THE NEW AUSTRALIAN SECONDARY MORTGAGE MARKET

by

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In Australia the Federal Government, perhaps encouraged by the failure of the Campbell Report (the Australian Financial System Inquiry) to support government development of a secondary mortgage market, has declined to provide any government backing to the embryo secondary mortgage market developing in the private sector. The State Governments of Victoria, N.S.W. and Queensland have seen this situation as an opportunity and all have at various stages moved to assist the development of a secondary mortgage market based in their own States. The Victorian State Government has organized its participation in the development of the secondary mortgage market speedily and efficiently, and through a joint venture with the private sector has created a new company which has now made its first issue.

A fully developed secondary mortgage market requires a sufficient number of participants to ensure that no one participant is able to influence unduly the terms or prices of mortgages: either a standardized mortgage instrument or a procedure for packaging mortgages into relatively homogeneous aggregates suitable for transfer; market participants sufficiently knowledgeable of market conditions to make rational choices based on market prices; a larger enough variety of mortgages or packages of mortgages to ensure continuous trading; and a close relationship between the mortgage market as a whole and other financial markets.

The design and implementation of the new company allow for the satisfaction of these requirements and this augurs well for the success of the new market. In the remainder of this paper the technical details of the market are set out and the way in which it copes with previous impediments to the creation of a successful market are discussed.

The Creation of the NMMC

The National Mortgage Market Corporation (NMMC) was incorporated on September 6, 1984 as a joint venture between the Victorian Government and private enterprise. The Victorian Government’s incentive to participate was the long term benefit to households of establishing a national secondary mortgage market while the private sector participants were interested in developing a new financial securities market. The Government holds 26 per cent and the private sector 74 per cent shareholding. Among the 27 private sector institutions are the AMP, MLC, Elder’s Finance Group, the State Bank of Victoria and the largest building societies in Victoria, South Australia and Western Australia.

Secondary mortgage markets usually take one of three forms: a “pass-through” market as in the US and Canada where writers of primary mortgages sell to secondary mortgage institutions which form pools of mortgages against which medium to long-term participation certificates are issued to investors; a mortgage-backed bond market as in Denmark and Italy in which a pool of mortgages provides collateral to ensure repayments of principal without the ownership of the mortgages being transferred; or a bill issue market as in France where primary mortgage writers issue short-term bills backed by their mortgage portfolio.

The NMMC, a recognized institution under Section 3A of the Victorian Trustee Act, issues a non-pass through mortgage backed promissory note of 185 day maturity, with not less than $A50,000 denomination, carrying trustee status. The company’s Articles of Association provide for “approved mortgage originators” defined as banks (either federally or state constituted), life assurance companies, building societies, public trustees, finance companies or any other person whose normal business includes taking first mortgages on the security of freehold property which is approved by directors. An approved mortgage originator applies to have a limit or pooling facility established by the company. The minimum amount of any pool is $A1

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million with the maximum amount and the limit or facility available to any originator is at the discretion of the company.

A secondary mortgage market agreement (SMMA) is concluded between the NMMC, a custodian trustee and the originator under which the originator agrees to deposit mortgages. Each mortgage deposited must be an unencumbered first mortgage of freehold land in Australia, registered under the Transfer of Land Act, 1958 in Victoria (or a corresponding Act in another State) where the principal sum secured by the mortgage does not exceed two-thirds of valuation or where the loan to value ratio does not exceed ninetenths of valuation if repayment of the principal sum in excess of two-thirds of valuation is mortgage insured.

The Issue of Aussie Macs

Pursuant to the SMMA, the originator deposits with the custodian Trustee, approved mortgages for the benefit of the NMMC which agrees to issue and deliver to the originator, Certificates with an agreed face value to an amount not exceeding the principal amount secured by the mortgages. It is the task of the trustee to check the mortgage documents, certify to the NMMC that the documents and pooling comply with its requirements and hold the mortgages in trust for the NMMC. The SMMA is a Deed of Deposit under which the originator mortgages his interest in the mortgage to the NMMC so that, unlike pass-through instruments which pass the whole of the beneficial rights interest in a mortgage, or a defined proportion of the total beneficial interest in a group of mortgages, the NMMC has prior rights to mortgages pooled through the SMMA.

Once the originator, through the mortgage security deposited with the trustee, guarantees performance of the mortgage pool including a covenant to place NMMC in immediately available funds on the maturity date of each Certificate, the NMMC issues Aussie Mac certificates which give the holder a right in debt against NMMC whose principal assets are mortgages. Aussie Mac Certificates are issued in the form of Promissory Notes of terms of not more than 185 days, payable to bearer with a value of not less than $A50,000 each. NMMC has the primary obligation to pay the notes according to their tenor.

The originator obtains Aussie Mac Certificates from the NMMC, pays the NMMC fee (which includes the Trustee's fee) of the face value of the Aussie Mac Certificates and either holds the Certificates or discounts them. Once the originator commits himself to mortgage pooling with the NMMC the nexus between the rate on the mortgage and the rate gained by the buyer from the seller of the Aussie Mac is broken and the latter two determine the yield on a homogeneous debt instrument, the Aussie Mac, which has authorized trustee investment status. The NMMC is directly liable for redemption to the end investor with the buy-back commitment from the originator to the NMMC ensuring that the noteholder has a market for his security.

The First Issue

The NMMC issued its first Aussie Mac promissory notes to the Australian capital market on April 4, 1985. The initial draw down of $A8 million saw the security trade at very fine margins over bank accepted bills. Australian Ratings Ltd, a domestic corporate credit rating agency, has given the notes an A1 rating, the highest non-bank rating for a commercial paper. It is confidently expected that the private sector will provide sufficient funds to sustain a continuous and liquid secondary mortgage market now that a single piece of "paper" — the Aussie Mac — can be traded, that paper is standardized and available from a number of vendors; the interest yield exceeds that available from more liquid sections of the finance market, and a buy-back arrangement is provided.

Benefits of Aussie Macs

The Aussie Mac certificate is a new investment opportunity offering attractive yields. For the holder of mortgages it offers the release of low-yield non-monetary assets from their portfolios into a high-yield debt security. Through NMMC intermediation, buyers and sellers of Aussie Macs, determine the yield on the security, separate from the yield on the mortgage.

For the investor, A1 rated paper backed by relevant mortgages and issued by a government-sponsored institution is offered with trustee investment status, assurance of homogeneity and of prompt payment of face value at maturity. The notes are payable anywhere in Australia through the National Australia Bank Ltd. An investor or originator can by roll-over, negotiate a rate fixed for 2, 3, 5 years or longer.

The NMMC is committed to develop a national secondary market in mortgages and already in this process it has developed some standard mortgage prerequisites such as the establishment of uniform credit evaluation procedures for mortgages to be pooled and the SMMA. It has simplified markedly the process of trading the rights to mortgages and offers the potential for developing an extensive secondary mortgage market in Australia.