IFC & World Bank Experience in Establishing Mortgage Refinance/Liquidity Companies

Workshop on Housing Finance in South Asia

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What is a Mortgage Refinance/Liquidity Facility?

- A specialized second tier institution which provides short term liquidity, long term funding or guarantees to housing finance lenders
- Acts as intermediary between lenders and capital markets
- Issues bonds to raise long term finance
- Purchases loans with recourse or receives assignment of mortgages/loans
- Low and simple to assess credit risk

Objectives/Benefits

- Develop the Primary Mortgage Market
  - Provide financial resources to enable primary lenders to grant more loans at fixed rates and for longer tenures
  - Help primary lenders to narrow the gaps between the maturity structure of the housing loans and the source of funds
  - Promote sound lending norms (eligibility criteria)
  - Allow smaller lenders to access long term funding, and foster competition
  - Lower the cost of long term funding (scale effect, liquidity, prime standing, limited intermediation cost)

A catalytic tool - unlike securitization it does not need a fully developed primary market with the history required to value securities

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Objectives/Benefits

- Develop the Capital Market
  - Provide more private debt securities (Bonds) with different maturities and rates
  - Issue secured and simple instruments (easy to assess risk, no valuation issues)
  - Create potentially liquid investment vehicles
  - Create a Yield Curve

Importance in the Current Environment

- Can provide liquidity relief to commercial banks and NBFI's (example: in the US, strong liquidity support by the FHLB to the mortgage industry - outstanding advances jumped from $600 bln in Q107 to $1,021 bln in Q308)
- Can help re-build market confidence by making available securities that are well secured, simple to value and potentially liquid
- May also help a bank cover an unexpected short-term deposit outflow (or other temporary losses of funds), thereby avoiding potentially costly short-term borrowing or asset liquidation
- Provides long term investment opportunities to institutional investors, and contributes to the deepening of the bond market
- Can help deliver policy objectives i.e. may set specific criteria for refinancing of loans to low income groups

Preconditions for Establishing a MRC

- Effective funding needs of financial institutions
- Sufficient demand for and supply of housing and housing finance
- A functioning primary mortgage market, based on a sound infrastructure
- Ability to effectively assign/transfer mortgage loans
- Existence of a capital market and a relatively diversified investor base
- Commitment by the Central bank and/or Government to support the new institution in a ramp phase and help name recognition
- Adequate regulation

Conditions for Success

- Support from the Banking Authorities
  - To encourage PML's to obtain refinance from the MRC
  - To encourage PML's to invest in the MRC bonds/securities
- Support from the Capital Market Authority
  - To facilitate issuance of bonds/securities by the MRC
  - To encourage investment in MRC bonds/securities
- Support from the Revenue/Tax Authority
  - To encourage PML's to obtain refinance from the MRC
  - To encourage PML's to invest in the MRC bonds/securities
- Support from the users
- Good governance

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Typical Business Model

- Short-Term
  - Refinance/Purchase mortgages loans with recourse to primary lenders
  - Refinance/Purchase based on interest review periods
  - Issue unsecured debt securities (bonds)
- Medium-Long Term (timing dependent on Board decisions and market need)
  - Help establish the foundations of a sound securitization market (standardization, transparency, master servicer role, etc..)
  - Issue secured mortgage-backed securities (MBS) and Sukuks

Another Model - Fannie/Freddie

- Structural flaws in the business model
  - Providers of finance assuming full primary credit risk
  - Government backing and rent seeking private shareholders
  - Weak regulator and lax prudential framework (high leverage, risk concentration - nearly ½ of the mortgage market)
  - Strong lobbying power
- Activity shifts
  - Large investors of MBS and CDOs, risky and illiquid despite their AAA (large losses on a marked-to-market basis)
  - Re-deployment in the Alt A and other high risk products (second lien, negative amortization…) to regain market share (counter example: Ginnie Mae/FHA)
- Currently
  - New regulator (Federal Housing Finance Agency, mandated by law to review prudential regime)
  - Placed into conservatorship and government ownership
  - Fund 80% of mortgage lending

GSEs = government chartered, privately owned second tier entities

Some MRC's in Existence

- With the support of the World Bank Group
  - Jordan (JMRC)
  - Algeria (SRH)
  - Palestine (PMHC)
  - Egypt (EMRC)
  - Tanzania (on going project)
- Others
  - USA (Federal Home Loan Banks)
  - Austria (Pfandbriefstelle)
  - Malaysia (Cagamas)
  - France (CRH)
  - India (NHB)
  - South Africa (NHFC)
  - Trinidad (HMB)
  - Indonesia (SMF)

Jordan Mortgage Refinance Company (JMRC)

- Incorporated in 1996 as a public shareholder company started operations in 1997
- Chaired and Supervised by the Central Bank
- 16 shareholders – 3 from public sector (contribute 38% of paid-up capital of JD 5 mn ($7.05 mn)) and 13 from private sector
- Has a long term subordinated loan of $19.6 mn from GoJ/WB
- 20% over collateralization based on full recourse to primary lender
- Exemptions granted:
  - For CAR, housing loans refinanced by JMRC have a 20% risk weight
  - Banks are not required to have a General Allowance for housing loans refinanced with JMRC
  - Bonds have priority in repayment, are risk-weighted at 20% and eligible to serve as liquidity reserves holdings of banks
  - Bonds are exempted from ownership transfer fees and charges
  - Bonds are tax exempt from interest as well as capital gains
- Till Dec. 31, 2007, refinanced loans of $405.6 mn with outstanding balance of $240.5 mn and issued bonds of $524.8 mn with outstanding balance of $212.9 mn

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Egyptian Mortgage Refinance Company (EMRC)

- Incorporated in 2006 as a Joint stock company with a current paid-up capital of $44 mn and long term GoE/WB loan of $39 mn
- 27 Shareholders: 16.6% Central Bank, 14.1% other public institutions, 7.9% IFC and 61.4% private primary lenders
- Only shareholders can benefit from the refinancing facility
- 20% over collateralization based on full recourse to primary lender
- Primary mortgage shareholders to replace loans that are prepaid / redeemed or more than 3 months delinquent
- Exemptions granted:
  - Refinanced housing loans are subject to general loan loss provision of 1% against the banks' general loan loss provision of 3%
  - Bonds are tax exempt from interest as well as capital gains
  - Bonds are eligible investments for banks and institutional investors
  - Bonds are eligible for liquidity requirements.
- Refinanced 4 loans totaling $23.7 mn with 3 PML's since operations began in July 2008

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Recap of Key Lessons

- A tool well fitted to a nascent housing finance market
  - Simple
  - Secure
  - Scale effect
  - Catalyst of the mortgage market development and diversification
  - Instrumental in the deepening of the bond market
  - Can be a first step to more sophisticated funding instruments, in particular by promoting the preliminary standardization and quality of the primary mortgage market
- Key conditions: existence of a mortgage market and bond market, corporate governance and regulation

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