, particularly the quasi depositor guarantee, should be reduced, if not eliminated.

- Pursuit of a monetary policy whose sole objective is price stability, and pursuit of a more medium term orientation to macro policy generally, would make for a more stable economy and financial sector, reducing the extent of prudential regulation needed.

GENERAL ISSUES CONFRONTING THE INQUIRY

THE EXPERIENCE OF DEREGULATION

- AHL expects that further deregulation would reduce the cost of capital, develop the capital market and so contribute to improving growth and living standards.

- AHL initiated lower cost home mortgages, and was able to do so partly because it was not a regulated FSP.

- There is scope and a need to develop other areas of the capital market, particularly to broaden the risk spectrum and reduce the cost of capital.

- US experience suggests that the capital market there has done this through developments largely outside the regulated financial sector, which appears to be shrinking relatively.

- Globalisation led to deregulation of international capital flows and exchange rates; similar forces may now be operating domestically. To the extent that they are, the regulatory arrangements should take full account of, even anticipate, them.

The Experience of the 1980s

- Misconceptions about deregulation in the 1980s need to be addressed because they have led to inappropriate re-regulation and affect ideas about regulation today.

- Deregulation has not imposed greater "discipline" on governments: if anything, the opposite. "Shocks" may be more readily absorbable than when capital markets were narrower and less liquid.

- While financial deregulation facilitated the excessive growth in credit during the 1980s, the underlying cause was the pursuit of macro-economic policies which sought to "stimulate" growth and were too accommodatory to inflation.

- The lesson is that the better behaved are government macro policies the less is likely to be the need for regulation of the financial sector.

- The deterioration in national saving started before deregulation and is due to other factors, such as higher inflation and the extension of welfare to middle and upper income groups.

- The experience of the 1980s should not lead to any conclusion that financial deregulation has been a failure, that further re-regulation is required or that there should be no further deregulation.

The Increase in Prudential Regulation

- Although no systemic risk developed during the 1980s, the prudential regulatory system did not function adequately

- While many financial institutions and individuals adopted inappropriate lending/borrowing standards during the 1980s, they were importantly the product of inappropriate macro policies.

- The authorities have reacted inappropriately by increasing the regulation of risk-taking in the financial sector: the wrong diagnosis was made.

- While this has been an international trend, in Australia the Reserve Bank (RBA) has carried the re-regulation too far. It has also reinforced the impression that bank deposits are effectively guaranteed and that major banks (at least) will be protected against "runs." This is inappropriate in a level playing field.

- Even with the increased costs of re-regulation, the present arrangements appear to provide a considerable net benefit to banks, which puts them in a privileged position and allows them to attract funds at lower rates than otherwise.

- The protection of the use of the term "bank" is one example of the privileged position.

The Slowness of Competition to Develop

- While consumers have benefited from a greater choice of services and institutions under deregulation, competition in prices and service quality is a relatively recent development except for larger businesses. Moreover, emergence of effective competition is largely due to AHL's innovations in the home mortgage market, which include 10,000 free home visits per month by AHL consultants.

- The failure of price competition to develop to the extent expected is relevant to the Inquiry.

- It reflected a number of factors centred around the excessive protection of existing banks, including the quasi depositor guarantee, the explicit guarantees given to government banks, intervention by the authorities in setting mortgage interest rates, and the accommodatory monetary policy.

- This severely inhibited competition and allowed banks to maintain above average returns on equity, except during the recession. Banks continue to earn above average returns on equity.

- It also appears that productivity in the banking sector is still well below international best practice, which indicates inadequate competition or excessive privilege, or both.

FACTORS LIKELY TO DRIVE FURTHER CHANGE

- The extent of competition and regulation are the most important factors that will influence change, along with technological advances.

- Maximising competition and minimising regulation are important if technological advances that have the potential to reduce costs are to be taken advantage of to the fullest.

- The interests of users of FSP's services are already adequately protected under existing legislation and common law. Additional protection will be provided by fostering competitive conditions and the natural (but often overlooked) self interest of FSPs in maintaining a reputation for care of consumers, within a framework of improved information flows and published regulatory assessments.

- There is clearly scope for substantial improvements in efficiency amongst banks, and mergers could help to achieve those - provided adequate competitive conditions exist.

- This makes reduction/elimination of banks' privileged position all the more important.

FUTURE REGULATORY ARRANGEMENTS

More emphasis should be given to the responsibility of boards and managements of FSPs for their sound management. Banks' privileged position needs to be reduced and preferably eliminated. There should be no quasi guarantee of bank deposits. Relevant considerations include:

a) Experience suggests that prudential regulators have consistently been engaged in "catch up" with inappropriate conduct - and have been behind the ball game.

b) Prudential supervisors may have no greater capacity to detect inappropriate practices than market watchers.

c) Prudential supervisors may also have less capacity to develop risk management systems than those operating financial businesses and market watchers.

d) To the extent that (a) (b) and (c) are true, the role of prudential supervision should be reduced, along with regulations.

e) The greater the extent of prudential supervision the less is likely to be the effort made by FSPs themselves, and by market watchers.

f) The threat of contagion should be capable of being handled in almost all cases by a combination of central bank injection of liquidity into the system and the takeover of an FSP in financial difficulties by another FSP.

g) The (remote) potential for financial difficulties of a major FSP to constitute a threat to the payments system is being reduced by technological changes. It should also be capable of being handled via take-over, subject to appropriate interim receivership arrangements being available.

This is the background to the Recommendations.

SECURITISATION AND THE HOME LOAN MARKET

- Securitisation allows functional specialisation of the financial intermediation process which leads to efficiency gains and cost savings. This results in lower finance costs for borrowers such as AHL customers.

COMPETITION IN THE HOME LOAN MARKET

- Historically, substantial margins in home lending provided banks with their most profitable business. Only the advent of strong competition from securitised lenders has made this market truly competitive.

- Over the last 2-3 years the share of the mortgage market going to non-traditional loan originators has increased to around 10% from 1% previously; mortgage backed securities now account for around 4% of the total value of housing loans outstanding.

- The initial response to deregulation by banks was product innovation rather than price competition in price and service quality. Non-bank originators/managers brought price competition to the market - offering their customers mortgage rates 1¼ - 1½% below bank rates and savings of tens of thousands of dollars.

- Banks have now lowered their standard mortgage rate and they also offer "basic" home loans. The latter significantly reduces loan features and benefits. In contrast, the AHL loan provides a low rate and has most of the features and flexibility of a so called standard loan.

- As banks have lowered their rates they have also introduced ongoing (usually monthly) fees. These fees are generally not well disclosed and result in a misleading impression of the true cost of a loan. AHL is in favour of the publication of comparison rates which facilitate informed choice by consumers.

- Competitive pressure is already causing banks to reduce cross subsidisation in financial service provision. Over time, banks will be forced to reduce the costs of service provision, resulting in greater efficiencies in resource use in the financial sector. It must be an imperative that regulatory arrangements do not impede greater benefits of this type for consumers and for the economy.

- Existing and impending regulation is more than required to give consumers appropriate protections. It consequently adds unnecessarily to the cost of providing finance and impedes market developments. There is thus a case for rationalising existing consumer regulation. COAG should examine the issue.

- Inclusion of home mortgages under the coverage of the Uniform Consumer Credit Code is not justified on the basis of the functioning of the market. Certainly, the performance to date of mortgage originators/managers has been one of consumer oriented service and a refreshing contrast to their bank competitors.

- The UCCC treatment of mortgage insurance commissions does not adequately take account of the intermediary role played by mortgage originators and the fact that the commissions are disclosed to borrowers. Moreover, this is discriminatory treatment as compared with the payment of commissions for other types of insurance. Recovering the administration costs of arranging mortgage insurance enables mortgage originators/managers to keep interest rates down.

- Market entry by new firms appears to be impeded in some States by Finance Brokers Licensing regulations which differ significantly between States. It is questionable whether mutual recognition arrangements designed to cover this are being given full effect.

- Prudential arrangements relating to the risk weighting of securitised assets do not meet level playing field tests. Risk weights for mortgage backed securitised assets for banks' capital adequacy purposes should reflect the quality of the underlying assets, as recognised in the 50 percent risk weighting of home mortgages with loan-to-valuation ratios of 80 percent or less held on banks' balance sheet. More generally, prudential arrangements should take account of potential developments in the securitisation area.

BORROWER PROTECTION

- Borrowers who arrange home loans through securitisation programs enjoy all the usual benefits and protections enjoyed by other home borrowers <u>plus</u> benefits deriving from the securitisation structure itself.

- AHL's corporate philosophy is about providing the best service to borrowers - reflected in full disclosure to customers in an easy to understand *Disclosure Statement* and attendance of a lawyer at the majority of mortgage contract executions. The mortgage itself is notable for its fairness and clarity.

- There are no contingent problems for AHL borrowers in the remote event that AHL withdrew as alternative arrangements would be made under the terms of the mortgage origination deed which would be seamless from the borrowers' perspective.

- High lending practice standards apply to loans originated to securitisation programs - including credit risk assessment by qualified personnel, repayment-to-income requirements, acceptance for mortgage indemnity insurance and prudent loan to valuation ratios; close to 75% of loans have LVRs at or below 80%.

- These standards ensure that borrowers are at least as able to withstand interest rate rises as bank borrowers. This is reflected in the quality and performance of the mortgage pools of securitisation programs. By contrast, the use of "honeymoon" interest rates by banks exposes their clients to a potential to over-commitment.

- In addition, Property Law, the Corporations Law, the Trade Practices Commission, the Privacy Commissioner and Fair Trading and Consumer legislation all provide protection to borrowers.

INVESTOR PROTECTION

- At present, investors in securitised assets in Australia are institutional investors who can obtain comprehensive and detailed particulars on the assets in an *Information Memorandum* which provides them with the information appropriate to their requirements. Securitised home loan programs typically attract triple A (AAA) rating - higher than ratings given to banks.

FUTURE DEVELOPMENTS

- It is desirable that the Inquiry recommend arrangements which allow the flexibility necessary to meet future demands and to respond to the opportunities which will be opened up by technological, product and market developments. Appropriate recommendations are included in Recommendations below.

RECOMMENDATIONS

- Recognise that financial deregulation was not the underlying cause of the experience of the 1980s and that the re-regulation that has occurred is based on a wrong diagnosis.

- Recognise that the slowness of price competition to develop in markets for consumer and smaller business services after deregulation mainly reflected the excessive regulation and protection of existing banks, and that, to date, this shield has only been penetrated largely at the initiative of a company that is not subject to financial regulation per se (Australian Home Loans Limited), resulting in a home loan market which is delivering greatly improved outcomes for consumers.

- Recognise that banks are still in a privileged position among financial service providers and that there is a strong case for reducing, preferably eliminating, that position.

- Recognise the potential for making the Australian capital market a leader in a global context and that that depends importantly on creating an environment more sympathetic to risk-taking and, hence, imposing a minimum of regulation of financial service providers (FSPs).

- Recognise that the pursuit of a medium term approach to macro-economic policy, and in particular to setting price stability as the sole target of monetary policy, is most likely to reduce fluctuations in the economy, thus reducing the need for prudential regulation.

- Separate the responsibility for the prudential supervision of banks and the operation of monetary policy, thus recognising that non-bank financial institutions provide about one-fifth of credit and that movements in monetary aggregates are now only one element of monetary policy. Thus, there is now little need for the RBA and the banks to have a “special” relationship.

- Establish one body to supervise the prudential regulation of all financial institutions so as to level the regulatory playing field as between FSPs to the extent practicable.

- Require FSPs to publish more information more frequently, including in relation to their balance sheets, volume of business and product pricing.

- Require regulators to publish frequent assessments of FSPs related to stated benchmarks.

- Base supervisory arrangements much more on transparency and greater acceptance of responsibility by boards and managements, as well as by investors in and users of FSPs’ services, within the framework of the two previous points.

- Widen the range of institutions able to describe themselves as “banks”, and in particular, allow "mortgage bank" to be used.

- Close the lender of last resort facility for individual institutions at the Reserve Bank.

- Indicate clearly that no guarantee exists on deposits (including by removing the "protection of depositors" in the Reserve Bank Act) with any financial institution and that a new approach is being adopted toward depositor protection. This involves the pursuit of price stability, the publication of more information and of regulatory assessments, the overcoming of any systemic risk through the provision of liquidity to the market and the placing of greater responsibility on boards and managements as well as on investors and users of FSP services.

- Remove restrictions on the amount of bank capital allowed to be held by one interest, subject to disclosure of lending to one interest above a specified proportion of assets.

- Remove restrictions on foreign investment in of Australian FSPs.

- Review the application of existing consumer protection legislation, and particularly the Uniform Consumer Credit Code (UCCC), in the light of existing protection provided through the Competition Commission and State authorities and the proposed new approach to prudential regulation of FSPs, with a view to rationalising such regulation and reducing the cost thereof.

- In any event, remove or exempt home mortgage lending from coverage of the UCCC, given that there is already adequate protection provided under other law.

- Allow the payment of insurance commissions to mortgage originators under the UCCC, subject to appropriate disclosure requirements, in line with the treatment of commissions on other types of insurance.

- Recognise the need for effect to be given by governments to mutual recognition arrangements relating to the regulation of FSPs and, in particular, to the licensing of finance brokers.

- Change risk weights for banks' capital adequacy in regard to for mortgage backed securities to reflect the quality of underlying assets as recognised in the risk weighting of home mortgages held on bank balance sheets (ie 50 percent where the loan-to-valuation ratio is 80 percent or lower for residential mortgages).

1 INTRODUCTIONError! Bookmark not defined.

As both a mortgage manager and a mortgage originator, Australian Home Loans Limited (AHL) welcomes the opportunity to make a submission to this Inquiry. We do so as a leading player in the housing market, which is our immediate area of interest, but also as an institution which has plans to become an innovator in other sectors of the financial market, as opportunities arise. We are very concerned, therefore, to see the development of a market that clearly provides for both new entrants and existing players to operate on a level playing field basis. As an innovator in home lending, AHL believes that its experience in opening up that market, and in demonstrating the benefits of competition, provide some useful lessons about the regulation of financial services and the development of the Australian capital market more generally.

