Chapter 11

Sources of Funds for Residential Mortgages

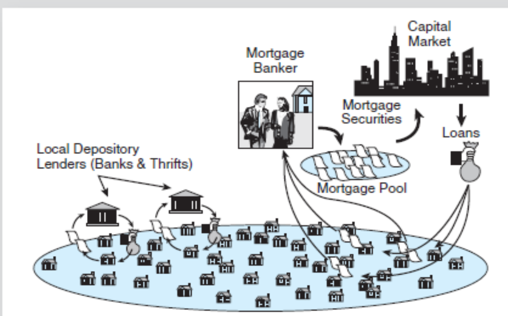
McGraw-Hill/Irwin

Mortgages and Mortgage Markets

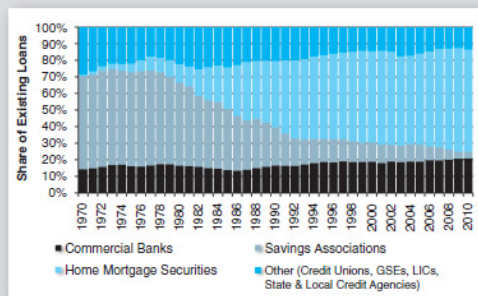
Loan Type	Amount	Percent of Total
Residential (1–4 family)	$10,336	76%
Apartment (multifamily)	841	6
Commercial	2,249	17
Farm	133	1
Total	$13,559	100%

Source: *Federal Reserve Bulletin*, December 2011. Table 1.54, "Mortgage Debt Outstanding."

Traditional and Modern Housing Finance



Traditional and Modern Housing Finance



Source: Flows of Funds Accounts of the United States

Thrifts

- Formerly backbone of home mortgage finance
  - Dominated mortgage lending
  - Extremely localized
  - Fatal flaw: Funded long-term loans with short-term savings

Thrifts Today

- Most are now banks (acquired or converted)
- Others often have “boutique” roles:
  - Mortgage banker Sub-prime lender
  - Commercial loans Multifamily loans
- Emphasis on ARM lending (40% of loans)

Commercial Banks

- Historically: Real estate needs of business clients
  - Business-related real estate loans
  - Home loans
  - Personal investments
- Assumed former roles of savings associations
- Large-scale construction lending

Portfolio and Non-Portfolio Mortgage Lenders

- Portfolio Lenders (depository institutions)
  - Banks
  - Thrifts
  - Large credit unions
- Non-portfolio lenders
  - Mortgage bankers
  - Mortgage brokers
    - May include credit unions and small banks

Non-Portfolio Lenders: Mortgage Companies

- Mortgage banker: Not a bank – accepts no deposits
  - Originates loans to sell
  - Retains right to service the loan for a fee
  - Borrows money from Banks to finance (warehouse line of credit)
- Mortgage broker: Brings borrower and lender together for a fee; never owns the loan

Mortgage Banker

- Originates and owns loans long enough to:
  - Sell loans, or
  - Pool and securitize loans
- Servicing is core profit center
- Three-step process:
  1. Issue mortgage commitment to potential borrower
  2. Close or originate loan (funding loan)
  3. Sell loan

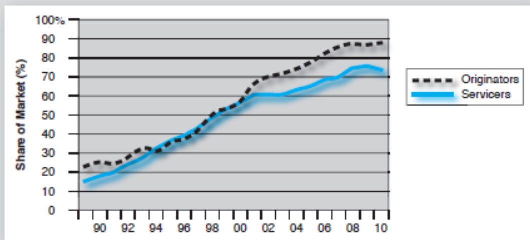
Mortgage Banker as Servicer

- Collects monthly payments, remits to investor
- Collects and remits payments for property taxes, hazard insurance and mortgage insurance
- Manages late payments, defaults, foreclosures
- Receives fee of .25% to .44% (25 to 44 bp)
- Typically accept loss at origination of a loan to obtain servicing rights

Emergence of Megamortgage Bankers

- Megabanks saw home mortgage lending as profit center
- Cyberelectronics imply huge economies of scale
- Four modes of operation:
  - Traditional "face-to-face" or "retail" lending
  - Wholesale mortgage banking (e.g. buys from mortgage banker)
  - Internet lending
  - Lending through brokers
- Tremendous consolidation in last decade

Consolidation of the Top 20 Home Mortgage Lenders



Source: The *2011 Mortgage Market Statistical Annual*, vol 1. Inside Mortgage Finance Publications Inc. Bethesda, MD, 20

