Mortgage-Backed Securities: Primer for Insurers & Risk Pools

Mortgage-Backed Securities (MBS) are bonds that derive its value from a pool of mortgages. These securities can be structured like a traditional asset-backed security, but are also commonly separated *(derived)* into different tranches that offer investors various levels of credit risk and compensation.

Insurance companies and risk pools (that have the investment flexibility to do so) consider mortgage-backed securities for their fixed income portfolio as they can potentially outperform corporate or government bonds, while also possibly offering less risk than other asset-backed securities.

Mortgage-Backed Securities fall into three types/categories based on the issuer:
Agency MBS | **Commercial MBS** | **Residential MBS**

Asset-Backed Security:
An asset-backed security is a bond made up of illiquid assets (excluding mortgages) that have been packaged and sold to investors. This includes assets such as car loans, student loans, leases, credit card debt, royalties, etc.

Typically, issuers of asset-backed securities are lenders. The interest and principal payments lenders receive from borrowers are funneled to investors of the asset-backed security.

For insurers, asset-backed securities potentially offer higher yield (relative to government bonds) and greater portfolio diversification.

Agency Mortgage-Backed Securities

U.S. Agency MBS are issued by one of three federal agencies:

- **Government National Mortgage Association** *(aka Ginnie Mae)*
- **Federal National Mortgage Association** *(aka Fannie Mae)*
- **Federal Home Loan Mortgage Corporation** *(aka Freddie Mack)*

Technically, Fannie Mae and Freddie Mack are government-sponsored enterprises, but are treated as federal agencies under the MBS-scope.

Given MBS are backed by the full faith and credit of the U.S. government, there is little to no default risk.

Pass-Through Securities:
Agency MBS are 'pass-through' securities, where any principal and interest payments are first collected by the Federal Agency (or other related servicer).

For insurers and risk pools, agency MBS can generally offer higher (potential) yields when compared to U.S. Treasuries, with relatively high liquidity. Of course, given the nature of the underlying mortgage exposure, investors are subject to prepayment risk.

Within this asset class are U.S. Agency Collateralized Mortgage Obligations (CMO), which are a type of Agency MBS where securities are separated into tranches offering different levels of risk and compensation investors can choose from. Any principal and interest payments made by borrowers of the underlying mortgages are directly distributed to the various tranches of the CMO.

With Agency CMOs, while the default risk remains minimal, the potential benefits and risks associated with the housing market persist.

Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities are fixed income bonds that derive its value from mortgages on commercial properties. Loans packaged within CBMS are typically for office buildings, hotels, malls, factories, etc.

CMBS are separated into tranches offering different levels of credit risk and compensation. As terms on commercial mortgages are generally fixed, CBMS can potentially offer less risk than other asset-backed securities.

In addition to potentially offering higher returns than corporate or government bonds, CMBS can provider insurers and risk pools with diversification and an alternative method to investing in the real estate market, while offering a (typically) consistent return rate.

The more common method of investing in the real estate market is through Real Estate Investment Trusts (REIT), a ‘risk asset‘ class, which do not offer a guaranteed return rate and have much greater volatility.

It is important to note that not all CMBS tranches are investment-grade. The default risk is also greater than that of Agency MBS, given CMBS are not backed by the U.S. Government.

CMBS Note:
CMBS often get confused with subprime residential collateralized mortgage obligations that contributed to the 2008 Financial Crisis, however they are not the same.

Unlike collateralized mortgage obligations, CMBS are ‘pass-through’ securities, where any principal and interest payments made by borrowers on the underlying mortgages are first collected by the issuer. After deducting associated fees, the issuer then passes payment onto investors of the CMBS

Residential Mortgage-Backed Securities

Residential MBS, also called “Non-Agency Collateralized Mortgage Obligation” (CMO), are a type of mortgage-backed security issued by a private institution, such as an investment bank, and derived of mortgages for residential properties.

Like CMBS, CMOs are separated into tranches offering different levels of risk and compensation and can provide insurers and risk pools with an alternate method of investing in the real estate market, while offering a (typically) consistent return rate.

However, unlike CMBS, any principal and interest payments made by borrowers of the underlying mortgages are distributed to the tranches of the CMO, instead of being funneled directly to investors.

Due to their structure, non-agency CMOs can sometimes offer less pre-payment risks compared with CMBS (although any security with underlying residential mortgage exposure is subject to prepayment risk). CMOs also provide exposure to both the benefits and downsides associated with housing markets and the mortgage industry.

Key Terms

Tranches: There are two general types of CMO tranches

Sequential-Pay Tranches
Tranches have different priority claims on the collateral's principal, meaning the tranche with higher priority has its principal paid entirely before the next class begins receiving payments

Planned Amortization Class Tranches (PAC)
Two tranches are formed: The "PAC Bond" and the "Support Class," which are formed by generating two monthly principal payment schedules.

The PAC bond is then set up so that it will receive a monthly principal payment based on the minimum principal from the two principal payments. The PAC bond is designed to have no prepayment risk. The support bond, on the other hand, receives the remaining principal balance and is therefore subject to prepayment risk.

Types of Residential Mortgages:
Residential mortgages can be divided into prime and subprime mortgages

Prime Mortgages
Prime mortgages include mortgages that meet the agency's underwriting standards and/or credit quality standards.

Subprime Mortgages
Subprime mortgages include mortgages with low credit ratings.

For More Information:

Alton Cogert, CFA
President & CEO
Strategic Asset Alliance
acogert@saai.com

Dan Smereck
Managing Director & Principal
Strategic Asset Alliance
dsmereck@saai.com

Nathan Simon
Director
Strategic Asset Alliance
nsimon@saai.com