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How to ask a question

ORIGINATIONPRO™
MORTGAGE SCHOOL

Understanding Rates & The Secondary Markets

Dave Hershman
Founder OriginationPro
Mortgage School

Certified Mortgage Advisor™

Dave Hershman

- Produced 600 transactions in his first 18 months in the industry—including closing 60 in his 12th month
- Run sales forces for large production organizations
- Directed the sales force for Ellie Mae
- Written seven books in the areas of finance, sales management—including two published by the MBA
- Director and founder of a federally-chartered bank
- A keynote speaker at hundreds of industry events
- Currently, Senior VP of Sales and Weichert Financial

OriginationPro.com

Welcome Members & Guests

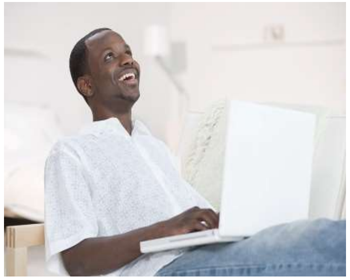
OriginationPro Marketing System
OriginationPro Mortgage School Students

- ✓ Our goal is to help loan officers become and stay experts & help them market like experts. ***Experts make more money in every industry.***
- ✓ That is why we focus on training and marketing systems.
- ✓ Trial members of the marketing system good for 14-days and you have access to all marketing materials.
- ✓ Students of our courses get extended free trials.
- ✓ We will not spend time today going over the system as this is a **commercial free presentation**—however, feel free to ask questions at the end.

Our Goals Today

- Rules/Legislative Update
- Market Update
- Why this topic is important
- Ten Important Rate/Market Concepts
- Summary

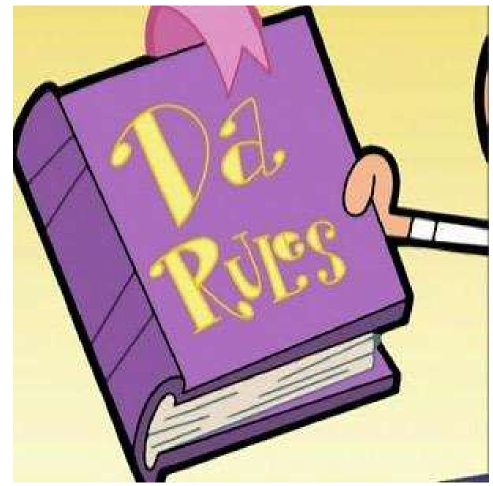
And Coaching—Q&A on any topic



Legislative & Market Update

Mortgage Rules Update

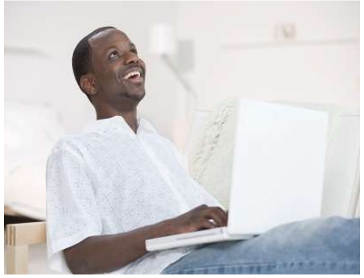
- VA and FHA lower maximum cash-out percentage.
- FHA allows spot approval for condos, effective October
- Feds signing off on rule not requiring appraisal below $400,000 (does not apply to FHA/VA and Fannie/Freddie).
- Administration releases GSE plan—don't expect Congressional action quickly, but that does not mean…



Market Update

- Economic Reports
  - August Jobs Data—slightly lower than expected
  - Second Quarter Economic Growth 2.0% (slower)
- Trade war volatility has affected
  - The stock market (vacillation)
  - Gold prices (higher)
  - Interest rates (lower) – Refis are back!
- The Fed Meets Next Week
  - Markets are expecting another rate decrease (0.25%)
  - Does not mean that mortgage rates will fall.
  - Biggest surprise will be if the Fed does nothing. Lesser surprise if they lower rates by .50%.
- If the trade war eases, will rates go up?



Understanding Rates & The Markets

This Webinar Will Not..

Help you predict the future…

…It will make you understand why you cannot predict the future.

Do not get lost in the terms of this webinar —try to understand the concepts.

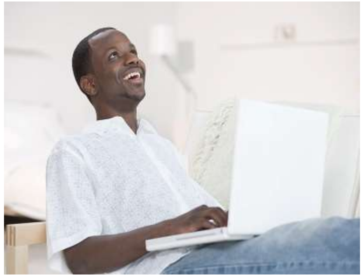
Why This Topic is Important

- We are subject to many cycles in this industry—and mortgage rates are a leading factor in determining cycles and what your income will be.

