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A PRIMER ON THE SECONDARY MORTGAGE MARKET

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A PRIMER ON THE RESIDENTIAL MORTGAGE MARKET

I. Overview

Primary Mortgage Market: Market where borrowers obtain loans from mortgage originators.

Secondary Mortgage Market: Market where mortgage loans are bought and sold; relationship between originator and investor.

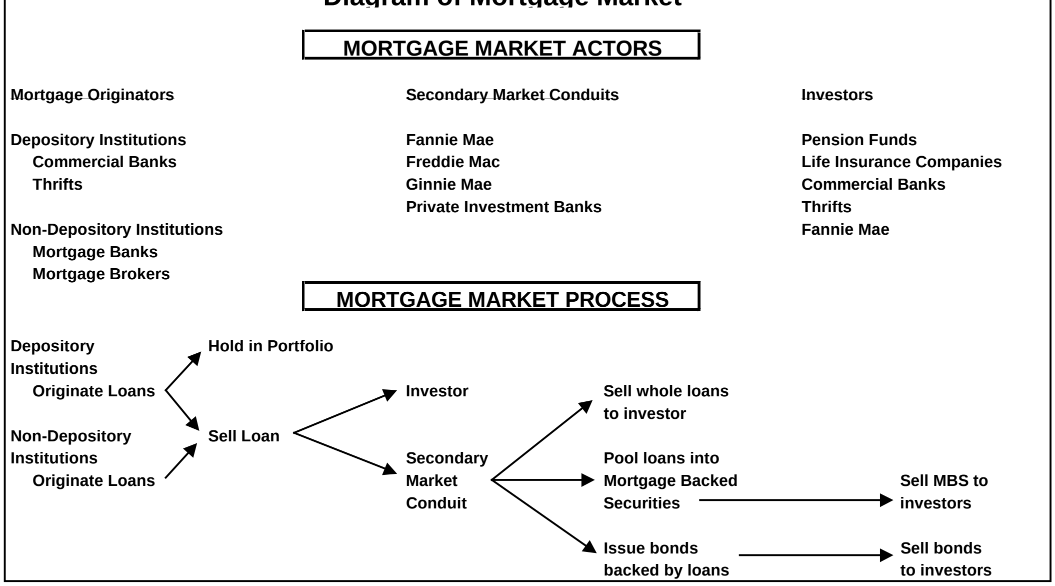


Diagram of Mortgage Market

Source: DiPasquale and Wheaton, *Urban Economics and Real Estate Markets*. Prentice-Hall, 1996.

Primary Mortgage Market

Origination Process

1. Application

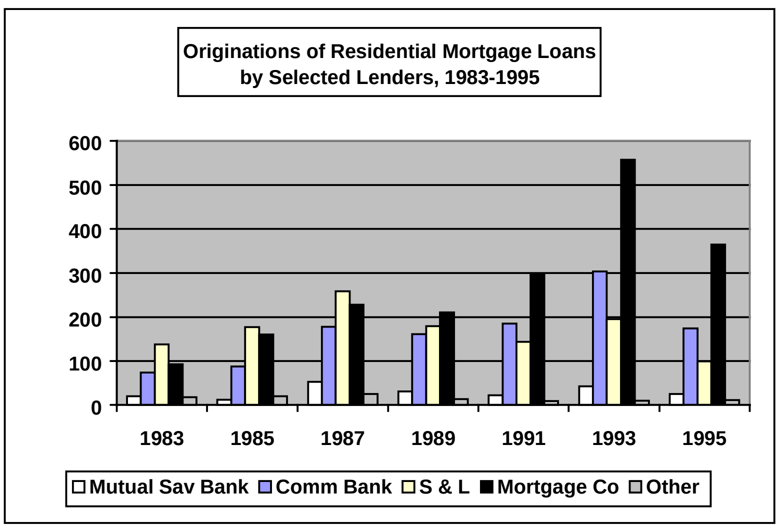
2. Underwriting
    A. Borrower Requirements: Does the borrower have both the ability and willingness to repay the loan?
    B. Property Requirements: Since the mortgage is a loan secured by the property, the lender needs to insure that the proceeds from the sale of the property would be sufficient to repay the debt if the borrower defaults on the mortgage. Property is appraised to insure that the borrower is not paying too much.

3. Closing: Production of legal documents to create the mortgage and transfer ownership of the property.

Servicing Process by Originator

1. Receive monthly mortgage payments
2. Manage tax and insurance escrows
3. Monitor delinquencies
4. Manage foreclosures
5. Make payments to investors

Who originates residential mortgages?



