

## A New Housing-Finance Vision

# Universal Accounts Could Make Mortgages Obsolete

SOMEDAY, MORTGAGE DOWN payments may cease to exist.

SOMEDAY, YOUR CAR PAYMENT may become indistinguishable from your mortgage payment.

SOMEDAY, YOU MAY GET A lower interest rate for sharing the default risk on your housing debt.

### A Universal Solution

Sometime in the next millennium, the idea of a mortgage may seem as outdated as the crank starter on Henry Ford's Model T. Perhaps aging baby boomers will regale their grandchildren with stories about the tough old days when a home loan required a separate down payment and a regular repayment schedule. The storytellers undoubtedly will dwell on how the younger generation has it so easy, now that universal accounts have supplanted the traditional mortgage. Today's kids, the tales will conclude, simply do not appreciate what life was like before universal accounts simplified grandma's financial affairs by merging borrowing and



lending needs into a single account.

Although the concept of a **universal account** may seem far-fetched, many of the elements needed for such a financial vehicle are evolving already. Today's multiline financial institutions, such as commercial firms and stock brokerages, already recognize the value in cross-selling products, a concept that is key to giving this futuristic financial instrument its universal applicability.

Convenience and ease of use probably would attract consumers to this product. The account would combine all of the assets of an individual or family—including real property—and all of the corresponding liabilities—including what is currently known as mortgage debt—into one ledger kept by one financial institution.

Smoothing the way for universal accounts would take only a few changes, given the ventures in which the primary and secondary mortgage markets are involved today.

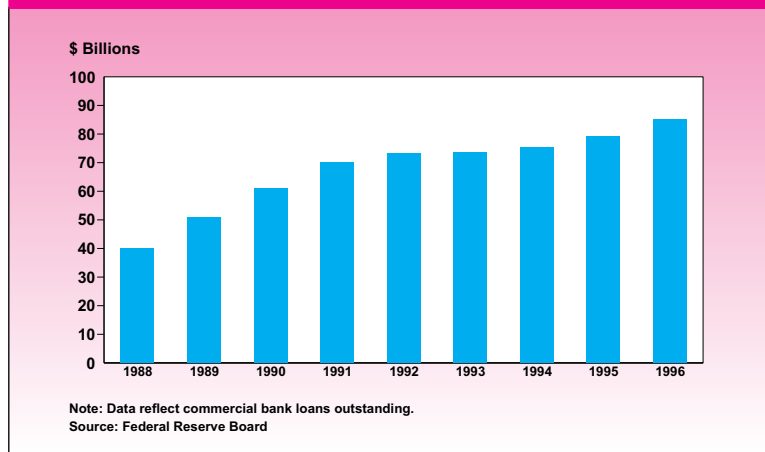
On the primary-market side, switching to the universal account would require changes in the laws and regulations governing banking and real estate practices. However, institutions such as bank holding companies already know how to administer the cash flowing in and out of their diversified product lines of consumer loans, mortgages and brokerage services; therefore, none of the behind-the-scenes administrative functions would need to change. Interactions with customers, though, would become friendlier because all the information the consumer wants is in one place, making it easier for the firm to help an individual.

The role of the secondary mortgage market would remain just as vital as it is now if a switch to universal accounts ever occurs. Universal-account

by *Ellen P. Roche*

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EXHIBIT 1: Home-Equity Credit-Line Debt Outstanding



**Growth in the volume of home-equity credit lines demonstrates that the practice of borrowing against housing equity has gained increasing consumer acceptance.**

originators could continue to sell the home-loan component of the debt to a secondary-market company, which still would pull it together with other housing-loan components into a larger mortgage-backed security. Such securities might look different from today's to reflect the risk of default on future liabilities such as car loans. The other conduits could continue to securitize car loans, credit cards, RVs and any other assets that collateralize securities today.

