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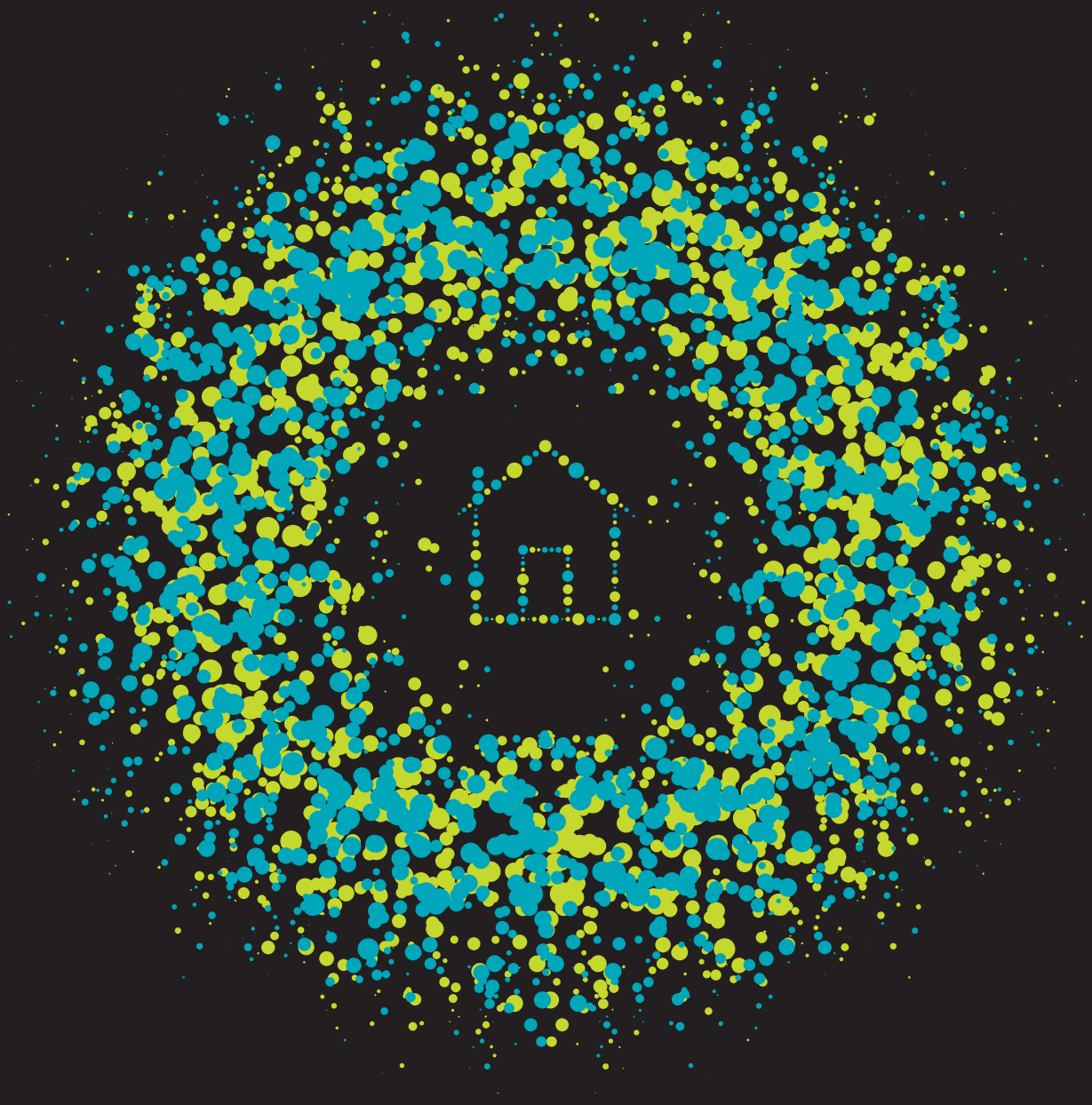


Finding focus in a complex market

Mortgage Report 2017

12th Annual Deloitte Australian Mortgage Report

Contents

Executive summary

Back row (from left): Steve Weston, (Consultant); Kevin Nixon, Heather Baister, Graham Mott (all Deloitte); Malcolm Watkins (AFG); Mario Rehayem (Pepper Money); Scott McWilliam (Homeloans); Meg Bonighton (NAB); James Hickey (Deloitte).
Front row: Peter Andronicos (eChoice); Louise Denver (Deloitte); Lisa Claes (CoreLogic); Jenny Wilson (Deloitte); Vimpi Juneja (BOQ)

Shifting to a year of personalised, innovative and more moderate mortgage activity dominated by availability and affordability...

The 2017 predictions from a roundtable of leading Australian financial services mortgage heads and lending experts are for an increasingly personalised but more subdued mortgage market that is still bedding down 2016's macro-policy changes. The market will be impacted by housing availability and affordability, and is expected to continue to be buffeted by international decisions.

The categories include

- Market forces
- Regulation
- House prices
- Profitability
- Funding
- Innovation
- Digital
- Consumers
- Regionals
- Brokers.

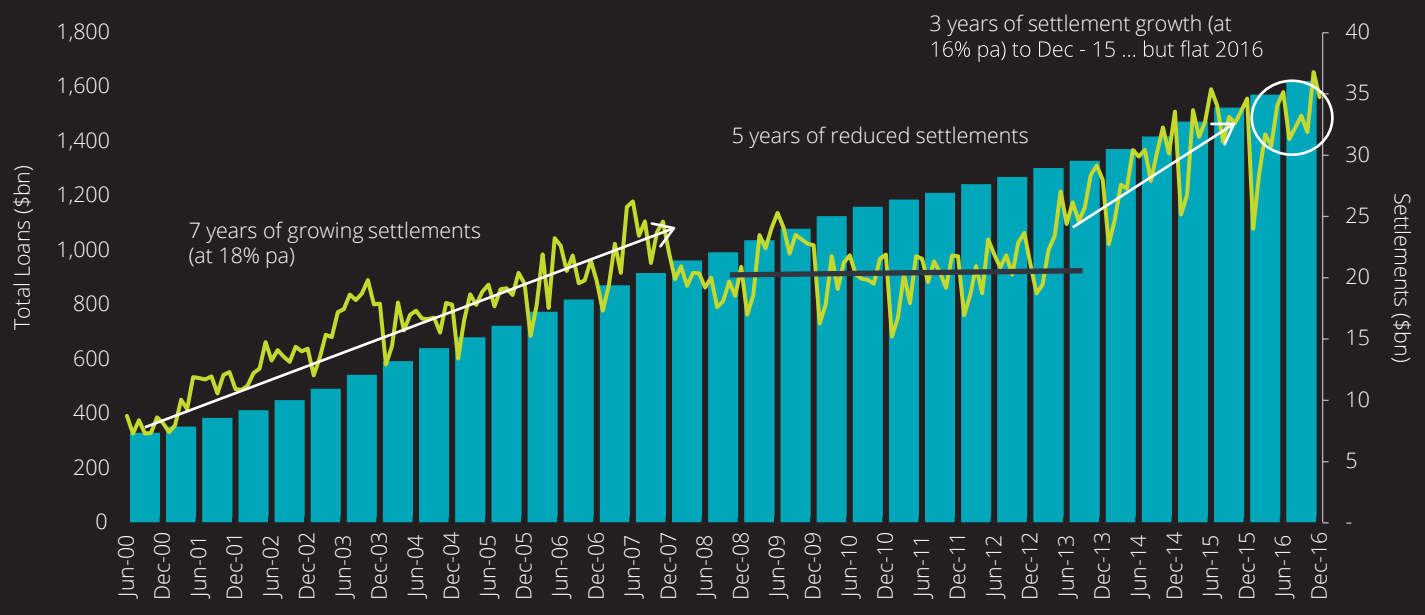
Mortgages 2017:
Finding focus in a complex market

In an insightful look at what is necessary to find focus in a complex market **James Hickey,** Deloitte Financial Service Partner analyses the Australian mortgage market and summarises much of the thinking in this year's Australian Mortgage Report.

The Australian mortgage market edged into 2017 with total new lending to households remaining flat over 2016. And while market participants remain confident about the fundamentals, they can see the signs of slowing growth.

Over the 12 months to December 2016, total new lending (including refinancing) was $384bn, which was the same as the 12 months to December 2015. This was the first year since 2012 when settlements did not grow over the previous annual period.

Residential Mortgage Lending
2000 to 2016



Lending

Settlements

Source: Australian Mortgage Report 2017

The Deloitte Mortgage Report roundtable participants, representing heads of lending at major and regional banks, and CEOs of mortgage broker groups, collectively expect 2017 to be a year of modest (1-5%) growth in new lending. This moderating settlement growth represents:

- **'Speed bumps' for investor lending –** while the APRA sound lending benchmark of 10% new annual growth to investors certainly led to some reduction in lending to investors during 2015 and the first half of 2016, together with differentiated (higher) pricing for such lending, there was a return to stronger investor lending in the latter half of 2016

- **Tightened lending criteria –** in addition to investor lending thresholds, there was also tightening of serviceability criteria, especially around non regular and offshore income sources, and closer scrutiny of household expenditure measures in testing the capacity of borrowers to repay in times of higher rates
- **Differential pricing –** lenders began greater pricing for risk, particularly for higher Loan to Value Ratio (LVR) lending, as well as actively choosing not to participate in certain parts of the market (such as reduced lending to property developments and off the plan).

However, against this background of sound practices resulting in slowing settlement growth, lenders were also deepening discounts to existing owner occupiers who were seeking to refinance from another lender. During the latter half of 2016 major lenders were offering discounts well in excess of 120 basis points (bps) or more, from their standard variable rate to new borrowers.

Key Themes of 2017

Into 2017 there is ongoing concern over housing affordability and in particular the pace of the Sydney and Melbourne property markets, ongoing political and public scrutiny into lending and mortgage pricing practices of the banks, funding cost uncertainty placing (upwards) pressure on rates, and reviews into the distribution of mortgages, and conduct by banks in treatment of customers.

Affordability

It is important to draw a distinction between 'affordable housing' and 'housing affordability'. While the former is vitally important in assisting households of lower socio-economic standing be able to have appropriate housing, it is the latter that is often discussed around the inability of otherwise financially able households to afford property (especially in the Sydney and Melbourne property markets). See the roundtable discussion page 13.

Historically: Housing, particularly for first home buyers, has always been a challenge. Raising the deposit for a property when commencing a career and often juggling growing family commitments has always been a challenge for Australians of any generation. However, for the current situation of first home buyers representing around 13% of new lending, there are some specific issues to be considered.

Geographically: Firstly, the capital cities of Sydney and Melbourne are home to more than 8.4 million people (over 35% of the national population) and therefore are considerable centres of employment. Being coastal based cities, with central business districts towards the coastal or harbour/port regions, places considerable concentration of employment and living into limited geographical areas. These all combine to place intense pressure on available housing in and around those areas.

Property prices: With property price growth of 15.5% and 13.7% respectively in 2016 for Sydney and Melbourne - a continuing trend since 2012 - compared to a downward trend of wage price inflation of 2-3% for 2016 across all states and employment industries, there is a growing gap. This is placing greater questions around affordability for households not currently in the property market in those cities.

Regions: However, while the focus is largely on affordability for Sydney and Melbourne, and that appears to be a price vs. wage growth concern, there is more to Australia than just those markets. Across other areas, including other states and regional areas of NSW and Victoria, the affordability issue is quite different. It is not so much property prices, but rather employment and availability of jobs and certainty of income which is the concern. Therefore, addressing housing affordability is not just solving a problem for Sydney and Melbourne, it is one that needs national consideration of all the issues impacting affordability including other states and regions.

The dilemma: Indeed this shows the challenge for the Reserve Bank of Australia (RBA). Should it seek to abate housing price pressure in Sydney and Melbourne by raising official rates, and should that result in banks increasing lending rates, this may dampen growth in Sydney and Melbourne, but would also adversely impact business and investment confidence in other states and regions. Thus potentially making the affordability issue outside the capital cities worse, rather than better.

The debate about potential short and longer term solutions need to be broad and should account for:

- **Taxation basis –** while negative gearing is often mentioned, for many Australians that is their wealth generation vehicle. Indeed many first time buyers they choose to be first time investors rather than owner occupiers. So any changes to this need not necessarily picture all investors as the same profile. Further, the discussion of broader ongoing tax bases, such as land based tax rather than stamp duty, is also merited. However this will likely give longer term structural benefits, rather than necessarily short term ones.
- **Supply release –** while state and local governments are addressing the process of releasing and approving new supply, there is also an opportunity to encourage greater release of existing supply. This would be a supportive policy for retirees in downsizing from their properties, without adversely impacting pension eligibility. And it would give other relief from e.g. stamp duty on repurchasing for retirees.
- **Infrastructure –** to alleviate the pressure on capital city prices investing in both physical and technological infrastructure will support workers to live in areas outside the city and be employed. This is vitally important. Improving remote working and other flexible work and travel solutions, is an emerging opportunity to address the problem.

The mindset: Lastly, while home ownership is strongly embedded in the Australian mindset (and favourably supported by tax and other incentives), focussing more on the benefits of long term 'permanent tenancy' should also be encouraged. Many European countries have systems with longer leases and greater support for tenants. This has resulted in renting being an entirely acceptable norm for housing over the long term.

> The need to have only one path of housing purchase, may not be the only model for many Australians going forward.

Mortgage Pricing

With official cash rates at record lows lenders have been able to offer competitive pricing to borrowers. However, this has mostly been of benefit to recent borrowers, or those who have actively refinanced or negotiated better deals with their lenders. While standard variable rates are the often quoted headline rate for lenders, a vast majority of borrowers (especially those having financed in the past five years) will be on rates well less than the Standard Variable Rate (SVR).

This then means that lenders' will need to carefully balance their 'front book' (ie new lending rates to borrowers) and their 'back book' (ie lending rates to existing borrowers). During 2016 it was not uncommon for major lenders to offer 120bps or more, discount on the SVR for new borrowers to the lender. This is around 50bps better than the long term discounting average (of around 70bps) across the 'back book'.

It is important to lenders' profitability that they carefully balance the desire to grow market share using deep discounts, as over the long term, the current front book will become the future back book.

From an existing borrowers' perspective, it is important to be aware of where current offers are in the market. Often a good deal some years ago, may not be the best that could be achievable in the current market. See more on Page 15.

Funding Costs

There was considerable focus over 2016, especially in the senate economics hearings, around the way banks price mortgages. Certainly the official cash rate set by the RBA is one measure impacting bank funding costs (primarily through deposits).

However, offshore wholesale funding costs (which can comprise 40% or more of bank funding) are largely dependent on offshore events and market conditions. In 2016 there was considerable volatility in such costs, ranging from the impacts of Brexit to the United States election. We also expect such volatility and uncertainty to continue throughout 2017. See our article on Page 15.

In addition, there are capital costs which lenders need to price for. These represent charges for the capital the banks must hold to remain 'unquestionably strong' and capital secure.

The greater perceived risk of investor lending, different economic and employment factors, higher loan to value ratio lending, and so forth, are all risk based factors that increase capital and hence cost. We expect there to be more risk based pricing points across mortgage interest rates in 2017, reflecting more granular risk assessment by lenders of specific borrower' and loan' characteristics.

Conduct

Related to all of the above is the way in which banks deal with borrowers in a fair and equitable manner. See page 21.

While a lot of the conduct spotlight throughout 2016 focussed on banks financial planning and life insurance arms, it remains that the most regular interactions with customers is through their banking activities.

James Hickey

In early 2017 the Australian Securities and Investment Commission (ASIC) released its review into mortgage brokers, and the impact of remuneration on customer outcomes.

This review identified a number of areas for both broker groups and the lenders, to improve their remuneration structures, and the transparency of their interactions with potential borrowers at point of sale when using a broker.

The Australian Bankers Authority (ABA) is also conducting a review into the sales practices of bank staff, which should cover similar aspects of the role remuneration incentives play for front line staff versus best interest for the customer.

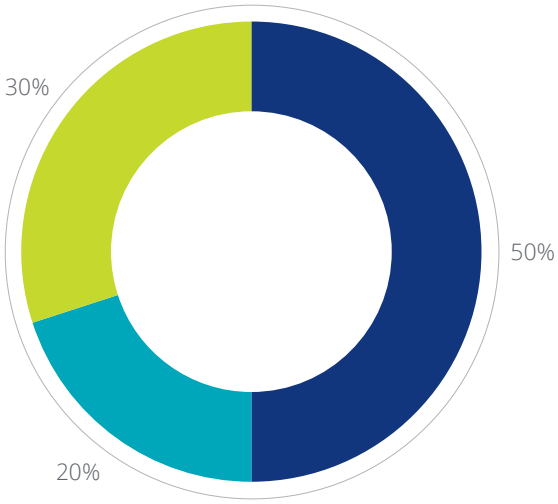
We will see a continuing elevation of the importance of conduct improvements across lenders through 2017. While very much stating they are 'customer first', there is a level of public confidence necessary to restore between customers and financial institutions. It is important that in 2017 concrete steps are made, to show the improvements being implemented by lenders in supporting this.

I hope you find our 2017 Deloitte Australian Mortgage Report both useful and an interesting read.

James Hickey – Partner

Market

What is your prediction for the rate of loan settlement growth nationally in 2017?



Legend

- Settlement volumes will reduce further compared to 2016 settlements
- Remain flat with 0% growth continuing
- A modest return to growth of 1 to 5%
- Between 6 to 10% growth in new settlements
- A bounce back and 10% growth in settlements

James Hickey (Deloitte)
Throughout 2016 actual loan settlements flattened. This reflected new flows of investor lending reducing, offset by owner occupiers continuing to grow.

With that backdrop we asked the group[1] for their predictions for 2017. Only three out of the five possible responses were selected: reducing further, remaining flat, or modest growth.

