



Australia's Mortgage Market, Coping with the Crisis

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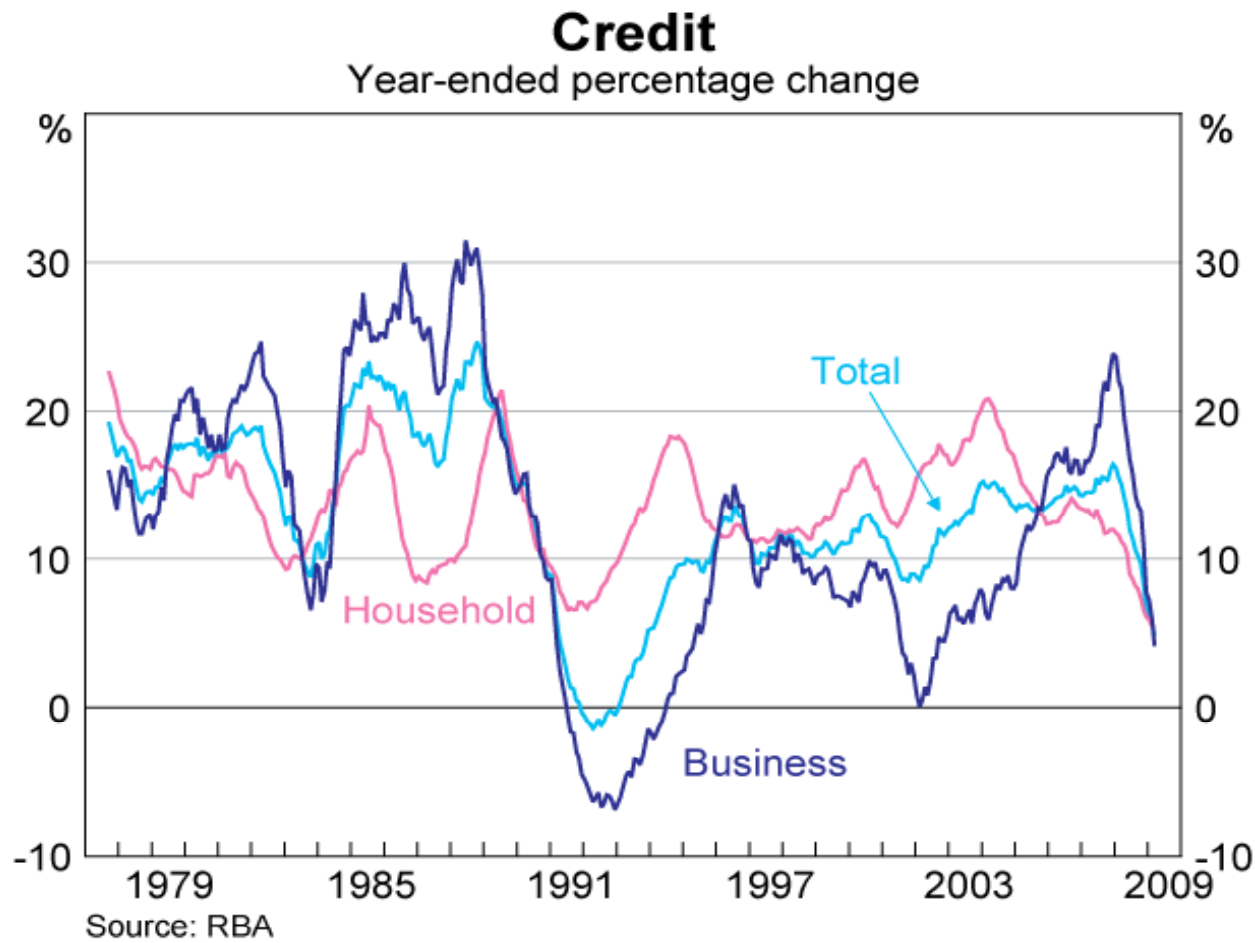
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Introduction



- Structure and Features of the Australian Residential Mortgage Market
- APRA's Prudential Approach
- Impact of the Global Financial Crisis
- Responses
- Outlook and Concluding Thoughts

