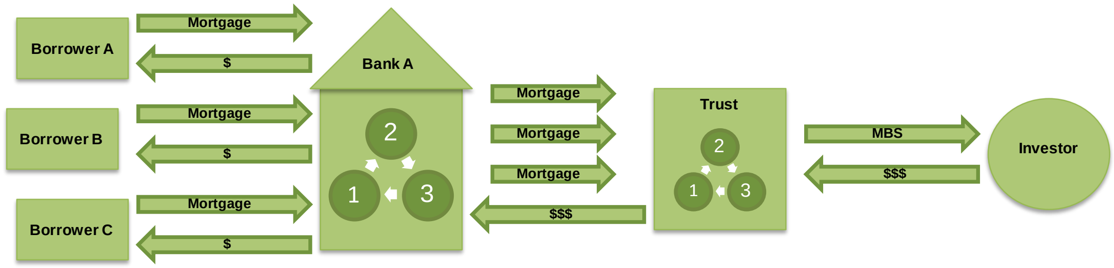
MBS

Overview

Mortgage-backed securities (MBS) are fixed-income securities that utilize mortgage loans as collateral and the source of funds for payments on the security. The creation of MBS begins with a financial institution such as a bank or credit union extending a mortgage loan to a borrower. The lender will then "pool" groups of loans with similar characteristics to create securities themselves, or sell the loans to issuers of mortgage-backed securities handle the aggregation of loans and pooling. The loans are sold to a trust, which will be the issuer of the MBS. Once securitized, the MBS can be sold to investors, or retained as investments.

Simplified MBS Transaction Diagram:



The process of securitization allows the lender to obtain funding quickly to make more loans, as opposed to waiting up to 30 years for the repayment of the original loan. Through the innovation of the to-be-announced (TBA) market, lenders can even sell their loans in a forward market prior to origination.[1] Securitization thus allows lenders to recycle their capital more quickly. At the other end, securitization allows investors in MBS to obtain specific levels of exposure to the risks and rewards of the mortgage markets. Out of the $14 trillion in mortgage loans outstanding, approximately $9 trillion are securitized in MBS, making the MBS market the largest sector of the fixed-income markets, even larger than U.S. Treasury debt.

The securities most commonly created from pools of mortgage loans are mortgage pass-through securities or participation certificates. As the name suggests, the issuer or servicer of mortgage pass-through securities collects monthly payments from the mortgagees whose loans are in a given pool and "passes through" the cash flow to investors in monthly payments that represent both interest and repayment of principal. As shown below, the pass-through rate to the investor is calculated by starting with the original coupon rate and removing the servicing fee and the guarantee fee (if any). The servicing fee is the fee paid to the entity that collects payments on the loans, commonly called the servicer. The guarantee fee is paid in securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae, which are government-sponsored enterprises (GSEs) or actual government agencies, in the case of Ginnie Mae, who provide a guarantee of payment of principal and interest on the securities to investors.

Coupon Rate	6.00%
Servicing Fee	0.25%
Gfee	0.30%
Pass-through rate	5.45%

MBS may also be issued as Collateralized Mortgage Obligations (CMOs) or Residential Mortgage Backed Securities (RMBS), which involves the allocation of payments of principal and interest into distinct 'tranches'. CMOs and RMBS are multiclass structures that give investors a choice of short, intermediate and long-term maturities, as well as varying levels of exposure to credit risk, allowing issuers to reach a wider range of investors than normally possible with a standard pass-through. CMOs and RMBS can have rather simple priorities of payments to different holders, or they can be very complex with allocation rules that relate to timing, credit losses, and a number of other variables.

[1] A factsheet explaining the TBA market may be found here: http://www.sifma.org/Issues/item.aspx?id=23775

