

The Deloitte Australian Mortgage Report 2015 Let the good times roll

10th Annual Deloitte Australian Mortgage Report





Executive summary

This is our tenth edition of the Deloitte Australian Mortgage Report – a great reason to celebrate! And with the Australian mortgage market experiencing such strong growth, we feel it is apt to title this edition ‘Let The Good Times Roll!’.

We are heading into 2015 with strong tailwinds. Interest rates are at record lows. Property prices are robust, with strong returns in the key markets of Sydney and Melbourne. Lenders are experiencing negligible levels of mortgage losses. And competition among lenders for borrowers is the most intense it has been for years.

However, the reason for the current low interest rates is a genuine concern about the economic outlook for Australia as a whole. With unemployment increasing due to the shifts in business focus, property price growth is far exceeding wage rises in many markets. Affordability and debt servicing levels remain high in Australia relative to overseas benchmarks and First Home Buyers are continuing to find it challenging to enter the mortgage market.

So while we may celebrate the strength in the market, we need to be cognisant that it is still a market with challenges as well as opportunities.

Deloitte Mortgage Report Roundtable

The centrepiece of this report is the insights from a facilitated roundtable of heads of lending and mortgages from Australia’s big four banks, credit unions, regional lenders and brokers.

The participants ranged across major lenders including the Commonwealth Bank of Australia and ANZ, non-major lenders including Macquarie Bank and ME Bank, specialist lenders such as Pepper Group and Resimac and the largest broker group in the country, Australian Financial Group (AFG).

The facilitated discussion covered market growth, customer expectations, digital disruption in mortgages, opportunities for regionals, and the challenges for brokers and the majors.

Points of view

This document also carries points of view from a Deloitte team of partners including Deloitte Access Economics as to the outlook for Australia’s strong housing market, Deloitte Treasury & Capital Markets on the expectations and regulatory requirements for product and consumer best interest from ASIC, Deloitte Financial Services Advisory partners on the Funding market; and Deloitte Consulting Financial Services partners on Fintechs and where they fit and the 21st Century mortgage customer.

10 years of wisdom

The lead authors of the report are Deloitte partners **James Hickey** and **Graham Mott** who have been involved since the original edition in 2005.

Thank you to all of our contributors over the past ten years and we trust you enjoy and find this special edition useful.



James Hickey
Banking Partner
Deloitte



Graham Mott
Banking Partner
Deloitte





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Where to next for the strong housing market?

David Rumbens & Michael Thomas

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- **National ABS House Price Index** growth at 9% over the year to September 2014
 - **Low interest rate** environment prevails, fuelling house price growth
 - **House prices growth** outstripping income growth
 - **Soft labour market**, pressure on valuations, big lift in housing supply and growth in construction expected to dampen upward pressure on prices
 - **Macroprudential measures** may be considered in the event of a housing bubble.

Financial Stability Review

There has been a continued focus on the hot domestic property market as an economic risk due to soaring property prices – especially in Sydney and Melbourne. The Reserve Bank fuelled this debate in September 2014 with its semi-annual Financial Stability Review taking aim at unbalanced housing markets. The Bank is concerned that house price growth is getting well out of kilter with income growth, creating the risk of a property price correction which then has broader economic consequences. It sees investor lending as the key culprit of late.

More recently, the Australian Prudential Regulation Authority (APRA) has reiterated its guidelines around sound residential mortgage lending practices, including addressing the growth in lending to property investors, focussing on higher risk mortgage lending and guidance on loan affordability tests for new borrowers.

It is true that the past 18 months has seen a stellar run for Australian house prices, particularly for Sydney and Melbourne. Those markets are still performing strongly, and should continue to be supported through 2015 by a pick-up in international student numbers into Australia, increased demand from investors and increased migration flows. Of late, more solid house price gains are also being registered for Brisbane and Adelaide, though post mining boom Perth has been weaker.

The ABS House Price Index

The ABS House Price Index for Australia shows that nominal house price growth was running at 9% over the year to September 2014. This compares to 8% over the year to June 2013, 0% to June 2012 and -3% to June 2011. Growth in Sydney over the year to September 2014 was nearly 15%. Monthly data since September 2014 suggests that recent house price strength has continued. Other indicators are also strong – auction clearance rates are above average, while the time taken to sell properties and average discounts being offered are currently low.

Low interest rates provide the potential for such rapid house price gains to continue. Measures of mortgage stress (the ability of households to service their housing debt) remain well below their average over the last decade. This suggests that households can afford to borrow more, although there is vulnerability if interest rates increase. Furthermore, access to credit remains high due to low funding costs for banks and increased competition.

Additionally, returns on other assets – such as equities and term deposits – remain low. We expect this to continue in a world of ‘easy money’ with global interest rates are expected to remain low for the foreseeable future. This will continue to increase investor demand for property – even as price to rent ratios continue to fall.

Constraints

But there are some constraints which will also start to kick in. The weakness in underlying income growth stemming from the soft labour market remains a drag on further housing price gains. The very strong rises in house prices already recorded, particularly in Sydney and Melbourne, are also beginning to stretch valuations in terms of rental yields for investors as well as affordability for first home buyers. In addition there is a big lift in housing supply coming through the pipeline, which will give property buyers more choice and dampen upward pressure on prices.

But until house price growth does settle down, the Reserve Bank of Australia (RBA) is left in a difficult waiting game. It needs to keep interest rates low to support a broader economy which is growing at below trend rates. But in doing so it can see that imbalances are building in the housing market.

The good news

There is some good news from an economic fundamental's perspective – rising house prices are changing the 'build versus buy' equation. The higher that house prices go, the less sense it makes to buy an established dwelling, and the more sense it makes to build a new one (or buy from developers). Combined with other favourable conditions – low interest rates, population growth, inducements for first home buyers and overseas investment (particularly from China) – there are many factors driving higher levels of housing construction at present.

Housing Activity Data

Housing finance statistics show that housing-related lending is up 7% for the year to November 2014. Similar gains are being seen for residential building approvals, up 8% over the same period. The quantum of residential building activity is also up 8% for the year to September 2014. This compares to 6% for the year to September 2013, -3% for the year to September 2012 and -5% for the year to September 2011.

This improvement in housing construction activity may extend into 2015 and beyond with State Governments working to reduce supply side constraints. However, approval for housing supply expansion also needs to go through local Council approvals processes, which can take time, and many local councils continue to stand in the way of increased property construction.

Balancing act

An increase in building sector activity will help to smooth the transition resulting from the end of the mining investment boom by absorbing mining construction sector workers. It will make the RBA's delicate balancing act on interest rates easier if there are broader reasons to suggest there should be an interest rate hike – not just rapid house price growth in two markets led by investors.

David Rumbens: is a partner of Deloitte Access Economics. He is a macroeconomist and regular commentator on the Australian economy, including via a weekly economic briefing newsletter.

Michael Thomas: is a director in Deloitte Access Economics, with more than two decades of professional experience, including 15 years in financial markets. Mike provides economic analysis and policy advice to clients in financial services and co-authored Deloitte's submission to the Financial Services Inquiry.

In the meantime there are alternative measures which could be employed to slow house price growth, other than the broad sledgehammer of interest rates, with discussion of macroprudential measures on the table at present. The rise in house prices has led to speculation that macroprudential measures may be employed to prevent the perceived 'bubble' bursting and sending shocks through the broader economy.

Financial System Inquiry

The Financial System Inquiry (FSI) Interim Report notes that a number of jurisdictions internationally, including New Zealand, have implemented macroprudential policies which are intended to improve their economies' resilience to shocks emanating from the financial system. While the RBA has commented on the current strength of investor activity in the housing market, especially in Sydney and Melbourne, it has not advocated new macroprudential policies to quell house prices. To date, Australia's financial system and its current approach to dealing with systemic risk – which consists of informal discussions between the APRA and the RBA, public communication and limited macroprudential powers – has proven to work well, including during the GFC.

Some countries have introduced additional macroprudential measures intended to help in the case of a 'bubble'. Australian regulators have expressed their satisfaction with the current arrangements.

Deloitte supports the RBA's view against a move towards a tighter macroprudential framework because:

- As seen during the GFC, systemic risk can be very difficult to predict, define and contain narrowly. To address risks in a formulaic manner is problematic and may in fact be counterproductive
- Australia already has two bodies dealing with macrostabilisation: the RBA (through interest rates) and the government (through policies addressing unemployment)
- International evidence around the ineffectiveness of macroprudential measures.

If house price growth does moderate over the next few months, either by such action, the RBA's jawboning, or just naturally running out of steam, there will be far less pressure for interest rates to rise in 2015. However at present it is a case of 'Let The Good Times Roll' for those in the property market.

The Deloitte Australian Mortgage Report 2015 Roundtable

Looking ahead to the next three years, and glancing back over the past ten, the Deloitte Australian Mortgage Report surveys the changing dynamics of the home loan market.

In the roundtable we capture the thinking from the leaders of lending and mortgages across some of Australia's largest financial institutions and broker groups.

Following their initial response to 14 specific questions these industry experts considered their observations across five general themes at a roundtable held in December 2014 and discussed their points of view.

1. **THE MARKET:** Future growth in the industry
2. **THE CUSTOMERS:** Consumer trends
3. **THE REGIONALS:** Challenges for regional lenders
4. **THE BROKERS:** Mortgage broking in the future
5. **THE MAJORS:** Challenges for the majors

“Home ownership is Australia’s largest and one of its most important capital markets.”

Frank Ganis Macquarie Bank



From left: Heather Baister, Graham Mott, Chris Wilson, Kevin Nixon, Louise Denver (all Deloitte); Bill Armour, ANZ (back); Malcolm Watkins, Australian Finance Group (centre); Luis Orp, Resimac (front); Mario Rehayem, Pepper Group (back); Angela Middleton, ME Bank; Frank Ganis, Macquarie Bank; James Sheffield, Commonwealth Bank; James Hickey, Deloitte

The Market: Future growth in the industry

MARKET

CUSTOMERS

REGIONALS

BROKERS

MAJORS

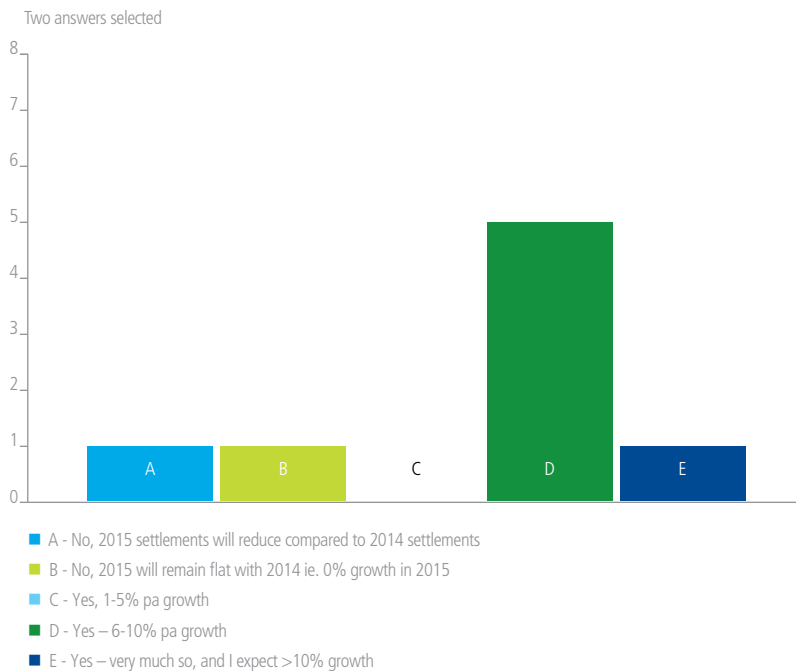


Figure 1. Source: Australian Mortgage Report 2015

Is loan origination growth of more than 20% sustainable in 2015?

James Hickey (Deloitte)

Chaired the meeting and began by asking if the recent 20% growth in loan settlements seen in 2014 was sustainable into 2015.

Initially the experts had been bullish, generally pitching for 6 – 10% growth in 2015 loan settlements but on reflection and discussion round the table they tempered their predictions.

Malcolm Watkins (AFG)

There has already been some decent growth in WA, and Queensland will continue to bounce back in 2015, but I think nationally the year ahead won't be nearly as strong as the year we've just seen.

We brought a lot of people to the market ahead of the national average and may well see some cooling off of that growth in 2015.

James Sheffield (CBA)

I'm more bearish because of macro issues including Chinese growth slowing; unemployment ticking up in some markets; and global regulation increasing. There are some concerns about higher LVRs (Loan to Value Ratios) and investment lending, which means the recent extraordinary growth in NSW will slow. It makes me think that we're driving towards a period of flatter economic growth because of these economic factors and the investment boom tailing off.

Where we've come from...

James Hickey (Deloitte)

Before the 20% growth in 2014, there were some years where settlement volumes struggled, particularly in 2009 to 2012. So, was what we saw in 2014 largely a release of pent up demand by existing home owners to upgrade, refinance or restructure?

Malcolm Watkins (AFG)

I think in the years leading up to 2014 people were just playing the 'wait and see game'. They then said: 'Now is the right time to renovate the house, put a second storey on, or move to a more desirable suburb. I can afford this and everyone is saying interest rates are going to remain low for a long period of time'. So they finally did it. I think that's what we saw in 2014.

Mario Rehayem (Pepper Group)

I agree. Another big driver was when people realised that the equity within their properties had actually increased, which enabled them to have access to surplus funds.



What categories of consumers will drive the greatest growth over the next three years?