No one saw a strong bounce back in settlement flows to the 2013–2015 days of 16% growth. Mal, let me throw to you first, given you're at the coalface as a broker group.

Malcolm Watkins (AFG)
Of the multiple reasons for the moderate outlook in 2017, the primary ones are the cost of housing and modest supply. Putting aside CBD apartments, there is only a relatively modest supply of urban residential housing. Couple this with population growth and net migration to the larger cities, and it is reasonable to predict demand and the cost of housing will not subside. We don't believe there will be a 'bubble' or a massive correction. In my view we are over the 'nervous nellies' and any talk of the market collapsing.

We think prices will stay high. Which means we won't see those historical 10% growth levels. Affordability will remain an issue as we start to see the interest rate come up a bit, as most lenders will put some margin back into their businesses. Also APRA is prudentially regulating, and demanding more from the industry, which ultimately adds costs to consumers wishing to borrow. So for those reasons we predict settlement growth somewhere in the order of 5%.

Meg Bonighton (NAB)
Given the number of changes in the market around investors and overseas borrowers, I think we'll see the macro policies that were put in place in 2016 continuing to moderate these segments in 2017. In general, it will soften the impact on house price growth that we've seen over the past couple of years, while pockets of major cities are likely to continue with solid growth.

James Hickey (Deloitte)
Sydney and Melbourne were probably the engines of settlement growth during the FY '13/14 period. Is that starting to come off the boil? Is that what is causing the national figures to slow down?

Lisa Claes (Corelogic)
The Australian residential property market is multispeed and variegated. The Australian hot spots are unequivocally Sydney and Melbourne, with the somewhat dubious pre-eminence of each having experienced stupendous growth rates since 2009 of more than 100% and 86.1% respectively. Not surprisingly, each share the nation's highest dwelling price-to-income ratios with Sydney tracking at 8.3%, Melbourne at 7.1%, dwarfing Brisbane at 5.7%.

1. Commonwealth Bank and Suncorp participated in the survey but were unable to attend the Roundtable so are not represented in the commentary in this report.

> You have to question how long these ratios can continue pressuring affordability and shutting out segments such as low income earners and first-home buyers. The proportion of new first home buyers in the market has halved.

Not too long ago we used to pride ourselves on having a high percentage of home ownership in Australia – in the upper quartile. In the last 24 months home ownership rates plummeted by 20%. So perhaps we are at the beginning of the long journey the Europeans have trodden… of not 'owning', but renting. Personally I don't think that sits well with the Australian psyche and our drive to capture a piece of this vast brown land.

Scott McWilliam (Homeloans)
I agree. And to answer your question on the rate of loan settlement growth nationally, I also consider whether it is fuelled by asset appreciation.

When you think of the size of the residential mortgage book in Australia, it is always good to draw it to an event. So when we had the Sydney Olympics in 2000, the resi book was $400 billion. Since then there have been periods of unprecedented growth. The mortgage market in Australia is now $1.6 trillion.

Settlement growth peaked at around 22% in the middle of that period, between 2000 and now, when it has come back to more normalised numbers. However the size of the pool now, and the size of the origination of mortgages, and the fact that it has been fuelled by property appreciation, is potentially unhealthy.

Steve Weston (Consultant)
So if we are saying organic growth in new lending volumes is going to be constrained, the question is whether brokers and lenders can use any surplus capacity they have elsewhere. I would have thought with the differential between the pricing of new and existing home loans, that refinancing would be the obvious segment to focus on.

Peter Andronicos (eChoice)
Our business is very much hinged towards new enquiries dealing with a lot of new consumer engagement and financing, and the one thing we've seen is that demand has not softened.

The demand from the consumer is still there, both as an investor and as an owner occupier. What we've seen is that the investor has started to shy away from the paranoia of the major cities, and is starting to venture further out into rural areas and coastal areas. The owner occupier just can't afford to get in to the big cities, and so are just waiting.

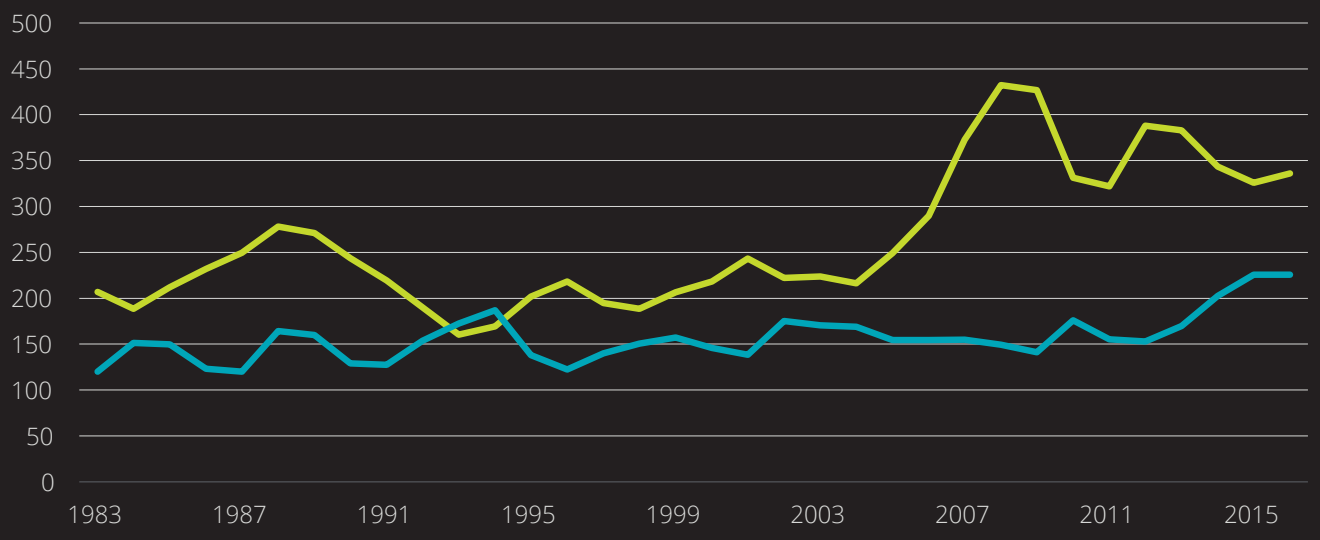
James Hickey (Deloitte)
So in general the feeling around the outlook for the market is that demand is still there but supply is the challenge.

> The demand from the consumer is still there, both as an investor and as an owner occupier… investors are venturing out into rural and coastal areas.
>
> **Peter Andronicos, eChoice**

Peter Andronicos, eChoice

Demographics and demand: a glimpse of the mechanics underlying housing demand

Population growth and dwelling starts



Population growth (000s)

Dwelling starts ('000s)

Source: ABS

Deloitte Access Economic Director Michael Thomas looks at the relationship of demographics and demand when it comes to housing and the mechanics underlying them.

The housing market story is a people story – or more accurately a population story. Population growth drives demand for housing, and the strength of Australia's population growth over the past decade is fuelling the current surge in building.

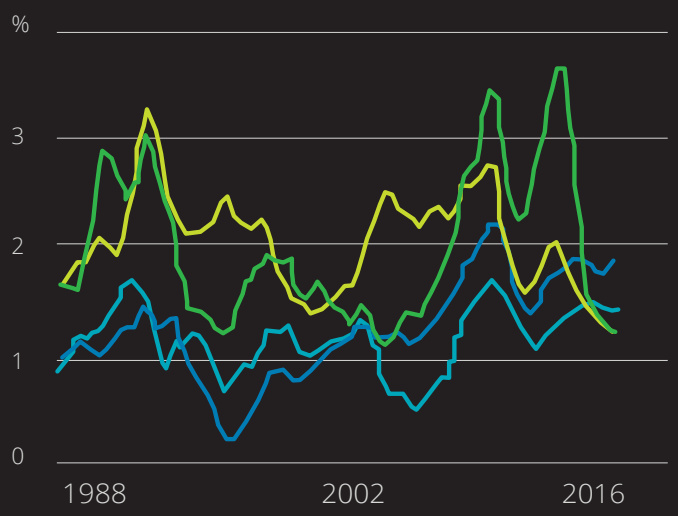
The chart above shows Australia's population growing at an average rate of around 220,000 p.a. in the two decades to 2005. By way of comparison, the number of new dwellings started ran at an average pace of 150,000 p.a. in the earlier two decades.

If we take into account replacement of existing stock, and a decline in the size of households (increased household formation), underlying demand for new houses probably exceeded the average pace of building towards the end of the period.

Then in 2005 things changed dramatically. Driven by stronger immigration and a new baby boom, Australia's population stepped up to 360,000 p.a. in the next decade. The average growth rate jumped from 1.2% p.a. to 1.6% p.a.

1. Household formation is an even better guide to dwelling requirements. It was growing faster than population around the time of the 2011 Census, increasing pent up demand for housing. However, the corresponding 2016 Census data have not yet been released, so it's not clear if household formation still is growing faster.
2. Housing formation is the number of new households being formed so when the children grow up and move out of the family home, they create a new household similarly, with relationship break-ups, if one party moves out, one household becomes two

Population growth
Year-ended



QLD
WA
NSW
VIC

Source: ABS, RBA

The home building response was tardy. Unmet demand kept mounting until 2013, when work on 170,000 new homes kicked off. Cyclical factors such as prices of new houses vs. established houses, renting vs. buying and interest rates all influenced the precise timing of the response.

But suffice to say building activity has surged since then, with dwelling starts reaching record heights of 226,000 in both 2015 and 2016.

Unsurprisingly, house prices have risen while the shortfall in dwelling construction is being made up. During this period, the quality of the supply response also mattered. For example building CBD apartments will not satisfy demand for large detached houses.

A similar population story has played out at a state level. The chart to the left shows that, in the two decades to 2005, interstate migration delivered Queensland and Western Australia relatively higher population growth rates than the other large states.

Post the resources boom, interstate migration trends favoured the broad-based economies of Victoria and NSW, with the former also attracting a greater share of migration from overseas.

So what does this tell us about future demand?

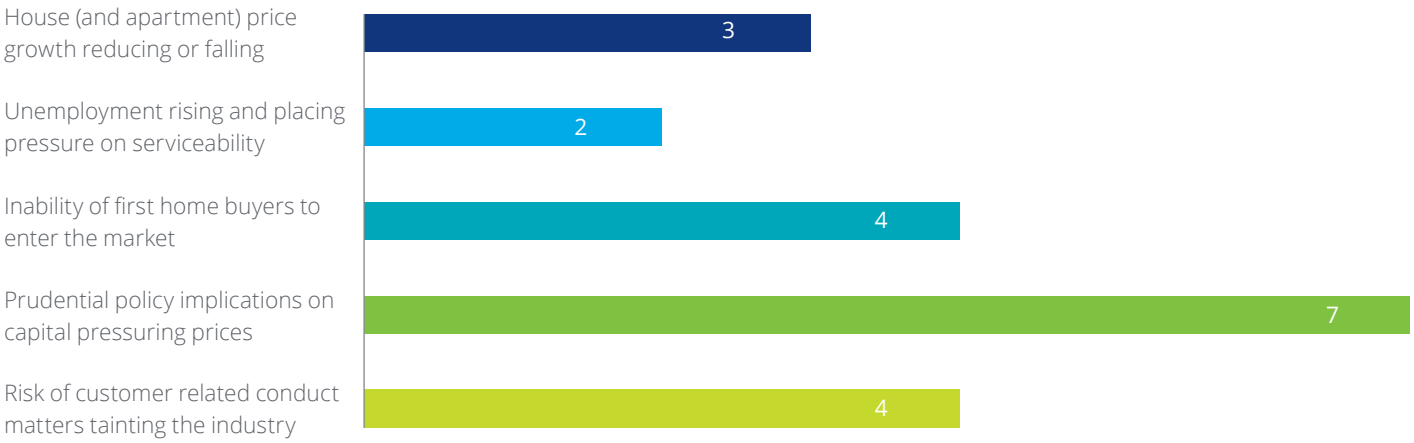
On current trends, Victoria and NSW are likely to continue to lead the way in the population growth stakes, with Queensland starting to close the gap and WA stabilising. These growth differences should be reflected in building activity over time.

Overall, Australia's population growth is likely to stay above 300,000 p.a. This suggests underlying demand for new dwellings will also be notably higher going forward.

Housing analysts suggest underlying demand now may reside in the 180-200,000 p.a. range (with the precise rate dependent on household formation). And this means if dwelling starts drop back below these underlying levels for any length of time, price pressures will begin to build again.

Regulation

What is your biggest concern for the mortgage market in 2017? (Two options selected)



James Hickey (Deloitte)
As you can see the implications of prudential policy on capital pressuring prices was the biggest concern. Lenders have been responding to this by adjusting their rates on investor lending and the availability of funding for certain borrowers.

Vimpi, from a regional bank's perspective, is this a key challenge for you this year?

Vimpi Juneja (BOQ)
I selected that as the #1 issue. However at a micro level our issues around the mortgage market and performance are very different. When I think about the industry as a whole, prudential policy implications on capital pressuring process is the biggest one. However as a regional bank our concerns are both regulatory and geopolitical – both of which are associated with uncertainty.

For instance earlier in 2016 year we had to set the investor cap very cautiously, which could easily offend both our property investors and customers.

> If you don't quite know what the rules of the game are and they keep shifting, then the decisions around which levers to pull becomes quite difficult.

This would in turn, impact growth. So determining what reputational and policy appetite to set, and managing the subsequent engagement with the regulator, are some of our biggest issues.

Although not on the minds of customers, it is on the minds of us as providers, as we try to second guess what levers to best use to operate in the context of a most competitive market. In addition to the reality of that competition, we are also seeing supply and demand dislocations on the basis of the regulation.

This means we start to narrow into smaller pools of competition, and start to second guess, almost to the point of negotiating against ourselves, in anticipation that something may not work.

Mario Rehayem (Pepper Money)
But that is also the joy of having access to the broker distribution channel. Brokers are nimble and very quick to vote with their feet when there is a shift in lender credit policies. You can see a dramatic swing in market share from one lender to another very quickly.

As lenders we need to be able to adapt to the brokers environment. For those lenders that are not broker-focused, it is a new world.

It is different to the days when it was simply a branch world vs. a broker world. Now the swing from one lender to another can be as much as 50 bps – which is a big swing.

If a policy changes overnight, you can literally lose a meaningful slice of business the following day. This is the new norm, the power of digital, consumer awareness and brokers doing their bit for their customers rolled into one.

> Clear choices need to be made when pushing book growth at the expense of profitability.

Heather Baister (Deloitte)
If you look at some of the smaller lenders and the regional lenders, many have been trying to chase market share through using the broker channel. As you say, brokers can move things very quickly with the change on pricing.

But for lenders, if the back office isn't set up appropriately to absorb the changes when the front office goes out with big headline rates, and gets all the interest, it cannot respond appropriately and so gets exposed to reputation risk.

Mario Rehayem (Pepper Money)
Absolutely, first mover advantage can very quickly become first mover disadvantage.

Malcolm Watkins (AFG)
We have done a lot of research which we have provided to ASIC, which clearly shows that most broker decisions are policy oriented, not rate orientated.

We have demonstrated, that despite the lowest rates, the market share of some lenders keeps falling due to tighter policies, such as LVR restrictions or dollar caps. There are a whole range of issues where both the rate, and volumes, have been going down at the same time.

Yet other less competitive products are going up because of service, with quick responses and offering more of what the customer wants. So the mistruth of the industry is that brokers are rate driven. They are not.

Those customers that are rate driven tend to be using digital channels and online comparators; they are savvier and more comfortable in making their own decisions. Over time that will grow.

Peter Andronicos (eChoice)
I think you're right. Now that the low rate approach has matured, the consumer with no exit fees etc is starting to move. Which backs the point made earlier that the refinance market continues to drive growth.

> The refinance market continues to drive growth.

James Hickey (Deloitte)
It is worth pointing out that the prudential changes being put in place are to help sustainability and security. It was interesting that not many people saw unemployment rising as a concern, nor house prices falling. So maybe we all looked at the market from a positive perspective. Clearly however the regulator is seeing something in the macro economic conditions.

Malcolm Watkins (AFG)
Well you also have the responsible lending side, which I think is even more of a threat and a fear for the regulators with spiralling enquiry costs. They want the industry to be responsible for their own activities.

Lisa Claes (CoreLogic)
I think there are valid concerns in pockets of the market, including certain developments and developers within Australia.

Certainly from the forecast settlement value data we harvest, there are buildings and apartments in selected pockets, where the contract price exceeds its value at settlement. I think that potential risk has a strong impact on the discriminatory regulatory response to investor loans.

Vimpi Juneja, BOQ

Regulatory themes

Kevin Nixon, Deloitte

Kevin Nixon (Deloitte)
The regulators are looking at the Australian markets against an international backdrop. They, and we, are still seeing the post-crisis reform agenda work its way through the system. It is much broader than capital.

For example, liquidity reforms will increase funding costs and pricing in the market. Basel still hasn't finalised its approach to bringing the internal model banks' capital calculations closer to the standard model banks.

There will be an overall floor on just how far you can deviate from the standardised model. APRA has already moved ahead of that global process, with its requirement to raise the average mortgage risk weight for internal models.

There is a continuing global trend just to make the industry more resilient, and fully price the risk of loss as well as the cost of funding.

That is the backdrop for Australia. I think the regulator is concerned about investment properties in particular as evidenced through recent commentary.

The APRA paper on culture, released in October 2016, observed that sound lending practices in the mortgage market had in some instances been sacrificed for market share and growth, as well as 25 years without a recession. Internationally our AAA rating is being questioned. So the market and the institutions active in it, are under close international and local scrutiny.

Vimpi Juneja (BOQ):
That's right. The global regulatory context and local macro-prudential measures introduced by APRA undoubtedly pressure the Australian economy, reducing its ability to respond and bounce back to the monetary stimulus to the extent to which we've grown accustomed.