Source: Fannie Mae, *A Statistical Summary on Housing and Mortgage Finance Activities*.

- In 1995, there were $674 billion in residential mortgage originations.

- Historically, S&Ls dominated mortgage originations.

- In 1995, mortgage companies were the dominant originators with 54.1% of the market.

- In 1993 and 1995, commercial banks originated 26-27% of the mortgage amounts.

Secondary Mortgage Market

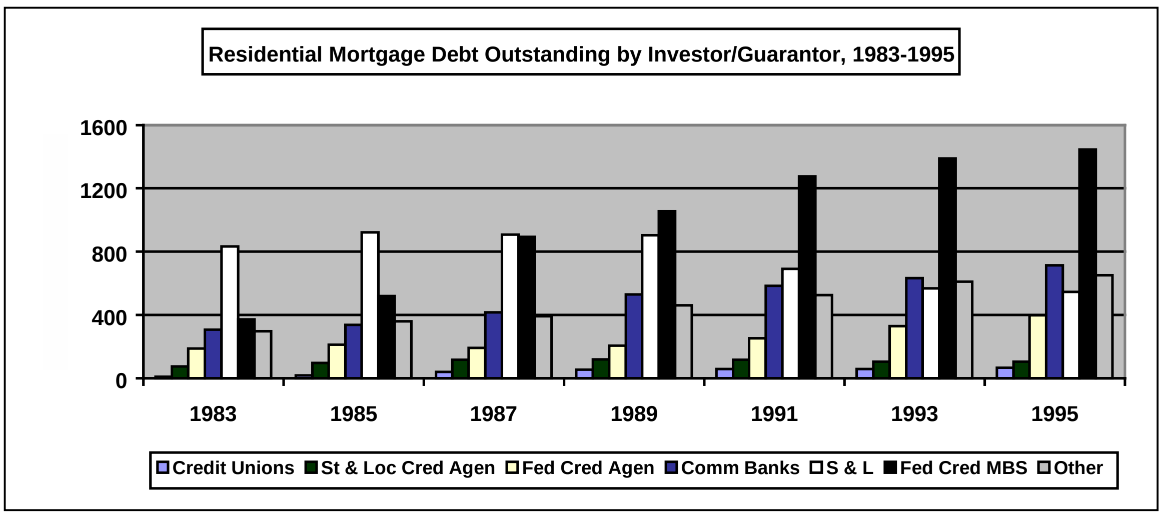
Process: Three Options

1. Mortgage originator can also be a mortgage investor by holding mortgages originated in portfolio.

2. Mortgage originator sells loan to an investor that holds the loan in portfolio.

3. Mortgage originator sells loan to conduit that packages loans into securities and sells interests in the securities to investors.

Who invests in residential mortgages?



Source: Fannie Mae, *A Statistical Summary on Housing and Mortgage Finance Activities*.

• In 1995, there were $3922.8 billion in residential mortgages outstanding.

• S&Ls were major investors in residential mortgages in the 1980s, but their share has dropped significantly in the 1990s.

• Since 1987, federal credit agency MBS pools have become dominant holders of residential mortgages. In 1995, they held 36.8% of all outstanding residential mortgage dollars; that year, the federal credit agencies also held 10.2% in portfolio.

• Others include mortgage companies, finance companies, life insurance companies, pension funds and state and local retirement funds, private MBS pools, etc.

II. Examining the Secondary Mortgage Market

A. Rationale for Secondary Mortgage Market

Housing markets are inherently local in nature but financing housing need not be. Mortgage availability should not be a function of local savings; regions that are growing but do not have much savings should be able to get mortgage funding from regions with excess savings.

B. Requirements for a Liquid Secondary Mortgage Market

1. Standardization: Mortgages must be a standard commodity regardless of originator.
   A. Mortgage contracts must meet industry standard.
   B. Underwriting standards must be similar so that investor knows that mortgages meet an industry standard, regardless of originator.

2. Information about performance and risk:
   A. Investors require information in order to consider moving into new markets.
   B. Information must provide basis of comparison for investments in mortgages versus alternative investments.

C. Role of the Federal Government in the Secondary Mortgage Market: Building Institutions[1]

Federal government role in the operation of the secondary mortgage market began in the 1930s with the creation of ***Federal Housing Administration (FHA)*** in 1934.

- FHA was created to encourage homeownership through promoting the 30-year fixed rate mortgage to lenders and investors by insuring these loans. (At the time, the dominant mortgage was a 5 to 7 year balloon.)

