'AussieMac'

Submission to the House of Representatives Standing Committee on Economics and its Inquiry into Competition in the Banking and Non-Banking Sectors

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The degree of competition in the Australian banking and non-banking lending sectors is critical to both enhancing housing affordability as well as providing an efficient supply of funds to both corporates and small and medium enterprises (SMEs). It is with this firmly in mind that we make this submission to the House of Representatives Standing Committee on Economics and its *Inquiry into Competition in the Banking and Non-Banking Sectors.*

Our submission concerns the sustainability of sources of baseline funding for the provision of home mortgages in Australia. In this regard, our analysis and proposal here addresses the Committee's goal of identifying *"any barriers that may impact on competition in the retail banking and non-banking sectors, and policies to enhance further competition and product choice for consumers."*

Our concern is that since the deregulation of the Australian financial system following the Wallis Inquiry, Australia has been left without key long-term, government-sponsored institutional support for the supply of third-party (or 'securitised') funding capital for home mortgages. This type of institutional support exists in our peer economies and, in recent times, its value as a safeguard to consumers and a provider of financial stability has been comprehensively established.

Here we submit that Australia needs to revisit its institutional arrangements with respect to markets for third-party funding for the purposes of providing home mortgages. This is not simply because a minimum level of liquidity in this sector will benefit Australian households. It is also because shocks to the securitised funding sector flow almost immediately through to riskier aspects of lending; in particular, to SMEs and corporates. This therefore threatens not only competition in lending, but also competition throughout the entire economy.

Our proposal is that the Commonwealth Government move to establish a government-owned enterprise – which we have termed 'AussieMac' – to provide a minimum level of back-stop stability to the residential mortgage-backed securities (RMBS) market in Australia. This market has generated significant long-term capital for banks, building societies and non-banks to expand lending for home mortgages and allowed previously tied-up funds to be redeployed to corporates and SMEs.

However, recent instability in global financial markets has resulted in the temporary disappearance of the 'primary' RMBS market as a source of funding for lenders. In recent times, this market furnished up to 20 per cent or more of all the funding for all Australian home loans. While the closure of this market may ultimately prove to be temporary, its failure for over nine months has wrought, and continues to inflict, severe havoc on the Australian financial system with no relief as yet in sight. This is in spite of the inherent strength and integrity of Australia's economy and the overwhelming evidence that our mortgage market does not suffer from any of the problems that have recently plagued the US (again, refer to our appended paper for more detail).

The evaporation of the supply of securitised funding for home loans has been extreme and has had the consequence of reversing the most significant increase in competition in Australia's retail lending sector seen in the history of the nation. That dramatic rise in competition was enabled by the ability of lenders to source funding from the primary RMBS market (via the process of securitising mortgages) and in turn facilitated the entry of a large number of new lending participants popularly known as 'non-bank' providers (e.g. Aussie, RAMS, Wizard, Resimac, Challenger Financial Services and others). Importantly, the advent of this entirely new source of funding for home loans in Australia also significantly improved the ability of smaller regional banks (e.g. Adelaide Bank, Bank of Queensland, and Suncorp) and building societies (e.g. Credit Union Australia and Heritage Building Society) to effectively compete with the big-5 banks in the provision of housing finance.

This submission proceeds as follows. This first part summarises the key elements of our argument including the international shocks that have so devastated the RMBS market, the economic case for the government provision of liquidity to such markets, and the various policy responses that have been proposed. We also outline the case for a permanent, long-term government-sponsored enterprise as a favoured direction.

Our more detailed initial report outlining the specifics of 'AussieMac' is available as a separate paper. Since the March 2008 publication of that report by the Centre for Ideas and the Economy at Melbourne Business School, there has been considerable public and governmental discussion of the AussieMac proposal. To assist the Committee in understanding the nature of the debate and continued developments in financial markets since the publication of our original paper, we have provided a 'Postscript' that serves as the second part of this submission. It details all of the arguments in favour of, or against, our proposal and our responses in each case. It also provides a thorough analysis of the current state of liquidity in the RMBS market and the competitive dynamics in the Australian home loan industry.

