

Government intervention in securitisation market

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FOR those of us in the business of coming up with good ideas, the innovations we propose rarely see the light of day. And when they do, it typically takes years of toil. But it was just six months from the publication of our paper by Melbourne Business School's Centre for Ideas and the Economy on March 26 to the Government's announcement on September 26 that it would adopt our proposal to intervene in the market for AAA-rated mortgage-backed securities.

In between, the idea was backed by industry groups, smaller banks, building societies and non-bank lenders. It was also supported by the 2020 Summit and a Senate select committee on housing affordability.

But there were also many critics, including the leading banks, the Reserve Bank and the Treasury. The Treasury at least appears to have changed its tune. And judging by the Opposition's comments, the proposal has bipartisan support.

Our idea was simple. We argued that when critical economic markets fail because of the absence of the public goods of a minimum-level liquidity (that is, trade) and pricing integrity, governments have a responsibility to temporarily intervene to assist in resuscitating activity and pricing visibility. The Reserve Bank does exactly this in the context of the banking and foreign exchange markets.

We were careful to note that the Government itself should intervene - not a subsidised private entity such as Fannie Mae or Freddie Mac - and that such injections of liquidity should only be justified by extreme emergencies.

In particular, we proposed that the Government capitalise on its AAA credit rating to issue low-cost bonds and use these funds to acquire very high-quality, low-risk AAA-rated mortgage-backed securities in order to assist in restoring liquidity to Australia's securitised home-loan market, which had not operated effectively since November 2007.

We were at pains to state that we were agnostic as to how our idea was put into operation, but did, for the record, advise the Government to use the Treasury's Australian Office of Financial Management.

Despite the predictions of many, Australia's mortgage securitisation market, which has served as such an important source of funding for non-bank lenders, building societies and smaller banks, has not yet recovered and remains economically shut to this day. By this we mean that the pricing available in the market is not sufficiently low to enable lenders to source capital to underwrite home loans on an economically viable basis. Even the Reserve Bank agrees with this point.

The closure of the securitisation market has, according to Fujitsu Consulting, resulted in the big five (now four) banks' market share of new home loans increasing from about 75 per cent before the sub-prime crisis to about 90 per cent today. At the same time, many non-bank lenders have fallen by the wayside while the smaller banks and building societies have struggled to compete. As we anticipated, the inability to source funding in this market has had other consequences, such as contributing to the severe credit rationing seen in the corporate and small-business lending markets, and wreaking havoc on the conduct of monetary policy with a deterioration in the linkage between the RBA's cash rate and actual lending rates.

Market failures of this kind can occur because of information asymmetries, such as we have seen in the US with the non-transparent AAA-rated investment structures that held sub-prime securities, and because investors have a tendency to over and under-react to events that can in turn trigger protracted asset-price booms and busts.

George Akerlof won the Nobel Prize in Economics for showing that while markets are ordinarily the best means to allocate goods and services, when you have imbalances in the information that people possess when engaging in transactions - such as an understanding of the true risks underpinning complex financial market securities - they can fail, with catastrophic consequences. The introduction of mark-to-market accounting practices, whereby assets are constantly revalued using (sometimes ineffectual) market prices, has only served to exacerbate these risks.

In today's highly interconnected world, global financial crises are being transmitted with ever-greater frequency. In the last decade we have been rocked by the Russian debt crisis and consequent collapse of Long Term Capital Management, the tech boom and subsequent wreck, and now the credit boom and bust. The point is that notwithstanding the intrinsic strength of Australia's economy and financial system, we can be adversely affected by events that are seemingly far removed from our shores.

Despite some of the protestations to our proposal, the notion that governments have a critical role preventing financial market crises is, in fact, a cornerstone of our capitalist system. One of the main reasons central banks were established was to serve as a lender of last resort and prevent bank runs. Bank panics in the US led to the establishment of its centralised banking system in 1913.

The stability of the financial system has been a long-standing responsibility of the Reserve Bank, which "focuses on the prevention of financial disturbances with potentially systemic consequences". The Reserve Bank also regularly intervenes in the currency market to stabilise our exchange rate on the basis of its belief that currency values have a tendency to deviate significantly from fair value, which can inflict significant costs on the real economy.

When Australia's central banking system was set up in 1959, home loans were funded almost exclusively through deposits. That is, securitisation markets and non-bank lenders did not exist. So while today, banks and building societies are regulated by the Australian Prudential Regulation Authority and have their liquidity needs protected by the RBA, the securitisation market, which has grown to provide nearly a quarter of all the funding for home loans and which was a key source of funding for so many non-bank lenders, building societies and smaller banks, benefits from no government infrastructure to protect it in times of extreme duress.

We need to go back to first principles and think about how we can improve the regulatory regime in order to accommodate recent capital market innovations such as the emergence of securitisation.

As the RBA and Treasury have noted over the years, there is a fundamentally sound economic basis as to why securitisation should exist. But we have an asymmetrical regulatory system that disproportionately favours deposit-taking institutions; indeed, it barely acknowledges these new markets. It is, therefore, time that Australia's Government developed an explicit policy regime to regulate the participants in, and protect the liquidity of, the AAA-rated mortgage-backed securities market.

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