The *Other* Subprime Debt Crisis: Australia's HomeFund Scheme

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Financial Innovation

- When we look at financial disasters, there does not seem to be much innovation.
- It is apparently quite difficult to find a new way of losing money; so people just keep repeating the same old mistakes
- Societe Generale → Barings, NAB, AI
- Fincorp → Estate Mortgage
- Subprime lending → HomeFund (ACST101)

Similarities

	Subprime	HomeFund
▪Low income customers	√	√
▪Supported by govt.	√	√
▪Promoted by Investment Banks	√	√
▪Financed by Securitisation *	√	√
▪Product Design – low start	√	√
▪Financial Risk Modelling	√	√
▪Poor Understanding by risk bearer	√	√

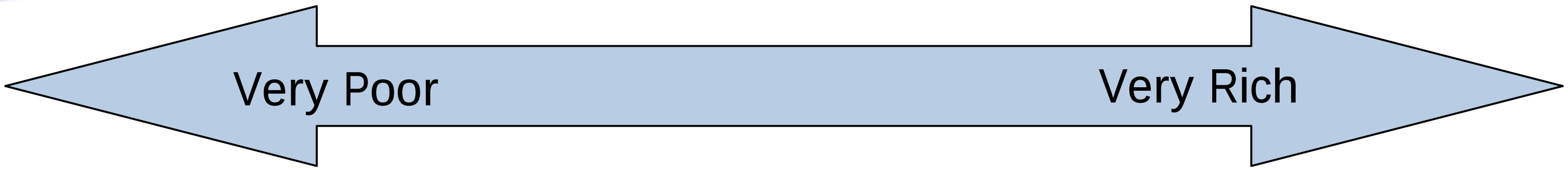
Comparison

	Subprime	HomeFund
▪Mis-Marketing Risks	√	√
▪Very rapid growth *	√	√
▪Followed by huge losses *	√	√
▪Loss minimisation -> borrowers	√	√
▪Govt intervention ? resisted	√	√
▪Litigation by all concerned	√	√
▪Flow on Effects	√	√

A Digression: Lending to Low Income Borrowers Is it a Good Idea?

- **Non Profit Lending**
  - Microcredit Programs (Grameen Bank)
  - Lending small amounts to start a business
  - Unorthodox Credit Risk Management
    - -> Positive impact on borrowers
- **Commercial Lending**
  - Suppose that you are marketing credit cards which have a 0% interest rate for 6 months followed by a 20% p.a. interest rate thereafter.
    - *Q. Who is your ideal customer?*

Strategic Lending



- Not too well-off (can re-finance)
- Not too poor (default)
- Someone who will borrow a lot of money, be constantly in debt, unable to refinance at lower rates, but never quite in default

Impact of guarantees?

- Now suppose that you can find someone who will take all the default risk at minimal cost ….
  - Government guarantor ?
  - Buyer of "toxic waste" Tranche of CDO ?

- *Q. Who is your perfect customer now?*
- *Q. Is this likely to have positive outcomes for the borrowers?*
- *Q. When does lending to the poor become predatory lending?   [After all they chose to borrow…]*

HomeFund Sources

- HomeFund started off as a government program which was supposed to help low income people to buy their own homes.

- But somewhere it all went terribly wrong….
  - Trade Practices Commissioner
  - NSW Auditor-General
  - Ombudsman (suppressed)
  - Special Enquiry – McMurtrie (UBS)
  - Parliamentary Investigation (Hatton)
  - HomeFund Commissioner

In the beginning – Securitisation of Home Mortgages

- Salomon Brothers (Liar's Poker, Michael Lewis)
- 1979 – Mortgage Trading Desk
- But....Zero Demand for Securitisation of Residential Mortgages (Sellers or Buyers)
- 1981 – Savings and Loan Crisis
  - a 3/6/3 business
  - becomes a 9/6/-3 business
  - aiming for a 9/12/3 business (did not turn out well)

Rivers of Gold

- Desperate Sellers (sitting ducks)
- Reluctant Buyers – Credit Risk
- Salomon persuades the Government to bear the Credit Risk (Fannie Mae)
- Salomon's mortgage trading desk makes a fortune, the heroes of Wall Street

"I wonder if this would work in other countries?"