THE NEED FOR AUSSIEMAC

The current global credit market crisis highlights the need for the Commonwealth Government to introduce a policy proposal that would insulate Australian households, and the key financial institutions that provide them with funding, from external liquidity shocks.

Our solution is motivated by the growing frequency with which extreme financial market dislocations appear to be occurring as a result of the tendency of investors to systematically overreact to positive (eg, the equities 'tech boom') and negative (eg, the subsequent 'tech wreck') events. These behavioural biases implicit in the actions of investors can persist for relatively prolonged periods of time. They have become increasingly well-documented in the academic literature over the past decade and undermine traditional notions of investor rationality and so-called 'market efficiency'. When markets do fail there is a clear role for governments to intervene and supply participants with the 'public goods' of a minimum level of liquidity and price discovery.

In a report by the Melbourne Business School's Centre for Ideas and the Economy (appended to this submission), we argue that there is an opportunity for the Commonwealth Government to intervene to mitigate the adverse competitive consequences associated with the current failure of the 'primary' RMBS market. The Government can achieve this objective without disintermediating private sector activity or drawing meaningfully on taxpayer funds.

THE CURRENT FINANCIAL SHOCK

It is now beyond dispute that the subprime crisis and flow on effects in the United States (US) has closed the primary RMBS market in Australia. We believe that this closure, even if temporary, will almost certainly have long-term consequences for the cost, flexibility and availability of Australian credit in both the residential mortgage and business lending sectors (see Part II for more detail). The difficulties faced by Australian lenders trying to securitise AAA-rated home loans via the primary RMBS market, which has been the source of over $284 billion of cost-effective 'off balance-sheet' funding since 2002 alone, has resulted in the effective withdrawal of important alternative credit providers (e.g. Macquarie Bank, RAMS, Virgin Money, GMAC and Seiza to name a few) and a dramatic reduction in the capacity of smaller providers to offer credit (e.g. Adelaide Bank, Challenger Financial Services, Members Equity Bank, Credit Union Australia, ANZ Bank's Origin operation, Resimac, and Heritage Building Society). The interested reader is referred to Part II of our submission, which provides a more detailed analysis of this subject. There have also been other, unforeseen, consequences, such as the disappearance of more than 23 per cent of the 'reverse mortgage' market (via the withdrawal of Australian Seniors Finance and Macquarie Bank, and dramatic credit rationing by Bluestone) which is the only source of 'equity release' finance available to the asset-rich yet income-poor retiree households. As Australia's population ages, these equity release solutions will become increasingly important.

The advent of RMBS securitisation in Australia during the mid 1990s transformed the mortgage market by intensifying competition to the demonstrable benefit of households. For example, **the 'spread' between the interest rates paid by borrowers and the bank bill rate fell from around 4 per cent in 1992 to about 1.4 per cent prior to the onset of the sub-prime crisis in August 2007.** This compression in the cost of mortgage finance was almost exclusively attributable to the competitive pressures enabled via the process of securitisation. With the effective closure of the primary securitisation market, the rationing of credit has already begun (on an 'intra-market' basis) with a striking increase in industry concentration. According to Fujitsu Consulting, the big-5 banks' new home loan market share has risen from 75 per cent (pre sub-prime) to 90 per cent today with the process of consolidation continuing – contrary to the claims of some that the market would return to normalcy – with force throughout 2008. The 'reintermediation' of the major banks back into the home loan market is also resulting in the rationing of credit in other, more capital-intensive, sectors, such as corporate and SME lending (which has a 100 per cent risk-weighting rather than the 35-50 per cent risk weighting applied to home loans).

Importantly, the present evaporation of third-party liquidity for prime Australian home loans has occurred in spite of their extraordinarily low historic default rates, which rank among the best in the world, and the exceptional overall health of our domestic economy. For example, despite eight official interest rate rises since March 2005 and two de-facto rate hikes effected by lenders, the default rate on prime Australian home loans is still only around 25 per cent of the level of equivalent US loans, and about 5-10 per cent of the level of US sub-prime loans. According to Standard & Poor's data, 30 day scheduled balance default rates on prime Australian home loans were just 1.04 per cent in February 2008.

