



AN ALTERNATIVE APPROACH TO SINGLE-FAMILY MORTGAGE FINANCING

MOVING BEYOND RISK ASSESSMENT TO RISK MITIGATION

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Over the last decade, the single-family mortgage market has not only expanded significantly, but in recent years we have also witnessed a weakening in the general performance of this loan class. It is apparent that the evaluation of the deficiencies inherent in single-family mortgage loans is critical to managing the exposures for lenders, investors and mortgage guarantors. While there is a renewed interest in the methods and tools for assessing risks, this paper shifts the focus to how to structure around and mitigate such risk. We argue that it is more logical to assess the financing approach taken in the basic structure of single-family mortgage loans. By making modifications to this structure, as opposed to solely changing risk assessment criteria, we will best be able to reduce future default losses and improve the performance of single-family mortgages in the United States.

BACKGROUND: DEFINING THE DEFAULT RISK ELEMENTS OF A MORTGAGE

In order to evaluate how best to mitigate risks associated with single-family mortgage loans, it is instructive to first define the fundamental risk elements of a single-family mortgage. Such risks fall into two basic categories: (1) debt serviceability, or payment default risk; and (2) asset, or collateral, value erosion risk.

Payment default risk results from the inability of a borrower to continue making loan payments to the mortgage holder on a prescribed basis during the loan term. To address this risk, underwriting procedures include limiting the amount of the respective periodic payment to a percentage of a borrower's income. However, this risk is exacerbated when changes occur as a result of either the payment amount increasing (ex. ARM adjustments) and/or the borrower's income is reduced. Payment default risk is heightened when the

level of absolute debt (i.e., the mortgage amount at the outset), was excessive. In these cases, a reduced overall level of debt would reduce payment default risk.

Delinquencies and arrearages reduce the value and salability of the mortgage to an investor from the originating lender. With the growing delinquencies, loan modification programs have been instituted to ameliorate the continued payment default, by reducing the amount of monthly payment. As interest rate and loan maturity provide the basic determinants for the monthly payment, methods of reducing payment levels include reduction of the interest rate, extending the ultimate maturity and/or forgiving a portion of the principal, thereby reducing the accruing interest cost. The lender's objective, of course, is to maintain the mortgage as a currently performing asset by balancing the payment with the borrower's current income.

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Asset value erosion risk emanates from excess levels of debt to the underlying asset being financed. When a mortgage defaults and the lender acquires the property through foreclosure, the property resale may or may not cover the mortgage amount, thereby exposing the lender to principal loss. If one reviews other types of "asset-based lending," there is a fundamental rationale about the level of lending based on how the asset may erode in value during the credit extension period. For example, in securities lending (margin loans), new purchases of securities are limited to 50% leverage, with a 33% maintenance margin (i.e. allowance for the diminution of value before the owner has to contribute additional funds). In commercial and industrial loans, there are general loan advance rates against business assets, such as accounts receivable (70-80%) and inventory (25-50%). Typically, the loan advance rate is driven both by the liquidity of the asset (i.e. can you sell it/collect on it quickly) as well as its potential for price or value erosion. Lenders are considerably more comfortable with higher advance rates and loan-to-value levels on non-volatile assets (i.e. collateral assets which do not have the propensity for significant value downswings). With the historical level of debt that has been allowable and deemed prudent for the purchase of homes (80 to 90 to 100%), it is implied that the lenders felt that residential real estate was collateral with little, if any, downward value exposure.

LESSONS LEARNED: THE DANGERS OF AN OVER-RELIANCE ON MORTGAGE DEBT

Whether driven by an easy money environment, the push for subprime home ownership, or the liquidity generated by loan securitizations, the value of residential real estate has become volatile, recently spiking in rises followed by a precipitous fall. The banks and other mortgage providers were lending at high loan-to-value (LTV) levels, never considering a diminution of value. Over the last eighteen months, the lending world has been faced with the reality that residential real estate is truly a volatile asset class, which requires a different approach for financing these assets. Referring back to other “asset categories,” where the LTVs are consistent with the price volatility of the asset, one can conclude the mortgage lending community must adjust its allowable leverage levels going forward.

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The use of high levels of mortgage debt has become systemic in the United States for home acquisition, and has contributed to some of the most challenging of economic periods. During the 1920’s, primary lending for home purchases tended to be rather conservative by today’s standards, with LTVs of 50-60%, but also had rather short term maturities (i.e. 3 to 15 years). With the lower LTVs, many borrowers took on second mortgages, leveraging to much higher levels, with such seconds having short term bullet maturities. Much like the present, there was a challenge in maintaining and refinancing such loans, leading to enormous levels of mortgage defaults and exacerbating what became the Great Depression. Starting with President Roosevelt’s New Deal (the National Housing Act of 1934), the formation of the Federal Housing Administration and later the housing Government Sponsored Enterprises, and the U.S. tax system, which provides for the mortgage interest deduction, the United States fully embraced the concept of mortgage debt. Private lenders and public housing programs have and continue to provide creative “debt” products, whether they are adjustable rates mortgages, shared appreciation mortgages, or even reverse mortgages. Even much of U.S. consumer activity has been made possible by the access, through borrowing, to their respective home equity. For many, with the expected appreciation of home values, leveraging has been part of their retirement and education cost strategies.