When I think about observed experience over the past 20 years in Australia – where we've seen the economy stumble – we've grown used to the 'Pavlovian' effect of dropping interest rates, prompting people buy houses and/or renovate, and then seeing the 'trickle down' effect into small business, retail spending, business investment and so on.

The movie appears to be unfolding differently this time though. It is true that lower interest rates are fuelling growth in residential property. However this growth appears to be more a function of price than volume; particularly given the price appreciation and concentration in Sydney and Melbourne.

However, business confidence and business investment remain stubbornly below trend. So you could argue that monetary policy is not achieving the same stimulatory effect on the economy as in the past.

Maybe there is some logic in the regulators creating constraints in an effort to hold back any residential property bubble and allow those lower rates to motivate business investment?

But I'm not sure the combination of macro-prudential intervention and the 'crowding out' of investment in growth initiatives by banks, by perennially rising costs of complying with regulation, are necessarily helping to get the economy to growth.

Working out how to get growth back when you can't rely on the proven lever of residential property, is an issue.

Steve Weston (Consultant)
From an international perspective, not only are our residential properties relatively expensive but our level of investment lending is very high at circa 40% of mortgage flow. In the UK when investment lending reached 15% of mortgage flow, the Government intervened and imposed an additional 3% stamp duty and materially reduced the level of tax deduction that can be claimed for interest expenses. In New Zealand investment lending is currently capped at 60% LVR. Given our high level of investment lending in Australia, to only have a 10% balance growth restriction applied doesn't seem unreasonable.

Conduct risk
Prudential regulation will pose some challenges for lenders but a much bigger challenge (at least based on what has happened overseas) is conduct risk regulation. In the UK, banks were deemed not to have complied with the "spirit of the laws and regulations" and that some of their behaviours (that may not have changed for many years, leading to banks thinking they were acceptable to regulators) caused customer detriment. This led to massive fines and customer redress payments needing to be paid and for trust to be broken with the community.

It seems to me that the 'conduct movie' is playing out in Australia in a similar way to the UK. Although four or five years later. Commentary from politicians and regulators about poor banking culture, holding executives to be more accountable, toughening whistleblower protection and the like, shows that the direction of travel for conduct risk is becoming clearer.

That is likely to prove problematic for all market participants in the medium term, but we will end up with a system that is more focused on doing the right thing by customers in the longer term.

An example where Australian mortgage lenders should be on notice, is with lines of credit, where customers may use funds for living expenses and end up owing a lot more than they would have, if they had taken out a standard P & I home loan.

Risks with lines of credit should be highlighted to the customer when the loan is taken out.

Additionally, the lender should look at the account to see if the customer is potentially using it in a way that may result in them owing more money than they would have if they didn't have access to the line of credit.

If there are signs that the customer is using the loan in a way that could be causing them trouble, the lender should discuss their concerns with the customer and potentially restructure their borrowings.

That is not something that happens regularly in Australia today.

Steve Weston (Consultant)
In Australia the definition of conduct risk and its implications, is too narrow. In the UK, boards' and senior managers' focus has shifted from primarily being on profitability and returns, to being on remediating 'sins of the past'. And putting frameworks and controls in place to prevent a recurrence of these problems in the future.

While this has led to a halving in RoEs, customers are genuinely being put at the heart of decision making.

Kevin Nixon (Deloitte)
The reality is it is already happening here. APRA will be piloting a culture review with a couple of banks, but then intends to roll it out to all banks.

We expect APRA to go to each bank's Board and ask how they make their decisions. And they will likely talk to each Board member asking them individually why and on what informational basis they made the decision.

This is happening in 2017. So yes, banks are there to make shareholders a profit, but only after meeting consumer obligations, regulatory obligations and legal obligations.

If you can make a profit after that, good. That's the way they're looking at it. It will, by design, change the focus of business activity.

Malcolm Watkins (AFG)
APRA and ASIC want to make us unquestionably stronger. However if you undermine the profit base you expose another danger.

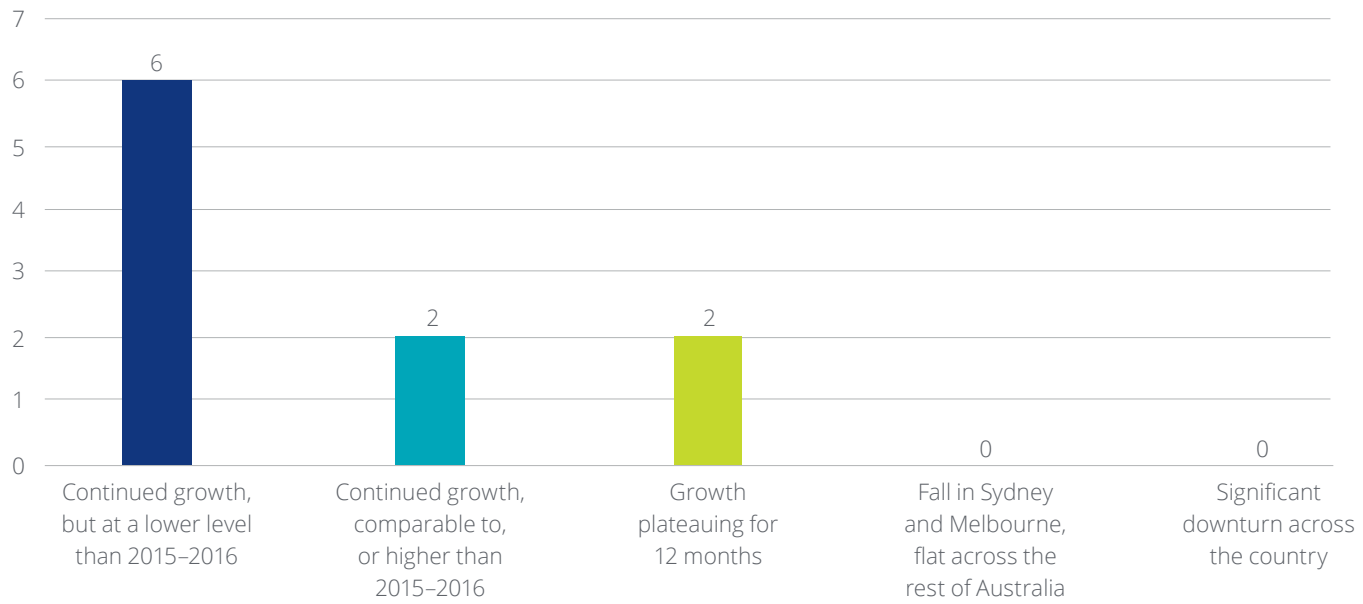
Certainly ASIC wants to protect against consumer harm at a product level. And they want APRA to continue to make the banks unquestionably strong.

That is why the political forum will continue to apply for the next few years. But also why as lenders we need to find the right way to manage.

Conduct risk is not just about making sure that a mortgage product, or your recommendation, is suitable for today. It is about making sure that recommendation, or that product remains suitable throughout the life of the loan.

House prices

What is your prediction for house prices nationally in 2017?



James Hickey (Deloitte)
As we can see from the answer above, the majority voted for continued but slower growth than 2015 and 2016. No one saw it falling in Sydney and Melbourne. Lisa now you are CEO at Corelogic. What are you seeing?

Lisa Claes (CoreLogic)
Our view is that house price growth will temper according to the elasticity of the household income to house price ratio. At the moment it is stretched to cyclical highs in Sydney and Melbourne. Less so in other capital cities.

Presently Brisbane is probably the most affordable city in which to buy a house based on the dwelling price-to-income ratio at 5.7%. Certainly lenders are alert to the jaws of asset price-to-income ratios. I believe this dynamic will start to moderate. However the pace of moderation will be hampered by the macro factors of supply and demand. Unfortunately there is no silver bullet on the horizon.

James Hickey (Deloitte)
However the resilience of our property market has hidden a lot of the issues that have been raised. Overseas countries on the other hand have not had the benefit of such a strong underlying or resilient property market as ours, and people haven't had to recognise capital losses on their property.

Malcolm Watkins (AFG)
Agreed. The two big cities with significant population growth, are beginning to be innovative around availability. By subdividing the 1200 square meter inner city blocks with a single home, into two new townhouses of say three-stories each, brings down the cost, and brings back affordability.

Lisa Claes (CoreLogic)
Sydney values in the last eight years have more than doubled and Melbourne's have increased by 76%. That is almost a doubling in less than a decade increasing the pressure on the price-to-income index.

Lisa Claes, CoreLogic

Steve Weston (Consultant)
Given the record highs we're seeing in Melbourne, the regulators are comparing us with the rest of the world and we are the outlier. It would be fine if we were at eight and the rest of the world was at 12 or 13 – but it is the other way around.

Graham Mott (Deloitte)
So the affordability gap is obviously getting wider. The levers available to Government to manage the soft landing we're seeking, include negative gearing. I think more than ever that debate has to result in some change.

James Hickey (Deloitte)
I think you have to look at negative gearing in the context of all the other tax benefits the family home gets, particularly for pensioners. Negative gearing can't be looked at in isolation. In Australia 85% of retirees own their own home outright, with no financial incentive to sell their property.

In fact they have a financial disincentive to downsize, because suddenly the home will no longer be either pension income, or asset exempt. So there are a number of rules that need to be looked at in combination, not just negative gearing. The impact on investor demand and supply is holding back supply, which artificially creates pressure on prices.

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Negative gearing can't be looked at in isolation. There are a number of rules that need to be looked at in combination. The impact on investor demand and supply is holding back supply, which artificially creates pressure on prices.

Malcolm Watkins (AFG)
I think the biggest threat to the mortgage market next year is the political uncertainty of where the economy is going. So decisions around negative gearing and superannuation is just a minefield. Therefore people are hesitant to reinvest in their business or reinvest in their local communities. That is the biggest concern.

Graham Mott (Deloitte)
The house price challenge has got to be one of the biggest threats in the medium-term to growth sustainability. As a group will you be able to see some form of mitigation to that risk and the form it could take? Is negative gearing part of the solution?

Steve Weston (Consultant)
The UK doesn't have negative gearing, but rental income can be reduced to nil by related expenses including interest. When investor lending increased to 15% of new lending, there was a concern that it was making it difficult for first time buyers to enter the market.

As a result, a 3% stamp duty was increased on subsequent property purchases and the maximum tax deduction for interest expense is being reduced for both new and existing investment loans from 45% to 20%. That makes a material reduction to the after tax returns for highly geared property investors.

Steps like this show that we should not remain too comfortable in thinking that negative gearing won't be touched in Australia.

James Hickey, Deloitte

Property prices: the stresses, their drivers, investors, and some solutions

Having covered the lending side of the equation in the roundtable, this article by **Deloitte Real Estate & Construction Sector Lead Alex Collinson** focuses on residential property prices which back most mortgages.

There are few topics which demand more column inches presently, whether it is the issue of housing affordability for first home buyers, interest rates, auction clearance rates, FIRB approvals for offshore buyers, capital gains tax, negative gearing, Sydney house prices, or apartment gluts in Melbourne and Brisbane.

The importance of this of course is that more than 50% of household wealth in Australia is tied up in property. With the growth in house prices post the Global Financial Crisis, it is one of the best performing investments since its onset, well in excess of the returns from the ASX.

This has enabled the banks' success to underpin the economy with balance sheets that are heavily leveraged to residential property. So there is little wonder that the topic is so discussed.

The stresses

However there is a flip side to such growth in asset values. In this case it is mortgage stress driven by loans increasing in size, in combination with the size of deposit required for first time buyers who struggle to enter the market.

This has created chronic social issues in particular in Sydney, where it isn't just that people can't afford to buy houses, they can't afford to rent properties near to where they work. Add the social environment to the list of constraints and pressures on banks' lending practices due to stiff global regulatory requirements, volatile investing economies, and increasing costs and risks.

Recently various lending institutions have had to announce they are tightening their lending requirements - good news for the Reserve Bank of Australia, and possibly good news for some more sluggish parts of the economy, as it offers more options, given the concern about asset prices.

So what does it mean for lenders in terms of residential property prices?

The drivers

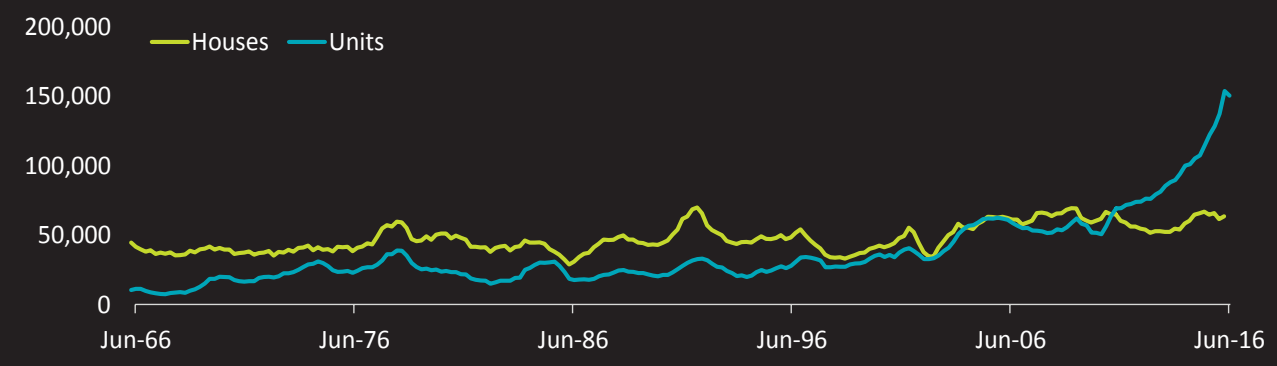
Supply is part of the solution. But not the sole answer given that housing construction in apartments in particular, is high by both international and historical comparisons, but is still struggling to keep up with demand.

Residential real estate underpins Australia's wealth and has reached $6.7 trillion

As at the end of October 2016

Source – CoreLogic

Number of dwellings under construction, national



Source - CoreLogic

New supply helps with those who can afford what is being built. But there is a parallel issue around social and affordable housing. Historically this was largely the domain of the public sector. Today we believe business has its part to play, something akin to the ' institutional multifamily dwellings' as exist in the US for instance, but policy settings need to be right.

Supply also needs to be coupled with infrastructure, so there are jobs near the new dwellings, or residents can commute to where jobs are easily and quickly.

Whether this is granting increased Floor space ratio (FSR) for developments in exchange for building affordable housing as part of development approval, changing zoning along transport links, reducing red tape and increasing the speed for approvals, this should serve to increase supply and keep costs in check.

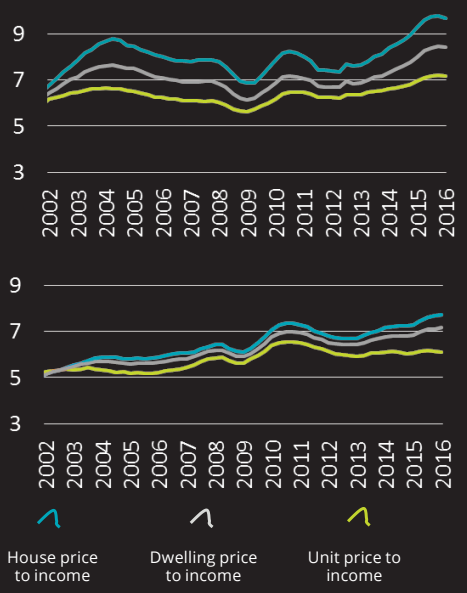
But there also needs to be a rethink of what people should expect and where the government should or shouldn't intervene. The demand side puzzle is ten times harder than supply side.

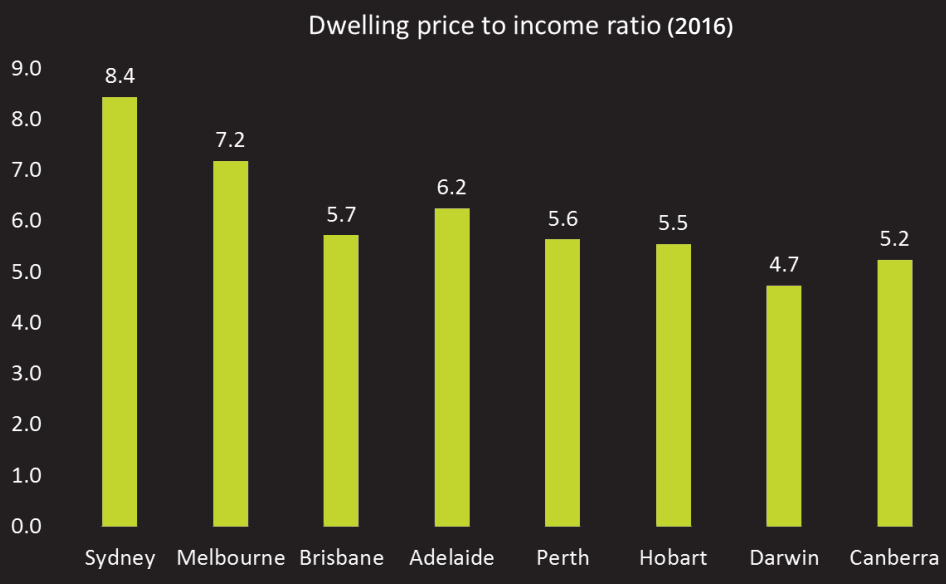
The investors

Banking profits have fallen due to increased regulatory capital requirements, low interest rates, a volatile economy despite the rise in commodity prices, a lower dollar and competitive pressures.

These pressures, coupled with uncertainty, have in turn caused lending to be increasingly cautious and has meant fewer people can afford to buy a property. So where then will growth come from? And who will own residential property in the future?