James Hickey (Deloitte)

Everyone selected existing homeowners either refinancing or upgrading as continuing to be the dominant driver of growth over the next three years.

Of the next category of responses, local investors were voted as also remaining strong into 2015.

Frank Ganis (Macquarie Bank)

Like every other bank we monitor trends in the market. Credit growth over recent years has been lower than historical levels. Lending growth has been in refinances, with new lending at lower levels of around three to four per cent. The market has also seen an increase in demand by investors.

Luis Orp (Resimac)

One of the things assisting the recent growth, is the recovery of the funding market. We've seen a significant drop in cost of funds in the capital markets and those savings have flowed into more competition and lower borrower interest rates. I think there will continue to be a level of uncertainty, but it's definitely a more sustainable market, at least from a funding perspective.

James Hickey (Deloitte)

Kevin, as a member of the Institute of International Finance in Washington for several years, if you look at what's been driving our Australian market – existing home owners refinancing or upgrading and relatively low levels of new home owners or first home buyers coming in – what do offshore industry observers make of the Australian market?

Kevin Nixon (Deloitte)

What do overseas people think of our housing market? Put simply – they are extremely sceptical that prices can be maintained. They generally hold the view that prices must fall. People around the world can't get their heads around how the Australian market didn't have a price collapse like the other markets in the crisis. They see that Australia had a bit of a pause and then shot off again.

So they ask: 'What's going on there?'

In my role in the IIF we worked very closely with the official sector. I was in a closed-door meeting – quite a senior meeting – of central bankers and industry representatives and one of the senior economists put up a chart that showed the experience of a number of different housing markets. Spain went up then down; Portugal also up, then down. The US was interesting.

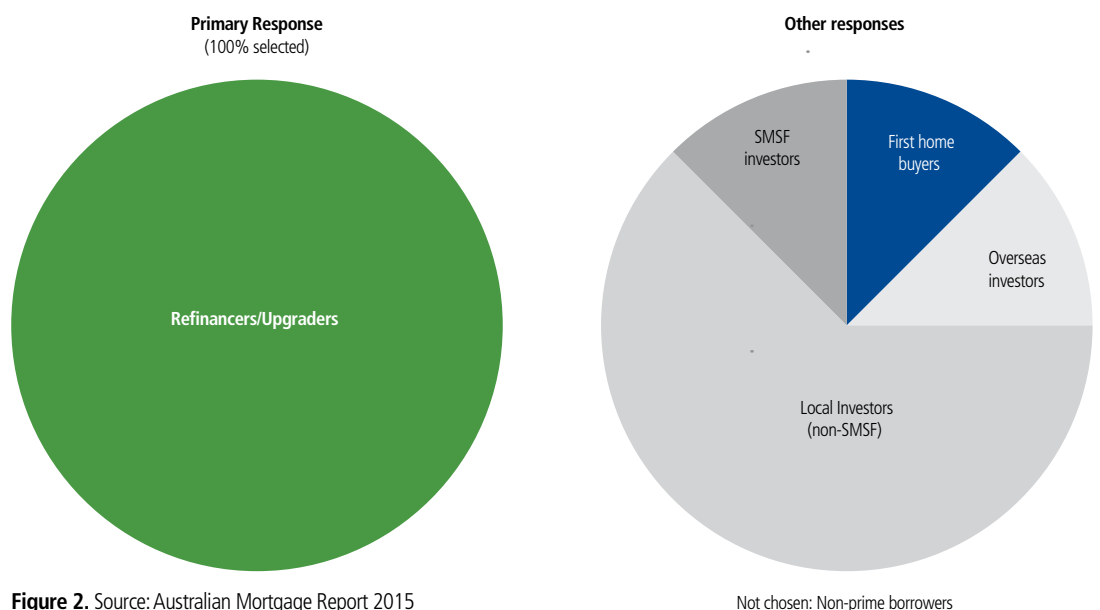


Figure 2. Source: Australian Mortgage Report 2015

It didn't go up as far, so the price falls across the board were less severe, but they were certainly a key driver of the financial crisis. And in the bottom right-hand corner was Australia which showed prices went up to the same extent of some of the other big housing booms around the world, but instead of collapsing, had flat-lined and started going up again. One of the central bankers present asked: "What's going on in Australia?" to which the research economist replied: "We've given up thinking about Australia. There is no economic rationale for it".

So that's how the international people view our housing market.

And looking at the numbers, when you look at international benchmarks like median house prices to median wages and salaries, Australia is certainly up there as one of the more expensive markets in the world. London, Manhattan or Tokyo are more expensive, but Australia's capital cities are in that benchmark.

I think it's very hard to be a first home buyer in the major metropolitan city markets these days. It's almost impossible.

Who is buying what in the Australian housing market and why?

Malcolm Watkins (AFG)

It depends where you take your statistics from. It is not that expensive to live in Preston which is only 10 kilometres out from inner city Melbourne, or Chelsea, a beach suburb down the bay, where you can buy a four bedroom house on land for \$500,000 which is smack bang in the middle of the first home buyer market. Out by the airport you can buy a big house with a swimming pool, and with a dual income you can service a \$700,000 or \$800,000 mortgage. So yes you may not get a large luxury two-bedroom apartment in the city but you certainly would get a significant house in the suburbs.

Bill Armour (ANZ)

People can't afford to buy where they want to live so they buy one suburb out and rent where they want to live.

Malcolm Watkins (AFG)

It's an interesting discussion isn't it? I also know people who are living in a lesser accommodation than they have actually purchased as they use negative gearing to get them into the property market over a period of time. In fact they've got several properties. Generally that's their goal with a view that in eight or 10 years, they'll be able to sell one and will have enough capital appreciation to help pay down the other. So that's an interesting strategy for a first home buyer coming in via the investment market.

Angela Middleton (ME Bank)

It's a lifestyle choice. Buy an investment property out of town but live in the inner city. Overall though, investors are dominating buying activity at the moment; although this includes an increasing number of first home buyers who are using an investment strategy to get into the property market. Recent statistics show 30 per cent of first home buyers are investors.

James Hickey (Deloitte)

Is there a risk then of the regulators coming in and blanketing all investors as people with multiple properties, who are well off, as opposed to first home buyers who enter as investors? Could it have the side effect of further blocking first time home ownership?

Bill Armour (ANZ)

It is a worry as there is a hidden amount of first home investors that don't get captured as first home buyers when you look at the official statistics. The risk is that they classify anyone who has said they're an investor as a non-first home buyer and as such are somewhat demonised as driving house prices up, but actually they are just savvy young people who have figured out a way to enter the market.

Mario Rehayem (Pepper Group)

The definition of an investor isn't truly defined. To pigeon hole and penalize all investors is not the right way forward. I believe there needs to be a clearer segmentation of what is deemed an investor before any knee jerk reaction comes to light.

James Sheffield (CBA)

If you look at the trends in the UK, the UK Government Regulator in the last three or four years has had a focus on investment lending. It is worth noting that it's interest only repayments that concern them and their sustainability over the 25 year loan term. There are concerns that there may be some sort of shock to the system as a result of this. So yes I think we've got to be careful about the different types of investors, but it is 'interest only' that the regulators will probably keep a closer watch on and could be a stronger factor in focus.

Could Australia weather a 30% house price fall?

Kevin Nixon (Deloitte)

As a forward looking risk to the system, one of the things about the average loan to value ratio (LVR) on a bank's book for mortgages, is that it's actually quite low in Australia because of the steady price appreciation we've seen, the aging of mortgages in a portfolio, and the propensity for Australian borrowers to pay down their mortgages over and above required monthly payments. So: 'Could Australia weather a 30% house price fall?' It would hurt, but for a lot of people it would just eat up their equity on paper, and as long as they don't lose their jobs, they can continue to service their loans.

Where one would become concerned on a forward basis is where we see people en masse refinancing their mortgages against their increasing housing value so that system-wide buffer disappears

Frank Ganis (Macquarie)

We regularly get asked: 'What is happening in Australia?' I think culturally Australians demonstrate a different behaviour, not incentive, when it comes to owning a house. For example in the US your interest payment on your primary residence is tax deductible. In Australia it's not.

In Australia people do pay off their mortgages at a quicker rate. Approximately two-thirds of real estate in Australia is owner occupied, and of those two-thirds, half have no mortgage. That is different to other parts of the world. Home ownership and the mortgage market is Australia's largest capital market.

I think what might be attracting attention at the moment is the growth in interest-only loans for residential owner occupiers. People are saying: 'I want the total 80% LVR because I can always redraw'. Borrowers may not appreciate that they only pay down approximately five per cent of their loan in the first five years of a 30 year principal and interest loan. And that this may not be as beneficial as they think.

Bill Armour (ANZ)

A lot of financially literate owner occupiers are doing an interest only loan and an offset account for the flexibility to manage their cash flow. So it's not about avoiding the ability to repay your loan, it's just the flexibility to pay off more when they can and less when they don't need to. They are savvy enough to be able to manage it themselves. Our offset portfolio grew by 15 – 20% last year and that was consistent across the four big banks where credit growth was only at 7%. So people are building up these considerable buffers. At a macro level, it is only looked at from the view that 'there are all these interest only loans', as opposed to 'there's all this money in the offset'. These owner-occupiers are repaying their loan, they're just doing it on one side of the scale versus the other.

James Sheffield (CBA)

Urbanisation is another thing that is skewing the statistics and international views. Because the US looks at their housing market from a very national basis, even though their market is not national, and then apply that national basis thinking to ours too. But ours is not a national market either.

We are a heavily urbanised country, with Melbourne, Sydney and Brisbane holding the majority of the population of Australia. Sorry if you're from Adelaide or Perth! If you analyse the average salaries of Australia, the calculations usually include metropolitan and regional area salaries against metropolitan house prices – driven by Sydney, Melbourne and Brisbane, which does not really reflect the reality.

The Australian residential real estate market is worth \$5.7 trillion and its home loan value is worth \$1.4 trillion. That's not an 80% LVR.

What is your biggest concern for the mortgage market in 2015?

James Hickey (Deloitte)

When looking at risks to the growth story in 2015, nearly everyone chose an economic downturn and macro prudential limits on lending being introduced. How likely is it these concerns will emerge?

Luis Orp (Resimac)

Well unemployment is always a significant driver for us. A downturn in the economy will probably signal higher unemployment rates. It is a concern that we will end up with a higher level of arrears. My view is that the property market will probably hold up and we're not going to see a significant decline in the property market which I guess in many ways will mean higher arrears but not necessarily higher losses.

James Hickey (Deloitte)

The other potential concern raised was around inappropriate lending and distribution advice, especially given all the activity in the market. We've seen advice issues identified across other financial services areas such as financial planning and life insurance – does mortgage lending face similar potential risks?

Malcolm Watkins (AFG)

You need to look at the quality of controls around distribution, and as the biggest distribution group in the country we always do. I didn't select inappropriate lending issues arising and bringing media and political spotlight on the industry as our number one concern because I think that we're a pretty sensible industry and sufficiently self-managed to make sure things don't get out of control. Lenders, brokers and the borrowers today are all educated people, so I don't think that's going to be one of the biggest concerns for the mortgage market in 2015. But it doesn't matter what industry it is, if it's selling suits or buying cars, life insurance or home aged care, there will always be some scandal or inappropriate activity somewhere, sometime.

Bill Armour (ANZ)

One of the big advantages of the home loan is that it's very transparent compared with the financial planning industry where it can actually be quite hard to figure out if you're given good or poor advice over a long period of time. Home loans are a vanilla product portfolio. They are pretty straight forward.

Heather Baister (Deloitte)

The challenge is that disconnects can happen. Originators do have a lot of faith in brokers, but if inappropriate behaviour is identified, ASIC will scrutinise it. ASIC recently did a review of specialist lending criteria and loan files that raised some issues around originators, brokers and the documented internal review processes not always being followed precisely. When issues surface, which inevitably they will, the question then becomes who has the responsibility for making sure the customer has been properly assessed. It will be a question of how big, how much, and where in the market the responsible lending issues will arise.

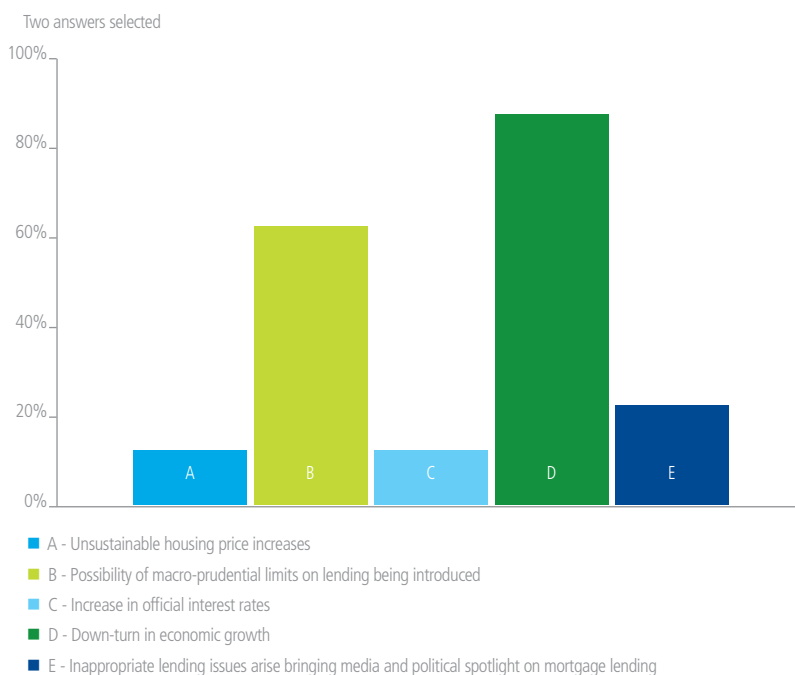


Figure 3. Source: Australian Mortgage Report 2015

“Home loans are close to being a commodity these days”

Malcolm Watkins (AFG)

Kevin Nixon (Deloitte)

The reality is we should always want to lift our game, because the risk of a regulatory response – as in the UK or US – is going up every day. The US did have some very poor selling practices – the wholesale Sub Prime market – and the put back to the industry has been huge. The UK has gone very hard on this as well. While Australia has different structures and product design, and this clearly separates Australia from these overseas markets, it is something to closely monitor.

