NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

IN THIS ISSUE ▸

Credit Risk Transfer Securities (CRT) – New Benchmark in U.S. Residential Mortgage Credit Investment

As the Federal Reserve raises short term interest rates, Credit Risk Transfer securities potentially offer an attractive floating rate opportunity.

INTRODUCTION

One of the watershed outcomes of the financial crisis was the government bailout of Fannie Mae and Freddie Mac (collectively known as Government Sponsored Enterprises or GSEs). This put taxpayer money directly at risk. While continued conservatorship of the GSEs remains a contentious issue, the Federal Housing Finance Administration (FHFA) has continued to focus on reducing the mortgage credit risk assumed by these entities. Since the introduction of the GSE scorecard of 2013,[1] the FHFA has directed the GSEs to demonstrate their ability to execute multiple types of risk transfer transactions involving single family mortgages. The goal was to explore the capital markets viability and response to mortgage credit risk via initial risk transfer on at least $30 billion of single family mortgage originations. Considering the favorable investor reception so far to these newly created mechanisms, the goal in 2017 has been grown to transfer a meaningful portion of credit risk to the private market on at least 90% of the unpaid principal balance of the newly acquired single family loan categories targeted.[2] The GSEs have also been tasked with, and have worked on, developing data standards to address underwriting shortfalls that became prevalent during the pre-crisis era.

GSEs have executed multiple forms of credit risk transfer mechanisms, mainly the Credit Risk Transfer (CRT) securities and Credit Insurance Structures. The former refers to securitization, which we will focus on here, whereas the latter refers to credit risk transfer via insurance/reinsurance contracts with global insurance companies.[3] Credit Risk Transfer securities collectively refer to the Connecticut Avenue Securities program (CAS) by Fannie Mae and Structured Agency Credit Risk program (STACR) by Freddie Mac.

CREDIT RISK TRANSFER (CRT) SECURITIZATION

Conceptually, mortgage credit risk transfer by the GSEs to private investors is aimed at reducing and limiting GSEs' adverse exposure to the broader U.S. housing market. By selling securities (henceforth, referred to as Notes or Bonds) that may bear losses up to a certain amount of underlying mortgage loan balance the GSEs are effectively buying loss protection from the capital markets.[4]

For more information on this topic, contact the author:

Rakesh Kansara
Senior Research Analyst
rakesh.kansara@neamgroup.com

neamgroup.com

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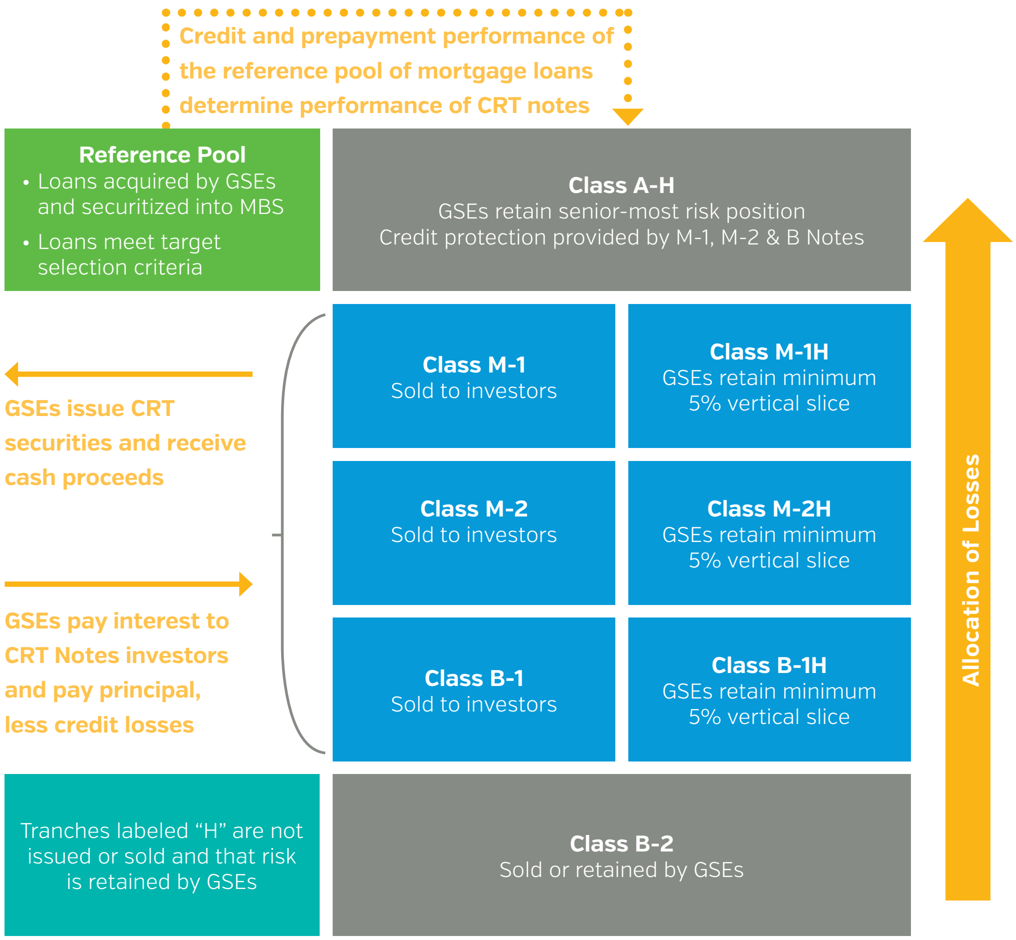
Nature of the Instrument

