

MORTGAGE BANKERS ASSOCIATION

# The Real Estate Finance Industry

## A Short Primer



# The Residential Mortgage Market

Financial institutions involved in the primary residential mortgage market originate and service residential mortgage loans. Loan origination includes processing the application for a new loan, underwriting the application to assess whether or not to make the loan, and, if approved, funding the loan. Loan servicing begins once the loan is closed and loaded into the servicing system.

## THE PRIMARY MARKET

### Loan Origination

The first step of the origination process is for the borrower, working with their lender or mortgage broker, to determine the type and size of the loan. After the borrower applies, the lender underwrites the loan to determine whether or not to make the loan to the borrower. Each lender has their own specific underwriting criteria but all underwriters evaluate the borrower's ability to pay (income and assets), willingness to pay (credit history) and the collateral (property value.) Federal Housing Administration (FHA)-insured loans or nonprime loans may be available to borrowers with more difficult credit profiles or those who want to put less money down. When a lender makes an FHA or nonprime loan, the borrower will pay the costs of FHA insurance and/or a higher interest rate to compensate for the higher risk of default that the borrower with lesser credit poses.

### Loan Options

There are two basic categories of mortgages: the fixed-rate and the adjustable-rate mortgage (ARM). Borrowers choose fixed-rate loans because the mortgage payments are steady and predictable, allowing for easier household budgeting and planning. Borrowers may choose ARMs because the mortgage payments are initially lower, but the borrower must also be able to pay an increased mortgage payment, sometimes significantly higher, in the future.

### Government Agencies

Three federal agencies work closely with lenders to expand the loan options available to Americans: The U.S. Department of Housing and Urban Development's Federal Housing Administration (FHA), the Veteran's Administration (VA), and the Department of Agriculture's Rural Development Housing and Community Facilities Program (RHS.) FHA operates the largest program, insuring loans made by FHA-approved lenders throughout the U.S. The VA program guarantees loans for veterans of the armed services, those currently on active duty or in the reserves, and widows or widowers of veterans. The RHS program provides a variety of financing options for low- and very-low income buyers in rural areas.

### The Application

Once the borrower is ready to make an offer on a home or decides to refinance his or her mortgage, the borrower submits a loan application to a lender or mortgage broker. In the application, the borrower gives the lender enough information to decide whether or not to make the loan including employment and financial information as well as information about the house being bought or refinanced. At or shortly after the application is completed, federal law requires the lender to give the borrower several disclosures including a good faith estimate, a truth in lending (TILA) disclosure, a HUD booklet on the settlement process, and, if applicable, a servicing transfer disclosure and an affiliated business arrangement disclosure.

## The Closing

The closing, which takes place either at a closing table with all the parties or remotely through an escrow agent, is the last step in actually becoming the owner of a home or refinancing a mortgage. A daunting pile of legal documents can make the closing confusing. At closing, the terms of the agreements among all parties are finalized, the loan goes into effect and the lender receives the mortgage note, funds are disbursed, and ownership of the home is transferred. A mortgage borrower receives many documents at closing including the HUD-1 form or settlement statement, a new TILA statement if necessary, the promissory note and the deed of trust.

## Loan Servicing

After the closing, loan servicing (also called loan administration) may be taken on by the original lender or transferred to a servicing company. Loan servicing begins once the loan is closed and loaded into the servicing system. Loan servicers are responsible for collecting the monthly payments from the borrower, forwarding those payments on to investors, keeping records, paying taxes and insurance from the borrower's escrow account (if applicable) and addressing any loan delinquencies. Servicers collect a servicing fee, which is a small percentage of each loan payment. Many financial institutions do not service the loans they originate.

## THE SECONDARY MARKET

The secondary mortgage market helps provide the primary mortgage market with the funds it needs to make mortgage loans available to borrowers throughout the United States. When a primary lender closes on a mortgage, the lender either retains the loan as part of its portfolio or sells it into the secondary market. The loan can be sold either directly to an investor or to a conduit or securitizer which will then package loans into securities and sell interests in the securities to investors.