WHY THIS REQUIRES A GOVERNMENT RESPONSE

Financial markets are prone to instability and liquidity shocks. This had led some economists and financial analysts to question whether any government response is needed, and if such issues should be 'left to the market.'

We argue here that such views are inconsistent with the latest economic and policymaking thinking on the subject of liquidity in capital markets.[1] Indeed, **the provision of a basic level of liquidity in key economic markets is a 'public good'**. Liquidity is important in the economy because there are many transactions and investments that cannot take place unless funds are pre-committed and available in an on-going manner. This is certainly true in home mortgage finance, but also extends to other areas such as small business lending where other forms of finance (such as equity) cannot be readily utilised.

The private supply of liquidity is likely to be adequate when risks are diversified. However, as we have observed in recent times, the Australian economy can face systematic shocks that oftentimes originate from external sources. These are becoming increasingly common and more quickly transmitted in today's highly networked world. Such risks are not easily diversifiable by private investors alone and, in times of crisis, the supply of liquidity can dry up well beyond what is necessary or prudent.

Away from the theoretical ideal of financial markets, in the real world, investors are finding that they are increasingly faced with periods of profound illiquidity, extremely poor price discovery, and, in certain cases, complete 'market failure.' In the financial market history of the last two decades, there are numerous examples of this illiquidity problem and governments acting to remedy it. In 1998, the massive hedge fund LTCM confronted severe illiquidity for its securities when the Russian government defaulted on its debt obligations. At that time, the US Fed acted to facilitate a bail-out of LTCM by a consortium of investment banks.

To many, these incidents highlight the increasingly accepted notions that markets are not always perfectly efficient. One source of this inefficiency relates to 'informational' problems whereby the costs of acquiring information (say, about the actual risk profiles of home loans underlying investment portfolios) can lead to credit rationing in times of aggregate uncertainty.

In addition, there is increasing recognition that market traders and investors are subject to systematic behavioural biases. Pioneering academics such as the 2002 Nobel Prize winner Daniel Kahneman and the late Amos Tversky have applied principles from psychology, sociology and anthropology to document that in practice people behave in a manner that can deviate strikingly from the 'equilibrium' predictions of the efficient markets hypothesis (and the notion of 'rational expectations' in particular). This has generated an academic movement in studying behavioural finance.

Arguments around investor fallibility make intuitive sense if we consider the speculative booms and busts throughout history such as the Dutch tulip mania, the rise and fall of junk bonds in the 1980s, the related 1987 stock market crash, the late 1990s tech craze, the inevitable tech wreck of 2001, and, finally, the recent credit boom and subsequent crunch. Over the last 20 years a large body of evidence has built up illustrating that humans are fallible and subject to a wide range of biases, including irrational 'loss-aversion', 'framing', use of 'heuristic' rules of thumb, 'hindsight biases', and 'cognitive dissonance' (ie, avoiding information that conflicts with our assumptions).

Importantly, academics have shown that there can be major mispricings and return anomalies in financial markets due to these behavioural biases. In particular, the tendency of humans to identify fictitious 'patterns' in otherwise random return sequences, and for us to be consistently 'over-confident' in our assessment of our own judgment, can result in significant over- and under-reactions in market prices. There is also compelling evidence of the anecdotally well-known market phenomenon of 'herding' and 'groupthink' whereby strongly anomalous market-wide effects can materialise when there is collective fear and greed amongst investors.

Recognising these information asymmetry problems and the occasional frailties in human decision-making under uncertainty has an impact on how we conceive of regulation and its effect on financial markets. For example, recent regulatory changes that require institutions to 'mark-to-market' securities that they would previously hold to 'term' can act to further exacerbate liquidity crises caused by irrational investor behaviour. In the presence of mark-to-market prices that do not accord with reasonable assumptions of fair value, institutions are reluctant to lend to one another. This creates potentially enormous problems for the financial system at large as transactions that were previously considered to be nearly risk-free are subject to perceptions of 'counterparty risk.' Bear Stearns discovered this in March 2008 when Goldman Sachs refused to deal with it. The result was a very rare 'non-bank' bailout whereby the New York Federal Reserve took Bear Stearns's otherwise illiquid assets as security and lent JP Morgan the US$30 billion that it needed to buy the company.