Did you expect rates to fall in 2019? The experts did not. If they can't predict the future—neither can you.

- The secondary market to a great extent contributed to the financial crisis, as well as the preceding real estate boom.
- If you want to be an expert in this industry—you must understand the dynamics of interest rates.
- You need to be able to advise your clients regarding the risks of locking a rate and the risks of floating a rate -- **but remember, it is their decision.**



Ten Important Concepts Regarding Interest Rates & The Secondary Markets

#1 --What is the Secondary Market?

- When a loan officer takes an application from a customer and the lender makes the loan, this is the **primary** market, or **retail**.
- When a mortgage company makes a loan and then sells it – that is the **secondary** market, or **wholesale**. That loan is now a **commodity.**

The History of the Secondary Market

- The history goes back to the great depression
- The dust bowl put our ***Agricultural*** nation in jeopardy. There was also a housing and financial crisis similar to our more recent great recession.
- Through the depression was born the **commodities** market
- The purpose of the commodities market? Minimize risk for farmers.
- Ability to sell commodities "in the **future**" (example corn), or hedging, protected farmers
- Why located in Chicago? The farm belt.
- Also the depression brought us **FHA** and **Fannie Mae**—the first "participants" of the secondary market for mortgages

Mortgage Secondary Market Benefits

- Selling loans into the “future,” or **hedging**, enables consumers to **lock-in** rates from a period of 10 days to 180 days out. Otherwise, their rate would be determined when they settle.

- Being able to sell loans means that there is a constant **supply** of mortgage available. If all entities had to hold their mortgages, they could run out of money to lend.

- **Product development** – because if the markets can find buyers, a particular loan product can be originated.

*As a matter of fact—product development became too easy during the real estate boom, which helped cause the **crisis** which followed.*

#2 -- What is a Mortgage Commodity?

- You should know what a mortgage is…
- After it is made it can be **sold**/**traded** like gold or oil or the dollar
- Mortgages are “interest rate denominated instruments” like Treasury Bonds. “**Denominate**” means named.

3 Values Go Up As Rates Go Down

- As a commodity, the **value** of a mortgage will go up or down depending upon the direction of interest rates:

  A 4.0% mortgage goes up in value when rates fall and down in value when rates go up – or, when the **bond market** is "up" that means rates are falling. Why?

  ✓ If rates go up from 4.0% to 5.0% and you "**owned**" or "**held**" a 4.00% mortgage -- would others be more or less likely to purchase the mortgage you held? Why would they purchase yours if they could earn 5.0% elsewhere?

- Value of a mortgage when you sell it—

  4.50% 101.00 **Over Par** (consumer gets a one-point credit). Produces **YSP***

  4.25% 100.00   **Par** (consumer pays no points)

  4.0% 99.00 **Under Par** (consumer pays a point)

YSP stands for Yield Spread Premium and makes "no closing cost**" and "**no point**" mortgages possible.*

#4 What is a Hedge?

- A hedge is a form of **protection**. A hedge around your house protects your house visually.

- The secondary market enables a lender to sell a loan into the **futures market** to reduce the risk of losses that occur between the time it is locked with the consumer and it closes and can be delivered to the investor. Same protection farmers get.

- If a lender has a pipeline of loans and they are not hedged (locked in the future), the **risk** is great.

$100 million unprotected pipeline and 2-point move in the markets in the wrong direction is a $2 million **cash** loss.

Futures Market

Price of 4.0% Mortgage in the **future**. Let's say today is June 1, 2019

-June Delivery: 100.50
-July Delivery: 100.00
-August Delivery: 99.75

- All are even numbers for sake of simplicity only.

- On a "rate sheet," assuming no "**add-ons**" these may be reflected as follows:

-10 Day Price: (.25%) -- borrower gets ¼ point credit
-30 Day Price 0 or Par – there are no points
-60 Day Price: 0.25% -- borrower pays ¼ of a point

#5 Interest Rates Are Based Upon Risk

Each of these three risks are interrelated—they do not stand alone.

- ***1--The Risk of Inflation***. If inflation is higher, your money is worth less. If you lend 100K at 10% inflation rate, the money is worth $90K if paid back in a year. A bank would have to charge 10% interest just to break even. In essence, the inflation rate becomes the "base" for interest rates.

  ✓ You can't predict the future of inflation—that is why bond trading is as risky as trading stocks.

  ✓ This is also why long-term rates are usually higher than short-term rates, or a "***positive yield spread***."

