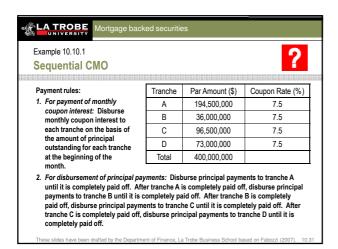
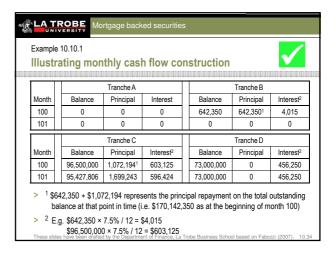
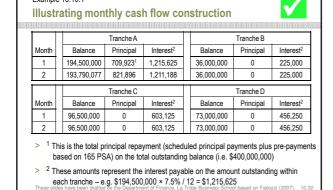
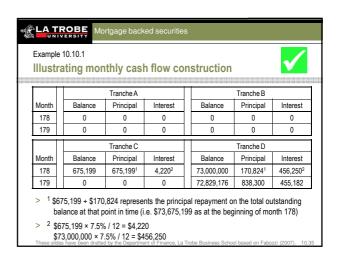


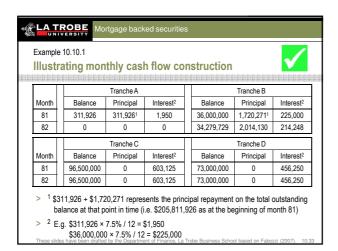
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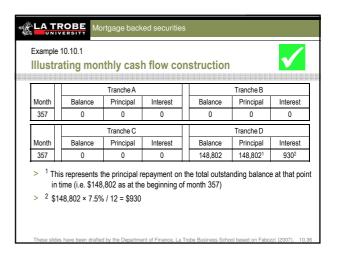














Mortgage backed securities

Focus on prepayment risk and the global financial crisis

- > Fabozzi textbook focuses on prepayment risk as being the primary concern in relation to mortgage passthrough securities and CMOs
 - Likely due to the buoyant housing market in the US in the last decade or so, with low default rates due to rising house prices and home-owners being able to re-finance using the equity in their homes
 - This is also correct in relation to securities issued by Ginnie Mae, which carry the full faith and credit of the US government.
- Credit risk also became a prominent concern during the sub-prime mortgage crisis which preceded the recent global financial crisis
 - Particularly in relation to Fannie Mae and Freddie Mac
 - Substantial defaults on 'sub-prime' mortgages which impacted on their cash flows, and their ability to meet the payment obligations on mortgage passthrough securities that they created by pooling mortgages
 - Led to significant bail-out funding being provided by the US Government
- These slides have been drafted by the Department of Finance, La Trobe Business School based on Fahozzi (2007), 10



Mortgage backed securities

Goldman Sachs CDO and SEC indictment announced in 2010

- Relates to a collateralized debt obligation (CDO), comprised mainly of mortgages, named Abacus 2007-AC1, that was issued in April 2007
 - It was indicated that the mortgages were pooled by ACA, a collateral manager, which helped the CDO obtain a AAA credit rating from Moody's and S&P. This CDO was then promoted to Goldman Sachs' clients
 - The indictment claimed that this security was actually structured by John Paulson, a hedge fund manager, and that it primarily comprised less-than investment grade (or 'junk') mortgage assets selected by Paulson
 - Paulson then short-sold the CDO expecting it to fall in value or default, and Goldman Sachs also entered into credit default swap transactions to provide insurance protection against the CDO defaulting
 - By January 2008, 99% of the CDO loans had been downgraded, and the Paulson hedge fund made approximately \$1 billion from this fall in value of the CDO

These slides have been drafted by the Department of Finance, La Trobe Business School based on Fabozzi (2007). 10.3