The Deloitte Australian Mortgage Report 2016

Delivering tomorrow, today?

11th Annual Deloitte Australian Mortgage Report

The Deloitte Australian Mortgage Report 2016 roundtable

The 2016 predictions from Australia's financial services heads of lending and mortgages, brokers, and fintechs are for an active and innovative mortgage market despite the headwinds of regulatory uncertainty.

The Deloitte roundtable industry experts discuss their observations across the general themes of the market's readiness to meet customer demand and economic challenges, as well as technological and regulatory change.

- Market growth
- Borrowers
- Regulation
- House prices
- Innovation
- Data
- Consumer trends
- Mortgage broking

From left: Louise Denver (Deloitte); Kevin Nixon (Deloitte); Luis Orp (Resimac); Josh Rowe (RealAs.com); Malcolm Watkins (Australian Finance Group); Graham Mott (Deloitte); Lisa Claes (ING Direct); Damian Horton (Huffle); Frank Ganis (Macquarie Bank); Will Rankin (ANZ Bank); Michael Russell (MoneyQuest); James Hickey (Deloitte); Patrick Tuttle (Pepper Group); Chris Wilson, Heather Baister (Deloitte).

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Mortgages 2016: Deliver tomorrow, today?

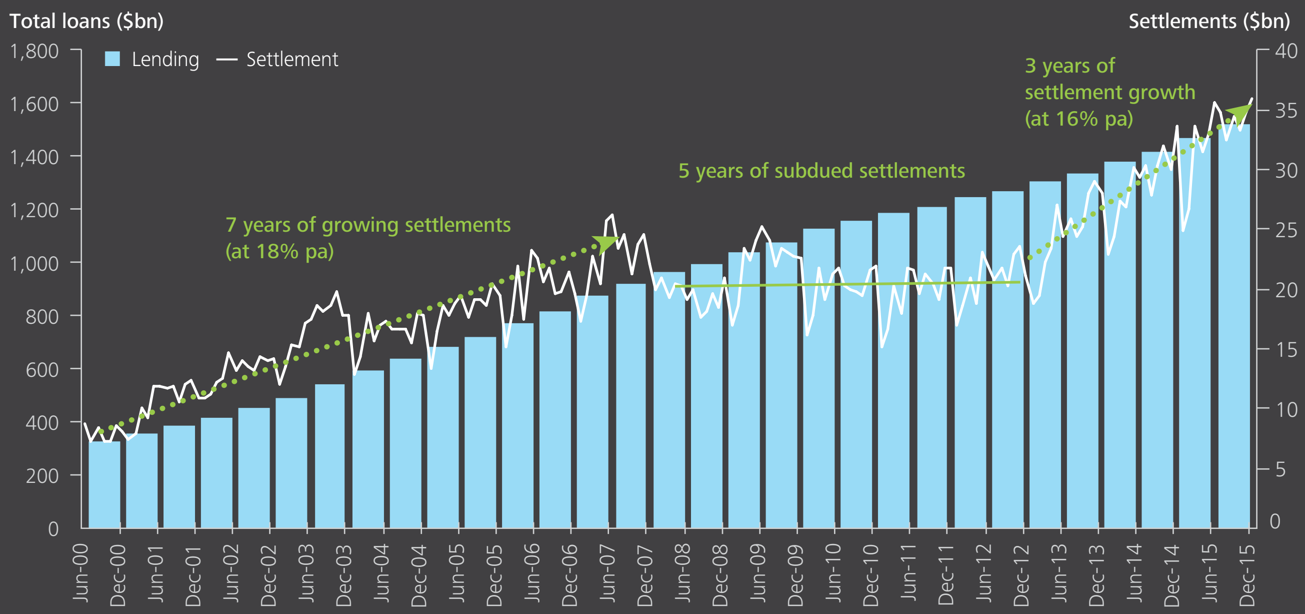
The Australian mortgage market continues to deliver. In October 2015 the total market for outstanding residential mortgages in Australia burst through the $1.5 trillion mark, with annualised lending growth of more than 7% p.a. for 2015. Settlements reached a record of almost $36 billion ($35.95bn) in December 2015 and mortgages continue to account for more than 60% of our major banks' earnings.

The total market, together with monthly settlements, is shown in the residential mortgage lending – 2000-2015 chart below.

The chart shows the historical performance of mortgage lending growth. There was a clear 'ramp up' in settlements leading to the Global Financial Crisis. During the five year period from December 2007 to December 2012, mortgage settlements plateaued as households took stock of their situation and waited to see where the Australian economy would move.

Reassured with record low interest rates and employment prospects, especially in capital cities and for higher income earners, the mortgage lending market picked up and has shown strong growth from 2013 to today.

Residential mortgage lending 2000-2015



Putting the recent growth into context against long term metrics:

- The official cash rate is at 2% as at March 2016, compared with 6% in June 2000
- Unemployment is around 6% as at March 2016, a similar level to that in 2000
- Inflation is at similar levels in 2016 compared with 2000, at around 2-2.5%.

These fundamentals give confidence in mortgage lending decisions to customers, as well as lenders. While the debt to income ratio is the one metric to have deteriorated, from around 125% in 2000 to more than 180% in 2016, this is against a backdrop of interest rates being substantially lower. This debt burden is being disproportionately shared by higher income households.

From a systemic risk perspective, Australian banks have had to increase their mix of deposit funding to ensure greater liquidity and sustainability than in 2000. Recently capital levels have been the focus as has greater enforcement of responsible lending standards.

So if the mortgage market is growing strongly and there are positive fundamentals, where are the challenges of what tomorrow will bring, and can they be addressed today?

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Deloitte Mortgage Report roundtable

We asked a roundtable comprising the heads of mortgage lending from major, regional and non-bank lenders, brokers and, this year, fintechs, to give us their views on the challenges ahead.

Customer – while a mortgage is a product, the delivery and interaction with the customer is a service. In a world where the average consumer is more technologically enabled than ever before, it is an ongoing challenge to adapt service models to meet the expectations of consumers. So what will these expectations be, and when and how will consumers give lenders the right to engage with them?

A key insight from our roundtable is the timing and type of service engagement with mortgage customers. No longer can a lender expect to wait for the customer to approach them about the mortgage product; the customer expects to be engaged in their exploration stage, in their property search stage, and their aspirational saving stage. They want service delivery to match. Once the mortgage is taken out, customers have ongoing needs around the property which go over and above the mortgage product. So how can lenders meet these expectations and differentiate? That is a challenge for tomorrow, today.

Distribution – the evolution of the broker channel is one of the glowing success stories of the past 15 years. This highly personal channel has brought the consumer a service which is valued and sought after, and should continue to be so.

However if up to 50% of all mortgages are written through a broker, where are the other 50% being written? It is not likely to be in the traditional branch. It will increasingly be digitally – but what exactly this encompasses, is the challenge for lenders. Is it a straight through end-to-end mortgage service? Is it a hybrid digital and call/mobile/video enabled support? Is it omni-channel? All these questions will be being tested by the majors looking at the way the distribution preferences of customers are evolving.

Scale – while the early 2000s was marked with increased providers, recently scale is the focus. We have seen increasing vertical integration of brokers and lenders, the pressure on smaller regional players and credit unions to merge to remain relevant, and most recently the pressure on the non-bank and mortgage manager providers to survive.

With the constant pressure to invest in technology, to develop more sophisticated risk systems, to source and manage capital, and raise sustainable funding, scale will be the enabler. However with scale comes the risk of losing nimbleness and agility – especially for customer service. This is the challenge in the race for scale.

EXECUTIVE SUMMARY

Fintechs – decreasing customer friction and enhancing innovation is the fintech promise. And to a growing degree we are seeing some of this disruption in the payments and personal lending space in Australia, albeit this is still in relative infancy.

What then for mortgages? This product and the service around it, is the largest single financial commitment a household will make.

The sheer size of the relative funds being advanced, the risk being borne by the lender (and subsequently investors and shareholders) and the regulatory framework, means it is not so easy to disrupt end to end. However, a question to address include the 'sandpits' needing to be carved out, or the partnerships put in place to enable fintech development in mortgages.

This will be a combined opportunity for lenders, technology providers, fintechs and regulators to work together. The promise holds much more for tomorrow, than we are seeing today.

…and the role of housing wealth

Lastly, it has been a fascinating period entering 2016 and being part of the very public discussion about the role of housing wealth for Australians and the equitable treatment of the benefits for those able to own, or take out a mortgage on a home.

The home – the principal place of residence – has long held a sacrosanct position for Australians. It is both a home in which to raise the family, and a wealth creation asset.

From the principal place of residence not being included in pension eligibility testing for retirees, nor incurring any capital gains tax on sale, to investment properties providing negative gearing benefits for investors to offset broader tax liabilities together with concessional capital gains tax treatment, property has many financial advantages afforded to Australians at all stages of life.

Deloitte encourages the discussion about the very important role housing and mortgages play for the economy and Australian households as a whole

However, so too have other investment options. Superannuation savings have tax concessions and threshold exemptions which make it a favourable place for investment. Other broader tax related aspects around property such as land tax and stamp duty also exist.

So in these discussions about the role of housing and its benefits, there needs to be a consideration of all of these aspects in totality, rather than isolating the discussion to focus on one particular treatment.

This is a discussion which Deloitte encourages and we believe brings to light the very important role which housing and mortgages play for the Australian economy and Australian households as a whole.

In the following pages we trust you will find our 2016 Deloitte Australian Mortgage Report thought provoking, as well as an enjoyable and interesting read.

James Hickey
Financial Services Partner – Deloitte

Q

MARKET GROWTH

Loan originations grew by more than 15% in 2015, is such a rate sustainable in 2016?

