

# **COASTAL SECURITIES**

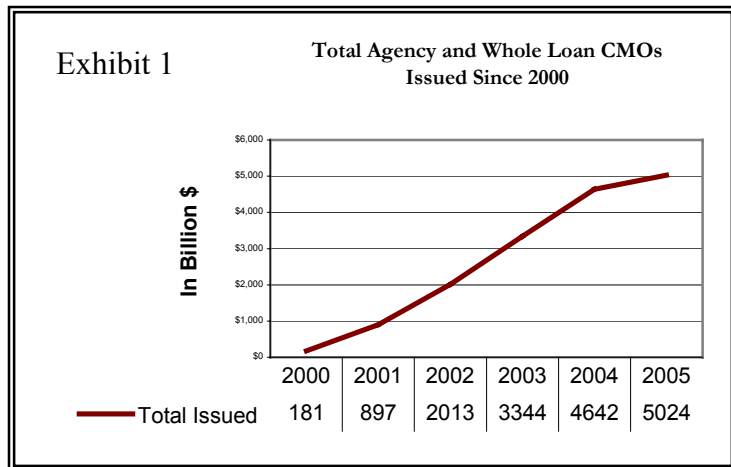
## **An Evolutionary Overview of the Agency and Whole Loan CMO Market**

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# An Evolutionary Overview of the Agency and Whole Loan CMO Market

## INTRODUCTION

Coastal Securities' institutional fixed income markets group trades many mortgage related products including collateralized mortgage obligations (CMOs). While much of the CMO product traded by Coastal is originated through Government Sponsored Enterprises (GSEs) such as GNMA, FNMA and FHLMC, Coastal also trades in the whole loan CMO market due to the unique structures and attractive spreads available. Once thought to be the "little sister" to agency CMOs with far less liquidity and information available, the whole loan CMO market has blossomed into a sibling that can now hold her own. Whole loan CMOs offer institutional investors a much wider variety of cash flows, structure, yields and durations. The whole loan CMO market has been a significant contributor to the current outstanding CMO universe. (Exhibit 1)



## HISTORY

Until 1983, the mortgage-backed securities (MBS) market consisted entirely of pass-through bonds (pools of individual home mortgages). These pass-through securities paid principal and interest to the investor as scheduled and prepayments as received. Although investors were attracted by the cash flow and yield offered by these securities, the long final maturities and potential for early repayment caused many investors to shy away. In 1983, a dramatic fall in rates combined with a robust housing market caused home mortgage origination volume to explode. The resulting supply, much of which was sold into the market, encouraged creative structuring of a new investment vehicle in the form of the first collateralized mortgage obligation issued under the FHLMC name. This early prototype included only three simple tranches that basically carved the collateral into short, intermediate and long cash flows.

From this early prototype came the creation (and re-creation) of many different classes or tranches within the broad category of CMOs. The payments of principal from the underlying mortgage collateral are prioritized to the investors of the CMO issue by order as specified in the bond's prospectus and on a tranche basis. The ability to customize desired performance characteristics, competitive yields, and AAA credit quality gave rise to higher demand. The expanding acceptance of the CMO structure combined with the favorable tax treatment afforded under the Tax Reform Act of 1986 paved the way for CMO volume to begin a rapid expansion. Practically speaking, most of the issues until 1987 were "non-agency" CMOs in that the structures themselves were not issued by one of the GSEs. It wasn't until the advent of the REMIC structure (a result of the Tax Reform Act of 1986) that the GSEs took over the bulk of the issuance.

Although issuance is certainly fueled by interest rates and mortgage volume, the following spot years illustrate the growth of this product: By 1992, annual CMO issuance was 395 billion; in 2003, volume hit the highest to date at \$970 billion!

