COMPETITION AND INNOVATION IN THE AUSTRALIAN HOUSING FINANCE MARKET: WHAT HAS DEREGULATION ACHIEVED?

COMMENTS AT

HOUSING INDUSTRY ASSOCIATION WORKSHOP ON HOUSING FINANCE

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Towards the end of his paper Geoff Gloster claims that "doubts... expressed, particularly in academic circles [my emphasis], concerning the efficacy of deregulation in producing the innovation "that banks said would occur" ... {are} ... naive and unconvincing". My remarks are directed towards that topic, since I happen to share such doubts.

Underpinning those doubts is the following basic point. Deregulation plus competition can undoubtedly bring benefits, but deregulation doesn't imply that effective competition will emerge. In a number of areas of the financial sector, competition has been strengthened. One of those areas is in the competition for retail deposits and that certainly affects housing financiers. But it is far from apparent that competition in the home lending market has increased to the same degree. To back up that, claim let me proffer two observations.

The first relates to the argument often heard that, because of the 13.5 per cent ceiling on "old" housing loans, the rate on unregulated "new" loans has had to be that much higher. But those old loans are akin to a "sunk" cost and in a truly competitive world shouldn't affect the pricing of new loans. The existence of these sunk costs will affect bank profitability as interest rates change but they shouldn't affect the pricing of new loans. Competition should drive the interest rate on new loans to equality with the economic marginal cost of deposit funds. Only if competition is less than perfect can banks protect their profit margins by adding a premium on to new housing loan interest rates!

The second comment leads me into my response to Geoff's paper. If there were effective competition I believe we would have seen much more innovative housing finance packages than we have. Note that I didn't say more complex housing finance packages: - if financing arrangements are going to be accepted they must be simple. I believe, and I hope I'll be able to convince you, that there is a large variety of simple innovate financing possibilities which haven't been tried, I suspect because the proper competitive spur hasn't been there. That worries me - because it was largely the dynamic efficiency gains rather than the comparative static welfare losses which got most emphasis in the arguments for deregulation. I'm most willing to concede that I may be wrong - but I would like to see some good evidence. That raises an obvious question of

what can we use as evidence of changes in effective competition in the housing finance market? I won't try and answer that but simply put it on notice as a question warranting serious attention.

Geoff starts his paper with a discussion of the functions of financial intermediation. I'd like to extend that discussion a bit further in order to develop a few arguments.

Financial institutions link together borrowers and lenders. They can do that in several ways. At one end of the spectrum of possibilities is a pure brokerage function. They can act like a marriage bureaux or dating service, simply bringing together borrower and lender (reducing search and transactions costs) and not actually interposing themself. That may work well in some areas of financing but not in all. Borrowers and lenders may have different preferences for the maturity of loan, size of loan and other terms and conditions and these may inhibit the consummation of the relationship. Moreover, lack of knowledge about the reliability of the other party, market conditions etc create further impediments to this process.

In some cases these impediments can be overcome without "fully-fledged" intermediation. For example:

- the existence of a secondary market (like the share market) can enable borrowers and lenders with non-matching preferences to come together. Lenders will accept securities with longer maturity than desired if they can dispose of them - and are not too concerned about the risk arising from the variability of the price at which they can be disposed.

- financial institutions can underwrite securities to be issued by borrowers who are searching for funds from lenders.

- financial institutions can add their guarantees to the securities issued by borrowers. The bank bill market is a good example of this.

I have mentioned these examples because they illustrate a point which is often forgotten in discussions of housing finance. The business of

providing housing finance does not necessarily involve the simultaneous holding of the assets so created. In the past it has, and current financing techniques tend to reinforce that jointness. There are many impediments to secondary mortgage markets which divorce the two activities and one of them is the unsuitable nature of mortgage instruments currently created.

As an aside, regulators need also to be made aware of that point. If the concern is to promote access to home ownership the critical point is the arranging of financing - not who holds the financial instruments so created. Regulations which force certain institutions to hold primarily housing loans may have an adverse effect, by preventing diversification by those institutions and perhaps increasing the cost of that funding.

Returning to my theme, financial institutions can in addition to "broking" etc. also facilitate financing by intermediation as we more generally know it in the housing finance area. In this, they purchase securities issued by borrowers and issue their own securities such as deposits to fund those purchases. Sometimes the securities issued are close replicas of those held - as for cash management trusts where the main function performed is one of "size" intermediation. There, investors who do not have sufficient funds to purchase a diversified portfolio can get a share of such a portfolio - at much lowered transactions costs.