RESPONSES:
(two answers selected)

2
No, I think 2016 settlements will reduce compared to 2015 settlements

1
I think 2016 will remain flat with 2015 i.e. 0% growth in 2016

2
Yes, 1-5% p.a. growth

3
Yes, 6-10% p.a. growth

1
Very much so, and I expect >10% growth in settlements to continue

James Hickey (Deloitte)
Loan origination growth is a good gauge of community confidence and our collective opinion for 2016 is for a positive 6-10% growth. Not as strong as 2014 (20%) and 2015 (15%) growth rates that were dominated by refinancers and recyclers.

Michael Russell (MoneyQuest)
Given the record levels of activity, I don't think settlement volumes are going to fall. People recognise unemployment is at an historical low and being confident about employment is probably the most significant driver to take a bit of a risk on purchasing property or upgrading your lifestyle.

Frank Ganis (Macquarie)
The question really is: How much of the expected 6% to 10% growth will be new originations versus refinance? Given the impact of recent regulatory recommendations and requirements, competition has been focused in the sub 80% loan to value ratio (LVR), owner/occupier market segment, and we endeavor to attract the right spread and quality of business to shape an appropriate portfolio. I believe 2016 will continue to be a competitive marketplace with regulatory changes bedded down by lenders with competition and pricing influencing market trends and growth.

Lisa Claes (ING Direct)
I agree. The activity will be very much around the refinancing cohort. Today we're seeing what once was heresy – out-of-cycle rate changes – now becoming the norm. Borrowers will become more fluid as they shop around for a better deal. Pricing will increasingly be determined by the type of loan quality banks want to attract to their books.

Patrick Tuttle (Pepper Group)
As a representative of the specialist mortgage market[1], I'd add that with all the regulatory capital changes going on, there is a huge opportunity for us. We expect above system growth this year, given our record November and December volumes combined with a strong start in the new year in terms of pipeline. Our challenge is to make that sustainable. We think we can, particularly as traditional lenders remain constrained by ever-changing regulatory capital requirements.


Patrick Tuttle and Lisa Claes

Malcolm Watkins (AFG)
I believe we will see closer to 5% growth. The uncertainty around the economy and the potential for sliding property values in a few states like Western Australia, will slow down refinancing and may have an effect on growth. But there are opportunities for some e-lending and particularly innovation, on procuring finance more quickly and more elegantly. I think the market will open up. There's a big space in personal lending, and the SME space and the mortgage market will remain constant. There is a lot of opportunity happening.

Lisa Claes (ING Direct)
Growth is always good, however share of wallet is more attractive, and a mortgagee certainly has ascendency in the wallet. At ING Direct, we're not obsessed with growth purely for the sake of growing market share. We do however work hard to attract a steady stream of mortgage customers to both build the balance sheet and expand share of wallet, with the other ancillary products that borrowers require. Ultimately this leads to a more robust and sustainable business and a better outcome for the customer.

1. Servicing self-employed borrowers, and people seeking debt consolidation, who may have minor adverse credit.

Q

BORROWERS

Which borrowers will benefit most from the opportunities in the mortgage market in 2016?

RESPONSES:
(two answers selected)

8
Re-financers will continue to take advantage of low rates

7
Existing owner occupiers as interest rates are used to differentiate from investors

2
First home buyers as clearance rates fall

1
Non-prime borrowers as lending and competition increases in this market

NOT CHOSEN
Existing investors – the recent interest rate rises for investors are not a concern given the other incentives to own investment property

James Hickey (Deloitte)
There's no surprise that refinancers and existing owner occupiers are taking advantage of low rates and property growth, but it's still a challenge for first homebuyers. As no-one chose existing investors, obviously the feeling is they will not be looking to re-enter the market with another investment property, or is it just becoming more challenging for investors to really benefit?

Patrick Tuttle (Pepper Group)
Many existing investors are not qualifying for new mortgages under the restrictive changes to investment loan criteria implemented by most lenders. This will inevitably constrain the growth of new investment lending in 2016. That said, investment lending will still represent a material percentage of the mortgage market, and a significant portion of each lender's total portfolio.

Malcolm Watkins (AFG)
Although the changes to investment lending happened fairly quickly, our volumes continued to grow. Our brokers just diverted their attention to upgraders and the first homebuyer space. I think the big changes to investor rules last year created an unjustified fear about exposure in the investor market. As a result, 2015 was a year of adjustment for both borrowers and lenders.

Frank Ganis (Macquarie Bank)
Given that investment loans are tax deductible, small interest rate increases should not dramatically impact an investor's thinking. Though the challenge of course for first homebuyers is affordability, particularly in Sydney and Melbourne's property markets.

Michael Russell (MoneyQuest)
'Rentvesters' is a new term for those who buy for investment, and rent where they want to live, for lifestyle.

Will Rankin (ANZ Bank)
We actually call them 'first time buyers' because at that point whether their first property is an investment property or a first home, when we look at those groups together they become a 'first time buyer'.

In our loan book, this group is actually growing faster than the owner occupier space. They are looking for a number of different ways to overcome the increasing barriers. Despite the increasing difficulties first home buyers remain motivated and for us it's about coming to the party with prudent measures that meet their needs.

Lisa Claes (ING Direct)
As a parent of three millennials, I have some concern around affordability (or unaffordability). The supply and demand metric will continue to play out as the Eastern seaboard remains a hot place to live irrespective of whether a 5%, 10%, or 15% deposit is required.

The regulatory focus on capital in the credit risk space is linked to quality, with the loan to value ratio (LVR) being the strong proxy. As a lender, I am stimulated by the challenge for increased product innovation. And I don't believe we've scratched the surface yet.

The Australian psyche is to 'live in and own our own home', unlike Europe where only 50% of the population owns their home. The question is therefore, how do we change the 'Dickensian' constructs of property ownership in Australia to mitigate the affordability burden?

James Hickey (Deloitte)
There are many legal constructs as well. A lot of households – that comprise children, parents, and grandparents – only have an individual on the legal contract and hence that individual's serviceability capacity. So is there an opportunity there for innovation to help people leverage a broader household balance sheet?


James Hickey, Will Rankin and Chris Wilson

Malcolm Watkins (AFG)

Loan to Value Ratio (LVR) is a big issue with first homebuyers, especially with rising property values. If you want to live within 20 miles of the city, you really have to be a 'middle income' couple to be able to a) save the money and b) service the loan.

First home buyers or those borrowers entering the market with minimal spare funds are very sensitive to the 'buy-in' price and the costs associated with acquiring a loan.

Chris Wilson (Deloitte)

It's also about how early can you get people involved in the process. When I think about superannuation, it is exactly the same challenge.

By setting expectations for say a 16-year-old, that there are assets that they will need over the course of their life, you can help them understand early on that they're saving for a purpose. It is not just a savings account.

Lisa Claes (ING Direct)

The demise of first homebuyer accounts was a shame. If it had been embraced (or regulatory mandated) more broadly like the Superannuation Guarantee Charge (SGC) in the super space – you could have had a levy for your first home when you commenced employment and started saving for your deposit.

Chris Wilson (Deloitte)

Investments now could be about creating products where there is the optionality to buy into property. By investing in options now you could structure a product that you could cash in when you are 30 or 40. There is an interesting product innovation discussion that needs to happen.

Lisa Claes (ING Direct)

I agree. I also like the idea of creating new legal constructs beyond joint and tenancy in common to leverage multiple balance sheets as raised by James Hickey.

Q

REGULATION

What is your biggest concern for the mortgage market in 2016?

RESPONSES:
(two answers selected)

3
Unemployment rising placing pressure on serviceability

3
House price growth reducing or falling

3
Risk of any inappropriate lending tainting the industry

4
Regulatory focus on investor lending stifling growth

5
Prudential policy implications on capital pressuring prices

James Hickey (Deloitte)
Kevin, I am keen to get your thoughts around our biggest concerns for the market in 2016? The two responses that stand out are regulatory focus and prudential policy implications on capital. Can you give us a quick update on where the landscape in 2016 might go?

Kevin Nixon (Deloitte)
We are all familiar with the Murray recommendation to get internal model banks closer to standardised model banks.

That recommendation was not made in a vacuum, and in fact the FSI final report refers to the international developments underway. APRA Chairman, Wayne Byres, when making his statements around the IRB risk weights, also refers to the comprehensive rethink of the Basel framework that is going on at the moment. Although the Basel Committee resists calling it Basel IV, preferring to think of it as adjustments to the Basel III framework, the reality is it's a fairly fundamental shift.

Credit risk and capital weightings

The debate about internal models started two years ago at Basel. It was triggered by analysis of the variance between banks using internal models for the same hypothetical portfolio and getting very different answers.

As the Basel Committee dug deeper it became increasingly concerned. In Australia we have focused on mortgage risk weights, but the global discussion is all about credit exposures. The current work – intended for completion during 2016 – focuses on every credit risk a bank has.

This international work on credit risk will impact mortgage capital calculation in three ways:

1. The new standardised Basel consultation paper that was recently published outlines new standardised calculations for mortgages.
2. A consultation paper on internal modelling in banks, due in the first quarter of this year, will propose constraints on the parameters to reduce the variance across internal models, including those for mortgages.
3. A consultation paper due later this year will detail the level of a floor. This is where banks will have to calculate their numbers on a standardised framework and then calculate their numbers on an internal model framework. The internal model framework won't be allowed to produce numbers below a fixed percentage of the standardised approach.

   A number often proffered is 80%. In other words, internal model numbers used for regulatory capital can't be lower than 80%, which will have the net effect of increasing capital for the internal model for banks. The actual number is far from final and will not be known for sometime yet.

APRA – national timing

The approach to internal modelling and standardised models is still being decided at a global level. However on mortgages, APRA has already moved by adjusting the internal model calculations such that they achieve an average mortgage risk weight on their portfolio of 25%. The Murray recommendation was a range of 25%-30%. This was announced as an interim move. As the global picture becomes clearer we should expect further changes in Australia.

