

Housing finance and securitisation: US MARKET GROWTH AND GLOBAL IMPLICATIONS



Over the past two decades the US debt market has grown rapidly. Between 1985 and 2005, total US debt issuance increased by approximately 600 per cent, reflecting the credit needs and appetites of American consumers and businesses alike. Securitisation has accounted for a large and increasing portion of this overall debt market growth trend.

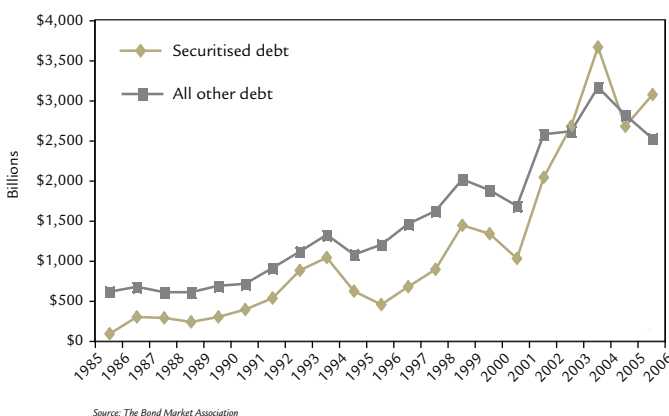
Over 1985 to 2005 securitisation issuance has grown faster than all other categories of debt and now constitutes over one-half of all US debt issuance. Many financial market participants – let alone legislators, regulators, and the general public – may not realise that since 2003, annual securitisation issuance in the US has exceeded total issuance of US government securities, corporate debt securities and municipal

(sub-sovereign) securities combined [figure 1]. In a very short period of time, securitisation has clearly become a mainstream and exceptionally important capital raising technique and has achieved a position of primacy in the US fixed income marketplace.

Historically, much of the size and growth of the US securitisation market can be attributed to the residential mortgage finance market and the leading role played by major housing-related government-sponsored enterprises, or GSEs – Fannie Mae, Freddie Mac and Ginnie Mae. Mortgage-backed securities (MBS) still remain the largest segment of the broader securitisation markets. However, non-mortgage asset-backed securities (ABS) have become a much larger share of the overall US securitisation landscape, as a wide range of consumer receivables, including credit card obligations, automobile loans, home equity loans and lines of credit, student loans, and other receivables have been securitised in increasing volumes [figure 2].

US corporations, banks and specialty finance companies who serve this growing consumer demand have come to view securitisation as an attractive funding source and as an efficient and low-cost complement to traditional

Figure 1: Securitised debt and all other debt issuance in the US



Source: The Bond Market Association

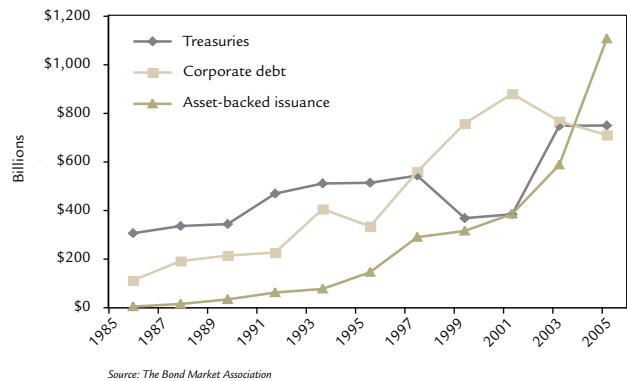
borrowing and debt and equity financing options. As a consequence, ABS volumes have grown to over \$1 trillion of issuance in 2005 – an amount larger than US Treasury and corporate debt issuance in the same year [figure 3].

Notwithstanding some of the secular shifts identified above and the growth of the ABS sector, the US securitisation market continues to be strongly tied to the housing finance market. Combining housing-related ABS (home equity loan and manufactured housing securitisation) with MBS, fully 85 per cent of all outstanding securitisations are related to the housing market in one way or another.

Moreover, these data do not account for the fact that much of the collateral underlying the booming CDO market – which is generally categorised as part of the ABS market – is in fact MBS or home equity ABS.

Within the MBS sector, significant growth and change is occurring, with ramifications for the structure and competitiveness of the broader securitisation and structured credit marketplace around the world. The MBS market in the US, like the primary mortgage origination market, is increasingly dynamic and diverse. The proliferation of non-traditional mortgage products (including interest-only loans and option adjustable rate mortgages), growth in extension of mortgage credit to non-traditional borrowers (“alternative A,” near-prime and sub-prime), and growth in home equity-based lending, coupled with steady housing price appreciation, has changed the mortgage finance landscape dramatically in a relatively short period of time. Not long ago, GSE mortgage lending and securitisation dominated the market – for example, in 1995, GSE MBS issuance accounted for 85 per cent of all mortgage-related securitisation issuance.

