

**Mortgage Bankers Association of America**

**IDENTIFYING BOUNDARIES:**

**The Distinctions Between the Primary and Secondary Mortgage Markets  
Using Statutory Construction to Clarify Congressional Intent**

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I. Introduction .....	1
Project Objective.....	1
Scope of Research.....	1
II. An Approach to Statutory Construction .....	2
III. Summary of Results .....	2
IV. The GSE Charters: Two Markets in Mind .....	3
V. RESPA: Congressional Definition of Mortgage Origination .....	6
VI. Legislative History.....	8
VII. Conclusions .....	9

## **I. Introduction**

### *Project Objective*

Fifteen years ago, if one looked at the advertising of Fannie Mae and Freddie Mac, there were pictures of futuristic space people and gnomes, both evocative of the mysteries and esoteric nature of the secondary mortgage market environment in which Fannie Mae and Freddie Mac plied their wares. Today, both Fannie Mae and Freddie Mac advertise with warm pictures of houses, families and examples of real case individuals who have benefited from their programs.

Fannie Mae and Freddie Mac have long had an influence on the development of standardized mortgage industry practices which have had an impact on the home buying public. However, with the advent of automated underwriting and their vastly increased domination of the residential mortgage market, questions have arisen about how close to the homebuyer Congress intended Fannie Mae and Freddie Mac to be when it created those agencies. The following is a discussion of an attempt to discern Congressional meaning with regard to the terms “primary mortgage market” and “secondary market” and the distinctions Congress intended when it used those terms in the statutes that created Fannie Mae and Freddie Mac.

### *Scope of Research*

The following sources were searched in pursuit of guidance on the way Congress sees the distinction between the primary and secondary mortgage markets: the statutes and the multi-volume legislative histories of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (12 U.S.C. 3331, et seq.), the Federal Housing Enterprises Safety and Soundness Act of 1992 (GSE Reform Act) (12 U.S.C. 4501, et seq.) and the Housing and Community Development Act of 1992. Also reviewed were the Federal National Mortgage Association Charter Act (the Fannie Mae Charter) (12 U.S.C. 1716, et seq.) and the Federal Home Loan Mortgage Corporation Act (Freddie Mac Charter)(12 U.S.C. 1451, et seq.) (referred to collectively as the GSE Charters) along with the West Annotations to the United States Code for the GSE Charters and applicable references in the United States Code of Congressional and Administrative News (USCAAN), a repository of limited legislative history. Also perused were the Truth In Lending Act (12 U.S.C. 1601, et seq.), the Real Estate Settlement Procedures Act (12 U.S.C. 2601, et seq.) and the Secondary Mortgage Market Enhancement Act (12 U.S.C. 24 and various other locations in Title 12 and Title 15), their West Annotations and applicable USCAAN references. Finally, the HUD GSE Oversight Final Rule, published in 1995, (24 C.F.R. 81) was consulted to determine if HUD had attempted to make a market delineation to assist it in its role as judge of what constitutes an appropriate activity. This body of research is by no means comprehensive, but it is

substantial given the importance of the statutes to the point at hand and the limited resources and research tools we have had available to us.

## **II. An Approach to Statutory Construction**

The attached article by Justice John Paul Stevens places into context the effort to construe the GSE Charters and perhaps helps to explain the paucity of helpful references in the section on legislative history. The article is “The Shakespeare Canon of Statutory Construction” and the Justice notes that “Because Shakespeare’s plays are typically divided into five acts, I must, of course, discuss five canons of statutory construction.” The “Canons,” reduced to their essential elements, are as follows:

- Read the statute.
- Read the whole statute.
- Read the statute in its contemporary context, including using the dictionary.
- If you are “desperate”, consult the legislative history which is, “a debatable and complex subject, including subtopics such as the respective importance of committee reports, debates on the floor of Congress[and] comments manufactured by staff members to appease lobbyists.” And, finally,
- Use common sense.

“The Shakespeare Canon of Statutory Construction”  
University of Pennsylvania Law Review, Vol. 140 No. 4, April 1992

## **III. Summary of Results**

The statutes reviewed did not contain definitions of the terms, “primary mortgage market” or “secondary mortgage market” nor do they describe the functions of those markets with reference to the terms themselves. The Fannie Mae Charter does not include definitions and the Freddie Mac Act includes only twelve, none of which address the primary and secondary markets’ distinction. The inference is that, even in 1938 when the National Mortgage Act was passed creating Fannie Mae, the legislators believed the terms to be in common usage and not subject to dispute as to their meanings. This view has persisted in Congress. Congress enacted the Secondary Mortgage Market Enhancement Act (“SMMEA”) utilizing the term secondary market with no need to define that portion of the Act’s title. The same view prevails at HUD. The HUD GSE Oversight Rule contains some seventy definitions, however, HUD, which even defined itself, saw no need to define the primary mortgage market or the secondary mortgage market.

