INTRODUCTION

The primary mortgage market brings prospective borrowers (market demand) together with individuals, agencies and entities that have money to lend (market supply) for the purpose of acquiring real estate. The prospective borrowers include households seeking funds to buy homes; investors seeking funds to buy investment property such as apartments, office buildings and shopping centers; and businesses seeking funds to buy property for their production plants and corporate offices. The providers of funds in the primary mortgage market are principally financial institutions such as banks, savings and loan associations, and mortgage bankers who have money to lend. The interaction of prospective borrowers and the lending institutions in the primary mortgage market plus the actions of the players in the secondary mortgage market and the financial regulatory agencies determine the amount of funds available for real estate loans and the interest rates on those loans.

The secondary mortgage market also operates on the principle of supply and demand. In the very simplest terms, the secondary mortgage market is a provider or source of funds to the primary mortgage market. Those people and institutions active in the secondary mortgage market (market supply) attract funds from the stock and bond markets and direct them to the lenders in the primary mortgage market (market demand). As a result, the secondary mortgage market directly affects the amount and the cost of funds in the primary market.

The entities that comprise the secondary mortgage market work in the financial market of our economy. They create financial instruments and offer them for sale to investors in the stock and bond markets and then make the proceeds available to the primary mortgage market by buying existing loans from lenders. As a result, the lenders have additional funds to make loans for households, investors, and businesses to acquire real property. The investors in the financial instruments are the demand side of this market while the issuers of the financial instruments are the supply side. In summary, the primary and secondary mortgage markets work in consort to affect the amount of funds available for loans to acquire real estate and to determine the interest rates on those loans. The following sections will provide more detail about the nature and function of these two markets.

THE PRIMARY MORTGAGE MARKET: SOURCES OF FUNDS

The level of savings in the U.S. economy is the principal determinant of the amount of funds available for loans in the primary mortgage market. In economic terms, savings is the stock of money currently accumulated because these funds were not spent on consumer goods and capital goods. The residential, business, and governmental sectors of the U.S. economy generate the savings used to make all forms of loans including the loans for the purchase of real estate. Foreign economies also generate savings and some of the savings come to the U.S. to acquire property and to make loans to American investors and businesses. In short, the amount of money available for real estate needs in our country comes from the savings of the residential, business, and governmental sectors of the domestic economy and from
foreign savings. The pool of funds available to finance real estate purchases and improvements is affected by the decisions of individuals and organizations as to what they do with their money and by the actions of financial intermediaries.

| (a) | THE ALLOCATION OF INCOME TO SAVINGS VERSUS SPENDING - The more savings in existence, the greater the pool of funds flowing to all financial markets such as the stock market, the corporate bond market, the government bond market and the primary mortgage market. So as attitudes toward savings become more favorable and individuals, households, business firms, and government entities (local, state, and federal) save more, the total supply of lendable funds in all of the various financial markets can increase. |
| (b) | THE ALLOCATION OF SAVINGS AMONG ALTERNATIVE USES - The household, business and government sectors can direct their savings along four alternative paths within the economy. |
| (1) | DIRECT REAL PROPERTY INVESTMENT - Households, business and governments can utilize savings to acquire real assets such as the family home, real property investments; consumer durable goods such as automobiles, appliances and furniture for households; and plant equipment and inventories for businesses. |
| (2) | DEPOSITS IN FINANCIAL INTERMEDIARIES - Households and businesses can direct savings into financial intermediaries such as savings and loan associations, commercial banks, insurance companies, pension funds, trusts, credit unions, mortgage companies and real estate investment trusts. These financial entities are intermediaries because they stand between the household or business that saves and the financial market that receives the savings. Based on their preferences and their market goals, these intermediaries distribute the savings they receive into consumer loans, mortgage loans, corporate stocks, corporate bonds, U. S. government bonds, state and local bonds, and other financial obligations. The financial intermediaries receive an interest payment or dividend from the borrower in the financial market which they use to pay some form of return in order to attract the savings from the household or business. |
| (3) | DIRECT FINANCIAL INVESTMENT - The households, businesses, and governments that save can also provide funds directly into the financial markets by buying consumer loans, mortgage loans, corporate stocks, corporate bonds, U. S. government bonds, state and local bonds, and other obligations. The interest payment or other form of financial return goes directly to the saver, and there is no involvement by a financial intermediary. |
| (4) | NON FINANCIAL EXPENDITURES - Households and businesses can also use savings to acquire assets that are not real property, financial assets, or intermediary-based instruments such as savings accounts and pension fund |
accounts. Households can use their savings to acquire precious metals; diamonds; gem stones (rubies, and emeralds); art objects; and other forms of collectables such as antiques, baseball cards, coins, currency, and stamps. Even though these items may bring a financial return and can bring pleasure to the individual, economists do not consider savings going into these activities as a productive use of the funds. Funds directed along this path do not create more goods and services and do not provide for additional employment in the same manner as funds directed along the other three paths.

