Primary vs. Secondary Market

In economic terms, the *primary mortgage market* describes the relationship between borrowers and mortgage lenders: a lender grants a mortgage loan directly to a consumer.  
  
The *secondary mortgage market* describes the activities between the mortgage lenders and other entities who wish to purchase or sell existing or prospective mortgage loans and/or the rights to service them.  
  
The secondary mortgage market also encompasses the activities involved in [securitizing](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

To*securitize*a mortgage loan is to combine the loan with other loans to create the underlying collateral for a*mortgage-backed security*(MBS) or*mortgage-backed bond*. The security itself (*NOT*the loans) is traded and valued based on the value and performance of the loans that serve as its collateral. This security or bond is bought, sold, and traded like stocks are. Investors who buy shares of the security or bond own a percentage of all the loans that make up the value of the security.  
  
A certain amount of income is needed to offset the expense of securitization. Often, the determining factor is the total loan amount securitized. If the loan is large enough, it is possible to securitize a single loan, too.

 mortgage loans. This includes creating and selling mortgage-backed bonds and mortgage-backed securities (MBS) and servicing portfolios from individual loans as well as buying and/or selling those financial instruments to investors.

# Two Assets

Once a mortgage loan is produced in the primary market, the lender has two sellable assets:

* The mortgage loan itself
* The rights to service the loan (mortgage servicing rights)

The mortgage servicing rights (MSR) are a separate asset from the mortgage loan itself because the owner of the MSR collects a servicing fee from the investor for servicing it.

The lender may elect to:

* Keep the loan in its own portfolio and keep the mortgage servicing rights.
* Sell the mortgage loan and the mortgage servicing rights to another entity
* Sell the mortgage loan and keep the mortgage servicing rights (service in house or hire a subservicer).

Source: Pinkowish, Thomas J., Residential Mortgage Lending: Principles and Practices, Sixth Edition, (Mason, OH., Cengage Learning, (c)2012, 2004) p. 112.

# Discovery Activity

Not all mortgage lenders sell loans in the secondary market. Ask your supervisor if your company holds its loans in portfolio or sells the loans in the secondary mortgage market.

Secondary Market Transactions

Secondary market transactions involve [the sale of mortgage loans](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**The Sale of Mortgage Loans**

Mortgage loans can be sold in several ways:

* The most basic secondary market transaction is a*whole loan sale*: the sale of one mortgage loan to an investor.
* Selling a partial interest in a loan is called a*participation sale*.
* Selling several whole loans at once is called a*pooled loan sale*.
* Pooled loans can also be combined to become the underlying collateral for a*mortgage-backed security*(MBS) or*mortgage-backed bond*. The security itself (*NOT*the loans) is traded and valued based on the value and performance of the loans that serve as its collateral.

 and/or [the sale of mortgage servicing rights](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**The Sale of the Mortgage Servicing Rights**  
  
The sale of mortgage servicing rights is separate from the sale of the loan itself. The largest purchasers of mortgage loans, Fannie Mae and Freddie Mac (the GSEs), are prohibited from servicing them. However, many large private investors often want to purchase the servicing rights along with the mortgage loan.

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Broadly speaking, "secondary marketing" means participation in any secondary mortgage market activity. Most secondary market participants specialize in one or a few segments of the broad range of secondary market activities that stem from these two basic transactions.   
  
From the point of view of a mortgage company, secondary marketing is the sale of existing loans to investors, and the management of the risk associated with mortgages. Normally the sale is arranged simultaneously with the origination of loans. Commitments are used to secure the future sale of loans and protect against interest rate changes that may occur between the dates of origination and sale.  
  
Secondary mortgage market activities are transactions between companies and do not change the terms in the borrower's mortgage note and deed. Although the sale of the loans or the rights to service them does not affect the loan terms, the borrower is indirectly affected by the change in ownership of the mortgage loan or servicing.

The Secondary Market in the Economy

There are four basic reasons why the secondary market plays such an important role in the economy. Click the links below to read more about each reason.

* [Provides market liquidity.](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Provides market liquidity.**  
  
Over time, Fannie Mae and Freddie Mac (the GSEs) standardized much of the secondary marketing process. For example, the GSEs:

* + Established uniform mortgage program eligibility requirements and underwriting guidelines
  + Created uniform mortgage note and security documents
  + Streamlined MBS design, purchase, and delivery

As a result, MBSs are now more liquid because the mortgage loans are more uniform and easier to create. Any originator, portfolio lender, or investor can buy or sell investment-grade mortgage loans in the market quickly and at any time to meet any immediate needs for cash.  
  
Other investors who were not likely to invest in residential mortgage loans are more likely to if they know that a ready market exists if they are forced to sell.  
  
*Source: Pinkowish, Thomas J., Residential Mortgage Lending: Principles and Practices, Sixth Edition, (Mason, OH., Cengage Learning, (c)2012, 2004) pp. 113-114.*

* [Moderates the cyclical flow of mortgage capital.](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Moderates the cyclical flow of mortgage capital.**  
  
Mortgage funding in a geographic region can become scarce during periods of general capital shortage. As a result, local lenders may increase their interest rates, which can slow down real estate activity.  
  
However, other secondary market lenders and investors can purchase existing mortgages directly from a region's local primary mortgage lenders—or purchase securities backed by mortgages in that region. Either way provides additional mortgage funds to the affected region.  
  
This availability of capital for mortgages helps to lessen the countercyclical nature of real estate.  
  
*Source: Pinkowish, Thomas J., Residential Mortgage Lending: Principles and Practices, Sixth Edition, (Mason, OH., Cengage Learning, (c)2012, 2004) pp. 113-114.*

* [Assists the flow of capital from surplus areas to deficit areas.](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Assists the flow of capital from surplus areas to deficit areas.**  
  
The operations of the secondary market allow an investor in a capital-surplus area (for example, a regional lender in New England), to invest in mortgages originated in a capital-deficit area (such the South or West).  
  
