

WHOLE LOAN CMO's

Yields of fixed income securities are at the lowest level in nearly 50 years. Many investors, who are searching for yield and do not want to give up safety, are considering government-sponsored agency Collateralized Mortgage Obligations (CMO) and government guaranteed Ginnie Mae CMOs.

In addition to straight agency issues from FNMA, FHLMC and GNMA there is another type of CMO available, commonly referred to as a "Whole Loan" or "Private Label" bond. Whole loan CMOs are collateralized by individual mortgages that do not qualify as collateral for U S Agency securitization programs. These non-qualifying mortgages include jumbo mortgages (in amounts above \$302,700) and other mortgages which do not conform to the rigid agency standards.

Whole loans CMOs are issued by lenders such as Chase and Countrywide. By dividing a pool of mortgages into a senior and subordinate structure, they are able to obtain AAA ratings on the senior portion. The subordinate portion is the first to receive principal losses due to default, largely insulating the senior portion from this risk. As a result, the senior portion, usually equal to 93% to 97% of the total pool of mortgages, receives the AAA rating. Occasionally the AAA rating is achieved through a letter of credit or bond insurance, but the senior/subordinate structure is the predominant method.

The primary advantage of Whole Loan CMOs is the additional yield, which depending on the structure can be as much as 25 to 50 basis points above the yield of U S Agency CMOs. Like Agency securities, Whole Loan CMOs are divided into tranches with varying pre-payment speeds and other characteristics.

A disadvantage of Whole Loan CMOs, although minor, can be the lack of compensating interest. When a mortgage is pre-paid, the interest on the mortgage stops, which if not compensated for by the CMO issuer would cause a shortfall in bond interest. Agency issuers fully compensate for this by paying bondholders an entire month's interest payment, even if an entire month's interest is not received due to a pre-payment. In the case of Whole Loans, a monthly reserve is usually established to cover this eventuality, but occasionally the reserve is depleted, causing that monthly interest payment to be slightly lower than the prior month's. Typically the normal interest payment resumes in the following month.

In summary, "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. In terms of credit quality they are considered to be one notch below that of U S Agency issues, and because of that the investor is compensated with a higher yield.