

## Key Aspects of Mortgage Backed Securities

Mortgage backed securities are asset-backed securities with cash flow that is backed by the payments of a pool of mortgages. For the owner of such securities, their investment generates monthly payments over the life spans of the loans that are contained within the pool. Mortgage backed securities are part of the secondary mortgage market, in which mortgages are bought and sold by mortgage originators (the lenders who issue loans to home buyers).

Mortgage originators issue mortgage backed securities for a variety of reasons. The main reason is that doing so allows them to generate funds with which to create new mortgages. In addition, selling mortgage backed securities allows loan originators to trade non-liquid assets for liquid cash, providing a source of financing that is generally more cost effective.

### Different Types of Mortgage Backed Securities

There are two main types of mortgage backed securities-pass-throughs, and Collateralized Mortgage Obligations (CMOs).

In a pass-through, the issuer of the securities collects monthly mortgage payments from the borrowers, and passes on the investor's share of the money, which includes both principal and interest. These represent a lower risk to investors because they have invested in a large pool of mortgages, and the larger the mortgage pool, the lower the impact of single instance of mortgage default or pre-payment.

Within the category of pass-through securities, there are two further sub-categories-securities backed by residential mortgages, and those backed by commercial mortgages. Due to the structure of commercial mortgages, these tend to be lower risk than residential mortgages. Commercial pass-through securities are often structured in a similar fashion to CMOs, as described below.

CMOs are essentially pass-through investments that have been repackaged to prioritize the cash flow of the investment. This provides investors with extra protection against the risk of pre-payment, based on their priority within the structure of the package. CMOs are also often repackaged into pools of mortgages that have similar characteristics in terms of rate of return, level of risk, and time to mature. This allows investors to choose their level of risk, thus providing an additional level of security.

### Benefits of Investing in Mortgage Backed Securities

The main benefit of mortgage backed securities for investors is that they provide potentially high yields over the long term. Mortgage backed securities typically offer a better rate of return than treasury bonds, for example, and are also very safe investments. In general, mortgage backed securities carry one of the highest returns of any collateral backed securities, whether issued by the federal government or an independent agency. In addition, the secondary mortgage market is highly liquid, and very sizeable. Mortgage backed securities generated by federal agencies such as Freddie Mac and Fannie Mae also tend to be very low risk.

### Investment Risks

Surprisingly, the most significant risk of investing in mortgage backed securities is not the risk that a home owner will default on their loan, but the risk that they will make mortgage payments early by paying more than their monthly minimum repayment. For an investor, this is risky because these situations are often an indicator of lower interest rates. This reduces the amount of principal owing on the mortgage more quickly than expected, reducing the amount of money that could be made from interest on the loan. Additionally, if interest rates decline significantly, home owners are more likely to refinance their mortgages, effectively removing the original mortgage from the security pool and removing the earning potential on that mortgage for the investor.

### What are the Implications for Home Owners?

If, as a home owner, your mortgage is sold on the secondary market as part of a pool of mortgage backed securities, very little will change. If your mortgage is sold by the originator, usually all that changes is that your payments are made to a different company. In such situations, the company that originated your loan will notify you that it has been sold, and will tell you where to send future payments.

For home owners, the existence of the secondary mortgage market is actually an advantage. It adds some competition to the mortgage business that serves to provide home owners with more mortgage options, and also helps to reduce interest rates. In addition, when banks are able to sell mortgages on the secondary market, the cash flow they generate allows them to continue offering new mortgages to new lenders. If the secondary mortgage market did not exist, it would be much more difficult for banks to offer new loans. This would mean that demand for mortgages would far

exceed the supply, allowing banks to charge higher interest rates; and further that requirements for mortgage loans would be much more stringent than they are.

### About the Author

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