Australian Competition & Consumer Commission

Public Competition Assessment

13 November 2009

National Australia Bank Ltd - proposed acquisition of mortgage management business from Challenger Financial Services Group

Introduction

1. On 7 October 2009, the Australian Competition and Consumer Commission (**ACCC**) announced its decision not to oppose the proposed acquisition by National Australia Bank Ltd of the mortgage management business from Challenger Financial Services Group (**proposed acquisition**). The ACCC was of the view that the proposed acquisition would not be likely to have the effect of substantially lessening competition in any relevant market, in contravention of section 50 of the *Trade Practices Act 1974* (the **Act**).

2. The ACCC formed its view on the basis of the information provided by the merger parties and information arising from its market inquiries. This Public Competition Assessment outlines the basis on which the ACCC has reached its decision on the proposed acquisition, subject to confidentiality considerations.

Public competition assessment

3. To provide an enhanced level of transparency and procedural fairness in its decision making process, the ACCC issues a Public Competition Assessment for all transaction proposals where:

   - a merger is opposed;
   - a merger is subject to enforceable undertakings;
   - the merger parties seek such disclosure; or
   - a merger is not opposed but raises important issues that the ACCC considers should be made public.

4. This Public Competition Assessment has been issued because the proposed acquisition is considered to raise issues of interest to the public.

5. By issuing Public Competition Assessments, the ACCC aims to provide the public with a better understanding of the ACCC's analysis of various markets and the associated merger and competition issues. It also alerts the public to the circumstances where the ACCC's assessment of the competition conditions in particular markets is changing, or likely to change, because of developments.

6. Each Public Competition Assessment is specific to the particular transaction under review by the ACCC. While some transaction proposals may involve the same or related markets, it should not be assumed that the analysis and decision outlined in one Public Competition Assessment will be conclusive of the ACCC's view in respect of other transaction proposals, as each matter will be considered on its own merits.

7. Many of the ACCC's decisions will involve consideration of both non-confidential and confidential information provided by the merger parties and market participants. In order to maintain the confidentiality of particular information, Public Competition Assessments do not contain any confidential information or its sources. While the ACCC aims to provide an appropriately detailed explanation of the basis for the ACCC decision, where this is not possible, maintaining confidentiality will be the ACCC's paramount concern, and accordingly a Public Competition Assessment may not definitively explain all issues and the ACCC's analysis of such issues.

The parties

The acquirer – National Australia Bank Ltd (NAB)

8. NAB is ASX listed and provides an integrated range of financial products and services: personal and business banking, insurance, superannuation, investment services and financial planning. The business also includes the wealth management operations of MLC Limited.

9. NAB is the 3rd largest retail bank in Australia by market capitalisation, valued at approximately $65 billion.

NAB's home lending business

10. NAB provides home loan products through two brands: NAB and Homeside. The NAB brand is primarily aimed at branch level customers, whereas Homeside is primarily aimed at mortgage brokers. Brokers are a key distribution channel for banks and non-bank lenders.

11. NAB does not provide mortgage distribution services to other lenders in the Australian home loan market, aggregation platforms or 'white labelling' of mortgages for mortgage originators multi-brand lending.

The target – Challenger Financial Services Group Limited's mortgage management business

12. The Challenger Financial Services Group (**Challenger**) is an ASX listed Australian based financial services company.

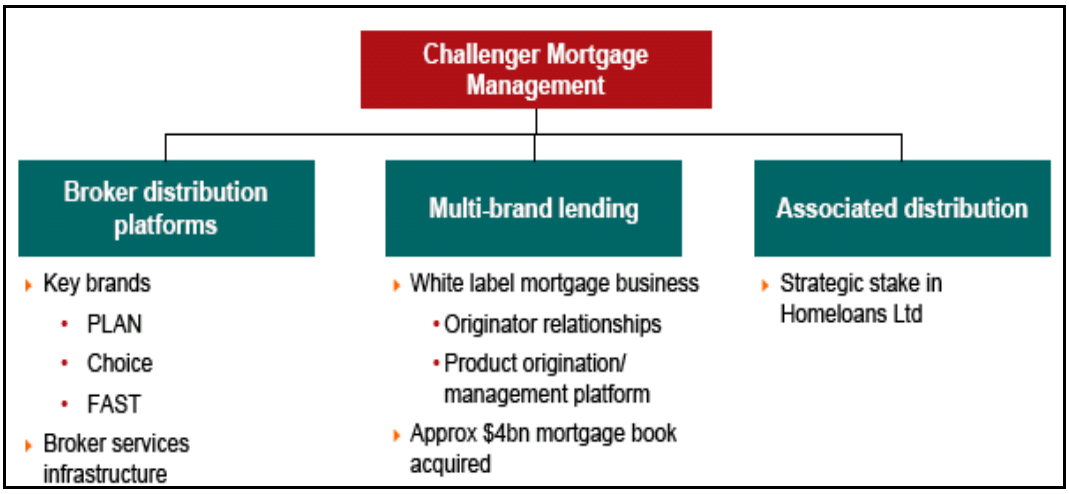
13. Challenger has stated that its mortgage management business is Australia's largest non-bank mortgage lender and mortgage broking aggregator.

