

## Principle of Balance Mortgage Lending: a Better Approach

By Alan Boyce CEO Absalon, July 14, 2009

The mortgage finance system in the United States needs to be rebuilt. Currently, nearly all new mortgages and a significant amount of the old loans depend upon some form of the financing or guarantee from the Federal Government. Policymakers thus have a unique opportunity to structure the market in a sound and sustainable fashion. We can do better than the old model. This plan enables homeowners to reduce principal owed and negative equity by providing capacity to repurchase their own loans when those loans are trading in the market at discounts. If this is pursued soon, this plan could help homeowners preserve equity in their homes. The goal is to create a standardized, transparent mortgage system which aligns the incentives of the homeowner, the bondholders and the intermediaries.

The better and simpler system revolves around The Principle of Balance (PoB). The central difference of a Principle of Balance system is foundational – homeowners under the Principle of Balance do not borrow their mortgage from either the mortgage originator or any other bank. They borrow from investors in a standardized and transparent bond market, through a Mortgage Credit Intermediary. Each performing mortgage is always exactly balanced by an identical and openly traded bond<sup>1</sup>.

Mortgage Credit Intermediaries (MCIs) play critical roles and advisors. They help the homeowner understand and navigate the process. Most important, MCIs bear the credit risk of the mortgage – they remain “on the hook” in the event of delinquency or default. They are mortgage credit insurers. In Denmark, where this system is in place, the MCI originator bears full responsibility for timely payments from the homeowner. If a homeowner falls behind on payments, the mortgage is removed from the bond by the MCI at the lower of the market price or par. The MCI deals with all ensuing credit and collection issues.

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<sup>1</sup> The mechanics of this system are simple, if unfamiliar. When a homeowner qualifies for a new mortgage, the Mortgage Credit Intermediary adds that mortgage to a pool of identical mortgages – 30 year fixed mortgages expiring in 2039 with a 4.75% rate, for example. This pool is financed by investors through bond purchases. The bond series is “open” while new mortgages are being issued into it. Once these mortgages are no longer being issued (for example, when 30 year mortgages come due in 2040), the bond series is closed. Throughout the process the bonds trade openly. Thus the mortgage loan is not made by a bank; it is made by the bond market, with the MCI facilitating. Since all of the mortgages in a given bond series are identical, it is possible to directly balance a performing mortgage – on the basis of its face value as a percentage of the face value of all mortgages in the pool – against an equal share of the trading value of the bond series.

This system cleanly separates credit risk (the risk an individual homeowner will not repay) and interest risk (the risk that changes in interest rates will raise or shrink the value of the mortgage) and manages them appropriately. Mortgage advisors have an incentive to get homeowners only into those loans that make sense for that family. Mortgage credit issuers develop expertise on understanding who can repay their loans. Meanwhile, bond investors worry about only interest rate risk, with complete insurance on any credit related issues. A good mortgage system will properly identify, minimize, and efficiently allocate these risks.

A main benefit of this system is that it offers performing homeowners the ability to buy back their own mortgages when the price of those mortgages drops in the open market. When interest rates rise, the value of existing mortgages drops. This optional redemption feature – akin to refinancing when interest rates drop -- is then available to homeowners who are current in their payments. The homeowner directs his/her mortgage company to purchase the correct current face value amount of the bond at its discounted price and use it to redeem the existing home mortgage loan. This is paid for by the simultaneous issuance of a new loan, for a smaller face amount, often at prevailing higher mortgage rates. This feature radically reduces the threat of foreclosures by eliminating the systemic risk to homeowner equity due to rising rates.

Right now many mortgages are trading for 60 cents on the dollar in the bond market. Even though the homeowner owes the face value of the mortgage, say \$100,000, that mortgage can be bought by an investor from the market for \$60,000. Why shouldn't the homeowner be allowed to purchase the mortgage at this lower price? This optional redemption is of particularly great value at times, as in 2009, when home prices and mortgage values decline in tandem. The ability of the homeowner to reduce his mortgage liability reduces the chance that he will be underwater when home prices fall due to changes in interest rates.

Transitioning to a new, simpler system could be done efficiently and effectively by refinancing all performing mortgage loans into new, standardized Principle of Balance loans. Many transition paths that could be considered. In the current U.S. environment, it may make sense to use the GSE's to lead this process by offering large scale, streamlined refinancings of all performing mortgages into full recourse PoB loans backed by federal guarantees. The GSEs could then transition into a pure insurance role – as the loans would no longer be on their balance sheets. This approach would run cash through existing non-agency securitizations, which is the most effective way to clean them up. We would need to expand underwriting criteria to include currently ineligible borrowers AND allow for higher loan

to value ratio (LTV) during the transition period. Loan limits could be raised readily to cover 99% of mortgages.

