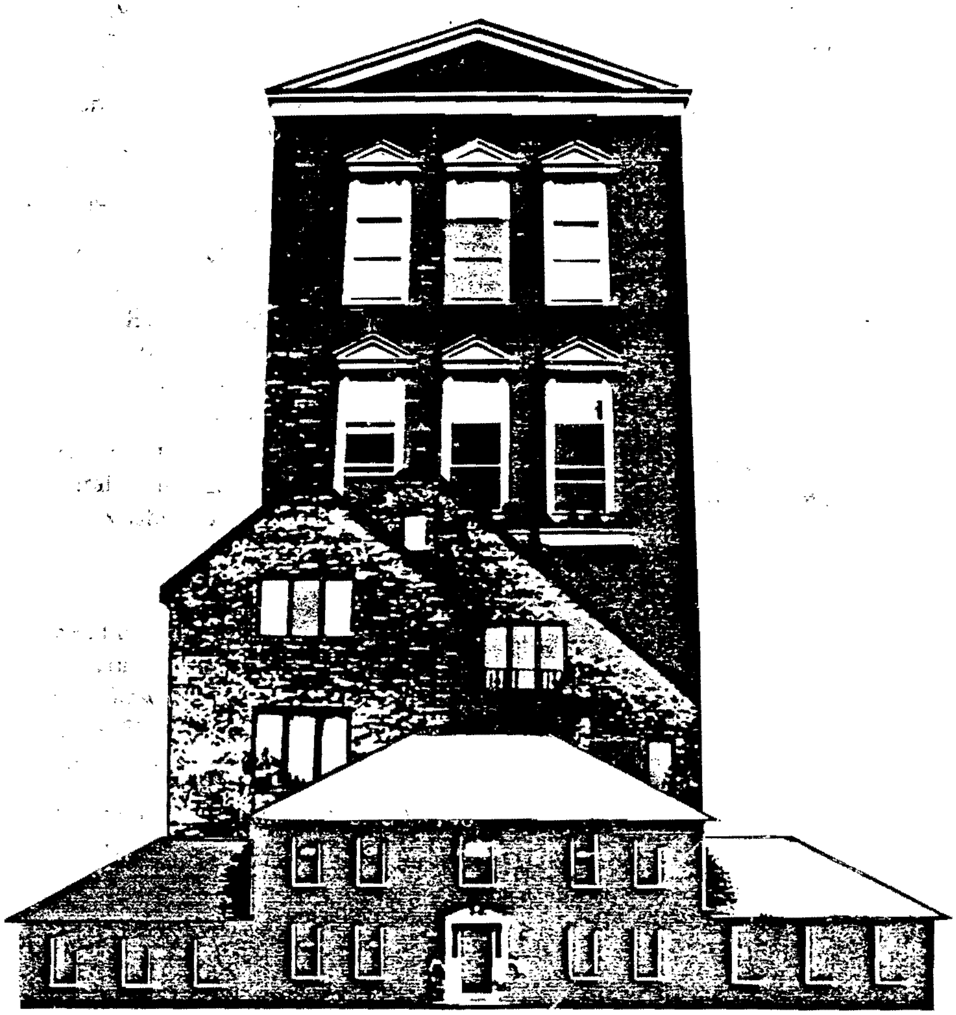
THE SECONDARY MARKET IN RESIDENTIAL MORTGAGES



INTRODUCTION

This book on the secondary market in residential mortgages was prepared by the Federal Home Loan Mortgage Corporation as a resource for its employees and as an information guide for members of the housing industry and related industries. The contents cover secondary mortgage operations, including those of the private secondary market, the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Government National Mortgage Association (GNMA). Emphasis is on the secondary market for conventional mortgages and the operations of Freddie Mac.

The book has three sections.

The first, "Definition of the Secondary Mortgage Market," defines the secondary market and describes its functions, the organizations that are the major participants, and the market's historical development.

The second, "Mortgage Sales and Purchases," illustrates the process by which mortgage originators sell mortgages and the process by which investors buy mortgages.

The third, "Operations of Freddie Mac," highlights the functions, purchases, sales, and related activities of Freddie Mac since its creation in 1970.

An appendix includes a list of Freddie Mac's home office and regional offices.

The text and illustrations in this book have been simplified for easy referral and to encourage discussion. They are not intended to be comprehensive explanations. The book will be updated annually.

TABLE OF CONTENTS

DEFINITION OF THE SECONDARY MORTGAGE MARKET

The secondary market in residential mortgages is a network of mortgage originators who lend money to homebuyers and investors who buy mortgage loans. Primary mortgage lenders make loans to property buyers and underwrite and service the loans, which can be held in lenders' own portfolios or sold to investors. By selling the loans they originate, lenders obtain funds that they can use to make new mortgages. Investors who buy mortgage loans after they have been closed by primary mortgage lenders usually consider the loans as investments, and usually pay the lender a fee to continue servicing the loans.

In the past, the role of the secondary mortgage market was primarily to help solve regional differences in the cost and availability of mortgage credit.

Thrift institutions have traditionally been the primary originators of conventional mortgages; thus, the availability of mortgage money depended heavily on their deposit flows. In the 1960s and 1970s, thrifts originated as much as two-thirds of conventional mortgages.

There was a regional mismatch between these deposit flows and the demand for mortgage credit, however. In older, slower growing areas of the country, the supply of mortgage credit available for lending by thrifts exceeded the demand for it by homebuyers. At the same time, thrifts in the newer, faster growing regions faced great demand for new housing but had relatively few deposits to lend.

Through its purchases of mortgages in the faster growing regions and sales of mortgages in the slower growing regions, the secondary mortgage market redistributed the available mortgage money by transferring funds from capital surplus to capital deficit areas.

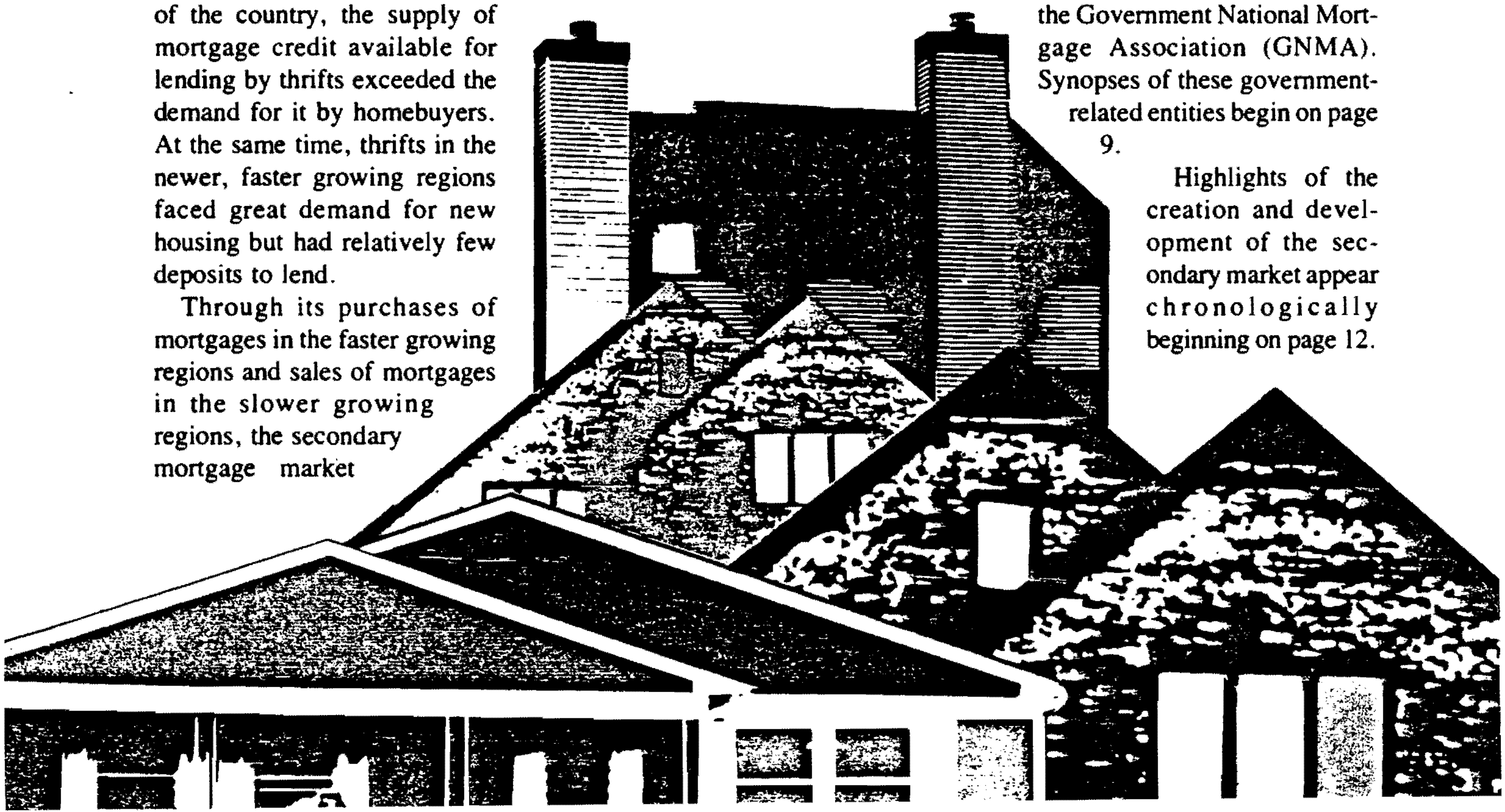
Today, in addition to redistributing funds, the secondary mortgage market links the capital and mortgage markets more closely through its sales of mortgages in forms that have attracted investment from outside the traditional mortgage investment community. The need for new sources of investment in residential mortgages has increased in recent years as the demand for mortgage credit nationwide has grown more rapidly than the deposit bases of traditional lending institutions.

The chart on the following pages illustrates secondary market activity in one-to-four family (non-farm) and multifamily mortgage markets since 1970.

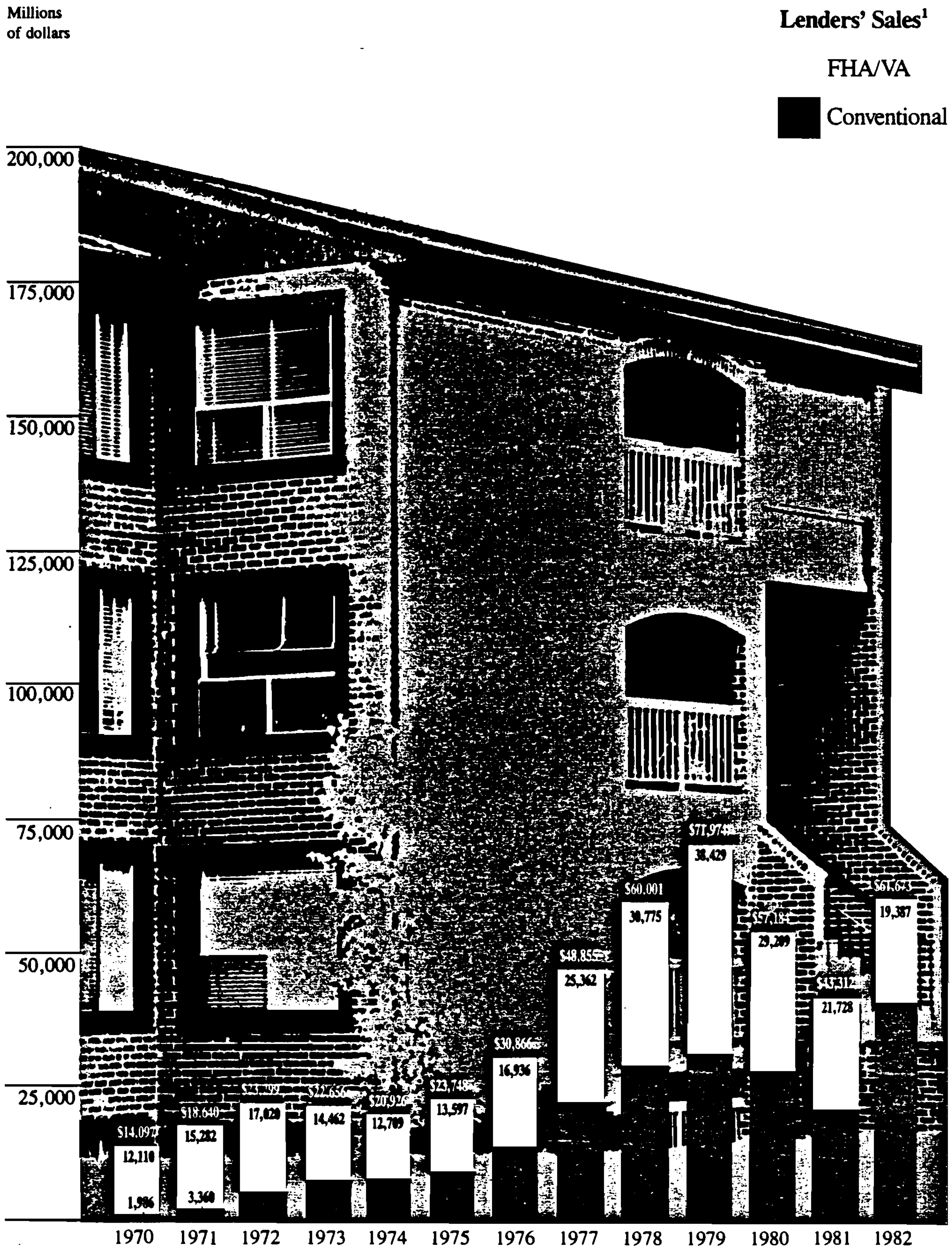
Much of this activity occurs among individual financial institutions. The roles and operations of private secondary market entities are described beginning on page 8.

Three entities were created by Congress to develop the residential secondary mortgage market. They have become important elements in its continuing growth. They are the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Government National Mortgage Association (GNMA). Synopses of these government-related entities begin on page 9.

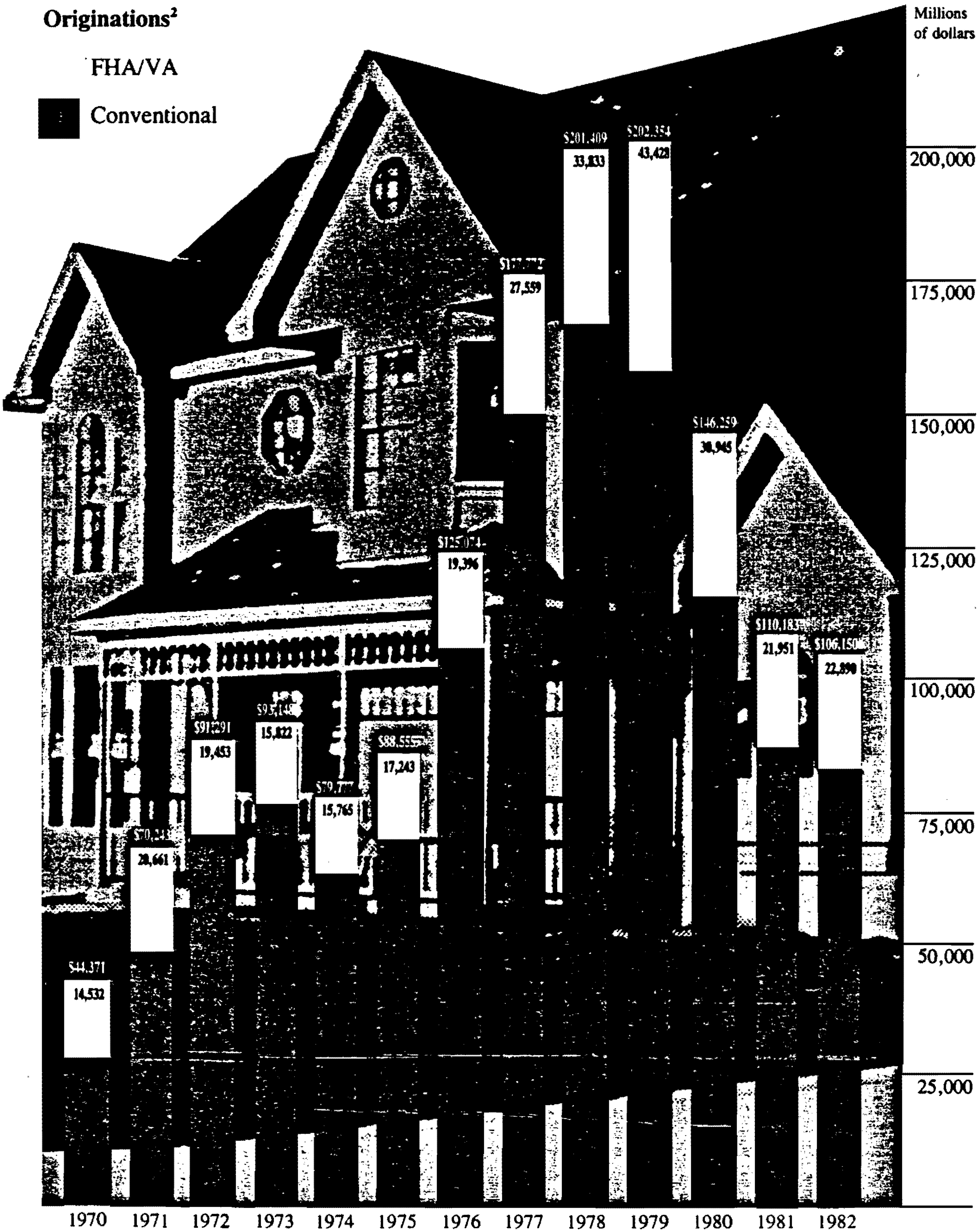
Highlights of the creation and development of the secondary market appear chronologically beginning on page 12.



SECONDARY MARKET ACTIVITY IN ONE-TO-FOUR FAMILY (NON-FARM) AND MULTIFAMILY MORTGAGE MARKETS SINCE 1970



[1]Net of federal credit agencies and mortgage pools and of sales of seasoned mortgages made under swap programs.



[2]Includes commercial banks, mutual savings banks, savings and loan institutions, life insurance companies, private noninsured pension funds, mortgage companies, real estate, investment trusts, state and local retirement funds, federal credit agencies, mortgage pools, and state and local credit agencies.

Columns may not sum to total due to rounding.

SOURCE: HUD "Survey of Mortgage Lending Activity"

PRIVATE SECONDARY MARKET ENTITIES

FUNCTIONS

Private secondary market entities increase the availability of financing for residential mortgage loans; they provide credit for innovative as well as traditional types of mortgages, and they serve homebuyers through their purchases of loans above the statutory loan limits of Freddie Mac and Fannie Mae.

OPERATIONS

A brief description of a few of the major participants in the private secondary market follows:

The Residential Funding Corporation (RFC) was established in 1982 as a subsidiary of Banco Mortgage Company, now Norwest Mortgage, one of the nation's largest mortgage banking firms.

RFC buys conventional single family fixed rate and adjustable rate mortgage loans, FHA and VA wrap mortgages, and mortgages where the borrower's monthly payment increases by a certain percentage each year, with the increase being applied against the principal balance. RFC buys from lenders nationwide, including mortgage bankers, savings and loan institutions, and commercial banks.

A private mortgage insurance company underwrites the loans for program criteria and mortgage insurance requirements and insures the mortgage pools.

RFC issues conventional securities through an investment banking firm.

The General Electric Credit Corporation (GECC) is the nation's largest diversified finance and leasing company. Through its various departments and subsidiaries it provides financing for first and second mortgages, homebuilder construction, manufactured housing, and commercial real estate loans.

GECC has been positioning to move fully into the private secondary mortgage market over the past three years. Through its subsidiaries it buys and underwrites mortgages and provides mortgage and title insurance. GECC has successfully marketed its mortgage pass-through securities, which carry a AAA rating by Standard & Poor's.

The Home Mortgage Access Corporation (HOMAC) was established in 1982 as a subsidiary of the National Association of Home Builders.

HOMAC provides homebuilders with more direct access to the secondary market by reserving mortgage funds for builders through investors who buy mortgage loans. Builders use the funds obtained from HOMAC to provide financing for potential homebuyers. Approved primary mortgage lenders originate the loans and then sell them to investors.

In 1982 HOMAC reserved funds for its participating builders through Freddie Mac and Fannie Mae.

FINANCING

Primary financing is provided by the sale of mortgage securities.

ORGANIZATION

Private secondary market entities operate as private corporations. Most are subsidiaries of larger corporate entities.

