AUSTRALIA MOVES TOWARDS A SECONDARY MORTGAGE MARKET

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There have been moves recently towards the creation of a private secondary mortgage market in Australia. In this paper we consider these moves in the context of the development of secondary mortgage markets in other countries and in the context of previous attempts to develop such a market in Australia.

The existence of a regular secondary market for any financial instrument depends on the existence of a large number of acceptable existing financial instruments which are able to be bought and sold. In order that a secondary market be efficient there must be sufficient participants in the market to prevent any one of them influencing the market price; the financial instrument must be standardized; there must be no barriers to the entry and exit of buyers and market participants have complete knowledge of existing conditions in the market.

Secondary markets may fail because there is no economic need for the service, or because the risk is too great or because of legal and other institutional barriers to performance. In both the Canadian and U.S. financial markets, government agencies have been a necessary element in the development of secondary mortgage markets and even in the U.S. it has been suggested that the Government agencies really provide intermediation which may act as a substitute for a secondary market.

In Canada the Residential Mortgage Financing Act authorized the establishment of the Federal Mortgage Exchange Corporation in 1974, whose task it was to develop the Canadian secondary mortgage market by developing the mortgage instrument into a more successful and more competitive financial instrument. Within the United States government credit agencies have not only provided the appropriate environment for an effective secondary mortgage market, but have in fact physically created the market. The Federal Housing Administration (FHA) provided insurance for loans on residential property so that home mortgages which previously had no market beyond their immediate locale, were provided with a national market.

A second government agency, the Federal National Mortgage Association (FNMA or *"Fannie Mae"*) provides a secondary market for mortgages. In tight money conditions it will lend against or buy acceptable insured mortgages, while in easy money conditions it will sell mortgages from its portfolio. When it buys or lends against mortgages, the FNMA requires the seller or borrower to buy FNMA stock to the value of one half of one per cent of the loan and between one and two per cent of the amount of mortgages sold, a procedure which increases FNMA's lending power. In 1968 FNMA was converted into a privately owned corporation and a new government agency, the Government National Mortgage Association (or *"Ginnie Mae"*) was created to increase the availability and reduce the cost of credit to homeowners. While the FNMA is now profit-oriented, the GMA is not and often sells mortgages at a loss to the FNMA, replacing government funds with private funds.

The Emergency Home Finance Act of 1970 (Title III) provided for the establishment of the Federal Home Loan Mortgage Corporation (FHLMC) or *"Freddie Mac"* to serve as a secondary market facility for residential conventional mortgages which had not had the advantage of federal insurance or guarantees. Although the operating procedures of these three institutions were quite cumbersome, they did serve to increase the volume of mortgage paper handled. Nevertheless, as mentioned above, they provided intermediation rather than a complete secondary mortgage market.

Of more importance in the expansion of that market were three changes in the nature of the mortgage commitments, that is, the increased tendency for Americans to move house which lessened the number of mortgages that exist to maturity; the creation of a wide range of mortgage loan types; and an increasing tendency for regional variations in mortgage lending. The combination of these factors with the backing and participation of the government agencies has improved the viability of the secondary market.

Within the Australian environment, all of the traditional arguments have been made at least until recently, against the likely success of a secondary mortgage market, especially as moves to provide these facilities have come entirely from the private sector. The non-homogeneous quality of mortgage contracts, legal stamp duty and security problems, lack of a last resort facility, an apparent absence of potential buyers and the essentially long-term nature of the contracts.

In March 1979, following four years of preparation, the Melbourne stockbroker, Randall and Co., together with Schroder Darling, established a mortgage-backed securities market. The basis of their operation is the 100% mortgage loan insurance cover provided by the Housing Loans Insurance Corporation over those forms of residence (primarily blocks of flats or single homes) specified in Regulation 4 of the Housing Loans Insurance Act 1965-73.

Randall's market utilizes this Government guaranteed characteristic to offer investors packages of residential mortgage loans of any term up to five years, with monthly interest payments. An associated company, the Central Mortgage Registry of Australia has been established solely to issue and service these loans of an *"interest only"* nature. A borrower must formally qualify for a loan and be able to fully service the repayment of *"interest only"* during the period of the mortgage, and he bears all costs associated with the mortgage loan investment, including legal and valuation fees, brokerage and stamp duty.

A special arrangement with H.L.I.C. gives investors insurance that the monthly interest payments on loans service by the Central Mortgage Registry will be paid promptly, even if the borrower's legal commitments do not include monthly payments. Where a borrower wishes to repay his loan before it matures, penalties are laid down in order to compensate the investor for any change in rates on re-investment. In July, investors were offered returns of approximately 12.3% per annum net, based on a mortgage rate of 12.8% and 0.5% p.a. for the costs of full loan serving facilities.

Investors are able to obtain packages of residential mortgage loans of a normal minimum amount of $A30,000. At settlement, they receive an interim certificate from two specified legal firms which verifies the validity and existence of title. Once the mortgages are registered, all the documentation is lodged in a sealed packet with C.B.A. Nominees Limited for custodial safekeeping for the life of the loan. Receipt of the documents is acknowledged by the Custodian on a special form and, in addition to this receipt, the investor receives a *"Mortgage-Backed Certificate"* for each mortgage loan. It is this freely negotiable and transferable certificate which the lender may elect to sell through his stockbroker or authorized money market dealer, if he wants his money before the term expires.

In selling the mortgage-backed certificate, the investor does not require consent of transfer, but is liable for stamp duty of 60 cents per $A1000 of consideration. The rate of interest attaching to the sale will depend on market rates for other financial securities at the time of sale.

