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Recent changes to banking regulation

The federal government has recently announced some substantial changes to banking regulation. The government anticipates greater protection for borrowers and greater competition for lenders. Two of the most significant changes are the banning of mortgage exit fees and the end of the prohibition on **Australian deposit-taking institutions** (**ADIs**) issuing covered bonds.

Banning mortgage exit fees

The National Consumer Credit Protection Amendment Regulations 2011 became law on 23 March 2011. These regulations amended the National Consumer Credit Protection Regulations 2010 by banning lenders from imposing 'back-end' charges payable on termination of home loans entered into after 1 July 2011, such as deferred establishment fees or early termination fees. The banning of exit fees further extends previous federal amendments in 2009 requiring lenders to advertise comparison rates.

This is not a blanket ban and it only applies to loans secured by residential property. The ban is limited to credit fees or charges and does not cover break fees for early repayment of fixed-rate loans or discharge fees that cover reasonable administrative costs of terminations. Crucially, it only applies to loans entered into after 1 July 2011.

The federal government has high hopes that these amendments will increase competition in the home loan market and enhance transparency by allowing borrowers to discern from the outset what the best deal is. The government anticipates that this increase in competition will drive down interest rates as lenders attempt to attract borrowers. Accordingly, borrowers could stand to benefit in a 'big picture' way and it already seems to have generated competition, with major banks launching massive advertising campaigns in an attempt to woo consumers. Unfortunately, it is difficult to know what practical effect this will have because many ADIs have already applied to ASIC for exemptions.

These reforms will affect different lenders in different ways.

If you are a lender who does not rely on mortgage exit fees, these amendments will provide an excellent marketing opportunity. You will not need to raise other fees or interest rates to recoup lost revenue. Your institution will appear stable and attractive when compared to lenders that will have hiked up their fees in response to the amendments, inspiring consumer confidence.

However, these amendments may strike a blow to the reputation of lenders relying heavily on home loan exit fees. They will have to raise other fees, charges and interest rates to remain profitable, which may make them

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appear unstable and mean-spirited. It will seem particularly distasteful because borrowers entering into home loans before 1 July 2011 will be stuck with the higher rates and charges and still be liable for exit fees.

Thus, lenders that are competitive without having to rely on back-end charges stand to prosper under the new regime. Conversely, lenders who rely heavily on revenue from mortgage fees look set to receive bad press when they have to raise other fees.

Covered bonds

Under the federal government's draft Banking Amendment (Covered Bonds) Bill, published on 24 March 2011, Australian banks, credit unions and building societies will soon be able to issue covered bonds. Covered bonds are subject to the asset coverage test; the asset pool relating to the bond must at all times be equal to the amount outstanding of the bonds. The draft regulations require ADIs to appoint a cover pool monitor, whose job is to ensure the asset pool is at all times larger than the debt. Covered bonds are common in Europe, but have so far been prohibited in Australia. The Australian Prudential Regulation Authority (**APRA**) had previously prohibited issuing such bonds because it would contravene the Banking Act by conflicting with depositor protection standards; depositors must be placed above all other creditors in claims for assets.

This is a significant change for the banking sector, but the ability to issue covered bonds will be limited. ADIs cannot issue more than the equivalent of 8 per cent of the issuer's total assets in covered bonds. Further, in certain situations, APRA can order ADIs not to issue such bonds. APRA can also impose additional requirements or limitations on issuance.

These changes may disadvantage deposit-holders, but should benefit investors and issuers alike.

Critics have suggested this will have an adverse effect on depositors, who will now come second to bondholders in priority. Treasurer Wayne Swan has dismissed these criticisms, stressing that deposits will continue to be protected under the Financial Claims Scheme.

Covered bonds are typically AAA rated. The credit rating ascribed to covered bonds is often higher than that of the issuer itself because bondholders will have recourse to a segregated asset pool maintained by the cover pool monitor. This will attract conservative investors looking to diversify their portfolio without sacrificing credit quality.

Allowing ADIs to issue covered bonds should benefit these institutions as well by diversifying their funds base. These changes are being considered a step towards giving ADIs access to cheaper, more stable and longer duration funding in wholesale capital markets. Importantly, this could potentially provide for lower borrowing costs.

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