Housing Finance and the Secondary Mortgage Market in Australia

by Anthony Gill

The Australian mortgage market has experienced a number of significant developments over recent years, the most notable of which have been its phenomenal growth and a major increase in competition within the market (see Figure 1). These changes have been facilitated largely with the development of mortgage securitization. The lower cost finance created by securitization has permanently boosted the affordability of housing for all Australians.

Traditionally, financial institutions have required significant capital to support balance sheet lending practices and compete in the mortgage market. Securitization of mortgage loans has eliminated this capital requirement, effectively lowering the barriers to entry into the mortgage market. Flowing on from this and the deregulation of the financial system in the 1980s, a new class of intermediary has developed. This class includes non-bank mortgage managers ("managers") such as insurance companies, brokers and even real estate firms. The emergence of these non-traditional lenders has been critically important in the development of the mortgage market. As can be seen in Figure 2, in Australia, banks and building societies alike have seen their share of the mortgage market decline as managers have propelled themselves into an extremely competitive position. Australia's largest nonbank lender is Aussie Home Loans which, together with PUMA Management Limited ("PUMA")—its strategic partner—has written in excess of 20,000 loans since January 1997 and radically changed the nature of the Australian mortgage market.

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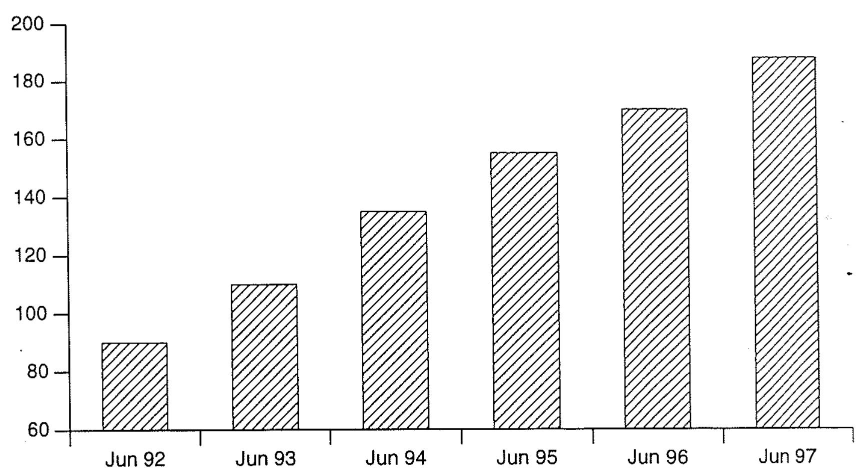
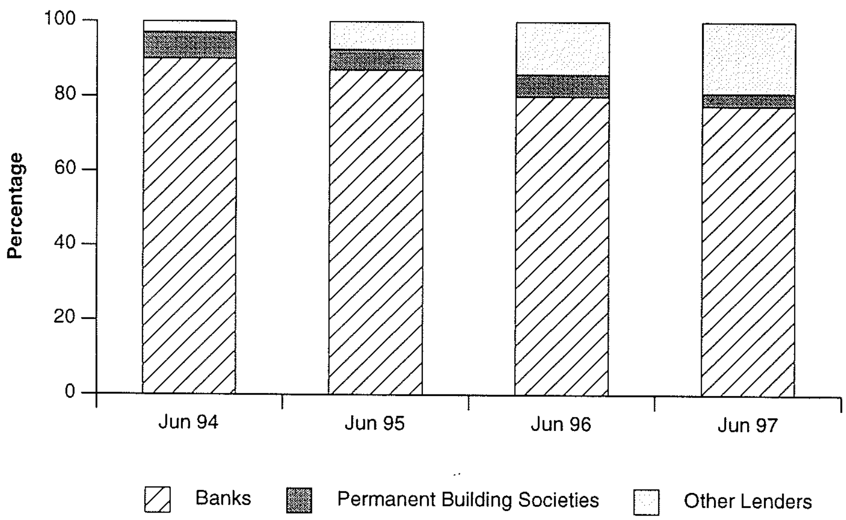
Banks were previously the driving force behind product availability in the Australian Mortgage Market. However, due to this, the products available were structured, inflexible and expensive. With the introduction of and increased competition from managers, there has been a large increase in mortgage product options. The ability to fix the interest rate on a loan, access equity or transfer a loan to an alternative security property are some of the options which borrowers are now able to demand from their lender at no cost. Previously these options were either not available or available only at a cost to the borrower.

