

# [Real estate finance: mortgage backed securities essay sample](https://assignbuster.com/real-estate-finance-mortgage-backed-securities-essay-sample/)

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A borrower may offer immovable property as a security for a loan to be granted by the creditor or banker. When a borrower offers his immovable property like building, land, factory premises etc. for a loan, a charge thereon is created by means of a mortgage. Mortgage is defined as “ the transfer of an interest in the specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt or the performance of an agreement which may give rise to the pecuniary liability” (Hu, Joseph , 36) mortgage is a type of contract. The borrower is called the mortgagor and the lender or the person with whom the property is mortgaged is known as the mortgagee. The document which specifies the terms of the mortgage is called the Mortgage deed. The essential features of a mortgage are as follows.

There must be a transfer of interest in an immovable property. Transfer of interest in the property means that the owner (mortgagor) transfers some of his rights to the mortgagee and some rights are still being held by the owner e. g. a mortgagor retains the right of redemption in the mortgaged property. Thus, mortgage differs from sale under which the ownership (i. e. all the rights) of the property is transferred.

The immovable property intended to be mortgaged must be a specific one, i. e. it can be clearly identified and described.

Mortgage of property must be supported by a lawful consideration. The consideration may be either money advanced or to be advanced by way of a loan or the performance of a contract. But a transfer of property for the discharge of a debt is not a mortgage.

Difference b/w mortgage and pledge

The main difference between a mortgage and a pledge is that in case of pledge,  the possession is transferred to the creditor, while it remains with the mortgagor in case of a mortgage unless otherwise stated in the mortgage deed. Delivery of possession is essential in a pledge, but the pledge has only a special interest in the property and the general interest remains with the pledger.

Goods must be movable in case of a pledge, but mortgage is possible only in the case of specific immovable property. Further, a mortgagee has the right of foreclosure in certain cases which is not available to the pledge in any case.

Types of mortgage

There are six types of mortgage given in the Transfer of Property Act. 1882, which are as follows:

* Simple mortgage
* Mortgage by conditional sale
* Unfructuatory mortgage
* English mortgage
* Mortgage by deposit of title deeds or equitable mortgage
* Anomalous mortgage simple mortgage

Under a simple mortgage, the mortgagor undertakes to bind himself personally to pay the mortgage amount and does not hand over the possession of the mortgaged property to the mortgagee. He, however, agrees either expressly or impliedly that in the event of his failure to pay the debt accordingly to the terms of the contract, the mortgagee shall have the right to cause the property to the sold and to apply the sale proceeds towards the discharge of the debt. Thus, the mortgagor is not himself authorized to sell the property, he has to apply to the court for leave to sell the mortgaged property.

* mortgage by Conditional Sale

As the name implies, the mortgagor ostensibly sells the mortgaged property to the mortgagee with any one of the following conditions that: The sale shall become absolute on the default of payment of the mortgage debt on a certain date, or

The sale shall become void if the payment of made on the stipulated date, or

The buyer shall re-transfer the property to the seller if he pays the mortgage debt on the stipulated date.

In this type of mortgage, the sale is ostensible and not real. Such a sale will become absolute only if the mortgage debt is not repaid by a certain date and the mortgagee gets decree from the court. The mortgagee can apply to the court for foreclosure of the mortgage and not for sale. Foreclosure means the loss of the right possessed by the mortgagor to redeem the mortgaged property. Banks usually do not prefer this type of mortgage because there is no personal covenant for the repayment of debt.

Usufructuary Mortgage

In this type of mortgage the mortgagee binds himself to deliver the possession of the mortgaged property to the mortgage and also authorize the mortgagee to retain the payment until the mortgagor makes the payment and also authorize him to receive any sort of income coming from the mortgaged property. Bankers do not like this type of mortgage because there is no personal convenant to repay the debt and the debt has to be recovered by appropriating rents and / or profits which will take a very long time.

Anomalous mortgage

An anomalous mortgage is a mortgage other then those discussed earlier. It includes the customary mortgage under which the rights and liabilities of the parties are determined by the local custom or by the contact between them.

Legal mortgage vs. equitable mortgage

A legal mortgage is one in which the mortgagor transfers his legal title in respect of the mortgaged property to the mortgagee. The transfer of title can be affected only by a registered instrument if the mortgage money is paid. When the mortgage money is paid off, the title in the property is transferred back to the mortgagor.

In case of an equitable mortgage, the mortgagor delivers documents to title to the immovable property to the mortgagee with the intention to create a security thereon.

Adjustable rate mortgages

Like other investors, financial institutions find that lending is more attractive if interest rate risk is lower. They would not want to make a mortgage loan at a 10% interest rate and two months later find that they could obtain 12% in interest on the same mortgage. To reduce interest-rate risk in 1975 savings and loans in California began to issue adjustable-rate mortgages, that is, mortgage loans on which the interest rate changes when a market interest rate (usually Treasury bill rate) changes. Initially, an adjustable rate mortgage might have a 5% interest rate. In six months, the interest rate might increase or decrease by the amount of the increase or decrease in, say the six-month T-bill rate, and the mortgage-issuing institutions to earn higher interest rates on mortgages when rates rise, profits are kept higher during these periods.

