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What are Mortgage-Backed Securities?

Many mortgage industry professionals and a vast majority of consumers are not familiar with Mortgage-Backed Securities (MBS), let alone the **critical role they play** in mortgage rate movements. Those with a basic understanding of that relationship will have a much clearer picture of the mortgage process.

What is MBS? Securitization?

MBS or "Mortgage-Backed Securities" are what groups of similar loans turn into in order to be sold, bought, and traded. This process of turning loans into securities is known as "securitization."

Securitization, though not without its risks, is largely beneficial for all parties involved, and is currently essential to maintaining availability of mortgage credit (ability of consumers to get a loan if they want one). It also helps rates stay lower than they otherwise could be, on average.

The **two basic building blocks** of a mortgage-backed security are the CONSUMER who wants to borrow money (a mortgage, in this case), and an INVESTOR that wants to lend money in order to earn a return on investment. No matter what you've heard about MBS, Fannie, Freddie, FHA, and other government programs, MBS cannot and will not exist without consumers who want to borrow and investors that want to lend.The remaining facets of mortgage securitization grow from those two building blocks.

How do investors benefit?

Investors want to lend, but they also want to be protected from risk. If one investor with $200k only made one loan to one consumer, and that consumer defaulted, that investor would shoulder the burden of the entire loss.

Even if that investor has $1 million, and makes 5 loans for $200k, depending on the rate of default, the investor could easily experience a very different rate of return than another investor with the same amount of money investing in the same kinds of loans.

Naturally, if the investor was a gifted underwriter with a perfect eye for risk in assessing potential borrowers, he or she could greatly reduce the risk of default for his or her investments. Lenders attempt to do this anyway, but even if we factor out underwriting standards and the loan process, securitizing loans into MBS reduces risks for investors.

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.07%	+0.02	0.00
15 Yr. Fixed	6.45%	0.00	0.00
30 Yr. FHA	6.51%	+0.02	0.00
30 Yr. Jumbo	7.26%	0.00	0.00
5/1 ARM	7.02%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.86%	-0.01	0.00
15 Yr. Fixed	6.16%	+0.03	0.00

Rates as of: 6/28

Market Data

	Price / Yield	Change
MBS UMBS 5.5	98.49	-0.45
MBS GNMA 5.5	99.10	-0.44
10 YR Treasury	4.3980	+0.1111
30 YR Treasury	4.5640	+0.1383

Pricing as of: 6/28 5:59PM EST

Recent Housing Data

		Value	Change
Mortgage Apps	Jun 12	208.5	+15.58%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%
Builder Confidence	Mar	51	+6.25%

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Reducing Risk.

Risk is reduced because securitization allows it to be “spread out” among similar loans. Consider the hypothetical scenario for an investor:

- - Average loan amount: $200k
- - Default Rate = 1 in 20 loans
- - Loss per default = $50

This investor has a 1 in 20 chance of losing $50k for every $200k they lend. If 20 investors each made one of these loans, 19 of them would be profitable and one of them would be out of business. They need a way to share this risk equally!

If Investor A and Investor B can afford to make 20 loans each, chances improve that actual defaults will match the anticipated default rates, but even if the default rate is accurate, Investor A could be holding both of the loans that default while Investor B holds none. These two investors STILL need a way to share risk equally!

Securitization accomplishes this goal of risk-sharing. It allows both of the investors in the example above more certainty as to the default rate. It’s a trade-off between the small chance of big losses and a near certainty of small, predictable losses. Investors will take the certainty every time because if they can reliably predict the risk, they can easily adjust the price to account for that risk.

In the example of 20 investors each making 1 loan of $200k, if they “pool” those 20 loans together, and if the advertised default rate holds true (1 in 20), then they’ll have only one $50k loss divided amongst them ($2500). In this way, the investor has traded the 5% chance of a $25% loss for 100% chance of 1.25% loss ($200k x 1.25% = $2500). Knowing that the 1.25% loss is coming makes it easy to adjust the price so that the lender is profitable and can stay in business.

Conclusion on Securitization

Securitization is helpful for several reasons. The greater the certainty with which lenders can predict losses, the smaller the margins can be that protect against losses. This translates directly into lower rates for consumers.

Securitization also means investors can buy a piece of a mortgage portfolio without financing every mortgage in it. This is akin to buying stock in a company rather than the company itself, and it allows for far greater participation in the mortgage market among investors. More participation makes for a more liquid market where buyers and sellers can be relatively more assured of finding other willing buyers and sellers near current prices. This also reduces margins in the secondary mortgage market, incrementally benefiting rate sheets.

Of course there are downsides to this model. One might argue that the level of detachment between investors and the loans in which they were investing in the run-up to the financial crisis was one of reasons for the crisis. Indeed, it would be hard to argue otherwise, but the benefits of securitization (much more liquidity in mortgage markets, more loans for more people, lower rates, and less risk for investors) will likely be seen as outweighing the costs (detachment masking the real risk of loss, borrowers having to fit the underwriting mold of housing agencies) for the foreseeable future.

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Real Talk

At The Rate Shop, we're not your average mortgage banker. We specialize in bringing you ridiculously low interest rates that will make you wonder what the other guys are doing. In fact the ONLY objection we ever hear is “your rates sound too good to be true”. Well they’re not, and here is why…

After 15 years in the retail banking world I was frustrated with the high interest rates that came from that business model. As I looked around at all the bloated layers of management and their expensive salaries and the overhead of running a larger company (think rent costs, employee health and benefit costs, payroll taxes, and on and on) it dawned on me that I was a part of the problem, and the solution, for me at least, was so easy to see.

Start my own mortgage brokerage shop. No expensive executive salaries, no expensive building to pay rent at, no unnecessary employees and all the costs that are associated with that. What happens when you cut out all the fat? You can provide lower rates and lower closing costs. It’s simple. Now here is the best part, you still get great service from a local Kansas City Lender. My mission is to let everyone know that low rates and great customer service are NOT mutually exclusive.

Thanks for coming along on this journey where Low Rates meet Great Service. The two do NOT have to be mutually exclusive. It’s just a lie that the big box mortgage companies have been telling you for years. Don’t believe me? Give me a call or shoot me a text on my personal cell phone today and compare my rates and costs up against any other lender in the country, and be prepared to be blown away.

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