When markets fail and price discovery collapses, the provision of a minimum level of liquidity acts as a public good. That is, it is something underprovided by the private sector relative to the benefits it confers on the whole. Critically, the knowledge that liquidity will be available even in situations where the economy faces an aggregate shock makes investments contingent on that liquidity (such as SME investing) cheaper at all times. It is not so much a stimulus in bad times as a form of insurance to mitigate costs at those times.

We are seeing the adverse effects of the disappearance of liquidity in Australia's 'primary' AAA-rated Australian mortgage securitisation market today for reasons that are largely unrelated to the quality of our financial institutions or the borrowers they service. This is a market that has funded up to 20 per cent of all Australian home loans and accounted for $284 billion worth of transactions since 2002. The ability to securitise very low-risk Australian home loans was critical to the emergence of competition in the home loan industry during the mid 1990s and the striking compression in mortgage margins. Since the closure of the primary securitisation market the share of 'new' home loans attributable to the big-5 banks has increased from 75 per cent to around 90 per cent according to Fujitsu Consulting. At the same time, the many smaller banks, building societies and non-bank lenders who have wholly or partially predicated their business models on having access to a minimum level of liquidity in third-party mortgage securitisation markets have either had to stop lending altogether or severely ration the home mortgage credit they can supply (see Part II for more detail).

This is the consequence of not having an Australian government infrastructure that protects the public goods of liquidity and price discovery in the market for mortgage-backed securities. We do have such an infrastructure, known as the central banking system (ie, via the RBA and APRA), which serves to furnish a minimum level of liquidity to deposit-taking institutions in this country. However, the central banking system was not created with 'non-banks' in mind and therefore confers no support to them. Indeed, as we show in our paper, a compelling case can be made for the current central-banking system further entrenching the market power of Big-5 Banks to the detriment of wider competition in the home lending industry. The central-banking system is also not geared towards provide long-term liquidity to the mortgage-backed securities market.

Similar infrastructures to our AussieMac proposal have been put in place in Canada with the government-owned CMHC and in the US with the once public and now privatised government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. As we show in our appended paper, the presence of these institutions has delivered tremendous benefits to households in those markets throughout the global credit crisis. For example, while in Australia there have been virtually no public securitisations of AAA-rated home loans since November 2007, with severe adverse consequences for competition in Australia's home mortgage market, Canada's CMHC has been able to successfully securitise C$20 billion worth of Canadian home loans in December 2007 and March 2008 at a cost dramatically lower than the indicative pricing available to Australian lender.

In summary, the Commonwealth needs to investigate in a considered manner the government institutions that can be introduced to support the provision of a minimum level of liquidity in the economy given the emergence of the new RMBS market since the early to mid 1990s. This will in turn have profound consequences for the depth and breadth of effective competition in Australia's mortgage market.

OPTIONS TO ENHANCE LIQUIDITY

Recent actions by the RBA, via the expansion of its repurchase (or 'repo') agreements to accept mortgage-backed securities as collateral and the lengthening of the typical term over which it will provide funding for such securities, and the Commonwealth Treasury, which has expanded the Australian Office of Financial Management's mandate in a similar way, demonstrate that our key economic agencies appreciate the public good aspects of liquidity in financial markets. The problem is that the beneficiaries of these public goods are limited and currently exclude the non-bank sector.

For example, one response of the RBA to the liquidity crisis has been to broaden the range of securities that can be used in its 'repo' facilities to include AAA-rated RMBS. However, the RBA will only provide funds for 90 per cent of the face value of the securities, thereby giving rise to a significant funding gap, and will only lend for a limited period of time, which is not normally longer than 12 months (i.e. the RBA does not actually buy the assets as would be the case with a conventional securitisation). This is, therefore, a very restricted solution to the inability of Australian lenders to securitise high-quality home loans, which, more importantly, is only 'practically' available to ADIs since non-bank lenders cannot repo their own assets and would not ordinarily have any other assets to use as security.

