It's all about money, of course

The secondary mortgage market: What is it all about?

By Menachem Feder

Recently, the finance minister announced long-awaited plans to foster a secondary mortgage market. Accepting the recommendations of the Talmon Committee, the minister said he intends to see that all the pertinent regulatory and tax barriers are removed so that the private sector can create such a market.

But what exactly is a secondary mortgage market and why should one exist? The answer lies both in the nature of home ownership and the financial intricacies of lending money to home buyers.

Today, once a bank lends money to a home buyer, the bank retains the mortgage loan in its portfolio, patiently collecting both the borrower's repayments of principal as well as payments of interest over the life of the loan. By doing so, the bank waits a long time for its investment return and faces various risks over that time.

The most obvious risk is default by the borrower. The risk is somewhat limited by the bank's access to collateral — the home itself.

The bank faces another, even more significant risk: prepayment. Mortgage loan payments are unpredictable because a borrower decides how to prepay his loan based upon capricious life events. These events include changes in interest rates, changes in the economy, loss of job, death in the family, divorce, birth of children, and a move to another area.

Upon a prepayment the bank must find new use for the money it had lent the borrower. If interest rates have fallen since the bank originated the loan, the bank will be averse to prepayment because it will have to reinvest the prepaid money at a lower return than it once anticipated. If interest rates have risen, however, the bank will welcome prepayment because it will be able to reinvest the prepayment proceeds at a rate higher than its cost of funds.

The central missions of a bank are attracting deposits and finding borrowers. Since deposits received by a bank constitute short-term money and loans originated by a bank constitute long-term money, a bank typically experiences a mismatch between its assets and liabilities. As a result, a bank would prefer to pass to others the risks inherent in holding long-term loans such as mortgage loans.

The others who would be interested in evaluating and accepting these risks, for a price of course, are investors with a need for long-term income streams. Their need is based on obligations they have to make periodic payments over time. Provident funds, pension funds and insurance companies would be classic mortgage loan investors in Israel. The buying and selling of mortgage loans after they have been originated takes place in what is known as a secondary mortgage market.

No matter how attractive mortgage loans are to investors, however, the investors are not in the mortgage lending business. They cannot find borrowers nor structure mortgage loans. Accordingly, they look to a bank to sell them mortgage loans.

In principle, a bank could sell discrete whole loans to investors. But the complexity, illiquidity and high risk of default or prepayment inherent in a single loan are prohibitive. A secondary mortgage market solves that problem. When such a market exists, a bank wishing to sell its loans first pools a large number of loans. It then sells to the investors the rights to those pooled loans in a manner that minimizes the problems of selling single loans.

The bank does this by issuing a security, whose investment return is based on the financial performance of the loans in the pool. Pooling a large number of loans and selling a security based on the pool decreases the impact of a single borrower's default or prepayment because that borrower is only a small contributor to the performance of the pool. Similarly, the effects of defaults and prepayments are distributed among various investors in the pool.

This pooling of loans creates a financial product that is more simple, more liquid and less risky than any single loan. This product is called a mortgage-backed security, or MBS.

Essentially, issuing an MBS converts relatively illiquid assets into a capital market product. This grand process involves certain fundamental metamorphoses. One is the transformation of discrete loans into a pool of loans that backs the securities issued to the investor. Two is the transformation of a loan, a contract right, into a security, a property right. The alchemy yields many benefits.

For example, once a bank sells its loans, it can use the proceeds of the sale to make new loans. It can then sell to investors the new loans as well, and the cycle can continue repeatedly. Sold loans can be removed from the bank's balance sheet, freeing capital for new loans. In effect, the bank transforms itself from a patient investor to an efficient loan originator.

Also, an MBS, if structured properly, can carry a credit rating even higher than that of the originating bank itself. This means that a bank can access capital even when it is in a troubled financial situation.

As for investors, a secondary mortgage market gains them access to loans they otherwise could not acquire. Moreover, as their needs change, investors can buy, sell and trade MBSs with others.

Borrowers, too, benefit from a secondary market. Securitization begets efficiencies, which means savings. Competition between banks should allow borrowers to share in those savings.

If the finance minister adopts in full the Talmon Committee's recommendations, the government will allow private actors to create a secondary mortgage market but will not take an active role itself. Time will tell if the private sector can provide the organization and credit support needed to lift the secondary mortgage market from the launch pad. In any event, kudos for at least the attempt to introduce the world of Israeli mortgage loans to the modern era.

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