



Home Grown

Mortgage Industry Perspectives

November 2010

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Financial



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Executive summary

Home Grown: Mortgage Industry Perspectives is a report by Genworth Financial (Genworth), revealing the findings of one of the most comprehensive industry surveys undertaken in the Australian mortgage market. The report features the results from an online survey conducted in September 2010 of over 350 industry professionals working for lenders and over 200 brokers. It also includes feedback from a series of in-depth face-to-face interviews with a number of leading industry figures, including industry associations and rating agencies.

The results conclude that the Global Financial Crisis (GFC) has reshaped the Australian mortgage market significantly in recent years causing many non-banks to scale back their operations and/or leave the market due to the lack of available funds, while many banks capitalised on their deposit bases as a source of additional funding.

More recently, the stronger performing economic environment in Australia has brought about stronger employment and an increase in interest rates. The rising interest rate environment, coupled with the winding-back of the Government's short term stimulus measure, the First Home Owner Boost (FHOB), is making it increasingly difficult for many first homebuyers (FHBs) to enter the market.

On the other hand, the stronger performing economy has helped to strengthen overall consumer sentiment, which has in turn raised expectations that investors are poised to return to the market in the near future.

Targeting tomorrow's borrower

Looking forward to 2011, **Home Grown** finds that all segments of the mortgage market expect FHBs to account for smaller

proportions of their lending than was the case in 2009. Many lenders are looking towards investors as an increased source of lending in line with rising market sentiment. Credit unions and building societies (CUBS) and originators are expecting increases in lending for refinancers, while banks and wholesale lenders are expecting increased business from upgraders.

The outlook for 2011

Those surveyed for **Home Grown** all agree that funding and future Government policy are likely to have the greatest impact on the market in 2011. There is a belief that the ability to obtain reasonably priced funding will become a large differentiator among lenders, while Government policy will contribute to an ever evolving mortgage market.

Future market growth

There is an expectation among those surveyed that growth in credit aggregates will slow in the future, averaging 5% in the next decade compared to more than 10% over the last decade. This will result from changes in borrower demand, such as a decrease in FHBs, as well as tighter lending criteria. Furthermore, as growth slows lenders anticipate a movement towards more efficient processing.

The mortgage market has certainly seen some challenging conditions over the last two years; we have seen the exit of some well-known brands and the landscape is forever changed. As we emerge from the GFC, there are green shoots of optimism and expectations of challenge in almost equal measure. This report seeks to highlight these issues and provide insight into the likely market makeup in 2011 and beyond.



Key definitions

- **Banks:** Major banks, regional and smaller banks as well as foreign banks which operate within Australia while being headquartered outside of Australia
- **CUBS:** Credit unions and building societies
- **Mortgage brokers:** A mortgage broker offers services to assist borrowers apply for a mortgage loan by acting as an intermediary between the borrower and the lender
- **Non-banks:** Financial institutions which are not registered as Authorised Deposit-taking Institutions (ADIs), which include wholesale originators and lenders:
 - **Originators:** An originator has access to mortgage funds via wholesale funding and in turn provides finance options to borrowers. An originator also manages a loan from inception through to post settlement
 - **Wholesale lenders:** Wholesale lenders are institutions that provide mortgage funds to originators to lend. In some cases, these wholesale lenders have a wider network than just originators, and they may also have their own distribution capabilities.
- **First homebuyers (FHBs):** Borrowers who are looking to purchase their first home, or who are paying off the mortgage on their first home
- **Investors:** Borrowers who hold, or are looking to take out, a mortgage on an investment property
- **Refinancers:** Borrowers who are switching their current mortgage from one lender to another
- **Upgraders:** Borrowers who are looking to move to a new home and obtain a new mortgage on that property.



Introduction

The **Home Grown: Mortgage Industry Perspectives** report, produced by RFi on behalf of Genworth Financial (Genworth), presents the results of one of the most comprehensive surveys of mortgage market participants conducted in Australia.

During September 2010, RFi conducted an online survey of over 350 industry professionals working for lenders in the areas of product, strategy and credit risk, and surveyed over 200 brokers. In addition, a series of in-depth face-to-face and telephone interviews with leading industry commentators from most segments was also conducted. This research has been combined

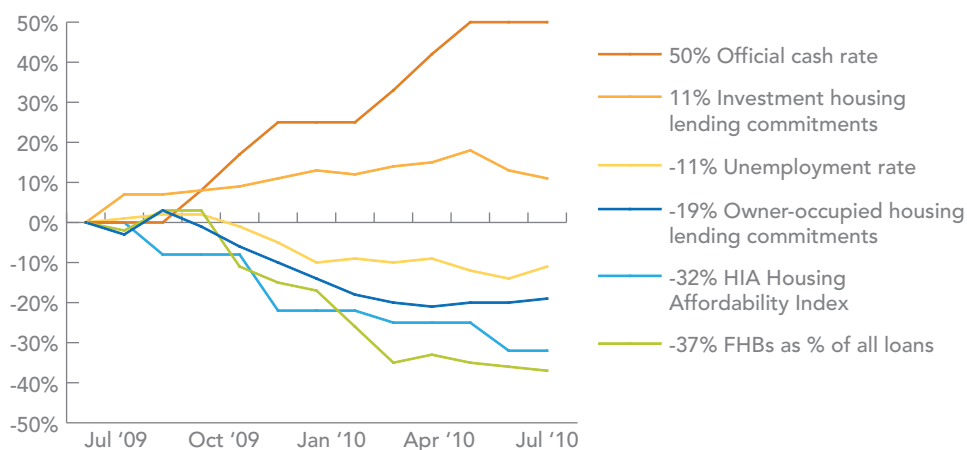
to create a comprehensive overview of the opinions of lenders, brokers and industry experts towards the mortgage market in terms of lending volumes, changes within the market, borrower hardship and the outlook for lending.

Home Grown has been created to complement our consumer research such as, in previous years, the **Mortgage Trends** reports and, more recently, **Streets Ahead: Genworth Homebuyer Confidence Index**. By providing a deep-dive into the various lender and broker perspectives of the market, we are able to provide a 360 degree view of the mortgage industry.



Annual % changes in key housing and property market indicators

Sources: RBA, HIA, ABS



Market overview: Reversals of fortune

Appetite for borrowing is down—investment lending buoys the market

According to Reserve Bank of Australia (RBA) figures¹, between July 2009 and July 2010, lending commitments for owner-occupied housing fell 19% after experiencing a growth of 36% the previous year, while refinancing of owner-occupied dwellings also fell by 17% in the year to July 2010. Investment housing lending commitments, however, grew 11% over this period after a small decrease of 2% during the previous year.

These figures suggest that lending growth trends are reversing. With the phasing out of the Government's First Home Owner Boost (FHOB), the proportion of FHBs entering the market reached a six year low of 16% in August 2010, according to statistics from the Australian Bureau of Statistics (ABS)², while returning consumer confidence has tentatively encouraged investors to re-enter the market.

Interest rates returning to long-term average

Interest rates have begun to return to their long-term average, with the RBA raising rates from 3.00% to 4.75% between October 2009 and November 2010 on the back of strong performance by the Australian economy. The Australian labour market is also performing strongly with unemployment reaching a peak of 5.8% in August 2009 before falling to 5.1% in August 2010³. Inflation stood at 3% in the June 2010 quarter, with the RBA expected to increase interest rates further in 2011 in order to keep inflation within the 2–3% target band⁴.

Consumer confidence on a knife's edge

The September 2010 edition of the Genworth Homebuyer Confidence Index (GHCI), a single measure of borrower and would-

be borrower sentiment, shows that homebuyer confidence is back to pre-Global Financial Crisis (GFC) levels; however, cautious optimism should prevail, with a number of signals suggesting confidence is on a delicate balance.

While most borrowers have comfortably met their mortgage repayments, rising interest rates and the rising cost of living are a key concern for homebuyers. The GHCI shows the proportion of respondents who expect to experience repayment difficulties in the next 12 months has jumped from 15% to 20% over the past year. Of these, the amount blaming the rising cost of living has increased to 61% from 48% in 2009, while 61% also nominated interest rates as the primary source of concern.

