

MEMO# 1950

June 4, 1990

PUBLIC SECURITIES ASSOCIATION MODIFIES GUIDELINES RELATING TO CERTAIN HIGH COUPON GNMA SECURITIES

June 4, 1990 TO: MEMBERS - ONE PER COMPLEX NO. 21-90 RE: PUBLIC SECURITIES ASSOCIATION MODIFIES GUIDELINES RELATING TO CERTAIN HIGH COUPON GNMA SECURITIES _____ The Public Securities Association ("PSA"), a trade association whose membership includes mortgage-backed securities dealers, has announced that effective June 1, 1990, it is modifying its guidelines with respect to 30-year fixed- rate single-family GNMA securities that have a coupon rate of 11% or higher and were issued after January 1, 1989 but before July 1, 1990. The modification to the PSA's Uniform Practices specifies that such securities will not be considered good delivery for TBA (to be announced). A copy of the PSA's related press release is attached. The PSA's action is intended to address problems caused by the irregular prepayment characteristics of so-called "live free" mortgages, which may be included premium mortgage-backed securities pools. "Live free" mortgages are originated at an above-market coupon rate and allow borrowers to avoid making monthly mortgage payments for an agreed-upon period (for example, six months). At the end of such period, the lender refinances the mortgage by selling it into a mortgage pool at a slightly lower but still premium rate. This process is then repeated several times until a market interest rate is reached. At that point, the borrower takes over the monthly payments on the mortgage. In the interim the sale of the high-rate mortgage at a premium price enables the lender to cover service fees, make pass- through payments on mortgage securities and still retain a profit. For investors in mortgage-backed securities such as mutual funds, however, "live free" mortgages, because they are quickly prepaid, create the potential for significant losses. If a mortgage pool contains "live free" mortgages, the substantial prepayment risk more than outweighs the benefit to the investor of a premium coupon rate. Unfortunately, investors may not be able to assess their prepayment exposure accurately because the mortgage pool may appear to be seasoned. In light of our concern that PSA's actions might impact the pricing of those GNMA securities covered by the new guidelines, we contacted a number of organizations which provide mutual fund pricing services. We were informally advised that these organizations do not expect the PSA announcement to interfere with the routine pricing of these securities. We will keep you informed of developments. Frances Stadler Assistant General Counsel

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