Mario Rehayem (Pepper Group)

Originators do place a lot of faith in brokers, and rightly so. Brokers are the face and distributor of lenders' products and services. We cannot shy away from the fact that the potential for fraud exists and is a concern in our industry. The responsibility should be placed on the lender if there are no discrepancies between what was presented to the broker, compared with what was presented to the lender. It goes without saying that everyone should play their part to best prevent fraud. Lenders should be responsible for issues due to credit policy gaps. They have to back their policies and bear the responsibilities associated when assessing a loan submission. It depends on the processes you follow internally separate from the flexibility you give a broker to go and offer your products. Ultimately both brokers and lenders need to be better equipped to prevent fraud as deceptive applicants today are much savvier than they were five or six years ago.

“Bad behaviour may be low probability in Australia, but it is high impact”

Kevin Nixon Deloitte



Conduct Risk and Mortgages

Martin Joy & Rosalyn Teskey

Conduct risk is a key Australian regulatory focus in 2015. Australian Securities and Investments Commission (ASIC) recently released ASIC's Strategic Outlook, indicating the conduct-related areas that it will look at this year. These areas include product design, disclosure and sales.

Interest Only Loans

In the mortgage market, ASIC flagged its conduct focus will specifically include interest-only loans for the housing market. To reflect new case law ASIC also recently released revised regulatory guidance on the responsible lending requirements.

This intense focus, and potential new powers and funding recommended for ASIC by the Financial System Inquiry, mean that home-loan lenders and distributors need to have strong conduct risk frameworks that put customers' interests first, and ensure compliance with responsible lending and other regulatory requirements.

Key Conduct Risk Actions

Firms in the mortgage market need to address the following:

- What conduct risk means for the firm
- What conduct risk issues arise in the mortgage market
- What the firm should do about conduct risk.

Conduct risk can be broadly conceived as the risk that firms fail to meet expectations that their customers' interests come first.

What is Conduct Risk?

Conduct risk can be broadly conceived as the risk that firms fail to meet expectations that their customers' interests come first. This can lead to customer detriment or the undermining of market integrity. Importantly, these expectations need not be purely regulatory. They can also come from social or contractual expectations. Settlements for contractual misrepresentation or irregularities (such as illegal penalties) can be just as damaging to a firm's bottom line and reputation as regulatory fines.

Firms need to develop definitions of conduct risk that take into account their unique circumstances. Only then will firms be able to develop conduct risk frameworks that are calibrated to the firm's risks.

These circumstances include the financial products that firms sell, the distribution channels that they use, and the regulatory framework in which they sit.

For firms in the mortgage market, the conduct risk framework will obviously need to take into account ASIC's responsible lending requirements as well as issues such as unconscionability and disproportionate fees. It will also need to consider the distribution channels used in the mortgage market, including broker channels and digital mediums.

What conduct risk issues arise in the mortgage market?

The current focus on conduct risk is being largely driven by the direction of regulation attention rather new obligations. In December 2014, ASIC stated that it would conduct a surveillance of the provision of interest-only loans as part of a broader *Council of Financial Regulators and Treasury review* into home-lending standards¹. ASIC's review is intended to look at how firms are complying with their responsible lending and other consumer protection obligations.

In announcing this review ASIC drew attention to the recent changes to its *Regulatory Guide 209 Credit licensing: Responsible lending conduct*. These changes were made to reflect the decision of the Federal Court in *ASIC v The Cash Store* [2014] FCA 926. This decision made clear that credit licensees need to inquire about credit consumers' living expenses and income as part their inquiries into whether credit contracts are not unsuitable.

Looking ahead, firms should be preparing for ASIC being granted new regulatory powers.

The Financial System Inquiry has recommended giving ASIC a product intervention power and being better funded. If granted, ASIC could use a product intervention power to ban or require changes to financial products and increased funding would allow ASIC to enhance its surveillance of the industry.

Beyond the substantive obligations that need to be considered, a key conduct risk issue for lenders in the mortgage market is how to manage the risk across a distribution chain that they may not fully control. Use of brokers and online mediums means that lenders need to find ways of upholding lending standards and preventing misrepresentations within environments that may be external to their organisation.

Lenders and brokers also need to consider the risk that borrowers engage in 'mis-buying' by either failing to fully consider the suitability of a mortgage product for themselves or by deliberately manipulating the application process to obtain a mortgage that is not objectively in their own interests.

What should firms do about conduct risk?

Key actions from firms could include the following:

- **Define** – Define what conduct risk means in the context of the particular business and how it should be managed.
- **Assess** – Identify conduct risk points within the organisation and through the distribution chains. Key issues to consider include whether business models and incentives are likely to lead to poor behaviour and whether product governance processes will result in products that are aligned with customer capabilities and needs.
- **Respond** – Select the appropriate tools to address identified conduct risk points. These tools clearly include rigorous compliance frameworks. Also think more broadly to consider how culture and individual decision making can impact conduct outcomes. Regulators are increasingly turning to behavioural economics to understand and change financial market behaviour and firms can do this too.
- **Monitor and manage** – The effectiveness of responses to conduct risk needs to be monitored to allow ongoing calibration. Data is useful but needs to be interrogated using clear outcome standards to ensure problems are identified.

Martin Joy is a Deloitte Director in the Financial Services Industry practice. A former lawyer and regulator, he advises clients on regulatory developments and responses.

Rosalyn Teskey is a manager in Deloitte's Governance and Regulatory Consulting team. Having recently returned from the UK she focuses on helping clients to proactively manage conduct risk within their business.

¹ Australian Securities and Investments Commission 14-329MR ASIC to Investigate Interest-Only Loans (9 December 2014); available at: <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2014-releases/14-329mr-asic-to-investigate-interest-only-loans/>

The Customers: Consumer trends



How informed are consumers today about mortgage products compared with three years ago?

Bill Armour (ANZ)

The distribution of home loans is not an online business. It is a multi-step process with face to face conversations that ask a lot of questions, and get a lot of information, as well as a huge amount of online research. I think consumers are going to expect even better access to their own information, so when they walk into a lender, they know even more about their own financial situation, and what they should borrow.

Angela Middleton (ME Bank)

There is a demographic change happening. While most property buyers probably don't feel the need to inform themselves about mortgage products until they need to, how they're informing themselves is changing. Millennials and Gen Z's do a lot more research online. And whether they do that through proprietary, mobile or a broker channels, younger generations are asking tougher questions thanks to the information they're accessing. They say: 'I'm coming to you because I want this. I've done my research and I want you to help me complete the settlement steps.' However, the broader market still needs that education. Trying to balance the different needs of different generations is the industry challenge.

Mario Rehayem (Pepper Group)

And they are also using the branch network and the brokers to validate what they've researched, rather than coming in and starting from scratch.

Malcolm Watkins (AFG)

It's a very big point and it's certainly true how much more savvy consumers are. For the first time this year – and we've been around for 20 years – we're starting to hear about more than one broker being utilised. That's never happened before. So when consumers are starting to do that it shows the consumer has come a long way from being beholden to just their bank manager.

Chris Wilson (Deloitte)

The reality is, if we believe the market growth is going to be refiners and upgraders, by default you will see more customers coming in saying: 'I've gone through this process before so I have a much better understanding, and as I'm refinancing don't try and sell to me, just move me to a better rate.'

James Sheffield (CBA)

The thing with the internet is, it gives transparency to the information and people can access and marshall that information better. But it is not going to give them the expertise. Although the internet has created the opportunity for a consumer, expertise comes from an investor doing it regularly.

Frank Ganis (Macquarie Bank)

I agree. I think consumers are better informed because of the internet and the quality of brokers. Previously the only relationship the consumer really had was with their bank. The consumer is substantially better informed today. But this market is also moving quickly due to innovation and competition.

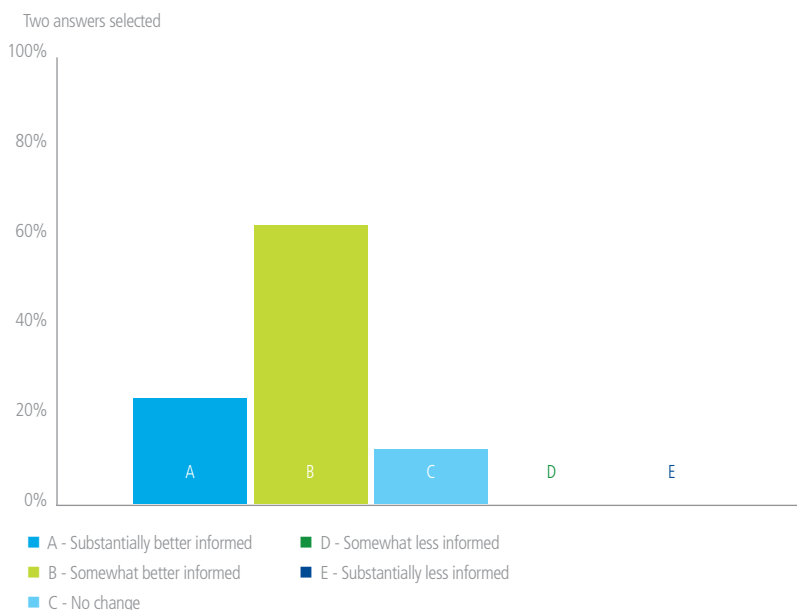


Figure 4. Source: Australian Mortgage Report 2015

“More than 50% of mortgages written are going through a mortgage broker”

Mario Rehayem (Pepper Group)

A commodity that needs trusted advice

James Sheffield (CBA)

Research says people shop around to find somebody they can trust and they go to different lenders and brokers until they find that someone. So it's still a trusted advice relationship. I think in the old days before the GFC, the broker was seen as great. It was a bit of a bad story from the USA on brokers, so now consumers are shopping around for the person they feel can they can trust.

Mario Rehayem (Pepper Group)

Home lending is becoming a commodity so consumers are chasing the experience. The experience from the moment they meet the broker until the time they settle... and then from settlement to post settlement. The broker issue of losing customers to their local bank branch is no longer their largest threat. It's now the broker next door. More than 50% of mortgages written are going through a mortgage broker, so the likelihood of them losing their deal to another broker is very high isn't it?

What will be most important to consumers in choosing a mortgage provider

James Hickey (Deloitte)

Not surprisingly competitive interest rates were seen as the most important consideration for consumers when choosing a mortgage provider. What is interesting though is that technology enabled innovation and accessibility online and real time access to the lender was seen as the next most important aspect for consumers.

Angela Middleton (ME Bank)

While more than 80% of consumers today will research mortgages online, less than 5% will actually proceed with an application online because it's too difficult. That just shows the opportunity that's there for banks.

Those that improve their online services, including the automation of some of the loan application process, making it simpler and appealing, will stand to capture some of that market.

Heather Baister (Deloitte)

I'm aware that true end to end online applications online aren't yet a reality, and that it is absolutely an area of focus. But what about post origination, and allowing the consumer to use technology to manage their interaction with the lender?

Frank Ganis (Macquarie)

Consumers expect funders to have the ability to service and support them through technology. Consumers are basing their decision on what happens post settlement. At least being able to access their account online, manage it, and perform other functions online. That's the real test.

James Sheffield (CBA)

Our research shows consumers are looking for more control around their decisions. So what you're seeing post settlement is consumers wanting to control their account and manage their money. To be able to put more money in and then take it out when needed, or redraw it. That is being facilitated by mobile technology and the expectation that lenders will enable the consumer to control their finances. Not to do it for them. They want us to tell them what we can and can't do. When they can do it, and if it's going to cost them more. So there is a massive need to drive that post settlement experience. People are looking for that flexibility.

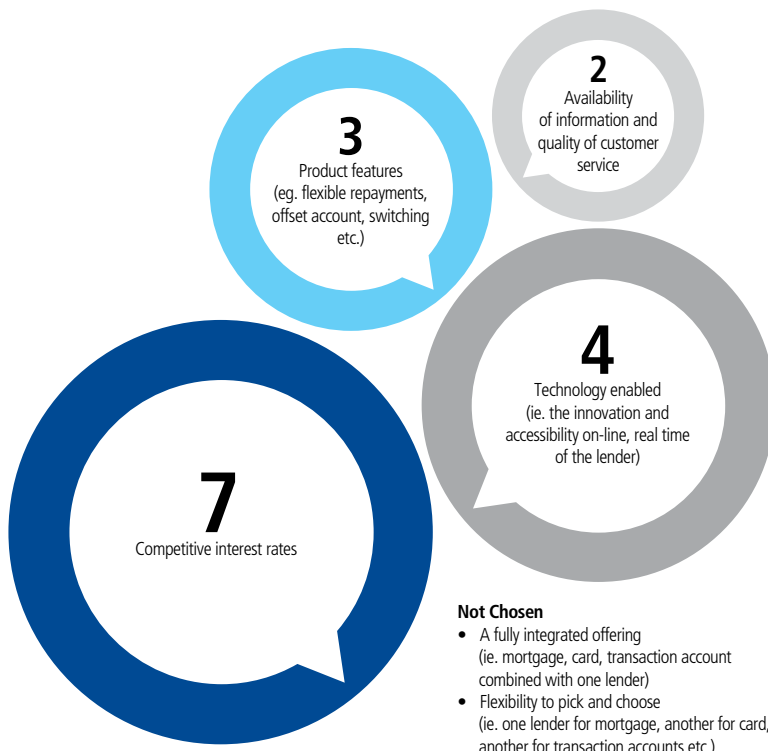


Figure 5. What will be most important to consumers in choosing a mortgage provider?
Source: Australian Mortgage Report 2015

Malcolm Watkins (AFG)

It's interesting though because I've come from a world where we've proven that the overall customer experience is your number one driver. However with all the comparison sites these days – and AFG also has a lending arm – we are learning that we've not been great on providing good 'after sales service'. To provide 'technology-enabled' after sales service will be a focus this year.