A full reading of the GSE Charters clearly indicates that Congress envisions that the primary and secondary markets are two different markets and intended to create

boundaries that would limit Freddie Mac and Fannie Mae (the “GSEs”) to a part of the secondary market. How Congress views the parameters of the secondary market can be determined by looking at the tasks they authorize the GSEs to perform, as discussed below. Also very helpful is the language added to the GSE Charters with the passage of FIRREA, expressly forbidding the GSEs from originating loans and providing interim or “warehouse” funding to primary market lenders.

There is useful definitional language in RESPA, particularly its definition of what constitutes settlement practices, including loan origination (everything from the application stage to funding). As described below, the RESPA definition of settlement services and loan origination is broad. As a matter of common sense, those are clearly primary market functions. While RESPA does not pertain specifically to the GSEs, this important and very visible statute represents contemporaneous Congressional understanding of what is viewed as loan origination, which, as noted above, Fannie Mae and Freddie Mac expressly are precluded from doing.

The legislative history reviewed also reflected that the words “primary” and “secondary” are used as commonly understood terms not requiring definition or parsing. Absent a clear statement in both House and Senate official committee reports, which I did not find on the point in question, legislative history is weak as a support for statutory interpretation of ambiguous language. It never overrules the plain words of a clear statute. While the GSE Charters may not be as explicit as they could be, at the least they clearly envision boundaries on the GSEs and Congress repeatedly has confirmed its intent that there be boundaries on the GSEs.

#### **IV. The GSE Charters: Two Markets in Mind**

To provide some insight into Congressional intent that the GSEs should be confined to the secondary market and what that term means, the GSE Charters have been examined and some particular sections are quoted and discussed. While each section taken alone may not be sufficient to clarify Congressional intent, when read together they form pieces of a puzzle that begins to take shape.

The first section of the GSE Charters specifies their mission. The mission statement was rewritten in 1992 so it reflects recent Congressional thinking on the roles of the GSEs. It reads as follows:

The Congress declares that the purposes of this subchapter are to establish secondary market facilities for residential mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible, and to authorize such facilities to---

- (1) provide stability in the secondary market for residential mortgages;
- (2) respond appropriately to the private capital market;

- (3) provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low-and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;
- (4) promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- (5) manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the residential mortgage market and minimum loss to the Federal Government.

See: 12 U.S.C. 1716 (underlining added)

While the purpose of restating the GSEs' mission was to clarify that they have an affirmative obligation to facilitate the financing of affordable housing, Congress could have used the opportunity to eliminate or subdue the references to the "secondary market." In fact the introductory paragraph remained unchanged and in the subparagraphs the word "secondary" appears twice rather than once in the then existing version.

A subsequent section in the GSE Charters strongly suggests the boundaries Congress intended to set. It is aptly captioned, "Secondary market operations" and reads in pertinent part as follows:

Section 1719. Secondary market operations

- (1) ...the corporation shall be confined, so far as practicable, to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors...
- (2) The volume of the corporation's lending activities ...(a) should be consistent with the objectives that the lending activities should be conducted on such terms as will reasonably prevent excessive use of the corporation's facilities...The corporation shall not be permitted to use its lending authority (i) to advance funds to a mortgage seller on an interim basis, using mortgage loans as collateral, pending the sale of the mortgages in the secondary market; or (ii) to originate mortgage loans.

12 U.S.C. 1719 (underlining added)

Subparagraph (a) (1) predates subparagraph (a) (2) which was rewritten with the enactment of FIRREA in 1989. While examining this section, Congress evidently intended to retain the language pertaining to the investment quality of the mortgages in which the GSEs should invest, "so far as practicable." Congress does not explain further what it means by investment quality other than to refer to what private institutional mortgage investors would find meets their standards. However, unless one believes that Congress accepted the cynical proposition that anything anyone will invest in is, by definition "investment quality," then the conclusion must be drawn that some standard of prudent investment is placed on the GSEs in the GSE Charters.

In a different context, Congress attempted in FIRREA to define what it intended as "investment grade" for savings and loans prohibited from making investments in non-investment grade corporate debt securities. 12 U.S.C. 1831 (e) (d). An "investment security" is defined as one rated in one of the four highest rating categories by at least one nationally recognized statistical rating organizations.

