



Institute of Actuaries of Australia

4th Financial Services Forum

Innovation in Financial Markets

19 and 20 May 2008 – Melbourne

Perspectives of the Australian Mortgage Market

Basel II and the credit crunch

Jason Slade

Tim Jenkins



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Agenda

- The Australian Mortgage Market
- Basel II Implications
- Credit Crunch Impact



Market Participants

ING Equity Fee product – Customer pays one off fee rather than LMI. This is referred to as a reduced equity fee.

Westpac is waiving LMI to approved customers in 80-85% LVR band, (though generally at the expense of other discounts).

Mortgage Providers	Current Market Participants	Main Source of Funding	Product Features	Average Term
Majors	ANZ, CBA, NAB, Westpac	Deposits Bank borrowing Internal Securitisation	Standard – Fixed/variable Low Doc Basic/Full features	4.5-5 years
Regional and Foreign / ADIs	ING, St George, Suncorp etc	Deposits Bank borrowing Securitisation	Standard – Fixed/variable Low Doc Basic/Full features	2.5-3 years
Non-Bank Lenders	Some non-bank lenders specialising in non-conforming loans (Liberty, Bluestone & Pepper) use higher credit spreads rather than LMI.	Securitisation Wholesale lending Bank borrowing	Standard – Fixed/variable Low Doc Basic/Full features	2.5-3 years



How it used to look...

1) Market Growth

- Steady but slowing in recent years (2004-2007)
- Majors were growing slower than Non-bank lenders and hence losing market share

2) The Mortgage Mix

- Low-doc lending grew strongly leading up to July 07 (credit crunch), at approximately 15% p.a.
- No-doc/non-conforming lending also grew strongly, accounting for 5% of total market



How it used to look...

3) Distribution

- Growth in distribution through mortgage brokers compared to branches
- Brokers, responsible for loan origination, determined the quality of loans issued by lenders

4) Pricing

- Pricing approaches driven more by other factors than by risk, e.g.
 - Size
 - Product type (bundled/unbundled)
 - Competition/customer shopping

5) Funding

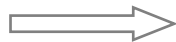
- Reduction in deposits received by banks
- Around $\frac{1}{2}$ of funding through securitisation and wholesale markets



But...

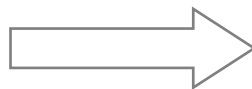
Conditions have now changed significantly!

Basel II



Shift in balance between bank lenders
and mortgage insurers

Credit Crunch



Shift in balance between bank
and non-bank lenders



Basel II Background

- Revised capital regulatory regime for ADIs (non-bank lenders still not regulated)
- Three Pillar structure
 - First pillar – minimum capital requirement covering credit, operational and market risk
 - Second pillar – supervisory review process (other risks/economic capital)
 - Third pillar – market discipline (and disclosure)
- Risk-based approach
 - Assessed loan by loan
 - Increased focus on risk and hence capital for institutional lending
 - Retail lending more attractive
- Constraints apply



Basel II Background

However, is Basel “Fawltly”?

It is **NOT** risk-based when it comes to LMI!

- Under Basel I –

	Capital required per \$100 lent
<80% LVR	\$4
>80% LVR (no LMI)	\$8
>80% LVR (with LMI)	\$4

- Under Basel II

- For Advanced Banks (i.e. the Majors): the minimum floor of 20% for LGD minimises any capital relief from LMI
- For Standard Banks (i.e. regionals): lower capital relief from LMI than under Basel I
- In addition, there is a 10% limit on overall bank capital reductions in the early years



What is the Credit Crunch?

- US Subprime problem
 - Highly attractive product (with a sting in the tail)
 - Weak underwriting and credit approvals
 - Poor asset quality
 - No incentive to manage risks
- Impact when the “honeymoon” was over
 - Increased awareness of credit risk
 - Freeze in demand for complex investment products based on securitised mortgages

Liquidity crisis and increased cost of funding



What is the impact on wholesale funding costs?

“Westpac used to be able to borrow at 0.1 percentage points [i.e. 10bps] over a benchmark interest rate. At the height of the credit crisis this soared to 1.4 percentage points [i.e. 140bps]...”

- The cost of borrowing increased by 14 times!

“It is currently sitting about 0.7 percentage points [i.e. 70bps] above the benchmark.”

“The bad news...the cost of borrowing for banks seems likely to remain permanently higher...about 0.5 percentage points above the benchmark - or five times more than it used to cost a bank to borrow.”



Impact on Mortgage providers

Increased cost of, and limited access to, funds for lenders



Non-bank lenders' business model under pressure



Increase in market share and market power to banks



Responses by Authorities

- US Federal Reserve securities lending program:
 - Issuing \$US200 billion highly-liquid US Treasuries to primary dealers, secured for 28 days
- Bank of England's Special Liquidity Scheme (SLS):
 - £50 billion package to allow banks to swap their high quality mortgage-backed securities for UK Treasury Bills over a period of 1-3 years
- European Central Bank:
 - €95 billion loans to 49 firms
- Reserve Bank of Australia:
 - \$AUS1.1 billion to purchase AAA-rating RBMS

Key objectives:

- Restore liquidity in the market
- Encourage lending activities between banks



In the old world (pre-**Basel II & credit crunch**)...

- Rise in non-bank market share
- Rise in non-conforming loans
- Rise in broker distribution
- Pricing not risk-based
- Funding from securitisation and wholesale markets
- Mortgage insurers provided risk and regulatory capital relief for lenders



In the new world (post Basel II & credit crunch)...

- Fall in non-bank market share
- Fall in non-conforming loans
- Fall in sale through broker distribution
- Pricing still not risk-based
- Flight to quality has led to a small increase in banks' deposit bases
- LMI provides risk relief in a more risk averse world, leading to true capital relief; but due to flaw in Basel II, not regulatory capital relief