

# Primary and Secondary Mortgage Rate Trends in Today's Economy

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Primary and secondary mortgage rates are an integral component to risk measure analysis. They help to establish the incentive that borrower's have to prepay their loans and are therefore a critical daily input to BondEdge<sup>®</sup>. The BondEdge prepay model uses daily mortgage rates to generate cash flows and effective measures, such as option-adjusted duration and spread.

It would be ideal to have a timely, authoritative and readily observable market source for daily mortgage rates, but this is not currently the case. Instead, daily mortgage rates are typically estimated from the secondary mortgage market via the computation of the par TBA coupon rate plus a primary/secondary mortgage spread.

This article describes primary and secondary market dynamics, defines the primary/secondary spread and provides an analysis of recent trends in the primary, secondary and jumbo mortgage markets.

## Primary and Secondary Mortgage Markets

To better comprehend primary and secondary mortgage rates, it is important to understand the dynamics between borrower, lender and investor.

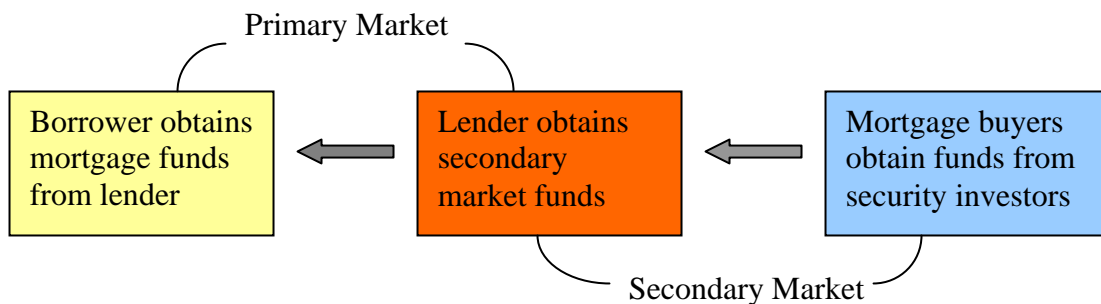


Chart 1: Mortgage Lending Flow Chart

The U.S. residential mortgage market is a huge industry with an estimated value of \$12.1 trillion as of September 30, 2008.<sup>1</sup> It consists of a primary mortgage market (i.e. actual borrowers and lenders) and a secondary mortgage market (e.g. securitized mortgage pools) that link homeowners to fixed income investors. Starting from the blue box on the right, chart 1 shows the flow of funds from security investor to homeowner. Borrowers in the primary market receive mortgage funds from lenders such as banks, credit unions or thrifts. Lenders obtain their funds from deposits or by selling their mortgages in the secondary market. Mortgage buyers in the secondary market consist of financial institutions such as Fannie Mae<sup>®</sup>, Freddie Mac<sup>®</sup> and others that generate funds by debt issuance or by grouping mortgages into securitized pools, known as Mortgage-Backed Securities (MBS). The liquidity of these secondary market securities provides primary lenders with a low cost, easily accessible source of funding.

## The Primary/Secondary Spread

The difference in mortgage rates between the primary and secondary markets, which will be referred to as the *primary/secondary spread* (PSS), is an important reflection of economic conditions. This section defines and interprets the mortgage rate estimation method used in BondEdge.

<sup>1</sup> According to Fannie Mae 2008 annual report

Freddie Mac provides an authoritative and comprehensive measurement of primary mortgage rates through a weekly survey. However, this can be estimated on a daily basis as the sum of the daily par TBA coupon rate and the PSS. The par TBA coupon rate is usually linearly interpolated using the two TBA coupons most closely bracketing par (i.e. 100).

The PSS is the servicing fee over the par TBA mortgage rate that delivers the primary lending rate. The buyer sends a monthly payment that is managed by the original lender or servicer for a fee. The rest of the payment is remitted to the loan purchaser, who also charges a fee for payment administration and protection from borrower default. The remaining portion of the payment is finally given to MBS investors.

As an example, on 12/17/08, the secondary market par coupon rate for a 30-year Fannie Mae (with zero points) was 3.95%. According to the Freddie Mac Primary Mortgage Market Survey (PMMS), the rate with zero points can be estimated at 5.37%. Therefore, the PSS for 12/17/2008 is 142 basis points.