Securitisation in NSW

- *"A number of senior executives of Salomon Brothers were at that time close to both the incumbent Premier, Mr Neville Wran and to the head of the NSW Treasury, Mr Percy Allen. They were instrumental in persuading the Government a secondary market in mortgages was viable"* (SMH)

NB Neville Warn was Premier of New South Wales from 1976 to 1986

The Push

“..every conference I went to, whether it was the building societies’ property movement, finance conferences, or various conferences of the building industry, this secondary mortgage market, particularly in the United States of America, was very high on everyone’s agenda.

The NSW Treasury was very strongly in favour. The Treasury had a great dream that Sydney was to become the finance capital of the Asia-Pacific basin…. But the building industry, the finance industry generally, the co-operative movement, and the Ministers around the country all felt something should be done about a secondary mortgage market and there was a great deal of discussion. It was on the agendas of most conferences at the time.

(Frank Walker, Housing Minister)

The 1980s Philosophy

- Note:1980s - fashionable for government to intervene, to help support the development of the local economy
- State Bank of Victoria
- State Bank of SA
- WA Inc

FANMAC

- Sept 1984 - NSW Govt supports establishment of secondary mortgage market:

  First Australian National Mortgage

  Acceptance Corporation Ltd (FANMAC)

- NSW govt owned 26%, a variety of financial institutions owned the rest
- Salomon owned 5%
- Chairman of FANMAC = MD of Salomon Aust.
- Salomon managed FANMAC’s first bond issue

FANMAC objectives

- Initially: Establish secondary mortgage market among **commercial** lenders
- No takers (RBA?)
- Change of Plans...
  - Q. where can we find another portfolio of home loans to securitise ????

NSW Housing Crisis

- Sydney: housing unaffordable
- Public Housing Waiting Lists
  - +10% in 1985
  - 2 bedroom unit: 19 months
  - 3 bedroom house: 26 months

- *Q. Why not borrow to build more public housing / subsidise home purchase?*

Financial Constraints

- **Global Borrowing Limits**

- <u>Help for the States</u>

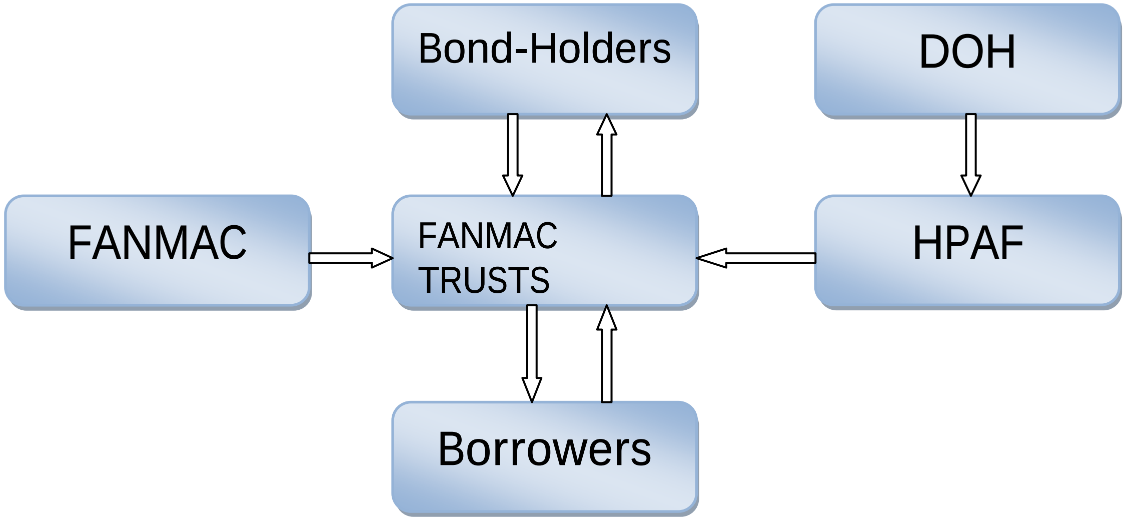
"…no end of bankers, merchant banks, brokers and other financial advisors trooped around visiting the states, telling them how they could do things which would enable them to escape the apparent constraint imposed by the global limits system."