Figure 1. Net Monthly Home Loans Outstanding



Source: *Reserve Bank of Australia Bulletin*, October 1997

Figure 2. Share of Owner-Occupied Housing Finance



Competition has improved borrower understanding of mortgage products, loan options and the service features available to them. The Australian home mortgage borrower now has unprecedented access to mortgage products, service and product options, and competitive interest rates.

The growth and development of the mortgage backed securitization market has been inextricably linked to the Australian Mortgage Market. Securitization has emerged as one of the fastest growing sectors in the Australian capital markets. From its beginnings in the mid-1980s, securitized debt as a proportion of Australian debts outstanding (face value) has grown to approximately 18%[1] (as of September 1997). Evidence that this rapid growth has been sustained is in Standard & Poor's report of a 94.9%[2] increase in new ratings during the six months to June 1997 (over the same period in 1996).

To date, the Australian securitization industry has been dominated by the mortgage-backed sector of which the market leader is PUMA. Launched in 1990, PUMA is a wholly owned subsidiary of Macquarie Bank Limited. It currently has a staff of 115, managing a portfolio in excess of 50,000 loans.

Since its inception, PUMA has accounted for a dominant share of all new mortgage securitization business in Australia. PUMA has issued over A$6 billion of mortgage-backed securities, with senior bonds rated "Aaa" by Moody's, "AAA" by S&P and, for the recent E-2 issue, "AAA" by Fitch Investor Services. The E-2 Eurobond issue in London has taken PUMA's offshore outstandings to A$2.2 billion and its total debt raisings in 1997 to A$3.2 billion.

The pricing of mortgage backed issues (and consequently the pricing of mortgages) has improved as the attraction of highly rated and keenly priced bonds has developed. This is illustrated by the pricing of PUMA issues as seen in Table 1.

At the same time, the banks have experienced a decline in their low-cost funding base, as low-cost deposits declined (demonstrated in Figure 3), which has diminished their competitive position.

Arguably, these two factors, that is lower cost securitized funding and a weakened bank funding position, have allowed the funders and the managers to compete on an equal footing with the banks.

Further, the managers' low-cost mortgages have served to focus attention on the high-cost structure, overheads and operating inefficiencies of the banks' branch networks. Technology, communications, centralized processing and new avenues of marketing have provided competitive advantage for the new entrants. An entirely new market is opening up for companies who are willing to offer traditional bank lending products that are cheaper and deposit products that earn higher rates of interest. Nonbank financial institutions are the ideal parties to offer these services as they now have access to various funding arrangements but do not have the massive overheads of the banks.

The competition was clearly evident in June 1996 and February 1997 when, arguably, PUMA prompted two rounds of mortgage-rate reductions. These movements set a precedent in Australia as they were not accompanied by official rate reductions.

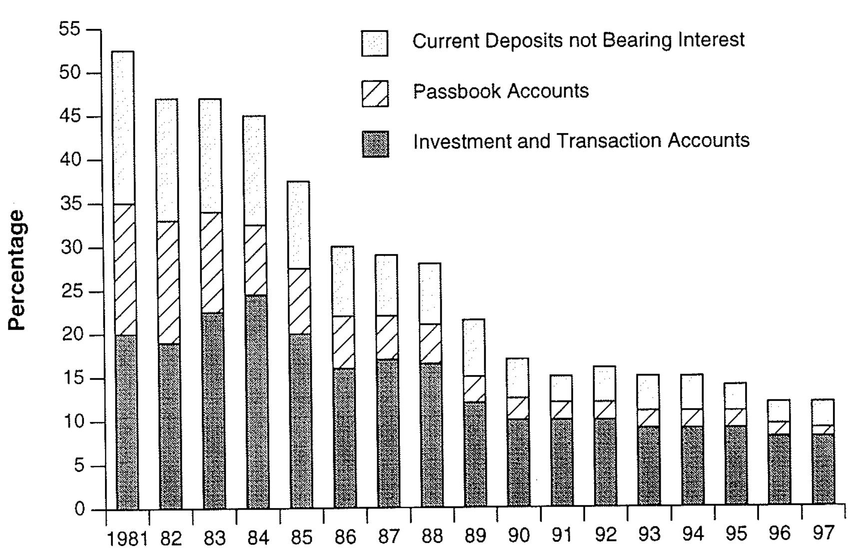
The reductions represented a repositioning of the market. Bank lenders reduced their mortgage rates in line with securitized products. For example, in 1993 the bank lenders headline rate was approximately 4% over the official cash rate[3]. Currently, this is approximately 1.5%.

