

AN INVESTOR'S GUIDE TO

PASS~THROUGH AND COLLATERALIZED

# MORTGAGE SECURITIES

*Long-term income  
paid monthly, quarterly  
or semianually.*



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## WHAT ARE MORTGAGE SECURITIES?

Mortgage securities represent an ownership interest in mortgage loans made by financial institutions (savings and loans, commercial banks or mortgage companies) to finance the borrower's purchase of a home or other real estate. Mortgage securities are created when these loans are packaged, or "pooled," by issuers or servicers for sale to investors. As the underlying mortgage loans are paid off by the homeowners, the investors receive payments of interest and principal.

Investors may purchase mortgage securities when they are issued or afterward in the secondary market. Investments in mortgage securities are typically made by large institutions when the securities are issued. These securities may ultimately be redistributed by dealers in the secondary market.

The most basic mortgage securities, known as "pass-throughs," or participation certificates (PCs), represent a direct ownership interest in a pool of mortgage loans. These mortgage securities may be pooled again to create collateral for a more complex type of mortgage security known as a Collateralized Mortgage Obligation (CMO) or, since 1986, as a Real Estate Mortgage Investment Conduit (REMIC). CMOs and REMICs (terms which are often used interchangeably) are similar types of securities which allow cash flows to be directed so that different classes of securities with different maturities and coupons can be created. They may be collateralized by mortgage loans as well as securitized pools of loans. (The various types of mortgage securities are explained in detail beginning on page 6.)

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Mortgage securities play a crucial role in the availability and cost of housing in the United States. The ability to securitize mortgage loans enables mortgage lenders and mortgage bankers to access a larger reservoir of capital, to make financing available to home buyers at lower costs and to spread the flow of funds to areas of the country where capital may be scarce. Mortgage securities also offer a number of benefits to investors.

## **WHO ISSUES MORTGAGE SECURITIES?**

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The majority of mortgage securities are issued and/or guaranteed by an agency of the U.S. government, the Government National Mortgage Association (Ginnie Mae), or by government-sponsored enterprises (GSEs) such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Ginnie Mae is a government-owned corporation within the Department of Housing and Urban Development. Fannie Mae and Freddie Mac are chartered by Congress, but owned by stockholders. These agencies buy qualified mortgage loans or guarantee pools of such loans originated by financial institutions, securitize the loans (i.e., place them in a pool and issue securities representing fractional undivided interests in the pool) and distribute the securities through the dealer community. They also provide different levels of guarantees to investors. (See page 11, "How safe are mortgage securities?")

Some private institutions, such as subsidiaries of investment banks, financial institutions, and home builders, also package various types of mortgage loans and mortgage pools. The securities they issue are known as "private-label" mortgage securities, in contrast



to "agency" mortgage securities issued and/or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac.

## **WHAT IS THE HISTORY OF THE MARKET?**

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The first pass-through mortgage security was issued in 1970, with a guarantee by Ginnie Mae. Soon, Freddie Mac and Fannie Mae began issuing mortgage securities as well. The development of the CMO in 1983 expanded the market for mortgage securities by appealing to investors with various investment time frames and cash-flow needs. The Tax Reform Act of 1986 allowed mortgage securities pools to elect the tax status of a Real Estate Mortgage Investment Conduit (REMIC). Since 1986, most new CMOs have been issued in REMIC form to create tax and accounting advantages for the issuers. A new "Callable Pass-through" was created in the mid 1990s. (See page 7 for a description of CMOs/REMICs and Callable Pass-throughs.)