Standardised model

The current Basel framework requires that standard mortgages should have a minimum risk weight of 35%, with discretion for national authorities to go higher, and a second weight of 75% for non-standard. So the only existing weight in Basel for standard mortgages is a minimum of 35%. APRA currently has a scale from 35% to 100% for standard mortgages. So it is important to note that we already have a framework that has higher numbers than the existing Basel minima.

The new proposed Basel framework provides a sliding scale of risk weights relative to LVR for standard mortgages with a range of risk-weights for loans of less than 100% LVR from 25% to 55%. This is against the existing flat rate of 35%. So some Basel risk weights have gone down and others have gone up, and again these are minima.

One should not therefore automatically assume that this means there will be any changes to current standardised APRA risk weights as a result of the Basel proposal.

Basel encourages national authorities to set standards above the minima if it is prudent for their banks and markets. In Australia, APRA does so for mortgages

Kevin Nixon and Frank Ganis

The Basel table certainly provides market participants with an argument for changes to those APRA weights. But APRA is under no obligation to change, and in fact Basel encourages national authorities to set standards above the minima if they believe it is prudent for their banks and market circumstances. And as noted APRA already exercises that discretion for mortgages.

Investment loans

Basel has singled out loans that are materially dependent on rental income for the servicing of the loan.

Patrick Tuttle (Pepper Group)

That's already having an impact in the UK mortgage market. We provide loan servicing to a large proportion of the UK residential mortgage market and are already aware of a potential buyer of a 'buy-to-let' portfolio withdrawing from a recent sale process due to the Basel Committee's recent announcement that it will apply a higher risk weighting to loans which rely on a rental income stream to service the loan.

Kevin Nixon (Deloitte)

Although there has been some press speculation that this will only apply to 2% of investor loans, it has yet to be defined. Another consideration is whether the investor needs to sell the home to repay the loan.

An interest-only loan could be classified in that area as well. That will take the risk weight for an LTV loan of between 60% and 80%, up to 90%; and if the LTV is greater than 80%, that risk weighting is 120% compared with a proposed standardised between 35% and 55%.

'Materially dependent' has not yet been defined, and is something to watch very, very closely. The distinguishing characteristic is the positive correlation between the prospects for repayment of the obligation and the prospects for recovery in the event of default.

Both depend materially on the cash flows generated by the property. The announcement[2] says the primary source of these cash flows would generally be lease or rental payments or the sale of the residential property.

Lisa Claes (ING Direct)

To service any mortgage where the term of the mortgage would exceed the borrower's period of earning, one would need to have significant lazy equity or deep pools of cash equal to the value of your borrowings. This is problematic for most.

Finished property vs under construction

Kevin Nixon (Deloitte)

The discussion we have had here so far applies to finished property. The Basel proposal now holds that for unfinished property (with an exception for one to four housing units on a property that will be the residence of the borrower) there will be a flat minimum risk weight going forward of 150%. This is a significant jump, and is well above the risk weight for general unsecured retail exposures of 75%.

Malcolm Watkins (AFG)

What this actually means is that it will impact fairly heavily on a large part of our employment base – the construction industry. So although the regulators may think they are protecting the health of the banking industry, their decisions could have a material impact on the health of the economy.

The problem is when you take a global viewpoint Australia doesn't sit in current global economics. We have to make sure our regulators see that.

The mortgage broking sector is highly regulated, and justifiably so. All broker mortgage deals are placed under tough scrutiny, and brokers are heavily regulated by ASIC and NCCP[3] laws.

A viable mortgage broking sector is crucial for retaining an element of competitive pressure in the mortgage market. All Australians currently have access to a 'free' mortgage broking service where the fees are fully disclosed, reasonable and provide real choice and competitive tension.

Many of Australia's smaller banks rely on mortgage brokers to act as a de facto distribution network for their products. If mortgage brokers had to apply a fee for their services, not only would their services become expensive and potentially out of reach for customers, but the products of smaller banks would no longer be competitive.

Just as importantly, without the diversity of the underlying mortgage assets particularly in terms of customer type and their location, the ability of these smaller financial institutions to attract ongoing funding at commercially competitive terms becomes hindered, thus driving a lack of competition in the market place.

2,3. NCCP – National Consumer Credit Protection

The Government has asked APRA to take additional steps in 2016 towards the ‘unquestionably strong’ goal


Patrick Tuttle


Frank Ganis

Patrick Tuttle (Pepper Group)
Also the Basel Committee is now advocating a position which requires bank warehouse facility providers to rely on external ratings provided by the rating agencies, despite the rating agencies being at the centre of all the pre-crisis problems.

My concern is that if the banks can’t be trusted to do their own sophisticated internal modelling, the regulations will dumb the market down to the lowest common denominator (in this case a rating agency), which will drive inefficiencies in the market and reduce competition.

Frank Ganis (Macquarie Bank)
We would expect that the re-pricing cycle for mortgages that started some six months ago across the industry will continue.

Kevin Nixon (Deloitte)
There is another reason as well. The Government’s response to Murray said quite clearly that it wants banks to have unquestionably strong capital.

The round of mortgage risk weight changes at the end of last year added about 80-100 basis points equivalent of capital. The Government has asked APRA to take additional steps in 2016 towards the ‘unquestionably strong’ goal, so in addition to changing how mortgages get calculated, there is the potential for further pressure for banks to hold more capital overall.

Q

HOUSE PRICES

What's your prediction for house prices in 2016?

RESPONSES:

2
Continued growth, but at a lower level than 2014-15

5
Growth plateauing for 12 months

1
Slight down-turn across all of Australia

1
Fall in Sydney and Melbourne, flat across the rest of Australia

NOT CHOSEN
Significant downturn across the country

NOT CHOSEN
Continued growth, comparable to, or higher than 2014-15

James Hickey (Deloitte)
A hot topic is always the direction of house prices. This is especially difficult with such a diverse population and geographic spread as in Australia.

I'd like to ask one of our fintech CEOs, Josh Rowe, who is: "talking to the people who are thinking of buying a house long before everyone else is, by offering predictions of residential property prices through the RealAs.com website." Josh what is your analysis and focus on the market and prediction for house prices across the board, including regional Australia?

Josh Rowe (RealAs.com)
As far as property price goes there's been a downturn in a number of markets already. *RealAs* has been running its data to predict for four years now. We've been on the market for a year and a half, looking at what's been happening across the whole property market, as well as from suburb to suburb, and at state level.

There are also differences between what happens in metro versus regional areas. There are no surprises with the links to unemployment, to mining towns shutting down etc.

As far as Sydney and Melbourne go, properties are still selling despite talk of reduced clearance rates. Properties are selling after the auction, so the price isn't changing that much. Melbourne is slightly stronger. So I see growth plateauing for 12 months.

Luis Orp (Resimac)
We saw a slowdown in the growth of property prices at the end of 2015. However there remains an increased demand for mortgage finance, even though the economy is cautious due to uncertainty overall, with various sectors such as the mining sector not doing well.

How will this play out in state and regional property prices?

Josh Rowe (RealAS)
The challenge is there are at least seven property markets in Australia. There are very good statistical reasons why the last 12-18 months in Sydney has been a catch up over ten years, returning to the same kind of levels in terms of income serviceability and debt to household income ratios. WA on the other hand has an oversupply of housing and net migration. Both Tasmania, and South Australia have had very poor performance and very poor prospects as well.

Graham Mott (Deloitte)
Do you think APRA's investor lending action, which applied across all investor lending, was targeted at house prices in Melbourne and Sydney? Was that the right action or should they have made it more targeted at the geographic differences?

Frank Ganis (Macquarie Bank)
Applying or adopting different lending criteria to different geographies would be very challenging. Regulators play an important role and do a great job, however ultimately the responsibility for maintaining prudent lending policies and parameters rests with lenders.

Michael Russell (MoneyQuest)
The only way property prices correct is if people are forced to sell. Presently there is plenty of work. Small businesses and housing are both doing well.

Frank Ganis (Macquarie Bank)
The reality is that home ownership in Australia is two-thirds owner occupied and one third investor. Of the two-thirds owner occupied, half are debt free with no mortgage, and since 2008 consumers and borrowers have been paying off debt with little, if any, accumulation.

The reality is there are at least seven property markets in Australia

Josh Rowe

*Deloitte partners **Graham Mott** and **Heather Baister** explore the outlook for funding in 2016.*

Funding: a sticky challenge?

Funding, and its impact on the Australian residential mortgage market is an area of focus as market participants and commentators analyse whether the slow start to 2016 is a precursor to a tough year ahead. Although the funding markets have come a long way since the financial crisis, access to liquidity is sensitive to global political and economic events. So what was the impact of the events of the last 12 months on mortgage originators, both ADIs and non-bank lenders, and how will this impact both the competitive landscape and consumer over the next year?

Impact on Net Interest Margin (NIM)

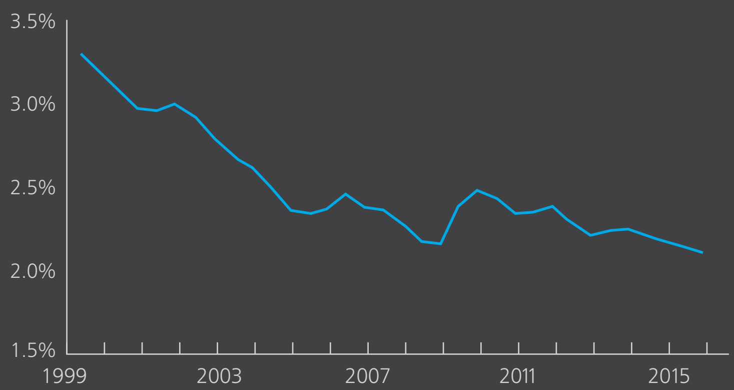
With the cash rate falling in early 2015 and reduced again mid-year, the two key challenges for banks was the management of margins and continued pressure to deliver expected returns on equity (ROE). Despite the out of cycle rate increases designed to protect NIM and buffer the impact on capital from regulatory change, average ROE fell slightly for most banks in 2015 as a result of increased competition and wider funding spreads at the end of 2015. NIM fell by almost 5bps between December 2014 and December 2015 across the majors.