Are Long-Term Rates Always Higher?

- We explained a ***positive yield spread***, which is normal. It means that long-term rates are higher than short-term rates.
- What happens when we have an ***inverted yield spread***?
- When you have a very high inflation rate which is expected to come down or another type of turn in the market, the spreads can invert.
- For example, today – many are expecting an economic slow down, or even a recession. Thus long-term rates, including mortgage rates have come down. But the Federal Reserve Board has not brought down short-term rates as much.

The Fed and Inflationary Risks

- A major goal of the **Federal Reserve Board** is to lessen the risk of inflation.

- Inflation risks explain why the Fed can raise short-term rates & mortgage rates can go down.
  - ✓ Because the market perceives the Fed will bring **inflation down** and therefore can react "positively" -- or bonds go up in price.
  - ✓ The Fed controls instruments such as the **discount rate** -- the rate that the Fed charges to banks to borrow short-term funds.
  - ✓ Therefore, the Fed affects short-term rates directly and long-term rates indirectly. Though, when the Fed purchases Treasuries and mortgages in the open markets, they can affect the long-term rates as well.

Two More Risks That Effect Rates

- Second, ***The Risk of Prepayment***
  - ✓ When the loan is paid back, let's say through a refinance, that is good news -- but only as compared to a default.
  - ✓ When the loan is prepaid an investor must re-invest your money at today's rates which will usually be lower, especially if the loan refinances.
  - ✓ Risk of prepayment goes up as rates go down.

- Third, ***The Risk of Default***
  - ✓ This is why "B" credit costs more than "A" credit. Loan level price adjustments due to credit score and other factors are an indicator of this issue.

What Happened to No Closing Cost Loans?

- In the past—one could opt for a higher interest rate, but pay no closing costs on their loan.
- Today, higher rates are not typically providing enough credit to pay all closing costs.
- This is because the big national on-line lenders have become so efficient refinancing clients, the secondary market "premiums" are disappearing.
- Think about it—if someone purchases a loan at a higher rate and gives a big credit for closing costs (yield-spread), they expect to get their money back over time with the extra interest. But if the loan refinances too quickly, they take a loss.

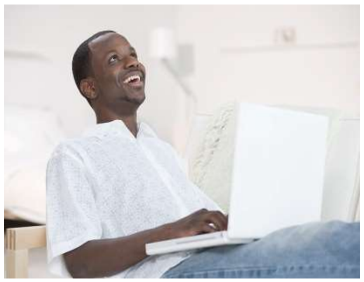
The Risk of Prepayment

Coaching

Remember that I will be answering questions at the end of the webinar

ON ANY TOPIC

Use the panel to submit a question.



Spreads--
Servicing--
Warehouse
Lines

#6 – You Must Understand Spreads

- **Spreads** are essential to understanding rates
- There are many spreads (nothing to do with cream cheese)…
  - ✓ The spread between **jumbo** loans and **conforming** loans
  - ✓ Between long vs. short-term rates
  - ✓ Between **mortgage** rates vs. other **financial** instruments
  - ✓ Between 30-year loans vs 15-year loans
  - ✓ Between 15-day vs 60-day pricing
  - ✓ "Between "A" **credit** vs "B" credit mortgages

10 Year Treasuries Have Dropped..

…But Mortgage Rates, not as much

Two separate interest rate instruments with similar drivers, but they can react differently.
*The "**Spread**" has changed in the past two months*