- Unsecured general debt obligations of the GSEs.
- Principal and interest payments directly paid by the GSEs monthly.
- Not guaranteed by the GSEs or U.S. Government.
- Subject to NAIC disclosures related to Structured Notes for insurance companies.
- Deals segregated by original loan-to-value (LTV) ratio of the reference pool.
- GSEs retain minimum 5% risk to comply with EU risk retention regulation.

Cash Flow Structure

- Notes cash flow based on reference pool performance.
- Scheduled and unscheduled principal cash flow move top-down, losses move bottom-up.
- Pro-rata payment of scheduled principal between seniors and subordinates.
- Activation of trigger(s) divert prepayment cash flow to A-H class (Fig. 1).
- Floating rate coupon indexed to 1-month LIBOR.
- Legal final maturity of 10 years or 12.5 years.

Figure 1. CRT Deal Structure

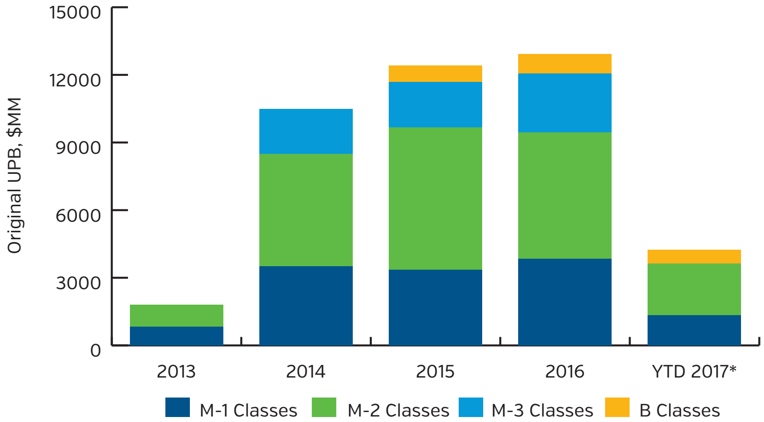


Source: NEAM, Fannie Mae, Freddie Mac

RELATIVE VALUE

As investor familiarity, issuance, and liquidity in CRT bonds have increased (Fig. 2 & 3), spread levels have approached comparably rated corporate bonds (Fig. 4). Additionally, with a floating rate indexed coupon, the interest rate risk on the front cash flow bonds (M-1) in CRT securities is significantly lower than fixed rate corporate bonds.

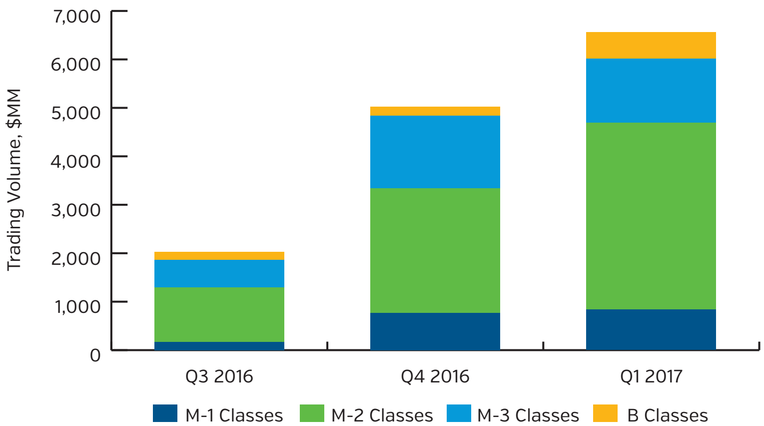
Figure 2. CRT Securities Issuance (CAS and STACR)



