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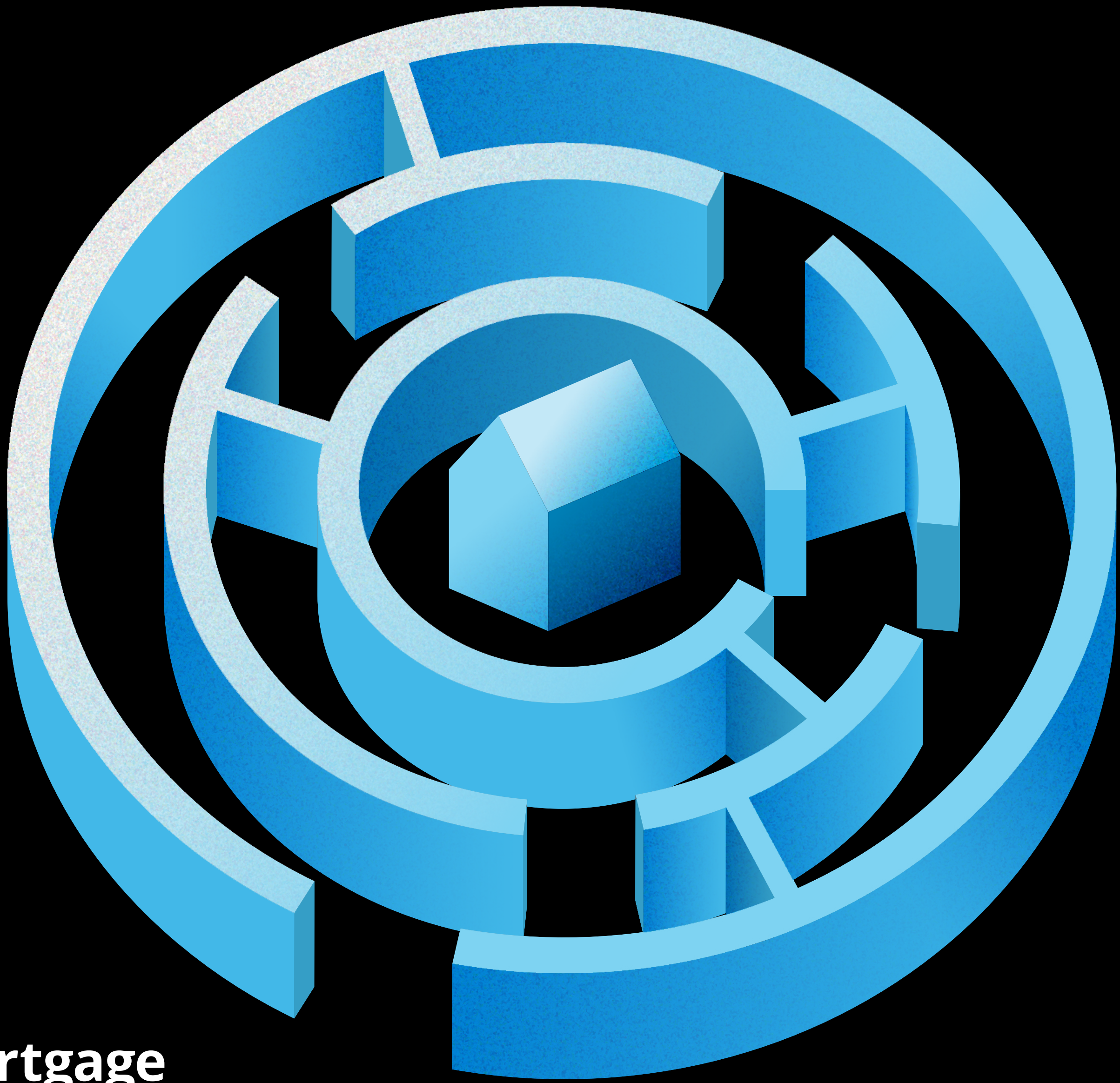


Australian Mortgage Report 2018

The 'customer-in-control' future

Contents

Executive summary

In this year of change, when the Royal Commission into Misconduct in the Banking, Superannuation & Financial Services Industry looks into the conduct of organisations in meeting customer expectations, Deloitte partners got together with representatives from the nation's biggest lenders and broker groups to discuss how the mortgage industry can continue to deliver to the realities for most Australian consumers – the desire to own their own home.

So in the face of uncertainty about possible new rules and potential legislative change, this year's Mortgage Report roundtable attendees took time out to consider the other ongoing forces shaping the sector, such as technology, open data, pricing and broker evolution and how these may play out over the next 12-24 months.

In this edition

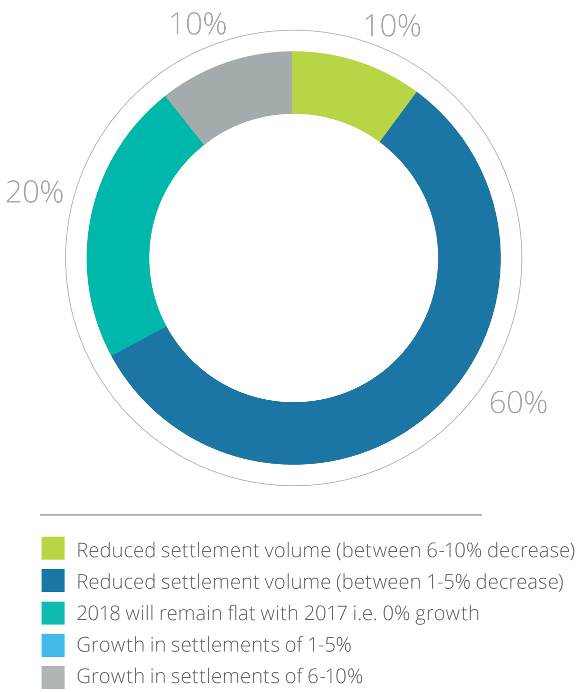
Across the board, 60% of Australia's leading financial services mortgage lenders and brokers predict housing settlement volumes to decrease by up to 5% in 2018, with a further 20% expecting them to remain flat.

The opportunities in the sector will be taken by refinancers and increasingly by first home buyers. Investor and interest-only loans will drag back to long-term levels, and owner occupied principal & interest (P&I) borrowers will continue to use the low interest rate environment to build up equity against their mortgage.

Distribution, compliance and conduct will have centre stage as the Royal Commission moves through 2018 and open data gives promise for what could be a more 'customer in control' future.

Figure 1. From the left: James Hickey, Louise Denver Deloitte; Alice Del Vecchio, HSBC; Peter Riedel, Liberty Financial; Tony Taylor, Police Bank; Andrew Toone, Bank Of Queensland; Nathan McMullen, Westpac Group; Melanie Evans, ING; Adrian Buckley, Suncorp; Lisa Claes, CoreLogic; Graham Mott, Arthur Calipo, Heather Baister, Deloitte; Joe Sirianni, Smartline.

Loan originations remained relatively flat in 2017. What do you see as the likely growth in settlements in 2018 across Australia?



James Hickey (Deloitte): The majority of our roundtable participants expect reduced settlement volumes this year, falling between 1-5% from 2017 when they reached around $36 billion a month, and totalled $380 billion for the year. One of us however was quite pessimistic and expects settlement volumes to fall between 6-10%.

Nathan McMullen (Westpac Group): I think most of us obviously think new loan settlement growth rates can't go up forever at the high levels seen in recent years. Asset prices have trended up, as have settlements. The rate of reduction in interest rates has almost stopped. There are headwinds from low wages growth, limiting consumers' capacity to borrow, as opposed to the tailwinds of more discretionary income boosting their capacity to pay off debt. On top of this, there is the flow through from changes to regulation.

When you put all these things together, the issue isn't so much a drop, it's more by how much and when. In fact, we probably expected the pace to drop a little faster than it has today. There was a fairly bullish run into late 2017 and earlier this year, which did cause some challenges around our views for the rest of the year.

Adrian Buckley (Suncorp): There are some segments which counteract that where pricing, particularly in the owner-occupied P&I (principal & interest) space, continues to be attractive.

In fact, mortgage rates haven't been cheaper for the past 30 or 40 years. I think that's driving first home buyer activity, particularly with the added incentives from State Governments. It depends how sustainable that sort of pricing is for the banks given some of the challenges that will come at us in the next 12 months.

James Hickey (Deloitte): Are there pockets of opportunity in certain states as those economies recover? Maybe Queensland or WA, which have been subdued for quite a while?

Melanie Evans (ING): Understanding the headwinds and tailwinds from a customer perspective in each of those segments it is an interesting sector to consider. I voted for a 1-5% drop in the settlement rate as I think banks have potentially overshot the 30% speed bumps. It may well be we've pulled back too much, and are likely to dive back into that space using levers like the cash rate.

I believe the first home buyer segment is a very good example of how a combination of incentives and affordability from a cash flow and an economic perspective, mean conditions are actually better for First Home Buyers (FHB) entering the housing market than ever before.

Also asset prices coming off are probably seen as a positive for a young Australian wanting to enter the market, versus those segments subject to more prudential intervention and regulation. I think the interesting conversation is not at aggregate level. It is looking at each underlying segment and understanding what drives the customers in it.

Peter Riedel (Liberty): I was much more positive, which probably doesn't surprise you as Liberty Financial is a smaller scale business. Since the inception of our business, as a competitive differentiator, we've deliberately invested in customer service and risk assessment through technology.

The current uncertainty for borrowers has allowed Liberty to grow above system. So, notwithstanding comments from the other panelists about the likely fall in system credit growth in the next 12 months, based on our track record we're confident of being able to grow in the 6-10% band from the perspective of our chosen segments.

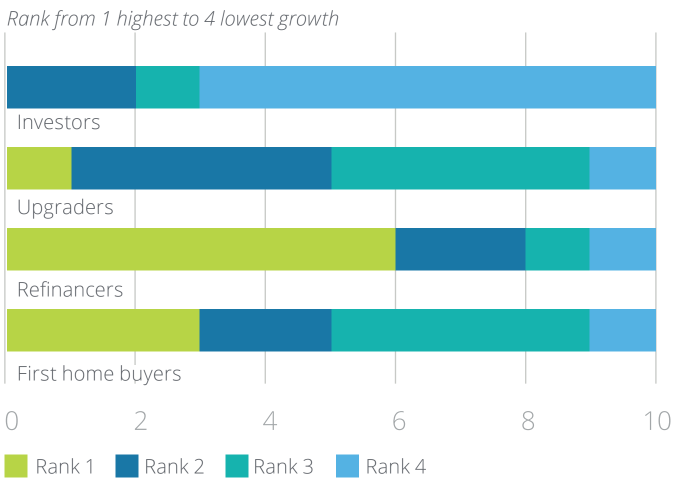
Tony Taylor (Police Bank): Deloitte Access Economics' Chris Richardson talks of total market (i.e. outstanding lending) growth in the 3-4% range for the next five to 10 years in the home loan market. So I still think there will be settlement growth to underpin this.

If you look at the current 4.5% growth in the total market today, any total system growth in 2018 is unlikely to come from growth in settlement volumes but rather from a focus on retention of current loans. I believe the investor leakage out of the foreign inflows market is going to have an impact and I think we all recognise that investors won't be the growth area.

James Hickey, (Financial Services Partner, Deloitte)

Nathan McMullen (Westpac Group: St George, Bank SA, Bank of Melbourne, RAMS)

What segments will have the largest relative growth in 2018 for new settlements compared to 2017?



