Mortgage-backed Securities & Collateralized Mortgage Obligations: Prudent CRA Investment Opportunities

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Mortgage-backed securities (MBS) have become a popular vehicle for financial institutions looking for investment opportunities in their communities. CRA officers and bank investment officers appreciate the return and safety that MBSs provide and they are widely available compared to other qualified investments.

Mortgage securities play a crucial role in housing finance in the U.S., making financing available to home buyers at lower costs and ensuring that funds are available throughout the country. The MBS market is enormous with the volume of outstanding MBSs exceeding $3.8 trillion. Investors include corporations, banks and thrifts, insurance companies and pension funds. MBSs are popular because they provide a number of benefits to investors including liquidity, yield and capital management flexibility. CRA officers should understand these benefits to enable them to work with bank investment officers.

Understanding MBSs

An MBS is similar to a loan. When a bank purchases an MBS, it effectively lends money to the borrower/homeowner who promises to pay interest and to repay the principal. The purchase effectively enables the lender to make more mortgage loans. MBSs are known as “fixed-income” investments and represent an ownership interest in mortgage loans. Other types of bonds include U.S. government securities, municipal bonds, corporate bonds and federal agency (debt) securities.

Here is how MBSs work. Lenders originate mortgages and provide groups of similar mortgage loans to organizations like Freddie Mac and Fannie Mae, which then securitize them. Originators use the cash they receive to provide additional mortgages in their communities. The resulting MBSs carry a guarantee of timely payment of principal and interest to the investor and are further backed by the mortgaged properties themselves. Ginnie Mae securities are backed by the full faith and credit of the U.S. Government. Some private institutions issue MBSs, known as “private-label” mortgage securities in contrast to “agency” mortgage securities issued and/or guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae. Investors tend to favor agency MBSs because of their stronger guarantees, better liquidity and more favorable capital treatment. Accordingly, this article will focus on agency MBSs.

The agency MBS issuer or servicer collects monthly payments from homeowners and “passes through” the principal and interest to investors. Thus, these pools are known as mortgage pass-throughs or participation certificates (PCs). Most MBSs are backed by 30-year fixed-rate mortgages, but they can also be backed by shorter-term fixed-rate mortgages or adjustable rate mortgages.

Liquidity

Agency MBSs are extremely liquid. Because there is a large amount of outstanding mortgage securities and investors, there is a sizable and active sec

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**U.S. Fixed Income Market**

**Outstanding Bond Debt as of June 30, 2001**

Total = $17.7 Trillion

- Money Market $2.6 – 15%
- Corporate $3.6 – 20%
- Municipal Securities $1.7 – 10%
- U.S. Government Agency $2.0 – 11%
- U.S. Treasury $2.8 – 16%
- ABS $12 – 7%
- Mortgage-Backed Securities $3.8 – 21%

Source: The Bond Market Association Estimates
ondary market. Investors can easily buy, sell or borrow against MBSs. The liquidity of MBSs is enhanced by the relative homogeneity of the underlying assets, compared with corporate bonds (different issuers, industries and credit) or municipal bonds (state issued, authority issued, revenue bond, etc.).

YIELD
Mortgage-backed securities offer attractive risk/return profiles. There are higher yielding fixed-income investments in the marketplace, but they have greater credit risk. MBSs have traditionally provided returns that exceed those of most other fixed-income securities of comparable quality. MBSs are often priced at higher yields than Treasury and corporate bonds of comparable maturity and credit quality.

CAPITAL MANAGEMENT
For banks and thrifts, agency MBSs are considered bank-qualified assets. They can be held in higher concentration than other assets. In addition, the risk-based capital treatment of agency MBSs is superior to that for corporate and many municipal bonds. For example, depositories holding Ginnie Maes do not have to hold risk-based capital (RBC) against the assets and they have to hold just 20% of the RBC requirement for Freddie and Fannie MBSs. This contrasts with a 100% RBC requirement for corporate bonds and up to 50% for municipal bonds. Finally, there is an active repurchase (“repo”) market for MBSs that enables institutions to earn increased income from their investments by lending in the repo market.

Supporting CRA Objectives with MBSs
The affordable housing goals that the U.S. Department of Housing and Urban Development (HUD) set for Freddie and Fannie (e.g., 50% of their business must be to low-and-moderate income (LMI) borrowers) help depositary institutions to achieve their LMI objectives through MBS investments.