The extent to which the household and business sectors select one path versus another path can greatly affect the amount of funds that flow into the primary mortgage market. For example, a decision to put savings directly into mortgage loans will generate more loadable funds and a lower mortgage interest rate than the decision to put the same amount of funds into a commercial bank. The commercial bank takes the incoming funds and allocates them across the full array of loan categories and financial markets with only a small portion going to residential financing.

(c) THE FINANCIAL INTERMEDIARIES - There are seven major financial intermediaries that can affect the availability of funds and the interest rates in the primary mortgage.

(1) SAVINGS AND LOAN ASSOCIATIONS - Savings and loan associations typically specialize in providing home mortgages; but they may also make loans for property improvement such as alteration, rehabilitation, renovation and repair. In the 1980's changes in law and regulation allowed savings and loan associations to make loans on non-residential forms of real estate such as office buildings, shopping centers, industrial warehouses and hotels. In addition savings and loans began to make construction loans and to enter into equity participation loans. Once a major force in residential lending in Georgia, the numbers of and, therefore, the role of the S & L's is greatly diminished currently.

(2) COMMERCIAL BANKS - Commercial banks must maintain a high degree of liquidity because the demand deposits they manage are subject to immediate withdrawal of funds by depositors. In order to maintain this liquidity, commercial banks focus on shorter term commercial loans that enable them to meet an anticipated need for cash. However, Commercial banks do make conventional loans on residential property for longer periods of time such as thirty years, although commercial banks generally view residential mortgage lending as a second preference to business loans. Commercial banks generally increase the volume of residential loans during periods of low demand for business loans. When the volume of business loans increases, the commercial bank directs its loanable funds to business loans.
and reduces the volume of money provided to residential loans and long term commercial loans.

(3) **MORTGAGE COMPANIES** - There are two forms of mortgage companies: the mortgage banker and the mortgage broker. A mortgage banker originates a real estate loan, charges a fee for the origination, and services the loan for the financial intermediary that provided the funds for that loan. When a mortgage banker or other entity "services" a loan, the mortgage banker collects the mortgage payment, records it, maintains a history of the borrower's payments, and distributes the funds to the entity that provided the money for the loan. The mortgage broker originates loans for a fee but does not service them.

(4) **LIFE INSURANCE COMPANIES** - Although they are involved in single-family residential lending, life insurance companies may concentrate their real estate lending on commercial properties and to a lesser extent on multifamily investment property. Real estate loans made on commercial properties are long term and thus particularly beneficial to life insurance companies because of the long term nature of financial obligations in insurance policies.

(5) **PENSION FUNDS** - Pension funds managers, like life insurance companies, concentrate their real estate loans on large-scale commercial properties. However, less than 5% of all pension controlled funds are invested in such real estate loans.

(6) **CREDIT UNIONS** - Credit unions are thrift institutions that resemble savings and loans in that they provide a means for households to save. They provide passbook savings accounts and offer certificates of deposit. Credit unions also loan funds to their members, but these loans are generally made for purchases of consumer durables such as automobiles, appliances and furniture, and a modest amount of funding for home renovation and expansion. Some credit unions also provide first and second mortgage loans to their members to acquire a house. However, credit unions currently provide a relatively small amount of funds to the real estate market for the acquisition of single family homes or commercial property.

(7) **REAL ESTATE INVESTMENT TRUSTS (REIT)** - Real estate investment trusts (REIT’s) are financial entities formed to acquire real property (equity REIT’s) or to loan money for real property acquisition (mortgage REIT’s). REIT’s that specialize in financing real property acquisition or development instead of acquiring real property, focus their lending on commercial properties and multifamily apartment buildings.

(d) **FINANCIAL INTERMEDIARY ALLOCATION OF FUNDS** - The selection of a financial intermediary by a depositor or investor can affect the supply of money available for the acquisition of single family housing, for the acquisition of commercial real estate, or for some other investment purpose. For example, if households save by putting money into pension funds, a very high percentage of the savings goes
to non-real-estate activities. However, if households direct their savings to lenders in the primary mortgage market or buy financial instruments created by the secondary mortgage market, a much higher percentage of those funds go to financing single family homes and commercial property.

