BASEL II AND THE AUSTRALIAN RESIDENTIAL MORTGAGE MARKET

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Background

Until the late 1970s regulation in Australia imposed heavy restrictions on how banks could structure their balance sheets. Those regulations did not prohibit lending for residential mortgage loans but as a consequence of them, banks were unable to fully meet the demand for such lending. Regulation prevented price being the rationing instrument and instead banks rationed the supply of housing credit using credit quality and other criteria. In particular, banks would typically lend only up to a conservative loan to valuation ratio. Commonly, banks then lent additional funds through their unregulated finance companies at interest rates significantly above those charged by the banks. As a result there was little competitive pressure on either the availability or price of residential mortgage lending.

The market responded to the restrictions on the availability of residential mortgage finance through the creation of non-bank institutions outside those owned by the banks. Many of these were building societies based on a mutual ownership structure. The mutual building societies were regulated, but under different arrangements to the banks and there were fewer restrictions on their ability to make residential mortgage loans. On the other hand they generally operated with a higher cost structure than that of the banks. Accordingly, the creation of these additional sources of residential mortgage lending added only limited competition to residential mortgage lending and then mainly on supply, not price. As events later unfolded it became clear that during this period of heavy bank regulation residential mortgage lending remained subject to only limited competitive pressure.

Deregulation of banking in Australia

By the early 1980s most of the regulation that constrained how banks structured their balance sheets was lifted and the ability of banks to make residential mortgage loans was limited only by their ability to fund them. For a time, however, restrictions remained on the interest rates that banks could charge for some such loans.

During the mid 1980s some of the restrictions on entry to Australian banking were removed and a number of foreign banks were invited to apply for a banking authority in Australia. Those limitations that remained required banks to hold a minimum dollar amount of capital and placed restrictions on the size of individual shareholdings, although provisions existed for exemptions to that last requirement allowing foreign banks to own Australian subsidiaries. Foreign banks entering the Australian market at this time had to do so through subsidiaries and they had to commit to having a presence in the retail market.

Although competition was being introduced into Australian banking and through that into residential mortgage lending, one of the features of residential mortgage lending that acted to constrain competition remained. That feature is mortgage stamp duties which operate as a disincentive for customers to disturb existing mortgage arrangements.

Through the regulated period banks had competed with each other not so much on price as on service, which included the convenience to customers of extensive retail branch networks. At the time of deregulation these branch networks served as a significant barrier to the entry of foreign banks. The cost of establishing a branch network was prohibitive and at that time electronic channels were neither sufficiently advanced nor sufficiently accepted by the general population to be a viable alternative to a branch network. In general, the foreign banks reacted to the difficulty of competing with the established banks and their extensive branch networks by competing aggressively for retail term deposits, which were considered more sensitive to price than convenience, and on the asset side by competing aggressively for the high yielding lending business of second tier corporate customers.

The implementation of the 1988 Basel Capital Accord

The implementation of the 1988 Accord provided an incentive for banks to switch from non-government, non-residential mortgage lending to residential mortgage lending as the latter required only half the regulatory capital of the former. Complicating any analysis of the impact of the relatively lower regulatory capital requirement in Australia though, was another consequence of the deregulation of the banking industry. In the environment of regulation on the composition of bank balance sheets and on some interest rates, cross-subsidisation had become the norm. With deregulation not only did banks begin to unwind the cross-subsidisation, but they also began to increase the level and range of fees charged to retail customers.

Consequently, as the 1988 Accord was implemented during the period when the deregulation of the Australian banking system was playing out, it is difficult to assess the impact of the Accord on the price charged by banks for residential mortgage loans or on the availability of residential mortgage lending.

During the first half of the 1990s there was a further opening up of the Australian banking market to foreign banks and an ending of the requirement that foreign banks had to have a retail presence. At the margin these changes had two positive impacts on competition in the residential mortgage market. Firstly, some of the new foreign banks were from countries from which there had been migration to Australia with the immigrants clustering around regions, or suburbs, within Australia's two largest cities. That enabled the banks to establish small but localised branch networks catering to those migrant communities and therefore to compete in their chosen niche markets with the established banks. Secondly the foreign banks were able to conduct their corporate and wholesale banking operations through branches of the parents while being free to establish focussed retail subsidiaries.

More recent developments

More recently, the major impact on competition in the residential mortgage market has been the advent of mortgage managers. Mortgage managers originate home loans that are then pooled and on-sold to investors through the creation of asset-backed securities. The mortgage managers are regulated under a disclosure regime but are not subject to banking regulation. Other changes that were taking place in the Australian financial system around the same time, including the introduction of compulsory superannuation with its ensuing demand for investments, arguably boosted demand for such securities. Also around the same time there was a breakdown in the "tradition" that customers would source all their banking requirements from the one bank. Whether that represented cause or effect is not particularly relevant to this discussion. What is important is that the mortgage managers competed aggressively with the banks on a one product offering.

