Prepayment spikes

Shift in focus for agency CRT investors?

Investors in US agency credit risk transfer (CRT) RMBS are taking note of recent STACR prepayment spikes. Robust performance and the re-emergence of a structural nuance have spurred a shift in focus for a sector historically focused on credit risk.

Freddie Mac STACR prepayment speeds for July continued their recent trend of increasing, with most deals surpassing their highs from earlier in the year. The highest voluntary conditional prepayment rate was registered by STACR 2015-HQ1 at 28.1%, up from 26.1% registered in April.

A number of seasoned Fannie Mae CAS deals have also produced their fastest prepayment speeds to date this year. Morgan Stanley RMBS analysts expect these speeds to continue rising at the release of the August remit data - due the middle of this month.

"The current market environment has effectively elevated the importance of analysing prepayments," says Andrew Davidson, founder and president of Andrew Davidson & Co. "If the Fed stays relatively dovish on potential interest rate hikes, mortgage rates should remain low and continue to support prepayment speeds. But I believe most deals are still currently remaining within model projections and not particularly anomalous."

Nonetheless, a small sample of deals from the STACR shelf has seen unusually high prepayments. In part, these are the result of small variables within the prepayment profiles of the respective transactions' pools, says Zach Cooper, deputy cio of Semper Capital Management.

"There's nothing special about the reference pools used as collateral in CRT deals. The higher prepayment rates in some are just contingent on the borrowers' situations," he explains. "I think the main drivers are refinancing incentives for mortgage holders and solid employment and income growth."

However, variations in prepayment speeds are emerging between certain STACR deals and their CAS counterparts. One example is the recently printed STACR 2016-DNA3 that posted a 28.6% prepayment rate in its first remittance, which is arguably even higher than expected for a low mortgage rate environment.

However, the reason behind this is an overlooked element within a number Freddie's STACR structures, which sees some deals accumulate approximately two months worth of prepayments prior to the initial payment - referred to as a 60-day reporting period by Wells Fargo structured products strategists. Following the first payment date, the deal reporting period reverts to the traditional monthly payment schedule, which therefore leads to a dip back to more standard prepayment speeds.

To date this year, three of the five 2016 STACR deals include this unique reporting period, but the concept is not new. It last appeared in the STACR 2014-HQ2 transaction.

"The initial reporting period exists to deal with the fact that there may be several months that pass between the deal's cut-off date and the time when the first payment takes place," the Wells Fargo strategists note. However, they point out that CAS deals do not feature these structural elements, due to their different payment and reporting cycles.

For Fannie Mae's CAS deals, the reporting period delay between when borrowers pay on their mortgages and when agencies pass the payments to investors is typically one month longer than Freddie's STACR deals. Because STACR deals are more susceptible to timing issues, the addition of the structural nuance lumps two payments into one.

These factors are driving recognition that credit concerns are perhaps not the primary risk when analysing agency CRT transactions, as had previously been assumed. Recent data suggests that credit quality across the sector is the healthiest in years, assisted by a new wave of stricter underwriting standards.

"The collateral is very robust. In fact, the quality is a lot higher than even the best performing pre-crisis transactions," says Davidson.

He continues: "Investors have realised this and while they may believe liquidity and spread concerns are perhaps a more immediate worry, these securities are in fact credit sensitive. So, long-term investors should remain focused on credit analysis."

Nonetheless, the 60-day plus delinquency rates in CRTs have been muted compared to pre-crisis GSE loans that possess similar LTV ratios. Specifically, the Wells Fargo strategists note that the delinquency rate in STACR 2014-DN3 - so far, among the highest of the CRT regular-LTV deals - is still far below 2003 Freddie vintages, which are considered the best performing pre-crisis deals.

Such performance has also prompted Moody's and Fitch to begin upgrading certain CRT bonds and, in some cases, assigning ratings to bonds that weren't previously rated (SCI 31 August). Most of the upgrades to date by Moody's have been in connection with M1 tranches of CAS or M1 and M2s of STACR, while Fitch assigned single-B plus and double-B plus ratings to eight CAS M2 tranches.

"I think these strong credit fundamentals and unwavering prepayments have prompted the shift of focus towards the latter when valuing bonds," says Cooper. "Spreads are tight in the CRT sector right now. So while fast prepayments may marginally improve credit enhancement, it's becoming a priority in the market to examine the negative effect this has for investors when everything is currently at a premium."

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