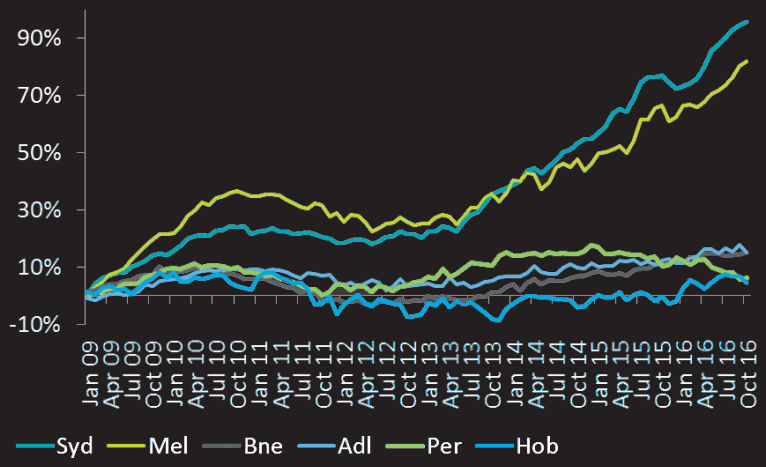
Affordability has become more challenging in Sydney (top left chart) and Melbourne (bottom left chart) which is likely stifling activity

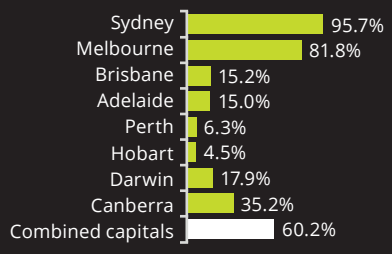




Source – CoreLogic

Cumulative growth in dwelling values, Jan 2009 to Aug 2016





Source – CoreLogic

Will the status quo continue in terms of the mix of buyers with another period of flat property prices like that after the house price increases up to 2003? Or will prices collapse?

Generally one of two things needs to happen to see prices fall leaving aside factors such as major tax reform or reduction in population growth:

1. Either wages fall in real terms or as a result of unemployment or
2. Interest rates rise significantly.

We believe interest rates rising is more likely than wages falling, given the fairly healthy current economic cycle, combined with the level of borrowings home owners have taken on to buy at current prices levels.

Some Solutions

However given low wage growth and low inflation, interest rates are remaining at their lowest ever levels and the RBA hasn't signalled any significant increases. It is possible that interest rates are more likely to rise now than 12 months ago, given the low levels of unemployment, commodity prices and positive economic sentiment in the US, but it is hard to see them increasing quickly.

Part of the conundrum is that investment income is becoming more important than wage income, and investors are becoming more important than owner-occupiers. So house prices are being more exposed to investment returns (from all sources) over time.

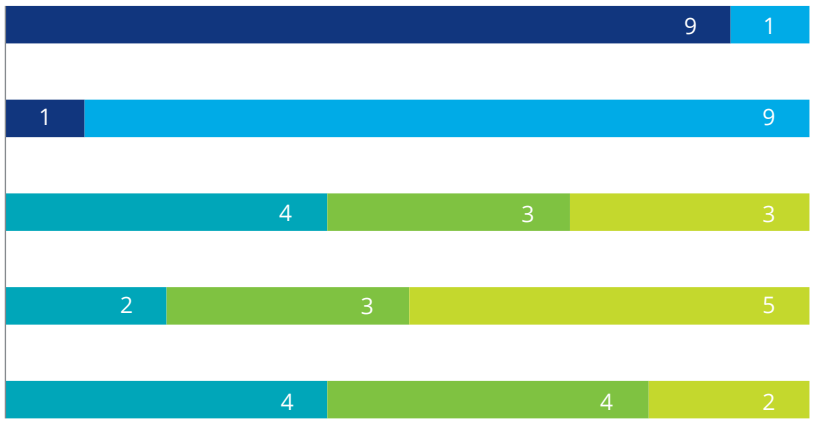
If house prices continue to rise at current rates, then the numbers of people who can afford to buy are reduced and with it a change in the make-up of ownership of our housing stock.

People may also vote with their feet, leaving high priced Sydney and moving to Melbourne with its recent lift on stamp duty for First Home Buyers, which should help absorb the apartments which have been built there.

Predictions are hard, but given the start to the year we've had, I think it is likely there will be growth in house prices in the current year but at more moderate levels the last couple of years. But as always this will be state and market specific with Sydney and Melbourne likely to outperform Brisbane and Perth.

Profitability

What is your view on mortgage profitability in 2017?



Legend

Rank: 1 2 3 4 5

James Hickey (Deloitte)
The consensus is that lenders will need to focus on profitability over book growth. This is an important challenge because it involves market share and loan book growth metrics. Although I am not so sure how this response will be sustained as reporting season comes up, when there's pressure to get market share.

As brokers know, the discounts offered by some lenders become very attractive at that time. It drives volume and helps with the book growth.

The second most popular response was the need to balance the net interest margins (NIM) and the pass through of out-of-cycle rate movements. At the moment we are seeing out-of-cycle rate adjustments, especially in segments of the portfolio to better balance the pressure points and capital costs.

Steve Weston (Consultant)
If conduct risk plays out as I expect, lenders will struggle to offer new borrowers a cheaper rate than existing borrowers for similar loans sizes, LVRs and the like. If they want to change SVRs out of step with RBA cash rate changes, they will probably need the blessing of ASIC first. At least that is what has happened in the UK. If the ability to reprice back books is constrained, that provides a material risk to mortgage profitability if funding costs increase going forward.

James Hickey (Deloitte)
That is response C. That may well come from the political pressure, and will encourage more alignment of rates and more transparency and greater alignment around other cash rate movements. Meg how is NAB meeting the challenge of explaining rate movements to customers?

Meg Bonighton (NAB)
We're absolutely committed to being very open and transparent with our customers about our decisions. And we need to do more to explain the many factors, we as a lender and as a business, need to balance and consider when we set interest rates.

The fact is, the cash rate is but one of many factors that influence how we set interest rates. We need to explain the different sources of funding, and the balancing act between our customers – both those who borrow and those who deposit - and our shareholders, which together ensure we continue to be a strong and stable bank.

We need to make sure we build the strength and safety of the bank in the long-term; as well as getting revenue and profit in the short-term. Added to that we need to provide a great experience for both our bankers and the brokers we work with.

So the balance has never been so delicate. And it has never been so important.

James Hickey (Deloitte)
Jenny Wilson and I did some research for the MFAA a few months ago and we asked 1000 demographically selected customers what they valued most about their lender or broker. The survey from the customer's perspective resoundingly answered: 'I chose you because I am confident that you (lender/or broker) are acting in my best interest.'

Jenny Wilson (Deloitte)
We ran a number of qualitative sessions as well as the survey. We put out a number of attributes which culminated in what it means to build a trusted relationship with a customer.

Examples included: 'giving me confidence that I'm making the right decision', and 'acting in my best interest'. Interestingly when it came to rates - and we looked at both banks and mortgage brokers – customers get annoyed if they don't feel their rate is fair.

> We also found policy changes and what that may mean for access, can really destroy trust. So the level of transparency becomes really important, particularly for mortgage brokers.

Our respondents were not going to the mortgage broker for the lowest rate. They were going because the mortgage broker typically helps them navigate the changes in a way they understand. I think that's what transparency means to the customer. I don't think that most customers grasp the dangers that could play out for them around conduct risk.

For them it is as simple as: 'If there's a person like me, who looks like me and acts like me, then we should get the same rate'. As organisations we quite rightly get nervous, about finding the balance between doing the right thing by the customer, and what that means for our overall book.

Conduct tends to incorporate product suitability. We need to think about conduct in the fullness of the product and in the behaviours it provokes in customers. We need to understand what good behaviour is, as well as 'not so good behaviour'.

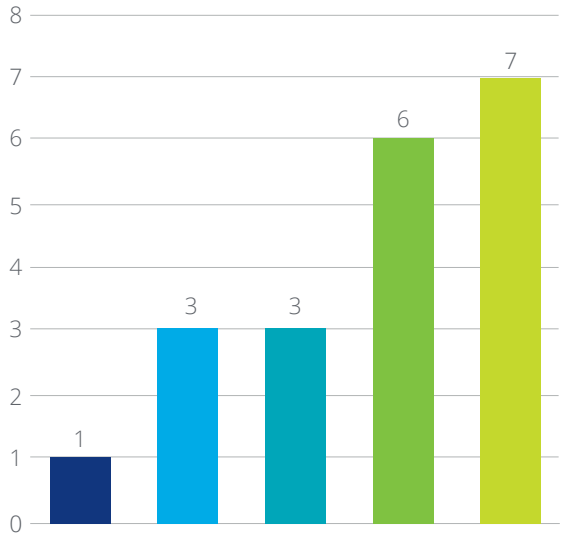
Mario Rehayem (Pepper Money)
And that should increase with the introduction of comprehensive credit reporting. People will better appreciate what that score means to them and what behaviours influence that score – whether positive or negative.

Scott McWilliam, Homeloans

> I think there is a lot of focus on the product itself, and not enough around the right behavioural nudging. Doing this right will in effect raise financial literacy over time.

Funding

What are the biggest funding challenges for the industry in 2017? (Two options selected)



Legend

- Managing interest offset accounts to minimise revenue leakage
- Balancing funding options and terms across the regulatory backdrop of NSFR & LCR
- Pressure to reward depositors
- Fluctuations in wholesale funding costs
- International decisions (political or financial) impacting local markets

James Hickey (Deloitte)
When talking about transparency, funding is one of the areas that is hard to be transparent about. The challenge is that ultimately lenders need to price for a return on the funding that they need to raise.

International decisions impacting funding are hard to explain to customers when we aren't certain as to what they will be, when they will happen, or even why they're happening.

As a customer, understanding why an issue in England, the US or Greece is causing my interest rates to go up, is hard to understand and is hard to be transparent about.

Scott McWilliam (Homeloans)
There was a very clear example of the impact of international event risk on the local capital markets last year, before the US election finalised.

When it looked like the outcome would be in line with election polling, markets were generally comfortable. But as it started to swing the other way, some deals were pulled off the table for fear of credit market volatility.

To Meg Bonighton's point earlier, I think lenders are getting better at explaining why they're doing what they're doing. But to be honest it has never been more challenging to explain.

Today, for anyone borrowing further out than three years, and most banks do borrow three, seven and ten years out, the curve has steepened. This means their cost of funds has gone up. But at the same time, capital requirements for certain asset classes have also gone up.

Frankly that is too much detail for a customer. It is quite hard. I think the banks have done a reasonable job of trying to keep it generic.

James Hickey (Deloitte)
Mal, do broker customers want a detailed explanation as to why the rates are different across different lenders, and why they are moving?

Malcolm Watkins (AFG)
Some may want it, but the question is, how do you do that? I think it is not actually realistic to think that you can bring them along that journey. I think they simply want to know, that the rate for their product is not going to rise disproportionately to the rest of the market.

I think it would prove very difficult for the securitisers to attract investors if the investment rate they are being offered today were significantly reduced. Basically the securitiser wants to compete in a market in a year or two's time.

So I think detailed explanations about different rates has major problems, and would be a huge funding challenge if it were forced on us. I can't see it happening.

Conduct Matters

Good conduct is when an organisation's behaviours and practices deliver fair and suitable outcomes for customers, employees, suppliers and markets.

Financial Services Director Tim Noad examines the opportunities identified by the roundtable and the market around conduct and how good conduct matters.

It is telling that the roundtable identified the risk of customer related conduct matters as the second highest risk to the industry, greater than significant macro-economic factors including unemployment rates and house prices that banks traditionally monitor in detail.

This is both a reflection of the roundtable's views that the macro-economic factors look fairly strong in 2017 and an acknowledgment of the importance of delivering the right outcomes for customers in light of greater community and regulatory focus. As noted, this is not just an Australia-centric concern, rather it has dominated retail banking internationally for a number of years.

Recent ASIC activity suggests a similar regulatory path to that prosecuted internationally will be followed locally.

Understandably, in the context of the industry focus, the roundtable's discussion of conduct was inextricably tied to discussions of risk and failure to provide customers with the right services or products. However, it is our view that equal attention should be paid to the opportunities arising from providing fair and suitable customer outcomes (the cornerstone of good conduct).

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> Equal attention should be paid to the opportunities arising from providing fair and suitable customer outcomes – that is the cornerstone of good conduct.

The roundtable identified using data to personalise customer offers, and holding the next best conversation as key drivers of change in 2017. Adapting the conduct view to this initiative, will both balance the fairness and suitability of the next best conversation and next best offer for the customer.

Customer Outcomes

Many factors are needed to determine the exchange of value that comprises the 'best outcome' for a mortgage customer.

Throughout the discussion, the roundtable dispelled any sense that price was the only factor to consider when looking at customers, instead promoting ease of doing business, and personalising products and service. Below we look at the key elements of fair and suitable customer outcomes.

Fair Customer Outcomes

Taking into account concerns regarding affordability raised by the roundtable, a mortgage has the ability to deliver benefits to both the bank and the customer. Fairness in the exchange of value is undermined where information asymmetry is either intentionally or unintentionally exploited by the bank or broker.

Fairness is typically considered at the distribution of the product, as evidenced by the ASIC review into broker remuneration structures. (see Page 46)

The roundtable also identified fairness as an issue throughout the term of the mortgage. In the discussion differential pricing of front and back books was identified as part of efforts to retain customers.

Such practices, although reasonably common in Australia, could be seen to take advantage of both the information asymmetry between bank and customer, as well as particular customer behavioural biases.

These practices are now rare in jurisdictions such as the UK, and we would expect differential pricing to become seen as unfairly impacting customer outcomes.

Ensuring the right product with effective controls, processes and systems is a key to achieving fair customer outcomes.

This issue is not limited to servicing mortgages as pointed out by Peter Kell (ASIC)[1] and Wayne Byers (APRA)[2] who stress banks' obligations to invest in systems, processes and controls that achieve fair customer outcomes in line with the product features sold to customers.

1. Bankwest remediation of interest offset
2. http://www.apra.gov.au/Speeches/Pages/Remarks-for-regulators-panel.aspx

What to look for to achieve customer fairness:

- Failed application of interest offsets
- Failed application of discounts for other packaged products
- Differential pricing by customer segments not linked to credit-worthiness
- Re-pricing of customer back-books
- Selective or concentrated broker introductions including 'too good to be true' application volumes
- Mortgage insurance products with poor terms and conditions
- Failed application of maturity terms of loan features

Suitable Customer Outcomes

The roundtable rightly identified that suitability, that is, whether the product meets customer needs and purpose, should be assessed and considered at the start when selling the mortgage to the customer, and constantly throughout the life of the product.

Whether customers are using products as intended can be particularly relevant to certain products. Similarly this can also be relevant to other products such as credit cards, where the customer's usage may more closely resemble a personal loan, rather than a credit card.

This is a fundamental shift for many lenders, as the focus has historically been at origination, rather than prospective, over the life of a loan. The ability to monitor, understand, anticipate and act on customer behaviour at both a product and customer level will require a significant uplift in a lender's data analytics capability.

However as was noted, it is not access to the data, but the ability to synthesise it to provide meaningful information, which is the primary challenge.

Thinking about conduct in this way may extend the lender's obligations to monitor suitability of products beyond current set-ups, however, getting there aligns to the focus of the roundtable's discussion of innovation in 2017 on personalised products and service.

> A suitability shift means a move from the lower threshold of 'not unsuitable', or 'OK' where 'near enough is good enough'. Achieving OK does not hold true in a world of good conduct.

Suitable conduct

For an outcome to be suitable, it must be appropriate for the needs of a particular stakeholder, purpose or situation. This implies several things.

Firstly, the situation in which customers will buy and use products and services must be appropriately considered. Secondly, organisations must ensure that products and services are 'sold' and delivered to the right customers in the right way. And finally organisations must continue to evaluate how customers are using their products and services.

Considering situations for products and services requires a change in mindset from 'can we sell this product/service?' to 'is there a genuine need for this product that will benefit our customers?' Many organisations are re-evaluating their business models and value propositions as a result of re-framing this very question.

A conduct lens can further enhance this process by getting to the heart of why, how and when your customers will use your products and services.

Suitability in the spotlight

- Assessing and understanding suitable mortgages, particularly interest only mortgages, has been a key focus of regulatory oversight in the last 12 months. This has been at the forefront of findings from industry reports (REP 443 (Review of Interest Only Home Loans), REP 493 (Review of Interest Only Home Loans: Mortgage Brokers inquiries into consumers' requirements and objectives).
- These reports and subsequent actions demonstrate intensified regulatory scrutiny over controls, processes and templates that lenders use during the underwriting process to protect customers from being approved for unsuitable loans We expect that the suitability of Interest Only mortgages for instance will continue and that this will be the catalyst for further products and underwriting practices to come under scrutiny.

What to look out for with regards to customer suitability:

- Affordability and serviceability of mortgages
- Suitability of mortgages
- Interest-only mortgages
- Lines of credit
- Reverse mortgages

Bringing it together

Organisations need to constantly monitor and supervise fair and suitable customer outcomes. To do this they must design and put in place frameworks that will detect and where needed control activities to ensure any vulnerabilities and opportunities are being constantly checked on. Some suggested steps to assist coordinate this, as well as some detail around each of the three main approaches are articulated below.

- **Equip to look forward –** (Identify and manage conduct vulnerabilities and find opportunities to better help stakeholders)
- **Detect and control –** (Design and operate monitoring and supervision processes / frameworks)
- **Remediate and accelerate –** (Take action to fix wrongs and to accelerate strategy).

Some suggested steps to **equip and look forward** include:

- Know who your key stakeholders in your particular business are
- Define and communicate the expected outcomes you will deliver
- Identify the parts of the business where vulnerabilities and opportunities exist
- Assess by gap analysis any current arrangements where conduct does and does not line up to the outcome you want to deliver
- Build and implement the necessary tools and processes to address any deficiencies.