The Inquiry's Terms of Reference covers three main areas - the effects of financial deregulation, factors likely to drive further change in the financial system, and future regulatory arrangements and other matters affecting the operation of the financial system. Importantly, the Inquiry is asked to recommend "regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness". It is directed not to make recommendations on certain other matters but may "take account of" them.

Comparisons with the situation at the time of the Campbell Committee Inquiry have led to suggestions that the present Inquiry will not be able to recommend the major changes Campbell did. However, while the general direction and speed of change may appear less obvious than at the time of Campbell, we believe that careful consideration will reveal the need and potential for changes which could have a major favourable impact on the capital market, and on the Australian economy, possibly within a shorter time frame. Moreover, the low inflation environment which has now been established offers less risk that substantial change could cause a repetition of the experience of the 1980s.

The main thrust of this submission is that, on the basis of historical experience properly interpreted, the now well established benefits from competition, and likely technological developments, regulation and intervention by governments and their authorities in the operation of the financial system should be much reduced. There is certainly no case to extend the regulation of the securitised home loan market beyond existing corporate and consumer legislation.

Generally, the regulation of providers of financial services should be as similar as possible to the regulation of other companies, with more emphasis being placed on the responsibility of the boards and directors of financial service providers (FSP's), and the users of their services, along lines similar to the way New Zealand has moved, but taking that a major step further. Looked at from one perspective, FSP's operate in much the same way as other companies in that both invest the funds of those who "deposit"[1] with them and both have a similar duty of care. Yet there has developed a much greater degree of regulation of the activities of financial institutions than of the "normal" joint stock company.

This tradition must be recognised and taken into account, of course. But it should be possible now to start to change the emphasis from regarding banks as "special" to one where all FSPs are required to make more information available more frequently to both the investing and borrowing public. At the same time, the regulatory authorities themselves could be required to publish frequent assessments of individual institutions against appropriate benchmarks. Such an approach would put more of the onus on the investing and borrowing public to decide on the relative merits of FSP's but in an environment where regulators make public assessments of performance and status, similar to the role now performed by credit rating agencies. This, together with competition between service providers, could become over time the main source of prudential protection for consumers of financial services.

As indicated later in this submission, AHL attaches great importance to fully disclosing to its customers all the conditions of their loans and their rights under loan agreements and we support the principle of full and frequent disclosure of the financial position, volume of business and product pricing of FSPs. Indeed, we believe that this is needed not only to provide a better basis for prudential regulation but to reduce the amount of misleading information which is being provided to the market by some FSPs.

The Inquiry should give particular attention to the case for reducing, preferably eliminating, the special treatment accorded to banks, which seems to us to give those institutions an unfair advantage. The widening of outlets for the investment or "deposit" of peoples' savings, and the development of payments arrangements which may not require the channelling through banks of payments between individuals and businesses, should allow a more level regulatory playing field as between FSPs. The threat of systemic risk should now be approached differently.

Also, while precluded from making recommendations on monetary policy, the Inquiry should emphasise the vital importance to FSP's and their clients, and to the health of the financial system generally, of pursuing a monetary policy whose *sole* objective is price stability and, more generally, of a macro-economic policy which does not attempt to "fine tune" the level of employment and economic activity in the mistaken belief that policy changes can be timed to offset other changes in the business cycle. A reduction in the volatility of interest rates and in average real interest rates, which would be major benefits of pursuing a consistent, medium term, low-inflation policy, would make a major contribution to the stability of both the economy and of financial institutions and their customers. The housing market would also benefit, of course.

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1 Of course, funds are not normally "deposited" with non-financial companies but an equity is purchased. While this implies a greater preparedness to accept risk, a duty of care remains. Also, many financial companies, including banks, now effectively act as agents for individuals in investing in equities.

Before discussing issues specifically relating to the securitised home loan market we wish to make a few observations on some general issues relating to the financial system and the role of government in that system. Our comments are related primarily to the role of banks mainly because of their importance as sources of finance for households, to whom they currently provide about 90 percent of total funding.[2] Given the limited time available to the Inquiry, it has been judged appropriate to avoid lengthy dissertations on the various issues which the terms of reference raise. Should our submission appear to have insufficient supporting argument or data on any point, we would naturally be pleased to supplement it on request.

2 GENERAL ISSUES CONFRONTING THE INQUIRY

2.1 THE EXPERIENCE OF DEREGULATION

As one of the products of the deregulation of the financial system, AHL would naturally be expected to extol its benefits. However, we do so on much broader grounds than self interest. We believe that further deregulation is important to the development of Australia's capital market, including further reductions in the cost of capital, and that this is one of the main ways in which Australia's rate of growth and living standards can be increased to the benefit of all Australians.

2.1.1 Developing an Efficient Capital Market

The development of a lower cost home mortgage market, in which AHL has played a leading role, is just one example of the benefits that an improved and less regulated capital market can provide. We note that, as both a mortgage manager and a mortgage originator, AHL's innovative development of the home mortgage market has been on the basis that it is a "normal" company rather than a financial institution per se. There may be an important lesson for financial regulation from this.

We doubt, for example, that AHL would have been able to develop as it has if it had relied, even in part, on the acceptance of deposits from the public. We would have been required to start with much more capital, for one thing. Yet, as our later description of the securitised home loan market shows, we are able to a considerable extent to derive a capital backing from the way in which our home lending operations are funded. There is virtually no risk that those who have borrowed through AHL could be required to repay their loan because of a lack of funding. Equally, those investing in AHL sponsored securities, which are insured first mortgages and have AAA credit rating, arguably have more security than those depositing their funds with a bank. Thus, AHL is able to operate as if it were a

2 See *Retail Banking, Technology and Prudential Supervision* by Deputy Reserve Bank Governor, Mr G J Thompson in Reserve Bank Bulletin May 1996, p.12. "Retail Banking" includes building societies and credit unions in this context.

mortgage bank - but without having to employ the wasteful amounts of capital (and other resources) to back its housing loan operations that banks do. Ironically, however, it cannot describe itself as a "mortgage bank".

Also relevant is the long history in Australia of complaints about the unwillingness of private financial institutions to provide "venture" capital, particularly for small business, and of government attempts to fill the perceived "gap" both through subsidised institutions and through tax concessions. These complaints have doubtless been overstated. Nonetheless, as AHL's own experience indicates, there have been and continue to be "gaps", particularly in regard to the provision of risk capital at a lower cost. Indeed, notwithstanding the apparent inventiveness of Australians outside the capital market, Australia clearly still lacks a substantive venture capital market, just as it also lacks a corporate bond market. Yet the authorities rather too often give the appearance that a new institution with a new product may constitute some sort of problem for "the system"; and that venture investment is dependent on government tax or other concessions.

We believe that there is considerable scope for economies to be made in other parts of the capital market and for the Australian capital market to develop the capacity to provide funding for a wider range of risks. There have been various attempts (such as the attempted development of a second board) to do this in the past and it is not entirely clear why they have not been more successful. Factors such as the failure of government macro-economic policies to provide a stable, low inflation investment environment and the entrenchment through regulation of high cost banks as conservative providers of debt finance doubtless played a part. The cultural change around the 1970s, which increased the antipathy to "profit" at a time when the capital market was starting to widen, may have been another.

Whatever, the Australian capital market now needs not only less regulation so as to allow the development of institutions such as AHL but a preparedness to contemplate the development of higher risk products/ financial institutions and, associated with that, a preparedness for users of financial services to accept higher risk.[3] That will require, inter alia, a cultural change which will take time - but such a change will only come if government is prepared to be less interventionist, to encourage financial entrepreneurship rather than surround it with a barbed wire regulatory fence, and to encourage investors to accept greater responsibility for their decisions.

Relevant are the recent suggestions that the development in the USA of new financial institutions, most notably mutual funds, which are not regulated as financial institutions per se, is "transforming" not only the structure of capital markets but the economy itself. According to an AP-Dow Jones report quoted in the Sydney Morning Herald of 11 June, the former Chairman of the US Securities and Exchange Commission, Mr Richard Breeden,

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3 It may be argued that, during the 1980s following deregulation, Australian financial institutions did extend the spectrum of their risk-taking, but to ill effect. However, as argued below, this was done in a context where macro-economic policy settings were inappropriate.

has claimed that new businesses and technologies are being created faster in the US not because "our scientists are smarter than their scientists" but because "we're creating a system that provides more capital more quickly to people willing to take the big risks and our economy is reaping the rewards." In the US, Mr Breeden reportedly argued, there are "literally thousands of gatekeepers in an increasingly decentralised capital market, many with a much higher appetite for risk" than in other industrialised countries "where investment-decision making is concentrated in the hands of just a few dozen gatekeepers at banks and investment firms".

In the same report, noted chief economist with Kemper Financial Services, Mr David Hale, is quoted as pointing out that "The US is in the midst of creating a whole new financial system in which the mutual fund sector is increasingly displacing commercial banks as the major repositories of household wealth, as well as suppliers of capital". US banks are now even expressing concern that the cost of regulation may be inhibiting their ability to compete. According to a Bloomberg report (AFR 25 July 1996), a US Bank Administration Institute and McKinsey & Co report shows that only 25 per cent of the outstanding credit market debt is held by government-regulated commercial banks, the remainder being in the hands of "market -regulated, non-bank companies that are outside of the heavily regulated banking sector." This report claims that companies that act like banks but are not subject to the same regulatory control include 5,300 securities firms, 13,000 credit unions, 8,300 insurance companies and 2,200 savings institutions.

It appears that there has been a similar development in Australia. According to Deputy Reserve Bank Governor Thompson, in Australia in each decade since the 1960s the proportion of household saving going into deposit-type accounts with retail banks has declined and has fallen to only 28 per cent in the 1990s compared with 42 percent in the 1970's.[4] Correspondingly, the proportion of household savings going to fund managers has risen significantly.

Thus, while the foregoing remarks by Messrs Breeden and Hale may overstate the comparative differences as between the US and other capital markets as well as in preparedness to take risks, they seem to us to contain more than a grain of truth. Australia needs to ensure that the regulatory system does not shackle us in to any particular financial structure but is flexible enough to allow the sort of changes that are occurring in the US, if that is appropriate to our market.

The basic question here, surely, is whether "special" regulation of banks is any longer needed, not that the other institutions should be more regulated. Indeed, one is led to wonder whether, just as the globalisation of international financial markets (which commenced with the development of the euro- dollar market about a quarter of a century ago) eventually forced regulators in countries that wished to remain serious participants in the international trading and capital markets to substantially abandon controls over

4 *Op. Cit*. p.11. Including building societies and credit unions, the proportion rises to 36% in the 1990s compared with 57% in the 1970s.

exchange rates and international capital flows, we are not in the process of witnessing a similar situation in regard to the regulation of domestic banking. If so, that should be fully taken into account, even anticipated, in framing Australia's regulatory system so as not to hold back unnecessarily the development of Australia's capital market. It is not simply a matter of adopting best international practice but of identifying an approach that provides the opportunity for the Australian capital market to become a leader.

2.1.2 The Experience of the 1980s

It has become a common-place in some quarters to see financial deregulation in Australia as the underlying cause of the recession at the end of the 1980s, as reducing the capacity of government to pursue "independent" macro-economic policies, and as contributing to the deterioration in the rate of domestic saving. We believe it is important that the Inquiry address these issues, and correct the misconceptions which exist, as they continue to influence the extent of financial regulation judged in some quarters to be needed in present and foreseeable circumstances.

In that regard, we make the following points:

(i) *Deregulation Does Not Excessively Discipline Government Policies*

The argument that financial deregulation has exposed Australian Governments excessively to the "discipline of financial markets" overlooks the fact that such discipline was imposed on many occasions prior to the 1980s when exchange rates and international capital flows were highly regulated. The existence of detailed controls over the volume and price of bank lending, and foreign capital flows, during the 1950s, 1960s and 1970s, for example, did not prevent the recessions of the early 1960s and mid 1970s that were partly, if not mainly, the product of policies allowing the situation to get out of hand and then having to tighten severely in order to restore stability.

Equally, while there is now a greater integration of financial markets and a more ready transmission of "shocks", Australia was not able to avoid the effects of past shocks because of regulation. The oil price shocks of the 1970s, for example, clearly impacted the Australian economy. Arguably, the widening and deepening of the Australian and international capital markets since financial deregulation has actually increased the potential for shocks to be absorbed without excessive disruption.

Indeed, the scope for governments to pursue "independent" policies has probably increased as financial markets are prepared to accommodate a wider range of risks. This is reflected in the wide range of credit ratings given to government foreign currency debt. There is certainly considerable scope for governments to pursue different macro policies and to operate widely different sizes of government and levels of taxation. Our concern is less with the potential for financial markets to discipline governments and more with the potential for governments to postpone the discipline which existed under the more regulated and less globally integrated financial system, at least in the short term. Of course, the bottom line is that, whatever the extent of financial regulation, Australia will eventually pay the price of undisciplined macro-economic policies.

(ii) *Financial Deregulation Not the Cause of the 1980's Problems*

Indeed, the experience of the 1980s illustrates this point. During that period, under an Accord with the trade union movement which supposedly provided for wage "restraint" (but which "delivered" a considerably faster growth in nominal wages than in our main competitors), the Commonwealth Government sought, through a combination of fiscal stimulus and relatively "benign" monetary policies, to achieve a higher rate of economic growth than would otherwise have been the case. The notion was that the Accord would prevent the wages upsurge which would normally occur as the economy approaches "full employment", thus allowing higher growth before policy restraint was implemented. The (newly floated) exchange rate would “absorb” any strain on the balance of payments.

However, the fact that productivity growth remained stagnant meant that the (stimulated) increase in national spending was not matched by an equivalent increase in national output. This resulted in a "blow-out" in external debt and other foreign liabilities and, to retain the confidence of foreign investors, necessitated the (eventual) severe tightening of monetary policy which produced the recession of the early 1990s and the associated steep rise in unemployment.

