The Australian Mortgage Report 2012

A 'new normal'

Deloitte Banking Report Series

Mortgages 2012
A 'new normal'

Deloitte banking Partner James Hickey considers how the 2012 year for mortgage lending in Australia will reflect a 'new normal'

The 2012 environment will be dictated by moderate growth, diversified and costly funding, consumer power and price wars, as well as raised lending and regulatory standards.

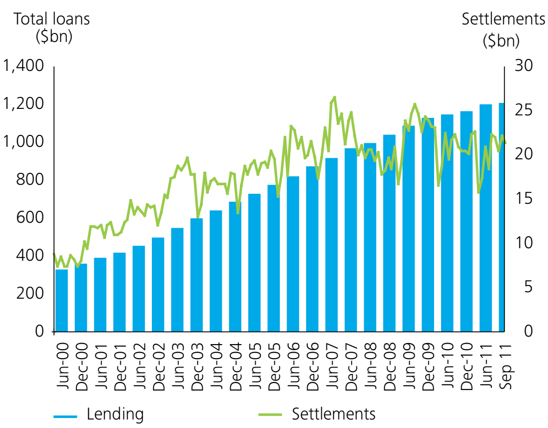
As these tighter scenarios play out across the mortgage sector, lenders and distributors will need to meet the market on pricing while deepening their customer relationships, and delivering on the promise of cross sell.

2011: light at the end of the tunnel?

The past year has seen a challenging environment for borrowers and lenders in Australia since the natural disasters in early January through to recent global events in Europe and beyond. As we look to 2012, however, there is hope that new mortgage lending will continue to return to positive, albeit moderate, growth levels.

In terms of significance, the Australian mortgage marketplace now totals more than $1.2 trillion of lending to Australian households. New settlement volumes across the nation averaged $20 billion of new lending per month in 2011.

Housing Lending Market – Australia

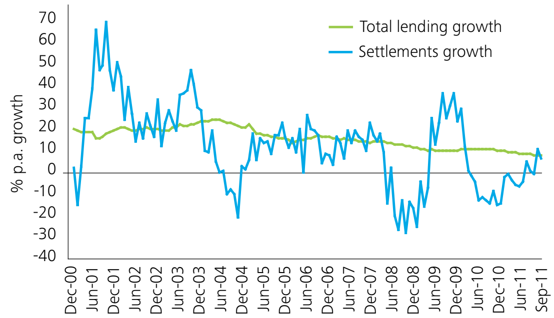


Source: RBA, ABS, Deloitte analysis 2011

The rate of growth of this total $1.2 trillion market has continued to slow, being below 6% p.a. (the lowest level of lending growth in more than 20 years).

However, settlement volumes are the oxygen to the system, and the encouraging sign is that growth in new loan settlements is showing improvement.

Total Lending vs Settlement Growth



Source: RBA, ABS, Deloitte analysis 2011

Continuing themes for 2012

The raft of changes introduced into the mortgage lending sector in 2011 include diversification of funding (in the form of covered bonds being permitted for banks), greater ability to switch lenders (by removing exit fees on new loans), raised standard of product disclosure and suitability testing (via the National Consumer Credit Protection Act (NCCP) Act) and an advanced implementation timeline of global regulations (via the Basel III capital framework). These changes will continue to play an important role in shaping the mortgage market over 2012. Particular themes we see emerging are:

- **System growth of 5%** – the recent uptick in mortgage settlements shows there is growth remaining in the sector. However, this will be predicated on consumer confidence in the Australian economy, property prices holding up and interest rates remaining at current relatively low levels.

  The structural drivers that led to total system lending growth of 15-20% p.a. during the 1990s and 2000s will not be repeated. Such structural drivers included deregulation of the financial system, widespread emergence of securitisation funding at unsustainably low levels, and leveraging up by Australian households (with dual income household borrowing). Such factors will not re-emerge.

  Market, or system growth, of 5% p.a. will be a "new normal". Together with the backdrop of an aging population moving from having a mortgage to downsizing, and households deleveraging, it will be a challenging environment for banks to achieve greater growth without taking market share from other providers.

- **Funding costs to remain high** – while the cost of deposits has lessened, external wholesale funding costs will remain at current levels (if not increase) as global uncertainty continues. This means that banks and other lenders will be unlikely to see any relief on their cost of funds, and will be in a difficult position balancing rate movements for borrowers while maintaining returns for shareholders.

  However, the Federal Government may be in a position to further assist the market with its use of the Treasury's Australian Office of Financial Management (AOFM) funding. This has been a valuable source of funding for those Authorised Deposit-taking Institutions (ADIs) and non banks which could access it to date. Options have been tabled to Treasury to further promote the smaller ADI and non bank sector, by both increasing the size of the AOFM funding, expanding its eligibility and allowing it to invest in AA notes (rather than current AAA only notes).

- **"Price War!"** – strong price discounting will remain in 2012, which is good news for borrowers. Major lenders will continue to need to balance the trade-off between market share (in a slow growth market) and profitable growth. With discounts on headline standard variable mortgage rates of up to 100 basis points (bps), and funding costs not reducing, such price wars will place considerable strain on bank pricing models to ensure profitability is sustainable. Indeed, major banks will remain under close watch from the regulator to ensure risk standards do not slip, and from the investor analyst community, to ensure margins are protected.

  Major lenders will need to be careful to avoid perpetuating a costly round of refinancing, or churn. In the grab for market share, lenders need to ensure it is not simply a "zero sum game" and erode system level margins. Many groups in 2012 will continue to heavily invest in retention strategies in order to maintain their valuable customers.

  Where such price wars leave smaller ADIs and non banks is another matter. Unable to compete on funding, it is hard to see that smaller lenders can profitably compete on price for any extended period. It may well be that such smaller lenders seek some "safe water" in higher risk segments of the market, such as "lo-doc" or "non-conforming" or higher loan to value ratio lending.

- **Innovate and differentiate** – with the price war to continue in 2012, many will also seek to differentiate on non-price levels, such as service, brand values, community relationships, channel usage, advice and customer relationship offers. We will continue to see multi-segment targeting by lenders, either via separate brands or channels (or both). Such approaches cost money, and lenders will need to ensure they leverage sophisticated segmentation models to ensure they get greatest return for the investment being made.

  The internet, and technology such as mobile apps and social media, will be a medium which will be a growing battleground in 2012 as lenders seek to innovate and set their brand and customer service experience apart. Internet based end to end lending will still not come of age in 2012, however it will be important for lenders to determine their strategy for using it to streamline processes – both saving cost and enriching the customer experience.

Cross sell will be the other 'holy grail' of mortgage lending to receive a strong focus in 2012

This will be cross sell of wealth and insurance products attached to the mortgage. Typically a high touch model, this will involve lenders needing to rethink the current simplistic approach of "would you like insurance with that?" which is done post approval by often inappropriately trained staff. Those lenders that integrate with their planner operations and understand the role of education and needs based advice with the mortgage sale, will be best positioned to succeed with cross sell. The margins generated on such cross sell will be important to balance the price war on the primary mortgage.

2012: The 'new normal'

The year ahead will reinforce the 'new normal' which the industry is facing. System lending growth will not return to previous levels. Return on capital by major banks will continue to be under pressure, with slowing growth combined with funding cost pressures, price wars and global regulatory capital changes, requiring banks to hold more capital.

However, there is also considerable upside for lenders and borrowers. Those lenders which can deliver on service, relationship and advice differentiation, will be successful. Smaller lenders have the chance to specialise and carve out their chosen customer base. And customers will continue to experience a stable mortgage lending market which will be increasingly focused on delivering customer value ●

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