Although there are a number of distinct factors that influence margins, this year, unlike many previous years, the developments do not appear weighted in favour of the largest market participants. This is contingent of course on the wholesale funding cost increases in early 2016 not being too prolonged. If they level off, we expect a commensurate levelling of the playing field ahead.

Deposit pricing

Given the major banks currently rely on deposits for 60-65% of their funding needs, how they manage their deposit pricing continues to dominate funding trends.

Figure 1: Major banks' net interest margin*
(domestic, half-yearly)



*From 2006 data are on an IFRS basis; prior years are on AGAAP basis; excludes St George Bank and Bankwest prior to the first half of 2009. *Sources: Banks' Financial Reports; RBA*

The introduction of the new liquidity coverage ratio (LCR) in 2015 – designed to ensure that financial institutions have the necessary assets on hand to ride out short-term liquidity disruptions has changed the nature of a 'desirable' deposit for banks.

Sticky retail customer deposits are now highly desirable, which has meant bonus offers on many savings accounts that are in excess of those being offered on term deposits.

By contrast, there is little commercial incentive for the banks to compete aggressively for wholesale deposits given their requirement to cover such funding with 100% High Quality Liquid Assets (HQLA) under the new rules.

Since the beginning of 2016, a number of banks increased rates on term deposits to provide funding diversity and counter the increased funding costs in the wholesale market.

Throughout 2015 and expected to continue in 2016, there have been greater penalties for any early redemption of term deposits to improve their 'stickiness' and deter customer driven redemption.

There has also been change in the deposit mix with growth in transaction deposits

Australia's macro economic conditions support a continued strong outlook for the housing market

(traditionally a low earning deposit account) as borrowers have utilised the availability of interest offset accounts which have been growing rapidly.

Utilising this structural feature allows customers to use their funds to save on interest charges given the rates charged on mortgages are significantly higher than those earned in a traditional deposit account. (See Figure 3)

Wholesale funding

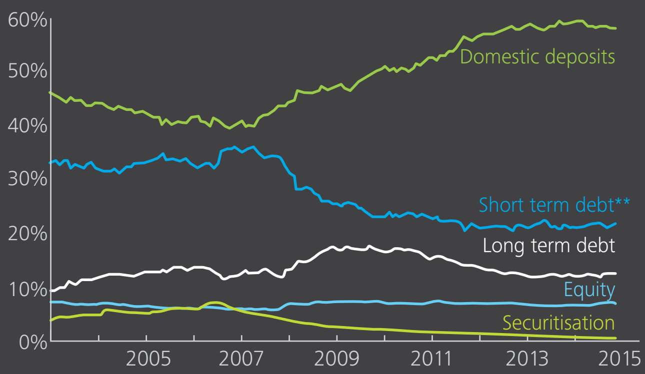
The trend of tightening spreads on wholesale funding continued throughout Q1 to Q3 in 2015, reversing in Q4 2015 and early 2016, as uncertainty over the downturns in the Chinese economy impacted the debt markets and spreads began to widen by around 20% between November 2015 and February 2016.

While these events are not welcomed by the market, and remind us of the susceptibility of funding to global political and economic events, the macro economic conditions in Australia, with its relatively low unemployment rate (6%), net immigration and minimal credit loss history, support a continued strong outlook for its housing market. Albeit at normalised growth rates, rather than the tremendous 20% rates seen in 2013-2015.

This quality collateral supporting Australian ADI balance sheets, should equate to continued demand for wholesale product, though it may be at a higher price, given global economic factors.

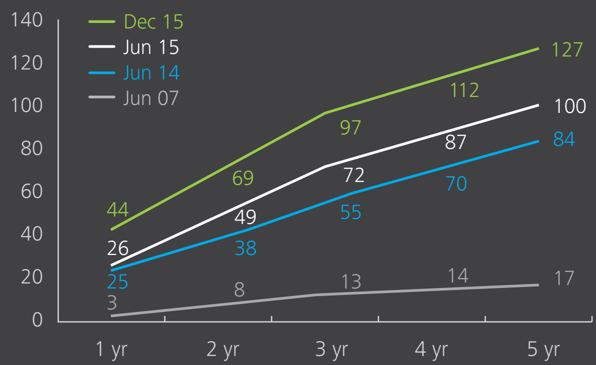
Inevitably, if the widening spreads continue through 2016, these costs will be borne by the underlying customer, or be at the expense of ROE.

Figure 3: Funding composition of banks in Australia*
(share of total funding)



*Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Figure 4: Indicative funding cost curves
(margin to BBSW, bpts)



Given banks' recent willingness to move their interest rate adjustments out-of-cycle, we suspect consumers, rather than shareholders, (though these can be and often are one and the same), will absorb much of the increases in cost.

Over the mid-term, if the relatively benign system growth is compounded by high mortgage prepayments, we expect protecting market share will become increasingly important, with banks concentrating on improving total value per customer (rather than simply mortgage NIM) by doing their best to increase the number of products and services per customer.

Despite the recent increase in wholesale funding costs, banks continue to benefit from the roll-over of the expensive term funding raised in 2011-12, when spreads were considerably higher. However this benefit is rapidly eroding. The graph in figure 4 shows the increased funding spread payable as at February 2016 compared with six months earlier.*

Basis risk, which results across all funding sources from the standard variable rate mortgage tracking the cash rate, whereas wholesale funding is priced as a margin above the Bank Bill Swap rate (BBSW), also increased in 2015 and 2016 to around 30bps, making the cost of basis swaps more expensive.

The same can be seen in cross currency swaps pricing for offshore issuance and is becoming increasingly significant to ADI treasury departments. Figure 5 below shows how a major banks' blended funding (wholesale unsecured and secured) curves have changed in recent years. Additionally, short term wholesale funding has diminished significantly, as ADIs reacted to the LCR rules by limiting its use given it requires 100% HQLA coverage.

Securitisation as a funding mechanism

The Australian RMBS and ABS markets were also strong throughout the first three quarters of 2015 with large issuances from major banks. However this then slowed significantly in Q4 2015 as debt markets became volatile. The first RMBS issuance of 2016 by CBA was $1.6bn compared with their initial issuance in 2015 of $2bn.

There was also a significant widening of spread of 50bps to 140bs over the corresponding period (albeit for slightly longer tenor). We are aware of other RMBS deals coming to market at slightly tighter spreads, but they are still expensive compared with 2015. (See figure 6)

Non-bank lenders need to be able to continue to access the securitisation market and will be impacted more than the banks by a prolonged rise in spreads, as they lack the flexibility to use increased deposit funding or covered bonds, to tide them over. However they often have borrowers who are less able to refinance quickly in response to increases in rates, and can therefore protect margin through customer pricing.

The largest non-bank lenders in Australia continue to have strong support from ADIs, with healthy warehouse capacity and a proven track record of delivering on their issuances, including calling all deals on time. The strength of the non-bank lender industry is important for consumers, as they are often the more flexible and agile originators, as well as being the source of much of the product innovation in the Australian market historically. This is demonstrated by continued investor support for non-bank lender issuances in early 2016.

Figure 5: Average long term funding costs (margin to BBSW, bpts)

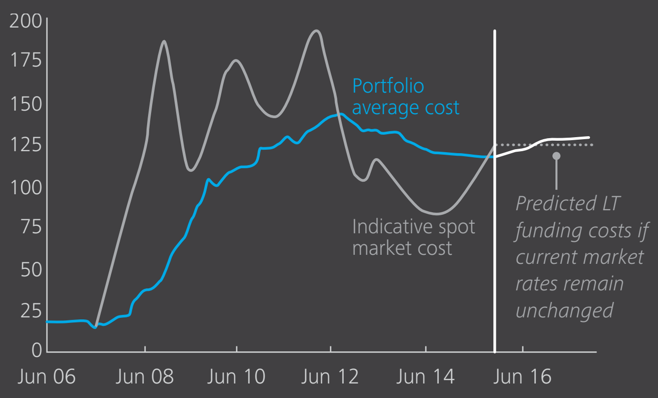
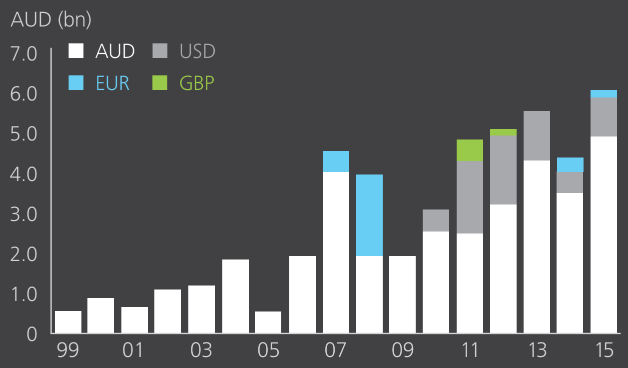


Figure 6: Australia ABS issuance (AUD)



Source: Macquarie Debt Markets Analysis © Macquarie Bank

* Source: CBA Investor Presentation Feb 2016.

The competition for customers means originators continue to keep mortgage rates low and pressurise NIM

The securitisation industry also received a boost towards the end of 2015, with the proposed revision to APS 120 *Securitisation* announced by APRA, which will likely support the issuance of master trusts. Master trusts have the advantage of allowing date-based calls, which in turn reduce swap costs and provide greater certainty to investors. As a result, the securities issued are attractive to a wider range of investors than the traditional pass-through structures used by Australian RMBS. Additionally, the costs of setting up a program can deliver benefits over a longer period, as master trusts can be used on a revolving basis to avoid the need to continually tap the market.