James Hickey (Deloitte): We asked which borrower segments will feature most prominently in settlements over 2018. Refinancers were #1 as they are already in the market. They can use asset appreciation to support their refinance and if they're meeting serviceability they can take advantage of the lower rate environment and chase better deals. No-one expects investors to be number one and it was encouraging to see first home buyers ranked well.

Heather Baister (Deloitte): When I compared these predictions with two years ago, the difference was that in 2015 almost 40% of new settlements were investors. Entering 2018, this was less than 30%. The shift to first home buyers is also quite noticeable, moving from just over 10% in 2015 towards 20% into 2018.

Joe Sirianni (Smartline): True but a lot of first home buyers (FHBs) were investors. I have four kids, all first home buyers, and they're all investors. They're not classified as first home buyers. So I think that has clouded the segment in the last year or two. It was the only way the FHBs could get in the market – buy an apartment and use it as an investment. They're still first home buyers.

James Hickey (Deloitte): It's quite interesting when you look at first home buyer proportions by states. The RBA found that in WA well over 20% of settlements were first home buyers, yet New South Wales is clearly hardest for first home buyers.

Tony Taylor (Police Bank): And that's not unexpected because with the significant drop in house prices in WA, first home buyers now have an opportunity to get into the market with the help of their parents. I think we're going to see the market vary significantly by state. In Queensland we're now starting to see a higher proportion of first home buyers as well.

Adrian Buckley (Suncorp): Another geographic lens is net interstate migration. We're starting to see that pick up in Queensland over the past two quarters. Typically, that happens after a period of sustained price rises across Sydney and Melbourne.

Andrew Toone (BOQ): An estate agent I talked with from the Bulimba area of Brisbane said she'd sold a couple of houses recently to people who decided to still commute to Sydney for work but get that better quality of life in Brisbane and more real estate for their money!

Graham Mott (Deloitte): Internationally how significant do you think the offshore investor retreat is? It does seem like a hot topic, but how big a proportion is it?

Nathan McMullen (Westpac Group): I think a lot of the retreat has already played through. The reality with property segments is that there is often another segment to enter. So maybe when there was some softening in that particular segment, there were opportunities for others to meet the appetite.

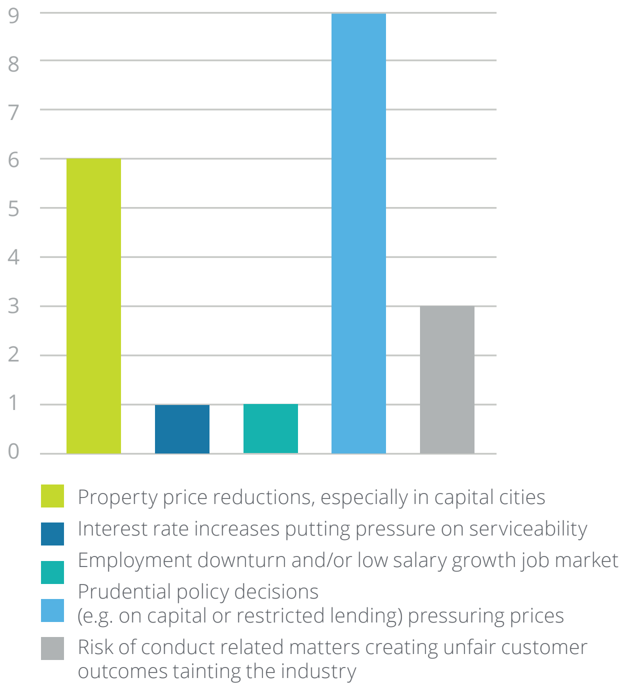
Alice Del Vecchio (HSBC): People often talk about buyers from China, but there are so many other international investors looking to purchase in Australia. For example, there are lots of Australian expatriates working in other countries like the UAE, still purchasing.

Graham Mott (Financial Services National Client Leader, Deloitte)

Adrian Buckley (Retail Lending Portfolio Leader, Suncorp)

What are your biggest concerns for the mortgage market in 2018?

Respondents selected two options



James Hickey (Deloitte): I observe the very low ratings for both interest rate increases pressuring serviceability and employment downturn. Is that a sign that we think we're in quite a good part of the economic cycle with positive prospects ahead? It appears your collective concerns are more around prudential policy settings impacting on the market dynamics.

Lisa Claes (CoreLogic): I think we all know the cash rate outlook will remain low. But we also know that interest rate servicing costs are almost 50% of household debt. So the sensitivity of that lever is enormous.

Tony Taylor (Police Bank): If the question had been: 'Where are things going to go in the next two to 2.5 years?' it would have had a different answer. Rates will increase eventually. The other change will be interest-only loans.

I expect to see a significant run off in them, not just because of the regulatory changes, but because you won't be able to refinance in the interest-only category. If you go from interest only to P&I (Principal and Interest), it's potentially up to a 40-50% increase in the servicing costs. In two years to three years out, there will be quite a different outlook from what's there now.

Melanie Evans (ING): APRA's demand for more information around serviceability, and the book's ability to repay debt under P&I and interest-only loans, may shift the focus from a black-and-white-category definition of serviceability to a detailed look at its underlying serviceability.

This will be a combination of rate, P&I versus interest-only, and a range of other things. So the prudential regulator has signalled its focus on affordability and serviceability, not rates.

Alice Del Vecchio (HSBC): That said, lenders have been diligent at building buffers to properly manage customers' serviceability. Today we have buffers that allow for a significant number of rate rises, making sure customers can absorb it.

But for interest-only, it does depend on how and when the loan was on-boarded. It comes back to how you assessed the loan in the first place and how much of this type of lending was done. This means the issues on interest-only loans are likely to be bank specific.

Adrian Buckley (Suncorp): There are a couple of angles to this. If you think about interest-only portfolios on bank balance sheets, given the regulatory limits, they are declining faster, so the portfolio needs filling up at the front end. This creates pressure on margin as the balance sheet mix trends towards principal and interest product.

We have also noticed a change in APRA's language around the prudential settings since it first came out. Initially they were expecting the proportion of interest-only loans to be around 30% of new business. Now they're expecting banks to be materially below that, and stay broadly where it is at the moment, around 23% or 24%. This is one of the drivers on our predicted views of restriction on settlements.

Graham Mott (Deloitte): What would we have our regulators do differently to balance a possible house bubble with household debt to income ratios? Would we say they're doing a good job in trying to navigate that balance? To me it can highlight a concern around growth and competition. What would we have them do differently to manage this if anything?

Lisa Claes (CoreLogic): I agree with the regulator in principle. Intrinsically it has to be a 'sheep dip' approach – a very blunt speed bump. But it is very hard for the participants as it can translate into an individual response such as: "Sorry Lisa, as you are the Xth investor borrower in 2018 and we've just hit our ceiling, we can't lend to you." To me that doesn't make sense. I don't know what better way granularity can be achieved, other than more insight into your customer base or potential base? Can ADIs use data to more democratically cherry pick their existing and potential borrowers?

The other change will be interest-only loans. I expect a significant run off, not just because of the regulatory changes, but because you won't be able to refinance them. In two to three years there'll be quite a different outlook from today.

Tony Taylor, CEO Police Bank

Macroeconomic backdrop

Australia has chalked up its 26th consecutive year of economic growth, and the clouds around Australia's economy are clearing. Commodity prices have firmed up and the slowdown in mining production growth (as 'in flight' projects finish up) is now mostly in the rear view mirror.

Authors

Kristian Kolding, leads the Deloitte Access Economic macroeconomic forecasting and policy team in Sydney.

Nicky Hutley, is a Partner in Deloitte Access Economics, and leads the national urban economics practice, which analyses issues such as housing affordability, urban renewal, and social and economic infrastructure investment.

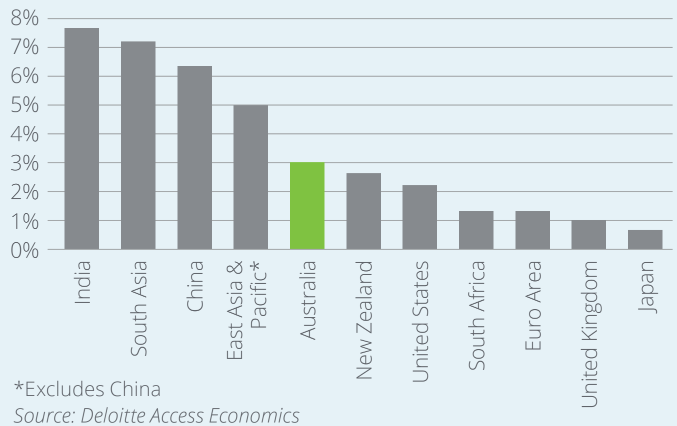
Mike Thomas, Director in Deloitte Access Economics is an experienced economist with broad-based expertise gained over two decades of practice, providing economic analysis and policy advice to clients in the financial services industry, the industry peak bodies and government.

Deloitte Access Economics analyses the big picture

The good news for Australia is that global economic growth picked up during 2017 and this has extended into 2018. Much of this growth is being driven by Asian economies, and in recent months that has translated into much stronger employment growth in Australia. That growth should also lift demand for capital, boosting the outlook for business investment.

Australia remains at the upper end of developed economies for projected growth, supported by population growth and linkages to Asia, but constrained by relatively higher household debt.

Chart 1: Expected GDP growth of major economies, average annual growth across 2017 and 2018 (forecast)



*Excludes China

Source: Deloitte Access Economics

But global growth is yet to translate to inflation. As such, while there are encouraging signs of global inflation emerging, which will eventually lead to rises in interest rates, the outlook is for official Australian interest rates to stay at record lows, until at least 2019. This is a blessing for real estate markets, especially so in NSW and Victoria.

Having said that, the Royal Commission into the Financial Services Industry is likely to raise the effective cost of borrowing for consumers and businesses as banks are likely to respond by continuing to limit how much they will lend to relatively higher risk households and riskier commercial initiatives, including some property development and foreign borrowers.

Chart 2: Australian interest rates, 90-day bank bill

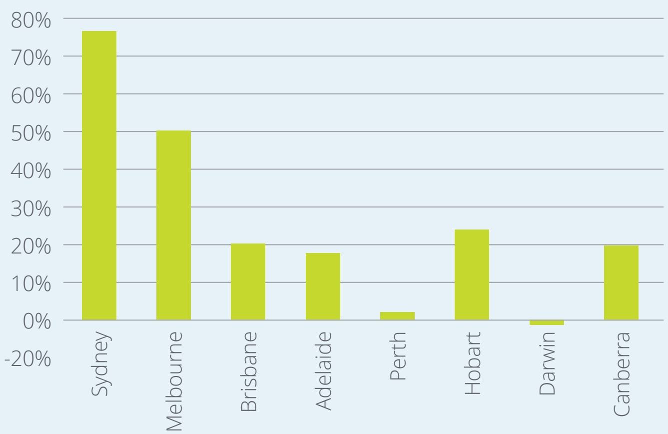
Source: Deloitte Access Economics

Outlook for the residential segment

Following a strong residential property price upswing, with prices rising around 47% across capital cities from December 2011 (around the beginning of the current upswing nationally), by late 2017 markets had begun to soften.

Chart 3 shows that, during the upswing period since 2011, price growth was uneven across the states, pulled along by the Sydney and Melbourne markets.