House price increases and falling affordability

The strong housing market in Australia, combined with increases to the cash rate, have negatively impacted housing affordability and the ability of FHBs to enter the market. The HIA Housing Affordability Index fell 31.6% between June 2009 and June 2010, and now stands just above levels experienced in June 2008. If this trend continues, decreasing affordability will have a significant effect on the housing market.

Meanwhile, the rental trap is set to return for many would-be homebuyers who are renting and finding that rent rises, coupled with increasing costs of living, are hindering their efforts to save for a deposit. The GHCI survey results also indicate that saving for a home is harder than it was before the GFC. Just 25% thought it was a good time to buy a house in 2010, a sharp plunge from the 50% in 2009.

¹ RBA Data Sheet DO6 released in October 2010

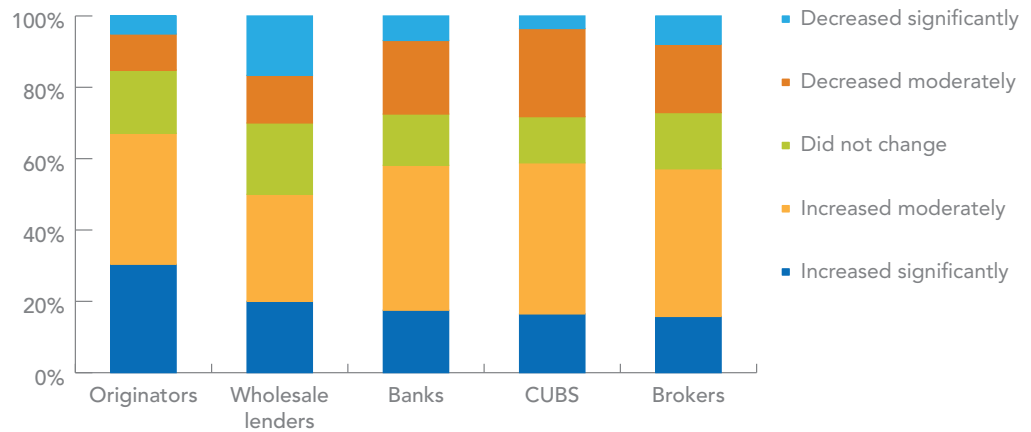
² ABS Data Series 5609 released in October 2010

³ ABS Data Series 6202 released in October 2010

⁴ ABS Data Series 6401 released in July 2010

How has your business performed in 2010?

Source: RFI



2010: The legacy of the GFC

Two sides of the coin for lending in 2010

Of those surveyed for **Home Grown**, 60% feel lending volumes increased in 2010 compared to 2009, while 25% feel lending volumes decreased. The remaining 15% feel volumes remained stable. Respondents that experienced increases in volume cite factors such as historically low interest rates and an expanded product offering as key drivers of this increase. On the flip side, respondents that experienced volume declines are in agreement that tighter lending criteria is the key driver of this decrease. Either way, it appears those surveyed believe strategy and lending policy are having a greater influence on new lending than demand and supply.

Wholesale lenders the most pessimistic in 2009 and 2010

According to the survey, wholesale lenders suffered the worst in 2009, with 33% saying lending volumes decreased during 2009 as funding dried up. Wholesale lenders are also the most pessimistic about 2010 lending volumes, with 30% stating lending had decreased, including 17% who feel it had decreased significantly.

CUBS less optimistic in 2010 than in 2009

Results show that CUBS became less optimistic about lending between 2009 and 2010. Whereas CUBS were the least likely to have experienced a decrease in lending volume between 2008 and 2009, at just 12%, some 28% feel lending volumes decreased in 2010.

Reasons for CUBS experiencing the lowest decrease in 2009 may have been largely due to their loyal customer base. This, coupled with the fact that they may have already experienced some declines in 2008, may have made any further dip in 2009 seem less severe.

Despite pessimism from wholesale lenders, originators most optimistic about 2010

When it comes to experiences in 2010, originators are the most

optimistic segment of those surveyed, with 67% stating lending volumes have so far increased relative to 2009.

One interesting aspect of the survey results is that originators are the most optimistic segment while wholesale lenders are the most pessimistic, despite funding coming from the same source. A number of industry commentators attributed this to a possible "head in the sand" outlook on the part of some originators, whereas wholesale lenders appear to be more realistic in terms of their lending outlook.

Large banks ride out the storm while smaller banks suffer

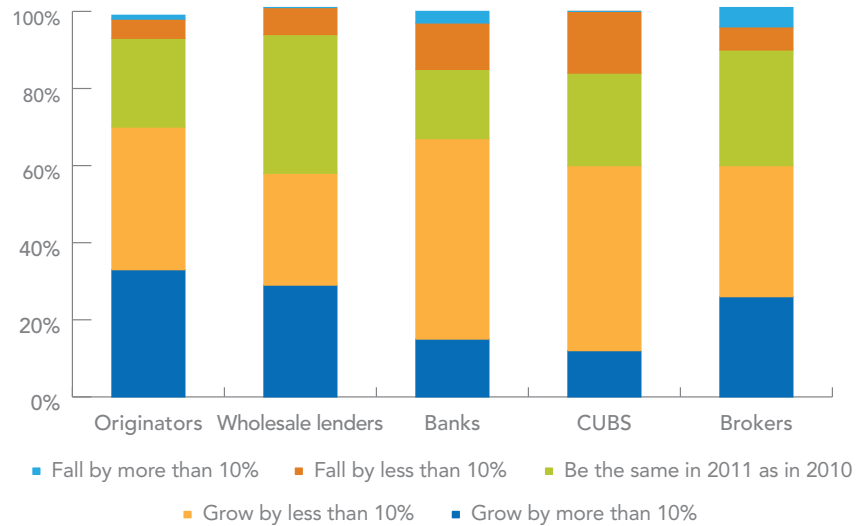
In general, the survey results found that banks are not particularly optimistic in terms of 2010 lending volumes—with 58% experiencing an increase in volume, ranked just below CUBS at 59%. The survey results also show that out of all the segments, banks are expecting the most significant decline in volumes in 2011 at 7%.

Over the course of the last couple of years, all lenders have experienced some degree of funding constraint as investor appetite for investment in securitised mortgages has fallen. It is worth bearing in mind that it is the smaller banks and CUBS that have suffered to a greater extent than the larger banks and that problems with funding are expected to continue to shape the market in the future.

As one expert commented, "the smaller bank lenders who were more reliant on their deposit bases for funding found the cost of funding increasing as lenders rushed to attract retail deposits. These same lenders then found it difficult to re-price as rates came down because of their skew towards term deposits. In effect they were squeezed in both instances."

Looking forward, how do you think the Australian mortgage market will perform in 2011, relative to 2010? (By performance we mean the volume of new lending)

Source: RFI



2011: Targeting tomorrow's borrower

Expectations for lending volumes for 2011

Overall, lenders were optimistic about mortgage volume growth for the Australian mortgage market in 2011. In total, 65% of lender respondents expect some growth in the mortgage market, while 22% expect lending to remain at 2010 levels and only 13% expect the market to contract.

The graph below uses RBA figures to show a forecast based on lending commitment growth and contraction expected by lenders in 2011.⁵

Among the segments, originator respondents were the most likely to expect growth, while banks were less likely to expect growth of more than 10%. Results show that wholesale lenders and CUBS are the least likely to expect growth in lending during 2011. This pessimism is likely due to a continued difficulty in the sourcing of funding combined with uncertainty in the market about the future direction of Government policy. This would account for the division

in sentiment among wholesale lenders: respondents from wholesale lenders were the least likely to expect growth overall, however of these, there is still a proportion who expect growth of more than 10%.

Source of growth—FHB, investor or refiner?

