

20091119 RBA: Remarks to Minter Ellison Financial Services Industry Forum (by Guy Debelle, Assistant Governor)

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I will focus on two issues in my remarks today: firstly, what is the future for securitisation, and secondly, and relatedly, developments in the provision of credit.

I spoke at length on the first issue yesterday at the Securitisation Forum, so let me recap the main points I made there. In brief, the future is looking brighter for securitisation, but I would not expect a return to the heady days of earlier this decade, when securitisation accounted for around one quarter of the flow of housing credit.

Securitisation will be an important part of the financial landscape in the future. Prior to the crisis, many commentators sung the praises of securitisation as a useful means of dispersing risk around the financial system, and in principle I think they were right. There were however, some major shortcomings in the implementation of securitisation.

I have said before that there are a lot of similarities between securitisation and junk bonds. Both were important financial innovations that were well-founded. Both grew too rapidly and expanded into areas they shouldn't have and were bought by investors who shouldn't have bought them. Both played important roles in generating financial dislocation. Just as junk bonds are now a regular (but smaller) part of the financial landscape, I believe securitisation will be similar in the future.

However, as with junk bonds, much needs to be done to restore the brand name of securitisation. Some of this will only come with the passage of time. However, there are steps that can be taken to hasten the process.

The message that Australian RMBS has been, and continues to be, a strongly performing asset needs to be continually reinforced. The differentiation between Australian RMBS and US RMBS needs to be highlighted. This message probably doesn't need to be delivered to the portfolio managers. It needs to be delivered to the superannuation trustees who from their continual exposure in the media to the US experience, may believe that all securitised assets are excessively risky. The Australian industry needs to differentiate its product from the US brand.

What are some of the main differentiating factors?

Unlike in the US, the credit quality of Australian RMBS has remained at the highest level throughout the financial crisis. Even at its peak in February 2009, the Australian RMBS arrears rate, at less than 1 per cent, was extremely low compared to international standards. By way of comparison, the US arrears rate is well above 5 per cent currently, and it does not look like it has yet peaked. Over the past year, the arrears rate in Australia has actually been declining slightly. The bulk of Australian RMBS are backed by prime full-doc loans.

Even with non-conforming loans, there is a marked difference between the standards in Australia and the US. We really did not and do not have a subprime issue here.

Despite this good performance, there are some developments on the demand side of the market which suggest that it is unlikely to return to its former self. At least one-third of the investors in Australian RMBS were offshore structured investment vehicles, the now notorious SIVs. These institutions just are not around anymore, and hence one part of the market which Australian issuers targeted is not there.

The liquidation of the portfolio of the SIVs has been one of the factors inhibiting the recovery in the Australian market. The liquidation generated an overhang of stock in the secondary market which saw spreads blow out to very wide levels. It appears now that this overhang in the secondary market has largely been eliminated which has seen spreads narrow significantly, and contributed to the revival of demand for primary issuance, which we have seen manifest in the recent successful issues of residential mortgage-backed securities (RMBS) without the support of the Australian

Office of Financial Management.

Reflecting the ongoing amortisation of principal (i.e. mortgage repayments), as well as a relatively low volume of issuance, the value of Australian RMBS outstanding has fallen more than 40 per cent below its peak in June 2007. This decline in the stock outstanding of RMBS should be starting to create some holes in investors' portfolios.

Hence, I think there are good reasons to believe that the signs of life that we have seen in the market in recent months presage more activity to come in the near future.

So securitisation may be coming back as a viable form of financing. However, a number of the larger non-bank originators are no longer around any more. So what does this imply about the supply of housing credit going forward?

First, it is worth stating that there has not been any material restriction in the supply of housing credit throughout the financial turmoil. Growth has slowed, but to an annual rate of 8 per cent, which in some countries is regarded as high!

Margins on variable rate housing lending relative to bank funding costs have actually declined a little over the past two years. The margin between the standard home loan rate and the cash rate has indeed increased, but with banks funding costs rising materially more than the cash rate, the overall margin has declined.

However, while margins on variable rate home loans have decreased, this has been more than offset by a widening in business and personal loan margins, so that overall bank margins have widened, as is evident in the banks' most recent profit statements.

While housing margins have declined, will that continue to be the case going forward, given that there are less competitors in the housing loan market after the crisis? I believe there are good reasons to think that competitive pressures will continue to restrain the ability for any margin-widening on the part of the larger banks. The housing loan market remains contestable, even if there are not as many competitors currently. By that I mean that any excessive widening in margins will attract new competitors back into the market. The return of securitisation, even if not to its former state, will clearly assist this.

I will now turn to the supply of credit to business. My colleague John Broadbent spoke about this last week. The stock of intermediated business credit, that is, businesses borrowing from banks and other intermediaries has been declining in recent months. The Bank's assessment is that this is a combination of both demand and supply.

A number of businesses have responded to developments in financial markets and the real economy by seeking to reduce the level of gearing on the balance sheet. As John noted last week, balance sheets which were regarded as 'lazy' pre-crisis are now de rigueur. Corporate equity raising has been at very high level over the past year. Much of this equity has been used to pay down debt which has seen the gearing level of the Australian corporate sector decline from 85 per cent at the beginning of this year to 65 per cent now.

Not all of this de-gearing however was voluntary. In some cases, there was pressure put on the company by its financiers to raise the equity.

In aggregate, taking into account both equity and corporate debt raisings, overall business funding has actually grown, albeit at a slower pace, even though intermediated credit has declined. This stands in marked contrast to the early 1990s episode where total business funding declined for a number of years through the recession.

On the supply side, there has been an overall tightening in the provision of credit, particularly to certain sectors of the economy. The most obvious case where this has occurred has been commercial property. Drawing on their experience from the early 1990s recession, banks were particularly concerned about their exposure to commercial property and hence have been very reluctant to take on any additional lending to this sector. However, again in light of the experience of early 1990s, they have not pulled the plug and rushed for the exits, but tried to manage their overall exposure.

More generally, we do not see much evidence of a wholesale withdrawal of credit provision by any

particular sector of the banking industry. Some foreign-owned banks have curtailed their provision of credit, some others have increased it. Foreign banks without any on-the-ground presence in Australia have tended to pull back the most. Our data also indicate that credit provision to the SME sector, which tends to come almost entirely from the local banks, has not declined unlike lending to larger corporates.

So the reduction in credit that has occurred is a combination of both reduced supply and reduced demand. Banks and corporates had both prepared for a much worse cycle than has so far eventuated. As confidence returns, one would expect to see business credit growth pick up again.

NovaRes Team