

**Authorizing the
Mortgage Holding Subsidiary
Concept when Privatizing
the Housing GSEs**

A Presentation by

Bert Ely

to the

American Enterprise Institute

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Authorizing the Mortgage Holding Subsidiary (MHS) concept

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 - **“In-situ securitization” and “ratchet mortgages” will help to produce lower interest rates than MBS**

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- Key provisions of the MHS authorizing legislation
- **A summing up**

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- **MHS will promote housing finance competition, which will foster innovation and greater efficiency**

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“moral hazard” and “cherry-picking”
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- **Synergies between mortgage lending and other consumer finance services provided by parent bank**

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The Mortgage Holding Subsidiary concept provides the basis for that restructuring

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- **Figure 1 illustrates the relationship of an MHS to its parent bank or thrift**

A Private-Sector alternative to Fannie Mae and Freddie Mac – the Mortgage Holding Subsidiary model

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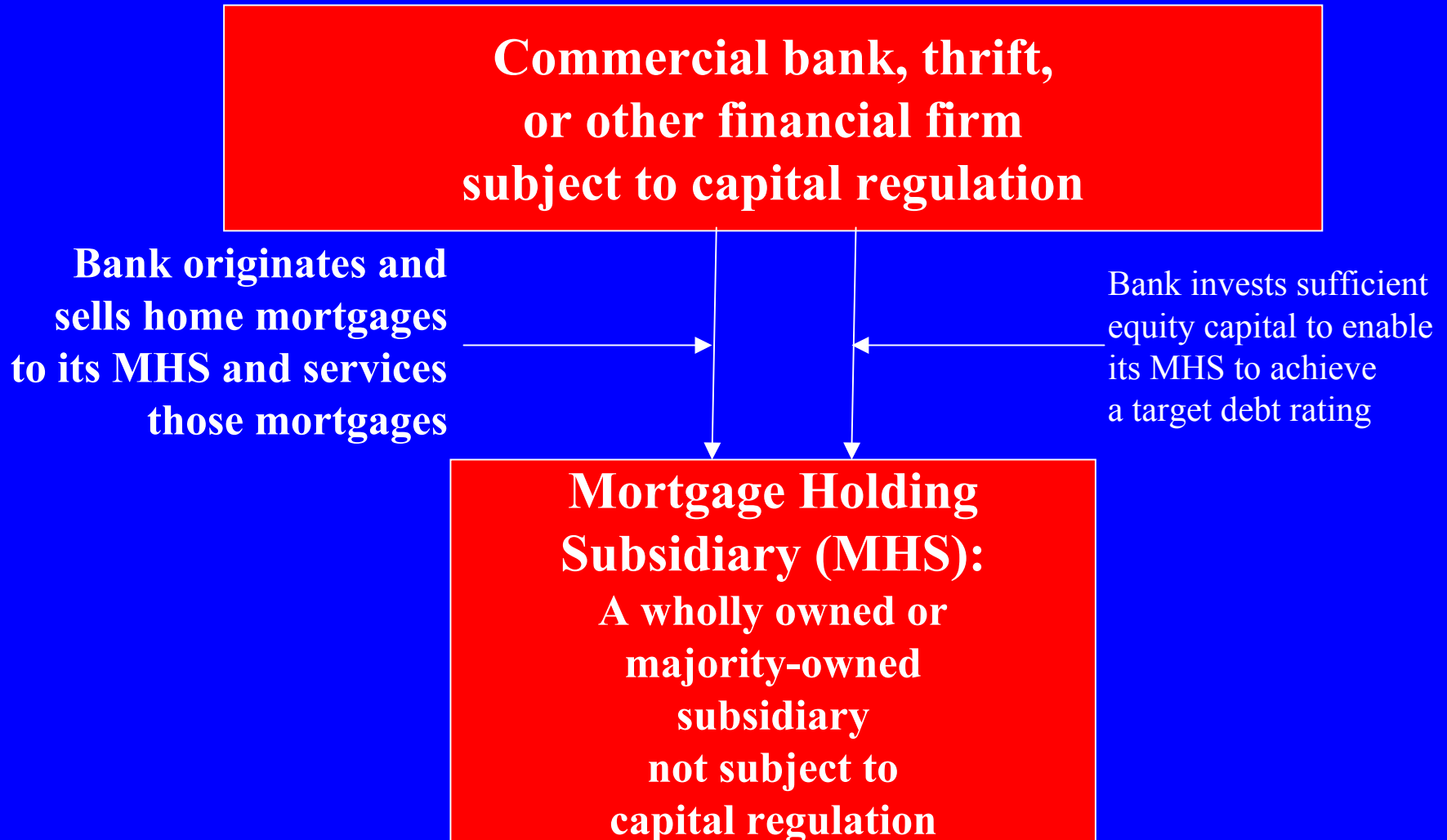
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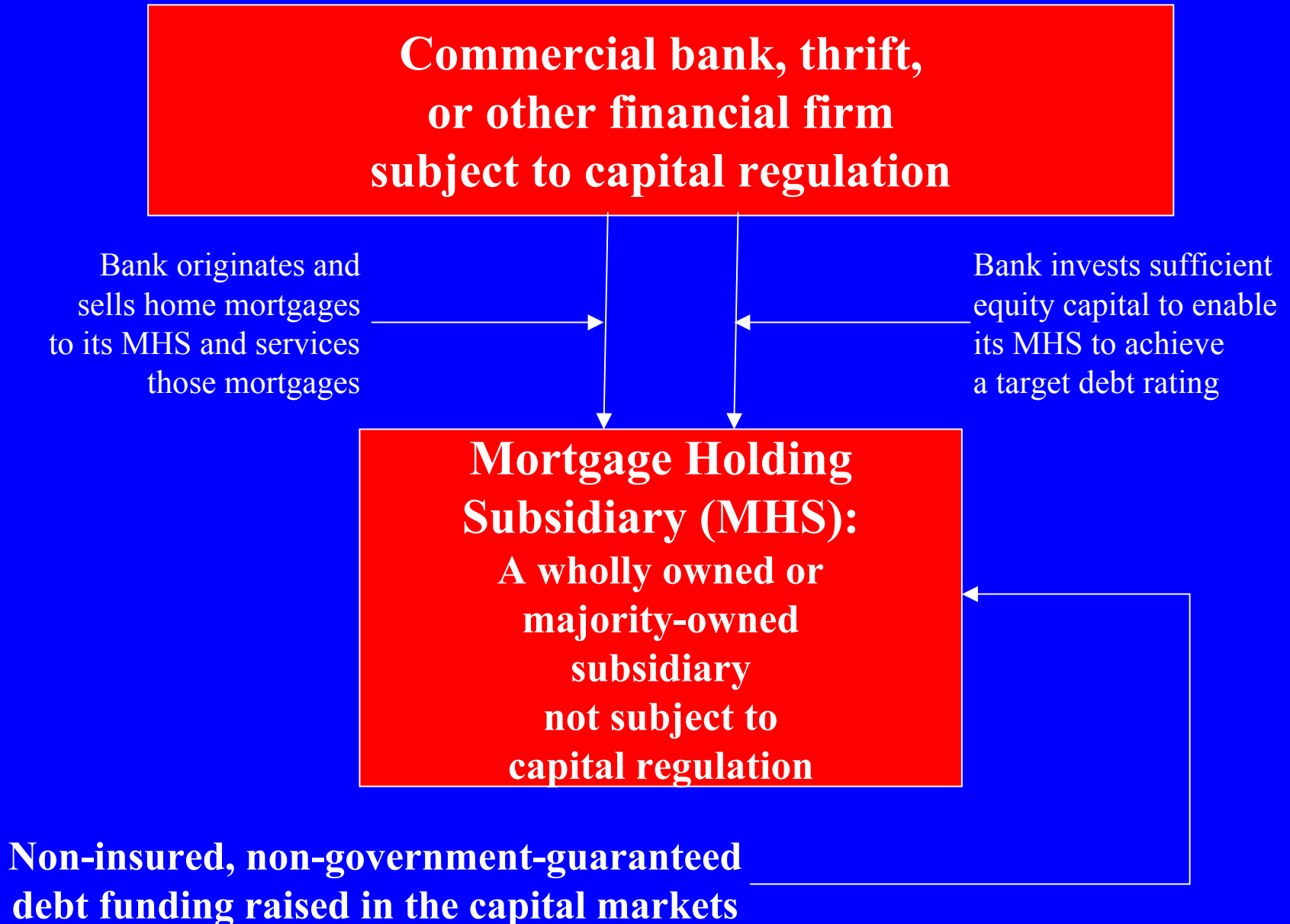
**Bank invests sufficient
equity capital to enable
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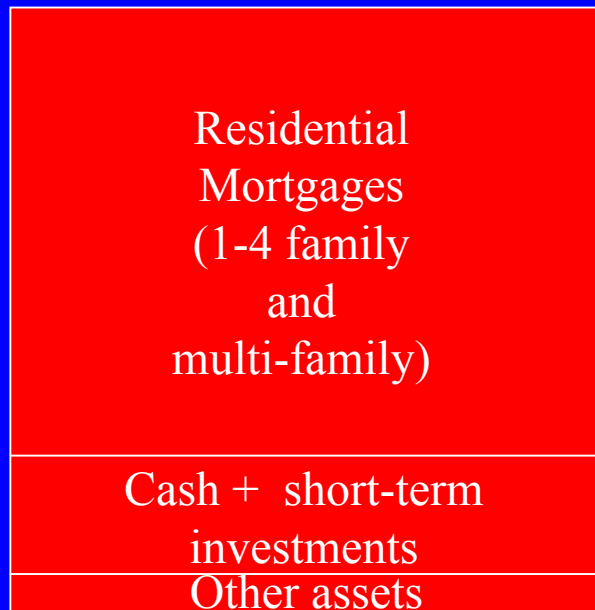
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 - **Figure 2 presents a conceptual representation of an MHS balance sheet**