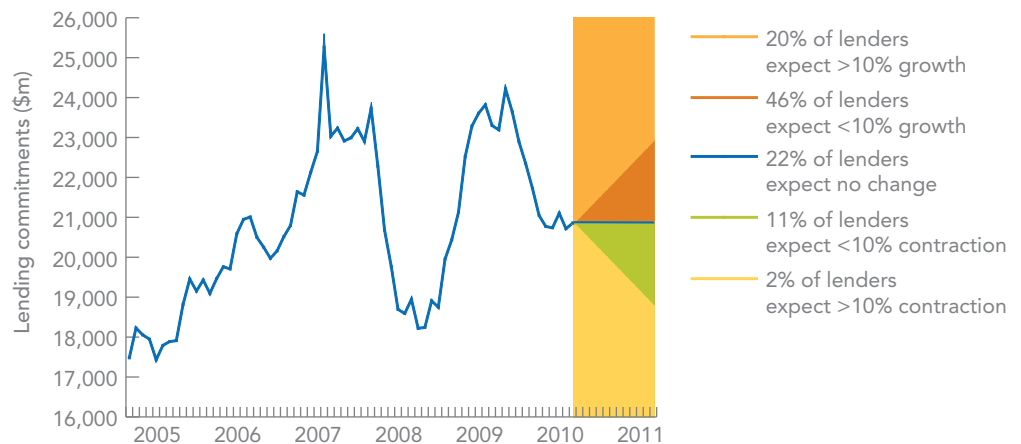
All segments were divided on the type of mortgage borrower that will provide their main source of lending in 2011. CUBS and banks predominantly expect upgraders to be their main source, at 39% and 31% respectively, while originators cite investors, and wholesale lenders expect their main source of lending to come from refiners.

Reduction in FHB lending

When comparing lending volumes in 2010 with expected volumes in 2011, it is the FHB segment that is expected to change the most. Every lender segment surveyed expects that this borrower group will see the biggest decline between 2010 and 2011.

Lending commitments (owner-occupied and investment housing)

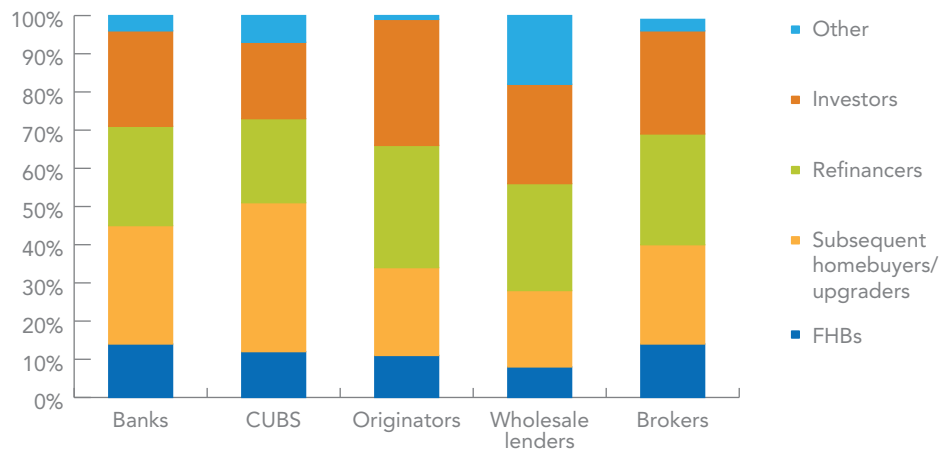
Source: Historic data from RBA with forecast data from RFI



⁵ RBA Data Sheet DO6 released in October 2010

Expected main source of lending for 2011

Source: RFI



As of July 2010, FHBs make up a smaller proportion of total dwellings financed than pre-GFC levels in 2008, but an additional factor is that the number of loans being originated has also decreased during this time. CUBS expect the largest decrease of FHBs in 2011, expecting 12% of their lending on average to be from this source, down 3% from 2010 when FHBs accounted for 15% of CUBS' lending volumes.

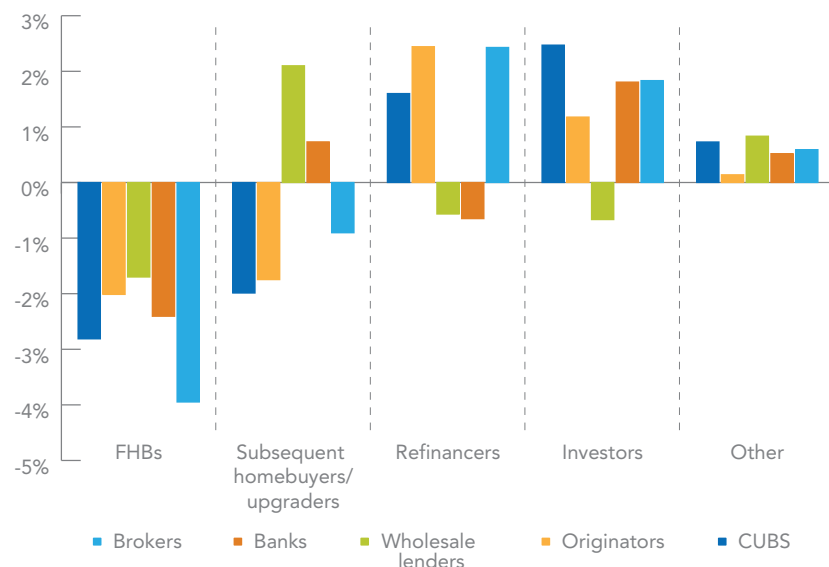
Cautious optimism from banks

Banks are the second most optimistic lender segment looking towards 2011, with 67% of bank respondents expecting an increase in lending volumes compared to 2010. And although they are the second most likely to expect growth, banks are less likely to expect growth of more than 10% with this growth expected to be mainly generated from investors and upgraders. They expect these segments to make up 25% and 31% of their lending growth in 2011 respectively.

Banks are expecting an average decrease in business from refinancers of only 1% in 2011 compared to 2010. At first glance this might not sound significant, but when put into context with the expectations of CUBS and originators, who were both expecting increases in business from refinancers of only 2% between 2010 and 2011, the contrast in outlook is starker. During 2008 and 2009 there was a movement of refinancers towards major banks and this may in part explain the differences in opinion. Perceived reputational damage to the non-bank sector caused by the exit of some high profile brands in 2008 may have made borrowers wary of non-banks, allowing the major banks to target these borrowers. Over the next year this trend may reverse as other lenders come back into the market and present borrowers with wider choice. As one expert said, "the reputation of the non-bank segment was undoubtedly hurt by the withdrawal of a couple of major brands and it has taken some time to recover."

Change in expected main source of lending between 2010 and 2011

Source: RFI





CUBS—declining volumes and looking to investors

CUBS are the most likely segment to expect a decline in volumes during 2011, with 16% of those surveyed stating this. CUBS are also the segment least likely to expect substantial growth of more than 10%.

CUBS are expecting the largest increase in investors, with expectations that this borrower segment will make up 20% of their lending in 2011. Conversely, CUBS are expecting the largest decrease in upgraders, even though this borrower segment is still expected to make up their main source of lending at 39%.

Wholesale lenders—pessimistic and betting on upgraders

Wholesale lenders are the least optimistic in terms of lending volumes for 2011, with 57% of those surveyed expecting an increase compared to the average of all lenders at 65%. Meanwhile, they expect their main source of business to be refinancers, at 28% of lending, while “other” forms of lending such as low-doc and near-prime lending are expected to make up 18% of their lending in 2011.

Compared to 2010, wholesale lenders are also expecting an increase in lending to upgraders in 2011, the biggest expected increase for upgraders among the lender segments. Interviews with industry experts indicate this increase may be due to upgraders who had previously deferred decisions to purchase or renovate due to uncertainty in the market, now returning. As confidence rises, provided interest rates do not rise drastically, it is anticipated that these upgraders will return to the market.

Originators—optimistic and relying on investors

Originators are the most likely to expect lending volumes to increase, at 71% of those surveyed, while they are also the most likely to expect high levels of growth, with 33% expecting growth of more than 10% compared to 2010 levels.