More often though, the intermediation process involves significant transformation of the assets held. Assets which have a possibility of turning out to be "lemons" are financed by deposits which are "safe" (or at least marketed as such). Fixed rate assets are financed by floating rate deposits, long term assets by short term liabilities and so on.

In doing this financial institutions or more precisely their owners are incurring often significant costs which must be recouped in the interest rate margin or by fees and are taking risks for which they naturally expect profits. As well as bringing together borrower and lender, this risk sharing function is an important component of intermediation.

What sort of risks are there in the area of housing finance. Geoff

Gloster spelt most of them out at several points in his paper. One is that individual loans have a possibility of default - but that is reduced by pooling many loans and can be off loaded through mortgage insurance. Another is that loans are for long maturities and are typically funded by short term borrowings. That immediately introduces an interest rate risk which must be borne by someone. Since depositors of short term funds can always avoid the risk by transferring funds, the risk must be shared between the borrower and the owners of the financial institution.

I would argue that in Australia, vis a vis other nations, too little of that risk is borne by the institutions. The standard variable interest rate credit foncier loan is a lender's delight from a risk sharing perspective. The borrower bears all interest rate risk (except to the extent that concerns about default or political pressure inhibit lenders from increasing rates too much). Moreover if interest rates and housing prices move inversely (so that increased interest rates depress housing prices) the borrowers get squeezed on both sides of their personal balance sheet. The possibility must of course be admitted that borrowers get rewarded for bearing this interest rate risk in the form of lower average interest rates charged than would occur under alternative loan arrangements. That, though, assumes effective competition which I have asserted has yet to be demonstrated.

Of course one can go to the other extreme, as happened with the Savings and Loan associations in the USA who got stuck with lots of fixed rate-low interest rate loans when inflation forced rates up for a sustained period from the early 1970s.

But there are many in-between solutions. A common one in North America is a long term loan which has a fixed interest rate for a defined period (say 2-3 years) which is renegotiated after that date. Another is an inflation indexed loan which protects the borrower against fluctuations in the real interest rate, but leaves them exposed to risk due to the effect of inflation upon interest rates. Another would be to link the interest rate to some indicator rate determined externally to the lending institution say a government security rate. That leaves the borrower exposed to movements in market interest rates, but not to the risk of a higher loan rate because, for example, a reduced credit rating of the

lending institution increases its borrowing costs. To emphasis that point suppose you as a housing borrower find that your bank discovers large losses on debt to third world countries. Its credit rating declines and its borrowing costs increase and its return on other assets falls. Why should you carry the can in the form of higher interest rates on your housing loan? The response to that last statement might be that the borrower always has the option to repay the loan early and refinance elsewhere. But to repay and refinance is a costly exercise-especially when stamp duty and early repayment penalties are included.

That early repayment option component to most housing loans, by the way, complicates any attempt at determining the "appropriate" interest rate on housing loans vis a vis the market rate.It is, of course necessary since many property owners want to move house before the term of the loan is up. Or is it? Another thing which strikes me about the Australian housing finance market is the minor role for transferable loans - either where the purchaser assumes the existing loan or the loan is simply transferred to a new property and if necessary "topped up". Perhaps there is no demand for that facility, perhaps legal problems preclude it, or perhaps our financiers prefer the current situation which would seem to induce a higher turnover rate of loans.

There are other possibilities to the in between solutions mentioned a few minutes ago. One is to go the route of fixed rate loans but not hold them on-balance sheet - divest them via the secondary mortgage market. I realise there are many legal impediments to the development of secondary mortgage markets and Geoff has also mentioned several of the institutional features of the US market which prompted its growth there. But I have a suspicion that a major impediment in Australia is the nature of the standard housing loan. A loan with an interest rate variable at the lender's discretion is not a particularly good candidate for securitization. Its not the diversity of instruments which might be an impediment since the rocket scientists in the financial sector can price anything whose financial characteristics can be precisely specified. The problem is that the risk element of our current loan arrangements cannot be precisely specified, since there is a discretionary element in the interest rate adjustment process. If, as overseas, they can and are securitizing such less likely instruments as credit card loans and

automobile loans, we need to ask why its not happening here for the simpler case of housing loans.

It might be argued that there are likely to be few interested holders securitized mortgages. I would simply make two comments. First, who would have predicted five years ago the phenomenal growth in unit and property trusts. That indicates the problem of predicting likely demand, but more significantly fixed rate loans (even where the borrower has the option to repay early) could be an attractive asset for a "mortgage trust". That might not even require a secondary mortgage market. It could be done " in - house " like the cash management funds run by savings institutions. Second, long term borrowers such as pension funds and life offices have in recent decades avoided the residential mortgage market despite the maturity matching available to them from such long term assets. Taxes, regulation of housing interest rates, etc. are obvious explanations for that, but in the new financial and taxation environment it is far from clear that securitized mortgages aren't an appropriate component of an optimal portfolio. Even though the tax reducing benefits of franked dividends make them appealing to superannuation funds, relatively low yields on such assets may make taxable higher yields on securitized mortgages attractive - particularly where a secondary market exists in those assets.