This attractive feature of adjustable rate mortgage has encouraged issuing institutions to issue adjustable-rate mortgages with lower initial interest rates than on conventional fixed-rate mortgages, making them popular with many households. However because the mortgage payment on a variable rate mortgage can increase, many households continue to prefer fixed rate mortgages then both type of mortgages are widespread.

Fixed rate mortgage

The basic features of a fixed rate mortgage are the amortization period, the stated interest rate, the frequency of mortgage payments each year, and in certain cases, the type of insurance against possible default. Prior to the 1980s mortgages almost always carried a fixed interest rate with a 30-year amortization period, a constant level monthly payment, and 12 payments in a year. They are referred to as level-payment, fixed rate mortgages (FRMs).

A fixed rate mortgage is rapid by a constant monthly payment throughout its maturity terms. The monthly payment consists of repayment of principle and interest on the remaining principle. The gradual pay down of a mortgage is called amortization. Given the size of the original balance of the mortgage, the monthly payment varies accordingly to the mortgage rate. The composition of the monthly payment in principal and interest also varies with different mortgage rates. Exhibits 1 to 3 demonstrate the amortization of two 30-years fixed rate mortgage. One FRM carries 5% interest rate; the other, 20%. Both have an original loan amount of $100, 000/-.

Several observations can be generalized.

The higher the mortgage rate, the higher will be the monthly payment. The 5% mortgage has a monthly payment of $ 537, whereas that of the 20% mortgage is 1, 671 (Exhibits 1 & 2)

While the monthly payment remains unchanged for the term of a FRM, its composition of principle and interest changes monthly.

In the early years of FRM, the monthly payment is represented mainly by the interest payment. The repayment of principal is only a minor portion of the early monthly payment. As the mortgage ages, however, the importance of principal repayment increases and the significance of interest payment decrease correspondingly.

Graduated payment mortgages (GPMs)

Other less popular mortgages were also offered in the 1980s to address the issue of home affordability caused by high mortgage rates. A graduated payment program has 30 years of maturity but a markedly lower monthly payment in the first year than a comparable rate level payment FRM. The first year’s low payment rises gradually for a predetermined period and then levels off. Because of the low initial payment a GPM has “ negative amortization” in the early years. That is the remaining principal balance of the mortgage rises initially rather than declines at the outset as in the cases of a level payment FRM.

Growing Equity Mortgages (GEMs)

Like a GPM, a growing equity mortgages also has a low initial monthly payment that increases gradually, but no negative amortization. The rising monthly payment of a GEM is designed to build up the equity for the home owner through a faster amortization schedule. Because of a quicker amortization the final maturity of a GEM is significantly shorter than 30 years, although the initial payment is figured on the 30 year schedule. The shorter final maturity allows the lender to charge a lower rate on the mortgage, therefore lowering the initial monthly payment of a GEM.

Biweekly Mortgages.

Based on the same concept of building up equity more quickly while maintaining a level payment, a biweekly mortgage was developed. Since increasingly pay cheques have been distributed on a biweekly basis, it would be convenient for mortgagors to write cheques for the mortgage payment on payday. More important a biweekly mortgage entails 26 payment i. e. 13 th monthly installments a year. It accelerates the amortization of the mortgage and shortens its final maturity to less than 30 years. Because of its shorter maturity, a biweekly mortgage is offered at a slightly lower rate than a 30 year mortgage.

Balloon Mortgages

Balloon mortgages also have a 30 year amortization schedule, but are due in just five or sever years. Balloon are suitable for homeowners who have a tendency to move frequently. Since they do not plan to stay at a residence for a long period of time, they do not need to obtain 30 year financing for home purchases. However they do need the financing which amortizes on a 30 year schedule. For them, balloons are ideal form of mortgages. Again, the shorter final maturity of balloon mortgages entails lower mortgages rates. It reduces the monthly payment and makes balloons popular among homeowners who are frequent movers.

Mortgage prepayment

In this area I will discuss the definition of prepayment its rates, measurements of prepayment rate, fundamental reasons for prepayment, impact of relative value of mortgage pass through and modeling prepayment.

As we already discussed that mortgage is a long term debt, so the mortgagor has a right to retire the debt before maturity. This process of early retirement of facility is known as mortgage prepayment. The prepayment rate of a mortgage pool is low right after its formation but it accelerates as the pool ages. In the initial years therefore, the prepayment rate is often measured in conjunction with the aging of the pool.

Single monthly mortality rate

SNM rate measures the percentage of a pool’s outstanding balance at the beginning of the month that was prepaid during the month

Formula for SMM rate calculation is

Mortgage pass through securities

A mortgage pass through securities, or simple a mortgage  pass-through is backed by a pool of mortgages whose monthly payments are the sole source of  cash flows of the security. The security is called a “ Pass through” because monthly payments generated from the underlying pool of mortgages are passed from mortgagors “ through” the issuer to investor in the security.

Analysis of dollar roll

The forward market is unique for mortgage backed securities. It exists because originating mortgages and pooling them for the issuance of the mortgaged backed securities is a very cumbersome and time consuming process. It normally takes up to four months from the time home buyer submits loan application  to the origination of mortgages and finally  the issuance of securities. To secure future delivery prices at current market interest rates, mortgage lenders needs to sell their production forward. This transaction / process is called a dollar roll, s special term in the mortgage securities market.

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