PRIVATE MORTGAGE INSURANCE COMPANIES (MICs)

FUNCTIONS

The availability of private mortgage insurance enables borrowers to obtain loans with higher loan-to-value ratios. Thus, individuals can purchase more expensive homes with smaller initial investments. The existence of private mortgage insurance makes investment in conventional mortgage loans more attractive to investors.

MICs insure conventional mortgage loans, thereby reducing the risk to the lender. They also arrange for and provide services in connection with the sale of conventional mortgage loans in the private secondary market. MICs develop underwriting standards for new kinds of mortgages.

OPERATIONS

A lender who has obtained a master policy from an MIC and who then seeks to insure individual conventional loans it has originated, submits the loans for review by the MIC. If a loan is acceptable to the MIC, the insurance policy insuring the lender against loss on a specified percentage of the loan (usually the top 20 or 25 percent) is issued.

Through their secondary marketing staffs, MICs find investors for packages of loans assembled by lenders. Generally, no fees are charged for this service although some MICs require that the loans carry the insurance of the MIC arranging the sales.

Another function of MICs is to serve as conduits for groups of lenders who individually lack a large volume of conventional mortgages to issue mortgage securities, or for other reasons choose not to issue mortgage securities themselves. An MIC may buy the loans from the lenders and then issue the securities in the name of the MIC or a subsidiary.

FINANCING
MICs finance their operations by premiums earned on individual mortgage insurance policies, by premiums on pool insurance policies, by return on investments, and by stock or debt issues.

ORGANIZATION
Private mortgage insurance companies (MICs) are chartered under state laws. They are usually subject to state insurance regulators. The management and boards of directors of MICs are similar to those of private corporations. Most are subsidiaries of larger corporate entities.

GOVERNMENT-RELATED SECONDARY MARKET ENTITIES

FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC)

CREATION
Freddie Mac was created by Congress in 1970 in conformance to Title III of the Emergency Home Finance Act of 1970, 12 U.S.C. 1451, et seq.

MISSION
Freddie Mac enhances the liquidity of mortgage investments and increases the availability of funds for mortgage lending by developing and maintaining a nationwide secondary market for conventional residential mortgages.

FUNCTIONS
Freddie Mac links mortgage lenders and capital markets through its purchase and sales functions. It buys conventional single family (one-to-four units) fixed rate and adjustable rate loans, FHA and VA fixed rate loans, multifamily fixed rate loans, and home improvement loans. It buys principally from savings and loan institutions as well as from mortgage bankers, commercial banks, and HUD-approved mortgagees.

It sells mortgage pass-through securities representing undivided interests in conventional mortgages and, to a lesser extent, FHA and VA mortgages.

It develops uniform mortgage instruments, forms, and underwriting guidelines that promote standardization of conventional loans on a national basis.

Freddie Mac also develops purchase programs and sales instruments that respond to the needs of the mortgage lending industry.

It develops processing mechanisms to support its standard business operations and to improve the efficiency and effectiveness of the secondary market.

OPERATIONS
Freddie Mac purchases single family, multifamily, and home improvement conventional mortgage loans under daily mandatory delivery programs. It purchases conventional single family mortgages under optional delivery programs that are offered once a week.

It supervises the servicing of all mortgage loans it purchases.

Freddie Mac sells mortgage-backed securities called Mortgage Participation Certificates (PCs) daily. It offers a Guarantor program under which mortgage originators sell conventional and FHA and VA mortgage loans at par for mandatory or optional delivery and simultaneously buy back PCs backed by those same loans. (For a detailed discussion of this program, see pages 31-33.)

FINANCING
Freddie Mac uses a mix of financing alternatives to accomplish its objectives. It finances most of its mortgage purchases through PC sales. Another type of mortgage-backed security, the Guaranteed Mortgage Certificate (GMC), has been sold periodically.

The corporation can also finance its operations through the issuance of debt obligations: long-term through debentures and short-term through discount notes, PC reverse repurchase agreements, and lines of credit obtained from commercial banks. Freddie Mac periodically issues Collateralized Mortgage Obligations (CMOs), which are debt obligations secured by conventional mortgages. CMOs employ short-, intermediate-, and long-term maturities and provide long-term financing.

ORGANIZATION

Freddie Mac was initially capitalized for $100 million through the subscription of nonvoting common stock by the 12 Federal Home Loan Banks (FHLBs). The FHLBs are the central banks for the nation's thrift industry, principally savings and loan institutions. The Federal Home Loan Bank Board (FHLBB) supervises the operations of the FHLBs and regulates member institutions. The FHLBB consists of three members, who are appointed by the president of the United States. These three members also serve, in a separate capacity, as Freddie Mac's board of directors.

With the first quarter of 1982, Freddie Mac began a policy of paying quarterly dividends to the FHLBs on their 100,000 shares of outstanding common stock. Special dividends have been issued periodically.

Also in 1982, Congress authorized Freddie Mac to issue preferred stock.

Freddie Mac operates from five regional offices and its home office in Washington, D.C. It also has three branch offices as extensions of its western and southwestern regional offices. (Locations of the home office and regional offices are printed on page 52.)

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FANNIE MAE)

CREATION

Fannie Mae was created by Congress in 1938 as a wholly owned governmental corporation. In 1954 it became a mixed ownership entity, owned partly by private shareholders and partly by the federal government. In 1968, in conformance to Title III of the National Housing Act, 12 U.S.C. 1716, et seq., it was partitioned into GNMA and Fannie Mae, with Fannie Mae owned by private shareholders.

MISSION

Fannie Mae is a major part of the secondary market for residential mortgages, providing additional liquidity to the mortgage market and improving the distribution of investment capital available for financing the construction and sale of housing. Initially, it provided a secondary market for FHA and VA mortgage loans only, but it was authorized in 1970 to purchase conventional mortgage loans also.

FUNCTIONS

Fannie Mae purchases single family and multifamily FHA, VA, and conventional mortgages.

It functions as a long-term investor in residential mortgages.

It conducts a mortgage-backed securities program for conventional and seasoned FHA and VA mortgages.

It also participates in construction and rehabilitation loans and makes direct loans to financial institutions.

It has also provided secondary market support to federal housing subsidy programs by purchasing, at market prices, loans originated under those programs.

OPERATIONS

Mandatory delivery commitments for fixed rate and graduated payment FHA and VA loans, fixed and adjustable rate conventional first loans, and fixed rate conventional second mortgages are issued at posted yields. For fixed and adjustable rate conventional loans, commitments are available for both whole loans and participations. Long-term standby commitments are available and may be converted to mandatory delivery commitments under any of Fannie Mae's standard purchase programs.

In addition to its standard purchase programs, Fannie Mae issues commitments and makes purchases on a negotiated basis.

Fannie Mae supervises servicing of single family mortgage loans by approved lenders; it services its own FHA multifamily loans. Its sellers are mortgage companies, savings and loan institutions, mutual savings banks, commercial banks, credit unions and, for second mortgages, finance companies.

Fannie Mae issues Guaranteed Mortgage-backed Securities (MBSs) backed by loans from its own portfolio as well as by loans pooled by lenders.

FINANCING

Fannie Mae's purchase activities are financed principally by the cash flow from its mortgage portfolio and high volume issuance of debentures and short-term discount notes. Its stock is publicly traded. In the past, Fannie Mae required lenders who sold it loans to purchase a certain amount of its stock. Although this requirement has been eliminated, some servicers are still required to retain a nominal amount of Fannie Mae stock. Fannie Mae sells conventional and seasoned FHA and VA mortgage pass-through securities. Also, a large and increasing percentage of Fannie Mae's earnings are generated from fees charged to lenders in its mortgage purchase and mortgage-backed securities operations.

ORGANIZATION

Fannie Mae is subject to regulatory authority of the secretary of HUD (Regulations at 24 CFR Part 81). This includes the establishment of a maximum debt-to-equity ratio and limits on Fannie Mae's total outstanding obligations. The U.S. Treasury, at its discretion, may purchase up to $2.25 billion of Fannie Mae debt; this backstop has never been used. Fannie Mae's debt issues represent general obligations of the corporation. They are not guaranteed or insured by the federal government. They have been classified by the credit markets as having "agency status," so that they generally yield investors a rate of return higher than Treasury issues and less than corporate offerings.

Fannie Mae has a 15-member board of directors, 10 elected by shareholders and five appointed by the president of the United States. (At least three of the appointees must represent the homebuilding, mortgage lending, and real estate industries.)

Its headquarters are in Washington, D.C. It operates from five regional offices located in Atlanta, Chicago, Dallas, Los Angeles, and Philadelphia. Fannie Mae also has a fiscal office in New York City.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)

CREATION

GNMA was created by Congress in 1968 in conformance to Title III of the National Housing Act, 12 U.S.C. 1716, et seq.

MISSION

GNMA supplies and stimulates, through secondary market mechanisms, mortgage credit that supports the government's housing objectives by assisting that segment of the housing market for which conventional financing is not readily available.

FUNCTIONS

GNMA has authority to purchase subsidized and unsubsidized single family and multifamily FHA and VA mortgages and, at times, conventional mortgages.

Also, GNMA guaranties pass-through mortgage-backed securities representing interests in FHA, VA, and FmHA mortgages. The securities are issued by HUD-approved mortgagees and guarantied by GNMA.

GNMA services a portfolio of mortgages owned by the federal government. Those mortgages were acquired from Fannie Mae or were transferred to GNMA by federal agencies.

OPERATIONS

Under various special assistance programs, GNMA purchases below-market-rate loans and then sells the loans to investors at a discount. GNMA no longer issues new commitments but is continuing to purchase mortgages for which commitments were issued previously.

Under its mortgage-backed securities program, GNMA had guarantied the issuance of more than $143 billion of GNMAs as of December 1982. It monitors the administration by the issuers/servicers of the mortgage pools.

As caretaker of a federally owned portfolio of mortgages, GNMA services the loans and liquidates the portfolio through sales, amortization, payoffs, and foreclosures.

FINANCING

Special assistance purchase programs are financed by Treasury borrowings, interest received on holdings, and commitment fees. The securities guaranty program is financed by application and guaranty fees paid by the issuers of the securities.

ORGANIZATION

GNMA is a wholly owned governmental corporation within the Department of Housing and Urban Development (HUD). The president of GNMA, a presidential appointee, acts under general policy direction of the secretary of HUD. GNMA operates from an office in Washington, D.C. It has no branch offices.

HISTORICAL HIGHLIGHTS OF THE DEVELOPMENT OF THE SECONDARY MARKET

1916

- First government credit program created for farmers at Federal Land Bank.

1930s

- Depression had devastating impact on real estate lending. Government's response was creation of the Federal Housing Administration (FHA) in 1934 through which insurance programs were created.

1938

- Federal National Mortgage Association (Fannie Mae) created as a subsidiary of the Reconstruction Finance Corporation.

1944

- Veterans Administration (VA) loan guarantee program created.

1948

- Fannie Mae purchased its first VA mortgages.

1949

- The first secondary market transaction between two savings and loan institutions was the sale of $1.5 million of FHA and VA mortgages from Prudential Federal Savings and Loan to First Federal of New York. The 4 percent and 4.5 percent loans were priced to yield 3.56 percent.
- Approximately one-quarter of outstanding home mortgage debt was held by households, one-fifth by commercial banks, and one-half by thrift institutions and insurance companies.

1954

- Fannie Mae became a mixed ownership corporation, owned partly by private shareholders and partly by the federal government.

1957

- Federal Home Loan Bank Board issued first regulations permitting the purchase and sale of participation interests in mortgage loans. First deal was from Sun Federal of Tallahassee to First Federal of Lowell, Mass.

1968

- Fannie Mae was split into two entities—a federally chartered corporation owned by private shareholders which retained the Fannie Mae name and a corporation within HUD known as the Government National Mortgage Association (GNMA). GNMA assumed responsibility for special assistance functions, such as programs requiring government subsidies, and for management and liquidation of certain federally owned mortgage portfolios which had been acquired by Fannie Mae between 1938 and 1954.
- Fannie Mae, while subject to certain federal regulations, was converted to private management and began to purchase market-rate loans. Its transition to private status was completed in 1970.

1970

- The secondary market for FHA and VA mortgages was well established, both through Fannie Mae and the long-established relationships between lenders and various types of mortgage investors such as life insurance companies and mutual savings banks.
- Conventional loans were made in the primary market, but lenders' forms and standards varied widely.

The lack of standard documents and requirements impeded private secondary market development with respect to conventional mortgages.

- GNMA created the first publicly traded pass-through securities representing undivided interests in pools of FHA and VA mortgages. The instrument, backed by government guaranty, enabled mortgage companies to sell mortgages to investors who were located in other sections of the country and to institutions and investors that had not invested in real estate loans in the past. The first issue was in February 1970.
- The volume of secondary market activity in 1970 was around $16 billion.[1] In that year, Fannie Mae's cumulative portfolio of FHA and VA loans grew to $15.5 billion from $2.5 billion in 1965.
- GNMA introduced a series of "tandem plans" under which it committed to purchase loans at below-market rates. It sold the loans to investors at market prices, absorbing the loss. The plans were tailored for mortgages insured under Sections 235 and 236 of the National Housing Act, as well as other special programs.
- Various regions of the country were experiencing rapid growth and building, but local lending institutions often lacked sufficient funds. Many areas had excess funds, but there were no means of transferring those funds.
- Conditions in the housing market reached crisis proportions. Key economic indicators pointed toward recession. Housing starts had dropped and interest rates were the highest since the Civil War.
- The Federal Home Loan Mortgage Corporation (Freddie Mac) was created by the Emergency Home Finance Act of 1970. Legislation was introduced by Sen. John Sparkman of Alabama and by Rep. Wright Patman of Texas. Within two months, it was passed by an overwhelming margin and signed into law (July 24). Freddie Mac was authorized to purchase FHA and VA loans and conventional loans. The corporation organized 12 regional offices in cities where Federal Home Loan Banks (FHLBs) were located, often using FHLB staff to conduct the corporation's operations. In its first year of operation, the corporation purchased $326 million in FHA and VA mortgages.
- Fannie Mae was given authority to purchase conventional mortgages.
- Secondary market activity by GNMA, Fannie Mae, and Freddie Mac totaled $6 billion in 1970.

1971

- Freddie Mac developed a continuously offered program for buying participation interests in conventional mortgages.
- The corporation began a continuously offered program to purchase FHA and VA mortgages.
- Freddie Mac introduced the first conventional mortgage pass-through security (the Mortgage Participation Certificate) with $67 million in sales the first year. Development of the security was part of the corporation's strategy to reach investors who traditionally had not provided mortgage credit.
- Freddie Mac issued standards for the qualification of private mortgage insurers. The establishment of these requirements encouraged lenders' acceptance of private mortgage insurance and was instrumental in the development of the 95 percent (5 percent down payment) conventional mortgage.

1972

- Freddie Mac implemented whole loan purchase programs for single family and multifamily conventional mortgages.
- It developed and introduced a computerized matrix to assist in underwriting single family conventional mortgages.
- Freddie Mac began purchasing conventional mortgages on condominium and PUD units.
- Fannie Mae implemented a single family conventional loan purchase program.

1973

- Freddie Mac and Fannie Mae developed and introduced a standardized loan application for conventional home mortgages and a single family appraisal report.

1974

- Freddie Mac and Fannie Mae played a major role in assisting the credit-strapped housing market. These two corporations committed to purchase nearly 20 percent of the loans originated in 1974. Commitments from the two institutions totaled $16 billion and purchases exceeded $9 billion for the year.

[1] Source: HUD

- Fannie Mae expanded conventional mortgage purchases to include condominium and PUD units.
- Congress passed the Emergency Home Purchase Assistance Act, P.L. 93-449 (The Brooke-Cranston Act), to establish a tandem program for conventional mortgages. Freddie Mac and Fannie Mae served as agents for GNMA in its purchase of below-market-rate conventional mortgages.
- Freddie Mac allocated $3 billion of commitments under a special forward commitment program made possible by a financing arrangement with the U.S. Treasury. It purchased $1.5 billion in mortgages under this program in 1974 and 1975.

1975

- Freddie Mac introduced and sold $500 million in Guaranteed Mortgage Certificates (GMCs) to attract traditional bond buyers.
- Freddie Mac reorganized regional operations among five regional offices.
- Freddie Mac began working with the Department of Justice to ensure the fairness of appraisal and underwriting guidelines. As a result, the corporation's guidelines have been held up as models of fairness.
- Outstanding volume of GNMA mortgage securities hit $20.8 billion.
- The Chicago Board of Trade established a futures market in GNMA securities to enable builders and lenders to hedge against rising mortgage rates.
- Freddie Mac and Fannie Mae introduced uniform legal documents for conventional mortgages in each state. (By the end of 1981, an estimated 80 percent of all conventional mortgages were originated on these documents.)

1976

- Fannie Mae's conventional loan purchases exceeded its FHA and VA loan purchases for the first time in its history ($820 million in FHA and VA purchases compared to $2.5 billion in conventional purchases).
- Freddie Mac succeeded in balancing its purchases of mortgages with commitments to sell its mortgage securities. It funded mortgage purchase activities almost exclusively with sales of PCs. Also, the corporation introduced a pilot program for six-month forward commitments for single family mortgages.
- Total secondary market activity rose above $43 billion for the year.[2] Fannie Mae and Freddie Mac commitments totaled $7.7 billion and their purchases were $5.7 billion. GNMA guarantied $14 billion in securities. Sales by mortgage insurance companies, as reported by their national trade association, were $2.9 billion.
- The Senate Banking Committee initiated oversight hearings on the operations, structure, and purpose of Fannie Mae.

1977

- Freddie Mac formed in January a group of securities dealers to market PCs. Prior to this time, all PC sales had been conducted by Freddie Mac sales representatives.
- PC sales to investors who had not traditionally invested in mortgages climbed to 46 percent. Sales to institutions other than thrifts had been less than 5 percent in previous years.
- Freddie Mac instituted, on a regular basis, a program for issuing six-month forward commitments to purchase single family conventional mortgages.
- Fannie Mae and Freddie Mac each initiated various efforts to encourage use of secondary market credit to stimulate revitalization of neighborhoods, particularly urban areas. Fannie Mae launched a number of special urban purchase programs. Freddie Mac formed a Community Lending Task Force to find ways of encouraging lending in urban and any other neglected areas through its regular programs.
- Building on the success of GNMA securities and Freddie Mac's PCs, Bank of America issued and sold the first publicly issued pass-through securities without guarantee of any government agency. In 1978, various issuers sold $728 million worth of such securities. The success of these mortgage securities prompted emergence of conduit issuers who market securities representing loans originated and serviced by many (ususally 30 to 40) lenders.

1978

- Freddie Mac secured congressional approval to purchase home improvement and energy conservation loans. In addition, the corporation received congressional authorization to buy loans on individual cooperative units.
- Freddie Mac introduced a pilot program for issuing

[2]Source: HUD

eight-month forward commitments to purchase conventional single family mortgages.

1979

- Freddie Mac issued a comprehensive revision of its conventional single family underwriting guidelines to enhance the availability of mortgage financing for certain classes of borrowers and properties that may have been neglected by traditional lending practices.
- Fannie Mae announced a number of programs intended to revitalize areas needing rehabilitation.
- Mortgage bankers and other HUD-approved mortgagees became eligible to sell mortgages to Freddie Mac.
- Interest rates began another monumental climb, resulting in serious credit shortages in many housing markets and forecasts of a housing recession.
- The median sales price of a home continued to increase at a much faster rate than the median household income. From 1975 to 1979, the annual increase in new home prices averaged 12.5 percent compared to a general inflation rate of 7.7 percent. This compared to a growth in average median household income of 8.8 percent during the same period.

