

California Real Estate Finance
Chapter 12
The Secondary Mortgage and Trust Deed Markets

Chapter Purpose

This following two chapters answer the question *What happens after the loan has been made?*, beginning with this chapter on the secondary loan market. With an overall mortgage debt in this country of over seven trillion dollars, it is important to discover how this much money is handled by all of the participants involved. On the one hand, we have millions of borrowers executing agreements to pay loans and sending payments to companies designated as collectors. On the other hand, we have lenders receiving these payments, reducing the amount of debt in a regular manner over time, with a constant inflow of new loans to replace those that are paid in full.

In the center of this ebb and flow of vast sums of money are the secondary mortgage and trust deed market participants, who, in moves designed to keep these money flows in balance, buy, sell and service the individual securities. In doing so, they redistribute funds from money-rich areas of our country to money-poor areas, offsetting, to a great degree, the difficulties caused by a mostly uncontrolled cyclical real estate market.

This chapter examines the activities of Fannie Mae, Ginnie Mae and Freddie Mac, plus the private collateralization conduits. Most of the real estate loans made in today's market are sold to these secondary market operators. The monies paid for these individual loans come from the millions of investors who participate in the action by buying shares in mortgage pools. Thus, the investors continue to provide the monies necessary to fund the enormous realty debt.

Suggestions to the Instructor

Besides the information in this chapter about the activities of Fannie Mae, Ginnie Mae and Freddie Mac, there is a movement into securitization at lower levels of the financial markets. Individual lenders who make a substantial number of loans are pooling them, rather than selling them, and then selling interests in these pools to investors, as described under Real Estate Mortgage Conduits, REMICs. It would enhance the presentation of the material in this chapter to invite a participant familiar with these pools to discuss them with the students.

Learning Objectives

Upon completion of this chapter, the student should be able to:

1. define the secondary mortgage markets;
2. recognize the influences of the secondary markets in facilitating the national redistribution of funds for real estate finance and providing a constant source of funds for local lenders who wish to roll their loans over;
3. understand the purpose and operations of Fannie Mae, Freddie Mac and Ginnie Mae;
4. define the Fannie Mae-Ginnie Mae tandem plan;
5. describe mortgage-backed securities and how they are pooled for sale to investors.

Presentation Outline

- I. The Secondary Market
 - A. Originators of new loans are called primary lenders
 1. Banks
 2. Thrifts
 3. Life insurance companies
 4. Pension funds
 5. Mortgage bankers
 6. Mortgage brokers
 - B. Most loans created by primary lenders are sold in the secondary market
 1. Lenders acquire money for new loans
 2. Many keep loan servicing responsibilities
 3. Provide sources of funds to all areas of the country
 4. Escape risks of holding long-term loans
- II. Fannie Mae (formally the Federal National Mortgage Association)
 - A. Originally a government agency
 1. Created to buy FHA-insured loans issued in the Depression
 2. Bought loans at par to stimulate economic recovery
 - B. Charter of 1954
 1. Allowed Fannie Mae to sell as well as to buy loans
 2. Added DVA-guaranteed loans to activities
 3. Changed to profit motive and not bought loans at discount
 4. Used open market auctions to buy and sell securities, allowing market to set prices
 5. Managed disposition of earlier marginal loans
 6. Required to purchase loans issued for special emergency circumstances

- C. Housing and Urban Development Act of 1968
 - 1. Fannie Mae reorganized as a private corporation
 - 2. Could now also purchase conventional loans
 - 3. Moved away from open market auctions to an administered price system
 - 4. Inaugurated stricter loan underwriting standards
 - D. Special programs
 - 1. Opening Doors to Affordable Housing program
 - a. financing for under served market
 - b. minorities, immigrants and inner city residents
 - 2. Community Home Buyer program
 - a. five percent down payment loans
 - b. borrowers must attend homebuyer education class
 - 3. The Flex 97 program
 - a. three percent down payment loans to qualified borrowers
 - b. down payment may come from family, friends, etc.
- III. Freddie Mac (formerly the Federal Home Loan Mortgage Corporation)
- A. Created in 1970 to offset credit crunch for the savings associations
 - 1. Purchased conventional loans from participating thrift organizations
 - 2. Provided funds to offset financial crisis
 - B. Reorganized in 1989 into private corporation
 - 1. Expanded its secondary market participation
 - 2. Could now purchase or sell any qualified security
- IV. Ginnie Mae (formerly the Government National Mortgage Association)
- A. Under the Department of Housing and Urban Development (HUD)
 - 1. Created in 1968 to assume Fannie Mae's responsibility to liquidate Depression-era and special assistance loans
 - 2. Charged with providing special assistance funds for urban renewal and other social programs
 - B. Securities pools
 - 1. Blocks of mortgage-backed securities used to securitize investors' contributions
 - a. homogenous loans in one program
 - b. nonhomogenous loans in another program
 - 2. Distribution of earnings to investors
 - a. straight pass-throughs: payments made as they are received
 - b. modified pass-throughs: guaranteed monthly interest payments
 - c. fully modified pass-throughs: guaranteed monthly principal and interest payments
 - 3. Investors charged a premium for Ginnie Mae guarantees
 - C. Tandem plan
 - 1. Monetary assistance in tight money cycles
 - 2. Funds available for high risk loans
 - 3. Ginnie Mae purchases loans at par from Fannie Mae

- V. Electronic Underwriting System
 - A. Desktop Underwriter
 - 1. Fannie Mae System
 - a. provides analysis of borrower's credit
 - b. provides analysis of collateral property's value
 - B. Loan Prospector
 - 1. Freddie Mac systems
 - a. provides automated analysis of borrower's credit
 - b. provides automated analysis of property' value
 - C. Credit scoring
 - 1. Objective method of evaluating credit risk based on statistical probability
 - a. credit data at Experian, Equifax, and/or Transunion
 - b. credit scores based on credit history and status of credit held
 - 2. Fair, Isaac & Company (FICO) credit scores range
 - a. 40 to 620 for slow payers
 - b. 700 to above 800 for applicants who always pay on time
- VI. The Real Estate Mortgage Investment Conduit (REMIC)
 - A. Concept created in the Tax Reform Act of 1986
 - 1. Allows private companies to securitize
 - a. pools of mortgage loans
 - b. acts as collateral for the sale of securities to institutional and private investors
 - 2. Allows REMICs to be exempt from income taxes
 - a. authorizes REMICs to hold real estate
 - b. income tax at the securities owners' level
 - c. eliminates double tax
 - B. REMIC flexibility
 - 1. Allows trading with foreign investors
 - 2. Allows creation of multiclass securities
 - a. short-term tranches
 - b. long-term tranches
 - c. a tranche is a portion of a multiclass security
 - 3. Commercial mortgage-backed securities