Balance sheet composition of an MHS

(not to scale)

Assets



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Assets

=

Liabilities +
equity capital

<p>Residential Mortgages (1-4 family and multi-family)</p>	<p>Unsecured preferential debt raised in the capital markets</p>
<p>Cash + short-term investments</p>	<p>Other unsecured liabilities</p>
<p>Other assets</p>	<p>Subordinated debt (optional)</p>
	<p>Equity capital</p>

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- **MHS could issue**
 - **Common and preferred stock to third parties**
 - **Subordinated debt**
 - **Preferential unsecured debt, unsecured debt**
 - **“In situ” securitizations and “ratchet bonds”**
 - **Secured debt**

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- **MHS not subject to Community Reinvestment Act**

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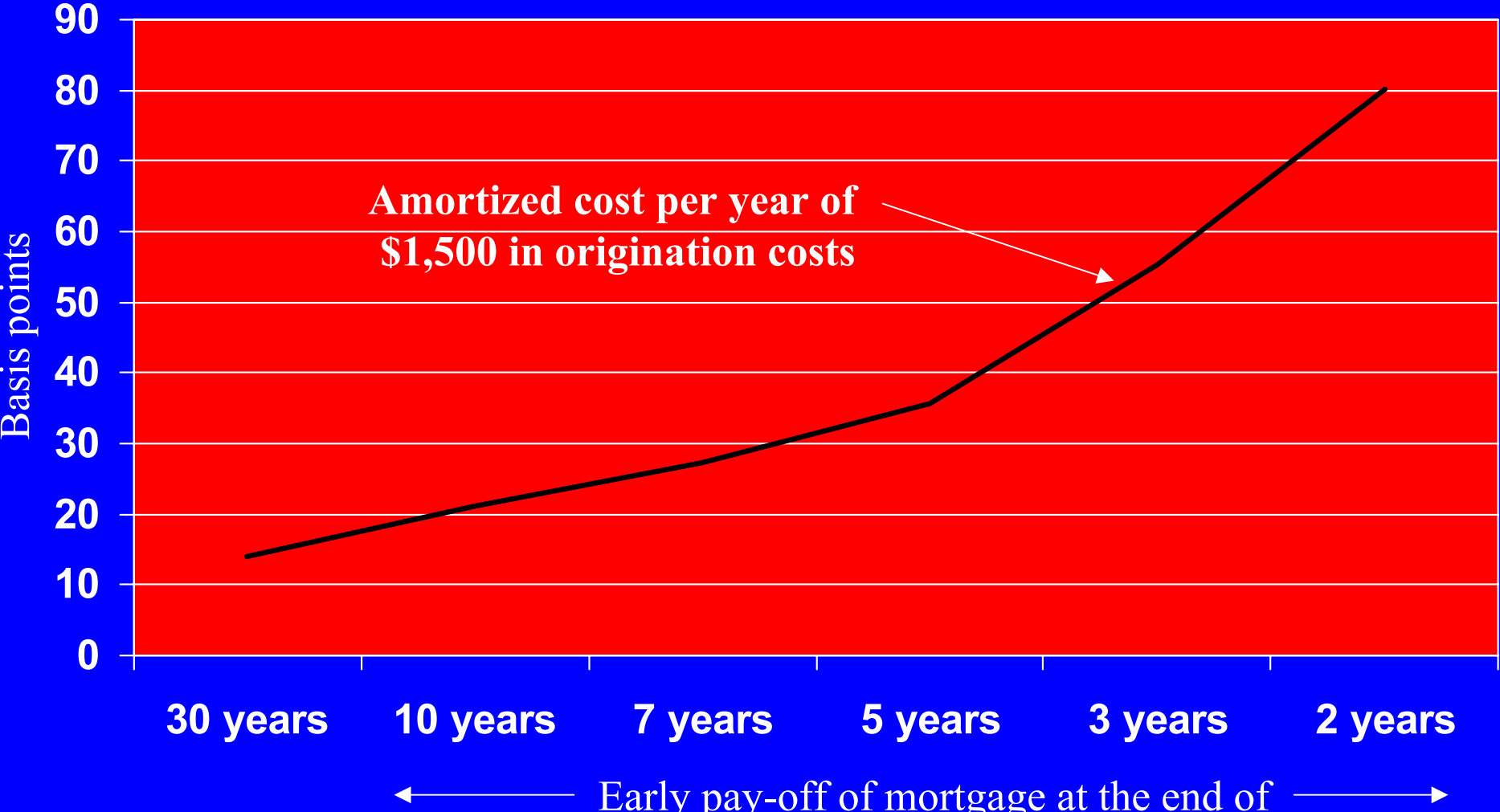
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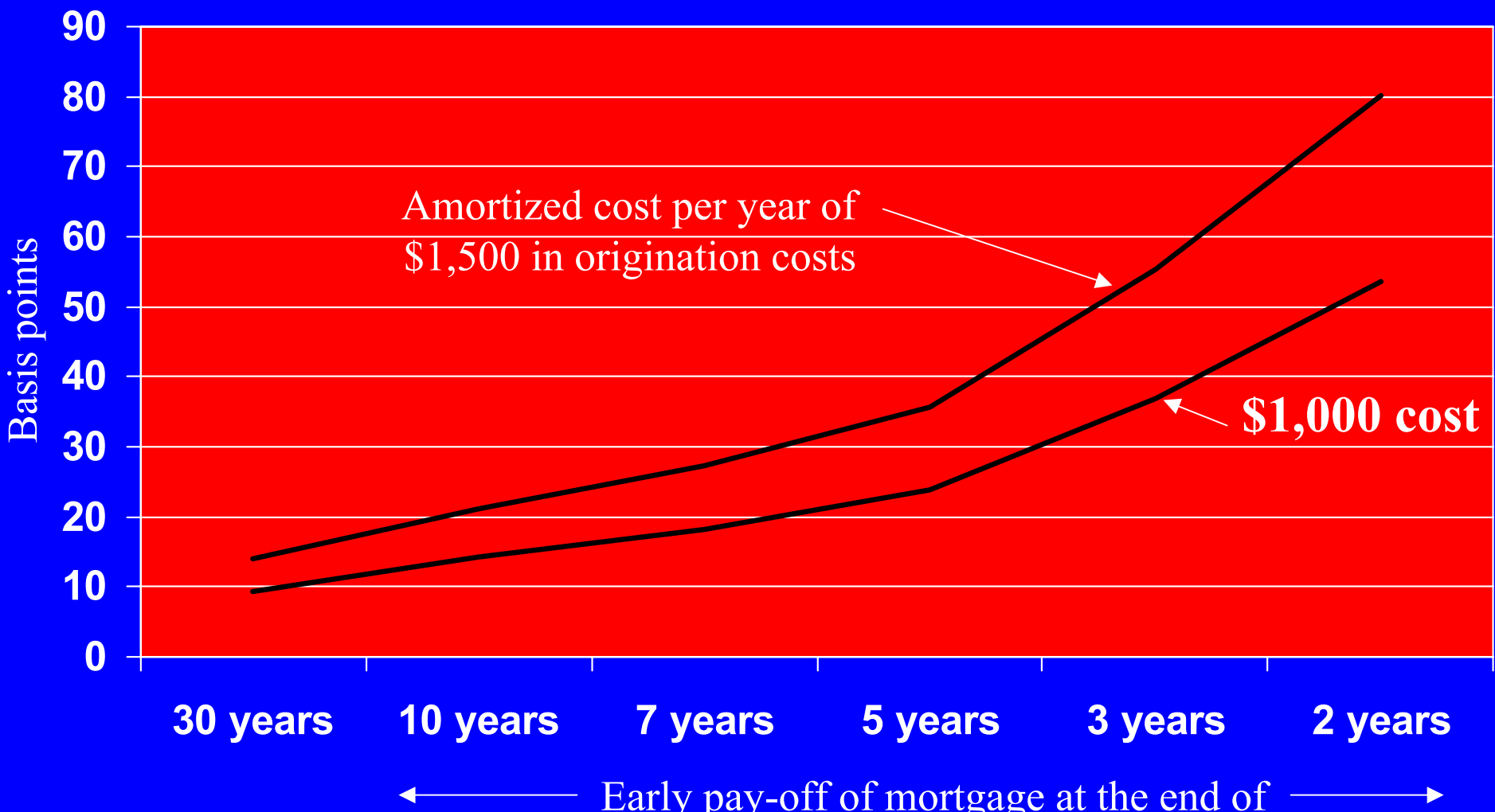
Lowering origination costs significantly reduces the effective mortgage interest rate

