

CHAPTER 13-2

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SECONDARY MORTGAGE MARKETS

1. Early Mortgage Market Problems

- o Bankers and S&Ls concerned for Safety
 - a. Short-term maturity (5 years)
 - b. Low L / V ratios (50%)
 - c. Payments usually interest only

2. Solution

- o Provide mortgage insurance
 - a. FHA insurance (1934)
 - b. VA guaranty (1944)
- o Create secondary market makers
 - a. FNMA
 - b. GNMA
 - c. FHLMC
- o Standardize home mortgage structure and terms
- o Standardize collateral on mortgage
 - a. Standard construction specifications

3. Secondary Market Makers (improve liquidity)

- o Reg. Q and disintermediation
- o FNMA (1934 - (Urban Development Act of 1968)

- a. **Private (govt. sponsored)**
 - b. **Originally GNMA-like activity**
 - 1) **Commitment to purchase govt. and conv. loans at posted yield**
 - 2) **Commitments to purchase at negotiated yields (purchasing more than committed in 1))**
 - 3) **Pass-through certificates**
- o **GNMA (1968)**
 - a. **Sells MBS to investors backed by pools of govt-backed mortgages (Mortgage-backed Securities) = pass through securities (investor receives principal and interest) – Sold to investors through investment bankers**
 - b. **MBS interest < W.A. interest of mortgage pool; spread provides GNMA coverage of admin. costs and risk guarantee.**
 - c. **MBS interest rate sensitive; market rate down and borrowers will refinance mortgages in pool**
 - o **FHLMC (Emergency Housing Finance Act of 1970)**
 - a. **Purchase conv. loans and sell pass throughs**
 - 1) **Guaranteed mortgage certificates (GMC)**
 - 2) **Mortgage participation certificates PC)**
 - 3) **Also, purchased some privately guaranteed securities originated by large institutions**

- o **Mortgage Bankers**
 - a. **Originate mortgages and package**
 - b. **Sell through commitment to FNMA, GNMA and FHLMC**
 - 1) **Give mortgages (title) for cash (FNMA sells MBB = stated interest for stated maturity just like bonds), OR,**
 - 2) **Receive Mortgage-Backed Securities (Pass-Throughs) that are then sold through investment bankers to investors in secondary market. - - - > Pass thru int. & prin. - - - > = prepayment risk:**
 - 1. **High int. rate pass-thru**
 - 2. **Mkt. Int. decline = Mort. paid off**
 - 3. **Have to reinvest at worst time when int. rates low!!!**
 - 4. **Since risk high - - > higher yield**
 - c. **Operation**
 - 1) **Origination**
 - 2) **Warehousing; Profit on spread between Mort. Int. Rate and rate paid for funds from CBs**
 - d. **Servicing**

- e. **Float (between servicing collections and payments to investors)**
 - f. **Marketing:**
Profit on spread between W.A. package (pool) mort. rate and FNMA commitment rate on package purchase.
Commitment locks in sales price; if mkt. rates fall MB can renege
 - g. **Sales to GNMA; GNMA holds no residential mortgages, MB sells MBS through investment banker; GNMA guarantees timely pmt. of int. and prin.**
 - h. **FHLMC - similar to FNMA and GNMA operation; priority to S&Ls**
- o Securities**
- a. **MBB = like bond**
 - 1) **contract interest**
 - 2) **maturity**
 - b. **Pass-throughs**
 - 1) **interest & principal**
 - 2) **interest rate sensitive**
 - 3) **risk = prepayment**
 - c. **CMOs = Collateralized Mortgage Obligations**
 - 1) **manage prepayment**
 - 2) **several tranches (segments)**

Example: \$900M mortgage pool

\$300M 1st tranche Interest + Prin + All 1st Prin Prepayments up to \$300M (S.T. investors)	\$300M 2nd tranche Interest + Prin + Subsequent Prin. Prepayments up to \$600M	\$300M 3rd tranche Interest + Prin + Remaining Prepayments
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- o **Stripped MBS = separate payments into interest and principal components. Investor buys rights to:**

Interest

interest only =
Int on TOT Bal
Outstanding
Wants Mort. to NOT
be paid off for Hi Rtn

Principal

principal only =
Rec Sched Mo. Prin
Rec flows as quickly as
possible for hi. Rtn