Credit Growth Trends





- Enforcement of property rights well established by law
- Full recourse lending - borrowers personally liable for any shortfall on realisation of collateral
- Responsible lending (Australian Uniform Consumer Credit Code) - onus on lenders to lend in a responsible manner

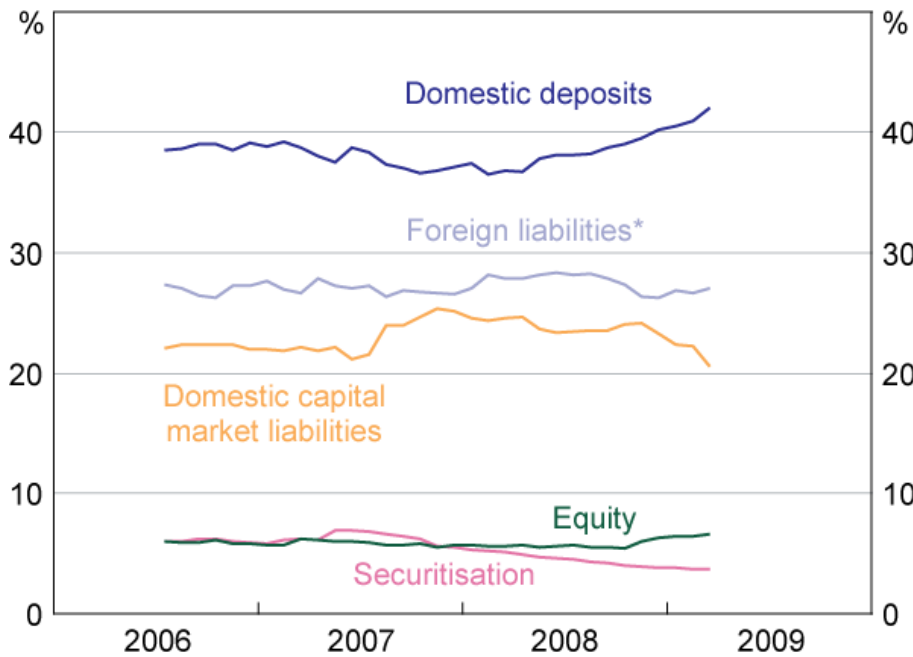


| Origination channel | Sources of funding |
|---|---|
| Traditional regulated banks, building societies and credit unions ('banks') | Initially on-balance sheet; may be retained or securitised later |
| Unregulated non-bank originators ('NBOs') | Until the closure of securitisation markets, financed through warehouse facilities and refinanced by term RMBS issues |
| Mortgage brokers, and other commission-based sellers | Typically do not fund originations but "white-label" mortgages using products offered by Banks or NBOs |