Chart 3: Change in nominal house values, Dec 2011-Dec 2017 (per cent)



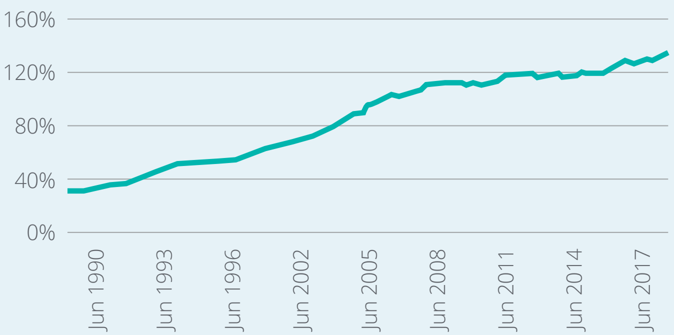
Source: ABS Cat. 6416

However, in 2018, prices in both Sydney and Melbourne have begun to decline, with Sydney now negative year-on-year (albeit fractionally), and the broader group producing positive, albeit lower, outcomes across the board. This current stabilisation and slight reduction though needs to be taken in context of the over 75% growth in Sydney house prices between 2011-2017 and over 50% in Melbourne over the same period (shown above).

In 2017, house prices fell in Perth and Darwin, linked to population movements and employment opportunities. Slower price growth in the Brisbane market also likely reflects low employment growth as well as the risks of oversupply in the apartment segment (but this may have bottomed out now).

Household debt has escalated with house prices – Australia's household debt to income ratio is now the second highest in the world, behind only Switzerland. And while growth in debt has been most pronounced for higher income households, higher debt adds to the economy's vulnerability in the face of a shock, and can also lead to lower future growth (IMF 2017).[1]

Chart 4: Housing debt to income



Source: Reserve Bank of Australia

[1] IMF, 2017, Global Financial Stability Report, October.

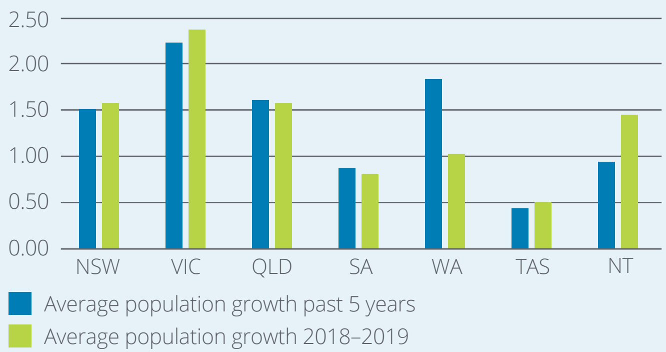
Various initiatives including those by different state authorities have introduced ways to boost first home buyer opportunities

(see article on HomesVic scheme p.19)

Regulators aiming to restrain increasing property debt amid concerns of an overheating market have targeted investor lending. Tighter lending standards and restrictions on the volume of 'interest-only' loans to total new residential mortgages, have pushed up rates for investors. Market activity has begun cooling with house price growth slowing in the latter half of 2017 and continuing into 2018.

Despite the vulnerabilities, the residential market generally continues to be buoyed by other fundamentals. Underlying demand remains solid with strong (albeit uneven) population growth expected to continue into 2020, and jobs growth has been strong, especially in Victoria.

Chart 5: Average population growth, past five years and 2018-19



Source: Deloitte Access Economics

The outlook for construction activity in the near term varies across the states:

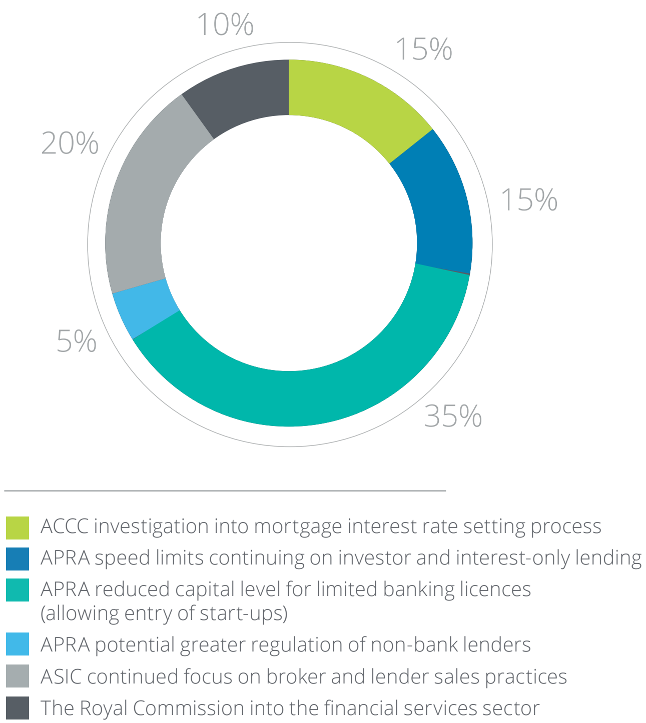
- For both NSW and Victoria, growth in housing construction has slowed from its peaks but remains at high levels and is underpinned by solid underlying demand. In Victoria, strong population growth is containing risks of oversupply.
- Housing construction fell in QLD over 2017, having reached its peak in mid-2016. Despite population growth edging higher, housing construction is likely to remain relatively flat in the near term. Similarly, for SA the housing construction outlook is also relatively flat, because while approvals have picked up in late 2017, population growth projections remain weak.
- WA's housing construction has seen a large downturn in recent years (including a large fall in 2017), but looks to be stabilising, with building approvals and loan approvals steadying.

Taken together with the outlook for interest rates, slowing house price growth (moderating the prospect of further capital gains), restrictions on lending (such as on interest-only loans and loans to investors, as well as to lending to foreign investors); we expect the current upswing to peter out and enter a period of moderation rather than an abrupt adjustment ■

Australia has chalked up its 26th consecutive year of economic growth, and the clouds around Australia's economy are clearing.

What will have the most benefit for consumers from the current regulatory and political focus on mortgages in 2018?

Respondents selected two options



James Hickey (Deloitte): There are a myriad of regulatory changes, responses and inquiries going on. Where will consumers see most benefit? While all participants recognise the importance of the Royal Commission, interestingly as a group, only 10% felt it is going to have a direct benefit for mortgage consumers in 2018. Is that due to any likely improvements from the Royal Commission emerging more in 2019 than 2018?

Adrian Buckley (Suncorp): I've noted commentators observing that previous Royal Commissions in various sectors often have tended to result in findings around culture and processes but with little ending up in actual legislation. So it will be interesting to see if this Commission has a greater impact into direct legislation.

Melanie Evans (ING): I think consumers will think there is a benefit. From their perspective with everything that's gone on, they will expect a benefit.

James Hickey (Deloitte): The Royal Commission will undoubtedly discuss important cultural and business practice issues, which will likely take time to be properly considered by the Government, regulators and business.

Looking at some of the other responses the most popular was the reduced capital level for limited banking licenses. Are we seeing the potential for the neo-banks to really leverage that and come into the market?

Adrian Buckley (Suncorp): It might be in the next 12 months. There are certainly a lot of start-ups seeking to build to scale and then get absorbed. It will be interesting to see the innovation they drive in their origination processes. Tic-Toc is an example. It's interesting how the technology pieces have been stitched together to create an experience which is different to what you would go through if you went direct to an ADI (Authorised Deposit Taking Institution).

James Hickey (Deloitte): From the perspective of the broker industry, 20% voted for ASIC's continued focus on broker and lender sales practices. How is that going to produce a benefit to the consumer in this coming year?

Joe Sirianni (Smartline): The recommendations from the ASIC report are reasonably moderate. They're not of themselves going to radically change behaviour. Stopping volume-based incentives, while an important hygiene factor for the industry, won't directly help consumers. Banning soft dollar commissions, while addressing an area of regulatory concern, again won't change the process but should give the consumer more confidence in the objectivity of the broker.

Lisa Claes (CoreLogic): I read of ongoing ASIC mystery shopping of brokers. So in spite of the fact that there has been a relatively clean report card delivered, there are certainly areas where the regulator wants the broking industry to remain vigilant. This will continue through 2018.

Joe Sirianni (Smartline): When that was announced I wrote to all our franchisees saying, "Be wary that you might get a mystery shop phone call. Make sure you follow the process." The large and reputable broker groups spend considerable effort to evolve and improve their broker to customer processes. Hopefully there will be a better outcome for consumers.

Melanie Evans (ING): It's a bit like financial planning 10 years ago. The really strong franchises that provided value to their clients, and were upfront about how their clients were being charged, are rising above the pack. The Future of Financial Advice had the largest impact on those that weren't transparent around their pricing or the value that they were adding.

James Hickey (Deloitte)
Alice Del Vecchio (Head of Mortgages and Third Party Distribution, Australia, HSBC)
Nathan McMullen (Westpac Group)

Melanie Evans (ING Head of Retail Bank)

Climate change disclosures: Are you prepared?

Sharanjit Paddam, Financial Services Actuary and climate change expert outlines the 2017 Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) recommendations[1] for disclosure of climate-related risks and opportunities.

While these disclosures are voluntary, many major institutional investors and financial regulators around the world have called on banks to disclose under the standards. Westpac and ANZ have already made initial disclosures, Suncorp has launched its Climate Change Action Plan, and we expect that trend to continue across the market, both here in Australia and globally.

The TCFD disclosure recommendations were deliberately principles based, with companies being left to develop their own detailed approach to disclosure. Various working bodies have brought together companies within the sector to further develop detailed approaches, including most recently 16 major banks providing guidance through the UNEP Finance Initiative.[2] The European Bank for Reconstruction and Development has also provided guidance[3].

The risks

Australian banks have some of the highest concentrations of residential lending assets in the developed world. Home loan contracts of up to 30 years means banks are already potentially exposed to climate risk. House prices could suddenly fall once climate risks are priced in, and homeowners (and their banks which hold first mortgage over the properties) may be unable to sell their home without crystallising potentially significant losses.

Banks are exposed to acute physical risk – increased severity of extreme weather events such as cyclones and floods – through lending secured by property, where increased maintenance costs or insurance premiums can reduce customers' ability to service loans, and severe damage to properties can lead to negative equity and a corresponding increase in credit risk. While banks have relied on customers purchasing insurance protection, that protection may become unaffordable or even not available.

Chronic physical risk – longer-term shifts in climate patterns such as higher temperatures causing sea level rise or chronic heat waves, droughts, or other changes – will increase the frequency of acute losses, and exacerbate perils such as coastal inundation and bushfires.

Temperature rises may lead to the loss of tourist attractions such as the Great Barrier Reef and associated economic sectors, increasing credit risk and reducing lending volumes from affected businesses and local residents.

The changing climate will affect yields and viability of agricultural sectors in different geographies, again increasing credit risk.

Transition to low-carbon energy through government policies to mitigate greenhouse gas emissions, accelerated by technological improvements or innovations such as battery storage, will increase credit risk on lending to customers in affected industries such as coal mining, power generation and distribution, and also reduce lending volumes.

Transition may also bring about legal action due to the failure of companies and governments to mitigate against climate change and to adequately disclose material financial risk, putting at risk both the institution and its commercial customers.

Transition may also lead to market risk – shifts in supply and demand for certain commodities, products and services – and banks may see increases in credit risk and reductions in lending volumes in affected sectors.

Lastly, transition may also see increases in reputation risk – changing customer or community perceptions of an organisation's contribution to a lower-carbon economy. Banks have already faced negative media attention for doing business with (or not doing business with) carbon-intensive projects. Banks that foreclose on customers who have just suffered physical losses also risk further reputational risk. Responsible lending standards may also put the onus on banks to ensure they are not lending to customers who will face their properties being flooded on a regular basis.