1980

- Issues of GNMA securities topped $100 billion in May. Total issues of Freddie Mac pass-through securities exceeded $21.2 billion at year's end.
- Freddie Mac paid its first dividend to the Federal Home Loan Banks (FHLBs) in the amount of $50 million and simultaneously issued subordinated capital debentures to the FHLBs for $50 million. The FHLBs, in turn, paid $40 million in dividends to member institutions.
- The economy showed strength in the first quarter, but the Gross National Product (GNP) plummeted to −9.9 percent in the second quarter before turning positive in the second half of the year. Housing starts declined to a total of 1,292,200 for the year. The Consumer Price Index (CPI) averaged 13.5 percent for the year. The prime rate hit a record 20 percent.
- Reflecting the dampening that occurred in the housing industry during the year, primary market mortgage originations declined approximately 29 percent from the 1979 level. Although conventional originations also declined, the ratio of conventional sales to total secondary market sales increased over the previous year, demonstrating the relative strength during the year of the conventional mortgage versus FHA and VA mortgages.
- In April Freddie Mac and Fannie Mae introduced uniform instruments for home improvement loan originations, laying the groundwork for a secondary market for home improvement loans.
- As part of its efforts to promote energy conservation, Freddie Mac surveyed mortgage lenders to learn how energy costs and the energy efficiency of homes were evaluated by lenders in their underwriting, appraising, and servicing of conventional home mortgages.
- The ceiling for single family mortgages purchased by Freddie Mac was increased according to the provisions of the 1980 Housing Act. The act specified that the corporation could adjust those limits each year in accordance with the annual increase in the national average price of a one-family home as reported by the Federal Home Loan Bank Board in its monthly surveys.
- Freddie Mac pooled its resources on its forward commitment programs. The industry indicated a preference for the longer delivery period offered under the eight-month forward commitment program, so the six-month program was dropped from the corporation's offerings.
- Federal Home Loan Bank Board staff and Freddie Mac staff, with the aid of an external consulting group, analyzed the adequacy of Freddie Mac's capital base. Both studies determined that while the corporation's capital base was adequate for current needs, potential for a future constraint existed. Recapitalization of the corporation to a more private structure in order to increase its capital base was necessary.

1981

- Freddie Mac introduced its Home Improvement Loan (HIL) pilot purchase program in January. It was the first national secondary market program for home improvement loans.
- The minimum denomination for Mortgage Participation Certificates was lowered from $100,000 to $25,000.
- In August Freddie Mac introduced its Guarantor program. Under the program, the corporation purchases from sellers at par home mortgages and simultaneously sells back interests in those same mortgages in the form of Freddie Mac PCs. By year's end, the corporation had committed to exchange more than $5.5 billion of mortgages for PCs.

- Housing starts fell to a 15-year low in October to an annual rate of 854,000. It was the second lowest total since World War II on a monthly rate basis, and 44 percent below previous-year levels. Building permits, an indicator of future construction activity, declined for the sixth consecutive month in October, to 722,000 units. Although rates declined slightly during the first part of the year, they accelerated to new peaks in the third quarter. The federal deficit exceeded the benchmark figure of $1 trillion in October.
- According to Freddie Mac's Primary Mortgage Market Survey, the lowest average mortgage rate in 1981 was 15 percent, on Feb. 6. The highest rate for the year was 18.63 percent as of Oct. 9.
- The high rate of savings withdrawals continued as savings withdrawals exceeded deposits by $206 billion as of August. It was the worst savings performance on record and reflected the continued drain of funds away from the savings industry.
- During the first six months, single family originations were down 11 percent from a comparable period in 1980 and 35 percent from 1979.
- Freddie Mac initiated two new debt programs in October with offerings of three-year senior debentures and short-term discount notes. Funds raised through these programs are used to supplement the corporation's primary funding method of selling mortgage securities. Debt funding in 1981 provided approximately 23 percent of Freddie Mac's portfolio financing needs.
- In October Freddie Mac temporarily modified its weekly auction method by announcing each week a minimum net yield at which lenders must submit loans for sale to the corporation. The change, applicable to purchase programs for single family conventional mortgages, was made so the corporation could relate the cost of buying mortgages to its cost of funds in the capital markets.
- Freddie Mac's recapitalization legislation was introduced in the House (H.R. 4787) on Oct. 19 and in the Senate (S. 1805) on Nov. 4.
- A multitude of adjustable rate mortgage (ARM) programs appeared in the marketplace following the issuance of regulations governing these new types of mortgages by the Federal Home Loan Bank Board (FHLBB) and the comptroller of the currency. Freddie Mac introduced capped and uncapped purchase programs using the FHLBB Mortgage Contract Rate as an index. Fannie Mae announced eight experimental purchase programs representing a number of indices and a variety of program characteristics.
- In December Fannie Mae initiated a conventional mortgage security program.
- Despite high borrowing costs, Freddie Mac remained profitable throughout the year, as it has been every year of its operation, because of its practice of selling the loans it buys, thus reducing its refinancing risk.

1982

- Freddie Mac's board of directors eliminated the nonmember fee charged to mortgage lenders who are not members of the Federal Home Loan Bank System.
- Congress authorized Freddie Mac and Fannie Mae to issue preferred stock.
- The secondary market translated declining capital market yields into lower home mortgage rates, thus contributing to the year-end housing recovery. According to Freddie Mac's Primary Mortgage Market Survey, the national average mortgage rate fell from a high of 17.66 percent on Feb. 19 to 13.57 percent on Dec. 31. In the last three months of the year, the yield at which Freddie Mac commits to buy mortgages dropped to an average of 13.3 percent.
- Housing starts climbed from a 15-year low of 839,000 in Nov. 1981 to an annual rate high of 1.4 million in Nov. 1982. Building permits, an indicator of future construction activity, also climbed to a year-end annual rate high of 1.3 million.
- Mortgage lending activity by thrifts fell below previous-year levels until August. Activity increased dramatically in the last five months of the year, with commitments to originate mortgages up 84 percent from previous-year levels and loan closings up 76 percent. After experiencing net deposit outflows in 18 out of 20 preceding months, savings and loans received record net inflows of $10.4 billion in December with the beginning at midmonth of Money Market Deposit Accounts.
- Fannie Mae instituted a program to purchase second mortgages, both from lenders and from individuals.
- Freddie Mac's Guarantor program allowed lenders to swap more than $25 billion in conventional mortgages being held in portfolio for PCs issued by Freddie Mac.
- Fannie Mae introduced graduated payment adjustable rate mortgages.
- The Residential Funding Corporation (RFC) began

operation in the private secondary mortgage market. RFC can purchase loans that exceed the statutory loan limits placed on Freddie Mac and Fannie Mae. Mortgage Guaranty Insurance Corporation underwrites the mortgages and insures the mortgage pools, and Salomon Brothers issues securities backed by the mortgages.

- Freddie Mac paid cash dividends for the year totaling $14 million, including a special year-end dividend of $12 million, to its stockholders, the 12 Federal Home Loan Banks.
- Freddie Mac had record earnings for 1982 of $59.9 million, nearly double the 1981 net income of $30.9 million.

1983

- Freddie Mac and Fannie Mae discontinued purchasing mortgages through weekly auctions in favor of accepting daily offers at posted net yields.
- After 17 months of recession, the U.S. economy expanded in the first quarter of 1983, though more slowly than in the initial period of any cyclical recovery since World War II. Residential construction spending climbed at an annual rate of 83 percent for the quarter, the fastest for any quarter since 1947.
- Housing starts for the first quarter amounted to nearly 1.7 million at an annual rate, the highest rate since the third quarter of 1979.
- Freddie Mac reported first quarter earnings of $26.6 million, the highest level of earnings in its history, up 30 percent from the previous record of $20.4 million earned in the first quarter of 1982.
- Fannie Mae reported a first quarter profit of $15 million, its first profitable quarter since the last quarter of 1980.
- In April Freddie Mac began purchasing adjustable rate mortgages indexed to three- and five-year U.S. Treasury securities and 15-year conventional fixed rate mortgages.
- Effective April 20 Fannie Mae began enforcing the due-on-sale provision in its mortgage documents by requiring that loans be paid off if transferred or sold. Fannie Mae previously enforced the provision by raising the note rate to a market level. Freddie Mac began enforcing its due-on-sale provision effective July 1.
- In May President Reagan signed into law a Joint Resolution of Congress clarifying that Freddie Mac securities are exempt under certain SEC statutes.
- In May Fannie Mae cut its eight standard adjustable rate mortgage plans to three. It offers ARMs indexed to one-, three-, and five-year U.S. Treasury securities. All have payment cap provisions and may be combined with graduated payment or buydown features.
- In the first six months of 1983, the national average mortgage rate declined from a high of 13.46 percent on Jan. 7 to a low of 12.55 percent on May 20, according to Freddie Mac's Primary Mortgage Market Survey. The May 20th rate was the lowest since Aug. 15, 1980.
- In June Freddie Mac began purchasing nonowner-occupied mortgage loans under its standard and Guarantor programs.
- In June Freddie Mac sold $1 billion in Collateralized Mortgage Obligations (CMOs), the largest issue of a mortgage-related security offered on the U.S. market.
- GNMA implemented its restructured mortgage-backed securities program in July. The program, called GNMA II, provides for payments to investors through a central paying agent and uses new technologies for accounting and reporting on pool activity. The increased efficiency in issuing and administering GNMAs should translate into lower borrowing costs for homebuyers.
- Fannie Mae formed a selling group to market its Guaranteed Mortgage-backed Securities (MBSs). Previously, all MBS sales were conducted by an underwriting syndicate.
- In July Freddie Mac announced that it had negotiated with Ticor Investment Securities Company (TISC) to make available to homebuyers a new type of adjustable rate mortgage (ARM). Its features allow homebuyers to convert the mortgage, after three or five years, to either a 27-year or a 25-year fully amortized fixed rate loan at the market rate for a 30-year fixed rate loan at the time of conversion. Under the program, $1.42 billion is available for adjustable rate and fixed rate home mortgages. The deal is the second between Freddie Mac and TISC in 1983; the first resulted in $281 million worth of commitments for ARMs.

MORTGAGE

SALES AND PURCHASES

The secondary market for residential mortgages has evolved into a multichanneled process, with the number and types of both mortgage originators and investors expanding as the market matures.

The secondary market process includes both sales and purchases of mortgages. A diagram on page 20 outlines the options mortgage originators can choose to reach investors. Those options are explained on pages 22 to 35.

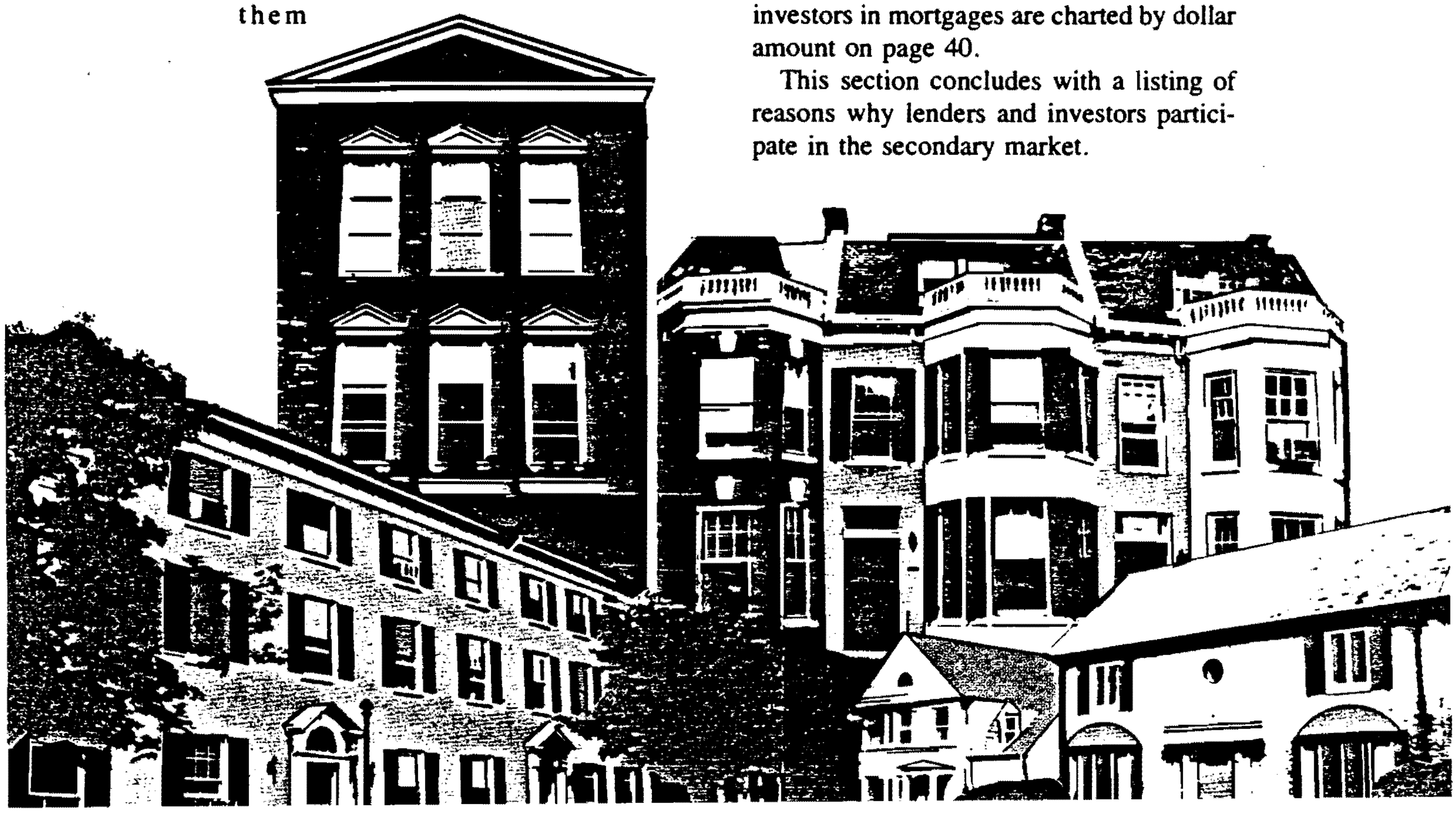
Originators can choose to sell whole loans or participations to investors through direct sales, through sales to Freddie Mac or Fannie Mae, or through sales to a conduit such as a private mortgage insurance company. Many purchasers, like Freddie Mac, Fannie Mae, and other conduits, resell the loans to other investors by means of mortgage-backed securities. Other purchasers, including Fannie Mae, may hold purchased loans in portfolio and not sell them to another investor.

Originators can choose to convert mortgages into pass-through securities as GNMAs, as private issues, as Mortgage Participation Certificates (PCs) under Freddie Mac's Guarantor program, or as Guaranteed Mortgage-backed Securities (MBSs) under Fannie Mae's program.

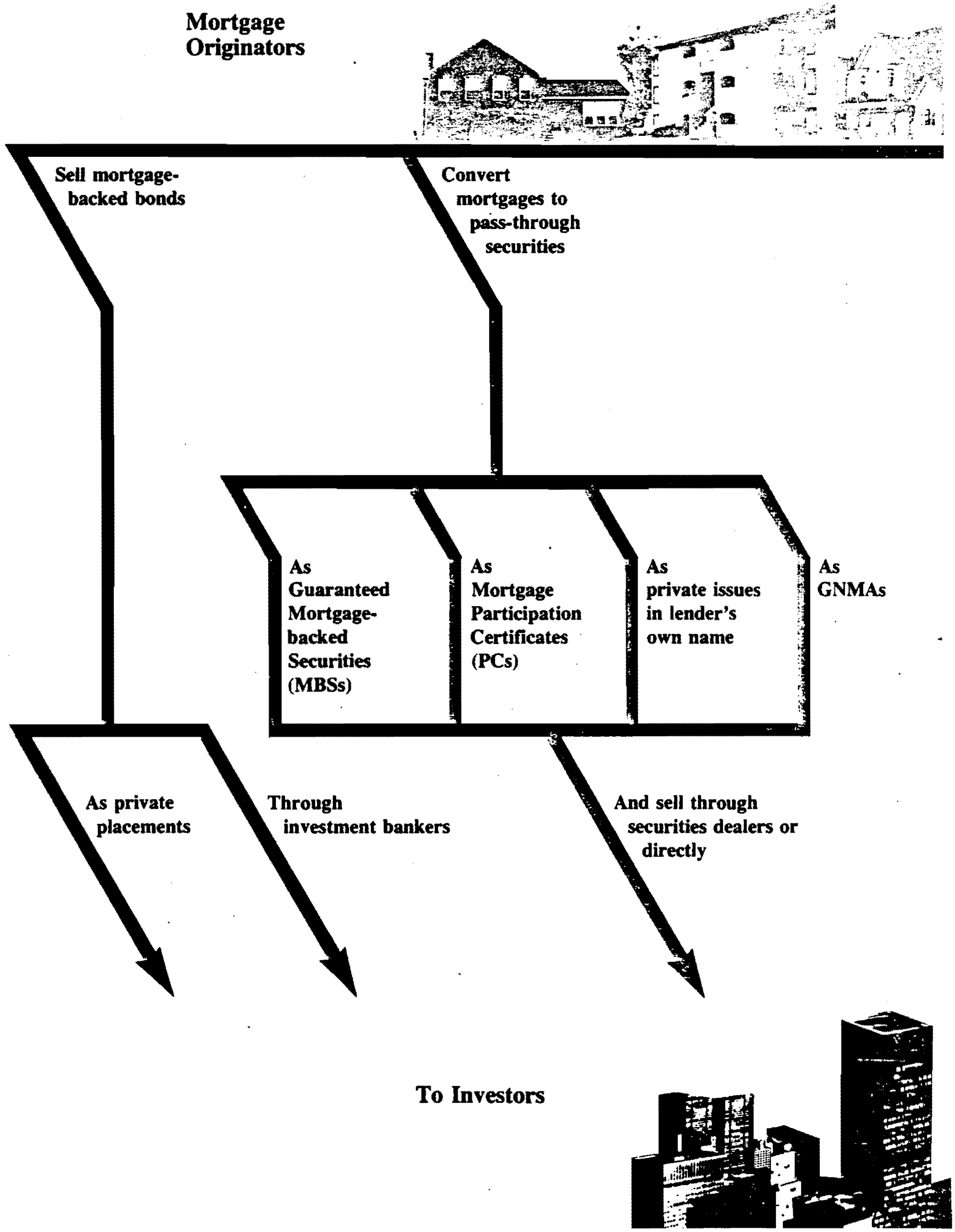
Originators can also choose to sell mortgage-backed bonds. To do this, they locate investors through investment bankers and private placements.

Following the explanations of the options available to originators for selling mortgages are several charts. The characteristics of mortgage pass-through securities are compared on pages 36 and 37. The dollar volume of sales of PCs/GMCs, GNMAs, MBSs, and private pass-through securities are shown in the chart on page 38. The major types of lenders who sell mortgages in the secondary market are charted by dollar amount on page 39. The major types of investors in mortgages are charted by dollar amount on page 40.

This section concludes with a listing of reasons why lenders and investors participate in the secondary market.



THE SECONDARY MARKET PROCESS



Mortgage Originators

Definitions of terms on the diagram:

(Descriptions of processes are contained on the following pages.)

Mortgage Originators include savings and loan institutions, commercial banks, mortgage companies, mutual savings banks, credit unions, and others.

A *Conduit* is an organization that buys mortgages and packages them to sell to other investors. This operation can be performed by any type of institution; conduits, however, are predominantly MICs and investment bankers.

Investors include thrift institutions, banks for their own portfolios and for trust accounts, pension funds, life insurance companies, and others.

Dealers are investment bankers.

GNMAs are pass-through securities guarantied by the Government National Mortgage Association and representing ownership of FHA, VA, and FmHA loans.

PCs are pass-through securities guaranteed by Freddie Mac and representing undivided interests in conventional and seasoned FHA and VA mortgages.

MBSs are pass-through securities guaranteed by Fannie Mae and representing undivided interests in conventional and seasoned FHA and VA mortgages.

Sell whole loans or participations

To Fannie Mae[1]

To Freddie Mac

To a conduit

Directly

Which sells Guaranteed Mortgage-backed Securities (MBSs)

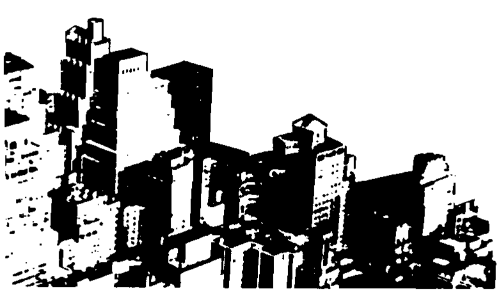
Which sells Mortgage Participation Certificates (PCs)

Which sells loan packages or pass-through securities

Through securities dealers

Through securities dealers

Through securities dealers or private placements



To Investors

[1]Fannie Mae has traditionally held loans it purchases in portfolio; however, it recently began selling pass-through securities backed by loans from its own portfolio.

SALES OF WHOLE LOANS OR PARTICIPATIONS VIA A CONDUIT OR DIRECTLY TO INVESTORS

Mortgage Originators

Sell whole loans or participations

To a conduit

Directly

Which sells loan packages or pass-through securities

Through securities dealers or private placements

To Investors

AVAILABILITY
Some lenders have agreements with their investors that allow them to sell on a continuous basis. Otherwise, deals are negotiated on an individual basis.

TYPE OF LOANS
Type of loans purchased varies from investor to investor. Some conduits have set programs, others do not.