When it comes to **detecting and controlling** it is important to design and operate monitoring and supervision processes and frameworks that are focused on conduct outcomes and let organisations monitor, address and improve conduct. Some suggested steps include:

- Use lead indicators to identify potential systemic issues before they crystallise
- Leverage the insights from data
- Integrate feedback and continuous improvement processes through all areas of the organisation.

Remediate wrongs: Where concerns around an organisation's operations begin to develop, it is essential to remediate any wrongs and listen to the concerns rather than let them grow. Developing a remediation framework is a first step.

Accelerate strategy: With many organisations focusing on fixing previous wrongs, it makes sense to assess whether there are lessons learnt and therefore opportunities to accelerate the achievement of a customer-centric strategy.

The customer conversations had; the way organisations motivate and reward employees; and the transparency and guidance provided through policies and frameworks; are some of the areas where opportunities to accelerate strategy are commonly identified.

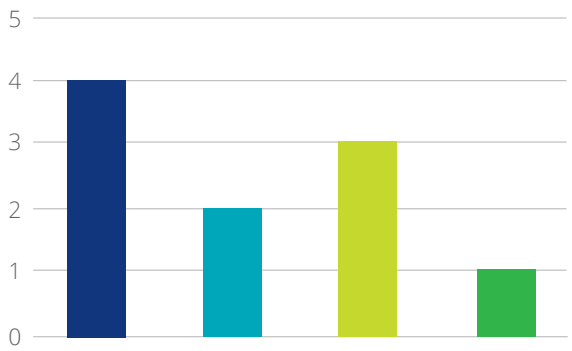
The value of accelerating strategy is to enable organisations to confidently grow in the knowledge that they do so in a way that will be sustainable; that grows consumer and market confidence and trust in our financial services providers; and enables innovation and so growth.

Conduct matters

Organisations that better understand the extent to which conduct will change their operations and outlook, will be better placed to evolve their business models and concepts to keep up with changing expectations and respond to competition and disruption, and most importantly to grow.

Funding

What level of 'front book' discounting on the standard variable rate will be the norm over 2017?



- <80 basis points discount
- 81–100 basis points discount
- 101–120 basis points discount
- >120 basis points discount

James Hickey (Deloitte)
This comes back to an earlier question about market share vs profitability, where I observed the race for market share triggered discounting prior to results announcements. This does link the front book and back book pricing. We wanted to get a feeling for the level of discounting that happened in 2016 and what discounting may be in 2017.

Malcolm Watkins (AFG)
I'm leaning towards 80 basis points (bps) next year.

James Hickey (Deloitte)
Someone did select greater than 120bps which is a sign of the competition. I know it was at least 130bps last year.

Malcolm Watkins (AFG)
It does hinge on the type of broker we are talking about, the level of volume a particular group originates, and how well their book is skewed to particular lenders. This defines whether the discount is going to be 120+bps in every discussion vs no more than 70bps at 500K.

Lisa Claes (CoreLogic)
It is also a segment play, with the discounting lever being adjusted according to the capital ballast that asset carries on the balance sheet.

James Hickey (Deloitte)
We did intend this to be a prime loan less than 80% LVR. I think any less than 80 bps won't make it for competitive reasons.

Lisa Claes (CoreLogic)
I think it will be greater than 80bps discount.

Graham Mott (Deloitte)
Thinking about the multiple channels and assets the big banks have, the question is where they will deploy funding this year. Will it go down the mortgage path, or down another asset class?

> The return on investment and return on equity on a mortgage loan today is extremely healthy compared with other asset classes. I think that will be where the bank will put its funding, its time and its resources this year.

Meg Bonighton (NAB), **Graham Mott** (Deloitte)

I think it will remain competitive until there is another asset class as attractive to encourage the bank to redeploy its capital and time. Almost everyone in the room agreed with profitability and NIM on the last question which goes hand in hand with this one to be competitive.

Kevin Nixon (Deloitte)
As already mentioned, APRA has already highlighted a concern it has around some in the market sacrificing sound practices for growth. It is something specific APRA wants to address under its broader focus on culture and behaviour.

> So you can expect we will see a higher focus on supervision.

If you are offering big discounts, you can expect APRA to ask why, particularly if it looks like the main goal is to increase volumes ahead of quarterly announcements. Further, under the broader culture remit there will be a focus on transparency and fairness in pricing.

James Hickey (Deloitte)
And if it comes back to that, the question will be how to be transparent to one customer to whom you give 80bps discount and to another one who looks exactly the same, and gets 100bps. It's a very difficult thing. You can be transparent on the LVR, but that's not the actual rate. The rate is about the individual customers and it can be difficult for frontline branch staff I'm sure, to be able to have those conversations with customers when they have to explain what goes behind their rate.

Funding: Explaining the gap

Deloitte Financial Services Advisory Partners Heather Baister and Graham Mott *consider why pricing of mortgages is more of an art than we realise and the criticality of educating all Australians on the funding balance.*

In 2016 bank funding costs were under a spotlight to an extent never seen before. The CEOs of major banks were quizzed by the House of Representatives Economic Committee and there was a passionate debate as to the role of banks in society.

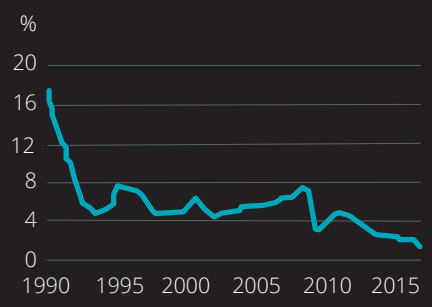
One of the key areas banks were eager to clarify was their funding and in particular, the link to the cash rate. While most Australians may struggle to understand why a change in the cash rate does not correlate to an exact change in mortgage rates, pricing of mortgages is far more of an art than most of the public are aware.

The RBA cut interest rates twice in 2016, by 25bps each time. This was prompted by weak inflation results and predictions, and a desire to return inflation to target over time. Much media commentary was focused on the extent to which these cuts were passed on to the end consumer. Many banks used the cuts, as an opportunity to rebalance their net interest margins (NIM), given the global focus on capital and the continuous need for book growth.

In response to the August 2016 rate review, the banks passed on part of the cut, to mortgage borrowers and to depositors. This move was publicly criticised when, after a relatively short period of time, deposit rates were scaled back. B anks need to be alert to attributing any reduced cuts to aiding depositors in the future. Depositors are integral to bank funding strategies. Given the wider international regulatory environment for banks with its emphasis on liquidity and stability, there remains a continued focus on reliable deposit funding. Domestic deposits across the Australian market, have remained relatively stable for the last two years at around 58-59% of bank funding, with the majors' proportion of deposit funded trending slightly higher.

Deposit management continues to focus on product mix, including the impact of the growth of offset accounts, which continue to grow by 10%+.

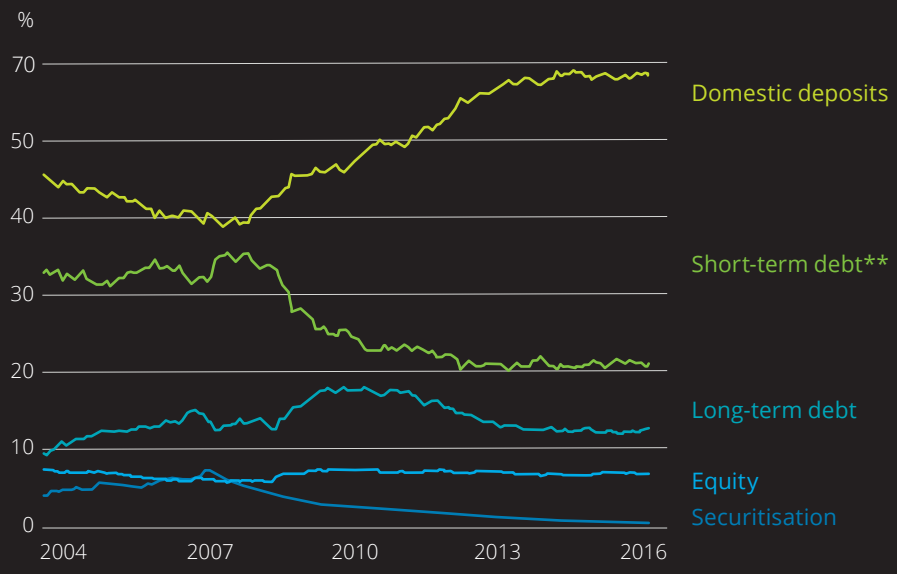
Reserve Bank Australia Cash Rate



Source: Reserve Bank Australia

Funding Composition of Australian Banks*

Share of total funding



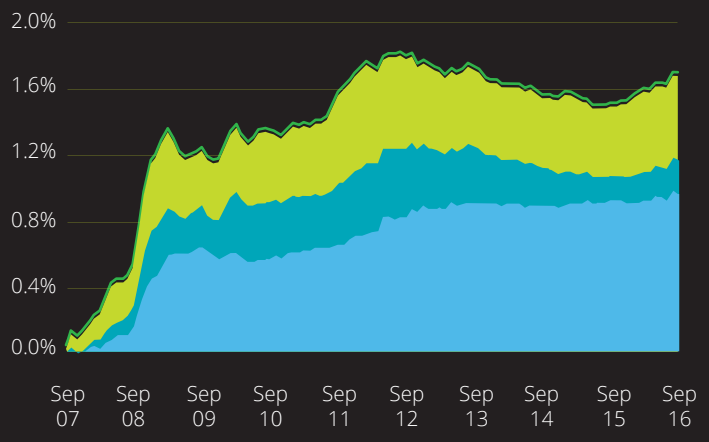
* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Source: http://www.rba.gov.au/publications/submissions/bank-fees-and-margins/handout-standing-committee-on-economics-2016-09-22

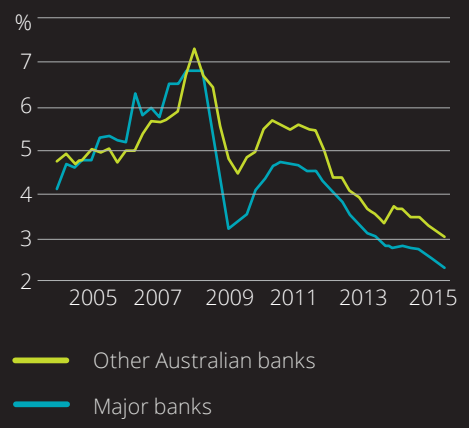
Weighted difference in home loan funding costs to official cash rate

Increase in funding costs relative to official RBA cash rate driven mainly by increased competition for deposits



Source: ANZ Bank [1]

Weighted average funding costs (per cent) for the major and other Australian banks



Source: RBA, Developments in Banks' Funding Costs and Lending rates

Not an island

International events can also impact the cost of funds. The economic turmoil in Europe in recent years effectively froze portions of the debt markets.

The rise of Trump during 2016 also caused disruption in funding markets while participants waited to see long term impacts. Approximately 70% of the banks overall wholesale funding is from international investors, and therefore it is important to have a constant eye on events overseas.

These offshore funding sources are vital for major banks that need greater access to markets and a range of investors, and are key contributors to understanding the gap between funding costs and cash rates.

Another key area which cannot be ignored when understanding the complexity of banks' funding, is the impact and continued focus on capital by our own regulators and those globally.

As APRA and the 2015 'Murray' Report into banks has specified; banks need to be 'unquestionably strong'. The major banks benefit from a perceived 'too big to fail' advantage over mid-tier banks, which impacts their funding costs, an advantage estimated by the RBA as far back as in 2013 to be worth $3.7billion.

However this advantage should diminish as capital holding requirements increase under Basel's intentions to reduce the variability between IRB banks, and those applying the standardised model. APRA implemented higher risk weights on Australian mortgages measured under the IRB approach on 1 July 2016, which is estimated to have increased the bank's capital requirements by up to 100bps. In addition across the system a number of banks that previously applied the standardised model have applied to APRA to move to IRB which will reduce the extent of the gap between majors and some next tier lenders.

At 10% of risk weighted assets, the major banks' CET1 ratios are well above the regulatory requirement, even after the high risk weights took effect.[2]

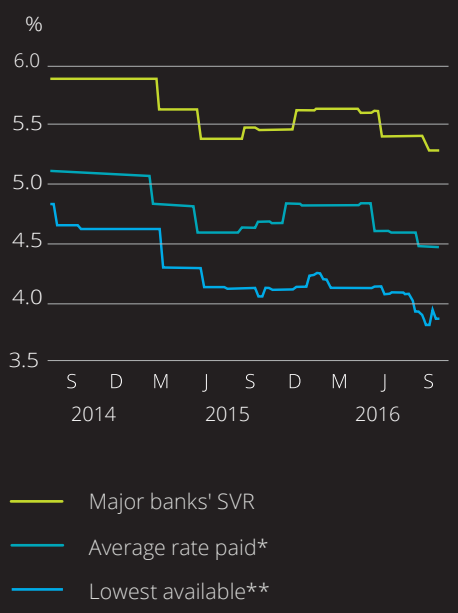
The major banks have been issuing additional capital throughout 2016 which has strengthened their international standing. An APRA international capital comparison released in 2016 showed that as at December 2015, the major banks had moved into the top quartile of international banks. However the trend for increased capital issuance has and will continue internationally. Therefore if the majors wish to remain in the top quartile, to demonstrate that they are 'unquestionably strong', they will need to keep increasing their capital ratios.

Impact on mortgages

The contribution of mortgages to the profitability of the major banks is still highly significant, despite the increased capital requirements. The retail banking arm, powered by mortgages, is by far the largest contributor to underlying profitability, and to the return on equity (ROE) by which all the large banks are measured.

1. Investor Discussion roadshow pack November 2016
2. RBA Financial Stability Review October 2016

Variable Housing Interest Rates



* RBA estimate for existing stock of mortgages
** Indicator based on selected lenders' lowest available advertised standard variable rates

Sources: ABS, APRA, Canstar, Perpetual, RBA

According to APRA during 2016 the ROE across the Australian banking market fell 23% compared with 2015. This would explain why banks absolutely have to focus on funding and capital management in 2017 and beyond. Because of this, we also expect that funding will still get primarily diverted to 'safe' mortgages over other, more capital intensive, asset classes with less predictable returns.

ROE was also impacted by the higher capital levels noted above, alongside a decline in interest rates that has impacted income for many lenders. Australian banks with their recent ROEs of 10%-15% are still high by international standards. However they are lower than shareholders and investors in Australia have been used to. The pressure to maintain ROE is acute, and it will drive decisions about rate movements and repricing the front books in particular.

This is why Australian banks need to protect their NIM in order to sustain ROE. Already this year the average rate for borrowers dropped below 4.5% for the first time in years, with an increasing discount between the benchmark Standard Variable Rates (SVRs) and advertised rates.

We note that only a small proportion of borrowers will actually be able to attract the headline-grabbing sub 4% rates, but significant discounts to SVRs are still available to most borrowers or refinancers.

These discounts only affect new borrowers and refinancers, as the back books are not repriced accordingly. (See page 24 for discussion on some of the challenges regarding pricing front vs. back books).

While APRA's activities have challenged bank profitability through increased capital demands, its investor lending oversight has resulted in banks raising rates to manage growth within prudential restraints. As a side effect this has increased investor lending NIMs, albeit not sufficiently to offset the increased capital costs.

Pressure on NIM, and wanting to avoid the political and social pressures of 'unwarranted' out of cycle rises, has led some banks to re-focus on their fee arrangements and product suites, to support the bottom line.

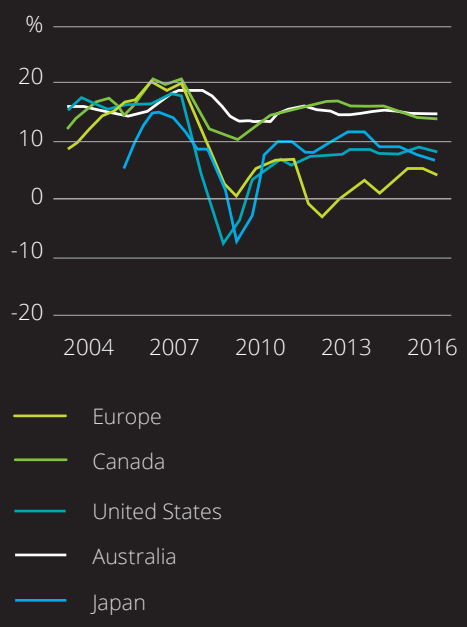
Other Funding Options

Securitisation continues to be a small portion of the overall Australian funding market, predominately used by non-bank lenders with an approximate share of the RMBS market of 25% compared with 5% pre-GFC. This is partly due to pricing on RMBS deals remaining challenging. While they have reduced from the spike at the end of 2015 into early 2016, these are still higher than equivalent issuances two years ago.

Direct link of cash rate to mortgage rates

- One solution, offered for the first time in Australia in 2016 to 'solve' for the misunderstanding between cash and mortgage rates, is the 'tracker mortgage'. This is a mortgage where the rates offered to customers are directly linked to movements in underlying cash rates.
- Proponents of tracker mortgages say they provide consumer certainty, comparability, competition and enhances understanding of what is behind the rates.
- Historically they have been very popular in Europe, however there are some significant concerns from some members of the banking community about their suitability in times of liquidity stress. This reflects the inability of banks to raise funding to match the duration of the mortgage.
- In addition, the 'disconnect' between cash rates and wholesale market rates can be significant, and prove a real threat to ongoing viability in non-liquid markets.
- As a result of these funding and liquidity risks, the tracker mortgages will need to be priced higher than other products offered by the bank. Accordingly our view is that tracker mortgages may be appropriate for a small cohort of customers, for a limited short term period which matches available funding (for example three years), and offered as a part of a suite of products.

Large Banks' Return on Equity
After tax and minority interests



* Number of banks: Australia (4), Europe (52), Japan (4), Canada (6) and United States (18); adjusted for significant mergers and acquisitions, reporting periods vary across jurisdictions

- The major Australian banks' return on equity has averaged around 15 percent over the past decade.
- It is similar to the return on equity for large Canadian banks, but higher than in United States, Japan and Europe

Sources: Bloomberg; RBA; S&P Global Market Intelligence

Senior unsecured debt is also treated more favourably than RMBS for NSFR purposes, making securitisation a relatively expensive funding tool for large banks.