Proof positive of the limited nature of the RBA solution is that it has had absolutely no impact in preventing either the complete withdrawal from the home loan market, or the introduction of extreme credit rationing, by important alternative providers of housing finance such as Macquarie Bank, Adelaide Bank, Challenger Financial Services, Members Equity Bank, Credit Union Australia, ANZ Bank's Origin operation, Resimac, Heritage Building Society, Virgin Money, and GMAC. In addition, GE Money has recently announced that it intends to sell Wizard Home Loans, which was reportedly motivated at least in part by the effects of the credit crunch, while one of the original non-bank pioneers, RAMS Home Loans, was also forced into a distressed sale as a consequence of funding pressures.

Perhaps the clearest indication of the competitive merits of our proposed AussieMac infrastructure is that the both the peak mortgage and securitisation industry associations, namely the Mortgage & Finance Association of Australia (MFAA) and the Australian Securitisation Forum (ASF), have been extremely vocal in their support for it (or an identical model). Many other leading industry participants, such as David Liddy, the CEO of the Bank of Queensland, and John Symond, the Chairman and CEO of Aussie Home Loans, have been exceedingly forthright in lending support to the AussieMac idea. Part II of our submission provides a more thorough review of the public responses for and against our AussieMac proposal.

One of the reasons that the RBA's actions do not resolve any of the competitive issues that we have identified is that the RBA's primary objective is 'system stability.' Consequently, its interventions are designed to mitigate any risks to the core financial system in the short term by dealing with Australian Deposit-Taking Institutions (ADIs) exclusively and leaving the task of putting liquidity through the system to them. The RBA, quite rightly, does not have a policy objective to promote or support any part of the system for its own sake nor to enhance the structure of competition in our financial sector (even despite the obvious benefits to borrowers from this). The privileged status of ADIs in the repo market does arguably give them a competitive advantage although the RBA does place conditions that mitigate this. In addition, non-bank lenders could apply to become ADIs or acquire one if they wanted to access this type of short-term emergency support.

In contrast, a government-sponsored enterprise, such as AussieMac, would have both an on-going and emergency response role. It could be given objectives to target housing affordability – as indeed similar organisations do in the US and Canada. And it could also play a key role in assuring the preservation of competition in Australia's home loan market against short-term liquidity shocks. This is a very distinct mandate from the RBA or the Treasury and one that we argue an independent agency can achieve in a more efficient and transparent manner than these organisations. **Indeed, an AussieMac-like institution could supply important new liquidity to the government bond market, which is a clearly recognised policy problem in and of itself, and/or create an entirely new market in the form of government guaranteed mortgage-backed securities such as the Canada Mortgage Bonds issued by the CMHC in Canada. These new securities could in turn serve as an alternative surrogate for the government bond market for both retail and wholesale investors.**

It has to be remembered that the public good characteristics of market liquidity are driven by the fact that there are times when the market cannot distinguish good securities from bad. By providing a basis for which there is always a minimum supply of good securities, one assures that market of the average quality of all traded securities. A government supported infrastructure of this kind prevents crises such as the current one from getting out of hand, which is especially important where such crises originate from international causes that have no basis in Australia.

HOW 'AUSSIEMAC' WOULD WORK

Under our proposal, the Australian Government would guarantee the creditworthiness of an Australian Government-owned agency, which we loosely call AussieMac, thereby lending it Australia's AAA credit rating. To the extent that there is an immediate need for a liquidity injection into the mortgage market, one short-term candidate for this role would be the Treasury's Australian Office of Financial Management. With the Commonwealth's credit rating, AussieMac would be able to issue substantial volumes of very low-cost bonds into the domestic and international capital markets. The funds raised by AussieMac through issuing these bonds could be used to acquire high-quality AAA-rated Australian home loans off the balance-sheets of lenders. It is critical to note here that AussieMac would not be able to fund low-quality or 'sub-prime' loans: lenders would have to satisfy AussieMac's strict, pre-determined credit criteria before their loans would be eligible for acquisition. By imposing these credit standards, AussieMac should mitigate any 'moral hazard' risks.