As a result of increasing investor interest in these investments, the mortgage securities market is one of the largest financial markets in the world. Total volume of outstanding mortgage securities exceeded \$4.1 trillion at the end of 2001. New issuance of agency pass-throughs for 2001 was \$1,088.8 billion, while agency CMO/REMIC issuance was \$362.2 billion.\*

## **MORTGAGE SECURITIES VS. OTHER FIXED-INCOME INVESTMENTS**

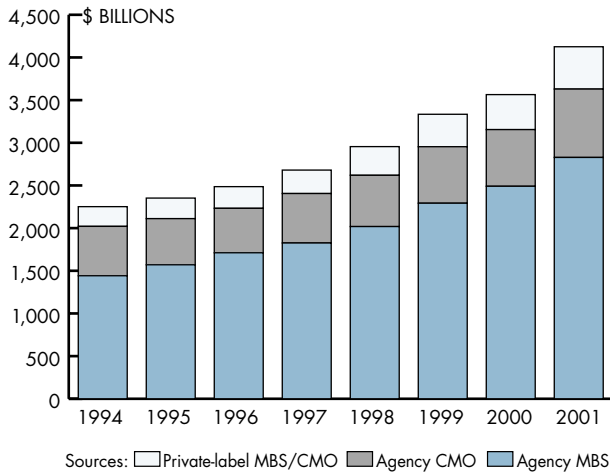
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With fixed-income securities such as corporate bonds, an investor effectively lends money to the bond issuer in return for a stated rate of interest (the coupon rate)

*\*Sources of all volume data are Ginnie Mae, Fannie Mae and Freddie Mac.*



**OUTSTANDING VOLUME OF  
MORTGAGE SECURITIES  
1994 - 2001**



over the life of the bond. The investor receives a repayment of principal—namely, the “face value” of the bond—in a single lump sum when the bond matures.

Investors in mortgage securities also earn a coupon rate of interest, but they receive repayments of their principal in increments over the life of the security, as the underlying mortgage loans are paid off, rather than in a single lump sum at maturity.

Because the timing and speed of principal repayments may vary, the cash flow on mortgage securities is irregular. If homeowners whose mortgages are in a pool sell their homes, refinance their loans to take advantage of lower interest rates, prepay their mortgages for some other reason or default on their loans, the principal is distributed on a pro rata basis to investors in pass-through securities. Investors in CMOs and REMICs receive these principal repayments according to the payment priorities of each CMO or REMIC and the class of securities they own. When this happens, the investors’ remaining interest in the pool is reduced by the amount of prepayments. Because the principal is reduced over the life of the secu-



urity, the interest income also decreases in terms of absolute dollars paid to investors.

Mortgage securities are sold and traded in terms of their assumed “average life” rather than their maturity dates. The average life is the average amount of time that will elapse from the date of MBS purchase until principal is repaid based on an assumed prepayment forecast. In other words, average life is the average amount of time a dollar of principal is invested in an MBS pool. However, some mortgage loans could remain outstanding for the entire life of the original loans—typically, 30 years.

As with any fixed-income security, the yield on a mortgage security investment depends on the purchase price in relation to the coupon rate and the length of time the principal is outstanding.

To compare the value of a mortgage security with other fixed-income investments, some prepayment assumptions, based on historic prepayment rates, are factored into the price and yield. The more accurate the prepayment projections, the more realistic the yield estimates. The most widely used prepayment assumption is The Bond Market Association Standard Prepayment Model. Developed by The Bond Market Association to standardize the measurement of prepayment risk, it assumes that, for new mortgage loans, the probability of prepayment increases as the mortgage “seasons,” or ages, eventually reaching a constant rate at 30 months. Both projected and historical prepayment rates are expressed or quoted as a percentage of The Bond Market Association Standard Prepayment Model.

While most bonds pay interest semiannually, mortgage securities may pay interest and principal monthly, quarterly or semiannually, depending on the structure and terms of the issue. Pass-through securities and most newly issued CMOs and REMICs provide monthly payments.

Mortgage securities also tend to carry higher coupon rates than U.S. Treasury securities. In part, this is because the



interest rates charged on mortgage loans are higher than the interest rates charged to the U.S. government. But the higher rates on mortgage securities also reflect the level of investment risk created by the prepayment uncertainty. Investors in mortgage securities may have their principal returned to them sooner (or later) than they expect when they make their investment. (See page 13, “What market risks are involved?”)