Opportunities

Climate change will also give rise to opportunities including:

- New energy sources through transitioning to clean energy sources
- New products and services that improve resilience to climate risk
- New markets that enable diversification and sustainable business growth.

For banks these opportunities include increased lending to renewable energy companies, new products to fund adaptation by customers, governments and communities, and new markets through bundling and securitising adaptation finance products into green bonds. The High-Level Expert Group of the European Commission recently set out strategic recommendations for a financial system that supports sustainable investments[4].

In addition, those banks that are first movers and best understand the potential impacts on credit risk will have a competitive advantage that can be used both to reduce risk and to offer preferential terms to potential customers poised to benefit from climate change.

Scenario analysis

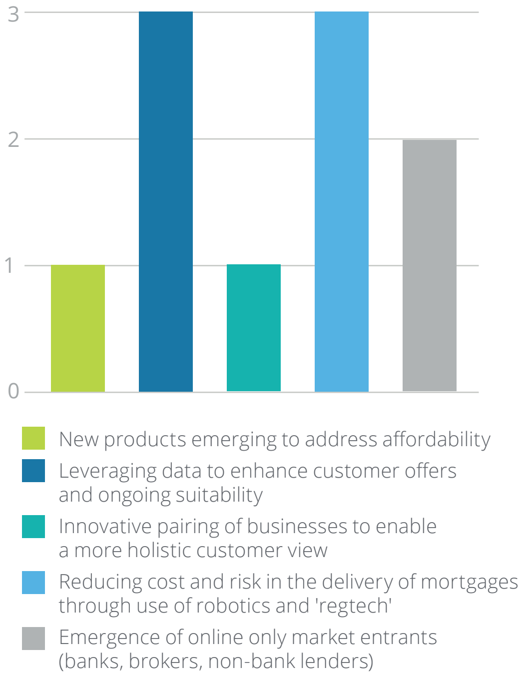
There remains a great deal of uncertainty in the policy responses to mitigate climate change, and how these risks will manifest. The TCFD disclosures recommend that banks adopt a scenario analyses to consider the financial impact to the bank under different temperature scenarios. For example, if significant action were taken to mitigate emissions in order to limit temperature rises to 1.5°C, how would that impact different economic sectors and affect credit risk, particularly in sectors such as energy and transport? Conversely if little action were taken, and temperatures rose by 4°C, how would that affect physical risk losses to property assets and mortgage lending by the bank?

Increasingly banks will need to develop strategic responses to these questions, integrate them within their governance and risk management frameworks, and develop metrics and targets to provide assurance to investors and regulators that they are managing the risks and seizing the opportunities presented by climate change ■

Pillars			
Governance The organisation's governance around climate-related risks and opportunities.	**Strategy** Actual and potential impacts of climate-related risks and opportunities.	**Risk management** The processes to identify, assess and manage climate-related risks.	**Metrics & targets** The metrics and targets used to assess and manage climate-related risks and opportunities.
Recommended disclosures			
Describe the board's oversight of climate-related risks and opportunities. Describe management's role in assessing and managing climate-related risks and opportunities.	Describe climate-related risks and opportunities identified over the short, medium, and long term. Describe the impact of climate-related risks and opportunities on businesses, strategy, and financial planning. Describe the resilience of the strategy, taking into consideration different climate-related scenarios, including a 2˚C or lower scenario.	Describe the processes for identifying and assessing climate-related risks. Describe the processes for managing climate-related risks. Describe how processes for identifying, assessing and managing climate-related risks are integrated into the overall risk management process.	Disclose the metrics used to assess climate-related risks and opportunities in line with the strategy and risk management process. Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas emissions and related risks. Describe the targets used to manage climate related-risks and opportunities and performance against targets.

[1] https://www.fsb-tcfd.org/
[2] http://www.unepfi.org/news/industries/banking/tcfd-recommendations/
[3] https://www.physicalclimaterisk.com/
[4] https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

Where will innovation drive change in the mortgage market in 2018?



James Hickey (Deloitte): The main responses were innovation in lender back offices using robotics and 'regtech', together with leveraging data to enhance customer offers (which is linked to our next question on open data).

Initially though, I would be interested to discuss why the choice of innovation around new products to address affordability only had one response. Are lenders not seeing product or servicing affordability innovation as a potential in the short to medium term?

Tony Taylor (Police Bank): We're looking at a couple of products at Police Bank. But when you go to APRA and say: "I'd like to give a loan to a first home buyer Senior Constable X at 98% LVR", I don't get such positive feedback from APRA.

Adrian Buckley (Suncorp): There are groups doing some interesting things in the affordability space. The concept of part-ownership, for example, where you build affordable housing in a reasonable area around Brisbane. You give access to people who don't have to go over the 80% LVR, because a contribution has been made by a trust. Then a bank funds the rest of the loan. Over time they pay down to bring their LVR down. There are examples of that, but not enough.

Tony Taylor (Police Bank): There are some great examples. Nightingale in Melbourne. Amazingly, San Francisco, London and New York, the iconic cities that we think are expensive, are doing that it in far greater volumes than us. Perth is also doing a lot.

James Hickey (Deloitte): Are banks the right provider for such innovation, or should alternative finance sources be found where there may be a better match to the return/risk profile? For instance, would accessing property capital growth instead of interest yield (as per current mortgages) be of greater interest to investors such as superannuation funds as an alternative asset class product?

Tony Taylor (Police Bank): It's really hard for them to accept less than 5% return on equity on their investment.

James Hickey (Deloitte): Yes, it has to be a fair investment. But there's no reason why social and ethically responsible investment can't also generate a reasonable commercial return if structured properly. Australian residential property as an asset class is significantly underweight by superannuation funds, and while the pathway to entry is challenging, the return/risk profile can be quite beneficial to a balance fund. That seems like a product innovation for the future.

Shared Equity Purchasing

James Hickey, lead author of the Deloitte Australian Mortgage Report, takes a brief look at recent product innovation to assist first home buyers. While the concept of shared equity is not new, it is an opportune time to reflect on whether more innovation like this should be offered to home buyers.

The traditional pathway to purchasing a first home generally involves saving for a deposit (ideally at least 20%) with the remainder funded by a mortgage from a bank or non-bank lender. The challenge with this approach is both the difficulty in saving for the deposit when house prices continue to grow at a faster rate than most investments available for savings, as well as being able to meet the regular servicing required once the mortgage is taken.

This approach to purchasing a property also results in the purchaser being entirely exposed to the capital growth movements on the property once purchased (in the case of an owner occupier), while the lender has its returns linked to the interest rate on the mortgage.

One is a quasi-equity return (property growth) and the other a fixed interest return (interest on debt). Each party, borrower and lender, is therefore faced with different return drivers and hence there is not a direct sharing of mutual interests in the return from the purchase decision.

Ironically, banks via residential mortgage lending do not seek to take property growth return risk on their balance sheets. They are exposed to it in downside scenarios should the loan become delinquent, but even then to a generally negligible level given the borrower's equity via the deposit and any lenders mortgage insurance tend to materially cover the lender's position.

But does this need to be the only available pathway?

An alternative has been around for a while, however not widely available nor used. It is the concept of shared equity. This involves the lender actually taking on property capital growth risk, alongside the borrower, rather than having all its return based on interest rate on the debt. The lender becomes like a co-investor, or shared equity investor, in the property with the borrower.

There can be many permutations of this concept:

- **First home buyer (deposit support)** – the borrower may only have a 10% deposit, and a shared equity lender could invest say 10% equity in the property and the residual 80% is taken from a traditional mortgage (avoiding lenders mortgage insurance)
- **First home buyer (servicing support)** – the borrower may have 20% deposit and while they can service an 80% mortgage they may choose to reduce their regular servicing in exchange for some of the equity in the property. This could see a shared equity lender investing 20% in the property and the borrower then only needing a 60% mortgage (ie lower servicing).

The above also can work with upgraders and other property purchasers.

The return dynamics need to be carefully understood by borrower and lender. Often in return for say a 20% equity investment in the property, the lender may require a return of 30-40% of the property growth. This is largely to compensate for lack of rental yield in their return (when co-investing with owner occupiers), time discount of money and property risk volatility.

However, it can provide a potentially different pathway to ownership, and alignment of interest (pardon the pun) between borrower and lender ■

Case study: HomesVic

In February 2018 the Victorian Government launched its HomesVic program. This was a shared equity scheme to assist up to 400 first home buyers by reducing the amount of money they would need to save to purchase their first home.

See website: https://www.vic.gov.au/affordablehousing/buying-a-house-in-victoria/homesvic.html

It was met with overwhelming interest and in certain geographic locations, the allocations have been fully subscribed. The key aspects of the scheme were:

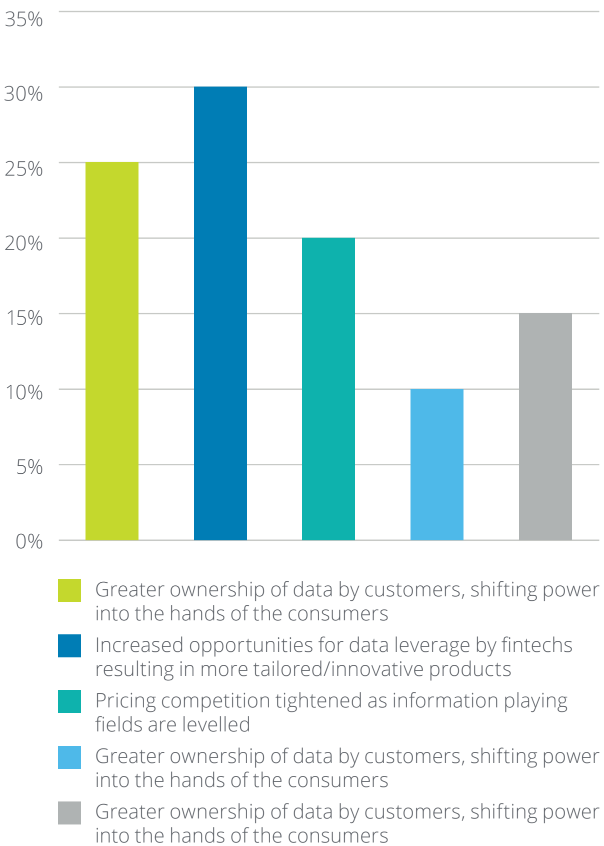
- Available to first home buyers in Victoria who would be owner occupiers
- Applicants must have saved at least 5% deposit (plus be able to cover other purchase costs)
- Maximum gross assessable income of $75,000 (single) or $95,000 (couple)
- HomesVic will take up to 25% shared equity (proportional beneficial interest) in the property
- Remaining mortgage will come via a panel of lenders – P&I for maximum of 30 years
- The mortgage servicing must not be more than 37% of taxable income of the applicant
- HomeVic return is their proportional beneficial interest in the property sale price (once sold or earlier refinanced)
- Once the borrower's future income exceeds the maximum eligibility threshold the shared equity is refinanced into the traditional mortgage.

If for instance a borrower had a 5% deposit and took the maximum 25% shared equity investment by HomesVic, then they would take a 70% P&I mortgage with one of the panel lenders. At commencement, the panel included Bank Australia and Bendigo Bank.

This is an example of the type of innovation which lenders can support, and when offered in conjunction with a state body, can result in effective financing options for first home buyers without the negative impacts of other potential first home buyer "incentive" packages (such as cash handouts which otherwise tend to increase demand and artificially inflate prices).

What will the biggest impacts be from 'Open Data' for mortgage customers?