APPROVAL OF SELLERS
Lenders typically sell their loans to insurance companies, pension funds, commercial banks, mutual savings banks, or savings and loan institutions. Lenders often develop sales agreements with their investors. Lenders without such agreements must produce and package whole loans and participations to meet the general demands of such investors.

LOAN REQUIREMENTS
Loans are sold on a gross or net yield basis on the outstanding principal balance for the life of the loans. Requirements vary, depending on investor.

OFFER PROCEDURE
To sell their mortgages, lenders first make contact with potential investors and negotiate the details of transactions. Such details include the following:

1. Whether whole loans or participations are sold;
2. Yield to the investor;
3. Total dollar amount of a transaction;
4. Fees paid to the purchaser at time of commitment;
5. Whether or not servicing is released;
6. Type of properties;
7. Location of properties;
8. Maximum and minimum loan amounts;
9. Loan-to-value ratios;
10. Method of monthly remittance to investor;
11. Coupon rate of loans in package;
12. Whether funding shall be immediate or in the futur
13. Underwriting standards to be applied; and
14. Type of loan documents used.

DELIVERY
This decision is established in agreement between seller and investor.

UNDERWRITING
Underwriting is normally performed by investors. Also, an investor often will conduct an on-site inspection of all or part of the properties financed by loans in the package sold.

PURCHASE PROCEDURE
Once lenders and purchasing investors reach agreement on the requirements of loan packages, packages are funded and the loan files or participation agreement are sent to investors.

FEES
Fees are established in agreement between seller and investor.

SERVICING
Servicing of whole loans can be retained by originators or transferred to purchasers at the time of sale. When participations are sold, originators almost always continue to service the loans.

ADVANTAGES TO LENDERS

Despite the inconvenience of negotiating deals individually, sales made directly to investors other than Freddie Mac or Fannie Mae have several advantages. Among these are that loans ineligible for sale to Freddie Mac and Fannie Mae can be sold.

A large volume of loans are traded each year among investors, thereby giving lenders more opportunities to sell loans and increase originations.

Note: Sales of participations are advantageous for savings and loans because paperwork requirements are simpler than for sales of whole loans. Mortgage companies prefer to sell whole loans; since they are not depository institutions, they usually lack the funds needed to retain ownership of a portfolio of loans.

SALES OF WHOLE LOANS OR PARTICIPATIONS TO FREDDIE MAC

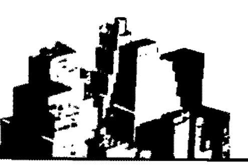
Mortgage Originators

Sell whole loans or participations

To Freddie Mac

Which sells Mortgage Participation Certificates (PCs)

Through securities dealers



To Investors

AVAILABILITY

Freddie Mac buys conventional single family, multifamily, and home improvement loans for mandatory delivery at a required net yield each business day. Under the Guarantor program, Freddie Mac buys seasoned (at least one year old) FHA and VA loans and conventional loans for mandatory or optional delivery at a required spread each business day. Freddie Mac also offers optional delivery commitments for conventional single family loans at a required net yield once a week.

TYPE OF LOANS

Freddie Mac purchases the following type of loans:

1. Conventional single family (one-to-four units) whole loans and participation purchases for 15- and 30-year fixed rate mortgages and adjustable rate mortgages (ARMs)[1] on which the interest rate and payment adjusts every one, three, or five years; Freddie Mac participation interests range from 50 to 95 percent in increments of 5 percent.
2. Seasoned FHA and VA single family whole loans and participation purchases under the Guarantor program for fixed rate mortgages with 10-to-30-year maturities; Freddie Mac participation interests range from 50 to 95 percent in increments of 5 percent.
3. Conventional multifamily (five or more units) whole loans and participation purchases; Freddie Mac participation interests range from 50 to 85 percent; and
4. Home improvement loans (HILs).

[1]Freddie Mac will begin to purchase in the fall of 1983 ARMs that give the borrower the option to cap payment increases at the time of adjustment and to cap the loan's negative amortization. Freddie Mac will also purchase ARMs based on a cost of funds index.

APPROVAL OF SELLERS

The Federal Home Loan Banks, the Federal Savings and Loan Insurance Corporation, any member of a Federal Home Loan Bank, any financial institution with deposits or accounts insured by an agency of the U.S. government, state-insured savings banks in the state of Massachusetts, and HUD-approved mortgagees may participate in Freddie Mac's purchase programs. Lenders who are not members of the Federal Home Loan Bank System must apply for approval, submitting information on their net worth, financial profile, volume of loans processed, servicing procedures, servicing experience, insurance coverage, and other required information.

LOAN REQUIREMENTS

Freddie Mac's Sellers' Guides outline in detail its requirements for selling and servicing mortgage loans. Loans sold to the corporation must be of investment quality. That is, in addition to satisfying Freddie Mac's appraisal and underwriting guidelines, the loans must meet other requirements, such as mortgage amounts, loan-to-value ratios, types and amounts of insurance required, loan terms, and documentation. Loans are purchased on a net yield basis.

OFFER PROCEDURE

To make an offer to sell mortgages, a lender telephones Freddie Mac on any business day between 11:00 a.m. and 2:00 p.m. eastern time, except under the four- and eight-month optional delivery programs. Offers are made under those programs each Tuesday. All offers are made by dialing one telephone number—(202) 789-2200.

For offer amounts of $25 million or less, Freddie Mac announces the required net yields at which it will consider offers on its Commitment Information Lines—(202) 789-4488 for adjustable rate mortgages and (202) 789-4500 for fixed rate mortgages—beginning at 11:00 a.m. eastern time each business day. The minimum required net yields for the optional delivery programs are announced each Tuesday. The required spreads under the Guarantor program will generally remain constant. Changes in the spreads will be announced on (202) 789-4500. In addition, the yields and spreads are available from the Freddie Mac regional offices.

Offer amounts of more than $25 million are considered on an individually negotiated basis through Freddie Mac's regional offices.

Offers are accepted on a first come, first served basis. Unless commitments are no longer being accepted that day for a particular program and/or delivery period, a lender may obtain one commitment for each delivery period for each program.

The minimum commitment amount for each transaction under the mandatory delivery programs other than the Guarantor and HIL programs is $100,000 per contract. For the Guarantor program, the minimum commitment amount is $1 million and for the HIL program, it is $25,000. The minimum commitment amount for each transaction under the optional delivery programs is $100,000 per contract. There is no maximum amount a lender can commit to sell except in the multifamily program, where it is $7.5 million under Plan A and $20 million under Plan B, and in the optional delivery programs, where it is $5 million per program per day.

DELIVERY

Freddie Mac offers sellers a choice of four commitment terms in which to deliver mortgages under its purchase programs for 15- and 30-year fixed rate mortgages and ARMs on which the interest rate and payment adjusts every three or five years. Delivery of loans under these programs is mandatory as follows: within 30 days after the purchase contract is signed, within 60 days, within 61-90 days, or within 91-120 days.

Delivery of loans is mandatory within 60 days after the date the purchase contract is accepted for the multifamily and HIL programs and for the ARM program under which the interest rate and payment adjusts every year. Beginning Oct. 1, 1983, delivery of multifamily loans will be mandatory within 30 days. Under the Guarantor program, delivery is mandatory within 90 days or optional within 180 days. Under the optional delivery programs for conventional home mortgages, delivery is optional within four or eight months after the date the purchase contract is signed. For the prior approval program for multifamily mortgages, delivery is optional within 70 days after the purchase contract is issued by the corporation. Beginning Oct. 1, 1983, a seller may convert a multifamily prior approval contract from optional to mandatory delivery within the 60-day commitment period. If a seller converts, delivery of loans is mandatory within 30 days.

Freddie Mac allows partial delivery of loans sold in the 30-year fixed rate, ARM, and Guarantor programs if the mortgages delivered have at least a $1 million total unpaid principal balance. Partial deliveries are allowed under the HIL program if the total unpaid principal balance of the mortgages delivered is at least $25,000.

UNDERWRITING

A package of loans delivered to Freddie Mac must include the documentation prescribed by the corporation for each purchase program.

Underwriters review and evaluate the documents submitted by lenders. In Freddie Mac's streamlined underwriting process, computer selection of single family loans that meet certain criteria eliminates the need for manual review of the credit documentation by the underwriting staff. Properties are physically inspected when possible adverse conditions warrant such a review. Properties may be inspected by the corporation's underwriter, a fee inspector, or accepted on the basis of the written appraisal.

The underwriter reviews the application and analyzes the credit of the borrower, the loan-to-value ratio, the ratios of income-to-total monthly debt obligations and monthly housing expenses, and other significant factors.

PURCHASE PROCEDURE

Once reviewed, the loans are purchased or rejected. If purchased, funds are transmitted from the corporation to an account specified by the seller. The turnaround time from delivery of the loan to funding of the contract is usually less than 21 days.

If a loan is rejected, a seller is notified of the reason for rejection.

A Quick Funding program was instituted in 1981 to minimize documentation submission requirements, reduce document duplication and delivery costs, and speed the funding of loan purchases. Lenders who had good records with Freddie Mac's delivery, purchase, servicing, underwriting, and accounting procedures were eligible to participate. They received funds 10 days earlier than the usual 21 days. Effective June 1, 1983, Freddie Mac expanded the program to allow new lenders preferred seller status once their application to become a Freddie Mac seller/servicer has been approved. An approved seller who has sold less than 20 loans to Freddie Mac may also be granted preferred seller status. The Preferred Seller program replaces the Quick Funding program and applies to all Freddie Mac purchase programs with the exception of the HIL and multifamily programs.

FEES

Fees are not normally charged under Freddie Mac's standard programs. The only commitment fees required by the corporation are as follows:

Single Family

- A fee of 0.75 percent of the principal amount of investment property loans delivered is required under Freddie Mac's standard programs; for investment property loans delivered without recourse under the Guarantor program, the fee is 0.5 percent.
- A fee of 0.01 percent of the contract commitment amount is required for loans delivered under Freddie Mac's Guarantor program for 180-day optional delivery.
- Commitment fees under the four- and eight-month optional delivery programs are based upon market rates and may change from week to week.

Multifamily

- A fee of 2 percent of the contract commitment amount is required under the multifamily prior approval program. One-half of this fee is refunded when a mortgage meeting the terms of the contract is delivered. A nonrefundable fee of $1,500 or 0.1 percent of the amount of the loan for which approval is requested, whichever is greater, is required to cover the corporation's cost in processing the multifamily loan and inspecting the property.

SERVICING

After Freddie Mac has purchased the loans, they are usually serviced by the seller.

A servicing spread, if any, retained by the seller varies by program and type of sale. A minimum servicing spread of 0.375 percent above Freddie Mac's net yield requirement is generally required for home mortgages purchased as whole loans under Freddie Mac's single family programs. A minimum servicing spread of 0.625 percent is required for whole loans purchased under the HIL program.

No servicing spread is required under the participation programs. The seller keeps the interest, if any, that exceeds the required net yield at which Freddie Mac purchased the loan.

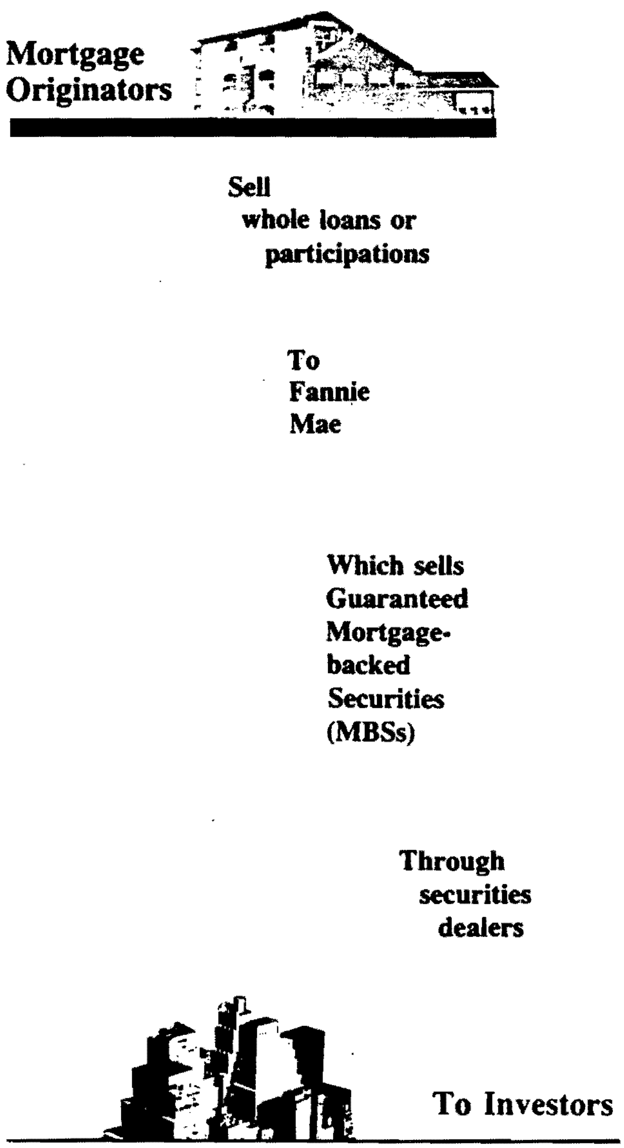
For the multifamily program, the servicing spread is 0.25 percent if the original loan amount is $1 million or less and 0.125 percent if the original loan amount is more than $1 million but less than $10 million. The servicing spread is negotiated for loan amounts over $10 million.

Both accounting and servicing reports are submitted by the seller to the appropriate Freddie Mac regional office.

ADVANTAGES TO LENDERS

Freddie Mac offers competitive purchase prices to lenders. The turnaround time from loan submission to settlement allows for rapid reinvestment of funds by lenders. Freddie Mac's programs are available each business day and are easily accessible. Freddie Mac's regional staff is continuously available to assist lenders in participating in any of its programs. The corporation provides a small number of efficient programs with wide industry acceptance that are aimed at bringing uniformity and depth to the secondary market. And, beginning in 1983, financing became available for nonowner-occupied units.

SALES OF WHOLE LOANS OR PARTICIPATIONS TO FANNIE MAE



AVAILABILITY

Fannie Mae issues each business day one- or two-month mandatory delivery commitments for fixed rate and graduated payment mortgages, one-, two-, three-, or four-month mandatory commitments for adjustable rate mortgages, nine- or 12-month standby commitments, and three-month resale and refinance commitments.

TYPE OF LOANS

Fannie Mae purchases the following type of loans:

1. On a one-to-four family whole loan basis, FHA graduated payment and fixed rate mortgages, VA mortgages, and conventional fixed and adjustable rate mortgages.
2. Participations in conventional fixed and adjustable rate one-to-four family mortgages. Fannie Mae purchases 50 to 95 percent (in 5 percent increments) participation interests in pools of conventional one-to-four family mortgages.
3. FHA-insured project loans.
4. Conventional second mortgages—Fannie Mae will purchase whole loans and participation interests in conventional second mortgages on one-to-four family homes.
5. Rehabilitation loans—Fannie Mae approves a first mortgage in a specified amount to be used for the acquisition or refinancing and rehabilitation of a property. A lender escrows the difference between the first mortgage amount and the acquisition or refinancing costs. Funds in the account are used to complete the rehabilitation work in accordance with the plans and specifications approved by Fannie Mae.

6. Resale and refinance loans—Fannie Mae will purchase loans made to refinance existing mortgages currently owned by Fannie Mae or to enable the sale of properties on which Fannie Mae holds the mortgage. Fannie Mae issues commitments to purchase these loans on an individual basis. The yield at which Fannie Mae will purchase the loan is determined by a formula based on such factors as the balance and interest rate of the old loan, the amount of new money required, and the proposed term of the new loan.
7. Real estate mortgage loans on manufactured housing—Fannie Mae will purchase loans made to finance the purchase of manufactured housing that conforms, generally, to its requirements for mortgages secured by site-built housing.

Fannie Mae also offers the following prior approval programs:

1. Conventional projects—Fannie Mae will approve entire condominium and PUD projects to facilitate the purchase of mortgages on one-to-four family properties in those communities.
2. Spot loans in condos or PUDs are eligible for purchase at the discretion of Fannie Mae's regional offices.

APPROVAL OF SELLERS

Savings and loan institutions, commercial banks, mortgage companies, mutual savings banks, and credit unions are among those eligible to sell to Fannie Mae.

Approval by Fannie Mae is necessary before the lender can participate in most Fannie Mae purchase programs. To obtain approval, lenders must originate real estate loans as one of their principal activities and have a minimum net worth of $250,000 plus 0.2 percent of the lender's Fannie Mae servicing portfolio. To participate in the programs for conventional mortgages, lenders must have experience in originating conventional loans. Any federally or state supervised and insured lender, whether or not Fannie Mae approved, may sell participations to Fannie Mae.

LOAN REQUIREMENTS

Fannie Mae issues guides that outline its requirements in detail. In addition to appraisal and underwriting guidelines, requirements are established for mortgage amounts, loan-to-value ratios, types and amounts of insurance required, the documentation Fannie Mae must review, loan terms, and other such characteristics. Except for second mortgages, loans are sold to Fannie Mae on a gross yield basis. The yield includes the servicing fee Fannie Mae pays lenders for servicing the loans—0.375 percent for fixed rate loans and 0.500 percent for adjustable rate loans. In pricing second mortgages, Fannie Mae assumes a minimum 0.250 percent servicing fee.

OFFER PROCEDURE

Fannie Mae sellers can request mandatory, optional, and standby delivery commitments under the corporation's standard programs by calling (202) 537-7100 between 11:00 a.m. and 5:00 p.m. eastern time each business day. Mandatory delivery commitments are issued at posted yields. Standby commitments carry no yield.

The minimum commitment amount is $10,000 for fixed rate mortgages, $100,000 for second mortgages, and $250,000 for first mortgage participations. There is no minimum commitment amount for adjustable rate mortgages.

There is currently no maximum commitment amount.

Sellers notified of offer acceptance must immediately remit to Fannie Mae any applicable processing and commitment fees.

Commitments can be issued by Fannie Mae's regional offices on a negotiated basis for a variety of standard and nonstandard products.

DELIVERY

Delivery of mortgages is mandatory under most Fannie Mae commitments.

UNDERWRITING

Fannie Mae does not underwrite FHA and VA loans prior to purchase.

Under Fannie Mae's single family mortgage, conventional participation, conventional second mortgage purchase programs, and mortgage-backed securities program, no loan underwriting is performed prior to funding. Post-purchase spot checks are made, however, to ensure that the loans meet Fannie Mae's investment standards.

PURCHASE PROCEDURE

Fannie Mae performs a computer edit of the loan data from a mortgage submission voucher. The submission is matched with the contract on file at the main office. The computer in the main office cuts a check, which is mailed to the seller of the loans.

If a loan is rejected, Fannie Mae notifies the seller and explains the reason the loan was not accepted. On participation sales, a lender submits to Fannie Mae two documents—a participation certificate and a schedule of loans—and Fannie Mae's regional office disburses funds within two days of receiving the documents. Lenders may be required to repurchase loans if they are found to be unsatisfactory in Fannie Mae's post-purchase review.

Fannie Mae mortgage-backed securities are issued to sellers submitting loans under pool purchase or swap agreements after Fannie Mae receives a certified schedule of mortgages from an approved document custodian indicating a seller has delivered all necessary mortgage documents.

FEES

Fannie Mae's fee structure varies, reflecting the different services provided under its various programs. Commitment fees, processing fees, conversion fees, and over-delivery charges are required, if applicable. These fees range from 0.001 percent to 2 percent. If whole fixed rate loans are delivered with coupon rates above Fannie Mae's required yield, Fannie Mae shares the excess interest with the seller according to a published schedule; on adjustable rate loans, lenders retain all excess interest. Sellers who wish to retain servicing must own Fannie Mae stock. For loans sold to Fannie Mae after Jan. 31, 1983, the servicer must own at least one share of stock, irrespective of the unpaid principal balances of the loans being serviced. For loans bought before that date, the amount of stock required is based on the unpaid principal balances of the loans being serviced and the purchase commitment date.

