

Housing Mortgage Contract Design and Banking Sector Competition – The Reform Package

Submission to Senate Economics Committee Inquiry: “Competition within the Australian banking sector”

Professor Kevin Davis, Research Director at the Australian Centre for Financial Studies recommends a 6-point reform plan to improve risk sharing and competition in Australia’s housing mortgage markets.

The Australian Centre for Financial Studies has released a submission to the Senate Economics Committee Inquiry into *Competition within the Australian banking sector*. The submission focuses upon a subset of the Committee’s terms of reference, and addresses the questions of whether the current structure of housing mortgage contracts involves appropriate risk sharing between banks and customers and implications for competition in banking markets. Analysis of the status quo led to arguments and in turn, recommendations which form the basis of this submission.

The submission reinforces the importance of legislating changes in the Australian mortgage contract design for social and economic benefits. Certainly, the sub-prime crisis in the USA was crystal clear in illustrating the importance of mortgage design for the efficient functioning of financial markets and avoidance of significant social and economic problems.

In summary, the submission elaborates on 6 recommendations:

- 1.** APRA should be required to make publicly available data on mortgage characteristics and terms from data provided by banks and ADIs.
- 2.** Prohibit loan contracts which give lenders absolute discretion to change the interest rate on existing loans.
- 3.** Loan contracts should allow for subsequent variations in the interest rate charged as long as the conditions for such changes are well defined at the initiation of the contract and are verifiable by reference to objective information.
- 4.** Lenders should be precluded from charging exit fees on housing loans if the loan is three years (or more) old and the customer wishes to exit at the end of a period when it is time for a reset (renegotiation) of terms.
- 5.** At a loan reset date, borrowers should be able to transfer a mortgage to another lender upon payment of the outstanding principal, without the mortgage having to be discharged. If the loan is in good standing, the accepting lender should not be required to obtain a new valuation of the property involved – since that would not have been required if the loan were not being transferred.
- 6.** Deferral of loan establishment fees should only be achieved by explicit addition of the amount which would otherwise have been charged into the initial loan principal.

The impact that these recommendations have on risk sharing and bank competition would understandably raise a number of prudential concerns, such as decisions on bank funding and problems of adverse-selection with loan transfers, though the latter is not

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likely to be a major issue in housing mortgage loans. Removing the variable-at-the-lender's-discretion characteristic will prevent lenders passing onto borrowers certain interest rate risks which lenders are better suited to manage via their funding choices. It is more reasonable for the consequences to impact upon shareholder profits rather than borrowers.

Kevin remarks, "*Not only are home borrowers unlikely to be able to anticipate the future implications of such market disruptions, it is more appropriate that those risks are borne by bank shareholders, and managed by the bank executives who are paid to do just that.*"

The recommendations presented in the submission are one way of achieving improved risk sharing and competition in housing mortgage markets in Australia.

To view the full Submission, please visit our website at

<http://www.australiancentre.com.au/category/publications/inquiry-submissions-publications/>

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This Submission was prepared by Kevin Davis, Research Director, Australian Centre for Financial Studies and Professor of Finance, University of Melbourne.

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