

# Mortgage-Backed Securities: Another Way to Finance Housing

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To be presented at the Joint Congress of  
UN-HABITAT and the European  
Federation of Building Societies,  
Berlin, September 24, 2004

# Overview

- Finance is special
- Alternative forms of housing finance
- MBS in general
- MBS in the U.S. context
- Conclusion

# Finance is special

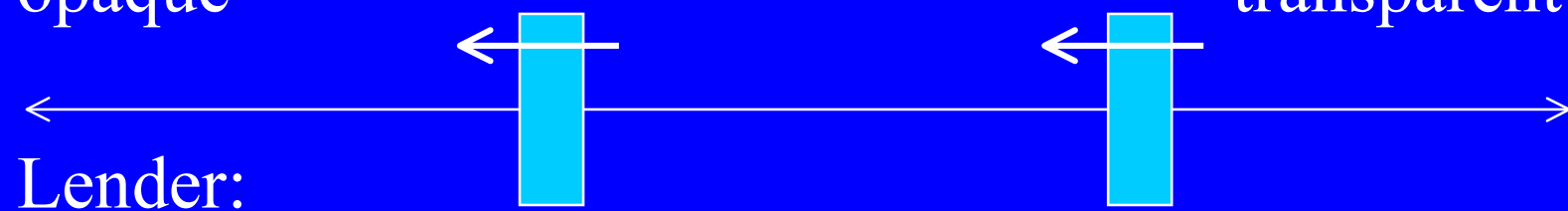
- Finance has an inherent time dimension
- The lender hopes to be repaid
- Implications:
  - Extensive pre-lending information gathering, scrutiny, legal arrangements, etc.
  - Extensive during-the-loan monitoring
  - Importance of legal, institutional arrangements

# The importance of informational opaqueness/transparency

Borrower:

opaque

transparent



Lender:

personal finance,  
friends, family

banks & other  
intermediaries

securities  
markets

# Essential elements of a loan

- The three essential elements of any loan:
  - Origination
  - Funding
  - Servicing
- These elements can all be performed by the same entity (vertical integration); or they can be performed separately by different “vertically disintegrated” entities

# Alternative forms of housing finance

- Owner self-finance
- Seller finance
- Third-party finance: family or friend
- Third-party finance: bank
- Third-party finance: insurance company
- Third-party finance: finance company
- Third-party finance: government
- Third-party finance: MBS

# MBS (1): The essence

- Mortgage loans are combined in “pools” or packages and sold as securities
- The securities represent claims on the interest and principal repayments of the underlying mortgages

# MBS (2): Allaying investors' concerns as to repayment (credit risk)

- The house is collateral
- MBS represent large numbers of mortgages
- Underwriting standards
  - LTV ratio < 80%, or mortgage insurance
- Issuers place mortgages in trusts
- Assurances from originators
- Guarantees from issuers
- Structured finance
  - Senior/subordinated arrangements



# MBS (3): Allaying the investors' concerns as to early repayment (interest-rate risk)

- Extensive modeling of prepayment patterns
- Structured finance
  - Securities can be structured into multiple tranches so that some recipients receive early payments and other recipients receive later payments

# MBS (4): Advantages

- Converts an illiquid mortgage into a liquid security
- Widens the potential market for housing finance
  - Increases the supply
  - Makes it more elastic;
  - But also links it to wider securities markets
- Allows housing finance to be more closely tailored to funders' preferences with respect to credit risk, interest-rate risk, and maturity
- Reduces interest rates for housing finance

# MBS (5): Disadvantages

- Potential for creating more problems of asymmetric information
- The use of governmental and quasi-governmental entities as issuers creates contingent liabilities for government
- The introduction of MBS into a bank-oriented housing finance system may create special frictions and strains

# MBS (6): General prerequisites for efficient housing finance

- Legal system
  - Property rights in housing, reporting of title and liens against title
  - Rights of and procedures for foreclosure in the event of borrower default
- Tax system neutrality
- Institution arrangements
  - Permit auxiliary institutions to help deal with asymmetric information
- Functioning market in house sales
  - Provide comparison value data so lenders can judge collateral

# MBS (7): Specific prerequisites for efficient MBS

- Legal system neutrality
- Tax system neutrality
- Institutional arrangements
- Securities markets

# U.S. Experience (1)

- First MBS in 1970 (Ginnie Mae)
- As of 2003, MBS accounted for over half of outstanding single-family mortgages and a third of multi-family mortgages
- Government and quasi-government MBS dominate, but privately-issued MBS is growing, especially for multi-family
- Growing political concern with respect to the government's contingent liability and other consequences of the dominance of Fannie Mae and Freddie Mac

# U.S. Experience (2)

- MBS are widely held
  - Banks are the largest holders (20% as of 2003)
  - Non-U.S. holders are the second largest group (13.5%) and growing
- MBS cause mortgage interest rates to be lower than would otherwise be the case
  - But it's hard to disentangle the special effects of the governmental and quasi-governmental presences

# Conclusion

- Finance is special
- An efficient housing finance system has important infrastructure requirements
- An efficient MBS system has additional infrastructure requirements
- An MBS system has advantages and disadvantages
- An MBS system is worthy of serious consideration for any country