

RMBS feel the squeeze

The announcement by the Treasurer of an additional \$8 billion allocation for the Australian Office of Financial Management (AOFM) program of purchases of new residential mortgage backed securities (RMBS) is undoubtedly good news for that industry.

But while it assists in propping up demand for such securities and thus assisting participating mortgage originators to continue to operate, there are questions to be asked about whether operating on the demand side is sufficient.

The issuance of RMBS to the market is the end-stage in a supply chain that is long and complex. A successful issue requires that a package of mortgages of at least \$350 million or so has been accumulated to provide the basis for an issue.

Except for the major banks, who have little need or inclination to securitise mortgages, origination of that volume of mortgages takes quite some time – as does the process of arranging all the necessary legal niceties. For smaller organizations wishing to play in this game, a particular challenge is that of arranging funding of the warehouse of mortgages originated before issuance.

Funds must be provided to the housing borrower when the mortgage is written, and must be raised from somewhere for the three to six month period over which a sufficient volume of mortgages is accumulated to make an RMBS issue feasible.

For banks and other large ADIs, this funding can be done “on-balance-sheet” using depositors’ funds. But for small ADIs or other originators, the funds must be borrowed either from institutional lenders or raised in the capital markets.

One option is loan funding of the warehouse from banks or other financial institutions, who would secure such loans by taking security over the mortgage assets in the warehouse. When the warehouse is “full” and RMBS can be issued, the proceeds of the issue would pay back the loan.

Another alternative is to have in place a commercial paper program, where short term paper is issued into the capital markets, again secured against the mortgage assets in the warehouse. Because such paper is normally short term, and would require roll-over during the stocking of the warehouse, one requirement of such a program is to have in place a liquidity facility from some major institution such as a bank. Such a liquidity facility (much like an overdraft facility) ensures that if the paper cannot be rolled over with new investors, funds can be obtained from the bank to repay maturing paper.

Both funding methods thus involve the originator being reliant on large financial institutions (such as banks) able to provide warehouse loans or liquidity facilities. The question arises of whether those markets operate competitively and effectively.

In the wake of the global financial crisis (GFC), there have been concerns expressed by some originators that the answer to this question is not a clear yes. Because the banks are also the major competitors in the housing loan market, it is not obvious that

it is in their interest to encourage securitisation based competitors by making warehouse funding easy. Higher warehousing costs mean that mortgage originators face a squeeze between the yields investors in RMBS demand and the interest rates mortgage borrowers are able and willing to pay.

Of course, credit market conditions tightened generally following the GFC reflecting concerns about credit quality. And Australian banks faced higher funding costs on their substantial offshore wholesale market funding, which need to be passed on to borrowers. Thus, some tightening of credit availability to mortgage originators (in the form of higher interest rates, facility fees, or increased collateral requirements) could naturally be expected.

But by how much? There may be grounds for examining whether this particular intermediate credit market operates competitively and effectively given the important role it has in facilitating the supply of RMBS and thus the ability of originators to compete with the banks in the home loan market.

Luckily the Treasurer stopped short of the AOFM providing “liquidity” (repurchase) facilities for purchasers as another demand side measure. This would most likely have involved some arrangement partially guaranteeing a repurchase price to purchasers of such RMBS. Winding back guarantees rather than extending them should be a main focus of policy. So also should be addressing the question of whether the supply side is working effectively.

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9-12-09