Thus, while financial deregulation *facilitated* the excessive growth in credit during the 1980s (20 percent per annum between the end of 1983 and mid 1989, only a small part of which was re-intermediation), the underlying cause was the inappropriate macro policies pursued by the Government. In particular, the fact that the Accord effectively set the rate of growth in wages meant that monetary policy had to accommodate that and could not operate to reduce the rate of inflation, which averaged around 7 per cent between 1983-84 and 1989-90 - well above the OECD average.[5] In these circumstances, borrowers and investors in assets appeared to have a virtual guarantee that they would benefit and it took the recession to actually bring inflation down to international levels.[6]

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5 In a paper on “The Lessons for Monetary Policy” delivered to the Reserve Bank’s June 1991 Conference on *The Deregulation of Financial Intermediaries*, the then Assistant Governor (Economic), Mr Ian MacFarlane admitted that it would be “foolish to claim that the setting (of monetary policy) was always right” and he conceded that the easing of monetary policy in 1987 may have been overdone. He concluded, however, that “ What could monetary policy have done about it? In principle, it would have been possible to devise a monetary policy tight enough to have prevented the acceleration in credit. However, it would have had to have been exceptionally tight,and in my view, tighter than would have been in the overall macro-economic interests of the country.” Mr Macfarlane did not, however, address the possibility of setting an objective earlier in the 1980s to progressively bring inflation down to, say, the rate in our major trading partners. Had that been done, it is most unlikely that Australia would have experienced the recession of 1990-91.

6 Of course, the recession was the product of the eventual severe tightening of monetary policy. But the monetary authorities are scarcely justified in claiming credit for lowering inflation in such circumstances!

In short, the lesson of the 1980s is not that financial deregulation was inappropriate or that regulation needed to be tightened but that macro-economic policies needed to be adjusted to ensure that they were directed to maintaining low inflation on a consistent basis and as the number one priority. Provided this is done there should be much less concern about further deregulation of the financial sector because, within an environment where it is evident that the authorities are pursuing a determinedly non- inflationary policy, the risk of excessive credit growth causing a "boom-bust" situation becomes negligible. While that would not mean that no financial institution would ever get into difficulties, it would significantly reduce the probability.

We hope that the Inquiry will, if not make a recommendation on the point, at least "note" that the better behaved are government macro policies, and monetary policy in particular, the less is likely to be the need for regulation of the financial sector. We note in this regard that the recent exchange of letters between the Treasurer and the Governor of the Reserve Bank increases the emphasis on price stability. Even so, there is a need for further significant changes to the monetary policy objectives.[7]

Of course, the object is not to pursue price stability for its own sake. Underlying the aim of price stability is also the now widely accepted belief that, the more closely it is achieved, the better the real economy is likely to perform, in terms both of average growth over the longer term and of reduced fluctuations; and the less likely there are to be problems in the financial sector.

(iii) *Deregulation and National Saving*

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As to the possibility that financial deregulation has contributed to the deterioration in the rate of domestic saving, there is again a need to examine the effects of government policies rather than jump to the conclusion that deregulation has been the culprit. Obviously, the removal of controls on the volume and price of credit extended by financial institutions provided greater *opportunities* for people to borrow and, hence, to reduce net saving. However, the question that must be asked in this context is whether financial deregulation or some other factor or factors have been the underlying causes of the decline in national saving, as shown in Chart 1.

In the case of the 1980s, a major cause of the excessive growth in debt (and the concurrent excessive growth in credit) was the poor macro policies pursued by the Government, as outlined in (ii) above. But there have also been more pervasive influences from poor government policies which date from the 1970s. They include the much higher rate of inflation (which reduced the incentive to save) as shown in Chart 2, and the extension of social security and associated forms of assistance to "middle" income groups. That

7 See *Monetary Policy Under the Coalition Government* by Des Moore, Business Council Bulletin, May, 1996.

extension of "middle class welfare" has reduced, and continues to reduce, the need for people to save; has reduced the incentive to do so; and (through the higher taxation required to finance it) has reduced the capacity to save. As Chart 3 shows, the decline in the rate of household saving (which has now reached almost zero) dates from the early 1970s when the extension of middle class welfare began. There is no indication that the rate of decline increased after financial deregulation.

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In summary, the experience of the 1980s should not lead to any conclusion that financial deregulation has been a failure or that it is the cause of on-going problems that require re-regulation or would prevent further deregulation. Nor does it even mean that governments must be more "disciplined" than before, desirable as that would be. The main lesson of the 1980s is that the best results are likely to be achieved if governments pursue macro policies which have medium-longer term objectives, such as price stability and increased saving, and which generally avoid intervention to try to achieve short term aims, such as "kick-starting" economic activity when it slows. The capacity of government to detect the timing of the business cycle, let alone to time intervention to stimulate or dampen activity without having eventual adverse effects that would not otherwise have happened, is extremely limited, if not non-existent.[8] If this lesson were to be recognised, the need for financial regulation would be much reduced.

2.1.3 The Increase in Prudential Regulation

One of the "outcomes" of the 1980s was that many financial institutions, including two major banks, got into varying degrees of financial difficulty mainly because their lending policies were based on assumptions that policies that were relatively accommodatory to inflation would continue. Such assumptions should, of course, never have been made and there is no doubt that financial institutions themselves must share the blame not only for their own problems but for those that affected the economy more generally. Even so, it is necessary to acknowledge that in circumstances where the "authorities" are pursuing such accommodatory policies, a strategy of conservatism in lending will inevitably result, in the short term, in a loss of market share and a profit performance that is relatively worse than one's competitors.

The response of the "authorities" to the difficulties experienced by financial (and other) businesses has been to increase prudential regulation in one form or another. In effect, the authorities concluded that, as experience showed that there were greater opportunities for risk taking in a deregulated financial market and as the various players in that market had shown themselves incapable of handling the situation, governments now had to ensure that

8 See *Economic and Savings Implications of the 1996-97 Budget* by Des Moore, Institute for Private Enterprise, July, 1996.

either risk taking decisions were supervised or that rules were in place which either inhibited or prevented "excessive" risk taking.[9] The real issue - the inadequacy of government macro-economic policies - went unrecognised, at least in this context.

There has also been no explanation as to why the prudential supervision system did not at the time even identify, at least publicly, that over-lending was occurring. The explanation - that supervisors "were not as well prepared for the shock of deregulation as they might have been"[10] - seems a rather unsatisfactory one, given the serious problems which arose. It is certainly difficult to accept that, "on the whole, our supervisory arrangements have served us pretty well"[11], a suggestion which seems to be based largely on the fact that no serious threat of contagion developed. Indeed, it is difficult to avoid the conclusion that prudential regulators have been consistently engaged in catching-up with the latest example of inappropriate conduct - and have generally behind the ball game.

It is not our concern here to comment in detail on the various steps in the various areas that have been taken to re-regulate over the past 6-7 years. We note, however, that in the case of banks alone this has led to the development of new and detailed prudential requirements by the Reserve Bank covering such matters as capital adequacy, banks' involvement in funds management and securitisation, supervision of the adequacy of liquidity of banks, supervision of banks' large credit exposures, banks' association with non-banks, and banks' asset quality. In addition, since 1992 the Reserve Bank has been paying "visits" to banks to review, first, credit and, then, market risk management systems. Now, bank chief executive officers as well as auditors will be required to sign personal endorsements of risk management practices in their banks.

Of course, the Reserve Bank says it is doing no more than to follow international best practice as indicated by the Bank for International Settlements. Thus, Governor Fraser said recently "there is not much Australia acting unilaterally can do about these standards, even if we wanted to."[12]

Even accepting that this is the case, however, the way the Reserve Bank has interpreted its role has reinforced the impression that the "authorities" have virtually accepted responsibility for the viability of the banks and that bank deposits are effectively guaranteed and free from risk. Indeed, it is a commonplace that "the authorities" would act directly to prevent a "run" on any of (at least) Australia's four major banks and would ensure no loss by depositors of any of those banks in the event that one was forced to cease business.

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9 See, Reserve Bank of Australia, 1996 Annual Report, p.52, for example.

10 *Op.Cit.* p. 52.

11 *The Wallis Inquiry: Perspectives From The Reserve Bank* by G J Thompson, Deputy Governor, 5 September, 1996

12 *Financial Regulation And The Financial System Inquiry* 5 July 1996.

This impression has been enhanced by the apparent change in the interpretation given to the statutory obligations of the Reserve Bank to protect depositors under the Banking Act. Under Governor Johnston it was stated that "the Banking Act is silent in regard to the priority to be given to depositors. So the legislation is less than a guarantee to depositors of full payment..."[13] However, in the case of each press statement issued on the "runs" on the Bank of Melbourne and Metway Bank, Governor Fraser indicated that the Reserve Bank would ensure that depositors were "fully protected".[14] Moreover, in his statement of 2 July 1990 on the arrangements to provide liquidity support to Victorian building societies, Governor Fraser said that, "while the Reserve Bank is not responsible for supervising building societies or for protecting their depositors", the Bank believed that the arrangements made would "fully protect depositors in the societies concerned." In addition, although the replacement of the LGS convention with the PAR (Prime Assets Requirement) in February 1990, was supposed to lead to the disappearance of the lender of last resort facility except when banks were helping non-banks, it appears that this facility has crept back.[15]

The extent to which the introduction of much more detailed supervisory arrangements of the banks has imposed *additional net* costs on them is a matter that we do not wish to pursue in detail here. The key point is that, while it is often said that banks have to bear the cost of regulation (which includes the de facto licence fee reflected in the cost of having to hold non-callable deposits at below market rates with the Reserve Bank), the substantial benefits to the banks from being banks are frequently overlooked. We point out that the current average risk-weighted capital ratio for banks of about 11.5 percent is well above the required ratio of 8 percent, that applications for banking licences continue to be made and, following the 1992 decision to permit additional foreign banks to enter, new banks have continued to be licensed. (Indeed, the number of banks is now up to 52). Moreover, as noted in the Reserve Bank's 1996 Report, "Even today, however, transactions accounts ... still represent about a quarter of total bank deposits on which banks pay an average interest rate of only 2.5 percent. In addition, no interest at all is paid on about 5 percent of bank deposits"[16].

Our concern is that the overall *net* effect of the arrangements is to put banks in a clearly privileged position in the financial system and enable them to attract funds at a lower rate than would otherwise be the case, and than competing institutions. We comment further on the prudential issue below and we simply note here the need for the Inquiry to carefully investigate the justification for the banks to be given such privileged treatment.

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13 *The Prudential Supervision of Banks* by R A Johnston, RBA Bulletin, March 1985.

14 See press statements by Governor Fraser of 16 July 1990 and 3 October 1990.

15 See remarks by Governor Fraser on *Financial Regulation And The Financial System Inquiry*, 5 July 1996, p. 11.

16 *Op.Cit.* p. 39.

2.1.4 The Slowness of Competition to Develop

A disappointing feature of financial deregulation has been the comparative slowness with which competition has developed. This is not to overlook that consumers have benefited from the doubling of the size of the financial sector and the consequent wider range of services and products, and wider range of institutions, from which to choose. However, notwithstanding the admission of a number of foreign banks (which now account for about 12 percent of total banking assets), for the general consumer and smaller businesses significant price competition has really only developed in comparatively recent times, most notably as a result of AHL's innovative operations. This is particularly apparent from the now well documented examination of trends in bank interest spreads, which remained virtually unchanged from the early 1980s until about 1994 if interest foregone on recession-induced, non-performing loans is excluded.[17] Even in the case of housing loans, the Reserve Bank has pointed out that, despite the recent narrowing of the spread, "It remains higher than comparable spreads in other countries, suggesting that scope exists for some further narrowing".[18] It is relevant to the Inquiry to consider why his price competition has been so slow to develop.

Our submission is that the failure of competition to develop as expected reflected on the one hand, the costly branch structure built up by the banks during the period of regulation and, on the other hand, the protection provided to existing banks as a result of government regulation of, and intervention in, the banking industry which allowed banks to maintain branches to excess. We make the following points:

(a) While deregulation made new bank entry possible, new entrants found it very difficult to become substantive participants by engaging in strong competition to obtain market share, without the risk of losing their capital or a substantial part of it, because of the privileged position accorded to existing banks as discussed above. That situation created a considerable degree of inertia amongst the customers of the respective banks and therefore reduced the incentive for the banking industry to engage in competitive activity. Non-banks also faced difficulty in competing for the same reason.

(b) The existing four major banks were effectively protected under foreign investment policy from take-over by a major foreign bank and were effectively protected under domestic competition policy from take-over by each other. The prohibition under the *Banks (Shareholding) Act* against any one shareholder holding more than 14.99 per cent of the capital of an Australian bank made it difficult in any event for a take-over to be mounted from a minority shareholder position - even apart from the difficulty that a very substantial outlay of capital would be required. This also

17 See, page 40 of the 1996 Report and Financial Statements of the Reserve Bank. It is worth noting, however, that it was not until fairly recently that the Bank addressed this issue.

18 *Op. cit.* p.39 The fact is that relatively wide spreads existed throughout the 1980s..

meant that existing boards and management of the major banks were protected against removal by dissident shareholders except in unusual circumstances.

(c) As recently as 1993, government owned and operated banks with specific government-backed guarantees accounted for nearly 30 per cent of total $A assets of the banking system. These banks had a history of operating with higher cost structures and paying less attention to return on capital than the private sector banks, and they also operated with a significant political brief, albeit rarely stated publicly. The existence of such a situation clearly acted as a major inhibitor on the other banks and financial institutions engaging in active competition. The government banks could more "afford" to be loss leaders as the lower returns would not necessarily affect their market standing.

(d) The continued control exercised by the Government over banks' home lending rates.

(e) The accommodatory monetary policy created conditions which required limited effort to earn a reasonable return - until, that is, monetary policy had to be tightened and the recession hit.