Other possibilities can be suggested which involve different risk sharing arrangements. One is the shared appreciation mortgage or other innovations involving a return to the lender linked to an equity investment in the property. Property trusts of course take that linkage to the extreme. What that suggests is the possibility that the need for innovation may be as much in creating new investment facilities for lenders which enable them to invest directly or "semi - directly" in housing finance instruments as it is in designing new loan types. That would be consistent with the unbundling of activities and securitization occurring in many aspects of intermediation in recent years.

While unbundling is one way to go, another possibility is to look the other way at techniques used in wholesale corporate financing. There relationships are one of the " in - words", and there are lots of arrangements which enable corporates to efficiently manage their cash

flows. But for households that doesn't seem to happen much. Geoff Gloster mentioned "reversible loan pre-payment" which to me seems eminently desirable. The idea is that household mortgagees with possibly temporary surplus savings could have those credited against their loan, and be able to withdraw them should they wish. In essence it would involve operating a housing loan account as if it were initially a fully drawn overdraft in which the overdraft limit came down each month in line with credit foncier requirements. Extra funds paid into the loan account which make the debit balance of the account less than the current overdraft limit would be available for withdrawal. The advantage to the household is twofold. One is the tax one - that interest earnings are a taxable but interest costs on housing loans are not tax deductible. The other is that the interest rate margin which exists between deposit and loan rates is avoided. (Consequently one would expect this type of housing loan to carry a somewhat higher interest rate than other loan types).

CONCLUSION

I've mentioned what I see as a number of areas of unseized innovative possibilities. Maybe they are not really possibilities. Maybe they are too complicated for the borrowers to grasp - although I find it hard to believe that either

(a) a loan rate tied to a government bond rate
(b) a reversible prepayment facility.

(to pick two examples) are two complicated.

But maybe I'm wrong. Maybe the average customer is incapable of understanding the complexities of modern financial arrangements. That would seem to be the message from the " success " of " innovations " in the way some financiers quote terms and conditions to customers who aren't sufficiently financially sophisticated to recognize the effect of fees, up front payments, and more rapid payments on the effective interest rates paid. True calculation of the effective rates on housing loans indicates a very wide variation. That can interpreted in two ways by noting that both perfect competition and monopoly lead to a market

result of there being only one common price in the market. I'd suggest that the variability of effective rates adds further support to my argument that we are well away from perfect competition. But on the other side it also indicates that it's not a monopoly situation out there. Competition exists, but it isn't of the textbook kind that removes the onus of proof from those asserting that the market brings an ideal outcome. Where the market is characterized by imperfect knowledge about how to calculate effective costs, how to evaluate risks etc., (as I'd assert is the case in the housing finance market), the likelihood of socially desirable contract structures being spontaneously adopted is far from obvious. Market Forces may need some extra push or pull.

What might be done? One possibility is to work towards improving the financial literacy of consumers via education, which may in the longer run help to create an informed demand for desirable innovations in loan arrangements. As part of that, it would seem appropriate that either government or self regulation ensured correct product labelling (or truth in advertising) about effective costs, terms and risks of financial contracts. Without come standardization of information availability, the educational task becomes that much harder.

A second possibility is for governments to induce changes by offering incentives. The problem with that option is the one of who receives the bulk of the benefits of any payers' tax money so used. Here, though, a significant opportunity currently exists in the form of the 13.5 per cent ceiling on "old" housing loans. There is little economic or social justification for protecting this category of housing borrowers (although a "moral" argument can be mounted that they borrowed under the expectation that a government enforced ceiling would prevail). Removal of that ceiling could be used as a lever to induce banks to introduce new loan arrangements (for both old and new loans) such as the two options mentioned several paragraphs ago.

The third possibility is for the public sector to lead by example in the introduction of innovative housing finance arrangements - as indeed they are. The problem with that approach is that it incorporates two types of innovation. One is innovative financing mechanisms, the other is innovative ways of delivering housing - related subsidies to the needy.

The packages that achieve those dual purposes may not be those most suitable for the private market and, to the extent that the private and public sector housing finance markets are segmented, the public sector lead may not spur a private sector response.

It is, of course, also possible that none of these stimuli is needed. Market forces may prompt those innovations which are warranted. I, though, am not convinced that we should simply wait for that to happen.