

By Chris Wright

Australia looks to Canada for the *answer*

Australia needs to inject some life back into its securitization markets because despite the quality of its mortgages the market is dead. An agency model with the federal government guaranteeing mortgage-backed issues seems the likely solution and Canada offers the best template.

Australia has taken its first steps towards an agency model for its securitization markets — a system in which the federal government would act



We're going to have to follow someone else's lead

Getty

as a guarantor for mortgage-backed issues. It's an idea designed to bring stability and confidence back to a market which, despite the world-renowned quality of its underlying mortgages, has almost completely died out this year.

The public face of this push is Greg Medcraft, the new chief executive of the Australian Securitisation Forum and the former head of its U.S. counterpart, the American Securitization Forum. He led a formal pitch to Australia's federal Treasury in April.

"Australia needs to look at an agency model," he says. "It's a little bit overdue." The idea is that it would bring investor support back to the market — not just now, but in future liquidity crunches — as well as improve liquidity, raise competition and reduce both the cost of funds for issuers and the rates of mortgages for borrowers. It might also help with a curiosity of the Australian market — that much of its paper goes overseas, not to Australian investors. "One issue with Australia is the imbalance of funding of mortgage-backed securities," Medcraft continues. "Most of the funding has always come from offshore as opposed to Australia, which has made the market very vulnerable to disruption

in foreign markets.”

Medcraft, who until recently was the global head of securitization at Société Générale in New York, has looked worldwide for the best existing model and concluded that the answer lies half the world away in Canada. “They took the American model and made it better,” Medcraft says. “The U.S. is issuer driven, Canada is investor driven.”

Canada has, after all, just made a strident assertion of the success of its system: in March Canada Housing Trust priced C\$11 billion (US\$10.75 billion) of Canada Housing Bonds, its largest ever quarterly issue, to follow on from a C\$9.5 billion

“They took the American model and made it better. The U.S. is issuer driven, Canada is investor driven.”
Greg Medcraft, CEO, Australian Securitisation Forum

issue in December. In the middle of a global credit crisis, that’s quite a feat: not one single public mortgage-backed (MBS) issue has made it out of Australia this year, this in a market whose arrears rates on mortgages is among the lowest in the world. Moreover, the more recent Canada issue priced at 58 basis points over Treasuries; in Australia, major bank MBS issues are trading in the secondary market at over 200 basis points over bank bills swap rates, giving an indication — if anything an optimistic one — of the cost of funding if any were desperate or reckless enough to attempt it.

The Canadian model works like this: lenders sell their mortgage-backed securities to a government-owned corporation. This corporation then issues them to investors every quarter as single maturity, liquid bullet bonds. As bullets, they are included in fixed income managers’ benchmarks, increasing liquidity. That’s a big difference from Australia where MBS issues are generally monthly pass through of principal, do not appear in major fixed income indices, and where there are a wide range of maturities from a host of different issuers.

Furthermore, the Australian government generally doesn’t issue fixed income supply — its policy in recent years has been to retire debt, not issue it — so one could argue that securitization issuers are missing an opportunity to find a local home for their paper, particularly in a market where superannuation (pension funds) assets have now topped A\$1 trillion (\$924 billion) and need more assets in which to invest.

There is another advantage. “For Australia, the model overlays the existing market much more easily than the U.S. market model,” he says. “In Canada the way it works is that it wraps over an existing mortgage-backed security. It doesn’t need a wholesale change to the market and could be implemented very quickly. That’s why I like that model.”

The response from the industry has been positive so far. “There are certain merits in being able to promote competition between banks and the non-bank sector,” says Bill Measday,

head of asset-backed securities (ABS) for Australia at UBS. “If it comes off, it will be an interesting development.”

Several issues would need to be sorted out. The Canadian program guarantees mortgage bonds issued by approved issuers. So an Australian agency would need to decide which entities to approve and is prepared to guarantee — in Canada, it’s about 50 banks, life insurers, credit unions and dealers, with a minimum net worth of C\$3 million plus 2% of the aggregate principle of the securities issued. The Canadian model also sets criteria for the underlying mortgages — first mortgage, owner-occupied, a maximum amortization of 40 years, mortgage insured and not delinquent, among other things. Most of those characteristics are already shown by Australian prime residential MBS, which in turn occupy the bulk of the approximately A\$170 billion Australian RMBS market. But it certainly doesn’t cover non-conforming loans, the Aussie equivalent of subprime — although it is a much smaller proportion of the market than subprime has been in the U.S., representing less than 1% of outstanding housing loans in Australia.