Further evidence of the impact of the secondary mortgage market occurred in September 1996 when Westpac, a major Australian

Table 1. History of PUMA Bond Pricing

Bond Issue	*Issue Size (AUD)*	*Margin Over Time (over 90 day BBSW)*	*Issue Date*
P1	$200 million	60.2 basis points	December 1994
P2	$300 million	57.2 basis points	February 1995
P3	$700 million	49.0 basis points	June 1995
P4, Series A	$600 million	33.8 basis points	October 1995
P4, Series B	$250 million	30.6 basis points	December 1995
P5, Series A	$800 million	32.3 basis points	May 1996
P5, Series B	$500 million	21.3 basis points	September 1996
P6, Series A	$500 million	16.6 basis points	February 1997
E1, Series 1	$912 million (US$700 million)	11.3 basis points (over US$ LIBOR)	March 1997
P6, Series B	$500 million	16.8 basis points	June 1997
E2, Series 1	$1,290 million (US$900 million)	17.2 basis points (over US$ LIBOR)	November 1997
Total	$6.710 billion		

Figure 3. Low-Cost Deposits of Banks as a Proportion of Total Liabilities



Source: *Reserve Bank of Australia Bulletin*

trading bank, first sold pools of its own mortgages, presumably seeking to access similar low-cost funding.

While the Australian market continues to mature, some issuers have already found they have outpaced the local market and have taken steps to diversify their funding base. A good example was PUMA's E-1 US$700 million transaction executed in March 1997. Its pricing at 11.3 basis points above LIBOR was one of the reasons why it was ranked in *Euromoney*'s "Top 50 Global Deals of the Year." It was the only Australian deal and the only public securitization deal worldwide to receive this recognition. This has proved that Australian transactions are now of a worldwide standard. A further affirmation of this was PUMA's recent US$900 million E-2 transaction, which was launched and priced competitively in November 1997. We believe this represents a further step in paving the way for Australian securitizers to tap offshore markets and raise more competitively priced funds while providing a source of highly rated assets for investors.

The securitizers have made their mark as credible and substantive funders, and the Managers are a viable, attractive and substantial alternative for Australian borrowers.

Despite the rapid growth in mortgage managers over the past few years, mortgage securitization is, relatively speaking, still in its infancy. In the US, for example, securitization funds over one-half of total mortgage lending. The mortgage market in Australia has, however, witnessed a permanent realignment. Non-bank mortgage lenders now represent almost 10% of the $180 billion (approximate) Australian mortgage market and around 15% of new Australian home loans are being funded by securitization. The development and growth of the secondary mortgage market to date has increased the affordability of housing in Australia. Home loan funding is, and will remain, cheaper because of securitization.

TRENDS
Globalization

The situation described above is not unique to Australia. Mortgage securitization is an increasingly global phenomenon across America, Europe and in the emerging markets of Latin America, Eastern Europe and Asia. It has assisted many organizations in diversifying funding sources by tapping deep, liquid and competitive domestic and offshore markets. Obviously, this "globalization" is not restricted to the securitization market. The world's capital markets are driving this trend with far-reaching consequences.

PUMA believes that the key issue for the secondary mortgage market as a result of globalization is that international wholesale funding will increasingly fund retail assets. This extends beyond mortgage loans to personal loans and credit cards. The role for banks will increasingly become that of arranger rather than intermediary.

New mortgage products and features, a greater penetration into nonmortgage asset classes, changing consumer buying habits and new capital market instruments will be a feature of the industry's near future. Clearly, in Asia alternative asset classes have led rather than followed the market (except in Hong Kong, where mortgages have been the major asset class) with auto loans and credit cards being the asset choice of arrangers.

Government Involvement

An issue that has been a key factor in the Australian market has been the development and maintenance of a "level playing field." How this has been achieved and what it means is worthy of comment.

Australia has limited government involvement in the securitization market. However, partially as a result of the corporate disasters in Australia of the late 1980s, but mainly because of the fundamental basis of the common law system, securitization has flourished in an environment of comprehensive and well-documented laws and guidelines.

Facilitation and not participation has been the hallmark of success for government involvement in the Australian securitization industry. The federal government has observed the emergent public benefit of the secondary mortgage market and has assisted its growth, not with subsidies or government sponsored operations but through the medium of facilitation. The most recent example witnessed government assistance of the market through changes in regulations.

In early 1997, the Australian government introduced changes to the regulation of the interest withholding tax. This served to assist all participants in the market without preference and allowed Australian issuers to move offshore, passing on cost benefits to the economy and home loan customers while avoiding market distortions. At the same time, this method of assistance incurred negligible costs to the government but increased its own popularity with the Australian people.

