Subprime Mortgages: What they are and why they went wrong.

- A mortgage is an extremely simple concept. Most people cannot afford to buy their own houses outright, so they get a loan to cover the rest from their local bank. This loan includes some interest so that the lender gets a return on its capitol. This, paid back over time, is their mortgage.
- The loan manager will try to sell this debt so that it can raise its liquidity and make more loans. However, a single mortgage is a very risky investment on its own, and as a result few ever buy them. Thus investment bankers will buy hundreds of thousands of the home loans and put them all together in a pool, which is much safer.
- However, the investment bankers don't really want to hold this on their books for such an extended period of time, so they securitize the big pool of loans. Sounds very complicated, but to put it simply, they merge all the values of the loans and their payments into each other, so that a buyer of a bond from this pool only experiences losses as a percentage of the whole pool. So if 10% of the borrowers default, a buyer of a bond from the pool would only lose 10% of his investment.
- As mortgage borrowers have a loan over a much longer time than corporate loans these are very good investments to make for hedge funds, pension funds rich individuals, etc.

This is the first generation of mortgage bonds as invented by Bob Dall and Lewis Ranieri at the Salomon Brothers in 1980.

The securitization was done by government backed companies, Freddie Mac Fannie Mae (later on) but originally by Ginnie Mae. This meant that the government risk assessed and guaranteed the loans, done by private companies but had the same effect.

- There was only one problem with this bond. It did not have a defined period, because homeowners have the right, both in America and in England, to refinance their mortgage at any time they wish. This means that they pay the original lender back in full or in part, by taking out another loan. So the lender- now the buyer of the bonds, receives his money back, but misses out on the interest he would have gained if the loan had not been re-payed. Wouldn't be a problem if he could simply reinvest the money at the same interest rate, but as homeowners are smart (mostly), they always do any refinancing when prevailing interest rates are low, so the buyer of the bonds knew he would receive his money back, when he least wanted it.
- The bond technicians at Salomon Brothers had another idea. They split a mortgage pool into three tranches. This first tranche would be paid in full before anyone in the second tranche received anything, and so one. This means that when people refinance and repay the loan, the buyers in tranche 1 are given their money back first. This allowed a rough time span to be given to each tranche of the pool, and so allowed them to be priced more accurately. This is called a CMO, A Collateralised Mortgage Obligation.
- A CDO, (Collateralised Debt Obligation) is just a big tower of debt al heaped in together. It could include student loans, corporate loans, mortgages, anything with a credit flow. CDO's from 2000-2008 were packed with ever increasing sums of