## Contents

**Abbreviations and glossary**  
Residential mortgage price inquiry—Interim report

**Executive summary**  
Residential mortgage price inquiry—Interim report

### Abbreviations and glossary

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abbreviations and glossary</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive summary</td>
</tr>
</tbody>
</table>

### Executive summary

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary findings</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where to next</td>
</tr>
</tbody>
</table>

1. **Introduction**  
   1.1 Residential mortgages in Australia  
   1.2 Types of residential mortgages and their add-on features  
   1.3 Components of residential mortgage prices  
   1.4 How are interest rate decisions made?  

2. **Lack of transparency in the pricing of residential mortgages**  
   2.1 The nature and effect of discounts on the interest rates paid by borrowers  
   2.2 New borrowers pay lower interest rates than existing borrowers  
   2.3 Basic (or ‘no frills’) residential mortgages are not always the cheapest after discounts  

3. **Key influences on prices and pricing strategies**  
   3.1 The role of internal performance targets  
   3.2 Signs of a lack of vigorous price competition  
   3.3 The public’s reaction has been a constraint on pricing  

4. **The effects of macroprudential and prudential measures on interest rates**  
   4.1 The effect of prudential benchmarks on the Inquiry Banks’ interest rates and lending activities  
   4.2 The effect of prudential regulation on funding costs  

5. **The Major Bank Levy**  
   5.1 About the Major Bank Levy  
   5.2 Decisions made by the Inquiry Banks  

### Appendix A. Direction to the ACCC  
Appendix A. Direction to the ACCC  
Appendix B. Funding the Inquiry Banks’ residential mortgage lending  
Appendix C. A comparison of the residential mortgages available in Australia with those overseas  

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix A. Direction to the ACCC</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix B. Funding the Inquiry Banks’ residential mortgage lending</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix C. A comparison of the residential mortgages available in Australia with those overseas</td>
</tr>
</tbody>
</table>
### Abbreviations and Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>Australian Bureau of Statistics</td>
</tr>
<tr>
<td>ACCC</td>
<td>Australian Competition and Consumer Commission</td>
</tr>
<tr>
<td>ADI</td>
<td>Authorised Deposit-taking Institution</td>
</tr>
<tr>
<td>ANZ</td>
<td>Australia and New Zealand Banking Group Limited</td>
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<tr>
<td>APRA</td>
<td>Australian Prudential Regulation Authority</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
</tr>
<tr>
<td>Average interest rate paid by borrowers</td>
<td>The average of the actual interest rates paid by borrowers after discounts have been applied. The average interest rates paid by borrowers were provided by the Inquiry Banks (defined below). These averages were calculated by the Inquiry Banks on a value weighted basis (except in the case of Macquarie Bank, where these figures were instead provided as a simple or straight average).</td>
</tr>
<tr>
<td>Back-book</td>
<td>Loans previously written by a bank and which are still being repaid by the borrower.</td>
</tr>
<tr>
<td>Big four banks</td>
<td>ANZ, Commonwealth Bank, National Australia Bank and Westpac</td>
</tr>
<tr>
<td>CCA</td>
<td>Competition and Consumer Act 2010 (Cth)</td>
</tr>
<tr>
<td>Commonwealth Bank (or CBA)</td>
<td>Commonwealth Bank of Australia</td>
</tr>
<tr>
<td>Council of Financial Regulators (or CFR)</td>
<td>The coordinating body for Australia’s main financial regulatory agencies, which aims to contribute to the efficiency and effectiveness of financial regulation and promote financial stability. The CFR’s members include the Reserve Bank of Australia (RBA), Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC) and the Australian Treasury.</td>
</tr>
<tr>
<td>Discounts</td>
<td>A reduction off the headline interest rate. The interest rate paid by the borrower is usually expressed as the headline interest rate less any discounts granted by the lender. There are two main types of discounts. The first type of discount is an advertised discount. The second type of discount is offered at the lender’s discretion on a case-by-case basis to individual borrowers.</td>
</tr>
<tr>
<td>Fixed rate residential mortgage or fixed rate loan</td>
<td>A residential mortgage where the interest rate is set and does not vary over a time period agreed between the borrower and lender, and set out in the loan contract (the fixed rate period).</td>
</tr>
<tr>
<td>Front-book</td>
<td>New loans written or being written by a bank.</td>
</tr>
</tbody>
</table>
| **Funds transfer price** | This is the interest rate charged by a bank’s Treasury unit for ‘lending’ money to the business unit(s) responsible for providing loans (such as residential mortgages). The transfer price is intended to reflect the combined cost of the bank’s funding sources (deposit, wholesale funding and equity) along with adjustments to cover other costs including:
| | ■ the costs, such as the cost of liquidity requirements, associated with managing the mismatch of funding long-term loans with short-term liabilities (such as deposits)
| | ■ the cost of hedging to manage the risk of borrowing at fixed rates (and sometimes in foreign currencies) and lending at variable rates (and in Australian dollars). |
| **Headline interest rate** | Headline variable interest rates are the reference or indicator rates on which the variable interest rates paid by both new and existing borrowers are based.
<p>| | Headline fixed interest rates are the reference rates on which the fixed interest rates paid by new borrowers are based. |
| <strong>Inquiry Banks</strong> | ANZ, Commonwealth Bank, Macquarie Bank, National Australia Bank and Westpac |
| <strong>Investor loan</strong> | A residential mortgage used to purchase or construct a residence as an investment. |
| <strong>Macquarie Bank</strong> | Macquarie Bank Limited |
| <strong>Macroprudential regulation</strong> | Regulations and measures that aim to address and mitigate risks to the financial system as a whole. These measures can overlap with prudential regulations (below) which aim to promote the safety and soundness of individual financial institutions. |
| <strong>Mortgage aggregator</strong> | Aggregators act between mortgage brokers (below) and lenders by providing technology and administrative support. Aggregators have contractual relationships with lenders, which allow the brokers operating under the aggregators to arrange loans from these lenders. Some aggregators are owned by lenders. |
| <strong>Mortgage broker</strong> | Acts as an intermediary between a borrower and residential mortgage lenders. A broker facilitates access to a range of residential mortgage products from different lenders. |
| <strong>National Australia Bank (or NAB)</strong> | National Australia Bank Limited |
| <strong>Net interest margin</strong> | The difference between the total interest earned by a bank (including, but not limited to, the interest paid by borrowers with residential mortgage loans) and the total interest paid by a bank (including, for example, the interest paid to people who have deposits with the bank). This difference is expressed as a percentage of the total interest-earning assets held by the bank (including, but not limited to, a bank’s mortgage back-book). |
| <strong>Official Cash Rate or OCR</strong> | The interest rate which banks pay to borrow funds from each other in the money market on an overnight basis. The cash rate is calculated as the weighted average interest rate on overnight unsecured loans between banks settled in the Reserve Bank Information and Transfer System. |
| <strong>Owner-occupier loan</strong> | A residential mortgage used to purchase or construct a residence for the borrower to live in. |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prudential regulation</td>
<td>Regulations and measures that aim to promote the safety and soundness of individual financial institutions. These measures can overlap with macroprudential regulation (above) which seeks to address risks to the financial system as a whole.</td>
</tr>
<tr>
<td>RBA</td>
<td>Reserve Bank of Australia</td>
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<tr>
<td>Residential mortgages</td>
<td>Loans made to persons that are secured by residential property. The residential property serves as collateral to guarantee the borrower will repay the lender.</td>
</tr>
<tr>
<td>Variable interest rate residential mortgage or variable interest rate loan</td>
<td>A residential mortgage that has an interest rate that can fluctuate over the period of the loan. The interest rate can be changed at any time at the lender’s discretion by altering the relevant headline interest rate.</td>
</tr>
<tr>
<td>Westpac (or WBC)</td>
<td>Westpac Banking Corporation</td>
</tr>
<tr>
<td>White label loan</td>
<td>A residential mortgage provided by a bank but distributed by a third party. The identity of the bank providing the loan may not be readily apparent, as the loan is branded with the brand of the distributor. The loan may be funded by the bank and held on its balance sheet or it may be funded via securitisation.</td>
</tr>
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</table>
Executive summary

In the 2017-18 Budget, the Australian Government announced additional funding for the Australian Competition and Consumer Commission (ACCC) to establish a permanent unit to undertake regular inquiries into specific financial system competition issues. The Government said it would facilitate greater and more consistent scrutiny of competition matters in the economy’s largest sector, which had been lacking to date.

The Residential Mortgage Price Inquiry is the first task of the ACCC’s Financial Services Unit (FSU) with the price monitoring period to finish on 30 June 2018.

The Australian Government announced the Major Bank Levy on 9 May 2017. The Treasurer, the Hon Scott Morrison MP, issued a direction on the same day requiring the ACCC to undertake an inquiry into the prices charged or proposed to be charged in relation to residential mortgage products by Authorised Deposit-taking Institutions (ADIs) affected by the Major Bank Levy. The Treasurer directed that the Inquiry cover the period from 9 May 2017 to 30 June 2018.

The Treasurer also directed that the ACCC have regard to the Government’s view that banks need to fully and transparently account for their decisions, ‘and hence how they balance the needs of borrowers, savers, shareholders and the wider community’. Transparency is of particular focus for this Interim Report.

A copy of the Treasurer’s direction to the ACCC is at Appendix A.

There are five ADIs subject to the Major Bank Levy:
- Australia and New Zealand Banking Group Limited (ANZ)
- Commonwealth Bank of Australia (Commonwealth Bank)
- Macquarie Bank Limited (Macquarie Bank)
- National Australia Bank Limited (National Australia Bank), and
- Westpac Banking Corporation (Westpac).

Combined, these five ADIs (the Inquiry Banks) held approximately $1.3 trillion in outstanding residential mortgages as at December 2017. This was about 84 per cent of all outstanding residential mortgages held by all banks in Australia at the time.

There is considerable disparity in the size of the residential mortgage portfolios of the Inquiry Banks. Macquarie Bank has the smallest residential mortgage portfolio of the five banks by a large margin (Table 1). The remaining Inquiry Banks—colloquially referred to as the ‘big four banks’—accounted for about 75 per cent of the value of all new residential mortgages approved by ADIs in the September quarter of 2017.1

There are over 100 other lenders, mostly ADIs, that also provide residential mortgages. The pricing of these other lenders is not the focus of this Inquiry.

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1 Australian Prudential Regulation Authority, Quarterly Authorised Deposit-taking Institution Property Exposures, September 2017, APRA, Sydney, December 2017.
Table 1 Inquiry Banks’ residential mortgage portfolios: December 2017

<table>
<thead>
<tr>
<th>Residential mortgage portfolio (outstanding balances)</th>
<th>Share of residential mortgages*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ billion</td>
</tr>
<tr>
<td>Commonwealth Bank**</td>
<td>413</td>
</tr>
<tr>
<td>Westpac**</td>
<td>398</td>
</tr>
<tr>
<td>ANZ</td>
<td>256</td>
</tr>
<tr>
<td>National Australia Bank**</td>
<td>252</td>
</tr>
<tr>
<td>Macquarie Bank</td>
<td>28</td>
</tr>
<tr>
<td>Other banks</td>
<td>253</td>
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</tbody>
</table>

* Share (by value) of residential mortgages outstanding with banks. Banks account for approximately 94–96% of all outstanding residential mortgages. Credit unions and building societies account for approximately 2% of all outstanding mortgages, while non-ADIs are estimated to account for between 2–4%.

** The data includes the Inquiry Banks’ other brands.


The ACCC has used its compulsory information gathering powers to obtain documents and data from the Inquiry Banks on their pricing of residential mortgage products. The ACCC has supplemented its analysis of the documents and data supplied by the Inquiry Banks with data from the Reserve Bank of Australia (RBA), Australian Prudential Regulation Authority (APRA) and the Australian Bureau of Statistics (ABS).

Overview

This Interim Report examines the motivations, influences and processes behind the pricing decisions of the Inquiry Banks during the period 30 June 2015 to 30 June 2017. These matters impact the Inquiry Banks’ prices for the review period set by the Treasurer. Unless otherwise indicated, our observations and findings relate to this period. The report also considers the consequences of these decisions for the Inquiry Banks’ current and prospective borrowers.

As per the Treasurer’s direction, a focus of the Interim Report is the transparency of residential mortgage prices. The Interim Report explores some of the challenges borrowers face in obtaining and comparing prices for residential mortgages. We explore how the Inquiry Banks’ discounting policies and other pricing strategies are leading to some unexpected outcomes for borrowers. These include:

- the large majority of borrowers with the Inquiry Banks are paying interest rates below the relevant headline interest rate (Figure 2.1)
- the Inquiry Bank with the lowest headline interest rate is not always the Inquiry Bank with the lowest average rate paid by borrowers (Figure 2.2)
- the average interest rates paid for basic or ‘no frills’ products have often been higher than for standard products, and
- existing residential mortgage borrowers are paying higher interest rates than new borrowers at the same big four bank. For example, based on data supplied by the big four banks for 30 June 2015, 30 June 2016 and 30 June 2017, their existing borrowers (owner-occupiers making principal and

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2 The ACCC sought data for the financial years 2015, 2016 and 2017, along with information and documents largely relating to the period 1 July 2015 to 16 June 2017, although with certain categories dating back as far as 1 September 2014. The ACCC sought information for the period prior to 9 May 2017, and has included such information in this report, to provide a baseline against which to compare pricing, and pricing decisions, for the review period set by the Treasurer, and to identify pricing trends that are relevant to that period. The ACCC also sought information and documents relating to the Inquiry Banks’ consideration of the Major Bank Levy for a period up to 22 November 2017.

3 Three of the Inquiry Banks sell mortgages under other brands in addition to their main brand (see Section 1.1). Our analysis of the Inquiry Banks in this report relates to their main brand only unless otherwise indicated.
interest repayments) on standard variable interest rate residential mortgages were paying interest rates up to 32 basis points higher (on average) than their new borrowers (Figure 2.3).

The other significant focus of the Interim Report is the dynamics between the Inquiry Banks in setting their residential mortgage prices. Our report reveals signs that the price competition between the Inquiry Banks, particularly the big four banks, has been less than vigorous. There are signs of accommodative oligopoly behaviour among the big four banks. We observe:

- the intense focus the big four banks have on each other when setting variable interest rates and the little regard they give to smaller lenders, and
- the way in which pricing strategies are often used to accommodate, rather than challenge, rivals which has likely affected residential mortgage interest rates.

Aspects of the level and structure of residential mortgage interest rates have been influenced by the prudential and macroprudential measures imposed by APRA. The Interim Report explores how the Inquiry Banks’ responses to APRA’s measures have led to increased interest rates for investor and interest-only borrowers. We observe that this may have decreased price competition among ADIs for these borrowers.

Finally, we observe that as at November 2017, the Inquiry Banks have stated that no specific decisions have been made to adjust residential mortgage prices in response to the Major Bank Levy.

The preliminary findings are set out below.