**PRIMARY MORTGAGE MARKET: DEMAND FOR FUNDS**

The demand for loans comes from households that wish to buy single family housing as well as from individuals and organizations who wish to borrow money to invest in multifamily housing and in types of commercial development such as shopping centers, hotels and office buildings. The demand for loans also comes from the business sector to construct both residential and non-residential properties and to finance the acquisition of those properties. Therefore, the number of households in the economy directly affects the demand for loans. As the number of households increase, more housing units are needed; so businesses borrow money to construct residential units. The households then borrow money to buy the residences. Increases in households and population also generate demand for more retail outlets. Consequently the business sector seeks more funds to construct and acquire stores and shopping centers. An increase in the population and number of households typically follows increases in employment opportunities. As employment opportunities expand, new firms as well as existing firms experiencing growth require more industrial and commercial space and the funds to acquire or build that additional space.

**THE SECONDARY MORTGAGE MARKET: THE AGENCIES AND THE ENTITIES**


(a) **FEDERAL NATIONAL MORTGAGE ASSOCIATION** - Originally the secondary mortgage market consisted of a single federal agency, the Federal National Mortgage Association (FNMA), known as "Fannie Mae." Fannie Mae was incorporated in 1938 to use money borrowed from the U. S. Treasury to purchase loans made by approved lenders. In 1954, Congress reorganized Fannie Mae and charged it with three major functions:

1. The special assistance function of designing special programs to assist the housing market where unfavorable economic conditions prevail;

2. The management and liquidation function for servicing and disposing of the existing mortgage portfolio; and

3. The secondary mortgage market function of purchasing and reselling home mortgages originated by approved lenders.

In addition, Congress gave Fannie Mae the authority to issue non-voting preferred stock that was purchased by the U. S. Treasury and non-voting common stock that was purchased by approved lenders. This transaction made Fannie Mae a quasi-public agency that
is privately owned by the lenders, although Congress still controls its services.

(b) GOVERNMENT NATIONAL MORTGAGE ASSOCIATION - In 1968, Congress transferred the first two functions from Fannie Mae to a new government agency, the Government National Mortgage Association, "Ginnie Mae," with Fannie Mae retaining the third function as its mission. The federal government owns, controls, and supports Ginnie Mae's financial activities. Ginnie Mae currently has three purposes:

1. to provide special assistance for disadvantaged residential borrowers,
2. to raise additional funds for residential lending, and
3. to manage its mortgage portfolio.

The special assistance function of Ginnie Mae involves providing funds for low cost housing in general and for residential loans in underdeveloped or capital-scarce areas. Ginnie Mae's mission is to buy, service, and sell residential loans in an orderly fashion, to minimize any adverse impact on the primary mortgage market, and to create loan opportunities that result in a minimal financial loss to the federal government.

(c) FEDERAL HOME LOAN MORTGAGE CORPORATION - In 1970, Congress created The Federal Home Loan Mortgage Corporation (FHLMC) known as "Freddie Mac." Freddie Mac has three principal responsibilities:

1. to circulate funds from capital-surplus geographic areas to areas that face a capital deficit,
2. to develop new sources of funds for the primary mortgage market during periods of scarcity of such funds, and
3. to develop new financing instruments to aid in the expansion and further development of the secondary mortgage market.

Today these three agencies are joined by several financial intermediaries in the secondary mortgage market. For example, even though most life insurance companies and pension funds do not make loans in the primary mortgage market for the acquisition of single family housing, these two financial intermediaries use funds to purchase large pools of existing single family mortgages as an investment vehicle.

THE SECONDARY MORTGAGE MARKET: THE FINANCIAL INSTRUMENTS

In order for Fannie Mae, Ginnie Mae, and Freddie Mac to benefit the primary mortgage market, they must raise funds. They do so by issuing financial securities that are sold to investors in the financial market. When these investors purchase Fannie Mae, Ginnie Mae and Freddie Mac financial securities, they provide the funds that the secondary mortgage market needs to increase the supply of funds in the primary mortgage market. There are five principal types of financial securities that Fannie Mae, Ginnie Mae and Freddie Mac issue. Each of these financial securities relies on a "mortgage pool" as collateral. The explanation of the "mortgage pool" appears in another section of this chapter.
(a) MORTGAGE BACKED BONDS (MBB’S) - Mortgage-backed bonds (MBB’s) issued by the agencies in the secondary mortgage market are similar to bonds issued by a corporation or by a government entity. The purchaser of the bond receives an interest payment annually and receives the principal invested in the bond when the bond matures. For a corporate bond, the financial backing comes from the assets and the income flow of the corporation. For a government bond, the financial backing comes from the tax revenue that the government can generate. For the mortgage-backed bond, the financial backing comes from the income generated from a "mortgage pool" that Fannie Mae, Ginnie Mae or Freddie Mac buys using the funds received from the investors who bought the MBB’s.

