

MEMO# 1937

May 23, 1990

GINNIE MAE TO PROHIBIT "LIVE FREE" MORTGAGES

May 23, 1990 TO: SEC RULES COMMITTEE NO. 30-90 INVESTMENT ADVISERS COMMITTEE NO. 17-90 RE: GINNIE MAE TO PROHIBIT "LIVE FREE" MORTGAGES

According to the attached Wall Street Journal article, the Government National Mortgage Association has decided to issue a letter to mortgage industry participants prohibiting so-called "live free" mortgages. "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. We will keep you informed of developments. Frances M. Stadler Assistant General Counsel Attachment