Based on a 30-year, \$100,000, 6% fixed-rate mortgage



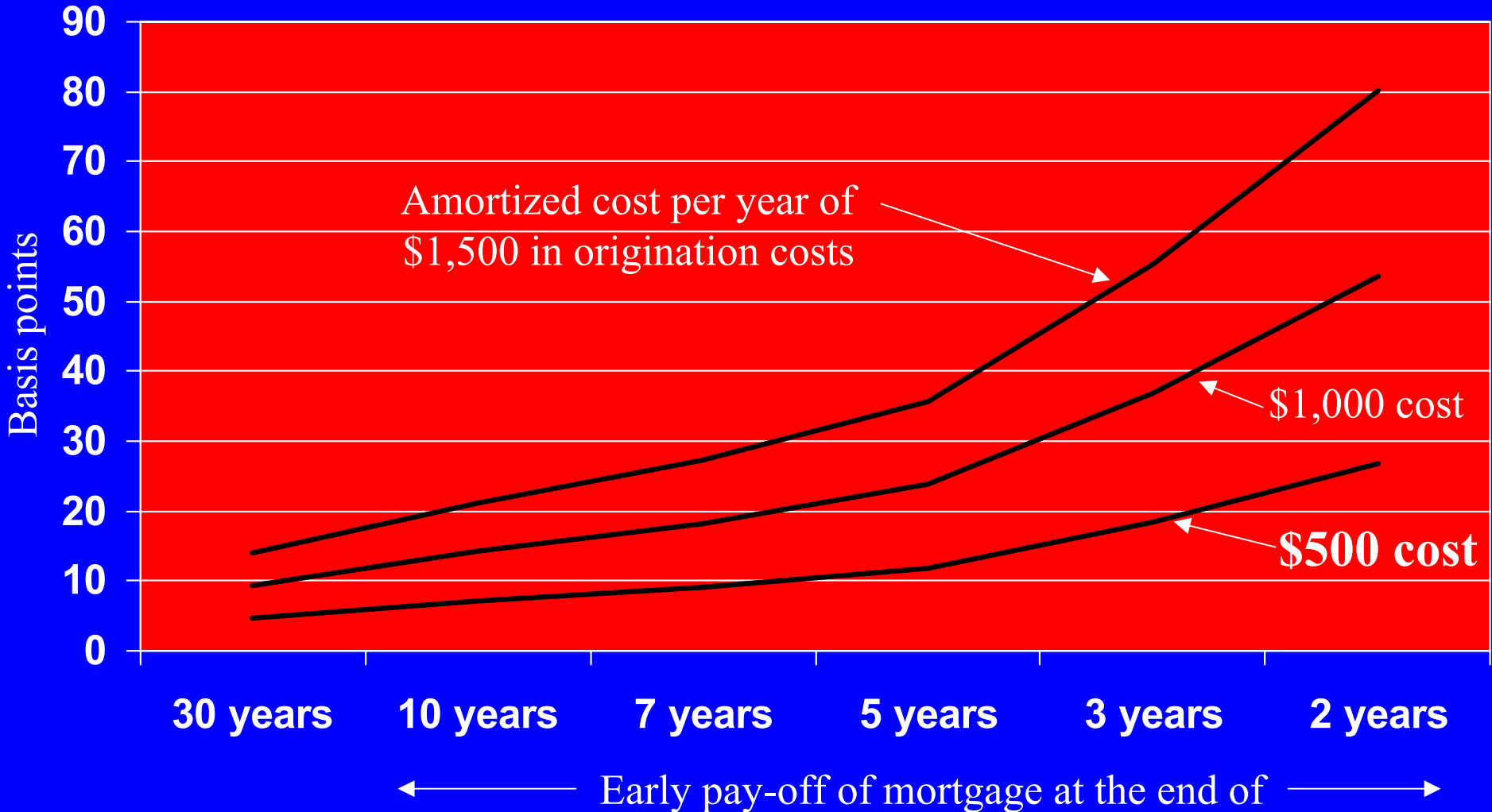
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 - **Cutting origination costs can materially lower all-in rates on mortgages that are refinanced frequently**