James Hickey (Deloitte)

Given that competitive interest rates and technology are the major determining factors for consumers, is there some "price elasticity" where consumers would trade-off not having the cheapest mortgage if it means they get better technology support and flexibility with their lender?

Malcolm Watkins (AFG)

It comes back to whether they're looking for someone that they trust. That trusted relationship starts at the point of introduction to the loan. Our brokers are not selling the lowest rate – it's more the online help centres and call centres selling the rate.

We sell a lot of bank products that are not rate driven. Our brokers will offer information such as: "If you want this to go efficiently, simply and effectively, and have a good ongoing relationship, then I recommend you look at this bank or that product." So there is a reasonable level of rate elasticity that needs to be positioned correctly at the point of discussion.

Mario Rehayem (Pepper Group)

Agree with Malcolm, rate should never be the focus point, but that's the hardest part for some brokers, because the experience is harder to sell than the rate.

Frank Ganis (Macquarie Bank)

New to industry intermediaries, who basically need to generate revenue quickly, may simply put a low rate in front of the client. The more experienced intermediary actually has an interest in the client's well being and the product. He or she actually guides the client to the product irrespective of rate, because of the overall package. So it's not just about the pricing elasticity, it's also about the broker's elasticity, which I think is very important.

Where is the biggest digital opportunity in mortgage lending for the next two years?

James Hickey (Deloitte)

We asked you to rate the top two biggest digital opportunities in mortgage lending in the next two years. You voted for 'A: straight through online mortgage' and 'E: omni-channel experience for the consumer'.

Straight through online mortgage have been mentioned for a number of years now, but are they really what the consumers want today?

Angela Middleton (ME Bank)

Because a significant number of people use the internet to research mortgages, there's an opportunity to offer online applications. But if you're going to provide the mortgage application process online, from the consumer typing in their details, right through to settlement, you want to minimise human interaction as much as possible and ideally, allow them to get approval on the spot. To that end, the process should be simple and easy to use.

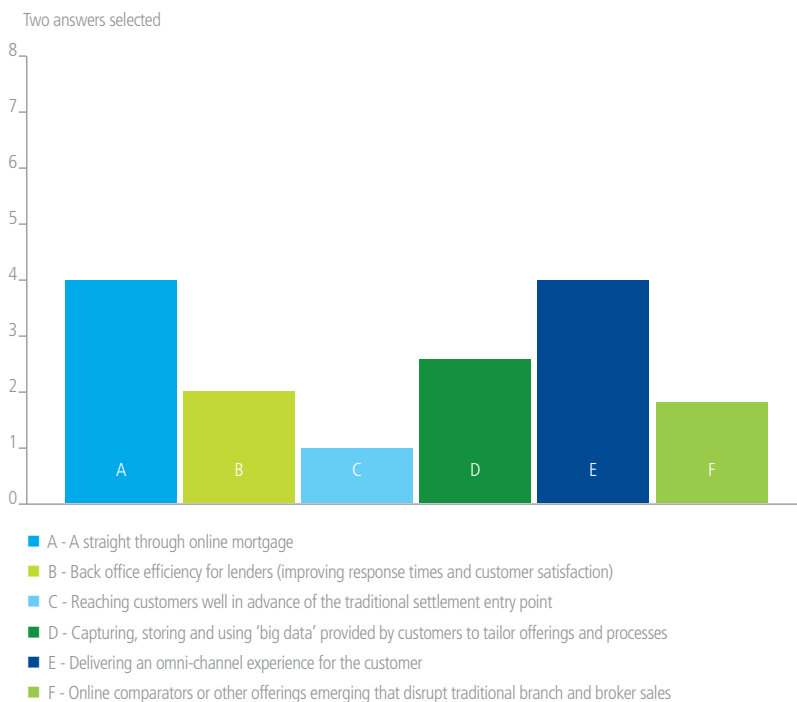


Figure 6. Source: Australian Mortgage Report 2015

I'm really not fussed as to the bank, what's important to me is the house. I'm happy to do whatever part of that process I can.'

Angela Middleton (ME Bank)

When we speak to customers a lot of them say: 'I just want a simple way to buy my house and I'm happy to help it along by entering in my details online as part of that process. I think a big issue for banks is we make it too difficult to complete a mortgage straight through online.'

Bill Armour (ANZ)

I think the key is to look at the straight through online mortgage and omni-channel experience for the customer together. In a straight through home loan you can do every part of the process online. But when you combine it with omni-channel it means that you can do any part of the process online.

For instance some just want to submit their docs online. 'Who wants to walk into a branch to hand over pieces of paper?' They'd far rather complete that online. Others want to be able to choose their own product online and then submit asking: 'Can I have this product?' When you offer those two things together, that becomes really powerful.

'Let me do the bits that I want to do online and then I will come to you when I need help. But I want to be able to come to you in the branch or through my broker or through my mobile lender and I don't want to start again. I just want help with this part of the process.'

James Hickey (Deloitte)

Would you say omni-channel is still an opportunity or is it becoming more of a reality with certain lenders in the market?

Bill Armour (ANZ)

I think home loans compared to other financial services is a slower adopter of digital technologies. When you consider the last time you bought a credit card or got a new savings account, it was pretty straight forward. You just go in, or ring someone, or do it online yourself. I expect that digital sales in straight forward products would be very, very high. However if you put the current laborious and challenging process for mortgages online for customers to sort out for themselves and expect them to complete it, there's little chance it would work. But if you make it as easy as it is to buy a credit card, or make a purchase through Amazon or eBay, well then people will probably give it a try. They may not do everything all at once and it won't be 100 per cent by any means.

The research that we've looked at suggests that it's one of those things that 20 to 40 per cent of people are willing to do. Which means that 10 to 20 per cent of people will actually do it. But even if you think about doing 10 per cent of your sales online, that's phenomenally big. Imagine if you were the only one in the market doing it. So that's why there's a big opportunity. Not because it's going to be 80 per cent of people tomorrow, but it might be 5 per cent and it might be 25 per cent of people in five years and maybe 70 per cent of people in 10 years.

Chris Wilson (Deloitte)

That's what we are finding, combining online straight through with omni-channel makes sense. And include back office efficiency and use the data, which is going to become more and more relevant particularly if you're really focusing on straight through online mortgages.

“If you make it as easy as it is to buy a credit card or make a purchase through Amazon or eBay, well then people will probably give it a try.”

Bill Armour (ANZ)

Malcolm Watkins (AFG)

Although, the problem with end-to-end is you start stumbling into regulator issues and APRA, because you have no way to ensure that the customer really does know what they're doing and has selected the right product. No one has given them any advice. No one has actually seen them or talked to them. I think when you rush down that path you will start to see the dangers of inappropriate lending. A consumer may well say: 'Well all I did was press buttons and send things in and I have ended up in trouble.' So there are dangers to be considered with going down that line.

Frank Ganis (Macquarie Bank)

We need to look at what has happened historically, for example what has been tried, what has worked and what hasn't. A lot of these initiatives have worked however, as there are businesses with a whole business plan around the straight through processing of home loans. Consumers may have the concept that it's purely online, however this isn't actually the case, as the 'process' is, in most cases, supported by call centres.



The rise and rise of the customer: Sharpening the customer edge

Andrew Pellow

As mortgages are increasingly viewed as commodities by customers, who are demanding more as their power increases and new competitive options emerge, businesses will need to sharpen their focus on the small things that count and face the realities that core institutional trust has been shaken.

Trust is being eroded:

Institutional trust is being eroded, but mortgage brokers are seen to be trusted

For a long time, all customers wanted from financial services companies was 'trust'; trust that their savings would be safe, that their provider would do the right thing and be there when needed.

In recent times, this trust has been eroded – first with the GFC and then further exacerbated by misconduct and poor performance across the advice sector.

In the roundtable discussion, mortgage brokers' ability to develop trusted customer relationships both in and out of formal business contact was clearly recognised. Although there have been some missteps by mortgage advisors², the key question for the mortgage market is whether brokers could face the same crisis of confidence that has befallen their peers in the financial advice sector, or will they remain a haven of trust in a changing market?

In 2014, one of Australia's largest independently owned mortgage broker franchises shook the trend. Mortgage Choice challenged the breadth of the trusted customer relationship and leveraged its brand in mortgages to enter the financial advice market. Is this trend set to continue, where mortgage brokers can leverage their trusted position with 'mum and dad' households to push their boundaries from traditional mortgage advice to broader financial needs advice?

Customer Power:

Customers now own the power in their financial relationship and as a result new business models are emerging

As customers are liberated by the intersecting trends of digital, data analytics, social and entrepreneurship, they are challenging the financial institution's guarded role as the safe haven of financial security. Customers are redefining how much, or how little, they engage with institutions and are creating movements like the 'shared economy' and the 'recommendation economy'.

Take the shared economy for example. This reflects a behavioural shift as customers become willing to place their financial trust in one another over an institution, to share the risk and rewards of a market be they lender, borrower or investor. In essence, customers are taking on the power of their financial relationships.

While Peer-to-Peer (P2P) lenders primarily play in the personal loan space of up to \$30,000, mortgage P2P players offering larger loans are starting to appear. For example, LendVest is a P2P marketplace for real estate mortgages, offering loans of up to \$5million and, has so far received \$200m in investment.

Even more disruptive than P2P mortgages is the emergence of crowd funded property investment, which removes the need for a mortgage provider at all. Instead, customers combine their funds with other customers to invest in a property; in effect buying a house 'brick by brick'. For instance, House Crowd has to date facilitated \$7million of property investment, and the speed at which a property is funded has increased 800% (from 26 days to just 3 days).

² John Rolfe, 'Australian Securities and Investments Commission investigating mortgage broker fraud', News (January 23 2014)

Hidden needs:

Low fidelity understanding of customers, promotes low appreciation of their underlying needs; many customer needs are therefore unseen or misunderstood and so not met

In the roundtable, as lenders identified and forecast increases in the Refinancing and Upgrader segments, they also touched on hidden needs.

Three examples of increasingly hidden needs of customers were identified:

- **First home owners:** A recent mistake of interpretation was recognised by the regulator, when it realised that the measure used to classify being a first home owner was whether the borrower received a first home owners' grant. However this is not the whole story. Given the nature of the market, some first home owners are having to take a different strategy to enter the market through purchasing an investment property. Looking deeper we see that often it is not just individuals, but families working together. Institutions may have core mortgage products that meet some of these needs, but if these more complex arrangements are hidden, does what is currently on offer actually meet underlying customer needs?
- **Flexibility seekers:** Customers that apply for 'Interest Only' mortgages invariably have combined offsets accounts which hold material balances. The resulting hypothesis is that these customers seek an increase in financial flexibility. However, maybe there is a hidden need driving this requirement for flexibility.
- **Post settlement needs:** A significant amount of institutional focus is placed on the improvement of the application process – with a clear goal to win the customer. However, customers take out multi-decade loans – and while many refinance – institutions want their customers' business throughout their life. The roundtable discussed the potential to create differentiation post settlement – and in essence focusing on retaining and growing the customer's bank footprint. Exploring the post settlement space could be far more productive for institutions.

What does all of this mean for mortgage lenders?

Of course, basic product needs must be met – what a customer wants, and how they want it – but in a commoditising market this is not enough.

Three takeaways to consider:

- **Leverage your position of trust wisely**
Customers are challenging the foundational proposition of traditional providers. They are reassessing who they trust and on what basis. This shift could simply be enough to tip a customer between providers and brokers or it could transform the complex advice model.
- **Innovation at the edge can help transform the core**
Although the new entrants are small today, these new niches can represent new ways of doing business that may, over time, displace key components of the value chain for larger players.
- **Look behind the obvious needs to uncover the 'hard to solve' problems**
While the core mortgage products are probably sufficient for many customers, are the more complex needs of these same customers being met? Are providers and brokers really listening for the hard problem customers have, and what solutions will they provide to embrace the true and hidden needs of customers?

Customers are insatiable and want more. Their view of value is being extended like never before. Ease of comparison and old propositions are displaced as expectations shift. Institutions need to look beyond the core proposition, to fight for the edges. Like – rebuilding trust, embracing a customer's power, or expanding one's view of a customer's needs.

As the mortgage environment becomes more complex, channels proliferate and new models disintermediate, continuing to positively and creatively engage customers will require innovation and courage.

Andrew Pellow is a partner in Deloitte's Financial Services Consulting practice. He is committed to helping clients achieve their growth agenda by combining analytical and design thinking. Andrew assists his clients shape ideas in the disruptive market.

