

**The Mortgage Holding
Subsidiary Concept:
A Fully Privatized
Mortgage-Financing Plan**

A Presentation by

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The Mortgage Holding Subsidiary Concept: A Fully Privatized Mortgage-Financing Plan

- Why authorize the MHS concept
- Key characteristics of the MHS concept
- Why focus on the all-in mortgage interest rate
- How the MHS concept will lower all-in mortgage interest rates
 - “In-situ securitization” and “ratchet mortgages” will help to produce lower interest rates than MBS
- Key provisions of the MHS authorizing legislation
- A summing up

Why authorize the MHS concept

- The MHS concept provides a genuine private-sector alternative to Fannie and Freddie (F&F) for financing long-term, fixed-rate mortgages
 - The MHS concept complements GSE privatization
- MHS will lower the all-in cost of making and financing fixed-rate mortgages
 - In many cases, MHS rates will be lower than rates on mortgages funded with F&F MBS
- MHS will promote housing finance competition, which will foster innovation and greater efficiency

How the MHS concept will reduce mortgage interest rates

- Lower mortgage origination costs
- Elimination of mortgage pooling and securitization costs
- Lower mortgage servicing costs
- Lower equity capital costs by eliminating arbitrary capital regulation – risk would determine capital level
- Reducing cost to investors of MBS “moral hazard” and “cherry-picking” – the “lemons” problem in MBS investing
- Synergies between mortgage lending and other consumer finance services provided by parent bank

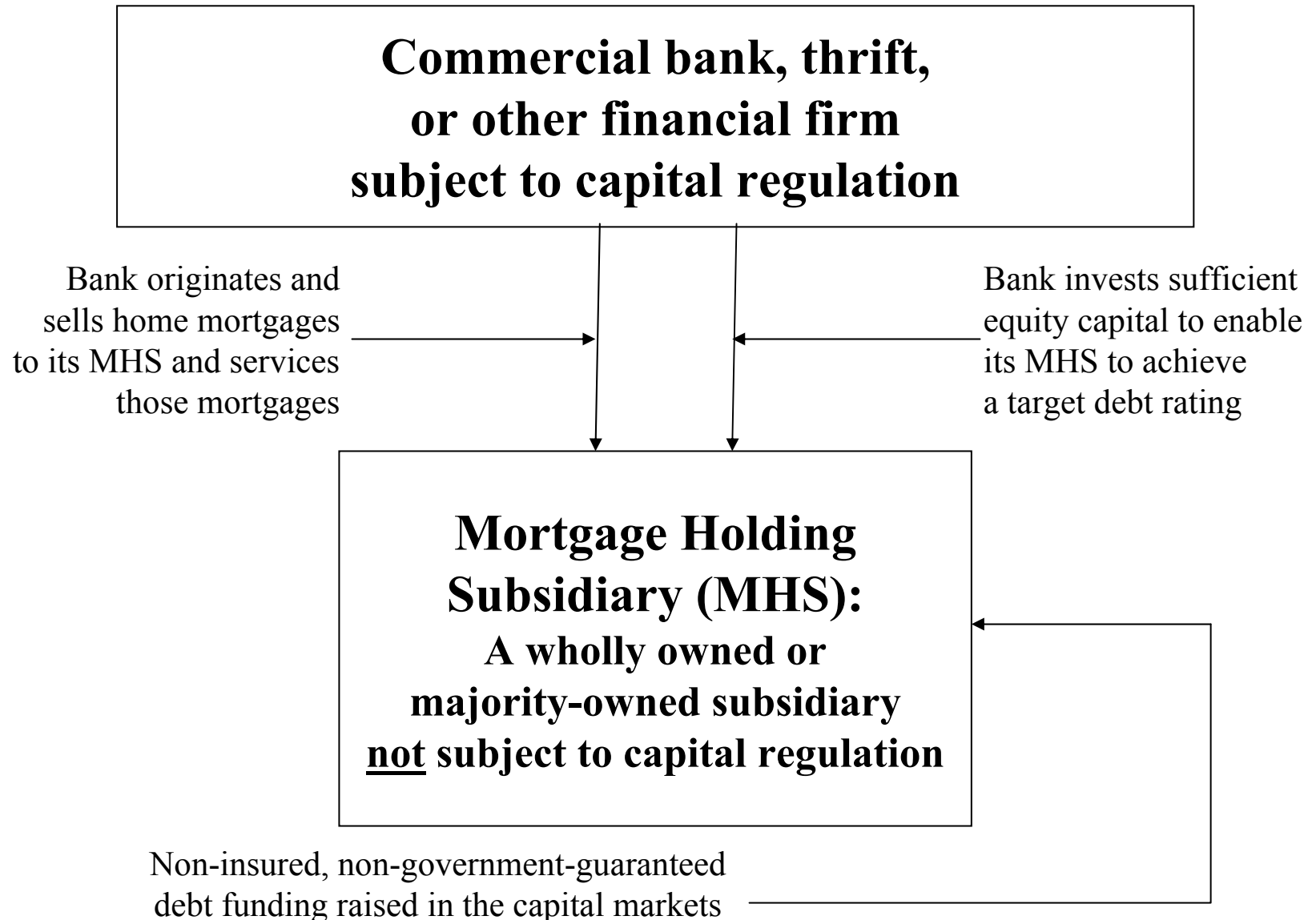
Key to achieving these cost savings is restructuring the financing of home mortgages