Alternatively, this could be done entirely through private institutions. The key issue is moving now, when the basic instruments and institutions of mortgage finance are being reviewed and rebuilt. Four elements are key to the success of this new approach.

### **Highly Standardized Loans**

All loans guaranteed under the new system need to have highly standardized characteristics so that each resultant bond series is made up of exactly identical loans. There can be different types of mortgages pooled into different bonds, but all the mortgages in a specific bond series (for example, the series made up of 30 Year fixed, 4.5% loans expiring in 2038) must be identical. This standardization allows for the Principle of Balance (PoB) – through which each performing mortgage is always and exactly balanced against an equal and redeemable share of a bond series. Given that all of the loans are identical (and the individual credit risk is fully borne by the MCI), a homeowner can easily identify and repurchase an amount of the bond equal to the value of his or her mortgage. New loans will carry full recourse, enforced by an agency of the U.S. Treasury Dept.

### **Highly Transparent Securitization**

The system needs to have transparency built in. The moment a mortgage is issued, it is sold into a bond series of mortgages with identical terms. The mortgage obligation never sits on any bank's balance sheets and never vanishes into a complex web of securitizations. Daily information is published on bond trades and how many loans were funded by bond issuance. Weekly information is published on prepayment option exercise. Quarterly information is published on credit metrics of each bond series. In Denmark, bondholders and investors go online as stockholders do here – they check the price, fundamentals, trades, and news about their mortgage series on NASDAQ OMX (<http://www.nasdaqomxnordic.com/bonds/denmark/>). It is an open system, where all are treated equally on a level playing field. Well tested systems are easy to transfer, monitor and regulate.

### **Well Aligned Interests**

Separation of credit risk from interest risk allows each set of financial markets and professionals to operate effectively, efficiently, and with well aligned interests. MCIs are shielded from any and all risks other than credit risk. MCIs become mortgage insurance companies that do the paperwork.

They make sure that bad loans are NOT produced, thus eliminating the fundamental problem vexing global financial markets. MCIs act as “liability advisors” to the homeowners, with every incentive to get each person into the mortgage most likely to be repaid and no incentive to drive volume when rates fall.

MCI’s become transparent information processors and fee for service providers. MCIs are incentivized to: survey the bond market for risk reducing transactions, advise and assist the homeowner in executing the mortgage refinancing transactions. By helping the homeowner, the MCI is able to also reduce the value at risk of the mortgage credit insurance.

MCIs must make all efforts to have their bond series trade as well as those of competitors. Homeowners have clear and transparent incentives to refinance with the MCI whose bonds trade at the highest prices.

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.

The bond market does not face credit risks when a loan is non-performing because it is removed from the bond series. The market deals only with pricing, allocating and hedging interest risk. The terms of the bond match the terms of the liability by definition<sup>2</sup>.

### **Counter-Cyclical Properties**

When interest rates rise, mortgage prices fall as do housing prices. The Principal of Balance allows homeowners to redeem their mortgage and refinance at a lower principal. If interest rates were to fall again, the homeowner would be allowed to exercise his/her imbedded call option and refinance into a lower rate loan. This is a very effective, markets-based approach that reduces long-term interest rate volatility.

Mortgages are callable, which provides the most effective mechanism for the transmission of monetary easing into stimulation of aggregate demand. Callable loans are also an effective way to reduce inter-generational moral

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<sup>2</sup> This is a benefit compared to a covered bond approach, where the term of the covered bond is not tied to the term of the included mortgages. Covered bonds can create a threat of being unable to roll forward financing at the expiration of their term; Principle of Balance systems avoid this risk.

hazards and accounting issues.

The correlation between interest rate risk and credit risk is reversed by following the PoB. This provides a counter-cyclical income stream for banks.

Capitalization of the margin between the loan and the bond is prohibited. This practice leads to a misalignment of interests and encumbers future credit events. Variable margins allow future unforeseen credit costs to be shared among the beneficiaries of the system rather than future taxpayers. This is the main reason that mortgage servicing rights (MSRs) should not be capitalized and booked as upfront income.

The PoB system acts outside of bank's balance sheets – we need “thinner” institutions that perform clear and identified functions, with stronger and “thicker” markets of standardized products.

### **Conclusion**

The U.S. government has become the “single payer” supporting the mortgage market. As such, it has profound ability to influence the design of the system moving forward. MCIIs should be required remain “on the hook” for the first 10% of any credit losses associated with their bond issuance. Mortgages should come with full recourse from the Federal government. Bond holders should be responsible for managing interest rate risks. We can build and transition to the Principal of Balance system now. Doing so should be a priority, even as we continue to work to clean up the problems of the previous system.