The Regionals: Challenges for regional lenders

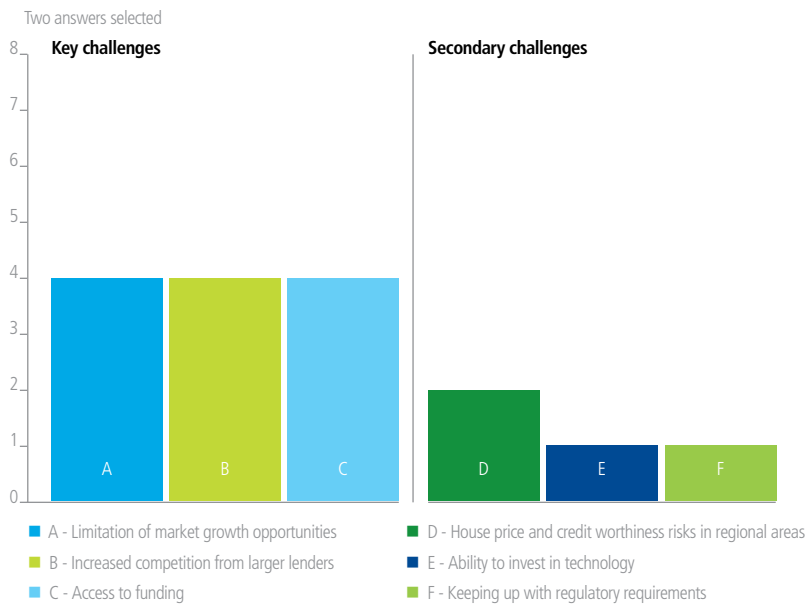


Figure 7. Source: Australian Mortgage Report 2015

Case Study: AFG and Macquarie Bank

Malcolm Watkins (AFG)

Although broking is a much bigger piece these days than it was in the early 2000s, but back then, Macquarie Bank for example got to ten per cent of our volume in less than 18 months. They engaged with the brokers and did it well. They didn't have the red hot rate, or the product selection, the branch infrastructure or the brand recognition. They flew in the face of all of the success factors supposedly required. They simply worked out how to get to the customer. They found the elasticity point and got their product in front of the customer, versus a better rate or a bigger brand. And it wasn't a remuneration thing. They weren't paying the broker more.

Frank Ganis (Macquarie Bank)

At the end of the day, mortgages are commoditised and in my view, success is about understanding your client. When we initially invested in AFG in early 2001, we made sure we offered AFG and its clients an experience that was second to none, because AFG trusted us with the distribution of their brand. This meant we had the responsibility to make sure we provided a good quality service. So while rates are important, and there are people who will follow on rates, I don't think it is, or should be the 'be all and end all'.

What challenges are facing the regional lenders?

James Hickey (Deloitte)

There has been a lot of talk about whether there is a need to re-balance the playing field between major banks and regional banks. What can and should be done? Sorting out capital relativities may be a start, but can't be relied on as the only answer for regional lenders to make them sustainably competitive.

The **key challenges** were seen to be the limitation of market growth opportunities, increased competition from big lenders and access to funding for regional banks.

It's interesting that technology and regulation get a lot of airplay when discussing holding the regionals back, but most of the key challenges we see are market facing and competition issues.

Graham Mott (Deloitte)

Access to funding seems to have improved again, and the funding gap between a major and a non-major has definitely reduced. Both majors and regionals have done deals on pretty similar terms recently. That differential would have been much wider a year ago. So you'd think that that funding gap is closing for the non-majors.

Frank Ganis (Macquarie Bank)

While the funding gap between regional banks and other banks has narrowed over the last 12 months, it is still wider than pre-GFC. However, it's probably as close a gap as we've had in the last few years.

Malcolm Watkins (AFG)

I think the biggest challenge for regional lenders is engaging with brokers and doing it well. They don't have massive branch networks, or huge budgets. The majors are going outside of metro more and more. They've got access to better funding. They've got great IT systems and big customer call centres. The challenge to regional lending is to engage with brokers and engage well. If they can do that, they will grow.

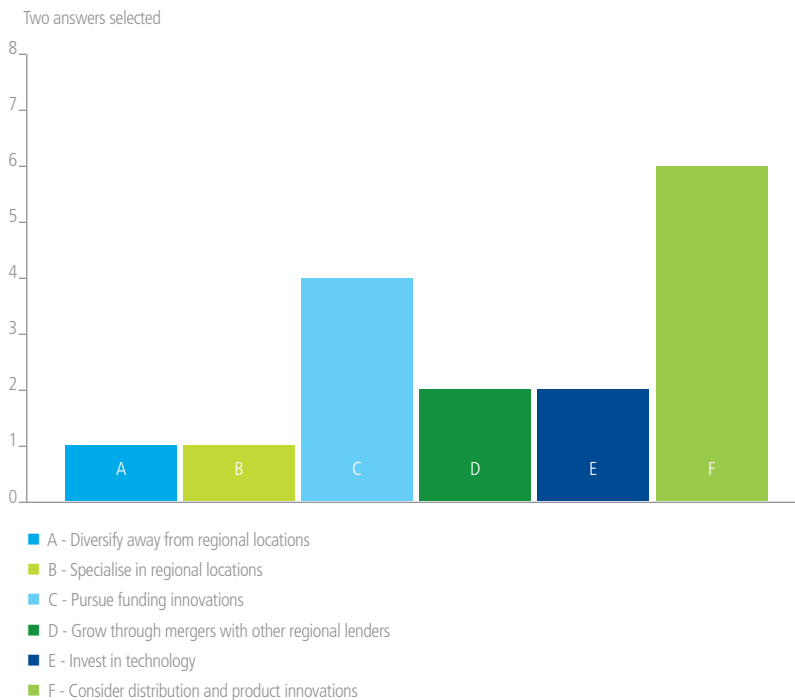


Figure 8. Source: Australian Mortgage Report 2015

“We have looked at many things but securitisation always seems to be the most efficient.”

Luis Orp (Resimac)

What do regional lenders need to do over the medium term to compete effectively?

James Hickey (Deloitte)

Distribution was quite clearly the primary response followed by funding innovations. We just covered a key aspect of distribution which is successfully engaging brokers to drive growth for regional lenders.

What about the other key response you gave to this question – funding. How can innovation in funding be done to assist regionals or other smaller lenders for that matter?

Luis Orp (Resimac)

We are diversifying. Getting larger deals away domestically has been difficult, so it has made sense for us to issue in the US and build that program. But it is going to be hard for us to move away from securitisation. It's probably the only way we can efficiently and effectively fund ourselves. We have looked at many things but securitisation always seems to be the most efficient.

Malcolm Watkins (AFG)

Another example of a funding opportunity is accessing superannuation. That's a potential funding source. More of that sort of innovation should be happening where you have locked up funds looking for a better than bank rate, without the risk of the equity markets.

Heather Baister (Deloitte)

There is also the option of smaller regional lenders combining together to access funding. The challenge is that they can end up with a complicated product without the necessary skills in their own Treasury Departments to manage such deals. But it is possible however to put together a theoretical pooled structure and take that to investors in the market.

James Sheffield (CBA)

I think the Japanese and Chinese markets are also potentials to explore for funding. We talk about America and Europe as the key offshore securitisation markets, but I think with the free trade agreement with China there are some opportunities there.

Funding: The outlook for 2015?

Heather Baister & Graham Mott

In this article, Deloitte partners Graham Mott and Heather Baister explore the various components of funding to try to make sense of the outlook for mortgage origination and competition.

Cost of funding

Deposits

Deposits have continued to be the mainstay of banks' funding profiles, with the proportion of funding from deposits remaining high (>60%) across the major banks and driving the growth in lending.

The nature of deposits shifted during 2014 with many of the bonus rates paid by banks moving from term deposit accounts which drove the competition for cash during 2011 – 2013, to online saving accounts.

As the market moves through 2015, a number of ADIs have cut the bonus interest by up to 20 bps (prior to the February 2015 interest rate cut of 25bp) thereby actually regaining some margin. The timing of cuts is being linked to the introduction of the Liquidity Coverage Ratio (LCR), which penalises banks for 'at-call' accounts (see Figure 9). As a result in order to maintain deposits that achieve optimal treatment under the LCR, some banks are now offering bonus interest on accounts which require 31+ days notice of funds withdrawal. The gap between term deposit special headline rates, and at-call savings deposits has contracted significantly to about 60bps compared to close to 200bps in 2010 at the height of the drive for cash, and we expect to now see the best rates to be generated on these "notice of withdrawal accounts" as banks aim for 'sticky' deposits.

With the cash rate falling in early 2015 and predicted to reduce again mid-year, the challenge for the majors is to carefully manage margin compression through a steady migration of customers from higher yielding accounts to low or non-interest bearing deposits. Without this, in a reducing interest rate environment, margins will naturally decline. Competition for borrowers has led to originators refocusing attention on brokers and in particular the service offering they provide borrowers. It also means that a number of ADIs have cut rates by more than the recent fall in the cash rate – which implies chasing new origination volumes over protecting margins and so further eroding margins.

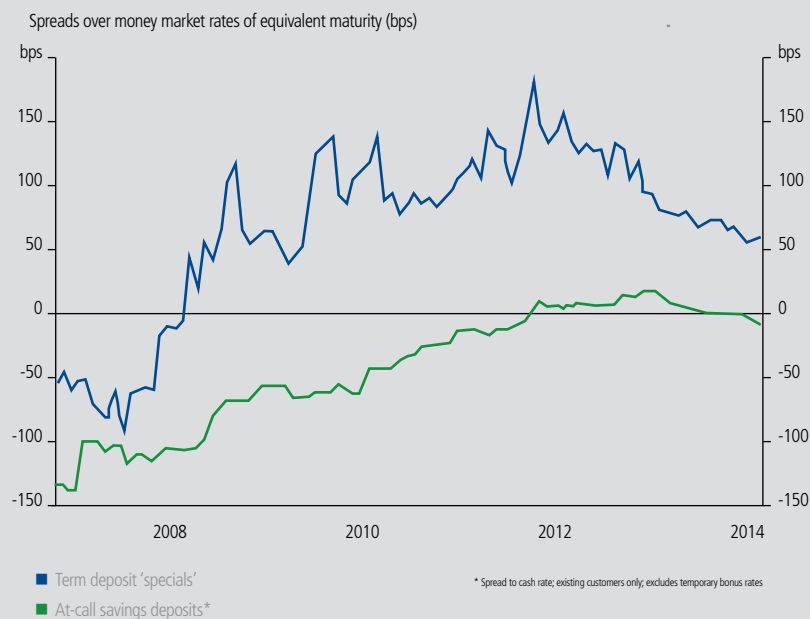


Figure 9. Major Banks' Deposit Rates

Source: Bloomberg, RBA, Major banks' deposit rates⁴

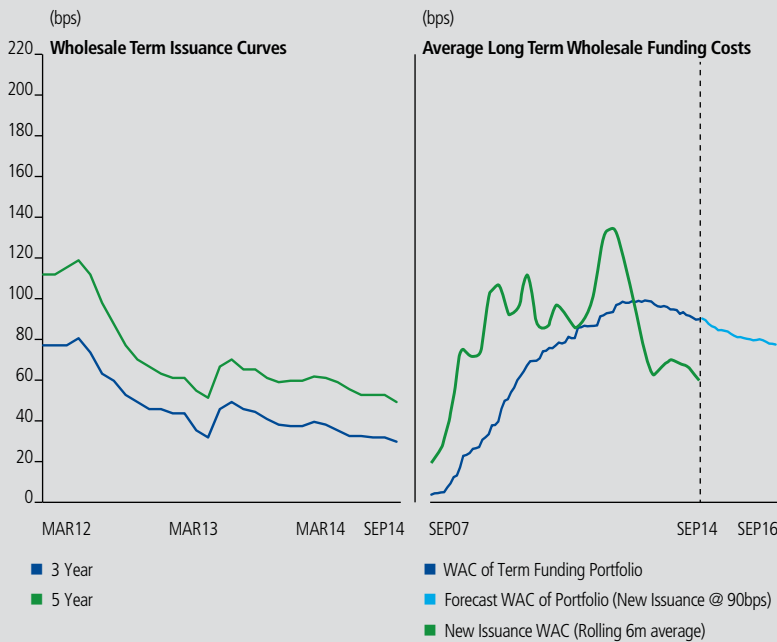


Figure 10. Wholesale funding costs⁴ Source: Australian Mortgage Report 2015

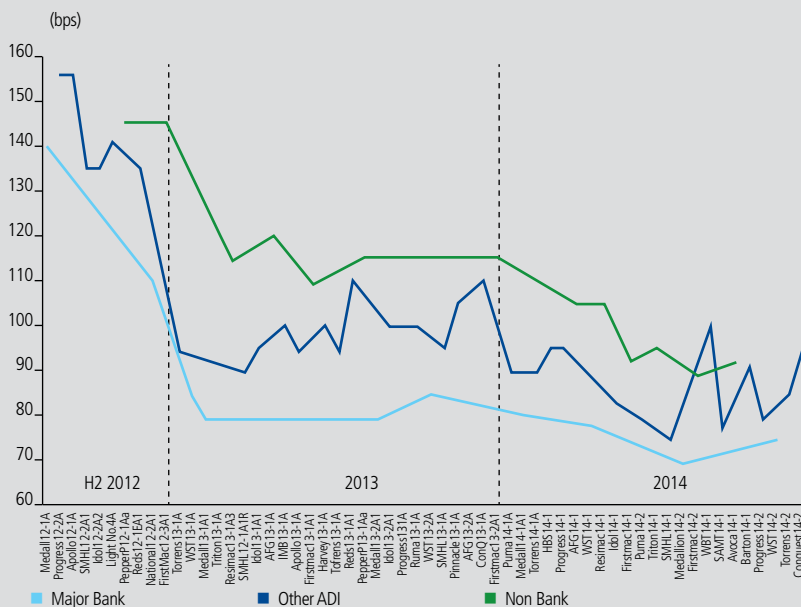


Figure 11. RMBS Primary Margin - Senior AAA 2.3.3.5yr WAL Source: Westpac ABS Strategy

Major Banks' Deposit Rates³

Despite the fall in spreads between different accounts, banks are still increasing their deposit bases, particularly as Australian consumers continue to pre-pay their mortgages and debts, and utilise facilities such as interest offset accounts. Approximately 75% of Australian residential mortgages are ahead of scheduled balance, and the stock market is not yet providing an attractive alternative for many cautious householders as volatility makes it relatively easy for banks to retain funds within deposits.