Usually, MBSs are comprised of loans scattered throughout the country to borrowers with varying incomes. To support CRA objectives, affordable housing MBSs are created with loans to LMI borrowers in specified geographies. As a “qualified investment,” the MBS should include loans in an institution’s assessment area or in a “statewide or regional area that includes the assessment area.” At least 51% of the dollars in the MBS should be in loans to LMI borrowers, although most total 100%. In addition, a financial institution that, considering its performance context, has adequately addressed the community development needs of its assessment area(s) will receive consideration for MBSs with loans located within a broader statewide or regional area. “Examiners will consider these activities even if they will not benefit the institution’s assessment area(s).”

The Federal Financial Institutions Examination Council (FFIEC) issued an opinion letter (#794) indicating that targeted MBSs may receive positive CRA consideration. This has been reinforced by scores of CRA examinations. Moreover, as lending-related qualified investments, CRA-qualified MBSs assist “small banks” with their CRA performance by enabling an upward adjustment of their loan-to-deposit ratio.

CRA-qualified MBSs increase the supply of affordable housing. Freddie Mac’s Securities Sales & Trading Group (SS&TG) pays a premium to originators for the LMI loans that they provide, giving originators an incentive to create additional LMI lending opportunities in communities, which is the essence of the CRA. Bank purchases of MBS pools from Freddie Mac support this affordable housing initiative. Since more than 2/3 of mortgages are originated by companies whose loan officers work on commission and have an incentive to originate mortgages on expensive homes. SS&TG creates an incentive to originate LMI loans.

Here are reasons to consider MBSs as part of a CRA strategy:

➤ Payment of principal and interest is guaranteed
➤ Market rate return
➤ No management fees
➤ Favourable capital treatment
➤ Liquid investment - can be sold or borrowed against
➤ Flexible - can be tailored to bank’s assessment area and sold in varying amounts
➤ Low transaction costs
➤ Available everywhere—even in rural areas

Evaluating and Purchasing MBSs
Banks and other investors buy MBSs from securities dealers such as SS&TG, Freddie Mac’s in-house mortgage securities dealer operation. New MBSs usually sell at or close to their face value. However, MBSs traded in the secondary market fluctuate in price as interest rates change. When the price of an MBS is above or below its face value, it is said to be selling at a pre

1 Source: The Bond Market Association

2 FFIEC Question and Answer Document on CRA
Yield is the return expressed as an annual percentage rate. Unlike other fixed-income investments, MBS principal payments are made monthly and may vary due to unscheduled prepayments (e.g., refinancing or sale of the mortgaged home), which may also affect the amount and timing of MBS interest payments and MBS yields. Prepayment assumptions are factored into price and yield to compare the value of a mortgage security with other fixed-income investments.

As fixed-income securities, MBS prices fluctuate with changing interest rates: when interest rates fall, prices rise, and vice versa. Interest rate movements also affect prepayment rates of MBSs. When interest rates fall, homeowners refinance mortgages, and prepayment speeds accelerate. Conversely, rising rates tend to decrease the prepayment speed. An earlier-than-expected return of principal increases the yield on securities purchased at a discount. However, when an MBS is purchased at a premium, an earlier-than-expected return of principal reduces yield.

Each MBS has a coupon, which is the interest rate passed on to the investor. The coupon is equal to the interest rate on the underlying mortgages in the pool minus the guarantee fee paid to the agency and the fee paid to the servicer. The WAC is the weighted average of the mortgage note rates and it is often used by investment officers to compare MBSs. In analyzing a potential MBS investment, the length of time until principal is returned is important and the concept of a weighted-average life (WAL) is used. Average life is the average amount of time a dollar of principal is invested in an MBS pool. The most important measure used by investment officers to value investments is yield.

shorter cash flows than the CRA MBS pools would normally provide. This enables many banks to invest more in CRA CMOs than they would be able to in CRA MBSs. Additionally, the innovative and complex CMO structure enables banks to leverage investment in affordable housing from non-CRA regulated institutions, since the long cash flows are sold to pension funds and insurance companies. This approach is not routinely provided by private investors. Additionally, CRA CMOs provide all the previously mentioned compliance and investment benefits of CRA MBSs. While the economics of developing complex securities like CMOs generally require development of tranches usually exceeding $20 million, pieces of tranches may be sold. Nevertheless, CRA CMOs are not as readily available as CRA MBSs.