14. The proposed acquisition of Challenger's mortgage management business includes the following (as illustrated in Figure 1 below):

    - **Distribution (broker platforms)**: The PLAN, FAST and Choice mortgage aggregation business which provide support services to accredited mortgage brokers.
    - **Multi-brand (white label) lending**: Challenger's white label product primarily provides wholesale mortgage loans to mortgage managers who distribute these products to borrowers under their own brands.
    - **Residential mortgages portfolio**: A select portfolio of approximately $4 billion of residential mortgages.
    - **Associated distribution**: An interest of 17.5 per cent in ASX listed mortgage management company, Homeloans Limited, with the potential to increase to approximately 41 per cent.

15. Challenger has integrated the PLAN, Choice and FAST platforms and support functions of these businesses. This network of platforms accounts for approximately 40 per cent of sales of mortgage products by mortgage brokers in Australia. Together, these broker platforms have relationships with about 5,700 loan writers/brokers and 400 mortgage managers.

Figure 1 Challenger Mortgage Management



Source: NAB Transaction Summary, 18 August 2009

16. Post acquisition, Challenger will continue to operate a commercial mortgages business . Commercial mortgages are commonly utilised by businesses when buying commercial property for either a business venture or for investment purposes. Post-acquisition, Challenger will also continue to operate its annuity and funds management businesses.

Industry background

Distribution of home loans / industry participants

17. The distribution of home loans to borrowers involves a range of industry participants, including mortgage brokers, mortgage managers, mortgage aggregators and broker platforms, as well as white label providers of wholesale funding products. Banks and non-bank lending institutions also directly distribute home loans from their branch and online channels.

Mortgage brokers

18. Mortgage brokers are intermediaries that specialise in residential loans and work with a borrower by providing advice on the numerous home loans available and assist in completing a mortgage transaction. A mortgage broker usually collects a commission fee from lenders. When a mortgage broker writes a loan they typically earn two types of commission, an upfront commission and a trail commission. The upfront commission is a percentage of the loan amount and the trail commission is an ongoing percentage based on the balance of the loan. Mortgage brokers can be independent, franchisees of mortgage groups, or organized into aggregator groups that pool individual brokers' business. It is estimated that approximately 43 per cent of recent mortgage loans are ‘broker-written’. Industry estimates of the number of mortgage brokers in Australia typically range around 14,000-15,000.

Mortgage managers

19. Mortgage managers are intermediaries between lenders and borrowers and specialise in administering the mortgage loan throughout its life, from the time the loan is provided by the funding institution until the borrower pays the final instalment of the loan. Mortgage managers are responsible for monitoring loan repayments, interest rate adjustments, loan variations and customer enquiries.

20. Mortgage managers may provide loan processing services to brokers as well as distributing home loans directly to the public under their own brands, for example, Aussie Home Loans and AFG.

Mortgage aggregators & broker platforms

21. Mortgage aggregators or broker platforms provide accredited brokers with access to the products of a range of lenders and also provide infrastructure (technology systems and software) and administrative support, education and training, communication and marketing assistance to member brokers. The aggregator organises a panel of lenders, facilitates processing of applications and enters into commission-sharing arrangements with broker members. Many mortgage brokers are aligned to a distribution platform/aggregator service. Broker platforms generally have commission-splitting arrangements with brokers and derive revenue by retaining a fee from brokers' commission payments.

White label providers

22. Wholesale mortgage lenders provide white label products to mortgage managers who distribute these products to borrowers under their own brand. The mortgage manager brand is used on loan correspondence, account statements and internet sites enabling the mortgage manager to appear as the lender in their own right.