As argued by Gizycki and Lowe[1] "an important lesson from the 1990s is that the competitive pressures needed to drive margins lower are more likely to come from new entrants, rather than from firms with large existing market shares".

[1] The Australian Financial System in the 1990s: Marianne Gizycki and Philip Lowe

None of the above is to deny that to the extent that banks do price off regulatory capital, the risk weighting of loans will reflect in the interest rate banks charge their customers. If we assume an 8 per cent regulatory capital requirement, that banks pay 6 per cent for liabilities but shareholders require a return of 18 per cent[2] then a change in the risk weighting from 100 per cent to 50 per cent, as occurred with the implementation of the 1988 Accord, will other things being equal result in a reduction in interest rates charged the borrowers of residential mortgage loans of around 50 basis points. The further reduction in the risk weight to 35 per cent as contained in the Basel II standardised approach to credit risk will have a much smaller impact, around 15 basis points. As discussed earlier, QIS5 suggests that banks adopting the advanced Basel II approaches will require less Pillar 1 regulatory capital than banks using the standardised approaches. However, that ignores the risks not addressed in Pillar 1 and also that supervisors may not fully accept the logic and adequacy of the banks' models.

The Australian experience, however, points to competition from outside the banking industry, and not the cost structure within it, having the greatest impact on the pricing of residential mortgage loans. Basel II will not change the cost or capital structure of Australia's mortgage managers, which do not operate with a regulatory capital requirement. Thus it can not be assumed that the introduction of Basel II will lead to a significant change in interest rates for residential mortgage loans. In respect of supply, many of the Australian ADIs that will be adopting the standardised Basel II approaches already have a high proportion of residential mortgage lending on their balance sheets and may be disinclined to seek more, notwithstanding the lower level of regulatory capital that will be required. Banks adopting the advanced approaches will see a change in the risk weights of many of their assets and it is too early to speculate how that will play out in terms of banks restructuring their balance sheets in order to maximise their use of regulatory capital.

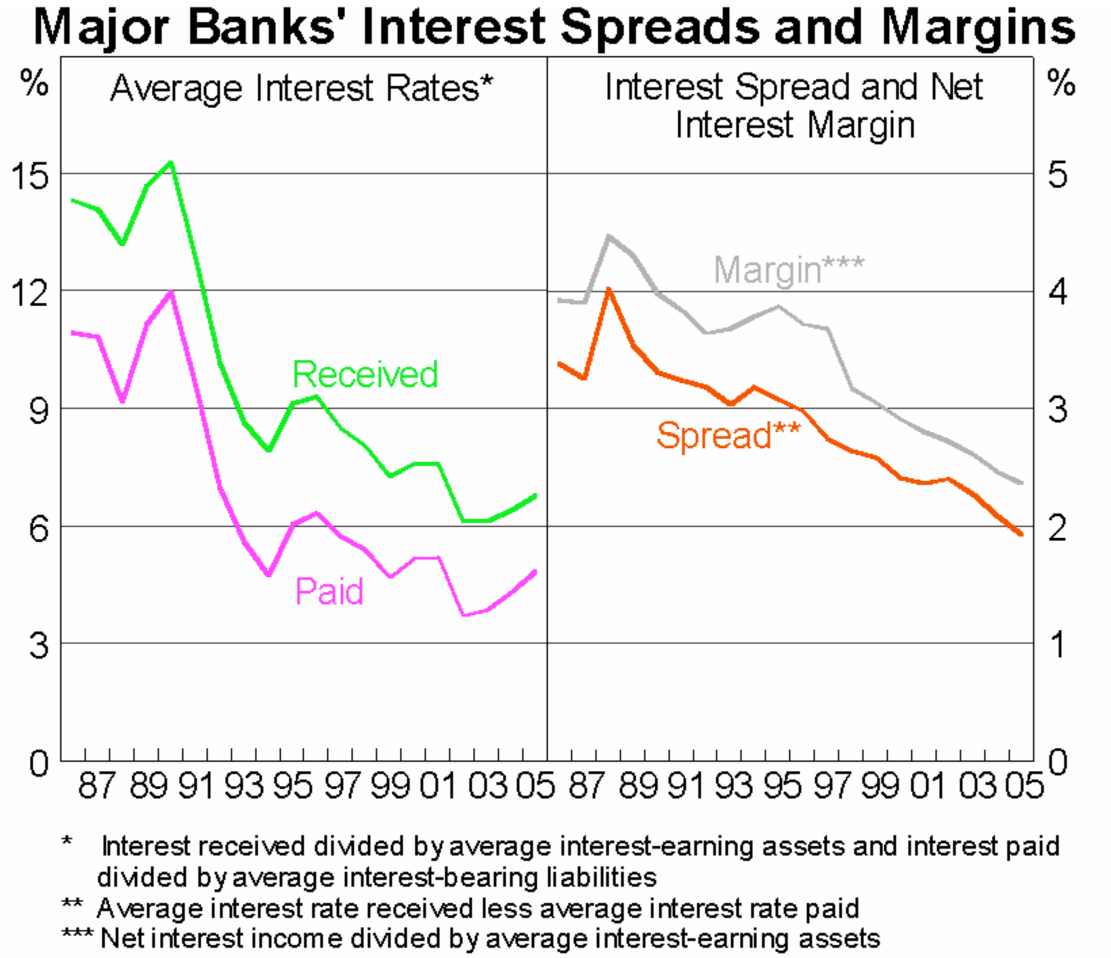
There is possibly another factor at work arising from the implementation of the advanced Basel II approaches that will impact on the cost and availability of residential mortgage lending. That is how the interaction between the regulatory capital requirements and banks' own economic equity models will play out. The use of such models may lead to banks emphasising or deemphasising a product