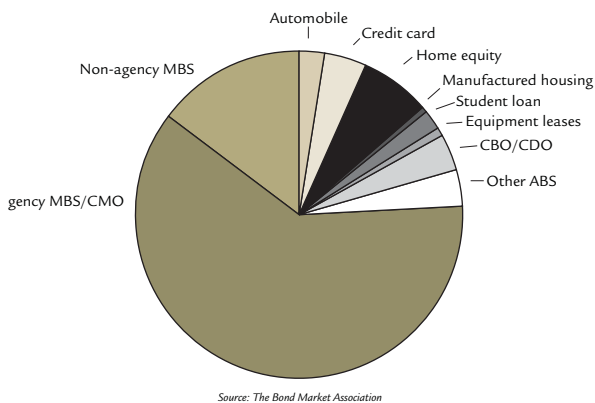
Figure 3: ABS issuance comparison with other debt in the US



Today, however, the GSEs account for slightly greater than 60 per cent of all such issuance, reflecting the tremendous relative growth in the private mortgage market. Borrowers have been the primary beneficiaries of GSE and non-GSE growth alike, as they have access to a wider range of housing-related credit options at lower cost than ever before.

The general economic environment in the US has played a major role in defining and accelerating these broader securitisation market trends. Since the dot-com bust at the turn of the century, the US housing market has enjoyed extraordinarily benign conditions. With the Federal Reserve Board consistently lowering

Figure 2: Amount outstanding in the US securitisation market as of 2006:Q2



Much of the collateral underlying the booming CDO market is in fact MBS or home equity ABS.

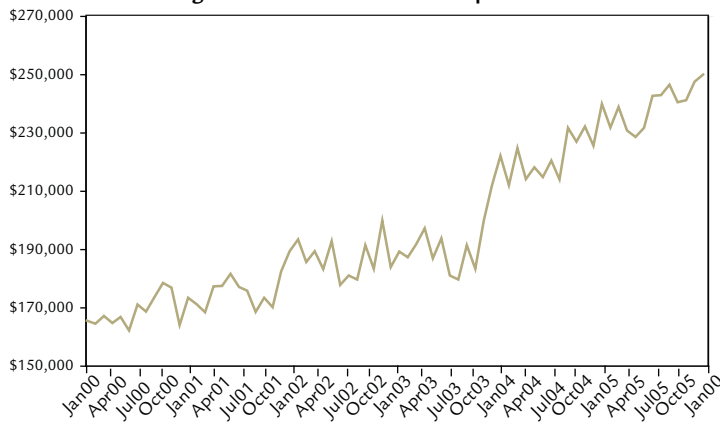
the Fed Funds rate beginning in late 2000, 30-year mortgage rates across the US began to fall and have remained at or near historical lows in real terms.

Falling interest and mortgage lending rates were accompanied by growth in new products described above, which in turn propelled corresponding growth in new and existing home sales, resulting in greater demand for acquisition, refinancing and home equity based-financing. The increase

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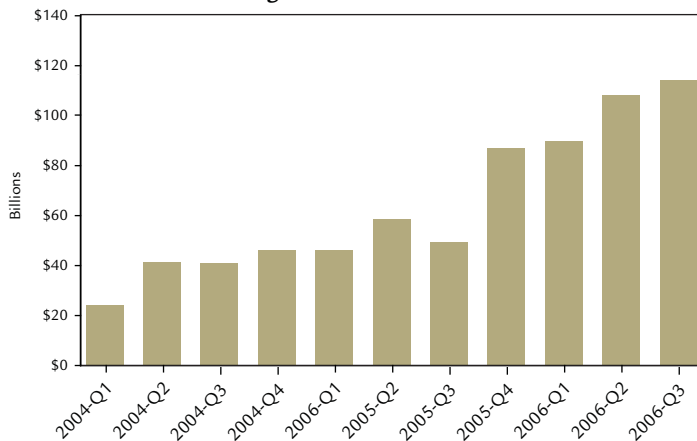


Figure 4: Median new home sale prices in the US



Source: US Census Bureau

Figure 5: Global CDO issuance



Source: US Census Bureau

in demand for new and existing homes – both as primary residences and as investment properties – helped median housing prices to grow by 50 per cent from January of 2000 to January of 2006 [figure 4].