Respondents selected two options



James Hickey (Deloitte): We asked you to select two responses and although varied, everyone saw open data benefiting all five categories.

Nathan McMullen (Westpac Group): I think everybody will increase their opportunity to leverage data to build more tailored and innovative products not just fintechs. We are all doing it at the moment.

Graham Mott (Deloitte): Isn't the ability to move quickly however more an opportunity for fintechs than incumbents?

Nathan McMullen (Westpac Group): Yes, that's true. It also depends on how you use the information. If you have a big existing portfolio with access to more information on what's going on with your customers, then you will use that as well.

Andrew Toone (BOQ): In the UK open data was brought in to encourage people to try and change banks. But even with it in, only less than 5% were going to move. So it's a really interesting hurdle to overcome.

Nathan McMullen (Westpac Group): If you take a US example, you have Quicken which basically drew up its whole business model on smart use of data. So I guess we're seeing different outcomes in different markets.

Andrew Toone (BOQ): Quicken took customer service and turned it on its head in the mortgage market. Yes, they used data to back it up, but its customer service is second to none.

Alice Del Vecchio (HSBC): In the UK I think customers took the opportunity to negotiate harder with their existing banks because they had that access to data. They just didn't switch. The sentiment was 'It's better the devil you know, but at a better price!'

James Hickey (Deloitte): It could be that for Australian borrows to fully utilise it, other changes such as account portability may need to be ultimately implemented.

Heather Baister (Deloitte): Logically you have to think generationally. Boomers and Gen X have been brought up to protect their data. To keep everything tight and only share your data with those you have to. However, the next generation coming through, the Ys and the Millennials, see their data far more as their asset to bargain with. So I think you will see generational shifts in how those generations would answer that question versus Xs and Boomers.

Peter Riedel (Liberty): I completely agree. At Liberty our focus has been on providing an outstanding customer experience. Access to third party data instantaneously and the availability of new data sources allows us to create a customer experience that no-one has had before. We prioritise three things: ease, speed and certainty. These are the key planks for providing an outstanding customer experience. Access to third party data quickly and the seamlessly embedding into credit assessment technology, are certainly important in achieving these aims.

James Hickey (Deloitte): With all the regulatory and political focus on lending and the investigations being conducted, it may be that the internal capacity to take on the opportunity of open data, will be a challenge for many incumbents. Maybe smaller, nimbler groups that aren't hampered by legacy, can focus on open data and its promise of differentiated service to the customer more effectively over the next coming two years.

In the UK open data was brought into encourage people to try and change banks. But even with it in, only less than 5% were going to move. So it's a really interesting hurdle to overcome.

Andrew Toone, BOQ

Andrew Toone (General Manager Products, Bank of Queensland)

Open banking: Are you prepared?

Deloitte Financial Services Advisory Partner Paul Wiebusch shares the firm's expertise on open banking with its focus on changing business models and technology platforms.

The introduction of open banking from July 2019 and of Comprehensive Credit Reporting (CCR) has the potential to significantly disrupt retail banking business models.

Intended to reduce barriers to entry and increase competition in banking, open banking will give back control to customers over their financial data and allow them to share it with third parties. CCR, or positive credit reporting, is an early component of data sharing. It requires organisations to report on customers' positive credit behaviours, instead of only defaults and missed payments.

Open banking is more than just compliance with data sharing regulations. To be prepared for open banking, organisations will also want to re-assess all aspects of their business model: the customers they choose to serve, the role of API-enabled marketplace banking as a channel, the products they provide (including potentially non-financial products), the processes particularly in relation to compliance with financial crime and conduct regulation, their data architecture, their technology platform, as well as the skills and cultures of their people and organisation.

Regulation and competition

Sharing customer data reduces barriers to entry. As customers choose to share their transaction data, existing entities such as mutual and regional banks as well as specialist non-bank lenders will (theoretically) be better able to compete by using this information to enhance their product offering, pricing and service.

Increased competition could also come from new entrants to the market including fintechs, with specialised offers such as loan auction platforms (e.g. Joust) and small business financing (e.g. Bigstone Capital, Brighte and Waddle), and 'tech-fins' (e.g. Amazon, which has already teamed up with Bank of America in the US[1]).

In fact, increased competition from fintechs was seen as the biggest impact from open banking for customers by respondents at the Deloitte 2018 Australian Mortgage Report roundtable. As global banks emerge from regulatory driven remediation and refocus on growth we could even see the emergence of foreign banks seeking to take advantage of open banking with digital only retail bank offerings.

The effectiveness of the promise that open data brings for greater competition however rests with the willingness and ability of organisations to invest in the capabilities required to harness the information. Such investments include access to funding or capital, capabilities in data mining, analytics and technological platforms, and ultimately an ability to strategically understand how to take this to market. It may well require material business model shifts for current incumbents. Simply having access to such open data will not of itself be enough for organisations.

Pricing and model change

Changes in ownership of data from organisations to customers results in a shift in power between the two parties. With the ability to shop around, customers are potentially able to negotiate better pricing for their loans. Although levels of switching have not significantly increased following the introduction of open banking in the UK (at least yet), it has improved customers' ability to negotiate with their credit provider.

As well as responding to customer negotiation, the additional information available as a result of open banking and CCR will require organisations to be more strategic about their pricing decisions and give greater consideration to customer profitability including risk, customer price elasticity and customer life-time value.

Of course, any changes to pricing strategy will need to meet responsible lending requirements. Risk-based pricing cannot come at the cost of fair outcomes, which is particularly important for vulnerable customers. It is also likely to result in a heightened focus on the transparency with which information about pricing is shared with customers, as well as the suitability of products for a customer given their circumstances.

Privacy and GDPR

Open banking and CCR are being introduced at the same time as there is a renewed focus on privacy, driven by the General Data Protection Requirements (GDPR) in the European Union, which sets the standard for privacy globally, and recent high profile privacy breaches. Some of the roundtable participants expect an increase in customers' concerns over their data privacy to be a key result of the introduction of open banking.

There also exists the challenge of engaging customers to want to access and use their information in their financial decision making. Should it be too confusing and perplexing for consumers, then it is likely that not everyone who may benefit from such open data will actually 'switch on' to using it to their advantage. So while instantaneous access to third party data should enable organisations to deliver ease, speed and certainty to enhance the customer experience and give better pricing options, customer inertia, and perhaps apathy, could mean little change in customer switching propensity. Which would be a pity for all.

It is the opportunity and duty of the industry and regulators to ensure customers can be educated in the benefits and the process to access and use their open data ■

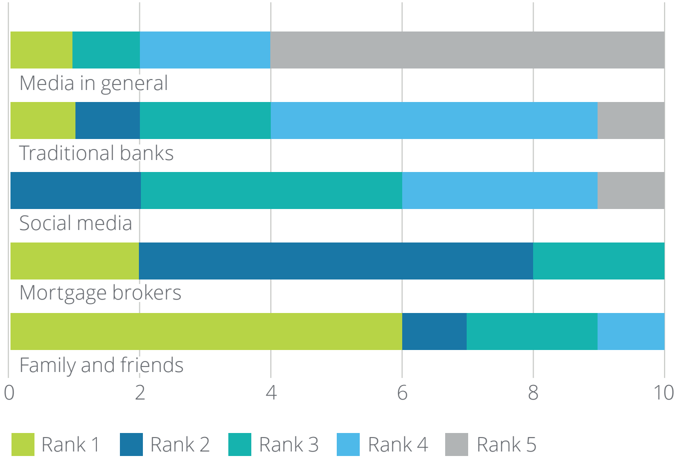
When faced with uncertainty the best response is preparedness. Are you prepared for open banking?

See https://www2.deloitte.com/au/en/pages/financial-services/articles/open-banking.html

[1] See also https://www.cnbc.com/2018/02/14/amazon-and-bank-of-america-partner-for-lending-program-but-growth-has-stalled.html

Rank the following information sources for their influence on consumers when considering mortgage products?

Rank 1 to 5, with 1 being most influential, 5 being least influential



James Hickey (Deloitte): We ranked the answers from 1-5. The most popular response was family and friends, followed by mortgage brokers. People may look at general media to get an understanding of how mortgages and products might work, but for decisions they seek specific support.

Heather Baister (Deloitte): Last year we asked for a single answer, rather than a ranking. The Millennials and Gen Y people did go to social media to sound things out. But they didn't share their personal financial information. They used social media for recommendations for good experiences around banks or brokers. It became almost an intermediary to the bank.

Joe Sirianni (Smartline): That is changing now as REA has an app where people actually load their financial information. In three months it had 60,000 consumer blogs in its financial information app. Now older generations wouldn't do that. But the dreamers and aspirers trying to get into the property market would go to REA.com website and be more than happy and comfortable to put their information in an app.

Adrian Buckley (Suncorp): You also have loan auctioning platforms, like Joust and Loan Dolphin, where people are providing minimal information that you can then bid on.

James Hickey (Deloitte): This is where there is a convergence of open data and more confident customers knowing more about themselves and being more prepared to put their information on social media.

Joe Sirianni (Smartline): Most social media, websites and apps, give a lot of content and information, but people do look for interpretation of that content into context. They want to know if it is a good deal. They want validation and confirmation. They're gathering information, but given that it's a significant purchase, when it comes to the final decision they want reaffirmation or confirmation.

Heather Baister (Deloitte): It's also about efficiency. I was talking to a fellow partner recently, so a relatively financially savvy individual, who bought a house and used a mortgage broker. They said the experience was 'wonderful'. The important issue for them, and most Gen Xers, is time. The mortgage broker took the hassle factor out, which was absolute gold.

James Hickey (Deloitte): The mention of REA and people giving them their information is interesting as REA is not seen as a traditional financial services group. Could people be more willing to share their information to non-traditional financial services providers? How hard is it for an existing brand, a bank, to earn the trust of the consumer in the social media space? Will they think that the only reason the bank is asking for their information is for their own good rather than the good of me, the customer'?

Alice Del Vecchio (HSBC): It's not dissimilar to parochial ownership, is it? If you come into one channel looking for a specific brand and what it stands for, and then you find out there is something else behind it, you get a bit anxious. I think the important point is to try to understand the bigger picture.

Melanie Evans (ING): I guess the flipside is that customers with whom we have very deep and broad relationships will say the exact opposite. "Why do I have to give you the information? You should have it." If they need to fill out another form, or give the data point again, they tear their hair out.

So I think there is not just an implied level of trust in some instances, there's an expectation that with the data we have, we use to the customer's advantage and make life easier and take the hassle out for them. For most major lenders, the first home loan discussion is still, 'Fill out these 105 questions'.

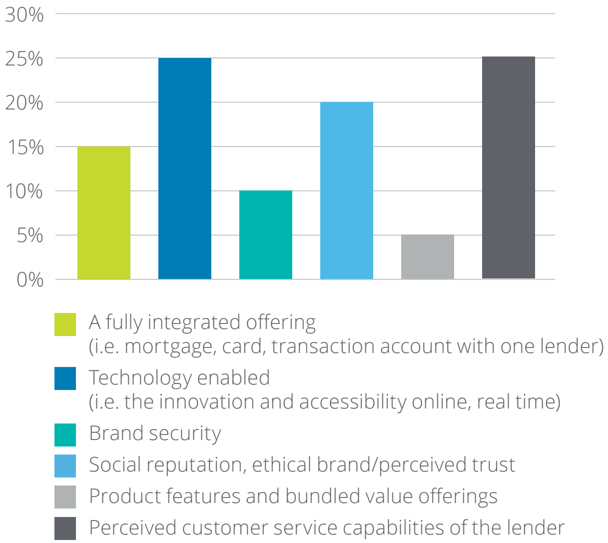
It should be: "Where are you thinking about buying? What's going on in your life?" That's a better conversation than a data entry process. But the reality is we tend to do the latter. There is an expectation for us to pull up our socks and make life easier.