23. Wholesale mortgage products are provided by both bank and non-bank institutions, such as ING Direct and Bendigo & Adelaide Bank.

Credit crunch & Australian Government policies

24. Recent industry developments relevant to this assessment are discussed below.

Global financial crisis

25. Since July 2007, the credit crunch has had an impact on the competitive dynamic in banking markets. With the virtual closure of asset securitisation markets and the increased cost of wholesale funds since late 2007, many non-bank lenders who were reliant on securitisation as a source of funding have had to exit or temporarily withdraw from the Australian market.

26. Securitisation, up until two years ago, represented a quarter of funding for all new mortgages in Australia, whether written by banks or non-banks. After peaking at $131 billion in August 2007, outstanding levels of Residential Mortgage Backed Securities (RMBS) continue to decline in Australia as loans are repaid and virtually no new issuance occurs. As at June 2009, RMBS of $82 billion are outstanding, down from $114 billion a year earlier.

27. In recent months, industry commentators have speculated that early signs are appearing of the Australian securitisation market re-opening. As reported on 25 September 2009, Members Equity Bank recently became the first bank to sell mortgage-backed securities to private investors this year.

Australian Government policies

28. In response to the global financial crisis, the Australian Government introduced a guarantee on retail deposits and a wholesale funding guarantee for the debt issues of Authorised deposit-taking institutions (ADIs). The Government has also invested in Australian RMBS.

Government guarantee of wholesale funding

29. The wholesale funding guarantee came into effect on 28 November 2008. A tiered fee structure based on the institution's credit rating was applied for the wholesale funding guarantee. AA rated banks could have access to a guarantee on new wholesale funding for a fee of 70 basis points, A rated banks for 100 basis points, and BBB or unrated ADIs for 150 basis points.

30. The Government has announced that the guarantee arrangements are designed to be temporary and will remain in place 'until conditions normalise'.

Government investment in Australian RMBS

31. On 3 October 2008, the Treasurer announced that the Australian Office of Financial Management (**AOFM**) was to invest $4 billion in Australian RMBS allocated to both the banking and non-banking sectors. On 12 October 2008, the government announced that the AOFM would add an additional $4 billion in funding for the purchase of RMBS directly for the non-bank sector.

32. On 11 October 2009, the AOFM invested a further $8 billion for the purchase of Australian RMBS.

Timing

33. The following table outlines the timeline of key events in this matter.

Date	Event
20-Aug-2009	ACCC commenced review under the Merger Review Process Guidelines.
10-Sep-2009	Closing date for submissions from interested parties.
07-Oct-2009	ACCC announced it would not oppose the proposed acquisition.

Market inquiries

34. The ACCC conducted extensive market inquiries in relation to the proposed acquisition. A range of interested parties provided responses including competitors, industry associations, mortgage brokers and interested third parties.

35. In the course of these inquiries, the ACCC explored a number of issues with market participants, including any potential implications the proposed acquisition might have on the operation of the broker platforms NAB would acquire. In particular, issues explored included whether and to what extent NAB may have the ability and incentive to: influence brokers aligned to the broker platforms such that NAB would originate a larger share of home loans, foreclose rival lenders from accessing the lender panels on the broker platforms, and/or obtain access to commercially sensitive information from the broker platform systems (e.g. customer details, credit policy, commission rates and product pricing).

The with/without test

36. Section 50 of the Act prohibits an acquisition if it would have the effect, or be likely to have the effect of substantially lessening competition in a market.

37. In assessing a merger pursuant to section 50 of the Act, the ACCC must consider the effects of the transaction by comparing the likely future state of competition if the transaction proceeds (the 'with' or 'factual' position) to the likely future state of competition if the transaction does not proceed (the 'without' or 'counterfactual' position).

38. Based on information provided by the merger parties and other available information, the ACCC concluded that Challenger's ability to vigorously and effectively compete at present has been temporarily weakened by funding conditions. The ACCC identified a number of possible counterfactual scenarios in relation to the position of the Challenger mortgage management business if the merger were not to proceed, including:

    (i) the sale of the Challenger mortgage management business to another acquirer that has improved access to funding;

    (ii) a temporary withdrawal by Challenger from mortgage funding.

39. The ACCC did not need to form a concluded view on the likely counterfactual position of the Challenger mortgage management business, as on either analysis, it found that the merger would not be likely to result in a substantial lessening of competition in a market. However, for the purposes of the following analysis, the the ACCC adopted a counterfactual that without the proposed acquisition, the Challenger mortgage management business would likely return to being a vigorous and effective competitor as funding conditions improve in the foreseeable future.

