



Economic Policy Program

Housing Commission

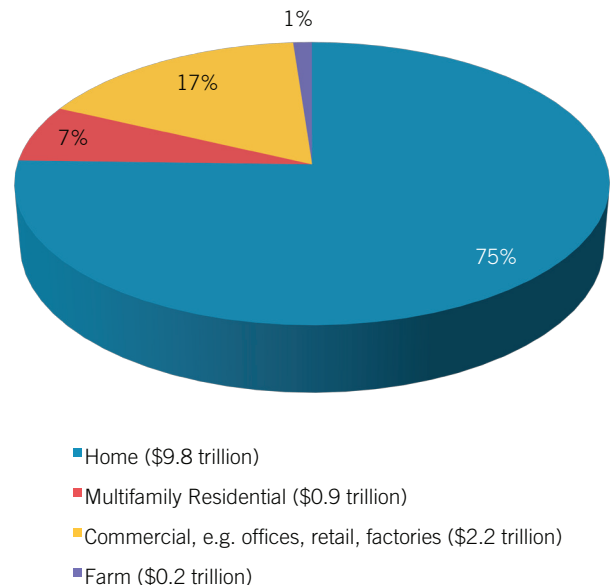
The Role of the Secondary Market in Mortgage Financing

The secondary market for mortgages plays a critical role in sustaining a healthy housing market. Few homebuyers have sufficient savings to purchase a home outright, and many need to borrow money to buy their first home or to move to another one. Without the ability to borrow against the value of the home they are purchasing, many prospective buyers would be shut out of the market. The secondary market allows participants in our mortgage system to access capital from investors in the United States and around the world. Any decline in the size of the secondary market would reduce the amount of capital available for mortgage lending and, in turn, borrowers' options for financing the purchase of a home.

Mortgages: A \$13.1 Trillion Market

The current size of the mortgage market is \$13.1 trillion, the largest share of which (75 percent) funds home mortgages. As displayed in **Chart 1**, another 7 percent of the mortgage market funds mortgages on apartment buildings and other multifamily properties.

Chart 1: Total Mortgages Outstanding (\$13.1 trillion)



Source: Federal Reserve Bank Flow of Funds. L.217. September 25, 2013.

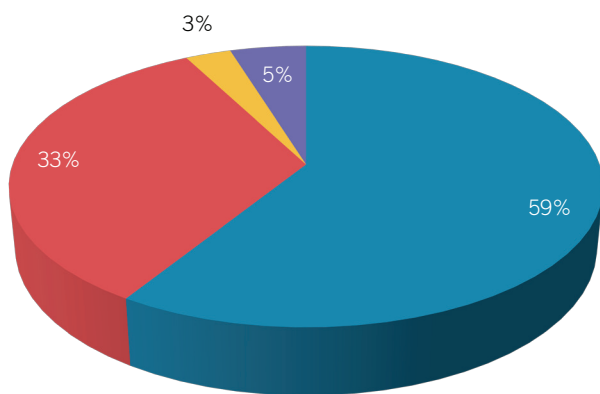


The dollar volume of mortgages that originators such as banks and credit unions can fund is determined by two key factors: (1) their capacity to hold mortgages on their own books; and (2) their ability to sell the mortgages they originate to third parties, i.e., the secondary market.

60 Percent of Mortgage Funding Comes from the Secondary Market

A secondary market for residential mortgages first emerged in the 1930s, when local and regional mismatches in the demand for mortgage credit and the supply of bank depository funds to meet that demand led to surpluses of mortgage credit in some parts of the country and shortfalls in others. Without a system to facilitate the flow of credit to high-demand areas, borrowers in fast-growing communities faced higher interest rates and limited financing. To help address this issue, the federal government bought mortgages originated by banks. Today, the secondary market relies more on securitization (the packaging of individual mortgages into mortgage-backed securities, or MBS), which plays a critical role in ensuring that qualified borrowers have access to mortgage credit throughout the system.

Chart 2: Share of Mortgages Sold and Held on Balance Sheets



- Sold into the secondary market (\$7.7 trillion)
- Held on bank balance sheets (\$4.3 trillion)
- Held on insurance/pension fund balance sheets (\$0.4 trillion)
- Held by others (\$0.7 trillion)

Source: Federal Reserve Bank Flow of Funds. L.217. September 25, 2013.

As described in **Chart 2**, at least 59 percent of mortgages as of September 2013 were sold to third parties.¹ By selling their loans into the secondary market, originators are effectively reimbursed for the mortgages they make. This process frees up capital for new mortgage lending, allowing additional borrowers to receive home loans.

Securitization Broadens Investor Interest

Securitization has opened up the market for mortgages to a broader universe of investors. Securitization works by aggregating mortgages into pools that, in turn, back securities. The simplest form of MBS is called a “pass-through.” In this arrangement, investors in the MBS purchase the rights to a share of the proceeds from the mortgages in the pool. Over the life of the mortgages, borrower payments of interest and principal are passed on to investors in proportion to their share of the pool. Aggregating multiple mortgages into a single pool reduces investors’ exposure to loss on any single mortgage. The ability to easily buy and sell these securities adds further to investor demand.