Normally, capital-surplus areas are the developed, slower-growing areas of the country—local lenders are able to meet the needs of the local, stable real estate markets.  
  
Capital-deficit areas are those with more rapid development or population expansion—the demand for housing credit exceeds the supply of capital created locally by the savings of individuals.  
  
Additionally, total funding for the U.S. mortgage market increased with funds from other nations seeking to diversify their investments.  
  
*Source: Pinkowish, Thomas J., Residential Mortgage Lending: Principles and Practices, Sixth Edition, (Mason, OH., Cengage Learning, (c)2012, 2004) pp. 113-114.*

* [Decreases the geographical spread in interest rates and allows for portfolio diversification.](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

The increased access to capital for mortgage loans moderates the geographical differences in mortgage interest rates.  
  
The standardized mortgage securitization process enables capital to flow to areas of high loan demand faster, thus pressuring rates downward. In addition, geographical risk (e.g., a large industry closing) is spread to more investors, thus lessening its effect.  
  
By spreading the risk among many investors, regional economic hardship or disasters (such as hurricanes and tornadoes) have less effect on local lenders than they could if their investments were heavily concentrated in the affected area. In theory, consumers benefit from lower rates overall.

Major Secondary Market Participants

* [Mortgage Bankers](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)
* [Government-Sponsored Enterprises (Fannie Mae and Freddie Mac)](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)
* [Ginnie Mae](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)
* [Private Conduits](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)
* [Investors](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

Generally speaking, **mortgage bankers** are responsible for creating the mortgage loans in the primary market. There are a number of types of mortgage companies, and they contribute in varying ways.  
  
Mortgage lenders create the loans, then either keep them in their own portfolio, sell them as whole loans or participations, or convert and sell them as mortgage-backed securities or mortgage-backed bonds.

Fannie Mae and Freddie Mac are **government-sponsored enterprises** (GSEs) that purchase mortgages and then typically package and sell pools of mortgages as mortgage-backed securities to an investor.

**Ginnie Mae** is a government-owned agency that guarantees mortgage-backed securities that are insured or guaranteed by other government agencies, such as HUD/FHA, VA, or USDA/Rural Housing Service.

**Private conduits** are companies that aggregate and sell groups of mortgages as mortgage-backed securities via Wall Street investment banks.

**Investors** are the entities that ultimately purchase the mortgage-backed securities. Typically they are looking for investments in which to place the funds they manage. Examples of end investors include pension funds and life insurance companies.

Loan Sales

Individual mortgage loans are the basis of all secondary market transactions, regardless of how large or financially complex they are. The legal manner in which a mortgage loan is sold is common throughout the country and takes two (legal) steps:

* **The mortgage note is endorsed to the buyer of the loan (investor).** This:
  + Gives the investor legal rights to the payments made by the borrower as described in the document.
  + Preserves the terms of the note for both borrower and lender (now endorsed to the investor).
* **The mortgage or deed of trust is assigned to the buyer of the loan (investor).** This:
  + Gives the investor the collateral securing the loan under the conditions described in the document.
  + Assigns the covenants the borrower *and* the lender must follow to avoid default (now assigned to the investor).

So whether a lender sells a single loan or sells a thousand loans as part of a mortgage-backed security (MBS), each loan needs to be endorsed and each mortgage/deed of trust needs to be assigned.  
  
When a loan is sold, the investor does not and cannot change the original terms of the note or the mortgage/deed of trust. The loan or mortgage terms can change only if both the lender and the borrower agree.

Loan Sales: Recourse

Unlike a participation loan sale, the whole loan sale may involve recourse. Simply put, sold *with recourse* means the seller might be required to buy back the loan from the investor if the loan defaults or the seller has breached one of the representations or warranties the seller made when the loan (or pool) was sold.

A mortgage lender has three recourse options when selling a mortgage loan:

* **Full recourse.** Seller must repurchase the loan if loan becomes delinquent for any reason or there is a violation of the loan sale agreement. This arrangement contains great risk for the seller, who could be forced to repurchase many mortgages that defaulted (possibly because of economic events, such as a factory closing) and could put that seller out of business.
* **Normal recourse.** Seller must repurchase after delinquency, but only if seller did not process or underwrite the loan according to the investor's requirements and that was the reason for the default. Note that both conditions must be present.
* **No recourse.** Seller is not obligated to repurchase any loans (with the exception of fraud), even if delinquent.

Today, most loans are sold with normal recourse.  
  
As an example, the seller of a mortgage loan warrants to Fannie Mae that a loan sold was originated according to Fannie Mae's Seller/Servicer Guide. If it is later discovered the loan was not originated according to the Guide, then the investor (in this example, Fannie Mae) may require the seller to repurchase the loan (normal recourse). Also, an early payment default (defined as within 3 months, or 6 months, or 1 year) is another situation which often requires repurchase regardless of other reps and warranties.

Loan Sales: Servicing Retained vs. Servicing Released

When a mortgage loan is sold on the secondary market, another asset is part of the transaction: the mortgage servicing right (MSR). The owner of the MSR has the right to a servicing fee for a sold loan, typically 0.25% of the loan (25 basis points). This fee income is offset by the cost to service that group of loans.  
  
The MSR is an important part of a loan sale, as it affects income and cost, as well as establishes who is authorized and responsible for carrying out the many mortgage servicing requirements contained in the mortgage and note.  
  
Servicing rights are also important in light of consumer privacy legislation because they allow a company legally to contact the borrowers whose loans they service; this becomes important for lenders that want to use portfolio for cross-sell opportunity. It is another aspect of the value of MSRs and is part of the consideration to buy or sell them.  
  
A mortgage banker can generate a profit by servicing sold loans for the investor. Some servicers will actively trade portfolios of loans serviced to increase profits, too.

