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Bonds with Backing: Asset-Backed Bonds, CBOs, and Mortgage-Backed Bonds

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Security for your loan

When you lend money to someone, you want some assurance from the borrower that the debt will be repaid. You get that assurance by knowing whether and how a bond is secured, or backed. In some cases, bonds are backed by a legal claim on specific assets that can be forfeited to the lender if the debt is not repaid. One of the most common examples of a secured bond is a mortgage. Your mortgage is secured by a lien against your house; if you don't make your mortgage payments, the lender has a legal right to the house. The house serves as collateral for the mortgage.

However, it's important to remember that even though a bond may be collateralized by other debt, it can still lose value if there are problems with the debt on which it's based. Concern about the quality of mortgage-backed bonds that were affected by high default rates was one of the factors that led to the financial crisis of 2008.

Note: *The principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk.*

Asset-backed bonds

Some bonds are actually backed by other debt. For example, asset-backed bonds are secured by assets that represent a regular stream of revenue or accounts receivable owed to a business. Such assets include payments on home equity loans; auto loans (certificates for automotive receivables, or CARS); credit-card debt (so-called plastic bonds); and consumer or student loans. A company that holds such debt--for example, a company that makes auto loans--sells those loans to what's called a special purpose vehicle (SPV). The SPV, which might be a corporation, a trust, or some type of partnership, pools and repackages some or all of them into new asset-backed bonds, sometimes known as collateralized debt obligations (CDOs). Those bonds then can be sold on the open market by broker-dealers. The collateral for each of those bonds is the payments on the underlying loans. This process of creating a new security from a collection of other loans is called securitization.

Asset-backed bonds are most frequently bought by institutional investors, though the minimum denomination of $1,000 means that they also are affordable for individuals. Asset-backed bonds are usually overcollateralized; in other words, the repackager includes more loans as collateral in the pool of underlying debt than are necessary to make the bond's interest payments. By providing a financial cushion, overcollateralization helps protect holders of asset-backed bonds against the risk that the original borrowers won't make their payments on the underlying loans.

Collateralized bond obligations (CBOs)

Collateralized bond obligations (CBOs) work in somewhat the same way as asset-backed bonds. However, the pooled assets that secure the bond typically are corporate high-yield (junk) bonds instead of business receivables, though some CBOs based on investment-grade bonds have been introduced. Also, even though the underlying bonds are pooled and used as collateral for the CBO, the cash flow that pool produces from the principal and interest paid on those bonds is sliced up into several tiers, or tranches (tranche is the French word for slice).

Each tranche is marketed separately, and is backed by multiple securities grouped according to their quality rankings. The highest (senior) tranches would be backed by the most highly rated underlying bonds; because of that higher quality, these tranches would offer the CBO's lowest interest rate. The middle (mezzanine) tranches would include somewhat lower-rated bonds and pay a higher interest rate. The lowest (subordinated) tranches would be based on the riskiest underlying bonds, and interest would be paid on these tiers only after all higher tranches had been paid. This division enables investors to tailor their CBO purchases to the level of security and return they prefer.

Like asset-backed bonds, CBOs typically carry an investment-grade rating, partly because the pool of underlying bonds diversifies risk but also because CBOs usually are overcollateralized to provide a financial cushion.

Mortgage-backed bonds

A mortgage-backed security (MBS) is secured by mortgages instead of corporate bonds or revenue streams. In its simplest form, it is backed by an aggregated pool of mortgages, and passes a portion of all principal and interest paid on those mortgages directly to investors each month.

Pass-through securities

A Ginnie Mae is one example of what's called a mortgage pass-through security. Each Ginnie Mae security has only one class of security, and each investor has a direct interest in the underlying pool of securities. Payments of principal and interest are passed through to those investors. What happens with that overall pool of mortgages affects each investor's return in direct proportion to his or her share of ownership in the pass-through security. If many mortgages in the pool are paid off early because homeowners are refinancing or paying off their mortgages, that's passed on in the share of interest and principal paid to each investor each month. This creates what is known as prepayment risk--the risk that such prepayments will reduce the yield on the investment when homeowners cut their interest payments by refinancing or paying off their mortgages early. The Federal Home Loan Mortgage Corp. (FHLMC, or Freddie Mac) and Federal National Mortgage Association (FNMA, or Fannie Mae) also issue as well as guarantee pass-through securities. However, Ginnie Mae only adds its guarantee to privately issued pass-throughs that are backed by government-insured (FHA and VA) mortgages.

Collateralized mortgage obligations (CMOs)

A collateralized mortgage obligation (CMO) works somewhat like a CBO. It groups many debt instruments--in this case, mortgages instead of high-yield bonds--and pays out to the CMO's investors the interest and principal owed on those mortgages. The CMO is divided into tranches, each of which is marketed as a separate bond with its own interest rate, maturity, risk level, and sensitivity to mortgage prepayments. That allows investors the flexibility to choose from a selection of investment-grade bonds to focus on whatever level of risk and return they prefer.

However, with a CMO, the tranches are based not on credit ratings but on the estimated payment periods of the various underlying mortgages. For example, a CMO might have 2-, 5-, 10-, and 20-year tranches, though neither the rate of return nor the maturity date of a tranche is guaranteed. With the most basic type of CMO, a so-called sequential pay or clean CMO, coupon (interest) payments are made to all investors. However, all payments of principal are paid to investors in the tranche with the shortest maturity (called the fast-pay tranche) until that tranche has been entirely retired. Once that first tranche has been paid off, mortgage principal repayments are then directed to holders of the next shortest maturity in the sequence. The process is repeated until all tranches have been repaid. Beyond this basic type, there are many different structures, each with its own prepayment characteristics.

A CMO's yield and average life will fluctuate depending on the actual rate at which mortgage holders prepay the mortgages underlying the CMO, as well as changes in current interest rates. However, because each tranche in a CMO has its own estimated start and ending date for when it will receive repayments of principal, prepayment risk is somewhat lower than with a pass-through security that doesn't segment its cash flow payouts according to maturity dates. The returns of investors in each tranche may be affected somewhat differently as interest rates change during the tranches' various maturities. Because their repayment risks are somewhat more targeted, CMOs may or may not offer somewhat lower yields than pass-through securities.

CMOs are issued by government-sponsored enterprises such as the Federal Home Loan Mortgage Corp. (FHLMC, or Freddie Mac), which also issue regular pass-through securities. CMOs also are offered by private issuers such as financial institutions and homebuilders.

Almost all CMOs today are issued as REMICs because of the way they are taxed, and the terms often are used synonymously. CMOs and CBOs are examples of what are called derivatives: securities that are based on other securities.

Equipment trust certificate bonds

These are corporate bonds that are used to finance the purchase of new equipment and materials by a transportation company such as a railroad or shipping line. The bond's collateral is the equipment purchased with its proceeds. Typically, a bank or other trustee holds title to the equipment until the bond is paid off.

To schedule an appointment with Faye Sykes, click [here](#) .

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