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SECURITIZATION

FDMA 307 Fixed Income Investments

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WHAT IS SECURITIZATION?

▪ Converting illiquid income-generating assets into marketable securities

▪ Traditional corporate bonds:

Investment  
(cash today)

Projects

Future cash flows

Company  
(has + NPV projects)

Future cash flows

Purchase bonds  
(cash today)

Bond Investors

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WHAT IS SECURITIZATION?

▪ Converting illiquid income-generating assets into marketable securities

▪ Securitization:

Company  
(owns assets)

Illiquid assets

Asset sale  
(cash today)

Assets will produce cash flows

Trust or SPV

Future cash flows

Purchase bonds  
(cash today)

Bond Investors

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WHAT IS SECURITIZATION?

- What assets can be securitized?
- Types of securities created
  - Mortgage-backed securities (MBS)
    - Residential mortgage-backed securities (RMBS)
      - Agency RMBS
      - Non-agency RMBS
    - Commercial mortgage-backed securities (CMBS)
  - Asset-backed securities (ABS)
  - Collateralized debt obligations (CDOs)

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RESIDENTIAL MORTGAGE  
BACKED SECURITIES

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PRIMARY MARKET  
FOR MORTGAGES

You want a loan to buy a new home



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# PRIMARY MARKET FOR MORTGAGES

You want a loan to buy a new home



PROMISE TO PAY BACK WITH INTEREST FOR 30 YEARS

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# MARKET FOR MORTGAGES

- Issues in the primary market for mortgages in the 1960s/1970s
  - Mortgages used to be financed by local banks using local deposits
  - Excess demand
  - Interest rate risk
- Improving secondary market liquidity as the fix
  - Don't Mess With The Mac*
  - We pay cash for mortgages!



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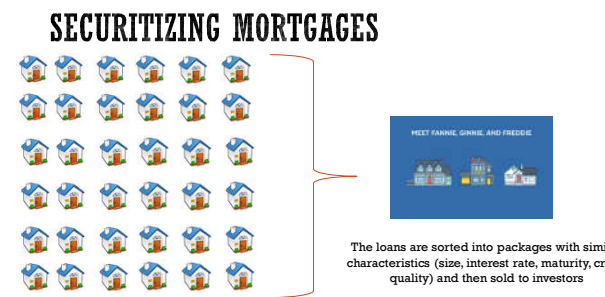
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# SECURITIZING MORTGAGES



The loans are sorted into packages with similar characteristics (size, interest rate, maturity, credit quality) and then sold to investors

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- Cash flows are *passed through* the bank to the investors

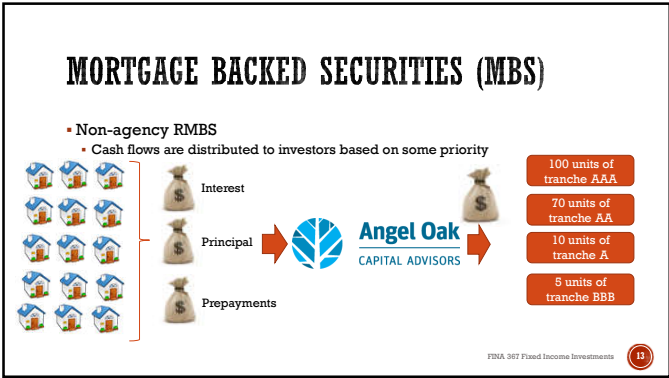
[illegible]

- Cash flows are distributed to investors based on some priority

[illegible]

- Cash flows are distributed to investors based on whether interest/principal

[illegible]



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