Whitlam Institute
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Executive Summary

Home mortgages are a simple product.

However, in Australia this simple product is now being sold mostly by organisations - the Big Four banks - better suited to tasks which are much more complex and which require the development of sophisticated skills in credit assessment and risk management (like business banking). Yet mortgage lending makes up more than half of the Big Four's business.

The Big Four's have a competitive advantage in mortgage lending largely because they can raise funds more cheaply on international wholesale markets. And they can do that largely because, whatever the government might say, financial markets perceive each of the Big Four to be too big to fail and so protected by an (implicit) government guarantee. Governments' response to the GFC has only validated those views.

And so the Big Four

- dominate the market,
- overcharge their home loan customers,
- avoid pressure to reduce their costs and
- distribute their excessive profits to their shareholders and employees, particularly senior executives.

Given the inevitability of the government's role in vouchsafing the financial system, the most efficient, transparent and fair way of doing so would be to *sell lenders' mortgage default insurance* (LMI) to lenders at a market price. This would;

- put the Big Four on even terms with other domestic home lenders;
- permit much greater competition in the home lending market; and
- reward taxpayers for the risks they assume in the financial system.

Because markets work well at managing individual risks which do not have systemic implications, the government's role should be confined to insuring catastrophic and systemic risk. It should provide insurance of mortgagees' losses from default at some level considered either safe – say 80 percent loan to valuation (LVR) – or virtually risk free – say 50-60 percent LVR). Where loans were within these benchmarks, the government would cover all default risk. Default risk on higher loan to valuation (LVR) mortgages would stay with the lenders or be available for insurance by the private insurance market.

Where LVRs were below the figures given above, a pool of such loans could be sold off - that is, 'securitised' - and would trade like government bonds in financial markets being fully government insured against default. This is a more conservative version of the Canadian home finance market (Canada's government owned CMHC offers LMI up to 95 percent LVRs.)

This model creates a deep market for securitised mortgages obviating the need for further regulation and/or for improvisation during a crisis. In effect it removes over half of bank assets from prudential supervision on bank balance sheets, by, in effect pricing and managing the risk more transparently on the government's balance sheet.

This arrangement plays to the relative strengths of the private and public sector. The government is on the hook for systemic, catastrophic risk – as it is today. But private banks, insurers and institutional (wholesale) borrowers bear smaller, more idiosyncratic up front risks and larger risks on riskier mortgages.

And mortgages would be supplied in competitive markets at a competitive cost. At last.