AUSTRALIA-NEW ZEALAND SHADOW FINANCIAL REGULATORY COMMITTEE

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Mortgage Markets After the Sub-Prime Crisis

In this statement ANZSFRC discusses how policymakers should react to the recent disruption in securitisation markets. The statement makes the following points

1. Despite its recent problems, ANZSFRC regards securitisation as a financial innovation which is now embedded in banking and capital market practices.

2. ANZSFRC recommends that authorities in both Australia and NZ give further consideration to the merits of allowing banks to issue covered bonds. Approval could be subject to strict limits on the proportion of total liabilities in the form of covered bonds.

3. ANZSFRC believes the involvement of the public sector in securitisation is a topic worthy of further exploration in the context of a broader investigation of mechanisms for enhancing the stability and efficiency of capital markets.

4. ANZSFRC believes it would be desirable to evaluate the effectiveness of existing regulation of investment advisors before replicating it for mortgage advice.

Background

The sub-prime crisis arose primarily from inappropriate credit practices in US mortgage markets and their transmission into capital markets via securitisation and the development of complex structured products. Neither Australia nor NZ appears to have encountered similar problems. Nevertheless, securitisation markets in Australia have been disrupted (even frozen) while many non-bank lenders in NZ (where securitisation is nascent) have experienced difficulties and some have failed. In addition, the mortgage broking industry in both countries has declined after growing substantially over the past decade to account for approximately 1/3 of mortgage originations by 2007.

In this statement ANZSFRC discusses how policymakers should react to the recent disruption in securitisation markets.

The Future for Securitisation

Securitisation converts loans or mortgages into capital market securities backed by pools of such assets. In the 1990s, financial institutions began to bundle relatively illiquid financial assets such as mortgages and sell them on capital markets for cash. This access to liquidity enhanced the flexibility of bank asset management, including the ability to take advantage of unexpected new lending opportunities. In effect, securitisation is an alternative funding channel to intermediated bank finance, through which credit risks are diversified within capital markets. Although the initial growth of securitisation partly reflected regulatory arbitrage under the Basel I Accord - albeit often with residual risk remaining on bank balance sheets or their securitisation vehicles - the increasing importance of institutional investors such as pension funds will continue to underpin demand for securitised capital market instruments, even in the presence of weaker Basel II regulatory incentives.

Thus, despite its recent problems, ANZSFRC regards securitisation as a financial innovation which is now embedded in banking and capital market practices.

Nevertheless, recent instability in capital markets poses a significant challenge to securitisation, prompting discussions about whether the securitisation process should be directly regulated. But securitisation per se is not the problem. Poor risk management, reliance on third party analysis, and flawed mortgage origination practices are more important sources of the recent turmoil.

Fluctuations occur in any financial market and excessive asset price volatility causes concerns for market participants and policymakers. But the recent problems in the secondary markets for securitized products have also led to the freezing of activity in their primary markets. In particular, many mortgage originators relying on securitisation have found their business models unworkable. The migration of mortgage business back to bank balance sheets potentially restricts the supply of credit to SMEs. This experience has prompted calls for intervention in securitisation markets.

The remainder of this statement considers three recent proposals for intervention in securitisation markets.

Covered Bonds
Common securitisation practice in many European countries involves the use of covered bonds, whereby a bank issues securities secured against a specific pool of assets, such as mortgage loans, on the bank balance sheet. In Australia, APRA has rejected approaches from the industry to permit covered bond issuance as being inconsistent with depositor preference legislation. In New Zealand, the issue is under consideration by the RBNZ.

Such "on-balance sheet" securitisation may create better loan origination incentives given the residual risk held by bank shareholders, a risk that arises because unmet obligations to covered bond-holders rank behind those to depositors but above those of shareholders in the event of failure. One consequence, however, is that using covered bonds may increase the cost of equity capital for the bank, offsetting any apparent lower funding cost. But, if Australian and NZ banks wish to use such a form of funding, there need to be compelling grounds for prohibition.