SERVICING

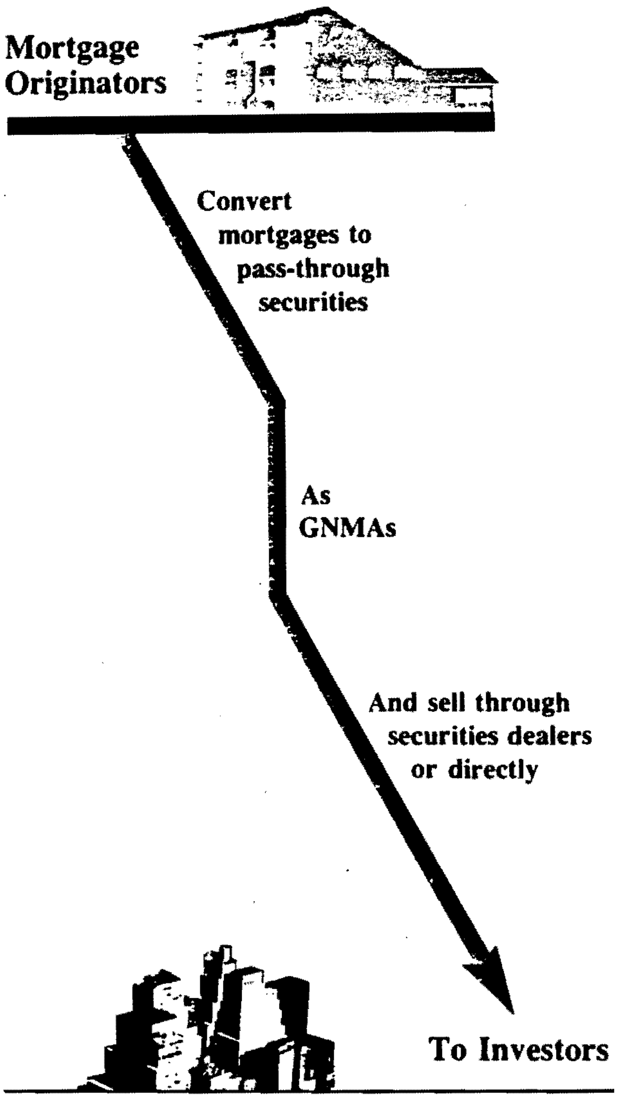
Generally, sellers elect to service the loans they sell. The servicing fee paid by Fannie Mae is 0.375 percent for fixed rate first mortgages, 0.500 percent for adjustable rate mortgages, and at least 0.250 percent for second mortgages.

ADVANTAGES TO LENDERS

Fannie Mae's programs are available each business day. Because of its policy of reviewing loans after, rather than before, purchase, loan submissions can be funded rapidly, allowing for quick reinvestment of the sale proceeds. Fannie Mae offers a wide variety of programs and special, negotiated deals. Also, financing is available for nonowner-occupied units.

It purchases both whole loans and participation interests and its adjustable rate mortgages may be combined with graduated payment features.

CONVERSION OF MORTGAGES TO PASS-THROUGH SECURITIES AS GNMAs



TYPE OF LOANS

Loans pooled must be insured by FHA or guarantied by VA or FmHA for less than one year from the date GNMA issues its commitment to guaranty a pool. GNMAs may include mortgages on manufactured homes, multifamily (construction and permanent) projects, or single family units.

POOL CHARACTERISTICS

Loans must be of similar type (i.e., interest rate, single family or multifamily, maturity). Minimum size of a pool is $1 million for single family loans and $500,000 for manufactured home and project loans.

In July 1983 GNMA implemented a major restructuring of its mortgage-backed securities program. Under this program, known as GNMA II, mortgages with different interest rates can be included within the same pool. Loans from many different lenders can be packaged in a jumbo pool or loans from a single lender can be packaged in a custom pool.

PROCESS

Lenders, in their capacity as issuers of the securities, complete the required GNMA commitment documents, forward them to GNMA, and request GNMA's commitment to guaranty the securities backed by the pooled mortgages. Subject to favorable evaluation, GNMA issues a commitment and assigns a pool number. Lenders transfer the mortgage documents to custodial agents and send the required pool forms to GNMA.

GNMA reviews the documentation and upon acceptance, guaranties mortgage-backed certificates, which may then be sold to investors. Generally, issuers have solicited advance commitments from dealers, investment bankers, or investors for specified amounts of the securities at a set price and yield. With GNMA's guaranty, certificates may be delivered to the respective purchaser or sold to dealers or investors.

Lenders also act as servicers. In this capacity, they collect monthly interest payments and principal reductions on the pooled mortgages and remit this amount, less the servicing fee, to certificate holders with a monthly accounting statement.

Under GNMA II, servicers collect the principal and interest payments and deliver them in a lump sum to a central paying agent, Chemical Bank, in New York. Chemical Bank pays each certificate holder through a single monthly check, regardless of the amount of GNMAs purchased. Pool processing and accounting, factor collection, and investor tax withholding and reporting are also performed by the central paying agent.

Issuers and investors have the option of using GNMA II with its new features or of staying with the traditional methods.

Servicers deduct 0.5 percent per annum of the outstanding principal amount of each mortgage for servicing and the GNMA guaranty. Of the 0.5 percent per annum, GNMA receives .06 percent and servicers retain the balance.

GNMAs are not debt obligations of issuers. When sold, they represent sales of real estate assets.

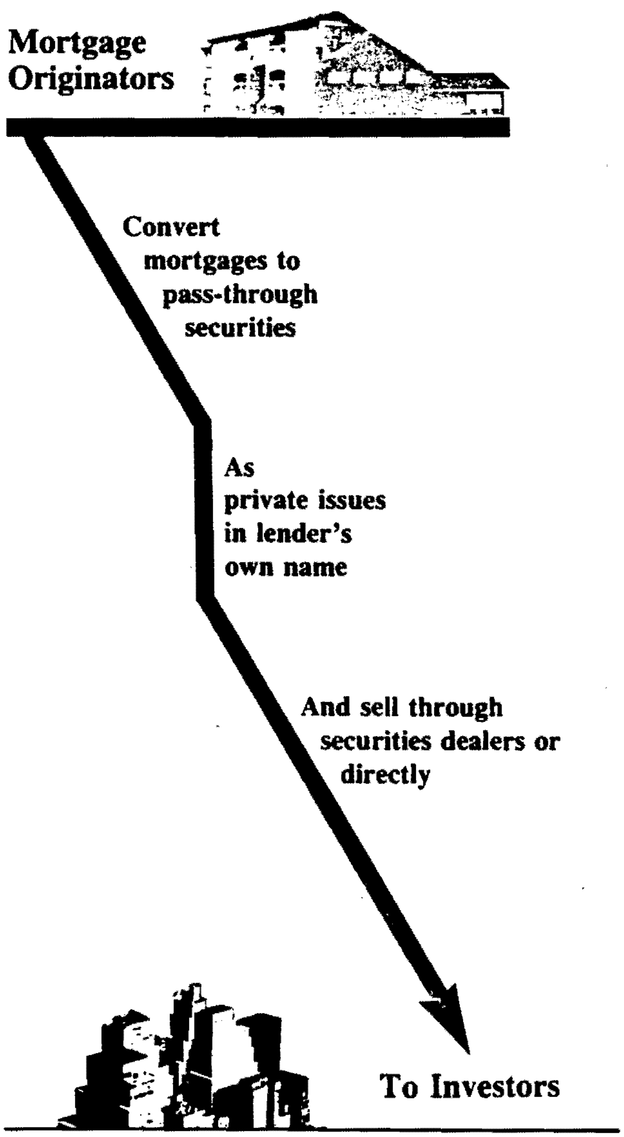
TYPES OF ISSUERS

Mortgage banking companies are the primary issuers. Other approved issuers are savings and loan institutions, savings banks, commercial banks, and credit unions.

ADVANTAGES TO LENDERS

GNMAs are an efficient and profitable way to market FHA, VA, and FmHA loans. GNMA's forward market provides lenders with the means to sell loans in the future and hedge interest rates for future loan production.

CONVERSION OF MORTGAGES TO PASS-THROUGH SECURITIES AS PRIVATE ISSUES



TYPE OF LOAN

Generally only single family loans on owner-occupied residences are included in private issues. Seasoned loans and variable rate loans can be included. The usual loan-to-value ratios of the loans grouped are 80 percent or less, but may be higher if the loans have mortgage insurance. Maximum amounts of individual loans usually range from $160,000 to $200,000. Usually the loans are conventionally financed.

POOL CHARACTERISTICS

The rating agency sets general requirements for the pools. On pools of conventional mortgages, there must be 5 percent mortgage guarantee insurance and 1 percent special hazard insurance for an AA rating by Standard & Poor's. This insurance is required over the life of the pool.

An alternative to pool insurance and special hazard insurance is a letter of credit from a major bank to cover a given level of principal losses. Bank of America introduced this method of backing pools with a letter of credit equal to 7 percent of the initial pool balance. The pass-throughs issued under this arrangement have received an AAA rating from Standard & Poor's.

The size of a pool of loans may vary. Twenty million dollars is usually the minimum for public offerings and $10 million for private placements. With less than $20 million, conduits may assist issuers by pooling loans with other lenders.

PROCESS

Once lenders decide to issue pass-through securities backed by their own mortgages, investment bankers generally coordinate the process. Registration with the Securities and Exchange Commission (SEC) is required along with a rating by a major rating agency, a prospectus, and legal documentation.

Once pass-throughs are ready to be marketed, underwriters are chosen. Underwriters guarantee the sale of the securities at a price that is determined at the day of offering.

Investment bankers also may be used to expedite the marketing process of private placements with investors. The particular terms, delivery (i.e., immediate or forward delivery), rated or nonrated, firm or standby, registered or nonregistered, are all negotiated. Private placement does not require a prospectus. A private placement memorandum, written by the seller for the buyer, may be issued. The memorandum is not available to the public; however, it may be used for rating purposes.

If lenders choose a conduit, the conduit becomes the issuer. In effect, lenders sell pools of mortgages as whole loans. Conduits determine whether they will place securities publicly or privately.

Public offerings are immediate delivery only. By going public, the offering is available on the secondary market and has a broad base of investors.

Private placements preclude an active secondary market. Generally, the investor base is institutional.

Servicing is performed by the sellers. For public offerings and private placements, servicers remit collected funds directly to investors. When a conduit has packaged the loans, the originator forwards the principal reductions and interest payments to the conduit, who in turn remits to the investor.

Pass-through securities are not debt obligations of issuers. When sold, they represent sales of assets.

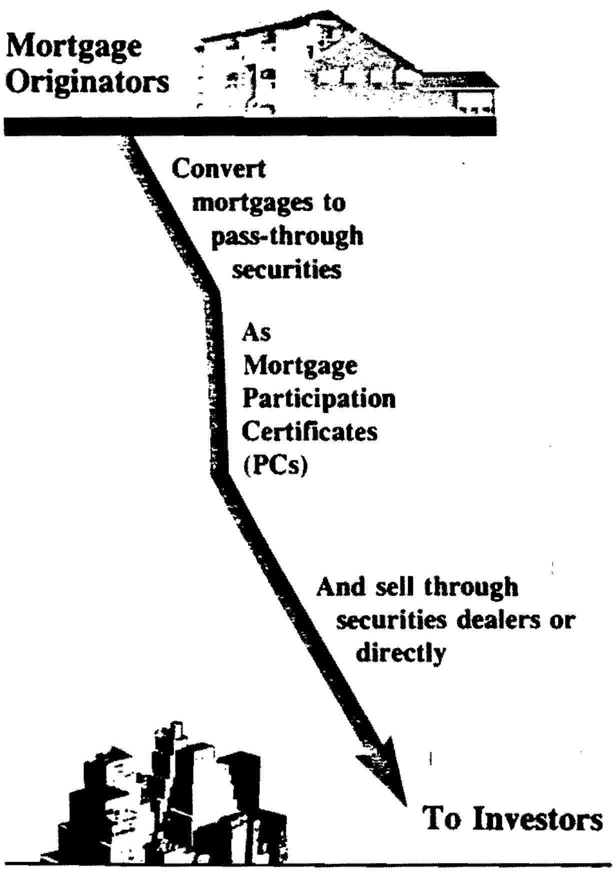
TYPES OF ISSUERS

Banks, conduits, savings and loan institutions, and investment bankers issue private pass-throughs.

ADVANTAGES TO LENDERS

Lenders can sell pass-through securities backed by conventional mortgages. Private placements allow lenders to negotiate terms. Also, seasoned loans may be added to the groups.

CONVERSION OF MORTGAGES TO PASS-THROUGH SECURITIES AS MORTGAGE PARTICIPATION CERTIFICATES (PCs) (FREDDIE MAC'S GUARANTOR PROGRAM)



TYPE OF LOANS

Freddie Mac purchases whole loans or participation interests in single family conventional and FHA and VA fixed rate mortgages. The conventional mortgages must meet Freddie Mac's definition of "investment quality" by satisfying the same underwriting and appraisal requirements the corporation applies to its standard purchase programs. The FHA and VA mortgage loans must be at least one year old and conform to the standards established by the Federal Housing Administration and the Veterans Administration, respectively. Adjustable rate mortgages, multifamily loans, and home improvement loans are not eligible for purchase under Guarantor. All loans are purchased at par.

POOL CHARACTERISTICS

The minimum eligible coupon rate on any loan submitted on a whole loan basis is equal to the PC certificate rate specified by the seller at delivery, plus the spread required by Freddie Mac, and the minimum servicing spread, which is generally 0.375 percent. The PC certificate rate specified must be evenly divisible by 0.25 percent. The maximum eligible coupon rate of any whole loan submitted under Guarantor is equal to the minimum eligible coupon rate plus 200 basis points. A basis point is one one-hundredth of one percent. The spread is the difference between Freddie Mac's required net yield and the PC certificate rate.

Freddie Mac purchases participation interests of from 50 percent to 95 percent, in 5 percent increments, in loans submitted on a participation basis. For loans submitted under Guarantor contracts on a participation basis, the minimum eligible coupon rate will be equal to the PC certificate rate specified by the seller at delivery, plus Freddie Mac's required spread. The PC certificate rate must be evenly divisible by 0.25 percent. The maximum eligible coupon rate of any loan submitted under a Guarantor contract on a participation basis is equal to the minimum eligible coupon rate plus 200 basis points.

The required net yield on loans delivered under a Guarantor contract will be equal to the PC certificate rate plus Freddie Mac's required spread.

PROCESS

On any business day, a seller may submit an offer for a Guarantor commitment by calling Freddie Mac at (202) 789-2200 between the hours of 10:00 a.m. and 2:00 p.m. eastern time.

The minimum commitment amount is $1 million; there is no maximum commitment amount. With a minimum commitment amount of $10 million, sellers can negotiate individual deals through Freddie Mac's regional offices on delivery, documentation, and other commitment terms.

When submitting an offer, the seller must specify the offer amount and the delivery period (90 days mandatory or 180 days optional) for which the commitment is desired. If the commitment is available as desired, the seller may obtain one commitment for each delivery period. Nationwide lenders may submit one offer for loans originated in more than one state.

Under Guarantor, Freddie Mac purchases conventional mortgages and seasoned FHA and VA mortgages with and without recourse provisions. Recourse is defined as the seller's obligation to repurchase a mortgage after foreclosure occurs.

Freddie Mac requires a spread of 25 basis points on its purchases of newly originated conventional mortgages without recourse and 20 basis points with recourse. For conventional loans over one year old, the required spread is 20 basis points without recourse and 17 basis points with recourse. FHA and VA mortgages are purchased at a spread of 17 basis points.

Under the 90-day mandatory program, the seller must deliver to the applicable Freddie Mac regional office within 90 days of commitment eligible fixed rate loans in an amount equal to the contract commitment amount plus or minus $100,000.

The seller may submit these loans in a single delivery or in partial deliveries at any time during the 90-day delivery period. Each partial delivery may include no fewer than 50 loans and no more than 400 loans and must be in an amount not less than $1 million. Only whole loans or participations, but not a combination of both, may be delivered under a 90-day contract.

Under the 180-day optional program, the seller may deliver to the applicable Freddie Mac regional office within 180 days eligible fixed rate loans in an amount less than or equal to the contract commitment amount.

The seller may submit these loans in a single delivery or in several partial deliveries at any time during the optional 180-day delivery period. Each partial delivery must be in an amount not less than $1 million and not greater than the remaining outstanding balance under the contract. Each delivery made under a 180-day delivery contract must include only whole loans or participations, but not a combination of both. If participations are delivered, the percentage of participation may be different for each delivery.

Freddie Mac may issue PCs for each partial delivery of mortgages, or if requested by the seller, may wait to issue PCs until all deliveries are made or more than one delivery of mortgages is made. The seller specifies the PC certificate rate at the time the mortgages are delivered.

Because of the simultaneous purchase of mortgages and sale of PCs that occurs in Guarantor transactions, a seller must report each month by telephone the unpaid principal balance of each group of mortgages purchased by Freddie Mac under this program.

Ownership interest in loans accepted for purchase passes to Freddie Mac on the settlement date. Normally, settlement takes place within 20 days from delivery of the mortgages to Freddie Mac for preferred sellers. On the settlement date, Freddie Mac issues to the lender PCs having original principal balances totaling Freddie Mac's interest in the loans purchased from the lender. The PCs are delivered to the lender or are available for pick up within five business days of the date of settlement.

TYPE OF ISSUER

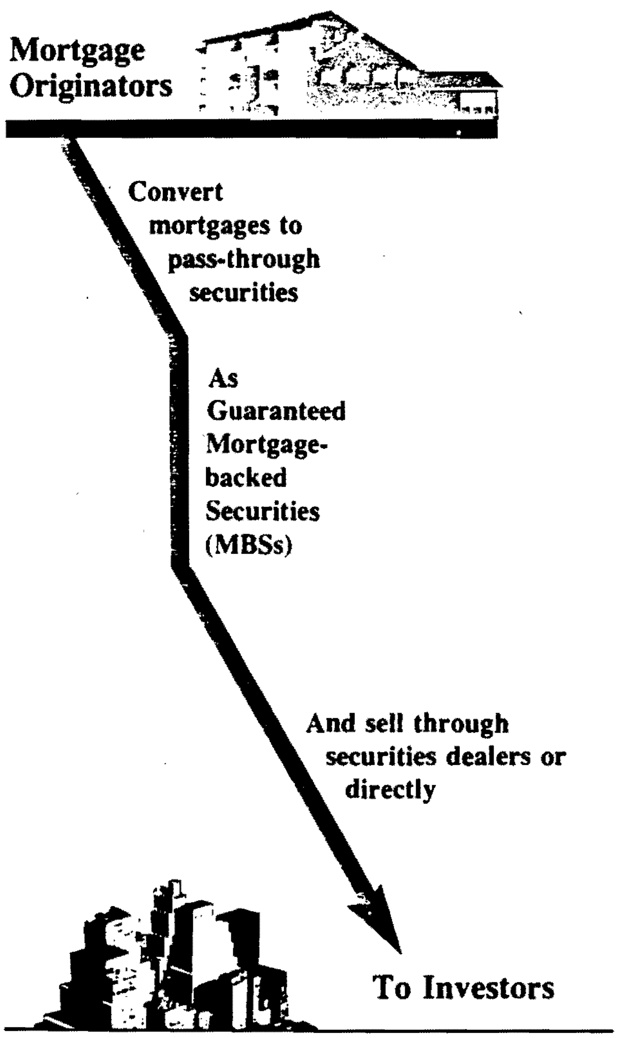
Freddie Mac is the issuer of the PCs under the Guarantor program.

ADVANTAGES TO LENDERS

Lenders who convert their mortgage portfolios into PC portfolios may improve their institutions' liquidity because the PCs, depending on market conditions and lenders' needs, can be used as collateral for repurchase agreements, retail repurchase agreement programs, and other borrowing programs. They can be hedged against futures contracts to minimize interest-rate risk. Also, PCs can be sold outright in the capital markets. The Guarantor program permits lenders to exchange older, below-market-rate mortgages for PCs or to originate new mortgages for conversion to PCs.

PCs are recognized in the capital market as premium-quality conventional mortgage securities. They meet requirements for investment in real property loans for certain thrifts. The underlying mortgage portfolio is of established investment quality and the securities' guarantee is backed by the financial standing of Freddie Mac.

CONVERSION OF MORTGAGES TO GUARANTEED MORTGAGE-BACKED SECURITIES (FANNIE MAE'S PROGRAM)



TYPE OF LOANS

Any conventional, one-to-four family, fixed rate, level payment mortgage with a loan term not exceeding 30 years and which meets Fannie Mae's normal purchase requirements, is eligible for inclusion in a pool. Conventional growing equity mortgages with 3, 4, and 5 percent annual increases in monthly payments and seasoned FHA and VA loans are eligible for separate pools. Pooled loans must meet the same standards as those loans which Fannie Mae normally purchases for its own portfolio. Adjustable rate mortgages are not eligible at this time. On a negotiated basis, other types of loans may be considered for securities pooling.