### Securitizers

The government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, as well as private companies known as private-label issuers, buy or pool mortgage loans that meet specific underwriting standards and product criteria, including loan limits, and package them together into mortgage-backed securities (MBS) to sell to investors. Securitizers may guarantee timely payment of principal

and interest to MBS investors. Proceeds from the sale of MBS replenish the funds available for new loans in the primary mortgage market. Currently, nearly two-thirds of residential mortgage debt, or \$7 trillion, is held in MBS.

Between their advent in the 1970s and 2006, private-label issuance grew rapidly, surpassing the issuance volume of the GSEs. At the current time, however, the GSEs are the dominant market players and private-label securitization has been scaled back considerably. In September 2008, in response to rapid deteriorations in their balance sheets, the GSEs were placed into conservatorship under the newly-created Federal Housing Finance Agency (FHFA).

### Ginnie Mae

Ginnie Mae, a wholly owned corporation within HUD, guarantees investors in specific MBS backed by FHA-insured loans that they will receive timely payment of principal and interest on the underlying loans. Ginnie Mae With approximately \$427.6 billion of MBS currently outstanding, Ginnie Mae's MBS program has been a significant contributor to the growth of the secondary mortgage market in the United States.

### Security Investors

Investors provide capital in exchange for a share of the interest and principal payments made by mortgage borrowers during the life of the loan. The introduction of products that offer multiple risk-spreading options has attracted capital from commercial banks, insurance companies, pension funds, mutual funds, and many other types of domestic and foreign investors.

### Federal Home Loan Banks (FHLBanks)

The FHLBanks offer another source of funding to the primary mortgage market. The 12 regional FHLBanks provide billions of dollars of primary liquidity to their 8,000 members which represent approximately 80 percent of the nation's financial institutions including banks, saving institutions, credit unions and insurance companies. By assuring liquidity to its members, the FHLBank System allows its member institutions to remain active lenders in all economic cycles, to help their local economies grow.

# The Commercial / Multifamily Mortgage Market

Financial institutions involved in the commercial mortgage market originate and service commercial mortgage loans which support the development of and investment in multifamily (apartments), office, retail, industrial, healthcare, and hotel properties. The commercial mortgage market focuses on income producing properties.

## PRIMARY MARKET

### Loan Origination

The commercial/multifamily lender underwrites the commercial loan evaluating the property's cash flow and its relationship to the debt being undertaken, the borrowing entity's creditworthiness as well as specific market characteristics.

### Loan Options

Most loans are non-recourse to the borrower and mortgage insurance is only available for loans secured by FHA-insured multifamily properties. Loan terms vary from short term gap financing to ten-year maturities with 30-year amortization schedules. In addition, FHA provides fully-amortizing loans for terms as long as 35 or 40 years. Most loans feature pre-payment restrictions which vary by product type and term duration. A mortgage banker frequently originates a loan which will be funded by an investor and held on the investor's balance sheet through maturity. These loans are called "Portfolio Loans". Investors such as banks, pension funds and life insurance companies generally hold their commercial loans on their balance sheets. Loans are also originated with a specific secondary market exit strategy and remain on the balance sheet until a pool of loans is created.

### Loan Servicing

The mortgage banker must retain the serving functions for Portfolio Loans sold to an investor. Servicing functions traditionally include the collection of monthly payments, escrow funds for taxes and insurance as well as reserve funds; conducting and analyzing property inspections; and collecting and analyzing property financial statements and

rent rolls. The mortgage banker will receive a fee for these ongoing servicing functions during the life of the loan.

## SECONDARY COMMERCIAL MORTGAGE MARKET

### Commercial Mortgage-Backed Securities (CMBS)

Over the past fifteen years, the CMBS market has emerged as a major source of commercial real estate finance. In a CMBS transaction, many individual mortgage loans of varying size, property type and location are pooled and transferred to a trust which then issues a series of bonds that may vary in yield, duration and payment priority. The typical vehicle is a real estate mortgage investment trust (REMIC) — which is a passive pass-through entity which is not subject to tax. There are a number of predominant parties in a CMBS transaction.