Booster Injection

Certainly, Australia’s markets need a shot in the arm. According to the Reserve Bank of Australia there were A\$45 billion of RMBS issues from Australia in the first half of 2007; by the second half, it had slumped to less than A\$6 billion. In 2008, it’s worse. Only one public asset-backed deal of note has got away in Australia this year: a US\$310 million-equivalent, multi-currency, auto loan-backed deal from Crusade, the funding program of St. George Bank. In the mortgage-backed markets, there’s been nothing. “You could do a deal,” says Measday. “Just not at spreads that would make it attractive for issuers to do one.”

“The market for Australian RMBS is effectively shut,” says Alexander Machliss, director at Barclays Capital in Australia. “The mortgages themselves do not yield enough to pay for the spread currently demanded by investors.” That’s not because of

“There are certain merits in being able to promote competition between banks and the non-bank sector.”

Bill Measday, head of ABS for Australia, UBS

credit problems: the performance of Australian mortgages is among the best in the world and the economy is buoyant. “It’s pure and simply a liquidity issue.” At Deutsche Bank, Glenn McDowell, managing director and head of securitization, adds: “The Australian securitization and mortgage markets are still exhibiting strong relative outperformance on credit, but are being constrained by this global contraction in liquidity.”

There is plenty of supply of Australian paper in the secondary market as international investors unload existing deals from their books, which also reduces the need or appetite for new deals. “Many Australian investors, confident in the domestic market, are happily picking up secondary paper from interna-

tional investors," Machliss says. "However, internationally there is still a lot of liquidity that has to drain out of the market, especially with the demise of a number of SIVs which were extremely geared." Some were up to 28 times leveraged — a dollar of real money buying \$29 of mortgage-backed securities. "Dispersing that \$28 of leverage to real money investors via an illiquid secondary market is one of the main pressures forcing secondary spreads wide."

The health of the underlying assets in Australia bears repeating. Remarkably, housing loans arrears rates actually fell in the second half of 2007, according to the Reserve Bank of Australia. In December, the ratio of non-performing housing loans to total housing loans on banks' domestic books was 0.32%; among securitized housing loans, the 90-day arrears rate is 0.4%. Unemployment is at a record low. There is a shortage of housing stock, exacerbated by a growing immigrant population. And the economy is booming, as the resource-rich country fuels the growth of China and India. The Reserve Bank of Australia, in marked contrast to most of the rest of the world, is raising interest rates, not slashing them. It's true that these rate rises are likely to cause some stress on home owners, but with so few households unemployed, that looks more like discomfort than default.

So it's not the assets that are causing the problem. Machliss was recently at the American Securitization Forum's January conference in Las Vegas. "With every U.S. investor I spoke to, the problem was not one of any expectation of loss on Australian-backed assets, but instead a function of their own problems," he says. They were either keeping cash for unexpected redemptions, or working through their own holdings of U.S. mortgages, "but all of them fearful of the mark-to-market impact on an illiquid secondary market." As one banker puts it: "They had all been told by head office: 'don't touch anything at the moment.'"

McDowell was at the same conference, hearing the same story. "Investors were saying: there's no problem with the Australian credit story or collateral performance but we're not going to buy until we see some stability in the marketplace. The Australian market feels somewhat of an innocent victim."

The St. George auto loan deal in March was at least a

good sign: it is expected to be followed by another from the Bank of Queensland, reflecting the fact that it is less easy for U.S. subprime problems to contaminate sentiment towards car loans than local mortgages. "The tone has all been around subprime mortgages creating contagion for other mortgages," says Measday. "There's a view that, since auto loans aren't mortgages,



Are those the Mounties on Sydney Harbor Bridge?

Getty

that was worth a try." But the commercial MBS market is in a worse state than the residential one. And getting the RMBS market going again is going to need some drastic changes in either pricing or expectation. "The real problem is the liability side has repriced faster than the competitive origination market has allowed the asset side to reprice," says McDowell.

No Way Out?

An important question is whether the closed markets create a problem for issuers who simply have to issue. Those who have 364-day warehousing facilities are surely running close to the end of that facility and simply rolling over debt is proving highly problematic. People differ in their views on the scale of this problem. "Various lenders in the market are in different phases depending on

what options are available to them," says McDowell. "Banks have other funding sources, such as retail deposits; generally they are originating without any due constraints. Banks and non-banks that relied solely on securitization have found it tougher, and in some cases have decided to substantially slow down new origination."

Machliss agrees. "It's the non-banks reliant entirely on securitization as an exit from their warehouse funding that will potentially be the ones to suffer," he says. "Those that have sufficient warehousing capacity, are well capitalized and have large back books providing a continuing revenue stream should survive."

Already many originators who have the option to do other things have shut down or at least declined. Puma, the securitization program of Macquarie Bank, announced that it is dramatically scaling back origination. ANZ's white label originator of housing funding, Origin, has been closed down and its staff absorbed into the bank's mainstream mortgage division. And non-bank lender Rams was sold to Westpac in January, for just a tenth of the value set in its stock-market debut early last summer, in order to ensure its survival. Meanwhile, Members

Equity's decision that its Maxis program will no longer accept loans from third-party brokers is emblematic of the broader trend among the country's credit unions.