Further examples have included:

- the introduction of uniform consumer lending laws;
- changes to State taxation systems to provide uniformity; and
- development of securitization guideline (C2) by the Reserve Bank of Australia.

This model stands in significant contrast to the approach of other countries that have strong government participation rather than facilitation.

In many cases the government-sponsored organizations do not facilitate funding diversification and have failed to develop sources of long-term, non-speculative foreign capital or true risk diversified domestic funding. Additionally, home loan lending rates often continue at high margins because cheaper avenues of finance are not provided and the funds in many cases are only provided to existing lenders. The benefit to consumers is quite hard to measure.

If the above example serves to illustrate any point, it is that government involvement can take many forms but these predicate two clear possible outcomes, which are:

1. Governments may choose to encourage markets through regulations, controls or government-sponsored operations. However, this is a potentially high cost option, which may well limit competition and benefits.
2. Alternatively, governments can facilitate the development of markets. This has been the case in Australia. In the Asian region, this also appears to be the approach of Indonesia, China and other countries. This approach (being equally high in commitment) does not use scarce sovereign capital and encourages participants via facilitating and enabling rules which provide regulators with confidence, gives a low-cost approach and opens the market to best practice.

The overall attitude of regulators toward and levels of understanding of securitization can influence greatly the development of securitization in any country. Clear and reasonable guidelines together with suitable legislation must be in place for the benefit of lenders and investors alike.

PUMA in Indonesia

In seeking to use its success, expertise and experience, PUMA is expanding its operations within Asia. In looking across the region, we reviewed many countries. Owing to a number of factors, we are initially working in Indonesia, which, we believe, will be every bit as successful as Australia. In devising our launch strategy, we are not only planning for a successful business, but also building the potential for social benefits for ordinary Indonesians and participating in the further development of its capital markets, particularly after the confidence-sapping effects of August.

We have been asked a number of times, "Why Indonesia?", so, for your interest, we have recorded the following key factors:

1. Critical mass. Given a population of 200 million people, Indonesia is a high-potential, long-term investment.

2. Indonesia has a 'BBB' investment grade rating. This makes securitization a suitable approach.

3. During recent years we have maintained regular dialogue with key regulators. It is our experience that Bapepam and Bank Indonesia are thoughtful, sensible and consistent regulators who take the opportunity to explain their goals to interested parties. This makes the decision to enter the market a controlled rather than random risk.

4. Despite the last few months, we believe that Indonesia's fundamental economics are good. Naturally, like most commentators, we anticipate considerable benefits from the micro-economic reform that seems likely to result from this year's shock to its capital markets.

5. Computing power is a key ingredient in PUMA's success. Easy adoption of our computer system to Indonesian standards is achievable because the incorporation of characters to communicate in writing with our customers is not required.

6. Indonesia's fast and growing investment in telecommunications, particularly in Jakarta, has made our initial transaction planning feasible and has provided confidence that our technology can be transferred.

Housing Market

- The home loan market is small at 16 trillion Rupiah, but it is growing. (With lower interest rates it is likely to recover within 12 to 18 months) and will build into a substantial and sustainable market.

- Indonesia has passed recent laws that assist registration of property titles and mortgages.

- Housing demand exceeds housing supply, and this situation is forecast to remain for the foreseeable future.

- KPR (housing loans) amortize over 10 to 15 years on a floating-rate basis. This is quite similar to Australian products, again aiding our development.

Capital Markets

- Many Indonesian banks are short of capital. Clearly this is a strategic benefit to securitizers.

- New Bapepam regulations will allow domestic issuing capacity to be established.

- Indonesia's payment system is consistently improving. A direct debit system is forecast for introduction within two or three years.

- Notwithstanding recent liquidity issues, domestic and offshore swap markets are developing. This makes bond structuring an achievable goal.

In seeking to launch its products in Asia, PUMA is initially focusing on Indonesia. We believe that the dynamic growth in the region will, over the medium term, be positively affected by the events of the last few months, but we continue to closely monitor the situation. The introduction of world class secondary mortgage market technology will obviously be to our benefit; however, it will also help Indonesian families and the market as a whole.

We believe we have accomplished this "double benefit" in Australia, an achievement of which we are particularly proud, and we hope to emulate this success in Indonesia and other selected Asian countries where both economic success and social benefits will be substantial.

We believe that securitization is the key to the long-term financing of housing.

NOTES

[1] Macquarie Bank Economics Division, September 1997.

[2] Standard & Poor's *Credit Focus*, August 1997, p.1.

[3] You will save on home loans, but watch the bank fees: *The Daily Telegraph*, August 2, 1996.