

MORTGAGE BACKED SECURITISATION: CONTEXTUAL SUCCESS FACTORS

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ABSTRACT

One of the perplexing problems for all nations is the housing of its people. The development of sophisticated public housing schemes is costly and involves significant public resources. The success of mortgage backed securitisation in the US as a generator of housing finance is unquestioned. However, securitisation has remained largely of marginal significance outside the US, and more recently, Australia. Why is this the case? While this question may be answered empirically in some years hence, a comparison of securitisation in the US and Australia may shed some light on the answer. Securitisation activity in Australia was, by comparison with the US, late in developing to any degree of sustainability. There were legal, institutional and economic factors inhibiting progress towards an Australian secondary mortgage market. While the technology of securitisation was available from 1970, only during the 1990s, did Australian securitisation activity achieve some degree of persistence, despite earlier attempts. In this paper, through a comparison of the development of mortgage backed securitisation in the US and Australia, an assessment of the importance of these factors is undertaken.

INTRODUCTION

US government housing policy since the 1930s has had two objectives: to provide a stimulus to the housing sector and thereby improve productive activity in the economy, and to provide adequate housing for its constituents. The consequent reliance on the private sector for home building and maintenance activity as well as the financing of housing, was a desirable outcome, which assisted in the reinforcement of the national approach to housing finance. Similarly, the Australian approach to social housing policy shaped the institutional structures established to support it. Concentration on broad based assistance to the housing sector through the provision of public housing to those in need, was in stark contrast to the approach of the US government. The US approach encouraged private market solutions for social housing problems, whereas in Australia, social housing was the domain of government only.

Another major difference between Australia and the US has been the level of government responsible for housing policy. In the US, the Federal government took primary responsibility, whereas under the Australian Federation, housing policy is a State responsibility. Consequently, while in the US, a national housing market developed, in Australia, housing markets development on a state by state basis (Finch, 1995; Conway, 1986; Thompson, 1995). The starkly different approaches by the governments in the two countries impacted the speed and structure of the development of mortgage backed securitisation. The integrated US approach stimulated the

development of a national housing finance market and the subsequent secondary mortgage market, whereas in Australia, the six state housing jurisdictions, often competing with each other, impeded the development of a national housing finance market

The US government's intervention into the housing and housing finance markets was, in part, a reaction to the failure of private markets to meet housing policy objectives prior to the 1930s (Vandell, 1995; Fabozzi & Modigliani, 1992; Grebler, 1980, 357). By 1970 the three secondary mortgage market institutions established as US government sponsored enterprises, FNMA, GNMA and FHLMC, accounted for between 60 and 70 percent of all mortgages purchased in the secondary mortgage market (Hollensteiner, 1988; Weicher, 1994; Canner & Passmore, 1995b). Government policy led to the perception that US Government intervention and involvement in the mortgage market, through its agencies, was an institutional "given".

In contrast, it wasn't until the mid 1990s that Australia's mortgage securities market developed into a viable market, with housing finance through securitisation representing a significant part of the market. The market had two growth spurts: from 1988 which reflected the early success of State government mortgage securitisation schemes, and after 1992, when private market innovation and growth became features of Australian mortgage securitisation. The initiatives of the Victorian and NSW state governments in 1984 began the move towards a viable secondary mortgage market, with desired legislative change, and State government schemes of the 1980s, attempted to copy US securitisation schemes but became reliant on Government housing programs (Lange, 1999).

Consequently, from 1988 to 1992, short term success in mortgage securitisation was achieved in Australia, and was due to government involvement, similar to the US. However, rather than working with private mortgage providers, the State government schemes in Australia relied on State government housing assistance programs, which worked independently of private market. However, by the close of the 1980s, most of the structural and institutional arrangements for mortgage securitisation existed. However, securitisation stalled until private sector activity revived it after 1992.

