Secondary mortgage markets — national or international?

Mark Boleat concludes that there is only limited scope for international secondary mortgage market operations

A MAJOR financial trend is the tendency towards the globalisation of the capital markets. Leading financial and commercial companies now raise funds in a number of financial centres, and the markets in London and Tokyo are competitive with that in New York. Partly, this reflects the fact that many businesses now operate on an international scale, but it also reflects the deregulation of the financial markets generally. The bond market is now international, and equity markets are increasingly becoming international. Not surprisingly, therefore, the possibility of mortgage markets becoming international is being seriously considered. To some this seems a natural follow-on from the development of secondary market activity in the US, and already a number of American institutions have successfully sold mortgage-backed securities on the international financial markets.

This article considers the theoretical aspects of secondary mortgage market operations, briefly describes the huge American secondary market and the emerging British secondary market, and finally discusses the possibility of international secondary mortgage market operations, and their relevance to developing countries.

Theoretical issues

Traditionally, in most countries, the

same institutions have made, serviced and held mortgage loans. That is, a building society, savings bank or mortgage bank makes a loan to a house-buyer, handling all the administrative arrangements; collects the regular repayments, dealing with any repayment difficulties; and holds the loan in its own portfolio, financing it by retail deposits or wholesale market funding.

Where the lending institution is not a deposit-taking body, for example, a mortgage bank, it will probably not have the branch network and customer contact with which to obtain new mortgage business directly and therefore may obtain its business through introductions, perhaps from banks or from brokers. In some cases the introducing agent may actually do some of the initial work in setting up the loan, while in other cases a mortgage bank may obtain business from related institutions in a group. For example, the public mortgage banks in West Germany obtain their business partly through introductions from the savings banks which collectively own the parent institutions of the mortgage banks, the landesbankes.

Once a loan has been set up it has been normal for the lending institution to continue servicing it; in most countries the possibility of the lender selling part or all of a loan portfolio has not been seriously considered. Theoretically, however, there is no reason why the processes of making loans, servicing them and holding them should be integrated. The qualities needed for each type of activity are not identical. In order to make loans, one needs regular contact with consumers and this is likely to mean high street branches and a large number of customers or, alternatively, contact with customers at the time they are purchasing a house, for

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example, through house-builders or real estate agents.

To hold loans, the main requirement is access to the cheapest source of long-term finance. In some countries, deposit-taking institutions may be in this position, while in others institutions which obtain their funds on the wholesale markets may be better placed. There is no particular reason why an institution which is well placed to obtain mortgage business should necessarily be well placed to hold long-term mortgage loans.

Servicing mortgage loans is, relatively speaking, a mechanical operation open to almost any institution with a reasonable computer facility.

One major trend in housing finance markets has been towards diversifying sources of funds. Deposit-taking institutions, such as savings associations and building societies, have increasingly used the wholesale markets as this has offered them, in many cases, cheaper funds than the retail markets and certainly more stable long-term funds. However, tapping long-term sources of funds in this way does not imply a secondary market.

As mortgage markets have become more competitive so financial institutions which traditionally have not held mortgage loans have been increasingly attracted to them. Mortgages generally offer a premium over other investment opportunities but the obstacle to institutions such as insurance companies and pension funds holding mortgage loans has been the difficulty of dealing with a large number of customers and handling the regular monthly repayments.

There are several ways in which financial institutions, with access to large sources of funds, can fund the housing market:

(a) By direct lending to housebuyers, the method used predominantly by banks.

(b) By direct lending to housing finance institutions.

(c) By purchasing marketable securities such as certificates of deposit or Eurobonds issued by housing finance institutions.

(d) By purchasing loans or securities backed by mortgages.

Each of these four options achieves roughly the same result, but only one of them involves a secondary market. Here it is important to recognise that a secondary market is only a means to an end. It is a method of channelling institutional funds into the housing market, and any such method is likely to improve the competitiveness of the mortgage market, generally to the benefit of consumers.

It is necessary to consider the four methods of institutional funding of the housing market to illustrate the role of secondary market operations.

Direct lending to house buyers is for the most part attractive only to retail financial institutions such as building societies, savings associations, savings banks and commercial banks. Such institutions already have a large customer base and have the computer and other facilities capable of handling the rather messy business of making long-term mortgage loans and receiving the monthly repayments.

Direct loans from institutional investors to housing finance institutions is an alternative method of operation. This system is already used in many countries, particularly by linked institutions. For example, in the Netherlands the Rabobank makes loans to its subsidiary mortgage bank, and in France the Compagnie Bancaire makes direct loans to one of its subsidiaries, the Union de Crédit pour le Bâtiment.

