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Secondary mortgage market: What it is and how it works

Written by
James Royal, Ph.D.,
Edited by
Laurie Richards,
Reviewed by
Thomas Brock,
_Expert verified

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Key takeaways

- The secondary mortgage market is a financial marketplace where investors buy and sell bundled packages consisting of many individual loans, also called mortgage-backed securities.
- While you, the homebuyer, aren't directly involved in it, the secondary market impacts your ability to get a mortgage and how much that loan costs.
- Borrowers can possibly benefit from decreased costs thanks to the secondary mortgage market.

When you get a mortgage, you might expect to repay your lender over the next 15 or 30 years. However, many banks and other lenders originate mortgages only to sell them to other investors. The secondary market plays a big role in your ability to get a mortgage and how much that loan costs, yet many homebuyers aren't aware of it or how it works. Here's what to know.

What is the secondary mortgage market?

The secondary mortgage market is a marketplace where investors buy and sell mortgages that have been securitized — that is, packaged into bundles of many individual loans. Mortgage lenders originate loans and then place them for sale on the secondary market. Investors who purchase those loans receive the right to collect the money owed.

Just like any market for securities, the value of mortgages on the secondary market depends on their risk and potential return. Higher-risk loans must offer higher returns, which is one reason why people with lower credit scores pay higher interest rates.

Primary vs. secondary mortgage market

The primary mortgage market is where borrowers get mortgages from lenders. For example, if you go to a local credit union and a couple of banks to get a quote for a mortgage, you're participating in the primary mortgage market.

The secondary mortgage market doesn't involve borrowers at all. Instead, it's where lenders sell loans they've originated to investors.

How the secondary mortgage market works

After originating a loan, a lender often sells it on the secondary mortgage market, though the lender may retain the servicing rights. Many lenders sell loans to the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac or other aggregators. These aggregators can repackage the loans as mortgage-backed securities (MBS) or hold them on their own books and collect the interest from borrowers.

Loans must be conforming loans to be sold to GSEs. In other words, it must meet certain standards set by the Federal Housing Finance Agency (FHFA), which oversees Fannie and Freddie. These factors include:

- A maximum loan amount of $766,550 (for 2024) in most markets, though it is higher (up to $1,149,825) in some expensive areas
- The down payment relative to the loan's size, typically at least 3 percent
- The borrower's credit score, usually at least 620 to 650
- The borrower's debt-to-income (DTI) ratio, which should ideally be 36 percent or less

The demand for conforming loans helps push down the mortgage rates for borrowers who can meet the standards. Note that jumbo loans, which are larger in loan size, are not considered conforming loans.

1. A borrower takes out a loan

A homebuyer borrows money from a lender by taking out a mortgage (a conforming loan). The homebuyer gets cash to purchase the home, while the lender holds the buyer's mortgage and a promise to be paid later at a specified interest rate.

2. The lender sells the loan to an aggregator

The lender sells the loan to a mortgage aggregator — often Fannie Mae or Freddie Mac, who buy two-thirds of the mortgages in the U.S. The lender gets cash for selling the mortgage note, allowing it to use the capital to write another loan. The lender may retain the right to service the mortgage, a service for which it receives a fee.

The lender foregoes any mortgage repayments of principal or interest — because the aggregator now owns the loan after paying cash for it.

3. The aggregator bundles the loans into mortgage-backed securities

The aggregator repeats the process of buying conforming loans, amassing hundreds or thousands of mortgages across the U.S. Then it packages, or "securitizes," these loans into mortgage-backed securities (MBS). For example, it might combine 1,000 mortgages into one series of MBS. Because the MBS has many mortgages, it's less risky than buying a single mortgage — similar to a mutual fund that invests in many companies.

Aggregators can structure MBS into many different types of investment products and then sell "shares" in them. They may create a range of bonds that are very safe to a little risky, with lower payouts for the safer bonds and higher payouts for riskier notes. They may also structure the payments to MBS bonds in ways that may appeal to certain investors. For example, many MBS only pay interest to investors while some pay principal; others pay a combination.

If an aggregator has also purchased the mortgages' servicing rights, it may retain them and service the underlying loans or sell them to a third party.

4. Investors buy the securities

The aggregator puts the MBS up for sale to investors — pension funds, mutual funds, insurance companies and other income-oriented investors. The aggregator receives cash, which it can use to buy more mortgage notes for later repackaging. In turn, the investor receives the MBS, which it can hold and collect income on (from the mortgage payments) or later sell to another investor.

Eventually, the MBS matures, and the investor is paid off. With this cash, the investor can then purchase another MBS or invest elsewhere.

