Mortgage Market Reform: The time has come.

The current bickering about bank housing loan interest rate increases and inadequate competition in banking, reflects two major deficiencies in the nature of housing mortgage loan contracts in Australia. Borrowers are exposed to the risk of their bank arbitrarily changing the interest rate on their existing loan, and there are significant costs for borrowers in changing banks.

Some simple legislative changes could largely resolve these problems and appropriately balance risk sharing between banks and their customers. First, preclude loan contracts which give the lender absolute discretion to change the interest rate on existing loans independently of movements in some market indicator rate. Second, allow borrowers under certain prescribed circumstances to shift a mortgage loan to an alternative provider at no cost, without having to discharge the mortgage.

Currently, borrowers under standard variable rate mortgages bear the risk of changes in their loan interest rate due to movements in both market interest rates and also any additional changes in their bank's funding costs. For example, a bank which suffered a credit rating fall, or which had managed its funding poorly can pass additional funding costs onto existing borrowers.

Not only is that not fair. It also does not appropriately allocate responsibility for risk bearing to bank executives paid for this responsibility, nor put the cost onto shareholders who profit from bank risk taking.

The bulk of Australian mortgages involve borrowers bearing this risk which they are not well suited to bear. Unfortunately, a paucity of publicly available statistics do not allow us to determine precisely what proportion of housing loans are of the "variable-at-the-bank's-discretion" type.

Fixed rate mortgages (as suggested by Jeremy Cooper, AFR November 8) are one possibility, which involve all interest rate risk being passed to the bank. Whether banks are able to fund themselves in a way that adequately hedges such risk over a long time horizon is a real problem for long term contracts of this type.

But mortgages with a medium term (3-5 year) fixed rate period until a "reset" date have a place in a solution to our politicized mortgage market deficiencies alongside two other reforms. These transfer some appropriate, manageable, part of interest rate risk back to banks, and facilitate mortgage market competition

One plank in a reform package is to prohibit "variable-at-the-bank's discretion" mortgages and encourage adjustable rate mortgages where the interest rate is tied at inception to some fixed margin over a suitable market indicator rate over some medium term horizon until a "reset" date. This would leave borrowers bearing general market interest rate risk, but force banks and their shareholders to bear and manage the risk of poor funding or risk management choices.

The second plank is to require that at the reset date at the end of the agreed medium term fixed rate or fixed margin period, borrowers are able to transfer the mortgage at no cost to another lender if they wish. Critically, rather than having to discharge the mortgage, it could be transferred to a different preferred lender upon payment of the outstanding principal amount.

To those of us unskilled in the legal profession, this would seem to involve no more than crossing out the name of the existing lender on the loan contract and inserting the name of the new lender. But undoubtedly lawyers can make it much more complicated!

With such a requirement in place, lenders will be forced to recoup up-front costs of mortgage origination either by up front fees or by interest rates charged over that initial medium term period. In those circumstances, they have nothing to lose at the reset date if the mortgage is transferred - other than the relationship with the customer, which gives the customer some improved bargaining power.

For the customer, the cost involved in switching banks is significantly lowered. Of course, should they wish to switch banks prior to the reset date, there would likely be some exit fees reflecting changes in interest rate levels in the case of fixed rate loans, or recoupment of any “up-front” costs which had been built into the interest rate.

One potential issue upon which APRA would no doubt focus, would be a problem of “adverse selection” where existing lenders happily let poorer quality loans be taken over by other banks whose due diligence procedures were not up to scratch. Another prudential concern would be that banks would bear, rather than pass onto existing borrowers, the risks of any funding or risk management errors.

But surely that is as it should be. Bankers are paid to manage risk and bank shareholders rewarded for bearing it.

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