"Where are you thinking about buying? What's going on in your life?" That's a better conversation than a data entry process.

Melanie Evans, ING

What features, other than price, will be most important to consumers in selecting a mortgage provider over the coming 12 months?

Respondents selected two options



James Hickey (Deloitte): Both technology-enablement and perceived ongoing customer service capabilities of the lender were the two most important non-price features selected.

Nathan McMullen (Westpac Group): Interestingly I think technology is the enabler of perceived customer service capability. The starting point is: 'How do I best deliver a service proposition for customers?' Sometimes it's face-to-face, and sometimes it's through a digital or a technology-led solution.

Andrew Toone (BOQ): I definitely agree. I think it is that concept of the 'omni-channel'. A potential customer might start the process online, but then realise that they would quite like to have a conversation with someone. And once they do that they want to know that it isn't 'memoryless'. They don't want to start again from scratch. So don't treat technology as a means to not talk to the customer, instead use it to flow seamlessly into the process the way they want.

Heather Baister (Deloitte): In fact, the regulations almost require you to 'have the conversation'. It seems to me to be too hard to do a fully automated mortgage in today's world where you have to understand the individual customer. Not just their financial numbers, but their mindset, their strategy, and their long-term view. You can't pull all that information from their numbers alone.

Lisa Claes (CoreLogic): In my experience, I've seen service and experience more as a reason to stay with a provider (retention), rather than as a reason to join (acquisition). It is really a leap of faith for a customer when she has not experienced you, but as a retention tool, it is hugely powerful.

Arthur Calipo (Deloitte): It could also link to where the source of referral is primarily family and friends. It's their experience that actually drives the appetite to join.

James Hickey (Deloitte): Another interesting ranking was social reputation – this accounted for 20% of votes, and that's noticeably higher than last year's response. Is it becoming more obvious?

Joe Sirianni (Smartline): From a broker's perspective, when you're talking to the client, despite the 35 lenders on our panel, around 80% of our business still goes to the four majors. And this is despite there being some really good alternative products, great offerings, great technology and great features.

When you sit with a client they choose to go with a particular bank, either because they know them or believe they are good. Is it brand security? Is it reputation or their service proposition? Or is it because they don't currently bank with them or simply don't like them?

From a customer's perspective when talking with a broker, they don't talk about technology. They don't care about the technology. They're more worried about who has the brand reputation and the social impact of that brand. We, the broker, work out the product features and the pricing for them.

Arthur Calipo (Financial Services National Leader, Deloitte)

Lisa Claes (CEO International Operations – UK, Australia, NZ, CoreLogic)

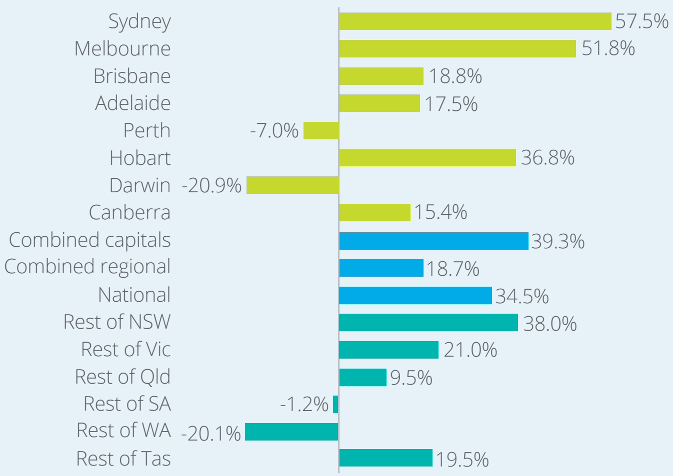
Housing market trends

Tim Lawless, Executive Research Director Asia Pacific, CoreLogic outlines the current housing market trends in Australia.

Valued at $7.5 trillion and approximately three times larger than Australia's superannuation funds combined, and four times the value of the ASX listed stocks, housing, as an asset class, plays a vital role in Australia's economy.

Australians hold 52% of their wealth in housing and almost 74% of household debt is dedicated to housing assets. Australian banks dedicate approximately 60% of their balance sheet to residential mortgages and transactional activity in the housing market provides a strong multiplier effect for the economy. Additionally, property related taxes are one of the largest sources of taxation revenue for state and local governments, while tax discounts related to property are one of the most heavily debated political issues at the Federal Government level.

Change in dwelling values, five years to April 2018

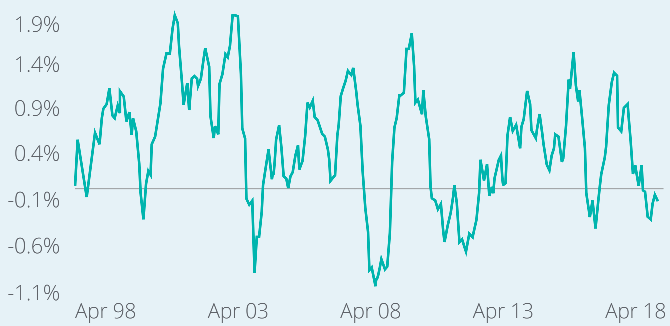


With all this in mind, the Australian housing market is the subject of a great deal of focus and scrutiny. This is not just from households and lenders, but also from a wide variety of industries impacted by the performance of housing, as well as government at all levels, regulators and policy makers.

Recently, housing market conditions have tracked at dramatically different speeds across the country. Dwelling values surged 58% and 52% higher in Sydney and Melbourne respectively over the past five years, while dwelling values in Darwin plummeted by 21% and Perth values are down 7%. Dwelling values broadly kept pace with inflation in Brisbane and Adelaide and recently accelerated across Hobart.

Strong economic and demographic trends have driven the success of housing markets in Sydney and Melbourne. And it's no coincidence that over the past five years, three quarters of Australia's jobs growth centred in New South Wales and Victoria, attracting approximately two thirds of the nation's population growth.

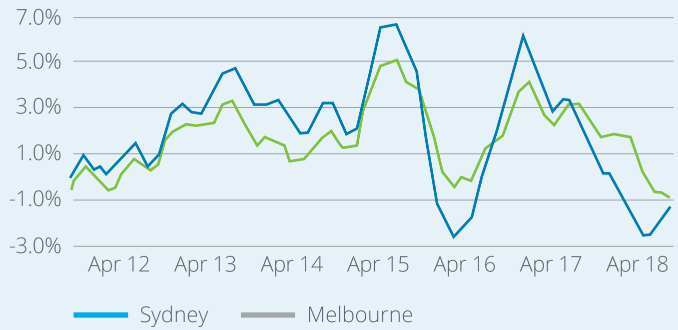
Month on month change in dwelling values, national



But those housing market trends have changed.

Since July 2017 Sydney dwelling values have been trending down and Melbourne values moved through a peak in November 2017. While there isn't a single catalyst causing the reversal in housing market conditions across Australia's two largest cities, a key factor has been changes in credit policy as well as affordability constraints, higher supply levels and lower housing market sentiment.

Rolling quarterly change in Sydney and Melbourne dwelling values



The first round of macroprudential policies, announced by APRA in December 2014, flowed through to bank credit policies, slowing investment activity which ultimately dragged Sydney dwelling values 3.6% lower between October 2015 and April 2016.

Growth in Melbourne dwelling values stalled over the same period. However capital gains bounced back across both cities once lenders achieved the new APRA benchmark relating to investment credit growth, and interest rates were cut by 50 basis points.

The second round of macroprudential changes, announced in March 2017, also had a dampening effect on the housing market. In fact, the trajectory of the downturn is almost identical to the previous decline in values following the first round of macroprudential changes. The big difference is this current phase of decline isn't likely to be reversed by a cut to mortgage rates, or a significant rebound in investment participation.

> The more likely scenario is that dwelling values will continue to drift lower, providing an opportunity for stretched housing affordability to repair, yields to recover, and debt levels to reduce relative to incomes.

The housing market will be tested as mortgage rates eventually move higher. With household debt at record highs, borrowers, particularly those that are more highly leveraged, are likely to be sensitive to changes in the cost of debt.

Even if mortgage rates rise, the trajectory is likely to be gradual and modest, keeping the cost of debt below the long-term average which will help to support housing market and mortgage activity.

While most borrowers have built up some level of buffer in their mortgage repayments, via higher than required repayment amounts or through offset accounts, the RBA has noted that approximately one third of borrowers haven't accrued a repayment buffer. This cohort is likely to be characterised as either recent purchasers, or highly leveraged households. It is this group who could be most at risk of defaulting on a mortgage should their financial circumstances change.

Interest- only home loans as a % of all lending

Another group at risk will be those borrowers who originated their loan on interest-only terms and will transition to principal and interest repayments in the future.

Lending on interest-only repayment terms peaked in June 2015 at 46% of all mortgage originations.

The proportion of borrowers who are repaying their principal has risen since that time, particularly after the latest round of APRA macroprudential changes which were aimed at reducing interest-only lending. However, with many interest-only mortgages on three to five year contracts, progressively larger numbers of borrowers will be facing a sharp rise in their repayment costs which may also be at higher interest rates.

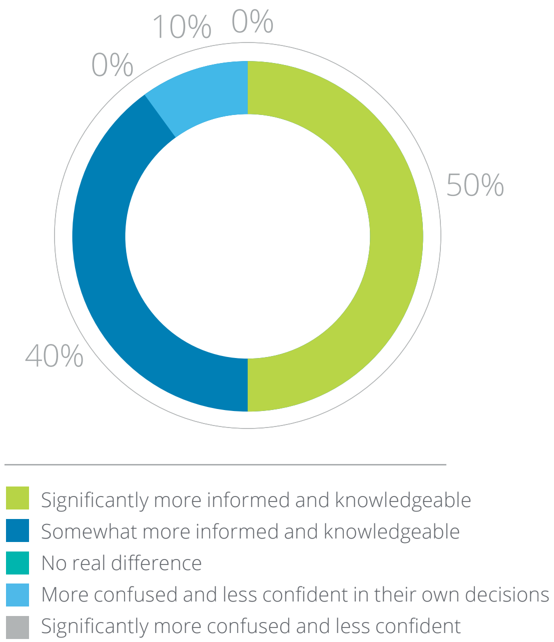
A Floor under housing prices

Despite these risks, from a macro perspective there are several factors that will help to keep a floor under housing prices such as reasonably healthy labour markets and strong jobs growth which is also becoming more geographically diverse.

Added to this, overseas migration rates remain high, particularly in New South Wales and Victoria, while interstate migration is now ramping up in Queensland, Tasmania and the ACT. Strong population growth is a key factor driving housing demand, which will help to support housing prices ■

Tim Lawless
(Executive Research Director Asia Pacific, CoreLogic)

Compared with five years ago, how much better informed and confident are consumers about mortgage product choices and pricing today?



James Hickey (Deloitte): It was interesting that most of you voted for significantly or somewhat more informed (90%). No one selected significantly more confused! However, to Joe's point, part of the reason brokers might be seeing more foot traffic is the proliferation of product options and the fluidity of changes to pricing features and assessment criteria of lenders. How do we reconcile consumers being more informed and confident with an ever complex mortgage product landscape?