Self securitisations continue to be a key tool however for ADIs, with APRA encouraging smaller ADIs and mutuals to establish such transactions so they can access the Committed Liquidity Facility from the RBA.

We expect that the market in 2017 will not change significantly for RMBS or ABS asset classes, however now that APS 120 *Securitisation* has been finalised, there will be some returnees to the market, now that much of the uncertainty is resolved.

Looking ahead

As we look forward, another question regarding the costs of funds, and therefore a potential wider gap between cash rates and consumer mortgage prices, is the focus on the sovereign rating.

If Australia loses its AAA sovereign rating, this will inevitably flow on to a downgrade of the Australian banks which are currently all rated AA to A. The impact of this has been estimated as increasing funding costs by between 10 bps to 20 bps[3].

This would flow through to the underlying borrower, on top of the continued costs of regulatory capital and liquidity, and further exacerbate the gap between the headline cash rates and the actual cost to consumer.

The more the industry can do now to educate consumers, the media and politicians, as to the balance of considerations from both local and international perspectives, including the need for strong banking institutions within society, the easier it will be to focus the debate on other pressing issues within the industry.

3. https://www.nationalaustraliabank.com/nabglobal/en/blog/2016/09/201609_AustraliaRating

Innovation

Where will innovation drive change in the mortgage market in 2017?

6 Greater use of client data to personalise offers to customers

0 New products emerging e.g. tracker mortgages

1 Improving the customer experience with a focus on building trust

1 Reduce cost of servicing and delivering mortgages through robotics and 'reg-tech' solutions

2 Greater direct-to-consumer distribution rather than traditional branch/broker channels

James Hickey (Deloitte)
The majority of you feel that greater use of client data to personalise offers to customers, is where innovation will drive change this year. I think this has always been the utopia. However each year it seems to take longer to actually leverage customer data to get true personalised offers to customers. What might be different in 2017?

Jenny Wilson (Deloitte)
Well it is slightly different. It is actually applying some innovation to the technology approach that you take to managing the data. A lot of the issues to date have been due to an incumbent technology environment that makes it hard to free up the data to actually get the sophistication and analytics happening to make the data an asset in itself.

Also how you provide the information to the frontline so they can offer the customer what they need, will take data to different level. I would like to see the data inform the next best conversation to be having with a customer. Not necessarily the next best offer.

That level of sophistication around understanding how a consumer is behaving around their accounts, and what you as a lender or broker can be doing to enable them to make better decisions around their financial situation, is the conversation you want to be having with the customer. Presently we are not there, although next best offer programs are out there and being achieved.

Lisa Claes (CoreLogic)
Also we need to increase focus on how to retain the customers we have worked so hard to acquire. Differential pricing between new and existing customers – and differential pricing according to tenure and risk profile – are levers that can be more fully explored. Existing customers provide a rich trail of data insights. You know their value via their transaction history and asset value.

This data can be augmented with external data sets to provide rich insights around propensity to re-finance, and propensity to list their property for example. Day to day lenders have the ability to track their borrowers' equity by marrying real time valuation data with debt data. And borrowers equally can know not only what they owe, but more compellingly, what they own.

> We need to navigate the expensive risk of re-pricing the back book by finding data led solutions to proactive retention.

I have yet to see a lender do this well. I think this is the biggest opportunity. What's attrition running at? About 15% or 17%? With the real potential to increase in this market. This is a trend worth arresting.

James Hickey (Deloitte)
As an actuary we help groups do detailed propensity modelling in the market. Where there is a three month forward looking window for instance, analytics enables the lender to identify those top 10-15% of customers most at risk of refinancing. This enables you to focus your efforts and energy on them. You don't worry about the other 85% – 90% who are less likely to shift.

Meg Bonighton (NAB)
Absolutely. We think about how we talk with the customer throughout their life. From the first time we contact them, which may not be a time that they buy a product from us, and how we link those early conversations all the way through. That is the biggest challenge for banks with the amount of data we have, along with all the different sources we receive it from, and the legacy systems we have to manage. How we execute all that complexity across the large beast that we have, is what we are currently working through. So we don't lack for data – how we synthesize all that data in a meaningful way and deliver flawless execution is the tricky piece.

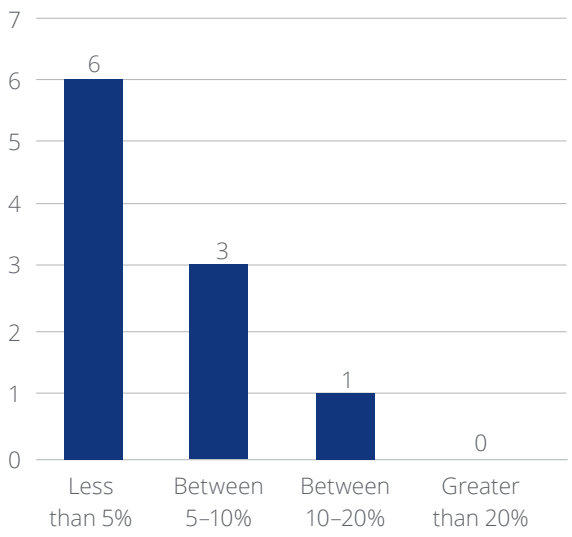
Meg Bonighton, NAB

Which brings me back to the balance we're always trying to achieve. If you're having the right conversations, with the right customer, at the right time, about a particular need they have, you will avoid disrupting them. Be there first with some information so they can make a better informed decision about their next step.

Jenny Wilson (Deloitte)
Absolutely although data is however only one piece of the puzzle when it comes to effective service. You have to look at some of the KPIs you put around staff members and how they can best use the insights from data to enable the right decision making process between them and a customer. There are so many elements that need to go around this, including the digital role to get to a good outcome for the customer.

Digital

Within the next two years, what % of new mortgages will be originated via digital only, from distribution through to settlement fulfilment?



> I think the digital home loan is going to be a very different thing. A better term is 'digitally-assisted'.

James Hickey (Deloitte)
This chart asks what actual percentage of mortgages would be originated fully online by a customer end-to-end. Sixty percent of us answered less than 5%.

Peter Andronicos (eChoice)
That resonates especially when you say end-to-end. I only know one that does end-to-end at the moment.

James Hickey (Deloitte)
That's precisely why we asked it, because we are seeing digitals interrupting the entire mortgage 'end-to-end' value chain. This response shows we don't think it is many and that it won't happen quickly. We allowed two years to give us a bit of time to get the model right.

But I think that plays into the strength of the existing role that brokers play; that lenders, face to face, call centre, or mobile lender channels actually play, in helping the customer through a very complex journey, and one which they're not quite ready to trust themselves to do end-to-end online.

Peter Andronicos (eChoice)
Digital is certainly a key area for eChoice, so this resonates well with our business. For us the consumer tells us what they want. We have to continuously adapt to be at the forefront for the consumer. The FinTechs are great, because they are trialling and testing the market for larger players or for more experienced players.

Presently we are not seeing a consumer wanting to do more than an assessment online. The consumer wants to talk.

That's the evolution; 70% of the 5,000 or 10,000 enquiries received a month, want to be handled over the telephone. The telephone is changing the landscape for the new enquirer.

Meg Bonighton (NAB)
I think this concept of one channel vs. 'omni-channel' is too constraining. Customers actually dip in and out of various media that makes sense to them at the time, wherever they are in their decision–making cycle.

Also digital does not have to mean 'not face-to-face'. You can be face-to-face digitally.

Arguably that could bring together the best of both worlds. A world where you have great visuals, scenario planning and demonstrations, as well as a person speaking to you digitally.

Whenever I see this question I think that ten years ago we would have thought digital was taking the home loan application and whacking it online. We agree no one is going to do just that. Digital is the backbone and from there the customer may seek assistance in whatever form.

Mario Rehayem (Pepper Money) **Lisa Claes** (CoreLogic) **Meg Bonighton** (NAB)

Mario Rehayem (Pepper Money)
The more confident the consumer becomes, the more they're going to self-help and self-service. As mentioned earlier, comprehensive credit reporting would give more confidence to a potential borrower because they know what they can obtain by way of a loan, due to knowing more about their eligibility. They know where they are placed in the risk realm of 'good', 'could be better' or 'bad'.

Think about the similarities between doctors and mortgage brokers. Two industries where their clients go to Google to self diagnose, and then they go to the expert and ask them to 'prescribe' on what they have read and believe is a solution that best meets their needs. That's the reality of it. If you throw comprehensive credit reporting into the mix, the consumer starts to better understand the leverage they have, when they know they are a 'good' risk. Or if a 'bad' risk they know where to shop first.

James Hickey (Deloitte)
Meg while it may not be a challenge to get a digital backbone, it may well be a challenge to get all the digital aspects perfect. How do you coordinate and control that? How do you manage each different junction point the customer may have, or different channels they may want to go through?

Meg Bonighton (NAB)
I think one of the best things you can do is try and understand the customer journey much better. I think as an industry we've spent anywhere between 150–200 years trying to teach customers how to apply for a loan in the way we'd like them to apply.

I guess the blinding obvious is that the customer goes through a journey when they look to buy property. Finance is intertwined with that. So we need to think of origination not being as simple as name, address and phone number. There's a whole conversation and thought process happening with the customer; as well as a whole online or face to face conversation. Only then can you get to the: "Okay we've made our decision and now we originate the loan."

At NAB we are thinking about how we link in much better with the customer journey and provide a lot more value and insight much earlier in that journey than we did historically. The approach of - "Once you've made the decision on which property you're going to buy and where, come to us and we'll help you finance it" - is an older world view.

Lisa Claes (CoreLogic)
In the Romania branch of ING, when a customer desires a personal loan, consent can be provided to the ATO equivalent, to access your tax records as part of the credit assessment, in order to get an unsecured or secured loan within a couple of hours.

Peter Andronicos (eChoice)
Consumers today are comfortable with digital in their data space. It has been going on for 20–25 years. People have been loading their credit cards onto online gambling sites for 25 years. This is not something new. So the evolution is just continuing. The FinTech evolution is just that. If you take the evolution of digital, it is just another step in this process of the consumer maturing through the journey.

> I think we will see a shift towards customers being savvier around what it means to be sharing data.

Lisa Claes (CoreLogic)
The opportunity here, is to piece together every piece of the puzzle of becoming a homeowner or borrower via digital means. We have electronic identification, smart-contracts and electronic settlement.

But as yet, no-one has seamlessly joined the dots digitally. Maybe that's what brokers can do. To your point Meg, digital does not mean NOT having humans involved. We all have these tools. It is just getting that digital cadence operating smoothly.

Peter Andronicos (eChoice)
But will the consumer want that level of data sharing? The consumer is becoming more savvy.

Lisa Claes (CoreLogic)
If Facebook is any indication, the answer is yes.

Peter Andronicos (eChoice)
In the digital footprint that people leave now, you get prompted as to whether you want to enable cookies – this triggers data-collection. Organisations are now having to build data systems around enabled and non enabled customers, and separate their paths. Consumers also might not be able to decide in an informed way, whether they want to share or not.

Jenny Wilson (Deloitte)
It also does not yet offer the opportunity to share for a portion of time. That means that the analytics capability has to be in the moment. There may be data you have for a certain decision, that the customer will then want you to delete.

This takes data collection and open source to a whole new level. It will mean pressure on Facebook and those types of organisations, to be more explicit with consumers about what 'sharing' means. That in effect someone they may not know well can see their information? This will teach consumers a whole new level of what good practices around the privacy of information means.

> We have electronic identification, smart-contracts and electronic settlement. But as yet, no-one has seamlessly joined the dots digitally. Maybe that's what brokers can do.

Jenny Wilson, Deloitte

FINTECHS: Looking back and ahead to 2018

Chris Wilson Fintech Partner Deloitte

In 2016 we expected to see more integration within the industry as smaller FinTechs sought scale. We expected to see more collaboration between large incumbent organisations and FinTechs, bring new offerings into the value chain. InsureTech and RegTech were going to grow, and Blockchain was going to come of age.

Specifically, in 2016 we forecast:

- **Scale**: more integration in Australia in 2016 as FinTechs sought scale and distribution
- **Collaboration:** more collaborative environments with increasing partnerships between financial institutions and FinTechs
- **InsureTech:** some 100 new insurance start-ups by year end
- **RegTech**: FinTech companies would also start to use algorithmic platforms and predictive analytics to help large companies and banks with their compliance overheads
- **Blockchain:** blockchain proof of concepts and pilots coming to market. We expect commercial grade scalable blockchain platforms in 2017.

But 2016 was not a smooth ride. The momentum that built across 2013, 2014 and 2015 continued into Q1 2016; but then things slowed down. Investment in the sector continued, and there was still a lot of new capital, but the large deals and rounds[2] were not as common as they were in 2015, which created a plateauing effect.

In 2015 more than US$45.9 billion of capital was invested in FinTechs. An estimated $88bn was looking for opportunity in 2016. This did not eventuate.

About $945.6 million flowed into FinTech in the third quarter (Q3) of 2016, according to Dow Jones VentureSource, a 57% drop from the same period a year ago, when venture capitalists (VCs) deployed $2.2 billion into the broader sector.

The amount invested in the Q3 was also down from the second quarter, when FinTech companies raised $1.04 billion. The Australian government did not move on regulation around equity crowdfunding, which impacted a segment of the market looking to expose retail investors to start up and FinTech investments.

In total the amount invested in FinTechs dropped to 20.8 billion in 2016, a considerable decline of ~50% from 2015, primarily because of geopolitical and macroeconomic uncertainty.

Globally there were no standout 'super rounds' as in 2013, '14 and '15. Alternative lending and alternative marketplaces together with InsureTech - investment in insurance technology companies - was on the rise. Venture capitalists put $167m into insurance tech in the third quarter. There was more funding in each of 2016's quarters than in any of the similar periods the previous year.

Looking at 2017 and beyond.

Many of the trends relevant in 2016 will continue in 2017/18. However, we expect to see some changes in growth areas around InsureTech and RegTech. Some more granular use cases for blockchain, and more cases of FinTechs collaborating and integrating with larger financial institutions.

In Australia

In Australia, it feels we are at an inflection point. The FinTech sector is maturing in many ways. But against the measure of successful FinTechs launching, disrupting, growing and surviving on their own, the volumes we expected more than a year ago are not there.

Nevertheless some very successful FinTechs made their mark in 2016, including three of the five top performing Deloitte Tech Fast 50[3] winners:

- **MoneyMe Financial Group Pty Ltd (NSW):** a diversified mass market direct lending FinTech that uses technology to revolutionise consumer lending to the millennial market in Australia
  - It was set up to disrupt the payday lending market through a proprietary tech platform called 'Horizon', a cloud-based database with a loan management/lending platform that includes customer relationship and payment management capabilities
  - The system enables automatic approval and funding of loans, and was the first to introduce risk-based pricing and to reward borrowers for positive repayment behaviour generating cost savings from lower default rates (2,811% growth)
- **OpenMarkets Australia Limited (Vic):** Australia's fastest growing stockbroker, consistently ranking in the Top 15 brokers in Australia by trading volume in less than three years
  - Independently-owned, innovation-driven and technology-focused, this 'fintech' stockbroker specialises in brokerage integration with third parties (2,778% growth)
- **HUB24 Limited (NSW):** An investment and superannuation platform offering a comprehensive range of investment options, including administration, transaction and reporting solutions
  - The company uses state-of-the art technology to deliver a fully integrated service that helps track and better manage investment and superannuation assets. (1,248% growth).

In 2016 there was also a definite increase globally and in Australia around InsureTech and alternative marketplace lenders.

2. A 'super round' is a raising greater than $1billion.
3. For a full list of winners and further information on the Deloitte Technology Fast 50 Australia program, go to www.tech50.com.au and use #TechFast50au on social media.

Technology companies are invited to self-nominate for the Deloitte Australia Technology Fast 50 list via the website. To qualify applicants must accumulate more than $8 million in revenue over the last three years. This financial data provided by entrants, is gathered by an online survey tool and is cross-checked using each company's financial information, verified by their accountants or a registered auditor.

Venture capitalists put $167m into InsureTech in the third quarter, and there was more funding in each quarter in the sector than in any similar periods in the previous year.

Regulatory support
With the Australian Securities and Investment Commission (ASIC) creating a sandbox and the ASIC Advisory Board, there was a healthy move towards create an environment more conducive for startups on the regulatory front.

However the equity crowd-funding issue is yet to be resolved. And those seeking to continue to harness innovation in the tech industry should closely monitor the Government's response to the Research and Development (R&D) Tax Incentive Review due this year (2017).

This combined with last year's 1.5% rate cut in the R&D tax incentive and further probable changes to the tax and regulatory environment could have a particularly significant impact on rapid growth tech start-ups, such as reduced cash flow benefits and fewer activities qualifying for tax benefits.

Blockchain
Although blockchain was again the tech 'term de jour' in 2016, we are now beginning to see more focus on sub sectors such as rewards and loyalty, digital identity and payments.

Last word

1. While much of the lustre and intrigue of the new technology phenomenon has rubbed off, what remains are clear use-cases that encourage different value exchange models, both cost constructs and time-to-value calculations when it comes to realising the value of a given transaction

2. FinTechs were and still are looking offshore for scale and capital

3. The hubs and accelerators continue on their marketing and PR journey, hopefully matching 'returns' with their activity in 2017/18.

The digital banking revolution – an example

Six million customers of one UK major bank are advised through their online banking account how much they can borrow on a personal loan of up to £50k and at what interest rate. It then takes six clicks on their mobile phone to have the loan instantly funded into the customer's account 24 hours a day, seven days a week.