There are two options for most secondary mortgage market loan sales:

* **Servicing *retained* —** obligates the lender to provide servicing for the loan; generates ongoing fees for servicing it.
* **Servicing *released* —**transfers the servicing responsibility to another entity; generates income to the seller immediately for future servicing income the mortgage servicer will receive from the investor over time.

Commitments

In mortgage lending, a [commitment](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Commitment**  
  
In mortgage lending, the term*commitment*is used in several ways. For example:

* The*commitment letter*issued to the applicant is a promise by the lender to provide financing under the terms and conditions stated in the letter.
* In order to be eligible to sell loans to a particular investor, the lender often obtains a*master commitment*with that investor, which outlines in general the business activity the lender and investor intend to do together.

 can mean several things. In secondary marketing, a loan commitment is an agreement between the investor and the lender. The lender agrees to deliver and the investor agrees to purchase a specific loan or a certain amount of loans by a certain date at a certain price or [yield](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

The ratio of investment income to the total amount invested over a given period of time.

. The commitment defines how the sale will be completed.

There are three basic types of loan commitments:

* **Mandatory -** An agreement between buyer and seller of a mortgage product in which both parties are obligated to perform. It requires the seller (lender) to deliver mortgages to the buyer (investor) by a specified date and at a fixed amount and yield. It is also known as a "firm commitment."   
    
  If the seller cannot fulfill its commitment by the expiration date, then it may have to purchase mortgage-backed securities or mortgages on the open market to meet the obligation, or pay a "pair-off" penalty to make up the difference.
* **Optional -** An agreement that requires the investor to buy the mortgages at a specified yield and amount, but does not require the lender to sell them. The lender has the option of delivering closed loans into the optional commitment at the stated price or selling them somewhere else at a better price. The lender may pay a small non-refundable fee for this agreement, but is not penalized for non-delivery.  
    
  Because an optional commitment is more favorable to the lender, the cost of obtaining the optional commitment is higher than the cost of obtaining a mandatory commitment.
* **Best Efforts -**An agreement in which the lender is required to sell the loan under the committed terms only if the loan closes under those terms. There is no fee for this agreement, however there is a penalty if the loan closes under the best efforts terms and not delivered to that investor.  
    
  Additionally, the lender receives less favorable pricing for best efforts vs. mandatory commitments.

Types of Secondary Market Sales: Whole Loans

|  | **Whole Loan Sales**  Whole loan sales are the simplest method of selling a mortgage. Whole loans are unsecuritized mortgages sold for cash to investors either individually or "pooled" (several loans in bulk). In the sale of a whole loan, the investor will have full ownership of the loan. |
| --- | --- |

The price paid by the investor to the seller of the whole loan(s) includes the long-term value of two things:

* The cash flows of principal and interest paid by the borrower
* The servicing fees paid by the investor to service the loan (the mortgage servicing right)

For example, a mortgage banker may agree to sell to a large commercial bank one 30-year fixed rate mortgage loan of $100,000 at 4.0% to be closed and delivered in 60 days. The commercial bank may agree to pay the mortgage banker a little more than $100,000 if the 4.0% rate is a little higher than current market rates, or pay the mortgage banker a little less than $100,000 if the interest rate is a little below current market rates.  
  
Most small- to medium-sized mortgage originators will use whole loan sales, simply because it is easier to manage the transaction and the amounts needed to deliver to an investor with a certain time period.  
  
Whole loans are sold either *with recourse* or *without recourse*. If a loan is sold with recourse and it goes into default, the seller may be required to repurchase the loan.

|  |
| --- |
| **Participation Loan Sales**  Mortgage lenders may also sell a partial interest or participation in a loan. A participation is a financing arrangement in which a mortgage lender sells only a percentage of the mortgage loan and retains a percentage (based on the loan amount). Both parties receive a portion of cash flow, gross revenue, or shares of ownership of a real estate venture as part of the loan. |

With a participation, the investor typically purchases a percentage of the loan or loan pool only. The mortgage banker or lender retains the balance and also services the loan. The mortgage banker and investors share the default risk.  
  
Participation loan sales are a type of sale used more with for mortgages on income or commercial properties. Primary investors include:

* Thrift institutions and credit unions
* The GSEs (Fannie Mae and Freddie Mac)

For example, a lender may sell a 70% participation in a loan to an investor and retain a 30% ownership, or a community bank may involve two to four other local lenders for a loan amount too large for it to accommodate alone. To protect its interests, the purchaser of participation may restrict the lender from selling the remainder of the loan to another investor. Because the interests of the buyer and seller are mutual, documentation requirements for participations are often less strict than those for whole loan sales. The seller who retains the servicing rights over the entire pool will increase its overall yield, but also assumes the cost to service the debt

Types of Secondary Market Sales: Mortgage-Backed Securities

Mortgage-Backed Securities (MBS)

Instead of selling its mortgage loans individually or in a pool, a mortgage lender may instead securitize its loan production. This can be done in one of two ways: by directly issuing an MBS secured by those loans, or by using a GSE or other conduit to issue the MBS. An investment-quality MBS often is more liquid than whole loans or participations. This type of sale typically require less paperwork, but the lender first needs to put in place the mechanisms and procedures for issuing securities, since it is not selling actual loans.

Advantages are:

* *Investor's viewpoint* - a guarantee (often from a GSE), a public market, and liquidity
* *Mortgage banker's viewpoint* - standardized commitments, reduced documentation, and most importantly, liquidity

One disadvantage is that with MBS, the issuer of the certificate must pay principal and interest, even if the borrower does not make payment. Another disadvantage is the time it may take the lender to accumulate enough closed loans into one security.

# How MBS Work

Loans are combined into one package, called a "pool," that forms a security. The collateral for the security are the underlying properties secured by the mortgages. The return to the investor is derived from the borrowers' payments on the loan notes.  
  