## **THE MARKET TODAY**

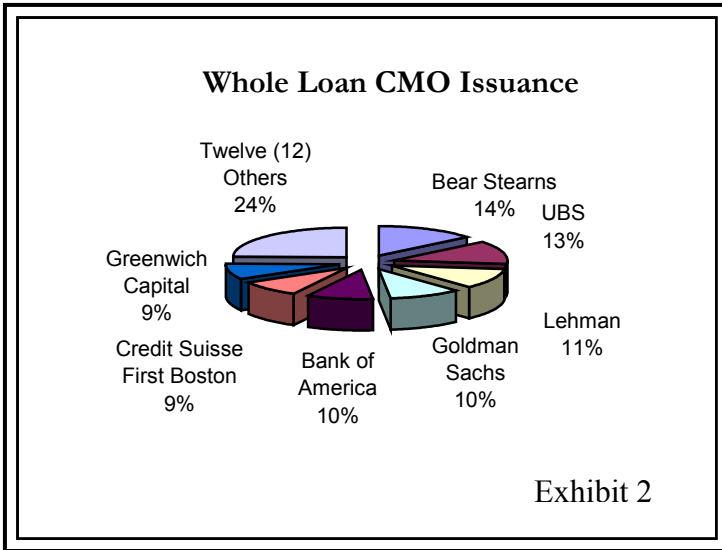
With the growing number of issuers and structures to choose from, portfolio managers can have their cake and eat it too. Not only are enhanced yields and competitive structures available in both the agency and whole loan CMO markets, but investors also have the ability to diversify portfolio credit risk away from traditional issuers to other established issuers. This ability ensures greater diversification within credit exposure than ever before. These private issuers are competitive and arguably equally efficient at underwriting and issuing mortgage-backed securities. As a result, today investors can choose between these two broad credit types of CMOs commonly referred to as agency issued CMOs and whole loan CMOs.<sup>1</sup>

Issuance and trading of new agency-issued securities underwritten and guaranteed by GNMA, FNMA and FHLMC continues to be a healthy part of the CMO market. These three GSEs require that the underlying collateral supporting the structures conform to pooling guidelines including but not limited to loan size, loan to value ratio, and timely payment constraints.

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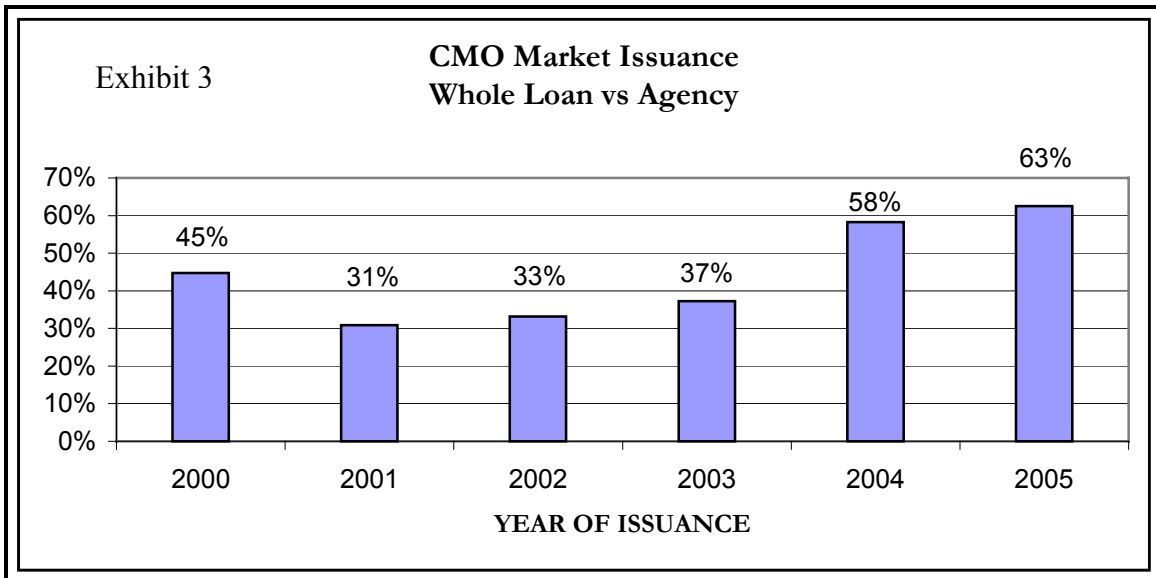
<sup>1</sup> Whole loan CMOs are also called privately-labeled CMOs.