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- **Etc., etc., etc.**

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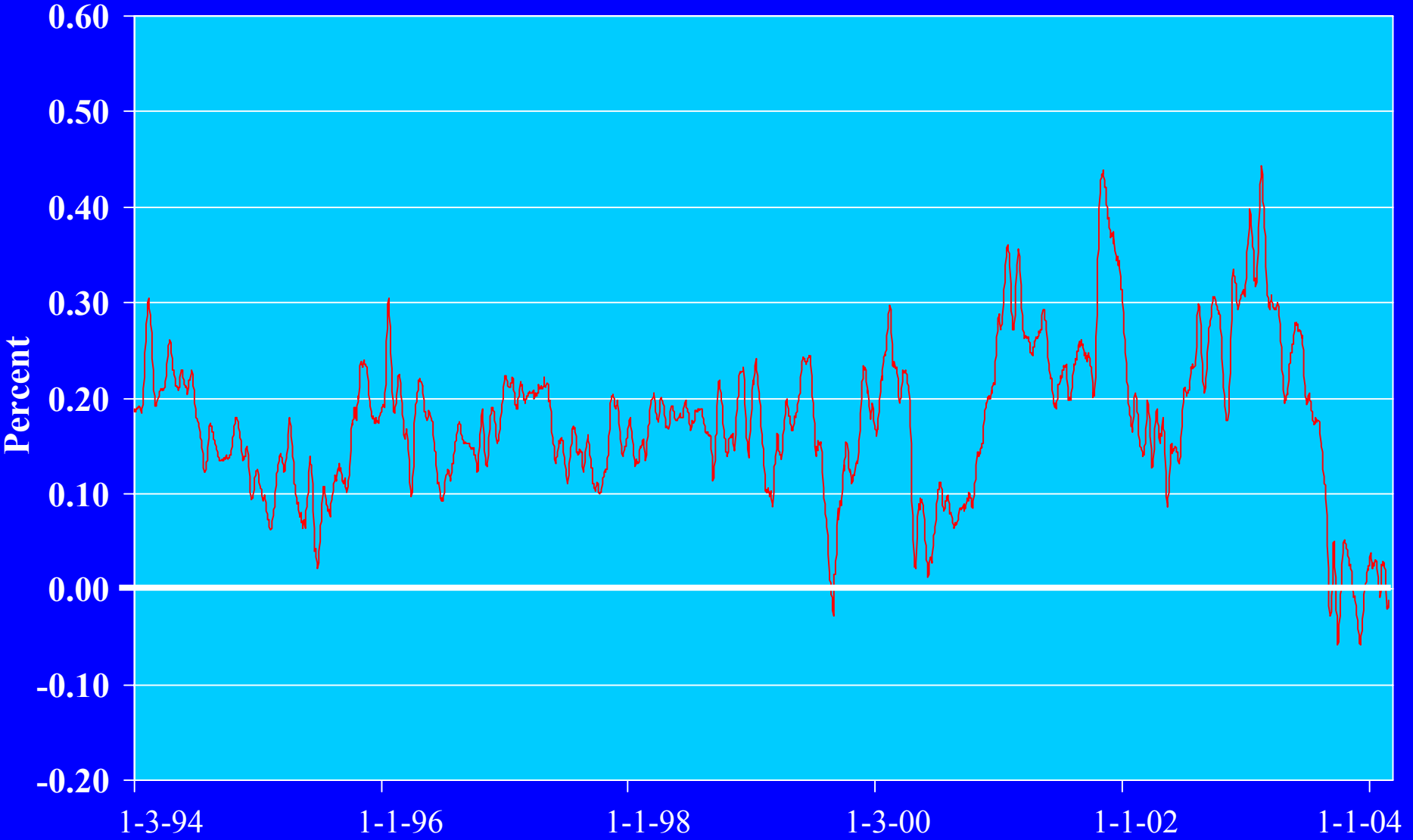
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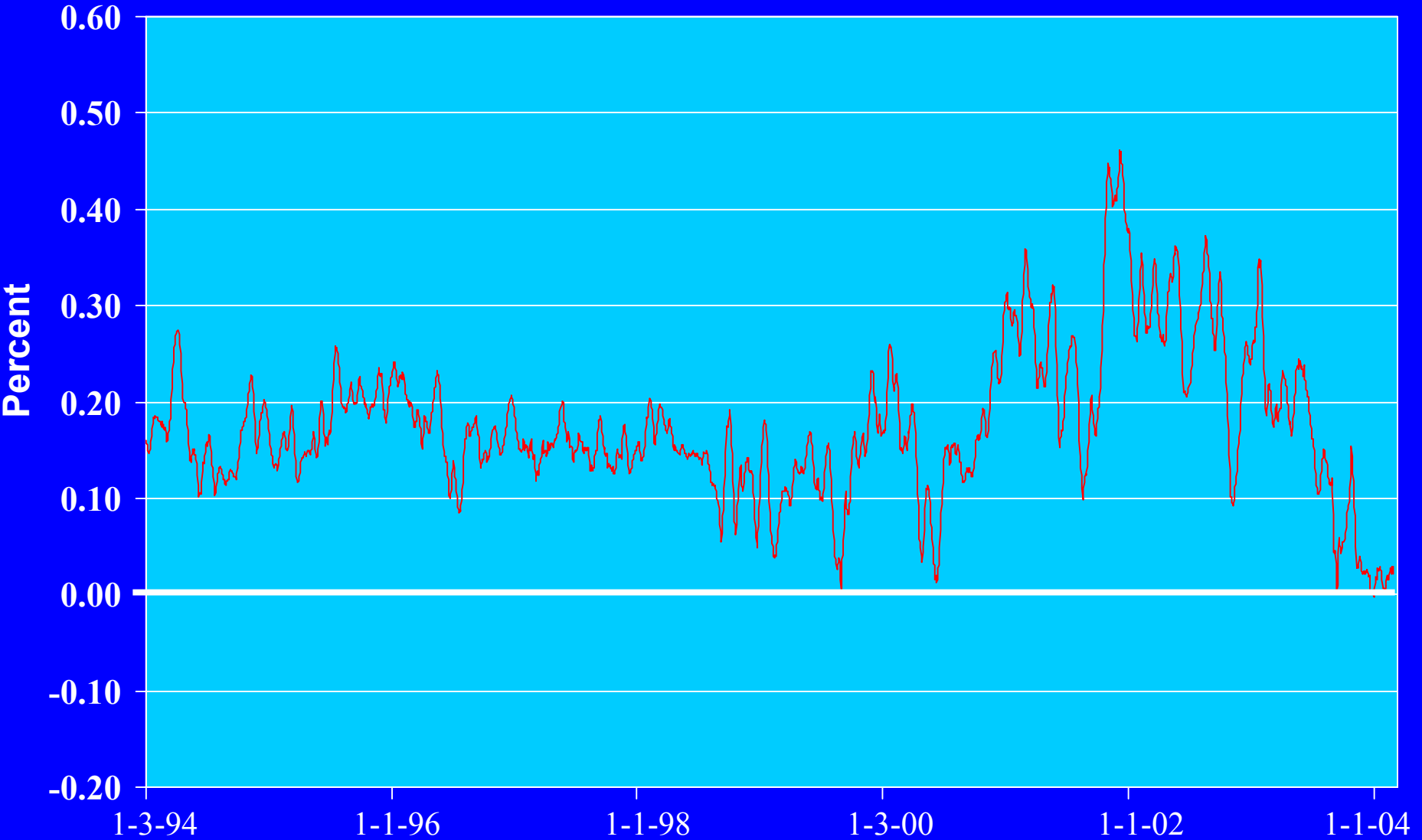
Industrial AA – Agencies, smoothed data, at 3 years

1/3/94 to 1/27/04



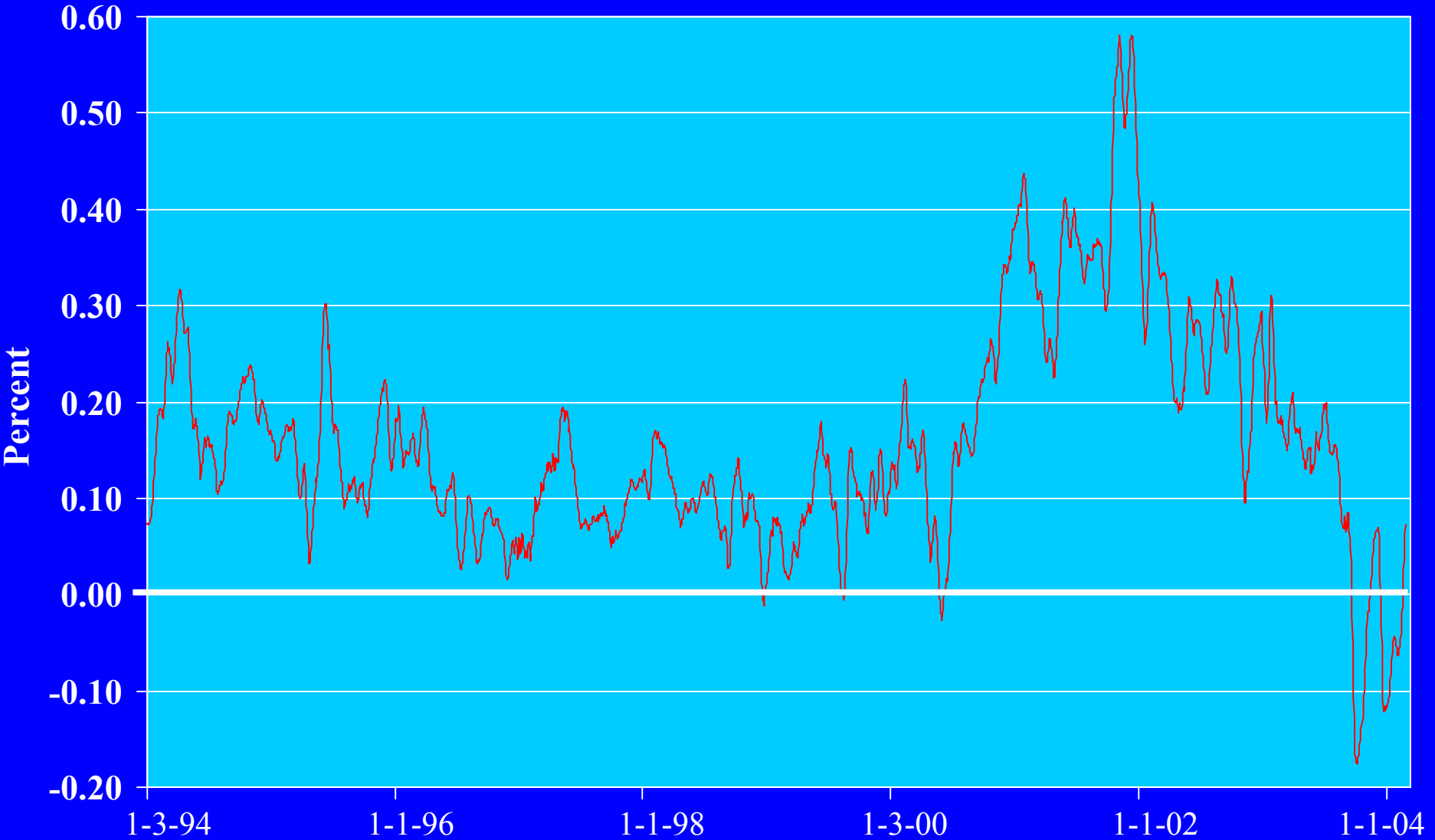
Industrial AA – Agencies, smoothed data, at 5 years

