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CABINET NOTE

TO: THE PREMIER FOR CABINET

RE: US SUB PRIME MORTGAGE MARKET

1. PROPOSAL

1.1 It is proposed that Cabinet notes the status of HomeStart Finance in the context of recent volatility in global financial markets.

2. BACKGROUND

2.1 In recent weeks there has been increasing volatility in global financial markets, stemming largely from concerns about the US sub-prime mortgage market. In turn, this has led investors around the world to re-assess their appetite for riskier asset classes, particularly mortgage backed securities. The scale of this volatility is such that some economists are forecasting that it will trigger a recession in the US, while the US central bank has been forced to cut official interest rates in an effort to prevent this outcome.

2.2 In Australia, attention has focussed on the impact of this volatility on a number of home lenders. For example, the non-bank lender RAMS has been forced to activate standby funding lines to continue operations, while Adelaide Bank needed to increase the interest rates applying to its "lo-doc" home loan portfolio by more than the Reserve Bank's recent 0.25% rate rise. Executives from some of the major banks have publicly raised the possibility that they may also be forced to increase their home loan rates if short term rates remain elevated. HomeStart is in the same position, and may be forced to raise interest rates if this situation continues.

3. DISCUSSION

3.1 In this environment it is worthwhile considering how these events may impact on the activities of HomeStart Finance.

3.2 HomeStart undertakes home lending to borrowers who typically fail to meet standard bank lending guidelines. In this context its loans could be considered to be sub-prime. However, there are three key aspects to HomeStart's operations which differentiate it from other lenders:

- At no time has HomeStart undertaken “lo-doc” lending. These loans require no documentary proof of key requirements such as borrower income, and are therefore subject to much higher levels of default in times of volatility.
- At no time has HomeStart offered “honeymoon” interest rates, which provide borrowers with attractive initial interest rates but ultimately subject them to repayment shock when their loans revert to standard rates. The HomeStart loan carries an implied safety net, whereby repayments are linked to income rather than interest rates.
- HomeStart has the benefit of the Treasurer’s AAA guarantee, providing it with certainty of access (via SAFA) to both short- and long-dated funding. In contrast, many other lenders have had difficulty accessing the money markets owing to investor reluctance to provide funding to mortgage portfolios.

3.3 The difference between HomeStart’s activities and those of other sub-prime lenders is best summed up by reference to the number of its customers whose loans are in default. Arrears levels (which refers to loan payments which are 30 days or more overdue) are currently at very low levels - HomeStart currently has 1.89% of its loans in arrears, while the latest figures from Standard & Poor’s show that prime home loans in Australia have an arrears rate of just 1.11%. However, Standard & Poor’s also shows that the arrears level in the Australian sub-prime market has reached 13.69%. Consequently it can be seen that HomeStart’s portfolio conforms more closely to the prime loan portfolios of other banks than to the sub-prime market.

4. RECOMMENDATION

- 4.1 It is recommended that Cabinet notes the status of HomeStart Finance in the context of recent volatility in global financial markets.

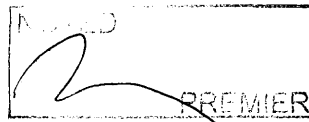


Hon Jay Weatherill MP
MINISTER FOR HOUSING

15/10/2007

In Cabinet

22 OCT 2007



PREMIER