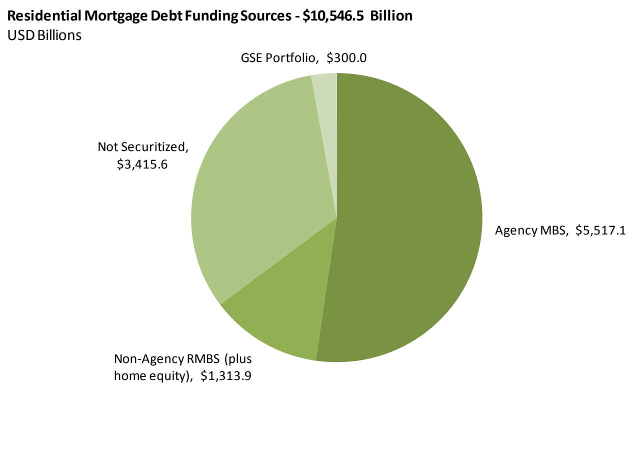
Agency MBS

MBS which are issued or guaranteed by a government-sponsored enterprise (GSE) such as Fannie Mae or Freddie Mac, or by the government agency Ginnie Mae are referred to as "agency MBS". At approximately $5.5 trillion, the agency MBS market is more than four times the size of the non-agency market. MBS issued by Ginnie Mae or one of the GSEs carries a guarantee of payment of the scheduled principal and interest due on the underlying mortgages even if payments on the underlying mortgages are not made by the borrowers. Ginnie Mae securitizes Federal Housing Administration-insured (FHA), Veterans Administration-guaranteed (VA) mortgages and Rural Housing Service-guaranteed (RHS) mortgages. As a government entity within the Department of Housing and Urban Development (HUD), timely payment of principal and interest on Ginnie Mae securities is guaranteed by the full faith and credit of the U.S. Government. The GSEs securitize so-called conventional mortgages that conform to certain size and underwriting criteria, and each agency provides its individual guarantee relating to timely payment of interest and principal for the securities it issues. The GSEs are considered to have an implicit guarantee of government backing, made somewhat more explicit, but not technically explicit, by actions taken by the U.S. Department of Treasury in 2008, opposed to the explicit guarantee which Ginnie MBS have.

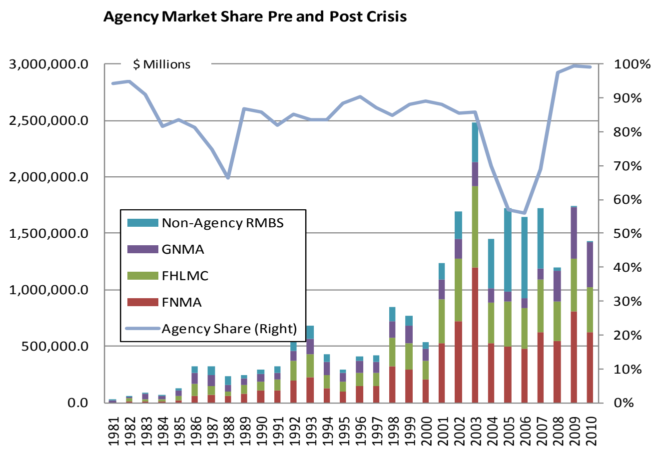
Non-agency MBS

Some private institutions, such as subsidiaries of investment banks, banks, financial institutions, non-bank mortgage lenders and home builders, also issue mortgage securities. Non-agency CMOs are generally referred to as RMBS. When issuing RMBS, they can use agency mortgage pass-through securities as "collateral"; however, their collateral may also, and in recent years primarily did, include different or specialized types of mortgage loans not eligible for the GSEs or Ginnie Mae programs. These so-called "private label" MBS are the sole obligation of their issuer. Sometimes issuers may contract with third-party insurers to guarantee all, or portions of an issuance of RMBS, and to the extent that private-label MBS use agency mortgage pass-through securities as collateral, their agency collateral carries the respective agency's guarantees. Private-label CMOs are usually assigned credit ratings by credit rating agencies based on their structure, issuer, collateral, economic outlook, guarantees, and a number of other factors.

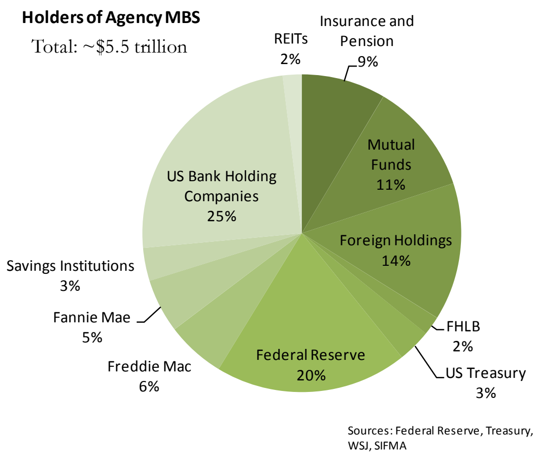
MBS MARKET STATISTICS

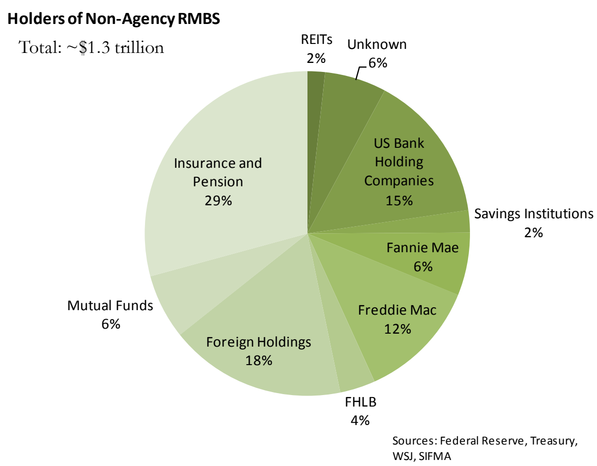


Source: Federal Reserve



Sources: Thomas Reuters, Federal Agencies, SIFMA





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