Introduction

The Australian residential mortgage market has performed comparatively well in contrast to other mortgage markets in the last two years. This performance is founded on several elements: economic, structural and institutional features including a well-performing economy, a sound legal and regulatory base and, for the most part, avoidance of the material erosion in underwriting standards pertaining to mortgage origination witnessed most notably in the US economy since 2002. I will expand on some of these factors in this presentation, within the wider context of discussing the liquidity, funding and capital issues facing Australian regulated mortgage lenders from the perspective of the prudential regulator.

Structure and Features of the Australian Residential Mortgage Market

Residential mortgage lending has, for a long time, provided a significant source of balance sheet growth and profitability for banks. On the demand side, growth has been driven by Australian's willingness to take on debt to finance housing assets (which hold an important place in household balance sheets), a supportive tax structure for investors, and in recent years generous incentives offered to first-home buyers.
The legal framework underpinning this growth provides a well understood and dependable platform for the enforcement of property rights. This, in conjunction with full recourse lending whereby the lender is able to pursue the borrower for any shortfall after realisation of the mortgage collateral, provides enhanced security for investors to consider when allocating capital amongst various competing asset classes.

There is also a strong obligation on lenders in Australia to make responsible lending decisions. The Australian Uniform Consumer Credit Code empowers the courts to set aside mortgage agreements where the lender could reasonably have known that the borrower would not be able to repay the loan without causing substantial hardship. There have been a number of cases that highlight the circumstances in which the courts have taken action to protect the interests of the borrower.

Residential mortgages are originated through a variety of channels:

- The traditional regulated banks, building societies and credit unions (‘banks’);
- Unregulated non-bank originators (‘NBOs’); and
- Mortgage brokers and other commission-based sellers.

Funding for bank originations is initially organised on balance sheet; non-bank originations were, until the closure of securitisation markets, financed through warehouse facilities which were in turn refinanced by term residential mortgage-backed security (‘RMBS’) issues. Mortgage brokers typically will not fund
originations but instead “white-label” mortgages using the product offerings of banks or non-banks.

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Approximately just under half of total on balance sheet liabilities are sourced from retail depositors, with the remainder sourced from wholesale markets. Approximately 45% of wholesale funds are short-term, and 30% is sourced from foreign markets. Retail deposits therefore provide a significant source of funds to banks. To the degree that such deposits are considered sticky (i.e. insensitive to changes in the customer rate) or can otherwise be classified as core, a bank is permitted to treat them as term liquidity, provided they can support this assertion with suitable analysis.

Market risks attaching to housing loans are relatively low because loans are originated with a variable rate repricing frequency. Borrowers may choose to fix their loan rate for periods of one to five years, and the resultant interest rate risk will be hedged by swapping from fixed to floating rate within the banking book. Alternatively wholesale debt (including RMBS) can be issued with fixed rate coupons to provide a similar hedging effect. As it is uneconomic to hedge loans at the individual transaction level there will be residual risk in the banking book caused by the mismatched date effects.

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The importance of securitisation markets for the funding of Australian mortgage assets up until the onset of the Global Financial Crisis (‘GFC’) cannot be
overstated. The ‘originate and distribute’ business models of non-bank originators and to a lesser extent the smaller regional banks (who possess a retail deposit base that diversifies their funding) were dominated by this source of funds, and needless to say the closure of these markets has had severe repercussions, to the point of major business restructurings. The majority of residential mortgage-backed security issuance has taken place in offshore markets.

A brief comment about covered bonds is appropriate here. APRA has taken the view that covered bonds subordinate the interests of depositors of banks to the interests of the covered bond holders. As such, these bonds are inconsistent with the Banking Act 1959 which requires that the assets of a bank are available to depositors in priority to the holders of all other liabilities in the case of a winding up. Accordingly covered bonds are expressly prohibited under APS 120 (Securitisation).

Securitised mortgage pools for the vast majority of Australian RMBS issues are insured against default by a lenders’ mortgage insurance (‘LMI’) provider. The LMI provider’s rating will support the credit rating attached to the RMBS issue.

While there is no prudential obligation to insure mortgages, the risk weighting applied to housing loans under the standardised Basel II approach will reflect whether the mortgage is insured or not. For insured mortgages, APRA requires that the insurance must provide cover for all losses up to at least 40% of the outstanding loan amount and that it must be insured by an acceptable (APRA-regulated) LMI provider.
Intense competition between lenders during the housing boom in the early years of this decade brought pressure to bear on lending standards in a number of ways:

- Increased reliance on mortgage brokers to originate loans;
- A move into higher risk products such as non-conforming, ‘low doc’ and ‘no doc’ loans;
- The relaxation of debt serviceability criteria; and
- The use of ‘streamlined’ property valuation methods.