**SUMMARY AND CONCLUSION**

Both CRA MBSs and CRA CMOs meet the investment objectives of CRA ofﬁcers while providing a safe and sound strategy with market rate returns. Investors increase the supply of financing for affordable housing through these products by leveraging investment in affordable housing from non-depositories and by incenting loan originators. As with all CRA products, institutions should discuss their unique circumstances with their regulator to determine suitability.

**ABOUT THE AUTHOR**

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### REGULATORY OVERVIEW

**INVESTMENT TYPE: MORTGAGE-BACKED SECURITIES**

**Definition:** Mortgage originators can either (1) hold a new mortgage in their portfolio, (2) sell the mortgage to an investor or conduit, or (3) use the mortgage as collateral for the issuance of a security. A mortgage-backed security (MBS) is a pool of mortgages that represent the collateral for a security. The cash flow pattern associated with an MBS is based on the payment of the individual mortgage loans underlying the security. The ability of borrowers/homeowners to prepay part or all of the mortgage at any time creates uncertainty regarding cash flow (above and beyond possible delinquencies), so investors usually wish to be compensated for accepting the risk of unscheduled payments. A targeted MBS is a security collateralized by a pool of mortgages originated to borrowers/homeowners whose incomes are 80 percent or below area median income.

**CRA Applicability:** As a general rule, mortgage-backed securities are not qualiﬁed investments under the CRA because they do not have as their primary purpose community development as deﬁned in the CRA regulation. Nonetheless, mortgage-backed securities designed primarily to ﬁnance community development are qualiﬁed investments. These housing-related securities must primarily address affordable housing needs (including multifamily rental housing needs) in order to qualify. In addition, an institution may receive investment test consideration for purchases of these targeted mortgage-backed securities as long as they are not backed primarily or exclusively by loans that the same institution originated or purchased.
The mortgage-backed securities market also includes "private-label" mortgage securities issued by such as subsidiaries of investment banks, financial institutions, and real estate investment trusts - issue MBS not guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac. Collateralized Mortgage Obligations (CMO) is a multi-class security backed by a pool of mortgage pass-through securities and/or mortgage loans. CMOs were developed to offer investors a wider range of investment terms and level of risk than is available for mortgage pass-through securities. Tab 2 of 12. How Securitization Works. Mortgage-Backed Securities. Collateralized Mortgage Obligations (CMO). Corporate Notes and Bonds. Commercial Paper. Community Reinvestment Act (CRA)-Eligible Investments. Community Impact Mortgage-Backed Securities Program. Funding. Overview. This type of mortgage-backed security was developed to provide investors a greater range of time frames and a greater cash-flow certainty than previously offered by mortgage-backed, pass-through securities. The difference between a CMO and a pass-through security is that in a CMO structure, many different securities are created from pools of mortgages by redirecting the cash flows of principal and interest. The issuer collateralizes a pool of various class mortgage loans and creates a tranche. A collateralized mortgage obligation (CMO) is a type of complex debt security that repackages and directs the payments of principal and interest from a collateral pool to different types and maturities of securities, thereby meeting investor needs. CMOs were first created in 1983 by the investment banks Salomon Brothers and First Boston for the U.S. mortgage liquidity provider Freddie Mac. Unlike traditional mortgage pass-through securities, CMOs feature different payment streams and risks, depending on investor preferences. For tax purposes, CMOs are generally structured as Real Estate Mortgage Investment Conduits, which avoid the potential for "double-taxation". Collaborated mortgage obligation. Transcription. We've seen that an investment Mortgage-backed Securities (MBS): any kind of asset-backed security where the underlying assets are mortgages. May have one class (tranche), as in the case of pass-through securities, or many classes... Collateralized Debt Obligations (CDO): the underlying assets can be any kind of debt (bonds, mortgages, even other ABS). Always has multiple tranches with different priority of payments. An MBS with a CDO-like structure is called a CMO (collateralized mortgage obligation). A bank gives mortgage to a household => investment bank buys mortgages from banks => investment bank puts the mortgages into a new company (special purpose vehicle) => investment bank sells shares from the SPV to other investors. At this point several things are key Mortgage-backed securities, called MBS, are bonds secured by home and other real estate loans. They are created when a number of these loans, usually with similar characteristics, are pooled together. Collaborated mortgage obligations: Called CMOs for short, these are a complex type of pass-through security. Prepayment risk that acts much like call risk: You get your principal back sooner than the stated maturity, but the reinvestment opportunities are limited due to the inconsistent prepayment rates. There is also the risk that interest rates will go up, lengthening the estimated maturity (but not the stated maturity) of your MBS and creating more holding-period risk.