The Mortgage Holding Subsidiary concept provides the basis for that restructuring

Key characteristics of the MHS concept

- **Figure 1** illustrates the relationship of an MHS to its parent bank or thrift
- MHS would be funded entirely in the capital markets with medium- and long-term debt
 - MHS would be barred from accepting deposits
- No limit on the number of MHS chartered
 - MHS would be general-purpose, state-chartered business corporations exempt from bank-like regulation
- MHS would not be subject to capital regulation
 - Marketplace would determine appropriate capital level
 - **Figure 2** presents a conceptual representation of an MHS balance sheet

A Private-Sector alternative to Fannie Mae and Freddie Mac – the Mortgage Holding Subsidiary model



Balance sheet composition of an MHS

(not to scale)

Assets

=

Liabilities +
equity capital

“Ratchet mortgages”		“Ratchet bonds” secured by ratchet mortgages
Residential mortgages securitized “in situ” (in-situ securitization, or ISS)		ISS debt (debt secured by mortgages securitized “in situ”)
Residential mortgages		Callable, noncallable debt secured by the mortgages
Residential mortgages (1-4 family and multi-family)		Unsecured “preferential” debt raised in the capital markets
Cash + short-term investments		Other unsecured liabilities
Other assets		Subordinated debt
		Equity capital

Key MHS characteristics – continued

- Parent’s investment in its MHS fully deducted from the parent’s assets and equity capital
 - MHS would be excluded from consolidated capital regulation
- FRA Sec. 23A and 23B would apply to transactions between an MHS and its parent
- Parent could not inject capital into the MHS if that would leave the parent less than “well-capitalized”
- MHS could issue
 - Common and preferred stock to third parties
 - Subordinated debt
 - “Preferential” unsecured debt and unsecured debt
 - “In situ” securitizations and “ratchet bonds”
 - Secured debt

Key MHS characteristics -- continued

- An MHS could be managed by its parent and could share officers and directors with its parent
- No restrictions on the size or type of residential mortgage an MHS could purchase
- An MHS would refinance a mortgage simply by repricing it rather than creating a new mortgage
- MHS would operate as giant mortgage pools
 - An MHS could use “in-situ” securitization and “ratchet bonds” to finance some of the mortgages it owns
- MHS could hedge interest-rate and credit risks
- MHS not subject to Community Reinvestment Act