As might be expected in a market this large, growth and change in the US securitisation market impact the global financial marketplace. One prominent example is the proliferation of CDOs, which affects supply and demand dynamics for MBS and ABS throughout the world. The global CDO market has roughly tripled in size since 2004, and through the first three quarters of 2006, over 80 per cent of all CDOs issued globally were denominated in US dollars [figure 5].

Although an increasing variety of collateral supports CDOs in both cash and synthetic form, over 60 per cent of all CDO issuance is supported by securitised instruments, including MBS, home equity ABS and other ABS. The CDO bid for these products has provided important demand-side support for the underlying securitisation products, which has helped to increase MBS and ABS supply and exert downward pressure on credit spreads – again to the ultimate benefit of consumers.

Securitisation, including CDOs, accounts for an increasing percentage investment in US debt market by non-US investors. In 2005, securitised debt constituted 17 per cent of all foreign holdings of US debt, compared with 12 per cent in 2003, and this growth trend is continuing [figure 6]. As this share has increased, US credit risk intermediated

via the securitisation market – much of it relating to the US housing sector – is increasingly being allocated throughout the world. As a consequence, within the global economy, there is also a growing, global housing economy. Viewed on a macro scale, the performance and prospects of the US housing market have become increasingly important to investors and economies around the world. The reverse is also true, as cross-border securitisations – much of them housing market-related – become more common, and as housing-related capital flows more readily both into and out of the US

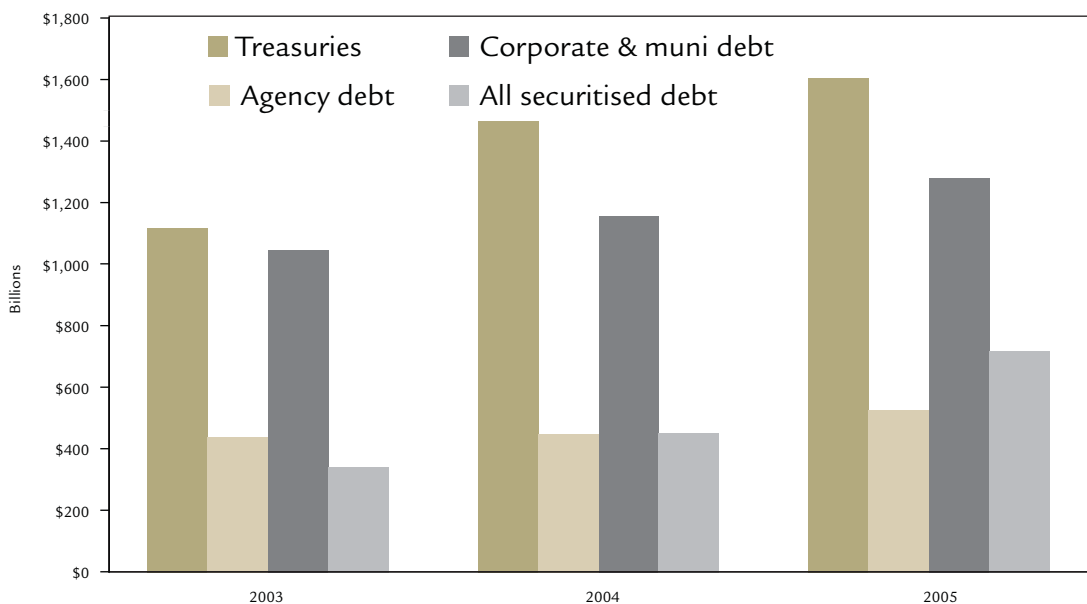
Such trends are likely to continue. Even if growth in underlying US housing or asset-based financing markets slows, advancements in financial products and structuring technology (witness the emergence of a large and increasingly robust CDS of ABS market), together with growth of new types of global investors and liquidity pools (including hedge funds and central banks), should stimulate an ever-more efficient and widespread allocation and assumption of risk within the global capital markets. Increasingly, the product offerings and lending rates available to US borrowers will depend on how efficiently their credit is allocated and absorbed by investors and financial markets and products not just in the US, but throughout the world. In the residential mortgage finance arena, the consumer benefits and efficiencies of a national



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mortgage market envisioned by the US Congress in the mid-1980s when it passed the Secondary Mortgage Market Enhancement Act may well be overtaken and improved upon by the transnational mortgage finance market that financial market participants are building today. ■

Figure 6: Foreign portfolio holdings of US debt



Source: The Bond Market Association