Nathan McMullen (Westpac Group): I think it's a universal thing that stretches across all categories. I don't see it as being limited purely to mortgages. I believe consumers are somewhat more informed about product choices and pricing. But they still don't know very well how the home buying and home financing process works. How do you manage the end to-end process?

How do you make it as convenient as possible? I think that is an enduring challenge for consumers. I think price and product will only get you so far. You still need to be strong in providing a very good service experience.

Heather Baister (Deloitte): Coming back to an earlier comment, most brokers bank on their experience and the products they know, primarily from five or six lenders. So the question is how do you actually open up the offerings of the smaller lenders in the industry that might be more suitable in many ways? Or even a different proposition?

How do you open the minds of people to see what products are out there as opposed to defaulting to: "I know this bank, I will go with this?" The big challenge for specialist lenders is to get a broker to distribute a specialist product when they're used to distributing a prime product.

Peter Riedel (Liberty Financial): These results really surprise me. I believe people are less confident and more confused, not less. How do you explain broker mortgages going from 40% to 55% in a period of two years and still say that everybody is more aware of what's going on in the mortgage space?

James Hickey (Deloitte): It could well be to Nathan's point, that people are somewhat more informed about pricing and choice. However, if we had put process in the question we may well have had a different response.

Andrew Toone (BOQ): If I could talk to the answers I'd say that they're somewhat more informed, knowledgeable and confused because I just think there is so much change going on.

Lisa Claes (CoreLogic): There is so much content available now through the internet, and so many apps and websites, that consumers can get the information, but they don't know how to interpret it for insight.

James Hickey (Deloitte): That must be a challenge for first party distribution, as there are now many more informed consumers coming in who have done considerable research themselves.

Melanie Evans (ING): Yes. There has been a lot of progress with human-centred design or customer-centred design, where people are understanding better what it feels like to be a customer buying a home, not applying for a mortgage.

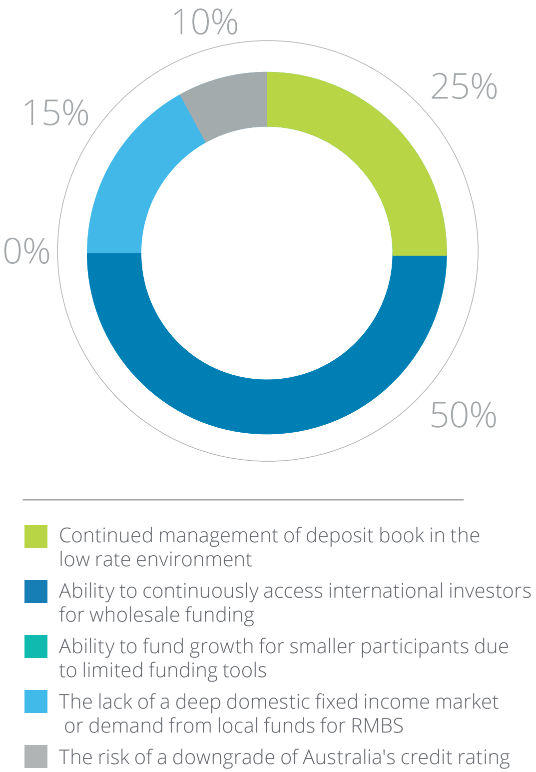
I always give the example, as the removalist's truck disappears down the street, most people don't think: "Oh, I hope my home finance manager gives me a call and sends me a bottle of champagne!" They are more likely to be thinking through the very pragmatic things such as: "Who has a set of keys to the house? Are we moving in tonight? What have we forgotten?"

So, to understand it from a human perspective most of the time it has nothing to do with the lender. Certainly not at that poignant moment when 'I have the keys and I am turning the lock'. I think we're all getting better at understanding that.

Tony Taylor (CEO Police Bank) Heather Baister (Deloitte)

Peter Riedel (CFO Liberty Financial)

What are likely to be the biggest funding challenges for market participants in 2018?



James Hickey (Deloitte): The majority of answers were for continuous access to international investors for wholesale funding, followed by managing the deposit book in this low rate environment. I also note that someone chose the risk of a downgrade to Australia's credit rating which was interesting.

Melanie Evans (ING): Yes, I think the macro themes can often go unnoticed or be unmanageable. The reality is they are out of our control to some extent, and it's those macro-economic factors and the risk of a downgrade that can significantly impact everyone.

Lisa Claes (CoreLogic): I agree because of the material contribution to household debt. If I were an international investor that would probably concern me as well.

James Hickey (Deloitte): Some people also thought the lack of a deeper domestic fixed income market would be a significant funding challenge. This always seems counter-intuitive given the size of our superannuation market with over $2.6 trillion of investment assets being managed for the long term on behalf of Australian households.

Peter Riedel (Liberty Financial): There is a strong commitment by Australian asset managers to support domestic issuers of fixed income securities. And we are very grateful for this support. Unfortunately, there is a ceiling to this support given the strong preference of Australian asset managers and investors to allocate into equities.

I understand only around 10-15% of the $2.6 trillion Australian superannuation market is allocated to the fixed income asset class whereas in other global markets, allocation to fixed income assets is closer to 40-50%. It seems to me that the only way to change this asset allocation imbalance is through legislation and/or regulation. Clearly a greater allocation to fixed income assets could benefit the funding program of all lenders in Australia.

James Hickey (Deloitte): Part of the structural feature of overseas markets, where there is a bigger proportion of assets allocated to fixed income, is a lot of defined benefit funds which require liability management, and an ageing population with annuity portfolios. In Australia we don't have such a mature defined benefits or annuity market which would otherwise drive a potentially higher proportion of fixed income funding.

Adrian Buckley (Suncorp): Some of that mix is driven by better product innovation in overseas markets with long-term fixed mortgages out to 30 years in the US, where you can switch with no costs. There also is a greater variety of mortgage products available in overseas jurisdictions than in Australia, where the choices are either fixed, variable or interest-only.

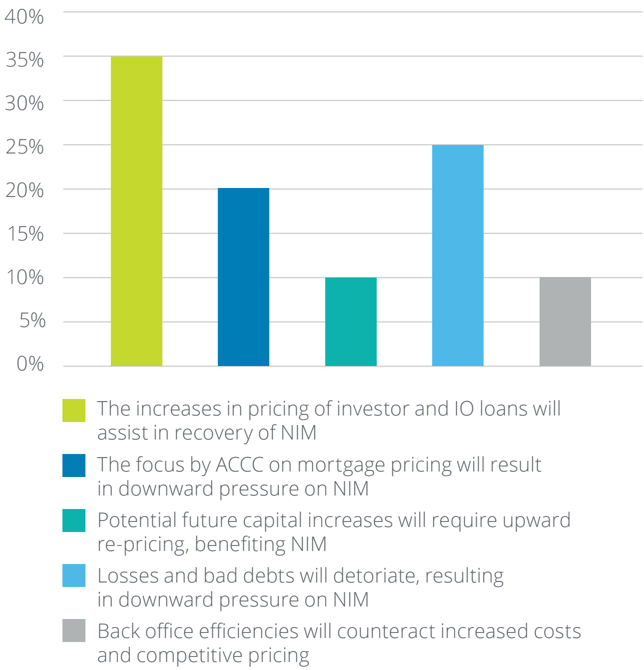
Heather Baister (Deloitte): There is also the opportunity for international markets looking at local residential mortgage-backed securities (RMBS).

2017 was a record year for RMBS, the highest since 2014, and almost a third up from 2016. A lot of that funding went overseas because there is margin in RMBS that you don't have in the mortgage products in the UK or the US presently. There is an opportunity for those that do use securitisation as a tool, but RMBS is only a relatively small proportion of the market, about 5% overall.

Tony Taylor (CEO Police Bank)
Heather Baister (Financial Servies Patner, Deloitte)

What will be the likely direction of mortgage book profitability in 2018?

Respondents selected two options



James Hickey (Deloitte): We asked you to select two options as to where profitability of mortgage books is headed in 2018. It is interesting that 35% of responses were that the increase in recent pricing of investor and interest-only loans would assist in recovery of Net Interest Margins (NIM), but a quarter also chose losses and bad debts deteriorating placing downward pressure on NIM.

Tony Taylor (Police Bank): I'm not surprised to see the increase in pricing associated with investor and interest-only loans increasing NIM, and losses reducing NIM, simply because they are the two major parts of profitability (pricing and bad debt). However, I am surprised not many selected back office efficiencies. I suppose we have reached a point that despite some efficiencies yet to be had, they are not nearly as effective as some of the other categories.

Melanie Evans (ING): I put losses and bad debts simply because they have been at such historically low levels for such a long period of time. If they start to creep up it will impact not just profitability, but also customer experience and a whole range of other things, as losses and bad debts also equal bad customer outcome.

James Hickey (Deloitte): It is interesting that at the start of our session not many people mentioned interest rate increases or unemployment worsening as being significant concerns in 2018. Yet would they be the most likely drivers that will translate into worsening losses on your portfolios?

Alice Del Vecchio (HSBC): It's more about a customer's ability to service their debt going beyond the rate. The macroeconomic factors that we have to keep an eye on as lenders often won't be the price point driving a customer to a serviceability issue, but is more likely to be a job loss, or an industry removing itself from a certain region. There is a whole range of other things that are beyond our control.

Lisa Claes (CoreLogic): Like Tony I was surprised that back office efficiency was so low. I'm certainly not in the camp that it would completely counteract increased cost, but I think there's a lot more headroom there. There's a difference between automation and digitisation, and I think lenders continue to make great leaps. But if you look at other industries by comparison, there remains enormous upside in terms of cost efficiency and customer experience.

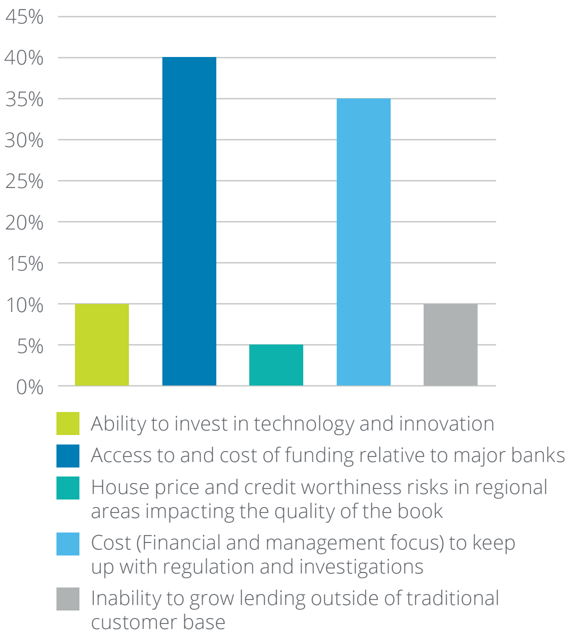
Joe Sirianni (Smartline): The other question I would have asked would be the impact of increased margin on interest-only loans and investment loans. The ACCC is now looking at these marginal spreads and being able to justify an 80 basis point differentiation.

I think the ACCC will be interested in the back book/front book dynamics. It is the fairness principle that underlies a lot of our cultural beliefs. I think the principles around fairness of pricing new versus existing customers will be the challenging conversation rather than the absolute numbers.

Melanie Evans, ING

What are the major challenges facing the regional lending sector in 2018?

Respondents selected two options



James Hickey (Deloitte): The cost of funding of course is a big challenge which could be about not having the same credit rating as the majors as well as being on a different capital footing. The other one that was dominant was the cost to keep up with the regulation on investigations which includes management focus, not just financial cost, linking back to those series of inquiries and investigations. Is that a new aspect for the regional lending sector over the past 12 to 24 months?