### Securitization Parties

Originator/depositors contribute loans to create loan pools that are constructed to be geographically and property-type diverse thereby mitigating risk to the investment community. The issuer is responsible for creating the securitization and is the primary seller of the resulting bonds to the investment community and conveys the loans to the Trust. The trustee distributes the cash proceeds and is also responsible for providing monthly remittance and reporting services to the pool investors. The trustee also traditionally provides document custodian services and tracks the receipt of loan documents.

## **Servicers**

The role of the servicer is critical to the CMBS transaction. The master servicer provides services such as information reporting, collecting and data standardization. The master servicer's most important role is to advance unpaid loan payments on the underlying mortgage loans in the pool to provide continuity of cash flow to the investors. The primary or sub-servicer traditionally maintains direct borrower contact and may, under subcontract, provide certain loan administrative duties to the master servicer. The special servicer provides services to the Trust and related parties for nonperforming loans and also may have decision-making authority for certain issues related to the underlying loan during the time the loan is performing.

## **Investors**

Investors purchase securities backed by the loans in the securitized pool. Investors in CMBS purchase specific risk positions from AAA to non-rated pieces. At the higher end of the credit, investors are conservative (such as pension funds) or may lack the real estate knowledge to invest in more risky tranches. Investors in CMBS include life companies, hedge funds, banks, sovereign wealth funds and other fund managers. Investors may opt to purchase whole loans or participating interests in individual loans on a one-off basis. In that case, the originating lender may retain a portion of the loan. The B piece investor is the most subordinate class and is usually the controlling class holder which appoints the Special Servicer.

## **Fannie Mae and Freddie Mac**

The GSEs are significant investors in multifamily mortgages, primarily through holding whole loans in portfolio, and Fannie Mae has served as a guarantor of MBS backed by multifamily loans. Both have been large purchasers of CMBS. They are, by statute, limited to multifamily loans and cannot provide a secondary mortgage market for other commercial property types.

## **AFFORDABLE RENTAL HOUSING**

While some families rent as a lifestyle choice, many families rent because their income, credit rating or savings for a down payment are not sufficient to purchase a home. For these families, affordable rental housing is a necessary first step toward homeownership or a longer-term necessity. Many of those families choose to rent single-family homes, but a large number choose multifamily housing

(developments containing 5 or more units/apartments). Of the approximately one-third of US households that rent, more than 16 million rent apartments in multifamily structures.

## **Government Agencies — Financing Support**

The federal government provides support for the financing of affordable rental housing in a number of ways.

### **HUD SUBSIDIES**

HUD subsidizes a number of multifamily rental properties through programs funded over the past 40+ years in various forms (e.g., interest rate subsidies, project-based and tenant-based rental assistance, etc.) Many of these older assisted properties need rehabilitation and are being refinanced through HUD's FHA insurance programs and through Fannie Mae and Freddie Mac multifamily programs.

### **ASSISTED HOUSING FOR SENIORS**

HUD also produces new assisted housing developments for seniors through the Section 202 program which provides a capital grant to reduce development costs and also provides rental assistance to lower-income elderly households.

### **FHA MULTIFAMILY INSURANCE**

The FHA multifamily insurance programs are used to produce and rehabilitate privately owned and operated workforce housing without any federal subsidy. The FHA multifamily programs charge mortgage insurance premiums that are adjusted annually, when necessary, to ensure that they do not require a federal appropriation of funds and, instead, actually generate revenue for the federal government. Much of the processing of these loans is delegated to approved lenders; however, each loan is reviewed and approved by FHA field staff prior to issuance of a commitment for insurance.

### **FANNIE MAE AND FREDDIE MAC**

Since 1992, both Fannie Mae and Freddie Mac have been required to facilitate the financing of housing for underserved families and markets through legislatively-established affordable housing goals. The goals were recently amended and now specify a goal for multifamily housing that requires a percentage of multifamily units financed by the GSEs to be affordable to lower-income families. While no subsidy is provided by the GSEs, they

must facilitate the financing of loans for these underserved markets.

### **Low Income Housing Tax Credits (LIHTC)**

The LIHTC program, initiated in 1987, is the only tax incentive specifically designed to promote the production of low-income rental housing. The LIHTC creates an incentive for private investors to provide equity for rental housing developments targeted at lower income households by granting tax credits to these investors. The LIHTC annually supports the construction or rehabilitation of approximately 135,000 rental units.