In 1938, the federal government created the ***Federal National Mortgage Association (Fannie Mae)***.

- Fannie Mae was created to purchase FHA-insured loans. The idea was that mortgage lenders would be more willing to originate the FHA fixed rate mortgage if they did not have to hold them in portfolio. In addition, by selling the mortgages, lenders could fund more mortgages.

- In 1948, Fannie Mae began purchasing VA mortgages. In 1970, Fannie Mae began purchasing conventional mortgage loans.

- Fannie Mae's dominant approach was to fund the purchase of mortgages by issuing debt and holding the mortgages in portfolio.

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[1] See Freddie Mac, *A Citizen's Guide to the Secondary Mortgage Market*, 1988.

- In the past 15 years, Fannie Mae has moved much more towards funding mortgage purchases by packaging mortgages into mortgage backed securities (MBS) and selling the securities to investors.

In 1968, Fannie Mae was split into two organizations: Fannie Mae, a federally chartered corporation owned by private shareholders, and the ***Government National Mortgage Association (Ginnie Mae)***, a government agency housed in the U.S. Department of Housing and Urban Development.

- Ginnie Mae is responsible for providing a secondary market for FHA/VA loans and other mortgages to support federal housing assistance efforts. Ginnie Mae acts as a conduit that purchases mortgage loans, packages them into securities and sells participation in the securities to investors.

- Unlike Fannie Mae, Ginnie Mae MBS are guaranteed by the full faith and credit of the U.S. government. The guarantee promises investors that principal and interest due will be paid by Ginnie Mae if not by borrowers. In addition, Ginnie Mae services a portfolio of mortgages owned by the federal government.

In 1970, Congress created the ***Federal Home Loan Mortgage Corporation (Freddie Mac)***.

- Freddie Mac was created to provide a secondary mortgage market for conventional mortgages with its focus on providing a secondary market for thrifts.

- Freddie Mac began with funding from the *Federal Home Loan Bank*, which served as the central banks for thrifts.

- Freddie Mac's dominant approach was to purchase mortgages, package them into securities and sell the securities to investors. Historically, Freddie Mac has held very little mortgages in portfolio.

D. Today's Mortgage Market: How the Federal Credit Institutions Have Evolved

1. The Institutions

FHA

- FHA promotes affordable homeownership for lower-income households through the provision of mortgage insurance for high loan-to-value loans, decreasing the downpayment required. In 1995, FHA insured 7.1% of the total dollar value of single-family mortgages originated.

- Over the past two decades, FHA has been the dominant source of mortgage insurance on multifamily mortgages. In the early 1990s, the multifamily programs generated substantial losses resulting in FHA retreating from this market. In recent years, FHA has been working on ways to re-enter the market. In 1995, FHA insured 3.4% of the total dollar value of multifamily mortgages originated, down considerably from the early 1980s when FHA insured close to one-third of multifamily originations.

• FHA promotes standardization in the mortgage market by setting underwriting standards for the mortgages it insures.

Ginnie Mae

• Ginnie Mae continues to provide a secondary market for FHA/VA loans by creating a secondary market for its MBS. In 1995, Ginnie Mae's net addition in MBS was $21.4 billion and they had $472.3 billion in MBS outstanding. In 1995, Ginnie Mae purchased 11.1% of single family mortgage originations and 5.7% of multifamily originations.

Fannie Mae and Freddie Mac[2]

• Fannie Mae and Freddie Mac are both federally chartered, private corporations with their stock traded on the New York Stock Exchange. Both firms have Boards of Directors with 18 members, 13 of whom are elected by shareholders and the remaining 5 are appointed by the President of the United States.

• Both firms purchase single family and multifamily FHA/VA and conventional mortgages to either hold in portfolio or package into mortgage-backed securities to sell to investors. Both are prohibited from originating mortgages.

• Securities issued by both firms have the guarantee of the issuing firm; there is no federal government guarantee on these securities.

• In 1995, Fannie Mae held $253.5 billion in mortgages in portfolio and had $513.2 billion in MBS outstanding; Freddie Mac held $106.9 billion in portfolio and had $459 billion in MBS outstanding.

The charter acts of both firms impose requirements and provide important benefits to these agencies:

Charter Act requirements of Fannie Mae and Freddie Mac:

1. Limits activities to providing a secondary market for residential mortgages.

[2] See Freddie Mac, *Financing America's Housing: The Vital Role of Freddie Mac*, 1997.

