What Now for Housing Debt

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In October 2008, the Treasurer directed the Australian Office of Financial Management (AOFM) to invest in residential mortgage-backed securities (RMBS) as a temporary measure in response to the Global Financial Crisis.

The AOFM has allocated most of the $8 billion earmarked for such purchases. With financial markets showing some signs of recovery, it is appropriate to ask: what next – particularly given calls for extending government guarantees to RMBS and/or extension of the AOFM scheme?

While the scheme does not appear to have achieved the objectives of promoting efficient financial markets, depressing mortgage interest rates, and maintaining competition in housing lending, things could have been much worse in its absence. There may thus be a case for a temporary extension while longer term policies towards resuscitating securitisation are worked out.

Extending the explicit government guarantee to RMBS is not desirable. Indeed, the AOFM investment scheme has similar effects to the guarantee scheme in that the Government bears the credit risk of those securities (by holding them). Rather than receiving a guarantee fee, it receives the credit spread over the risk free rate.

That has pluses and minuses. The AOFM scheme is quantity rationed (unlike the guarantee scheme) so that only a few successful issuers can participate. But the credit spread (unlike the guarantee fee) is, at least partially, market determined and should decline as market conditions ease and investors return to the market.

The limited participation possible in the scheme is perhaps one of its drawbacks, as only a small number of mortgage originators benefit. At the end of June 2009, the AOFM had invested just over $6 bill in 13 series of RMBS from 9 different issuers.

The scheme has also not been particularly successful in drawing private sector investors back into the market. AOFM investments accounted for 75 per cent of the total value of these RMBS issues. There have been virtually no other Australian RMBS issues since the introduction of the scheme.

It may be that the AOFM has simply substituted for (crowded out) private sector investors who have taken up government (or government guaranteed ADI) debt (some part of which is funding AOFM purchases of RMBS) instead.

But the crowding out story should involve declining RMBS spreads and lower variable rate mortgage spreads. The margins (over BBSW) on new RMBS issues are not much changed from immediately prior to the scheme. And the margin on bank (and mortgage manager) standard variable home loan rates has increased by around 50 basis points.

Thus, the scheme appears to have boosted the quantity of RMBS issues and mortgage originations somewhat above what would otherwise have occurred. But the relatively modest scale of the scheme ($8 bill over eight months versus housing loan commitments averaging around $14 bill per month for the last year) has meant that it has not been able to prevent increasing dominance of the four major banks in the housing mortgage market.

With the secondary market overhang of RMBS disgorged at high margins by the winding down of SIVs there was, short of massive explicit subsidization, little likelihood of any alternative outcome. New RMBS issues at high, competitive, yields can't be created profitably from new mortgages made at sufficiently low interest rates to attract borrowers.

Who has benefitted most as a result of the scheme? Mortgage borrowers have benefitted a little from the increased supply, and some mortgage originators fortunate enough to participate have been able to maintain some semblance of business activity.

Hopefully fierce competition for mandates between large banks to act as lead managers/arrangers for desperate mortgage originators wanting to issue to a ready investor (the AOFM) has meant low fees rather than enhanced investment bank profits!

Extension of the scheme as a short term measure may have some merit, but in designing longer term policies, it is critical to understand more about the preferences of potential investors in securitisation products. Unfortunately, there is a real paucity of public information about the demand side of the securitisation market in Australia.

How much, for example, do superannuation funds hold? Would they prefer the default and prepayment risk characteristics of "covered bonds" (as advocated by the Australian Securitisation Forum) over "traditional" securitisation products.

Increased concentration in the banking sector makes it important to understand what, if any, changes to the securitization model might be needed. While there is substantial transparency about Australian RMBS characteristics, and a concentration internationally on failings in the supply side of securitization markets, there is a need for more information and analysis of the demand side if effective longer term policies are to be developed.

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