Whole loan CMOs represent a different credit type as these structures are issued by private entities including subsidiaries of investment banks, financial institutions, and homebuilders. The major players in the whole loan arena include Credit Suisse First Boston, Bear Stearns, Lehman, Bank of America, Goldman Sachs, UBS, Lehman, Greenwich Capital and others. The whole loan CMO market is dominated by the above seven underwriters as



indicated by their share of total market issuance in the last five years (see Exhibit 2). Whole loan CMOs are collateralized by mortgages – sometimes even agency mortgage pass through collateral – that do not qualify as collateral for agency issued CMOs.<sup>2</sup> These securities are made up of nonconforming and jumbo loans and tend to have larger average loan size than those found in an agency issued CMO. The major buyers of this paper are banks, insurance

companies and money managers. Through the first quarter of 2005, over 63% of all CMOs were issued by non-agency public corporations. (Exhibit 3)



<sup>2</sup> To the extent that whole loan CMOs use GSEs' mortgage pass-through securities as collateral, the agency collateral carries the respective GSEs' guarantees.

## **THE TREND CONTINUES**

We expect the issuance of whole loan CMOs to continue for several reasons. First, because of technological developments, barriers to entry have fallen in the mortgage origination business as more and more homebuilders and non-traditional mortgage originators package loans to homebuyers. Second, the financial private sector will continue to benefit from the efficiencies that have made origination more efficient and more profitable. Third, just like in the early 80's when depository institutions drove the supply and structure for agency paper, demand continues to spur supply as investors realize the relative value of these AAA credit quality securities compared to traditional AAA agency issued paper. Fourth, historical analyses become easier as this sector matures. Specifically, prepayment determinants and expectations have become more identifiable. Finally, and very importantly, diversification away from agency paper is prudent for an individual institution and necessary for the financial sector given the current regulatory environment and the pressures under which our GSEs operate today (more about this later).

## **CREDIT ENHANCEMENTS**

Because the loans that underlie whole loan CMOs do not conform to the agencies' pool requirements, does not mean they are inherently riskier for the investor. It simply means that they do not conform to rigid structural underwriting characteristics set up years ago. However, as a result of the non-conformity of the underlying loans, whole loan CMOs have attractive credit enhancements that ensure the investor receives timely principal and interest payments.

To a greater or lesser extent, guarantees on both whole loan and agency paper depend upon the entity making it. GNMA, for example, guarantees the timely payment of principal and interest on its mortgage securities, and its guarantee is backed by the "full faith and credit" of the U.S. government. Holders of GNMA are assured of receiving payments on time each month, regardless of whether the underlying homeowner makes its payment on time. FNMA guarantees timely payment of both principal and interest on its mortgage securities whether or not the payments have been collected from the borrowers as well. Freddie Mac guarantees timely payment of both principal and interest on its Gold PCs and CMOs. Despite the fact that neither FNMA nor FHLMC CMOs carry the "full faith and credit" guarantee, the markets consider the credit on these securities to be equivalent to, or slightly better than, AAA.

Because whole loan paper does not carry an agency wrapper, credit enhancement is used to achieve AAA ratings. To obtain this credit rating, whole loan CMOs make use of three distinct credit enhancements: senior/subordination, lines of credit, and insurance. The senior/subordinate structure is the predominant method of credit enhancement. These structures are created by dividing pools of mortgages into senior and subordinate tranches, allocating the highest certainty and credit rating to the senior pieces. Subordinate tranches are the first to receive principal loss due to default, largely insulating senior pieces from this risk. As a result, the senior pieces, often exceeding 92% of the total pool of mortgages, receive the AAA rating. Like agency securities, whole loan CMOs can be divided into tranches with varying prepayment speeds and other payment characteristics. Additionally, these whole loan issuers typically further insulate investors by distributing the CMO collateral to the care of a “trustee,” who holds it for the exclusive benefit of the CMO bondholders.