It can be difficult to predict the precise return on a pool of mortgage loans. However, because of this uncertainty, mortgage securities have traditionally provided returns that exceed those of most other fixed-income securities of comparable quality.

## WHAT TYPES ARE AVAILABLE?

**Pass-throughs or Participation Certificates (PCs).** As the name suggests, the issuer or servicer of pass-through securities collects the monthly payments from the homeowners whose loans are in a given pool and “passes through” the cash flow to investors in monthly payments which represent both interest and repayment of principal. Most pass-through mortgage securities are issued and/or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac and carry an implied AAA credit rating. The remainder are privately issued and generally rated AAA or AA. The payments of principal and interest on pass-throughs are considered secure; however, the cash flow on these investments may vary from month to month, depending on the actual prepayment rate of the underlying mortgage loans. At issuance, the stated maturity of pass-through securities is generally 30 years, although an increasing number may have 15-, seven- or five-year stated maturities.



Most pass-throughs are backed by fixed-rate mortgage loans; however, adjustable-rate mortgage loans (ARMs) are also pooled to create the securities. Most ARMs have caps and floors limiting the extent of interest-rate changes, and these option-like characteristics require that pass-throughs backed by ARMs have higher yields than pure floating-rate debt securities. The market for ARMs is largely an institutional market.

**CMOs or REMICs\*.** The CMO is a multiclass bond backed by a pool of mortgage pass-throughs or mortgage loans. CMOs may be collateralized by (i) Ginnie Mae, Fannie Mae or Freddie Mac pass-throughs; (ii) unsecuritized mortgage loans insured by the Federal Housing Administration or guaranteed by the Department of Veterans’ Affairs; (iii) unsecuritized conventional mortgages; or (iv) any combination thereof. In structuring a CMO, an issuer distributes cash flow from the underlying collateral over a series of classes (called tranches) which constitute the bond issue. Each CMO is a set of two or more tranches, each having average lives and cash-flow patterns designed to meet specific investment objectives. The average life expectancies of the different tranches in a four-part deal, for example, might be two, five, seven and 20 years. Some CMOs issued have had more than 50 tranches.

As the payments on the underlying mortgage loans are collected, typically the CMO issuer first pays the coupon rate of interest to the bondholders in each tranche. All scheduled and unscheduled principal payments generated by the collateral, as loans are repaid or prepaid, go first to investors in the first tranches. Investors in later tranches do not start receiving principal payments until the prior tranches are paid off. This basic type of CMO is known as a *sequential pay* or *plain vanilla* CMO. Any collateral remaining after the final

\*The terms CMO and REMIC are used interchangeably.



tranche has been paid is known as a *residual*. The residual in a REMIC may be traded as a stand-alone security.

Sometimes CMOs are structured so that the prepayment and/or market risks are transferred from one tranche to another. Prepayment stability is improved in some tranches because other tranches absorb more of the risk of prepayment variability. Therefore, it is important to know the characteristics of other tranches in the offering before selecting a tranche as an investment. Some of the more common tranche types are described below.

The final tranche of a CMO often takes the form of a *Z-bond*, also known as an *accrual bond* or *accretion bond*. Holders of these securities receive no cash until the earlier tranches are paid in full. During the period that the other tranches are outstanding, the periodic interest accruals are added to the initial face amount of the bond but are not paid to investors. When the prior tranches are retired, the Z-bond receives coupon payments on its higher principal balance, plus any principal prepayments from the underlying mortgage loans. The existence of a Z-bond tranche helps stabilize the cash-flow patterns in the other tranches. In a changing interest rate environment, however, the value of the Z-bond itself tends to be more volatile.

As the CMO has evolved, some modifications in the classes of bonds have become more prevalent. The *planned amortization class (PAC)* and *targeted amortization class (TAC)*, for example, were designed to reduce investors' prepayment risk by establishing a sinking-fund structure. PAC and TAC bonds assure to varying degrees that their investors will receive payments over a predetermined time period under various prepayment scenarios. Although PAC and TAC bonds are similar, PAC bonds tend to provide more stable cash flow under a greater number of prepayment scenarios than TAC bonds.