The case for prohibition, which to date has been made on depositor protection grounds, is less than compelling. Both off-balance sheet securitisation and the issuance of covered bonds remove the mortgages involved from the asset pool against which depositors have first claim, and thus have similar implications for depositor protection. Australian depositor preference legislation may need to be amended to accommodate such a change, but the planned introduction of the Financial Claims Scheme reduces the emphasis which needs to be given to that feature of depositor protection.

ANZSFRC recommends that authorities in both Australia and NZ give further consideration to the merits of allowing banks to issue covered bonds. Approval could be subject to strict limits on the proportion of total liabilities in the form of covered bonds.

Government-backed Securitisation
One suggested intervention intended to support securitisation is the creation of a government-backed institution to supplement private demand for mortgage-backed securities. This institution's demand would backstop private market demand in the event of a pronounced downturn as recently experienced. The institution would fund its purchases by issuing its own debt instruments with an explicit government guarantee. An advantage claimed for this approach in Australia is that it would supply a risk-free asset for retail investors. However, there are more direct ways to fill this gap short of creating another public institution which may itself be in no better position to assess and price credit risk than the market, and whose activities may crowd out, and thus further harm, the industry it was intended to support.

That said, the idea of backstopping demand for securitized assets is intuitively appealing to some. Others point out, however, that this role is already fulfilled by central banks, and that a new institution is therefore redundant. Indeed, both the RBA and the RBNZ have intervened during the current sub-prime crisis. However, central bank intervention relieves short-term liquidity constraints whereas the essence of the current sub-prime crisis is the disappearance of credit. Buyers of ostensibly high-quality mortgage-backed securities have simply disappeared.

ANZSFRC believes the involvement of the public sector in securitisation is a topic worthy of further exploration in the context of a broader investigation of mechanisms for enhancing the stability and efficiency of capital markets.

Regulation of Mortgage Advice

An immediate reaction to any problem in financial markets is to suggest an extension of regulation and indeed the Australian Green Paper on Financial Services and Credit Reform canvasses just this option with respect to mortgage advice. It has a point, because unlike investment advice, advice on borrowing is largely unregulated, or rather self-regulated, in both Australia and New Zealand.

However, before rushing ahead it is worth reflecting on three points. First, unlike the United States, there is no evidence of widespread mis-selling or misrepresentation of the client's characteristics to the lender despite extensive use of mortgage brokers in both countries. Second, no amount of regulation can compensate for financial illiteracy in the face of increasingly complex financial products. Third, it is not at all clear how effective the regulation of investment advisors has been in any country.

ANZSFRC believes it would be desirable to evaluate the effectiveness of existing regulation of investment advisors before replicating it for mortgage advice.

Australia-New Zealand Shadow Financial Regulatory Committee
Following the example of the Shadow Financial Regulatory Committees in Asia, Europe, Japan, Latin America and the United States, a group of well known professors from Australia and New Zealand, who are all experts in the fields of banking, finance, and the regulation and supervision of financial institutions and markets, set up the ***Australia-New Zealand Shadow Financial Regulatory Committee*** (ANZSFRC). The ANZSFRC had its inaugural meeting in Sydney in December 2006 when its first statement entitled "Managing Bank Failure in Australia and New Zealand: Rapid Access Matters" was issued during the 2006 Australasian Finance and Banking Conference.

Co-chairs of the ANZSFRC are Prof. Glenn Boyle and Prof. Kevin Davis. Glenn Boyle is Professor of Finance at the Victoria University of Wellington and Executive Director of the New Zealand Institute for the Study of Competition and Regulation. Kevin Davis is Commonwealth Bank Chair of Finance at the University of Melbourne and Director of the Melbourne Centre for Financial Studies. They can be reached at glenn.boyle@vuw.ac.nz and kevin.davis@melbournecentre.com.au.

