Lenders' funding decisions: On- or off-balance sheet bonds?

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	Mortgage Bonds (on-balance sheet)	Mortgage Backed Securities (off-balance sheet)
Cheaper than deposits?	*NO*	*NO*

Then why are mortgage bonds and MBS an important funding source in developed markets?

	Mortgage Bonds (on-balance sheet)	Mortgage Backed Securities (off-balance sheet)
Cheaper than deposits?	*NO*	*NO*

Because mortgage bonds and securities reduce lenders' risks...

Lender's Balance Sheet - *Before*

Assets		Liabilities	
Long Term Loans	100	Short Term Deposits	100

A classic funding mismatch

Lender's Balance Sheet - *After Mortgage Bond*

Assets		Liabilities	
Long Term Loans	100	Long Term Bond	100
Cash	100	Short Term Deposits	100

A matched position

Lender's Balance Sheet - *After Mortgage Backed Security*

Assets		Liabilities	
Cash	100	Short Term Deposits	100

A matched position

Mortgage Lender's Risks

- Credit risk
- Liquidity risk
  - Maturity matching
  - Diversification of funding sources
- Interest rate risk
- Prepayment risk
- Currency risk
- Regulatory risk
  - Capital adequacy ratio, etc.

	Mortgage Bonds	Mortgage Backed Securities
Regulatory issue: *improve capital adequacy ratio?*	*NO*	√

	Mortgage Bonds	Mortgage Backed Securities
Transfer of credit risk to bondholders	√	√
Improve liquidity *Maturity matching* *Diversification*	√	√
Reduce interest rate risk	√ *if bonds match the interest rate basis of existing assets*	√ *when loans with unwanted interest rate basis are securitized*

	Mortgage Bonds	Mortgage Backed Securities
Reduce prepayment risk	NO	√
Can reduce currency mismatches	√ if bonds match the currency of existing assets	√ when loans in unwanted ccurrency are securitized

Other Considerations	Mortgage Bonds	Mortgage Backed Securities
Lender retains customer relationship	√	√
Mortgage servicing fee income	NO	√
Complex accounting for retained portion		**YES**

Key Considerations

- *Both* on and off-balance sheet bonds reduce lenders' risks
- *Only* off-balance sheet bonds (MBS):
  - Directly increase the capital adequacy ratio
    - No other funding source besides equity capital has the same positive effect on the CAR
  - Reduce lender's repayment risk