

Originate-and-Hold versus Originate-and-Disseminate Mortgage Models

Despite turmoil and meltdown in the world’s financial system, Bermuda’s remains resilient. Overall the banking system remains highly capitalized and liquid. Disturbingly, in the third quarter of 2008, Bermuda dollar loans (\$4686 m) exceeded deposits (\$3821m), with the shortfall being financed by foreign currency borrowing. This trend started in the fall of 2005 and has progressively increased Bermuda’s exposure to foreign exchange risks. Foreign currency borrowing now exceeds one billion dollars.

Our mortgage market operates under an originate-and-hold system. Ordinarily, sellers of mortgages, principally banks, hold onto the mortgages for the life of the agreement. The bank accepts sole responsibility for the risk of default - that the homeowner will honour the monthly payments schedule. Under such an arrangement, the lending bank or originator of the mortgage will err on the side of caution with respect to a homeowner’s credibility and ability to sustain monthly mortgage payments. It would be unlikely that a bank would lend to someone with a low credit score, or a high debt-to-loan or loan-to-value ratio without a guarantor.

The process of securitization allows a bank to immediately realize the value of its mortgages, rather than spreading the payment stream over time. This is the originate-and-disseminate model. Banks, as originators of mortgages, can sell these to an underwriter, usually an investment bank, in exchange for a lump sum payment. A securitized mortgage is known as a mortgage-backed security (MBS) or a collateralized debt obligation (CDO). Pension funds, insurance companies, money managers, mutual funds, and commercial banks buy MBSs and CDOs on behalf of their clients.

To make MBSs and CDOs more attractive to investors, the financial services sector created and sold credit default swaps (CDS) to provide cover against the possibility of these securities becoming worthless. CDS are effectively insurance policies. By the end of 2007, over \$62 trillion worth of CDS were outstanding. This amounts to more than the value of all the goods and services produced globally. American International Group (AIG) is one of several financial products companies that sold CDS.

This breaking of the link between the originating banking and the homeowner incentivizes originators not to err on the side of caution with respect to a homeowner’s ability to sustain monthly payments. It was in this context that the sub-prime mortgage market grew exponentially. Securitization allowed originating banks to pass the risk of default on to the MBS buyer. As a result, a bank’s borrowing costs were reduced, which allowed bank capital to be put to other uses. Securitization is a financial innovation that allows a bank to increase profits.

The world of finance is subject to volatility not found in the natural world. Sudden and unforeseen market changes can wipe away a decade’s worth of gains. At the heart of the present financial crisis, is the inability of finance professionals to anticipate, with any degree of certainty, where the market will go next. It is therefore important that individual investors, whether in real estate, stocks, bonds or derivatives, understand the markets in which they invest, before accepting the recommendations or conclusions of experts.

Craig Simmons - March 10, 2009

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