Off Balance Sheet

- FANMAC suggested NSW govt could obtain “off-balance-sheet” funding for housing – by securitisation.
  - FANMAC to issue bonds
  - Lend money for low income borrowers
  - Govt to guarantee repayment of bonds (“nominal cost”)

- *“The combination of components of the scheme is a world first for home loans and one that other states of Australia are bound to follow. It is another feather in our cap in leading the way in promoting the use of capital markets for meeting our social objectives”*

HomeFund Structure



An Unhappy Auditor-General

- NSW Auditor General : if NSW govt was providing guarantees, accepting the financial risks, and effectively controlling the HomeFund program,
  - this should really be shown **somewhere** in the accounts....
- Govt did not agree (after all, the whole point was to bypass the Loan Council Restrictions)

Evasion of Financial Responsibility

- The Auditor General: This was *“evasion of financial responsibility”*

- Since the Government’s liabilities were not shown in any government accounts, the usual financial controls were not in place.

  - --> The HomeFund program expanded out of control, with no effective supervision, no effective measurement or management of risks, and no accountability.

HomeFund: the first Australian Dirty Securitisation?

- Note: Still a problem for prudential regulators (and contributed to subprime debt crisis)
  - Risk supposedly moved off to an SPV etc
  - Hence parent **apparently** has lower risk
  - But parent company actually retains risk

    i.e. not a “clean” securitisation

Putting Dracula in Charge..

- FANMAC's legal advisors drafted all HomeFund documents
  - ..."*with its own interests to the fore". (Hatton)*

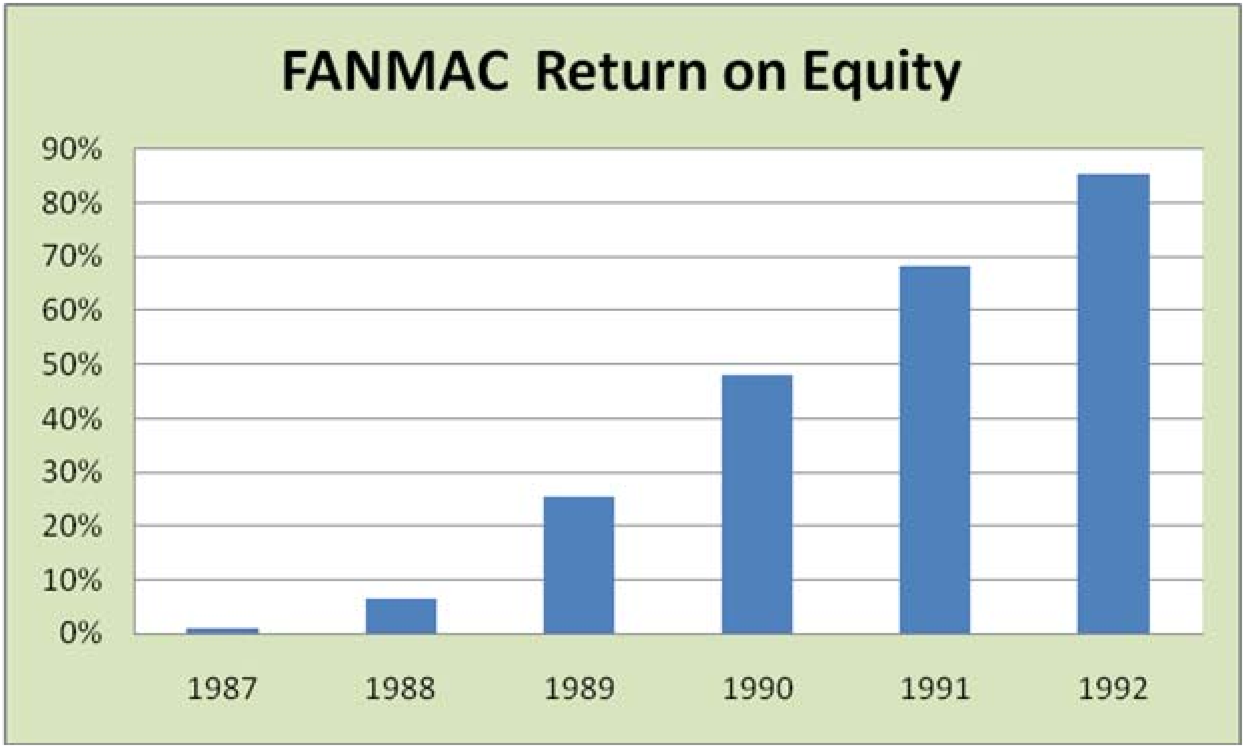
- *"The structure of the documentation passes all of the legal risks of the transaction to the State by one means or another, but currently gives the State no means of controlling those risks, even where those risks eventuate as a result of default by FANMAC." (Legal Consultant)*

Program design

- FANMAC paid by commission
- Risks were transferred to NSW govt.
- Program evolves...
  - *"The tendency of all the revisions to the FANMAC proposal were to lend more money, to more people, with less stringent requirements"*

- After you shake hands with a merchant banker….

