

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.

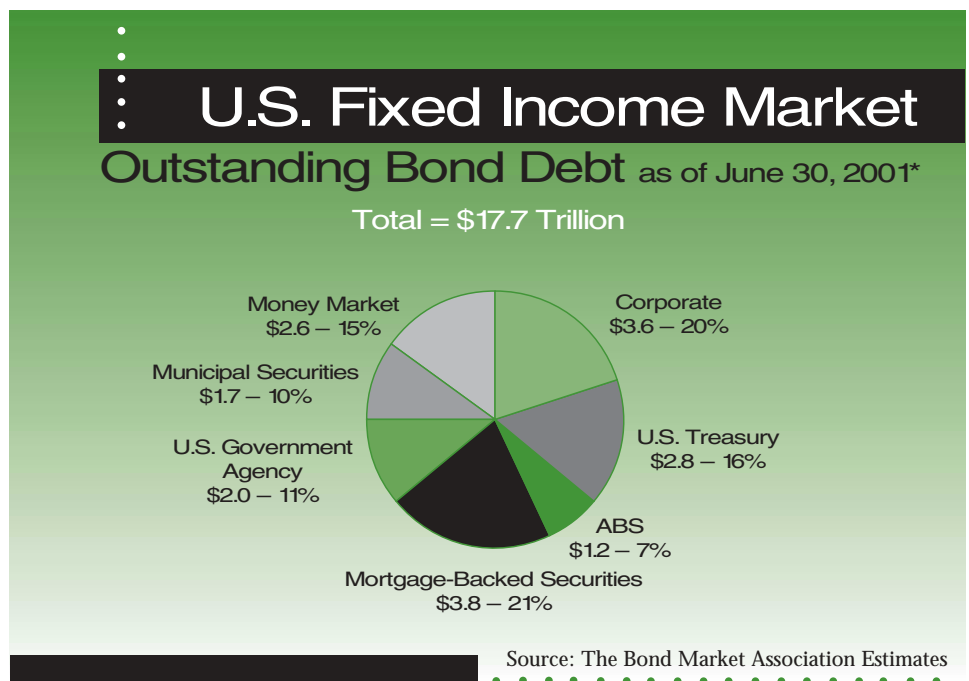
Here is how MBSs work. Lenders originate mortgages and provide groups of similar mortgage loans to organizations like Freddie Mac and Fannie Mae, which then securitize them. Originators use the cash they receive to provide additional mortgages in their communities. The resulting MBSs carry a guarantee 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



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.¹ 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 Ur-

ban Development (HUD) set for Freddie and Fannie (e.g., 50% of their business must be to low-and-moderate income (LMI) borrowers) help depository 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).”²

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
- Favorable 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*

mium or a discount, respectively. The price paid for an MBS is based on variables including interest rates, the coupon rate, type of mortgage backing the security, prepayment rates and supply and demand.

MBSs issued in book-entry³ form initially represent the unpaid principal amount of the mortgage loans. Freddie Mac and Fannie Mae MBSs issued in book-entry form are paid by wire transfer through the central paying agent, the Federal Reserve Bank of New York, which wires monthly payments to depository institutions. Depositories put the MBS in “held to maturity” or “available for sale” accounts, depending on their investment strategy. Some investors hold bonds until they mature, while others sell them prior to maturity. Buy-and-hold investors worry about inflation, which makes today’s dollars worth less in the future.

Bank investment officers analyze the economic value of MBSs using a number of terms, including “weighted-average coupon” (WAC), which is the weighted average of the mortgage note rates, and “weighted-average life” (WAL), which 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.

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 WAL is influenced by several factors, including the actual rate of principal payments on the loans backing the MBS. When mortgage rates decline, homeowners often prepay mortgages, which may result in an earlier-than-expected return of principal to an investor, reducing the average life of the investment. This can be thought of as an implied call risk. Investors are then forced to reinvest the returned principal at lower interest rates. Conversely, if mortgage rates rise, homeowners may prepay slower and investors may

find their principal committed longer than expected, which prevents them from reinvesting at the higher prevailing rates. This scenario can be thought of as extension risk.

COLLATERALIZED MORTGAGE OBLIGATION (CMO)

The prepayment uncertainty of MBSs led to Freddie Mac’s development of the collateralized mortgage obligation (CMO) in 1983. This more complex type of mortgage security helps compartmentalize prepayment risk and better addresses investment time frames and cash-flow needs. Since 1986, most CMOs have been issued in real estate mortgage investment conduit (REMIC) form for tax purposes. The terms are now used interchangeably.

MBSs are pooled to create CMOs. In structuring a CMO, an issuer distributes cash flow from the underlying collateral over a series of classes called tranches, each having average lives designed to meet specific investment objectives. As the payments on the underlying mortgage loans are collected, the CMO issuer usually first pays the coupon rate of interest to the bondholders in each tranche. All scheduled and unscheduled principal payments go first to investors in the first tranches. Investors in later tranches do not start receiving principal payments until the prior tranches are paid off. This basic type of CMO is known as a *sequential* CMO.

Almost all CRA MBSs are comprised of 30-year fixed-rate mortgages. Some bank investment officers find the average life of 30-year MBSs too long (since bank funding sources tend to be shorter). These investors can support affordable housing by purchasing a **CRA CMO** tranche, which is structured with CRA MBS pools to provide

3 *An electronic issuance and transfer system for securities transactions*

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 exceed-

ing \$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. **CI**

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.