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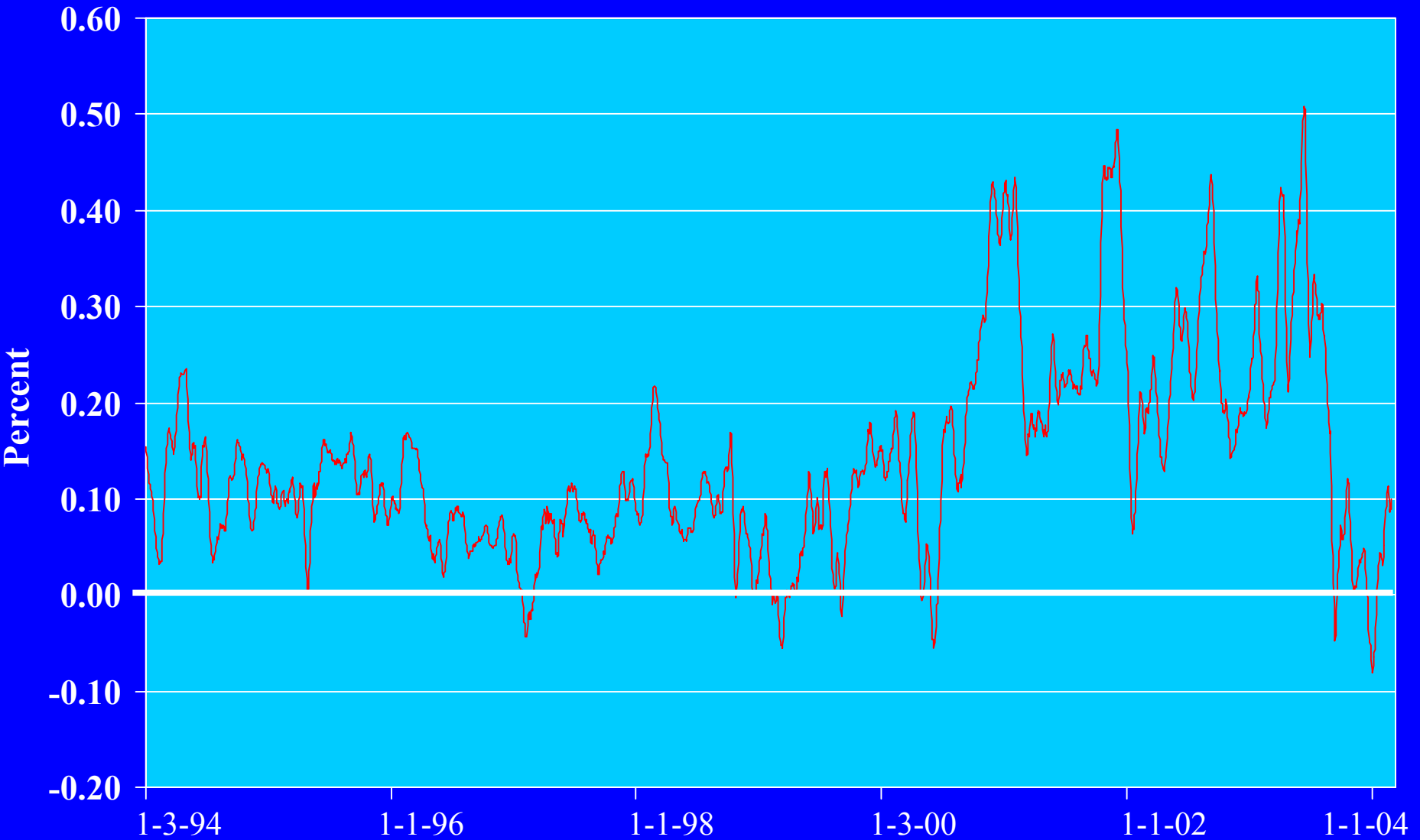
Industrial AA – Agencies, smoothed data, at 7 years

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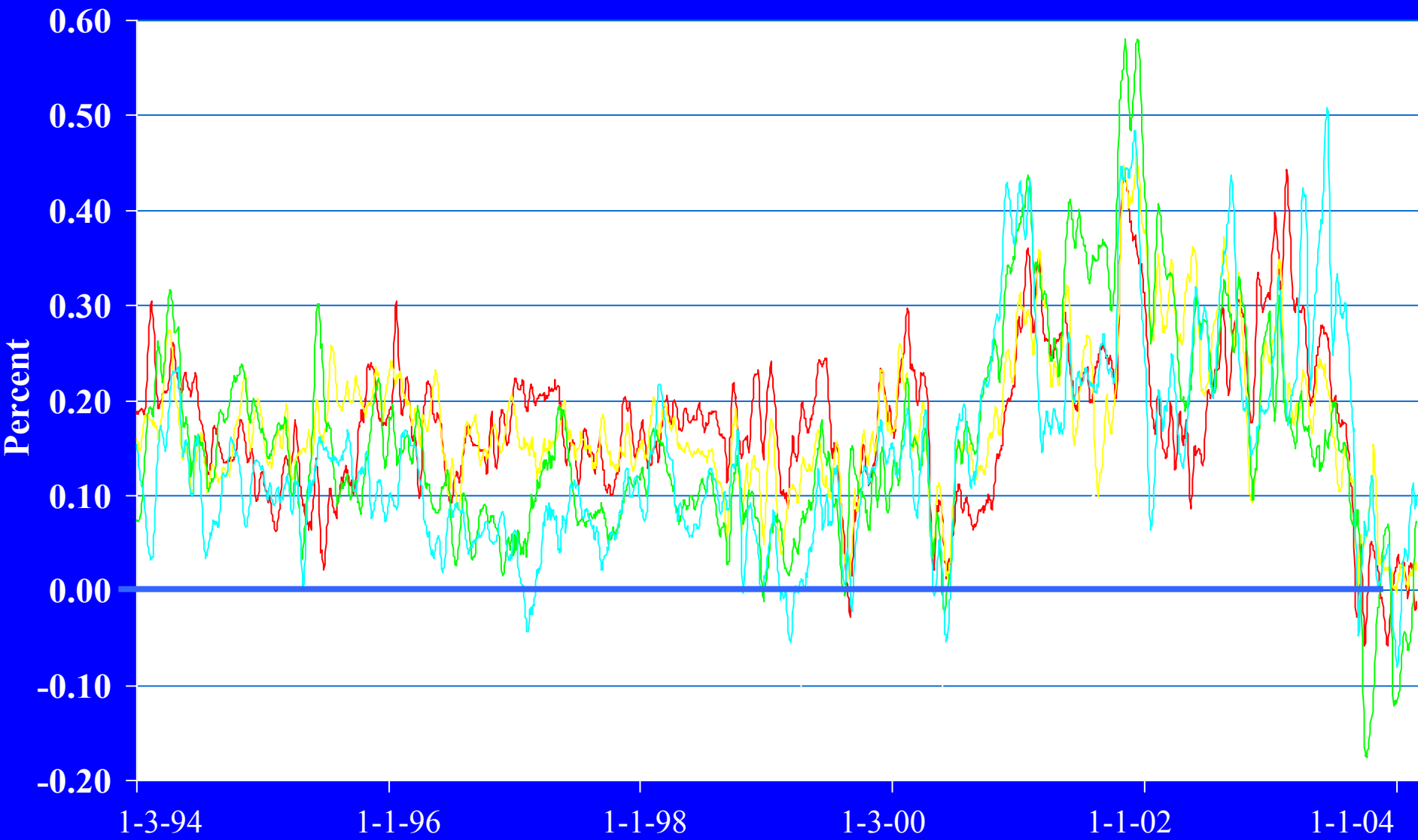
Industrial AA – Agencies, smoothed data, at 10 years