The establishment of the FHA and FNMA programs in the US facilitated the development of an integrated, national mortgage market, reinforced by the consequent revisions to lending practices in the 1930s, including the standardisation of mortgages and mortgage documentation, and common insurance underwriting standards. This provided market confidence to both lenders and investors that the loan, the borrowers and the underlying assets met certain quality standards (Vandell, 1995; Fabozzi & Modigliani, 1992). When mortgage securitisation was contemplated in 1970, it was made relatively simple through standardised mortgage products, contracts and laws. This however, was not the case in Australia.

In Australia, efforts of the early secondary mortgage market participants were largely hampered by legislation and regulation inappropriate for securitisation, including, stamp duties on mortgage transfers and restrictions on asset sales in some institutions. Further, the lack of mortgage pool insurance significantly diminished the appeal of mortgages as an investment vehicle. Many different Australian laws impacted securitisation including bankruptcy, securities, trustees, contracts and property transfers. Complexity also arose as the legislation was usually state based. The regulation of financial institutions also established barriers to securitisation in Australia, as

regulations did not apply neatly to mortgage securitisation schemes, and in some instances, was intended to delay development, such as the Reserve Bank of Australia's strident opposition, until 1995, to the securitisation of bank assets. The institutional changes required in Australia produced a shock to the markets over a relatively short period of less than 20 years, and it was not until most of these adjustments were in place by the early 1990s, that a deep market in securitised assets could be contemplated.

Part of the success of securitisation in the US has been due to the market preference for long term, fixed rate mortgages. In addition, the securitisation of fixed rate mortgages produced long term, fixed rate securities, which generally met investors' preferences. However, more than 80 percent of Australian mortgages are variable rate mortgages. Consequently, it was not appropriate to simply apply the US securitisation template to the Australian market.

From the experience of both the US and Australia, we see that prevailing economic conditions had to be consistent with the introduction and sustainability of a new financing source. In the US, the time was right in the 1930s, following major market corrections, to introduce a secondary mortgage market which both stimulated building and improved confidence in housing markets. In Australia, while all the institutional arrangements necessary for securitisation were in place by the late 1980s, the economic and market conditions were not appropriate, and it was not until the 1994 that suitable conditions occurred. In Australia by 1994, as in the US earlier in the century, a convergence of economic events created a market opportunity for an alternative source of housing finance, mortgage backed securitisation. Mortgage backed securities were also used to fill the growing gap in demand for quality investment grade investments.

The experience of both Australia and the US indicates that attention to each of these is likely to lead to a successful securitisation market. A summary of the conditions identified, is provided in Table 1.

Table 1
Necessary Conditions for Sustainable Mortgage Backed Securitisation Program

Necessary Conditions	Description
Legal and Institutional Arrangements	The appropriate legal framework and institutional structures must be in place to support the development and survival of mortgage backed securitisation.
Government Involvement	Government/Authority sympathetic to the need for mortgage backed securitisation, and makes appropriate changes to the legal framework and institutional environment to enable securitisation activity.
Alternative Sources of Housing Finance:	<i>Demand Side:</i> Alternative sources of housing finance are limited leading to imbalance in the supply of and demand for housing finance. <i>Demand Side:</i> Alternative sources of housing finance is highly priced, and that there is a sufficient difference in the price of alternative provides to attract customer switching to lower cost alternatives. <i>Supply Side:</i> Securitisation may provide competitive funding to banks and other housing loan providers, relative to deposit funding. <i>Supply Side:</i> Securitisation may provide mechanisms to reduce capital pressures on lenders of housing finance.
Meeting Investor Preferences:	The need for the securitisation program to develop investment

<i>Preferred income streams (fixed versus floating rate streams)</i>	securities that satisfy investors' preferred income streams.
Meeting Investor Preferences: <i>Appropriate investment grade securities</i>	The need for a securitisation program to develop appropriate investment grade securities. There is no requirement that this be achieved through either government or private insurance.
Meeting Borrower and Mortgage Originator Preferences	The need for a securitisation program to use "common" mortgages that meet the preferences of home loan borrowers and providers.
Sustainable Demand for Mortgage Backed Securities	There need for sustainable demand for investments like mortgage backed securities. The demand could be natural, or artificially created from time to time.
Sufficient Market Liquidity	The supply of the mortgage backed securities is sufficient to allow the development of a liquid market.

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