The existence of a PAC or TAC tranche can create higher levels of risk for other tranches in the CMO because the stability of the PAC or TAC tranche is achieved by creating at least one other tranche—known as a *companion bond* or a *support* or *non-PAC bond*—which absorbs the variability of collateral principal cash flows. Because companion bonds have a high degree of average life variability, they generally pay a higher yield. Companion bonds are not always labeled as such, however. Moreover, a TAC bond can have some of the prepayment variability of a companion bond if there is also a PAC bond in the issue.

*Floating-rate CMO tranches (“floaters”)* pay a variable rate of interest which is usually tied to the London Interbank Offered Rate (LIBOR). Institutional investors with short-term liabilities, such as commercial banks, often find floating-rate CMOs to be attractive investments. “*Superfloaters*” (which float a certain percentage above LIBOR) and “*inverse floaters*” (which float inversely to LIBOR) are further variations of the floater structure with highly variable cash flows. These securities are used by sophisticated institutional investors to hedge interest rate risk in their portfolios and to invest on the basis of their interest rate outlook.

**Strips.** Stripped mortgage securities, first introduced in 1986, are created by segregating the cash flows from the underlying mortgage loans or mortgage securities to create two or more new securities, each with a specified percentage of the underlying security's principal payments, interest payments or a combination of the two. For example, the cash flow on an 8 percent pass-through security might be redistributed to create one new security with a 10 percent coupon and another security with a 6 percent coupon.



Securities may be partially stripped so that each investor class receives some interest and some principal. When securities are completely stripped, all the interest is distributed to one type of security, known as *interest-only (IO)*, and all the principal distributed to another, known as *principal-only (PO)*. These securities may be custom-made to suit individual portfolio needs, depending on which portion of the cash flow the investor wants. Strips, IOs and POs can be created in a pass-through structure or as tranches of a CMO.

The market values of IOs and POs are very sensitive to fluctuations in prepayment rates and interest rates, making them more volatile than standard pass-throughs. As with most fixed-income securities, POs, for example, increase (or decrease) in value as interest rates decline (or rise). For this reason, the investors in these securities are primarily institutional.

Price behavior also depends on whether the mortgage collateral was purchased at a premium or a discount to its par value. Prepayments on discount coupon POs generally are much lower than prepayments on premium coupon POs.

On the other hand, IOs increase (or decrease) in value as interest rates rise (or decline). Since prepayment rates generally decrease as interest rates rise, investors in IOs are likely to receive interest payments over a longer time period, thus increasing the value of their investment. However, in a low-interest-rate, high-prepayment environment, the market value of an IO may decline considerably, and an investor may not recoup his or her initial investment. IOs can function as portfolio hedging vehicles, because prepayments cause the value of an IO strip to move in the opposite direction from many other mortgage and fixed-income securities.

**Callable Pass-throughs.** One of the newest developments in the MBS market is the Callable Pass-through.



A Callable Pass-through is created by splitting a pass-through into two classes: a “Callable Class” and a “Call Class.” The Callable Class receives all of the principal and interest from the underlying collateral. The Call Class receives no principal or interest. The holder of the Call Class has a right to call the underlying pass-through at a stated price (usually par plus accrued interest) from the Callable Class holders after a specified period of time has passed from issuance of the two classes.

The **Callable Class** holder is still long a bond and short a call option, as is any MBS investor. But rather than just being short a series of call options to a number of underlying borrowers who may or may not exercise their option, the holder is also short one call option to one other investor. This other investor, given his/her economic incentive, will call the underlying pass-through from the Callable Class holder in a much more efficient manner than the mortgage borrower will. Thus, the Callable Class holder will have reduced performance relative to pass-through holders if rates fall. For the more limited upside performance potential, the investor is usually paid more in yield.