** As of 2/28/17*

Source: NEAM, Bloomberg

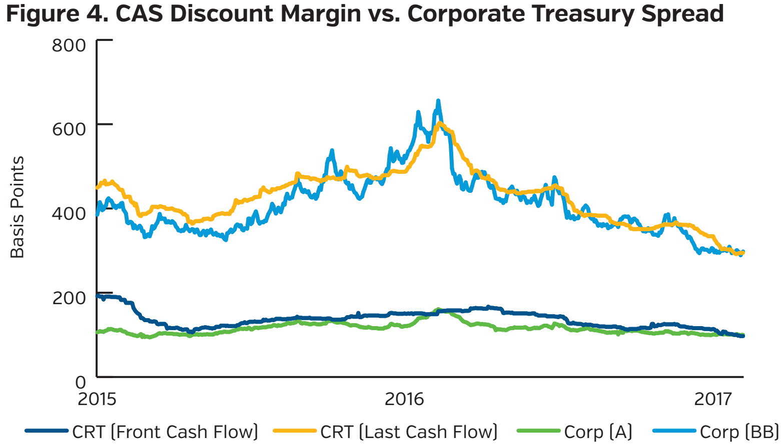
Figure 3. CRT Securities Secondary Trading Volume (CAS and STACR)



Source: NEAM, TRACE, Bloomberg

Credit rating agencies have been consistently upgrading CRT bonds as they delever and delinquencies remain subdued in an improving housing market. As per Bloomberg, of the total 144 CRT securities (M-1, M-2, M-3, and B classes) issued from 2013 to 2016, 64 have been upgraded from their original rating by at least one credit rating agency (as of 3/31/17).

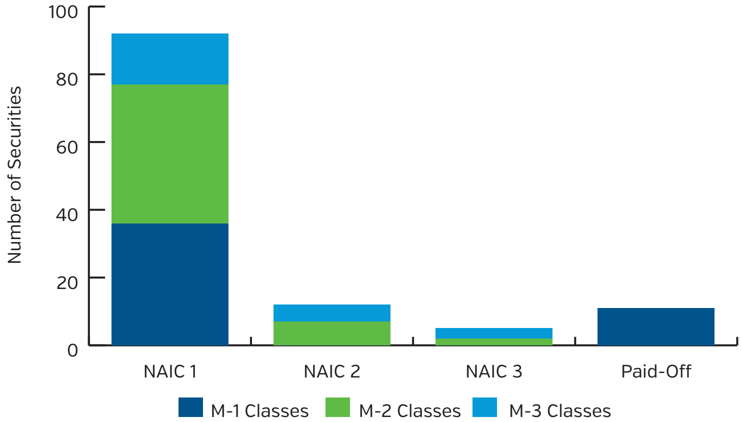
Figure 4. CAS Discount Margin vs. Corporate Treasury Spread



Source: NEAM, Morgan Stanley, Yield Book

For insurance company portfolios, NAIC designations of CRT bonds in 2016 have been favorable. Of the total 120 Mezzanine bonds issued from 2013 to 2016 (i.e. M-1, M-2, and M-3), 92 received NAIC 1 designation, 12 received NAIC 2 designation, and 5 received NAIC 3 designation while 11 bonds paid-off (Fig. 5).

Figure 5. CRT Securities - 2016 NAIC Designations



Source: NEAM, Fannie Mae, Freddie Mac

KEY TAKEAWAYS

- CRT securities potentially offer attractive risk-adjusted yield opportunity with a floating rate coupon, especially in the rising rates environment.
- Large, geographically diverse, and uniform credit collateral underlying CRT securities provides an avenue to obtain systematic exposure to U.S. housing market.
- Consistency of deal structure, programmatic issuance, and trade reporting on Trade Reporting and Compliance Engine (TRACE) improves liquidity and participation by a variety of investors.
- GSEs' ability to enforce robust, transparent, and consistent underwriting standards as well as uniform servicing management practices mitigate idiosyncratic investment risk.

END NOTES

[1] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2013EnterpriseScorecard_508.pdf

[2] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2017-Scorecard-for-Fannie-Mae-Freddie-Mac-and-CSS.pdf

[3] Fannie Mae's "Credit Insurance Risk Transfer" program http://www.fanniemae.com/portal/funding-the-market/credit-risk/credit-insurance.html

Freddie Mac's "Agency Credit Insurance Structure" program http://www.freddiemac.com/creditriskofferings/creditrisk_insurance.html

[4] Depending on the deal, the possible loss amount shared to date has been as high as 5.9%. However, since the GSEs retain a 5% vertical slice of securitized tranches sold (except the first loss tranche in some deals), effective maximum loss amount to date possibly born by investors may be less than 5.9%.

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