Evolution of the Secondary Mortgage Market

- Pre-1970: Limited and informal
- Lack of standardization a barrier
- Large interregional differences in home mortgage interest rates (100-200 bps)
- Rising interest rates could shut down home mortgage lending through disintermediation

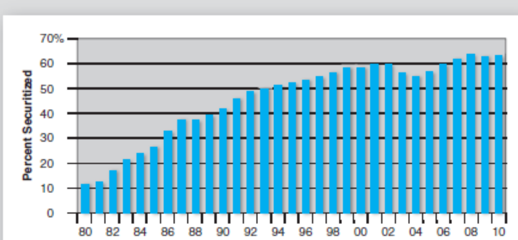
Beginning of the Modern Secondary Mortgage Market

- Fannie Mae (1968): Spun off from HUD to become a primary purchaser of FHA and VA mortgage loans
- Ginnie Mae (1968): Empowered to guarantee "pass-through" mortgage-backed securities based on FHA and VA loans
- Freddie Mac (1970): Formed to purchase and securitize conventional home loans from thrifts

Mortgage-Backed Securities (MBS)

- Multiple mortgage loans in a single pool or fund
- Security entitles investor to pro rata share of all cash flows
- Loans in a given pool will be similar:
  - FHA/VA; conventional
  - Same vintage (new or recent loans)
  - Similar interest rates
- **Nearly two-thirds** of all new home loans have been securitized in recent years

The Growth of Home Mortgage Securitization



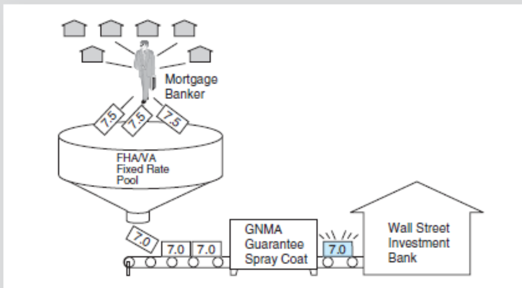
*First-lien home mortgage loans

Source: *Federal Reserve Bulletin*, December 2011, Table 1.54.

Role of Ginnie Mae in the Secondary Mortgage Market

- GNMA created first major pass-through MBS program
  - Does not buy mortgages
  - Guarantees timely payment of interest and principal to holders of GNMA securities.
  - Guarantees only securities based on FHA/VA loans

The Ginnie Mae Mortgage-Backed Security Process



Fannie Mae

- Original mission: Secondary market for FHA/VA
- Became privately owned but still U.S. chartered
  - Public mission for housing
  - U.S. Treasury financial credit line available
- Surpasses Freddie Mac in buying conventional loans
- Funded through both debt issues and mortgage securitization
- Has securitized and sold, or owns, about 23% of outstanding home loans
- Taken into conservatorship by U.S. in 2008

Freddie Mac

- Chartered by Congress
- Deals exclusively in conventional loans
- Securitized all loans purchased until recent years
- Financially similar to Fannie Mae
- Has securitized and sold, or owns, about 15% of outstanding home loans
- Taken into conservatorship by U.S. in 2008

Importance of Fannie Mae and Freddie Mac

- Have brought about standardization in:
  - Mortgages and mortgage notes
  - Appraisal forms and practices
  - Underwriting procedures and standards
  - Also, influence practices and standards in nonconforming mortgage markets

Importance of Fannie Mae and Freddie Mac

- Have increased liquidity of mortgage markets
  - No interstate differentials in mortgage interest rates
  - No home lending disruptions when interest rates rise
  - New sources of mortgage funds in security investors
- Heavily influence what type loans lenders make

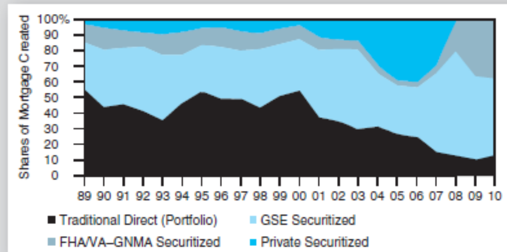
Private Mortgage Conduits

- Grew out of the market for non-conforming "Jumbo" loans
- Small market share until sub-primes emerged
- Grew explosively post-2000, mainly for sub-primes
- Diminishing rapidly as sub-prime diminish
- Likely to continue as a conduit for "Jumbos"

The U.S. Home Mortgage System Today – Four Channels

- Local depository lending (very limited)
  - Home Equity loans via credit unions
- FHA/VA – GNMA securitization process
- Conforming conventional – GSE process
- Non-conforming conventional – private security process

Market Shares of the Four Channels of Home Mortgage Lending



Where Do You Get a Mortgage Loan in Today's Complex System?