Wholesale Funding

The general trend over recent years has been to tighten spreads on wholesale funding. Credit spreads however widened in the second half of 2014 and early 2015 by 10 – 15 bps from mid 2014, reflecting local and global investor appetite for risk adjusted yield.

Wholesale Funding Costs

In Figure 10 we can see that where funding raised in the peak is now being rolled. This is being done at a considerably lower cost to the banks. However with the weighted average cost of funding remaining above the marginal rate, the majors will be required to continue to protect margin on new business relative to their non ADI competition through retail deposit pricing and management. Additionally the fall in the AUD relative to the USD means that as ADIs' USD exposures roll (for the majors approximately 30% of their wholesale funding) their overall funding gap is reduced.

With many uncertainties remaining regarding the regulatory outcome in respect of master trusts, APS 120, skin in the game rules and potential changes to the capital regime, we predict 2015 will continue to present challenges to many originators.

3 RBA Speech on Liquidity by Guy Debelle 16 December 2014

4 NAB End of Year 2014 Investor Presentation.

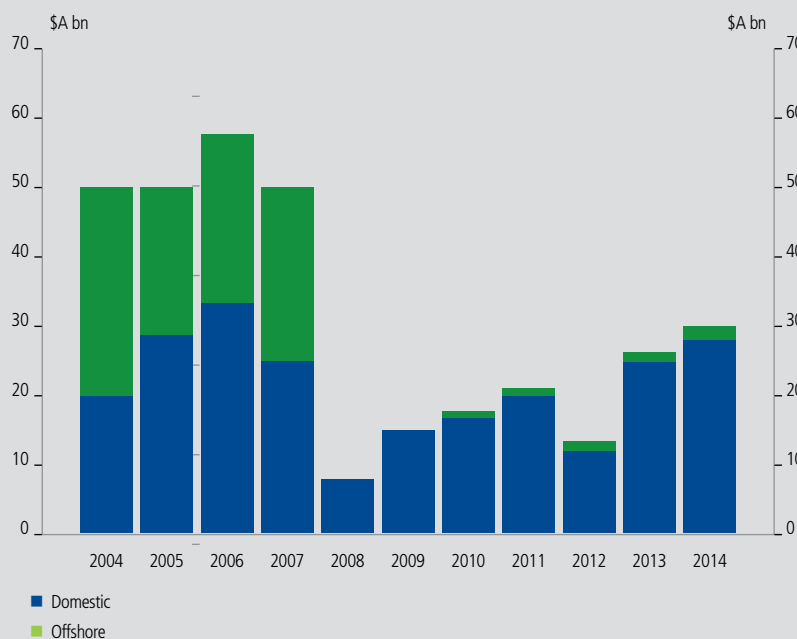


Figure 12. RMBS Issuance 2004 - 2014 Source: Westpac, S&P, Bloomberg

Impact of LCR on Funding Mix and Tenor

The LCR requires banks to comply with Basel III liquidity requirements, however it is well documented within the Australian market that there are insufficient high quality liquid assets (HQLA) to enable banks to meet their requirements. As a result the Reserve Bank of Australia (RBA) has launched a Committed Liquidity Facility (LCF) accessible by the banks to meet their HQLA shortfalls. The cost of this to Australian banking institutions is 15bps on the committed amount (more if the facility is actually drawn), and the banks in turn have had to ensure sufficient collateral to access the facility, being RBA repo-eligible securities. All the major banking institutions have been keen to demonstrate that they meet the LCR requirements, particularly holding 100% of required cash outflows over a 30 day stressed scenario in qualifying liquidity assets.

This has meant higher prices through increased demand for Commonwealth and State government debt instruments by ADIs. Additionally, all the major banks, and a number of the smaller ADIs have been undergoing internal securitisations which can be treated as repo-eligible assets by the RBA with a number of the banks increasing their internal transactions by up to 25% in the last 12 months. The reality of preparing for this new liquidity environment has however demanded significant resource allocation for many market participants, particularly with regards to the data requirements demanded by the RBA for certain repo-eligible securities. This has exposed data gaps for many issuers.

The RBA⁵ stated that banks should fully reflect the liquidity cost in the price of various services they offer customers, which in turn has flowed into the pricing and terms linked to certain facilities (for example lines of credit). Additionally, the new liquidity regime has helped widen the spreads between bank bills and Overnight Index Swaps, particularly for three and six month maturities, as these issuances will not require the issuer to hold equivalent HQLA against the exposure (unlike 30 day bills), and so the spreads have widened as more paper has been issued.

The issuances that occurred in 2014 have also pushed the weighted average tenor of banks' funding out. The majors currently have a weighted average maturity profile of four to five years (with a maturity spike in 2017 as the five year covered bonds issued during 2012 mature), with most showing an increase in tenor from 2013.



Our view is 2015 issuance is likely to fall just short of 2014 levels

Securitisation as a Funding Mechanism

Last year, in this publication we called out the opportunity for both regional and non-bank lending institutions. During 2014, the share of the mortgage market continued to move gradually away from the majors as banks such as Macquarie actively sought to strongly grow its business. This reflected the improvement in wholesale funding costs and the narrowing of the gap between major bank spreads and non-ADI spreads.

Additionally, the trend for the majors and Macquarie to support other market participants through providing warehouse origination facilities and through direct equity investment continues. The market remained strong through 2014, and most pleasingly, a number of entrants returned to RMBS issuance after a hiatus, including Citibank, La Trobe, and the securitisation of the RHG portfolio by RESIMAC. It was also a strong year for the non-conforming market, with a total of \$2.3bn placed publically, and at least one issuance by each of Pepper, Liberty, RESIMAC and Bluestone as well as a small placement by RedZed.

Total RMBS issuance for the year, was up on 2013, to \$28.9 bn (2013:\$26.0bn).⁵ This was the strongest year for issuance since 2007, which can only benefit competition, as funding options increase for smaller ADIs and non-bank lenders. With spreads widening recently, and economic and political uncertainty constraining confidence our view is 2015 issuance is likely to fall just short of 2014 levels.

Regulatory uncertainty

Disappointingly there has been little progress on APS 120 during 2014, and the Financial System Inquiry, while supportive of securitisation as a funding solution to support competition, did not find room for any clear cut recommendations.

So those originators looking to plan ahead in 2015 are probably best served by taking a view that the current regulatory stance is unlikely to change dramatically. Master trusts amendments remaining, difficult to execute in practice, warehouse funding likely to carry a capital cost should term out not occur within 12 months.

The consistent use of standardised models being applied to risk weighted assets is looking more likely, and together with the one size fits all cost for the LCR facility, the "level playing field" gap between major banks and other ADIs will inevitably reduce. For long-term strategic funding planning, all eyes look to BIS to determine where the future lies.

In summary

With market expectations of interest rates remaining low for the near term, credit growth will continue. However for the majors, the management of assets and liabilities will be driven by the requirements to conform with BIS guidelines. The requirement to maintain and nurture 'sticky' deposits and protect mortgage market share, will continue to be the focus for the major banks, and innovation within the regulated environment is likely to remain difficult.

For those outside the APRA regulatory requirements, with a strong history of delivery and maximisation of opportunities, there remains good appetite to fund, including at the mezzanine level. This can only increase competition both locally and globally for those participants willing to keep innovating. Challenges will however continue for new enterprises that have not yet demonstrated delivery and for those non-banks without the scale of the large participants, or the support of the main financing institutions.

Heather Baister: is a partner in Deloitte's Financial Services Assurance and Advisory practice. She has focused on mortgages and securitisation for over 10 years and has also worked in Deloitte's London and New York offices. Heather leads Deloitte's Securitisation Advisory services and is known for her close connections to the Australian securitisation market and works closely with the Australian Securitisation Forum via their Education Committee and Accounting and Tax Committee.

Graham Mott: is a senior partner in Deloitte's Financial Services practice. He has co-authored the mortgage report for 10 years having specialised in securitisation for more than 12 years. He has been a member of the National Committee Australian Securitisation Forum for 7 years and chairs the Accounting and Tax Committee. Graham also leads the Deloitte relationship with the Commonwealth Bank of Australia.

⁵ RBA Speech on Liquidity by Guy Debelle 16 December 2014

⁶ Excludes private placements.

The Brokers: Mortgage broking in the future

6 out of 8 respondents said broker market share would grow to 51-60% of new flows

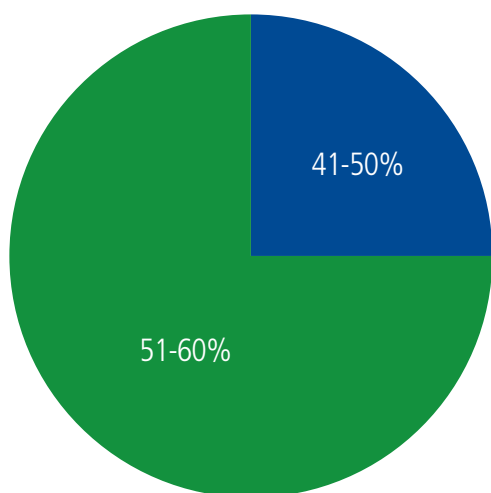


Figure 13. Source: Australian Mortgage Report 2015

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

James Hickey (Deloitte)

You gave a vote of confidence to the intermediated channel with three-quarters of the group saying the proportion of mortgage settlements represented by brokers will grow to between 51 – 60 % over the next three years.

It currently hovers around 50% so most of you believe brokers will get a bigger share ahead.

Bill Armour (ANZ)

I think if you take all the conversation we've had so far about putting the customer experience to the front of everything that you want to do, in a lot of cases brokers just present a very good experience for customers.

When you have an entire industry that is focused around one sole purpose which is look after customers who are after a home loan, you can do amazingly good things and the challenge we have from a bank point of view is to do that as well as we do 175,000 other things. I think it all comes down to the proposition that brokers can offer customers in an industry that is still very much based on a trusted relationship; working with someone who can make the process easy for you, because it's not.

James Hickey (Deloitte)

If digital is going to move towards online end to end, how do brokers still make sure they're going to grow market share and also remain relevant to those consumers in the marketplace?

Mario Rehayem (Pepper Group)

With the aggregators and the lenders out there really focusing on Big Data and getting smarter and more involved in their businesses, I believe the customer experience is just going to keep on getting better and better, and I think the brokers are steering that in a big way. It's evolved.

James Sheffield (CBA)

I used to love going down to my bookshop and looking for the best books to read. It was fantastic. Times have changed very quickly. I'm in the blue part of the pie. I actually think digital is going to impact all of our businesses more dramatically than our generation understands. I think we are potentially seeing the high tide of 'physical only' distribution. You've got to believe in a stronger digital focus with probably some advice behind it in an omni-channel way.

We are at an inflection point where we're educating customers who are shopping around, and although we haven't got e-conveyancing up and running yet, it's going to happen. And we are potentially talking about greater commoditisation. With the digital experience creating the differentiation. So as much as I remember going to my local bookshop five years ago, now we don't think twice about going onto Amazon to buy our books due to the experience they offer.

"I think digital is going to impact all of our businesses more dramatically than our generation understands"

James Sheffield (CBA)

Malcolm Watkins (AFG)

I would have liked an option that said brokers are at 50% market share and in three years' time will still be at 50%. I think there's a really strong case to say we will be. Our business is around the three Cs – choice, convenience and cost. If you can do low cost and you can potentially do convenience through your omni-channel, you're still not offering choice. I think that is a component that most people like. They can make that choice on the web but they still haven't made the decision to walk in and buy. They need someone to run them through the choices. That's what will hold brokers in position for a good time.

Angela Middleton (ME Bank)

As direct online applications start to emerge you will see some customers use that channel, which is good for choice. But there will always be an important role for brokers to have a face to face with customers, particularly customers who wish to better understand the product and get more information about what is available and what's best for them.

Mario Rehayem (Pepper Group)

It will be a good idea for the right lenders to always make sure that they do evolve in the digital world but at the same time assist the broker channel evolution into the digital world as well.

Malcolm Watkins (AFG)

I think the pressure is on the brokers to respond to the way the consumer is moving. We need to continue to provide constant ongoing service to our customer base. I don't think that's going to fall off. I think most of the big broking groups around the country are investing in ongoing customer communication pushing through that value proposition of choice and convenience and independence.