[2] These numbers are for illustrative purposes only; they would tend to overstate the outcome rather than understate it.

offering where the bank believes the regulatory capital cost is misaligned with the true cost as estimated by the economic capital models. However, under Basel II that distortion will be reduced to the extent that Basel II results in regulatory capital being closer to economic capital.

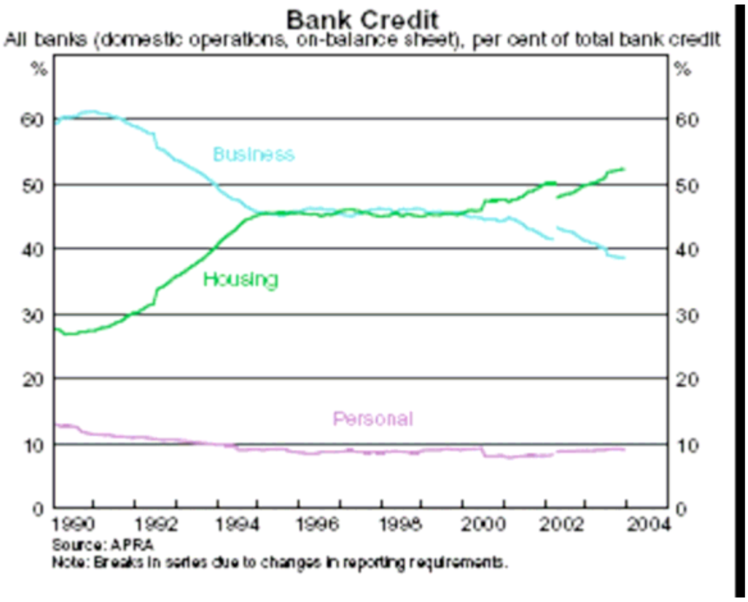
The following graphs illustrate the preceding discussion. Graph 1 shows the decline in interest spread and net interest margin over the last 15 years.

Graph 1



Graph 2 illustrates the move from corporate to retail lending. While one factor at work here would have been the lower regulatory capital impost from residential mortgage lending, others would have been the increased ability of larger corporates to borrow directly from the wholesale markets and the banks' experience of corporate losses in the early 1990s.

Graph 2



During the late 1990s and early 2000s, Australia experienced a boom in housing prices. Undoubtedly there were many factors at work, including those discussed above. During that time, however, inflation and inflationary expectations in Australia fell significantly. Interest rates were accordingly lower. Many people were prepared to leave their servicing costs unchanged and to utilise the increased availability of credit to gear up their balance sheets.

Conclusion

The evidence suggests that the recent boom in the Australian housing market was driven by a willingness of the Australian community to "gear up" and an increase in the supply of credit to meet that demand.

The implementation of Basel II will reduce the regulatory capital requirement on bank lending for residential mortgage loans. That will enable banks to lend more for residential mortgage loans for any given amount of regulatory capital and this, other things being equal, will lead to a reduction in mortgage interest rates. Both in theory and in practice, however, the differences are likely to be at the margin, especially compared to the other factors that feed into the price and availability of residential mortgage loans. In Australia, at least, there is no reason to suggest that the implementation of Basel II will reignite a housing boom.