Chapter 10
The Secondary Mortgage Market

The Good Old Days
- Banks and Savings and Loans made loans and held these loans in portfolio
- The interest paid on the loan was used to pay interest to the depositors
- Mortgage brokers originated some loans for out of state “thrifts” and for insurance companies

The New Way
- There is usually a separation between loan origination and loan ownership
- Even if a bank “makes” a mortgage loan, it most often “sells” it
- Most of the origination business today is done by Mortgage Bankers and Mortgage Brokers
- Servicing rights may be separate from ownership

Depository Lenders in the Primary Market
- Commercial Banks
- Savings Institutions (thrifts)
- These institutions take customer deposits and originate and service loans.

Nondepository Lenders in the Primary Market
- Mortgage bankers
  - originates and services loans which are sold on the secondary markets
  - warehouses loans to package as pools (may bear “pipeline” risk
- Mortgage brokers
  - finds other loan originators to place a loan with

Secondary Markets
- Standardization and known products allows for efficient secondary markets which was helped by:
  - Uniform underwriting standards
  - Title Insurance
  - Hazard Insurance
  - Mortgage Insurance for low down payment mortgage and possibly other credit enhancement
Mortgage Markets

- Primary mortgage market – money flows between the people whose name is on the note
  - Lenders and borrowers
- Secondary mortgage market – money flows among investors
  - Conduits, investment bankers and investors
  - Mortgage-backed securities

Secondary Mortgage Markets

- Purpose:
  - To replenish mortgage funds to originators
  - To provide investors with mortgages or mortgage backed securities as investment alternatives
- Early days:
  - Eastern Thrifts with surplus funds would buy mortgages from California
  - Life insurance companies would buy packages of mortgages from mortgage bankers or brokers

Secondary Mortgage Markets

- The first large scale secondary market was for FHA and VA loans. These loans have Federal guarantees as to timely payment of principal and interest
- After the success of the secondary mortgage markets for FHA and VA loans, similar programs were adopted for conventional loans

Government-Sponsored Mortgage Programs

- FHA-Insured Loans
- VA-Guaranteed Loans
  - Neither the FHA or VA originates loans

FHA-Insured Loans

- FHA loans are made by private lenders through various programs (e.g. section203 loans)
- FHA insurance protects the lender from losses due to default and foreclosure
- FHA borrowers pay an up front premium, plus a monthly premium for FHA insurance
- Maximum FHA loan amounts vary depending on an area’s median house price
- Allows for very low down payment

VA-Guaranteed Loans

- VA loans are made by private lenders (available to U.S. Veterans)
- VA guarantees the lender against loss up to 100% of a property’s value
- VA charges a funding fee based on the size of the LTVR
- Maximum VA loan amounts exist
- No down payment is required and no discount points can be paid by the borrower
GNMA Payment Guarantee
- GNMA was empowered to guarantee timely payment of PI on securities backed by FHA, VA, and FmHA
- GNMA resulted in an expansion of secondary market
- Pass-through securities (MPTs)
- Default risk minimized

Secondary Mortgage Market
- GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GINNIE MAE)
  - Created in 1968 within HUD
  - Does not purchase mortgages or issue securities
  - Market focus is to guarantee FHA and VA pass-through securities

Operation of Secondary Market
- Direct sale programs – sell loans to life insurance companies and other financial institutions that wish to hold mortgages as part of their financial assets
- Mortgage-related security pools – sell securities on Wall Street that are backed by mortgages

Direct Sale Programs
- Originators
  - Mortgage companies
  - Thrifts
  - Commercial Banks
  - others
- Buyers
  - Life insurance companies
  - Eastern thrifts
  - FNMA
  - FHLMC

Mortgage Related Securities
- MBS – mortgage backed securities (generic term)
- MBBs – mortgage backed bonds
- MPTs (mortgage pass throughs) – money from mortgage payments are passed through to investors of these securities
- MPTBs (mortgage pay through bonds) – act like a pass through in terms of payouts, but are technically bonds
- CMOs (collateralized mortgage obligations)

COMMERCIAL MORTGAGE BACKED SECURITIES (CMBS)
- Started with S&L crisis of 1980s when RTC packaged commercial loans of failed thrifts and sold CMBSs
- Senior tranche received all principal payments including prepayments
- Subordinated tranche bore all losses from defaults
CMBS (cont.)

- Securitization process is same as for CMOs with different tranches
- May be backed up by many mortgages on many properties, a single loan on a very large property, or a single loan on many properties
- Loans are credit rated and contributed to a REMIC

FNMA – Fannie Mae

- Federal National Mortgage Association, FNMA (Fannie Mae)
  - Used to be part of HUD (Housing and Urban Development).
  - It is a quasi private firm with stock that trades on the NYSE
  - About 1/3 of its Board of Directors is appointed by the President of the United State
  - Has some rights to borrow from the Treasury

Fannie Mae, FNMA

- FNMA was organized in 1938 to purchase FHA loans
- FNMA reorganized in 1968 and authorized to purchase conventional mortgages in 1970
- FNMA obtains funds from the sale of its stock, its MBS, by issuing bonds, and from its earnings
  - Earns money from a spread on which it earns on mortgages and pays to bond holders
  - Earns guarantee fees on Pass Throughs
- The mortgages held and MBS issued by FNMA account for $2.8 trillion (Annual report, 2007) of the $11.8 trillion of residential mortgages outstanding

Freddie Mac, FHLMC

- Federal Home Loan Mortgage Corporation
- FHLMC was created in 1970 to provide a secondary market for S&L associations
- FHLMC currently buys both government-underwritten and conventional loans
- Freddie Mac and Fannie Mae are now operationally similar
- The mortgages held and MBS issued by Freddie Mac account for $2.1 trillion (Annual report, 2007) of the $11.8 trillion of residential mortgages outstanding

Freddie Mac, FHLMC

- Freddie Mac purchases both newly issued and seasoned (those with some expired term) mortgages
- Freddie Mac will also purchase construction/permanent loans that are FRMs, ARMs, or balloon/reset. These must be new dwellings and not rehabs.

Freddie Mac, FHLMC

- Freddie Mac issues a wide variety of securities:
  - Discount Notes and Debentures
  - Mortgage Participation Certificates (Pass-throughs) on FRMs, ARMs, and multifamily
  - Collateralized Mortgage Obligations in several classes or tranches
Regulation of Government-Sponsored Enterprises

- GSEs are not officially part of the federal government.
- They appear to enjoy the backing of the federal government.
- Federal government does not guarantee these agency’s obligations but Congress has implied that federal funds might be expended to pay off investors.

Regulation of Government-Sponsored Enterprises

- GSEs operate similarly to thrifts in purchasing long-term mortgages.
- They face interest rate risk, default risk, and management/operating risk.
- Office of Federal Housing Enterprise and Oversight (OFHEO) oversees the operations of the GSEs.