Members of the Committee
The ANZSFRC currently consists of the following 14 members:

Christopher Adam
Professor of Finance, University of New South Wales, Sydney
Head, School of Banking and Finance, University of New South Wales, Sydney

Jonathan Batten
Professor of Management, Macquarie Graduate School of Management, Sydney

Glenn Boyle
Professor of Finance, Victoria University of Wellington
Executive Director, New Zealand Institute for the Study of Competition and Regulation

Steven Cahan
Professor of Financial Accounting, University of Auckland

Jenny Corbett
Professor of Economics, Australian National University
Executive Director, Australia-Japan Research Centre

Kevin Davis
Professor of Finance, University of Melbourne
Director, Melbourne Centre for Financial Studies

Members of the Committee (cont.)

Alex Frino
Professor of Finance, University of Sydney

Ian Harper
Professor of Commerce and Business Administration, Melbourne Business School
Executive Director, Centre for Business and Public Policy, Melbourne Business School

David Mayes
Adjunct Professor, Europe Institute, University of Auckland

John Piggott
Professor of Economics, University of New South Wales, Sydney

Ian Ramsay
Professor of Commercial Law, University of Melbourne
Director, Centre for Corporate Law and Securities Regulation, University of Melbourne

Lawrence Rose
Professor of Finance, Massey University, Auckland
Pro Vice-Chancellor, College of Business, Massey University, Auckland

Alireza Tourani Rad
Professor of Finance, Auckland University of Technology
Chair, Department of Finance, Auckland University of Technology

Andrew Worthington
Professor of Finance, Griffith University, Nathan

Harald Benink (invited member)
Professor of Finance, Erasmus University Rotterdam
Senior Research Associate, Financial Markets Group, London School of Economics
Chairman, European Shadow Financial Regulatory Committee

Statements
Since December 2006 the following statements have been issued:

1. "Managing Bank Failure in Australia and New Zealand: Rapid Access Matters" (Sydney, December 2006).
2. "Lessons from Recent Financial Turmoil", jointly with the Shadow Financial Regulatory Committees of Asia, Europe, Japan, Latin America and the United States (Copenhagen, September 2007).
3. "Responding to Failures in Retail Investment Markets" (Melbourne, September 2007).
4. "Mortgage Markets after the Sub-Prime Crisis" (Wellington, June 2008)

Independence of the Committee
The Australia-New Zealand Shadow Financial Regulatory Committee meets approximately twice every year in one of the major cities in Australia and New Zealand. The 'shadow' function of the ANZSFRC is related to the Committee's purpose of following and analysing critically the existing and evolving regulatory framework for financial institutions and markets. At the end of each meeting the ANZSFRC issues a public statement on topics discussed during its meeting and presents this at a conference or briefing session. The Committee is fully independent of the providers, regulators and supervisors of financial services whose behaviour it aims to evaluate.

Analytical Mission
The analysis of the regulatory framework is based on existing and proposed national regulations in Australia and New Zealand, recommendations by international forums such as the Basel Committee and the Group of Thirty, and on relevant academic research in this field. Typically, the Committee tries to translate concepts drawn from academic literature into concrete policy recommendations with respect to certain subject areas.

Worldwide Network of Shadow Committees
The ANZSFRC is part of an emerging worldwide network of Shadow Financial Regulatory Committees (SFRCs). Once every year or two years the Shadow Committees of Asia, Australia-New Zealand, Europe, Japan, Latin America, and the United States meet in a major international city to discuss a theme of common interest, resulting in a joint policy statement. The last joint meeting took place in Copenhagen (Denmark) in September 2007.

The other SFRCs are:
Asian SFRC (**www2.hawaii.edu/~fima**)
European SFRC (www.ceps.be)
Japanese SFRC (www.econ.keio.ac.jp/staff/masaya/shadow/shadow.html)
Latin-American SFRC (www.claaf.org)
U.S. SFRC (www.aei.org)