Funding Profiles

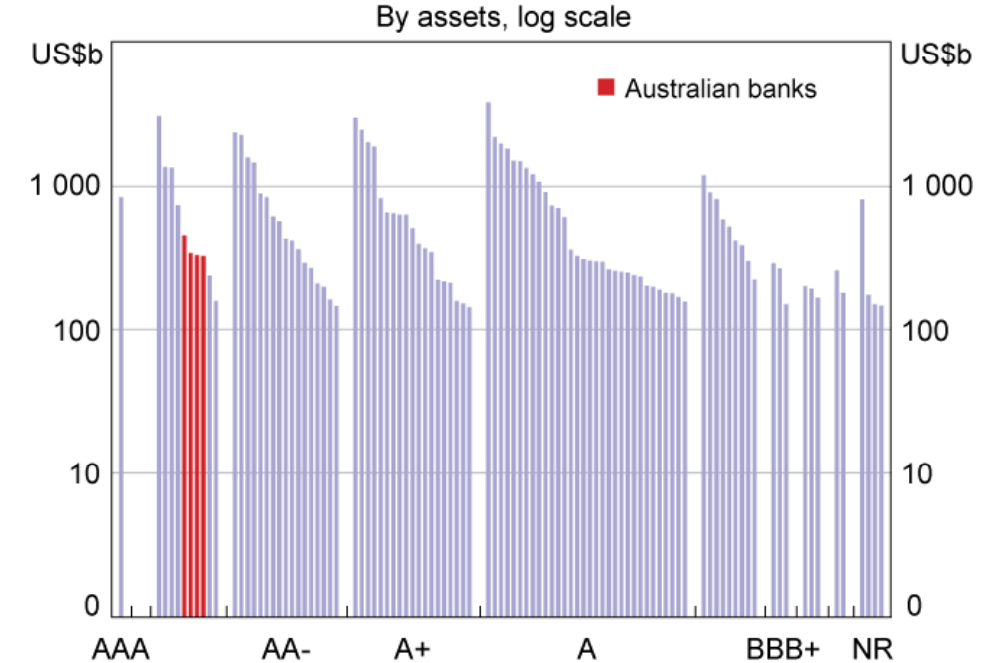


Funding Composition of Banks in Australia



* Adjusted for movements in foreign exchange rates
Sources: APRA; RBA

Credit Ratings of the Largest 100 Banking Groups*



* Holding company ratings; predominantly Standard & Poor's
Sources: Bloomberg; *The Banker*



- Important source of funds for smaller banks and NBOs as it was embedded in their 'originate and distribute' business models
- Less important for major banks with diversified liability bases
- Lenders' mortgage insurance
- Now used to create repo-eligible securities for liquidity management purposes
- Covered bonds are prohibited under APS 120



Intense competition between lenders brought pressure on underwriting standards through:

- Increased reliance on mortgage brokers to originate loans
- Increased appetite for higher risk products
- Relaxation of debt serviceability criteria
- Use of 'streamlined' property valuation methods

However, despite complacency weakening in standards did not evolve to the degree experienced in the US mortgage market



- Strengthening credit standards through ongoing on-site and off-site supervision as well as specific studies including:
 - 2006/07 Survey of debt serviceability practices by 44 largest lenders
 - 2003/04 Survey of property valuation practices
 - 2002/03 Common stress test - 30 percent price fall and high default rates
Survey on broker-originated lending
- Tightening of capital adequacy requirements, especially in the context of Basel II

APRA's Prudential Approach



- Stress-test provided evidence that banks were reasonably insulated from lending risk, although the riskiness of some loan portfolios was understated
- Outliers were identified and supervisory activities were intensified and targeted accordingly
- Enhanced understanding of lending risks has provided critical input into the tightening of capital adequacy requirements including:
 - Introduction of more granular risk weights
 - Increased loss given default floor for advance IRB Banks
 - Increased supervisory regime for more vulnerable LMI providers
- Reviewed approach to the management of liquidity risk by Banks and continually strengthening the prudential framework

Housing Loan Risk-Weights under Basel II



| LVR (%) | Standard eligible mortgages | | Non-standard eligible mortgages | |
|-------------|--|--|--|--|
| | Risk-weight (no mortgage Insurance) % | Risk-weight (with at least 40% mortgage insurance) % | Risk-weight (no mortgage Insurance) % | Risk-weight (with at least 40% mortgage insurance) % |
| 0 – 60 | 35 | 35 | 50 | 35 |
| 60.01 – 80 | 35 | 35 | 75 | 50 |
| 80.01 – 90 | 50 | 35 | 100 | 75 |
| 90.01 – 100 | 75 | 50 | 100 | 75 |
| > 100.0 | 100 | 75 | 100 | 100 |