FANMAC Profitability



HomeFund Product Design

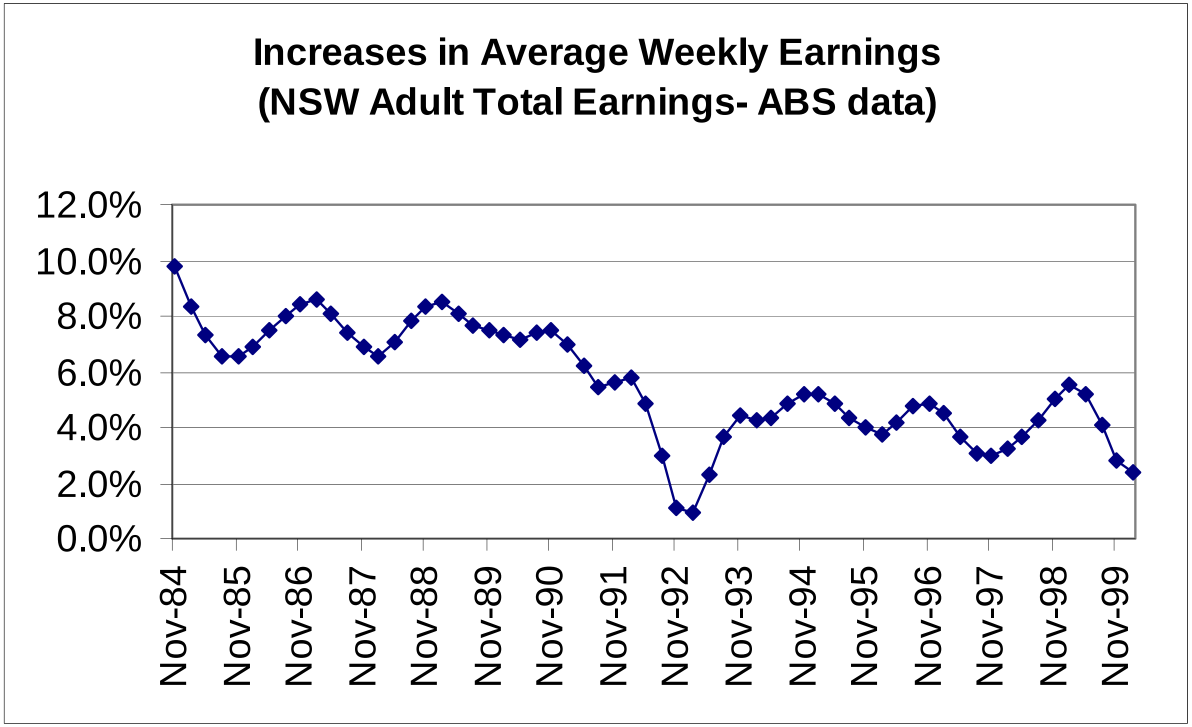
Low Start Loans

- Available to low income people
- 10% deposit
- Repayments escalating at 6% p.a
- Rates fixed for term of loan (15%)
- No prepayment penalties

Impact of 6% Escalating Repayments

- Maximised the amount borrowers could borrow in year 1
- BUT if borrower's income did not increase by >= 6% p.a., then it would become increasingly difficult for borrowers to pay. (*repayment shock*)
  - Co-operatives expressed concern
  - SMH writers expressed concern
- DOH said not to worry,
  - historical AWE increases were more than 6% p.a.