The net effect of these factors was, as Chart 4 shows, to allow the banks to maintain higher returns on equity than other companies, except for the period of the recession. Moreover, while some of the factors listed above are either no longer operative or have a much reduced effect, it appears that banks are continuing to earn higher returns. This reinforces our perception regarding the banks' privileged position and raises a serious question as to the validity of the Reserve Bank's "explanation" of the reason for the slowness of price competition to develop, viz, that it was only the fall in inflation in the early 1990's that reduced the advantage of low cost transactions accounts.[19].

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Overall, then, we submit that the experience with financial deregulation has been disappointing, not because of the usually stated reasons but, rather, because it produced the mistaken response that increased regulation of the finance sector was required and because of the limited nature of the competition that has developed, at least until recently. In this regard, we note that a recent article in the McKinsey Quarterly estimated labour productivity in Australian retail banking to be only 60 per cent of that in the US. Westpac Managing Director, Mr Robert Joss was also reported in The Age (15 July) as acknowledging that the ability of groups with lower cost methods of distribution will eventually force the banks to adopt their methods; and in the AFR of 8 August as indicating that substantial cost savings are achievable in Australian banking if a more competitive environment existed.

[19] *Op cit.* p. 39

These references confirm that there is either inadequate competition or that banks are unduly privileged - or both. The bottom line is that Australian banks are relatively inefficient and their inefficiencies should cease to be protected.

2.2 FACTORS LIKELY TO DRIVE FURTHER CHANGE

Our views on this aspect of the terms of reference will be readily apparent from the above and we do not have much to add here. From our own experience, and from more general common-sense considerations, we believe that the most important driving force for change in the financial sector will be the extent of competition and, associated with that, the minimum amount of regulation.

For competitive forces to operate satisfactorily, however, it is important that the playing field be as level as possible. In particular, competition and the benefits that flow from it will continue to be inhibited so long as banks continue to be accorded privileged treatment because this allows those institutions to postpone structural reforms to bring themselves up to international best practice. It may also make it easier for banks to operate loss leaders in order to overcome challenges to their markets.

Technological advances are making it all the more important that fully competitive conditions be established and sustained because they open up the possibilities for lowering costs and/or expanding services. It would be regrettable if the potential for such advances were to be held back by an inadequately competitive framework.

As to the needs of users of FSP's services, we see those as being adequately protected under existing legislation and common law. Additional protection will be provided by allowing competition to flourish and by ensuring an improved flow of information. It is too little recognised that it is in the interests of the providers of financial services to ensure that their customers are well treated. A business that develops a poor reputation in that regard will inevitably suffer. This is not to say that regulatory authorities should have a reduced role in this particular area: as indicated below, there is a case for those authorities to make more public assessments of the performance and financial situations of FSP's so that competition occurs within a framework of improved information. In this regard, the role of market watchers (such as credit rating agencies) should not be underestimated.

In regard to the question of competition as between financial institutions, there has been some discussion about whether economies of scale exist in the financial sector and the extent to which mergers/take-overs should be permitted, particularly as between major banks. Some of this discussion appears to have been based on a misunderstanding of the meaning of economies of scale, which basically relate to whether improved returns occur if *all* inputs are increased *simultaneously* by the same percentage. The point about mergers/take-overs in the financial sector is, however, that they potentially - and, in most cases, actually - involve a *reduction* (at least proportionately) in the use of some resources.

We note that, in the USA, the potential for cost savings, particularly from branch closures, has recently prompted a number of bank mergers. If the cost savings achieved in the US are as large as indicated (20-43 percent), and are potentially as large in Australia as suggested (27-35 percent), in one recent analysis,[20] it would be difficult to justify stopping them, provided the sector retains contestability.

It can be argued that such cost savings are achievable through internal rationalisations. However, if the adoption of a more relaxed attitude towards mergers/take-overs in the Australian financial sector would spark moves to take advantage of the considerable potential for reducing costs which appears to exist, there is a prima facie case for allowing that to occur. At the least, the requirement for the Treasurer to approve bank mergers, on the basis of a public interest test, should be removed.

While we have no particular concerns about the potential for AHL to face greater competition on this basis, we would again emphasise the importance of reducing/eliminating the privileged position of banks. If banks were allowed to merge under existing supervisory arrangements, that could make it more difficult to compete against them.

Subject to that important proviso, for purposes of competition policy, there should be no objection to treating the financial sector in the same way as other sectors and, subject to appropriate disclosure arrangements as discussed below, no need to retain the prohibition against any one shareholder holding more than 14.99 percent of an Australian bank. An important step towards ensuring contestability, would be to remove all restrictions on foreign investment in Australian financial institutions, which is desirable in any event if the Australian capital market is to become a leader.

2.3 FUTURE REGULATORY ARRANGEMENTS

It will be apparent from what we have already said that we believe that less emphasis should be put on the responsibility of the "authorities" for the health of financial institutions and providers of financial services and more emphasis should be put on investors and users of financial services, together with managements and boards of the respective institutions. In its 1995 report, the Reserve Bank stated , correctly we believe, that "No amount of supervisory oversight can provide complete protection against the possibility of problems arising within banks as a result of their derivatives (or any other banking activity). The

20 *Financial Services Convergence* by Robert Townsend, County NatWest, 5 August 1996

prime responsibility for the sound management of a bank must rest with the management and board of individual banks."[21]

That emphasis by the Reserve Bank on the responsibility of boards and management is ~~a~~ welcome and, if carried through, would desirably move Australia closer to the New Zealand arrangements. However, as already indicated, the present extent of supervision and regulation puts banks in a de facto privileged position with questionable benefits for the financial system and the community more generally. There are several points that are relevant to considering the reduction/elimination of that position:

(i) In a world where very large financial risks are being assumed on a day to day basis, the capacity of prudential supervisors to detect even poor management, let alone fraud, seems likely to be little if any greater than that of market watchers. Experience over the past fifteen years certainly provides clear examples of the apparent failings of the prudential supervisory system of both bank and non-bank financial institutions in both Australia and overseas. In this regard, a survey in the US recently reported to a seminar at the University of NSW showed that institutions, the sharemarket and ratings agencies were on balance slightly better than the regulator in monitoring the financial condition of firms.[22] The continued failings of the supervisory authorities certainly raise a question about their response of *further* increasing regulation of the regulated sector.

(ii) It is true, of course, that the main focus of the regulatory authorities is on establishing and maintaining *systems* to take account of the degree of riskiness of various assets/transactions and the capital judged as required to be held against such risks, rather than assessing individual transactions. Even so, it seems questionable whether regulators who are not involved in operating financial businesses are likely to have greater capacity to determine appropriate systems than managers of those businesses, particularly given the capacity of financial businesses to pay higher levels of remuneration for risk management expertise. In this regard, it is noted that, in deciding to allow banks to use their own model for calculating capital requirements for market risk, the Reserve Bank has acknowledged “the sophisticated risk-management systems already in place in many banks, which are capable of assessing risks more accurately than the proposed standard methodology.”[23] Again, "The decision to allow the use of sophisticated in-house models to measure risk represents a significant departure from past supervisory method and recognises the shortcomings of a prescriptive approach in an area

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21 *Op. Cit.* p. 42.

22 *Summary of Professor Flannery’s Paper and Empirical Findings* by Vic Edwards, Director, National Centre For Banking And Capital Markets, 1 July 1996

23 1995 Report, *op cit*, p. 41.

characterised by ongoing innovation"[24] This raises wider possibilities for self-regulation but based on requirements to provide more information.

(iii) There is a real danger that, the greater the effort by the authorities to monitor an institution's risk of default, the less will be the effort made by the institution itself and, just as importantly perhaps, by market watchers. Indeed, there is potential for a moral hazard situation to develop if too much responsibility is assumed by the authorities or if, as was the case with government banks during the 1980s, a government guarantee is provided.

(iv) While there is always a possibility that the default of one institution, particularly a large one, will have a contagious effect that could threaten the stability of the financial system and have wider repercussions through the economy, in the great majority of cases such a situation should be capable of being handled without excessive disruption by the Reserve Bank injecting liquidity into the financial market system by purchasing commercial bills or other high quality paper. Further, there is no obvious reason why a financial institution which gets into financial difficulties would not be taken over by another institution, just as happens with other types of companies.[25] The freeing of restrictions on foreign investment in Australian financial institutions would greatly reduce the potential for systemic risk to occur in Australia.

(v) While currently the banks operate the payments system, and while this often leads regulators to argue that this alone justifies special prudential supervision of banks to ensure the "integrity" of that system, it is not clear that the payments system need be excessively disrupted in the event (acknowledged by the authorities to be "remote") that even a major bank started to experience difficulty in meeting its overnight obligations. Nor is it clear that the Reserve Bank should act as the clearing house or that non-bank financial institutions should be prohibited from issuing cheques in their own names.

The proposed introduction in 1997 of real-time gross settlement for high-value payments indicates the potential for settling inter-bank transactions by electronic processing between banks at the same time as the payment instructions are sent. Presumably, as technology develops, the capacity will also develop for other institutions, even individuals, to participate in such settlement arrangements.

Again, a bank that got into overall financial difficulties would be open to be taken over, although the time likely to be taken to consummate a take over in such

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24 1996 Report, *op cit*, p. 43.

25 At the Money and Banking Forum held by the Economic Society of Australia (Victorian Branch) on 5 September, 1996, the Chairman of the Australian Competition and Consumer Commission, Professor Allan Fels, indicated that the ACCC would deal quickly with competition policy issues in such circumstances.

circumstances would clearly require the early appointment of a receiver with authority to trade if the payments system was to avoid undue disruption.

(vi) This is not to suggest that there would not be potential adverse effects for the wider economy if a major bank experienced serious financial difficulties. There would also be such adverse effects if BHP got into difficulties. Yet we do not have special prudential supervision of that or other large Australian companies.

(vii) While the Reserve Bank acknowledges the blurring of traditional functions and products as between financial institutions, it maintains that financial institutions offer two conceptually different sets of liabilities, reflected in the different risks attached to deposits, on the one hand, and investment-linked products, on the other hand.[26] However, such a sharp distinction seems to us highly questionable for purposes of prudential regulation. Those who invest their savings in investment-linked products certainly accept the risk in the decline in capital value but they also expect the institutions offering such products to be prudently managed.

Against the background of the foregoing, the Inquiry should give careful consideration to the scope for reducing the special supervisory arrangements for the banks so that their privileged position is reduced, preferably eliminated. In that regard, the following main changes should be considered:

(a) Separation of the responsibility for prudential supervision of banks from the responsibility for operating monetary policy as is already done in some overseas countries. This would recognise the realities that, while banks are still the major supplier of credit, non-bank financial institutions now supply about one-fifth of credit to the private sector and that, in any event, monetary policy is now determined by assessments of movements in a range of economic indicators of which changes in monetary aggregates are only one element. Moreover, monetary policy is now basically interest rate policy rather than money supply policy. In these circumstances, there seems little, if any, need for the central bank and the banks to have a "special" relationship and separation would help eliminate the perception that banks are "special".

(b) To the extent practicable, making prudential supervision of the banks just one part of the supervision of the financial sector. Over time, this should help to reduce the special attention paid to banks and level the regulatory playing field.

It is sometimes argued by the Reserve Bank that, through its supervision of banks, appropriate standards are set by the banks and that it is a matter for

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[26] *Op cit* pp. 53, 54

individuals to then assess and take any additional risk of investing in other financial institutions. However, from one perspective, it seems somewhat anomalous to adopt the position that the riskier the institution the less the supervision required. This is not to suggest, of course, that non-bank financial institutions should be subject to greater supervision; the regulatory playing field should be lowered as well as levelled.

In short, the idea of a "super-regulator" seems to us to be both sensible and appropriate, at least so far as financial institutions are concerned. While it is true that it is institutions rather than products which need supervision, there is now a developing product overlap as between financial institutions and a super-regulator should make for greater consistency in regulation as well as, hopefully, rationalising regulations and putting them on as similar a basis as possible.

(c) As already indicated, moving towards supervisory arrangements which are based much more on transparency and the acceptance of responsibility by, on the one hand, boards and management, and, on the other hand, by investors in financial institutions' products and users of their services. This is not intended to be a simple "caveat emptor" approach. Institutions would be required to publish more information more frequently about their balance sheets, volume of business and product pricing; and regulators would be required to *publish* frequent assessments of those institutions based on benchmarks related to capital, liquidity, non-performing assets, cost to income ratios, interest spreads and the like. Regulators would be liable to severe penalty if they did not publish information when they became aware of a material change in the circumstances of an institution.

The main object of such an approach would be to change the culture of supervision. At present that is based in part on withholding information about an institution's financial difficulties from "the market" and trying to work out possible measures to remedy the situation in cooperation with the organisation. On one view such a policy might be said to constitute a neglect of duty to both customers and shareholders of that organisation.

While it will doubtless be argued that a policy of regulation by transparency would risk "runs" on financial institutions if they were constantly exposed to the possibility of adverse comment, the very existence of such arrangements would almost ensure that, shocks aside, financial institutions would themselves take particular care to avoid getting into a situation where they would attract seriously adverse comment from the regulator. Major financial institutions are already exposed to possible adverse public comments by credit rating agencies. What is envisaged here is essentially a major extension of the credit rating system which already exists.

(d) Widening the range of institutions permitted to describe themselves as "banks" to include any which accept deposits or provide loans. Such an approach would help move existing banks on to a similar basis to other financial institutions. However, it would be appropriate to require that institutions that do not provide the full range of banking services include some qualifying phrase in their titles, such as "mortgage bank." It should be noted that mortgage managers/originators in the USA are permitted to describe themselves as mortgage banks.

If such an approach is not acceptable, all financial service providers should at least be able to describe their business as involving a form of banking, such as "mortgage banking".

(e) That the lender of last resort facility be closed to individual banks and that, if the liquidity of the financial system becomes threatened as the result of a "run" on an individual institution, the Reserve Bank should reiterate that it stands ready to purchase good quality paper as necessary, and it should act accordingly. No assistance should be provided by the Reserve Bank directly to individual institutions.

