The secondary market is vital to the scale of the modern mortgage lending industry. The secondary market is not a place. Instead it refers to the resale market for loans. After a lender originates a loan, the lender may retain ownership of it (called holding a loan in portfolio) or, more commonly, sell it to someone else at a profit. The payment received for the loan replenishes the lender’s coffers and enables the lender to make more loans. When lenders have no option but to hold all their loans in portfolio and wait for borrowers to make their payments, there is less capital available to make new loans. 368

Selling loans also relieves the original lender of the risk that the borrower will default (credit risk), that interest rates will rise before repayment (interest or funding risk), or that the borrower will repay the loan early (prepayment risk)—all of which could be expensive to whoever holds the loan. 369 From the borrower’s perspective, the mortgage is a monthly bill to pay. But from the loan holder’s perspective, it is an investment similar to a bond. The “yield” is the return earned by the purchaser of a loan or a mortgaged-backed security. 370

The risk of owning a loan, including any litigation risk (real or perceived), as well as the anticipated profitability of a loan, affects the price that secondary market participants will pay for loans. Relevant factors include the loan terms (such as the note rate, whether the borrower paid discount points, and whether there is a prepayment penalty), the type of underwriting used, the loan-to-value ratio, the borrower’s credit score, market conditions, the costs of origination, the value of the right to service the mortgage, 371 and any fees charged by a guarantor (such as one of the GSEs). 372 A creditor’s profit is roughly equal to the amount paid by whoever buys the loan, plus any origination fees, plus the value of mortgage servicing rights, minus the cost of originating the loan. 373

Secondary market participants—those buying loans from the lenders originating them—may also choose to retain possession of loans as an investment (sometimes referred to as “whole loans”) 374 but the majority of loans sold on the secondary market are securitized. 375 Securitization is the process of pooling the ownership of thousands of loans and then selling bonds entitling investors to a portion of the income generated by payments on the loans. 376 These bonds are referred to as asset-backed or mortgage-backed securities. Securitization is discussed in more detail in § 1.5, infra.

The most important participants in the secondary market are Fannie Mae, Freddie Mac, and Ginnie Mae. They purchase or guarantee more loans than anyone else in the secondary market. The FHLBanks also have a secondary market program catering to small banks, thrifts, and credit unions that have too few loans to do business with Fannie Mae, Freddie Mac, or Ginnie Mae. 377 Through this program, the FHLBanks either purchase and hold the loans in portfolio, resell them to other partners, or issue their own mortgage backed securities. There are also large banks and investment funds that purchase whole loans in the secondary market.

Footnotes

368 [368] See § 1.2.3 [2], supra.


370 [370] Cf. Daniel J. McDonald & Daniel L. Thornton, A Primer on the Mortgage Market and Mortgage Finance, Fed. Reserve Bank of St. Louis Rev. 39 (Jan./Feb. 2008) (lender making 30-year fixed-rate loan of $200,000 at 6% “is, in essence, purchasing an investment that pays $1,199.10 per month for each of the next 360 months”).


372 [372] Mortgage servicing rights are a valuable asset frequently sold separately from the note or retained by the originator.
373 [373] Guarantee fees are often called “g-fees.”


376 [376] As of December 2011, sixty-seven percent of home mortgage debt was either securitized in mortgage-backed securities or held by Fannie Mae and Freddie Mac. James Vickery & Joshua Wright, TBA Trading and Liquidity in the Agency MBS Market, FRBNY Econ. Pol’y Rev. 2 n.5 (May 2013).

377 [377] See § 1.5 [1], infra (describing securitization).