#### Integrating Today's Forerunners

A universal account could develop from a commingling of several financial offerings already in existence—including credit

cards, stock-brokerage sweep accounts, mortgages and, in particular, home-equity credit lines. Expanding on the way people use home-equity loans and home-equity lines of credit to finance automobiles and other expenses, the universal account would leverage a wider assortment of financial assets. The growing popularity of home-equity credit lines provides one indication that consumers would accept universal accounts (*Exhibit 1*).

Diversified financial institutions could offer these accounts individually or through strategic partnerships. Information technology—used with increasing frequency these days to evaluate the creditworthiness of loan applications for houses, cars and credit cards—could provide companies with the means to track and analyze savings

patterns and other credit information needed to make universal accounts work.

The sum of these parts, however, would equal more than their whole, by enabling consumers to leverage their financial assets to the fullest extent. Under a universal-account arrangement, an array of assets—not just a house—would become the collateral for any loans taken out through the account. From such an extremely secure position, lenders could provide borrowers with a low-cost means of obtaining no-down-payment financing. Currently, borrowers pay dearly through a high interest rate for the privilege of 100-percent financing when they buy a home or car.

The universal account would owe a debt of gratitude to the accounting profession. It would more closely resemble a financial statement—with assets toted up on one side and liabilities on the other—than a mortgage with its one-way flow of funds to the lender.

#### Glimpsing into a Mortgage-Less Future

Here is how a typical universal account, opened at the hypothetical WorldWide One, might operate over time. In this case, a hard-working account holder decides that 2007 is the year to take the plunge into homeownership. She has saved \$10,000, which is squirreled away in stocks, bonds and a money-

market fund. These investments show up on the asset side of the universal-account ledger (*Exhibit 2*). In addition, she has another \$20,000 in retirement funds, life insurance and stock options.

These funds are not included in the universal account; retirement laws would need to change first before borrowers could pledge these assets to lenders.

Instead of submitting a mortgage application, the customer fires off an electronic message informing WorldWide One of her intent to buy a home. She also requests a **purchase limit**, an agreement needed whenever the lender places a lien against account collateral to secure a new round of borrowing.

After evaluating the customer's savings pattern, a WorldWide One analyst retrieves her current credit-bureau score from an online database and runs the information through the company's automated underwriting system. Satisfied, the WorldWide One representative wires back the company's approval less than a minute later, tentatively authorizing the customer to borrow up to \$100,000 to purchase a home, repayable

through the requested 30-year, fixed-rate mortgage carrying an 8-percent interest rate.

Purchase limit in hand, the prospective homebuyer makes a \$100,000 purchase offer,

universal account through an automatic deduction.

Like any prudent universal-account provider, WorldWide One requires the borrower to keep a minimum amount of assets in

the account to secure the total liability. In this case, net assets refer to the value of the assets in the account less that of the liabilities (\$110,000 - \$100,000), or \$10,000 (*Exhibit 3*). The minimum net assets required would equal 10 percent of the outstanding liability balance, or \$10,000 (10 percent x \$100,000). In the event of default on the monthly liability payment, the lender could take legal action to acquire the financial assets in the universal account, in addition to foreclosing on the house or any other real assets.

That alone may dissuade some consumers from opening a universal account.

The deal closes the next morning when WorldWide One electronically transfers title and funds to the seller's financial institution. By pledging the assets held in the WorldWide One account, the borrower avoids the need to liquidate her stocks or other holdings; under a traditional mortgage arrangement, the borrower most likely would have to sell those

EXHIBIT 2: Universal Account, January 1, 2007	
Assets	Liabilities
Stocks = \$5,000	
Bonds = \$3,000	
Money Market = \$2,000	
Total Assets = \$10,000	Total Liabilities = \$0

EXHIBIT 3: Universal Account, January 2, 2007	
Assets	Liabilities
House = \$100,000	House Debt = \$100,000
Stocks = \$5,000	
Bonds = \$3,000	
Money Market = \$2,000	
Total Assets = \$110,000	Total Liabilities = \$100,000
LTA = 91%	
Net Assets = \$10,000	
Minimum Net Assets = \$10,000	

contingent on obtaining financing within one hour, on a home she likes.

