

Mortgage-Backed Securities

A man who owned a mortgage-backed “pass-through” security was pleasantly surprised when he received his first payment. “This is paying more than I expected,” he thought. Do you know why the security appears to be paying an amount above his expectation? You will know the answer when you are finished with this chapter.

Mortgage-backed securities are debt instruments, the payment on which is collateralized by a pool of mortgages—usually for single-family homes. The pool of mortgages is packaged by commercial banks, savings institutions, mortgage banks, and other institutions that make and/or service mortgage loans. Each mortgage in the pool is of the same type, same interest rate, and same maturity, and all the mortgages meet certain requirements of the particular government agency issuing the securities.

Pass-throughs. While there are many types of mortgage-backed securities, the most basic ones are called “pass-throughs” because the interest and principal from the mortgages are passed from the loan payer (the “mortgagor”) through the servicer of the loan to the investor. If a loan payment is not made, the loan servicer pays the investor that payment anyway and, in turn, gets payment from the guarantor of the securities. Interest is taxed as ordinary income.

The three main guarantors of mortgage-backed securities are Ginnie Mae (formerly known as the Government National Mortgage Association or GNMA), Fannie Mae (formerly known as the Federal National Mortgage Association or FNMA), and Freddie Mac (formerly known as the Federal Home Loan Mortgage Corporation or FHLMC). Ginnie Mae is a government agency and Ginnie Mae securities are the only mortgage-backed securities guaranteed by the U.S. government. It is *presumed* that Fannie Mae and Freddie Mac securities also would be backed by the federal government if they could not make their payments. This

presumption proved true during the recent recessionary period. The degree to which it may remain true in the future is unknown.

Mortgage-backed securities play an important part in financing homes throughout the country. By “securitizing” mortgage loans, capital from investors all over the country is used to effectively buy these loans. This allows more loans to be made in a region that otherwise might be short of capital. In other words, “securitizing” loans increases the availability and decreases the cost of mortgage loans throughout the nation.

Many investors like pass-through securities because they pay somewhat higher interest rates than Treasury securities. In addition, like mortgage payments made to a bank, these securities make payments each month to investors. You should note, however, that each payment consists of part interest and part principal, not interest only as with regular bonds. Therefore, the principal is *gradually* paid back, in contrast to U.S. Treasury securities, where the principal is *all* paid back at maturity. The amount of each monthly payment also differs from month to month as principal is paid off. For example, if a person sells his or her house, thereby paying off the mortgage, that mortgage principal then is paid to investors. So, in that month, the payment will be greater than in months where no “prepayments” (mortgage payments made before they are scheduled to be made) occur. And as total mortgage principal changes, the interest likewise changes.

Yields on mortgage-backed securities are estimated based on prepayment assumptions and called an “anticipated yield to maturity.” These assumptions recognize that mortgages normally do not exist their full term, which is why mortgage loan rates tend to follow the 10-year Treasury note rate. An *exact* yield-to-maturity cannot be determined because there is no way to know when homeowners are going to pay off their mortgages. Very few mortgages last their entire length because people move and therefore pay off their loan or refinance their mortgages.

Prepayment of mortgages is a risk to owners of these securities because mortgagees prepay when they refinance their mortgage. Refinancing occurs when mortgage rates go down, so any principal paid back to investors due to refinancing typically is received when rates are low. As a result, reinvestment of that principal will earn low rates. Because of this “prepayment risk,” when interest rates fall, prices of mortgage-backed securities usually do not go up as much as prices of regular bonds with similar maturities.

The minimum denomination for newly issued pass-through securities is \$25,000, although smaller amounts can be bought in the secondary market from older securities that already have had some of the principal paid back. Interest from mortgage-backed securities is fully taxable at the state, local, and federal levels.

Incidentally, by now you should know that the reason the man in the example given at the beginning of this section was getting larger payments than he expected is that he was getting back part of the principal; the payments were not all interest, as he assumed. Clearly, he did not understand that with mortgage-backed securities, each payment consists of part interest and part principal.

Bank Products

Traditionally, commercial banks have offered fixed-rate savings instruments to their customers—*savings accounts* or *certificates of deposit (CDs)*. Savings accounts allow withdrawals at any time without penalty, making them a ready source of cash for emergencies. Accounts are insured by the Federal Deposit Insurance Corporation (FDIC), an agency of the U.S. government, for up to \$250,000 per account owner; however, savings accounts also pay a low rate of interest, with each individual bank determining what rate it is willing to pay.