(f) The Government and the Reserve Bank should clearly indicate that there is no guarantee of any sort on deposits with banks or other financial institutions and the Reserve Bank Act should be amended to remove the "protection of depositors" provision. It should also be made clear that individual financial institutions will not be "rescued" and that institutions experiencing financial difficulty would be open to be taken over, subject only to clearance by the ACCC. Such a statement should be accompanied by a careful explanation of new, more transparent, arrangements for protecting depositor interests, including the policy of price stability, and its likely effects.

(g) Confirmation that prime responsibility for the sound management of all financial institutions rests with the boards and managements of those institutions.

(h) As indicated, removal of restrictions on the amount of a bank's capital capable of being held by any one interest. Such removal should be accompanied, however, by a requirement that significant changes in ownership of capital be publicly released and that, where lending to one interest exceeds a specified proportion of total lending, that should also be publicly released.**Error! Bookmark not defined.**

(i) Removal of restrictions on foreign investment in Australian financial institutions.

In sum, we believe that there is a sound case for giving serious consideration to a major change in existing supervisory arrangements with a view to reducing prudential regulation in the way it has hitherto been conducted and replacing that with a system of regulation by transparency.

3 SECURITISATION AND THE HOME LOAN MARKET

Securitisation of the type referred to here[27] involves the transformation of non-marketable assets (such as individual home mortgages or credit card receivables) into marketable assets (ie bonds such as collateralised mortgage obligations). The underlying assets can, potentially, be any type of credit product and may already be in existence on the balance sheets of banks or other financial institutions or they may be originated specifically for a securitisation program. Investors in the bonds can be major institutions (such as insurance and superannuation companies - the institutional or wholesale market) or small investors (the "mums and dads" of the retail market). Securitisation developments in Australia to date have focused on residential mortgage and credit card receivable assets marketed exclusively to the wholesale market. But developments in the United States (where a much wider range of asset type is securitised) and Europe (where there is a flourishing retail bond market - the "belgian dentist" market) demonstrate that there is scope for a diversity of development in Australia. AHL would like to see a retail market develop in Australia as these bonds are extremely low risk and an ideal investment for small investors.

Securitisation is a process of financial intermediation and is thus part of the broadening and deepening of Australia's capital market which has resulted from financial deregulation. As with a number of other developments, securitisation impacts the overall functioning of the financial system and must be taken into account in the management of monetary policy. This is in line with the changes to monetary linkages and the general broadening of indicators which the monetary authorities must consider when setting policy instruments in the deregulated environment. But securitisation does not necessarily add to the supply of credit: it may simply be an alternative form.

Securitisation reveals the distinct and separate activities of financial intermediation in a way that is far from transparent in the conglomerate activities of banks which provide both the interface with savers (depositors) and the interface with borrowers. This dis-integration

[27] The term securitisation is also used to refer to the shift in business finance from traditional bank loans to issuing corporate securities (commercial paper) on financial markets. This usage is not as common in Australia as it is in the United States.

allows functional specialisation resulting in significant cost savings and, from that, the major benefit for consumers of financial services - a lower cost of finance. These benefits are very evident in the home loan market where AHL has spearheaded the competitive push which has translated cost efficiencies into much lower mortgage rates.

Although the following is put in the context of the residential mortgage market, many of the issues raised are generic in nature. It is nevertheless useful to focus on the home loan market, not only because it is the market in which AHL operates, but also because it is the most developed area of securitisation.

3.1 COMPETITION IN THE HOME LOAN MARKET

The benefits of financial sector deregulation are evident across the full spectrum of financial products and services. But nowhere can they be more simply and powerfully demonstrated than in the market for residential mortgages. Historically, home lending in Australia has been the domain of the banks, with some competition from building societies. Substantial margins between the variable mortgage interest rate and the average cost of funds has meant that residential lending provided banks with their most profitable business. Not surprisingly, banks sought to protect this position and, as a consequence, home lending has been slow to show the competitive benefits of financial deregulation. In fact it has only been when banks have faced strong competition from new, non-deposit-taking lenders that this market has become truly competitive.

3.1.1 Growth in Securitised Home Loans

Housing loans funded by the issue of mortgage backed securities are not new to the Australian market but growth in this type of mortgage origination did not really get going until almost a decade after deregulation of the financial sector commenced. Prudential arrangements have lagged market developments and this tended to retard development of this market, particularly securitisation of assets other than residential mortgages. Changes to prudential arrangements impacting securitisation represent some move forward but the existing arrangements remain an unnecessary potential inhibitor of securitisation programs. We take this point up further in what follows.

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After a slow start, recent growth has been very strong, with home lending by mortgage managers rising from less than 1 percent two to three years ago to 8 percent now.[28] These figures, however, underestimate the level of mortgage *origination*[29] outside the traditional sector as they do not include loans which are originated for banks and which are thus

[28] *The Evolution of the Housing Loan Market in Australia* published by the Reserve Bank of Australia in the June 1996 issue of its Bulletin provides a timely summary of recent developments in this market.

[29] Mortgage origination is the process of establishing a loan while mortgage management is the ongoing servicing of the loan. Many originators, including many small operators, in the home loan market are originators but not managers.

recorded on banks' balance sheets. Total origination by mortgage originators is close to 10 percent of all housing finance according to the Mortgage Managers Association of Australia. Unfortunately, the quality of data available on this growing segment of the industry is poor. At present, AHL accounts for at least 70 percent of loans originated to securitisation programs.

Already, mortgage backed securities account for around 4 percent of the total value of housing loans outstanding[30] and this percentage is likely to grow as entrenched consumer expectations regarding the provision of financial services, which reflect the previous culture of regulation, are further eroded by experience and the maturing of a generation knowing only a deregulated and competitive environment. Indeed, clear evidence is emerging that consumers are appreciating that the loans offered by AHL provide the same benefits, including the backing of a reputable organisation, as bank loans - but at a considerable interest saving. In the United States, where securitised mortgages are a long established part of the market, home loans funded in this way account for close to half of home loans outstanding with approximately 70 percent of all new lending undertaken by mortgage originators.

3.1.2 Product Innovation and Choice

The initial response of the major home lenders to the advent of a more competitive environment in the eighties was to provide greater choice through product innovations such as fixed rate loans and flexible repayment and redraw options. Price competition was limited to "honeymoon" interest rates designed to entice new borrowers without significantly impacting the overall margins on housing lending.

3.1.3 Lower Cost Loans for Consumers

Whilst these types of product innovation are undoubtedly of value to home borrowers, the major benefit which competition can deliver is lower interest rates over the life of a loan. This can mean savings of tens of thousands of dollars. For example, a one percentage point difference in the interest rate on a $100,000 loan amortised over 25 years means a difference of $20,851 in repayments over the life of the loan and, if the monthly repayment savings were invested at 5%, compounding monthly, their future value at the end of the loan term would be $41,388.

It is just this major consumer benefit which mortgage managers have delivered through home loans financed by the issuance of mortgage backed securities. Until recently, mortgage rates offered by AHL have been 1¼ to 1½ percentage points below the standard rates of the major banks.

30 *op cit*, p.2

Now that mortgage managers have made significant inroads into home lending the traditional providers of housing finance have been forced to compete on price. As a consequence the gap between the interest rates offered by banks and mortgage managers has narrowed as banks have lowered their standard variable mortgage rates in an attempt to arrest the erosion of market share. A number of traditional lenders have also responded to the greater competition by introducing a "basic" mortgage with a lower interest rate than the standard variable rate. However, these loans provide consumers with significantly reduced features as compared with both bank "standard" loans and with AHL loans. Generally, with the "basic" bank home loans now coming onto the market, features such as redraw facilities and "cocktailing"[31] are not available, and accelerated repayment opportunities may be limited

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Moreover, as interest rates have come down, there has been an increasing trend by banks to impose or increase ongoing non-interest charges in the form of account keeping fees on their home loans as well as now introducing new exit penalties (generally three months) if a loan is discharged within three years.

3.1.4 Aussie Home Loans

In contrast to these "basic" offerings by the banks, AHL have the features and flexibility which borrowers are looking for in a home loan, including fortnightly repayments, choice of variable rate, bank bill linked rate or fixed rate, option to select a part fixed rate / part variable rate loan, interest only option, lump sum or additional payments, redraw facility and the ability to transfer a loan to another property. However, these loans do not have any periodic fees other than interest charges. AHL borrowers thus enjoy the benefits of a basic price for a non-basic product. In contrast, borrowers choosing a bank "basic" home loan may find that they are they are unable to redraw extra repayments if that becomes necessary; or to convert part, but not all, the loan to a fixed rate; or to change the loan to another property if they decide to move house. A detailed, easy to understand description of the Aussie options and of loan terms and conditions is contained in the AHL *Disclosure Statement* which is provided in Attachment A to this submission.

3.1.5 Structure of the Market

The market for residential mortgages which are originated outside the traditional financial intermediation industry is highly competitive with around 100 originators Australia wide. The industry is, of course, relatively young as well as highly competitive and it is likely that some of the smaller operators will exit the industry given the high volume / low margin

31 Loans which are part fixed and part variable rate loans.

nature of this business. However, even if the number of participants in the industry falls significantly its highly competitive nature will continue. Contestability, and hence competition, is ensured because entry is relatively easy. Moreover, the major source of competition in the home loan market will continue to be from banks for some time to come.

3.1.6 Fostering a Competitive Environment

Developments in the residential lending market show clearly the benefits in terms of choice of product, choice of supplier and lower price which result from deregulation. These benefits have been achieved without any diminution in the protections afforded to borrowers or increase in borrower risks, as is detailed in the following sections.

Moreover, the impact of this competition is not confined to the home loan market itself. It is a force driving the move away from cross-subsidisation in the provision of financial services towards pricing which more accurately reflects the costs of providing services. Over the longer term this competitive pressure will impel banks to reduce their costs. Both these developments will result in greater efficiencies in how resources are directed towards meeting the needs of financial service users.

It must be an imperative that regulatory arrangements do not impede progress towards even greater benefits both for consumers and for the overall performance of the economy. The Inquiry has an opportunity to propose arrangements and, where necessary, suggest changes which foster dynamic and innovative market developments and which improve the operation of markets by removing or rationalising arrangements which impose costs not justified in terms of the benefits realised. Such opportunities of particular concern to AHL are discussed below.

3.1.7 Consumer Protection in a Competitive Environment

The best protection for consumers is achieved by ensuring that they are in a position to make informed choices within a legal framework that attempts to ensure "fair trading". A prerequisite for making informed choices is the availability of comprehensive, regular and relevant information on which consumers can base their decisions. This gives rise to the double benefit that consumers are in a position to make the best choice for their needs and requirements which, in turn, contributes to the competitiveness of the market and hence produces efficient economic outcomes.

There are two elements necessary to ensure that consumers can readily obtain information relevant to their decision making. Firstly, information on the product or service must be provided in a clear and accurate manner. In the case of financial services this encompasses the rights and responsibilities of both the customer and the service provider as well as full disclosure of all fees and charges.

AHL attaches considerable importance to providing intending borrowers with all relevant information about Aussie loans up front, including information on all fees and charges. Unfortunately, these standards are not met by all home loan lenders. In particular, where borrowers will be charged monthly or quarterly account keeping fees, this is not always made clear.

Second, product information should be made available to market watchers who provide consumers with assessments which facilitate product comparison, and hence informed choice. In the case of lending products such as home loans the calculation of "comparison rates" which take account of non-interest fees and charges as well as interest costs have been developed, and these assist consumers to make an informed choice. There are a number of providers of this type of consumer information service and AHL views this development as an important contributor to the competitive operation of the home loan market.

3.1.8 Regulatory Impediments to a Competitive Market

The objective of ensuring appropriate standards of disclosure and market information should not require excessive regulation. Competitive forces will generally ensure that service providers meet consumers' information requirements. Where there is some failure in this regard opportunities emerge for third parties to fill the vacuum and, increasingly, these opportunities are resulting in the development of new, competitive markets for the provision of consumer information through publications and individual advice. In these circumstances, where there is clear evidence that market solutions are being found, it is both unnecessary and undesirable to impose detailed regulations.

AHL is concerned that, rather than ensuring arrangements which foster dynamic and innovative market developments, there has been a tendency towards the introduction of regulations, and a proliferation of regulatory authorities, which do not deliver any benefit but which can materially impede the competitive operation of markets. A more desirable approach is a broad supervisory framework directed at ensuring that the efficiency of markets is not impeded by inadequate information flows and that consumers are adequately protected against unfair trading. This role is currently filled by the Competition Commission, however there are also State authorities with overlapping responsibilities. It would be desirable for a rationalisation and streamlining of these functions to be implemented and we suggest that this is a matter which should be reviewed by the Council of Australian Governments. When considering the residential mortgage market we commend the words of the Governor of the Reserve Bank[32] to the Inquiry: the home loan market is not "broke". It does not need fixing. Indeed, the home loan market is operating more effectively and efficiently and delivering better outcomes for consumers than it ever has in the past. We now raise some specific concerns in relation to the housing finance industry and to the operation of mortgage managers in that industry.

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32 *Financial Regulation and the Financial System Inquiry*, op cit.

Consumer Credit Code: General The development into legislative form of the Uniform Consumer Credit Code (UCCC) demonstrates the tendency to over regulation and to the introduction of regulations in areas where the need for greater regulation is questionable. While the broad objective of introducing the UCCC, namely achieving uniformity of regulation across States and Territories, was desirable, the development of the Code has been used as an opportunity to unnecessarily increase the level of regulation. In particular, AHL doubts that the decision to extend the coverage of consumer credit legislation to include residential mortgages will deliver benefits which warrant the additional costs of compliance or the disadvantage to consumers of the likely reversal of the recent trend to straight forward mortgage documentation. It is an unfortunate fact that lenders, in their anxiety to ensure that all the pedantry of the Code is met, are likely to revert to a more legalistic terminology in their mortgages. Yet legislation pertaining to the transfer of land and property law together with the common law establishes the rights, duties and obligations of both mortgagors and mortgagees. These and other borrower protections afforded by existing regulation are detailed in section 3.3.4 of the submission. To overlay this with further regulation simply adds to the cost of compliance and, hence, undermines mortgage managers' capacity to provide low cost finance to their clients.

