

It's time for

# AussieMac

The current global credit market crisis highlights the need for the Federal 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.



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**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 (e.g. the equities 'tech boom') and negative (e.g. 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, we argue that there is an opportunity for the Federal Government to intervene to mitigate the adverse consequences associated with the current failure of the 'primary' residential mortgage-backed securities (RMBS) market. The Government can achieve this objective without disintermediating private sector activity or drawing meaningfully on taxpayer funds.

Our concern is that the (temporary) closure of the primary RMBS market 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. 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 withdrawal of major participants (e.g. Macquarie Bank, ANZ Bank's Origin operation, and RAMS) and a dramatic reduction in

the capacity of smaller providers to offer credit (e.g. Adelaide Bank, Challenger, Credit Union Australia, Wizard, Resimac, Heritage Building Society).

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% in 1992 to about 1.4% today. 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 majors' new home loan market share has risen from 75% (pre sub-prime) to nearly 90% today. Fujitsu expects this figure to stabilise at around 85%. The 'reintermediation' of the major banks back into the home loan market is also forcing them to ration credit in other, more capital-intensive, sectors, such as small business lending (which has a 100% risk-weighting rather than the 35-50% risk weighting applied to home loans).

Importantly, the 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, the default rate on prime Australian home loans is just 25% of the level of equivalent US loans, and about 6% of the level of US sub-prime loans. According to S&P data, default rates on prime Australian home loans were just 0.93% in December 2007.

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## How 'AussieMac' would work

Under our proposal, the Australian Government would guarantee the creditworthiness of an Australian Government agency, which we loosely call 'AussieMac', thereby lending it Australia's AAA credit rating. This would allow AussieMac 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. 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 United States, 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 United States, which do not draw on any government funding to support their securitisation activities. ●

<sup>1</sup> It should be noted that our AussieMac proposal is unrelated to the NSW Government financing entity FANMAC, which suffered significant difficulties in the early 1990s through financing low income and poor credit quality 'sub-prime' borrowers with very risky products.