As the borrowers pay off their mortgage loans, the agencies in the secondary mortgage market receive income that represents both payment of interest and a repayment of principal. Fannie Mae, Ginnie Mae, and Freddie Mac retain this income and use it to meet the financial obligations of the bonds they issued to the investors. Like corporate and government bonds, the mortgage-backed bonds are fixed coupon financial securities with specific maturity dates. These mortgage-backed bonds are typically underwritten by investment bankers and given an investment rating by independent bond raters. The investment rating of the MBB depends on the criteria discussed in Section 46.06 of this chapter.

(b) MORTGAGE PASS-THROUGH SECURITIES (MPT’S) - The mortgage pass-through security (MPT) is a financial instrument backed by a mortgage pool in which the investor receives the interest payment and the principal repayments made by a borrower whose mortgage is in the mortgage pool. The role of the issuer of the MPT is to "pass through" to the investor the borrower’s interest and principal payment. Each investor in an MPT has an undivided equity interest in the mortgage pool which backs that instrument.

(c) MORTGAGE PAY-THROUGH BONDS (MPTB’S) - Mortgage pay-through bonds (MPTB’s) are financial instruments that blend the characteristics of the mortgage-backed bond and the mortgage pass-through security. A mortgage pool is the financial backing for the mortgage pay-through bond just as it is for the mortgage pass-through security and the mortgage-backed bond. Like the mortgage pass-through security, the principal and the interest payments go to the security owner. However, this financial instrument is a bond and thereby the financial obligation of the issuing agency, either Fannie Mae, Ginnie Mae, or Freddie Mac. It does not convey an undivided equity ownership interest in the mortgage pool as does the MPT.

(d) COLLATERALIZED MORTGAGE OBLIGATIONS (CMO’S) - The collateralized mortgage obligation (CMO) is a debt instrument just like the mortgage-backed bond (MBB) and the mortgage pay-through bond (MPTB). The collateral for the CMO is likewise a pool of mortgages. The issuing agency of the CMO such as Fannie Mae retains ownership of the mortgage pool and issues a bond against that mortgage pool. However, like the mortgage pass-through security and the mortgage pay-through bond, the CMO is also a financial
security in which the interest and repayments of principal flow directly to the investor.

The major difference between the CMO and the other mortgage backed securities lies in the process of issuing the bonds. For a CMO the issuing agency establishes a number of different bond maturity classes such as three year (Class A), five year (Class B) or seven year (Class C) bonds. By doing so the issuer creates financial securities that have different characteristics of risk and maturity from those of the mortgage pool which backs the bonds. The issuer segments the cash flow and establishes different priorities for the payment of interest and principal (including prepayment) derived from the mortgage pool among the various maturity classes of the CMO’s. Some classes of CMO investors received pro rata cash flows like investors in conventional debt securities while investors in other classes of the CMO agree to defer cash payments to latter periods. For example, investors in Class A securities receive periodic cash flows from interest and principal payments and prepayments until their short term bonds mature. Investors in Class B and Class C bonds receive only an interest payment because all principal repayments in the first three years go to the Class A securities. Then all of the principal repayments plus interest payments go to the Class B security until it matures. Investors in the final class of securities may defer all receipts until the higher priority, shorter maturity securities mature.

These different options for receiving the income from the mortgage pool appeal to different investors. Investors seeking short term opportunities can take a Class A position in the CMO. This group of investors might not consider a MBB or a MPT because of the longer term nature of those financial instruments. Thus the CMO appeals to a broader range of investors in the financial market.

(e) MORTGAGE STRIPS - Mortgage strips are a financial security that are a refinement on the CMO. This financial security separates or “strips” the interest payment from the principal payment and creates an interest only security (IO) and the principal only security (PO) based on a mortgage pool. The return from the security rests on the allocation of interest and principal payments over the term of a fixed rate loan. With successive loan payments, the interest payment declines while the principal repayment increases. The IO appeals to investors who want a cash flow that is large in the short term and declines over time, while the PO appeals to investors who want a cash flow that increases over time.