## **RISK WEIGHTING RULES CHANGE**

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. An institution's risk-based capital ratio is calculated by dividing its qualifying capital by its weighted risk assets. Lowering capital requirements increases the lending capacity of depository institutions.

Prior to the end of 2001, depository institutions calculated non-agency CMO capital ratios for meeting minimum risk-based capital standards at 50% or more, regardless of credit rating. Agency issued CMOs were calculated at 20% risk weight. Depository regulators<sup>3</sup> changed this standard in 2001<sup>4</sup> to more accurately realign the risk assessment of AAA and AA rated whole loan CMOs with their agency counterparts and certain other AAA rated securities. Thus, agency issued CMOs and AAA and AA rated whole loan CMOs now fall in the 20% risk weight category.

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<sup>3</sup> Regulators referred to include FDIC, OCC, and OTS.

<sup>4</sup> Federal Register, Part II, Volume 66 No. 230 (November 29, 2001).

## **DUE DILIGENCE**

Investors must understand the nuances of any product before purchasing. Fortunately, by and large, this product is structurally very similar to agency issued CMOs. The major difference is that whole loan CMOs are packaged by private corporations such as those illustrated in Exhibit 2 (located on page 3) and not by FNMA and FHLMC. Most of the collateral for whole loan CMOs is underwritten by experienced mortgage originators like Wells Fargo, Countrywide, WAMU and ABN AMRO.

Although senior structure investors are more likely to rely on rating agencies' evaluation, the subordinate structure investors' due diligence will be much more extensive. Why are investors in AAA senior structures so confident in the rating provided by the major rating companies? Bottom line, from the years 1991 through 2004, **99+**% of AAA rated classes are still AAA!<sup>5</sup>

Whole loan CMO buyers might experience a minor interest income shortfall given specific borrower prepayment behavior. With whole loan CMOs, when a borrower prepays, interest on the mortgage ceases. If the CMO issuer does not compensate the investor, interest income falls short of the expected monthly interest income payments. This lack of timely interest income is otherwise known as "compensating interest" income. Agency issuers guarantee that the full interest payment is made to the investor, even if the entire month's interest is not received due to the prepayment. In the case of whole loan CMOs, an issuer can establish a monthly reserve to cover this potential shortfall of interest income. However, in many cases, no guarantee is made with respect to payment of the compensating interest. In this case, an investor's monthly interest payment will be slightly lower than the prior month's interest payment. Generally, however, the full interest payment is paid to the investor the following month.

