AlphaCentric Insights

A Look at Credit Risk Transfer (CRT) Investing

In this piece we'll explore:

1. What is a CRT and how is it structured?
2. How do CRTs fit into an investment portfolio?
3. What are the risks of CRTs?

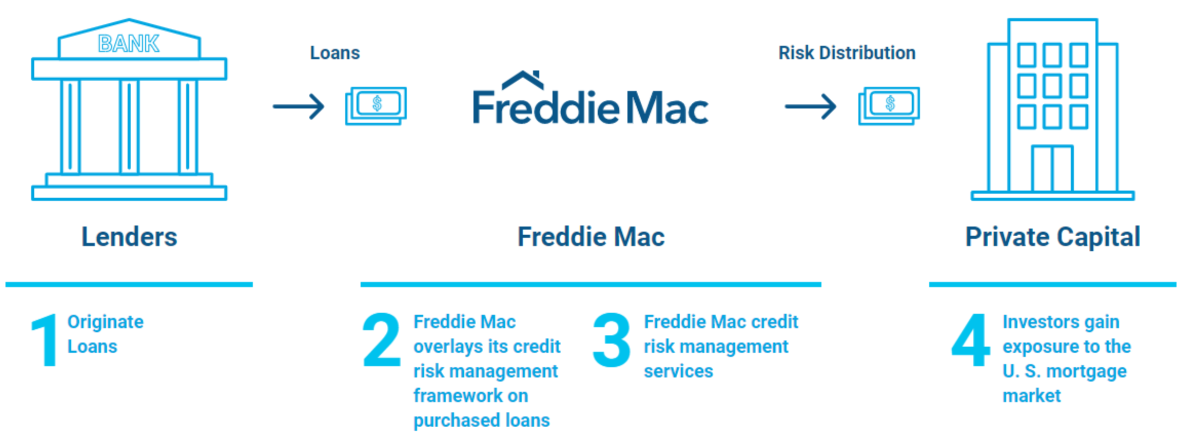
HISTORY OF AGENCY MORTGAGE CREDIT RISK

Prior to the 2008 housing crisis, Freddie Mac securitized mortgages as participation certificates and sold the interest rate risk to investors. Under this business model, Freddie Mac retained 100% of the associated mortgage credit risk.

In 2012, the Federal Housing Finance Agency (FHFA) initiated development of a credit risk transfer program intended to reduce Fannie Mae's and Freddie Mac's credit risk and, therefore, the risk they pose to taxpayers while in conservatorship. Fannie Mae and Freddie Mac implemented their credit risk transfer programs in 2013 and now transfer a substantial amount of the credit risk the enterprises (Fannie Mae and Freddie Mac) assume to private investors. The programs include credit risk transfers via debt issuances, insurance/reinsurance transactions, senior-subordinate securitizations, and a variety of lender collateralized recourse transactions.

FREDDIE MAC CRT:

In 2013, Freddie Mac engineered the STACR program, developing a structure to transfer mortgage credit risk to investors. Mortgages are required to meet the credit and underwriting standards of the Freddie Mac Single-Family/Servicer Guide and Freddie Mac continually collaborates with sellers and servicers to deliver results for borrowers and practice loss-mitigation practices for investors. The STACR structures issue notes out of a trust, which pays periodic payments or interest to noteholders.



