

GSE Credit Risk Transfer Securitizations (CRTs): An opportunity for attractive risk-adjusted returns in RMBS

SUMMARY: Semper believes that GSE-issued CRTs offer RMBS investors an opportunity for attractive levered and unlevered returns and also provide access to a relatively liquid set of instruments for tactically trading residential mortgage credit risk.

This piece also serves as an overview of a sector evaluation performed internally that resulted in our investment in CRTs.

Market and Offering Overview

Credit Risk Transfers serve as a way for government-sponsored enterprises (GSEs) to share credit risk with the private markets. The first CRT transaction was issued by Freddie Mac in 2013 following direction from the Federal Housing Administration (FHA) to transfer credit risk from their guarantee books to private investors in order to reduce the government's footprint in the mortgage finance market.

KEY COMPONENTS:

- CRT deals primarily come in 2 series: Structured Agency Credit Risk (STACRs) for Freddie Mac, and Connecticut Avenue Securities (CAS) for Fannie Mae
- 23 CRT deals with combined security balances of \$12B have been issued since July 2013
- These represent exposure to ~\$750B of residential single-family mortgages
- GSEs typically sell subordinate tranches representing up to the first 7% of collateral exposure
- Structured as unsecured general obligations of the GSEs and their cash flows are based on the performance of a large pool of reference loans
- Unlike traditional RMBS securities, bond payments do not come directly from underlying mortgages and are instead remitted by Fannie/Freddie to CRT investors

The deal structures have been evolving since 2013. In its latest STACR transactions, Freddie sold A-, BBB, BB, and B rated tranches, while Fannie CAS transactions usually deploy two class structures with tranches backed by two collateral groups: 60-80% LTV mortgages and 80%+ LTV mortgages with mortgage insurance. All CRT tranches are uncapped Libor floating rate securities with losses allocated reverse sequentially from the bottom of the capital structure. Principal prepayments are paid pro-rata between senior and subordinate tranches and sequentially within the subordinate tranches.

Most CRT deals have collateral performance triggers that could shut off principal payments to subordinate tranches. These triggers are based on minimum senior credit enhancement, cumulative defaults and cumulative delinquency rates in some deals. Loans exit the pool in a credit event (180 days delinquent, short sale, note sale, deed-in-lieu of foreclosure, REO (real estate owned) sale) are typically assigned a fixed loss severity based on the default schedule.

Generally, GSEs are required to buy back all of the CRT tranches at par in 10 years thereby preventing all tranches from extending. Based on coupon costs, operation costs, and GSE's required return on capital, the implied guarantee fees calculated from previously issued CRT deals average 56 basis points.

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Pros / Attractive attributes:

- 6-8% unlevered yields, assuming a fundamentally stable housing market
- Limited interest rate risk due to floating rate nature of CRT coupons that reset to LIBOR + margin
- GSE guaranteed with reference collateral consisting of newly-originated qualifying mortgage loans underwritten using strict credit standards (average FICO 750-770)
- Low idiosyncratic risk due to very high loan count backing each deal (over 100,000 reference loans in most CRT deals)
- Prepayments favorable, as they help de-lever junior tranches by paying off most senior tranches thereby decreasing credit risk and creating upside in lower rate environments
- High liquidity, strong dealer support and broad participation by institutional investors
- Large volume of issuance (\$750B) allows for scaling of investment
- Future REIT participation, upon approval as real estate securities, may provide a valuation boost to the CRT market space

Cons / Potential downsides and risks:

- Limited credit support for most junior tranches, resulting in sensitivity to dramatic housing market downturns
- GSEs have guaranteed around \$4T of similarly underwritten collateral (compared to \$750B of issuance), which could create an over supplied market, thus increasing spreads
- High beta to other credit risk products could cause higher spread and price volatility

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- Independent investment management firm specializing in residential and commercial mortgage-backed securities
- Offers institutional and high net worth investors access to multiple mortgage-centric investment platforms, ranging from private absolute return to public index-based strategies
- Minority Business Enterprise (MBE) certified and has been an SEC - registered investment advisor since 1992

DEFINITIONS:

RMBS: Residential Mortgage-Backed securities

FICO: credit score, used to measure consumer credit risk

Idiosyncratic risk: risk from individual assets underlying a security

LTV: the ratio of a loan to the value of an asset purchased

Return on capital: after-tax operating income divided by debt and equity capital less cash and equivalents

Libor: London Interbank Offered Rate

REIT: real estate investment trust

Beta: risk associated with the market as a whole

Credit risk: risk of borrower default on debts

Basis points: one hundredth of one percent

Tranche: a portion of a pool of bonds with like attributes

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