Investors are expected to be the main source of lending for originators, with an increase to 33% expected, followed by refinancers at 32%, and upgraders at 23%. This indicates that many originators are relying on investors as their main source of lending in the future. This expectation may be the reason behind why originators are particularly positive about 2011.

When comparing

lending volumes in 2010 with expected volumes in 2011, it is the FHB segment that is expected to change the most

Every lender segment surveyed expects this borrower group will see the biggest

decline between 2010 and 2011

CUBS are the

most likely lender segment to expect a decline in volumes during 2011

Banks predict

flat growth for 2011 and negative growth in new lending volumes

2011: The lenders' perspective —a snapshot of survey results

Banks

- 15% of bank respondents expect negative growth in new lending volumes during 2011 relative to 2010
- Banks expect their main source of lending will come from upgraders, at 31% of business, followed by refinancers at 26%, investors at 25%, and FHBs at 14%
- Banks are expecting an increased volume of investors and upgraders in 2011 compared to 2010, while they are less likely to expect FHBs or refinancers to make up their lending.

CUBS

- CUBS are the segment most likely to expect their main source of lending to come from upgraders, at 39%, followed by refinancers at 22%, investors at 20% and FHBs at 12%
- CUBS are expecting refinancers and investors to make up a larger proportion of their lending sources in 2011 compared to 2010
- CUBS are the most likely to expect the volume of new lending to contract, at 16%.

Non-banks

- Refinancers and investors are expected to comprise the main sources of lending for non-banks in 2010, making up 31% of lending each, followed by upgraders at 22%
- Non-banks are expecting an increase in the proportion of lending to both refinancers and investors in 2011 compared to 2010
- Non-banks are less likely than banks or CUBS to expect a decreased volume of lending in 2011, at just 7% compared to 15% of banks and 16% of CUBS.

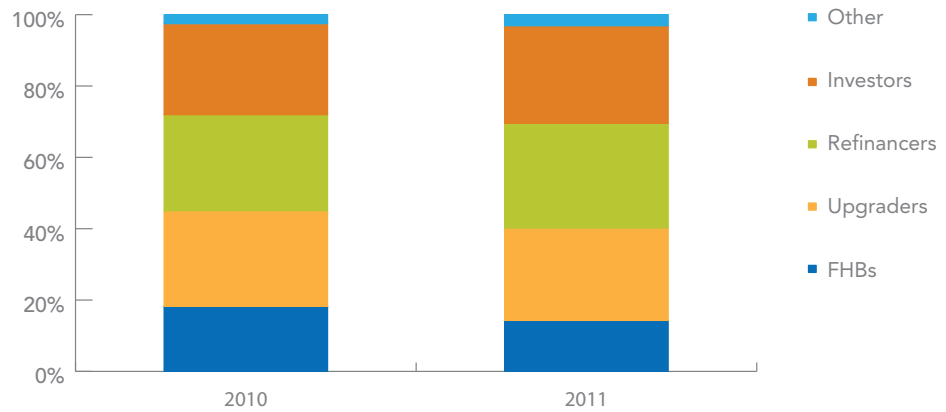
Wholesale lenders

- Wholesale lenders expect 28% of their business to be refinancers, while wholesale lenders also expect "other" forms of lending such as low-doc and near-prime lending to make up a larger portion of business compared with other lender segments
- Wholesale lenders are expecting an increase in the proportion of upgraders in 2011.



Source of lending for brokers

Source: RFI



The voice of the broker

Experiences over the last 2 years

Over the last couple of years brokers have been hit hard. In previous years, market changes brought challenges for this segment and drove consolidation. Of brokers surveyed, 36% state lending volumes decreased between 2008 and 2009 compared to an average of 24% of lenders. However, sentiment appears to be more positive in recent times, with 57% of broker respondents now of the opinion that lending volumes have increased in 2010 compared to 60% of lenders overall. When asked, brokers cite an increase of investors entering the market as driving an increased demand for brokers.

Majority of brokers expect lending volumes to increase

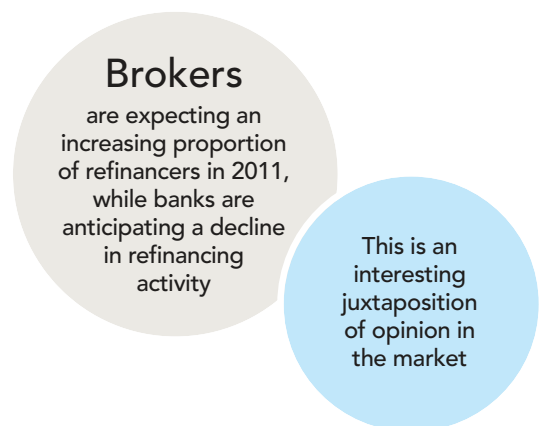
When comparing broker and lender expectations, 60% of broker respondents think lending volumes will increase during 2011, while 11% expect volumes to decrease, and 30% expect no change. Brokers are more optimistic about 2011 than 2010, with only 11% expecting a decrease in 2011 compared to 27% who feel lending volumes decreased in 2010.

Brokers expect a fairly even split between refinancers, investors and upgraders as their sources of lending in 2011, at 29%, 27% and 26% respectively.

It is worth highlighting that brokers are expecting an increasing proportion of refinancers in 2011, whereas the banks are anticipating a decline in refinancing activity. This is an interesting juxtaposition of opinion and could serve as an indicator of the landscape of the market in the near future. Brokers may well be looking to focus their attention on existing customers, providing them with a broader range of mortgage options in 2011 as a source of repeat business and growth.

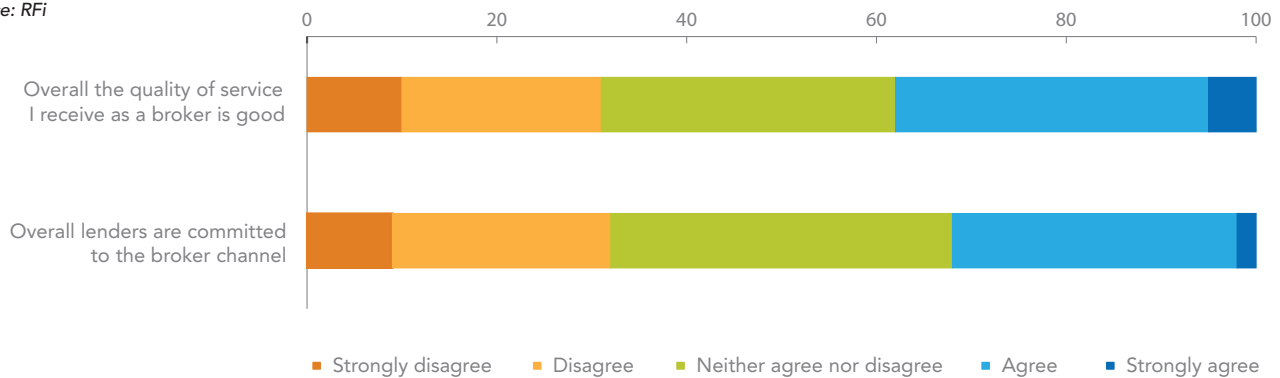
Certainly, the market is increasingly offering more choice for the borrower as we move towards 2011 and this view is supported by the opinions of industry experts interviewed who indicate increasing activity in the non-bank sector. One industry expert pointed out that "there has already been a noticeable increase in above-the-line activity on the part of several of the larger credit unions and we are hearing about them pooling together to obtain funding. [I expect that] as we move into 2011 we will see more of the non-banks competing also."

However, it is worth pointing out that not everyone was in agreement that there would be an increase in competition. An industry expert at one bank commented that from one perspective "there is already a decent amount of competition in the market, there are over 100 lenders and many hundreds of products on offer."



To what extent would you agree with the following statements:

Source: RFI



Broker commissions still under threat

The broker channel has experienced many changes over the past few years, with decreased commissions from some of the larger banks affecting the business as a whole. Industry experts interviewed revealed the broker channel could come under increasing pressure if it does not remain commercially viable for lenders and their margins. There is a perception, on the part of banks in particular, that further efficiencies are required in the broker channel, and that the business model needs to evolve further towards quality over quantity. Although the market is currently strong, this perception appears to create a large divide between lenders’ views of brokers and brokers’ own views of the broker segment.

