Overview of Securitization

Buy loans (ex: @101)

Aggregate pools

Add Credit enhancement/structure bonds

Sell bonds (ex: @102)

Gain of 1pt

Whole Loan CMOs

– Structures directly from cash flows of loans
– Tend to be larger, Jumbo, loans
– Rating agencies rate resulting structures
– Need credit enhancement to get AAA or AA ratings (senior or subordinated structures and third party pool insurance)

Agency CMOs

- Loans already pooled and securitized by agencies (mortgages all of a similar size, age, quality, and have similar rates)
- Loans tend to be smaller, since must conform to standards of agencies
- Loans carry backing by US Govt for GNMA and implicit backing by US Govt for FNMA and FHLMC passthroughs so resulting structures do not have to be rated

Period Recognition

- P&L Day 1 issue: recognition of P&L related to portion of deal sold
- Should recognize P&L when substantial risk is sold, but leftover bonds usually are the hardest to sell and the most illiquid
- Sale of leftover bonds should be allocated as part of securitization P&L up to 90 days after settlement of deal

Margins & Profits

- Margins should represent arbitrage and trading P&L on deal minus any expenses as a function of the overall size of deal
- Margins should change as MTM on leftover bonds changes and trading gains are recognized.

Spreads

- Spreads represent a return on a bond above or below a benchmark (ex: BBB tranche of deal pays Libor + 45bps)
- Spreads drive the economics of the deal, offering value above that of similar bonds in the marketplace

Types of Deals

- SubPrime – residual (excess interest), NIM