However, despite complacency in the attitude of some lenders, this general weakening in standards did not parallel the shift occurring in other markets. Product innovation (such as negative amortisation loans), high loan-to-value (‘LVR’) lending, and introductory rate offers did not evolve to the degree experienced in the US mortgage market.

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**APRA’s Prudential Approach**

Credit standards in residential lending have been a major focus of APRA’s prudential oversight of banks for some time and the importance of this has been borne out by recent events. APRA’s approach has been to ensure that residential lending would not become a systemic risk in Australia and we have taken opportunities to offset the weakening of underwriting standards (noted earlier) by tightening capital adequacy requirements for banks, especially in the context of Basel II.
In recent years we have taken the following steps:

- Undertaken a major stress-test of the resilience of housing loan portfolios to a substantial housing market correction;
- Conducted a survey of property valuation practices used by banks and LMI providers;
- Conducted a survey as to how banks assess the ability of their customers to service their housing loans (debt serviceability).

The stress-test provided evidence that regulated lenders were reasonably well insulated from lending risk, although it also highlighted that the worst-case downside exposure was larger than what some banks had previously supposed, by a factor of 10! So while Australian housing lending remains a sound asset class, it is evident that loan portfolios are riskier than previously believed.

An IMF report on financial system stability in late 2006 underlined our concerns, highlighting banks’ significant exposure to a highly leveraged household sector and high exposure to the residential housing market.

APRA’s approach has paid dividends. From the survey results we have been able to identify outliers in terms of risk appetite and lending practices and so have been able to better direct our supervisory activities. Our warnings about credit risk have helped to suppress any overly aggressive lending strategies being pursued by banks. Lastly, our enhanced understanding of lending risks has provided critical input into
the tightening of capital adequacy requirements, prior to and as part of the Basel II implementation process.

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This has included:

- The introduction of more granular risk weights under the standardised Basel II approach, from 35% for conservative loans, and varying up to 100% subject to whether the loan is full doc or low doc, insured or not insured, and varying with the LVR of the loan;
- An increase in the loss given default floor for advanced IRB banks from 10% under the framework, to 20%; and
- A tightening of minimum capital requirements and other aspects of the supervisory regime for LMI providers who were identified in the stress-test as being more vulnerable to shocks than previously thought.

APRA also reviewed its approach to the management of liquidity risk by banks with a view to strengthening the prudential framework; however, prior to the onset of the Global Financial Crisis, progress in this area was overtaken by implementation of Basel II. Our comfort factor at the time - that wholesale markets would continue to support sound banks - now requires rethinking.

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Impact of the Global Financial Crisis

The immediate first round effects at the onset of the crisis included:
- Closure of securitisation markets;
- Depositor flight-to-safety and reduced access to foreign wholesale funding markets, which has materially affected not only the cost and availability of funding, and the asset/liability composition of bank balance sheets, but also the strategic business models adopted by smaller originators (regulated and non-regulated). These effects culminated in the rebalancing of funding mix towards retail liabilities, and shortening of the duration of wholesale liabilities with relatively more being sourced from domestic markets.
- In some cases major business restructuring has occurred to address business model failures.
- On the asset side of the balance sheet there has been a trend to reintermediation as borrowers who have been shut out of securitisation and corporate bond markets have turned to the (regulated) banking system for funding.
- Another development has been increased precautionary holdings of liquid assets within the system.
- Banks have also had to attend to the refinancing of warehoused assets, in some cases requiring repurchase of the underlying mortgage assets.

Second round effects are now emerging as the underlying economy responds to the initial shocks. Throughout 2008 the GFC was slow to materialise in Australia as the economy generally performed well. However deterioration in asset performance is now evident through the rising trend in arrears and default rates, and this is expected to worsen in 2009 as GDP growth slows, property prices fall and unemployment rises. For housing loans this rising trend is coming off a low base,
and it remains lower than in many other countries. I will shortly discuss the ramifications of this new economic environment.

Banks have responded in a number of ways to the crisis:

- By protecting lending book margins through restricting the pass-through of official rate cuts to customer lending rates;
- By tightening lending criteria;
- By repricing credit risk margins for some borrowers;
- Through increased provisioning, as expected default rates trend higher;
- By reassessing and revising liquidity management and funding strategies based on recent experiences;
- By assessing the feasibility of transitional arrangements for borrowers experiencing financial hardship.

At the aggregate level domestic credit growth is still positive but has moderated. Demand for new loans has levelled off as households take a more cautious approach to gearing levels, but pockets of demand have been stimulated through, for example, incentives for first home buyers. This grant was initiated and recently extended in order to encourage housing activity, support the construction industry and assist first home buyers to enter the housing market.