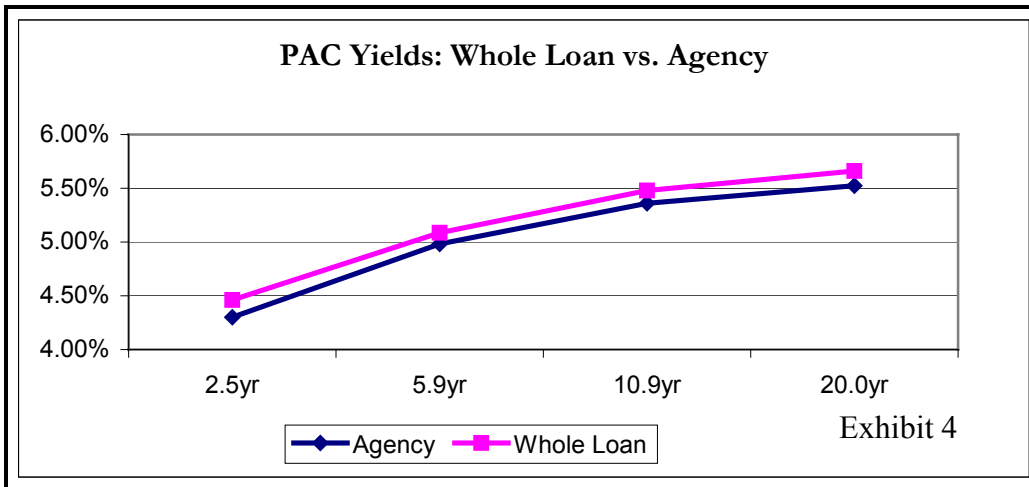
## **YIELD ADVANTAGE**

Like all CMOs, whole loan CMOs are priced at a spread over a comparable duration Treasury. These spreads are determined by the market and change over time. Whole loan paper generally offers higher yields than traditional CMOs due to the unconventional characteristics of the underlying loans and credit structures. Because type of collateral has an impact on spread, bonds using GNMA collateral typically have tighter spread than bonds that are supported by whole loan collateral. Relative to corporate bonds, these bonds have comparatively excellent credit quality. Compared to their

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<sup>5</sup> Source: "Fitch Ratings 1991 2004 Structured Finance Transition Study", March 22, 2005.

GSE counterparts, credit quality is perceived to be slightly less, and thus investors are compensated with higher yields. The graph below (Exhibit 4) illustrates the yield pickup on 5½ % coupon Planned Amortization Classes (PACs) using new production collateral. (This exhibit represents only one type of CMO tranche. Yield pickup will vary depending on many factors including, but not limited to, structure, duration, coupon, and collateral.)



## CREDIT DIVERSIFICATION

In April 2005, Fed Chairman Greenspan suggested the two largest MBS originators, FNMA and FHLMC, dominate the mortgage origination market to an extent that might not be healthy for our domestic financial system. Specifically, the amount of homeowner debt held by these institutions is too great. The domestic financial system, just like any country, corporation or depository institution, should benefit from more credit diversification on its balance sheet.

Whole loan CMOs have evolved to the point that investors should have confidence in this product. Diversification into whole loan CMOs might just be the most prudent thing a portfolio manager can do. Imagine owning **only** two corporate names in a corporate portfolio – not PRUDENT! The Fed has issued a warning. Owning only FNMA and FHLMC is equivalent to owning two corporate names in an entire portfolio. We all know that diversification – or prudent allocation among securities – is the number one determinant of long-term portfolio performance. Managers today have an excellent opportunity to diversify credit risk and receive the same cash flow structures as those available with FNMA and FHLMC wrappers.

## **PROFILE OF A WHOLE LOAN CMO BUYER**

Since the early 1980's the CMO market has been evolving such that today the CMO buyer is everywhere. The ability to purchase securities with durations that closely match liabilities is expected by banks, thrifts, insurance companies, public and private pension funds. Many of these traditional CMO buyers have begun to realize the return advantage to owning whole loan CMOs as these instruments have delivered consistently with respect to cash flow and yield. Now that risk-based capital rules have changed, depository institutions have begun to purchase more and more whole loan paper given the high credit quality and superior spreads. While depository institutions have become active participants in whole loan CMOs over the last several years, insurance companies and money managers have been taking advantage of the attractive risk/reward profile of whole loan CMOs for quite some time. This should not come as a surprise since the whole loan counterparts can boast of many of the same structures as those found in agency issued CMOs. Whole loan CMO structuring provides the client with an equivalent, or potentially greater degree of flexibility than CMOs issued by GSEs.

## **CONCLUSION**

In summary, all CMOs and especially "AAA" rated whole loan CMOs may be an attractive alternative for investors looking to maximize their yield without substantially increasing their exposure to credit risk. For offerings appropriate to your institution's portfolio and performance objectives, or further information about the CMO market, please contact your Coastal Securities representative or our Financial Strategies Department.

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