

Can Elements of the Danish Mortgage System Fix Mortgage Securitization in the United States?

Comments by

Bert Ely

on a paper presented by Alan Boyce

at the

American Enterprise Institute

March 26, 2009

Summary of Ely comments on the Boyce proposal, the ‘Principle of Balance’ Mortgage Lending – PoB

- **I agree with Boyce that the U.S. residential mortgage market needs fixing**
 - **Need first to understand the causes of the crisis before trying to fix it – see ‘Bad Rules Produce Bad Outcomes’**

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- **I will outline two reforms that improve upon the present U.S. system for financing home mortgages**

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- **Mortgages will have full recourse to borrowers**
 - **How popular will that be politically?**

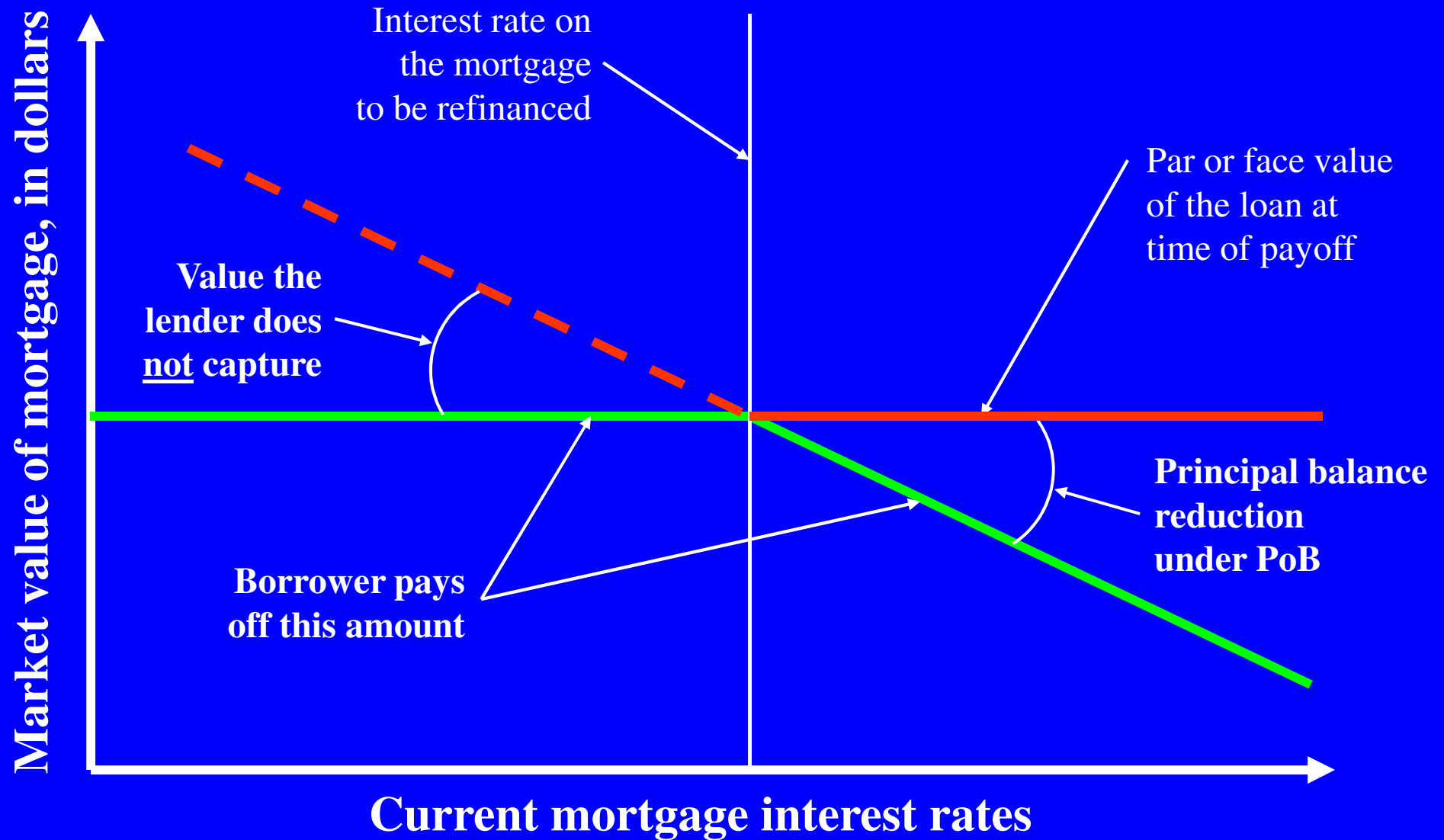
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The essence of the PoB, as I understand it