Does this arrangement meet the difficulties encountered by earlier proposals?

We have argued elsewhere[1] the necessity for official involvement in a viable secondary mortgage market to ensure that cyclical instability in the flow of funds does not threaten operations. The danger of any private market mechanism is that it will exacerbate the effects of the business cycle.

The proponents of secondary mortgage transactions argue that by providing marketability for mortgages they release the constraint on the supply function. Historically, the size of mortgage loans has been extremely large relative to both the current assets and incomes of borrowers and this together with the long-term nature of the contracts have resulted in the Australian home loan industry being serviced either by specialist institutions (e.g. building societies) or by institutions with long-term liabilities (e.g. life offices) or with quasi-long run liabilities (e.g. banks). This has meant that the supply of funds to the residential mortgage market has been dependent on two factors: the ability of the building societies to attract funds, and the extent to which the banks and life offices were prepared to make commitments from their fund flows. Against this institutional background there has been an obvious unwillingness to participate by those investors whose liquidity requirement might change over time.

Some attempts have been made to meet the needs of investors with shorter term funds available, with solicitors, accountants and others being able to marshall considerable funds on a three-year roll-over basis with some flexibility to enable investors to recover outlays early and borrowers to make pre-payments of their loans.

It has been the changing opportunity cost of home loans for some of the institutions, reflected in the proportional importance of mortgages in their asset portfolios, that has been blamed at least partly for the cyclical sensitivity of the building industry in the post-war period, but particularly in the 1970s. This sensitivity has led to the revived interest in a secondary mortgage market in the belief that this would facilitate the adjustment of funds supply to the dictates of the cycle.

The problem has not been to provide a means of arranging mortgage transfers on a continuous basis but rather how to organise for this to occur in a system which eliminates the risk of default in terms of both interest payments and the repayment of capital at maturity. Our own previous work in this field has been primarily concerned with the macro-economic consequences of the unstable funds flows of lending institutions. The Australian Government has only paid lip-service to the need for stabilisation by, for instance, changing the home loan/bonds portfolio ratio of the savings banks.

It has been our view that a Mortgage Bank Corporation (MBC) ought to be introduced under Government aegis, to play the *"Ginnie Mae"* role of provider of funds or seller of mortgages as required by changing economic circumstances. These are really two separate functions. If the MBC was seen, initially at least, as dealing only with the Permanent Building Societies, the minor role was simply the redistribution of cash and assets in the system, while the principle function was to provide cash to the entire system during periods of illiquidity and to divest mortgage assets when the P.B.S. had an embarrassment of funds. Government backing would ensure that a lender of last resort facility existed, thus fulfilling the essential role of eliminating risk.

We consider that any secondary mortgage market must offer this guarantee, more particularly if the market extended into the private arena. Thus it was no surprise that the first development in Australia claims to utilize *"Government-insured mortgage loans"* by only trading in residential mortgages *"with 100% cover provided by the Housing Loans Insurance Corporation (HLIC)".*

Unfortunately for the market, the Federal Government is at present in the process of selling of H.L.I.C. to private enterprise, a process which appears certain to diminish the government backing aspect. Prior to this development the new market had already attracted $A14 million with a maturity range of 3 to 5 years, and thirteen institutions, either nominee companies or those with an insurance/pension fund bias. Some, if not all of these, represent the supply increment discussed earlier.

In the present circumstances, the H.L.I.C.'s status aside, there must be strong doubts about whether this new interesting device in fact will emerge as a true secondary mortgage market. It is currently aimed at the *"top end"* of the borrowing market, that is loans of over $A30,000 which fall outside the normal P.B.S. and bank rules. It is possible that there will merely be a transfer of *"solicitor"* funds into this more formal mechanism offering transferability.

The short-term mortgage effect and the present high yields, particularly in an environment in which the Federal Opposition Leader is attempting to *"talk up"* the riskiness of finance companies, may ensure the attraction of some institutions but it is debatable whether these elements are able to provide a *"brisk"* market. To the extent that such a market is achieved it appears to be able to occur only by a transfer of funds from other markets and this must have effects on normal borrowers from those markets.

There is no doubt that the timing of the market launching has been strategic with interest rates expected to be at or close to peak levels, so that any downward movement will enable holders to realize paper profits within the market mechanism. We are more concerned, however, with the level of trading when the interest rates fall and shows signs of bottoming, as there can be no guarantees of supply at such times.

The details of the market's operations emphasize the lender with little consideration for the borrower. A borrower's funds are secured only for the 3 to 5 year period of the *"short"* mortgage with no guarantee of roll-over. The developers of the market allege that refinancing will not be *"a great problem for the traditional home buyer after the period of mortgage expires"* but we do not see that this allegation will be sustained in operation.

In his last report (1977-78) the Insurance Commissioner expressed concern about the ability of mortgage insurers to remain solvent in troubled economic conditions and commented that his own office lacked effectiveness to supervise this type of cover properly. The private insurers have claimed that these comments were overstatements, but the strong cyclical swings in funds flows continue to claim victims on their downward legs.

It was our view of previous Australian proposals for a secondary mortgage market that they suffered from the defect, potentially fatal on overseas evidence, of a lack of government participation. It remains to be seen whether the present development is able to overcome the loss of the lender of last resort facility in a country in which *"lifeboat"* operations are still only confined to banks.

1. W. Horrigan and C.R. Weston, *The Viability of a Secondary Mortgage Market in Australia,* Australian Association of Permanent Building Societies, 1975.