Frank Ganis (Macquarie Bank)

We should not take broker growth for granted. If as a business or an industry we don't stay focused and continue to improve our products, digital and our online capability, relationships will be difficult to sustain. When I answer this question, I go beyond the broker to the intermediary, because it's not just mortgage brokers who are distributing and accessing new borrowers. Suffice to say, brokers will continue to play a very important part in this industry.

James Hickey (Deloitte)

I think your point is good Frank. We shouldn't just think that all brokers will grow with the rising tide. Those brokers who invest in digital, who actually try to embrace the changing consumer trends and needs, will grow. Those who exist only in the paper world will really struggle going forward.



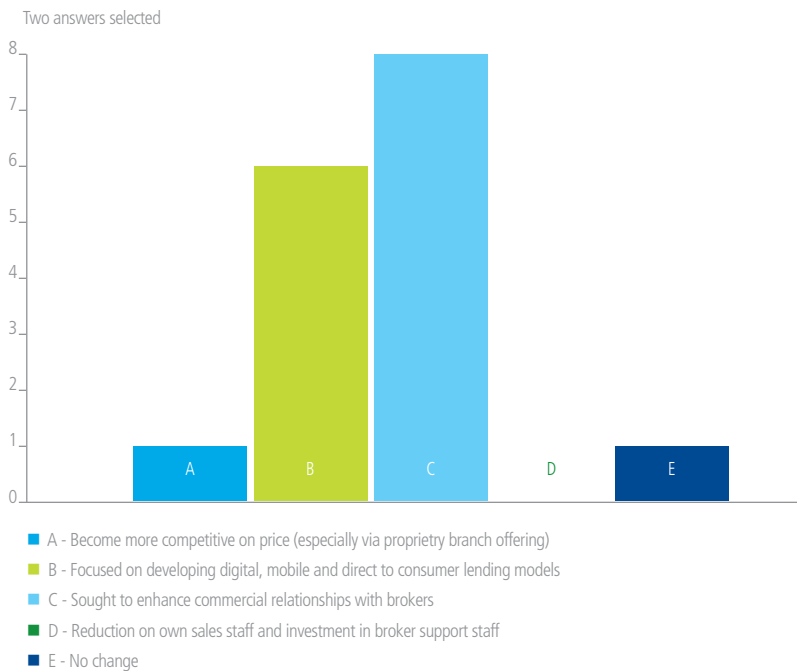


Figure 14. Source: Australian Mortgage Report 2015

“But it will be very different in five years’ time as to what a broker looks like and what part of the transaction that broker facilitates”

Malcolm Watkins (AFG)

What responses have lenders taken to the increasing momentum of broker distribution?

James Hickey (Deloitte)

This question is a bit of a sanity check. Lenders have been focusing on their own digital, mobile and direct consumer lending models at the same time as supporting brokers.

James, from a CBA perspective, how does a major bank choose the right balance of where to invest in respect to distribution channels?

James Sheffield (CBA)

During the financial crisis lenders were deserting the market. They couldn’t get funding and the big decision for the CBA was whether brokers would be a long-term viable proposition. And the answer was very simple – customers’ needs are first. If customers are saying: ‘The brokers offer us a choice’, then you’ve got to invest in that channel and continue to invest in that channel. In the same way customers are telling us we want digital and mobility, so you’ve got to invest in those channels. At the end of the day the customer owns the customer!

Bill Armour (ANZ)

We talk about digital being upfront, but there is that ongoing relationship model that is the broker’s base, and is actually quite hard to replicate within the network. When you talk about a digital relationship, you don’t necessarily think in terms of a face to face relationship for the rest of the ongoing period of the home loan. You may set it up initially over three months, but then you have to maintain an effective relationship for five years, 10 years, 15 or 25 years with ongoing servicing. How do we get good at maintaining a really effective institutional relationship digitally?

Malcolm Watkins (AFG)

How do you get good on Facebook with Ma and Pa in the suburb? The broker on the other hand picks up their children from the same school and can get really good at relationship management. You can go down the track of Facebook, digitals, LinkedIn and all the rest of it, and get good at delivery of systems, efficiency and information, but it’s very tricky thing to become good on a relationship basis. I think this is where it needs to reach to really start impacting on the existing broker model.

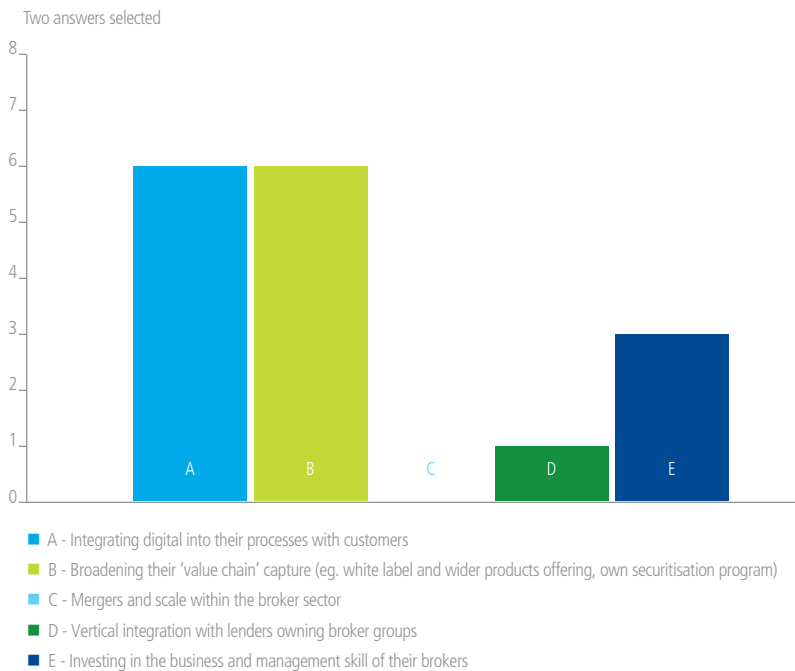


Figure 15. Source: Australian Mortgage Report 2015

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

James Hickey (Deloitte)

Integrating digital into their processes with customers was selected by most of you as one of the priorities for brokers and their aggregator groups.

The other interesting response was leveraging the relationship to get more from the value chain. This could mean a white label product, but it could also extend to wider products, insurance or other personal household finance needs. Such cross sell has always been a bit of a Utopia even for banks. I wonder if it is still a Utopia for brokers, even though they have a strong relationship?

Malcolm Watkins (AFG)

I think integrating digital into their processes, A, makes B, broadening the value chain, infinitely easier. In fact we've been doing that for a long, long time. Whether it's actually taking the product and selling it themselves, or whether it's linking it through their proposition to a second person, a call centre or to the institutions that are offering the product.

Chris Wilson (Deloitte)

This in fact is 'Facebook at the pickup of the kids at school'. It is the brokers' face-to-face that got the initial trust through seeing the customer every day. Now they can offer a digital channel where you can learn more and help manage your finances. 'By the way, I've got some connections into other digital platforms as part of our managed lenders arrangement.' The customer might end up at a CBA or ANZ website, but they still go through the broker's portal and this helps the customer manage their finances and the broker still gets to see the customer face to face at the drop off.

Luis Orp (Resimac)

The Resimac experience of digital within our broking operation has been quite good. We have a business that originates online. The enquiry comes in online followed by some of the processes done electronically, supplemented with people on the phone. So it's not completely digitised, but we found our retention rates are better than the rest of our book. We also find that their performance is also very good with lower levels of arrears.



Fintech in mortgages: locating the next inevitable disruption

Chris Wilson & David Johnson

Fintechs are disrupting the financial services industry at an increasing rate and mortgages are no exception. Deloitte looks at how to identify the source of your next disruptive play.

In our submission to the Murray Financial System Inquiry, Deloitte called for fintechs to be let loose. We applauded proposals to recognise the role of these disruptors in the financial services ecosystem and collaborate to develop new ideas.

Fintechs are disintermediating segments of the banking value chain by launching new products and platforms with an increasing level and pace of innovation. But this does not inherently mean that banks are being disintermediated – because banks are themselves fintechs.

‘Fintech’ can equally refer to an individual company or the industry of companies that use technology to make financial systems more efficient and easy to interact with. Indeed, the major banks increasingly refer to themselves as “*technology companies that sell financial products*”⁷.

Social media threads on fintechs commonly focus on the latest Silicon Valley start-up threatening disruption, whether it is a PayPal, Simple or Square. But equally as many significant, lasting and disruptive innovations have come from the banks themselves. The online banking models first introduced by Citi and Chase in the 1980s forever changed how we interact with our banks. Similarly, the emergence of digital-first banks like uBank and homeloans.com.au, are serving the growing customer segment that prefers online only origination and servicing propositions.

What will the next fintech disruption look like?

The essence of a fintech is to find a *differentiating technology capability* that can better serve a customer need or reduce the cost of service. Five key themes have been dominating fintech innovation in recent years and are yet to fully play their role in mortgages:

1. Data analytics

What is it: To improve targeting of customers, assess risk, design and price products.

Impact on mortgage: While we have already seen improvements to the use of customer, corporate, social and public data stores to drive better credit risk assessments and pricing models⁸, there is still scope to deliver more targeted offers based on customer insights available from big data.

2. Cloud and service oriented technologies

What is it: Continue to gain traction as a method of increasing access to scale and integrations at a reduced cost of ownership.

Impact on mortgage: These integrations often look to identify non-core elements of the target value proposition that can be delivered, upgraded, scaled and maintained on demand by a third party, for whom the service is their core value proposition. This can be hardware (private clouds), reference data (postal data or real estate sales data) or ubiquitous functionality (e.g. Salesforce).

7 James Sheffield, CBA – Deloitte Mortgage Report 2015

8 Example of some early global shifts include US startups HomeUnion and CUnexus' Comprehensive Pre-Screened Lending.

3. Digital and mobility

What is it: Consumers are doing more of their own research, online and are increasingly bridging to online service support, education and even advice on mobile.

Impact on mortgage: An increasing segment expects to be able to originate and service themselves online – using multiple devices and platforms in a seamless experience. Barclays has recruited 7,000 employees, ‘Digital Eagles,’ to offer free advice on how to manage digital transactions, as well as everything else the internet offers. Video banking capability for high value transactions exists in many banks, a trend that is now shifting to brokerage distribution models – enabling the mobile lender to become truly so and available for more customers more of the time.

4. Connectedness

What is it: Was called out as a key theme in the FSI, with the continuing impact of social, online and peer-to-peer networks bringing customers closer together.

Impact on mortgage: Peer-to-peer insurance models like Friendsurance have been extending the application of takaful insurance models and peer-to-peer lending seen in SocietyOne and LendingHub. A model of peer-to-peer mortgage loan communities is not inconceivable.

5. Loyalty and lifestyle

What is it: The digital and connected consumer expects ever more of their service provider delivering both lifestyle requirements and loyalty arrangements.

Impact on mortgage: An increasing incidence of loyalty and related-value offers has seen the emergence of cross-sector fintech offers such as Qantas Cash. The cross-sector parallels for the mortgage industry could mean integration of offers to key property purchase considerations such as wealth and tax strategies for the investment property buyer, schools and medical facilities for the family buyer, or the local golf clubs for the down-sizing retiree. These key is the integration of offers that simplify or enrich the core experience in a differentiating, brand-enforcing way.

In assessing the viability and robustness of innovation, fintechs focus on opportunities that cross multiple themes, both from the table and new uncharted domains of differentiation.

Where will fintech disruption come from?

The two key functions of a fintech’s ability to disrupt your business model are scale, i.e. its existing customer base and brand recognition, and adjacency, or its capability and reputation for delivering financial services.

- **Major financial institutions:** The major banks domestically and globally gain a natural amount of focus from competitive and industry analyses, employee networking and movements.
- **Major players from other industries:** The big technology companies increasingly offering financial services like Alipay, Apple Pay and Google Wallet. These large scale players have just as much, if not more, market share as the banks. Research⁹ has already shown that a not insignificant share of the market would be willing to bank with Apple. When these large technology companies enter a segment, they often seek to dominate it but have demonstrated willingness to partner to get there.
- **The middle ground:** Financial service providers from related fields may not have the scale of a major bank, but do have the brand and agility to quickly eat into market share with innovative offerings. As an example, a Youi home loans offering is not inconceivable. If a financial planning software providers extended their mortgage risk assessment capability into origination platforms under a partnership
- **The start-ups:** There is a long history of small tech start-ups led by experienced bankers that are not necessarily a threat to the major banks market share. These start-ups can rapidly take new concepts to market because they are not laden with hefty integrations or competing for investment slate. However they also take time to develop consumer confidence in an unknown brand unless they partner with a trusted finance brand. In this light they can also be an exciting avenue for selling more mortgages for such a partner.

⁹ <http://kae.com/ideabank/in-apple-we-trust/>

So the key question in monitoring emerging start-ups is not so much whether they will disrupt you, but whether they are suitable to engage, partner with, or buy?

So what do you do about it?

Given the depth and diversity of fintech news and innovation, it's essential to have a focused approach. Three simple steps to doing the right things:

1. Have a strategic radar

It's important to understand what the other players in the market are doing, but don't try to do everything yourself.

The nature of our economy today has an increasing number of specialists in almost everything. Engage research houses and specialists to find the emerging market trends and players. Let them help you identify the fintechs that can deliver a niche piece of your solution.

2. Focus on the customer, with the customer

Great fintech innovations make life simpler. To design the next fintech disrupter, start with a deep look at the customer and the journey they are on. Observing them – not just when they are buying a mortgage – but in the months before and years after. What is it that they find difficult to do, what causes them stress or what causes them to look elsewhere. What services could make their life easier and make them a stickier customer?