We recognise that there have been complaints about housing finance, but these have primarily been directed at banks and it is questionable whether the UCCC will overcome the problem. Mortgage managers should not have to suffer for the sins of the banks. We at AHL are consumer driven, which is reflected in high self imposed standards of disclosure and customer relations, with better systems for delivering that service to our clients than the banks.

Existing arrangements have seen the emergence of a new force in residential lending which has unequivocally delivered substantial benefits to home purchasers and which emphasises service quality. Increasing the level of regulation risks impeding the vigorous development of this market and limiting future consumer benefits without promising any compensating benefits. We consider that it would be appropriate for the Inquiry to recommend that the decision to include home mortgages under the UCCC be reviewed.

Consumer Credit Code: Mortgage Insurance Commission An issue of considerable concern to AHL is the fact that mortgage insurance commissions currently paid by insurance companies to mortgage originators will be proscribed under the UCCC. While recognising the need for "truth in lending" and open disclosure to intending borrowers, we are concerned that the new arrangements, when introduced, will have the effect of undermining originators' capacity to keep interest margins at their present low level. It is a particular concern that the new Code does not distinguish between situations where commissions are paid to agents who are not beneficiaries under the policy (such as mortgage originators) and situations where the commission is paid to the beneficiary of the insurance policy. Further, the treatment of commissions for mortgage insurance is discriminatory as compared with the treatment of commissions for other types of insurance, including treatment of other insurance commissions elsewhere in the UCCC.

There are significant costs associated with processing the insurance policies and the receipt of a commission as an agent at present provides a considerable offset to those costs and helps keep interest rates down. Provided that the borrower is informed of their existence, as they are at present (see item 14 of the *Disclosure Statement*, Attachment A), there should be no objection to the payment of commissions to agents, as occurs with other types of insurance.

State Legislation: Finance Brokers Licence Another concern is the lack of uniformity in Finance Brokers' licensing arrangements across States and consequent delays which originators who are operating in one State encounter when seeking to establish operations in another State. Such delays constitute an impediment to the competitive operation of the market. Mutual recognition arrangements established between States are supposed to cover this but we question whether States are giving adequate effect to them.

Prudential Arrangements It is a concern that prudential arrangements should not impede innovation and growth of securitisation. This applies to regulations which unnecessarily hamper the structuring of securitisations or which impose an inappropriate capital cost on financial institutions which hold securitised assets on balance sheet. In particular the 100 percent risk weighting of mortgage backed securitised assets on bank balance sheets is inconsistent with both the treatment of the underlying mortgages and with practice in other countries, including the United Kingdom. Bank loans fully secured by a registered mortgage over residential property where the loan to valuation ratio is 80 percent or less attract a risk weighting of 50 percent. Where the pooled residential mortgages of a securitisation program contain mortgages which would attract the lower risk weighting if held on banks' balance sheet, there should be at least a pro-rata adjustment of the risk weighting of the assets issued by the securitisation program. Indeed, there is a strong argument that credit enhancement provided by the mortgage indemnity insurance which applies to all the supporting mortgages, and is reflected in the triple A rating the securities attract, should be recognised in the risk weighting assigned to the securitised assets.

3.2 SECURITISED MORTGAGE FINANCE

The provision of mortgage finance through the issuance of mortgage backed securities is an alternative to the funding of mortgages on balance sheet by financial institutions. The bonds issued are very low risk, being backed by a pool of first mortgages on residential property, all of which are covered by mortgage insurance. They provide a low risk option for insurance and superannuation companies in their portfolio management. The securitisation process provides an important conduit for funds to flow from the superannuation industry into uses in the real economy. AHL via PUMA is now the largest private issuer of bonds in Australia.

As noted previously, securitisation involves the breaking down of financial intermediation into its subsidiary elements. Mortgage managers, such as AHL, provide the interface with borrowers while other participants in the process provide the interface with the savers whose funds finance the loan facilities.

Details of a securitisation process and the role of the various participants are provided in Attachment B. The next section deals in detail with issues relating to the treatment of borrowers and the protections they are afforded under a securitisation , with particular reference to AHL practices. The following section briefly addresses issues related to investors in the bonds of securitisation programs.

3.3 BORROWER PROTECTION

Borrower protection derives from two sources. First, the systems and operations put in place by AHL and the financiers of the securitisation process (what we label as "Protections Deriving from Securitisation Structure" below) which ensure that lending is prudent and that, within the bounds of reasonable eventualities, borrowers do not take on commitments they are unable to meet. Second, there are the protections afforded by State and Commonwealth statutes. AHL is of the view that it is quite appropriate to provide legislative backing to ensure that basic protections for market participants are in place. However, as we have already noted, concern arises when there is a proliferation of laws and regulations some of which may add little to consumers' rights but which add significantly to the compliance costs - both of time and money - which financial service providers must meet.

3.3.1 Protections Deriving from Securitisation Structure

In fact, the protections discussed in this section derive not only from the formal securitisation arrangements but, importantly - and certainly in the case of AHL, from a corporate philosophy of basing its business on delivering services and benefits to consumers which are superior to those provided by traditional home loan lenders. AHL is here for the long haul and the reality is that this can only be achieved by recognising and discharging with integrity the obligations, both contractual and moral, owed to clients. It is contrary to AHL's own interests not to look after its clients interests. Indeed, Aussie is all about delivering the best available service to home borrowers and has established itself as the best practice benchmark which other lenders - both bank and non-bank - are struggling to meet.

<u>*Consumer Information and Disclosure:*</u> AHL processes ensure that there is full disclosure and understanding by intending borrowers of loan terms and conditions. These are set out in clear English in Aussie's *Disclosure Statement* (see Attachment A). In the case of AHL (and in contrast to usual procedures by banks) execution of the majority of mortgage documentation is undertaken by a solicitor not by a lending officer. This means that any questions which a borrower may have in relation to the mortgage can be answered by a legally qualified person.

Mortgage: The mortgages entered into by AHL clients are prepared in accordance with appropriate State laws and meet all expected requirements. They provide AHL borrowers with the same legal rights as do bank mortgages. Indeed, the AHL mortgage stands out for both its fairness and clarity when compared to the mortgages used by other lenders. A copy of the AHL mortgage used in New South Wales is provided in Attachment C.

The mortgage, of course, sets out the circumstances under which a loan becomes in arrears and/or in default and the consequences of such event(s), including provision for mortgagee sale. AHL encourages its clients to make contact if there is going to be difficulty in meeting a repayment by the due date (see *Disclosure Statement* in Attachment A). Otherwise AHL contacts a borrower as soon as a mortgage becomes in arrears to establish the circumstances. If a borrower's repayment difficulties are short term, then it is in the interest of both the borrower and the lender that the mortgagor be given time to bring the mortgage up to date and AHL goes to considerable lengths to ensure borrowers do not need to default. Instances where problems are not short term can and do occur, however. In these situations, it is in the borrower's interest to sell the mortgaged property and repay the loan as soon as possible so as to preserve as much equity as possible.

Code of Ethics: AHL considers that it is of primary importance that operators in the mortgage industry meet high standards of ethics and performance. AHL is a member of the Mortgage Industry Association of Australia and adheres to the Association's Code of Ethics which is included as Attachment D.

Mortgage Origination Deed: The Deed establishes the terms under which a Mortgage Manager originates loans to a securitisation program. This includes the relationship between the Mortgage Manager and both the Trustee and the Fund Manager as well as the lending parameters. The Deed allows the Trustee, through its delegate, the Fund Manager, to transfer the management of approved mortgages to a standby Manager in the event that an existing Manager no longer satisfies the terms of the Deed, including in the case of an insolvency. The borrower is unaffected by such an event other than by the fact that client services would henceforth be provided by the replacement Manager.

AHL has now achieved a market share which, together with the company's strategic alliance with Macquarie Bank, provides a strong base for future growth and development. Effective use of technological innovation and appreciation of consumer needs and requirements enable AHL to deliver its services at low cost and on lower margins than its competitors. All of this points to a secure long term future for AHL, with its operation unlikely to encounter financial pressures it could not resolve.

It is understandable, however, that some may want to know the consequences for AHL clients in the unlikely event of the company not being able to continue. As noted above, securitisation Mortgage Origination Deeds provide for this contingency. In AHL's case Macquarie Bank would make the necessary arrangements - both interim and long term.

Given that AHL's systems would still be in place, there is no reason why clients should be troubled by such an occurrence beyond receiving advice as to the changed arrangements for servicing their loans.

3.3.2 Lending Practices

Only "Approved Mortgages" are accepted into the pool of mortgage assets to be securitised. The criteria which mortgages must meet to be accepted into the pool provide protection for borrowers as well as for investors in the securitised assets. These criteria include credit risk assessment by appropriately qualified and experienced personnel.

In the case of Aussie loans (which are all originated for the PUMA Funds) this assessment is undertaken jointly by AHL and PUMA. The lending criteria includes a requirement that repayments be not greater than 30 percent of gross income for multiple borrowers and 35 percent of gross income for single borrowers. Other factors taken into account in considering a loan application are employment stability, credit history, overall assets and liabilities of applicant, type of security and its location. Mortgages must also be accepted for mortgage insurance. These requirements ensure that borrowers are well placed to meet any increase in payments occasioned by a rise in the mortgage rate.

Prudent lending policies are also reflected in conservative loan-to-valuation ratios: typically around seventy to seventy-five percent of loans have an LVR below 80% (the level selected by the RBA to qualify for 50% risk weighting of banks' on balance sheet loans for capital adequacy purposes). This is illustrated in the mortgage pool analysis of the recent securitisation (PUMA "Masterfund" P-5) which is provided in Annexure 2 to Attachment B. Securitised lending criteria generally contain stricter guidelines than the banks and have resulted in better quality lending practices.

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As that analysis shows, 99.5 percent of loans had LVRs below 90% and 72.3 percent had LVRs below 80%; the weighted average LVR was 68.9%. Chart 6 shows the distribution of loans by loan-to-valuation ratio. These figures show that Aussie Home Loan borrowers are not imprudently exposed to a weakening in the property market.

3.3.3 Borrower Exposure to Interest Rate Rises

A concern from both borrowers' and lenders' perspective is that upward movements in interest rates do not cause an unacceptable level of difficulty for borrowers in meeting their loan repayments. It is inevitable that in adverse economic circumstances the incidence of problem loans will be higher than when the economic climate is benign. The important point is that such problems should not arise as a result of inappropriate lending practices at the time the loan is taken out. Lending policy and the quality of credit risk assessment procedures are the critical determinants of such appropriateness.

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As outlined in the preceding section, AHL applies prudent lending criteria of a standard at least as high as banks. This is reflected in the mortgages in arrears/default statistics. Unfortunately, it is not possible to obtain directly comparable statistics (see note to Table 2) and information on the quality of bank residential mortgage assets is limited to an aggregate figure which does not break down loans in arrears by number of days or as between the majors and the regionals. When the difference between the bases for measuring the quality of loans (ie cash vs accrual) is taken into account it is not necessarily the case that the quality of bank loans is marginally higher than the average of all securitisations, as suggested by the figures provided in Table 2. If the bank data were available on an individual bank basis we are confident that the quality of mortgage assets originated by AHL would be shown to be superior to most, if not all, regional banks.

An important mechanism for protecting against adverse interest rate movements is the availability to borrowers of a fixed interest rate option for either part or all of a loan. AHL loans offer such an option.

On the basis of the foregoing it is reasonable to conclude that AHL borrowers are at least as able to withstand the impact of interest rate rises as are bank borrowers. Indeed, there is a strong argument to be made that AHL borrowers are better placed to withstand such an impact. Most banks discount their home loan interest rate for the first year. This has the effect of giving borrowers a misleading impression of the true on-going cost of the loan and may lead to the acquisition of other commitments during that period, resulting in an over commitment which only becomes evident once the loan moves to the normal standard rate at the end of the "honeymoon" period.

3.3.4 Protections Deriving from Existing Regulation

Various regulators govern the conduct of mortgage managers including AHL. These provide protections and include the following:

<u>*Property Law - Legislated and under the Common Law:*</u> Property law establishes the rights and obligations of mortgagees: (i) in relation to giving notice of default and reasonable time to remedy; (ii) in relation to limitations on foreclosure and forfeiture, including requirement to exercise power of sale and obtain best possible price and to account to the mortgagor for any excess realised over the mortgage debt, interest and proper costs; and (iii) in relation to the physical rights of possession. These rights provide significant protection to home loan borrowers.

<u>*Australian Competition and Consumer Commission and Similar Authorities:*</u> The Trade Practices Act contains strong provisions in relation to unconscionable conduct, misleading

or deceptive conduct and false representations which provide necessary consumer protections. In addition to trade practices legislation, the company's operation is subject to the Privacy Commissioner at the Federal level and to relevant State and Territory Fair Trading and Consumer legislation and to legislation governing the operation of finance brokers.

Corporations Law: AHL is subject to regulation under the Corporations Law and the ASC. As an unlisted public company AHL is required to report its shareholding and its audited accounts.

3.3.5 Proposed Legislation

Consumer Credit Code: The UCCC, which is due to replace the various State and Territory Consumer Credit legislation on 1 November, 1996, covers home mortgages as well as "small amount" consumer credit, which was the subject of the previous legislation. As already noted, AHL considers that the UCCC constitutes over regulation and that it should be reviewed in order to achieve an environment more conducive to the innovation and development which forms the basis for further consumer benefits.

3.4 INVESTOR PROTECTION

The mortgage pool cash flow of a securitisation program is allocated to a series of bonds (or tranches) which have differing maturity characteristics and priorities in terms of receiving principal repayments on the underlying mortgages. These arrangements are detailed for the PUMA Sub-Fund P-3 in the *Information Memorandum* provided in Annexure 1 to Attachment B.

