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PARKES ACT 2600

Comments on the Exposure Draft- National Consumer Credit Protection Amendment Regulations 2011- Exit Fees

My name is Kym Dalton and I offer these comments as an individual with lengthy experience in the mortgage markets in Australia and the United States.

From 1989 until 2001 I was the Chief Executive Officer of Australian Mortgage Securities Ltd (AMS). AMS was the largest private sector issuer of Residential Mortgage Backed Securities (RMBS) in Australia and New Zealand at the time of my departure from the firm.

In 1989 the RMBS sector in Australia was embryonic and activity was limited to two entities, the First Australian National Mortgage Acceptance Corporation (FANMAC) and the National Mortgage Market Corporation (NMMC). Both of these entities enjoyed substantial shareholdings from the New South Wales and Victorian State Governments respectively and operated primarily as an instrument of social housing policy initiatives.

AMS (then MGICA Securities Ltd), was ultimately owned by the AMP Society and it was determined that private sector involvement in RMBS was timely.

I was despatched on a lengthy study tour of the United States in 1990 to explore how precedent from that market could be adapted for application to Australia.

I had extensive engagement with senior levels of business across the broad spectrum of involvement with RMBS and securitisation in general.

It quickly became apparent to me that the US market had certain, profound, structural features that meant that there was little that could be adopted for application to Australia.

The most noteworthy of these features were;

- The involvement of the Government Sponsored Enterprises (GSE’s) at the core of the US housing loan market.
- The predominance of long dated fixed rate mortgages funded by the GSE’s
- The opacity of the operations of the GSE’s – how they operated and how they funded the long dated fixed rate mortgages lacked transparency
- The operations of the GSE’s were significantly dependent on the implied faith and credit of the Federal Government of the United States
• Private sector RMBS activity focussed on non standard product such as home equity loans and large ("Jumbo") loans
• The long dated fixed rate mortgages funded by the GSE’s lacked any exit or prepayment fees
• The homogeneity of the long dated fixed rate loan products funded by the GSE’s
• The lack of genuine product innovation in the “prime” mortgage market
• The prevalence of substantial “establishment fees” for prime mortgages. In US parlance; “points” paid by the borrower; with “2 points” (200bp) being commonplace.
• The ‘prime’ mortgages funded by the GSE’s had the attributes of a product that was commoditized and differentiated primarily on price.

Observations

• The absence of a prepayment or exit fee on prime mortgages in the United States may at first appear to amount to a ‘free option’ granted to the mortgagor to repay the mortgage
• Financial markets theory would hold that there is no such thing as a ‘free option’ – there is a cost to either the grantor or the grantee of an option.
• The prevalence of long dated fixed rate mortgages with no prepayment or exit fees meant that in a declining interest rate environment it was an arithmetic exercise for borrowers to refinance once the costs of mortgage establishment ("points" and costs) could be recouped by entering into a new long dated fixed rate mortgage at a lower interest rate
• This phenomenon led to periodic “refinance booms” where a substantial proportion of mortgagors exercised their option to prepay and enter into a new long dated fixed rate mortgage¹
• This phenomenon, with its causal link to macroeconomic, fiscal and monetary policies of the US Federal Government, meant that genuine asset and liability management opportunities for the funding of prime mortgages was denied to the private sector
• Pragmatically, it was the GSE’s with their implied credit support from the Federal Government that were capable of dealing with the volatility caused by this periodic refinancing activity
• Being denied the opportunity to participate in the “prime space” of residential mortgages, the private sector increasingly ‘innovated’ in non prime mortgages that were not subject to such volatility in term, duration and prepayments encouraged by the lack of prepayment fees, i.e. the private sector focussed on ‘credit products’ as a way to differentiate in a commoditized market.
• This “innovation” ultimately and lamentably, found expression in the subprime mortgage phenomena.
• The systemic contagion initiated by the collapse of the subprime mortgage market led to the GSE’s being placed in conservatorship by the US Federal Government.