3. Make some bets

With so much innovation going on, it's easy to end up spreading your investment slate too thin. Once you've picked the fintech solutions you want to pursue – go hard, be focused and fast. The innovation you release to market needs to balance delivering a beautiful, stable customer experience while being fast to market. This cannot be done with too many bets running at once.



***Chris Wilson** is a partner in Deloitte's Financial Services Consulting practice. He has focused on financial services for his entire career, building a passion for all things customer and digital. Chris leads a global digital initiative for Deloitte that is focused on the next wave of digital transformation within financial services.*

***David Johnson** is a director in Deloitte's Financial Services Consulting practice. He has previously worked for online insurance start-ups, the financial services regulator and advises financial services institutions on customer strategy.*

The Majors: Challenges for the majors

MARKET

CUSTOMERS

REGIONALS

BROKERS

MAJORS

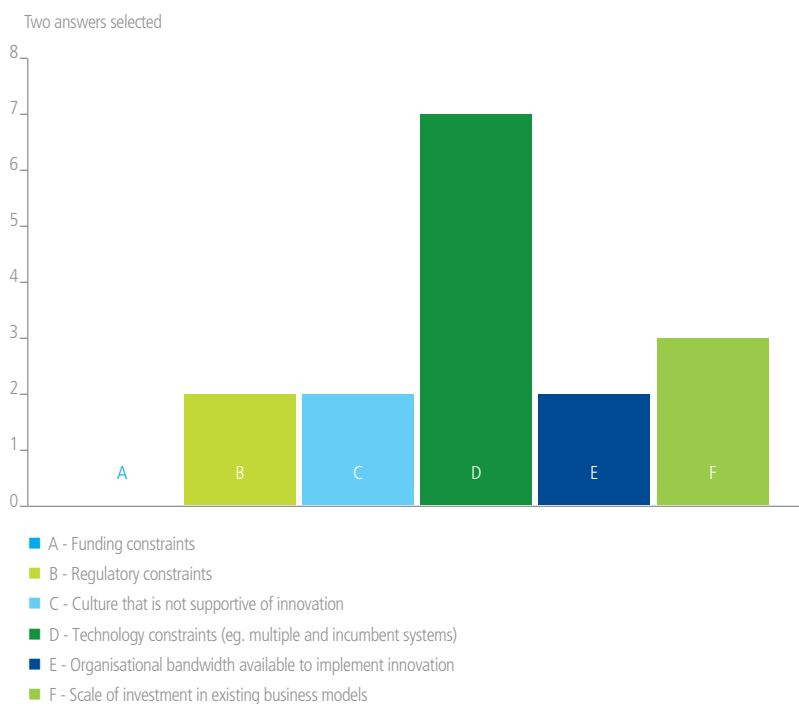


Figure 16. Source: Australian Mortgage Report 2015

Where are the greatest challenges to innovation among the major lenders?

James Hickey (Deloitte)

We asked about the greatest challenge facing the majors as they embrace innovation.

We discussed earlier that what consumers want is not just being competitive on rates, but they want the technology promise or the innovation promise. Nearly everyone said technology constraints were the greatest challenge to driving that promise forward.

I'm interested in how hard it is to actually navigate through the myriad of legacy systems and IT prioritisation queues at major banks, to get the technology changed to better the lives of consumers when it comes to mortgages?

James Sheffield (CBA)

Well obviously we've made a significant investment over the last six years in our systems and have significantly simplified them. They're not perfect, but they're certainly in a much better place than they were. I think the constraints in technology are how to keep on investing at the sums required. Technology is such a large investment, especially when I think of the investments that the Googles and major technology players in our customers' space are making, which makes all of our investment look small. So I think you have to take multiple bets.

Not all those bets will come off because nobody knows where the next disruption technology players are going to come from. I think the hardest thing for banks is to continue to keep those investment levels up while continuing to invest in core existing businesses. Where you put your investment dollar will continue to be critical. There are also physical assets to be maintained and updated, as well as back office systems which also need to be digitised.

Of all the banks we've taken a pretty sizeable focus on this. We are more like a technology company that sells financial services products now. We've got to be realistic that it is technology that drives our business, more than anything else, other than people. Even the brokers now have major technology systems investments. And what do the aggregators sell? They sell their systems as a point of difference.

Malcolm Watkins (AFG)

At AFG, that's exactly what we are. We're a technology company and we have 2000 brokers connected to it.

"We are a technology company that sells financial services products"

James Sheffield (CBA)

Graham Mott (Deloitte)

Which is where the disruption is going to come from. If you were to design a technology company with financial services products, you would probably design it differently because of all the legacy constraints we are working with.

Bill Armour (ANZ)

But also home loans are quite different to other financial products when you talk about having multiple systems. Which is not necessarily a bad thing, because you want a system that's really well designed for its purpose. You want a really great system that does pricing, or origination, or you want really great internet banking, a mobile banking platform and so forth. So actually it may not be a single system solution for all requirements. It may just be components that work really well together.

Google could do an amazing front end, but could Google also do a credit risk system? And then map that to a pricing system, a funding system and a core banking system?

That's where home lending will have technology constraints just because it's a big complicated end-to-end process. That's not to say that people can't come in at points of that and do it amazingly well. But for someone to come in from scratch and build every single component which the banks have invested in it for decades with billions of dollars? I don't think it's likely.

Chris Wilson (Deloitte)

So what's the alternative? If it is not to build, then is it to rent or to outsource it?

Bill Armour (ANZ)

That's the hard thing. And the issue with the technology constraint. You will have to invest in multiple things over time and you can't afford to do it all at once.

Frank Ganis (Macquarie Bank)

Be prepared to have lots of attempts, accept that sometimes you might get it wrong, but don't get discouraged if you do. Learn from this and just move on. That's really important. You've got to be resilient because sometimes you don't get it right the first time.

Angela Middleton (ME Bank)

It's just got to be that agile environment where you test, learn and try.



Malcolm Watkins (AFG)

I don't think technology in itself is the constraint, it's prioritising your limited resources. It's which bits do you do first and who in the pecking order gets it first.

Bill Armour (ANZ)

Just in terms of prioritising investment, it's also scary to invest at the curve. Big banks like really safe bets.

Malcolm Watkins (AFG)

I was in San Francisco only a couple of weeks ago and sat down with the CIO of Wells Fargo and her IT Department which has 35,000 people, thinking 'Oh my gosh' that's mind boggling and that's just the IT! And that's repeated across a host of other international financial services firms with more people in their cyber teams than we might have in a bank. My point is however that these big firms are only just implementing data systems to manage their databases which for instance we at AFG implemented six years ago. So it's just phenomenal how long it takes for innovation to be adopted into those large systems because they have to check and double check to make sure it's right.

“Everybody is talking about being agile”

Frank Ganis (Macquarie Bank)

How can innovation be pursued while increasing margin?

James Hickey (Deloitte)

We then asked how you can pursue innovation while increasing margin. Half of you chose the 'self-funding' option, investing in technology by increasing cost savings in other areas, followed by taking the long term view of investing today with the expectation that margin will increase tomorrow.

James Sheffield (CBA)

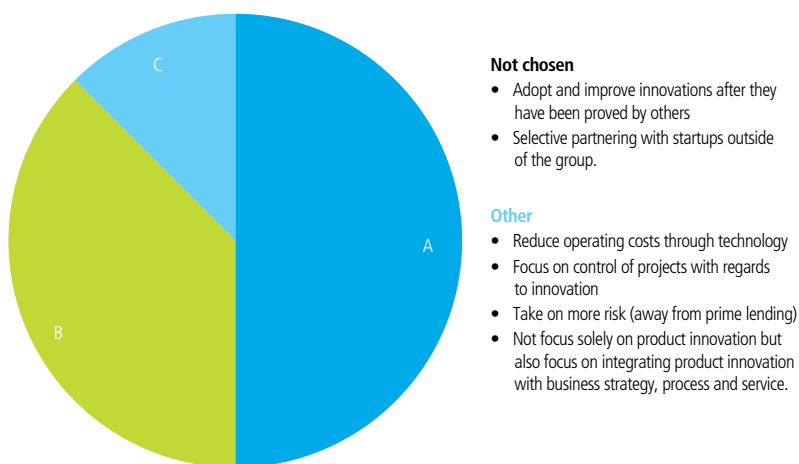
And through all of that you're making strategic choices as a business. We all have to make larger bets on technology and innovation that's all.

Frank Ganis (Macquarie Bank)

You have to be prepared to allocate a portion of your profit to stay in touch with market innovation. You must invest to increase your business, because if you're not prepared to do that, you will go backwards.

James Hickey (Deloitte)

One option that wasn't chosen was selective partnering of startups outside the organisation. Which is interesting, as many industry leaders often say that it is harder to foster a culture of innovation in a major organisation than in a start up?



- A - Free up capital for innovation by increasing cost-savings in other areas
- B - Take a long-term view and invest in innovation today with the expectation that margin will increase tomorrow
- C - Other (Please specify)

Not chosen

- Adopt and improve innovations after they have been proved by others
- Selective partnering with startups outside of the group.

Other

- Reduce operating costs through technology
- Focus on control of projects with regards to innovation
- Take on more risk (away from prime lending)
- Not focus solely on product innovation but also focus on integrating product innovation with business strategy, process and service.

Chris Wilson (Deloitte)

I think there is more of an acceptance that fintechs will, by their very nature, try and push the edges a little bit harder than perhaps they would let you in the big banks. It's all about how a large organization engages in that process. Some of you will be able to buy and take them in, and some will be more 'you've come up with something which is interesting'. It's not always about whether you bring the fin tech in house and then have trouble with integration costs and operational issues.

Actually I think there are more fintechs now that would be willing to say: 'We've built a pretty funky little engine that does front end customer data gathering. Let's just talk about it'. I think we've seen this with some of the investments happening around peer-to-peer lending. The debate is does it work? People are beginning to put some money into it, so at least they are prepared to see if it can. So for me is not about buying the fintech to integrate them, because it does become really complicated, but more thinking about how other people are looking at the same issue but slightly differently and how to support this.

Malcolm Watkins (AFG)

Of course one option to free up capital for innovation is to consider outsourcing. The amount of money spent on keeping the lights on every day within big banks is astronomical, when a lot of it can be outsourced these days. It's just a case of getting comfortable with the risks and the disaster recovery systems that are offered.

Graham Mott (Deloitte)

And APRA's response.

Luis Orp (Resimac)

Or compliance.

Malcolm Watkins (AFG)

That's right, but the reality these days is that some of these data centres are probably more secure than ours. The Amazons, Googles and Oracles are running pretty secure databases these days. I don't know how many people are needed to 'keep their lights on', on what I call 'business as usual' systems, but if you have that amount of people no longer needed, then you've many people that can be looking at innovation instead.

Figure 17. Source: Australian Mortgage Report 2015

James Hickey (Deloitte)

Frank, Macquarie has always been willing to take stakes and invest in opportunities. Is it still a culture within the group?

Frank Ganis (Macquarie Bank)

Absolutely. Our business model is unique in that we are a relatively new participant compared to the established banks. Our model is very much one of partnering with core, well identifiable, well-regarded brands. We are fortunate to have partnered with a number of high quality brands, including AFG, Aussie, Connective, Mortgage Choice, Yellow Brick Road, Vow, Homeloans and others. Having relationships with brands that have a national reach provides a distribution footprint across the whole country, which is important and works very well for us. We focus on what we're good at, manufacturing, processing and funding, and partnering with brands that distribute in an effective and efficient way works well. It's a model that Macquarie has leveraged over a long period across multiple products.

“Fintechs – Have a look at them. If you think they're interesting then investigate.”

Chris Wilson (Deloitte)

On that note
the roundtable
wrapped up...

Deloitte wishes to thank all the participants.





Deloitte Team



Graham Mott
Partner, Financial Services
Audit & Assurance Banking Practice
Tel: +61 2 9322 7970
gmott@deloitte.com.au



James Hickey
Partner, Financial Services
Actuaries & Consultants
Tel: +61 2 9322 5009
jahickey@deloitte.com.au



Kevin Nixon
Leader, Financial Services
Risk & Regulatory
Tel: +61 2 9322 7555
kevinnixon@deloitte.com.au



Chris Wilson
Partner, Financial Services
Growth & Strategy
Tel: +61 3 9671 7411
chrwilson@deloitte.com.au



Rick Porter
National Leader
Financial Services
Tel: +61 3 9671 7922
rickporter@deloitte.com.au



Heather Baister
Partner, Financial Services
Audit & Assurance Banking Practice
Tel: +61 2 9322 5911
hebaister@deloitte.com.au



Martin Joy
Director, Financial Services
Treasury & Capital Markets
Tel: +61 3 9671 7863
majoy@deloitte.com.au



Andrew Pellow
Partner, Financial Services
Customer
Tel: +61 2 9322 5430
apellow@deloitte.com.au



David Johnson
Director
Customer Strategy
Tel: +61 402 247 939
davidjohnson@deloitte.com.au



Michael Thomas
Director, Financial Services
Deloitte Access Economics
Tel: +61 2 9322 7145
michaelthomas@deloitte.com.au



Louise Denver
Director, Financial Services
Corporate Affairs/Communication
Tel: +61 0414 889 857
ldenver@deloitte.com.au



Deloitte Sydney

225 George Street
Sydney, New South Wales
Australia

Tel: +61 2 9322 7000

www.deloitte.com.au

Deloitte Melbourne

550 Bourke Street
Melbourne, Victoria
Australia

Tel: +61 3 9671 7000

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