POOL CHARACTERISTICS

Loans with varying loan-to-value ratios and interest rates may be included in a pool. Within a single pool, however, loan coupons may vary only within 2 percentage points. Overall, loans with coupon rates ranging from 4.5 percent to 20 percent are eligible.

The amount of spread between the mortgage rate in a pool and the securities' rate and its distribution are determined according to the responsibilities assumed by Fannie Mae and the lender. If the lender fully assumes the risk of borrower default, requiring Fannie Mae to absorb losses only in the event of lender default, the minimum spread will be 50 basis points, with Fannie Mae retaining 25 basis points as a guarantee fee and the lender retaining a minimum 25 basis points as a servicing fee. Under this arrangement, lenders make necessary advances and absorb foreclosure losses.

If Fannie Mae assumes the entire risk of loss from borrower default, the minimum spread for new loan pools must be at least 60 basis points, with Fannie Mae receiving 35 basis points; for seasoned loans of three or more years in pools of $25 million or more the minimum spread may be 55 basis points, with Fannie Mae receiving 30 basis points. Lenders assuming this option will make necessary advances in the event of payment shortfalls, but will subsequently recoup their losses.

In both arrangements, the difference between the minimum note rate and the actual pooled mortgage rates is retained by the lender.

PROCESS

A Fannie Mae approved lender applies for a securities commitment by calling Fannie Mae anytime between 11:00 a.m. and 5:00 p.m. eastern time. A seller must specify during the telephone application, (a) the estimated pool transaction amount, (b) the issue date (if known), (c) the certificate's pass-through rate, and (d) the type of servicing option. The lender, however, is not bound by these terms.

The minimum pool size is $1 million. A single lender may package a loan pool and request that a security be issued on that pool alone. Or, a lender may package a smaller pool to be repackaged into a joint pool with pools from other lenders. Each joint pool has a lead lender who obtains the securities commitment, delivers the pool package, and is responsible for reporting to Fannie Mae. Periodically, Fannie Mae will also offer to purchase loans from lenders to be included in a multiple lender pool, which is then sold by Fannie Mae. These pools that are made up of loans from a number of lenders will usually be larger than those packaged by an individual lender.

Once loans are assembled for a pool package, a lender arranges for an eligible custodian to hold certain documents associated with each mortgage. These documents include, (a) the mortgage note, (b) assignment to Fannie Mae of the mortgage instrument, (c) evidence of private mortgage insurance, if applicable, and (d) evidence that no adverse security interest in the mortgage is outstanding.

The lender selects the issue date for each security and before that date delivers the following documents to Fannie Mae: the custodial agreement, the schedule of mortgages certified by the custodian, the schedule of subscribers, and the custodial account letter agreement(s).

When Fannie Mae receives a pool package, it issues mortgage pass-through certificates representing undivided fractional interests in the pools.

Lenders service pooled loans according to Fannie Mae's guidelines. Lenders make regular reports to Fannie Mae only after loans have been placed in pools. No later than the second business day of each month, beginning with the month following the month of issue of the securities, the lender telephones Fannie Mae to report the aggregate security balance for each pool as of the close of the preceding month.

A monthly accounting report must be received by Fannie Mae no later than the seventh business day of each month, beginning with the month following the month of issue of the securities. The lender then transfers by wire, on the 18th of each month, the interest and principal amount due. Fannie Mae in turn pays the holders of the securities on the 25th business day of the same month.

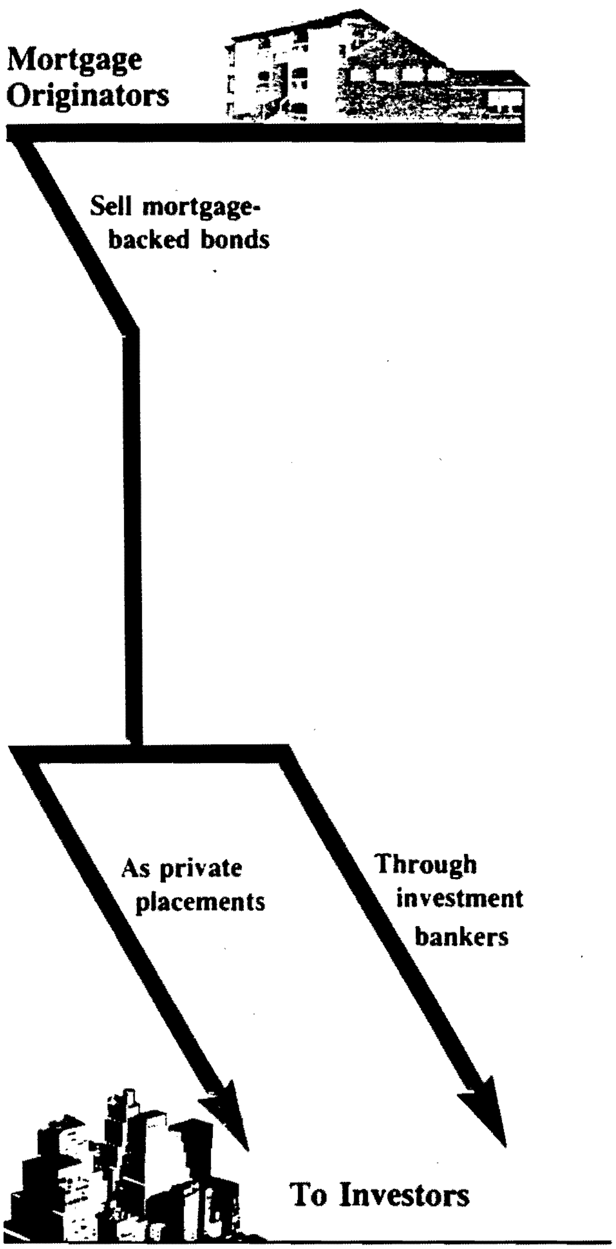
TYPE OF ISSUERS

Fannie Mae issues the securities and guarantees full and timely payment of both interest and principal due on the securities, whether or not collected.

ADVANTAGES TO LENDERS

Fannie Mae's securities program may allow lenders to enhance their liquidity. By exchanging mortgages for conventional or FHA and VA mortgage-backed securities, lenders may reduce the risk from volatile interest rates. Because lenders may market their securities on a forward placement basis—before the loans are actually closed—warehousing costs may be reduced.

SALES OF MORTGAGE-BACKED BONDS



TYPE OF LOANS

The makeup of a pool varies from issue to issue.

POOL CHARACTERISTICS

There is no set pattern. Typically, bonds are collateralized by loans having an unpaid principal balance, evaluated at current market rates, in an amount of 150 to 200 percent of the indebtedness. The collateralization must be maintained at some established percentage of indebtedness through the addition of loans, as the outstanding principal balance of the collateral loan balances is reduced through amortization and payoffs.

BOND CHARACTERISTICS

There is no set pattern. Typically the bonds have a maturity of five to 10 years, making them intermediate-term bonds. They pay interest semiannually. Total amount of debt is due and payable at maturity. Many have a call provision allowing borrowers to redeem a part of the bonds outstanding at a price of par (par being 100 percent of the face amount of the debt) prior to maturity of the bonds. This reduction, or payoff, could be accomplished through use of the income from the collateralized loans.

The pay-through bond is a modified pass-through security with scheduled monthly payments. It represents a contractual debt obligation of the issuer. Payments on the underlying mortgages flow through to holders of pass-through certificates, but ownership of the underlying mortgages is not transferred to the investor as in a pass-through security. The mortgages simply collateralize the debt as in other mortgage-backed bonds.

Mortgage-backed bonds are classified as debt collateralized by mortgage loans. Although loans are not sold, they are pledged to repay the debt and cannot be used for other purposes until the debt is repaid.

PROCESS

There is no set pattern for issuing. Typically, the bonds must be registered with the SEC and be rated by a national rating service. Loans are held by a trustee with income from the collateral loans going to borrowers as long as the terms of the trust and bonds are maintained.

PLACEMENT AND UNDERWRITING

Bonds are sold through investment bankers who underwrite issues and form underwriting and selling syndicates, unless issues are privately placed with investors.

TYPES OF ISSUERS

Homebuilders, commercial banks, conduits, savings and loan institutions, and investment bankers issue mortgage-backed bonds.

ADVANTAGES TO LENDERS

Loans that have a rate of return lower than prevailing secondary market rates can be used to collateralize the pool. Since the loans would be held in portfolio as borrowers continue to receive the income from the loans, borrowers generate new funds without incurring a loss by selling the loans.

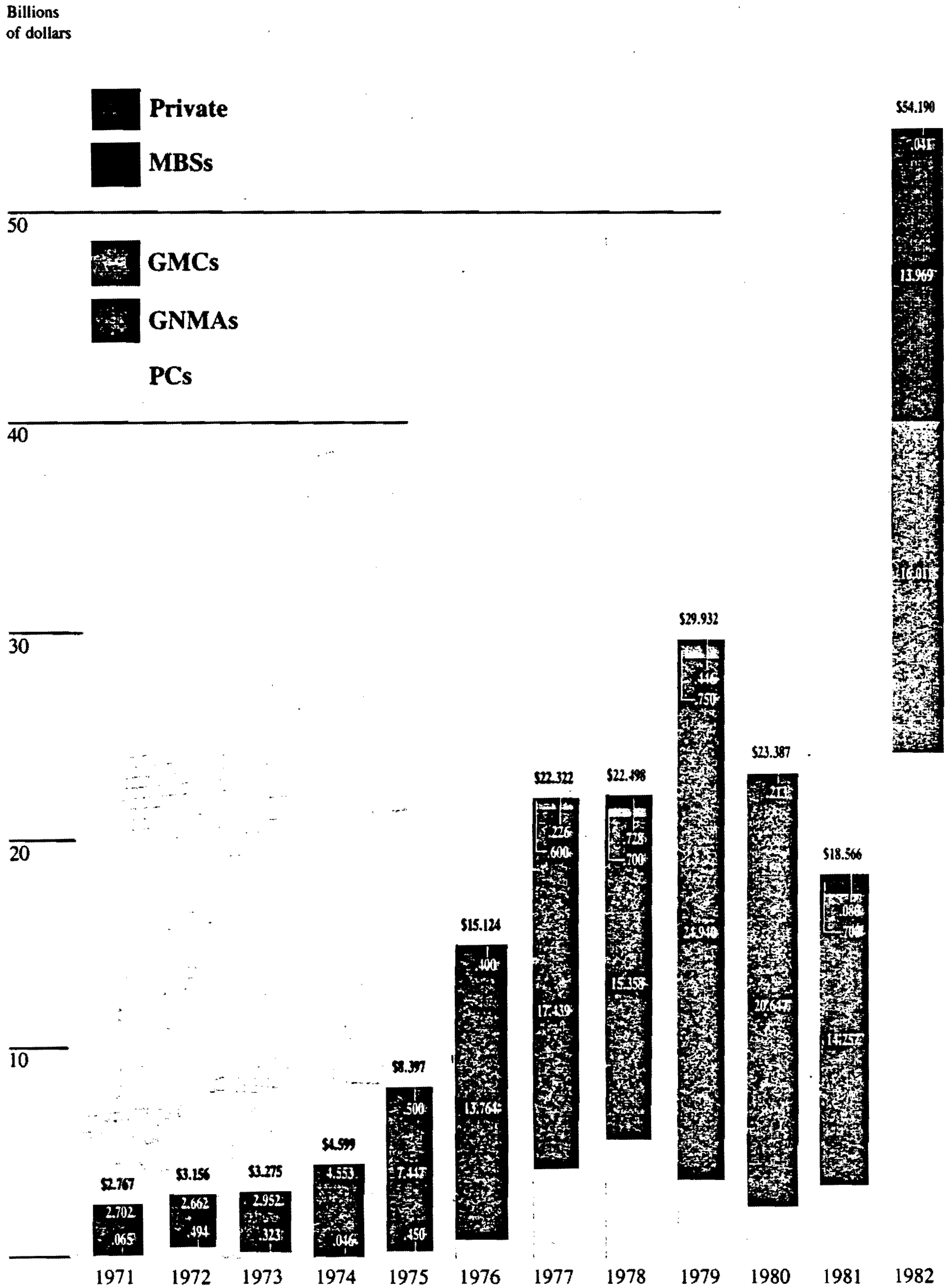
COMPARISON OF MORTGAGE PASS-THROUGH SECURITIES

Packager	PCs	GNMAs
	Freddie Mac; under Guarantor program, eligible seller/servicer	FHA-approved mortgagees (65 percent have been mortgage companies)
Underlying Loans	Conventional/seasoned FHA and VA loans of established investment quality	FHA/FmHA/VA loans
Type of Loans	Single family (fixed payment), except multifamily (5 percent max) and flexible payment (2½ percent max) per pool.	Separate pools of single family (fixed payment, graduated payment, growing equity), multifamily (construction or permanent), and manufactured home loans
Guarantor	Freddie Mac only	GNMA (full faith and credit of U.S.)
Guarantee	Timely payment of interest, full collection of principal	Timely payment of interest and principal
Sale Method	Daily auction through selling group	Continuous—direct by originators
Pool Size	\$50 million—\$300 million under standard programs; under Guarantor program, \$1 million minimum	\$1 million minimum for single family loans; \$500,000 minimum for manufactured home, project, and construction loans
Transfer Agent	Chemical Bank	Chemical Bank
Denominations	\$25,000 minimum	\$25,000 minimum
Year First Issued	1971	1970
Amount Issued[1]	\$46.1 billion	\$143.2 billion
Delay Until First Remittance Check	Up to 75 days	Up to 45 days
Remittances	One check monthly	Multiple monthly checks under GNMA I, one monthly check under GNMA II

MBSs	Typical Private Issues
Fannie Mae, eligible seller/servicer	Banks, thrift institutions, private conduit companies
Conventional/seasoned FHA and VA loans	Conventional loans
Separate pools of single family (conventional fixed payment, growing equity, seasoned FHA and VA), other types of loans on negotiated basis	Single family, either 100 percent fixed rate or 100 percent variable rate
Fannie Mae only	Stated intentions of issuing institution to make advances up to the amount recoverable under mortgage pool insurance policy
Full and timely payment of interest and principal	Timely payment of interest and eventual collection of principal reasonably assured by mortgage pool insurance policy of 5 percent original principal balance
Continuous—direct by originators or through public offerings held periodically by Fannie Mae	Irregularly scheduled sales, depending on market conditions
$1 million minimum; smaller pools may be aggregated through lead lender into joint pool	$25 million—$200 million, consisting of 400–2,800 mortgages
Chemical Bank	A commercial bank which acts as trustee of the issue
$25,000 minimum	$25,000 minimum
1981	1977
$14.7 billion	$1.7 billion public offerings, $3.1 billion private placements
Up to 55 days	Up to 55 days
One check monthly	Multiple monthly checks

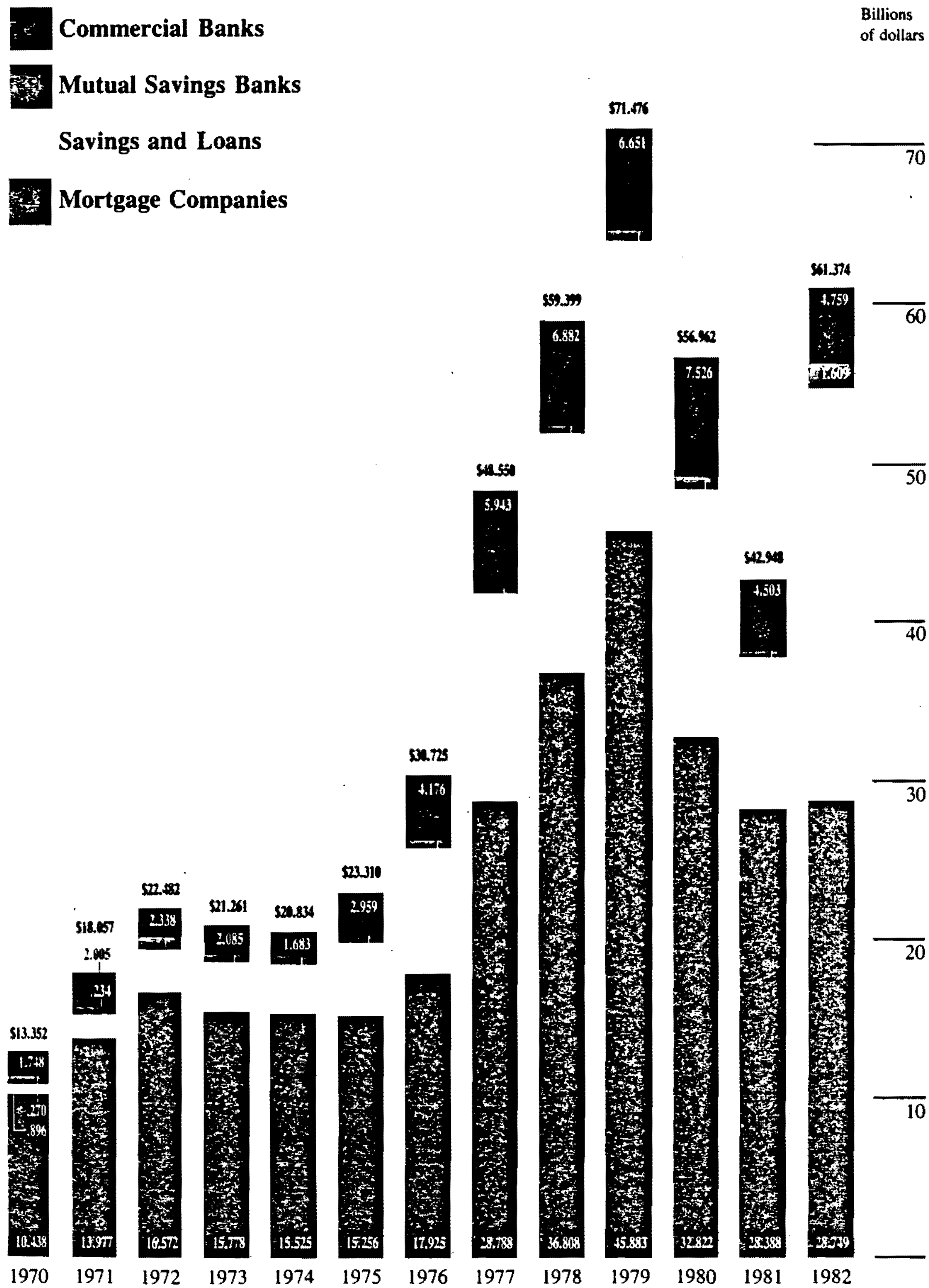
[1]As of December 31, 1982

ISSUES OF PCs/GMCs, GNMAs, MBSs, AND PRIVATE PASS-THROUGH SECURITIES 1971-1982



Sources: Freddie Mac, GNMA, Fannie Mae, Lepercq, de Neuflize & Co., Inc.