The net promoter score (NPS) is off the Richter scale, bad debts are at historic lows as data is being used to make more intelligent lending decisions and cost to income ratios are at levels not seen before due to automation.

Situation

In the same UK bank, the only thing customers could do on their online banking was to get their mortgage balance. Today customers can go onto the bank's home owner app and see every property that is for sale throughout the country. The customer can talk to a call centre operator instantly, or make an appointment with their local branch or one of 14,000 accredited brokers. They can also get a 'genuine' approval in principle in minutes, and can lodge the application online themselves if they want to.

Customers can also track progress of their application through to settlement and they can then do all of their servicing online. The transformation from being able to do almost nothing with their home loan online, to doing almost everything took just four years. That is the pace that incumbent players are going to need to move at to remain relevant in the future.

Complication

Customers' main transactional bankers at are a distinct advantage because they hold customer data they can use to accurately make lending decisions, including advising pre-approval.

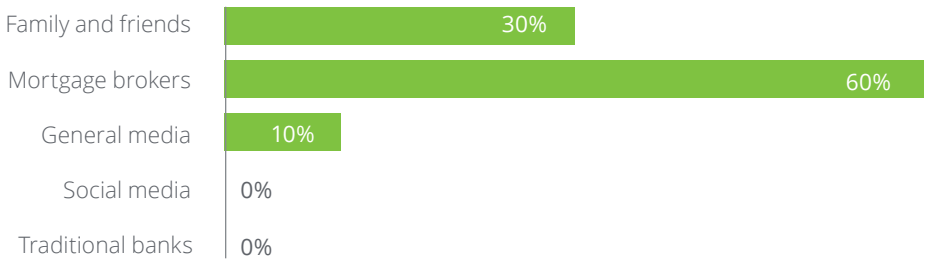
Solution

By 1 January 2018, consumers in the UK and Europe will be able to tell organisations that hold their financial data, to place it into a central repository where it can be accessed by other firms they authorise. This will be as a result of the EU legislation, Payment Service Directive 2.

Once this happens, both FinTechs and customers' non-transactional bankers, will be able to access this data and use it with their credit algorithms to assist them make quicker and more robust lending decisions. This will drive competition among lenders. Australia is not as advanced with its data sharing plans as the UK but we can expect calls for that to occur to grow louder.

Consumer

What are the most influential information sources for consumers on mortgage products?



James Hickey (Deloitte
What is the most influential source for consumers around the mortgage process? This is not how they do it, or how they choose to engage, but to whom they turn initially to understand the processes. The consensus was 60% brokers.

Heather Baister (Deloitte)
A member of my team, a young woman of around 25 could not believe it. She does all the research legwork, and in her millennial world social media, friends and family all intertwine. She may go and talk to 10 people in person, but over social media she can ask thousands to recommend a broker or a bank home loan. As a representative of the millennials she was astounded that social media was not picked.

James Hickey (Deloitte)
The results probably indicate that with all the changes to pricing, their differentials and impact, and the fact that products are changing all the time, brokers are the ones with a finger on the pulse across the whole marketplace of current offers.

Peter Andronicos (eChoice)
Again that comes down to the point of engagement with the consumer and the information source. The initial engagement point for the average consumer looking for a property or information to purchase, is either with a real estate agent, through searching property sites like Domain.com.au, Realestate.com.au or through Google.

The mortgage broker can pay $20–$30 for every click on targeted search engines, or between $3–$5 on property-related web sites or apps.

> The average consumer looking for a property either goes to a real estate agent, or a property site like domain.com.au or realestate.com.au or Google. The mortgage broker can then pay $25–$30 for every click; or between $3–$5 on property-related web sites or apps.

A bank or a major financial service provider has a limited budget and broad approach. But for a local mortgage broker who only looks after three post codes, and is after two to three leads per week, they can buy the post code out and compete with a big brand. As a company they can buy 10 clicks a day. One conversion from the 10 clicks should deliver a very cost effective Return on Investment; and the consumer can see the local location and engage with a local service provider. So the competition is there. The various media channels and ease of access make sure the initial engagement is vastly different and competitive.

Malcolm Watkins (AFG)
When it comes to the introduction point, you would have a different answer for a 25-year-old. However the most influential information source is going to be the mortgage broker, and family and friends. For a 25 year old, online would probably be more likely. But there is also a decision point.

Scott McWilliam (Homeloans)
What is interesting is that traditional banks or lenders know they can't just be product providers. They also need to be seen as providers of information. Lenders need to connect earlier than the point where the consumer actually decides who to go with.

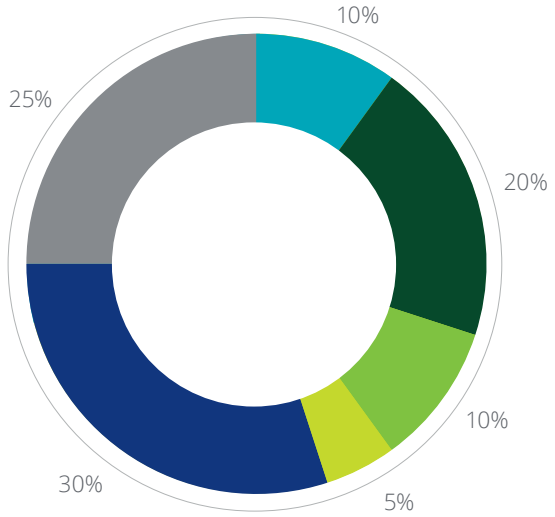
Consumers tend to go to a bank site or a familiar brand. The strategy is hopefully that the potential customer will stick to the path. Although we know we need to go forward with the education piece and be part of that information source, it is interesting that everyone has touched on product.

Mario Rehayem (Pepper Money)
It will also be interesting to see how the family and friends' role has evolved over time. Now they may well be deemed more as a referrer, than a person that is going to give them financial advice.

> Traditional lenders know they can't just be product providers. They also need to provide information.

Consumer

What features, other than price, will be most important for consumers selecting a mortgage provider over the coming 12 months? (Two options selected)



Legend

- A fully integrated offering
- Technology
- Security (perceived) of lender
- Social reputation, ethical brand/perceived trust
- Product features
- Customer experience in the end-to-end mortgage process

James Hickey (Deloitte)
We removed price from the equation. So it is interesting to see the top three features expected to be most influential for consumers when selecting a mortgage provider in the next 12 months are product, customer experience and technology.

Scott McWilliam (Homeloans)
I think the customer experience is interesting. I daresay it is broker-led. Unless you have been through the process before, you will need someone to help you understand the lender options given the interest rates are pretty close. Someone who knows that lender A offers a better experience, and that lender B trades off a bit of interest rate will be useful.

Meg Bonighton (NAB)
I think all of these options are tickets to play. You need to have a good reputation, and you need to be trusted as an institution. You also need to have security. I think security of the lender, as well as trust are linked. Product features are a ticket to play to get the mortgage process to hang together. So the important breakthrough will be to deeply understand the customer's journey, and add insight, and value throughout it.

> Money is ultimately a source of either great fear or great joy to customers.

As a bank we see our role as making sure it's a joy. And the way to get to the joy is to 'enable'. This is usually to inform, to give transparency around market data or whatever it might be, to enable the customer to feel confident in the choices they make. They need to feel that when buying a house it has been a victory, and not an ordeal, because they felt really well informed along the way. And confident of the decisions they were making both for now, and for the long term. So for me that sits above all those options.

Mario Reyahem (Pepper Money)
From a customer perspective, what experience would attract them to go to a particular lender or product? Versus those who might be a repeat user of that particular brand? The question is what value does the consumer place on that particular experience being an end-to-end or a fully integrated offering? Attracting new business from a new customer, compared to attracting repeat business from an existing customer. They are two very different interactions, requiring completely different approaches.

Jenny Wilson (Deloitte)
To be fair on the banks, the research we've done with consumers show that if they are already in a relationship with a bank, they will typically go to them for information. So where you're looking at someone who has never been there before, and doesn't have a deep relationship with their bank, the bank doesn't have an advantage.

Our consumer research shows that trust would be more important to consumers. Also maybe replace the word technology with innovation. Our research shows that consumers are really looking to mortgage brokers to think innovatively. They have a perception that banks are spending a lot of money on innovation, so they need their brokers to be up to speed in that regard. So I think there are different perspectives depending on the consumers' mindset.

Peter Andronicos (eChoice)
Everyone is different. Every consumer is different. Everyone has a different lever and a different driver. We are lucky enough to be part of a business where we hear every phone call.

We hear the questions, and we hear the consumers' need. In one discussion it may be: "Okay, you love technology and you want an app and you want to be able to do everything at your fingertips. X bank and Y bank have the best apps. If that's the path you potentially want to go down, and you're interested, I will send you a link to have a look at what their app offers etc."

To another consumer the conversation may be: "I hate that company. I worked with them before. I want to use this one. Who else can you recommend?" Everyone is different. There is no cookie cutter approach.

James Hickey (Deloitte)
It goes to show how important it is that the lender has the broker's confidence. The process both the broker and his/her customer will be put through to get the loan approved, is so important. The lender needs the broker to be their advocate, because the customer asks the broker which lender has the best experience.

Malcolm Watkins (AFG)
Correct, I was suggesting that you replace the word 'experience' and put 'customer expectation' in the process. Lenders that are most effective in explaining what's going to happen and how it's going to happen. And give the peace of mind that it's not going to be difficult or painful. Those lenders are going to be most successful.

Lisa Claes (CoreLogic)
Once upon a time as a banker all we talked to customers about was what they owed and not about what they owned. Today we need to engage customers and share our insights about the equity customers are accumulating.

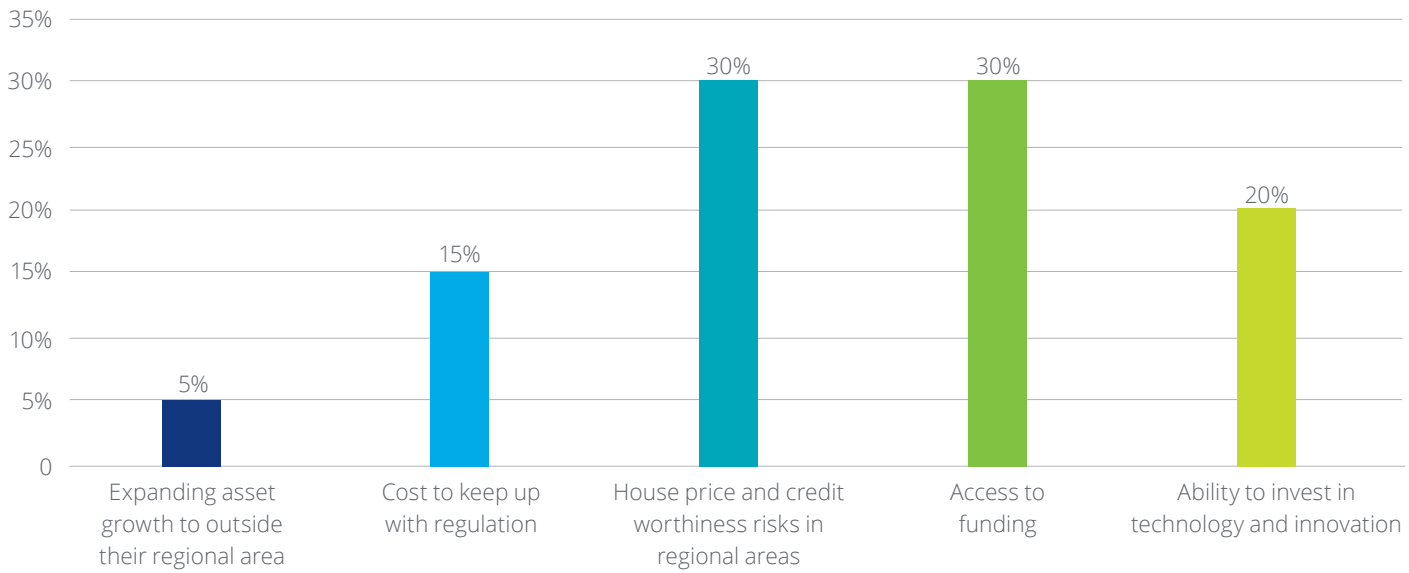
The dialogue needs to shift away from debt to equity. We all have access to this information. Customers are more interested in understanding how their bank or broker is going to assist them to build wealth.

> Once upon a time bankers talked to customers almost exclusively about what they owed and not what they owned. Differentiation today is about assisting them build wealth.

Malcolm Watkins, AFG

Regionals

What are the major challenges facing the regional lending sector? (Two options selected)



James Hickey (Deloitte)
Here we asked for the two challenges for the regional lending sector. Clearly it is access to funding on one side but also growth and how to play in a bigger part of the market to get the scale that may be desired?

It is interesting that 60% selected either actual access to funding, or particular credit risk exposure in those areas in which regional players traditionally operate. From my perspective I was surprised that only 5% said expanding their asset growth outside their regional area as being a major challenge. Vimpi, can you reflect on that?

Vimpi Juneja (BOQ)
The reason expanding outside of regional areas isn't a challenge is because you can work with Malcolm's AFG team! It is well understood that between 50%–60% of new flows go through brokers.

Brokers are great for regional banks because they allow us to compete in the commodity market of mortgages, and reach a national footprint efficiently by converting distribution into a variable cost. As a regional bank with 1%–2% market share, you need to think differently and more boldly to the major banks.

In my opinion, the single biggest challenge regional banks like BOQ face in being a legitimate and profitable competitive alternative in mortgages is access to funding.

We have to pay more for wholesale funding. Also because we have a smaller branch footprint, you have lower transaction deposits. Put that together with higher operating costs – though in the case of BOQ, we can outsource a lot of them through our franchise model – and you see the economic challenge for regional banks.

However whether a regional bank or not, we are all in the same market and have to respond to the same regulation. We have similar technology requirements to the majors; we just need to spread them over a smaller customer base. So the nature of the competitive challenge from a mortgage perspective comes back to pricing. And that's 120bps discount on the front book. That's the only way, whether we want to or not. Mortgages are a vanilla product. Maybe you change the payment frequency or the rate, but there is no competitive differentiation on that.

So for regional banks it comes back to how we're going to make money and survive in this market when you have a higher cost of funding. Regionals still have to meet the market on vanilla pricing so that means we need to differentiate on service and relationships. For BOQ, our customers have the mobile number of their branch manager. Customers are a big fish in our small pond.

These days 'Main Street' customers cannot go into a big four branch and be treated like anything special. The big four banks invariably have to prioritise how they get scale into servicing their large number of retail customers and focus their resources on their High Net Worth borrowers.

Branch managers at the major banks also turn over every 12–18 months so there is no relationship continuity. That creates a group of customers that the major banks have largely forgotten and underappreciated. So as a regional bank we must maximize that relationship focus.

It is a segmentation play. It is not about house prices and credit worthiness in regional areas, because we don't have to compete in those areas. It is simply about how you make an economic return when you have these fundamentals.

The biggest thing that we need to do, is get much better at appealing to, and pricing for, the group of customers in the middle that have been neglected by the major banks and who deserve to be treated better for their custom.

James Hickey (Deloitte)
Vimpi, has that been a challenge for a traditional bank such as BOQ whose heritage is large in Queensland? When you are competing for prime customers in your home market then it must be difficult to price that premium.

Vimpi Juneja (BOQ)
I agree James, that's exactly what's behind my point on why regional banks need to be realistic about what customers they can profitably compete for. Where we can get a premium is with customers who may be more 'risk-challenged' using traditional risk measures.

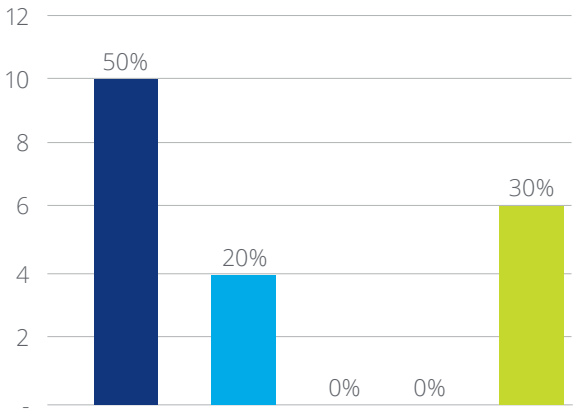
That's why for us we focus on process innovation into risk-based pricing to profitably service a market where we know that 3% of the population doesn't want to, or can't deal with the conventional approach of the big banks.

Mario Rehayem, Pepper Money

Heather Baister, Deloitte

Brokers

Where is the greatest opportunity for the broker model to evolve in two years' time? (Two options selected)



- Integrate digital into their processes with customers
- Broaden value chain capture e.g. white label offering, own securitisation program etc.
- Mergers and scale within the broker sector
- Vertical integration with lenders owning broker groups
- Invest in the business and management skill of brokers

James Hickey (Deloitte)
What do brokers need if the 'new' broker model is about bringing digital into the customer journey and experience? Are brokers integrating digital effectively into the way they interact with both lenders and customers? A lot of customers expect the broker to be digitally enabled.

> We now know how to tap into and create the environment that the consumer wants to be in.

Steve Weston (Consultant)
We are hearing the term 'robo-advice' a lot recently, which sounds like brokers are no longer required. The truth is that brokers overseas are getting customers to self-complete their application form and upload their bank statements and pay slips before a physical meeting takes place. This allows brokers time to do all the affordability checking and finalise a list of recommended loans before the meeting. Brokers can then spend more time with customers talking about home buying education, product recommendations and the need for insurance and the like. The day that a robot can do all of that is still some way off.

Malcolm Watkins (AFG)
I think brokers want to be able to offer digital facilities to their customers and want the customers to work collaboratively and independently of them at the same time. That's where I think the integration is. New ways for end-to-end valuations.

All the things such as title searches, online instant conveyancing and settlement. Brokers want to integrate their services to improve the customer experience while they travel through their end-to-end process. That's where the big opportunity is and their strong point.