(f) REAL ESTATE MORTGAGE INVESTMENT CONDUIT (REMIC) - The real estate mortgage investment conduit (REMIC) is an Internal Revenue Service special tax vehicle for entities that issue mortgage-backed security offerings with multiple security classes or tranches, characteristic of CMO’s. Congress created the REMIC in the tax reform act of 1986 to provide regulation of private issuers of mortgage-backed securities and to offer pass through (tax-exempt) status to qualified partnerships, trusts, and similar entities. The income of the REMIC is passed through to the investors and reported on their individual tax returns.
In order to obtain REMIC status the issuer of the mortgage-backed security must adhere to the general requirement that all of the assets in the REMIC must consist of “qualified mortgages,” “foreclosure property,” cash flow investments, and a qualified reserve to offset the risk of loan default. More specifically, the REMIC must meet four qualification criteria.

(1) Qualified mortgages are those loan agreements secured by real estate in part or entirely. The mortgages must be in the mortgage pool prior to the creation of the REMIC or within three months thereafter. The REMIC cannot acquire or sell new mortgages. However, the REMIC can substitute new mortgages for defective or defaulted mortgages for up to two years after the mortgage pool's creation.

(2) Foreclosure property may include real estate that was the collateral for a loan in the mortgage pool that is in default.

(3) The issuer of the mortgage-backed security can only use short-term, passive, interest-earning assets in which to reinvest cash flows received from the mortgages but not yet paid to the investors in the mortgage-backed securities.

(4) The issuer can establish a qualified reserve fund that contains longer term assets that generate income to cover the expenses of managing the mortgage pool and provide additional assurance against the risk of default. The reserve fund can contain passive investments. This reserve fund is more important for mortgage pools containing loans that are not insured by FHA or a private company, or guaranteed by the VA.

A REMIC retains its federal income tax-exempt status if it avoids prohibited transactions. The prohibited transactions focus on the receipt of income by the REMIC from sources not directly associated with the purpose and operation of the mortgage pool. In other words, the rules prohibit receiving income from the following activities:

(1) assets that are not qualified mortgages, foreclosure property, cash flow investments, and passive investments in the qualified reserve;

(2) fees or compensation for services performed that are not associated with the mortgage pool;

(3) the sale of a qualified mortgage unless a special condition exists such as the proper substitution of another mortgage for the mortgage sold, the default of the mortgage, the insolvency or bankruptcy of the mortgage pool, or the liquidation of the REMIC according to plans on file with the IRS; and

(4) the cash flow investments except at the time of liquidation of the REMIC.
Each mortgage-backed security provides collateral for the return of the investor's funds. The collateral is the underlying "mortgage pool" that the security issuer in the secondary mortgage market purchases from a financial entity in the primary mortgage market. For example, a savings and loan association may not have sufficient available funds to make real estate acquisition loans for its customers. To raise funds to lend, the savings and loan association assembles mortgages or loans from its assets to offer for sale. To be marketable, the loans assembled must have common characteristics. In this example, the loans are recent fixed rate residential loans at approximately 9 percent contract rates with thirty year terms, all maturing in approximately 29 to 30 years. Our S & L assembles ten such loans with existing loan balances of at least $100,000.00. (It could be 20 loans with existing loan balances of at least $50,000.00; or even 31 different loans whose total loan balance is at least one million dollars.) The S&L adds three additional loans with $100,000.00 loan balances to increase the collateral by at least 25 percent. Mortgage-backed bond and security issuers typically provide at least 125% more collateral than the par or face value of the mortgage-backed securities they issue. This excess collateral is necessary because some borrowers whose loans are in the mortgage pool may default or become delinquent on their loans. The additional collateral insures that the issuer of the bond or security will continue to make interest payments and to return principal to the investors even though some of the loans in the pool are in default.

The S&L sells this package or "pool" of mortgages to Fannie Mae or one of the other entities in the secondary mortgage market. Upon the sale of the mortgage pool, the savings and loan association receives one million dollars which it can then loan out to buyers of residential real estate or even commercial real estate.