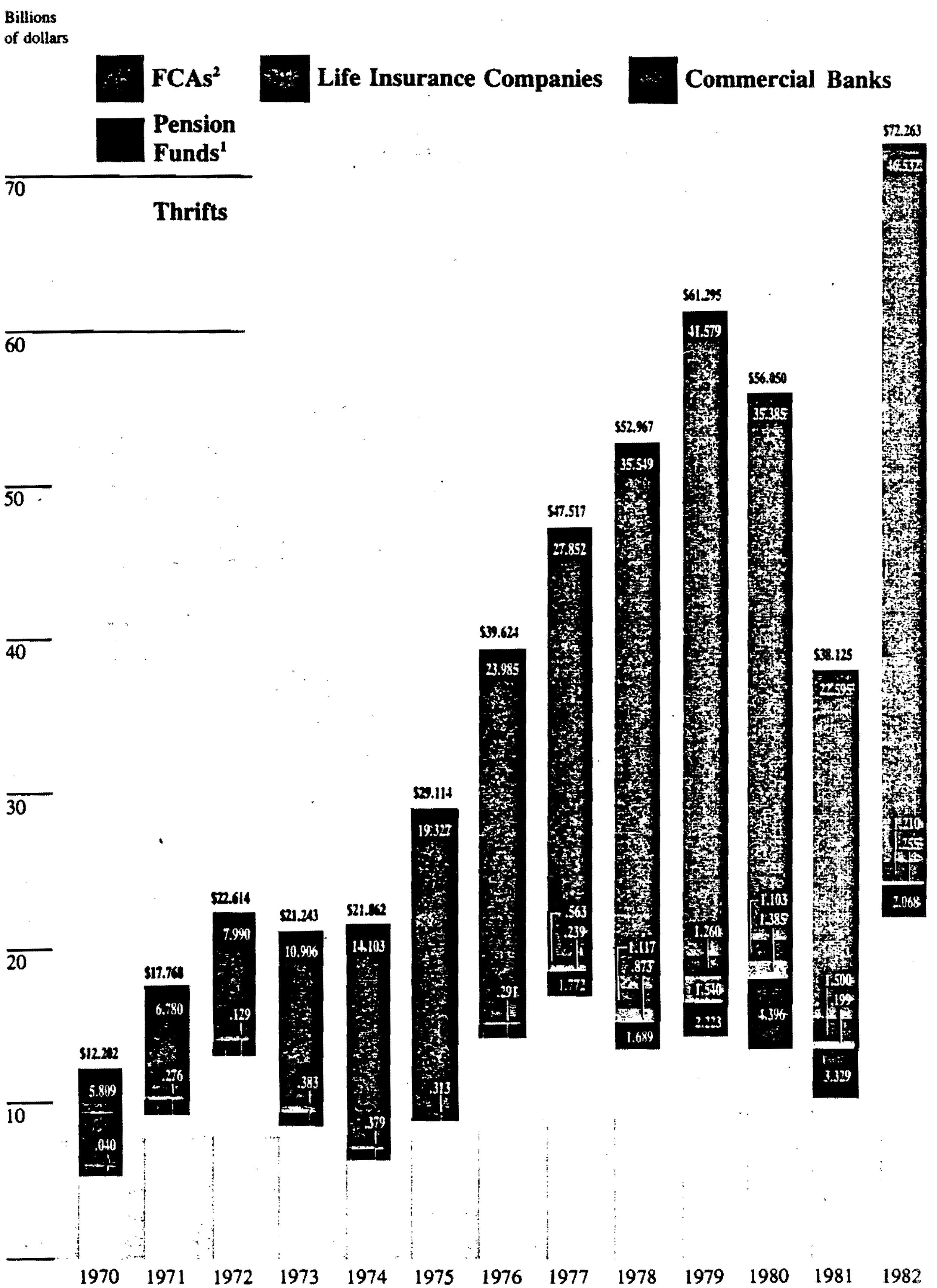
MORTGAGE SALES BY MAJOR TYPES OF LENDERS[1]
1970-1982



Source: HUD

[1]Net of estimated sales of seasoned mortgages made under swap programs.

MORTGAGE PURCHASES BY MAJOR TYPES OF INVESTORS 1970-1982



Source: HUD "Survey of Mortgage Lending Activity"

¹Pension funds comprised of private pension funds and state and local credit agencies.

²Federal credit agencies (FCAs) comprised of all FCAs and FHA and VA mortgage pools for 1970-1981. For 1982 FCAs comprised of all FCAs and all mortgage pools. FCA purchases in 1981 and 1982 have been reduced by estimates of Freddie Mac and Fannie Mae seasoned swap activity.

REASONS LENDERS AND INVESTORS PARTICIPATE IN THE SECONDARY MARKET

Selling loans in the secondary market has the following advantages for primary mortgage market lenders:

1. Higher yields—When interest rates are rising, lenders have the opportunity to make new loans at higher rates by selling existing loans and reinvesting in new mortgages at the higher rates. Lenders are able to turn over their portfolios rapidly and increase their total yields. When rates are declining, lenders are able to collect the difference between the rate charged the borrower and the yield required by purchasers of the loans and still offer savings to borrowers.
2. Increased originations—From the sale of loans, lenders may recapture 50 to 100 percent of their funds for reinvestment in new mortgages. To decide whether to sell loans, lenders compare the yield opportunity at the current primary market interest rate and the yield required to make the sale in the secondary market. If primary market rates exceed secondary market rates, lenders can sell at a profit and generate additional funds for lending with less capital.
3. Increased profits—When lenders increase their origination activities by selling loans in the secondary market, they increase their income from origination fees. They also increase the effective yield of the money available for investment and often can make a profit on the sale.
4. Efficiencies—As lenders increase their portfolios, the marginal cost of servicing each additional loan is reduced. Record keeping and calculations for taxes, insurance, amortization payments, collection on bad loans, and similar factors are generally performed by computer. Lenders gain efficiencies of servicing a larger portfolio because the greater the volume, the lower the cost per transaction.

Mortgages are attractive as investments for several reasons. First, governmental guarantees or insurance and private mortgage insurance assure the investor of repayment of all or part of the original principal balance. Second, the introduction of uniform mortgage documents, loan applications, appraisal forms, and underwriting standards for conventional mortgages make conventional mortgages more standard and more liquid. Thus, mortgages usually can be resold if investors need to recoup their funds.

The advent of mortgage pass-through securities has made mortgages more attractive to investors. Advantages investors gain by purchasing pass-through securities include the following:

1. A pass-through security provides a monthly cash flow to investors.
2. During periods of rising interest rates, investors benefit by investing the monthly cash they receive at continually higher market rates.
3. A mortgage security is liquid and can be traded as part of a total portfolio strategy. It is relatively high yielding and, although marketed at a long-term security's yield, its true weighted average life is similar to an intermediate-term security. Also, it can be used as collateral for short-term borrowings.
4. Because forward commitment markets exist for pass-through securities, investors can lock in current market rates or hedge against future market rates.
5. Future liquidity for pass-through securities is enhanced by the growth of the mortgage pass-through market.

OPERATIONS OF FREDDIE MAC

The mission of the Federal Home Loan Mortgage Corporation is to enhance the liquidity of mortgage investments and increase the availability of financing for conventional residential mortgages.

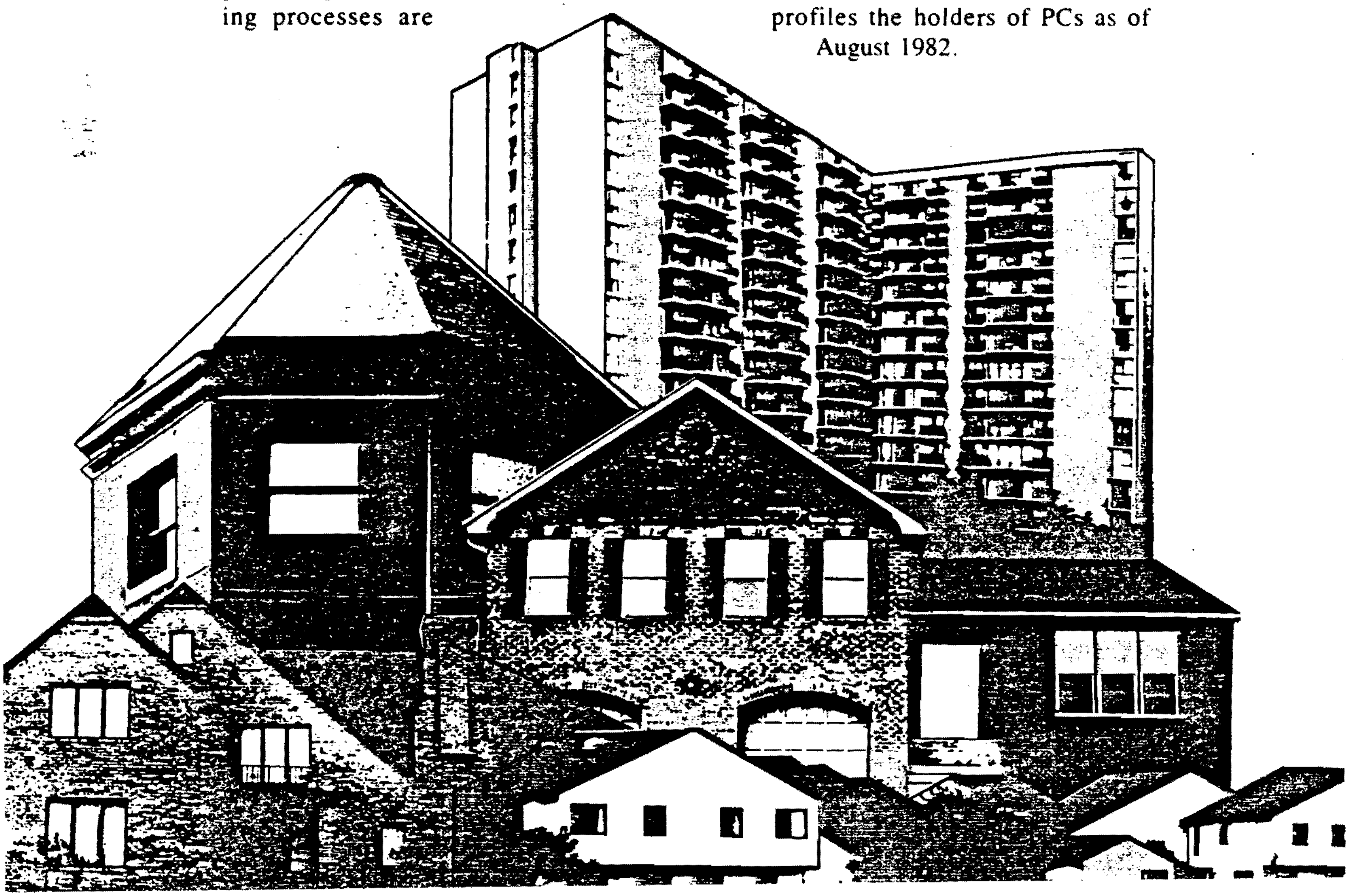
Freddie Mac does this by purchasing conventional mortgages originated by savings and loans and other mortgage lenders, aggregating the mortgages into pools, and selling percentage interests in those pools of mortgages to investors by means of its mortgage securities, mainly Mortgage Participation Certificates (PCs).

This section focuses on the distinctive secondary market operations of Freddie Mac.

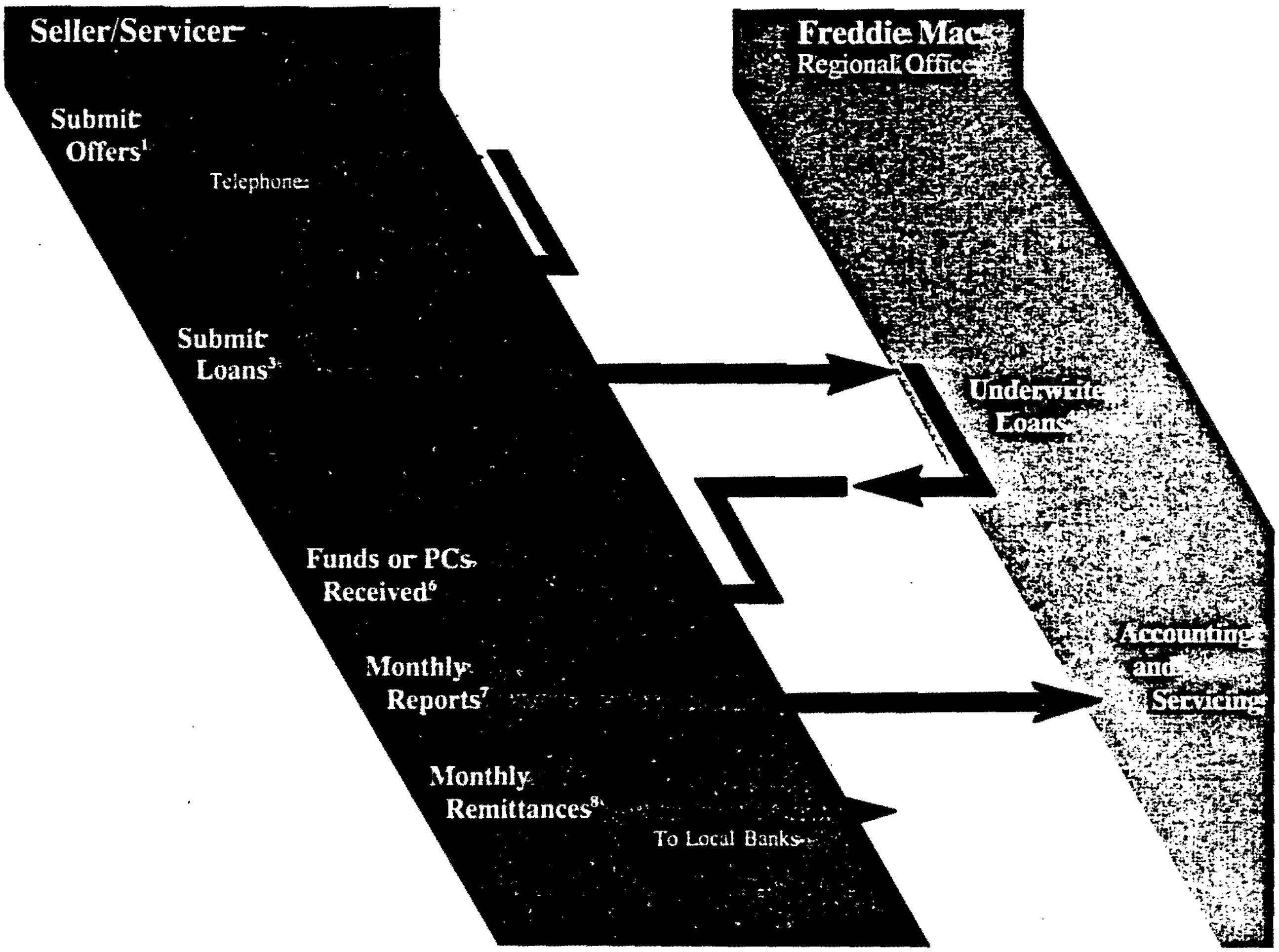
Freddie Mac's methods for accumulating and selling mortgages are discussed in the opening pages. The corporation's mortgage purchasing and selling processes are diagrammed on pages 44 and 45, followed by charts on pages 46 and 47 of Freddie Mac's yearly commitment volumes from '71 through '82 and changes in the percentages of participation by various types of primary lenders who received commitments from the corporation in '80 and '82.

A diagram of the tools Freddie Mac uses to finance its mortgage purchases is on page 48.

Three charts follow the diagram. The first shows the sources of Freddie Mac funds as a percentage of the total portfolio from '71 through '82. The dollar amount of a year's total portfolio is printed at the top of each column. The second chart compares the characteristics of Freddie Mac's three mortgage-backed financing tools—the PC, the CMO, and the GMC. The third chart profiles the holders of PCs as of August 1982.



FREDDIE MAC'S MORTGAGE PURCHASING PROCESS



1. To submit an offer, a lender agrees to sell a specified dollar amount of mortgages at the net yield required by Freddie Mac. Offers are telephoned to the Washington, D.C. office between 11:00 a.m. and 2:00 p.m. eastern time each business day for all programs except four- and eight-month optional delivery commitments; offers are made under those programs each Tuesday.

2. Offers are accepted on a first come, first served basis. Unless commitments are no longer being accepted that day for a particular program and/or delivery period, a lender may obtain one commitment for each delivery period for each program.

3. Lenders who have been notified that their offers were accepted forward the required loan documentation to the appropriate regional offices.

4. Loans are underwritten and accepted if they meet Freddie Mac's underwriting requirements.

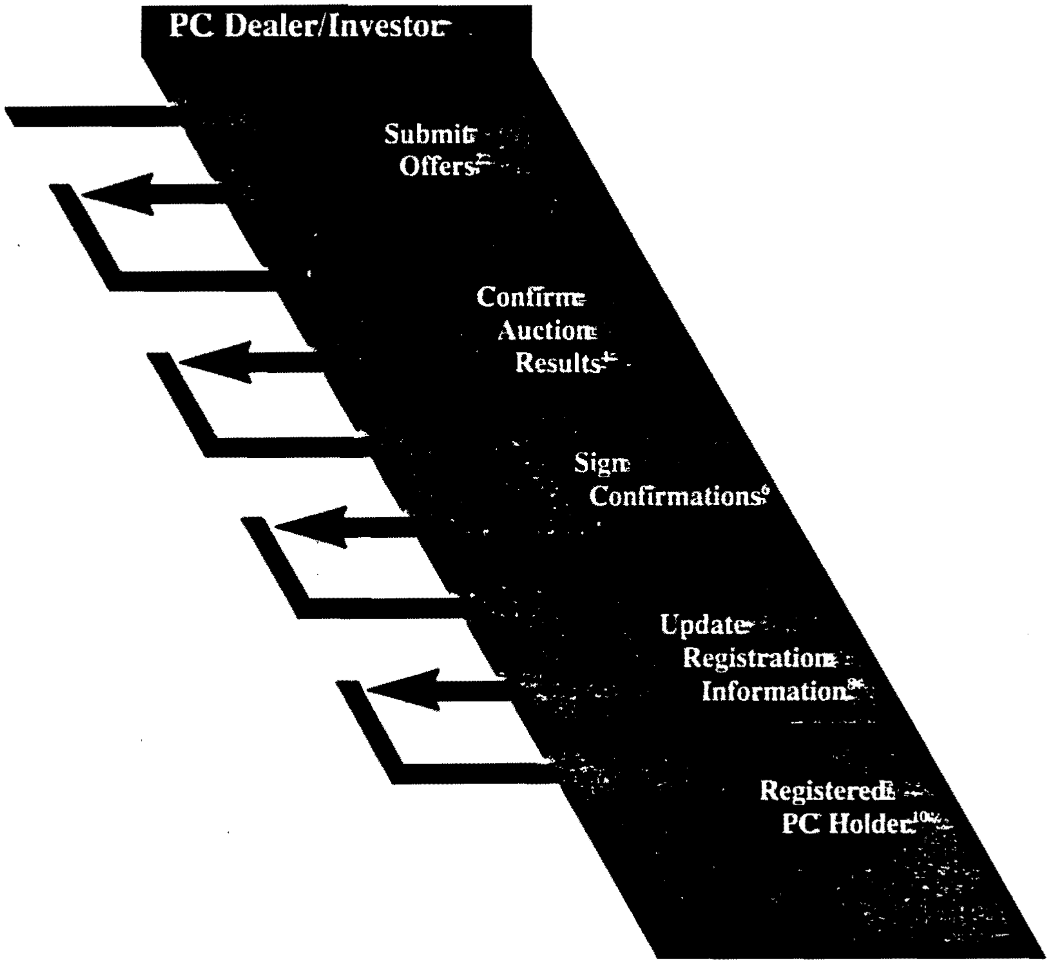
5. Freddie Mac purchases the loans. For all loans except those purchased under the Guarantor program, the D.C. office transmits funds. For transactions under the Guarantor program, Freddie Mac issues PCs to the lender instead of transferring funds. Freddie Mac places purchased loans in inventory to await pooling and sale as PCs to other investors.

6. Lenders can use the funds obtained from sales of loans for new originations. When lenders receive PCs under the Guarantor program, they can hold the PCs in portfolio as assets, hedge them to protect against interest-rate risk, sell the securities to other investors, or pledge the PCs as collateral for borrowings, depending upon the lenders' needs and marketing conditions.

7. In their role as servicers, lenders forward to the appropriate regional office:
   a. Accounting reports due within five business days of the 15th of each month; and
   b. Servicing reports due within five business days after the last day of each month.

8. Lenders retain loan payment funds until remitted to Freddie Mac, normally on the first Tuesday of the month following the month in which payment is received from the borrower.