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The U.S. housing stock, estimated to be valued at \$19 trillion, is the single largest asset class in the country, if not the world, and constitutes the preponderance of an individual's net worth. For comparison, the collective value of equities on the major U.S. stock exchanges amounts to \$15 trillion. With the level of "acceptable and available" debt, the acquisition of homes has allowed the prospective resident to be the sole equity investor, and thus sole owner, almost agnostic to income levels and down payment amounts. In one respect, this enabled a national agenda of broader home ownership, due to lower down payment requirements and the desire of raising economic standards with the prospective wealth creation of home ownership. But there were also negative effects of such leverage, as we have seen with the sharp increase in mortgage defaults since mid-2005. Under the current model, any debt incurred remains an unconditional and preferred obligation (in terms of liquidation), and any erosion of property value accrues first to the equity holder (home owner). With the "correction" in real estate values, we have witnessed the *largest wealth destruction in history*, which will adversely affect the U.S. and world economies for years to come. True, we attained home ownership, but the wealth gain was ephemeral. The overuse of debt and its attendant priority features had a back-firing effect.

MOVING FORWARD: REDUCING RISKS BY CHANGING THE CAPITAL STRUCTURE OF HOME OWNERSHIP

To reduce these risks, which are attributable to excessive debt, we need to find a more prudent financing, or capital, structure for the acquisition and maintenance of owner-occupied real estate. Like corporate financing methods, which optimal/sustainable capitalization blends the use of debt vis-à-vis equity (risk) capital, the inclusion of incremental levels of equity capital should be included in U.S. housing finance. In order to reduce debt and address any "financing gap" in the acquisition of homes (to supplement those with limited down payment funds), or to monetize existing equity, capital must be made available. Pools of capital, namely equity capital, could be supplied by third-party, private sector investors to share both in the risk (price volatility) and financial return of ownership. Under this scenario, home ownership is bifurcated into "utility value" and "financial value". A resident would still enjoy the benefit of "owning the roof over his head." Yet, the resident would have an equity partner. Characterized as "equity sharing" or "co-ownership," this financing technique enables home ownership, albeit participatory, and ultimately benefits all those that participate in the financing of homes. The addition of

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non-interest bearing, junior capital can positively impact the housing finance landscape by addressing the gap between income levels and housing prices, reducing monthly mortgage payments and absolute debt levels of borrowers, and creating more prudent LTVs for lenders. All the benefits of home ownership still remain, such as family and neighborhood stability, potential wealth creation, and even increased property tax revenues to local governments.

In addition to the benefits of home ownership, this structure would also allow an individual to monetize their housing asset. As mentioned, the size of the U.S. housing stock is the largest single asset class, but uniquely, it has never been monetized or liquefied, as an investable asset class. By creating an equity capital market system for the investing and trading in “residential real estate,” we can revolutionize housing finance bringing substantial levels of new capital to the market, while alleviating the current and considerable stresses on the existing financial system.

IMPLICATIONS FOR THE FUTURE: HOW SHARED EQUITY HOME OWNERSHIP WILL POSITIVELY IMPACT THE ECONOMY

An observation by many economists is that the revival of the current U.S. economy is predicated on the revival of the housing market and, in particular, the attainment of price stabilization. At present, the housing market is “over-sold” with excess housing supply dwarfing the buying demand. Buying demand in this market currently consists solely of “owner-occupying investors.” Due to economic and mortgage market conditions, such demand will be muted indefinitely and inventory absorption will be long. For any stabilization to be accelerated, the market will require the increase of demand from other sources. The shared equity home ownership model supplements demand with “non-owner-occupying investors” (i.e., third party investors deploying equity capital), with the intent of participating in future property appreciation. Such funds can be provided for new home purchases or enable existing home owners to diversify away from their housing-biased wealth. By creating a broader “shared ownership” environment, we can better balance the supply and demand of properties and their underlying values.

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Our nation's orientation toward the systemic use of debt for our home purchases and home ownership has and will continue to be a disruptive and destructive force. Only a new approach, a risk/return adjusted approach, to prudently finance an individual's single largest asset will enable more sustainable home ownership and a sound economic environment. While the requested subject matter of this submission was to discuss ways to improve assessment of default risk of single family mortgages, this assessment only treats the symptoms of a fundamentally broken methodology after the fact, but does not cure the disease. For the reasons outlined in this paper, we believe that the endemic mortgage model should be reconsidered and a broad and deep "residential real estate" equity capital market should be developed.