After the seller accepts the offer, WorldWide One orders an appraisal of the house through its automated property-valuation system. With 55 minutes left before the contingency clause expires, WorldWide One agrees to finance the home at the full \$100,000 offer price. Each month, then, WorldWide One will move \$734 in principal and interest out of the borrower's

assets to convert them into a down payment, incurring a capital gains tax in the process. At this juncture, then, the house gets added to both the asset and liability sides of the universal ledger, as Exhibit 3 shows.

Today's mortgage underwriting system would not count the financial assets pledged as acceptable collateral. That, then, would produce a **loan-to-value ratio (LTV)** of 100 percent ( $\$100,000 \text{ house debt} \div \$100,000 \text{ collateral value} \times 100$ ) and zero net housing equity ( $\$100,000 \text{ house value} - \$100,000 \text{ house debt}$ ). In contrast, a universal account would measure the borrower's relative indebtedness using a **liability-to-asset ratio (LTA)**, which in this case works out to 91 percent ( $\$100,000 \text{ house debt} \div \$110,000 \text{ in total assets}$ ).

**A Matter of Leverage**

In this example, the traditional mortgage might seem to constitute the better deal in the example because the traditional borrower now is leveraged to buy a more expensive \$110,000 house. However, this additional purchasing power comes at the price of liquidating the stocks, bonds and mutual fund for the down payment. Further, the capital gains law forces the traditional borrower to cash in more than \$10,000 in assets to

net \$10,000 after taxes. The universal borrower, though, is free to hold and manage the \$10,000 equity. Which borrower is better positioned depends on several variables, including the cost of the desired house and whether the \$10,000 will produce a better return as a real estate investment that is subject to local appreciation rates or as a portfolio investment that is subject to market swings.

risen to \$18,000 ( $\$115,000 - \$97,000$ ). As *Exhibit 4* indicates, that puts the current LTA at a robust 84 percent ( $\$97,000 \div \$115,000$ ). To simplify matters, the financial assets used in this example have remained constant.

WorldWide One is willing to extend the original 8-percent rate to the combined loans because all the account holder's creditworthiness indicators have remained positive. For example, her credit-bureau score has stayed in the low-default range, she has made all payments on time and she has not overextended her credit. Had any delinquent payments turned up, WorldWide One might have elected to charge a higher interest rate for the car loan, increasing the average interest rate on the account. More than likely, the

EXHIBIT 4: Universal Account, February 1, 2010	
Assets	Liabilities
House = \$105,000	House Debt = \$97,000
Stocks = \$5,000	
Bonds = \$3,000	
Money Market = \$2,000	
Total Assets = \$115,000	Total Liabilities = \$97,000
LTA = 84%	
Net Assets = \$18,000	
Minimum Net Assets = \$9,700	

**Borrowing Urge Strikes Again**

Taking a longer view of the universal account reveals its comparative advantage. Suppose that, after three years, the account holder wants to buy a \$20,000 car. WorldWide One consents, given the healthy state of the current universal-account balance sheet. The borrower owes less on the house because the mortgage has amortized. Furthermore, an automated appraisal reveals that the home's value has increased. As a result, the homeowner's net assets have

weighted-average rate would equal what a traditional borrower could get on a higher-equity loan, such as a traditional car loan.

Besides benefiting from a lower interest rate, the universal-account holder would not need to pledge any additional equity for the car loan, because both the house and car loans are leveraging the same \$18,000 in net assets. With the addition of the car loan, the LTA rises to 87 percent ( $\$127,000 \div \$145,000$ ), as shown in *Exhibit 5*. One

monthly payment would cover both loans. Likewise, a default would jeopardize all the financial and real assets.

Contrast that to a typical car loan. Today's lending practices prevent housing equity from doing double duty as collateral for a house loan and an auto loan. Even though the borrower would have \$7,000 in net equity (\$105,000 - \$97,000), it would not apply to a traditional car loan. The borrower would need to take out a home-equity loan to access the \$7,000 to secure the car loan. Moreover, a traditional borrower would need a separate loan for the car, one that could require a 20-percent down payment of \$4,000 (*Exhibit 6*). With a universal account, however, borrowing is not limited to the value of the house; it extends to the value of all assets in the account.