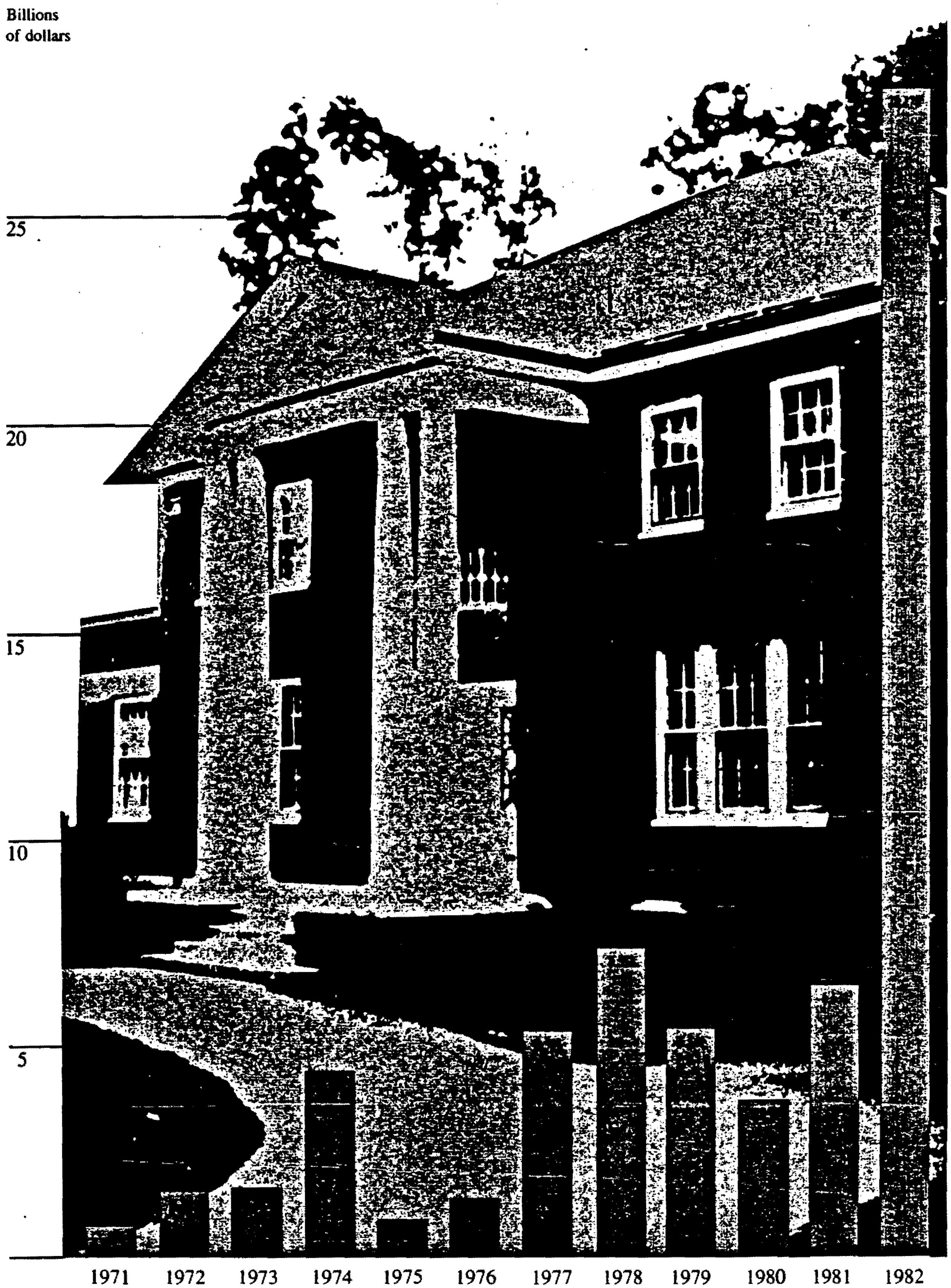
FREDDIE MAC'S MORTGAGE SELLING PROCESS



1. The D.C. office announces criteria for its daily auction of PCs each business day to a 13-member security dealers group. The criteria include the amount of PCs offered and the certificate rate for the various settlement dates. A sale of PCs for optional delivery is held each Tuesday to coincide with the four- and eight-month optional delivery purchase programs.
2. Investors tell dealers the prices at which they are willing to purchase PCs. Dealers submit investors' offers by 2:20 p.m. each business day. When placing competitive offers, dealers state the price. Any noncompetitive offers are also made at this time. Noncompetitive offers are accepted at the weighted average price of the competitive acceptances.
3. Offers are accepted or rejected based on whether they fall within an acceptance range determined by the corporation.
4. Dealers confirm the amount of their investors' accepted offers by telephone after the auction results have been released. At that time, the dealers give the corporation data on each transaction, including customer type and settlement date.
5. Confirmations and settlement notices are mailed to investors the afternoon following the transaction.
6. Dealers and, in some instances, investors are required to sign and return confirmations to the corporation within 10 days. For the sale of PCs for optional delivery, fee checks must be sent within five business days of the corporation's receipt of signed confirmation notices.
7. Settlement notices are mailed to dealers and, in some instances, investors five business days before mandatory settlements and seven business days before optional settlements. The settlement amounts are calculated and sent to the corporation's cash management section for verification. Chemical Bank, transfer agent for the PCs, is notified three days prior to a scheduled settlement.
8. The registration system is updated daily based on input from the corporation's marketing section and Chemical Bank.

9. & 10. A registered holder of a PC receives the first remittance check normally by the 15th day of the second month following the month in which the purchaser became a registered holder of a PC on the corporation's records. Thereafter, checks are mailed monthly to the registered holder for receipt by the 15th of each month.

FREDDIE MAC COMMITMENTS
1971-1982



[1]This amount includes loans funded under a special U.S. Treasury program.

[2]This amount includes commitments issued under both the corporation's standard purchase programs and the Guarantor program.

FREDDIE MAC COMMITMENTS BY TYPES OF SELLERS IN 1980 AND 1982

Savings and Loan Institutions

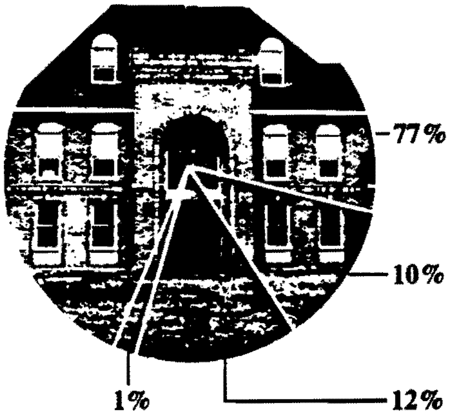
Mutual Savings Banks

Commercial Banks

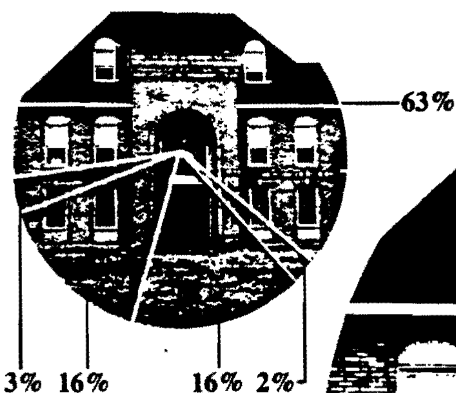
Mortgage Companies

Others[1]

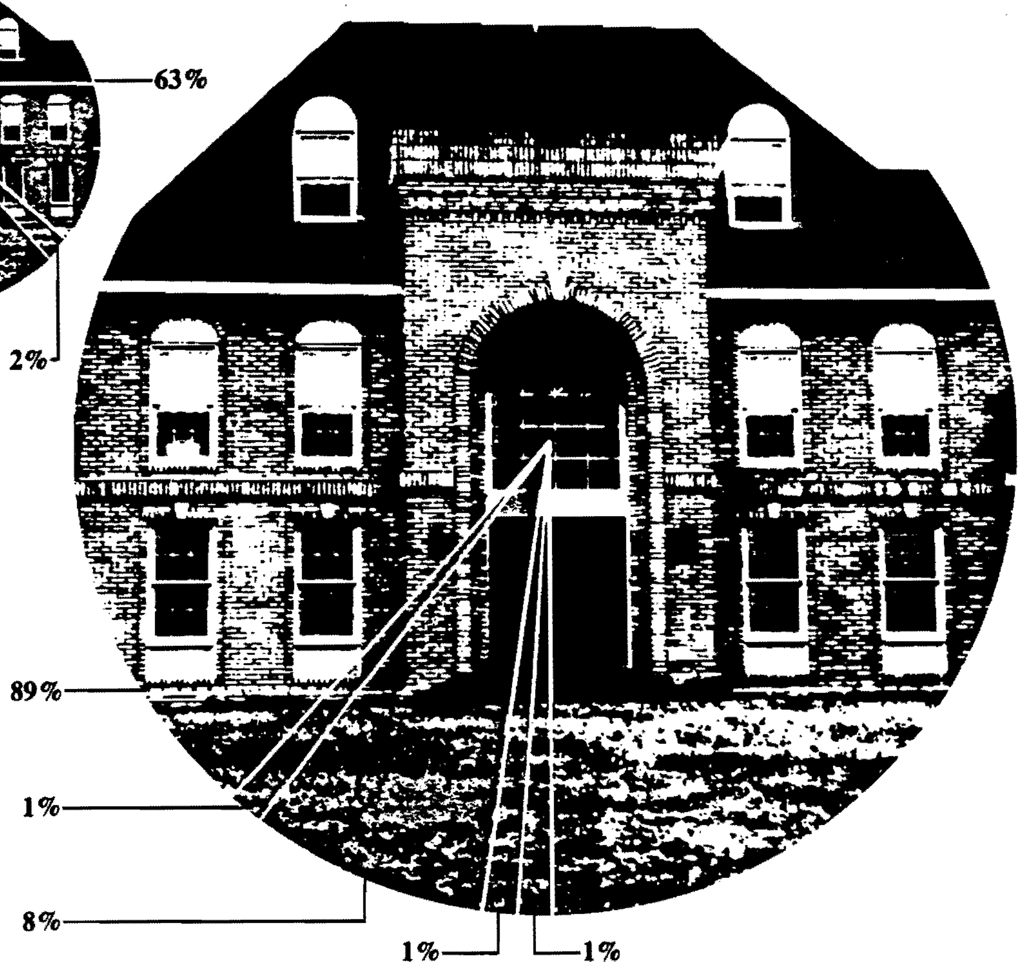
1980
$3.8 billion



1982
Standard Programs
$2.9 billion

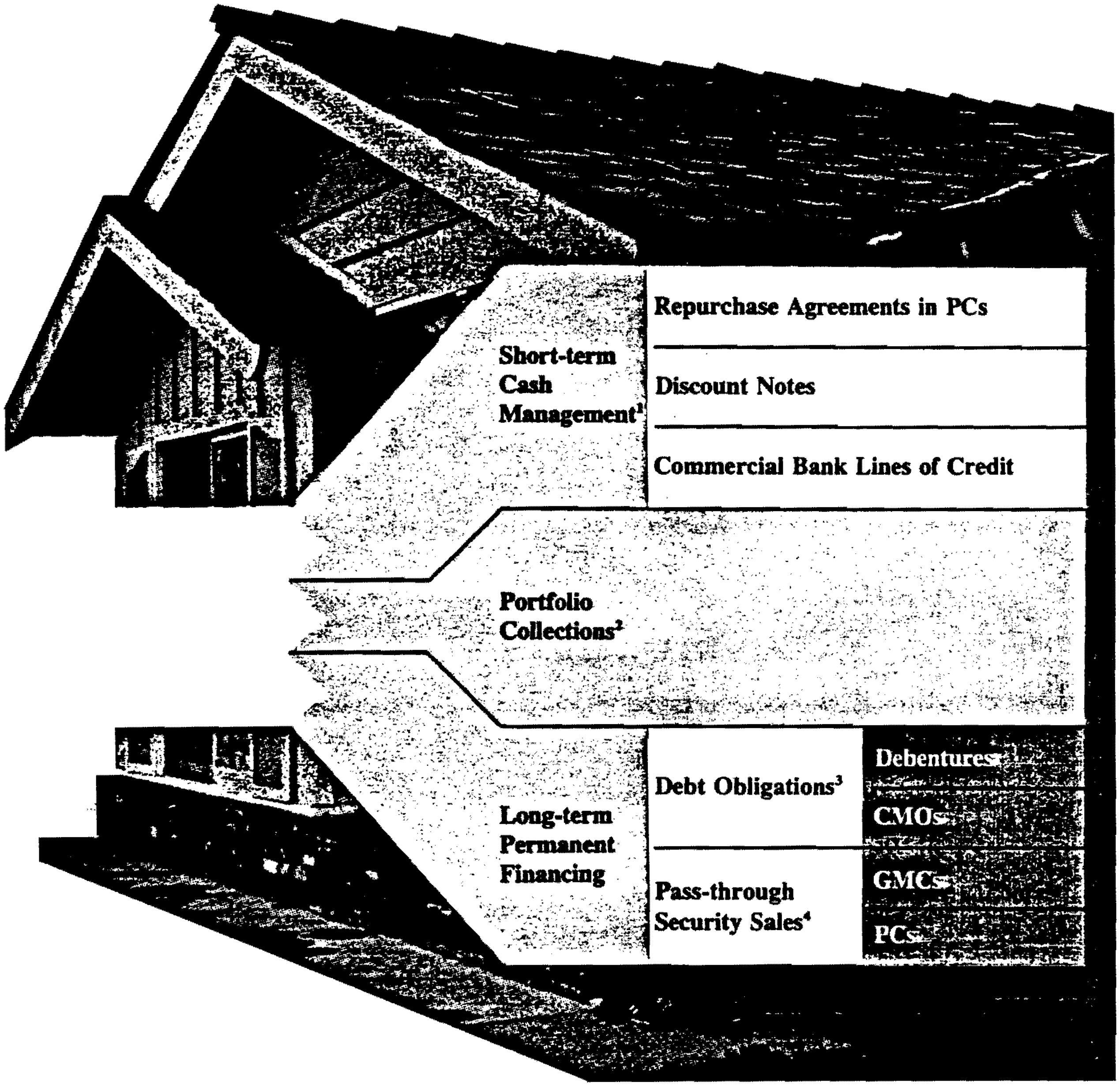


1982
Guarantor Program
$25.3 billion



[1] Includes life insurance companies, private noninsured pension funds, REITs, and state and local retirement funds.

FREDDIE MAC'S FINANCING TOOLS



The corporation's financing plan is based on its mortgage purchase plan and considers cash flow needs, spread relationships, and market conditions. This plan determines the amount and types of financing to be obtained through:

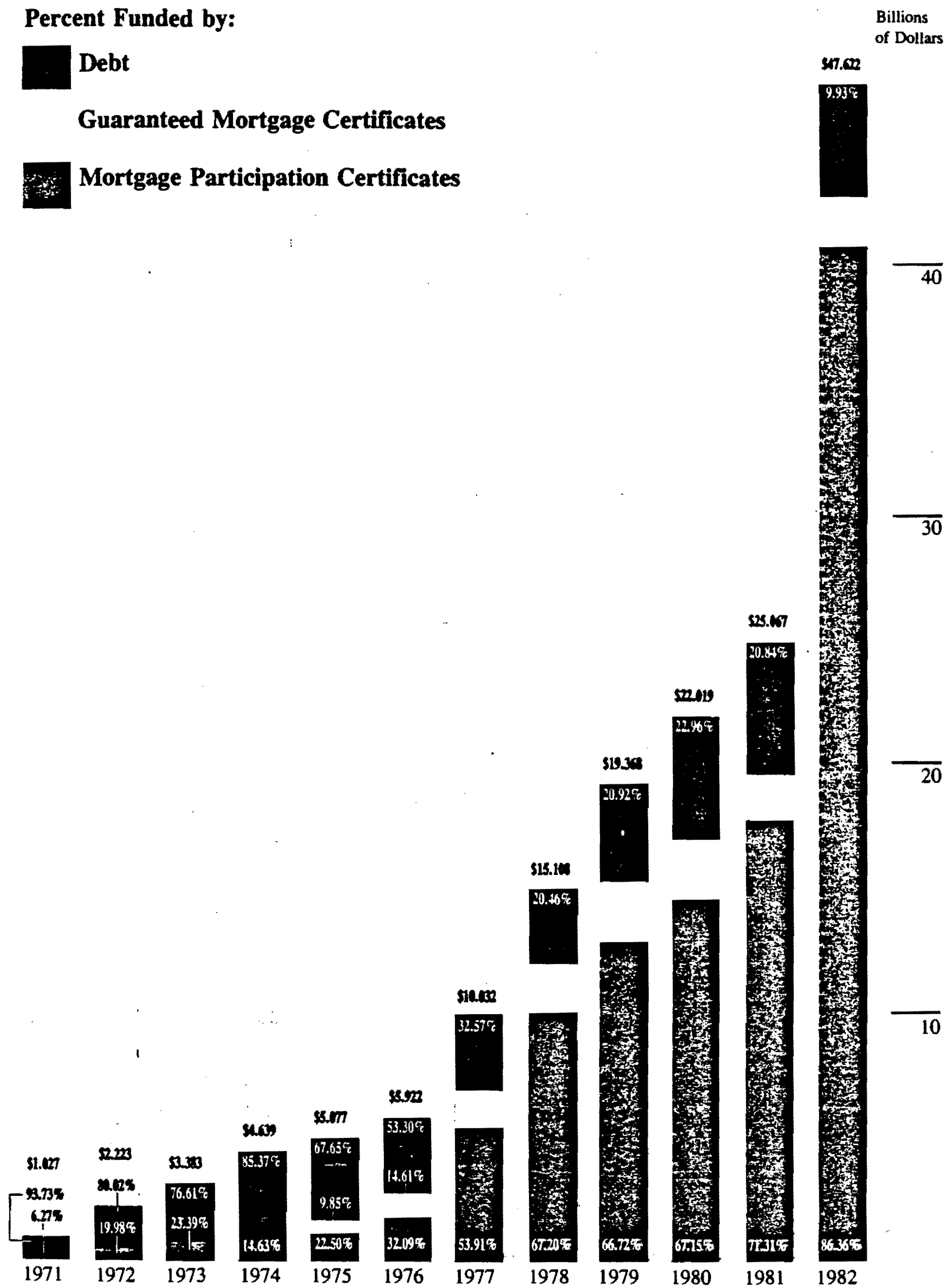
1. Short-term Cash Management—The corporation uses reverse repurchase agreements, discount notes, and commercial bank lines of credit.

2. Portfolio Collections—Estimates are made, based on prepayment experience, of that portion of the retained portfolio that will be collected and will be available to supplement security sales as a means of financing.

3. Debt Obligations—The corporation has the flexibility to issue long-term debt in the form of debentures, which are senior debt, capital debentures, which are subordinated debt, or Collateralized Mortgage Obligations, (CMOs), which are secured by conventional mortgages.

4. Pass-through Security Sales—The corporation's principal source of financing since 1976 has been its sales of two types of mortgage-backed securities, Mortgage Participation Certificates (PCs) and Guaranteed Mortgage Certificates (GMCs). PCs are sold each business day through a 13-member investment banking group and the corporation's own retail sales staff. GMCs have been sold periodically as needed.

SOURCES OF FREDDIE MAC FUNDS AS A PERCENT OF TOTAL PORTFOLIO[1] 1971-1982



[1]The portfolio figure is net of unamortized discount and portfolio valuation allowance.

PC/CMO/GMC COMPARISON

	PC	CMO	GMC
Principal Payment	Monthly	Semiannually	Annually
Interest Payment	Monthly	Semiannually	Semiannually
Amount of Principal Paid	Actual pass-through	Guaranteed minimum sinking fund payment schedule plus excess collections over schedule	Guaranteed minimum principal schedule plus excess collections over schedule
Sale Frequency	Daily	Periodically	Periodically
Sale Method	Freddie Mac and 13-member dealer group	Underwriting syndicate	FHLB Office of Finance
Delivery Options	Immediate, forward, and optional	Immediate only	Immediate only
Maturity	30 years, 12-year prepayment assumption (for yield quotations) 15 years, 7-year prepayment assumption (for yield quotations)	25 to 30 years, with a 25-year put	30 years, last issue had a 25-year put
Amount Issued	$46.1 billion[1]	$1 billion[2]	$2.95 billion[1]
Transfer Agent	Chemical Bank of N.Y.	Federal Reserve Bank of N.Y.	Federal Reserve Bank of N.Y.
Federal Income Tax Classification	Qualifying real estate asset	Corporate obligation (non-real estate)	Corporate obligation (non-real estate)

[1]As of December 31, 1982
[2]As of June 30, 1983

USES OF PCs

PCs may be used in various ways, depending on an institution's needs and market conditions.

PCs may be sold or held in portfolio by their purchasers. They may be sold either directly to an investor or through a securities dealer, and for immediate delivery or on a forward delivery basis. In the latter case, upon receiving a commitment from the corporation to exchange mortgages for PCs, lenders may arrange in advance to sell the PCs when delivered to them, usually in 60 or 90 days, thus setting the resale price to reduce the risk of adverse interest rate movement.

PCs may also be retained in portfolio and used, for example, as collateral for borrowings from banks, brokers, dealers, and other financial institutions, and in repurchase and retail repurchase agreements.

The repurchase agreement transaction, referred to as an RP or repo, is a short-term borrowing arrangement whereby the securities holder sells the security to an investor with a simultaneous arrangement to repurchase it at a later date. It can be a cost-efficient method for institutions.

The retail repurchase agreement (retail repo) is similar in concept to the traditional repurchase agreement, except that in this case the institution holding the security borrows from individual savers who invest in the repurchase agreements for up to 89 days, and retail repos may be in smaller denominations (less than $100,000). The repurchase agreement is collateralized with agency or government securities. The Federal Home Loan Bank Board has ruled that PCs are eligible collateral for retail repurchase agreements. A retail repo transaction can be a source of relatively lower cost funds for thrift institutions.