**Callable Pass-throughs in CMOs.** Callable Pass-throughs can be used as collateral to back CMOs or REMICs. Investors need to pay attention to this, as a call of the underlying Callable Pass-throughs would result in a call of all the outstanding tranches in a deal. This can be particularly important to holders of long-term classes.

## HOW SAFE ARE MORTGAGE SECURITIES?



Issuers of mortgage securities are typically very selective in choosing the mortgages which make up their



pools. Beyond the basic security of the mortgage loans themselves, mortgage securities issued and/or guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac carry additional guarantees which enhance their creditworthiness.

Ginnie Mae guarantees the timely payment of principal and interest on all of its pass-through and REMIC securities, and its guarantee is backed in turn by the full faith and credit of the U.S. government. This means that holders of bonds and certificates issued by Ginnie Mae will receive their payments promptly each month, whether or not mortgage payments are collected, and they will receive full repayment of principal even if the mortgages in the pool default.

Fannie Mae guarantees timely payment of both principal and interest on its mortgage securities, whether or not the payments have been collected from the borrower.

Freddie Mac also guarantees timely payment of both principal and interest on its Gold PCs. Some older series of Freddie Mac PCs guarantee timely payment of interest and ultimate payment of principal.

Neither Fannie Mae's nor Freddie Mac's guarantees are backed by the full faith and credit of the U.S. government. However, each entity has a line of credit to the U.S. Treasury, and the credit markets consider the securities of both entities to be nearly equivalent to those issued by agencies which have the full-faith-and-credit guarantee.

Private-label mortgage securities, whether pass-throughs or CMOs, are the sole obligation of their issuer and are not guaranteed by any governmental entity. However, many private-label CMOs are backed by pass-through securities issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac, meaning that



the collateral backing these securities carries the respective agency's guarantees.

## **IS THE MARKET LIQUID AND ACCESSIBLE?**

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A national network of securities dealers sells, trades and makes markets in mortgage securities. Mortgage securities transactions are executed "over-the-counter," between dealers, rather than on an exchange.

The high volume of outstanding mortgage securities, combined with the large number of investors who hold these securities, creates a sizable and active secondary market for mortgage pass-throughs. To a lesser extent, CMOs, and REMICs issued or guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac, and private-label mortgage securities are also traded in the secondary market.

## **WHAT MARKET RISKS ARE INVOLVED?**

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Mortgage securities are often priced at a higher yield than Treasury and corporate bonds of comparable maturity, but their opportunities for profit (and loss) are also greater. They may be sold at par, or at a premium or a discount to their face value. As with other fixed-income securities, mortgage securities' prices fluctuate in response to changing interest rates: when interest rates fall, prices rise, and vice versa.

Interest rate movements have an additional impact on mortgage securities because they affect prepayment rates, which in turn affect yields. When interest rates decline, prepayment speeds generally accelerate, because homeowners may refinance their mortgages at a lower interest rate and thus reduce their monthly obliga-





tion. Rising interest rates may decrease the assumed prepayment speed. The impact on yield will depend on whether the security was purchased at a premium or a discount. Moreover, the market values of certain types of CMO tranches, strips, IOs and POs are more vulnerable to changes in interest rates. Investors who may wish to sell their mortgage securities prior to maturity should take care to understand how the direction of interest rates might affect the value of their holdings.

Mortgage securities also have implied call and extension risks. The implied call risk means that investors may have their principal returned to them sooner than expected, because of accelerated prepayment speeds. In this case, investors may be forced to reinvest the returned principal at lower interest rates. On the other hand, the life of the security may turn out to be longer than anticipated, because prepayment rates are slower, creating an implied extension risk. In this scenario, investors might miss an opportunity to earn higher prevailing rates of interest on their principal.

In general, before investing in a mortgage security, investors should consider the expected performance of that security if interest rates should rise, fall or remain the same.