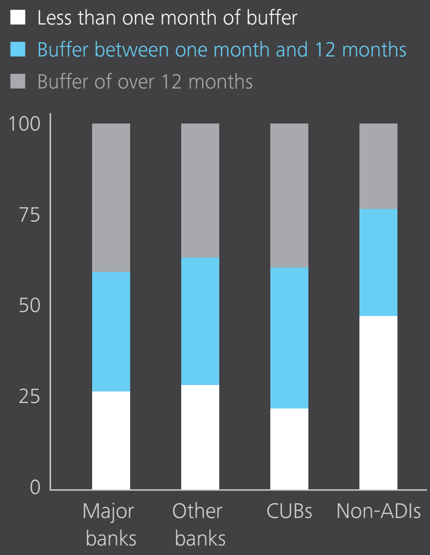
We think master trusts will be less appealing to the small ADIs due to their complexity, and need for a strong pipeline of mortgages required to access the cost benefits of the structure. We therefore envisage small to mid-tier ADIs to continue to be more reliant on basic wholesale funding and deposits.

APS 120 will also impact non-bank lenders through the likely rise in the cost of warehousing as a result of the capital implications on banks providing that funding. Market participants have indicated that this will be approximately 20 bps across facilities, although it should be partially offset by improved liquidity and investor appetite resulting from the ability to use date based call features.

Competition and customers

During 2015, competition among all players for new business was so intense to counteract the low system growth that resulted from continued high prepayment rates (CPR). Customers continued to use the low interest rate environment to pay down their loans, particularly through off-set accounts, and grow increasingly savvy as to how best to use them instead of traditional redraws or P&I pay down structures, when they required flexibility. Offset accounts grew faster than any other type of account in 2015 and currently make up approximately 6.5% of at-call transaction accounts.

Figure 7: Repayment buffer (marketed RMBS; share of value of loans; includes offset account balances)



Customers are also continuing to access the benefits of the low interest rate environment by paying down their loans faster than their contractual obligations. At the end of 2015, two thirds of borrowing was covered by at least one month's repayment buffer. And for around a third of the loans for which data was available, the buffer was greater than 12 months.**

This demonstrates some of the capacity of borrowers to absorb any potential, albeit modest, near term interest rate rises and is a strong indicator of the serviceability of loans. (See Figure 7)

The low wholesale funding costs in mid-2015, that assisted in narrowing the gap between major bank spreads and non-ADI spreads, benefitted customers through enabling market participants to offer low mortgage borrowing rates, reflecting the aggressive pricing and increased competition (particularly in the mid-tier ADI space).

The competition for customers has meant originators continue to keep mortgage rates low and pressurise NIM.

** RBA speech 'Some Effects of the New Liquidity Regime' 16 December 2015

Major banks have focused on growth of market share, and together with other ADIs, done so through enhancing broker relationships as well as analytics to identify how to reduce refinancing. Upfront broker commissions have increased since 2014, and many ADIs are now focusing on the speed and quality of service they provide brokers in an attempt to differentiate the value proposition for customers.

This has enabled above system growth for a number of mid-tier ADIs like CUA, AMP and Macquarie, and some highly competitive prices for borrowers, with discounted variable rates of under 4% offered by a number of market participants.

Throughout 2016, there will need to be some careful thought given to the on-going pricing strategy as a number of ADIs have had to attract and raise deposits or tap more expensive wholesale funding markets in order to finance increased growth. Again this will create further pressure on NIM as the more profitable back-book continues to pay down.

Regulatory developments

During 2015, APRA announced an increase in the amount of capital required for Australian residential mortgage exposures by ADIs accredited to use the internal ratings-based (IRB) approach to credit risk. This included the major banks and Macquarie.

This change will mean that these dominant lenders in the Australian property market will increase their average risk weight on Australian residential mortgage exposures from approximately 16% to at least 25%.

This will result in narrowing the advantage that the IRB banks have over the rest of the market which, for ADIs, use a standardised risk weights calculation consistent with the direction of the global Basel changes.

The impact will take effect on 1 July 2016, although the major banks have already increased their capital reserves to be well positioned for the change.

APRA estimates the impact of the changed requirement to be approximately 80bps on minimum capital currently held for the IRB banks. This announcement was widely expected, and is seen as a boost to the regional and mid-tier ADIs which have long held the view that the IRB banks enjoyed an unfair competitive advantage. It will be seen to level the field and improve customer choice.

Summary

Twelve months in from the LCR introduction, the effects have impacted bank pricing liabilities, particularly short term wholesale funding and deposits. With interest rates forecast to remain low in the near term, credit growth is expected to continue at a steady and reasonable rate of around 5% throughout 2016.

The majors are expected to keep one eye squarely focused on global markets including the US, where the first US cash rate increase in nearly a decade occurred in 2015. The major ADIs will focus on efficiently managing their assets and liabilities, and particularly their deposit mix and pricing, with capital management increasingly under scrutiny.

Mid-tier ADIs have a real opportunity with the capital changes benefiting their competitive position. They will need to carefully weigh up growth against profitability, particularly now 2016 funding spreads could erode the relative improvement from capital changes.

For non-bank lenders, while still largely reliant on wholesale markets, the opportunity continues to be in the near prime rather than prime sector, where a premium can be priced-in, due to less competition from the banks.

Customers should continue to benefit from competition in the market, though interest rates cannot stay this low forever. However the high levels of prepayments and the increased focus by APRA on serviceability, demonstrate that there are sufficient buffers in most portfolios to ensure the continued strong performance of the Australian mortgage market, and its funders.

The buffers in most portfolios are sufficient to ensure the continued strong performance of the Australian mortgage market, and its funders

Q

INNOVATION

Where will innovation drive change in mortgages in 2016?

RESPONSES:

3
Improving the customer experience

3
Greater use of client data to individualise offers to customers

1
Reducing cost in the service and delivery of mortgages

1
New products emerging to address serviceability challenges

1
Related consumer services around the primary mortgage

James Hickey (Deloitte)
Damian, given the majority believe that innovation will improve the customer experience, and given that the potential of fintechs to change and innovate in the market, what do you think fintechs are doing around improving the mortgage experience for the customer?

Damian Horton (Huffle)
There are a couple of different types of fintechs emerging around improved customer experience. Some are very data driven to provide a better customer experience, or they collect data in innovative ways. Others focus more on the financial process. As innovation builds, we are gathering new customer data and identifying new ways to offer a better loan product.

Huffle for instance is scheduled to bring new products to market this year and sees a lot of opportunity in the product space. An obvious comparison is the 25-year fixed rate pre-payable loan available in the US versus just five years in Australia – the upper limit of what most lenders are willing to fix, without significantly higher rates. And in Australia, borrowers still effectively face a prepayment penalty if they pay early.

Now there's a difference in the mortgage structure between the US and Australia, but as lenders struggle to differentiate, there is an opportunity to offer a new product. Although the capital requirements and market make it harder to structure due to fewer distribution models being available compared with the US. The innovation for fintechs will be around who will bear the risk and where it goes to.

Frank Ganis (Macquarie Bank)
Having spent a fair bit of time working and reviewing a number of offshore markets, and experiencing scenarios when borrowers could complete the process of application, valuation, contract execution and settlement of a loan in a short timeframe of just hours, there are challenges which would need to be overcome before this could be applied in our market.

Lisa in your capacity as the chair of the Global Mortgages Forum for the ING Group, what do you see coming out of Europe at the moment?

Damien Horton

Lisa Claes (ING Direct)
When it comes to capital, the European markets are further advanced than we are in terms of the evolving capital landscape. Equally, in many offshore markets' mortgage distribution is more regulated than it is in Australia. Some markets mandate fee-for-service or fixed commission models.

Apart from remuneration, the banks in Europe use digital more intrepidly to partner with intermediaries and customers, and to improve the customer experience, whether that be at the onboarding stage, or throughout the maintenance stage. Banks attract the borrowing and broking customer by performing aggregator type services in the provision of software and education services to the broker.

We tend to think of Europe as being very traditional. I can assure you it is not. For instance in the SME business segment lending through APIs and open databases providing a customer with instantaneous access to credit, has been occurring for quite some time.

Q

INNOVATION

Who will drive innovation in mortgages?

RESPONSES:

2
Existing non-financial institutions (supermarkets/ Amazon / Google etc.)

3
Non-banks

3
New technology-driven market entrants

1
Major banks

NOT CHOSEN
Regional banks

Michael Russell (MoneyQuest)
We've been hearing about the data and digital revolution for 15 years in the mortgage industry, but in terms of delivering new innovative products, we haven't seen much. In terms of the customer experience in third party, turnaround times from submission to unconditional approval remain largely unchanged.

Brokers have certainly done their bit, investing heavily in online submission capability, process efficiencies and post settlement customer contact optimisation. But alas we still only achieve less than 40% system generated submission to conditional approval.

And at the other end, it still takes 60 to 90 days on average to settlement which hasn't moved for decades. Prior to NCCP[4] legislation, it would take a broker maybe two to three hours to meet the client, assess their needs and capacity to service and submit a loan application.

Today it can range from four to eight hours depending on the broker group and technology supplied.

In summary, technology and innovation have not really helped us to deliver a better customer experience. If you look at peer to peer in the American mortgage market and our mortgage market, you look at two very different cultures. The difference is customers' aptitude or readiness to trust beyond traditional banks.

Will Rankin, Chris Wilson and Josh Rowe

Malcolm Watkins (AFG)
The banks in the US can be more direct. They can use direct mail very accurately. If they want to send an offer only to doctors in a particular postcode they can do so.

Our privacy laws prevent such access to customer information and you cannot make a specific offer of finance to a customer without proving you know the customer in the first place. Mortgage brokers are an invaluable customer contact resource in Australia.

Lisa Claes (ING Direct)
As banks we have the expertise on risk and access to deep pools of customers and their behaviours. At a fundamental level we also have the intelligence around analytics. But we need to be smarter about how we utilise these tools to better serve the customer as the customer appetite is shifting dramatically.