- No simple answer, except to shop aggressively
- Portfolio lenders may offer cost and interest rate advantage
- Brokers may offer service and down payment advantage
- Depository lenders may have best ARM offers
- Non-depositories may have best fixed-rate offers
- SHOP!

Lenders' Underwriting Decisions

- Underwriting: Process of determining whether the risks of a loan are acceptable
- Three "Cs" of traditional underwriting:
  - Collateral: URAR appraisal
  - Creditworthiness: Credit report
  - Capacity: Ability to pay (payment ratios)

Traditional Payment Ratios for Mortgage Underwriting

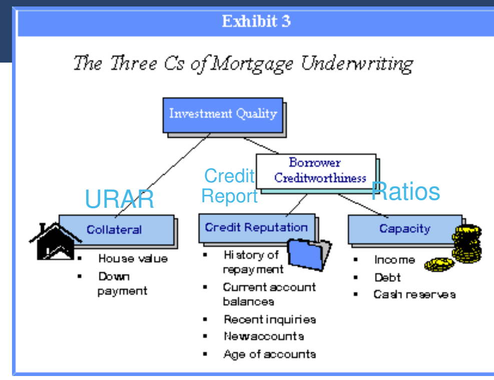
- Housing expense ratio = *PITI/GMI*
  - *PITI* is principal, interest, (property) taxes and insurance
  - *GMI* is gross monthly income
  - Recent convention set maximum at:
    - 28% for conventional loans
    - 29% for FHA
  - Known as "front-end" ratio

Traditional Payment Ratios for Mortgage Underwriting

- Total debt ratio = (*PITI* + *LTO*) ÷ *GMI*
  - *LTO* is long-term obligation
  - Recent convention set maximum at:
    - 36% for conventional loans
    - 43% for FHA
  - Known as "back-end" ratio
- Note: GMI is critical. Its computation is closely regulated by ECOA

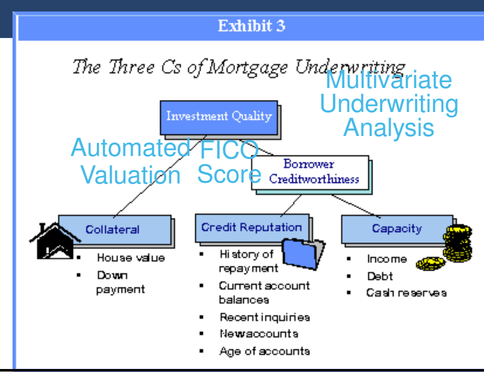
Thinking about buying a house?

- Keep your LTO as low as possible if you want to maximize the amount of your mortgage



Modern Home Loan Underwriting

- Automated underwriting is dominant
  - Creation of single statistical score
  - URAR appraisal for to "automated valuation"
  - Credit report displaced by credit score
- Single underwriting index incorporates: house value, credit score, income and obligation data



Subprime Lending

- Many households unable to qualify for "affordable" home loans
- Subprime originally targeted three borrower deficiencies:
  - Lack of income documentation
  - Weak credit
  - Seeking financing for 100% LTV or higher

Subprime Lending (continued)

- More expensive than standard home loans
- Polar views of subprime lending:
  - Fills compelling, legitimate need (beats credit cards)
  - Hunting ground of predatory lenders
- In any case, spun out of control, and to disaster

Qualified Mortgages

- In response to the "mortgage meltdown" following the 2008-2012 house price declines, mortgage credit has been tightened
- Top quality applicants have no problems getting loans, and interest rates are very low by historical standards
- The required documentation for borrowers has increased significantly
- The Consumer Financial Protection Bureau (created by congress) has defined a type of mortgage known as a Qualified Mortgage (as of January 1, 2014)

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Qualified Mortgage

- No negative amortization allowed
- No IO payments allowed
- The points and fees on a mortgage over 100,000 can not exceed 3%
- Limits the fees that someone can earn for steering you to a QM (cannot earn more on a non-QM)
- All FHA/VA and conforming loans must be QM (for next 7 years)
- Must show a borrower can afford the loan over the life of the loan (cannot be qualified on the Teaser Rate).
- Back end ratio cannot exceed 43%

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End of Chapter 11

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