¹ The National Australia Bank’s 2001 write down of A$3.6bn following the diminution in the value of Homeside Lending’s “mortgage servicing rights” on a portfolio of GSE funded mortgages was primarily a consequence of a periodic “refinance boom”
• With the operations of the GSE’s constrained, there is currently a lack of adequately priced and structured residential mortgage finance availability in the United States

Discussion

• Whilst there are clear structural differences between the US mortgage market and the Australian, the adoption of a “no exit fee” regime in Australia may lead to the emergence of some attributes of the US market in this country

The granting of an option to the mortgagor to prepay at no, or minimal cost, may;

• Lead to the re-emergence of establishment fees as lenders seek to price the costs of origination on a definable basis rather than seek recoupment based on the term or duration of the mortgage- i.e. “all borrowers” pay the costs of origination rather than “some borrowers”

• Lead to a focus by consumers on price as the prime determinant of a purchase decision and therefore to favour the lowest cost producer. Prime mortgages may therefore attain the attributes of a commoditized product; leading in turn to a requirement for increasing returns to scale and the encouragement of oligopolistic forms of business activity

• As “prime” Australian mortgages transition to a commoditized product, those entities that do not enjoy the attributes that enable them to be the lowest cost producers may seek to continue to compete and enter into price activity that is not in their long term interests

• Transition to a commoditized product may restrict product innovation and indeed some of the product features that Australian consumers now enjoy may not be able to be accommodated

• Transition to a commoditized product may necessitate a pricing frame of reference for product providers. The current “discretionary variable” mortgage that predominates in Australia may in turn transition to a mortgage that is benchmarked; either to the official cash rate or another benchmark such as BBSW. Should this structural change take place, it may not always be in the long term best interests of consumers at all stages of an interest rate cycle.

• Ultimately, those providers that are not able to adequately compete in a commoditized environment by being the lowest cost producers may seek to ‘innovate’ with ‘credit products’ as a point of differentiation

Some Possible Consequences

• In the absence of exit fees, with a singular focus on price, there is chance that the phenomenon of a ‘hot mortgage market’ could emerge

• If, structurally, prime Australian mortgages remain “discretionary variable”, a ‘hot mortgage market’ could well make the treasury and funding task of lenders increasingly problematic. Regrettably, ‘hot markets’ could encourage providers to engage in short term tactical marketing and pricing initiatives, making it difficult to formulate an acceptable duration profile for an ADI’s liabilities
• Due to increased uncertainty, there is some potential for lenders to increase the margins on mortgages to compensate for volatility

• In the RMBS environment, already fragile post GFC, a ‘hot market’ could destabilize the Constant Prepayment Rate (CPR) assumptions that have long underpinned this market. This could lead to increased investor fragility and act as a disincentive for the rejuvenation of the RMBS market as an agent of increased competition

• In both the ADI and RMBS sector, there is a reliance on domestic and foreign wholesale funding. There is the potential for there to be an extraneous event in wholesale markets of short to medium duration that may increase lenders’ funding costs, necessitating a short or medium term repricing of mortgages to reflect this occurrence. In the absence of exit fees and in a ‘hot market’, mortgagors may refinance away from an impacted lender when they are particularly vulnerable to a loss of earnings. At the most extreme this could cause systemic dysfunction.

Consumer Protection Legislation

In my opinion, Australia has ‘world’s best practice’ consumer protection legislation in the form of the National Consumer Credit Protection Act, and the “Unfair Contracts” amendments.

Via these legislative initiatives, including their IDR and EDR requirements, consumers have significant protections and avenues for redress for inappropriate, unjust, unconscionable and unsuitable exit fee structures.

This legislative framework, overlaid with increased transparency and a commitment to an improvement in financial literacy for consumers, provides very significant protections.

Summary and Conclusion

It is my opinion that a ‘ban’ on ‘exit fees’ has the potential to lead to unforeseen consequences.

These potential unforeseen consequences are such that, on balance, the consumer could be disadvantaged should the changes to the regulations proceed in the manner contemplated.

I am grateful for your attention

Yours Truly.

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