## WHAT ARE THE MINIMUM INVESTMENTS AND COSTS, AND WHO INVESTS?

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**Investments.** Mortgage securities are offered in minimum amounts ranging from \$1,000 to \$25,000, depending on the issuer of the security. (See the Tables on pages 16 and 17.) Mutual funds and unit investment trusts specializing in mortgage securities offer minimum investments as low as \$1,000.



**Costs.** Mortgage securities are bought and sold between dealers and investors much like other debt instruments. Dealers trade the securities at a net cost which includes their own spread, or profit, on the transaction.

**Who Invests.** Investors in mortgage securities include institutions of all sizes: corporations, commercial banks, life insurance companies, pension funds, trust funds and charitable endowments.

In recent years, individual investors have also become increasingly active in the mortgage securities market, largely as a result of the attractive yields, relative creditworthiness and diversity of available securities.

## THE TAX STATUS OF MORTGAGE SECURITIES

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Investors in mortgage securities are subject to tax on a current basis with respect to both the interest payments on the securities and accrued original issue discount (“OID”). (The portion of any payment that represents return of principal or original cost is not taxable.) OID will exist if a mortgage security is issued at a discount from its face value and, in such a case, the investor will be taxed on the OID over the life of the security. Both cash interest payments and OID will be reported on Form 1099-INT or Form 1099-OID. These forms will be issued to investors on or about March 15 of each year.

A security can also have market discount, which will occur if it is purchased in the secondary market at a discount. In such a case, the investor will recognize ordinary income equal to the amount of accrued market discount at the time the security matures or is sold.



**COMPARISON OF PASS-THROUGH****MORTGAGE SECURITIES CHARACTERISTICS**

SECURITY	GUARANTEE	MINIMUM INVESTMENT	PAYMENT DATE
GINNIE MAE I AND II	Full and timely payment of principal and interest, backed by the full-faith-and-credit guarantee of the U.S. government	\$25,000 minimum; \$1 increments	15th or the 20th of the month for Ginnie Mae I and II pools, respectively, following the record date and every month thereafter
GINNIE MAE PLATINUM	Full and timely payment of principal and interest, backed by the full-faith-and-credit guarantee of the U.S. government	\$25,000 minimum; \$1 increments	15th or the 20th of the month for Ginnie Mae I and II pools, respectively, following the record date and every month thereafter
FANNIE MAE MBS	Full and timely payment of principal and interest guaranteed by Fannie Mae	\$1,000 minimum; \$1 increments	25th of the month following the record date and every month thereafter
FHLMC PC (75-day PC)	Full and timely payment of interest and ultimate payment of principal guaranteed by Freddie Mac	\$1,000 minimum; \$1 increments	15th of the second month following the record date and every month thereafter
FHLMC Gold PC	Full and timely payment of interest and scheduled principal guaranteed by Freddie Mac	\$1,000 minimum; \$1 increments	15th of the month following the record date and every month thereafter

**COMPARISON OF CMO/REMIC****MORTGAGE SECURITIES CHARACTERISTICS**

SECURITY	GUARANTEE	MINIMUM INVESTMENT	PAYMENT DATE
GINNIE MAE REMIC	Full and timely payment of principal and interest, backed by the full-faith-and-credit guarantee of the U.S. government	\$1,000 minimum; \$1 increments	16th or the 20th of the month for Ginnie Mae I and II collateral, respectively, following the record date and every month thereafter
FHLMC REMIC	Full and timely payment of interest and scheduled principal guaranteed by Freddie Mac	\$1; \$1 increments (most dealers, however, require a minimum investment of \$1,000 or more)	15th of the month following the record date and every month thereafter
FANNIE MAE REMIC	Full and timely payment of interest and scheduled principal guaranteed by Fannie Mae (collateral of Fannie Mae "G" series is also backed by the full faith and credit of the U.S. government)	\$1,000 minimum; \$1 increments	18th or the 25th of the month following the record date and every month thereafter
AGENCY-BACKED, PRIVATE-LABEL CMO/REMIC	Collateral guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac. Structure provides basis for AAA rating, but these securities carry no explicit government guarantee; they are the sole obligation of their issuer	Varies	Varies; may be monthly, quarterly or semiannually; with or without payment delay
WHOLE-LOAN BACKED, PRIVATE-LABEL CMO/REMIC	Credit support provided by some combination of issuer or third-party guarantee, letter of credit, overcollateralization, pool insurance, and/or subordination. Generally rated AA or AAA	Varies	Varies; may be monthly, quarterly or semiannually; with or without payment delay