Market definition

40. The ACCC considered that the relevant market for the purposes of assessing this transaction was a national market for the supply of home loans, including mortgage lending by banks, building societies, credit unions and other financial institutions as well as mortgage brokers.

Product dimension

41. Home loan products are supplied to individuals for the purpose of acquiring residential property and include financing from retail banks, non-bank lenders, mortgage brokers or originators and other financial institutions.

42. The ACCC considers that broker platforms and multi-brand white labelling platforms provide alternative distribution and manufacturing options for suppliers of home loans. The ACCC considers that these alternative methods of supplying home loans are close substitutes for home loans supplied directly by lenders and accordingly form part of the national market for the supply of home loans.

43. The ACCC's analysis focussed on two key areas of the market for the supply of home loans in which Challenger's mortgage management business is active:

    (a) distribution and aggregator services (**broker platforms**); and

    (b) manufacturing/lending (**multi-brand white labelling**).

Geographic dimension

44. In previous banking mergers the ACCC has concluded that the geographic dimension to the home loan market is national. This is based on evidence that consumers do not require the physical presence of a distribution point to access a wide variety of mortgage products. Further, evidence indicates that price competition for retail banking products, including home loans, is national.

45. Consistent with previous banking mergers, market inquiries undertaken during this matter supported a national market for the supply of home loans.

Competition analysis

46. The ACCC considered several theories of competitive harm that may arise in the national market for the supply of home loans as a result of the proposed acquisition:

    (i) The ACCC considered whether NAB would have the ability and incentive, post-acquisition, to induce brokers to redirect flows to NAB products over those of rival lenders;

    (ii) The ACCC explored several potential methods by which NAB may be able to foreclose its rivals as a result of its ability to control Challenger's broker distribution platforms, specifically:

        - Foreclosure by restricting rival lenders from lender panels of broker platforms;

        - Foreclosure by restricting affiliated brokers from switching to rival aggregators;

- Foreclosure by refusing to deal with other aggregators/brokers.

(iii) The ACCC considered whether NAB would obtain access to commercially sensitive information of rival lenders as a result of its operation of Challenger's broker distribution platforms.

Market concentration

47. The proposed acquisition involved NAB acquiring a select portion of Challenger's loan book, amounting to approximately $4 billion. It was found that this would result in a minor degree of horizontal aggregation in the national market for the supply of home loans.

48. Challenger holds only 1.5 per cent of the home loans market. Post-acquisition, NAB would have a market share of 13.2 per cent. The proposed acquisition would have increased NAB's market share in the home loan market by less than 1 per cent.[1]

Table 1 Share of home loans – June 2009

Home loan provider	Share (%)
NAB	**12.8**
Challenger	**1.5**
Merged entity	**13.2^**
CBA (incl. BankWest)	24.9
Westpac (incl. St George)	23.1
ANZ	12.5
ING	3.4
Suncorp	2.7
Bendigo & Adelaide Bank	2.5
Bank of Queensland	1.9
Macquarie Bank	1.7
Citigroup	0.9
AMP	0.8
HSBC	0.5
Other institutions	10.8
Total	**100**

Note: The market share figures are derived from a number of sources. The ACCC considers these figures to be the best estimates available for the purposes of this assessment.

^ NAB is acquiring $4 billion of Challenger mortgage management's loan book which equates to 0.4% of its 1.5% market share.

[1] NAB's current market share is 12.8 per cent. Challenger's current market share is 1.5 per cent – however, NAB is only proposing to acquire $4 billion of Challenger's loan book. Therefore, NAB's market share post acquisition will only rise by 0.4 per cent.

49. In respect of the distribution of home loans via broker platforms, Challenger's group of aggregator platforms (PLAN, FAST and Choice) have affiliations with approximately 40 per cent of brokers in Australia (although not all of these affiliations are exclusive). These brokers sell mortgages supplied by a range of bank and non-bank lenders.