Why focus on the all-in mortgage interest rate

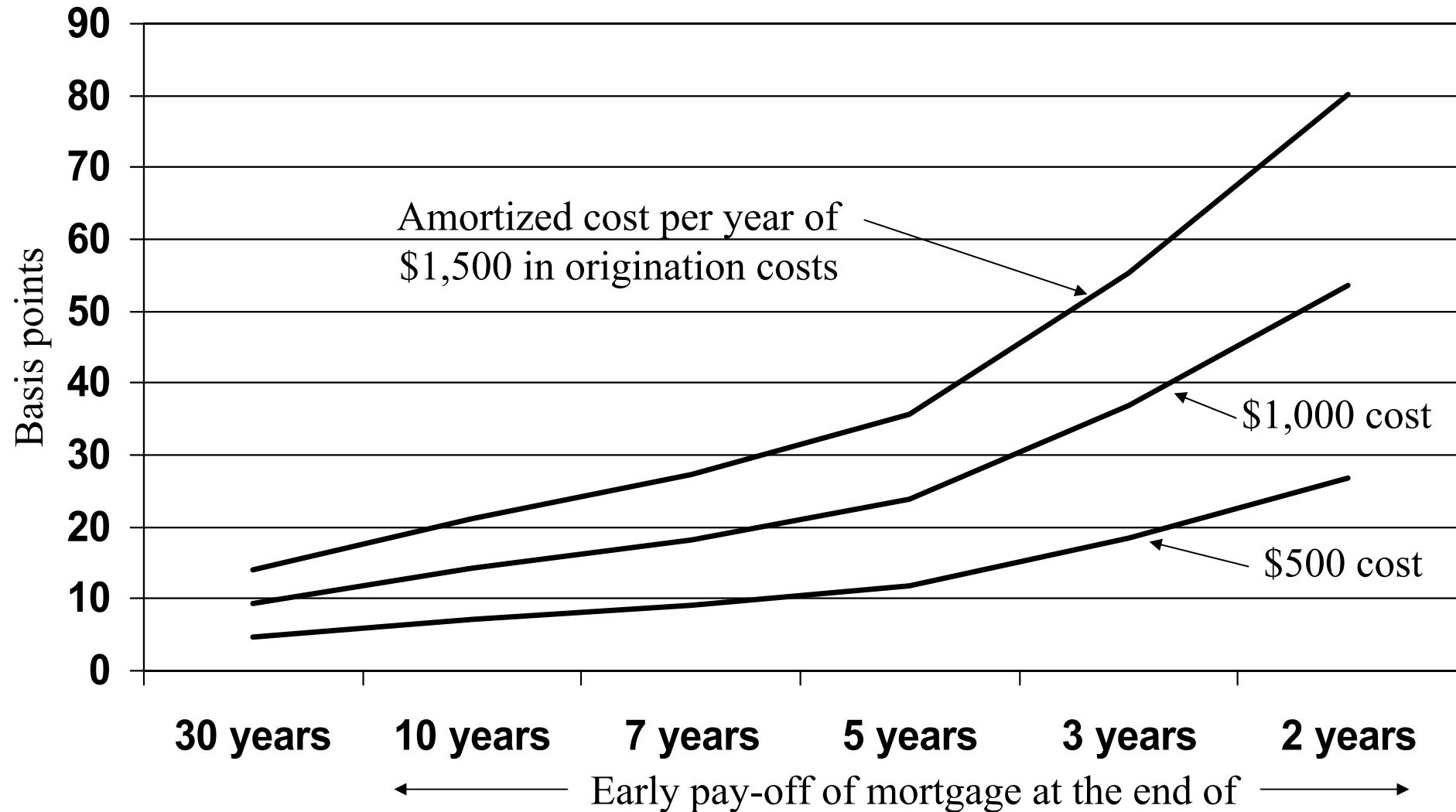
- The all-in mortgage interest rate includes
 - Stated rate of interest on the mortgage
 - Amortization of mortgage origination costs paid by the borrower over the effective life of the mortgage; i.e. until the mortgage is refinanced or paid off
- Upfront origination costs paid by the borrower are the equivalent of an interest-rate buydown
 - The effect of this rate buy-down must be included in the calculation of an all-in interest rate
- **Figure 3** shows the amortization of different origination costs over varied mortgage lives
 - Cutting origination costs can materially lower all-in rates on mortgages that are refinanced frequently

Mortgage origination costs include

- Loan application fees
- Credit reports
- Appraisals
- Title insurance
- Flood certification
- Termite inspection
- Mortgage broker commission
- Loan closing and settlement costs
- Mortgage recordation fees
- Courier charges
- Etc., etc., etc.