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Rate differential -- Industrial AA – Agencies, smoothed data, at 3, 5, 7, and 10 years

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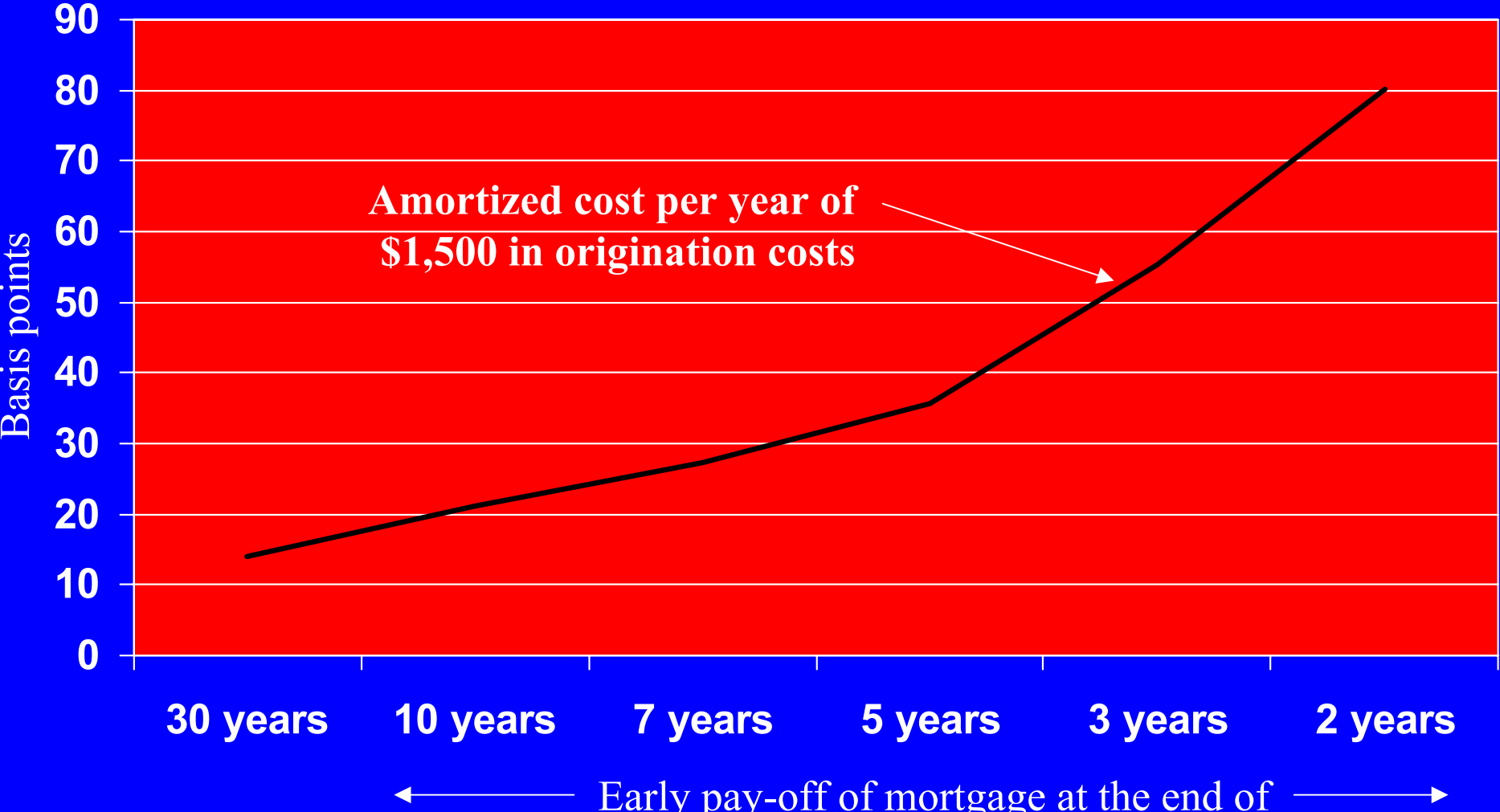
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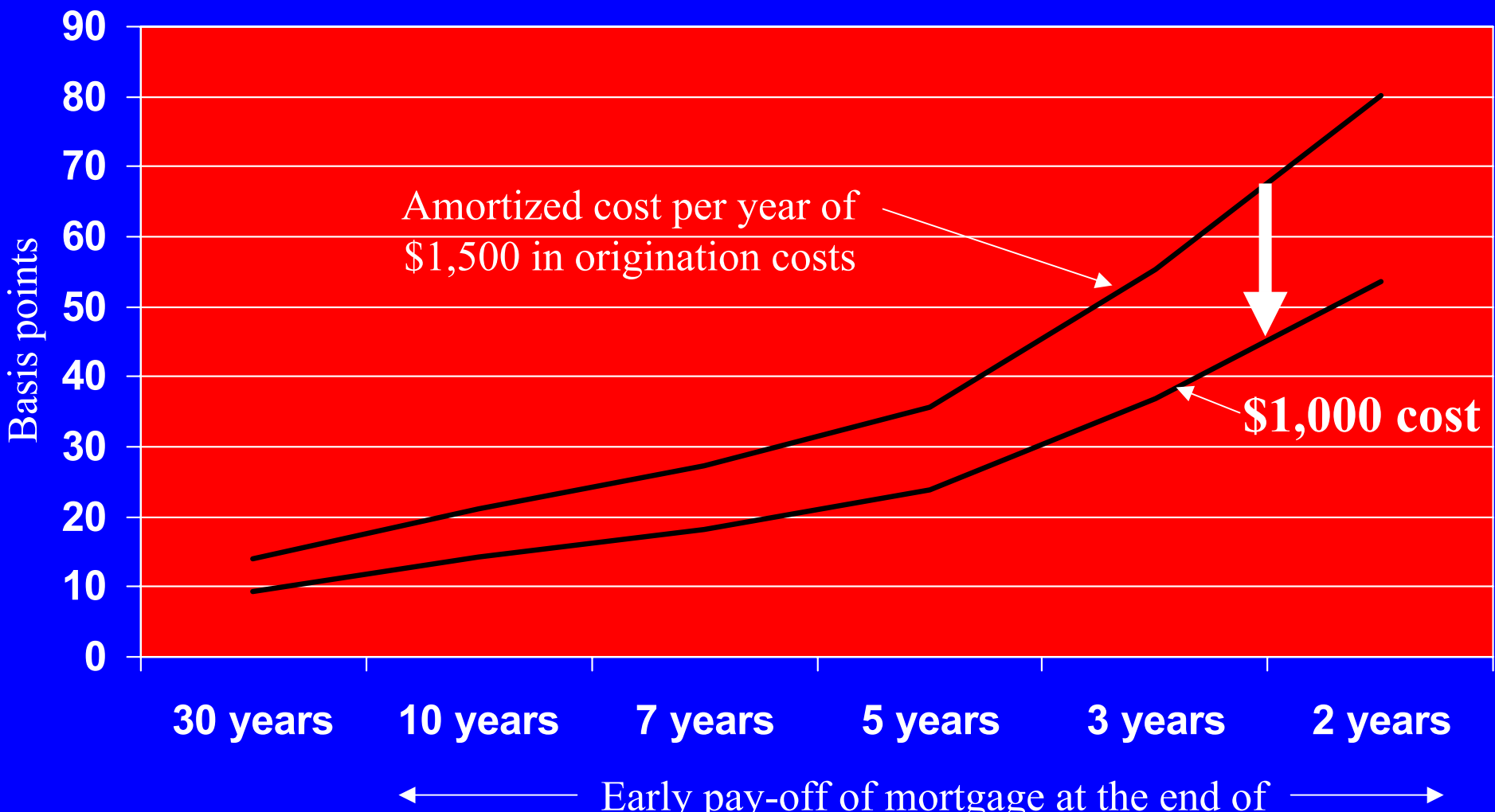
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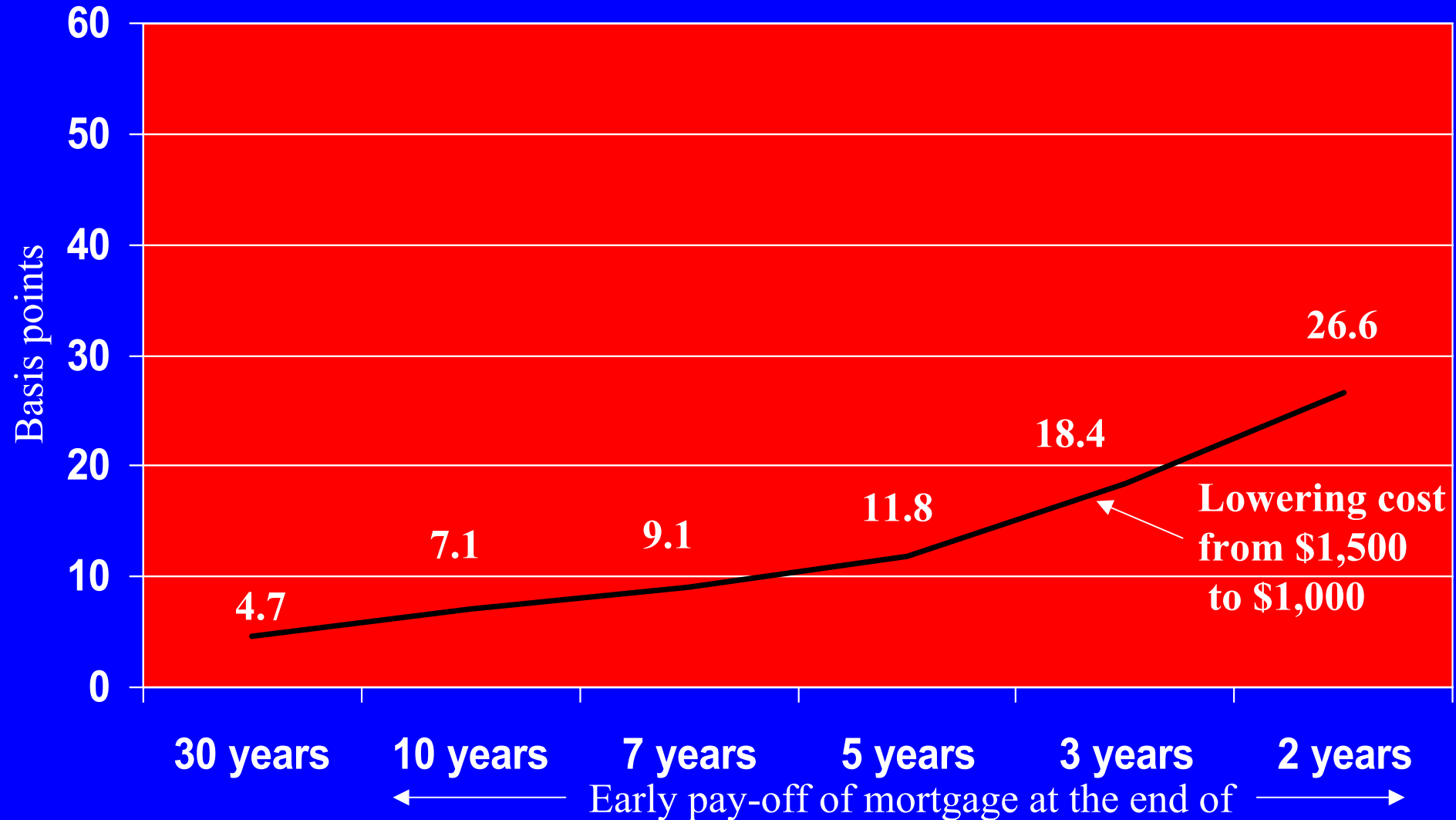
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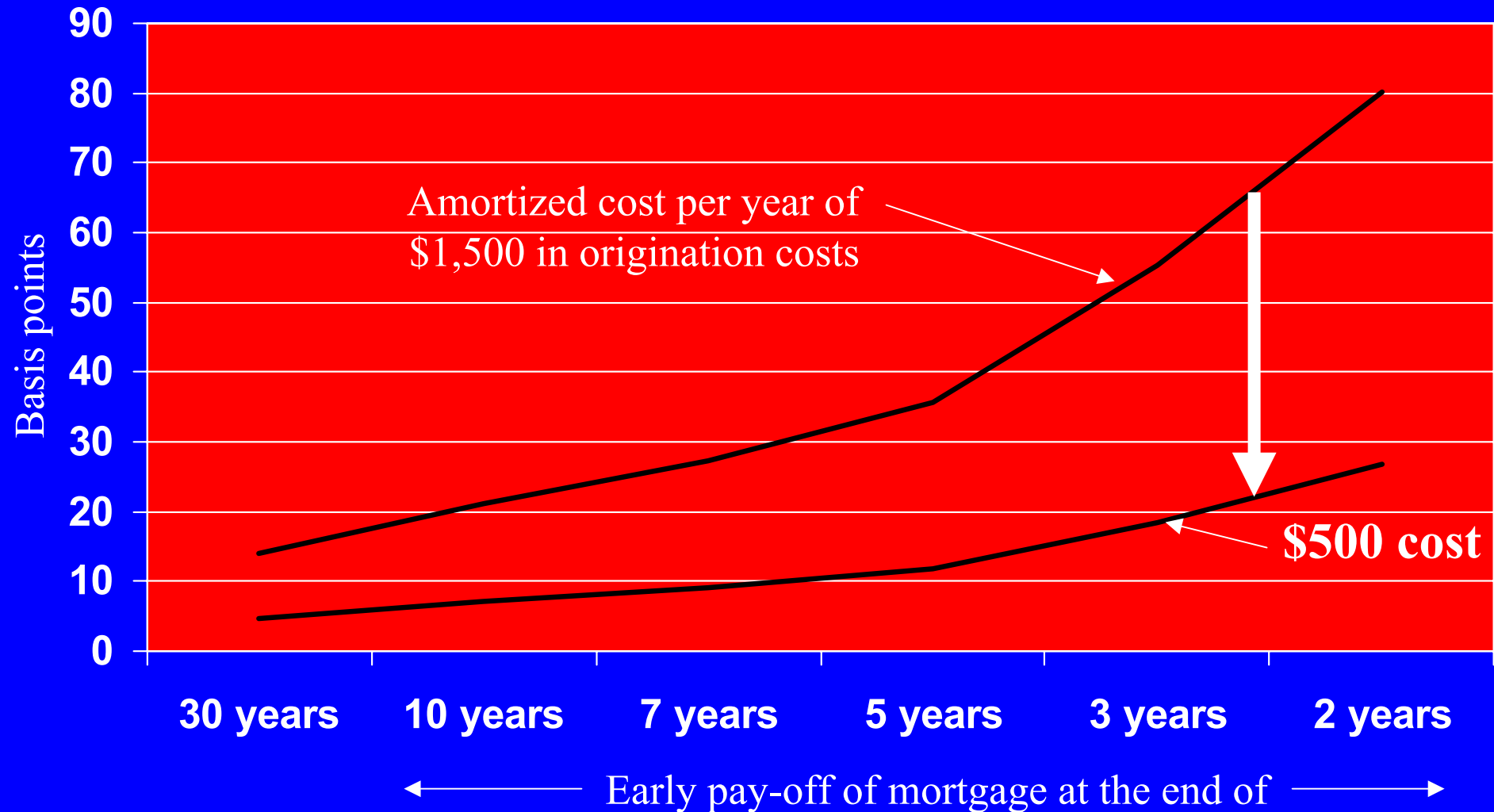
Annual reduction in effective interest rate by lowering mortgage origination costs

