Mortgage Backed Securities & Asset Backed Securities

Mortgage backed securities are basically bonds that investors lend money to, this bond is a mortgage, and the bank issues these mortgages to their customers. However, the issued mortgages usually have a maturity date, often times 30 years, thus banks have to wait 30 years before they get back their principal amount plus the full interest that the bank charges their customers. In order to attain more capital gain, the bank decided to sell the stream of principal payments and interest to investors, thus they have more money to lend out and also is a transfer of risk from the bank to their investors. How a regular mortgage becomes a mortgage backed security MBS is that the bank would pool or join a customer's mortgage to many other of the bank's customers' mortgages, this pool of assets is then sold to investment banks and firms in the form of a single bond. The investment banks or firms divides this pool of loans by its quality or rating, and sells it to investors. So the payment you make towards your house? That money goes to investors indirectly, and not the bank, the bank acts as the middleman between their customer and the investors.

There are two types of MBS, the **pass through** and the **collateralized mortgage obligations**. Pass throughs are structured as a trust and in which the mortgage payments collected by the bank is passed through to the investors. Adjustable rate mortgage and fixed rate mortgages are pooled in together to create pass throughs. Average life of pass throughs are usually lower or shorter than the maturity date depending on the principal payments of the mortgages. CMOs are like CDOs, but with mortgages only. The pool of mortgage loans are sliced into pieces (tranches), each piece is given a credit rating, and each piece is bought by investors depending on which risk factor they choose to be on. For example, senior tranches have a lower risk of default but also lower rate of return as opposed to junior tranches which have a higher risk of default but higher rate of return.

An **asset backed security ABS** is pretty much itself like MBS, instead of mortgages, it is backed by a pool of assets generally not including mortgages, such as student loans, credit card and car loans. CDOs (Collateralized Debt Obligations) are a type of ABS, but will sometimes pool in mortgages as well.

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