**Preliminary findings**

**Opaque discretionary discounts make it difficult for borrowers to compare products**

Borrowers generally pay a headline interest rate less an applicable discount. Discounts can have a significant effect on the interest rates paid by borrowers. The total discounts (a combination of advertised and discretionary discounts) offered to eligible borrowers by the Inquiry Banks, took the average interest rates paid by borrowers as at 30 June 2015, 30 June 2016 and 30 June 2017, to 78–139 basis points below the applicable headline interest rate.

Lenders determine discretionary discounts against a range of criteria, some of which are opaque to the borrower. For example, some of the factors in the Inquiry Banks’ decision criteria for discretionary discounts have included:

- the borrower’s risk profile
- the geographic location of the borrower or their residential property
- the borrower’s value (or potential value) to the bank, and
- the bank’s desire to write new business.

A borrower’s ability to negotiate has also been an important factor in what, if any, discount they receive. Since the decision criteria for discretionary discounts vary across lenders, borrowers can find it difficult to determine in advance what, if any, discount they may be eligible for. Further, borrowers may be required to lodge a loan application to confirm the discretionary discount that would be available to them or may be required to supply evidence of another lender’s offer if they want their lender to match or better that offer. These requirements increase the time and effort associated with obtaining accurate interest rate offers, making it difficult for borrowers to determine the range of effective interest rates available to them.

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4 This is broadly consistent with RBA reports that the variable interest rates of existing home loan customers average around 30–40 basis points higher than rates on new home loans, as referred to by the Productivity Commission (see Productivity Commission, 2018, Competition in the Australian Financial System, p. 6).

5 ACCC analysis of data supplied by the Inquiry Banks. This range has been adjusted to account for potential anomalies in one Inquiry Bank’s data caused by a change in its product categorisations that was being implemented during June 2017. If that bank’s original data were considered, the upper end of this range would be higher.
Borrowers have increasingly turned to mortgage brokers to give them a broader view of the options available across a range of residential mortgage lenders. The ASIC Review of mortgage broker remuneration indicated that over half of all new residential mortgages are originated through a mortgage broker.6 While borrowers might assume a broker is offering them independent advice, this may not always be the case as many large mortgage broking businesses are owned by or affiliated with an Inquiry Bank, and brokers are generally paid commissions by the lenders. These Inquiry Banks have tended to gain a disproportionately high share of referrals from the mortgage broking businesses in which they have an ownership interest.7

Basic (or ‘no frills’) residential mortgages are not always the cheapest after discounts

The big four banks offer standard variable rate residential mortgages that have a variety of add-on features as well as basic (or ‘no frills’) variable rate residential mortgages with more limited features. Basic loans are often promoted to consumers as being a cheaper option than standard variable loans. Examples of basic products are ANZ’s Simplicity Plus and Commonwealth Bank’s Economiser product. Depending on the bank, the headline interest rates for basic loans were (as at 30 June 2017) up to 65 basis points lower than the headline interest rate of the same bank’s standard variable loans.

However, once discounts are factored in, the average interest rate actually paid by existing borrowers on basic loans at the big four banks since July 2015 has often been higher than the average rates paid by existing standard variable loan borrowers. We consider it to be doubtful that this would accord with most borrowers’ expectations.

New borrowers pay significantly lower interest rates on average than existing borrowers

Discounts are a key tool used by residential mortgage lenders to secure new borrowers. In recent years, residential mortgage lenders have been increasing the discounts offered to their new borrowers (also referred to as the front-book) compared to the discounts they offered to new borrowers in the past. This practice has resulted in new residential mortgage borrowers often paying a lower interest rate than existing borrowers (also referred to as the back-book). Based on data supplied by the big four banks for 30 June 2015, 30 June 2016 and 30 June 2017, their existing borrowers on standard variable interest rate residential mortgages were paying interest rates up to 32 basis points higher (on average) than their new borrowers (Figure 2.3).

Such a difference can result in significant savings for new borrowers. For example, on a $375 000 residential mortgage (the Australian average for new residential mortgages), paying an interest rate that was 32 basis points lower would save approximately $1200 in interest over the first year of a loan.

Signs of a lack of vigorous price competition

The internal documents of the Inquiry Banks reviewed by the ACCC to date reveal a lack of vigorous price competition between the Inquiry Banks, and the big four banks in particular.8 The pricing behaviour of each of the Inquiry Banks appears more consistent with ‘accommodating’ a shared interest in avoiding the disruption of mutually beneficial pricing outcomes, rather than consistently vying for market share by offering the lowest interest rates. We observe that:

- The big four banks focus largely on each other when they determine headline interest rates and discounts on variable rate residential mortgages. The actions and reactions of over 100 other residential mortgage lenders do not appear to have had a significant bearing on interest rate decisions for the big four banks’ main brands during the period examined.
- The Inquiry Banks generally have not sought to compete by consistently offering the lowest headline variable interest rates to borrowers.

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7 Ibid.
8 As contemplated by the Treasurer’s direction, the focus of this report is on the pricing of residential mortgage products. The non-price dimensions of competition, and their impact on price, will be considered in the final report.
During late 2016 and early 2017, two of the big four banks decided (independently of each other) to take action to reduce discounting in the market. They each reduced their own discounts and sought to trigger reduced discounting by rivals, even though this was likely to be costly for them if other banks did not follow their lead. We observe that by early 2017 the two banks considered they had been successful in leading competitors to reduce discounts for a time.

One of the big four bank’s accommodating approach to pricing to avoid disrupting mutually beneficial pricing outcomes is reflected in some of the language used when its executives contemplated changes to mortgage interest rates. For example, in various documents prepared by senior executives at the bank during 2015, there are explicit references to ‘encouraging rational market conduct’, ‘maintaining orderly market conduct’ and maintaining ‘industry conduct’.

The public’s reaction has been a constraint on pricing

The Inquiry Banks are sensitive to the media attention and public criticism that can follow a decision to raise prices or to ‘hold back’ part of a reduction in the Official Cash Rate (OCR). In one case, for example, an Inquiry Bank began considering an interest rate increase, but staff recommended deferring any increase until a ‘trigger event’ occurred (either an OCR change or a rate change by a big four bank) due to concerns about adverse publicity. At a different Inquiry Bank, as another example, a proposal to increase fees was substantially modified due to concern about reputational damage.

These examples illustrate that expectations of strong public reaction have acted as a constraint on pricing decisions, and that without this reaction residential mortgage interest rates could have been higher and/or increases could have been introduced earlier.

It appears that once one of the big four banks announces its decision to increase headline variable interest rates, or to hold back part of a reduction in the OCR, the other Inquiry Banks find it advantageous in managing any reputational damage if they announce their interest rate decision soon after. This is referred to as a ‘fast follower’ approach, where the Inquiry Banks follow the first mover by making their own decisions (and announcements) in quick succession, and usually in the same direction as the first mover, although not necessarily by matching the prices of the first mover. In most cases, the Inquiry Banks have not attempted to win business by leaving their own interest rates ‘on hold’ or materially undercutting rivals.

The fast follower approach is apparent from the observed number of days (sometimes hours) it can take a big four bank to decide whether to match or marginally undercut another big four bank’s interest rate increase in contrast to the many weeks a bank can take to deliberate on a decision where it anticipates being the first to increase rates.

The big four banks have stated publicly that the OCR is not the only factor influencing their interest rate decisions for residential mortgages. Despite this, we have observed that they have timed their announcements of headline interest rate changes to follow RBA OCR announcements where possible. At times, this has resulted in them absorbing months of rising funding and/or other costs as they waited for a change in the OCR (or a rival’s interest rate increase) to change their headline interest rates.

They may do this because the public has come to expect an announcement on headline interest rates at that time and this expectation reduces the potential for reputational damage. Similarly, it could be that they perceive there to be fewer reputational risks to changing interest rates at this time because they expect the other Inquiry Banks to also change their headline variable interest rates in response to a change in the OCR.

Public messaging on rate changes do not always tell the full story

We observe that there are often multiple factors contributing to the Inquiry Banks choosing to change their headline interest rates but those reasons are not always disclosed in the media releases or other public statements accompanying the rate changes. Instead some public communications focus on one factor, or a subset of the factors, influencing the decision to change rates.

We observe that the Inquiry Banks have tended to explain interest rate increases since July 2015 as being the result of increased funding costs and/or prudential regulation. At the same time, relevant
decision documents indicate that some Inquiry Banks also considered that the higher headline variable rates would allow them to increase the revenue (and, in turn, profit) generated from existing borrowers (or their back-book).

We consider that there has also, on occasion, been selective reporting of how prudential regulation has affected interest rates. For example, it appears that part of the reason one Inquiry Bank increased rates in July 2015 was to bolster their return on equity following an APRA announcement that they would need to hold more regulatory capital. The rate increases were, however, ascribed to a direction from APRA to limit lending to investors.

**Prudential benchmarks have led to increases in some interest rates**

We observe that residential mortgage interest rates have been particularly affected by the Inquiry Banks’ reactions to two policy initiatives by APRA aimed at addressing emerging risks to both individual ADIs and the broader financial system from the housing sector. The first of these initiatives, announced by APRA in December 2014, was for ADIs to limit their annual growth in residential mortgage lending to investors to 10 per cent. The second initiative, announced by APRA in March 2017, was to limit residential mortgages with interest only repayments to 30 per cent of total new mortgage lending.

The Inquiry Banks tried a number of different approaches to comply with the investor cap, including reducing discounts for new investor borrowers and tightening their criteria for approving new investor loans. However, these actions were deemed to be insufficient by some Inquiry Banks to ensure their compliance. These banks chose to also increase their headline interest rates on investor loans to limit the flow of new investor loans onto their books. While the decision of at least one Inquiry Bank to increase headline variable interest rates was prompted by APRA’s benchmark, the expected ‘substantial economic benefit’ of hundreds of millions of dollars in additional revenue was an important consideration in the decision. The opportunity to bolster its return on equity was part of the reason another Inquiry Bank increased its headline variable interest rates for investor loans in July 2015.

Once some Inquiry Banks began to increase their interest rates on investor loans, some of the other Inquiry Banks stated that they needed to follow those increases otherwise they would risk being inundated with new loans that (if approved) would put them in breach of APRA’s investor growth limits. As a result, there is now less scope or incentive for Inquiry Banks (or other ADIs) to lower interest rates to attract investor borrowers due to the risk of non-compliance with APRA’s investor growth limits.

In mid-2017, the Inquiry Banks all increased their headline variable interest rates for interest-only loans, affecting both new and existing loans. The big four banks each publicly attributed their increases in interest-only interest rates effective July 2017 to APRA’s interest-only cap.9

The Inquiry Banks created new categories of headline interest rates specific to investor borrowers and interest only borrowers during 2015, 2016 and 2017. This has resulted in the headline variable interest rate for investor borrowers making interest only repayments being up to 110 basis points higher than owner-occupiers making principal and interest repayments (Table 2).10 Prior to 2015 the same headline interest rate would have applied to both groups of borrowers.

**Table 2 Headline variable interest rates for standard residential mortgages: Inquiry Banks (1 July 2017)**

<table>
<thead>
<tr>
<th>Borrower type</th>
<th>Owner-occupier</th>
<th>Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and interest</td>
<td>5.20%–5.35%</td>
<td>5.79%–5.92%</td>
</tr>
<tr>
<td>Interest only</td>
<td>5.35%–5.83%</td>
<td>5.94%–6.30%</td>
</tr>
</tbody>
</table>

Source: ACCC analysis of publicly available data.

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9 Due to the time period for information and documents reviewed (largely 1 July 2015 to 16 June 2017), we have not reviewed this change in detail in this Interim Report. This will be considered further in the final report.

10 The difference in interest actually paid (on average) across the same groups of borrowers was up to 98 basis points in 2017.
The effects of macroprudential and prudential regulation on headline interest variable rates are set out in Chapter 4. That chapter also considers the implications for price competition between the Inquiry Banks (and other ADIs) for investor and interest only borrowers.

**The Major Bank Levy**

As at November 2017, the Inquiry Banks have stated that no specific decisions have been made to adjust residential mortgage prices in response to the Major Bank Levy.

We have observed consideration by some Inquiry Banks of a mix of possible strategies to recover the cost of the Major Bank Levy. These include having shareholders bear the cost of the Major Bank Levy or recovering the cost of the Major Bank Levy through a mix of stakeholders including customers, staff, suppliers and shareholders. One Inquiry Bank has considered different stakeholders bearing the cost over time. That Inquiry Bank considered that shareholders could initially bear the cost of the Major Bank Levy, followed by customers and suppliers beginning to bear the cost of the Major Bank Levy later, including at a time that is after the conclusion of the ACCC’s inquiry.

We also observe that the Inquiry Banks are aware of the potential political and public impacts of their decisions on how to deal with the Major Bank Levy.

The Inquiry Banks have all decided to treat the cost of the Major Bank Levy as an interest expense in their financial statements. In reaching this decision, the Inquiry Banks consulted with each other. In those discussions with each other all the Inquiry Banks expressed a desire for a consistent or common treatment.

The ACCC will continue to monitor the Inquiry Banks’ response to the Major Bank Levy, including any changes to their residential mortgage product prices as a result of the Major Bank Levy.

**Where to next**

The ACCC will issue a final report after 30 June 2018. The final report will:

- consider the residential mortgage pricing decisions of the Inquiry Banks through to 30 June 2018, and
- explain how the Inquiry Banks have dealt with the Major Bank Levy in pricing their residential mortgages and more generally.

In addition, the ACCC will examine fees for residential mortgages and also consider non-price dimensions of competition. The ability of smaller lenders to compete with the Inquiry Banks will also be considered, as well as how consumer behaviour may influence residential mortgage pricing.
1. Introduction

This chapter provides information about the demand for and supply of residential mortgages in Australia. It describes the current state of residential mortgage lending in Australia, the various different types of residential mortgages on offer, the components of residential mortgage prices, and how the Inquiry Banks make decisions about their interest rates.

1.1 Residential mortgages in Australia

Residential mortgages are loans made to persons that are secured by a residential property. The residential property serves as collateral to guarantee the borrower will repay the lender.

Borrowers

Australians currently owe over $1.6 trillion in outstanding residential mortgage debt\(^{11}\) (roughly the same amount as Australia’s entire gross domestic product for the year ending September 2017\(^ {12}\)). That debt is spread across nearly six million loan contracts.\(^ {13}\)

A residential mortgage is usually a major financial commitment for the borrower. In 2017, the repayments on new residential mortgages accounted for over a quarter of the average borrower’s household disposable income.\(^ {14}\)

Around one-third of Australia’s almost 10 million residential properties are occupied by owners who are repaying a residential mortgage on that property. Another third are rented out by landlords, many of whom are repaying a residential mortgage on that property, while a further third are owned outright.\(^ {15}\)

Lenders

There are well over 100 residential mortgage lenders in Australia.\(^ {16}\) ANZ, Commonwealth Bank, National Australia Bank and Westpac are the four largest residential mortgage lenders in Australia. Combined, they account for over 80 per cent of the value of all residential mortgages outstanding with banks in Australia as at December 2017 (Table 1.1).