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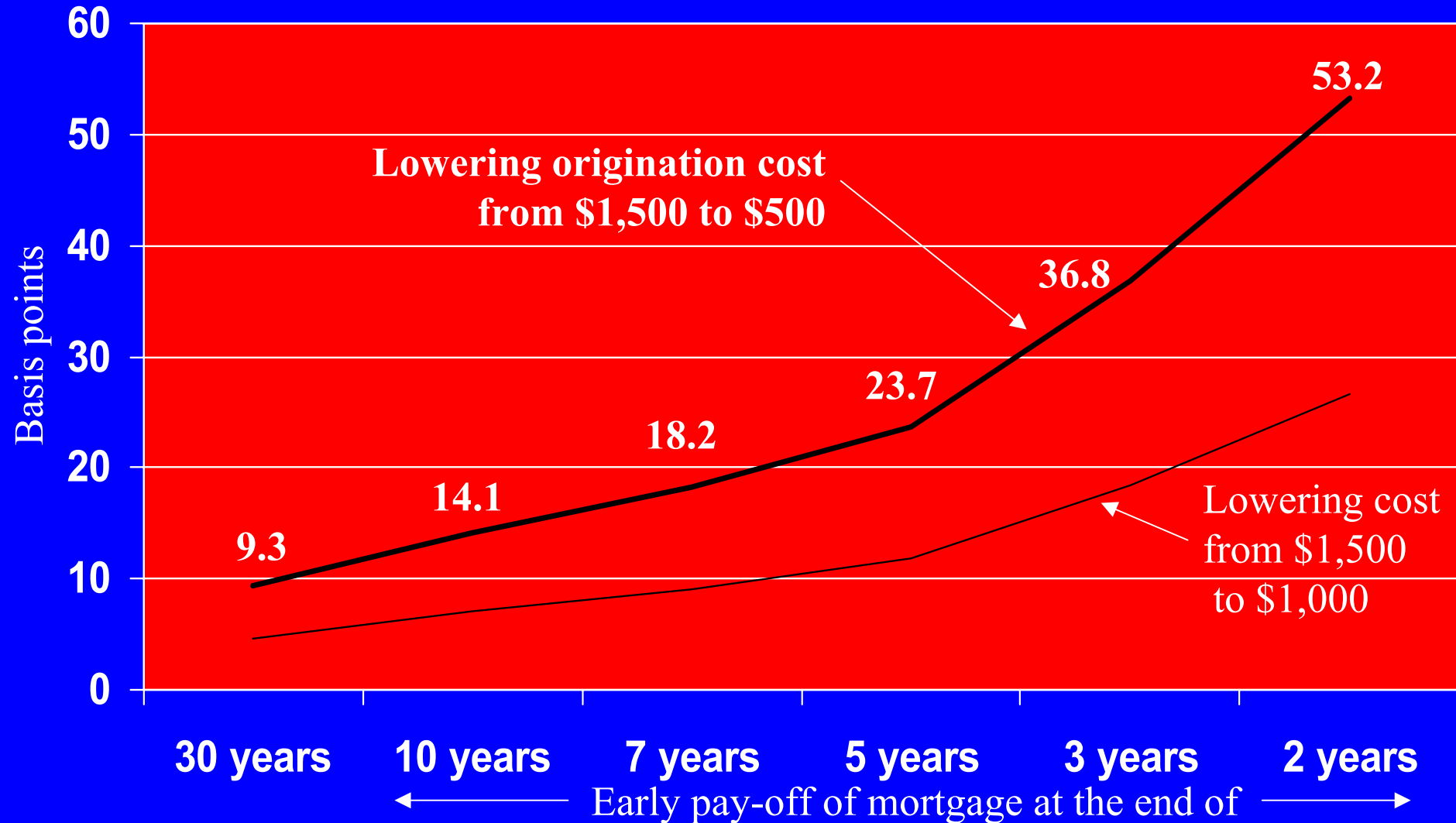
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 - **Synergies between mortgage lending and other consumer finance services provided by parent bank**