An MBS investor owns an undivided assigned interest in the pool of mortgages or trust deeds and an undivided endorsed interest in a pool of similar maturity and interest rate mortgage loans. The investor's return comes from the borrowers' interest and principal payments on these underlying mortgages in the MBS security.

Advantages and Risks of MBS

Mortgage-backed securities have become very popular. MBS are the main secondary market investment vehicle for single-family, residential mortgages. In just one decade (1975-85), the mortgage-backed security transformed mortgage-related debt into investment instruments that could compete with corporate and government bonds in the capital markets.

Reasons for MBS popularity:

* MBS are more liquid than whole loans or participations, and they typically require less paperwork.
* Investors in any section of the country or the rest of the world can invest in mortgages as easily as buying stocks and government or corporate bonds, while receiving a similar or better assurance of [safety](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Safety**

The element of safety for the MBS is two-fold:

* + **Guarantee against default.**The issuer of an MBS provides a guarantee to the investment quality of the security or a guarantee against default. The growth in MBS issuance was made possible through the GSEs, who offered at different times the implicit or explicit guarantee of the United States Treasury, one of the most risk-free guarantees in the world.
  + **Quality and consistency.**By making the products, documentation, and securitization process of the MBS uniform, the GSEs and other issuers created a more desirable investment. This brings more funds in total into the mortgage market — and from more sources. A fundamental element to the MBS, like other investments, is quality and consistency. These traits allow investors to predict MBS financial performance better and price them accordingly. When the secondary mortgage market fails to maintain the quality in MBS issues, then trust in the market deteriorates rapidly and investors quickly move their money elsewhere, as we have seen since 2006.

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There are risks associated with MBS as well. Irregular cashflow — from [prepayments](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Prepayment**  
  
Prepayment can be any additional amount of money paid to the loan principal by the borrower before it is due according to the terms of the note. This includes:Prepayment can be any additional amount of money paid to the loan principal by the borrower before it is due according to the terms of the note. This includes:

* Extra principal payments with a regular monthly payment
* Paying down the balance with an extra large payment
* Paying off the loan completely before its maturity date

Most borrowers refinance or pay off their mortgages before the due date to take advantage of lower rates, to pay consumer debt, or to save money.  
  
Prepayment affects the yield of mortgage-backed securities and the stability of regular payments to the investor. When the borrower prepays, the lender must reinvest the money and it might be at less favorable rates or terms.

 or [delinquency](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Delinquency**  
  
In difficult economic times, borrower delinquency increases to different levels, depending on the credit and collateral quality of the mortgages comprising the MBS.

 — is one of the risks assumed by investors in mortgage-backed securities.

Major Types of MBS

Because investors have varying amounts of risk tolerance, there are alternative structures of MBS. The various types of mortgage-related assets and their derivative securities appeal to investors with higher or lower risk tolerances for cash flow, credit quality, or interest rate risk.

The major types of mortgage-backed securities are as follows:

* [Pass-through security](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Pass-Through Security**  
  
The servicer collects the principal, interest and prepayments and "passes through" the payments to the investors each month, but only the actual amounts received (not the "scheduled" amounts). This type of MBS represents an undivided interest in a group or "pool" of mortgages.

Typically, a servicer:

* + Holds responsibility for the mortgages underlying the securities
  + Collects the loan payments and disburses the funds to the security holders
  + Has the power to liquidate the mortgage collateral in the case of default

"Participation certificate" is a different name for a pass-through mortgage-backed security. Freddie Mac finances its operations chiefly through its participation certificate (PC) program. Under this program, Freddie Mac purchases and packages mortgages that meet its requirements into participation certificates.  
  
**Example:**  
  
An investor purchases a $10,000 certificate of a $1,000,000 pool — a 1% share. This means that the investor now owns 1/100 of each mortgage in the pool and should receive 1/100 of all the loan payments. The servicer "passes through" these payments to all holders of this security, with 1% going to this particular investor.

* [Modified pass-through security](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Modified Pass-Through**  
  
A special type of pass-through, the*modified pass-through*assures cash flow to investors and adds safety to MBS investment. The modified pass-through requires the issuer to pay, on a timely basis, all principal and interest due to investors, regardless of whether or not the borrower makes the required payment.  
  
The Ginnie Mae mortgaged-backed security was and still is a fully modified pass-through certificate. The first Freddie Mac PCs were of this form. All Fannie Mae MBSs are fully modified, as are Freddie Mac Gold PCs. Providing a guarantee for the required payment means a more stable cashflow to the investor. However this more secure MBS structure lowers its yield compared to other similar MBSs.

* [Mortgage-backed bond](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Mortgage-Backed Bond**  
  
The lender owns the mortgage notes, while the investor owns the bonds secured by the mortgage note.  
  
Since ownership of the mortgages and bonds is separate, each may be liable for taxes on any interest rate they earn.  
  
This dual taxation makes bonds less attractive to investors than pass-through securities.

* [Collateralized mortgage obligation (CMO)](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Collateralized Mortgage Obligation (CMO)**  
  
These are multiclass mortgage-backed securities that combine aspects of the*pass-through security*and the*bond*.  
  
A CMO is divided into three or more classes; each class is called a "tranche." Each tranche pays interest and principal regularly to the investor, but each has a different rate, maturity or payment type. The CMO suffered from double taxation as well as limited cash flow and redistribution possibilities.  
  
Now most CMOs are issued in the form of REMICS that offer tax and accounting advantages. The two terms often are used interchangeably.

* [Real estate investment conduit (REMIC)](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Real Estate Mortgage Investment Conduit (REMIC)**  
  
These are mortgage-derivative securities that redirect the payment of principal and interest stemming from the collateral pool to different sub-securities with varying prepaying risk protection, maturities, and yields.  
  