The next largest providers in December 2017 were ING Bank (Australia) Limited, Suncorp Metway Limited, and Bendigo and Adelaide Bank Limited who, between them, accounted for about 7.5 per cent of the outstanding mortgage debt owed to banks.\(^ {17}\) Macquarie Bank, the fifth Inquiry Bank, accounts for less than 2 per cent of outstanding mortgage debt with banks.\(^ {18}\)

Non-ADIs\(^ {19}\) cannot accept deposits and are not subject to prudential oversight by APRA. It has been estimated that, as at September 2017, non-ADIs accounted for between 2 and 4 per cent of outstanding residential mortgages (by value) in Australia. Non-ADIs’ share of outstanding residential mortgages was almost 10 per cent before the global financial crisis, after which the availability of wholesale finance (on which many of them were heavily reliant) reduced significantly.\(^ {20}\)


\(^{13}\) Australian Prudential Regulation Authority, Quarterly Authorised Deposit-taking Property Institution Exposures, September 2017, APRA, Sydney, December 2017.

\(^{14}\) Gianni La Cava, Hannah Zeal and Andrew Zurawski, Housing Accessibility for First Home Buyers, Reserve Bank of Australia, Sydney, December 2017, p. 21.

\(^{15}\) Australian Bureau of Statistics, 2024.0 – Census of Population and Housing: Australia Revealed, 2016, ABS, Canberra, June 2017.

\(^{16}\) Australian Prudential Regulation Authority, Quarterly Property Exposures, September 2017.

\(^{17}\) Australian Prudential Regulation Authority, Monthly Banking Statistics, December 2017, APRA, Sydney, January 2018.

\(^{18}\) Australian Prudential Regulation Authority, Monthly Banking Statistics, December 2017.

\(^{19}\) Examples of non-ADI lenders include Firstmac, La Trobe Financial, Liberty Financial, Pepper Group, Resimac, Bluestone Mortgages, Latitude Finance Australia, RedZed Lending Solutions and Thinktank Commercial Property Finance.

Table 1.1 Inquiry Banks’ residential mortgage portfolios: December 2017

<table>
<thead>
<tr>
<th>Residential mortgage portfolio (outstanding balances)</th>
<th>Share of residential mortgages*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ billion</td>
</tr>
<tr>
<td>Commonwealth Bank**</td>
<td>413</td>
</tr>
<tr>
<td>Westpac**</td>
<td>398</td>
</tr>
<tr>
<td>ANZ</td>
<td>256</td>
</tr>
<tr>
<td>National Australia Bank**</td>
<td>252</td>
</tr>
<tr>
<td>Macquarie Bank</td>
<td>28</td>
</tr>
<tr>
<td>Other banks</td>
<td>253</td>
</tr>
</tbody>
</table>

* Share (by value) of residential mortgages outstanding with banks. Banks account for approximately 94–96% of all outstanding residential mortgages. Credit unions and building societies account for approximately 2% of all outstanding mortgages, while non-ADIs are estimated to account for between 2–4%.

** The data includes the Inquiry Banks’ other brands.


Residential mortgages are sold by the Inquiry Banks through their main brand (for example, Commonwealth Bank, National Australia Bank and Westpac) or through other brands (Table 1.2).

Table 1.2 Other brands of the Inquiry Banks

<table>
<thead>
<tr>
<th>Commonwealth Bank</th>
<th>National Australia Bank</th>
<th>Westpac</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankwest</td>
<td>UBank</td>
<td>St George</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bank SA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bank of Melbourne</td>
</tr>
<tr>
<td></td>
<td></td>
<td>RAMS</td>
</tr>
</tbody>
</table>

Mortgages originated by ADIs directly through their own channels accounted for about 45 per cent of new loans by value in 2015. The remaining mortgages were originated through mortgage brokers and aggregators (Box 1.1), although the degree to which individual lenders rely on brokers and aggregators varies significantly.

Box 1.1 Who are mortgage brokers and aggregators?

Mortgage brokers act as an intermediary between consumers and residential mortgage lenders, facilitating access to a range of residential mortgage products from different lenders. Mortgage brokers can help by matching the needs of consumers with a residential mortgage product and lender, but their duty is only to ensure a loan is ‘not unsuitable’ for the consumer. They also assist with the loan application and finalisation processes.

Most of the loan applications sourced by mortgage brokers will be processed through a mortgage aggregator. Mortgage aggregators earn commissions from lenders on the successful loan applications they source for those lenders. Aggregators are typically paid an ‘upfront’ commission when a loan is taken out, and a smaller ‘trailing’ commission for each month that the loan is active. They pass on most of the commissions to the broker who originated the loan. Aggregators can also receive volume-based commissions from lenders when they reach particular sales targets. The level of all these commissions varies between lenders and aggregators.

Mortgage aggregators also sometimes offer residential mortgage products through ‘white label’ loans. These residential mortgages are offered under the aggregator’s branding (for example, Aussie Home Loans) but are actually approved, provided and serviced by another lender. The Commonwealth Bank, National Australia Bank and Macquarie Bank provide white label residential mortgages.

These three banks also have direct or indirect ownership interests in various mortgage brokers and aggregators. The Commonwealth Bank owns Aussie Home Loans and has an ownership interest in Mortgage Choice, National Australia Bank owns Choice Aggregation Services, FAST, and PLAN Australia, and Macquarie Bank has an ownership interest in the aggregators Yellow Brick Road, Connective, and Vow.

These banks have tended to gain a disproportionately high share of referrals from the aggregators in which they have an ownership interest. For example:

- compared to the Commonwealth Bank’s overall market share of 20.9 per cent for new residential mortgage lending sourced from the broker channel in 2015, the combined share of Commonwealth Bank-branded and Commonwealth Bank-funded home loans was 37.3 per cent (by value) of home loans originated through Aussie Home Loans and just over 25 per cent of the loans originated through Mortgage Choice
- similarly, 22 per cent of home loans (by value) sold by National Australia Bank-owned aggregators in 2015 went to National Australia Bank-branded or National Australia Bank-funded white label home loans, compared to National Australia Bank’s overall market share of just over 13.2 per cent in the broker channel
- finally, about 23 per cent (by value) of Yellow Brick Road’s home loans in 2015 were Macquarie Bank-funded white label loans compared to Macquarie Bank’s overall market share of 4.8 per cent in the broker channel.


1.2 Types of residential mortgages and their add-on features

Lenders offer a variety of residential mortgage products to suit different borrowers. Residential mortgage products can broadly be grouped by a combination of the loan’s purpose, the type of interest rate and the repayment arrangements. Within these broad categories there are various add-on features available depending on the loan and lender. Appendix C explores some aspects of how Australia’s residential mortgages compare internationally.
A loan’s purpose: owner-occupier or investor

Lenders offer residential mortgages to suit two main purposes. The first is for borrowers to purchase or construct a residence for the borrower to live in (known as an owner-occupier loan). The second is for borrowers to purchase or construct a residence as an investment (known as an investor loan).

Owner-occupier loans are the most common type of residential mortgage, comprising about two-thirds of both new loans written and all residential mortgage debt owed to ADIs in September 2017.²²

The choice between variable and fixed interest rates

The interest rate applying to a residential mortgage can be either variable or fixed. Under a variable rate residential mortgage, the interest rate can be changed at any time at the lender’s discretion by altering the relevant headline interest rate (discussed in Section 1.3). Under the National Credit Code²³, a lender must advise the borrower of a change in their interest rate no later than the day on which the change takes effect.

By contrast, under a fixed rate residential mortgage, the interest rate does not change over a set period. Fixed rate terms of 2 and 3 years are the most common selected by borrowers but fixed rate terms of 1–10 years are usually available from lenders. After the fixed rate period expires, the borrower usually has the choice between ‘locking in’ another fixed rate period based on the then prevailing fixed interest rates, or reverting to a variable rate loan.

Many lenders also give borrowers the option of splitting their total borrowing requirement across fixed and variable rate residential mortgage products. Where this occurs, the borrower will usually have two or more loan accounts created—one for each residential mortgage product they choose.

Despite the interest rate certainty offered to borrowers by fixed rate loans, these types of loans have accounted for no more than around 25 per cent of new owner-occupier residential mortgages (by value) in each year since 1991. Sometimes their share has been as low as five per cent.²⁴ This relatively small share may be due to the lack of product add-on features (Box 1.2) that fixed rate loans offer compared to variable rate loans. For example, redraw, offset and progressive drawdown features are often unavailable on fixed rate loans. The ‘break fees’ charged by many lenders upon a loan’s repayment before its fixed rate period expires might also be a deterrent to borrowers choosing fixed rate loans.

The relatively small share of fixed rate loans among new residential mortgages is the reason this Interim Report has primarily focused on variable rate residential mortgages.

²² APRA, Quarterly Property Exposures, September 2017.
²³ National Consumer Credit Protection Act 2009 (Cth), Schedule 1.
There are a number of features that lenders make available on the residential mortgages they offer. Not all lenders offer all add-on features and not all add-on features are available on the different types of residential mortgages a lender offers. Some of the more common add-on features are listed below.

<table>
<thead>
<tr>
<th>Add-on feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offset account</td>
<td>An at-call transaction account, the daily balance of which is ‘offset’ against the amount outstanding on a residential mortgage for the purpose of calculating the interest payable on that residential mortgage.</td>
</tr>
<tr>
<td>Redraw facility</td>
<td>The ability to make additional repayments to a residential mortgage and withdraw them at a future date (assuming the loan remains ahead of its scheduled repayments). A redraw facility allows a borrower to make interest savings in a similar manner to an offset account but, unlike an offset account, the funds held under a redraw facility are not guaranteed by the Australian Government under the Financial Claims Scheme.</td>
</tr>
<tr>
<td>Portability</td>
<td>The ability to change the collateral for a residential mortgage from one property to another without writing a new loan contract.</td>
</tr>
<tr>
<td>Progressive drawdown for construction use</td>
<td>Funds are progressively drawn on an agreed schedule in order to pay for the construction of a residential property. Drawdowns are usually subject to some form of validation of the construction work completed. Loan repayments are limited to interest only during the period when the loan is being progressively drawn.</td>
</tr>
<tr>
<td>Repayment holiday</td>
<td>The ability to reduce loan repayments below the contractually required minimum for a period of time. Some lenders only allow access to this feature when a loan is ahead of its scheduled repayments. After a repayment holiday, repayments may be higher for the remaining term of the loan than they otherwise would have been.</td>
</tr>
</tbody>
</table>

**Loan repayment arrangements: principal and interest or interest only**

Lenders often provide borrowers with a choice between making principal and interest repayments or interest only repayments. Interest only repayment options apply for a set period of time.

Interest only repayments are more popular with investors than owner-occupiers. As at the end of June 2017, about two-thirds of all investor loans with the Inquiry Banks required interest only repayments, whereas just over one quarter of owner-occupiers were making interest only repayments. At least part of the reason for this is that the interest paid on investor loans is often tax deductible, whereas that is not the case for owner-occupier loans. Accordingly, investors may have an incentive to maintain their tax deductions for as long as possible by not paying down their residential mortgage debt.

However, this approach comes at the cost of a higher lifetime interest expense on the loan, and higher loan repayments once the interest only repayment period expires, compared to making principal and interest loan repayments from the outset.

**1.3 Components of residential mortgage prices**

Residential mortgage pricing is comprised of the interest rates and fees paid by borrowers to lenders. There are two components of the interest rates borrowers pay: the headline interest rate and any discount off the headline rate granted by the lender. Each is considered below.

**Headline interest rates**

Headline variable interest rates are the reference or indicator rates on which the variable interest rates paid by both new and existing borrowers are based. Lenders also maintain separate headline interest rates for new and existing loans. The headline interest rates are based on the Reserve Bank of Australia (RBA) cash rate. Lenders often offer a margin over the headline rate. These margins are usually fixed for a certain period of time, although some lenders allow borrowers to vary the margin during the term of the loan.

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25 ACCC aggregated analysis of data supplied by the Inquiry Banks.
26 These shares are likely to have fallen following APRA’s introduction of measures in March 2017 that required ADIs to limit new interest only lending to 30 per cent of total new residential mortgage lending. These measures are discussed further in Chapter 4.
rates for their fixed rate residential mortgages on which they base the fixed interest rates offered to new borrowers. Generally, the headline interest rate (fixed or variable) is the maximum rate a new borrower will be offered on a residential mortgage.

Prior to 2015, lenders typically had a single headline variable interest rate that was often referred to as the ‘standard variable rate’. Lenders now generally maintain a number of headline variable interest rates for various products and combinations of borrower and repayment types. For example, it is common for lenders to have different headline variable interest rates applying to residential mortgages for:

- owner-occupiers making principal and interest repayments
- owner-occupiers making interest only repayments
- investors making principal and interest repayments, and
- investors making interest only repayments.

It is changes to the headline interest rates that lenders are referring to when they announce a change in their interest rates.

**Discounts**

The interest rate a borrower actually pays is the headline interest rate (fixed or variable) less any discounts granted by their lender. For example, if the lender’s headline interest rate is 4.50 per cent and the borrower is granted a 0.50 per cent (50 basis points) discount, the rate paid by the borrower is 4.00 per cent. The discount agreed between a borrower and lender applies for the life of the loan unless otherwise specified in the loan contract—for example, lenders sometimes provide short-term discounts that run for 1–2 years as part of a promotional campaign. As a result, the variable interest rates paid by borrowers change by the same amount as any change in their lender’s headline variable interest rates.

There are two main types of discounts. The first type of discount is an advertised discount (such as a packaged discount). Packages involve discounts on a suite of the lender’s products such as transaction accounts, credit cards and residential mortgages. The borrower often has to pay an annual fee for the package and, in turn, receives reduced (or waived) fees on their residential mortgage, credit card and transaction account as well as a discount on the interest rate applying to their residential mortgage.

The second type of discount is offered at the lender’s discretion on a case-by-case basis to individual borrowers. As a result, these ‘discretionary discounts’ are less easily discovered by borrowers compared to advertised discounts.

Not all borrowers will be eligible for a discount or willing to agree to the terms on which a lender offers a discount.

**Fees**

The fees borrowers typically pay on residential mortgages include the establishment or setup fees at the beginning of a loan and service or administration fees during the life of a loan. Borrowers may also pay an ongoing fee as part of a package discount which results in most (if not all) of the administration fees being waived. The Comparison Rates advertised by lenders can help consumers to see the impact of fees on the cost of a loan (Box 1.3).

**Box 1.3 Comparison Rates**

A Comparison Rate can be used to better understand and compare the total cost of a residential mortgage. Providing a comparison rate requires lenders to calculate a single, percentage figure cost of the loan which incorporates the product’s advertised interest rate as well as most of the prescribed fees and charges associated with the loan. Under Part 10 of the National Credit Code, lenders must provide a comparison rate whenever they advertise an interest rate for a credit product, including mortgages. The required methodology for calculating a comparison rate is set out in the National Credit Regulations, and includes the designated amounts and terms upon which the comparison rate example has to be based.
Fees are a relatively minor component of overall residential mortgage pricing and accordingly this Interim Report has focused on interest rates rather than fees. While borrowers paid over $1.2 billion in fees to banks in relation to residential mortgage products in 2016, the total interest they paid was much greater at over $78 billion. Should interest rates increase from their current historic lows, the share of fees in the total costs paid by residential mortgage borrowers would be even lower.