As one industry expert from a bank said, “consumers will go to brokers regardless of whether we offer our products through them, so as long as the channel makes sense from a margin perspective, then it is in our interests to continue offering loans through brokers.”

Service innovation

The survey revealed 87% of brokers feel lenders should concentrate on innovation in processing technology, while 77% state lenders should focus on technology innovation for broker portals. Some 75% of brokers believe lenders should focus on automated valuation model technology, compared to just 30% of lenders who state they were focusing on technology innovation in this area.

Brokers’ “ideal” lender service

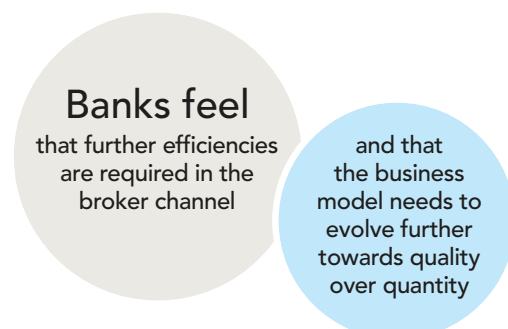
Brokers surveyed were asked about the features that would be included in their “ideal” lender service: the aspects that lenders could improve to help brokers and their business. The key aspects to this service revolved around three areas: communication, support and application process tools.

Communication—In total, 20% of brokers state that lenders could help by improving communication, particularly in terms of ensuring quick, accurate and consistent information. One area highlighted, by 10% of these brokers, involved better use of phone and electronic channels.

Support—One quarter of the brokers feel that lenders could provide better support at some level. Of these brokers, 25% feel banks could help their business by providing greater Business Development Manager support and availability through convenient channels. Of those surveyed, 16% feel that banks should provide better staff training in order for bank staff to better understand brokers and their lending practices. The remaining 59% of brokers who mentioned support generally felt that banks should treat them as partners rather than competitors, while also asking that banks not “steal” their customers.

Consistent, transparent and common sense credit checks were sought by brokers, who also state they would like flexibility so they can deal with customers on an individual circumstance basis.

Application process tools—Brokers state banks could assist their business by providing online access to client applications throughout the process, so they could provide accurate, up-to-date service to their clients.





State-by-state comparison

State highlights

New South Wales/Australian Capital Territory

- NSW/ACT lenders are the most likely to expect some growth in lending commitments during 2011, at 67% of those surveyed. NSW/ACT lenders expect growth in the investor segment, in line with the expectation that high demand and low supply will continue the upward movement of housing prices and investment returns.

Victoria/Tasmania

- Lenders in VIC/TAS are particularly likely to expect growth in the market, although predominantly at conservative levels of growth, similar to NSW/ACT lenders
- VIC/TAS lenders expect growth in the investor segment. Some industry experts surveyed point to a boom in building of units in the Melbourne CBD, which could drive investment in the short-term but ultimately risk an over-supply.

Western Australia/Northern Territory

- Lenders in WA/NT stand out as the lenders that are most divided in terms of growth expectations, with 38% of those surveyed expecting growth of more than 10%, and with 5% expecting a decrease of more than 10% by volume of new lending
- Lenders in WA/NT are expecting the largest proportion of FHBs in 2011 at 15% of lending, down from 18% in 2010
- WA/NT lenders expect a large increase in upgraders during 2011, with an expected 38% of lending to come from this borrower segment.

Queensland

- QLD lenders are the most likely to have seen decreased lending volumes in both 2009 and 2010, with 31% of respondents seeing a decrease in volume during 2009 and 32% expecting a decrease during 2010
- 13% of QLD lenders surveyed expect lending volumes to decrease in 2011.

South Australia

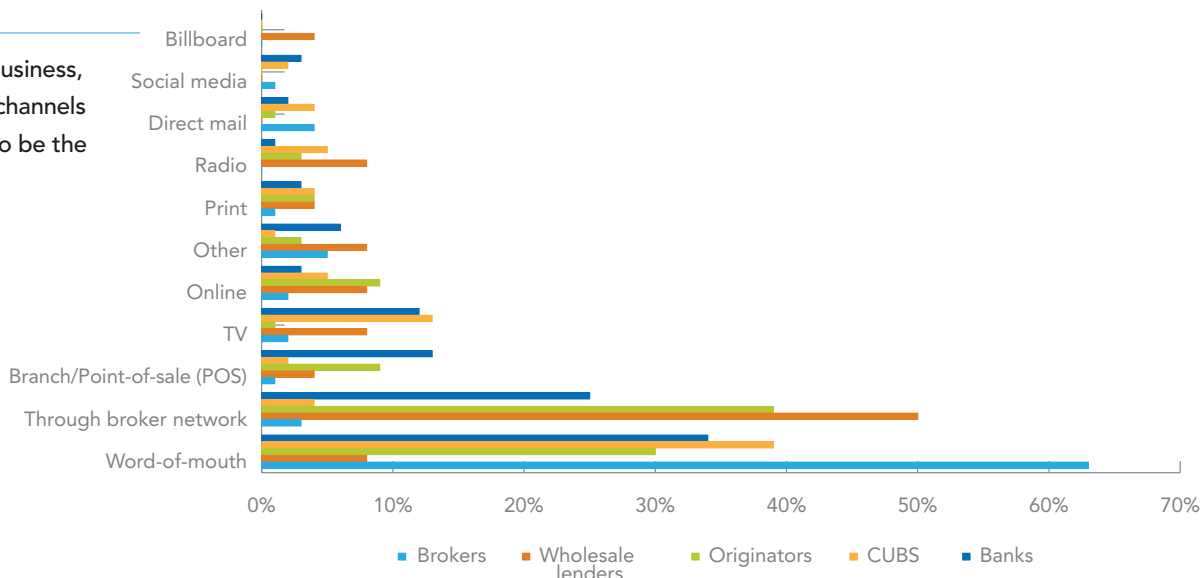
- 18% of SA lenders who took part in the survey are expecting a decline in lending volumes during 2011
- SA lenders expect their main source of lending to come from upgraders, at 35%, while investors are expected to make up 29%.

NSW/ACT
lenders are the most likely to expect some growth in lending commitments during 2011, in line with the expectation that

high demand and low supply will continue the upward movement of housing prices and investment returns

In growing your business, which marketing channels do you consider to be the most important?

Source: RFI



Issues impacting the market

Sales and marketing to target borrowers

Survey results show 32% of lenders state word-of-mouth is the most important marketing channel in growing their business. This indicates lenders are likely to link future growth aspirations with word-of-mouth marketing and, as a result, with improving customer service.

There is currently an increasing trend towards lenders looking to measure and drive levels of customer advocacy, which is one method of harnessing word-of-mouth marketing. It is interesting to note that despite the emphasis placed on word-of-mouth marketing as a means of business growth, lenders do not place a high priority on social media, which could be used to leverage word-of-mouth marketing online.

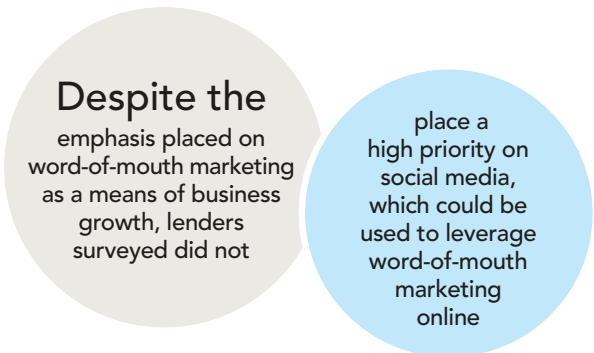
The online channel was rated below television for lenders and rated higher than other traditional media such as print and direct mail. Social media ranked below all channels except for billboard advertising. For lenders, traditional media such as television rated the highest priority for 10%, while print and radio account for 3% each.