As multiclass mortgage-backed securities, they are similar to CMOs, but more flexible. REMICs can be structured as*mortgage-backed bonds*or as*pass-throughs*. The Tax Reform Act of 1986 effectively created REMICs, as it gave them the advantage of single taxation.

* [Stripped mortgage-backed security](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Stripped Mortgage-Backed Security (SMBS)**  
  
These are single class security instruments formed by*stripping*principal cash flows and interest cash flows to make separate securities. An investor may receive 60% principal and 40% interest cash flows, or a 100% principal or 100% interest cash flows.

The most prominent SMBSs are:

* + IO strips—Interest only cash flows
  + PO strips—Principal only cash flows

Click the links to read more about each type of security

CMO, REMIC, and SMBS Differences

With CMOs or REMICs, principal prepayments are directed to one class at a time until that class is retired. This reduces the prepayment risks for the investors in the subsequent classes.  
  
REMICS are popular with investors like pension funds that are willing to accept less yield to receive low-risk cash flows that meet their needs for retirement payments. In contrast to the pass-through structure (interest and principal payments from the collateral pool being passed through pro rata to the owners), each class of a REMIC is paid from and secured by a priority structure of payment. The shortest term class has priority with respect to payments of principal to assure its earlier maturity. The realized maturities within any REMIC are based on the actual prepayment speeds experienced over the life of underlying collateral.  
  
In SMBSs, the division of principal and interest creates single-class securities that perform differently from pass-through securities.

* IO strips — Mortgage prepayments create some uncertainty about the timing and dollar amount of interest cash flows.
* PO strips — The dollar amount of cash flows is certain, but not the timing of when investors will receive them
* There are three major types of issuers of mortgage-backed securities:

| **Issuer** | **Type of MBS** | **Mortgage Programs** |
| --- | --- | --- |
| Government | Ginnie Mae | FHA/VA/[RHS](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)  Rural Housing Service  /[PIH](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)  Public and Indian Housing |
| GSE | Conventional MBS/PC | Fannie Mae/Freddie Mac conforming |
| Private Institution | Private label security | Non-conforming |

* Pinkowish, Thomas J. (2012, 2004). Residential Mortgage Lending: Principles and Practices, Sixth Edition. Mason, OH: Cengage Learning.

# Guarantee Fee

* The fee that an entity (such as Ginnie Mae, Fannie Mae, Freddie Mac) receives for guaranteeing the timely payment of principal and interest to mortgage security investors. The "g-fee" is one element taken into consideration when a mortgage banker prices loans.

Secondary Marketing Operations Overview

*Secondary marketing operations* describes generally how a company organizes and performs its secondary market activities and functions and tasks. There is no one right way to engage in secondary marketing and, as a result, no one right way to organize operations. The success of a mortgage banker depends on balancing investor appetites for products and pricing with the those of the investors: the secondary marketing operation is largely responsible for managing this balancing act.

Secondary Marketing Functions

The main responsibilities of the secondary marketing department involve the buying, selling, and trading of mortgage loans and mortgage servicing. A lender must coordinate secondary marketing operations with all other lending departments, including production and servicing, as well as investors, servicers, and other vendors. Depending on the organizational structure of a company, the secondary marketing department will either control directly, or work closely with, the following functional areas:

* Program development
* Pricing
* Loan sales
* Loan funding
* Pipeline management
* Shipping and delivery
* Quality control
* Servicing
* Investor relations and reporting
* Risk management

# Organization

Secondary marketing activities also can vary widely in companies which participate in exactly the same area of the secondary market. Companies organize their operations under different names (secondary, wholesale, correspondent, retail). Many different factors influence its organization, including the company's business plan, how the operation has evolved over time, or in which areas the company is most active.

**Program development**performs the following functions:

* Works with senior management and production area to determine target market areas.
* Selects appropriate and effective mortgage programs.
* Selects investors who offer the appropriate range of mortgage programs.
* Coordinates with production and technical areas (including IT, vendors, and compliance).
* Develops mortgage program marketing plans and training programs/aids for employees.
* Implements new mortgage programs.

**Pricing**performs the following functions:

* Establishes pricing policy and financial modeling programs.
* Prices loans in relation to market forces to maintain desired production and profitability levels.
* Coordinates pricing activities with investor commitment and delivery requirements.
* Monitors results.

**Loan sales** performs the following functions:

* Sells whole loans, participations, mortgage-backed securities, and loan servicing.
* Monitors/manages the risks of mortgage trading. Offsets risks via investments.
* Coordinates with program development, shipping/delivery, and quality control areas.

**Loan funding** performs the following functions:

**Loan funding** performs the following functions:

* Keeps track of warehouse line limits, loan pipeline, and fund sources.
* Tracks wired funds from investors and manages investor accounts.

**Pipeline management**performs the following functions:

* Matches production activity and pricing with investor commitments.
* Estimates and tracks closings and monitors sources of funding.
* Hedges production to minimize losses from fallout and interest rate risk.
* Co-ordinates with production and sales and funding and shipping/delivery.

**Shipping and delivery**performs the following functions:

**Shipping and delivery**performs the following functions:

* Prepares and delivers documents to mortgage investors promptly to meet commitments and to obtain funding.
* Physically transfers loan documents to an investor or agent in conformance with investor requirements.
* Coordinates with production, pipeline management, and investor relations activities.

**Quality control**performs the following functions:

* Performs independent review of all secondary marketing operations, as determined by investor.
* Performs independent review of production applications and sold loans, as determined by investor.

**Servicing** performs the following functions:

* Performs all the various mortgage servicing activities required by the mortgage and the investor.
* Can also mean the practice of managing Mortgage Servicing Right (MSR) assets through the purchase, sale, and trading of individual loans or servicing portfolios.
* Coordinates with shipping and delivery and investor relations and reporting areas.