1.4 How are interest rate decisions made?

Decisions on variable and fixed interest rates

Decisions on headline variable interest rates are made in a variety of ways by the Inquiry Banks: by a formal pricing committee in the case of some Inquiry Banks and by key executives in the case of the others. Senior executives, sometimes including the Chief Executive Officer, are typically involved in the decision-making process. The relevant decision-makers (including committees) may regularly meet up to 12 times each year at some of the Inquiry Banks. Decision-makers at the Inquiry Banks may also meet in response to an event such as a change in the OCR or a significant price announcement by a big four bank. The decision-making process usually involves staff formulating a proposal and presenting it to the decision-makers for consideration.

The timeframe for coming to a decision on headline variable interest rates at the Inquiry Banks can extend into weeks or longer. This sometimes happens, for example, where the reputational risks or financial implications are significant. Over that time, pricing proposals may be discussed and refined a number of times by senior executives. This approach appears to be compressed when an Inquiry Bank wants to react quickly to a competitor’s unexpected interest rate announcement.

Headline fixed interest rates are generally considered more frequently than headline variable interest rates. Decision-makers can meet once a week at some Inquiry Banks. Part of the reason for this may be that these decisions can be implemented (and changed) in a very short space of time, as there is no need to notify existing borrowers, given the changes only affect new borrowers or existing borrowers looking to renegotiate the terms of their loan. The decision-making for fixed interest rates is made by a formal pricing committee at some Inquiry Banks and at less formal meetings of decision-makers at other Inquiry Banks. At some Inquiry Banks, staff such as product managers and pricing managers are responsible for making decisions about headline fixed rates.

Decisions on discounts

Some of the Inquiry Banks have discounting policies that contain different levels of discounts that employees are authorised to offer borrowers. At one Inquiry Bank, this process is automated, with a pricing tool determining the discount offered to an individual customer. The levels of discounts are generally agreed by senior managers or executives. For one Inquiry Bank, this takes place within a formal pricing committee. Generally, the more senior the employee, the higher the range of discounts they are authorised to offer, and requests for a discount may be progressively escalated to more senior employees.

These arrangements appear to allow these Inquiry Banks to manage the large numbers of requests for discounts that they receive. For example, one Inquiry Bank reported that they dealt with approximately 225 000–275 000 decisions regarding discounts to individual customers in one year.

For similar reasons to those applying to headline fixed interest rates (above), decisions on discounting policies are considered weekly at some of the Inquiry Banks. However, one Inquiry Bank only considers its discounting policy on an ad hoc basis.

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27 Based on a survey of 12 banks accounting for 90 per cent of the Australian banking sector by balance sheet size.
28 Rachael Fitzpatrick and Graham White, Banking Fees in Australia, Reserve Bank of Australia, Sydney, June 2017, p. 36.
2. Lack of transparency in the pricing of residential mortgages

We observe that there is a lack of transparency in the discretionary discounts provided by the Inquiry Banks, particularly the big four banks. This chapter assesses how that lack of transparency affects the ability of consumers to meaningfully compare residential mortgage products and the interest rates applying to those products.

2.1 The nature and effect of discounts on the interest rates paid by borrowers

As at June 2017, an overwhelming majority of borrowers with variable rate residential mortgages at the Inquiry Banks were paying interest rates significantly lower than the relevant headline rate (Figure 2.1). This was due to the discounts made available to those borrowers by their lender—each Inquiry Bank had 44 per cent or more of its borrowers receiving a discount of over 90 basis points in June 2017. A borrower’s eligibility for a discount typically depends on a number of factors, including the borrower’s characteristics and the lender’s policies at the time the discount is sought.

Figure 2.1 Total variable residential mortgage book by size of discounts—30 June 2017

There are typically two types of discounts: advertised discounts and discretionary discounts (explained in Section 1.3). Advertised discounts—for example, ‘package’ discounts—are, by their nature, visible to borrowers. Information on discretionary discounts however, can be difficult for borrowers to obtain. Lenders know the size of discounts they are prepared to offer and the type of borrowers they are prepared to offer them to but this information is not publicly available.

However, the ACCC’s review of the Inquiry Bank’s internal documents suggests that the Inquiry Banks are aware of the big four banks’ interest rates and discounts. There are a number of ways this information could be sourced including through relationships with mortgage brokers, mystery shopping and potential borrowers presenting competing offers for them to match. We observe that some of the Inquiry Banks use this knowledge to refine their offers to ensure they set their prices no lower than they need to be to win or retain borrowers.
The effect of discounts on the interest rates paid by borrowers

A common form of advertised discount is the ‘package’ discount. Since July 2015, banks have advertised package discounts of around 75–85 basis points off the headline variable interest rate for eligible borrowers.\(^{31,32}\)

The average interest rates paid by borrowers of the Inquiry Banks on variable loans have been significantly below the relevant headline variable interest rates due to the combination of advertised and discretionary discounts. The discounts applied by the Inquiry Banks resulted in the average variable interest rates paid by borrowers, as at 30 June 2015, 30 June 2016, and 30 June 2017, being between 78 and 139 basis points below the relevant headline interest rate.\(^{33}\) One Inquiry Bank observed in 2017 that some lenders were providing total discounts of up to 150 basis points off the applicable headline interest rate to eligible borrowers.\(^{34}\)

The effect of discounts of this size can be substantial for borrowers. For example, across the Inquiry Banks in July 2017, the average total discount received by owner-occupier borrowers making principal and interest repayments on variable interest rate loans was 103 basis points below the applicable headline interest rate.\(^{35}\) On a $375 000 residential mortgage (the Australian average for new residential mortgages)\(^{36}\), this translates to a reduction in minimum monthly repayments of about $230 or up to $3863 in interest in the first year of a loan.

We consider that different approaches by the Inquiry Banks to discounting means it is difficult for borrowers to draw conclusions about the relative attractiveness of a residential mortgage based on headline interest rates. For example, for owner-occupier borrowers making principal and interest repayments, the Inquiry Bank with the lowest headline rate is not always the bank with the lowest average rate paid by borrowers (Figure 2.2).

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\(^{31}\) Where a bank offers a tiered discount structure based on the size of the loan, the discount reported relates to loans of $250 000 or more.


\(^{33}\) ACCC analysis of data supplied by the Inquiry Banks. This range has been adjusted to account for potential anomalies in one Inquiry Bank’s data caused by a change in its product categorisations that was being implemented during June 2017. If that bank’s original data were considered, the upper end of this range would be higher.

\(^{34}\) Based on ACCC analysis of documents supplied by the Inquiry Banks.

\(^{35}\) Owner-occupier borrowers making principal and interest repayments on variable rate loans comprise the largest group of borrowers. Combined they account for 31 per cent of all residential mortgage borrowers outstanding with the Inquiry Banks and 38 per cent at one Inquiry Bank.

Figure 2.2 Headline and average interest rates* paid for standard* variable interest rate residential mortgages—owner-occupier with principal and interest repayments**

<table>
<thead>
<tr>
<th>Date</th>
<th>CBA</th>
<th>Westpac</th>
<th>ANZ</th>
<th>NAB</th>
<th>Macquarie</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 2015</td>
<td>5.45%</td>
<td>5.48%</td>
<td>5.38%</td>
<td>5.43%</td>
<td>5.50%</td>
</tr>
<tr>
<td>30 June 2016</td>
<td>4.66%</td>
<td>4.62%</td>
<td>4.54%</td>
<td>4.53%</td>
<td>4.43%</td>
</tr>
<tr>
<td>30 June 2017</td>
<td>4.49%</td>
<td>4.45%</td>
<td>4.36%</td>
<td>4.30%</td>
<td>4.22%</td>
</tr>
</tbody>
</table>

* The solid bars show the average rate paid by borrowers at 30 June 2015, 2016 and 2017. The shaded sections show the average discount received by borrowers.

* For the big four banks, the figure reflects each bank’s largest standard product by value. In the case of CBA, NAB and Westpac, the interest rates reported relate to borrowers on a package (packages are explained in Section 1.3). The interest rates reported by ANZ (and reflected in the figure) relate to both packaged and ‘unpackaged’ borrowers. Macquarie Bank applied the same headline interest rate to its standard and basic products over the period—accordingly, a weighted average across both products has been reported in this figure.

** Individual products may have different fees (which have not been taken into account here). Those fees will affect any comparison of the overall cost of these products to borrowers. A borrower’s eligibility for a discount typically depends on a number of factors, including the borrower’s characteristics and the lender’s policies at the time the discount is sought.

Source: ACCC analysis of data supplied by the Inquiry Banks.

Opaque discretionary discounts make product comparisons difficult for prospective borrowers. We observe that the big four banks employ a tailored approach to discretionary discounting. One Inquiry Bank has stated that this enables it to attract and retain borrowers through actions such as offering larger discounts to borrowers who might otherwise switch to another lender, while limiting discounts to those borrowers who are considered unlikely to switch. A proposal on price differentiation put before an internal pricing committee at one Inquiry Bank in June 2015 explained that:

As a large, incumbent player the tiered approach allows [the bank] to derive superior profitability by limiting access to our [best prices] to elastic customers. [Our ‘next best’] prices are generally set in line with competitor’s advertised prices, allowing less elastic customers access to a market competitive price. In both instances higher discounts are given to higher value customers.

Tiered discretions also allow the bank to target the best available discounts to drive new business while minimising the proportion of the existing portfolio that is unnecessarily repriced to a larger discount.

The discretionary discount available to an individual borrower depends on their circumstances. Some of the factors influencing the discounts provided to individual borrowers since 2015 have included:

- the purpose of the loan (owner-occupier or investor), the repayment method (principal and interest or interest only) and the type of loan (standard features or basic features)
- the amount of the loan
- the geographical location of the residential property used as security and/or the borrower
- the borrower’s risk profile, such as the borrower’s ability to repay their mortgage and the amount of the loan compared to the value of the residential property (the loan to value ratio or LVR), and
the Inquiry Bank’s assessment of the value or potential value of the borrower to the bank.

Not all of these factors are (or have been) considerations for all Inquiry Banks and some of them will likely have other considerations. We observe that the Inquiry Banks also assess the above factors differently. For example, they have their own ways of assessing a borrower’s risk profile and they may have different views on how the location of the property used as collateral will affect the discount they offer.

Since the decision criteria for discretionary discounts vary across lenders, borrowers may find it difficult to identify and assess the discounts for which they are eligible. Further, borrowers may be required to lodge a loan application to confirm the discretionary discount that would be available to them or they may be required to supply evidence of another lender’s offer if they want their lender to match or better that offer. These requirements increase the time and effort associated with obtaining accurate interest rate offers, making it more difficult for borrowers to determine the range of effective interest rates available to them.

Borrowers could be deterred from spending this time and effort given the uncertainty over what (if any) discount they will be eligible for. Further, the potential gain for some borrowers may only be a marginal improvement on the advertised discounts available to them. For these borrowers, the investment of time may not be worth that potential benefit.

The actual discount a borrower receives can also be influenced by their ability to negotiate or the knowledge that they can negotiate. We observe that Inquiry Banks are incentivised to only provide the discount needed to win a borrower and do not necessarily offer the largest available discount upfront.

Perhaps as a result of the factors outlined above, borrowers have increasingly turned to mortgage brokers to give them a broader view of the options available across a range of residential mortgage lenders. The recent ASIC Review of mortgage broker remuneration reports that over half of all new residential mortgages are originated through a mortgage broker. While borrowers might assume a broker is offering them independent advice it may not always be the case, as some of the larger mortgage broking businesses are owned by or affiliated with an Inquiry Bank and recent evidence indicates that referrals from these mortgage broking businesses are disproportionately skewed towards the Inquiry Banks that have an ownership interest in them (See Box 1.1).

### 2.2 New borrowers pay lower interest rates than existing borrowers

In recent years lenders have been increasing the discounts offered to their new borrowers (also referred to as the front-book) compared to the discounts they offered in the past. This practice has resulted in new residential mortgage borrowers paying lower interest rates (on average) compared to existing borrowers (also referred to as the back-book). We observe similar outcomes across the big four banks—for example, based on data supplied by the big four banks for 30 June 2015, 30 June 2016 and 30 June 2017, existing borrowers on standard variable interest rate residential mortgages were paying interest rates up to 32 basis points higher (on average) than new borrowers at the same bank (Figure 2.3). The broader trend across residential mortgage lenders, based on the RBA’s analysis of securitised loans, is illustrated in Figure 2.4. This suggests that there would likely be considerable savings available to borrowers who switch mortgage provider.

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We observe that back-book repricing can be a significant means of increasing revenue for the Inquiry Banks. One senior executive at an Inquiry Bank explained to a colleague in an email in October 2015 that ‘back-book repricing has historically allowed NIM [net interest margin] to recover after compression’.
The risk of existing borrowers leaving in response to an increase in interest rates appears to receive varying levels of consideration across the Inquiry Banks. For example, one Inquiry Bank has conducted analysis on how a potential interest rate increase might affect the volume of new borrowers coming to the bank. We have not observed that bank meaningfully analyse the potential for existing borrowers to switch to another lender when deliberating on increasing headline interest rates.

This focus on new borrowers by some Inquiry Banks might be because the risk of existing borrowers leaving is well understood by decision-makers and so not documented in the material reviewed by the ACCC. It could also be as a result of an awareness that the majority of existing borrowers are unlikely to switch in response to a relatively small increase to their interest rate. This is often referred to as ‘consumer stickiness’ or ‘inertia’.

While this issue is not comprehensively addressed in this Interim Report, documents obtained from some Inquiry Banks indicate that they have taken steps to inform themselves on matters such as borrower behaviour, using tools such as market research, data analysis, and short-term trials. A study by one Inquiry Bank into customer refinancing requests found that where an existing borrower requests a discount, the Inquiry Bank only needs to come close to the discount requested in order to retain the borrower. The Inquiry Bank observed in a presentation to its executives in the residential mortgage lending division in June 2015 that ‘where we allowed repricing to occur, customers are price inelastic when the discount offered is close to their requested discount’.

We consider that similar insights may have informed the discounting policies of some Inquiry Banks which favour new borrowers. For example, the policy of one Inquiry Bank is that the discounts available to existing borrowers seeking to renegotiate their interest rate are less than those available to new borrowers.38

2.3 Basic (or ‘no frills’) residential mortgages are not always the cheapest after discounts

The big four banks each offer a basic or ‘no frills’ residential mortgage that does not include all the same add-on features (Box 1.2, Chapter 1) that are available on their standard residential mortgages. For example, ANZ offers a Simplicity PLUS residential mortgage39 and the Commonwealth Bank offers an Economiser residential mortgage40, neither of which allow for the offset account add-on feature available on their respective standard residential mortgages.