Product innovation—the shape of the future market

Product innovation has slowed recently, with lenders more focused on issues such as loan quality and funding. With the Australian economy strengthening however, and the eventual phase-out of the Australian Government Deposit Guarantee, there may be a separation in the market between those who have adequate portfolios and can invest in product innovation and process efficiencies, as opposed to those who will be dealing with funding issues.

Interviews with industry experts indicate product innovation may not return to the agenda for lenders in the short-term, with constrained credit supply impacting the landscape for the next five or six years. There is a belief that innovation may be confined to niche players in the market, in regards to specialised policies and differing credit criteria, rather than to the major lenders.

One industry expert states, “better packaging of good quality deals” for borrowers would be the most important aspect of product innovation in the future, expecting a demand for a “whole of business” approach. This would bundle a suite of products in addition to a mortgage, rather than more exotic innovations to the mortgage product.





Also of note, is that in recent years consumers have sought flexibility and a “cocktail solution”, whereby part of a portion of the loan is subject to a fixed interest rate, while the remaining portion is variable. With interest rates expected to rise, one potential area of innovation is in fixed-rate mortgage products. Innovation may rely on adding a greater degree of flexibility to these loans.

All segments agree that FHBs would benefit most from innovative new products, in particular, 39% of brokers and 36% of lenders surveyed stated this. Lenders surveyed indicated they want to see innovation that would help buyers enter the market, such as higher loan-to-value (LVR) loans and a lower genuine savings requirement (which would help borrowers with small deposits), as well as flexibility of loan terms and greater use of capitalisation for lenders mortgage insurance (LMI).

With the phasing out of Government incentives provided to FHBs during the GFC and as part of the economic stimulus packages, the number of FHB loans, as a percentage of all loans, has quickly fallen. As discussed in Genworth’s **Streets Ahead** report, the re-emergence of the rental trap for FHBs is now becoming a significant issue. The increase in FHB loans due to the Government stimulus and low interest rate environment indicate affordability concerns play a large role in FHBs entering the market. As a result, greater product options such as the adoption of higher LVR loans, which would allow FHBs to escape the rental trap and enter the market earlier, would likely boost the demand for FHB loans also.

Suggested first homebuyer innovation from the survey:

- Higher LVR loans—enabling FHBs to borrow a greater proportion of property value and realise home ownership sooner
- Flexibility with loan terms—allowing FHBs flexibility when facing changes in their circumstances
- More flexibility with LMI payment, for example greater use of premium capitalisation—easing strain on FHBs when paying for LMI associated with mortgage.

After FHBs, lenders and brokers agree investors are most likely to benefit from product innovation, at 23% of lenders and 20% of brokers surveyed. For investors, lenders want to see products that include financial advice and take advantage of tax benefits (such as capitalising interest for negative-gearing). Lenders also note that, to attract more investors into the market, it is important for product innovation to take into account the repeat business of investors and possibly offer discounts on interest rates across multiple properties. Lenders suggest that this should be done in addition to providing simpler products. With lenders in general anticipating a larger proportion of future business to come from investors, to remain competitive, innovation in this area will become increasingly important.

One industry

expert states, “better packaging of good quality deals” for borrowers would be the most important aspect of product innovation in the future

Both CUBS and

banks expect their main source of lending to be upgraders in 2011

Suggested investor innovation from the survey:

- Products that include financial advice—a bundling of products which could help fuel investor appetite in property
- Products which take advantage of tax benefits—such as capitalising interest for negative gearing
- Simpler products—so that investment products are easier to understand.

Of those surveyed, 39% of CUBS and 31% of banks expect their main source of lending to be upgraders in 2011. As a result, product innovation for these segments should be seen as a priority. Lenders surveyed feel that innovation for upgraders would include increased access to bridging loans to finance borrowers between loans, greater portability of loans when moving home, improved access to higher LVRs and interest rate incentives.

Suggested upgrader innovation from the survey:

- Bridging loans—loans to cover the payout of an existing mortgage and finance a new property, to encourage upgraders
- Mortgage flexibility—to allow upgraders to move their mortgage to their new property
- Interest rate incentives for those with good record of repayment—giving incentive for borrowers to upgrade and increase borrowing
- Higher LVRs—to allow upgraders to borrow larger proportions of property value.

Lenders see refinancers as least likely to benefit from product innovation, however their ideas for refinancer products include a simplified refinancing process, rate discounts and higher LVRs on offer for debt consolidation.

With lenders

in general anticipating a larger proportion of future business to come from investors,

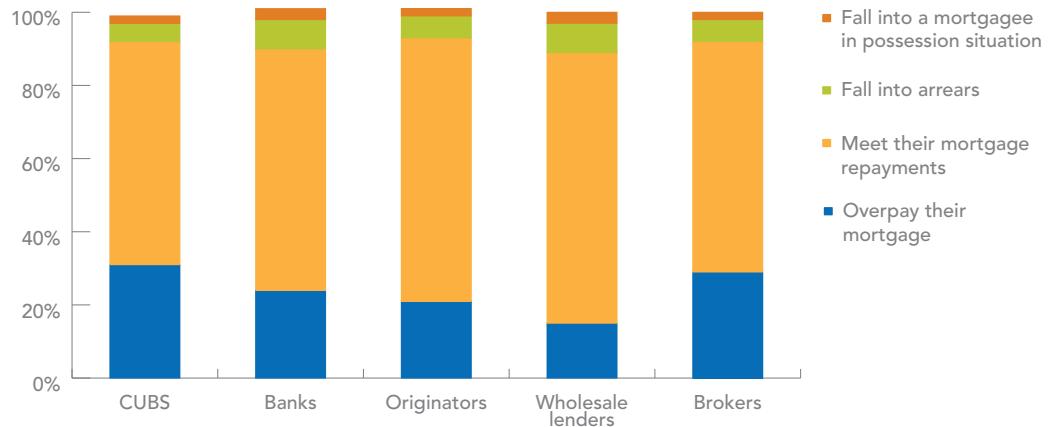
to remain competitive, innovation in this area will become increasingly important

Suggested refinancer incentives from the survey:

- Simplified refinancing process—an easier process will encourage refinancing
- Rate discounts and higher LVR on offer for debt consolidation—encouraging refinancers to manage their debt with their mortgage.

Expected borrower behaviour over the next 12 months

Source: RFI



Funding constraints the key to growth

According to industry experts interviewed, the two major factors impacting the mortgage market in the immediate future are funding constraints and changes to Government policy. We are already seeing a move in this direction with the Senate inquiry into competition within the Australian banking sector announced on 28 October 2010 and with the Government's comments in the media the following week regarding the work it is doing around options to support competition in the banking sector.

Funding constraints have had a big impact on mortgage lenders in recent years. The major banks have been able to take advantage of their access to lower cost funding to consolidate their market share, whereas the regionals and smaller lenders have had to pull back harder on lending volumes. Funding constraints for all lenders and increased focus on credit quality has resulted in tighter credit policies, which has led to a decrease in high LVR loans and a restriction on taking on new-to-lender customers.

Industry experts believe more could be done to help funding. As one expert stated, "while the Government has made steps with the AOFM (Australian Office of Financial Management) to help funding, ultimately there is more that could be done to facilitate securitisation. The Canadian Government does this and provides a good example of how funding can be eased."

A movement towards more sustainable credit policies permeates the market in 2010, with increased importance on deposit-based funding and credit ratings.

Government policy shaping the market

Government initiatives in the funding of Residential Mortgage Backed Securities (RMBS) resulted in funding being made available through 2009 and 2010 to non-bank lenders and smaller ADIs. With the Government providing an increased source of funding to those lenders who were adversely impacted by the decline of the RMBS due to the GFC, there is the possibility of increased competition from non-bank lenders during 2011.

There is a perception among industry experts who took part in the survey that Government policy will greatly impact the mortgage market in the immediate future. One such policy is the mining tax proposed by the Government. According to industry experts, "the uncertainty created by the mining tax debate has definitely impacted on the WA and QLD markets as the outcome of this will have big implications for employment and therefore housing demand."