**SELLING THE MORTGAGE POOL**

Mortgage originators in the primary mortgage market such as savings and loan associations and mortgage bankers can sell mortgage pools to Fannie Mae and Freddie Mac under a series of programs. The first program is the "direct standard purchase program." Under this program, Fannie Mae and Freddie Mac identify the characteristics of the mortgages in several categories of mortgage pools that they are willing to buy. One category could be fixed rate loans with 30 year maturities; another could be adjustable rate loans. Any loan originator that forms a pool of such mortgages can bring them to Fannie Mae and Freddie Mac for a possible sale.

Fannie Mae and Freddie Mac also have a "negotiated purchase program" in which the originator of a loan that does not fit into any of the standard loan categories can bring the loan or loans to the agencies for their consideration.

In addition, Fannie Mae also offers both a mandatory and an optional commitment purchase program. Under the mandatory commitment program, the mortgage originator pays a fee to Fannie Mae for its commitment to purchase the mortgage pool at a certain price and at a certain time. Fannie Mae must purchase the mortgage pool, and the originator must sell the mortgage pool according to the terms of the commitment. Under the optional commitment program, the mortgage originator pays a fee to Fannie Mae for the option to sell the mortgage pool to Fannie Mae at a certain price and at a certain time. Fannie Mae must purchase the mortgage pool but the originator does not have to sell the mortgage pool. If interest rates rise before the time of sale, the loan originator may choose to sell the...
mortgage pool to another buyer for a higher price or to negotiate a higher price with Fannie Mae.

THE "SWAP" PROGRAM

When the secondary mortgage market agencies first issued mortgage pass-through securities (MPT’s), they used the funds obtained from investors to buy mortgage pools from financial entities in the primary mortgage market. For example, a savings and loan association would assemble a mortgage pool valued at a million dollars, send the mortgage documents to Fannie Mae, and receive a million dollars in cash or credit. The savings and loan association could then loan out the million dollars. In 1981, Freddie Mac instituted a "swap program" by which Freddie Mac traded mortgage pass-through certificates (MPT’s) for the underlying mortgage pools. In this instance, a savings and loan association would assemble a mortgage pool valued at a million dollars and send the mortgages to Freddie Mac. Freddie Mac would then issue MPT securities valued at a million dollars and send them to the S & L. The savings and loan association could then hold the MPT’s as income earning assets or sell them in the government bond market to raise cash for loans.

THE INVESTMENT RATING OF MORTGAGE-BACKED SECURITIES

Independent bond rating agencies rate investments in mortgage-backed securities, basing their ratings on five factors.

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>The first consideration is the type of mortgage in the mortgage pool that backs the financial security. The loans can be first or second mortgages secured by either residential or commercial properties. The quality of the mortgages depends upon the loan to value ratio and the existence and extent of any mortgage insurance or guarantee against default by the borrower.</td>
</tr>
<tr>
<td>(b)</td>
<td>The geographic diversification that exists among the mortgages forming the mortgage pool is also a factor. This diversification is typically a distribution among several markets within the lender’s area of operation.</td>
</tr>
<tr>
<td>(c)</td>
<td>The raters look at the contract interest rates and the loan to value ratio on the mortgages in the pool. The current market interest rate compared to the contract interest rates of the loans in the pool directly affects investor interest in the financial securities. The loan to value ratio of the mortgages in the pool is directly related to risk since the higher the loan to value ratio the higher the perceived risk of borrower default.</td>
</tr>
<tr>
<td>(d)</td>
<td>For commercial property loans, the raters consider the magnitude of the performance and profitability measures such as the operating expense ratio, the debt service coverage ratio, the break-even ratio, the equity dividend rate, and the internal rate of return. When the operating expense ratio and the break-even ratio are low and the debt service coverage, the equity dividend, and the IRR are high, the return from the property is higher and the default risk is lower.</td>
</tr>
<tr>
<td>(e)</td>
<td>The raters also look at the extent of the excess collateral. In order to increase the investment rating of the mortgage-backed bond or</td>
</tr>
</tbody>
</table>
security the issuer places mortgages into the pool so that the total loan balances in the pool exceed the dollar amount of the mortgage-backed securities issued against the pool.

THE PRIVATE SECTOR IN THE SECONDARY MORTGAGE MARKET

In addition to Fannie Mae, Ginnie Mae and Freddie Mac, financial institutions can do the things that these entities do in the secondary mortgage market. For example, a bank, a savings and loan association, or a mortgage banker can create a mortgage pool and use it as collateral for a mortgage-backed bond or pass-through security that it sells in the financial market. The funds from the buyers of the security come directly to the bank, savings and loan association, or mortgage banker. Moreover, other private entities such as pension funds and REIT's participate in the secondary market by buying mortgage pools.