Acting as a lender of last resort, AussieMac would serve to guarantee the public goods of liquidity and price discovery in the Australian home loan market in the event that other private sources of capital were to supply insufficient funding, such as is currently the case. Its presence need not, however, significantly disintermediate private-sector activity as is sometimes alleged. It would, for instance, be straightforward to place constraints on the volume of liquidity that AussieMac can supply during the ordinary course of market operations (say 10 per cent of total market liquidity). These constraints would be relaxed only during times of extreme illiquidity, or total market failure, when AussieMac would be able to step into the breach and act to normalise demand and supply. Historically, similar initiatives in the US, with the now privatised GSEs, Fannie Mae and Freddie Mac, and in Canada, with the government-owned CMHC, were created with precisely the same mandate that we have in mind.

AussieMac's liquidity guarantee would restore deep competition in the Australian mortgage industry and enable lenders that originate high credit quality home loans to always access a readily available source of finance. In this way, the establishment of an AussieMac-like agency would help to resolve the illiquidity currently evidenced in the primary RMBS market and insulate Australian households and the financial system at large from 'exogenous' global shocks that have nothing to do with the integrity of the Australian economy.

The funding advantages afforded to AussieMac should ensure that it is a profitable going concern that does not require any meaningful public subsidies. This is certainly the case with the CMHC in Canada and Freddie Mac and Fannie Mae in the US, which do not draw on any government funding to support their securitisation activities.

WHAT IS AT STAKE

The sources of the supply of funding for home mortgages have, for the time being, been reduced from two (deposits and securitisation) to one. The consequences of this have been:

- A dramatic increase in home mortgage funding costs, which has in turn resulted in lenders being forced to pass on to borrowers interest rate increases (2-3 thus far) over and above RBA changes to the official cash rate;
- A striking reduction in competition in Australia's home mortgage market with a spate of withdrawals and severe credit rationing by those smaller banks, building societies and non-bank lenders that can no longer compete with the big-5 Banks;
- A huge rise in the new home loan market share of the big-5 (and perhaps soon to be big-4) banks from 75 per cent prior to the sub-prime crisis to around 90 per cent today;
- Growing evidence of rationing of credit to both corporates and small businesses as the major banks re-allocate their capital away from the more expensive 100 per cent risk-weighted corporate and SME markets to the much more lucrative 35-50 per cent risk-weighted residential mortgage lending area; and
- Other unforeseen consequences, such as the complete disappearance of up to 25 per cent of the 'reverse mortgage' market which is the only source of 'equity release' finance available to aged households that are asset-rich yet income-poor.

This supply shock as well as its asymmetric impact on deposit and non-deposit taking institutions has the potential to permanently reverse the competitive gains in retail credit markets achieved over the last 20 years. As a consequence, should the RBA move to lower interest rates to stimulate economic activity, it is possible that retail interest rates will not immediately follow that downward pressure. The efficient conduct of monetary policy could be weakened as a result.

While the solutions to this situation are several-fold, here we argue that Australia lacks a committed, transparent and long-term response. It is to address this that we have proposed AussieMac – a government-sponsored enterprise based on successful models in our peer economies. AussieMac would be a low cost method of providing a minimum level of liquidity to Australia's home loan market while also supplying the foundations for a vigorous level of competition amongst lenders. With careful design, AussieMac should not serve to disintermediate any meaningful private sector competition. It is simply the government infrastructure that guarantees that competing participants will have access to a minimum supply of funding in the event that there is a major financial shock that would otherwise eviscerate available liquidity (i.e. as we are seeing today). Precisely the same infrastructure exists for ADIs via the central banking system – with the evolution in capital markets over time, and the emergence of securitised funding in particular, it is time for the Commonwealth to put in place new protections that accommodate these innovations.

It is critical to note here that the policy rationale for AussieMac is not simply motivated to mitigate the current financial crisis (our opportunity to prevent that has passed and we must, for the time being, rely on the RBA and other interventions for relief). On the contrary it has been conceived to ensure that we can more effectively protect Australia from *future* financial crises, which will inevitably materialise, and to restore a vigorous level of bank, building society and non-bank competition to the retail lending market.

NOTE

1. We document the key economic literature in our appended original report.