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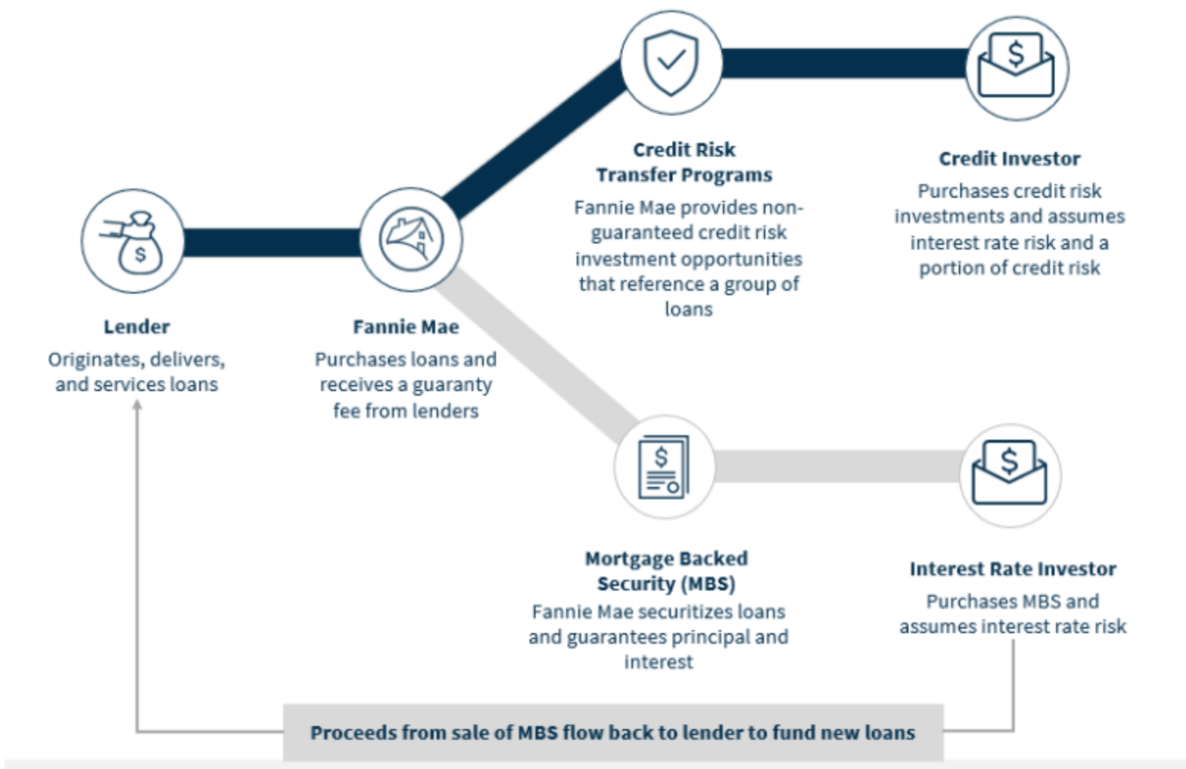
FANNIE MAE CRT:

Fannie Mae partners with private sources of capital to transfer mortgage credit risk, develop broad and liquid markets, and reduce taxpayer risk as a key part of its single family and multifamily business models. The credit risk transfer transactions facilitate the flow of private capital between Fannie Mae's lender customers and a diverse group of investors, therefore reducing the credit risk of the taxpayer backed by Fannie Mae and moving that risk onto private investors. Fannie Mae is the largest credit risk manager in the mortgage industry and offers a suite of CRT vehicles.

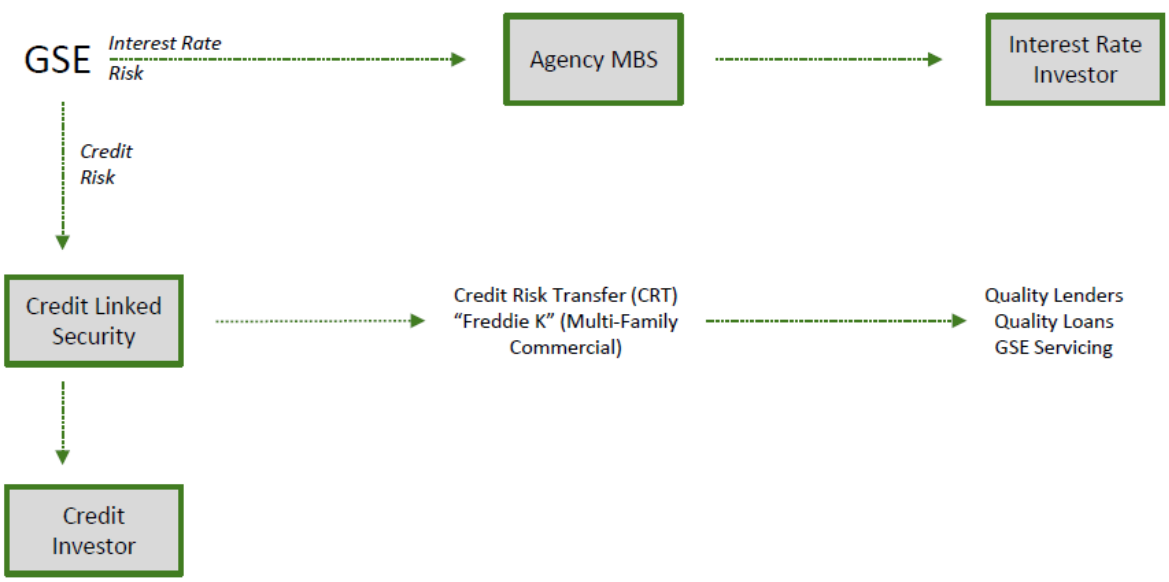
What is Credit Risk Transfer?