Some of the advertising for basic residential mortgages suggests that the borrower is being compensated for a lack of add-on features through a lower headline rate (and sometimes lower fees). For example:

*If you need a variable rate loan but you don’t want to pay for extra features you won’t use, consider ANZ Simplicity PLUS.*

*A home loan with a lower variable interest rate, useful for first home buyers or anyone who doesn’t want to pay for features they won’t use.*

This is confirmed by a comparison of the big four banks’ headline variable interest rates for their standard and basic residential mortgages (Table 2.1); without exception the headline rate for the basic loan is listed as lower than that for the standard loan.

However, contrary to what these headline interest rates suggest, a comparison of the rates actually paid by borrowers as at 30 June 2017 shows that borrowers on basic owner-occupier loans with ANZ and the Commonwealth Bank paid higher average interest rates than borrowers with standard owner-occupier loans once discounts are factored in. This is part of a broader trend across the big four banks

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38 A borrower’s eligibility for a particular discount typically depends on a number of factors, including the borrower’s characteristics and the lender’s policies at the time the discount is sought.
since July 2015 where the average interest rate paid by borrowers has often been higher for basic loans than for standard loans (right panel of Figure 2.5). This has occurred despite the headline interest rates for basic loans being consistently well below those of standard loans (left panel of Figure 2.5). Westpac was an exception to this trend in 2017 (Table 2.1) but not in 2015 and 2016.

The reason for this disparity is the discounts offered by the big four banks on their standard loans. The discounts available on standard variable interest rate loans to owner-occupiers at some big four banks appear to have, from time to time, been sufficient in and of themselves to take the average of the interest rates actually paid by all standard variable rate loan borrowers below the average of the interest rates actually paid by all basic loan borrowers. In addition, we observe that the regular availability of a discretionary discount (in addition to the advertised discount) has further contributed to the degree to which borrowers have paid lower interest rates (on average) for standard loans compared to basic loans. In these circumstances, we consider that the opaque nature of discretionary discounts may be limiting the ability of borrowers to make informed product choices.

Table 2.1 Headline variable interest rates and average interest rates paid on standard and basic residential mortgages of the big four banks—owner-occupier with principal and interest repayments: 30 June 2017*

<table>
<thead>
<tr>
<th></th>
<th>ANZ</th>
<th>Commonwealth Bank</th>
<th>National Australia Bank</th>
<th>Westpac</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard</td>
<td>Basic</td>
<td>Standard</td>
<td>Basic</td>
</tr>
<tr>
<td>Headline variable interest rate</td>
<td>5.20</td>
<td>4.55</td>
<td>5.25</td>
<td>4.79</td>
</tr>
<tr>
<td>Average interest rate paid by borrowers (that is, back-book)</td>
<td>4.18</td>
<td>4.54</td>
<td>4.22</td>
<td>4.78</td>
</tr>
</tbody>
</table>

* This figure is based on data from the big four banks and relates to each bank’s largest standard and basic products by value. The averages reported are value weighted averages. In some cases, the interest rates initially paid by borrowers will be lower than those set out in the table due to advertised discounts that apply for a limited period at the beginning of their loans. Individual products may have different fees (which have not been taken into account here). Those fees will affect any comparison of the overall cost of these products to borrowers. A borrower’s eligibility for a discount typically depends on a number of factors, including the borrower’s characteristics and the lender’s policies at the time the discount is sought.

Source: ACCC analysis of data supplied by the big four banks.

43 A borrower’s eligibility for a loan product, or for a particular discount, typically depends on a number of factors, including the borrower’s characteristics and the lender’s policies at the time the loan is sought. As a result, the interest rates paid by or offered to an individual borrower taking out a standard or basic loan may vary from the historic averages reported here.
Figure 2.5 Headline variable interest rates and average interest rates paid on standard and basic residential mortgages of the big four banks—owner-occupier with principal and interest repayments

This figure is based on data from the big four banks and relates to each bank’s largest standard and basic products by value. The solid purple and blue lines are calculated by the ACCC as simple (or straight) averages across the big four banks of the headline and average interest rates. Note that average rates paid by borrowers were provided by the Inquiry Banks as at the time of each headline rate change. The average rates paid by borrowers reported in the figure are based on an assumption that those average interest rates remained constant between the changes in headline interest rates.

Source: ACCC analysis of data supplied by the big four banks.
3. Key influences on prices and pricing strategies

We observe that since at least July 2015, the achievement of internal performance targets has been an important consideration in the Inquiry Banks’ residential mortgage interest rate decisions, along with prudential requirements (see Chapter 4).

We consider that there are signs of a lack of vigorous price competition between the Inquiry Banks (and the big four banks in particular) which has likely affected residential mortgage interest rates over the same period.

The Inquiry Banks have been concerned about the public reaction to their interest rate decisions. This concern has been a significant factor in the timing of some decisions and how those decisions were explained to the public.

3.1 The role of internal performance targets

An important consideration of the Inquiry Banks in their decisions on residential mortgage interest rates has been achieving the profit and/or revenue related performance targets they have set for themselves. Such targets may apply to the bank as a whole or may be specific to the business unit responsible for residential mortgages.

We observe that, on several occasions since July 2015, individual Inquiry Banks reconsidered their residential mortgage interest rates in light of their expected performance against these targets. For example, concern about a shortfall relative to target was important in decisions by two Inquiry Banks to increase headline variable interest rates in March 2017 (Box 3.1). For both of these banks, higher funding costs among other factors contributed to the shortfall.

Box 3.1 Shortfalls in revenue relative to target prompted two banks to announce interest rate increases in March 2017

The increase in headline interest rates announced in March 2017 by one Inquiry Bank was triggered by a forecast revenue shortfall (relative to target) of $XXX million [confidential]. Some of the factors contributing to the shortfall included increased costs of funding loans (resulting in lower net interest income, which was one source of revenue) and lower lending volumes than planned. By increasing interest rates on its residential mortgage portfolio, the bank expected to boost its revenue by $XXX million [confidential] and so significantly reduce the shortfall.

A different Inquiry Bank identified a revenue shortfall (relative to target) of approximately $XXX million [confidential] for the business unit responsible for its residential mortgages. A mix of reasons were identified internally as the cause of the gap including: write-offs and reduced margins in relation to residential mortgages securitised by the bank and ‘headwinds’ in relation to the bank’s credit card portfolios. Increased funding costs were a lesser factor in causing the shortfall.

That bank was considering how best to address that shortfall (and had already identified $XX million [confidential] worth of additional revenue measures) when the National Australia Bank announced its increase in interest rates on 16 March 2017. The bank considered three options for increasing interest rates following that announcement. It chose the option that was expected to raise the most revenue.

Funding costs pressures in general (the components of which are described in Box 3.2) are one reason why an individual Inquiry Bank may not achieve an internal performance target and were a significant factor in the decision of some Inquiry Banks to ‘hold back’ part of the reduction in the OCR in 2016.

44 Profit related performance targets can take various forms including a return on capital, a return on equity or a net interest margin.
Box 3.2 The components of a bank’s funding costs

There are a number of components to the funding costs of the Inquiry Banks (figure below and Appendix B). Some of these (such as the cost of raising deposits) are more transparent to the outside observer than others (such as the liquidity premium). It is the responsibility of a bank’s treasury unit to combine and transform the various funding costs into the ‘funds transfer price’ (Box B.1, Appendix B). The transfer price is the interest rate charged by the treasury unit for ‘lending’ money to the business unit responsible for providing loans (such as residential mortgages).

A hypothetical example of the components of a bank’s (pre-tax) funding costs

<table>
<thead>
<tr>
<th>Component</th>
<th>Cost of funds</th>
<th>Additional costs</th>
<th>Total funding costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale funding</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity premium</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedging premium</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Term premium</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating and other costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total funding costs</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source:
Ramona Busch and Christoph Memmel, ‘Quantifying the components of the banks’ net interest margin’, Deustche Bundesbank, July 2014.
See the glossary and Appendix B for an explanation of terms used in this box.

To address expected shortfalls against their performance targets, we have observed the Inquiry Banks choosing to increase their headline variable interest rates. Sometimes this was done in combination with other actions to address those expected shortfalls. We consider that Inquiry Banks may favour increasing headline variable interest rates because:

- changes in headline variable interest rates affect both new and existing borrowers (the front-book and back-book)—this means that even small increases in headline variable interest rates can have a significant impact on revenue.
- increases in headline variable interest rates have a more immediate impact on revenue than attracting new borrowers, and
- the majority of existing borrowers may not be very sensitive to small changes in the rates they pay and therefore unlikely to switch in response to a small increase in the headline rate.
Other ways the Inquiry Banks may address shortfalls in performance against their internal targets include changes to fixed interest rates and by reducing discounts. However, unlike increases to the headline variable interest rates, such measures predominantly affect new borrowers and thereby the Inquiry Bank’s ability to win the business of these borrowers. Given the relatively small size of the frontbook compared to the back book, these alternatives generally are less effective at raising revenue.

The Inquiry Banks generally would need to win a significant number (and value) of additional new borrowers to achieve the same revenue as they can generate by increasing their headline variable interest rates. For example, one big four bank estimated that increasing all of its headline variable interest rates by 20 basis points would increase its gross revenue by hundreds of millions of dollars. To raise the same amount of revenue without increasing interest rates, the same bank estimated that it would have needed to write an additional $XX billion [confidential] in new residential mortgages in one year. We note that the total value of new residential mortgage loans written by all lenders in the year to October 2017 was about $400 billion. We consider that this is an important part of the reason why individual Inquiry Banks have chosen to increase headline variable interest rates in response to shortfalls to their internal performance targets, in preference to lowering interest rates to attract new borrowers and thus build volume (and revenue).

An increase in interest rates would be more likely to improve an Inquiry Bank’s revenue if the other banks are expected to also raise their interest rates in a similar manner (for example, this may be the case if all Inquiry Banks face similar cost or regulatory pressures).

### 3.2 Signs of a lack of vigorous price competition

The documents reviewed to date reveal a lack of vigorous price competition between the Inquiry Banks, and the big four banks in particular. The pricing behaviour of each of the Inquiry Banks appears consistent with ‘accommodating’ a shared interest in avoiding disruption of mutually beneficial pricing outcomes, rather than consistently vying for market share by offering the lowest interest rates. For example:

- when setting variable interest rates for their main brands, the big four banks focus largely on each other and do not appear to have had meaningful regard to the pricing decisions of smaller lenders
- the Inquiry Banks did not consistently seek to compete with each other by offering the lowest headline variable interest rates to customers
- during late 2016 and early 2017, two of the big four banks each adopted pricing strategies aimed at reducing discounting in the market even though this was potentially costly for them if the other major banks did not follow their lead.

#### The big four banks are focused on each other with limited regard to smaller lenders

The big four banks have largely focused their attention on each other (including some of their other brands) when making decisions on variable interest rates. Other lenders, of which there are over 100, appear to have rarely been central considerations in their decisions on headline variable interest rates. For example, one big four bank’s home loan pricing strategy paper from March 2015 notes:

> [We] will not compete nationally above the line with the headline pricing of the second tier lenders as this would generate a main bank response and lead the market down.

Other lenders were generally a lesser consideration for the big four banks in their approach to discounting. For example, in around 2016 one of the big four banks provided internal guidance to staff to match any interest rate offer from a big four bank (including one of their other brands) but to only offer rates 10–20 basis points higher than interest rate offers of other lenders.

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The mid-market strategies of the Inquiry Banks

We observe that the Inquiry Banks generally do not seek to compete by consistently offering the lowest headline variable interest rates. Two of the Inquiry Banks aim to maintain a ‘mid-market’ position among the big four banks and not be the lowest priced among the big four. As one of these Inquiry Banks put it:

*A key underpinning objective being to position our [headline variable interest rates] ‘mid’ ranked among major peers in line with our longer term natural market position and compete primarily on the basis of superior product, service and customer experience.*

Each of the other Inquiry Banks generally aim to set their headline variable rates to broadly align with the big four banks.

At a given point in time, one of the Inquiry Banks will have the lowest headline variable interest rate out of all the Inquiry Banks. However, this may be unintentional on the part of that Inquiry Bank. Once a bank is in this position it may have to hold it for several months until another ‘trigger event’ provides it with an opportunity to increase its headline rates. We observe that the Inquiry Banks try to avoid the bad publicity and political scrutiny that accompanies interest rate increases that cannot be clearly linked to external cost and regulatory pressures. This is explained further in Section 3.3.

While there may be reluctance on the part of some Inquiry Banks to reduce headline variable interest rates to avoid reducing profits, there have also been limits from time-to-time on their ability to reduce interest rates. Those limits have included the effects of prudential benchmarks for investor and interest only lending (Chapter 4).

Attempts by two of the big four banks to reduce discounting in the market

During late 2016 and early 2017, two of the big four banks separately decided to take action to reduce the size of the discounts they were offering borrowers and lead rivals to follow suit.

An employee of one bank explained that the strategy in reducing discounts was *‘to go hard early so the market would follow’*. An employee of the other bank described, internally, its objective as to *‘deliver a reduction in broker sales and reduce the perception that [the bank] is driving down the price in market with high discounting’.*

While the two banks decided to take action to reduce discounting independently, they became aware of each other’s actions over time. For example, an executive of one bank noted in September 2016 that *[rival bank] have officially followed us by reducing discretionary discounts*. The other bank noted in November 2016 that its efforts to lead a decrease in *‘industry discounting’* were *‘not supported by majors at this stage’*. The bank also noted a decline in the volume of loan applications it was receiving in the early months of its campaign.

By January 2017, however, one bank had observed a decline in the extent of discounting among the big four banks. In March 2017, an employee of the other bank observed:

*It is obvious that we have driven a material decrease in market discounting especially in the high end loan sizes. Agree that some Majors particularly [rival banks] are still going to [over 100] bps [basis points], however this appears to be more targeted as opposed to blanket pricing that was observed at the peak of market discount ..*

We observe that, by early 2017, the two banks considered they achieved their intention to encourage their competitors to follow suit for a time.
A big four bank’s ‘accommodating’ approach to pricing in order to avoid disrupting mutually beneficial pricing outcomes is reflected in some of the language used when its executives contemplate changes to interest rates. For example, in a November 2015 internal presentation, the bank described one of its residential mortgage pricing principles as:

*Seek to improve margin or minimise margin decline in decreasing rate environments by encouraging rational market conduct.*

In considering how to respond to what was considered to be aggressive pricing by another big four bank, an executive at the bank noted internally in September 2015:

*We do not want to counter with aggressive above the line offers as we want to maintain orderly market conduct.*

In another instance in October 2015, part of the internal recommendation from a senior executive at the bank to increase interest rates in response to another big four bank rival’s unexpected increase included:

*.. I will be seeking your approval to increase our SVR [standard variable rate] .. It’s fair to say that we have arrived at this recommendation reluctantly. The financial rationale is compelling—the gross revenue benefit is $XXXm [confidential] and allowing for some additional re-pricing of the back-book and front book pricing to maintain flow, we expect to generate net incremental earnings of $XXX-$XXXm [confidential], of which [more than half] will be realised in FY16. To generate the same incremental revenue we would need to write an additional $XXb [confidential] in volume. However, the absolute size of the increase is very large and [rival bank]’s move is arrogant and reckless. It is very tempting to leave them there .. We should debate timing tomorrow, I am a firm believer in industry conduct but we could justifiably wait until the RBA decision in November.*

In the analysis supporting this recommendation, the same senior executive noted that if the bank left its headline variable interest rates on hold rather than increasing them in response to their rival’s increase:

*It would also mark an historic departure from industry conduct that would make future responses to price changes much harder to predict.*

The reference to ‘historic departure’ in this quote suggests that ‘industry conduct’ has been an understood term within the bank over a period of time to at least 2015. The quote also suggests that such conduct makes it easier for the bank to predict how its competitors may respond to interest rate changes.