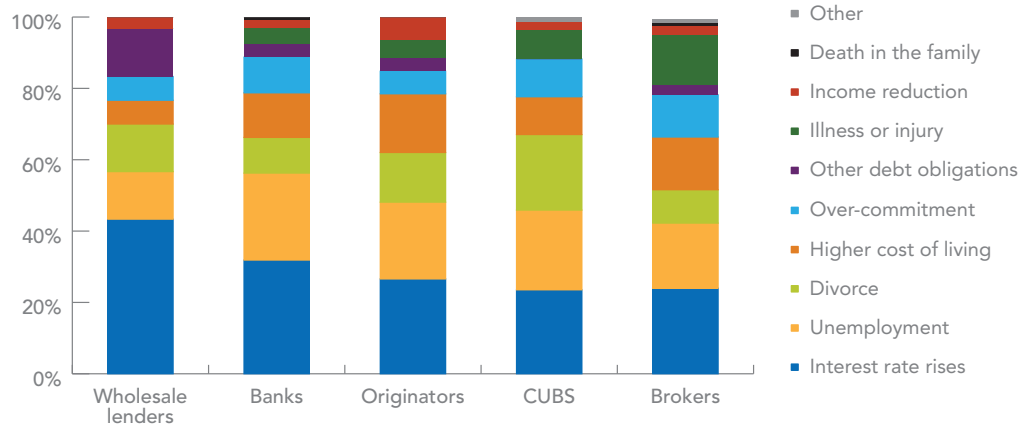
State Government policy that industry experts speculate could impact on demand in the mortgage market includes alterations made to stamp duty by the NSW Government, where stamp duty relief is currently provided to varying degrees for: property bought off-the-plan, for newly constructed homes, for empty nesters and for FHBs.

According
to industry experts surveyed, the two major factors impacting the mortgage market in the immediate future

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Lender perception of causes for borrower hardship over the next 12 months

Source: RFI



The NCCP Act and the effect on hardship

It is uncertain how the implementation of the National Consumer Credit Protection (NCCP) Act will affect lending volumes in the future. Requirements of the NCCP Act mean that lenders and brokers need to comply with certain responsible lending provisions, designed to ensure that loans are not unsuitable for borrowers, as well as new compulsory licensing requirements. Survey results show that brokers and lenders hold varying opinions on how the NCCP Act will affect their business, with 28% of lenders believing the NCCP Act will have a negative impact on lending, whereas 32% of brokers believe that the NCCP will have a negative impact on brokers.

In terms of the effects of the NCCP Act, brokers surveyed were asked whether they considered these changes could put greater pressure on ensuring borrowers do not make fraudulent applications. Of brokers surveyed, 43% stated they were concerned about borrower fraud, while 30% stated they were not concerned. Despite the large proportion of concerned brokers, 85% agreed they had the right controls in place to ensure that any attempted fraud is captured.

When interviewed, industry experts were divided on the effect the NCCP would have on brokers. One industry expert noted the broker channel will become an increasing liability to banks with the introduction of the NCCP, as banks are relinquishing some control to brokers in ensuring that fraud is controlled and as a result are presented with a risk from broker operations. On the other hand, another industry expert predicted "the balance of power could potentially swing back to the broker channel in the next year or so, with the NCCP weeding out the bad brokers and the rest commanding greater consumer and lender respect. It would not surprise me to see the channel account for half of the originated loans in the near future [up from approximately 40% today]."

Overall, the majority of brokers appear to be going through the NCCP licensing process without major concern. Just 17% of brokers surveyed stated they felt they did not have the support of industry bodies, while 16% of brokers stated they were not fully prepared for NCCP licensing.

A movement

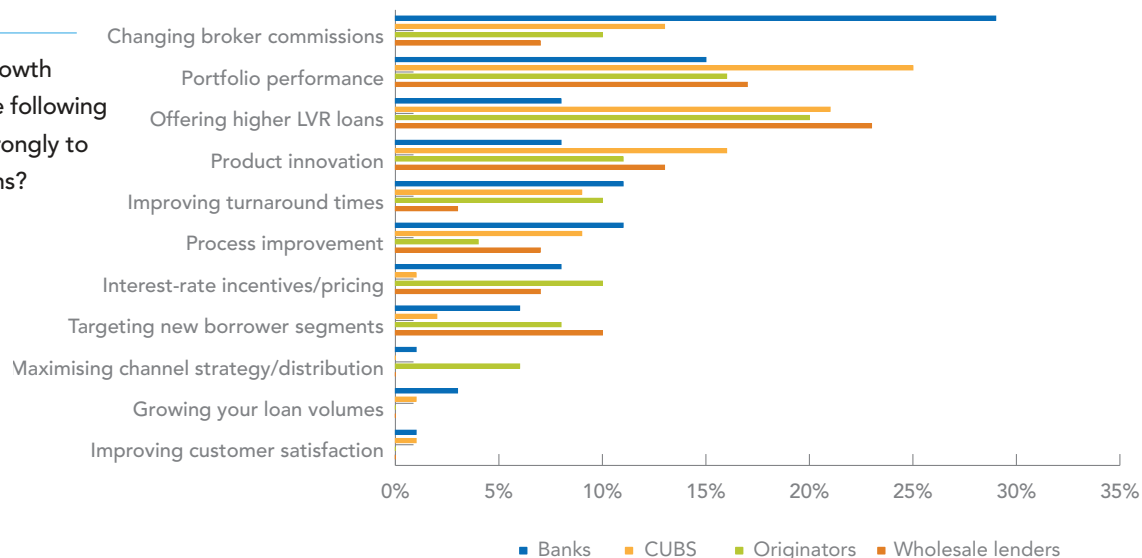
towards more sustainable credit policies permeates the market in 2010, with increased

importance on deposit-based funding and credit ratings



Bearing in mind your growth aspirations, which of the following will you rely on most strongly to achieve these aspirations?

Source: RFI



The impact of the NCCP on hardship

With increased focus on serviceability and responsible lending under NCCP, the effect on hardship applications should be positive.

However, borrower hardship in the mortgage market is always an issue for lenders, and mortgage stress, caused by rising interest rates and a general increase in the cost of living, is fuelling repayment concerns. Lenders list interest rate rises as the most likely primary cause for hardship, with 30% of lenders surveyed stating this.

On average, survey results showed that lenders expect 7% of borrowers to fall into arrears and 3% to become a mortgagee in possession.

Unemployment a major driver of hardship

Survey responses also indicate lenders and brokers view unemployment as a continuing concern and cause of hardship, with 82% of lenders rating it among their top five factors which will contribute to hardship. This reflects the findings of the recent Genworth **Streets Ahead** report, which showed unemployment and income reduction were the two primary causes of hardship during the first half of 2010, despite the improvement of the unemployment rate.

Although the unemployment rate has continued to improve in Australia, there is currently a higher proportion of part-time workers compared to pre-GFC levels, which indicates under-employment may continue to be an issue for borrowers being unable to meet their mortgage repayments.

Of lenders surveyed, 42% expect rising costs of living and interest rates to drive hardship applications over the next 12 months and hence to have a significant impact on the repayment ability of borrowers.

Service innovation from technology and processing

Processing technology is the area of innovation lenders feel requires the most focus, with 69% of lenders and 87% of brokers surveyed stating this was the case.

As margins become more constrained, markets, expenses and improvements in processing and servicing are expected to continue to become a more important aspect of their business. Improvements in servicing at the front-end and back-end of lending will be important, especially in the survival of smaller lenders.