Lowering origination costs significantly reduces the all-in mortgage interest rate

Based on a 30-year, \$100,000, 6% fixed-rate mortgage

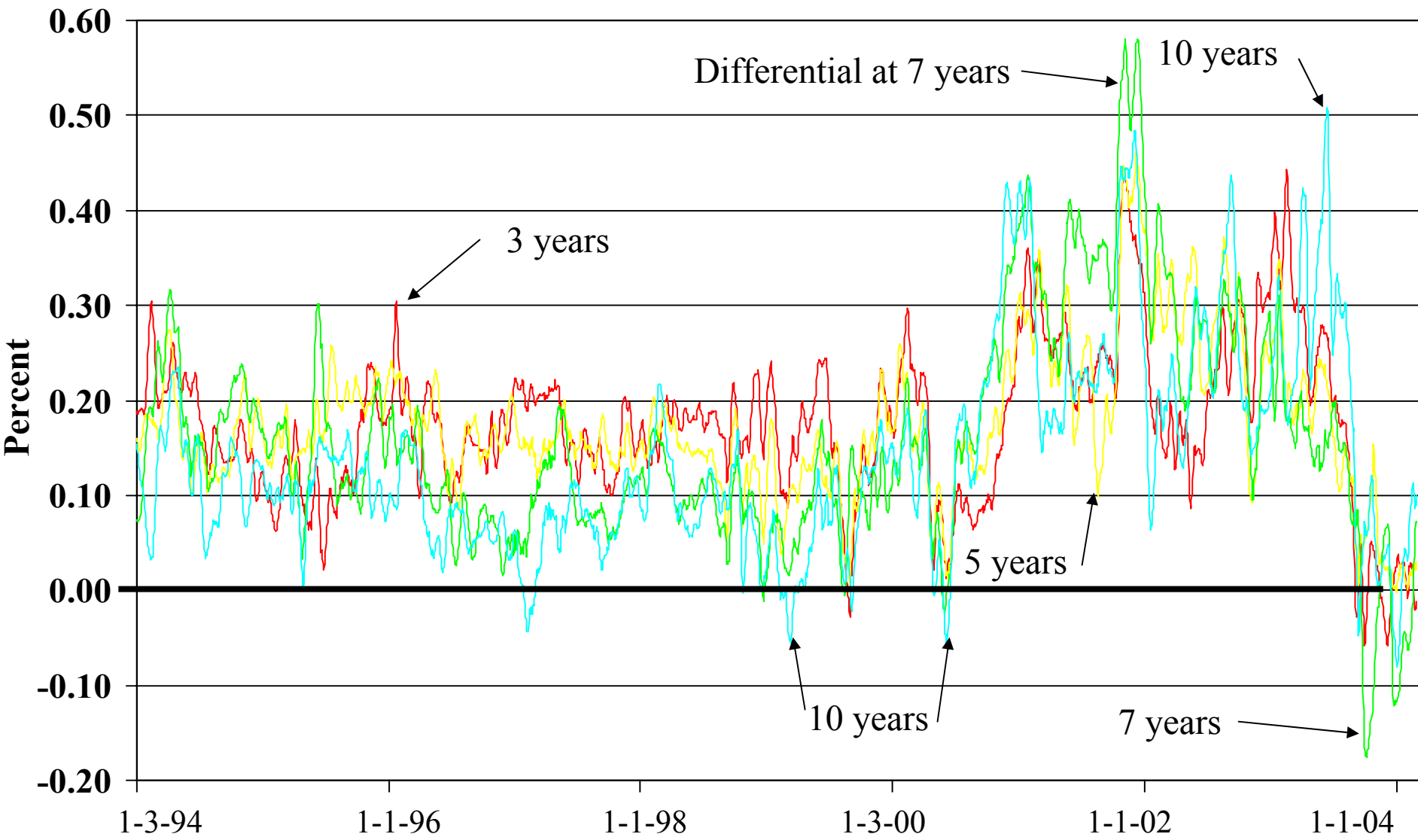


MHS will match or beat F&F rates

- MHS will match or beat the all-in interest rate on mortgages funded with F&F-guaranteed MBS
- The F&F rate advantage, across the yield curve, is approximately 20 basis points
 - MHS most likely will seek AA rating status in order to achieve the lowest all-in funding cost (debt + equity)
 - Industrial AA – Agency rate spread has averaged 20 basis points over the last decade – **Figures 4 to 7**
- MHS cost savings often will exceed 20 basis points
 - Savings will be greatest on smaller mortgages and on refinances

Rate differential -- Industrial AA – Agencies, smoothed data, at 3, 5, 7, and 10 years