Secondary mortgage market example

Imagine you take out a mortgage to purchase a new home. The lender gives you the funds to purchase the property, and you agree to pay the money back over a certain number of years. On the back end, however, the lender sells your mortgage to the secondary market for cash. This gives the lender more capital to lend to more borrowers.

There are a few things that can happen to your mortgage once it's sold to the secondary loan market. The buyer may decide to hold your mortgage and collect the interest, or your loan could be bundled with other home loans and sold as a mortgage-backed security. Ultimately, what the lender decides to do with your mortgage does not impact you as the borrower.

Why does the secondary mortgage market exist?

Creating a completely new security from mortgages is a complex process, so why would the players involved in the mortgage market do this? The secondary market creates benefits for each economic player — including borrowers, investors, banks/lenders, aggregators and rating agencies.

Because it allows lenders to slice up their mortgages, the secondary market also enables financial firms to specialize in various market areas. For example, a bank may originate a loan but sell it on the secondary market while retaining the right to service the mortgage.

As a loan originator, the bank underwrites, processes, funds and closes the loan. It collects fees for these services and then may or may not hold onto the loan.

As a loan servicer, the bank receives a fee for processing the monthly payment, tracking loan balances, generating tax forms and managing escrow accounts, among other functions.

Even if the lender decides to keep the loan it originated, it benefits from having an active and liquid secondary market where it can sell its loans or servicing rights.

Pros and cons of the secondary mortgage market

Advantages and disadvantages of the secondary mortgage market include:

Pros

- **Lower costs**: Borrowers can potentially benefit from lower expenses because of the secondary mortgage market.
- **Investors can pick and choose loans**: Investors (including institutional players such as banks, pension funds and hedge funds) get exposure to specific kinds of securities that better meet their needs and risk tolerance.
- **It keeps money moving**: Lenders can move certain loans off their books while retaining other loans that they'd prefer to keep. It also allows them to use their capital efficiently, generating fees for underwriting mortgages, selling the mortgage and then using their capital again to write a new loan.
- **Aggregators collect fees**: Aggregators such as Fannie and Freddie earn fees from bundling and repackaging mortgages and structuring them with certain attractive characteristics.

Cons

- **It can come with risk**: Mortgage-backed securities can be a risky investment. If borrowers default on their loans, investors could lose money, and the economy could take a hit.
- **Impact on returns**: Investors' returns can also be negatively affected if borrowers refinance or pay back their loans quicker than expected.
- **Strict eligibility criteria**: GSEs have strict criteria for what types of loans they'll guarantee in the secondary market, so lenders usually won't issue loans outside of these parameters. As a

result, borrowers with poor credit scores may not qualify for a loan, or if they do, they'll likely face higher interest rates.

FAQ about the secondary mortgage market

- **Who is involved in the secondary loan market?**

  The secondary loan market involves multiple parties:

  - **Mortgage loan originators (MLOs):** MLOs work closely with borrowers to create loans. Later, they may sell these loans on the secondary mortgage market.
  - **Aggregators:** Government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, are aggregators that purchase mortgages from lenders and repackage them into mortgage-backed securities to be sold on the secondary market. MLOs may also act as aggregators.
  - **Investors:** Investors buy mortgage-backed securities on the secondary market. As borrowers repay their loans, investors see returns.
  - **Homeowners:** Homeowners aren't directly involved in these transactions. However, they're still an important piece of the puzzle because their loans are what's being bought and sold on the secondary real estate market.

- **How do mortgage lenders make money in the secondary market?**

  Mortgage lenders make money in the secondary market when they sell a loan. Selling a mortgage gives the lender access to liquid capital, which allows them to write new mortgages and sell them.

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- **Who is the largest purchaser in the secondary mortgage market?**

  Fannie Mae and Freddie Mac support about 70 percent of the mortgage market and are two of the biggest purchasers in the secondary mortgage market, according to the National Association of Realtors.

- **What is the history of the secondary mortgage market?**

  In 1938, Congress established the secondary mortgage market by creating Fannie Mae. This move provided liquidity for lenders, allowing them to issue more loans without tying up capital for extended periods. In 1970, Freddie Mac was formed with similar objectives. It acted as a market-maker to facilitate the buying and selling of mortgages, encouraging lenders to extend financing with the assurance of being able to sell the loans. Before this secondary market, lenders typically held onto the loans they originated, which limited the availability of mortgages based on individual bank capacities and loan book space.

Standard criteria were established to ensure loan quality, leading to the creation of conforming mortgages. Today, the secondary mortgage market enables those meeting conforming loan standards to secure funding for their mortgage, even if local lenders are not inclined to hold onto the loan.

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