More complex types of securitization allow the interest and principal payment streams to be divided into tranches with different risk/return characteristics that suit the particular needs and appetites of various kinds of investors. Some MBS, for example, split off the payments of interest from the payments of principal. Other types of MBS pay investors in some of the tranches before others, creating what are called senior/subordinate securities. The investors in tranches that get paid last take a disproportionate amount of the risk, but earn a higher rate of return. Tranches can even be created that have little or no exposure to real estate risk (e.g., the risk of losses related to default and foreclosure, particularly when the value of the property has fallen) but still have interest rate risk (that is, the risk that interest rates will rise and the value of the securities will fall).

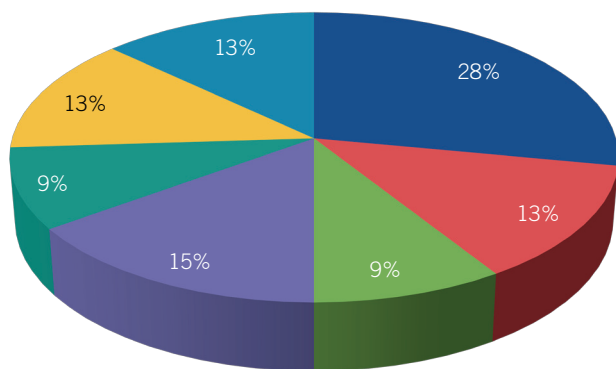
1. Includes home mortgages as well as multifamily residential, commercial, and farm mortgages. This is a conservative estimate and does not reflect mortgages on the balance sheets of banks, insurance companies, pension funds, and other institutions that were purchased from other originators.

Limiting the Secondary Market Would Likely Reduce Mortgage Originations

The size of the secondary market is determined by investors' appetite to purchase mortgages and MBS. If less funding were available through the secondary market, then fewer or smaller mortgages would likely be originated. The only way to avoid this result would be for mortgage originators to expand their balance sheets to hold more mortgages.

Such an increase in balance sheets would be difficult to achieve, particularly in the short run. Banks, for example, already devote almost one-third of their \$15.6 trillion portfolios to mortgages (see **Chart 3**). While bank balance sheets are technically large enough to hold all the mortgages now outstanding (\$13.1 trillion), neither the bank nor its regulators would want to see such a concentration of risk. (Banks also hold MBS that may or may not involve real estate risk and generally have different risk characteristics than whole mortgages.)

Chart 3: Diversity of Assets of Depository Institutions (total \$15.6 Trillion)



- Mortgages (\$4.3 trillion)
- Mortgage-backed securities (\$2.0 trillion)
- Consumer credit (\$1.5 trillion)
- Depository institution loans (\$2.3 trillion)
- Other credit market instruments (\$1.4 trillion)
- Other assets (\$2.0 trillion)
- Reserves at Federal Reserve (\$2.0 trillion)

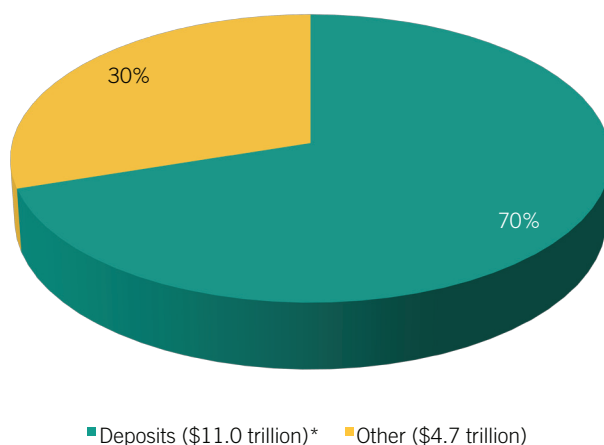
Source: Federal Reserve Bank Flow of Funds. L.109. September 25, 2013.

Absent an increase in the share of mortgages on bank balance sheets, bank portfolios would have to triple in size, from \$15.6 trillion to more than \$46 trillion to be able to finance all outstanding mortgages and still keep the total

share of mortgages on balance sheets at 30 percent. This would require banks to triple both their equity capital (e.g., by issuing more stock) and the money raised through deposits or other bank debt.

In addition, bankers and bank regulators seek to match the maturities of their assets and liabilities. The majority of bank funding (70 percent) is from deposits, which are considered to be of “short duration” (see **Chart 4**). Even if banks were to increase their capacity to hold more mortgages on their balance sheets, they are unlikely to hold as large a proportion of the long-term, fixed-rate mortgages (15- and 30-year) that borrowers prefer.

Chart 4: Liabilities of Depository Institutions



*Includes checkable deposits, small time and savings deposits, and large time deposits. Source: Federal Reserve Bank Flow of Funds. L.109. September 25, 2013.

A similar situation exists with insurance companies and pension funds, which also hold a diverse set of assets, although neither property and casualty insurance companies nor federal government retirement funds hold mortgages as a predominate share of their assets. Life insurance companies have the largest share of their assets in mortgages—6 percent of \$5.7 trillion, or \$348 billion. Insurance companies and pension funds (with the exception of government retirement funds) generally have larger investments in MBS.

This is one in a series of primers on key concepts in housing finance prepared by the Bipartisan Policy Center. Visit www.bipartisanpolicy.org/projects/housing to view the full series.