Whether their current activities in the subprime market would be considered "investment quality" is a legitimate question. The GSEs justify these activities as necessary to achievement of their affordable housing goals but the mission statement cited above indicates only that their affordable housing investments may result in a lower rate of return, not a risky investment. Certain subprime investing may exceed the GSEs' authority although that does not seem to be the concern of their regulator. HUD sent to the Hill a draft of a rule the agency wants to propose that would increase the GSEs' affordable housing goals. The draft states in part,

"...There is ample room for further enhancement of both GSEs' roles in the A-minus market. A larger role by the GSEs could help standardize mortgage terms in this market, which would lead to lower interest rates....The GSEs, along with primary lenders and private mortgage insurers, have been making efforts to reach out to these underserved portions of the markets. However, more needs to be done, and the proposed increases in the housing goals are intended to encourage additional efforts by Fannie Mae and Freddie Mac." 24 CFR Part 81 p.34, 37

Thus, there is a tension between the GSE Charter Acts' safety and soundness goal mandating that mortgages purchased should be of investment quality and the goal of providing more affordable housing, both goals enacted by Congress. But, in fact, the existence of these goals goes to the nature of the GSEs as creatures of statute with boundaries contained therein.

Subparagraph (a) (2) contains even more language setting boundaries on the GSEs. It states expressly that the GSEs should do their business so as to prevent “excessive use” of the GSEs’ facilities. With their active pursuit of “double digit earnings” increases, their aggressive expansion into subprime lending and their ownership of half the mortgage market, it would seem that concern about “excessive use” is low on the part of the GSEs. The “excessive use” language was in the GSE Charters prior to the rewrite of subparagraph (a) (2) and Congress chose in its redraft to include it.

More to the exact point of this paper, the language in subparagraph (a) (2) (A) and (B) goes directly to the heart of the industry’s concern and it is very clear. The GSEs are expressly prohibited from advancing funds against mortgages prior to the sale of the mortgages “in the secondary market.” Common sense would support the conclusion that the secondary market is the market in which mortgages are sold after they are originated and that warehouse lending cannot be undertaken by the GSEs. To further expand on its limitations to the GSEs’ roles, Congress adds expressly that the GSEs are forbidden “to originate mortgage loans.” Lest there be some credible doubt as to what Congress means by “originate,” the contemporaneous definition of “origination” contained in RESPA is discussed below and encompasses the process from application to funding. Taken together, the prohibition from interim, or warehouse, lending and the specific prohibition from origination create a kind of firewall between the agencies and the process of loan underwriting and funding that takes place prior to loan origination. Even the early funding programs of the GSEs, such as the Fannie Mae “As Soon As Pooled” program must be conducted on the GSE side of the firewall. While lenders can receive funding on the loans they deliver to Fannie Mae prior to the settlement date on the MBS, the loans the lenders submit through MORNET must be closed loans.

In conclusion regarding the GSE Charters, the GSEs have broad powers to buy, sell, service, deal in, lend on the security of and issue securities backed by mortgages when they enter the secondary market and after origination. This would suggest that the secondary market begins certainly after origination. This leaves unclear whether mortgage transfers among subsidiaries should be considered primary or secondary market functions and perhaps the existence of tax consequences could be helpful to this analysis. However, that aspect of primary versus secondary market delineation does not impact the analysis as to the GSEs.

## **V. RESPA: Congressional Definition of Mortgage Origination**

The Real Estate Settlement Procedures Act (RESPA) was enacted by Congress to increase disclosure to homebuyers and to prevent abusive practices that could occur during settlement, such as kickbacks, misleading of consumers, imposition of unconscionably high escrow requirements and the requirement that the homebuyer use a designated title company. While not directly related to the GSE Charters, RESPA is a prominent statute in housing law that has been repeatedly examined and on occasion revised. As such, its definitions can be used to establish the accepted understanding of

the word “origination” as used by Congress when it added the constraint to the GSE Charters that the GSEs not be allowed to originate mortgages. (See Justice Stevens’ Third Canon, above.)

The term “settlement service” is defined in the statute to include:

Any service provided in connection with a real estate settlement including, but not limited to, the following: title searches, title examinations, the provision of title certificates, title insurance, services rendered by an attorney, the preparation of documents, property surveys, the rendering of credit reports or appraisals, pest and fungus inspections, services rendered by a real estate agent or broker, the origination of a federally related mortgage loan (including, but not limited to, the taking of loan applications, loan processing, and the underwriting and funding of loans), and the handling of the processing and closing or settlement.(Underlining added)

12 U.S.C. 2602(3). The Housing and Community Development Act of 1992 included the underlined language that added the “origination” of mortgage loans within the “settlement service” definition. Based on Canon Five of Justice Stevens’ article, stating that common sense should be applied to statutory construction, it would be difficult for any party to argue against the premise that what is viewed as “settlement services” is a partial laundry list of primary market functions.