"Even those that have warehousing capacity are looking to put in arrangements to get through the year: raising rates, letting staff go, reducing origination volumes," says one banker. "This is the year when you just want to survive. Some are not

"Before this happened it was the fourth-largest credit market in the world. And the longer it's frozen the more damage is being done longer term." Greg Medcraft

going to make it, and you're already seeing them not make it."

Others are more confident. "If we thought there was that desperate urgency we would have reached it already," says one banker. A year or so after subprime first became a global issue "clearly a number of triggers that would have forced them to issue have happened already, so they are getting reasonable accommodation from their bankers in that respect."

A side issue is Australia's mortgage insurers. Groups like PMI and MGIC are subsidiaries of U.S. entities but are separately regulated by the Australian Prudential Regulation Authority, which requires them to have their own capital in Australia. Nevertheless, their troubles in the U.S. have had a knock-on effect in Australia. Moody's recently put A\$83 billion of Australian MBS insured by PMI on negative watch, while Fitch's downgrade of MGIC in April applied to the Australian subsidiary as well as the parent in the United States.

Outside of the public markets there is some activity, but nothing to compare with the well-established U.S. private placement markets. "There are isolated pockets of demand, with deals getting done on a private basis," says McDowell. Others are unsure. "We keep hearing mumbles about private deals but whether they're actually getting done or not is another matter," says Measday. "I suspect they're not."

For his part, Medcraft says the Australian market is "dead. There is no market." Naturally, that bothers him. "Before this happened it was the fourth-largest credit market in the world. And the longer it's frozen the more damage is being done longer term." So in his ASF role he wants to make bigger changes than the shift to the agency model.

Central Bank Bias?

One priority concerns central bank liquidity in the market, and perhaps extending access to that liquidity to the non-bank mortgage sector. He would like to see the cost of accessing that liquidity made less prohibitive and as he puts it, to remove the stigma attached to accessing central bank liquidity. "It's called the lender of last resort," he says. "That means as soon as you access it people assume there is a big problem. There's got to be much more of a smoothing system."

Another priority concerns market transparency — both in terms of issuer reporting, dealer reporting and ratings agency disclosure of methodology. "Ratings were the cement that held the whole thing together and now it's gone, I don't think that confidence is going to come back overnight," he says, which brings us back to his theme of promoting an agency environment in order to underpin investor confidence.

Not everyone shares the need for greater transparency. "For Australian deals, the ratings agencies are fairly transparent in their methodology," says Measday, who thinks that the up-front, pre-sale reports in particular are open. "In terms of ongoing re-

porting, there's a move to increase the level of disclosure from issuers. I don't think that's from any intent not to report well, it's just one of those things that comes over time — a deeper knowledge of what investors want to see in terms of reporting."

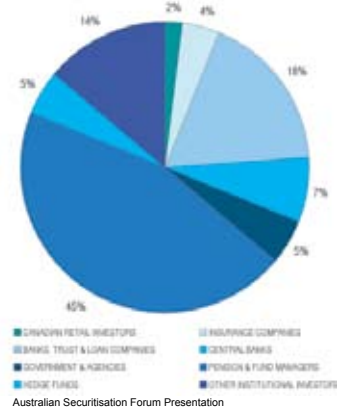
And when the dust settles? "It'll be back to basics, with smaller, more frequent transactions," says Machliss. McDowell

argues that the longer the liquidity crunch lasts, the more the shift of recent years from banks to non-banks will reverse. "The market share swing away from banks and towards broker lines for origination for the last 10 years has definitely slowed down, and is probably in the process of reversal right now," he says. But he expects the Australian market to emerge from the crisis earlier than others. "One of the first markets people will be willing to buy is the Australian prime RMBS sector," he says. "When it does, people are going to have a lot less in their portfolios than they would ideally like."

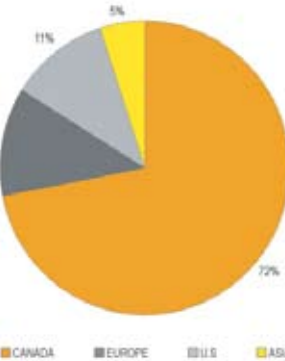
But the really good times are gone — for a while at least. "In May last year we lead arranged a \$7 billion deal for Westpac," says Machliss. "Will we see that again? Not any time soon." ▼

Canadian Mortgage Bond Investor Base

Original Distribution by Investor Type
(For Issues in 2007)



Original Distribution by Region
(For Issues in 2007)



Chis Wright is a freelance journalist based in Singapore. Previously editor of *Asiamoney* in Hong Kong, he writes for *Asiamoney*, *Euromoney*, *Institutional Investor* and the *Australian Financial Review*.