As already noted, investor protection is inherent in the securitisation process and arrangements. Full investor information is prepared for each securitisation and provided in an *Information Memorandum* in accordance with the requirements of the Australian Securities Commission. These memoranda clearly set out information in relation to the pool of underlying assets, the credit and liquidity enhancements and the ranking of the various tranches of bonds issued for a securitisation with respect to income payment and capital repayment priority, all of which go to determine the risks and returns associated with each class of bond. Ratings by ratings agencies provide investors with an independent assessment of the risk attached to the securities. Ratings given to securitised assets in Australia have generally been AAA and this high rating results in lower interest rates for home borrowers.

Bond issues for securitised asset programs in Australia have, to date, only been offered to institutions, the so called professional market, with minimum investments frequently set at $½ million. The information available in the memoranda is appropriate to the requirements of these investors.

3.5 FUTURE DEVELOPMENTS

Securitisation is an efficient method of financial intermediation capable of generating major benefits to both borrowers and investors. We have already seen these benefits in the home mortgage market. Credit card receivables have also been the subject of securitisation programs, although in this case the securitisation has generally been a method of transferring existing bank assets off balance sheet rather than involving origination of new credit card facilities.

There is scope to extend funding through securitisation programs to other areas of lending, such as motor vehicle loans as has occurred in the United States, which has a long experience with securitisation. Business loans also provide securitisation potential which is already being developed in Australia.

Future directions could also possibly involve development of a retail market for securitised assets. The availability of such relatively low risk assets to households would be a positive for the objective of increasing national saving. The Eurobond market demonstrates that it is possible to develop an effectively functioning financial assets market which offers retail investors alternatives to deposits with financial institutions, the stockmarket and the present range of fund and similar investments.

It is an imperative that future innovations such as these be allowed to occur to ensure that capital market developments keep pace with the demands of both savers and borrowers. It is not possible to know now precisely all the directions the evolution of financial markets will take. If history is a guide, however, there will be some developments which are not now foreseen.

AHL considers it important for the Inquiry to recommend flexible arrangements which can accommodate future demands and do not place unnecessary restrictions on the directions in which markets and products develop.

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to

AUSTRALIAN HOME LOANS

SUBMISSION TO

FINANCIAL SYSTEM INQUIRY, 1996

ATTACHMENTS

A	Disclosure Statement	
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	Annex 1:	PUMA Information Memorandum
	Annex 2:	Mortgage Pool Analysis
C	AHL Mortgage	
D	MIAA Code of Ethics	

ATTACHMENT A

Disclosure Statement

ATTACHMENT B

Annex 1

PUMA INFORMATION MEMORANDUM

See hardcopy Attachment

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SECURITISATION PROCESS

ATTACHMENT B

Annex 2

MORTGAGE POOL ANALYSIS

See hardcopy Attachment

ATTACHMENT C

AHL Mortgage

ATTACHMENT C

AHL Mortgage

See hardcopy Attachment

ATTACHMENT D

MIAA Code of Ethics

ATTACHMENT A

DISCLOSURE STATEMENT

Questions and Answers About Your Mortgage with *Aussie*

The following conditions relate to mortgages involving the PUMA Fund with Aussie Home Loans.

PUMA Management Limited is a major institutional funder in the Aussie programme. It is the securitisation subsidiary of one of Australia's most successful and respected investment banks, Macquarie Bank Limited.

1. What Is The Role Of Perpetual Trustees Australia Limited?

Perpetual Trustees Australia Limited acts as Trustee to the PUMA Fund. It is one of the largest trustee companies in Australia. It is responsible for ensuring that PUMA Fund operates in accordance with the contractual obligations of the programme. It is also responsible for contractual obligations as mortgagee (the lender) under your mortgage.

2. What Is My Interest Rate?

Depending on your choice, the initial rate for your mortgage will either be variable or fixed.

If your rate is variable, it can rise or fall as determined by the Trustee based on the Trustee's costs of funds. If your variable rate increases, your monthly instalments will increase.

3. Can I Switch Interest Rates?

During the term of the mortgage you can switch at no cost from the variable interest rate to a fixed rate. All interest rates will be quoted to you by *Aussie*. Interest rates will depend on the Trustees cost of funds at that time.

You will only be able to convert on the 1st banking day of each January, April, July or October, and you must give 21 days written notice to *Aussie*.

If you convert to a fixed rate, you should be aware that at the end of the fixed period your rate will **automatically** convert to a prevailing residential variable rate which will be quoted to you by *Aussie* or your have the option to go back onto the Fixed Rate at no cost to you.

4. How Will I Be Advised Of Rate Changes?

Aussie will advise you in writing of any changes to your interest rate. You will be advised at the same time of any changes to your monthly instalment as a result of these rate changes.

5. Can I Fix My Rate?

You will have the opportunity four times a year (on the 1st of each January, April, July and October) to change at no cost from your variable rate to a fixed rate for a set period subject to the Trustee having fixed rate funds available at that time. The fixed rate will depend on the Trustee's cost of fixed rate funds at that time. By contacting *Aussie* prior to each of these fixing dates you will be able to obtain a quote for the term and the fixed rate that is available.

You must give 21 days written notice to *Aussie* of your intention to convert to a fixed rate. We are unfortunately unable to accept verbal requests to change from variable to fixed rates.

At the expiry of each fixed rate period, the trustee may have further fixed rate funds available to enable you to fix for a further set period. this can be arranged by contacting *Aussie*.

If you do not advise *Aussie* that you again wish to fixed your rate, it will automatically revert to the prevailing residential variable rate at the expiry of the fixed rate term.

The opportunity to split your loan ie; part fixed rate and part variable rate is only available at the commencement of your loan and should be discussed with your Loans Consultant when arranging your loan.

6. What Is The Term Of My Mortgage?.

Your mortgage is progressively repaid over a term of approximately 25 years. You can however repay your loan earlier if you wish. The term is subject to the Trustee's rights under the mortgage following a default. In this case the loan can become repayable at the Trustee's request.

7. How Are Instalments Made?

All regular instalments are made by a Direct Debit from your bank account on the first working day of each month. There is a nominal bank charge of $0.15 for each direct debit.

Whilst you have a variable rate loan you may choose to make your regular payments either monthly on the 1st day of each month or fortnightly on Fridays on the cycle of your choice. For loans on a fixed rate, repayments are only available on a monthly basis.

Fortnightly repayments are calculated as half of a regular monthly repayment. For example, your monthly repayment may be $1000. Your fortnightly repayment is therefore $500.

The Direct Debit may only occur from bank or building society cheque or savings statement accounts. Some Credit Union accounts may also be debited. Deductions can not be made from Savings Passbook accounts.

The account from which funds are debited to make loan repayments must be identical to the name of the loan.

Third party or indirect accounts are unacceptable with the exception where a borrower operates as a sole trader under a registered business name or a payment is made as part of a salary payment in a bona fide employer/employee relationship. Payments direct from a company's account to support a director's loan are not acceptable.

8. Can I Make Additional Repayments?

Yes. Additional payments can be made on variable rate, principal and interest repayment loans without penalty. Additional payments on interest only loans are not permitted.

Additional payments to fixed rate loans will attract payment of additional interest in the form of break costs.

Additional payments should be made by either personal or Bank cheque and clearly identified with the loan account name and number. Additional payments should be posted to Aussie Home Loans, Post Offie Locked Bag 95, Parramatta NSW 2150.

You will receive interest benefit for any additional payments immediately on the monies being received and credited to your loan account with the Trustee.

Upon receipt of your cheque, *Aussie* will deposit the monies directly to your loan account up until 12 noon on the day the moneys are received and if the day of receipt is not a working day the deposit will be made on the next available working day.

All cheques should be payable to **Perpetual Trustees Australia Limited** and forwarded to the *Aussie* office.

Should a substantial principal reduction to your loan be made, a restructure of your repayment schedule to reflect the reduced repayment can be arranged by contacting the *Aussie* Client Services Department.

9. Are There Any Costs If I Partially Repay Early

No prepayment fee will be charged on early partial repayments. However, **while your interest rate is fixed**, you must pay any Breakcosts on **all** early partial repayments. Breakcosts compensate the Trustee for the loss of income resulting from your prepayment, and their method of calculation is set out in detail in your mortgage.

Interest due on the prepayment amount up to the date of prepayment must also be paid. *Aussie* can advise you of the amount of these costs on request if you wish to make a prepayment.

10. Can I Fully Repay Early?

Yes, full repayment of your mortgage can be made at any time. Prior to repaying your mortgage in full, 1 months notice must be given in writing to the Trustee through *Aussie*.

11. Are There Any Costs If I Fully Repay Early?

a) Variable Rate Loans

Yes, if the loan is fully repaid during the first 7 years of the Mortgage, there is a prepayment fee of an amount equal to one months interest at the prevailing rate on the original amount borrowed.

No early repayment fee will be charged if the loan is paid out after 7 years.

For Loan Loans and Construction Loans refer to separate annexure.

b) Fixed Rate Loans

While your rate is fixed, there is a prepayment fee of an amount equal to one months interest at the prevailing rate on the original amount borrowed, plus any Breakcosts.

Interest due on the prepayment amount up to the date of prepayment must also be paid. *Aussie* can advise you of the amount of these costs on request if you wish to repay your mortgage early.

The prepayment fee does not apply if you are simply switching securities. For example, you sell one house and purchase another. As long as the new property is also mortgaged to Perpetual Trustees Australia Limited through Aussie Home Loans, you will not incur the prepayment fee for paying out the first mortgage with Perpetual Trustees Australia Limited which of course is subject to the simultaneous settlement of the sale and purchase of your property. There is however a cost involved in substituting security properties. *Aussie* can advise of the costs involved.

12. What Happens If I miss An Instalment?

If you are unable to meet your instalment for any reason, contact *Aussie* ***immediately***. If an instalment is late or not paid, the interest rate applicable to the period covered by that instalment will be your usual variable rate (or fixed rate, as the case may be) plus 2%, and interest at this rate is payable immediately. This higher rate will continue to apply until the account is brought back to order.

Non payment of a regular loan repayment or interest payment for interest only loans, constitutes default under the mortgage document.

Non payment gives the trustee the right to exercise routine recovery action as provided within the mortgage.

13. Are There Any Other Costs in Addition to Loan Application Fees?

Yes. You will be responsible for paying your own out of pocket expenses in relation to the transaction. Such expenses include Stamp Duty, Searches, enquiry fees, bank cheque fees, registration fees and Lender's Mortgage Insurance if applicable. You may also be required to pay professional fees to your legal representative. In the case of refinance, some lenders charge a fee for discharging mortgages.

It is your responsibility to ascertain the costs involved by consulting your legal adviser as costs will vary depending on your individual circumstances.

14. Am I Required to pay Lender's Mortgage Insurance?

All of our loans are covered for Lender's Mortgage Insurance however, you will only be required to pay the cost of the Lender's Mortgage Insurance where the loan to value ratio is 76% or more of the value of the property. In the event the loan exceeds $500,000, Lender's Mortgage Insurance is payable by the borrower where the loan to value ratio is 65% or more.

The premium payable is a "one-off" payment and is paid by you at settlement of the loan. Your *Aussie* representative will advise you of the indicative cost involved.

Aussie may earn a commission from the insurer on any mortgage insurance that it arranges for your representing reimbursement of *Aussie* administration costs in processing the application for Lender's Mortgage Insurance cover.

It is important to understand that Lender's Mortgage Insurance is a benefit to the lender only. It does not provide protection for borrowers if they are unable to make their mortgage repayments.

15. Should I Obtain Legal Advice?

The mortgage, and if applicable the guarantee contained in it, contains important obligations and we recommend that borrowers and guarantors seek legal advice regarding the terms and implications of their mortgage or guarantee.

It is a provision that applicants who have attained the age of 65 years and all guarantors obtain independent legal advice regarding their financial and legal obligations.
We recommend that borrowers do not act for themselves without seeking professional advice.

16. Should I Obtain Financial Advice?

You should satisfy yourself that you will be able to meet your repayment obligations, including increased instalments should the rate on your variable rate mortgage increase. If for any reason you are uncertain about this you should seek expert financial advice to confirm that you will be able to meet your financial commitments under your mortgage.

17. What is Acceptable Security?

Your mortgage must be over residential property which is either freehold Strata Title or Torrens Title, or leasehold in an approved area. Certain restrictions apply to Strata Title properties in so far as, the floor area of the security should generally exceed 50 square metres, small units may be considered as the exception.

Property held under the old system or qualified title system will generally be accepted but extra legal costs will be payable by the borrower.

18. When Must Settlement Occur?

Settlement of your loan should take place within 2 months of the date of your loan approval letter. If settlement occurs after this time, you may also be charged the cost of updating the valuation and you may be required to provide updated financial information to *Aussie*.

19. Ongoing Insurance Requirements.

Subsequent to settlement of your loan you will be required to provide evidence of the renewal of your householder's fire insurance on an annual basis.

20. How Often Will I Receive Loan Statements?

Loan statements will automatically be mailed to you shortly after 30 June of each year. Additional statements may be provided on request by contacting *Aussie's* Client Services Department.

21. Can I Borrow Further Monies In The Future?

Further borrowings are permitted however are subject to compliance with our funder's lending criteria at the time of application of the new advance, Credit Act requirements and payment of fees to cover costs.

22. Re-draw Facility

A Re-draw facility is documented within your mortgage. This allows you to Re-draw, subject at all times to the trustee's consent and at no cost, minimum amounts of $5,000 from your loan which have of course, been previously pre-paid. The maximum amount you are permitted to draw is limited to the reducing projected balance of your loan throughout the term of the loan.

Formal application must be submitted through your *Aussie* office for each Re-draw.