2. Limits the maximum size of single family mortgages that can be purchased (1996 loan limit was $207,000).

3. Mandates HUD to set annual housing goals.

4. Requires federal monitoring of the corporation's financial condition.

Charter Act benefits to Fannie Mae and Freddie Mac: Fannie Mae and Freddie Mac enjoy significant benefits, which give them advantages over other investors, notably:

1. Securities are exempt from registration requirements of the Securities and Exchange Commission.

2. Exempt from state and local income taxes.

3. The Secretary of the U.S. Treasury is authorized to purchase up to $2.25 billion in securities of each firm in order to enhance liquidity.

Do Fannie Mae and Freddie Mac Securities Have an Implicit Federal Government Guarantee?

There is no explicit guarantee by the federal government of the securities issued by Fannie Mae or Freddie Mac, unlike Ginnie Mae securities. In addition, there is no federal obligation to bail out either corporation if they have financial problems. However, Fannie Mae and Freddie Mac enjoy a substantial benefit because of the widely-held view in the marketplace that in the event of financial problems with either institution the federal government will be there to bail them out. As a result, both firms can borrow at lower rates and their securities carry a AAA rating.

E. The Impact on the Market of the Agencies

• **Fannie Mae, Freddie Mac and Ginnie Mae are very large players in the mortgage market**.

In 1995, there were $3,922.8 billion in residential mortgages outstanding. 46% of that mortgage amount was either held by Fannie Mae and Freddie Mac in portfolio or was in MBS with a guarantee from Fannie Mae, Freddie Mac or Ginnie Mae.
In 1995, the three institutions purchased 41% of residential mortgage originations.

- **What is the economic rationale for supporting Fannie Mae and Freddie Mac?**

  The fundamental aim of government involvement in the provision of a secondary mortgage market is to increase the funding of mortgages through the capital markets, thereby increasing efficiency and ultimately insuring that mortgage credit will be readily available at lower prices.

- **Is there a market failure?**

  An active secondary market requires both *standards* and *information*, both of which have attributes of *public goods*. While the overall market reaps substantial benefits from industry standards and information, no individual firm may have sufficient incentive to produce those standards and information if their production is costly and outweighs the benefits to the individual firm. This is a classic case of market failure where government intervention may be warranted to ensure that these public goods--standards and information--are produced.

- **Have Fannie Mae and Freddie Mac Addressed this Market Failure?**

The Single Family Market. The traditional focus of the GSEs has been on mortgages for owner-occupied housing. Fannie Mae and Freddie Mac played an important role in developing standards and information in the single family mortgage market.

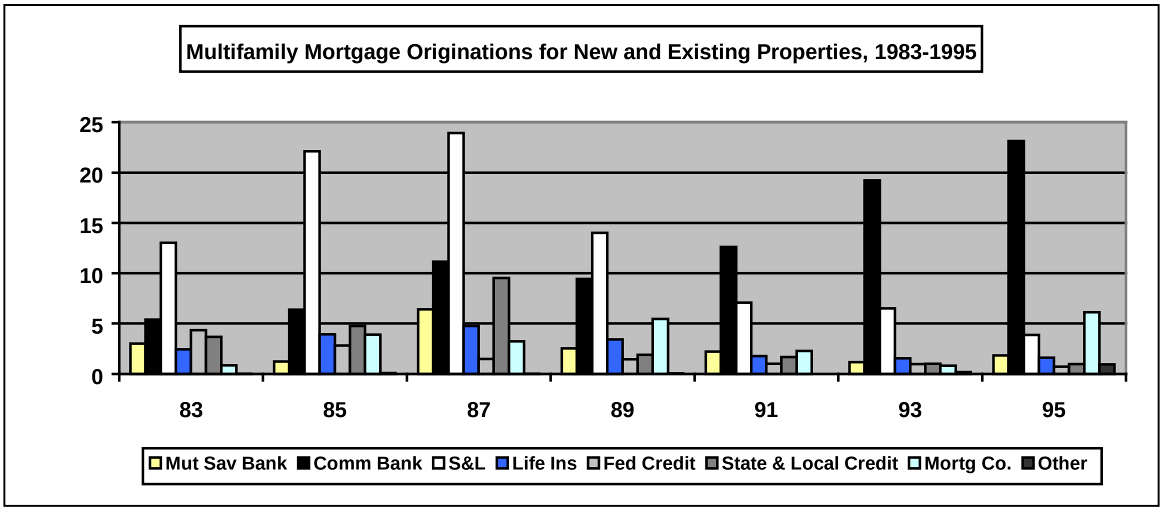
> Fannie Mae & Freddie Mac introduced the standard mortgage application in 1973 and the standard mortgage note for all states in 1975. These were two important milestones in making mortgages a commodity.
>
> Fannie Mae and Freddie Mac mortgage underwriting guidelines are the industry standard.
>
> The volume and track record of Fannie Mae & Freddie Mac provide a substantial information base for investors to assess.