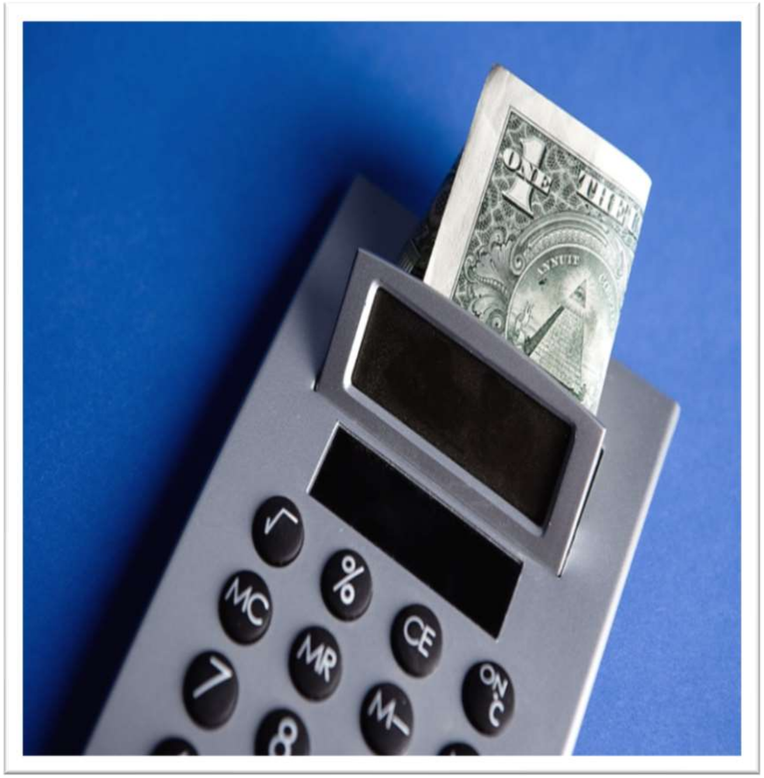
#7 --The 2nd Commodity: Servicing

- We indicated previously that we create a commodity when we make a mortgage.
- Actually it is two commodities..
  - ✓ The loan itself
  - ✓ The **right to service** the loan
- The value of servicing is a separate commodity that affects the rate of your loans.
- When your lender says "**your loan is sold**"—it actually means the servicing is transferred. A lender can actually sell the loan but keep the servicing.
- As there are interest-rate risks, there are also servicing risks. During the economic slump—value of servicing went down because of a high-level of defaults. Also when rates fall, the risk of prepayment goes up.

Why Would Servicing Have Value?

First, what does the **servicer** do?

- Collects payments
- Sets up escrows
- Pays escrow bills when due
- Sends principal to owner of mortgage
- Sends out reports (investor reporting)
- Forms for the IRS-1098
- Gives out payment information
- General customer service
- Escrow analysis at the end of the year
- Collections
- If that does not work foreclosure
- And more…



Would you do that for $750?

- Of course not!
- Then how can it be value?
- Originations is labor intensive—what does it take to close one loan?
- **Servicing** is a technology-based business.
- It is more conducive to volume.
  - ✓ One $300,000 loan $750 annually
  - ✓ 100 loans $75,000 annually
  - ✓ 1,000 loans $750,000 annually
  - ✓ 1,000,000 loans $750 million annually

- Anything less than several thousand loans is too small for a servicer to be profitable.
- Plus-of major importance. A servicer is in the home of the client every month -- **a long-term relationship**. This is added value that cannot be measured.

Why is Servicing Value Important?

- What affects the value of servicing affects the value of the loan…
  - ✓ **Loan size** – smaller loans are more expensive to service.
  - ✓ Fixed vs. adjustable rates
  - ✓ B credit vs. A credit—Rate of default
  - ✓ Higher rate as compared to market (5.0% no-closing cost vs. 4.0% and two points). Higher rate more likely to prepay
    - While you hedge loans against rate going up---you would need to hedge a servicing portfolio against rates going down.
  - ✓ VA loans vs FHA loans – 100% insured vs. 25% guaranty.
  - ✓ **Escrows or no escrows**

#8 Your Lender Does Not Have Money

- A lender that does $1 billion in fundings per year does not have $1 billion in the bank.
- They borrow the money: a **warehouse line** is a line of credit secured by the closing instruments
- Short term lending (lender must pay interest) because loans are sold so quickly.
- Lender keeps interest paid until loan is sold.
- If lender collects 5.0% and warehouse line cost is 4.0%, there is a **positive warehouse spread**. If you have an "inverted yield spread," there may be a loss.
- The financial crisis affected the availability of warehouse lines which means that some companies had to close just because they could not get lines.
- When the loan is sold, the money goes back to pay off the warehouse line.

#9 -- What Do You Say….

When They Ask –
Where are rates headed?

- No one knows where rates will go. Economists are paid hundreds of thousands per year to analyze the markets and they can't tell. My job is to keep on top of the markets in order to give you quality information so that you can make the best educated decision. **Bernanke Example.**
- It is also my job to educate you on what is the real cost and benefit of rate movements—after taxes. What is your cost or benefit if rates move .125% in one direction or another on a monthly **after-tax basis**.

#10- Rates Going Up?

Lenders do not make more money

when rates rise,

even though consumers think so!

Typical profit may be 25 basis points or .25%!

What We Covered Today

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Ready For Questions/Coaching?

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