Potential MHS rate savings

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Mortgage amount \$100,000

Cost savings, in basis
points per mortgage dollar:

Origination 31

Servicing 5

Greater transparency 5

Larger financing tranches 2

Total savings 43

GSE funding advantage (20)

Net savings for borrowers 23

Potential MHS rate savings

Mortgage amount	<u>\$100,000</u>	<u>\$200,000</u>
Cost savings, in basis points per mortgage dollar:		
Origination	31	22
Servicing	5	5
Greater transparency	5	5
Larger financing tranches	<u>2</u>	<u>2</u>
Total savings	43	34
GSE funding advantage	<u>(20)</u>	<u>(20)</u>
Net savings for borrowers	<u>23</u>	<u>14</u>

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- **Mortgages and ISS liability would remain on the MHS balance sheet**

ISS concept -- continued

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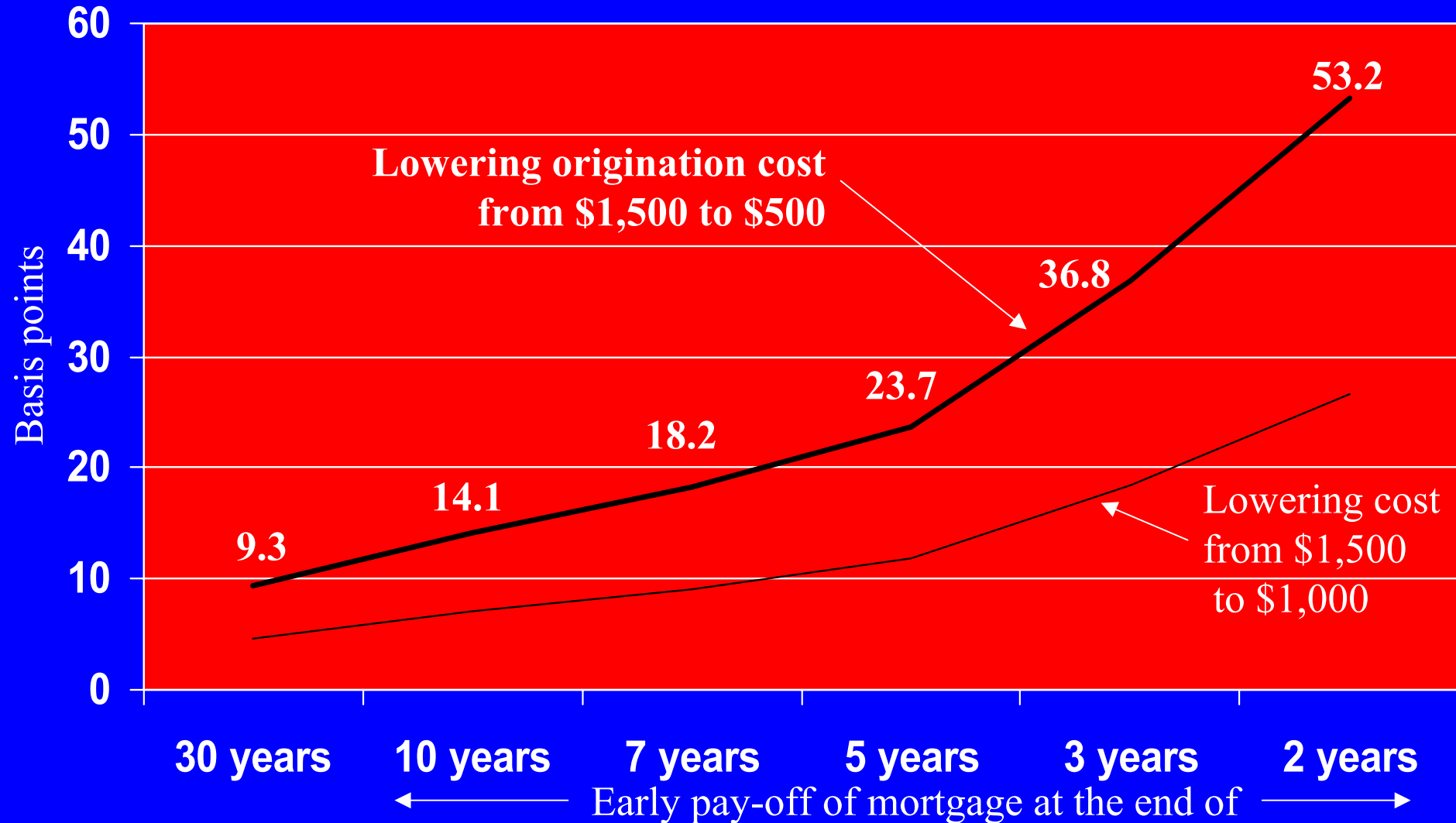
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 - **Reduced mortgage origination costs, particularly for mortgage refinances – Figure 8**

Annual reduction in effective interest rate by lowering mortgage origination costs

Based on a 30-year, \$100,000, 6% fixed-rate mortgage



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- **Sec. 407 – Conforming amendments – page 70**

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- Cost competition must be based on all-in mortgage rates, including loan origination cost amortization
- **More detailed research is needed to further quantify MHS cost savings**

Thank you!

I welcome your questions