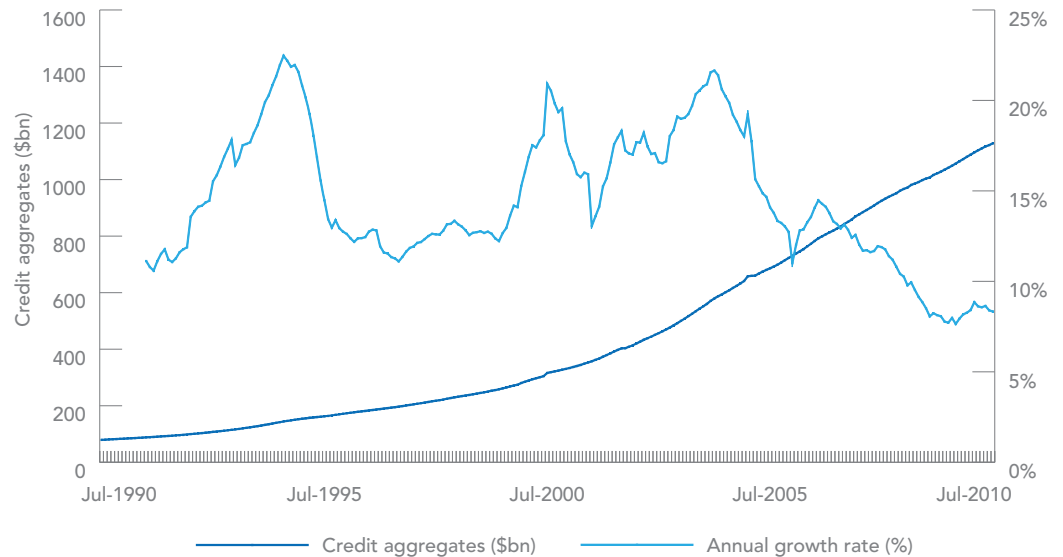
For lenders, service is the most likely area of innovation to be focused on by 69% of those surveyed, followed by 51% who state they are focusing on direct application channels and 45% who state they are focusing on website development. In total, 20% of lenders state they are not focusing on any form of technology development.

Industry experts single out after-sales care of mortgage customers as an important area for service innovation. One expert notes it is important to develop a “boutique relationship” with the customer during the life of the mortgage. When asked during the survey, banks commented they would rely on improving customer satisfaction to drive their growth at 29%, far ahead of growing loan volumes at 15%.

CUBS, on the other hand, are the most likely to focus on growing loan volumes at 25%, followed by maximising channel strategy and distribution. Compared to the rest of the lender market, banks appear to be focusing on business growth through customer satisfaction as opposed to targeting new borrowers and maximising their channel strategy. This reflects that a large amount of work has been done on channel distribution during previous years.

Credit aggregates including securitisations (owner-occupied and investor housing)

Sources: RBA (historical data), forecast based on interviews conducted by RFI



Credit aggregate growth expected to slow

The net result of the industry outlook from survey participants regarding new lending is that overall, credit growth is expected to slow in the next few years. Industry experts interviewed anticipate average growth of approximately 5% over the 2010–2015 period, with some expecting the slower growth rates to prevail for much longer periods. As one industry expert commented, “we have had a decade of 10% average growth, I think we will see a decade of 5% growth.”

Based on RBA figures for credit aggregates, including securitisations for owner-occupied and investment housing lending, 5% year-on-year growth over the next five years will result in an increase of credit aggregates from \$1,128bn in July 2010 to \$1,440bn in July 2015.⁶

The contributors to growth

There are a variety of factors currently at play in the market which encourage and discourage the growth of housing credit aggregates.

Pushing up growth rates:

- Fewer people overpaying: means credit aggregates are not seeing the same outflows as previously, keeping credit aggregate levels high
- Interest rates rising: higher interest rates mean the amount owed on mortgages is increasing faster than previously
- Higher housing prices: mean higher amounts are borrowed on average by new entrants into the housing market.

Depressing growth rates:

- Funding constraints and decreased lending: tighter lending regimes mean loans may not be granted to borrowers with the same repayment ability as in previous years, restricting new borrowing and pushing the growth of credit aggregates downwards
- Borrower demand reducing: falling demand from borrowers, particularly FHBs due to a reduction in incentives, will reduce new entrants into the housing market and new borrowing.

Lenders

and brokers view unemployment as a continuing concern, and cause of borrower hardship, with 82% of lenders rating it among their top five factors which will contribute to hardship

The net

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⁶ RBA Data Sheet DO2 released in October 2010



Conclusion

The fall-out from the GFC affected the mortgage market in a variety of ways. In particular, many non-bank lenders scaled back their operations and/or left the market because of a lack of available funds and borrower preference, while larger banks were able to capitalise on their deposit bases and leverage their funding competitive advantage over smaller banks, CUBS and wholesale lenders.

In 2010 the fortune of homebuyers within the Australian market has changed rapidly. The FHB segment, which drove growth in 2009 and early 2010, has retreated from the market due to decreasing housing affordability in combination with the withdrawal of Government incentives (which were short-term economic stimulus measures). Meanwhile, interest rates are returning to normal levels. Increasing house prices in conjunction with returning consumer confidence and the diminishing FHB market appear to have opened up the market to investors in terms of future growth. All segments surveyed see confidence in the residential property market as likely to have the most positive impact on new lending in 2011. Respondents also see "major bank lenders having greater availability of funds" as a strong influence on the lending market.

There is an expectation that growth in housing credit aggregates will average 5% during the coming decade compared to over 10%

during the previous decade. This will result from an adjustment in borrower demand, such as decreasing demand for FHB loans, and a combination of tighter lending criteria. The place of the broker channel will also be affected by this, with indications that banks will consider removing support for brokers if they do not remain profitable.

Looking ahead, industry experts interviewed agree funding and Government policy could have the biggest effects on the market, and increasing interest rates and unemployment will also be important. There is a belief that the ability to obtain funding at a reasonable price will differentiate lenders, shaping the market in terms of process and service innovation. In addition, future shaping of Government policy will contribute to an ever evolving mortgage market.

Whatever their individual perspective, all participants in this research were united in the opinion that the next 12 months will be a critical phase in the future of the Australian mortgage market. The solutions to funding, in whatever form, are likely to define the growth of the market and the players that participate in it. From a mortgage market perspective, we are and will continue to live in interesting times.



About Genworth

Genworth Financial (Genworth) is a leading provider of Lenders Mortgage Insurance (LMI) in Australia and New Zealand. In partnership with lenders, our aim is to make home ownership more accessible to borrowers through the provision of LMI solutions.

Working with close to 200 lenders, Genworth has built a reputation for its expertise in understanding the evolving mortgage market. Our financial strength is underpinned by our AU\$3 billion investment portfolio, as well as our rich data gained through insuring mortgages for over 45 years.

Our Hardship Solutions team was formed in 2006 and, in conjunction with lenders, has assisted over 15,000 borrowers to stay in their homes.

For more information visit genworth.com.au

About RFI

RFi is a strategic research business that delivers research and analysis by identifying and formulating projects within the arena of retail finance. RFi's business model is underpinned by B2B and B2C primary research, a factor which enables RFi to determine the key issues affecting any market.

For more information visit rfintelligence.com.au

Methodology

The **Home Grown: Mortgage Industry Perspectives** report is produced by RFi on behalf of Genworth. It presents the results of one of the most comprehensive surveys of mortgage market participants conducted in Australia.

To formulate the report, RFi conducted an online survey in September 2010 of over 350 industry professionals working for lenders in the areas of product, strategy and credit risk, and surveyed over 200 brokers.

To supplement this, a series of in-depth face-to-face and telephone interviews with leading industry commentators from various segments, some trade associations and ratings agencies was conducted.

Notes

This independent report is based on survey results of over 350 people working for lenders and over 200 brokers and does not represent the views and opinions of Genworth. While the information contained in this report is current as at the date of publication, it is subject to change without notice. Genworth is under no obligation to update the information or correct any inaccuracy which may become apparent at a later date. Permissions should be sought from Genworth for use of this report by third parties. Genworth does not take any responsibility for reliance on the information contained in this report, nor for its accuracy or completeness.

Streets Ahead: Genworth Homebuyer Confidence Index

Streets Ahead, Genworth's biannual report that explores borrower and would-be borrower sentiment, is now available.

Find out more at genworth.com.au/streetsahead



genworth.com.au/homegrown

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