The basics of the CRT program is to reduce taxpayer exposure to Freddie Mac and Fannie Mae and offer capital market investors new and innovative ways to invest in the creditworthiness of the U.S. residential housing market in the post-2008 crisis era. The goals are to maintain borrower access to credit, minimize volatility through economic cycles, and strengthen the mortgage market by providing liquidity. For investors, the goal is to achieve attractive risk-adjusted returns while accessing various parts of the post-crisis mortgage credit and origination.

The CRT deals are issued as unsecured debt obligations of GSEs and are structured as credit-linked notes. The performance of the CRT notes are linked to a reference pool of loans that have been sold into MBS guaranteed by the GSEs; the GSE pays interest on the CRT notes and repays principal based on the prepayment and credit performance of the underlying loans. If the underlying loans incur credit losses, the CRT notes are written down and the GSE is no longer obligated to repay that portion of principal to investors. As a result, the burden of the loss is shifted to private investors. The notes are issued at par and are uncapped, floating, and based off LIBOR.

The CRT is designed to share credit risk on a portion of the GSEs newly originated mortgage loans underwritten according to the GSEs approved guidelines. Credit underwriting standards and risk controls have been tightened following the 2008 financial crisis. The loan categories that GSEs have targeted for CRT transactions generally consist of fixed-rate, single-family conventional loans with terms greater than 20-years, and have met the GSEs underwriting standards, with a loan-to-value (LTV) greater than or equal to 60%, but less than 97%. For the most part, bond interest is paid monthly and the GSE pays interest on the notes. Principal payments are ~~also~~ paid monthly, based on principal collection on the reference pool, subject to trigger tests.



CRTs tend to have an inverse relationship to interest rates:

CRTs have generally outperformed other residential mortgage sector investments with rising rates. They have the potential to offer value by trading at respective discounts and premiums to par, which can help manage duration for a diversified portfolio.

Buying securities at a discount can provide total return potential and purchasing at a premium can have the potential advantage of lowering portfolio duration when combined with other securities. In either case, what remains is collateral backed by housing and there is opportunity to take advantage of spread widening or tightening. Furthermore, tranches in the securities create potential for credit profile enhancements that can further balance, support, or bolster portfolios. Senior traches may offer more liquidity while junior tranches may offer larger returns relative to other structural opportunities.

Traditional agency mortgage backed securities are backed by GSE conforming mortgages while the typical MBS bond is paid a fixed rate coupon. Here, the GSE will take on the risk of any mortgages that might default. CRT bonds also hold as collateral GSE conforming mortgages. However, CRT bonds pay an uncapped floating coupon that resets each month. This is different from a typical agency MBS as a CRT creates a bond where investors bear some of the credit risk, while potentially mitigating the interest rate risk of the underlying bonds.

Perhaps one of the most attractive aspects of the CRT universe is that mortgages are made to borrowers who have average FICO scores near 750, debt-to-income ratios around 30%, and income and employment verification. We see continued support to homeowners generally and a commitment by the Federal Reserve to bolster housing broadly-speaking, which gives us confidence in these borrowers going forward. No to mention what we see as fundamental strengths in the housing market given supply-and-demand, house price appreciation, and the overall position of home-owners as we have shared in previous presentations. All loans are 30-year fixed rate mortgages. The potential to add CRT investments to a portfolio may offer several benefits including diversification and added liquidity when compared to other asset backed investments.

Sources:
Fannie Mae: https://www.fanniemae.com/portal/funding-the-market/credit-risk/index.html
Freddie Mac: https://crt.freddiemac.com/about-crt.aspx

Glossary:
GSE – Government-sponsored enterprises issue short- and long-term bonds (agency bonds) that carry the implicit backing of the U.S. government. Mortgage issuers Fannie Mae and Freddie Mac are examples of government-sponsored enterprises.

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