The availability of loans has not materially reduced for low risk lending prospects, but has become constrained for higher risk borrowers as lending criteria has tightened. The supply of residential mortgage finance is now concentrated in a
smaller group of lenders as the larger banks have benefited from the exit or incapacity of marginal and smaller lenders. Unsurprisingly, competition in the mortgage market has lessened.

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**Responses**

Policy responses to the crisis have come on a number of fronts:

- Expansion of Reserve Bank liquidity provision to the banking system by increasing the supply of Exchange Settlement balances;

- Widening of the criteria governing the eligibility of assets permitted for repurchase transactions with the Reserve Bank. This has included measures enabling the liquification of mortgage assets held on bank balance sheets through the creation of so-called ‘internal’ or ‘self’ securitisations, with two caveats: no capital relief for securitised loans at inception, and disallowance of the security as qualifying liquid assets for liquidity ratio purposes, although the securities are ‘repo-able’ with the Reserve Bank;

- The instigation of the Government’s wholesale funding guarantee and financial claims scheme for retail depositors. Since November 2008 bank’s have taken advantage of these guarantee arrangements to issue over AUD 80b of medium-term debt instruments (terms of 3 to 5 years) predominantly to foreign investors. This issuance has helped to arrest the trend of shortening liability duration. It is positive to note that recently banks have been able to tap capital markets on a non-guaranteed basis;

- The establishment of a funding facility for conforming RMBS where the Australian Office of Financial Management (AOFM) will act as a cornerstone
investor in primary issues. Preference will be given to new issues by non-
bank lenders, who do not have the benefit of the guarantee scheme. The
facility is intended to foster competition in housing lending by encouraging
investors to return to the securitisation market;

- Other funding initiatives e.g. for motor vehicle financing, and the proposed
  Australian Business and Investment Partnership to support commercial
  lending

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APRA’s initial response over 2007 and 2008 was to bring heightened scrutiny to
bank liquidity management and funding strategies. This included increased
liquidity reporting, and the requesting of forward-looking funding plans from a
range of banks. This, in conjunction with maintaining close contact with treasurers
during periods of acute market stress, made it possible to identify the pressure
points ahead of time.

As the tone of credit markets in 2009 has improved it has now become possible to
reassess our priorities. Whilst maintaining our focus on funding plans, we have
turned our attention to issues of deteriorating credit quality and the rising trend in
asset impairment. After a raft of high-profile domestic corporations exposed to
short-term borrowings and commercial property led to a rise in problem loans
during the last two years, a more broadly based increase in problem loans and
 provisioning levels is becoming apparent. Amongst a range of other indicators,
APRA’s oversight focuses on close monitoring of internal ‘watch-lists’, lists of
exposures considered vulnerable by the larger banks themselves. We have also
emphasised to banks the importance of applying appropriate risk grading, valuation and provisioning against problem assets.

As mentioned earlier APRA commenced updating its liquidity prudential standard in late 2006 for a planned 2007 consultation process. This was suspended to enable us to absorb the implications of recent events, but the process has restarted and draft rules are expected later this year.

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**Outlook and Some Concluding Thoughts**

Housing lending which makes up about half of the total bank loan portfolio is expected to remain a sound asset class. Problem loans have been rising but off a low base, and recent rate reductions have eased the debt-servicing burden of households. However the performance of housing loan portfolios in the period ahead will depend critically on the trend in unemployment.

As I noted earlier, APRA’s focus on the credit quality of housing loans and the related tightening of capital adequacy standards, pre-dates the GFC by some years. This has meant generally good discipline amongst our mortgage originators over the critical period when standards could easily have slipped in line with trends offshore.

The future for mortgage securitisation (and more widely the ‘originate and distribute’ model) remains clouded. Commentary about this has tended to support the theory underlying securitisation, but to criticise its practical implementation. Conditions remain difficult and issuing spreads remain uneconomic. RMBS issuance
volumes are subdued, averaging AUD 2.5 billion per quarter since mid 2007 compared to a quarterly average of AUD 15 billion over the two years prior to this. Since October 2008 the bulk of new issuance has been purchased by the AOFM. In my view the preconditions for a revival hinge largely on restoring confidence, through improving transparency and disclosure, and reforming risk management practices. This will take time.

Though recent signals from debt capital markets are encouraging, it is clear that the underlying economic circumstances have changed and that trend rates are either flattening or reversing. Although the signs are that the Australian banking system is stabilising, until the economic picture further unfolds an assessment of the full impact cannot be made. However it is apparent that residential mortgage lending in Australia remains viable and in adequate supply relative to the reduced demand.

It is my belief that APRA has provided appropriate oversight both prior to the crisis, and concurrently as it has evolved. That is not to say that some of our underlying assumptions may require critical re-examination given the events that have transpired. This can only strengthen our regulatory framework going forward.

Thank you.