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They Came to Help the Secondary Mortgage Market, They Left Injurious

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[This article first appeared in Hebrew in the Israeli newspaper Globes on December 23, 2002.]

This year's budgetary Arrangements Law imposes rules that needlessly burden development of a secondary mortgage market in Israel. To be sure, the rules do lower some barriers to this market and this should be applauded. But, the overall impact will be to shrink the likelihood of a secondary mortgage market, in the misperceived name of borrower protection. The rules should be changed.

Typically, a mortgage bank collects principal and interest payments over the life of a mortgage loan it makes. During this time, the bank faces a number of risks. An important one of these is liquidity risk. Because banks often fund floating rate mortgage loans, which are long-term, with floating rate deposits, which are short-term, the bank must pay off expiring deposits with new deposits. This means that a mortgage bank runs the risk that deposit funding will dry up. Today, this risk looms especially large, given the credit standing of some banks and the state of the economy.

Because of liquidity risk and a number of other factors, a mortgage bank would do well to sell the loans it originates. The parties who would buy these loans, for a fair price of course, are investors that need long-term income streams to match long-term payment obligations. Provident funds, pension funds and insurance companies would be classic mortgage loan buyers. Buying and selling mortgage loans after a bank originates them are done via mortgage-backed securities and make up a "secondary mortgage market". This market promotes efficiencies, which usually lower mortgage loan interest rates.

The Arrangements Law imposes specific rules on secondary mortgage market transactions -- even though these transactions do not yet exist here. The claim is that some of the rules will encourage mass sales of mortgage loans and that others will protect borrowers. Regarding the encouragement: the initiative is welcome. Regarding the claimed protection: borrowers do not need what is offered.

For example, the new rules require that mortgage loans sold by a bank be serviced by a bank only. The idea must be that banks do not collect loans too aggressively because they are regulated. If that is the case, the wise path is to license mortgage loan collectors or to strengthen consumer protection rules, to the extent necessary, not to burden transfer of particular assets. In any event, no mortgage bank wants a competitor to access its borrower database. Since a mortgage-backed security must provide for a primary servicer (commonly the originating bank) and a backup servicer (in case the primary servicer does a bad job or fails), the proposed requirement could turn into a deal killer. For another example, the rules require a mortgage seller to notify borrowers and property owners (they may not be the same person because of delays in registration) of the sale of a mortgage. The new law does not even permit waiver of the notice.

Oddly, requiring the notice implies that the government, which pushed the Arrangements Law, considers the Assignments Law and the Lands Law, which generally govern assignment of rights and transfer of land security interests respectively and do not require such notice, to be inadequate. If that is the case, the principled approach would be to review the Assignments Law wholesale, not to supplant them piecemeal with budget-linked legislation. Requiring notice adds an unnecessary expense to a mortgage-backed security, since Israeli mortgage banks do not typically send out

monthly payment notices. Even if the expense is bearable, borrowers and owners do not obviously benefit from notice -- notice does not give them a right to prevent either the loan or the mortgage. Moreover, most borrowers and owners probably do not care to whom the mortgage belongs, all other things being equal. On a more fundamental level, there often is no way for a bank to determine the location of a property owner, as banks track borrowers only.

If the government wants to encourage a secondary mortgage market, it can do many things. It can sell government subsidized loans. It can waive its right to prevent the sale of a loan that contains a government subsidy. It can take a secondary secured position behind the buyer of a mixed government-bank loan. It can waive the requirement that a mortgage for a loan that supplements a loan which contains a government subsidy and which the borrower drags to a new property have equal standing with the initial mortgage. It can work to ease the transfer of cautionary notes. It can arrange to enlarge the stamp tax exemption on the sale of housing loans to include the sale of construction loans. It can act to cancel fees for bulk transfer of mortgages. If any of these jeopardize borrowers -- and most do not -- solutions should be explored, not ignored.

The Arrangements Law has set back prospects for a secondary mortgage market. The newly imposed rules should be changed and more help should be put in place. A secondary mortgage market deserves to be promoted -- to the maximum point of fairness and reason -- because it enhances efficiencies and allocates risks appropriately, all to the ultimate gain of the borrower public. While an Israeli secondary mortgage market has yet to arise, its delay should result from market forces, not unnecessary rules or overlooked relief.