Narrow Road Capital

A double win for the major banks

Whether it's by deliberate decision or by happenstance, the Federal Government has handed the Australian major banks two big wins over their non-bank competitors. The decision to undo the current responsible lending framework is a major victory for the majors, whose inferior credit skills and processes meant they were limited to a smaller group of borrowers than non-banks. The emergency funding from the RBA has provided a buffet of cheap funding to banks, with the RBA earning no margin on its pass-through funding. This is a stark contrast with the AOFM's non-bank funding program, which is of a decent size but comes at market rates which are roughly 1.25% higher than the RBA is charging. The result of these two changes has and is likely to continue to be a substantial shift of borrowers away from non-banks towards the major banks, which is ultimately a long term negative for competition and consumers.

Why the majors wanted responsible lending killed off

Contrary to the narrative promoted by the major banks and many in the media, responsible lending is about far more than just who is responsible when a loan goes bad. I acknowledge that the moral arguments are important and that both sides have good points.

Banks will point to the fact that a substantial portion of borrowers readily admit (after the fact) to lying on their loan applications. There's also the wagyu and shiraz opinion, that borrowers often have a level of flexibility in adjusting their lifestyle if they want a bigger loan for a better home. There's also the personal liberty arguments; that one person is comfortable owning ten highly geared investment properties whilst another would rather clear the debt on their home and stick to one investment property. The highly geared borrowers typically claim to be sophisticated investors when they are rapidly building a geared portfolio but often turnaround and claim to be naïve and misled when it all comes undone. Responsible lending is a hindsight process that assesses risk after the event, rather than the risk that was presented at the time the loan was made.

Conversely, banks know far more about finance than the vast majority of borrowers. An experienced credit analyst can spot potential problems early and can either turn down the application or dial down the risk. It can be argued that debt is like a doctor prescribing drugs, the two parties aren't equally skilled so the expert (the physical or financial doctor) should not allow an unsuitable prescription to be made. Considering potential life events (unemployment, sickness, having children, caring for relatives) is something many borrowers don't factor in, but a prudent lender does. Bank employees are often rewarded for generating greater volumes or higher margin loans, an obvious conflict of interest that has resulted in some borrowers being lent far too much. There are many good reasons that responsible lending protections in some form should still exist.

What really got up the noses of the major banks was that non-banks were able to write loans that major banks couldn't. This was partly a choice (especially non-conforming loans) but also due to major banks neglecting credit skills over the last two decades. As someone who started my post-university working life in a major bank, I've seen the decline in lending standards firsthand. Where major banks typically taught credit skills to their graduates and other staff coming up through the ranks, increasingly the decisions have been delegated to systems.

Major banks have deliberately underinvested in their staff, meaning they have few remaining who are able to assess complicated loan applications. They have effectively ceded the self-employed borrower segment to non-banks, lacking staff skilled enough to assess the financial position of small and medium size business owners. Conversely, non-banks have generally trained their staff to ask more questions and assess more information. This not only allows non-banks to assess and approve non-standard applications, but it helps weed out higher risk borrowers.

An often repeated lie from the major banks is that they see the best applications with non-banks left to fight over the crumbs. The data has for many years shown this assertion to be steaming horse manure. Prior to Covid-19, many prime non-banks were reporting 30+ day arrears of less than 0.50%, compared to the 1.50-2.00% level of the major banks. Since the onset of Covid-19, the deferral rates for major banks have been roughly double that of the prime non-banks. The accusation that non-banks were gaining market share by writing poor quality loans has been disproven; non-banks were gaining market share by offering a better service and price, to a larger pool of borrowers.

This gets us to why the major banks wanted responsible lending killed off. Rather than training their staff and improving their systems to be able to service a wider range of potential borrowers and conduct detailed credit analysis, major banks figured out that killing off responsible lending would be easier. If they can operate in a buyer beware world, they can write the loans without undertaking the appropriate credit assessment.

This will likely increase the gap in arrears between the two groups, as the inferior credit processes by major banks are likely to approve more low quality applicants. It's the applications that prime non-bank lenders reject that make prime non-bank lenders the best when it comes to arrears. (Note than small ADIs also typically have low arrears levels.) These lower quality applications would be classified as non-conforming by non-banks, but major banks will call them prime and charge interest rates reflecting an overly favourable assessment of their risk. Despite claiming it's the other way around, major banks may end up being the muppets targeted by weaker borrowers as a result of responsible lending regulation being killed off.

Funding costs

The RBA's term funding facility has allowed the major banks to borrow tens of billions of dollars of senior funding at a fixed rate of 0.25% for three years. This has had the impact of throttling the sale of major bank senior bonds and leaving some depositors struggling to find a home for their cash reserves. The major banks have responded by offering cheap fixed rate home loans, kicking off a refinancing wave that has seen major banks win back several years of market share in a matter of months.

In contrast, the government funding for non-banks is expensive, functioning as a backstop program at market prices. Whilst not a complete like for like, prime senior AAA RMBS is selling at an all-in cost of around 1.40-1.60%, roughly 1.25% higher than the RBA's facility.

In the short term, the biggest winner of this tilt in the competitive playing field are borrowers refinancing to major banks at cheaper rates. However, in the long term this undermines competition in the home loan market and makes it harder for non-banks to enter and survive. Like most stimulus measures, the long term negative consequences outweigh the short term positives.

I see the best solution to this funding imbalance to be adopting the same stance towards banks as is in place for non-banks. This would mean the RBA makes funding available to banks as needed, but at a market rate rather than a heavily discounted rate. This would ensure that both banks and non-banks can compete fairly, with the government earning an appropriate return for its intervention in both cases.

Written by Jonathan Rochford for Narrow Road Capital on 3 October 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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