

Mortgage-Backed Securities

Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

Most MBSs are issued by the Government National Mortgage Association (Ginnie Mae), a U.S. government agency, or the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), U.S. government-sponsored enterprises. Ginnie Mae, backed by the full faith and credit of the U.S. government, guarantees that investors receive timely payments. Fannie Mae and Freddie Mac also provide certain guarantees and, while not backed by the full faith and credit of the U.S. government, have special authority to borrow from the U.S. Treasury. Some private institutions, such as brokerage firms, banks, and homebuilders, also securitize mortgages, known as "private-label" mortgage securities.

Mortgage-backed securities exhibit a variety of structures. The most basic types are pass-through participation certificates, which entitle the holder to a pro-rata share of all principal and interest payments made on the pool of loan assets. More complicated MBSs, known as collateralized mortgage obligations or mortgage derivatives, may be designed to protect investors from or expose investors to various types of risk. An important risk with regard to residential mortgages involves prepayments, typically because homeowners refinance when interest rates fall. Absent protection, such prepayments would return principal to investors precisely when their options for reinvesting those funds may be relatively unattractive.

We have provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.