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Secondary Market Products in the Mortgage System and Global Practices

Erhan EROĞLU

erogluerhan@mynet.com

The most important component in the property industry is financing. In the housing industry where there is a high demand and low offer, the housing financing systems and resources, other than the traditional approaches must be used more efficiently. The most widespread form of this is "Mortgage Financing Method". This is a process which begins by obtaining long term housing loans wherein a mortgage is established on the houses which are pursued by natural entities for a purchase. In this process, the house ownership rate increases thanks to reducing interest rates in the primary markets, and through converting the loans granted by loan institutions into securities, the loan granted institutions raise a new financing, in addition to conventional funding resources. Thereby, the funds raised in the secondary markets through the investors are returned to the industry as loans. While many people are now house owners, many other investors have the opportunity to raise revenue.

In other words, within the mortgaged housing financing with this mechanism, in fact there are many corporations or institutions. Such corporations or institutions generally are faced by us in developed countries as state supported entities. In addition to their existence in the industry as a supervisor and organizer, they can also appear as market contributor.

Considering the global practice, it can be said that in the secondary markets, many mortgaged securities are offered to investors and they attract quite a demand. The secondary market entities existing particularly in the USA for long years were referred to in this study extensively.

The securities issued on the basis of a mortgage pool formed by means of collecting the issued mortgage loans are called as Mortgage Backed Securities (MBSs). The mortgage backed securities are divided into two, namely, pass-through and pay-through. The institutions organizing the mortgage loan or buy organized mortgage loans transfer the amount outstanding after setting off the service, guarantee or other fees from the mortgage loans repayments, to the security owners (investors). The balance of this security would drop as the repayments are transferred to security owners after a mortgage. As the mortgage repayments are transferred to mortgage pass through security owners, the balance of the security would drop. Mortgage pass through securities are divided into two, namely, the ones issued by private sector, and the ones issued by public sector.

Securitization is issuing by the institution itself or through a special purpose institution established for this purpose of securities backed by a credit pool by means of compiling its non-liquid receivables of similar nature in the balance sheet of the (loan awarding institution) and refinancing of the payments by means of repayment of the receivables in the pool. This process could also be defined as transforming the non-liquid assets, which however provide a certain income, into securities which can be purchased or sold.

Issuing the mortgage backed securities in 1970 in the markets, has pioneered the developments which contributed the reaching of the secondary markets to their current volume and level (Tantan, 1996, p.8). The functioning of the mortgage backed securities may be defined as buying the mortgage loans by deposit or loan banks, commercial or mortgage banks from the institution issuing the mortgage loans or by means of securitization of the mortgage pool formed by the mortgage loans of similar maturities issued by the institutions and selling the papers representing the pool to entrepreneurs. For example, in case the pool is formed by mortgage loans of 10 years maturity and if any entrepreneur invested into the pool by 1%, he / she will deserve to receive 1% of the principal and interest repayments of the mortgage loans for 10 years (Kidwell and Peterson 1990, p. 540).

In the case of Mortgage Pay Through Securities - Pay Through Bonds, the property in the side of assets (subject to the security) remains in the balance sheet, and the security can be issued on the basis of the pool formed by such assets. These assets, are now, seen as the items of liabilities in the financial statements (Uludag and Arican, 1999, p.59)

The Collateralized Mortgage Obligations - CMOs, developed by Freddie Mac in 1983, is a form of security which aim to reduce the early repayment risks in relation with MBS'. These securities may be backed by mortgage loan group or MBS portfolio or both. When they are backed by MBS portfolio, they are also named as derivative securities since their cash flows are provided by mortgage loan groups.

Planned Amortization Class Bonds - PACs, differ from a typical CMO due to two reasons (Bruggeman and Fisher, 2005, p. 558). One of those differences is that it is a security against the early repayments of the mortgage loan backing them, and forming of a fund which will provide regular fund flows. Second is that, the principal is paid to all classes simultaneously. In such securities, the cash flows are planned exactly, so, it may attract the entrepreneurs who do not consider mortgage markets attractive.

Target Amortization Class – TAC, is in the market as a new derivative of CMO. With these bonds, some corporate entrepreneurs would like to be secured against recall and extension risks while some others require to be secured against only one risk.

Mortgage Pass Through Securities - MPSs are also named as the securities passing through a mortgage. They are formed by collecting mortgages in a pool and selling the interest and principal cash flows arising out of the mortgages. The MPS, first issued through Ginnie Mae guarantee in 1970, is the most common security within the MBSs. (Hepsen, 2005, p. 38). Instead of investing on a mortgage loan, the investment is shifted to mortgage groups, thereby the risk is reduced by means of applying variation. When the investor invests on one mortgage, he/she faces systematic and non-systematic risks. Systematic risk is failure of the loan receiver to repay the loan he/she received, due to

any reason, while non-systematic risk is, the risk of early repayment of a mortgage loan by a loan receiving party.

Real Estate Mortgage Investment Conduits-REMICs, is a new version of CMOs and mostly CMO and REMIC may substitute each other. The concept of REMIC was first employed in the US Tax Reform Law which was first announced in 1986[1]. In the process of transferring the CMOs, considering the interests received out of the mortgage loans as liabilities, issuer institution faced the problem of taxation and provided a solution to the problem through the tools named REMIC.

Stripped Mortgage Backed Securities - SMBSs, are derivative securities backed by mortgage groups formed through compiling mortgage loans. They were first issued in 1986 by Fannie Mae[1]. The SMBSs are formed by distributing the MBSs in a form differing from cash flows. In this security, the distribution of the cash flows depends on the qualities specified in the process of security sales.

Synthetic-Coupon Pass Through Securities: The synthetic coupon mortgage pass through securities, that is the first type of the stripped securities, are issued considering the entrepreneurs who have expectations of increasing or dropping interest rates in the market, and are effective in the fluctuating or expected to be fluctuating interest rates. Differing from the interest rates of the mortgages included in the pool for this purpose, securities have been formed through synthetic coupon pass through securities which have two types of interest

Interest Only / Principal Only Pass Through Securities – IOs / POs are the forms of security issued in the market in 1987 where the interest repayments of the mortgage loans in the pool are allocated to a class, and the principal repayments are allocated to another class (Uludag and Arican, 1999, p. 62). It responds to the variations in the interest rates by means of price changes. Principal only securities' prices vary counter-proportional to the interest rates, while interest only securities' prices are proportional with the interest rates. In the periods where interest rates increase, the price of the principal only stripped securities would drop, while that of the interest only stripped securities would increase. Because, increasing interest rates would reduce repayment risk, whereby the life of the cash flows would increase (Bruggeman and Fisher, 2005, p. 531).

Mortgage Backed Bonds – MBBs exhibit the entire properties of a bond, yet they are superior to all other bonds since they are secured by mortgage loans. These bonds do enjoy a cash flow totally independent from the mortgage loans backing them. In the periods the institution issuing these bonds fail repay to the bond owners, it honors its obligations through selling the secured mortgage loans.

To summarize, the secondary market instruments of which details are examined above, are formed according to entrepreneur profiles and the requirements forming by the time. In the end, the secondary market products applied globally, particularly in the USA, provided many credit institutions with a larger loan volume and thereby, with a larger asset size. It is however evident today that, the said mortgage backed products do have intrinsic risks. Because of this, the global crisis suffered in 2008 must serve as an example and similar crises must be prevented.