Frank Ganis (Macquarie)
Technology and digital are critical for every business that has aspirations to grow. You need to be in a position to push and pull information digitally, effectively and efficiently with customers, or you risk being left behind.

For example, Quicken is regularly highlighted as being potentially the fastest growing mortgage business in the US. But with the opportunity to understand the operation and process applied, it benefits from a competent group of professional sales and service executives who personally support the digital footprint and activities of the business.

The combination of digital supported by the 'human touch' is why the Quicken offering is so compelling.

Malcolm Watkins (AFG)
Consumers are now seeking a trusted resource in the middle to validate their decisions and be the 'go to' point through the application and settlement process.

4. NCCP – National Consumer Credit Protection

Frank Ganis (Macquarie)
Absolutely. Financing a car is comparatively simple. If the consumer gets it wrong, they can still fix it. But when considering perhaps what may be the most important emotional financial decision a family makes, buying property – whether a home or an investment – that is different.

Chris Wilson (Deloitte)
The danger is that to date digital has just facilitated the existing process. Customers are starting to say: 'Don't just use digital to make an existing process better'. We can go for the low hanging fruit and turn three months into five minutes, which is fantastic.

But how can we manage the emotional attachment digitally? Going to a bank for a $500,000 mortgage – that is a big decision – and the attachment is to what I'm buying, not to the person giving it or financing it.

So if you can use digital to make the customer quickly feel they have made a good financial decision, that's the secret. They are not actually emotionally attached to their bank. They are buying their home. If they make a mistake buying the home it's because they bought the wrong home.

There's a real estate agent behind that decision along with a whole marketing process. The danger is confusing these two things and seeing them as the same thing.

If a person can get a $500,000 finance decision done well digitally and quickly that's great. The people they really need advice from though are buyers' advocates or real estate agents, or their family. There is a huge culture of listening to and trusting friends and family.

Malcolm Watkins (AFG)
I believe our future customers will still want a fulfillment service. They will use comparators, the internet, and gather the information to refine their decisions but will seek validation of those decisions and want a go to point if they need more help along the way.

Lisa Claes (ING Direct)
Absolutely they want validation. I think that's the evolution of the intermediary, to diversify, and become more of a validator should the appetite for delegation wane.

Malcolm Watkins (AFG)
They already are the trusted contact for validating customer research, but just as importantly they provide the personal contact point during the application through to settlement process.

They are the customer service centre that needs to endure past settlement, ensuring the customer receives everything they require, as well as any future needs.

Damian Horton, Malcolm Watkins and James Hickey

Jenny Wilson

A CONVERSATION ABOUT INNOVATION AND CUSTOMERS

*Passionate customer advocates **Jenny Wilson** (Deloitte Customer lead) and **Lisa Claes** (Executive Director, Customer Delivery ING Direct)*

Lisa Claes

Lisa Claes (LC): There are three main ways you can innovate in Financial Services:

1. Products
2. Customer experience
3. Segments.

The single or party of one segment is a sleeping giant. Recent statistics show that, whether by choice, divorce, longevity, etc., this cohort, which in the USA is traditionally around six to seven percent, is predicted to reach 20% to 21% in the next 25 years.

Other industries are already way ahead catering for the rise of this party of one. The travel industry for instance is beginning to cater for singledom and develop ways to serve this new segment.

In Financial Services, we largely default to the concept of the nuclear family – a construct that will become the minority. The one size fits all mentality of: "Here is a product. This is how we market it. You either, fit in, or don't," will be completely upended.

We know these segments, their behaviours, their preferences. We have to use the data intelligently to be appealing and help each segment meet their particular needs.

Jenny Wilson (JW): I think the fintech wave is good for the sector as a whole. Some fintechs are already working with the banks; some will get it wrong, and go. That is inevitable. In any transformational or evolutionary shift in an industry, there will always be part of the mix that gets it wrong. The good thing is that the journey is making the sector at large, sit up and rethink.

Questions include whether there are enough segments currently, and seeking niche opportunities. There is still significant focus on traditional youth, pre-retiree and post-retiree segmentation, which feels a bit staid.

Even many of the new innovation centres are product driven structures, which can dismantle a lot of creative thinking through bottlenecking and pushback, especially around product sales.

LC: We use a lot of terminology in Financial Services. But customers come to organisations without any barriers or vocabulary.

To go to the heart of what is attracting customers to certain organisations, let us look at what has fueled the phenomenal success of Uber for instance, which doesn't own taxis; of Airbnb which doesn't own properties; and Amazon that doesn't manufacture books. So what is it about these organisations? It must be the experience, not their labels or products.

Their success is delivering what customers want – which is easy to say, but hard to do. It is about saving customers' time, doing things quickly, and being transparent. Showing customers exactly where their assessment information is for example, and asking just once for information.

At ING we are trying to do that by working with Deloitte to re-platform our digital assets to get to the heart of what is fueling this appetite, and so determining what customers really want from us.

We are trying to bring the attributes that have made non-financial services players so successful to financial services, while keeping within our risk appetite, meeting necessary regulatory constraints, and serving our stakeholders.

JW: I think there is a danger in letting regulation be the excuse for not rethinking how we deliver. Our work with the World Economic Forum (WEF) on the taxonomy of innovation involved a number of discussions with regulators, the financial businesses, innovators and fintechs. It started from the base that financial services triggered the global financial crisis. And explores how to meet the challenge of new technologies; how to think about data; and the new ways customers behave and want to engage.

LC: Yes. Even customers would have sympathy with the regulatory push, because they realise that regulators are acting in the best interest of the customer.

In essence more capital needs to be injected into the system across all sectors globally.

So how you adapt to the 'new black of capital', as well as modify your proposition to attract more customers, is key.

Having more capital, means to produce the same return to your shareholders – another stakeholder group – you certainly have to generate more revenue.

The easiest way to do that is to ensure that you are attracting and sustaining your customer base. And that you are getting greater share of wallet from your customers.

You won't do that by acting in a way that's not customer centric.

You will need to mimic the attributes of the innovators and the successful fintechs. Regulation is here to stay and it is well intentioned.

There will be more demands on capital and I direct my energy towards how I ensure that I can attract more customers and keep them rather than resist or deny a constructive regulatory regime.

Ideally, I want ING DIRECT to be part of those customers' family balance sheet in their financial lifecycle journey.

A taxonomy of innovation, WEF research – the future of banking

Financial services are being disrupted across the value chain – the six areas of greatest disruption.

"Disruption happens where the greatest customer friction meets large pools of profit"

The World Economic Forum report on the *Future of Banking*

Some principles and outcomes

LC: The principles and attributes we try to imbue, revolve around:

1. **Onboarding for life:** When you join an organisation, you don't just get that one product but with access to those fundamentals about a customer you should be able to predict and provide what that customer will need in his or her entire financial lifecycle. This is onboarding for life; with only a need to adjust when the customers' circumstances change.

2. **Time:** We are all time poor and the data shows that if your site doesn't load within four seconds the prospective customer moves on. Conversely there are some offerings from Financial Services where there is an expectation from the customer that you will take some time to consider their offer or their proposition. Generally however, you need to be quick. Whether it is a 'yes' or a 'no'.

3. **Next best offer:** By using data intelligently, you can predict and tap the customer digitally in a respectful way with the next best offer. By seeing their digital footprint, knowing their behaviour, knowing age, demographics and transactional behaviour, you can predict where they are in their financial lifecycle and what may assist them in the next phase. The reward is loyalty.

   By sharing something significant, meaningful and relevant to the customer, there is an amazing opportunity for loyalty as you are almost in a partnership with the customer as they go through their financial lifecycle.

JW: By letting a customer know where they are in the journey you also save them money; and as an organisation, potentially cost. I also think the concept of an exchange of information equals an exchange of value that builds intimacy, relevancy and convenience.

- **Trust:** It starts with a sense of mutual trust
- **Equality:** Delivering a customer experience that doesn't feel like a set of transactions, or even a set of interactions, will feel more equal. By sharing in that way, both parties learn and build trust
- **Simplicity:** With financial literacy and simplicity, customers will also be more able to make better decisions
- **Outcome focus:** By changing the language and moving from 'product' to a 'next best outcome' approach for the customer, will assist them better manage their finances, and make better decisions.

LC: In fact we could have a universal offering, on the basis that we all save, transact, borrow, insure, retire and invest – activities I believe will endure for some time. If the customer's behaviour telegraphs: 'I am going to want this in the next 30 years?' We can respond with: 'How can we help you achieve that? Etc…'

JW: I really do hope that by collaborating we embrace the benefits of innovation. If that means taking audacious steps with more of an open source mindset to data exchange, to the way the banking sector collaborates with customers, with fintech partners, and with the regulator, then we should be able to build a true community of commerce.

Q

DATA

What is data's role over the next three years for lenders?

RESPONSES:

5
Significant enabler, allowing for better pricing/cross sell/servicing

4
A challenge – system constraints will mean that the value within data is not being realised

NOT CHOSEN
A valuable asset which will be a revenue generator in its own right

NOT CHOSEN
Overwhelming as more and more data is captured

James Hickey (Deloitte)
Data is a significant enabler for better understanding the customer, but it's a real challenge to make it work.

Heather Baister (Deloitte)
In the larger institutions, data is becoming overwhelming. If you are small enough and have your systems right, you only have one system to mind. As a major bank you have many systems, particularly if you want to cross sell.

Chris Wilson (Deloitte)
Correct – the big banks have masses of data. It is complicated from a systems perspective, and the large players will always have that challenge. But data drives a customer's experience.

Really understanding when somebody starts to think about a process and knowing when to plant the seed means that in the future there will be a series of things a bank needs to be ready for. A key one is the starting of the property purchase process. And affordability will not go away anytime soon.

I remember talking about Google knowing when people started searching before anybody else did and how threatening that was. Today most of the big players are very aware of that within their own ecosystem – when and where someone visits to their website.