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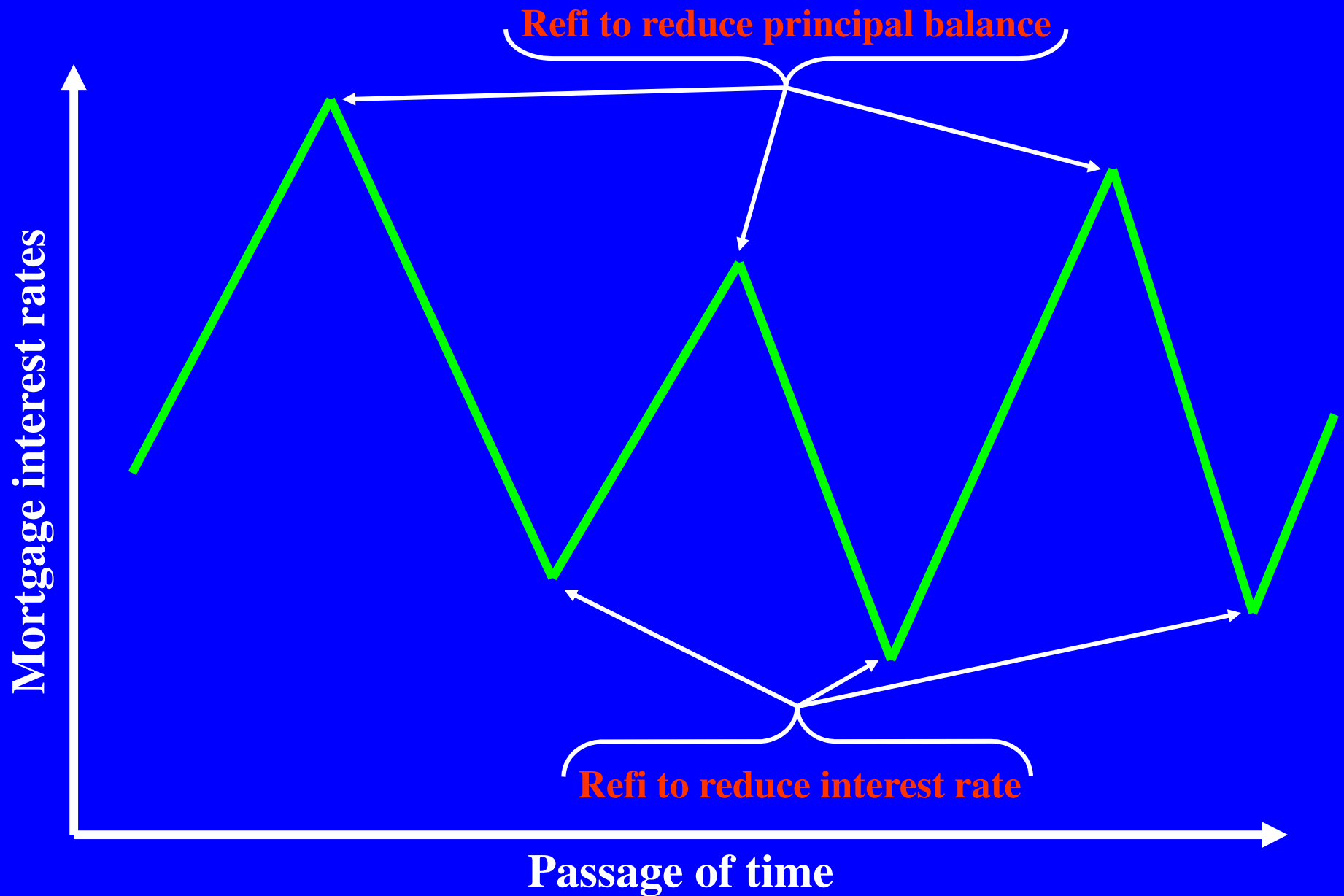
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- **PoB is asymmetrical, in the borrower’s favor – serial refinancings are great for the borrower**

Serial refinancings great for the borrower



PoB is costly to lenders, a cost which they must recover through higher rates

- **Upon each refinancing, the lender either**
 - **Gets back less than face value, which he reinvests at a higher rate, but for a shorter expected duration**
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- **For a given mortgage rate and a given set of interest-rate fluctuations, over time a PoB lender will earn a lower return than a non-PoB lender**
 - Due to the fact that the lender has less to reinvest when high rates trigger a refinance
 - PoB lenders must compensate with higher mortgage rates

Other problems with PoB

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- **The requirement for “highly standardized loans” introduces rigidity into mortgage lending, impeding innovation**
 - **Are highly standardized loans practical for the U.S.?**
 - **Is transparency needed if credit risk not transferred?**

A PoB contradiction?

An MCI conflict-of-interest?

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An MCI conflict-of-interest?