1/3/94 to 1/27/04

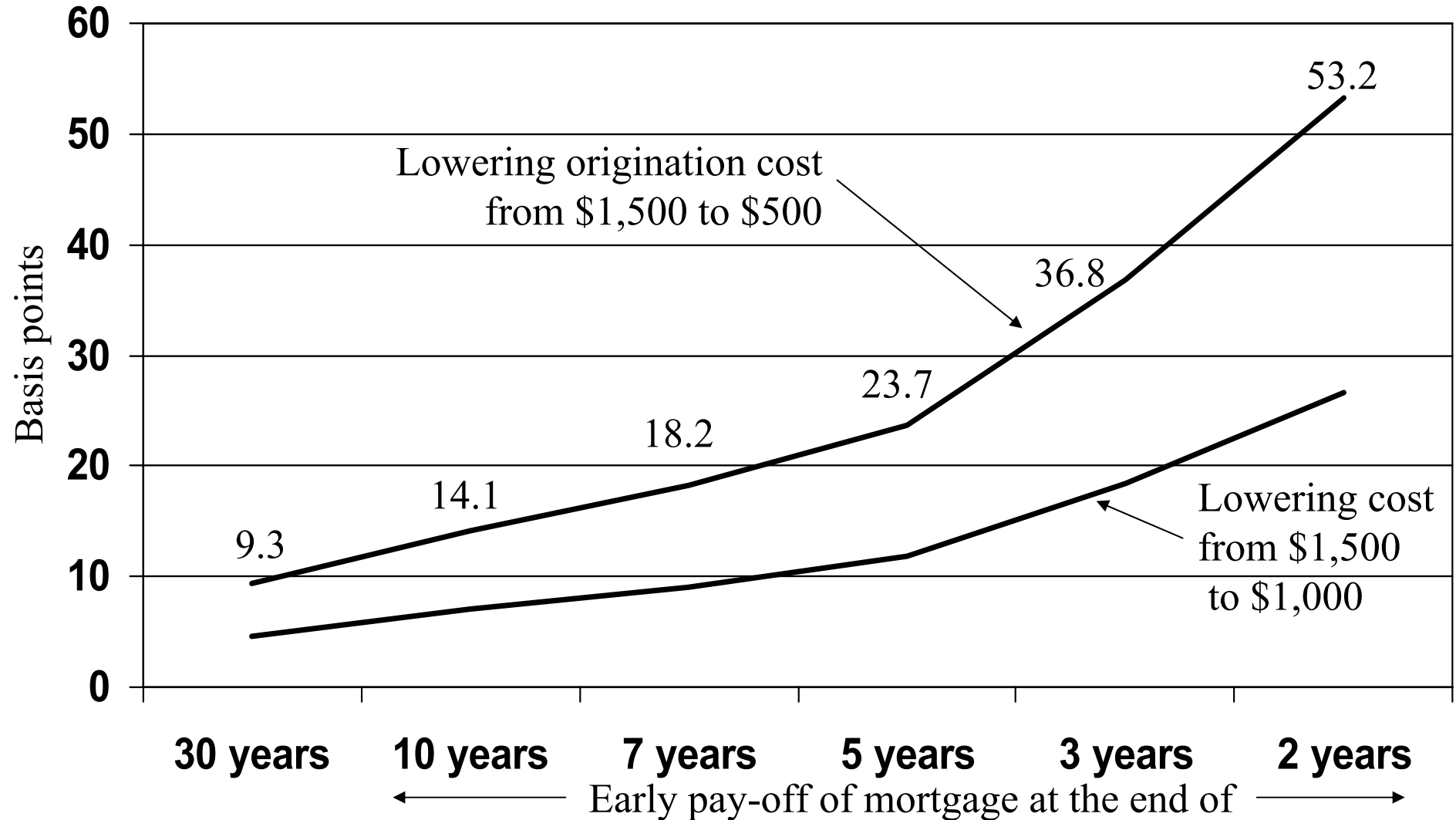


How the MHS concept will lower all-in mortgage interest rates

- MHS cost savings derive from
 - Reduced mortgage origination costs – **Figure 3 and 8**
 - Elimination of mortgage pooling and securitization costs
 - Reduced mortgage servicing costs
 - Lower equity capital costs by eliminating arbitrary capital regulation – risk would determine capital level
 - Reduced cost to investors of MBS “moral hazard” and “cherry-picking”
 - Synergies between mortgage lending and other consumer finance services provided by parent bank

Annual reduction in effective interest rate by lowering mortgage origination costs

Based on a 30-year, \$100,000, 6% fixed-rate mortgage



Potential MHS rate savings

Mortgage amount	<u>\$100,000</u>	<u>\$200,000</u>
Cost savings, in basis points per mortgage dollar:		
Origination	31	22
Servicing	5	5
Greater transparency	5	5
Larger financing tranches	<u>2</u>	<u>2</u>
Total savings	43	34
GSE funding advantage	<u>(20)</u>	<u>(20)</u>
Net savings for borrowers	<u>23</u>	<u>14</u>

MHS “in-situ” securitization will produce lower mortgage rates than F&F MBS

- An MHS would create a pool of designated mortgages within its balance sheet that would be financed with an “in-situ” securitization, or ISS
- Funding participations, comparable to MBS, would be sold to the public to fund the ISS
 - The mortgages secure the ISS funding
 - ISS investors bear all interest-rate, prepayment risk
 - MHS retains credit, operational risk
- Mortgages and ISS liability would remain on the MHS balance sheet

ISS concept -- continued

- ISS costs savings should exceed the F&F funding cost advantage
 - Investors enjoy cheaper management costs