### 3.3 The public’s reaction has been a constraint on pricing

The Inquiry Banks are acutely aware of the reputational impact of the timing of their decisions and announcements on interest rates. Changing headline variable interest rates without a reason that can be easily understood by the general public (such as a change in the OCR or the imposition of a regulatory requirement) has, in the words of a draft internal presentation at one Inquiry Bank, the *potential to attract a lot more attention and focus*.\(^{46}\) We observe that there have been times when these concerns have led some of the Inquiry Banks to temper decisions on interest rates and fees outside trigger events such as an OCR change or a rate change by a big four bank. For example, a decision to raise interest rates was deferred by one Inquiry Bank when a senior executive considered the ‘reputational impact [would] be too high’. Concerns at another Inquiry Bank about adverse publicity saw a proposal to increase fees substantially amended from the initial recommendation. In another example, an executive at one Inquiry Bank made the following preliminary observation in an email discussion with

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46. This observation was made in an internal presentation on residential mortgage pricing options during 2016.
other executives at the bank in relation to a recommended increase in headline variable interest rates (although ultimately that bank did opt to reprice its back-book):

Personally, I don’t think that we have made the case for repricing the back-book. I am also very conscious that we suspect that many first home buyers, unable to afford owner occupier homes, have instead have [sic] bought an investment property to take advantage of the low interest rates, tax break and keep a foot on the housing market. I don’t think that this would play well from a customer or community standpoint.

These examples suggest that expectations of strong public reaction have acted as a constraint on pricing decisions and that without this reaction residential mortgage interest rates could have been higher and/or increases could have been introduced earlier than they were.

The timing of interest rate announcements

The Inquiry Banks seemed to have found it easier to manage the adverse media attention and public criticism that can follow a decision to increase interest rates (or ‘hold back’ part of a reduction in the OCR) if they made their announcement soon after a big four bank had announced its intention to increase interest rates (or hold back part of an OCR reduction).

For example, internal documents from three of the Inquiry Banks provide:

- If no one else goes and we move, [our] name and reputation will be up in lights in every media outlet, radio, TV news/financial broadcast and with politicians. .. my recommendation is.. let others distract and get all the media and political pressure.

- While the financial case for increasing headline SVR [standard variable rate] is compelling, a fast follower approach is recommended [original emphasis] given reputational, market share and momentum considerations.

- In the event of an RBA move, if we do want to hold some of the rate cut back, we would be better off not being the first mover to reduce the reputational impact (slightly).

We observe that the Inquiry Banks have also been quick to follow a change in headline interest rates by a big four bank. When a big four bank has announced its decision to increase interest rates (or hold back part of a reduction in the OCR), it appears that, in most cases, the Inquiry Banks have not attempted to win business by leaving their own interest rates ‘on hold’ or materially undercutting rivals.

The fast-follower approach is evident in the time the big four banks took to respond to each other’s headline variable interest rate announcements. Since July 2015, decisions on how to respond to a big four bank’s headline variable interest rate increases were made in a matter of days and sometimes on the same day.

In contrast, we observe that the timeframes for coming to a decision on headline variable interest rates sometimes extended into many weeks where a big four bank expected to be the first to move. Over that time, pricing proposals could be discussed and refined a number of times by senior bank staff including the Chief Executive Officer. It appears that much of this deliberation was compressed when the big four banks wanted to react quickly to a big four bank’s interest rate announcement.

There were six times over the review period when the big four banks announced changes to their headline interest rates in close succession. Four of these changes resulted in increases in headline variable interest rates and two were decreases.

The two interest rate decreases announced by the big four banks were in response to a decrease in the OCR (May 2016 and August 2016). On both occasions, all four banks made their announcement on interest rates on the same day as the RBA’s OCR decision.

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47 Macquarie Bank has been excluded from the discussion of announcement dates because it does not publish media releases regarding interest rate changes.

48 Those changes were announced in July 2015, October 2015, May 2016, August 2016, December 2016 and March 2017.
The four increases were each in response to an initial announcement by one of the big four banks. In each instance, the other three banks made their own announcements on interest rates within 10 calendar days of the first bank’s announcement. (Figure 3.1 (a–d)). In some cases the second bank’s announcement followed the first by one day, whereas other cases involved a longer lag time. For example, when Westpac announced that it would increase its variable rates in October 2015, the second bank to make an announcement was Commonwealth Bank 9 days later. ANZ and National Australia Bank then announced changes the following day.

Figure 3.1(a) Big four banks fast-following on rival’s headline interest rate increases: July 2015

* This figure covers headline interest rates on variable residential mortgage products for investors making interest only repayments. The crosses indicate the date on which a bank has announced an interest rate change prior to the date on which the change took effect. National Australia Bank announced interest rate changes on 27 July 2015 which took effect in two stages—10 August 2015 for new interest only loans and 10 September 2015 for existing loans. The figure depicts the latter.

Abbreviations: INV investor, IOL Interest only (repayment) loans.

Sources:


Figure 3.1(b) Big four banks fast-following on rival’s headline interest rate increases: October 2015*

Response to change announced October 2015 (OO P&I)

* This figure covers headline interest rates on variable residential mortgage products for owner-occupiers making principal and interest repayments. The crosses indicate the date on which a bank has announced an interest rate change prior to the date on which the change took effect.

Abbreviations: OO owner-occupier, P&I principal and interest (repayment) loans.

Sources:


Figure 3.1(c) Big four banks fast-following on rival’s headline interest rate increases: December 2016

*This figure covers headline interest rates on variable residential mortgage products for investors making interest only repayments. The crosses indicate the date on which a bank has announced an interest rate change prior to the date on which the change took effect.

Abbreviations: INV investor, IOL Interest only (repayment) loans.

Sources:


OCR decisions are a trigger for interest rate changes by the Inquiry Banks

Some Inquiry Banks have at times absorbed months of rising funding and/or other costs as they waited for an event, such as a change in the OCR or an increase by a competitor, to act as a trigger for a change in their interest rates. For example, in relation to deliberations on an increase in headline variable interest rates, one Inquiry Bank noted in an internal draft presentation:

*While the financial case for increasing headline SVR [standard variable rate] is compelling… Any rate changes would also be preferably linked to an RBA rate cut [sic].*

The big four banks have stated publicly that the OCR is not the only factor triggering banks to adjust interest rates for residential mortgages, yet we have observed that they have made headline interest rate changes immediately after the RBA changes the OCR. This is likely to be because the public has come to expect an announcement on headline interest rates following a change in the OCR by the RBA and this provides some public relations ‘cover’ for their resultant decisions. We consider it is also likely that the Inquiry Banks expect each other to change their headline variable interest rates in response to a change in the OCR.
Public messaging on rate changes do not always tell the full story

Issuing a media release has become part of the big four banks’ processes for announcing and justifying a change in headline variable interest rates. While there are often multiple reasons why a bank will have chosen to change its interest rates, we consider that their media releases have sometimes been selective about the factors influencing the decision. We consider that the media releases of some big four banks during 2015 are examples of this selective reporting.

All of the big four banks attributed the interest rate increases announced in July 2015 to APRA’s limits on investor lending. Extracts from those announcements, in the order they were made, are as follows:

- ANZ today announced interest rates for residential investment property loans will increase to manage investor lending growth targets and in response to changing market conditions.50

- Commonwealth Bank has today taken further steps to moderate investor home loan growth and to manage its portfolio to address the Australian Prudential Regulation Authority’s concerns regarding investment home lending growth.51

- The changes are in response to industry concerns about the pace of investor growth, and NAB’s focus on delivering responsible lending practices into the Australian housing market.52

- Today’s announcement is an important step in ensuring that Westpac meets APRA’s benchmark that investor credit growth should be no more than 10 per cent.53

While one Inquiry Bank’s decision to increase headline variable interest rates was prompted by APRA’s benchmark, the expected ‘substantial economic benefit’ of hundreds of millions of dollars in additional revenue was an important consideration in its decision. For another Inquiry Bank, APRA’s growth limits were considered. However, for that bank the increase in headline variable interest rates also provided an opportunity to meet their performance targets following APRA’s announcement that more regulatory capital would need to be held against residential mortgage portfolios (Chapter 4). These reasons were not mentioned in the media releases of those banks.

Subsequent interest rate increases announced by the big four banks in October 2015 were attributed to APRA’s July 2015 announcement that those banks would be required to hold more regulatory capital.54 However, these capital requirements were only one of the matters considered by some of the big four banks in making their decisions to increase interest rates.


For example, in October 2015, two senior executives at one big four bank had an email discussion about an increase in the headline interest rate. Consideration of the matter appears to have been prompted by a recent interest rate increase by another big four bank. To one senior executive, the arguments in favour of an increase included responding to the other bank’s recent headline interest rate increase and the potential to generate hundreds of millions of dollars in additional revenue by matching (or nearly matching) that increase. The need to maintain ‘industry conduct’ (Section 3.2) also formed part of the basis for the recommendation to increase headline interest rates. The cost of holding additional regulatory capital was also one of the considerations forming the basis of the recommendation to increase interest rates.

In response, the other senior executive went on to outline a proposed media release focussing on the additional capital the bank was required to hold, the cost of that capital and how that cost needs to be shared by both bank customers and shareholders. While the bank ultimately increased its headline variable rates by less than the initial recommendation, the bank’s media release was prepared along these lines and contained no mention of the bank’s other considerations or drivers of its final decision.
4. The effects of macroprudential and prudential measures on interest rates

APRA has broad powers over ADIs to ensure they meet their obligations to depositors and to protect the stability of the financial system. Since December 2014, APRA has implemented a number of new and amended macroprudential and prudential measures to deliver against these objectives. This chapter explores how the Inquiry Banks’ reactions to these key macroprudential and prudential measures have had a continuing influence on interest rates for residential mortgages.

4.1 The effect of prudential benchmarks on the Inquiry Banks’ interest rates and lending activities

Over the course of 2014–2017, APRA and the Council of Financial Regulators judged that current and emerging risks in the housing sector required a targeted regulatory response. That response included APRA’s introduction of:

- an annual 10 per cent growth benchmark for residential mortgage lending to investors (announced in December 2014)\(^55\)
- a 30 per cent benchmark on the share of new residential mortgage lending to borrowers making interest only repayments (announced in March 2017).\(^56\)

Prudential benchmarks for residential mortgage lending to investors

APRA wrote to all ADIs in December 2014 and advised that:

... annual investor credit growth materially above a benchmark of 10 per cent will be an important risk indicator that supervisors will take into account...\(^57\)

While APRA said its benchmark was not intended to be a hard limit and was intended as a temporary measure, it also noted that ADIs with ‘investor loan growth materially above this rate will likely result in a supervisory response’\(^58\) which potentially could include additional capital requirements.\(^59\) APRA reinforced the benchmark, and the potential for additional capital requirements should it be breached, in another letter to ADIs in March 2017.\(^60\)

The Inquiry Banks initially responded to APRA’s benchmark by implementing one or more of the following to reduce the volume of new investor loans they were writing:

- reducing discretionary discounts available on residential mortgages to investor borrowers
- reducing marketing and/or incentives to investor borrowers
- removing fee waivers on some residential mortgages for investor borrowers
- tightening loan approval criteria for investor borrowers.

Despite these measures, some of the Inquiry Banks found that in mid-2015 they were either exceeding APRA’s benchmark growth rate for investor lending or were likely to. As a result, these banks decided to increase their headline interest rates for investor borrowers to reduce demand and ensure their total investor borrower portfolio did not grow by more than the 10 per cent benchmark.

For at least one of the Inquiry Banks, increasing headline variable interest rates for investor borrowers was one of a number of possible responses. The bank noted in an internal July 2015 pricing strategy

\(^{55}\) Australian Prudential Regulation Authority, Letter to all ADIs: Reinforcing sound residential mortgage lending practices, APRA, Sydney, December 2014.

\(^{56}\) Australian Prudential Regulation Authority, Letter to all ADIs: Further measures to reinforce sound residential mortgage lending practices, APRA, Sydney, March 2017.

\(^{57}\) APRA, Reinforcing sound residential mortgage lending practices, December 2014, p. 2.

\(^{58}\) ibid.


\(^{60}\) APRA, Further measures to reinforce sound residential mortgage lending practices, March 2017, p. 1.
discussion paper that both pricing and non-pricing measures were available to assist the bank in reducing the flow of investor loans:

.. we are faced with a choice of either following our competitors and making further significant changes to credit policies (e.g. introducing a maximum LVR of 80% like [another Inquiry Bank]) or repricing investor loans, which will necessarily include both [new borrowers] and back-book loans (from a systems perspective our ability to further restrict front-book pricing is limited to XX bps [confidential]). Both measures are expected to be effective in reducing flow, however repricing brings with it substantial economic benefit (albeit also reputational risks).

The expected ‘substantial economic benefit’ referred to by this Inquiry Bank was annual revenue gains of over $XXX million [confidential]. Some of this Inquiry Bank’s other considerations in deciding to increase its headline variable interest rate for investor loans included:

- Competitors cannot ‘harvest’ investor volume, so are likely to follow [the] reprice..
- [it] preserves options to make further changes to credit policy ..

APRA’s growth limits were also a consideration in another Inquiry Bank’s decision to increase its headline variable interest rates for investor loans in July 2015. However, for that bank the increase in headline variable interest rates also provided an opportunity to meet their performance targets following APRA’s announcement that more regulatory capital would need to be held against residential mortgage portfolios.

Once some Inquiry Banks began to increase their interest rates for investor loans, some of the other Inquiry Banks stated that they needed to follow those increases otherwise they would risk being inundated with new loans that, if approved, would put them in breach of APRA’s benchmark. For example, an employee at one Inquiry Bank noted in an email to a senior executive in December 2016:

.. we need to take some action to slow down the flow [of new loans]. especially after the [other Inquiry Banks'] moves, if we do nothing the current price differential will flood us with volume and cause us to breach.