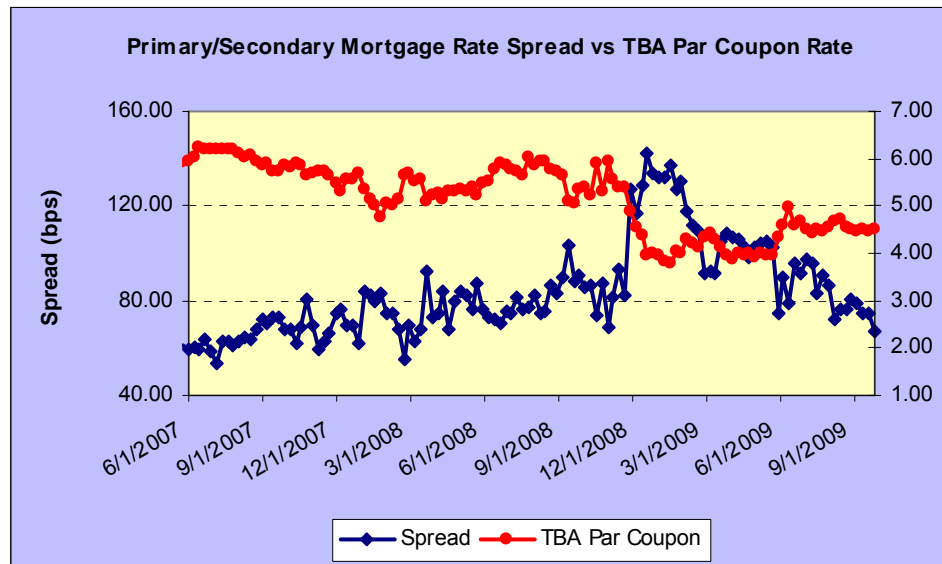


Chart 2: Primary/Secondary Mortgage Rate Trends

### Recent PSS and Jumbo Mortgage Analysis

From 2003 through 2007, the 30-year Conventional PSS was on average about 71 basis points. During this time, par coupon rates were high (above 5%). However, in the wake of the 2008 credit crisis, par rates dropped below 5% and the PSS rose above 120 basis points as seen in Chart 2.

What caused this spread to widen? This phenomenon of high spreads and low par rates is a trend typically attributable to a high volatility environment, such as in late 2008. Referring again to Chart 2, during late 2008 par TBA coupon rates were falling from about 6% to just over 4%. However, primary mortgage rates did not fall as dramatically. The higher volatility environment in late 2008 forced many primary lenders to increase hedging activity resulting in higher transaction fees, thus giving lenders little incentive to drop primary mortgage rates in parallel with secondary market rates.<sup>2</sup>

There are some signs of market recovery. For example, after May 2009 the PSS tightened as par coupon rates rose. In addition, jumbo mortgage lending is becoming more affordable. To further confirm this notion, Chart 3 below shows the relationship between Jumbo and Conventional mortgage rates from June 2007 to October 2009.

<sup>2</sup>Analogous results were concluded in a similar market environment in "Forecasting Mortgage Rates in Today's Environment," by Kamel Bazizi in the January/February 2002 issue of *On the Edge*.

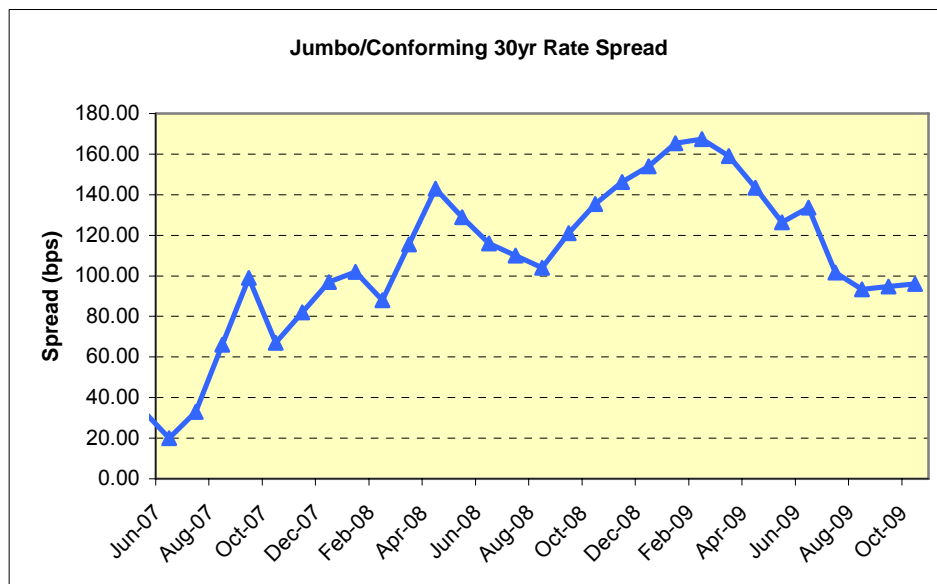


Chart 3: Jumbo and Conventional Mortgage Rates

Under normal economic conditions, the historical Jumbo to Conventional spread<sup>3</sup> is 30 to 40 basis points. Notice that the spread peaked at 167 basis points in February 2009.<sup>4</sup> Since then, the spread has been on a downward trend, ending 96 basis points October 2009. This is still about 60 basis points above the norm, but it reflects improved market stability.

**Summary**

Daily mortgage rates are estimated in BondEdge to be the par TBA coupon rate plus a primary/secondary mortgage spread (PSS). Analysis of recent PSS movements and jumbo mortgages reveals signs of economic recovery and indicate improved secondary mortgage market stability. As the market rollercoaster ride carries on, we continue to closely monitor the PSS for important timely prepayment model adjustments in BondEdge.

<sup>3</sup> The spread between jumbo and conventional mortgage rates measures the higher risk posed by jumbo mortgage borrowers and additional costs associated with jumbo loans.

<sup>4</sup> Jumbo and Conventional rates were obtained from Bankrate.com

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