23. Refund of Application Fees

Application fees are charged to offset some of the costs associated with establishing a loan. Therefore, refunds can only be made on the following basis:

Loan Declined or }
Withdrawn prior } Full refund less cancellation fee of $250 for each
to Approval } property offered as security.

ATTACHMENT A continued

Loans Withdrawn after Approval No refund, however we will credit the fee towards any further application made within three months of you notifying *Aussie* of your intention to withdraw.

IMPORTANT

IF YOU ARE UNSURE OF ANY MATTER REFERRED TO IN THIS DISCLOSURE STATEMENT PLEASE CONTACT YOUR AUSSIE HOME LOANS REPRESENTATIVE FOR CLARIFICATION OR DISCUSS THE MATTER WITH YOUR LEGAL OR FINANCIAL ADVISOR

ATTACHMENT B

THE SECURITISATION PROCESS

It is the securitisation structure and process itself which provides the security and protection to both borrower and investor. The following outlines the key elements of a securitisation program.

C.1 Securitisation Structure

The diagram on the following page shows the relationship between each of the parties to a securitisation. See Annex 1 for the PUMA Fund Sub-Fund P-3 *Information Memorandum* which provides comprehensive and detailed information on the securitisation process, the roles of the various parties, and the features of both the fund's assets and liabilities in a typical securitisation.

C.2 Role of the Mortgage Originator/Manager

Mortgage origination is the process of establishing a loan. It can be done by a lender on their own behalf, as is the case for most bank loans, or it can be done by a third party acting as an agent or broker who has no ongoing role in the conduct of the loan. Mortgage management is the process of servicing the borrower and his/her loan during the life of the loan. Mortgage management can be undertaken on own account by a lender or as a third party service provider. AHL is both an originator and a manager of mortgages but there are many operators - particularly small operators - who originate but do not manage loans.

Originators/managers of "approved mortgages" for a securitisation are appointed by the Fund Manager subject to the approval of the Trustee by way of a Mortgage Origination Deed and can be removed by the Fund Manager if there is a failure under the terms of the Deed, including an event of insolvency on the part of the mortgage originator/manager. Such a contingency would simply result in the replacement of the originator/manager by another originator/manager and has no repercussions for mortgagors. The duties and responsibilities typically required of originators/managers are detailed in the *Information Memorandum* (Attachment 3) and are summarised below.

<u>Origination:</u> In response to an inquiry by a potential borrower, the mortgage originatorarranges a meeting to discuss the customer's needs and explain the loan. If the customer wishes to proceed, a proposal is put to the Fund Manager for approval and to the mortgage insurer for acceptance and a property valuation from an Approved Valuer is obtained. Mortgages are financed through a *Warehouse Fund* until sufficient mortgage assets have been accumulated for securitisation and the issue of investor securities.

<u>Mortgage Management:</u> The mortgage manager is responsible for processing any payments additional to the normal monthly or fortnightly repayments a borrower may choose to make. The normal repayments themselves are debited directly from each borrower's account to a Trustee controlled collection account. Mortgage managers' responsibilities also include following up with any

borrowers whose loan accounts become in arrears and making arrangements appropriate to the resolution of the situation.

Client Services: Mortgage managers also provide on-going client services to the borrowers. As well as processing any additional payments, this includes answering any questions the client may have and arranging requested switching to fixed rate loans, redraws or early discharge of the mortgage.

C.3 Role of the Trustee

A Trustee is appointed to control the funds of a securitisation program and is the mortgagee on the home loan mortgage contracts. Its duties include a general obligation to exercise all due care and diligence in carrying out its roles as trustee, a duty to protect the interests of bondholders and a duty to conduct all transactions relating to the fund in a proper and efficient manner.

The Trustee appoints a Fund Manager and delegates to that Fund Manager a number of its duties and responsibilities in relation to the day-to-day operation of a fund. The trustee obtains an indemnity from the mortgage manager with respect to its responsibilities in its dealings with the mortgagors.

C.4 Role of the Funds Manager

The fund manager has a wide range of responsibilities including:

- the appointment of originators and thereafter management of the origination of approved mortgages in accordance with the provisions of a mortgage origination deed, the programme parameters, the management deed the trust deed and other relevant transaction documents;
- co-ordinating the raising of funds by the issue of bonds;
- the selection and management of authorised investments; and
- the establishment and monitoring of mortgage insurance policies, stand-by arrangements and other security enhancements and hedge arrangements in respect of the fund.

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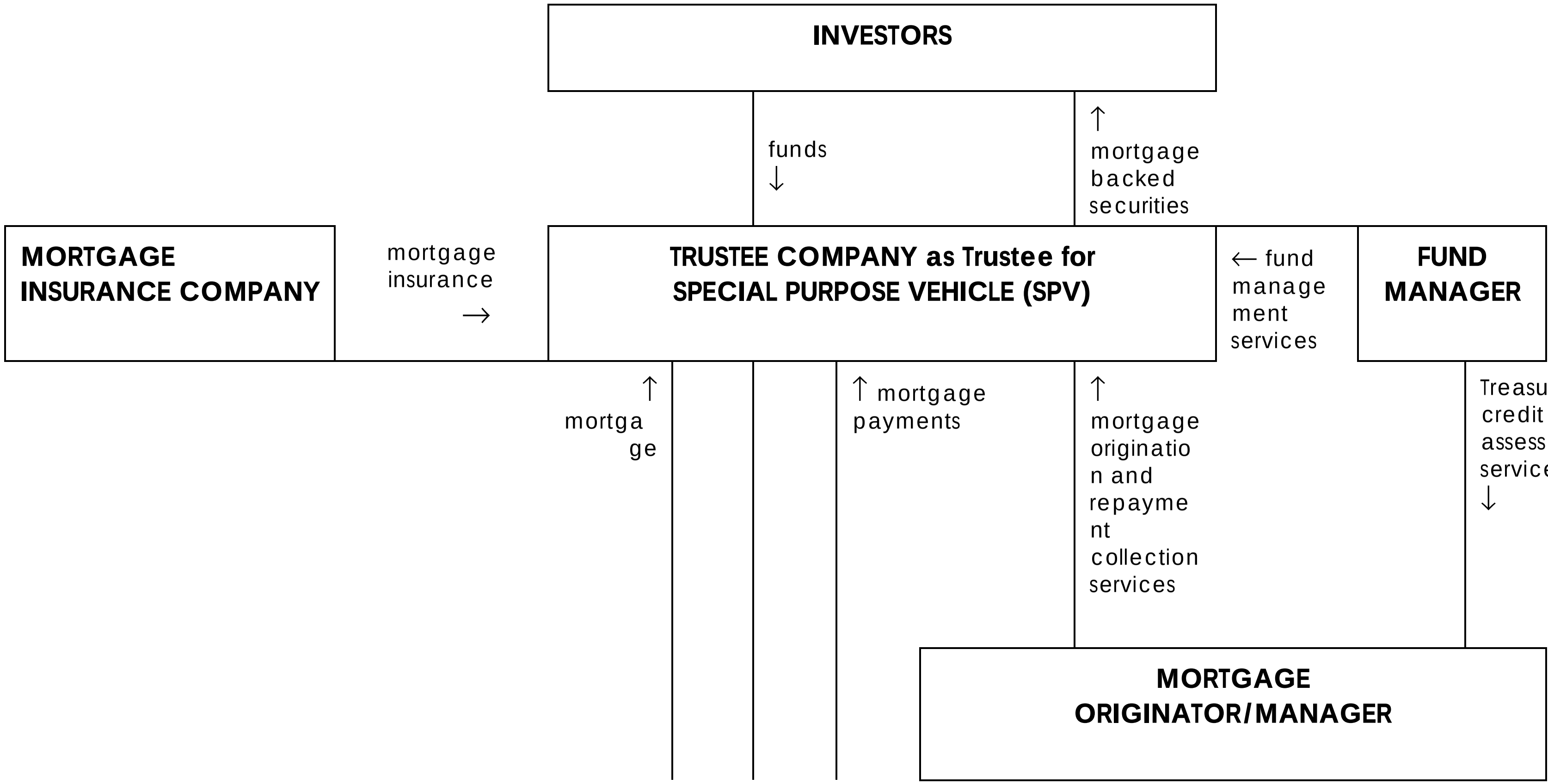
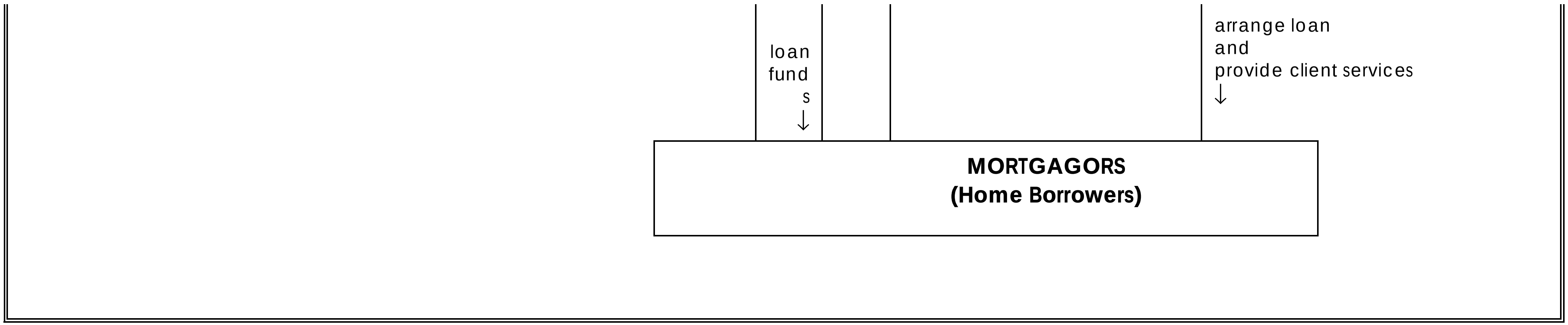
SECURITISATION STRUCTURE

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MORTGAGORS
(Home Borrowers)

MIAA Code of Ethics

I. Preliminary

Prescribed standard

1. This Code of Ethics sets out minimum ethical standards to be observed by the members ("the Members") of the Mortgage Industry Association of Australia ("the Association") in their professional and commercial activities.

Objectives of Code

2 This Code of Ethics seeks to:

(a) create a high standard of ethical conduct for Members,
(b) safeguard the reputation and standing of the Association and the Members, and
(c) secure and advance the development of the mortgage industry in Australia.

Commitment to Code required

3. Members shall affirm their commitment to this Code of Ethics upon beginning or renewing their Membership to the Association which shall be conclusive evidence of the Member's intention to properly and duly abide by the ethical standards embodied within this Code.

Compliance required

4. Members shall know and observe and shall ensure that their employees or representatives know and observe the ethical standards prescribed by this Code in all of their professional and commercial activities.

Contravention

5. Members shall contravene this Code where they participate in or directly or indirectly condone any behaviour which breaches the ethical standards embodied

within this Code.

6. Members shall be subject to the disciplinary action contained within Part III for contravening this Code.

II. Ethical Standards

Legal obligations

7. Members shall know and comply with all laws governing their professional and commercial activities.

Discharge of duties

8. Members shall conscientiously discharge their professional and commercial duties to whomsoever those duties may be owed.

Due skill, care and diligence

9. Members shall act with due skill, care and diligence.

Honesty

10. Members shall establish and maintain honest and honourable relationships with all persons with whom they may come into contact in the course of their professional and commercial activities.

Misrepresentation

11. Members shall not engage in any acts or omissions of a misleading, dishonest, deceptive or fraudulent nature.

12. Members should be aware that non-disclosure of relevant facts to other parties involved in a lending transaction including borrowers, mortgage insurers, solicitors and valuers may constitute a breach of Clause 11.

Advertising

13. Members shall not publish any misleading, dishonest or deceptive advertisements or publications.Standing of MIAA7

14. Members shall refrain from any conduct that may embarrass, impune or discredit the Association or bring the Association into disrepute.

Licenses and qualifications

15. Members shall hold all necessary licenses and qualifications required under the relevant legislation or regulations to conduct their activities.

Duty of confidentiality

16. Members shall not disclose any confidential information entrusted to or otherwise obtained by the Member in the course of the Member's activities unless:
    (a) the client has consented to the disclosure, or
    (b) the disclosure is required by law, or
    (c) the disclosure is made to a person who necessarily must have the information in order to discharge legitimate occupational or professional duties.

Disclosure of information

17. Members shall:

    (a) advise borrowers and other involved persons of all relevant information known to the Member pertaining to a lending transaction to the extent that such information concerns the person in question, and
    (b) disclose all relevant particulars in relation to the proposed loan in the letter of offer to the borrower.

Conflicts of interest

18. Members shall fully and frankly disclose any actual, apparent or potential conflict of interest of which the Member is or ought to be aware to the extent that such a conflict of interest concerns a particular party.

Declaration of relationships

19. Members shall advise the applicable lender, manager, mortgage insurer and solicitor in a lending transaction if that Member has any financial interest, relationship or association whatsoever with a proposed borrower or any guarantor or other party in relation to the loan.

Representing Association

20. Unless authorised by the Association, Members shall not purport to represent, act or speak on behalf of the Association.

III. Contravention

Hearing

21. The Association may appoint a person or authority to determine whether a Member has contravened this Code.

22. In determining whether a Member has contravened this Code, any statements, act or omissions of its employees or representatives shall be considered to be statements, act or omissions of the Member.

Sanction for contravention

23. Where a person or authority appointed by the Association for the purpose of deliberating upon an alleged contravention of this Code finds that a Member has contravened this Code, that person or authority may make a declaration to that effect and may further in its discretion publicly declare that the Member has acted in an unethical manner.

24. Notwithstanding that the Member has been found to have contravened this Code, the Association may at any time rule that the power to publicly declare a Member to have acted in an unethical manner not be exercised.

Payment of costs

25. Where it has been found that a Member has contravened this Code such finding shall be conclusive of that fact and the offending Member shall pay to the Association all costs, charges and expenses incurred by it in the investigation and deliberation of the matter.

Mortgage Industry Association of Australia

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