- “MCIs act as ‘liability advisors’ to the homeowners . . . mortgage advisors have an incentive to get homeowners only into those loans that make sense for that family”
- **“MCIs must also make all efforts to make the prepayment characteristics of its bond series no worse than that of its competitors for investors. This creates an incentive for MCIs to make loans to those homeowners who have a lower probability of refinancing, including first time homeowners and others who have been underserved in the past”**

My recommended innovations

- **Covered bonds**
 - **On-balance-sheet borrowing secured by mortgages**

Balance sheet of a covered-bond issuer

Assets

= Liabilities + Capital

Assets in the
cover pool
(1xx% of
covered
bonds
outstanding)

Other types
of loans and
other assets

Covered
bonds
outstanding
(secured by
the cover
pool)

Other
liabilities

Equity capital

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 - **Eliminates the need to securitize mortgages by permitting the mortgage originator to hold the mortgage in portfolio without incurring severe maturity mismatch**
 - **Permits mortgage credit risk to be held within diversified lenders**
 - **Greatly reduces the need for mortgage standardization**
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 - **Ratchet mortgages will work with covered-bonds**

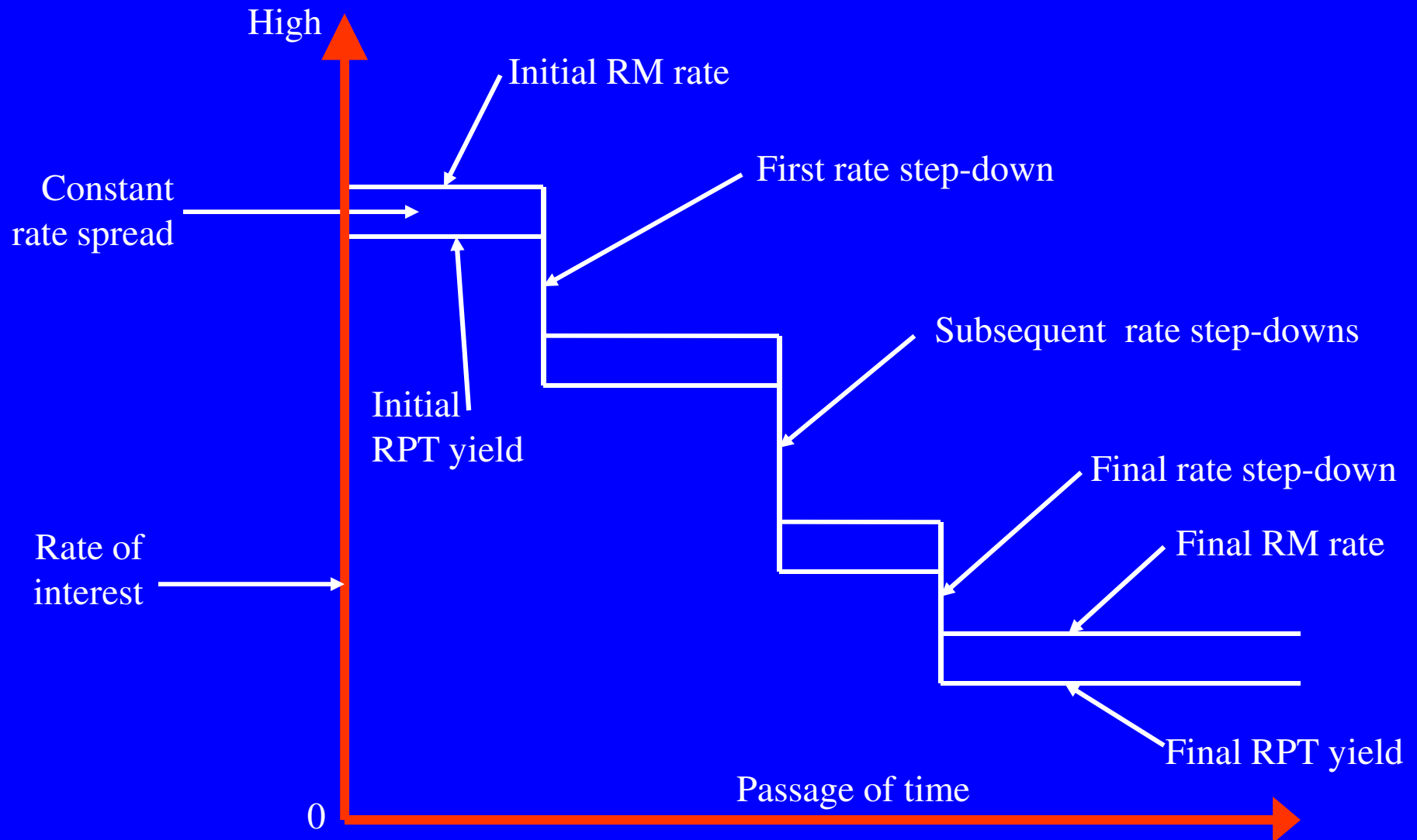
The Ratchet Mortgage™ concept

- **A Ratchet Mortgage™ (RM) is the functional equivalent of a series of refinanced, fixed-rate mortgages (FRM)**
 - **The RM's interest rate indexes down in sync with a published index, but the RM rate does not rise if the index later rises**
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The RPT yield automatically declines as the RM rate ratchets down



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- **RMs will bring many benefits to originators, including**
 - **Better customer retention since borrowers won't refi away**
 - **A more profitable mortgage business**
 - **Less volatile mortgage origination activity**
 - **Greater cross-selling opportunities**

Thank you!

I welcome the discussion