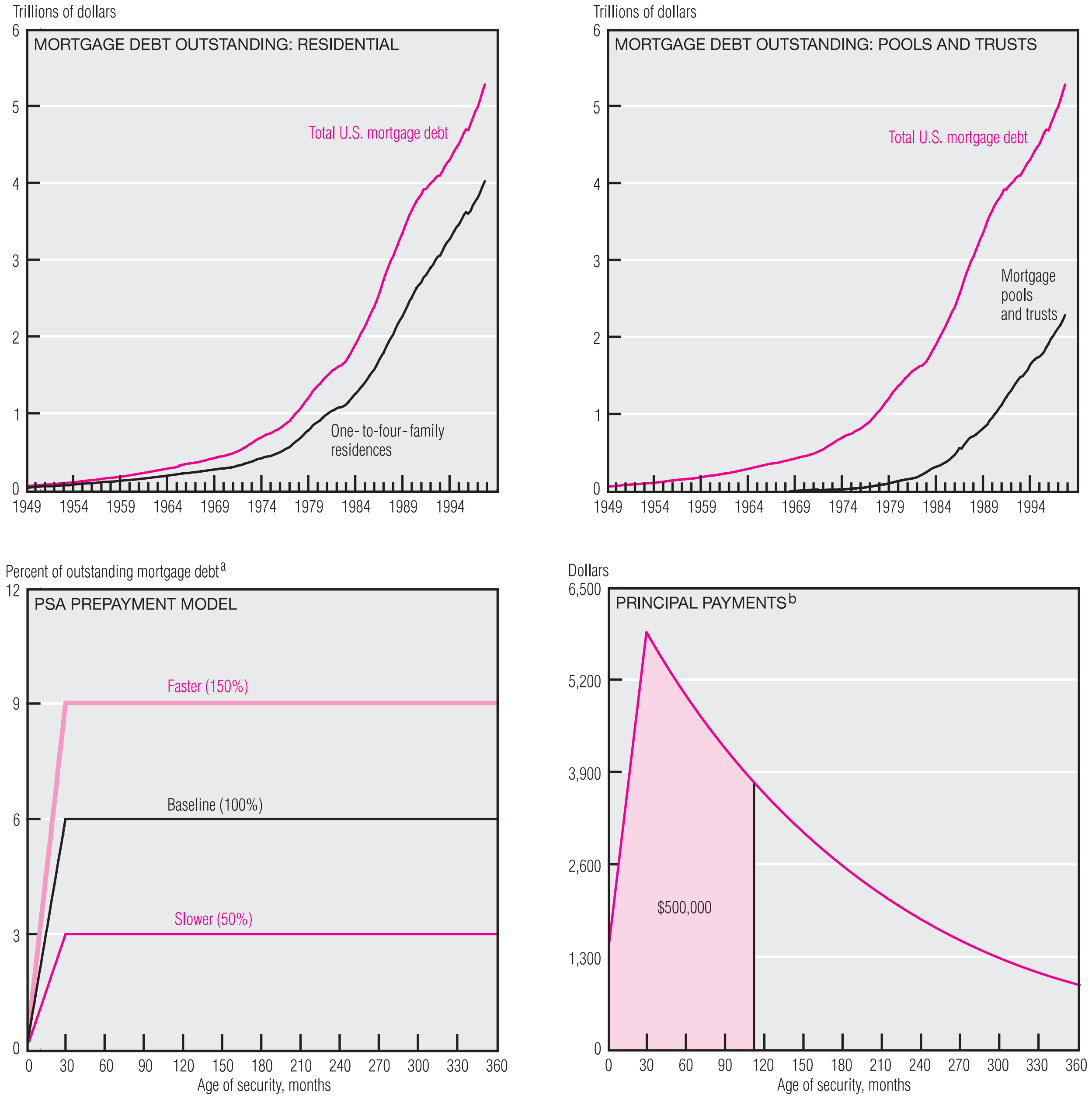
# Mortgage-backed Securities




a. Annualized monthly prepayment rate.
b. Based on the PSA model.
SOURCE: Board of Governors of the Federal Reserve System, Mortgage and Consumer Finance Section, *Mortgage Debt Outstanding.*

There are several reasons why the American dream of home ownership has become a reality for so many people. One of them is growth and innovation in the mortgage market. Although mortgages on commercial property and apartment buildings make up an important part of the market, the bulk of mortgages are for family residences—more than $4 trillion of the $5.3 trillion total.

A large share of U.S. mortgage debt is not held by the originator. Rather, it is bundled into pools or trusts and used to collateralize mortgage-backed securities (MBS). These securities allow investors to reduce their risks (buying one share in an MBS backed by thousands of mortgages is less risky than buying a single mortgage that might default). Standardizing such securities also makes them more salable and liquid.

A prime risk in the MBS market arises from individuals prepaying their mortgages, perhaps to refinance or to move. Valuing MBSs means making assumptions about prepayment rates. A baseline industry standard is the Public Securities Association (PSA) model, which assumes that prepayments rise linearly to 6% at 30 months and then level off. Faster or slower prepayments are expressed as a percentage of PSA.

The prepayment pattern determines the flow of principal payments to the MBS. These are often assigned to different securities. For example, one MBS may get all of the principal payments until those payments reach $500,000. Another may get only interest payments until that amount is paid off, and then receive principal payments.