**Investor relations and reporting** performs the following functions:

* Manages investor-related activities such as monthly reporting and remittance, servicing, collections.
* Maintains master commitments, contracts, collateral and security documentation.
* Coordinates with loan sale and delivery, pipeline management, servicing, and quality control areas.

**Risk management** performs the following functions:

* Monitors and manages the many different operational financial, and risks in secondary marketing.
* Includes the following risks: operational, financial, market and interest rate, credit, compliance, investor and vendor, business continuity, and safety and soundness.

# Operations Coordination

A primary responsibility of the secondary marketing manager is to coordinate closely with practically all the mortgage banker's departments, especially loan production and shipping.

The secondary marketing department coordinates with:

* Loan production — To determine pricing strategies and develop and implement loan programs.
* Finance — To understand the company's warehouse lines structure and the availability of funds for various lines of production. Each assists the other in negotiating warehouse-funding percentages, determining the company's approach to excess servicing and how best to use commitments.
* Shipping and delivery — To communicate investor sales and commitment requirements, and in return, receive information regarding the delivery status of various sales and the company's use of mandatory commitments.
* Underwriting and quality control — To monitor underwriting parameters and feedback from investors. Each commitment or sales agreement affects these functions.

# Major Risks

The secondary marketing manager's overriding concern is to maintain the lender's desired volume and quality of production, and preserve the value of its mortgage pipeline. The major risks inherent in achieving these goals are shown in the table below.

| **Risk Type** | **Description** |
| --- | --- |
| [Interest rate risk](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)  **Interest Rate Risk**  At times, a lender will commit to the applicant (i.e., lock-in specific interest rate and terms) without obtaining a corresponding commitment from an investor. In this situation the committed application isuncovered. In doing this the lender takes oninterest rate risk: the financial exposure from a change in the value of a loan if market interest rates change from the terms the lender already committed to the applicant.  A lender will leave a loan or several loans uncovered if it thinks market interest rates will decline. The lender will wait before making a commitment to the investor, hoping to get better pricing. However, if market interest rates go up, pricing will worsen and the lender will have to sell the loan at a loss. Each company has different ways of managing this risk.  If interest rates go up in relation to closed or committed loans, the price of the mortgages will go down. On the other hand, if interest rates decline, the price of the mortgages will go up. The lender can purchase investments whose value will move in the opposite direction of the loan's value when interest rates change. | A change in the value of an application as a result of a change in market interest rates. Typically this is from the time an applicant locks a rate to the time the mortgage banker sells the loan to an investor. |
| Product risk | The risk that the market for a particular mortgage program may disappear. This occurs after an application is taken for that program but no investors are available to purchase it. |
| Investor risk | The investor may default on its mortgage commitment(s) to the lender, leaving the lender with applications that need funding. |
| Fallout risk | An applicant does not close (for any reason) under the original terms applied for. |
| Liquidity risk | The operational risk that the lender will not have enough funding available to close or warehouse loans until the investor purchases them. |
| Repurchase risk | The investor may require the lender repurchase (buy back) the loan due to a production error, mortgage fraud, or early payment default. |
| Compliance risk | The risk of originating loans with federal or state compliance violations, which may expose the lender to fines, lawsuits, and other enforcement actions. |
| Price / warehouse risk | The risk of a change in value of loans in the lender's warehouse as interest rates change. These are closed loans that are not yet sold. |

Secondary marketing uses a variety of strategies, tactics, and tools to manage these different risks to the lender.

# Fallout Risk

Fallout is a term that applies to applications which do not close under the terms originally applied for. This does not include applications that are denied or withdrawn. Fallout can occur at any point in the process, including after closing if something occurred which made that loan ineligible to meet the commitment the lender obtained on it. However, the most common form of fallout is a change that occurs during processing and the application still moves forward under different terms.

* It includes all applications (even if approved and closed) that change from the original terms applied for.
* If a change occurs and the lender has NOT yet committed the loan to an investor or sold the closed loan, then the impact of a change in terms is zero or minimal. So in practical terms there is "no fallout."
* If a change occurs and the lender has committed or sold the loan to an investor, then the lender needs either to substitute another loan to meet the original commitment, to re-negotiate the unmet commitment, or to otherwise minimize its loss from this event.

# Think About It

What are some of the terms on an application that are likely to change from the time an applicant first applies? [Answer](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Answer**Some of the terms that could change on an application from the time an applicant first applies are shown in the table below:

| **Change In:** | **Example:** |
| --- | --- |
| Loan amount | $100,000 to $110,000 or $90,000 |
| Loan program | 30-yr fixed to 20-yr fixed |
| Interest rate and points | 4.0% / 0 points to 3.75% / 1 point |
| Loan level pricing adjustments | rate/term refinance to cashout refinance |
| Closing and delivery date | closing date beyond commitment delivery date |

# Strategies to Manage Fallout Risk

To manage fallout risk, sometimes lenders need to use both commitment strategies and hedging methods. A lender can use a best efforts commitment to manage the fallout of a particular loan or many loans. If the loans do not close as submitted under best efforts, there are no penalties.  
  
If a lender wants better pricing from the investor and has sufficient volume, it might commit 60% or 70% of its pipeline at very good mandatory delivery pricing. In this scenario the lender assumes that 30% or 40% of the pipeline will fallout and does not need coverage. Many lenders monitor fallout percentages and reasons over time to establish a reliable percentage of coverage in their pipeline.  
  
Another technique to manage fallout is by the lender's rate lock-in policies. If a lender does not lock in a rate until right before closing, then the effects of fallout are minimized. Competition from other lenders can make this strategy difficult to implement.  
  
A final technique for managing fallout is to raise or lower rates relative to market rates. Having the lowest rate available in the market can increase the pipeline quickly and counter the effects of unanticipated fallout in prior weeks. This is a difficult strategy to sustain, as the lender may make little or no profit on this loans. But it will avoid fallout penalties for non-delivery on its prior commitments.