They can track that over time, record when they come back, where they went, whether they are a consumer or customer, and how to start working with them.

The opportunity now is, how much earlier could you start influencing? And who are the other players in the ecosystem?

How far can you stretch the 'rubber band' of the bank's boundaries? The obvious ones are real estate agents and the buyers' advocates.

It gets even more interesting when you start considering the actual home. As policies on energy and renewables change, how people want to update and renovate their homes becomes important.

It is no secret that all large banks are looking at that broader ecosystem. It may coalesce around somebody buying a home, but there are many different avenues available, particularly for large banks with large small business arms.

Lisa Claes (ING Direct)
As banks we can get blinded by the heady lights of data. Data comprises the behavioural and the demographic. Demographically we as financial services customers are highly predictable and I don't see this changing.

We save, we transact, we borrow, secured and unsecured. We invest, we insure, we retire. When we look at this progression more critically, we see that for the Australian middle classes, we make these types of transactions all within close proximity: in fact within a five to seven year radius of each other.

Behaviourally, as an example, I see 1.5 million savers in our database; some are transacting, some starting to accumulate balances. Some even display a banner on their savings that specifies home loan deposit.

When you consider their age, their savings patterns, as well as their digital footprint across our product range, rather than wait for them to come to the direct mortgages site or start a conversation with a broker, we can preemptively tap them on the shoulder.

Luis Orp and Heather Baister

James Hickey (Deloitte)
Is this where Huffle sees an opportunity Damian? Using data to tackle the big consumer problems?

Damian Horton (Huffle)
It is hard. There's so much noise to decipher to come up with a model. It is challenging to use data for credit risk. It is actually easier to model other types of risk such as prepayment risk where you might see through a social network e.g. Facebook, that someone has moved from Melbourne to Sydney.

You can start to use that data to help on the prepayment side which obviously reduces churn rates if you can manage it correctly. So we see more opportunity in prepayment than on the credit risk side. Fundamentally credit risk goes back to your core metrics. That won't really change for a long time.

Frank Ganis (Macquarie)
Data is critical and growing across three areas:

1. Customer acquisition
2. Retaining customers and meeting their needs to continue an alignment of interests
3. Understanding and delivering for a customer's future needs and expectations.

If you want to anticipate your clients' expectations, particularly if the customer has a number of products delivered by you and not just their mortgage, the data a bank retains assists beyond the acquisition point to retention.

While a mortgage may be the way a customer comes to engage with you in the first place, how you enhance and retain the relationship for the customer is where data and digital become absolutely critical.

James Hickey (Deloitte)
For instance with retirees, there's no mortgage attached to the relationship with the retiree as they own the home, so what role can the financial institutions have with that individual? To answer my own question it is worth considering the other things retirees are doing around their home.

This includes improvements, lifestyle or travel, so more financial needs than just a mortgage. It's an opportunity to think about that ecosystem that's broader than just financing at origination and settlement. Understanding the ecosystem is an opportunity for digital and data.

Michael Russell (MoneyQuest)
When we talk about digital in the same breath as customer experience, one of the big frustrations is in post underwriting. Or to be more specific in getting documents prepared, mailed, executed out, and returned. Time delays and errors are still far too prevalent. Motor finance agents can fulfill in a day. This is the ideal opportunity to look at innovation and make the customer experience better.

A CONVERSATION ABOUT DATA & DIGITAL

Jenny Wilson

Lisa Claes

Jenny Wilson *(Deloitte Customer lead) and* ***Lisa Claes*** *(Executive Director, Customer Delivery ING Direct) in conversation.*

Jenny Wilson (JW): In parts of Europe and the US, data is treated as an information exchange, as opposed to a privileged asset which tends to be more how our Australian banks treat it. There are some examples where banking data is actually helping improve the vehicular traffic flow in communities! The findings are that sharing data can solve some unexpected problems.

But if you only consider data at a financial edge, you don't see these other opportunities. Rather than perceiving data as an asset to keep privileged, the more open we are with data, the more value it can create.

The more we give the more we receive.

Lisa Claes (LC): Data is one of the greatest underutilised assets many organisations have. There is a great example of sharing data in Romania. Our bank, together with a few others, lobbied the equivalent of the Australian Tax Office (ATO) – and what I'm going to tell you sounds like heresy! – to build a pipeline to the Romanian tax office, so with the customer's consent, a borrower seeking secured or unsecured credit can permit that bank access to their income records to verify serviceability and capabilities.

It is instantaneous. It's similar to electronic verification in Australia. Within minutes these banks, with the customer's consent, have access to the applicant's previous income history. This enables them to say 'yes' or 'no' straight away.

You might think a potential customer would never show a bank their personal balance sheet, but if they want a loan and they know the data is going to be encrypted and secure, they do.

Rather than seeing data as a privileged asset, the more open we are with it, the more value it can create.

That is a very obvious example of the utility of data using external databases. However, if you think beyond Financial Services to say, electricity usage data, the opportunities are exponential. The sentiment this triggers is: 'I will share data with you, if you can help me make my life better'.

JW: Yes customers will trust innovation if the innovation delivers a better outcome for them. But it will come undone for the bank if the innovation is only for its own gain. Innovation needs to pivot on collaborating with a customer to drive benefit for them. That is the same with data.

There is so much we can do for the customer to help them with the decisions they make in their business – improving cash flow management for instance. This can be done through conversation, either person to person – such as a banker and a customer – or digitally.

LC: I often talk about a digital dialogue. It is a more slippery pipeline to do that. And as much as the mobile can be the bane of our existence, they do make interacting easier. Digital and specifically the mobile is a driver of the tectonic shifts happening in consumerism.

This implies a radical change in the balance of power between traditional providers of services and products, and the customer.

A beta example is **Hi Maxwell.** It is a fintech in the US that is completely revolutionising the balance of power from the financial service organisation to the customer.

Traditionally, a customer pitched to the provider who decided whether to say 'yes' or 'no'. Hi Maxwell invites customers to place their data on a platform, stating their need – whether a mortgage or a wealth product.

The Hi Maxwell platform reorients the balance of power back to the customer with: "Pitch to me and I will choose which bank I will take."

JW: It is a bit like the *Air Tasker* of banking.

LC: Similarly, screen-scraping aggregation sites, irrespective of whether or not they actually house the product, are places where a customer can aggregate all their financial holdings across multiple providers and get a one-stop shop universal view of their finances, whether the aggregation provider provides them with products or services or not.

The reason – it helps the customer.

Q

CONSUMER TRENDS

Where will the largest digital opportunity in lending be over the next two years?

RESPONSES:
(two answers selected)

3
Reaching customers well in advance of the traditional settlement entry point

4
A straight through online mortgage

5
Delivering an omni-channel experience for the customer

6
Back office efficiency for lenders (improving response times and customer satisfaction)

NOT CHOSEN
Capturing, storing and using 'big data' provided by customer

James Hickey (Deloitte)

When asking about the largest digital opportunity over the next two years we talked about the big picture.

The response was back office efficiency for lenders. It is improving the response times, customer satisfaction and we probably should have said broker workload as well, because it is all about improving the efficiency and using digital in that process.

Frank Ganis (Macquarie)

I think all of these options are important and it's tough to pick two. The customer experience is very important and so our model is to leverage well recognised and trusted partners to distribute our products. Therefore we look at it as having two relationships, with the distributor and the end customer.

We all have to work to make it more efficient and straightforward for the intermediary to manage the customer and provide an experience that is satisfying and exceeds expectations for the customer.

Digital can and will assist all aspects of the mortgage process, from distribution, manufacturing, to servicing and pricing.

All of these key aspects of the process are enhanced by new digital capabilities and will assist brokers and other intermediaries with customer acquisition, particularly as digital will enable access to other ancillary financial products that borrowers now expect and demand.

Malcolm Watkins (AFG)

There are many new lenders coming into our market this year, particularly in the SME and non-prime lending markets. These will be the first places we will really see a big change in the ability to talk to a customer and offer a product and a rate very rapidly, with a very fast approval.

By pulling in the APIs they will be able to say to the customer: "We can get $xxx for you to retool your workshop," or "$xxx of cash flow lending."

Many brokers are red hot in residential, but not that experienced in commercial funding, for instance. So, to be able to offer commercial finance solutions using technology that enables fast collection and analysis, and then quick approvals, is a huge opportunity.

Lisa Claes (ING Direct)

I agree. We can take inspiration from what is happening in the SME space. In our Spanish operation we've partnered with Kabbage[5] which offers instant lending following servicing and verification using open data bases.

There is an opportunity for brokers to evolve towards the attributes the model embodies.

Digital warriors, in the 16-34 age group, who like to DIY, may only require validation rather than delegation in their interaction with a broker.

So, the current one size fits all, largely delegator model, will have to adapt and modify to appeal to the new order of customer.

Another digital opportunity to improve efficiency is an example from Romania of all places, where we have teamed up with other major banks and through lobbying with the Romanian ATO, have access to a customer's income details with their consent.

This gives the bank the ability to accurately assess serviceability, which when coupled with positive credit reporting enables a borrower to obtain instant access to credit, secured and unsecured.

Customers love it. Call it 'big brother' but it is becoming the way of the world. Customers being willing to share intimate financial data where it helps them obtain something they value!

Patrick Tuttle (Pepper Group)

We do personal loans in Spain where the same thing is happening. We get access to social security information from the Government in a direct feed. So we have a lot of data that makes online personal loans much easier to process with automated decisioning.

5. Kabbage provides on the spot small business loans through online loan application.

Digital can and will assist all aspects of the mortgage process, from distribution, manufacturing, to servicing and pricing

Malcolm Watkins (AFG)
In Australia, the hurdles will be regulation. The current regulatory systems prohibit that kind of loan approval or access to customer data.

Lisa Claes (ING Direct)
Correct. You can't do what we are doing in Romania, in Australia. Not yet.