With the increasing trend towards securitisation it has become more attractive to both housing finance institutions and institutional investors for the latter to fund the former by purchasing marketable unsecured securities rather than by making direct loans. These give liquidity to the institutional investor, while providing a steady source of funds to the lender. Many mortgage banks operate in this way while building societies and savings institutions have increasingly raised funds through certificates of deposit and Eurobonds.

Secondary market operations can be seen as a special case of housing finance institutions obtaining their funds through issuing securities, the refinement being that the funds raised are backed by mortgage loans or result from the sale of such loans. It is inevitable that in any portfolio of mortgage loans there will be some bad loans, so the institutional investor will want the loans to be insured. He will also require a higher rate of interest than, for example, on government securities to compensate for the fact that the loans are likely to be prepaid prematurely.

For a housing finance institution, the motives for raising funds through the secondary mortgage market can vary. For many institutions it may be possible to obtain funds at a cheaper rate by using the secondary mortgage market than by raising funds on an unsecured basis. More importantly, perhaps, all financial institutions have to maintain capital and if assets can be got off the balance sheet for capital adequacy purposes then a given amount of capital can be used to fund a greater amount of activity. If a housing finance institution can make loans and sell them it has the opportunity to earn fee income from making the loans, it may be able to sell the loans at a premium and if it continues to service the loans it will also earn fee income.

The secondary market in the United States

The US is the only country which has a significant secondary mortgage market, and that market has grown rapidly in recent years. The original rationale for the American secondary market was to overcome regional imbalances caused by restrictive legislation. The bulk of savings were raised in the long established centres on the East coast, while the demand for funds was predominantly in the developing areas of the South and West of the country. Banks and savings associations were largely confined to operating within individual states and a secondary market was needed to switch funds between parts of the country.

The secondary market in America then developed further partly because of the activities of a number of government and quasi-government agencies. They helped to establish two important variables which are essential if secondary mortgage market activity is to be achieved:

(a) Uniform lending criteria. The secondary market in America has led to the adoption of standard criteria and also standard forms for mortgage applications and appraisals. Government bodies which purchase mortgage loans or guarantee them have effectively determined the criteria for mortgage loans which may subsequently be used as security for mortgage-backed securities.

(b) Insurance of mortgage loans.

The American secondary market was given a considerable impetus in the late 1970s and early 1980s as a result of the financial crisis which affected the American savings institutions. They had been forced to borrow short and lend long, which inevitably caused problems when interest rates rose rapidly. The institutions simply did not have access to long-term sources of finance at fixed rates of interest, yet they had been forced to lend long-term at fixed rates. By selling mortgages they were effectively laying-off the interest rate risk, and the institutions which bought mortgages could fund them through long-term fixed rate financings.

The extent of the secondary market in America is shown in the accompanying table. The principal originators of mortgage loans are thrift institutions, that is, savings associations and savings banks, commercial banks and mortgage banks. The latter institutions originate and service loans and do not hold them long term in their portfolio. Mortgage banks effectively sell all the mortgage loans which they originate, but increasingly thrift institutions also sell a high proportion, in particular those made at fixed rates of interest. Purchasers of mortgage loans include thrift institutions (which may well purchase mortgage backed securities backed by loans which they themselves have made) and the federal agencies which then fund their operations by issuing mortgage backed securities which are purchased by a variety of institutional investors.

A number of government or quasi-government agencies effectively make the secondary mortgage market work.

The *Government National Mortgage Association* (GNMA) operates within the Department of Housing and Urban Development and works through the mortgage backed securities programme by which privately issued securities backed by mortgages insured by the Federal Housing Administration, the Veterans Administration and the Farmers Housing Administration are guaranteed. The initial lender markets and administers these securities and GNMA earns its income through charging a guarantee fee.

The *Federal National Mortgage Association* (FNMA) purchases mortgage loans, holding them in its own portfolio, and financing these by a variety of funding instruments. More recently, FNMA has begun to sell mortgage backed securities backed by its own loans.

The *Federal Home Loan Mortgage Corporation* (FHLMC) purchases mortgage loans and then re-sells them by means of mortgage participation certificates.

The importance of these institutions is that not only is the institutional investor purchasing mortgage backed securities: generally there is

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USA Residential Mortgages, 1985

Institution	Originations		Sales		Purchases		Net Acquisitions		Net Acquisitions of Mortgage Related Securities		Total Source of New Housing Credit	
	$m	%	$m	%	$m	%	$m	%	$m	%	$m	%
Thrifts	143,753	50	102,566	52	55,145	25	96,332	62	7,856	5	104,188	34
Commercial banks	56,622	20	18,154	9	5,828	3	44,296	29	11,693	8	55,989	18
Life insurance companies and pension funds	4,176	1	1,655	1	964	—	3,485	2	26,886	17	30,371	10
Federal agencies	5,154	2	884	—	133,540	60						
State and local agencies	4,870	2	0	0	6,005	3						
Builders	4,053	1										
Mortgage banks	66,201	23	75,505	38	20,997	9						
Others							10,625	7	107,370	70	117,995	38
Total	284,829	100	198,764	100	222,479	100	154,738	100	153,805	100	308,543	100

Source: Freddie Mac, *Secondary Mortgage Markets,* Summer 1986.