**Prudential benchmarks for residential mortgages with interest only repayments**

APRA wrote to all ADIs again in March 2017 and noted that the risks within the housing market had not lessened. It also put forward further measures to strengthen residential mortgage lending standards. As part of those measures, APRA said that it expected ADIs to ‘limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending’.61

Somewhat similarly to the regulatory benchmarks for investor lending, the Inquiry Banks planned to implement (or had already implemented) a range of measures including one or more of the following:

- restricting the availability of interest only repayments on higher risk loans (such as those with high loan to value ratios or high loan to income ratios)
- restricting interest only lending to some groups of applicants (for example, one of the Inquiry Banks limited the availability of interest only loans to non-residents)
- increasing interest rates on fixed rate interest only loans
- reducing the discretionary discounts available to borrowers of interest only loans
- reducing the interest only period available on some loans
- placing restrictions on new customers with principal and interest loans from switching to interest only loans.

The Inquiry Banks each announced and implemented increases in their headline variable interest rates affecting both new and existing interest only loans in mid-2017. The big four banks each publicly attributed these increases to APRA’s interest only cap.62

**Prudential benchmarks have led to increases in some interest rates**

In response to APRA’s caps on investor and interest only lending, all of the Inquiry Banks began creating new classes of headline variable interest rates from July 2015 to better target the loans subject to APRA’s growth limits (Figure 4.1). It took until mid-2017 for all of the Inquiry Banks to have differential headline interest rates for:

- owner-occupiers making principal and interest repayments
- owner-occupiers making interest only repayments
- investors making principal and interest repayments
- investors making interest only repayments.

**Figure 4.1 Headline variable interest rates of the big four banks for standard loans***

![Graph showing variable reference interest rates](image)

*Interest rates advertised by the big four banks during the period 1 January 2014 to 1 November 2017.

Source: C Kent, *Some Innovative Mortgage data*, RBA, Sydney, 14 August 2017, Graph 1 (Updated data supplied by the RBA)

By July 2017, the headline variable interest rate for investor borrowers making interest only repayments was up to 110 basis points higher than for owner-occupiers making principal and interest repayments (Table 4.1).
Table 4.1 Headline variable interest rates for standard residential mortgages: Inquiry Banks (1 July 2017)

<table>
<thead>
<tr>
<th>Borrower type</th>
<th>Owner-occupier</th>
<th>Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and interest</td>
<td>5.20%–5.35%</td>
<td>5.79%–5.92%</td>
</tr>
<tr>
<td>Interest only</td>
<td>5.35%–5.83%</td>
<td>5.94%–6.30%</td>
</tr>
</tbody>
</table>

Source: ACCC analysis of publicly available data.

**Prudential benchmarks may be reducing price competition among ADIs for investor and interest only mortgages**

The Inquiry Banks, and presumably other ADIs, have at times been concerned about complying with APRA’s growth benchmarks for investors and interest only loans. In practice, this would likely have resulted in some Inquiry Banks being reluctant to set interest rates for these loans below the interest rates of their competitors.

Further, APRA’s benchmarks (among other reasons) have also resulted in some Inquiry Banks (and other ADIs) largely matching increases by competitors to headline interest rates for investor and interest only loans. For example, the Inquiry Banks increased their headline variable interest rates for investors making interest only repayments by 25–36 basis points through early to mid-2017. The benchmarks may also have given some Inquiry Banks confidence (at least initially) to increase interest rates in the knowledge that competitors will follow those increases (as noted above in relation to the limits on investor lending).

Overall, APRA’s prudential benchmarks have impacted the scope for ADIs to compete on price for residential mortgages for investor and interest only borrowers as any offer of interest rates below those available from other lenders may attract too many new borrowers and put the ADI at risk of non-compliance. This is apparent, for example, in the experience of another brand of an Inquiry Bank that decided in early 2016 to advertise ‘special rates’ to attract investor borrowers. By mid-2016, the other brand noted in an internal pricing committee paper that:

> The current investor special advertised .. will be withdrawn. This will ensure that the APRA growth cap will not be breached in September..

> Investor volume will continue to be monitored weekly to ensure the Cap is not breached.

APRA has noted that the Inquiry Banks’ (and most other ADIs’) respective shares of new residential mortgages have remained almost unchanged since its benchmarks were implemented.63

### 4.2 The effect of prudential regulation on funding costs

APRA ensures that ADIs hold minimum levels of capital and liquid assets as part of how those ADIs manage their credit and liquidity risks (Box 4.1). Some of these requirements, such as the Liquidity Coverage Ratio and Net Stable Funding Ratio (Box 4.1), have affected the interest rates paid on deposits by the Inquiry Banks since July 2015 (Appendix B) and, in turn, the funding costs for residential mortgages. Some banks have publicly attributed particular increases in their headline rates during 2015 to the increases in the minimum level of regulatory capital that APRA required them to hold.

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Box 4.1 Prudential requirements for the management of credit risks and liquidity risks

**Prudential requirements for the management of credit risks**

APRA requires ADIs to hold a minimum level of regulatory capital based on the credit risk of their loan portfolios. The level of regulatory capital to be held is determined by an ADI’s risk weighted assets—high risk loans receive a greater weighting in the assessment process and result in an ADI needing to hold more regulatory capital than it would for lower risk loans. There are two approaches to risk weighting for credit risk exposures: the standardised approach and the internal ratings based (IRB) approach.

The majority of ADIs use the standardised approach, which is the default approach. Under the standardised approach, APRA prescribes fixed risk weights for different types of loans. ADIs require APRA’s approval to use the IRB approach. Once approved, an ADI may use its internal modelling to determine the risk weights (subject to various constraints and APRA’s review). Risk weights applied for mortgage exposures under the IRB approach are, on average, lower than those under the standardised approach.

At present, the only ADIs accredited by APRA to use the IRB approach are ANZ, Commonwealth Bank, Macquarie Bank, National Australia Bank and Westpac. While these are the same banks to which the Major Bank Levy applies, their liability for the Major Bank Levy and accreditation to use the IRB approach are unrelated.

**Prudential requirements for the management of liquidity risks**

APRA requires ADIs to maintain an adequate level of liquid assets to meet its obligations to depositors and bondholders (among others) as they fall due. In recent years, APRA has implemented two new liquidity requirements that apply to the larger and more complex ADIs (including the Inquiry Banks).

The first is the Liquidity Coverage Ratio, which took effect from 1 January 2015. The Liquidity Coverage Ratio requires ADIs to hold enough high quality liquid assets to cover expected cash outflows during a 30 day stress scenario of depositors being more likely to call on their funds, and when rolling over wholesale debt is more difficult.

The second is the Net Stable Funding Ratio, which took effect from 1 January 2018 (the final prudential standard giving effect to the Net Stable Funding Ratio was issued on 20 December 2016). The effect of the Net Stable Funding Ratio has been to encourage ADIs to fund their lending activities with more stable sources of funding.

APRA announced the need for ADIs to hold additional regulatory capital on 20 July 2015. The announcement affected all five Inquiry Banks and took effect from 1 July 2016 when these banks were required to increase the average risk weight on their Australian residential mortgage portfolios to at least 25 per cent from an average of about 16 per cent previously. The big four banks collectively raised about $20 billion in new equity in advance of the measure becoming effective to ensure compliance with the new requirement.

The big four banks’ capital raising resulted in downward pressure on their expected returns on equity (and similar performance targets). It appears that some of the big four banks saw increasing headline variable interest rates as a way to increase revenue and meet performance targets (Section 3.1).

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65 Tim Atkin and Belinda Cheung, ‘How have Australian banks responded to tighter capital and liquidity requirements?’, RBA, Sydney, June 2017, pp. 41–45.
66 Australian Prudential Regulation Authority, APRA releases final revised prudential standard on liquidity for the Net Stable Funding Ratio, media release, APRA, Sydney, 20 December.
67 Australian Prudential Regulation Authority, APRA increases capital adequacy requirements for residential mortgage exposures under the internal ratings-based approach, media release, APRA, Sydney, 20 July 2015.
68 Atkin and Cheung, p. 43.
5. The Major Bank Levy

As at November 2017, the Inquiry Banks have stated that no specific decisions have been made to adjust residential mortgage prices in response to the Major Bank Levy. This chapter summarises our observations on how the Inquiry Banks have considered the Major Bank Levy up until November 2017. The ACCC’s final report will further explore the Inquiry Banks’ response to the Major Bank Levy.

5.1 About the Major Bank Levy

The Major Bank Levy came into effect on 24 June 2017 with the commencement of the Major Bank Levy Act 2017 (Cth). The Major Bank Levy applies from 1 July 2017 to ADIs whose total liabilities exceed the levy threshold of $100 billion in any quarter. ANZ, Commonwealth Bank, Macquarie Bank, National Australia Bank and Westpac have been subject to the Major Bank Levy since it commenced. The first instalment is due to be paid by 21 March 2018.

The Major Bank Levy is applied at a rate of 0.015 per cent of the applicable liabilities each quarter (0.06 per cent annually). The applicable liabilities are an ADI’s total liabilities less exclusions such as deposits protected by the Financial Claims Scheme, certain debt instruments that qualify as regulatory capital and the balances in the Exchange Settlement Account with the RBA.

Financial impact of the Major Bank Levy

The big four banks estimate that the combined (after tax) cost of the Major Bank Levy to them will be in the order of $1 billion annually (see Table 5.1). Reflecting its comparatively smaller size, Macquarie Bank has forecast that the Major Bank Levy will cost it approximately $66 million annually before tax.

Table 5.1: Forecast cost of the Major Bank Levy for the big four banks as at May 2017

<table>
<thead>
<tr>
<th>Annual after tax cost of the Major Bank Levy</th>
<th>$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANZ</td>
<td>240</td>
</tr>
<tr>
<td>Commonwealth Bank</td>
<td>220</td>
</tr>
<tr>
<td>National Australia Bank</td>
<td>245</td>
</tr>
<tr>
<td>Westpac</td>
<td>260</td>
</tr>
</tbody>
</table>

Sources:
Australia and New Zealand Banking Group Limited, Update on the impact of the Australian Government’s proposed bank tax, media release, ANZ, Melbourne, 22 May 2017.

The Inquiry Banks have consulted with each other on how the Major Bank Levy would be reported in their respective financial statements. After that consultation, the consensus view appeared to be that they will treat the cost of the Major Bank Levy as an interest expense (or funding cost) in their financial statements rather than an operating expense.

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69 The Major Bank Levy threshold is indexed to grow in line with Australia’s gross nominal gross domestic product.
70 The first instalment of the Major Bank Levy (for the quarter ending 30 September 2017) is due to be paid by 21 March 2018 as is the second instalment (for the quarter ending 31 December 2017). From that date onward, instalments of the Major Bank Levy will generally be due by the twenty-first day of the third month after the end of the quarter.
71 The deposits protected under the scheme are those up to $250 000 for each account holder at each ADI.
The effect of this accounting treatment is evident in the 2017 annual reports of some Inquiry Banks. For example, Westpac and National Australia Bank have said that the Major Bank Levy decreased each bank’s net interest margin by 1 basis point over the year to 30 September 2017. ANZ and Commonwealth Bank have also said that the Major Bank Levy impacted their net interest margin.

5.2 Decisions made by the Inquiry Banks

Public impact of Major Bank Levy decisions and the ACCC’s Inquiry

It appears that the Inquiry Banks are very aware of the potential political and public impacts of their decisions on how to deal with the Major Bank Levy. For example, one Inquiry Bank in weighing up its options said in a board paper that:

> In considering our final approach we will also take into account key reputational risks associated with the various courses of action. In the current uncertain and somewhat volatile political environment, it is important that we seek to mitigate risk of further government intervention.

The Inquiry Banks also appear to be aware of the ACCC’s Inquiry and the scrutiny this will bring particularly to pricing decisions. An executive at another Inquiry Bank noted internally that:

> The ACCC will be scrutinising the bank’s actions with regard to repricing home loans in light of the levy.

Allocating the cost of the Major Bank Levy internally

Since the Major Bank Levy was announced, the Inquiry Banks have devoted resources and attention to considering its impact on their businesses, and to considering how to deal with its cost. Discussion about the impact of the Major Bank Levy has taken place at senior levels of the banks. Decision making has or will involve one or both of the Chief Executive Officer and Chief Financial Officer of each bank as well as drawing on the expertise of relevant committees and divisions such as the banks’ asset and liabilities committees and treasury units.

Some of the Inquiry Banks have decided that their funds transfer pricing mechanism (see Appendix B) will be used to transmit the cost of the Major Bank Levy to relevant business units and divisions. Some of the Inquiry Banks allocating the cost of the Major Bank Levy through their funds transfer pricing mechanism as at late 2017 were nevertheless allocating the cost at a central business unit level and were not allocating the cost at a product level. One Inquiry Bank said in a draft board paper (in the context of apportioning the cost of the Major Bank Levy to divisions based on relevant liabilities) that:

> We also plan to allocate the costs to the division level only (ie not to individual businesses or products). We see this as a way of managing the ACCC risk on pricing.

Impact on residential mortgage prices

As at November 2017, the Inquiry Banks have stated that no specific decisions have been made to adjust residential mortgage prices in response to the Major Bank Levy. Further, there have been no changes to headline variable interest rates announced by the Inquiry Banks for the period 1 July 2017 (when the Major Bank Levy commenced) to November 2017. While the Inquiry Banks announced changes to headline variable interest rates in June 2017, they said those increases were not in response to the Major Bank Levy. However, this does not necessarily mean that the Inquiry Banks have not changed prices for other products in response to the Major Bank Levy. Employees from one Inquiry Bank observed in internal emails in November 2017 that:

> Regarding the pricing landscape, there is evidence to suggest that the Australian majors have repriced non-transactional institutional deposits, however we have not seen evidence of repriced lending products. It is important to note that the evidence regarding loan pricing is likely to be
We will be seeking further information from the Inquiry Banks on the pass through of the cost of the Major Bank Levy as the Inquiry progresses.

Consideration of stakeholders who may bear the cost of the Major Bank Levy

Based on the material provided to it, the ACCC has observed that the following possible options were considered, or are to be explored further, by one or more of the Inquiry Banks for recovery of the Major Bank Levy:

- there be no explicit recovery of the Major Bank Levy with shareholders bearing the cost through a reduction in dividend
- a mix of stakeholders could potentially bear the cost of the Major Bank Levy. Stakeholders considered include customers (including mortgage customers, depositors and businesses), shareholders, staff and suppliers. Options considered to pass on the cost of the Major Bank Levy to stakeholders include repricing for mortgage and business lending, deposit repricing and/or reduced discounting, reducing upfront mortgage broker commissions and absorbing the cost of the levy in cash earnings and reduced dividends.
- one Inquiry Bank considered different stakeholders bearing a different share of the cost over time. That bank considered options where, in the 2017 financial year, shareholders would bear the initial cost of the Major Bank Levy, followed by customers and suppliers beginning to bear the cost later, including at a time that is after the conclusion of the ACCC’s inquiry.