Focusing on the parenthetical that elaborates on “origination,” Congress states in the statute that it includes at least (1) taking loan applications, 2) processing the loan, 3) underwriting, and 4) loan funding. When that understanding is juxtaposed against the GSE Charter Acts’ prohibition from warehousing lending or “origination,” this is a very strong indication of how Congress thinks about the difference between the primary and secondary markets. Given the close proximity in time between the passage of the Housing and Community Development Act of 1992 and the passage of FIRREA in 1989, the RESPA language with its expressly non-exhaustive list of examples of origination activities, is persuasive evidence of what Congress thought of as “origination” as the term is used in the GSE Charters. This is the contemporary context for the use and understanding of the term (Canon Three of Justice Stevens).

RESPA has been interpreted extensively in regulations promulgated by HUD. At 24 C.F.R. 3500.5, HUD defines the coverage of RESPA and defines “Secondary market transactions” as follows:

*A bona fide* transfer of a loan obligation in the secondary market is not covered by RESPA...In determining what constitutes a *bona fide* transfer, HUD will consider the real source of funding and the real interest of the funding lender. Mortgage broker transactions that are table-funded are not

secondary market transactions. Neither the creation of a dealer loan or dealer consumer credit contract, nor the first assignment of such loan or contract to a lender is a secondary market transaction.

The HUD regulations for RESPA have been further interpreted by the courts and the approach seems to be a literal one. Where the lender is the real source of the money, even if a subsequent secondary market transaction is anticipated and agreed to regarding terms, the loan is made in the primary market and is subject to RESPA. Chandler v. Norwest Bank Minnesota, Nat. Ass'n, 137 F.3d 1053 (8<sup>th</sup> Cir. 1998)

## **VI. Legislative History**

A substantial, but by no means complete, review of the available legislative history of pertinent statutes was conducted as described above under “Scope of Research.” It is noteworthy that the history of the original Fannie Mae Charter, the National Mortgage Act, is not included. Obtaining that history, if it exists, demands more time and resources than were available for this paper. For legislative history from more than half a century ago, laborious searches of microfiche or possibly the Library of Congress would be required.

Over the years since enactment of the National Mortgage Act in 1938, Congress has heard testimony from representatives of all sectors of the mortgage industry. Those individuals use the terms “primary” and “secondary” mortgage markets and on occasion they furnish Congress with general definitions of the terms. As an example, at a 1991 hearing before the Subcommittee on Consumer and Regulatory Affairs of the Committee on Banking, Housing, and Urban Affairs in the Senate on redlining and the secondary markets, John Ols, representing the U.S. General Accounting Office stated that,

“As you know, Mr. Chairman, secondary mortgage market agencies buy and sell mortgage loans or securities backed by mortgage loans. By purchasing home loans, the secondary mortgage market agencies spread financial risk and provide liquidity to primary lenders, thereby making additional credit available to qualified borrowers.

These agencies are not primary lenders and have no direct contact with borrowers. They do not originate mortgage loans; rather, they purchase loans from lenders or guarantee securities based on the loans. However, the agencies do provide guidance to lenders on the types of loans they will buy and the documentation required. Many lenders accept these as standards for loans they originate.”

This is a general definition of the separation of the markets but it is as close a delineation as experts seem to have made on the public record in the documentation searched. It is

similar to other general definitions and probably reflects Congressional understanding of the difference between the primary and secondary markets.

## **VII. Conclusions**

The research done did not reveal any clearcut answers. There is no place in the record examined where Congress in statute or legislative history has done an exhaustive list of the functions of the primary or the secondary markets. The RESPA definition of “settlement service” containing its parenthetical on origination comes closest to providing a list of functions of primary market participants. The parenthetical following the reference to “origination” is helpful to the analysis by including among origination functions loan application, processing, underwriting and funding of loans. It is particularly helpful in view of the express prohibitions in the GSE Charters against their originating mortgages.

However, there is no doubt that from the enactment of the National Mortgage Act and, over the years, in revising the GSE Charters, Congress has intended to create boundaries for the GSEs. They are to operate in the secondary market where their purpose is to provide liquidity for lenders. They are not to originate loans. There is a limit to the size of the mortgages they can purchase or securitize. Congress recently rejected efforts by the GSEs to move into the mortgage insurance business. Senator Jake Garn, commenting on the Senate Banking Committee’s actions concerning the GSEs in connection with the hearings on redlining stated that,

“In light of affordable housing concerns, ...certain affordable housing advocates urged the Committee to redefine the purposes of Fannie Mae and Freddie Mac in order to redirect their activities and resources to address the housing needs of those currently assisted directly by federal housing subsidy programs. However, the Committee chose not to take this approach; choosing instead to ensure these GSEs maintained their current statutory role in facilitating mortgage credit for all homebuyers throughout the United States.”

Senator Garn’s statement indicates that Congress does think about the GSEs and thinks about what their roles should be in a manner that is not open-ended. They have a particular purpose: it is to provide liquidity, not to originate loans.