Impact of the Global Financial Crisis

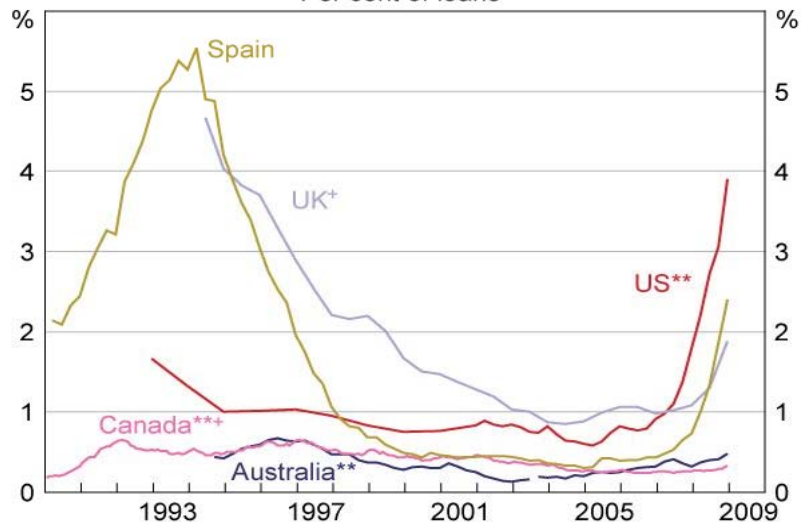


First round Adjustment to balance sheets and funding composition

Second round Deterioration of asset performance through increasing impairment

Non-performing Housing Loans

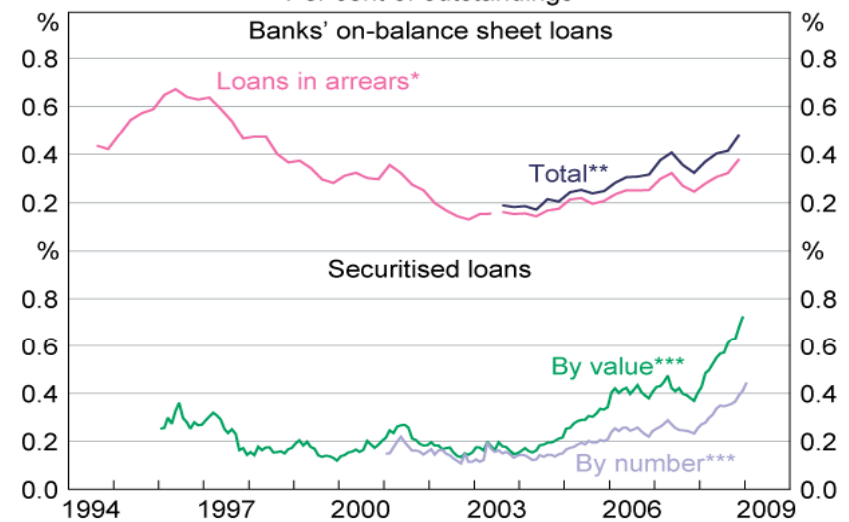
Per cent of loans*



* Per cent of loans by value. Includes 'impaired' loans unless otherwise stated. For Australia, only includes loans 90+ days in arrears prior to September 2003.
 ** Banks only.
 + Per cent of loans by number that are 90+ days in arrears.
 Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC

Non-performing Housing Loans

Per cent of outstandings



* Loans that are 90+ days past due but otherwise well secured by collateral
 ** Includes 'impaired' loans that are in arrears and not well secured by collateral
 *** Full-doc and low-doc loans securitised by all lenders, 90+ days past due
 Sources: APRA; Perpetual; RBA; Standard & Poor's

Bank Responses



- Protecting lending book margins by restricting the pass-through of official rate reductions by the Reserve Bank of Australia
- Tightening lending criteria
- Repricing credit risk margins
- Through increased provisioning
- Reassessing and revising liquidity management and funding strategies
- Assessing the feasibility of transitional arrangements for borrowers experiencing financial hardship
- **Supply is now concentrated in a smaller group of larger lenders, which has lessened competition.**



- Expansion of Reserve Bank liquidity provision to the banking system
- Widening of criteria governing eligibility of assets permitted for repurchase with Reserve Bank
- Instigation of the Government's wholesale funding guarantee, and financial claims scheme for retail depositors
- Establishment of funding facility to allow purchase of conforming RMBS from non-bank lenders
- Other funding initiatives



Liquidity:

- close contact with bank treasurers
- enhanced reporting of liquidity
- reviews of longer-term forward-looking funding plans
- 'up close and personal' with institutions of concern

Credit:

- close monitoring of internal 'watch-lists' and lists of vulnerable exposures
- emphasised importance of appropriate risk gradings, valuation and provisioning levels



- Future for mortgage securitisation is clouded
- Conditions remain difficult and issuing spreads remain elevated - despite recent signs of improvement
- Underlying economic situation has changed
- However, residential mortgage lending in Australia remains viable and in adequate supply relative to more subdued demand