 - Increased transparency by eliminating F&F's conflict-of-interest as both MBS guarantor and MBS investor
 - Extremely liquid ISS debt
 - Reduced mortgage origination costs, particularly for mortgage refinances – **Figure 8**

“Ratchet Mortgages” will trim rates more

- “Ratchet mortgages” are one-way adjustables – rates index down, but not back up
 - Funded with “ratchet bonds” adjusting the same way
- Ratchet bonds more efficient funding for lenders
 - Reduced prepayment risk and transaction costs
 - Callable debt needs management and incurs refunding cost when called
- Ratchet mortgages reduce life-cycle borrowing cost
 - Zero refinance cost – rates adjust down automatically
 - Zero reinvestment cost for investors
- Ratchet mortgages are fairer to consumers
 - Rates reset regardless of borrower’s creditworthiness

Structure of the MHS legislation

- Sec. 401 – Definitions – page 91
- Sec. 402 – Mortgage holding subsidiary – page 93
- Sec. 403 – Safeguards for the mortgage holding subsidiary parent – page 95
- Sec. 404 – Capital deduction – page 97
- Sec. 405 – Regulations – page 97
- Sec. 406 – Coordination examination of mortgage holding subsidiaries – page 98
- Sec. 407 – Conforming amendments – page 98
- Section-by-section discussion on pages 47 to 58

A summing up

- Overall objective
 - Eliminate taxpayer risk by privatizing F&F
 - Create a more efficient U.S. housing finance system
- If MHS can knock even 5 or 10 basis points off the rate charged on mortgages F&F securitize, that will greatly enhance GSE privatization prospects
- Cost competition must be based on all-in mortgage rates, including loan origination cost amortization
- More detailed research is needed to further quantify MHS cost savings

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