

Burning Down The House



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Mortgage Backed Security (MBS), Structured Investment Vehicles (SIV'S), Derivatives, Collateralized Debt Obligations (CDO's) and other follies

In **finance**, a **mortgage-backed security (MBS)** is an **asset-backed security** whose cash flows are backed by the principal and interest payments of a set of **mortgage loans**. Payments are typically made monthly over the lifetime of the underlying loans.

A **structured investment vehicle (SIV)** is a fund which borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. SIVs are a type of **structured credit** product; they are usually from \$1bn to \$30bn in size and invest in a range of **asset-backed securities**, as well as some financial corporate **bonds**. A SIV has an open-ended (or evergreen) structure; it plans to stay in business indefinitely by buying new assets as the old ones mature, and the SIV manager is allowed to exchange investments without providing investors transparency / the ability to look through to the structure.

Derivatives are **financial instruments** whose value changes in response to the changes in underlying variables. The main types of derivatives are **futures**, **forwards**, **options**, and **swaps**. The main use of derivatives is to reduce **risk** for one party. The diverse range of potential underlying assets and pay-off alternatives leads to a huge range of derivatives **contracts** available to be traded in the market. Derivatives can be based on different types of assets such as **commodities**, (**stocks**), **bonds**, **interest rates**, **exchange rates**, or indexes (such as **stock market index**, **consumer price index (CPI)** — see **inflation derivatives** — or even an index of weather conditions, or other derivatives). Their performance can determine both the amount and the timing of the pay-offs.

Collateralized debt obligations (CDO's) are a type of **asset-backed security** and **structured** credit product. CDO's are constructed from a portfolio of fixed-income assets. These assets are divided into different **tranches**: senior tranches (**rated AAA**), mezzanine tranches (**AA to BB**), and equity tranches (**unrated**). Losses are applied in reverse order of seniority and so junior tranches offer higher **coupons** (interest rates) to compensate for the added CDO's serve as an important funding vehicle for fixed-income assets.

- The emperor's new clothes. <http>

Figure 1: Illegal Property Flipping Scheme



The House that Credit Built



arhousingbubble.blogspot.com