Andrew Toone (BOQ): I wouldn't say it is new, but it is certainly growing. Despite the fact that BOQ is about a tenth the size of a major, we don't provide 10% of the samples of a major. So yes, the reality is that in relative terms there's a much greater weight of time spent by the regionals on regulations than the majors and it is much more challenging to absorb that cost.

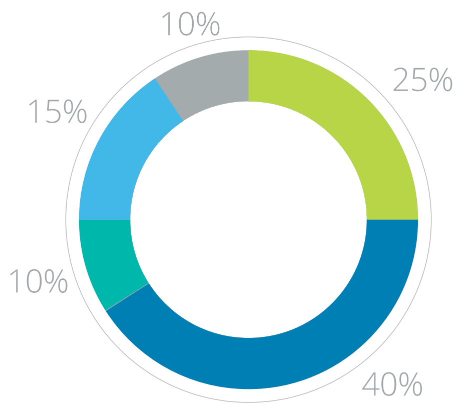
Melanie Evans (ING): I answered this on the basis of big bank versus small or major versus a non-major bank. I have worked in both parts of the industry, and as a smaller player you just don't have the same access to the infrastructure or the people available to help you as in a large major bank. You are far more focused as to who in the team you will give the task to as opposed to a Regulatory Affairs or Compliance department. It's just fundamentally different. I'm not saying it's easier, but it is a real challenge on a resourcing level, as well as process and infrastructure.

Lisa Claes (CoreLogic): People do underestimate the depth and breadth of resources available to focus on addressing a granular issue, which is of course related to the ability to invest in technology and innovation. These systems, particularly if automated cognitive technologies, can deliver massive cost efficiencies. But it is a huge investment to make.

Melanie Evans (ING): From a smaller bank's perspective, the value is in the person you give the project to, because they have to be generalists as well as specialists, and as such they generally understand a whole lot more.

Nathan McMullen (Westpac Group): There's an absolute and a relative here. At an absolute level the costs and resource issues apply to everybody. It certainly applies to all of the brands in the Westpac Group. On a relative basis, bigger ADI's may have more resources available but there is also a mobilization issue that arguably can be more challenging.

Where are the opportunities for the regional lending sector to enable it to better compete with the majors?



- Continued focus on brokers as a distribution channel
- Levelling of the capital discrepancy between advanced and standarised banks
- Consolidation with other industry participants / alinged regional businesses
- Identifying niche segments and playing to brand strength with such customers
- Investing in more agile systems enabling speed to market and flexibility

James Hickey (Deloitte): We talked about the challenges for the regional lending sector. This question shone a light on where the focus could be for the regional lending sector to enable better competitive forces to be played out.

It also picks up on what you said earlier Adrian about capital disparity. Forty per cent (40%) of you highlighted levelling the capital disparity between advanced and standardised banks as the most important opportunity. A quarter of you (25%) also wanted to continue the focus on brokers as a distribution channel.

Adrian Buckley (Suncorp): One of the issues for the regionals is a level playing field from a capital perspective. The classic scenario is of two neighbours with similar houses. One has a mortgage with a regional bank and the other has a mortgage with a major. Yet there is significantly less capital held by the major for essentially the same property. From a risk perspective, that doesn't necessarily make sense.

James Hickey (Deloitte): Fifteen percent (15%) identified niche segments as a major opportunity. Andrew, BOQ has been successful with its niche segments strategy delivering strong growth. Do you see identifying niches as an area where regionals as a whole can create specific competitive advantage?

Andrew Toone (BOQ): Yes. I think there definitely is that advantage. It comes back to the advantage of being a smaller regional player. You can be much more nimble and able to see the upsides more quickly. Peter you were making the observation earlier about the ability, when you're smaller, to actually go there if you see a niche and so box above your weight.

That can be a really significant additional return for the smaller player whereas a major might ask: "Is it worth me bothering about?"

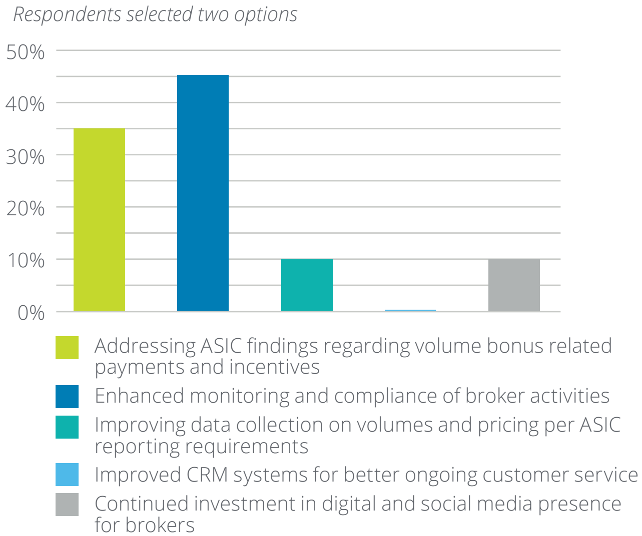
At BOQ we have many small business owners that are actually part of our network because of the franchisee model. They actually talk peer-to-peer with small businesses, and find a niche where they can actually help through having a conversation and understanding the challenges of a particular business. It is definitely a strength that we're looking to build on.

Joe Sirianni (Smartline): From a broker's perspective a number of our panel lenders are non-bank lenders. And unless they have a niche they just get absorbed as the majors have got it pretty down pat. After all a home loan, is a home loan, is a home loan. For instance, a number of franchisees contacted me and asked for HSBC on their panel because they have a niche product.

Lisa Claes (CoreLogic): I think there are some very rich pickings for the underserviced, the ignored or the misunderstood segments in the market. That's where the small banks and the regionals should plough in and be at the forefront.

Alice Del Vecchio (HSBC): You have to have a niche now because we are now forced into an environment where we're actually have to become more like the majors, so if you don't have a niche, you just get buried.

In what areas will broker distribution improvements be focused in 2018?



James Hickey (Deloitte): We asked where broker distribution needs to improve or focus in 2018. Not surprisingly, given the findings released in 2017 of the ASIC review, there was a heavy focus on embedding the required changes to remuneration design and compliance systems and monitoring. But there does seem to be less focus on the business aspects that are probably going to be advancing brokers and making them even better and more efficient. Is that a fair observation?

Joe Sirianni (Smartline): It is. Our franchisees are good-quality mortgage advisers and good writers of business, but getting into the detail of book-keeping and compliance could be improved on. There is no doubt about that. They need to have better housekeeping and better documentation. The lenders want a record of the conversation you are having with the customer.

James Hickey (Deloitte): So how significant is this step up going to be for broker groups?

Joe Sirianni (Smartline): It will be big. The four major banks have developed a diagnostic questionnaire. Westpac is leading with this questionnaire. It falls in line with what we've been doing for eight years, so it's easy for us. But a lot of other aggregators don't do that. We are telling our brokers that they need to record and document the conversation they are having with their customers.

Alice Del Vecchio (HSBC): We have now returned to the broker channel with the benefit of experiencing what has happened in Australia over time plus what has gone on overseas, particularly from a regulatory perspective. In anticipation of what is likely to come here, we've built a lot of the compliance processes and systems in advance.

Our initial concern was how hard it would be for brokers because we are asking for so much more; more data, more customer information, as well as more checks on what we receive. I'm pleased to say we haven't had as much push-back as expected. Probably because we provide the commentary in a format that's easy to complete so it becomes part of the submission process and brokers know they can't proceed without giving us what we need.

As a lender it makes it easy for me to decide who to partner with. I want to partner with groups who are happy to be part of this process, who are comfortable with it and also put procedures in place to allow for it to happen. At HSBC we are being asked to go onto a lot of panels. If I get asked by a group with no real interest in supporting our enhanced process, then it's a no-brainer to decline.

Heather Baister (Deloitte): As well as the brokers, it also involves the lenders checking that the aggregator groups are looking after the brokers. Twelve to 18 months ago, who was doing what was hugely disparate. There were some hindsight reviews, some training, very little was consistently applied beyond the majors.

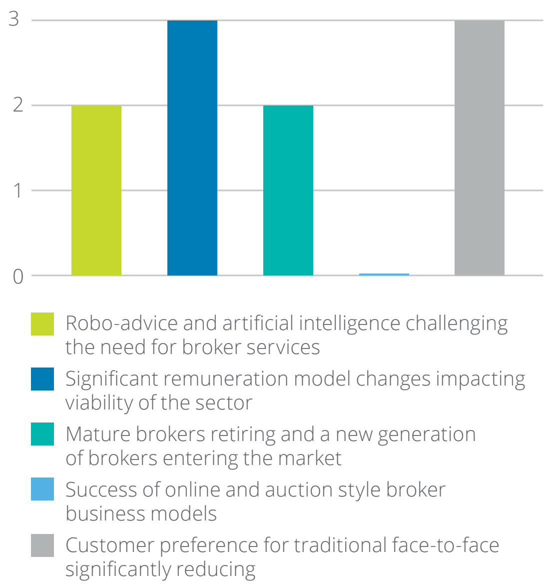
With the Combined Industry Forum that's been set up to deal with lenders, aggregators, broker groups and industry bodies, I think you will start to get a framework that will need to be applied across the board.

A challenge I am aware of though, is balancing the need to get this up and running as soon as possible to respond to the ASIC Inquiry as agreed by the industry as fit for purpose, with the concern that the Royal Commission might decide on a different approach in several months' time.

Tony Taylor (Police Bank): Looking back, it is interesting that 80% of us saw compliance as an opportunity for investment or improvement as opposed to the choices around improving service through better data use, and systems and digital channels.

> Because there is such a disparity around how broker groups work I think this compliance will bring everyone into line as all lenders insist on it. So I think it needs to be there and it is a good thing.
>
> **Alice Del Vecchio, HSBC**

What will the major disruptive force to the broker channel be over the next five years?



James Hickey (Deloitte): The final question we asked was about the major disruptive forces to the broker channel over the next five years. Interestingly, no-one voted for success of online and auction style broker businesses.

Joe Sirianni (Smartline): In our business there is an impending demographic change, with many of the old school brokers ready to retire. I too was surprised that no-one put online auction style broker business models.

James Hickey (Deloitte): Many of you identified the challenges with customers moving away from face-to-face proprietary channels to different channels. I presume these would be digital and social media channels giving additional pathways to reach the customer.

Joe Sirianni (Smartline): I think it is a generational thing. The younger generation are more comfortable with online and they will dominate more in five years' time.

Nathan McMullen (Westpac Group): There is a lot of focus within our organisation on customer preferences for traditional face-to-face significantly reducing (30%). Recognising that, we need to adapt in order to reflect that reduction. The reality is when we talk about quality growth in our business, historically there was a channel composition element to that. Today those conversations are happening a lot less. Many customers that apply through the broker channel have an existing relationship with the bank already, so that's their channel preference around how they come to us. We respect that choice and will continue to service it.

Melanie Evans (ING): I chose to think about the quality of an external channel versus a proprietary. I think what is good for everyone is to stop viewing the situation from a bank balance sheet/ROI perspective, and start thinking about why a customer chooses to use a broker versus directly engaging with their main bank. If we consider the decision from the customer back, rather than looking at the process as pure return on investment or equity, a better perspective can be gained.

James Hickey (Deloitte): It seems that what has made brokers successful to date needs to be constantly challenged and evolved to meet customer needs.

And on that note Deloitte thanked all the attendees for coming along and sharing their insights with us.

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