Average Weekly Earnings

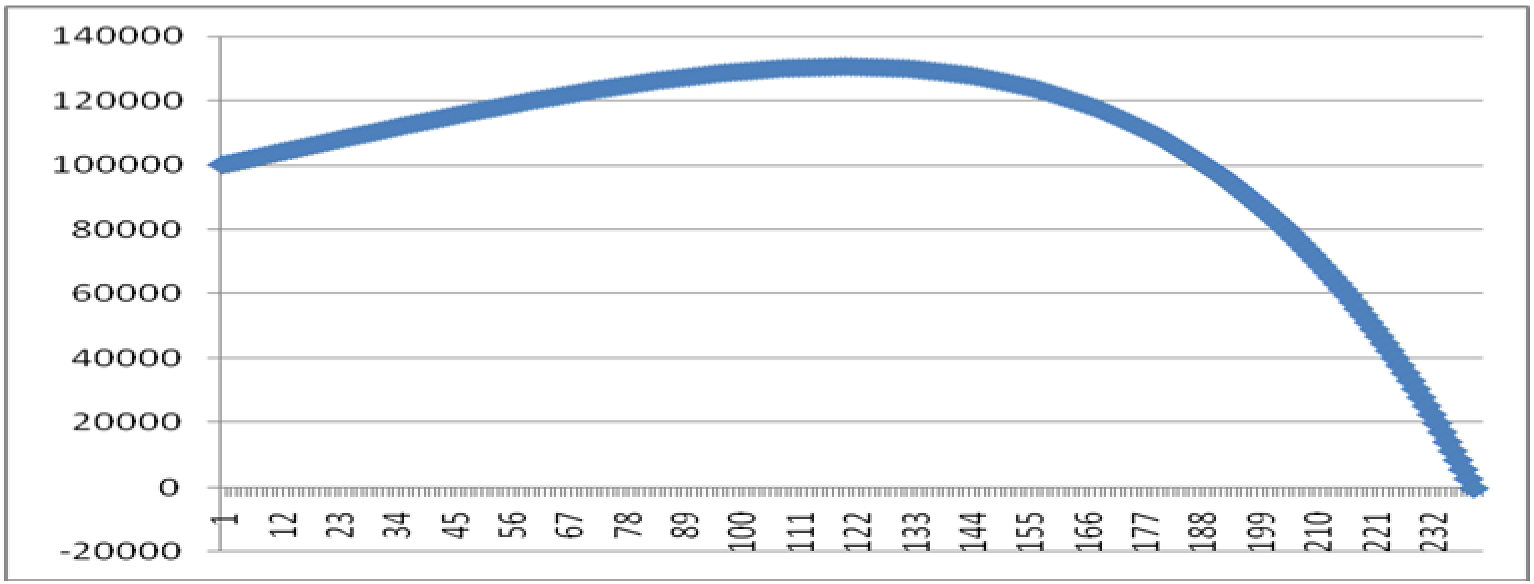


- *Q. Was this foreseeable?*

Unemployment Rates

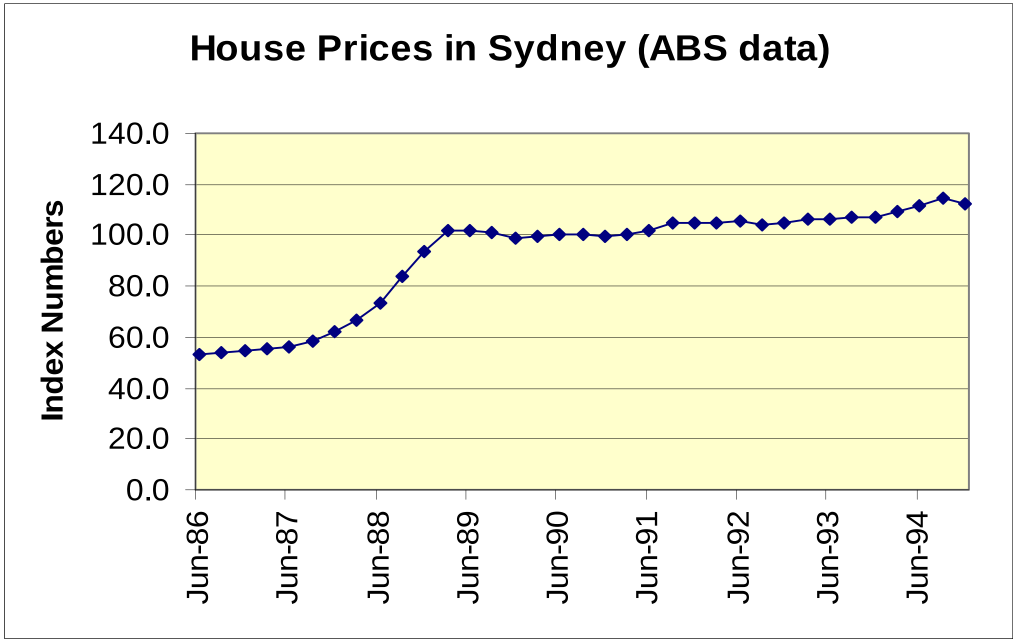
- By 1993, 11% of borrowers were in arrears by at least 2 months payments and in danger of losing their homes.
- Even worse – would be homeless AND deeply in debt.