Malcolm Watkins (AFG)
Right now we would love to be able to tell a customer they are pre-approved to upgrade their motor vehicle based on their existing loan payment history for example, assuming their employment and expense scenarios have not changed since last we spoke to them. The current regulatory and systems environment slows that kind of innovation.

That's why we can't deliver tomorrow today. Not yet.

Frank Ganis

James Hickey

5 FINTECH TRENDS IN 2016

*Deloitte consulting partner and fintech practice leader, **Chris Wilson** highlights expected fintech trends for Australia in 2016*

Scale

In Australia, we expect more integration in 2016 as current fintechs seek scale.

Although in 2015 Australia had less than one percent of global fintech investment, Sydney, along with Berlin, is under the investment microscope as a hot city.

With $20bn of capital invested in fintechs in 2015 globally, there is an estimated $88bn looking for opportunity in 2016.

The very early stage startups, and fintech angel investments in Australia, will have to step up to get to the incubation stage to build sustainable businesses to attract some of this finance.

Collaboration

We expect a more collaborative environment with an increasing number of partnerships between financial institutions and fintechs.

There areas ripe for collaboration with fintechs, include scaled up peer to peer (P2P) lenders and bank mortgage lenders. In the insurance industry, we expect fintechs assist incumbents within their regulatory value chain.

Predictive analytics

Some 100 new insurance start-ups are anticipated by year end.

Partnerships will aim to improve the customer's end-to-end experience in mortgages. Banks could team up with a property data provider to give the customer an accurate valuation of their prospective purchase.

The earlier in that cycle that they can engage, the better opportunity they will have to become the bank of choice when it gets to financing. Collaborative partnerships can continue with post-purchase stakeholders such as utility providers.

Be mindful of the 'creepy line' – once crossed it is very hard to recover from the loss of trust. Banks, insurers and wealth managers have to be very careful, to balance anticipation of need, with the implicit trust consumers have in them.

EVERY HOUR IN FINTECH…

- **3.3m** people use *ALIPAY* for transactions
- **16** people invest in *BETTERMENT*
- **$958,900** is loaned by *LENDING CLUB*
- **$32.19m** is processed by *PAYPAL*
- **$4.8m** of invoice volume handled by *ZUORA*
- **$60,388** is pledged to *KICKSTARTER* projects
- **11,544** transactions are executed using *BITCOIN*
- **4,450** US auto insurance quotes are given online
- **$37,000** is loaned to small businesses by *PAYPAL CREDIT*
- **9,000** P2P money transfers executed by *VENMO*
- **$4.66m** is processed by *SQUARE* registers

Regtech

Fintech companies will also start to use their algorithmic platforms and predictive analytics to help large companies and banks with their compliance overheads.

Fintech providers will be able to help identify front line issues, by applying different or unusual data sets to help with the decision-making processes to deal with money laundering, know your customer, and sanctions type work.

Through carefully monitored access to internal data, fintechs will assist financial institutions generate more accurate regulatory compliance reporting on issues such as default risk.

Blockchain

We don't expect commercial grade scalable blockchain platforms until 2017, but in 2016, a lot of blockchain proof of concepts and pilots will come to market.

Australian banks are busy exploring what that will mean to them.

Blockchain technology is often used as the generic name for the family of technologies known as distributed ledger technology (DLT). It provides the same functionality as bitcoin (the digital currency), but uses different approaches to realising it through alternate algorithms and solutions.

Blockchain is used to transfer value through a consensus of replicated, shared, and synchronised digital data spread geographically across multiple sites.

Despite a range of competing standards and a large number of apps, the three core functions are to keep records immutably, transfer value and write smart contracts.

MORTGAGE BROKING

What proportion of mortgage settlements will brokers represent in three years' time?

RESPONSES:

2
41-50%

4
51-60%

2
> 60%

James Hickey (Deloitte)
In this response we have a vote of confidence in the broker sector – up to 60% of new lending. It does leave open a question of what channel the remaining 40% use.

Lisa Claes (ING Direct)
I think the broker channel in the three year horizon will continue as a stalwart in the mortgage industry. Over the seven to ten years' horizon, branch distribution will follow the lead of global banks and diminish as an origination channel as digital distribution increasingly gains ascendency and customers' digital confidence.

Brokers need to be alert to the attributes which drive customers to digital. A prominent broker tells me his biggest competitor is loans.com.au.

Luis Orp (Resimac)
We are originating around 30% of our business through our digital channel and it is continuing to grow. We offer a retail product directly to the borrower. And then assist them post initial enquiry and application.

Malcolm Watkins (AFG)
The big brokers will deploy service centres to deal with digital. They may have to incur additional costs associated with the call centre or the service centre fulfillment costs as part of that process.

The quid pro quo will be the ability to do twice as much volume. That's where they can adapt. And businesses that are large enough to invest in such centres will still hold market share and their brokers will do more volume.

Frank Ganis (Macquarie)
I have a different perspective irrespective of whether origination and customer acquisition is proprietary, intermediary or third party sourced. Brokers play a critical role and are here to stay.

This is reinforced by the activity in the UK where in the stressed 2008 environment, intermediary and broker market share fell below 40% which has now recovered to around 65%.

The real focus in the consumers' mind is on choice, trust and convenience, keys features of what intermediaries and brokers offer.

(L-R) Damian Horton, Malcolm Watkins, James Hickey

Brokers need to be alert to the attributes which drive customers to digital

Q

MORTGAGE BROKING

Where is the greatest opportunity for the broker channel to evolve in three years' time?

RESPONSES:
(two answers selected)

1
Investing in the business and management skill of their brokers

1
Mergers and scale within the broker sector

6
Integrating digital into their processes with customers

8
Broadening their 'value chain' capture (e.g. white label offering, own securitisation program, wider products offered etc.)

NOT CHOSEN
Vertical integration with lenders owning broker groups

Josh Rowe (RealAs)
What is the primary purpose of a broker? What would a customer or a broker answer? Price competitiveness? Or is it actually helping that person buy their first or second home?

Malcolm Watkins (AFG)
I'd say service, fulfillment and information. Brokers are about choice, convenience and cost (CCC). And we expect that the broker channel will play an increasingly important role in obtaining finance for small business on the basis that the banks do not have the resources, or desire, to get close to a smaller client, as the economics do not work.

Frank Ganis (Macquarie)
To reiterate, it is about choice, trust, convenience and absolute fulfillment. As well as ease of use a number of the leading intermediaries and brokers have established brands that are well recognised and trusted. It is about service and convenience. I strongly believe the market is evolving to multi-product financial services intermediaries that will provide access to a broad range of financial services products to their customers.

James Hickey (Deloitte)
If consumer expectations are changing and their choices are also changing around how they engage, whether digitally or with mobile, what do brokers need to do to evolve? We have said broaden their value chain.

But traditional insurance cross sell is less than 10% of a broker's revenue. And when the mortgage market is hot it falls even lower. No-one wants to risk their primary focus – the mortgage settlement. So what does it take for brokers to broaden their value chain?

Malcolm Watkins (AFG)
To cross-sell more effectively using life insurance as an example, our brokers need to be more automated and immediate.

Electronically they need to quote the cost to insure at the time of application, using a certain value with a number of built-in basic assumptions – like the value of the mortgage etc.

The quote and offer would be generated automatically and offered at point of sale to the customer. The customer can accept that quote and proceed or defer it until the loan is approved. That gives them the time to think about the levels of insurance they are most comfortable with.

To make that work the system needs to be automated and supported by a customer service available to answer questions and make it more personal.

James Hickey (Deloitte)
Are there new areas opening up that you're seeing as well other than the traditional insurance cross sell? Around estate services for instance?

Michael Russell (MoneyQuest)
I am interested in opening up more of a public discussion around reverse mortgages. At present we only have four or five lenders offering the product, which to me is disappointing given the solution it provides to our seniors who own $920 billion in residential property.

Frank Ganis (Macquarie)
It is similar to self managed super fund lending, diligently and responsibly managed and overseen will provide access an important market.

Q

MORTGAGE BROKING

Is the current focus on the broker industry sustainable for the next five years?

RESPONSES:

5
Yes, brokers and their influence on the market is here to stay

3
It is a sustainable business model, but the industry will need to adapt to stay relevant in the future

James Hickey (Deloitte)
Finally looking at whether the current focus on the broker industry is sustainable for the next five years, the majority response was that it is, but that the industry needs to adapt.

It needs to adapt to emerging areas. It needs to embrace digital, to continue to evolve the service offered to borrowers.

This may be tough for some brokers but it will mean freeing up more time to go and do more business.

Malcolm Watkins (AFG)
As long as it is in their interest and that of their business, they will embrace it.

Frank Ganis (Macquarie)
Lenders have developed and delivered sound products and competitive rates to the market and brokers, as they are key business partners.

It is important to assist intermediaries and brokers by helping them to grow their businesses, provide a broader suite of financial services products and assist with efficiency. It's about being committed to sponsoring and assisting the industry to grow.

James Hickey (Deloitte)
That's a great point Frank because if 60% of lending will still be going through brokers in the future, the lenders' and brokers' responsibility is to make sure they support brokers.

Lisa Claes (ING Direct)
I think there is a tectonic change emerging apart from that precipitated by the Millennials. I see every consumer model shifting fundamentally. The 'uberfication' of finance is among us. It may not happen tomorrow, but I think financial services are ramping up to the edge of a steep cliff.

The broker channel is currently robust, but it needs to pay close attention to what it is about interacting digitally that drives and keeps customers. The same conversations are happening at the board table. Overlaying the digital lens has to be immersive and integral to conducting commerce.

We have to embrace this and it doesn't necessarily stop within one part of the value chain such as distribution. It has to cut through and envelop the entire value chain.

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On that note the roundtable wrapped up. Deloitte heartily thanks all the participants and their contributions.


Lisa Claes and Luis Orp

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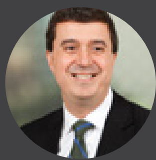

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