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some form of government backing as well.

Many countries look to the American experience to see if it is applicable to their countries. In considering this the following points need to be noted:

(a) The American secondary market grew in response to the peculiar American situtation, in particular, restrictions on interstate activity and regulations which effectively forced the housing finance institutions to borrow short-term at variable rates and lend long-term at fixed rates.

(b) The American secondary market is dependent on the activity of the governmental agencies which transform mortgage backed securities into government backed securities.

The British secondary market

Britain has a very sophisticated financial system and has a housing finance system which in principle is not dissimilar to that of the US. Nevertheless, there is only a tiny amount of secondary mortgage market activity in Britain. Building societies, the principal lenders, have traditionally raised their funds through short-term retail deposits. Over the past few years they have seen a necessity to diversify their sources of funds and have raised substantial amounts from the wholesale markets, through certificates of deposit, Eurobonds, bank loans, tender facilities and other instruments. However, societies have not had to pledge any of their mortgages as security for this form of financing and have not, as yet, issued any form of mortgage-backed securities.

This partly reflects the fact that British building societies are mutual institutions and the holders of unsecured wholesale deposits or Eurobonds rank before their ordinary investors who provide most of their funds. However, building societies do have capital requirements and they are also subject to a limit of 20% on funds which they may raise from wholesale sources. There is provision for this limit to be increased but to no more than 40%. If building societies start bumping up against this limit then they may well be attracted to using the secondary market as a method of increasing their mortgage business while staying within the limit for wholesale funding.

However, an embryonic secondary mortgage market is beginning to emerge. The British mortgage market has now become much more competitive and mortgage rates have settled down at an attractive premium over money market rates. The mortgage loan is therefore now an attractive investment for institutional investors and five mortgage companies have been established by institutional investors to take advantage of this. These institutions are all funded from the wholesale markets and obtain their mortgage business through introductions from estate agents and insurance companies. Three of the companies have now made issues of mortgage backed securities. However, the cost of the funds generated in this way is higher than the cost of the wholesale funds which building societies are able to raise unsecured from the wholesale markets.

'Mortgage loan an attractive investment'

The extent to which the secondary market in the UK will develop, will depend to a large extent on how building societies react to the new market position. If they continue to be restricted in the extent to which they can raise wholesale funds then the secondary market may well grow considerably as this will be an attractive method of funding for societies. If, however, they are allowed to raise more funds on their balance sheet then most would probably prefer to continue their funding on the balance sheet as long as they can do so within their capital adequacy requirements.

International secondary market operations

Mortgage backed securities issued by American institutions have been sold in the international financial markets and the same applies to the three issues of mortgage backed securities by British institutions. In deciding whether to purchase these securities, an international investor will first consider in what currency he wishes to hold securities. If he wishes to hold dollars then that decision is taken first and the various dollar instruments are considered. The high yield on mortgage backed securities will be an advantage but the uncertain prepayment pattern will be a disadvantage and the investor will have to make his own decision. The same would apply to anyone purchasing a mortgage backed security denominated in sterling. The initial decision to take is what currency does the institutional investor wish to invest in, and then the mortgage backed securities are examined against other investment opportunities.

It follows that an international secondary market is simply not realistic as a means of increasing the flow of mortgage funds to countries which are unable to attract international funds because of the exchange rate risk. In some cases a central bank or commercial bank may be willing and able to take the exchange risk and where this is the case, foreign funding for mortgage institutions, through a secondary market or more conventional loans, can be achieved. However, for most countries this is simply not feasible.

In many countries, there is perceived to be a shortage of funds for house purchase and naturally one is inclined to look to the secondary market, national or international, as a method of raising more funds. While in some countries this may be

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appropriate, it is important not to see a secondary market as a panacea. The first critical point is that a secondary market can operate only where the yield on mortgages is higher than the yield on, for example, government securities, which, by definition, offer better security, greater liquidity and a definite repayment date.

The differential between the rate on mortgage backed securities and that on government securities will depend on the sophistication of the secondary market. In America that differential is quite low because the secondary market is very sophisticated; in other countries the premium would be much higher, perhaps as high as five percentage points depending on such factors as the default rate and any government insurance of the mortgage loans.

It follows that in any country where the mortgage rate is not at an attractive premium over the rate on government securities, a secondary market could not be established and, of course, it is in precisely such countries where there is likely to be a

'Shortage of mortgage funds in many countries'

perceived shortage of mortgage funds. Such a shortage, by definition, must be caused by the price being too low. A necessary condition for establishing a secondary market is for the mortgage rate to be at the appropriate market level and that this in itself would generate more funds into housing finance regardless of the secondary market aspect.