Negative Equity



- Loan Balance on $100,000 loan peaked at $130,000
- Not a problem as long as house prices were rising...

House Prices In NSW



- Most HomeFund loans made at the peak of the market. (1988-90)
- Borrowers forced to sell at a loss, i.e. left homeless AND with large debts.
- *Q. Was this foreseeable?*

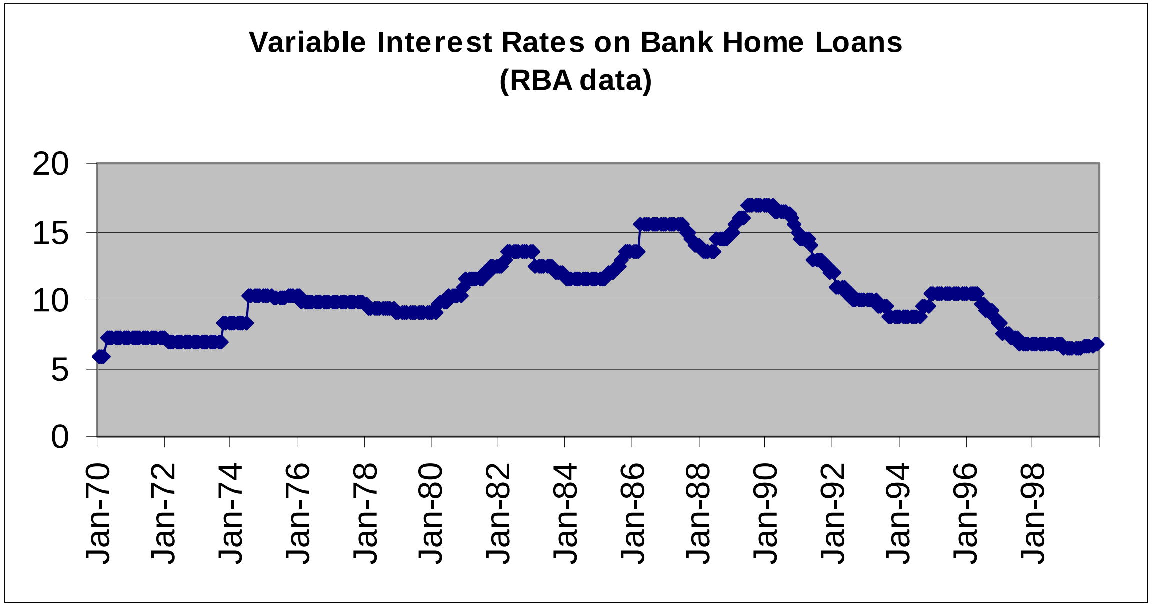
Fixed Interest Rates

- Most Aussie loans have variable rates
- BUT bond buyers like fixed rates
- So bonds were issued at fixed rates

  and HomeFund loans had fixed interest rates
    - Initially 15% p.a, later 15.9% p.a.

- *Q. Was this good for borrowers ?*
    - Protected from risk of future rate increases
    - Looked cheap in first year (1/2% below variable)

Interest Rates



- By 1993, home loan rates were below 10% but HomeFund borrowers were still paying 15.9%
- Q. Couldn’t they refinance?

Outcomes

- By 1993, (HomeFund closed down)
  - Default rates up
  - Foreclosures increasing
  - Remaining borrowers – the poorest people in the community – were paying the highest interest rates in the state
- Difficult to argue that this was a good outcome for the borrowers ?

Alternative Realities

- The Official Version & the Conspiracy Theory
  - JFK ?
  - 9/11 ?

- Sometimes the official version requires you to believe that someone is incompetent rather than immoral.
  - AWB and DFAT ?
  - Iraq and WMD ?

- HomeFund was clearly a disaster for borrowers -

  so was this incompetence or was it designed that way?

Q.Stupidity or Iniquity?

- A. These two explanations are not mutually exclusive

- Incompetence:

“The investigation revealed no evidence to suggest that the initial external assumptions, critical to product design, were seriously and thoughtfully reconsidered on a regular basis at any stage, to assess what might happen to the borrower’s position over the life of the mortgage…”(Ombudsman)

Incompetence ?