Table 2 Share of broker flows / affiliated brokers

Broker groups/aligned aggregators	Share of flows (%)	Affiliated brokers	
		No.	%
PLAN (Challenger owned)	**16**	**2,468**	**19**
FAST (Challenger owned)	**13**	**1,856**	**14**
Choice (Challenger owned)	**11**	**1,386**	**10**
Merged entity	**40**	**5,710**	**43**
AFG	15	2,129	16
Aussie	9	800	6
Mortgage Choice	9	577	4
Loan Market Group / Xinc	5	400	3
National Brokers Group	3	600	5
Others (Connective, Astute, etc)	19	3,039	23
Total	**100**	**13,255**	**100**

Note: The market share figures are derived from a number of sources. The ACCC considers these figures to be the best estimates available for the purposes of this assessment.

50. As NAB is not presently a supplier of broker distribution platforms, it was found that the proposed acquisition would not, at the outset, result in any increased concentration with respect to broker flows or affiliated brokers aligned to aggregator platforms.

Barriers to entry and expansion

51. In the current economic climate, access to funding is the main issue faced by prospective lenders seeking to enter the market for the supply of home loans. Closure of securitisation markets and the increased cost of credit has had the effect of raising barriers to entry for lenders. Accordingly, the ACCC considers that barriers to entry for the market for the supply of home loans are high.

52. The ACCC found, based on market inquiries, that the key requirements to establish a broker platform service at the 'simple' end of the aggregator model spectrum are access to lender agreements and product selection software.

53. Broker platforms range from 'full service' franchise models through to simple, low cost models providing a product access portal and remuneration management. Challenger's FAST broker platform is an example of a simple, low cost model, as is Connective's model, while the PLAN and Choice broker platforms are more akin to full service broker platforms.

54. There are over 150 aggregators actively operating in Australia. Over recent years, several new entrant aggregators have gained scale quite rapidly, including Connective, established in 2003.

55. The ACCC concluded that under normal market conditions, barriers to entry are likely to be low for establishing broker platform services as there is limited capital required and the necessary software can be leased.

Availability of substitutes

56. The ACCC concluded that competition offered from alternative suppliers of home loans will continue to constrain NAB in the supply of home loans post merger.

57. The ACCC found, based on market inquiries, that brokers may source mortgage products from a wide range of potential lenders. Market inquiries also provided that brokers have effective alternatives in their dealings with mortgage aggregators as a result of their ability to switch between broker platforms.

58. The ACCC conducted detailed analysis of the existence of restrictive conditions in the contractual terms agreed between brokers and mortgage aggregators which may prevent brokers from switching to rival broker platforms. Aggregator-broker contracts are not uniform across the industry. Accordingly, the incumbent agreements with brokers vary by aggregators with respect to the effort and cost involved in transition to another aggregator or with respect to restrictive conditions with regard to retaining commission trail.

59. Market inquires revealed many aggregators consider that the restrictions on the retention of commission trail are predominantly a legacy issue and one that the industry is gradually moving away from.

Ability to influence brokers to redirect flows to NAB products

60. The ACCC considered that post-merger, NAB would not obtain the ability to use its position as owner of the three mortgage aggregator platforms to induce mortgage brokers to redirect flows to NAB products and thus originate a larger share of home loans.

61. As discussed above, market inquiries revealed that although the three mortgage aggregator platforms to be acquired by NAB account for approximately 40% of flows of products distributed via mortgage brokers, brokers have a number of effective substitutes, including dealing direct with lenders.

62. Market inquiries indicated that in practice it is difficult for lenders to direct or mandate affiliated brokers to only sell their products as the whole brokerage industry is founded on brokers comparing mortgage products and finding the product that best suits a customers needs.

63. Market participants consistently provided that it is unlikely NAB would be able to compel affiliated brokers to recommend NAB products as this would destroy

the value proposition offered by brokers and would result in an outflow of brokers to rival mortgage aggregators.

64. Accordingly, it was found that post-merger, NAB would not have obtained sufficient market power through the acquisition of the three mortgage aggregator platforms to significantly influence brokers to redirect flows to NAB products.

Foreclosure by restricting rival lenders from lender panels of broker platforms

65. The ACCC considered that post-merger, NAB would not obtain the ability to use its position as owner of the three broker platforms to restrict rival lenders from participating in lender panels on these platforms.

66. Market inquiries showed that if NAB were to restrict rival lenders from being on the panel of lenders for the acquired broker platforms, NAB would likely see a mass defection of mortgage brokers from its broker platforms as it impedes the broker's value proposition.

67. Further, brokers also have the option of going direct to a lender rather than through the aggregator's platform. Accordingly, in instances where affiliated brokers deal directly with rival lenders outside of its aggregator platform, NAB would forego a share of revenue it otherwise would have received if it were to restrict lenders from participating on lender panels.

