Prerequisites for Secondary Mortgage Market Development[1]

Securitization and secondary mortgage market development are major topics of interest throughout the world. The success of the secondary market in the US has led both private and public sector officials in many countries to recommend its creation as a way of enhancing the flow of funds to housing. However, what is often overlooked in such discussions in the readiness of the primary market. True and sustainable secondary market development cannot proceed unless and until the primary market is able to produce a sufficient volume of high quality mortgages that meet the servicing and performance requirements of investors.

What are the major primary market prerequisites for secondary market development? There are at least 8 major prerequisites:

1. Stable Macroeconomic Environment: Macroeconomic stability is very important for several reasons. First it has a major effect on the demand for mortgages. High rates of inflation and nominal interest rates are typical features of volatile economies. These features have the effect of reducing the affordability of conventional mortgages. A volatile economy also affects the supply of funds and the characteristics of mortgages offered by lenders. In a volatile environment, lenders are reluctant to offer long term loans. This may lead them to not offer mortgages or only offer short maturity loans that in turn are less affordable for consumers. A volatile macroeconomic environment also creates difficulties for investors. Like lenders they may prefer short-term assets, in part because of the difficulties of forecasting inflation and interest rates. Investors must be able to forecast cash flows with a tolerable level of variance in order to price and evaluate the risk of their investments.

2. Developed Legal Environment: A well functioning title and lien registry are important underpinnings of both the primary and secondary market. Without good title, borrowers cannot use their homes as effective collateral for loans and investors will not view securities backed by such loans as safe. A key legal prerequisite is the timely and cost effective registration of title and lien. A barrier that exists in many developing countries is the impostion of transfer taxes or stamp duties on title and lien registration or transfer. Long delays in the registration process can also increase the risk of both primary market and secondary market transactions. A workable foreclosure and repossession system is an important although not essential component of an effective legal environment.

3. Competitive Market Structure: Mortgages must be attractive investments. The interest rates on the mortgages must be market determined and provide investors with a positive, real, risk-adjusted rate of return. The spread must compensate the investor for the risks of the investment including credit risk, liquidity risk and interest rate risk. The more competitive is the mortgage market the greater the potential for secondary market development. This is particularly the case if the market

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environment will support the entry of mortgage companies that rely on securitization (off-balance sheet finance) for funding. In countries in which the dominant lenders are depository institutions with abundant capital and access to relatively cheap retail funds, securitization is often not a cost effective form of finance and it is difficult to create a secondary market. There must be a significant volume of loans to justify the up-front costs of developing the secondary market infrastructure.

4. <u>Mortgage Instruments</u>: The cash flows from mortgages must be predictable. There must be relative standardization of the instrument, documentation, and underwriting. Standardization of the mortgage instrument is a key factor in secondary market development. Mortgages should be pooled with similar characteristics to facilitate larger pool size and more liquidity and to reduce the due diligence costs of investors and rating agencies.

5. <u>Proper Origination Techniques</u>: Solid and consistent underwriting is key to secondary mortgage market development. Investors must have confidence that lenders are properly judging risk and using a consistent set of criteria in evaluating loans. A degree of standardization is necessary to lower costs of due diligence and allow investors, rating agencies, guarantors to quantify credit risk. An accurate assessment of the value of the property is fundamental to determining whether, in the event of borrower default, the lender could recoup enough from the sale of the home to cover losses. A repository for credit information that can be used to ascertain a borrower's track record of handling credit is an important component of underwriting. Credit bureaus can provide lenders with detailed credit files; they also can provide a credit-bureau score, which summarizes the information into one number reflecting an individual's expected credit performance.

6. <u>Secondary marketing expertise</u>: Secondary marketing is the function of financing and, subsequently, selling the originated mortgage to institutional investors. This activity includes the warehousing of the mortgage between the time the mortgage is closed and subsequently sold to an investor. There are at least 3 major risks the seller must manage as part of the secondary marketing function:

   - *Commitment risk*: The risk that an interest rate commitment ("rate lock") offered to a home buyer for a loan is made and the firm is unable, generally due to market forces, to earn an adequate sales price to cover the costs of providing the commitment.
   - *Pipeline risk*: The risk that a closed loan will change in value between the time of closing and shipment to an investor. This risk is often hedged using forward, option or futures contracts.
   - *Documentation risk*: The risk that a closed loan is underwritten improperly and does not conform to the investor's requirements. These loans are known as "lame loans" and frequently can be converted into acceptable loans for delivery, but usually after months of seasoning and additional documentation. The delays in delivery, or inability to deliver, produce costs for the originator.

7. <u>Proper Servicing techniques</u>: The servicing of mortgages is a critical component of a viable secondary mortgage market. The collection of mortgage payments and the periodic remittance of these payments to the investor (or conduit) are the major tasks of servicers (whether they are originators or third parties). In addition, servicers are the primary repositories of information on the mortgage loans. Thus, they must maintain accurate and up-to-date information on mortgage balances, status and history and provide timely reports to investors. The ability to collect payments on delinquent loans and institute timely foreclosure, repossession and collateral sale in the interest of the investor is necessary to safeguard the investor's interest.

There are undoubtedly other important factors in developing a secondary mortgage market. The prerequisites listed above are necessary but not necessarily sufficient conditions. The lack of these prerequisites does not mean that securitization is impossible as it may be possible to do a few transactions with a narrow range of collateral in the form of private placements. But a sustainable secondary market involves generating an on-going flow of transactions that will develop liquidity in the market, enhance investor and regulatory understanding and comfort and achieve the desired increase in availability of funds and decreased relative cost of mortgage credit. This can only be done if there is a sufficient volume of attractively priced, well-documented and underwritten mortgage loans that are serviced by competent and reputable organizations.

There is of course an element of which comes first, the chicken or the egg. Some will argue that creating a secondary market is necessary to provide the proper incentives and guidelines for standardization, processing and management in the primary market. A well-developed secondary market can indeed have these benefits. But there are clearly minimum requirements regarding the economy, instrument and institutions that must be met before a viable secondary market can be created.