## GLOSSARY

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**Accrued interest.** Interest deemed to be earned on a security but not yet paid to the investor.

**Adjustable-rate mortgage (ARM).** A mortgage loan on which interest rates are adjusted at regular intervals according to predetermined criteria. An ARM's interest rate is tied to an objective, published interest rate index.

**Amortization.** Liquidation of a debt through installment payments.

**Average life.** The average amount of time that will elapse from the date of MBS purchase until principal is repaid based on an assumed prepayment forecast. Alternatively, average life is the average amount of time a dollar of principal is invested in an MBS pool.

**Basis point.** One one-hundredth (1/100, or .01) of 1 percent. Yield differences among fixed-income securities are stated in basis points.

**Beneficial owner.** One who benefits from owning a security, even if the security's title of ownership is in the name of a broker or bank ("street name").

**Bid.** The price at which a buyer is willing to buy a security.

**Book-entry.** A method of registering and transferring ownership of securities electronically, thereby eliminating the need for physical certificates.

**Confirmation.** A document used by securities dealers and banks to state in writing the terms and execution of an oral agreement to buy or sell a security.

**Conventional mortgage loan.** A mortgage loan granted by a bank or thrift institution collateralized solely by real estate and not insured or guaranteed by a government agency.

**Coupon rate.** Stated annual percentage of interest paid on a fixed-income investment.

**Current face.** The current monthly remaining principal on a mortgage security. Current face is computed by multiplying the original face value of the security by the current principal balance factor.

**CUSIP number.** A unique, nine-digit identification number permanently assigned by the Committee on Uniform Securities Identification Procedures to each publicly traded security at the time of issuance. If the security is in physical form, the CUSIP number is printed on its face.

**Face value.** The par value of a security, as distinct from its market value.



**Factor.** A decimal value reflecting the proportion of the outstanding principal balance of a mortgage security, which changes over time, in relation to its original principal value. *The Bond Buyer* publishes the "Monthly Factor Report," which contains a list of factors for Ginnie Mae, Fannie Mae and Freddie Mac securities.

**Fixed-rate mortgage.** A mortgage featuring level monthly payments, determined at the outset, which remain constant over the life of the mortgage.

**Ginnie Mae I.** Pass-through mortgage securities on which registered holders receive separate principal and interest payments on each of their certificates. Ginnie Mae I securities are single-issuer pools.

**Ginnie Mae II.** Pass-through mortgage securities on which registered holders receive an aggregate principal and interest payment from a central paying agent on all of their Ginnie Mae II certificates. Ginnie Mae II securities are collateralized by multiple-issuer pools or custom pools, which contain loans from one issuer, but interest rates that may vary within one percentage point.

**Interest.** Compensation paid or to be paid for the use of money, generally expressed as an annual percentage rate.

**Issue date.** The date on which a security is deemed to be issued or originated.

**Issuer.** An entity which issues and is obligated to pay amounts due on securities.

**Jumbo pools.** Ginnie Mae II pass-through mortgage securities collateralized by pools which are generally larger and contain mortgages that are often more geographically diverse than single-issuer pools. Mortgage loans in jumbo pools may vary in terms of the interest rate within one percentage point.

**Market price or market value.** For securities traded through an exchange, the last reported price at which a security was sold; for securities traded "over-the-counter," the current price of the security in the market.

**Maturity date of MBS.** The last possible date on which the last payment of the longest loan may be paid (also known as "stated maturity").

