FIXED INCOME

Fundamental Differences Between Agency and Non-Agency Mortgage-Backed Securities

January 2, 1995

Chapter in Whole Loan CMOs (Frank J. Fabozzi Associates, 1995)

The most important differences between agency and non-agency mortgage-backed securities (MBS) are the extra yield available on the non-agencies and the chance of default on the non-agencies. This trade-off is easy to understand. An investor assumes the risk of default in order to get the benefit of extra yield.

If these were the only differences between agencies and non-agencies, choosing between them would be straightforward. The investor would weigh the estimate of the probability of default against the benefit of the extra yield. Life is not that simple, however. There are many differences between agency and non-agency MBS that can affect our opinion about their relative value and risk.

These differences vary in their impact, but have several things in common. First, each one has a negative effect on non-agency MBS value. Second, they hurt the value of non-agency MBS because they add to the negative convexity already present in most mortgage-backed securities.

None of these differences implies that an investor should avoid non-agency MBS. The substantial spreads available in non-agency products may well compensate — even overcompensate — for the features we discuss. At the same time, it is important to understand the special characteristics of non-agency MBS.

This chapter explains and illustrates these differences between agency and non-agency MBS using a simple example. We explain the differences in detail, and we attempt to put in perspective the magnitude of each effect on the value of non-agency MBS.