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# Pipeline Management Overview

At the core of a successful secondary market operation is effective pipeline management. The mortgage pipeline is the term used to describe all applications in production, whether the applicant's rate and terms are locked or floating, approved or without a decision. It includes applications:

* Just taken and being processed
* Approved and awaiting closing
* Closed but not yet funded

# Goals of Pipeline Management

In general, pipeline management has three goals:

* **Pipeline value:** Maintain and protect the value of the applications and closed loans in the pipeline.
* **Pipeline funding:** Make sure enough resources are available to handle the pipeline volume efficiently.
* **Pricing:** Price applications and closed loans in the pipeline so they are sold at a profit.

# Pipeline Value

Collectively, all the applications in the pipeline have a potential value if sold in the secondary mortgage market. Pipeline management includes all the steps performed to maximize their actual value for the lender active in secondary marketing. This includes the followin:

* Obtaining commitments on applications
* Hedging the pipeline for changes and fallout to minimize losses
* Moderating the total volume of applications for efficient production
* Delivering closed loans on time to avoid penalties
* Maintaining quality to minimize repurchases
* Pricing each loan properly

The pipeline value will change hourly, daily, and over time:

* With new applications coming in and closed/funded loans leaving the pipeline
* With different market conditions as interest rates and volume changes
* With changes in the funding sources
* Pipeline Funding
* Besides maintaining the value of the pipeline, another aspect of pipeline management concerns funding. The pipeline manager estimates how many loans will actually close and how the company will fund those closings, using pipeline reports, financial models, and experience. A mortgage banker or mortgage broker must use its warehouse lines effectively to ensure the availability of funds for its pipeline. A depository lender must make sure it has sufficient deposits and cash on hand to support the pipeline as well.  
    
  To accomplish this, the pipeline manager must keep track of warehouse line limits and requirements, coordinate with the finance department, monitor cash requirements constantly, and anticipate the pipeline needs as soon as possible.

# Pricing Overview

A third area of pipeline management involves pricing. Pricing is very important to maximize the profitability of each loan sold, a critical activity for the lender. The secondary marketing manager has to consider the following:

* The lender's price to the consumer
* Risk-based pricing adjustments
* Investor's price to the lender

# Risk-Based Pricing Adjustments

Risk-based pricing adjustments are charged for certain loan features which increase risk of default. This compensates the investor for a[higher-risk feature](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Higher**-**Risk Features**  
  
Risk-based pricing refers to adjusting the price of the loan based on loan features that are considered to indicate a higher risk of default. For example, owner-occupied, primary residences have a lower rate of delinquency and default than nonowner-occupied properties. As you can imagine, people have a greater stake in, and emotional attachment to, the family home that they are living in, compared to an investment property that they might own.  
  
Accordingly, "nonowner-occupied" and/or "second homes" are consideredhigher risk featuresrequiring a pricing adjustment (often commonly referred to as an "add" or "bump" to pricing). A typical add for a nonowner occupied price may be a 1/4 point (.25), so, for example, if a loan for an owner-occupied home has a note rate of 4%, the exact same transaction but nonowner occupied would have a note rate of 4.25%.

 in a mortgage application. There are many different areas of higher risk features.  
  
Each fee ranges from 0.25% to 1.5% or more. If more than one higher risk feature is present in an application, then the fees are added together. The borrower pays them at closing and the lender passes them onto the investor upon sale. Fannie Mae calls them Loan Level Pricing Adjustments (LLPAs) and Freddie Mac uses the term Post-Settlement Delivery Fees (PSDFs).

# Think About It

One example of a risk feature is transaction risk, such as cash-out refinance. A cash out refinance is considered a riskier transaction to the lender/investor than a rate and term refinance because the borrower is reducing equity from the property. Can you think of any other examples of features that could result in a higher risk for the investor? [Answer](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

# Investor’s Price to the Lender

This is the price the investor offers the lender to purchase a mortgage loan. Investors supply lenders with pricing quotes that show the lender what they will pay for a loan with a given interest rate for delivery by a given date. These quotes can change throughout the day in active interest rate periods. A lender must lock in the price to know exactly how much it will receive at closing for a particular loan.  
  
However, investor pricing differs from the price to the consumer. It involves the concept of [yield](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

**Yield**Yield is the ratio of investment income to the total amount invested over a given period of time. In loan sales, it is the total amount of principal and interest payments an investor receives over time compared to the total price the investor pays for that mortgage note.

, which recognizes the value of the mortgage note over time based on present market conditions. This is similar to bond pricing.  
  
This is partly because some income from the loan (discount points) are received at closing and not returned. Other income from the loan (interest) is received over monthly payments over years and is much more uncertain due to prepayments, payoffs, or delinquency.

# Think About It

What is the basic challenge to setting pricing that's appealing to both borrowers and investors? [Answer](http://education.mbaeducation.org/courses/1/DL2_011013/content/_172525_1/index.html)

Common Pricing Terms

| **Type** | **Description** |
| --- | --- |
| Par value | In loan sales, this is a price of a note (what an investor will pay a lender) that *equals* the note's face value (what the borrower pays the note holder). Typically, this means the interest rate on the note is at current rates in the marketplace.  The note dollar amount does not need an adjustment to convert expected future cash flows into a present dollar value equivalent. |
| Discounted value | In loan sales, this is a price of a note (what an investor will pay a lender) that is *less than* the note's face value (what the borrower pays the note holder). Typically, this means the interest rate on the note is below current rates in the marketplace.  The note dollar amount is reduced by a discount amount to convert expected future cash flows into a present dollar value equivalent. |
| Premium value | In loan sales, this is a price of a note that is *greater than* its face value. The investor pays more than the borrower is borrowing. Typically, this means the interest rate on the note is above current rates in the marketplace.  The note dollar amount is increased by a premium amount to convert expected future cash flows into a present dollar value equivalent. |

Pricing and Volume

Pricing can also be used as a technique to manage the overall volume in the lender's pipeline. Controlling volume allows the company to maximize the people and resources employed to handle the pipeline effectively and meet existing commitments. In general, raising a lender's interest rates above market rates will moderate or decrease application volume and, over time, the size of the pipeline. Decreasing interest rates will help increase volume and the size of the pipeline.