**Mortgage.** A legal instrument that creates a lien upon real estate securing the payment of a specific debt.

**Mortgage banker.** An entity that originates mortgage loans, sells them to investors and services the loans.

**Mortgage loan.** A loan secured by a mortgage.

**Offer.** The price at which a seller will sell a security.



**Original-issue discount.** The amount by which a security's price at issuance is lower than its par value.

**Original face.** The face value or original principal amount of a security on its issue date.

**Par.** A price equal to the face amount of a security, as distinct from its market value. On a debt security, the par or face value is the amount the investor has been promised to receive from the issuer at maturity.

**Paying agent.** An entity responsible for making the payment of interest and principal to bondholders on behalf of the bond's issuer.

**Payment date.** The date that actual principal and interest payments are paid to the registered owner of a security.

**Pool.** A collection of mortgage loans assembled by an originator or master servicer as the basis for a security. Ginnie Mae, Fannie Mae or Freddie Mac pass-through securities are identified by a number assigned by the issuing agency.

**Prepayment.** The unscheduled partial or complete payment of the principal amount outstanding on a debt obligation before it is due.

**Price.** The dollar amount to be paid for a security, stated as a percentage of its face value or par in the case of debt securities.

**Principal.** The face amount of a bond, exclusive of accrued interest, if any, and payable at maturity. With mortgage securities, principal refers to the amount outstanding on the mortgage loans.

**P & I.** Principal and interest. The term is used to refer to regularly scheduled payments or prepayments on mortgage securities.

**Ratings.** Designations used by investors' services to give relative indications of credit quality.

**Record date.** The date for determining the owner entitled to the next scheduled payment of principal or interest on a mortgage security.

**Registered owner.** The name in which a security is registered, as stated on the certificate or on the books of the paying agent. P & I payments are made to the registered owner on the record date.

**Safekeeping.** The storage and protection of customers' securities, typically held in a vault, provided as a service by a bank or institution acting as agent for the customer.

**Secondary market.** The market for securities previously issued and sold.

**Servicing.** Collection and aggregation of principal, interest and escrow payments on mortgage loans and mortgage securities, as well as certain operational procedures such as account-

ing, bookkeeping, insurance, tax records, loan payment follow-up, delinquency loan follow-up, and loan analysis. The party providing servicing, the servicer, receives a servicing fee.

**Servicing fee.** The amount withheld from monthly interest payments made on a mortgage which is retained by the mortgage servicer.

**Settlement date.** The date agreed upon by the parties to a transaction for the delivery of securities and payment of funds. This may vary from other bonds.

**SMMEA.** Secondary Mortgage Market Enhancement Act of 1984.

**SMMEA securities.** Securities that are both ultimately secured by a first-lien mortgage loan and rated in one of the top two rating categories by at least one nationally recognized statistical rating organization. The complete definition may be found in Section 3(a)(41) of the Securities Exchange Act of 1934, as amended. Institutional investors should check state laws regarding investments in SMMEA securities.

**Transfer agent.** A party appointed to maintain records of securities owners, to cancel and issue certificates, and to address issues arising from lost, destroyed or stolen certificates.

**Weighted average coupon (WAC).** An arithmetic mean of the coupon rate of the underlying mortgage loans or pools that serve as collateral for a security.

**Weighted average loan age (WALA).** The weighted average number of months since the date of note origination of the mortgages in a PC pool.

**Weighted average maturity (WAM).** An arithmetic mean of the remaining term to maturity of the underlying mortgage loans that collateralize a security.

**Yield.** The annual percentage rate of return earned on a security, as computed in accordance with standard industry practices. Yield is a function of a security's purchase price, coupon rate and maturity.



40 Broad Street, New York, NY 10004-2373  
212.440.9430

1399 New York Avenue, NW  
Washington, DC 20005-4711

St. Michael's House, 1 George Yard  
London EC3V 9DH

[www.bondmarkets.com](http://www.bondmarkets.com)

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