

SUBMISSION TO THE COMPETITION COMMISSION OF SA ON THE REPORT "THE NATIONAL PAYMENT SYSTEM AND COMPETITION IN THE BANKING SECTOR"

The report prepared by FEASibility entitled "The National Payment System and Competition in the Banking Sector", is indeed **"a comprehensive analysis of the national payment system (NPS)"** as stated in the press release, issued by the Competition Commission of SA on 20 April 2006.

According to the press release there are, however, a number of concerns to the Competition Commission. To me, the crux of the matter is, **"Any link that there may be between the operating costs associated with a payment transaction and the charges made by banks in that regard is not transparent. It thus may be the case that bank fees have less to do with the cost of the payment system and more to do with the market power of the big banks in setting fees."**

The simple answer is there is no relation between these two aspects. As with any company, banks have income and expenditure accounts. As expenditure increases, so must income in order to grow profit. It does not matter where and how this is achieved. Apart from other possible ways and means available to banks, what better way than increasing bank charges, which are spread over a wide range of products and services. There obviously are various other causes which may result in a steep hike in expenditure, but there is one common factor which is causing significant problems to all four major banks and that is the commission which they pay to bond originators.

For the last few years, I have been advocating in numerous letters to the press, the Banking Council, The Office of the Banking Adjudicator, the Ministry of Finance, the Reserve Bank and others, that the single most important contributing cause of high bank charges in this country, is the excessive commission paid by banks to mortgage originators. I was, therefore, encouraged by the above quote from the aforesaid report, to make this submission to the honourable commission.

1. Introduction:

While certain arrangements in respect of the payment of commission for bond applications have existed between banks and estate agents for many years, the concept of bond originators came to South Africa in about 1999. The idea of a bond originator basically entails a person or institution shopping around for the best mortgage interest rate for prospective homebuyers. In a relatively short period of time they have become the major source of bond applications for banks and are now responsible for between 65% and 70% of all home financing deals. Abroad, where the idea of originators evolved, banks actually charge different bond interest rates. Here, all four major banks involved in housing finance, charge the same prime bond interest rate. The commissions paid to originators in other countries are also considerably lower than here. It appears, however, as if banks, because of their fear of losing market share and not using their own marketing structures properly, have fallen prey to the concept of originators. This was really unnecessary as banks have all along negotiated discount interest rates with clients, more particular in terms of schemes entered into with employers or packages offered to individuals, who qualify. It is certainly not the novelty that originators make it out to be.

The originators have inexplicably taken over the function of the banks' own loan consultants and created a niche for themselves. The commission paid to them and the discount interest rates which they negotiate on behalf of applicants, have severely impacted on the cost structure of banks, as there are nowadays very few bond applications which are not referred to them by originators, or where lower than average interest rates do not apply. Banks are locked into long term agreements with originators from which they cannot renege and which are shrouded in secrecy.

There can be no doubt that the profit margins of banks are under pressure. A bank does not have money of its own, only that of its depositors and shareholders and if margins come under pressure somebody has to pay. Each and every bank client (also those bond applicants "who don't have to pay a cent") accordingly pays for the services rendered by originators. No wonder bank charges have rocketed since banks bought into the concept of bond originators. Standard Bank, for instance, shocked the market in April last year by increasing its administration fee on home loans by 305% in order to recover portion of its costs. The fee was increased from R5,63 to R22,80 per month, for mortgage loans in excess of R500 000,00. I submit that clients and shareholders of banks have no idea of the amounts of commission paid to originators.

In a recent article in the SA attorneys' journal by Roger Green (De Rebus, April 2003) he had the following to say about originators:

"It has been reported in the press that Nedbank has cut the commission payable to Mortgage SA.Com which is the largest mortgage originator. Mortgage SA.Com has responded by stating that it will not pay its staff commission on business referred to Nedbank".

He also makes the following interesting observation:

"Although mortgage originators claim to obtain the best rates for members of the public, loans are not referred to SA Home Loans which has rates lower than all the banks. The reason being that SA Home Loans will not pay commission to a mortgage originator."

2. Commission Structures:

Banks are paying originators commission of between 1 and 2% of the capital amount of bonds referred to them. To illustrate the effect of this, I refer you to an in house report compiled by Paul Buys, an analyst at NedSec, Nedbank's investment and share broker subsidiary, entitled **"Mortgage Originators and the banks"**. I could not obtain a copy of the report as I am not a client of NedSec, but in FIN Week of 26 October 2005 there appeared an article by Vic de Klerk on the report by Buys. According to De Klerk, Buys found that, ***"Over the past 12 months, mortgages worth around R115bn have been granted to mortgage originators, the largest of which are PA Betterbond, MortgageSA, BondChoice and Loan Link. That's about 70% of the total growth of R165bn in SA's Big Four banks' mortgage advances.***

In exchange, the banks have paid mortgage originators – at a commission of up to 2% of the value of a loan around R1,4bn in the past year.

That's about 6% of the banks' total profit over the same period."

According further to the article, the average lifespan of a bond is 4,5 years which has the effect that commission paid to originators severely impacts on the profitability of banks. ***"In***

Nedbank's case – partly as a result of its low profitability – the figure is as much as 25%. First National Bank's high profitability reduces commission to 7,5% of its profit. Over the past year, Standard Bank paid 11,9% of its profit from retail banking to mortgage originator; Absa's figure is 19,1%.

If one considers the total amount of commission paid to originators by banks over the past financial year, questions may well be posed as to whether depositors and shareholders of banks are aware of the extent of their banks' involvement with originators and why it was necessary for them to get involved at all.

3. In Conclusion:

- ❑ The mere fact that originators submit the same bond application to more than one or all four major banks is a wasteful to banks as only one bond is taken up by a specific client, while all the banks to which applications were submitted, necessarily incurred administrative costs in processing the application.
- ❑ The main function of originators is to find the best "deal" for prospective buyers. This normally means the best interest rate. However, all the major banks have certain credit criteria whereby they qualify bond applicants. An originator cannot, therefore, obtain a better mortgage interest rate for a client than his credit profile allows. If any bank were to sacrifice this principle, it would place itself at risk. There is, however, no duty on originators to disclose to prospective buyers their ties with banks and the commission paid to them. Accordingly banks that pay a higher introductory commission receive more loan applications.
- ❑ As a consequence of banks paying for bond applications their respective market shares in the mortgage industry do not necessarily reflect the true position, but rather the extent to which they are prepared to pay for such.
- ❑ None of the four major banks are prepared to break the mould, for instance, by offering to pay the registration costs of bond applicants who approach them directly. This is a far cheaper option than to pay commission to a bond originator. The commission on a bond for R500 000,00 calculated at 1,8% is R9 000,00 whereas the bond registration cost would be approximately R4 500,00. They are simply too scared to do this lest it may affect their standing with originators. On the other hand, originators use this exact same enticement by paying bond registration costs from their commission, which leaves a bitter taste with clients who apply directly to their banks for mortgage loans.
- ❑ If the intention of banks were to outsource the completion of their mortgage bond applications it is all very well, but then the fee for this should be commensurate to the effort involved and not the ludicrous sums they are paying at present.
- ❑ The relationship between banks and originators should be investigated in depth, if not by the Competition Commission, then at least by the Department of Trade and Industry.

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