The Multifamily Market. While their charters cover both single family and multifamily mortgages, Fannie Mae and Freddie Mac contributions to the multifamily mortgage market have been much more limited.

> Multifamily mortgages are far less standard than single family mortgages.
>
> There is little systematic information on the risk and performance of multifamily mortgages for investors to assess.

F. The Multifamily Mortgage Market

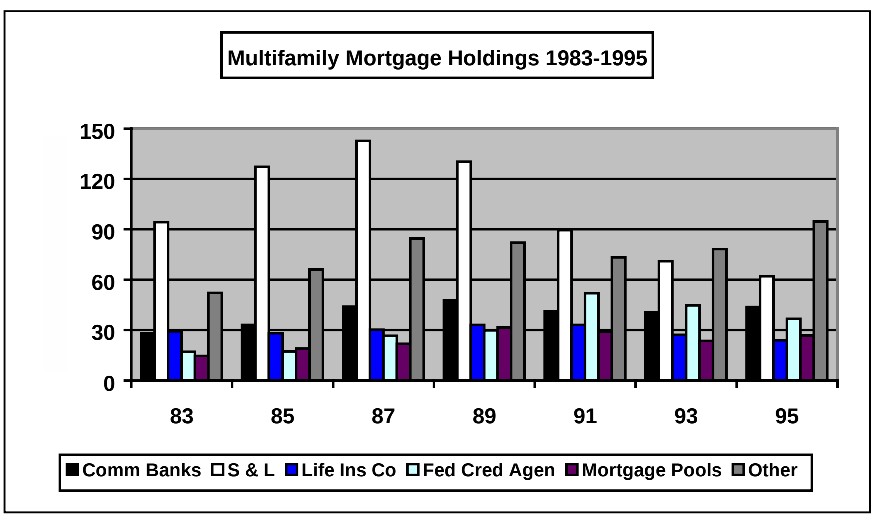
Who originates multifamily mortgages?



Source: U.S. Department of Housing and Urban Development, *Survey of Mortgage Lending Activity*, Annual Tables, table 3.

• In 1995, there were $39.2 billion of multifamily mortgage originations.
• In 1985, S&Ls originated 49% of multifamily originations. In 1995, their share was 10%.
• By 1991, commercial banks were the major originator of multifamily mortgages. In 1995, they were responsible for 59% of the market.

Who invests in multifamily mortgages?



Source: Board of Governors of the Federal Reserve System.

• Again, S&Ls were major investors, holding 41% of the market in 1987 and 37% in 1989. By 1995, their share dropped to 22%. The S&L crisis and the changed risk-based capital requirements of FIRREA in 1989 severely limited the extent to which S&Ls could invest in some mortgages.

• In 1995, 33% of mortgage holdings were held by “others,” about two-thirds of which were state and local credit agencies. The rest include mortgage companies, retirement and pension funds, credit unions and finance companies, and individuals.

• Of the $288 billion in multifamily mortgages outstanding in 1995, 12.3% was either held by Fannie Mae and Freddie Mac in portfolio or was in MBS with a guarantee from Fannie Mae and Freddie Mac. Fannie Mae accounted for 10% and Freddie Mac accounted for 2.3%. Ginnie Mae MBS accounted for an additional 3.8% of multifamily mortgage debt outstanding. In contrast, Fannie Mae, Freddie Mac, and Ginnie Mae portfolio holdings accounted for 48.2% of the $3,634 billion in single family mortgages outstanding.

• Virtually all single family mortgages originated are purchased in the secondary market. In 1995, 40.5% of multifamily mortgages were purchased in the secondary market.

Should Fannie Mae and Freddie Mac Have Greater Multifamily Activity?

• The multifamily secondary mortgage market is in the early stages of development. There is a clear need for leadership in the multifamily market in creating standards.

• It could be argued that today there is more of a rationale for government sponsorship of Fannie Mae and Freddie Mac to intervene in the multifamily mortgage market than in the single family market. In many ways, the goals of creating standards and an information base have already been achieved in the single-family market.