The ACCC will issue a final report after 30 June 2018 by which time the Inquiry Banks will have paid at least three quarterly instalments of the Major Bank Levy. In the meantime, the ACCC will continue to monitor the Inquiry Banks’ response to the Major Bank Levy, including any changes to their residential mortgage product prices.
Appendix A. Direction to the ACCC

Mr Rod Sims
Chairman
Australian Competition and Consumer Commission
GPO Box 3131
CANBERRA ACT 2601

Dear Mr Sims,

I am writing to advise you that I have issued a direction under section 95H of the Competition and Consumer Act 2010 to the Australian Competition and Consumer Commission (ACCC) to inquire into prices charged or proposed to be charged by Authorised Deposit-taking Institutions (ADIs) affected by the Major Bank Levy in relation to the provision of residential mortgage products in the banking industry in Australia from 9 May 2017 until 30 June 2018.

The direction provides for the ACCC to report to me and provide information to the market as it deems appropriate, with a final report to be delivered at the conclusion of the inquiry.

I note that I would be particularly interested in receiving an update from the ACCC if it begins to find any evidence of relevant ADIs passing on the costs associated with the Major Bank Levy to their residential mortgage product customers.

It is essential that this direction is not released publicly until 7:30 pm on 9 May 2017.

A copy of the direction is enclosed for your convenience.

Yours sincerely,

The Hon Scott Morrison MP
9/5/2017

Parliament House Canberra ACT 2600 Australia
Telephone: 61 2 6277 7340 | Facsimile: 61 2 6273 3420
PRICE INQUIRY INTO RESIDENTIAL MORTGAGE PRODUCTS

1. the Hon Scott Morrison MP, Treasurer, pursuant to section 95H of the Competition and Consumer Act 2010, hereby direct:

1. the Australian Competition and Consumer Commission (ACCC) to inquire into prices charged or proposed to be charged by Authorised Deposit-taking Institutions affected by the Major Bank Levy in relation to the provision of residential mortgage products in the banking industry in Australia from 9 May 2017 until 30 June 2018;

2. the ACCC is to have regard to the Government’s view that banks need to fully and transparently account for their decisions, and hence how they balance the needs of borrowers, savers, shareholders and the wider community;

3. the Inquiry is not to be held in relation to the supply of goods or services by particular persons; and

4. the ACCC to report to me on its inquiry in paragraph (1) and provide information to the market as it deems appropriate, with a final report to be delivered to me at the conclusion of the inquiry.

DATED THIS 9 DAY OF MAY 2017

The Hon Scott Morrison MP
TREASURER
Appendix B. Funding the Inquiry Banks’ residential mortgage lending

The traditional core of a banking business is accepting deposits and using those funds to make loans. ADIs make their profits by charging their borrowers a higher interest rate than they pay to depositors. However, deposits are not the only source of funds for the loans that ADIs make and these other sources of funds can be more costly than deposits. There are also risks associated with acquiring different sources of funding, for which ADIs seek compensation for bearing and managing.

This appendix explains developments in these areas over the period from July 2015 to June 2017 that affected residential mortgage interest rates. The impact of the Major Bank Levy on residential mortgage interest rates is discussed in Chapter 5.

The composition and cost of funding sources

Residential mortgage lending is just one of the lending activities of the Inquiry Banks. The Inquiry Banks do not source funding for each loan, or each type of loan, individually. Rather, the treasury unit of each bank (Box B.1) pools funds from different sources. As a result, the cost of funding residential mortgages cannot be isolated from a bank’s cost of funding its broader lending activities. The treasury unit then allocates that funding internally across different types of loans.

Box B.1 The role and functions of a treasury unit

The treasury unit essentially operates as a ‘bank within a bank’, and sits separate to a bank’s lending and deposit-taking business units. Banks also generally govern the treasury separately: the Chief Financial Officer (or equivalent position) is usually responsible for the treasury, whereas lending and deposits-taking business units will generally report to executives responsible for the bank’s retail operations.

Treasury units ‘borrow’ funds raised by a bank’s deposit-taking business units, raises wholesale funding itself, and then ‘lend’ these funds to business units that write loans. Like a bank, the treasury will pay the bank’s deposit taking units an interest rate for the funds raised (known as a ‘transfer price’), and charge another interest rate (another transfer price) on the funds that it lends to units that write loans. Given the transfer prices that they receive, the business units will then look to maximise their profits on their own operations through the interest rates and fees that they offer to customers.

Treasury units are responsible for setting transfer prices and they use those prices to manage the funding risks within their respective banks. These risks particularly arise because loans have much longer terms (up to 30 years) than funding sources (the majority of which have terms less than three years). Risks also arise because loans and funding liabilities may not be denominated in the same currency or may not have the same interest rate characteristics (for example, the variable interest rate that a bank receives on its residential mortgages may not match the fixed interest rate that it pays on some wholesale debt). Banks incur some costs from managing these risks. The treasury will incorporate these costs into the transfer prices to make sure that business lines account for these costs in the interest rates that they offer to customers.

continued...
Box B.1 continued

The treasury also plays a significant role in implementing the bank’s overall strategy. It does this by adjusting the transfer prices for different business units in order to vary the incentives to raise funds from different sources and lend funds to different borrowers. For example, the treasury can help execute a strategy to increase a bank’s share of deposit funding by increasing the transfer price paid for raising deposits (and therefore the return that deposit-taking units receive).

The components of the transfer price paid by a bank’s lending units — a bank’s costs associated with acquiring deposit and wholesale funding, managing risks that come with lending these funds, and implementing the bank’s strategic direction — are some of the main costs associated with writing residential mortgage loans. As a result, the transfer price accounts for a large part of the final interest rate paid by residential mortgage borrowers and any changes in transfer price may significantly influence these interest rates.


Deposits have long been an important source of funds for the lending activities of the Inquiry Banks and their importance has only increased since the global financial crisis (Figure B.1), in part because of regulatory requirements. However, the Inquiry Banks also fund their loans by borrowing from wholesale debt markets (both within Australia and overseas), use equity raised from shareholders and, in some (limited) circumstances they also use securitisation.75

Figure B.1 Funding composition of banks in Australia (as a share of total funding)

![Figure B.1 Funding composition of banks in Australia](image)

* Data covers the period between 31 March 2002 to 30 November 2017. Data are adjusted for movements in foreign exchange rates. The tenor of debt is estimated on a residential maturity basis. Short-term debt includes deposits and intragroup funding from non-residents.

Source: B Cheung, Developments in Banks’ Funding Costs and Lending Rates, RBA, Sydney, March 2017, pp. 45-50, Graph 1 (Updated data supplied by the RBA)

75 A bank raises funding through securitisation by pooling together its loans and selling them to another entity. This entity then repackages the cash flows arising from the loans (which comprise borrowers’ loan repayments to the bank) as assets (such as bonds) that can be sold to investors. Securitisation accounted for up to 7 per cent of bank’s funding in 2007, but now securitisation accounts for less than 1 per cent (Figure B.1).
The cost of deposits and wholesale funding have fluctuated relative to the OCR since 2015

The OCR is a major influence on the interest rates paid to depositors and holders of domestically issued wholesale debt, but it is not the only influence. The following factors influenced the big four banks’ total funding costs (relative to the OCR) from January 2015:

- changes in demand for deposits by other ADIs, which affect the interest rates that need to be offered to win deposits and therefore affect the cost of deposit funding
- changes relative to the OCR in the benchmark interest rates (such as the Bank Bill Swap Rate) that banks’ wholesale funding are priced against, and
- changes in the composition of their funding sources, both overall and within particular funding categories (such as a shift from shortterm to longterm wholesale funding).

These factors (and others) contributed to the big four banks’ funding costs relative to the OCR varying at different points between 2015 and 2017. For instance, the RBA estimated that the difference between the big four banks’ cost of funds and the OCR increased from around 15 basis points at end 2015 to around 30 basis points at end 2016. The increase was mainly because of higher costs of deposits relative to the OCR. At the time, the big four banks’ demand for deposits strengthened significantly because, in part, they began to position themselves for the Net Stable Funding Ratio (Box 4.1, Chapter 4) which was a prudential regulation that came into effect from 2018.

The cost of equity funding

The Inquiry Banks need to hold a certain amount of equity if they are to attract debt funding (including depositors). They are also subject to prudential regulation that requires them to hold a minimum level of equity. The minimum equity they are required to hold depends on various factors, including the risks they take in their lending activities.

Equity is generally more expensive than other sources of funding. This is because, in the event of a bank’s insolvency, deposit holders and bondholders will be repaid before shareholders. While the cost of equity is unobservable, the RBA estimated the big four banks’ (nominal) cost of equity at over 10 per cent for each year since the late 1990s. By comparison, the interest rates paid on deposits were 0–3 per cent, while the interest rates paid on wholesale debt were 2–4 per cent at the beginning of 2017.

Even though equity accounts for less than 10 per cent of all bank funding sources (Figure B.1), the relatively high cost of equity means that an increase in the amount of equity a bank holds, or is required to hold, can have a significant effect on the cost of funding its lending activities. Combined, the big four banks issued about $20 billion of new equity from early-2015 to mid-2017 and the cost of that equity contributed to some of their increases in headline interest rates over the same period (Chapter 4).

The risks and associated costs inherent to borrowing and lending of money

The Inquiry Banks face numerous costs in sourcing and lending funds that are in addition to those outlined above. In many cases, these additional costs arise because of the risks inherent in the business of borrowing and lending money.

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76 The discussion of cost of deposits and wholesale funding focuses on the big four banks rather than the Inquiry Banks as most publicly available information is on the big four banks.
77 Examples of some of the other factors influencing the big four banks’ funding costs include (but are not limited to) the size of their respective funding requirements and changes in returns required by investors to hold bank debt.
79 David Norman, Returns on Equity, Cost of Equity and the Implications for Banks, RBA, Sydney, March 2017, p. 54.
80 Cheung, pp. 47, 49.
81 Tim Atkin and Belinda Cheung, How have Australian banks responded to tighter capital and liquidity requirements?, RBA, Sydney, June 2017, p. 43.
Perhaps the best known risk banks need to manage is the potential for losses on their loan portfolios. These losses arise when borrowers are unable to repay their loans and the sale of collateral pledged for the loan does not fully cover losses. The potential for loss from this source is known as credit risk and it adds to the cost of residential mortgages as the banks need to set aside funds to cover their losses if they are to remain solvent.

The Inquiry Banks generally take a forward looking approach to their funding decisions. A long term view of funding costs is critical for residential mortgage lending as loans can have terms of up to 30 years (although their ‘behavioural maturity’, which is the term in which loans are actually repaid, is often shorter). In contrast, funding terms are significantly shorter: as at March 2017, the majority of banks’ funding had maturities below three years. As a result, the banks may need to renew (or ‘roll over’) their sources of funding multiple times over the life of a residential mortgage. This maturity mismatch creates potential risk that funding sources will not be renewed or will only be renewed at an increased cost. There are costs to managing these risks, including the term premium a bank will need to pay if it issues longer-term debt.

The term mismatch between long term loans and short term funding liabilities also means banks must hold sufficient liquid assets to meet the withdrawal demands of depositors and repayment demands of bondholders. Liquid assets, such as Australian Government bonds, generally earn a much lower return than the other assets (including loans) in which a bank could invest. This creates an opportunity cost for the banks which their treasury units reflect by including a liquidity premium within their internal transfer prices, which ensures banks’ interest rates on deposits and lending account for the cost of liquidity. Put another way, the liquidity premium recognises that not every dollar raised from depositors and bond holders can be lent out by a bank.

There can be mismatches in the currency in which funding is raised and loans are made, and also in the basis of the interest paid on liabilities and that received on loans. For example, a bank may issue bonds that pay a variable rate of interest based on the London Interbank Offered Rate (LIBOR) and are denominated in UK pounds but use the proceeds for residential mortgages in Australian dollars. This creates a number of risks for the bank, such as exchange rate risk from a loss if the Australian dollar depreciates against the UK pound and thereby increases the cost of servicing the UK denominated bonds, and the risk of changes in LIBOR contrary to interest rate trends in Australia where the money was lent. Banks commonly use derivative contracts, such as swaps, to hedge these risks. The costs associated with those derivative contracts are part of the cost of raising funds. The portion of the transfer price intended to allow for these costs is often referred to as the hedging premium.

Finally, the banks have operating and other costs such as personnel expense (collectively, the personnel expenses of the big four banks were around $22 billion in the year to June 2017), significant information technology expenses and branch networks to maintain. Banks also incur costs that are specific to residential mortgage lending such as the commissions paid to mortgage brokers.

Banks need to raise sufficient revenue to recover and compensate them for these various risks and costs in order to earn market rate of return on equity. This is achieved in the funds transfer price set by each bank’s treasury unit and which incorporates a combination of the factors detailed above (Box B.1).

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82 Atkin and Cheung, p. 45.
83 Australian Prudential Regulation Authority, Quarterly Authorised Deposit-taking Institution Performance, September 2017, APRA, Sydney, December 2017.
Appendix C. A comparison of the residential mortgages available in Australia with those overseas

Variable rate loans are the most common type of residential mortgage in many countries around the world, including in Australia. However, there are differences between countries in just how ‘variable’ interest rates are.

The variable interest can be changed at the lender’s discretion in Australia. This is a trait shared by variable rate loans in Germany and many of the variable rate loans in the UK. In contrast, ‘tracker rate’ residential mortgages—where the interest rate rises and falls in line with a benchmark rate (such as the Euro Interbank Offered Rate)—are prominent in the United States, Canada, France, Korea and Japan.

Lenders in some countries allow for caps and/or floors on the interest rates borrowers pay. A cap prevents the interest rate paid by borrowers rising above the specified rate while a floor prevents the interest rate paid falling below another specified rate. Interest rate caps and floors are available for some commercial loans in Australia but are generally not available for residential mortgages.

Some interest rate caps are the result of regulation, such as that applying to savings and loan associations in the United States. Others are the result of a separate contract under which the borrower buys the cap from the lender. Caps can apply to discretionary variable rate loans and tracker loans.

Residential mortgage lenders in some other countries also offer other loan features not currently available in Australia. For example, flexible-term mortgages are available in Canada, France, and Japan. Under a flexible-term mortgage, the repayments remain constant over the life of the loan but the term of the loan varies depending on the interest rates charged by the lender.

As another point of difference from Australia, lenders in the United States offer borrowers the option of purchasing discounts through upfront payments for ‘discount points’. One ‘discount point’ typically costs 1 per cent of the initial loan amount, and provides a discount off the headline interest rate over the life of the loan. For example, a borrower may be offered a $300 000 variable rate mortgage, with a current headline interest rate of 5.50 per cent. They may then purchase one discount point for $3000, which might provide them with a 0.15 per cent (or 15 basis points) discount (the discount offered varies depending on the lender and prevailing market conditions), reducing their actual interest rate to 5.35 per cent. The discount remains constant over the life of the loan, meaning as the headline rate rises and falls, the rate that the borrower actually pays will rise and fall by the same amount.