- “The question has less to do with whether the assumptions embedded in the program design were reasonable, or were proved right or wrong, or by how much. Rather, it is about the lack of evidence of serious study of these assumptions, of methodical research which reasoned through the proposals and the possibilities which might undermine the program. *(Hatton)*

The Alternative Theory?

- Bonds were issued on a pass-through basis
- Bondholders were guaranteed of a high interest rate (say 15.9%) UNTIL the home loans were repaid
- If interest rates fell, and people refinanced with a bank at the lower interest rates, then the loans would terminate early
- Bondholders would then be paid out and would have to reinvest the money at the lower rates
- *SO….*
- *Bondholders would like the risk of prepayments to be minimised*

Selling the bonds

- By a lucky coincidence (?), the product design ensured that the risk of prepayments was likely to be quite low.
- Bond underwriters explained: when valuing the bonds, the investors who bought the bonds "made an informed judgement that the ability to prepay was likely to be limited for the Low Start borrowers and almost negligible for the Affordable borrowers".
  - *"..one of the main reasons why the securities were attractive initially was because the supporting mortgages were trapping borrowers"*

Preventing Prepayments

- 1. Safety net
  - Concerns raised during design phase
  - DOH **repeatedly** promised a refinance option for anyone in trouble
  - Never happened: it would upset bondholders

- 2. Refinance grant $5000
  - Underwriters protested / claimed compensation
  - Squashed after just a few days

Affordable Loans

- Product #2: Affordable Loans
- Targeted at very low incomes (public housing)
- Like Low-Start, but subsidised by govt. **(planned)**

- Special feature: Repayments limited to 27% of income (even if income went down).
- Govt subsidy would increase to cover shortfall. (**unplanned** subsidy)

Compliance Problems

- Unplanned subsidies could get expensive...
  - Moral hazard here ?

- Guidelines were issued to loan administrators making it quite difficult to get repayment reductions

- You might suspect that the NSW Government was deliberately ignoring its legal obligations, and saving money by ignoring the rights of its most vulnerable borrowers ???
  - No No No! DOH explained:
- a. Drafting error by Mallesons
- b. Mistake due to high staff turnover

A deliberate breach?

- Staff training: "*Those people that make a noise, adjust their repayments back to 27%. Everyone else, use this formula.*"
- Confused about the rules? In all DOH promotional brochures: an accurate description of the repayment reduction rules. Apparently confusion only arose when it was time to actually reduce the repayments.
- Someone queried this rule when the product was designed. Reply: the clause had to go in, but they didn't actually intend to implement it, because it would be too expensive

Hatton’s Dilemma:

- “the senior management of FANMAC and/or the Department of Housing were <u>simply incompetent</u>...”; or

- “the senior management of FANMAC and/or the Department of Housing <u>knew exactly</u> <u>what the terms of the Affordable Home Loan were and</u> <u>made a decision to flaunt its provisions;</u> thereby denying borrowers their contractual rights. The power at the disposal of FANMAC and the Department of Housing vis a vis the borrowers allowed them to force the borrowers to conform to the repayment reduction conditions set by both bodies in their respective guidelines and thereby prevent borrowers from exercising their proper entitlements”.

Correcting the error

- After the “error” was “discovered” (about the same time it was publicised in SMH?), in May 1992 the Department of Housing made adjustments to payments for more than 1300 borrowers.

- By 1992, about 20% of subsidised borrowers were on repayment reductions
  - -> cost blow-out for unplanned subsidies

