

# The case for mortgage-backed securities

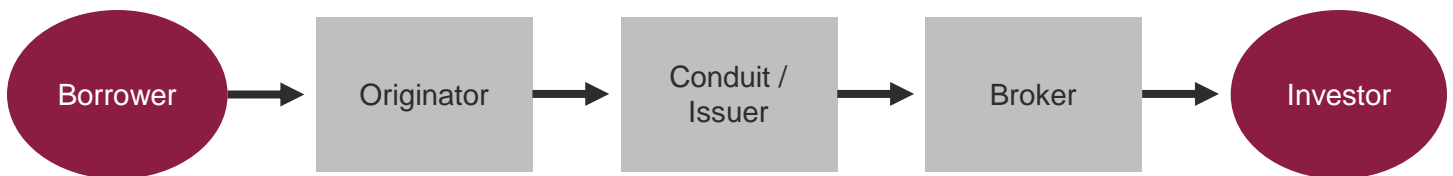
By Head of Fixed Income, [Tim Musial, CFA](#)

The residential loan market in the US is estimated to be a staggering \$12 trillion,<sup>1</sup> offering borrowers a variety of products tailored to their specific needs. While many types of mortgages are available, the majority carry a fixed interest rate with level payments, fully amortizing over 15 or 30 years. The size and diversity of the mortgage loan market drive the enormous scale of the mortgage-backed securities (MBS) sector within the fixed income market. Its size isn't just a statistic—it plays a crucial role in providing liquidity, stability and a yield advantage in a well-structured fixed income portfolio.

## The securitization process

The securitization process transforms individual mortgage loans into tradeable securities, directly impacting the risk, liquidity, and return profile of MBS. MBS serve as the conduit through which investors receive principal and taxable interest payments from a collection of residential mortgages. This “passing” of payments to investors is why MBS are often called “pass-through” securities.

### Exhibit 1: Key participants in the creation of MBS



- **Borrower:** The homeowner that takes out a mortgage loan.
- **Originator:** Typically, a bank or a finance company that originates the loan.
- **Conduit/Issuer:** Usually a bank or finance company that purchases individual mortgage loans from originators and pools them into MBS. MBS guaranteed by a US government agency against defaults are known as ‘Agency MBS’ and make up the majority of the market.
- **Broker:** Typically, a bank or brokerage firm specializing in trading MBS. The broker purchases MBS from the conduit/issuer and sells them to ultimate investors.
- **Investor:** The investor base in MBS is diverse, including banks, investment companies, insurance companies, foreign central banks, and others.

Historically, the default risk of individual residential loans was borne by the originator, often a bank that held the loan on its balance sheet. Pooling numerous mortgage loans into an MBS allows multiple investors to own a stake in a diversified pool of loans, helping to mitigate the unique risks associated with individual loans or geographic areas.

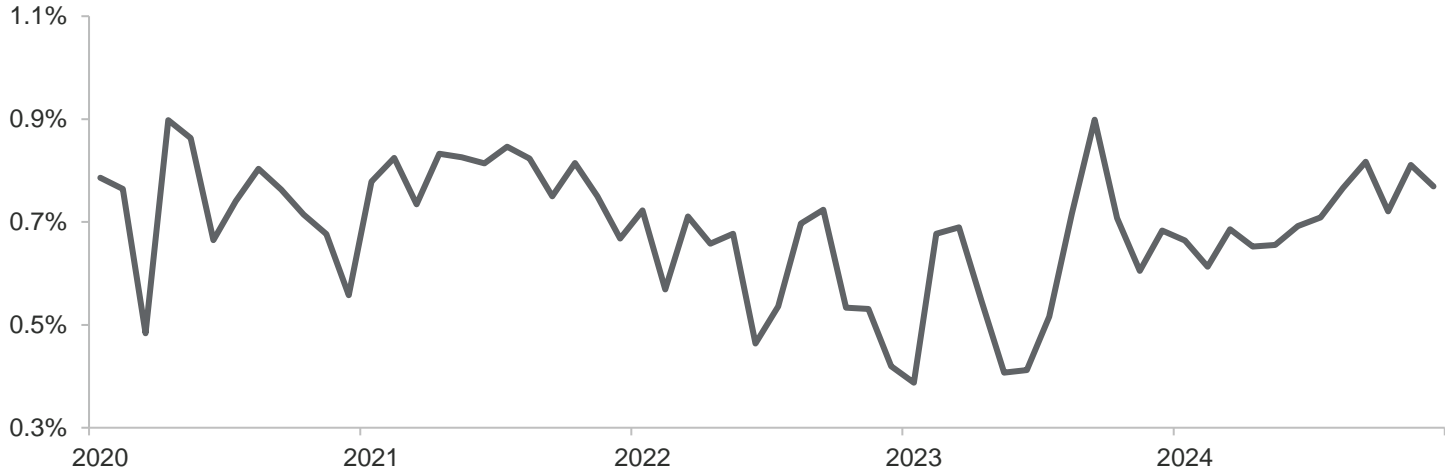
## MBS investments

MBS generally offer higher yields than similar-duration US Treasuries to compensate investors for two main risks:

- 1) **Prepayment risk**—the uncertainty regarding when underlying mortgages will be repaid, as borrowers can typically prepay at any time; and
- 2) **Credit risk**—the risk of mortgage defaults leading to losses. For most MBS, the credit risk is minimal due to guarantees against losses from government-sponsored entities. Consequently, the majority of the extra yield available in MBS compared to US Treasuries compensates investors for prepayment risk.

When interest rates rise, borrowers are less likely to refinance their mortgages, leaving investors with lower-yielding securities. Conversely, when interest rates fall, borrowers are more likely to refinance, resulting in prepayments for investors when reinvestment alternatives offer lower yields. The uncertainty regarding the timing of prepayments increases with interest rate volatility, leading investors to demand a larger prepayment risk premium in the form of higher yields.

## Exhibit 2: Yield pickup: MBS Index vs. US Treasury Index



Source: Bloomberg, as of January 31, 2025.

## Agency MBS

Entities such as the Federal National Mortgage Association (FNMA), commonly known as Fannie Mae; the Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac; and the Government National Mortgage Association (GNMA), commonly known as Ginnie Mae, facilitate the securitization process by guaranteeing timely payment of principal and interest on individual mortgages within an MBS. In return for this service, they receive a guarantee fee. While only GNMA has an explicit government guarantee, FNMA and FHLMC (known as Government-Sponsored Enterprises or GSEs) are often perceived as having an implicit government guarantee. Investors in Agency MBS are protected by this guarantee against defaults in the underlying mortgages, with risk limited to the uncertain timing of principal payments (prepayment risk).

## Summary

Agency MBS represent one of the largest and most liquid sectors of the bond market. These securities offer higher yields compared to US Treasuries and are an attractive option for generating income. Backed by government-sponsored entities, Agency MBS ensure a high credit rating and minimal risk of principal loss. The combination of safety, yield, and income generation makes Agency MBS a valuable component for enhancing the overall strength of a taxable fixed income portfolio.

*For more information on mortgage-backed securities and other fixed income investments, please reach out to a member of your CIBC Private Wealth team.*

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1. Securities Industry and Financial Markets Association (SIFMA), Q4 2021. This is the most recent data published.

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