The secondary mortgage market cannot be seen as an easy solution to problems which, in fact, are caused by the mortgage rate being held, for whatever reason, at below the proper level. Similarly, a secondary mortgage market is not going to lead to more funds going into the housing market if the general problem is the shortage of funds.

In most developing countries, therefore, a secondary market is likely to be of little benefit as the problems they face are not those that can properly be addressed by a secondary market. However, there is scope in both industrialised and developing countries for secondary market or quasi-secondary market activity to develop where there is a mismatch between institutions' abilities to originate and service and to hold loans.

It has been found in developing countries that mortgage lending is a far from easy task and most general financial institutions shy away from it. Accordingly, the major lenders are specialist institutions which develop the necessary expertise in mortgage lending. However, these institutions often find difficulty in raising the funds which they need and permanently have to ration their mortgage loans. If in such countries there are other institutions which would find investing in mortgages an attractive proposition were it not for their

'Scope in developing countries for secondary market'

inability to originate and hold loans, then the two sets of institutions can be brought together.

This can be done in one of the various ways described earlier in this article; for example, loans to be sold

A modern residential home.... but which institution is servicing the loan that is helping to buy it?

on the pattern of the secondary market in America. A simpler option is for the institutions which are specialists in originating and servicing loans to originate those loans directly onto the balance sheet of the institution which wishes to hold them. In either case the investing institution needs to be satisfied about the quality of its investment, and experience suggests that such satisfaction will derive from examining a number of factors:

(a) Appraisal — it is necessary for the property in question to be appraised according to accepted standards, possibly by people in certain professional bodies and possibly on a standard form.

(b) Lending criteria must be realistic, acceptable to the investing institution, and rigidly adhered to. Typically, such criteria will cover the loan to value ratio and the income multiple.

(c) The originating and servicing institution must have a sound policy for dealing with arrears, and, moreover, a policy which it adheres to. Obviously, this is something which can be tested only over time and hence a track record is important.

(d) Insurance may be desirable, particularly in the case of high percentage loans. Such insurance can be granted either by a commercial insurance company or by a governmental or quasi-governmental agency.

'Need for sound policy on arrears'

In industrialised countries the task of producing acceptable mortgage backed securities is in some ways eased by the activities of rating agencies such as Moody's and Standard and Poors as they use the experience which they have gained in the United States to rate securities in that country and increasingly to rate securities in other countries as well. Among the major factors that such agencies look at are those listed above.

It follows, therefore, that if lending institutions are constrained simply by inability to raise funds themselves, then they do have an opportunity to develop either secondary market activity (selling loans) or quasi-secondary market activity (originating loans for other institutions in this case) and in either case such activity is likely to develop and become more sophisticated over time. The sooner the opportunity is taken to produce policies which are acceptable to institutional investors in respect of appraisal, lending criteria, management of arrears and mortgage insurance, the more likely it is that fruitful working relationships can be developed and the amount of finance going into housing can be increased.

'Mortgage lenders diversifying their sources of funds'

Summary

(a) A major financial trend is the tendency towards the globalisation of capital markets; logically this might be expected to lead to the globalisation of the mortgage markets.

(b) Traditionally, most institutions which make mortgage loans continued to service and hold them throughout their life. However, there is no logical reason why the act of originating loans should be linked with that of holding them.

(c) Mortgage lenders have increasingly been diversifying their sources of funds; even those which have traditionally relied predominantly on retail deposits have been obtaining finance from the wholesale money markets.

(d) There are a number of ways in which institutional investors can fund the mortgage market — direct lending to house buyers, direct lending to housing finance institutions, purchasing marketable securities issued by housing finance institutions and, finally, the secondary mortgage market, that is, purchasing loans or securities backed by mortgages.

(e) America has a huge secondary market which has developed largely because of the special circumstances of that country, in particular, the limits on inter-state banking activity and the savings associations being forced to borrow short and lend long.

(f) A limited secondary market is developing in a number of other countries such as Britain.

(g) The secondary mortgage market is not a way of overcoming mortgage market problems caused by interest rates being held at too low a level. Within countries the secondary market can increase the flow of funds into the housing market only where the problem is that the institutions which can make and originate loans do not have the capacity to hold them, but where mortgage interest rates are at an attractive level to institutional investors.

'Limited scope for international operations'

(h) Where this problem exists it can best be overcome by the mortgage loan originators developing acceptable appraisal techniques, lending criteria, management of mortgages and, where necessary mortgage insurance. This will make investing in residential mortgages attractive to institutional investors.

(i) There is only limited scope for international secondary mortgage market operations. The first decision of an institutional investor is the currency in which he wishes to invest and mortgage backed securities or mortgages have to take their place alongside other investment opportunities. ■