Foreclosure by restricting affiliated brokers from switching to rival aggregators

68. The ACCC considered whether NAB would have the ability and incentive to vary the terms of its broker-aggregator contracts to introduce increased restrictions on commission trails for exiting brokers. That is, whether NAB is likely to insert 'handcuff' clauses into its broker-aggregator agreements to reduce the ability of brokers to switch to rival broker platforms.

69. Market inquiries provided that as brokers rely on ongoing commission trail, restrictive conditions which limit the provision of commission trail upon a broker transferring to another broker platform may restrict affiliated brokers from switching to rival platforms. Market participants provided that the willingness of a broker to switch despite restrictive conditions on commission trail will depend on the value of the business they have built up with the relevant platform.

70. Industry trends have moved towards the removal of restrictions on brokers receiving commission trail upon switching to a rival aggregator platform such that commission trails will continue to be paid to the non-member broker. This has followed the recent entry of broker platforms which do not include restrictive conditions on commission trail, such as the Connective model.

71. The ACCC concluded that NAB is unlikely to attempt to 'handcuff' brokers to its broker platforms by introducing increased restrictions on commission trail.

72. The ACCC's market inquiries indicated that such a strategy would discourage new brokers from becoming affiliated with NAB's broker platform/s and would

still result in an outflow of brokers that do not have a significant value of business built up with the relevant platform.

73. Further, direct dealings between brokers and rival lending institutions will also limit the profitability of a strategy of raising restrictions for brokers in switching to other broker platforms.

Foreclosure by refusing to deal with other aggregators/brokers

74. The ACCC considered whether NAB would have the ability and incentive to refuse to deal with other aggregators/brokers, for instance, by removing itself as a lender from other aggregator panels.

75. Market inquiries provided that while NAB may have the ability to stop dealing with other aggregators/brokers and only accredit the 5,500 brokers on the Challenger broker platforms, that it would be unlikely to have any incentive to remove itself from the panels of other aggregators.

76. The ACCC found that NAB's presence in the market for the supply of home loans is not large enough to provide it with the incentive to remove itself from the panels of other aggregator platforms as this would limit distribution of NAB home loan products.

77. Notwithstanding, the ACCC considered that even if NAB did remove itself from other aggregators' lender panels, this would be unlikely to substantially hinder the ability of those aggregators to compete effectively.

Access to commercially sensitive information

78. The ACCC considered whether NAB would obtain access to commercially sensitive information of rival lenders as a result of its operation of the broker platforms. Market inquiries provided that NAB may potentially have access to commission rates, product pricing, credit policy information and customer details of its rival lenders via the broker platforms.

79. The ACCC concluded that ownership of broker platforms will not enhance the ability to access commercially sensitive information to the extent that this is likely to have a material impact on the competitive dynamic for the supply of home loans.

80. In respect of product pricing, commission rate and credit policy information, market participants consistently submitted that this information is either publicly available from market intelligence websites or can be obtained relatively easily from brokers.

81. In respect of customer details, market inquiries provided that several restraints exist to prevent NAB from using rival lenders customer information for marketing purposes, including confidentiality provisions and reputational risks.

82. Based on market inquiries, the ACCC concluded that the benefits to NAB of using customer information of rival lenders for marketing purposes are likely to be low given that broker-sourced customers have demonstrated a preference and propensity to seek advice from a broker, rather than responding to bank marketing. Further, the risks of using customer information of rival lenders for marketing purposes is likely to be high as NAB would likely expose itself to reputational risks and many brokers may exercise their discretion to switch to an alternate aggregator.

Conclusion

83. The ACCC found that in respect of "white label" wholesale mortgage lending and manufacture of retail mortgage products, the proposed acquisition would not result in a significant increase in market concentration, and the merged entity is likely to be constrained by other suppliers of wholesale mortgages.

84. Further, the ACCC found that although the merger would result in the acquisition of a number of broker platforms by NAB, it would be unlikely to use its control of these platforms to favour its own products; constrain the ability of other lenders to utilise these platforms; remove its products from competing platforms; or restrict the ability of mortgage brokers to utilise other platforms to the extent that this would be likely to result in a substantial lessening of competition.

85. On the basis of the factors set out above, the ACCC formed the view that the proposed acquisition would be unlikely to result in a substantial lessening of competition in the national market for the supply of home loans.