**A Better Mousetrap**

An approach that combines a borrower's assets and liabilities on one balance sheet at one institution would operate more efficiently than the present system, lowering the borrower's costs and time investment while reducing the lender's overall risk.

A major cost savings accrues

from adopting a **pool-insurance** approach, used to offset the risks associated with several different loans. With pool insurance, a lender needs less equity to achieve the same level of risk protection. Absent pool insurance, each loan needs its own equity; therefore, the lender would have to require a higher interest rate, a larger down payment or both. When a lender has access to all the collateral in

pool going into default, meaning the events are not **perfectly correlated**. For example, the likelihood that a car financed through a universal account will get stolen is not closely related to the probability that a consumer's home, also financed through the account, will decline in value. Furthermore, both probabilities are unrelated to the future value of stocks and bonds. Events that are more highly correlated with

house prices, such as bankruptcy, would increase the collateral requirement.

Overall risk also is reduced whenever a lender can capitalize on the increased information available to better assess risk. Before any loans are extended through a universal account, the lender would have the opportunity to observe the borrower's savings patterns in much greater detail than is done routinely today. By carefully scrutinizing a saver's behavior month by month, lenders would become better equipped to evaluate the risk of default. Any early warnings of impending

defaults gleaned through continuous monitoring of a universal account also would allow a lender to work with the borrower earlier in the process to

**EXHIBIT 5: Universal Account, February 2, 2010**

Assets	Liabilities
Car = \$20,000	Car Debt = \$20,000
House = \$105,000	House Debt = \$97,000
Stocks = \$5,000	
Bonds = \$3,000	
Money Market = \$2,000	
Total Assets = \$135,000	Total Liabilities = \$117,000
LTA = 87%	
Net Assets = \$18,000	
Minimum Net Assets = \$11,700	

**EXHIBIT 6: Traditional Car Loan, February 2, 2010**

Down Payment	\$4,000
Loan	\$16,000
Purchase Price	\$20,000
LTV	80%
Term	5 Years
Interest Rate	9%, Fixed

a universal account, it can make do with less collateral. This is because the chance of a single loan going into default is higher than the chance of all loans in a

resolve the delinquency more quickly. Thus, uncertainty would decrease with improved information, which would reduce the risk-premium component of the interest rate. Then again, some consumers might elect to keep all of their accounts separate to protect their privacy.

Better information also could lead to greater efficiency by allowing the re-allocation of risk between lender and borrower; the total amount of risk, however, would remain the same. For instance, in exchange for a lower initial interest rate, a borrower might agree to a riskier repayment agreement under which the interest rate on the

*Universal accounts bring the efficiency of the mortgage-finance system to all consumer-financing arrangements.*

liability payment would increase if the value of the combined assets in the account declines. Normally, the lender bears most of the default risk, such as when house prices fall. In this case, though, the borrower would share in the risk as her payment rises in response to falling house prices or a declining stock market. The higher LTA would signal this higher risk to the

lender, which might raise the borrower's repayment rate. This type of loan is not for everyone—in the same way that today's adjustable-rate mortgages are not for everyone—but would represent an increase in consumer choice and, thus, an increase in efficiency.

By tying together savings, investment and borrowing functions at one institution, a universal account can carry lower interest rates. If current tax laws do not change, the account holder could continue to deduct the interest on this liability. The consumers of the next decades surely will not have lost the comparison-shopping skills they so finely honed in the 20th century. Consequently, universal-account dealers that fail to offer competitive products and prices may find their customers moving entire universal accounts to their competitors.

#### **Doing the Possible**

Universal accounts bring the efficiency of the mortgage-finance system to all consumer-financing arrangements, lowering borrower costs in the process. A thriving universal borrowing and savings system along the lines described is within the eventual grasp of the U.S. financial industry and achievable sometime after the turn of the millennium. **SMM**