James Hickey (Deloitte)
Does that rely on lenders to give that level of digital information, transparency and communication to the process?

Malcolm Watkins (AFG)
It's a combination. There's a lot of pressure as an aggregator to provide front end digitally enabled processes integrated into the lenders. At the same time you must have the back end CRM to assist ongoing customer service and loan maintenance.

Lisa Claes (CoreLogic)
I see brokers as a financial concierge. They are really about facilitating access to the consumer's largest asset. So it's not just about the process. It is good if it is digital and seamless, but for me, I want a broker who can clearly make the process of origination seamless and timely.

For me it would be about liberating the financial balance sheet, accessing an adviser that is able to deliver via digital corridors meaningful data to aid my decision-making process. I think brokers are really well equipped and positioned to do this.

This service I believe would be pivotal in my decision to return to the broker as a guide on my financial journey. Essentially I see the broker leveraging the armoury of digital tools and data sets, in order to provide a fuller picture to a customer.

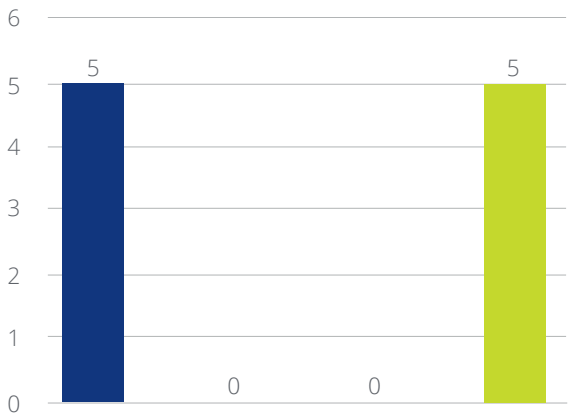
Mario Rehayem (Pepper Money)
It has evolved over time. Historically in the financial services industry the consumer had to adapt to our environment. We now know how to tap into and create the environment that the consumer wants to be in.

The first evolution of that was mobile bankers and mortgage brokers going to the customer's home, rather than the customer visiting the branch or office.

The next phase was the digital piece around being able to apply online and upload documents. Now it is about having the conversation via digital, at the consumer's leisure, fused with artificial intelligence and bots.

Brokers

Is the current focus by lenders on the broker industry sustainable for the next 3 years?



- Yes, brokers and their influence on the market are here to stay
- No, online technology distribution will reduce the impact of brokers long term
- The current focus on brokers is part of a cycle, in a few years they will be out of favour again but will recover
- It is a sustainable business model, but the industry will need to adapt to stay relevant in the future

> The brokers that focus on their customer's needs, will have a sustainable future for years to come.

James Hickey (Deloitte)
The responses were overwhelmingly positive. Half of you said that brokers and their influence on the market are here to stay, and the other 50% believe the broker has a sustainable business model but does need to adapt to the changing times. So they are both saying that brokers are here to stay but there does need to be evolution of what that model offers in the way it engages with the customer and uses digital.

Meg Bonighton (NAB)
So I think you have brokers who are very much into the customer journey. The ones who ask how do I be there in the right place at the right time? Who is the aggregator I work with who can help me do that best? And I think there are others who still use the message of face-to-face is king. I feel they are the ones that are in the D model, who attach the success of their model to face to face vs thinking about this as a financial concierge concept. It's just playing that role in a very different media.

Malcolm Watkins (AFG)
I totally agree that there are those two types of brokers. But I think that consumers are going to drive what they want and how they want to interact. At the end of the day brokers will need to become more digitally enabled and capable of providing the consumer an experience that fits with the number of steps they want to manage themselves, vs being broker assisted.

Mario Rehayem (Pepper Money)
It is a very similar transaction to someone lodging their tax returns. People have the ability and access to facilities to carry out the transaction on their own.

Or they can rely on a subject matter expert to give them the reassurance that it's done right. The brokers that focus on their customer's needs will have a sustainable future for years to come.

Peter Andronicos (eChoice)
One of the things about making the jump to digital and building yourself a social presence, is it can actually become detrimental for some brokers. The reality is that all of a sudden you're public. Previously you haven't been. And if you aren't educated as to how social media works or you expect somebody else to manage your page once a month or once every two months, you suddenly have users being able to make public reviews about your service.

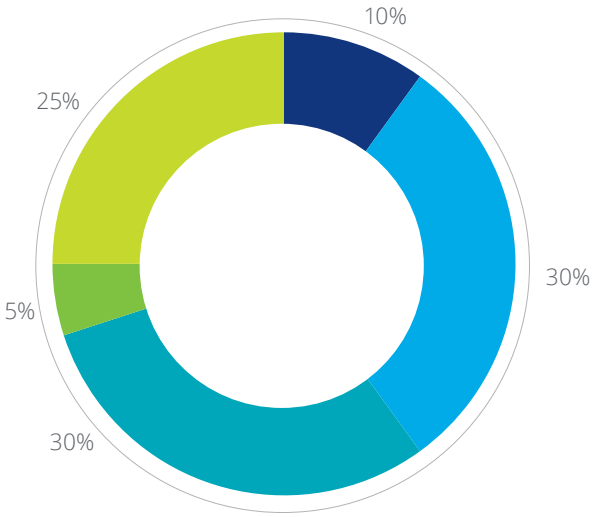
This can be good or bad. For example you may get: 'broker XXX didn't call me back'; 'XXX never did this' etc. When someone goes to Google and types in the broker's name, the first thing that is likely to come up is the product review. So it is a double-edged sword and needs education.

Malcolm Watkins (AFG
We do media training and some social media content provision for our brokers. But we're also very aware that if brokers do not monitor what's going on, they can get themselves into more trouble than if they were not there at all.

I think the answers were split equally because there will always be a place for someone who wants to sit down face to face. Gen Y, X and Millennials want to be able to do a lot of the work upfront themselves, and then connect at a relevant time to validate their decision.

Brokers

What are the likely consequences of the current ASIC inquiry into broker remuneration structures?[4] (Two options selected)



James Hickey (Deloitte)
This question asks about ASIC's inquiry around broker remuneration structures. It comes back to conduct. ASIC is I'm sure learning a lot from what it has collected from the industry around compliance and conduct risk in the last several months.

Steve Weston (Consultant)
In December last year the UK regulator commenced another review into broker commissions, which they call 'incentives'.

James Hickey (Deloitte)
We asked everyone to select two responses. Transparency absolutely is there, as well as the soft dollar incentives are likely to be reined in with other arrangements unchanged.

Vimpi Juneja (BOQ)
Would you expect any different outcome from the FOFA reforms?

James Hickey (Deloitte)
I think it's quite important to realise that they are different. With a mortgage it's the lender extending money to the borrower. It's the reversal of the flow of funds. And secondly with financial planning, there is gearing.

What I call the gearing ratio was the upfront commission that could be more than 2% with a trail of 20bps. That's a 10 times factor difference between upfront and trail. While in broking it is 60bps upfront and a 20/25bps trail.

Jenny Wilson (Deloitte)
Our MFAA research, also included a dialogue where most brokers disclose the fees they are getting upfront from different banks. Our surveyed consumers felt there was little bias and appreciated the transparency. So the broker is already being transparent. It should therefore be taken off the table as a potential issue.

Scott McWilliam (Homeloans)
Brokers are required by law to do that today. Those things have been in place now for a number of years; even disclosing going to a product providers' conference. In some cases however, only a range is needed, but the range is pretty tight e.g. 50 – 70 bps upfront.

Steve Weston (Consultant)
Politicians will be the ultimate decision makers on whether the current commission regime continues or not. Lower commissions that could lead to lower interest rates for borrowers would be a popular decision for politicians.

To avoid such an action occurring, the broking industry needs to be able to clearly articulate the important role they play in providing consumers with better outcomes. Additionally, the industry will need to be able to show that the current payment structure is fair when compared to broking markets in other countries and compared to similar industries like distributors of life insurance in Australia.

4. The ASIC inquiry recommendations were released just prior to publication of this report. See page 46 to see who close the roundtable members were with their predictions.

James Hickey (Deloitte)
Jenny and I did a separate report for the MFAA on customer experiences using brokers and direct to lender. One of our findings was that customers believe that the lender should pay commission.

So we believe that's the right way in which brokers should be remunerated because they're doing a service to the lender. But there were some hygiene things that brokers do need to do which is follow up, which is why they are given a trail in the first place.

The other strong finding was our hypothetical "If the lender wasn't required or didn't pay the commission to the broker, how many of you would be willing to pay for it yourself?" We found that a third of those surveyed said they would not be able to afford to pay the broker, and therefore would be forced to go through another channel which may not be in their actual best interest.

Malcolm Watkins (AFG)
To ask someone to value the service once they have experienced it, is no surprise they valued it highly. But would they have paid for that service upfront before they had experienced it? It was fine to get a positive answer post experience. Ask the same question to someone only considering a home loan for the first time, and I believe the response would be very different. An upfront fee for service is just not going to work.

James Hickey (Deloitte)
The finding was, if you changed the way the consumer had to pay, then a lot of people couldn't afford the services of a broker. Which in turn would be detrimental to their best interests. So it's good to see only 5% felt there would be a move to a flat fee.

I think that is one of the differences to the FOFA requirements. It isn't just FOFA, it's also ASIC's Life Insurance Review. Their finding was that commissions were fine for life insurance because people wouldn't necessarily get the opportunity to get advice.

ASIC recommended going from 120bps upfront and a trail of 10 bps, to 60 bps upfront and a 20 bps trail by 2019. Now that is where the current broking industry is at. So ASIC already has given a vote of confidence to a commission-based structure.

Vimpi Juneja (BOQ)
You are not cross selling anything and you aren't making a credit decision either. So it's not like you're placing it there so you can't pay it back.

James Hickey (Deloitte)
A good point Vimpi. And the products are reasonably commoditised. Most people, while they don't know the finer details of how a mortgage works, but at least know the mortgage well. Whereas for financial planning there is a myriad of investment options out there, which are very confusing.

Malcolm Watkins (AFG)
We don't have endowment products which are linked into savings and all those things which were a horrible mess in the UK.

We don't have those products and so we don't have people's life savings getting wrapped up into their mortgage and assessed as an asset of the home. Which if the property market drops, they've lost everything. So those sorts of components are just not the same as the Australian market.

James Hickey (Deloitte)
This is a good way to maybe end the discussion. We've had a lot of chat around APRA and the impact that's had on the pressure on prices and the differential pricing we're seeing in the market and best interests of customer.

Then coming through on the ASIC side, looking at the way the product is actually distributed out in the marketplace.
So there is a lot of activity going on for lenders and brokers alike; and the regulators are right in the front and centre of all of that.

On that note the roundtable wrapped up. Deloitte heartily thanks all the participants for their openness and candour.

In the Spotlight

In March 2017 ASIC announced its recommendations from its review of mortgage broker remuneration[1] to mixed reviews. The recommendations are generally in line with industry expectations, given ASIC's trend to ask for greater disclosure to customers from both lenders and broker groups.

Pleasingly, the review acknowledges the critical role that mortgage brokers play in the Australian mortgage market, in promoting competition, helping match individual customer needs to products, demystifying the house buying process and in guiding good customer outcomes. It also recommends a number of areas for improvement to ensure that the incentives framework does not drive unfavourable outcomes.

The review included 17 lenders, 15 aggregators, 55 brokerages, four comparison websites and three referrer aggregators, as well as meetings with stakeholders such as the Finance Brokers Association of Australia (FBAA), the Mortgage & Finance Association of Australia (MFAA), the Customer Owned Banking Association (COBA), the Australian Bankers Association (ABA) and the Australian Finance Conference (AFC).

The significant data requests from many of these stakeholders added to the delay in issuing the recommendations.

In summary, ASIC proposed the following recommendations to improve consumer and market outcomes:

- Recommended that the standard upfront/ trail commission model be revisited to reduce the risk of brokers seeking to inappropriately maximise their commissions by having the commission driven by total loan approved.
  - A suggested example is to link the commission to the LVR of the individual loan.
  - However it is important to note that the Review found that the current model was almost universal and the core commission model was still supported, albeit the link between commissions and total borrowings could be improved.
- Movement by the mortgage industry away from bonus commissions and payments, both to brokers and to staff at lenders.
- Move away from soft dollar benefits such as loyalty programs and generous 'perks' to brokers which can increase risk of poor customer outcomes and undermine competition.
- Clearer disclosure of ownership structures between lenders and aggregators to improve competition
- Implement a new public reporting regime of consumer outcomes and competition, to enhance the data available to assist in analysing the performance of lenders and individual brokers with regards to customer outcomes.
- Governance and oversight of both lenders and aggregators/ broker groups need to be enhanced to increase the focus on individual, as opposed to portfolio, customer outcomes.

ASIC noted that loans originated via brokers tended to be larger, with higher LVRs than direct-to-lender loans. Also it noted there is a greater proportion of interest only loans, even after taking into account the natural customer base of brokers, being those customers seeking to access the benefits of the broker distribution channel and its ability to advise them on navigating the market, across multiple products etc.

ASIC also acknowledged that the average broker consumer was two years younger than a direct-to-lender, and paid a lower average salary.

Additionally, ASIC noted that the key consideration in assessing customer outcomes is not the nature of the product per se (its IO, LVR, use of offset accounts etc), but rather the extent to which the product was suitable for the consumer. This of course will depend on the individual customer's requirements, objectives and circumstances.

Ultimately, the legal responsibility for concluding suitability rests with the lenders, though in today's world, the broker cannot absolve itself of the ethical responsibility for ensuring fairness of customer outcomes[2].

This review makes it clear that customer outcomes need to be at the forefront of broker minds, as well as monitored carefully by both aggregator and lender.

1. Report 516 - Review of Mortgage Broker Remuneration; released 16 March 2017 http://download.asic.gov.au/media/4184768/rep516-published-16-3-2017.pdf
2. See Page 21 Conduct Matters

The recommendation to implement a new public reporting regime, and to increase monitoring and oversight of origination activities will likely prove a challenge for both lenders and aggregators,

The new regime should cover:

- the remuneration received by aggregators and the potential value if all criteria for remuneration are satisfied
- the average pricing of home loans that brokers obtain on behalf of consumers
- the average pricing of home loans provided by lenders according to each distribution channel
- the distribution of loans by brokers between lenders to give consumers a better indication of the range of loans that brokers within the network offer.

Lenders are expected to:

- require aggregators, through their relevant commercial agreements, to actively monitor the consumer outcomes being obtained by brokers and broker businesses
- provide consistent reporting to aggregators to allow adequate oversight of brokers and broker businesses
- use a consistent process to identify each broker and broker business (e.g. use of the Australian credit licensee or credit representative number where relevant, or a unique number provided by the aggregator).

Aggregators are expected to:

- require lenders, through their relevant commercial agreements, to provide consistent reporting to the aggregator on the outcomes obtained by individual brokers and broker businesses, including those relating to loan pricing, features, clawbacks, and refinancing and default rates;
- actively monitor the consumer outcomes being obtained at a broker and broker business level, including those relating to loan pricing, features, clawbacks, refinancing and default rates, and distribution of loans among lenders; and
- retain this information in a way that can be provided to ASIC to allow us to review outcomes across the mortgage broking market

As ASIC notes in the review, the data challenges that exist when looking across the industry at both lender and aggregator level, and the comparability of data, will make the consistency of its expectations a challenge. This therefore will require considerable communication and agreement between lenders and aggregators, as well as cross industry views on what data points are relevant, accessible, historically available, and system supported.

We believe it will take some time to embed and require investment by all parties to reach an industry consistent level.

Additionally ASIC noted that the ownership structures of aggregator groups, by the major banks, particularly when assessed alongside white label arrangements, did have an impact on home loan flows, which could be seen as inhibiting competition.

We see the broker channel as an enabler of competition, particularly when the recent trend of focus on broker distribution by mid-tier lenders and mutuals is considered, and the recent growth of lenders such as CUA and ME is testament to this.

Removing the soft dollar benefits recommended by ASIC will assist this as it will continue to level the playing field and assist competition. It was noted in our panel, however that the back-office function efficiencies and consistency of application of underwriting policies will also be key for smaller entities continuing to focus on this method of distribution.

The industry is frustrated however by ASIC's intention to revisit the commission model in three to four years' time. Given the time taken to undertake this review, the data requirements and the desire by the industry to have a cohesive, market agreed approach for moving forward, it is unhelpful to perpetuate uncertainty around recommendations in the near future which could again change the model.

This proposal will continue to raise questions rather than provide clarity and a momentum to change.

Overall though our view is that the review is fair and supportive of the broker industry, acknowledging its critical role in enabling competition and in assisting consumers to their goal of home ownership. The recommendations were largely anticipated and embraced by the industry which welcomes the chance to demonstrate the benefits of its business model to consumers.

Contact us

James Hickey
Partner, Consulting
jahickey@deloitte.com.au
+61 2 9322 5009

Heather Baister
Partner, Assurance & Advisory
hebaister@deloitte.com.au
+61 2 9322 5911

Jenny Wilson
Partner, Consulting
jewilson@deloitte.com.au
+61 2 9322 7475

Alex Collinson
Partner, Assurance & Advisory
acollinson@deloitte.com.au
+61 2 9322 7921

Tim Noad
Director, Assurance & Advisory
TNoad@deloitte.com.au
+61 2 9322 5152

Graham Mott
Partner, Assurance & Advisory
gmott@deloitte.com.au
+61 2 9322 7970

Kevin Nixon
Partner, Risk Advisory
kevinnixon@deloitte.com.au
+61 2 9322 7555

Chris Wilson
Partner, Consulting
chrwilson@deloitte.com.au
+61 3 9671 7411

Michael Thomas
Director, Financial Advisory
michaelthomas@deloitte.com.au
+61 2 9322 7145

Louise Denver
Director, Corporate Affairs & Communication
ldenver@deloitte.com.au
+61 414 889 857

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