Hedging Overview

Hedging is a financing technique to minimize or protect against loss by counterbalancing one transaction against another. In secondary marketing, hedging is used as a pipeline management technique almost like insurance: the lender pays for something up front to avoid a possible larger, catastrophic loss.  
  
Each area of secondary marketing has its challenges. Pipeline hedging conceptually may be the most difficult and complex aspect of secondary marketing, especially for large lenders managing a variety of commitments and millions of dollars in their pipelines. Improper hedging can result in such large losses from which the lender may not recover, so it is of critical importance to the mortgage banker.  
  
The lender is trying to avoid a loss a) in the value of a loan, or b) from pipeline fallout. The lender buys another financial instrument that will increase in value should that loss occur. Often, the offsetting price movements are not perfectly matched, so there may be a small net loss or net profit from the hedging.

# Complying with Regulations Overview

As with loan production and loan administration, secondary marketing is subject to multiple regulations. On the federal level, there are a host of agencies and standards bodies that affect secondary marketing directly or indirectly. In addition to the Department of Housing and Urban Development (HUD) (which administers the FHA program and is involved in many areas of mortgage lending, sales, and rental), and the Veterans Administration (which oversees the VA program), the following agencies play an important role in secondary marketing:

| **Agency** | **Role in Secondary Marketing** |
| --- | --- |
| Federal Finance Housing Agency (FHFA) | Regulates the GSEs and the Federal Home Loan Banks. |
| Consumer Finance Protection Bureau (CFPB) | Regulates large lenders and all state-licensed mortgage bankers and brokers. |
| Various federal depository and banking regulators, including Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), National Credit Union Association (NCUA) | Regulate banking activities but also mortgage lending and secondary marketing operations within those depositories. |
| Financial Accounting Standards Board (FASB) | Create accounting rules and provide guidance for secondary market transactions and investments, as well as business operations. |

Many of these involve rules and regulations surrounding:

* The GSEs
* Accounting practices
* Licensing, examination, and supervision
* Consumer compliance
* Regulating the GSEs
* The Housing and Economic Recovery Act of 2008, enacted in July of that year, created the Federal Housing Finance Agency (FHFA) by combining the Office of Federal Housing Enterprise Oversight (OFHEO) with the Federal Housing Finance Board (FHFB). The Act empowered the Federal Housing Finance Agency (FHFA) with all the authorities necessary to oversee secondary mortgage markets, including oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. In September 2008, the GSEs were placed in conservatorship under the direction of the FHFA.

# Accounting Practices

Although the Financial Accounting Standards Board (FASB) regulates the accounting industry and not the real estate finance industry, its pronouncements have affected the accounting requirements for mortgage bankers dramatically. Some of these rules were intended to remove risks brought to public attention by corporate accounting scandals such as Enron.   
  
In the mid-1990s, FASB issued its Statement of Financial Accounting Standards (SFAS) No. 122, Accounting for Mortgage Servicing Rights. This pronouncement and its successors, SFAS 125, 133 and 140, required the mortgage banker to:

* Account for the present value of originated mortgage-servicing rights (OMSRs) in terms of their anticipated earnings.
* Include those OMSRs on the mortgage banker's balance sheet.
* Write-down or reduce the value of those servicing assets if their value declines.
* Remove certain assets or liabilities from the balance sheet when events such as securitization occur.
* Record the fair value of derivative investments on the balance sheet.
* Record any excess hedge gains or losses in earnings.

The net effect of these pronouncements on mortgage banking has been to increase the size of the mortgage banker's balance sheet.

# Basel III

Basel III is a global regulatory framework for bank capital adequacy, stress testing, and market liquidity risk that was agreed to by the members of the Basel Committee on Banking Supervision, an international body in Basel, Switzerland.  
  
In June 2012, the Fed, OCC and FDIC released proposed new capital rules for comment for the U.S. version of Basel III. The proposed capital rules would directly affect banks (but not necessarily independent mortgage banks) in an effort to conform U.S. capital standards to international capital standards recommended by the Basel Committee.  
  
The proposal would strongly impact banks that have significant mortgage servicing rights on their balance sheet. Under Basel III, the following items would be capped at 10 percent of a bank's common equity:

* Investments in non-consolidated banking, insurance and financial entities
* Mortgage Servicing Rights
* Deferred tax assets that arose from temporary differences

In addition to the adverse treatment to MSRs, Basel III also affects securitizations, commercial mortgages and residential mortgages. Overall, U.S. banks would be required to maintain higher levels of capital than their European counterparts.

Secondary Marketing Impacts of Dodd-Frank

The Dodd-Frank Act specifically impacts secondary market sales in several ways. Section 1412 creates a "Qualified Residential Mortgage" class of loans with several parameters. Section 941 states that "*non-QRM* loans in mortgage-backed securities require that the lender must retain at least five percent (5%) of the loan balance on reserve for the life of the loan for credit risk." The Consumer Financial Protection Bureau is charged with creating the final rule to implement this section of the Dodd-Frank Act.  
  
The intent of this area of the Dodd-Frank Act was to address the problem that mortgage bankers sell the risk of default when they sell a loan, and therefore had no substantial stake in preventing default risk. Risk retention intends to ensure that loan originators have "skin in the game" for the life of the loan. The legislation exempts a certain group of loans from risk retention, those are the "Qualified Residential Mortgages" or QRM, which adhere to particular underwriting standards. All other loans would be "non-QRM" and subject to 5% risk retention, as described above.