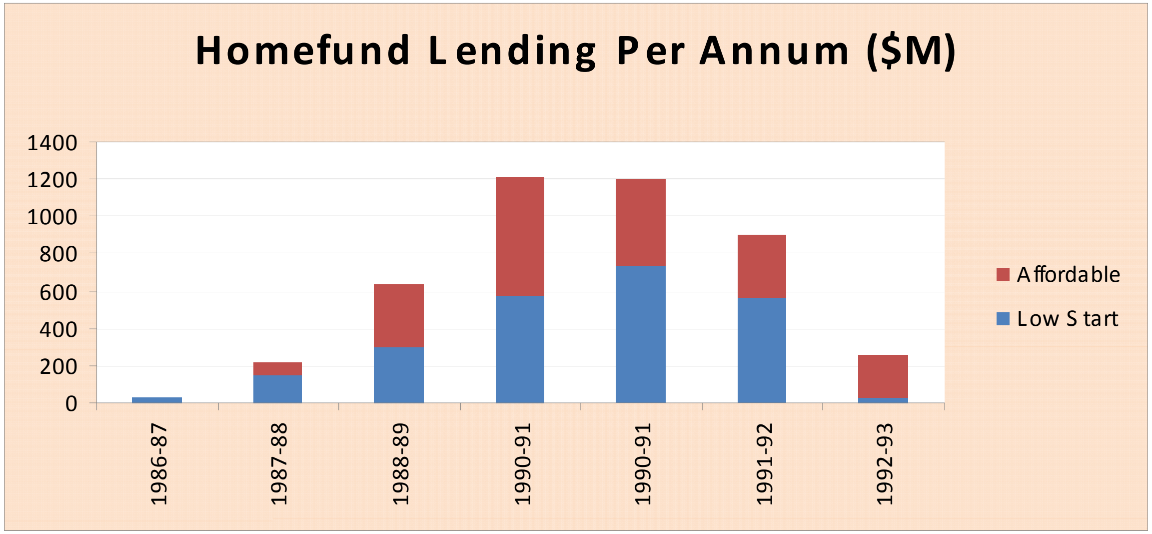
Financial Controls

- NSW govt was liable for
  - Default risk
  - Planned subsidies
  - Unplanned subsidies
- Clearly, size of liability would depend on size of the HomeFund program and types of loan
  - –> important to have strong controls

Financial Modelling at DOH

- Model had numerous errors
  - Inaccurate in predicting future or past
- No one at DOH understood the model
- Model input assumptions were manipulated to give answers the govt wanted to hear
- The government tended to ignore the advice of the Treasury experts anyway.

HomeFund Expansion



- Treasury recommended maximum of $200m pa.
- After 1988: Rapid expansion, for riskiest loans, to highest risk customers, with lower deposits.

Political objectives

- Get people out of public housing
  - Mrs Thatcher

- Support the building industry
  - NSW Govt worked with building industry to develop land-home packages suitable for low income earners (western suburbs of Sydney).
  - Landcom sold thousands of blocks of land in Western Sydney to property developers, who sold homes to low income earners.

Marketing

- Marketing was via Co-operative Building Societies.
- Who often working closely with real estate agents & property developers.

  - **“Some builders, real estate agents, valuers and solicitors** acting for Societies and borrowers have each had a commercial interest in the origination of HomeFund loans. This has led to close association with Societies; and a tendency to ignore or understate the risks of such loans to their respective clients. In some instances it has also resulted in **a willingness to distort the facts to achieve the required outcomes”**

Co-ops Marketing

- Co-ops were paid by commission
- And encouraged to make as many loans as possible
- Credit Risk Assessment was not always done competently
- DOH had virtually no risk management controls on marketing

Trade Practices Commission Enquiry

- “...*claims that* ***HomeFund*** *borrowers have been misled over their obligations, that there has been ‘unconscionable conduct’ by* ***HomeFund****, FANMAC and other lending bodies, and that consumers have been induced to borrow more than they could repay.”*

- The result : a damning report, which said that many borrowers had been deceived about the terms and conditions of their mortgages.

    - *"For many people who were former public housing tenants, the security of tenure, fixed repayment, maintenance system and quality of life of public housing were changed forever into a cycle of debt, poverty and hardship".*

HomeFund Commissioner

- Set up in 1993 to investigate complaints and to award compensation for damages.
  - **26,000 loans outstanding at the time**
  - **8,400 complaints.**

Some Borrowers subsequently sued, and eventually (after several years and numerous appeals) received a settlement of $75 million from the NSW government (mostly in having loans written off).

Restructure

- Homefund lending ceased in 1993.
- Some borrowers survived HomeFund – many others were financially devastated.
  - Class A 8,000 : no change, refinance
  - Class B 13,000: reduced interest rates
  - Class C 4,000: lose home but could rent it out 5 years
  - Class D 1,000: lose home but could rent it for 18 months
- BUT give up all legal rights to sue.

Q. Total Cost to NSW Taxpayers ?

- A. We may never know.
  - **<u>At least</u>** $400 million.
  - HomeFund accounts qualified each year by NSW Auditor-General.
  - Some mystifying transactions ?
    - E.g NSW govt bought Zero-coupon irredeemable bonds from FANMAC – is this an asset ??? Auditor thought an expense...

Conclusion

- We're from the government,
  we're here to help you?