CRT customisation gains traction

The GSE credit risk transfer (CRT) market has continued to evolve since it began in 2013, with Fannie Mae and Freddie Mac respectively issuing US$23.9bn and US$19.8bn in CAS and STACR securities to date. The sector has taken a further step forwards in recent weeks, following the execution of the first exchangeables trades.

GSE CRT deals are a compelling investment in post-crisis credit, according to Semper Capital Management portfolio manager and RMBS head Neil Aggarwal. "The CAS and STACR programmes offer different attachment points and coupons, whereby investors can express various views on collateral, structure and more fundamentally on home prices and interest rates."

The ability to customise these investments has gained traction over the last few weeks, with the execution of the first five modifiable and combinable (MAC) note exchanges, four of which Semper Capital Management was involved with. The MAC structure allows the holder of various bonds (such as a premium priced M2 class) to: strip off the interest-only portion and sell either the IO portion or a reduced coupon principal bond; or create additional credit tranching in the form of more senior and subordinate notes (for example, M2A and M2B classes).

"Structural optionality is a big step in furthering the CRT programmes: it allows investors to take explicit views on both the credit curve and the interest rate curve. The principal flowing in facilitates time tranching and also allows views on interest rates to be expressed. At the same time, protection from subordination provides the ability to express views on credit quality," Aggarwal explains.

According to TRACE reported data, the recent exchangeables trades involved: CAS 2016-C06 1M2, which was both credit and rate tranched into 1M2I (IO), 1M2T (senior) and 1M2B (sub); STACR 2015-DNA2 M3, which was rate tranched into M3F (reduced coupon) and M3I (IO); STACR 2015-DNA3 M3, which was rate tranched into M3F (reduced coupon) and M3I (IO); STACR 2017-DNA1 M2, which was rate tranched into M2R (reduced coupon) and M2I (IO); and STACR 2017-DNA2 M2, which was rate tranched into M2R (reduced coupon) and M2I (IO).

Aggarwal suggests that the exchanges were largely an interest rate play, while taking advantage of liquidity and tightening spreads. He expects more exchangeables trades to occur and investor focus on this area to increase going forward.

Indeed, Aggarwal indicates that increasing investor interest is spurring the GSEs on to continue innovating. "The GSEs have significant oversight on the underlying collateral and they are very involved in the process. As an investor, I feel that if I have a question, they're willing to discuss it. There are so many investors involved in the CRT programmes and their programme's survivorship means they have to be open; they are willing to hear different views and take action to improve the investor experience."

Mike Reynolds, vp at Freddie Mac, confirms that his organisation is continually seeking to refine the STACR programme to make it more accessible to investors. "Credit risk transfer is a huge component of our strategy: our mission is to increase market liquidity and the availability of affordable housing, and STACR is the full solution to that. We already have over 200 unique investors participating in the STACR programme, including from Europe and Asia. But we're mindful of the need to keep broadening our investor base, so the next step is to make the product more attractive to REITs."

He continues: "Our biggest challenge is that many investors in the non-agency RMBS market lost money during the financial crisis and so their credit committees no longer have the desire to invest in the housing market. Our message is that the products and mortgage loans of today are different to those seen pre-2008."

CRT is the most transparent securitisation product in the market, according to Reynolds. He cites Freddie's disclosure of documentation, pricing and origination criteria as examples. Most recently, the GSE began providing estimated current LTVs as part of the ongoing loan-level disclosure data set for each STACR transaction.

"Investors are hiring Freddie Mac to perform a range of duties, including managing counterparty risk, REO dispositions and loss mitigation. Consequently, they need to feel comfortable with the underlying loans and that there is no adverse selection," Reynolds observes.

Laurel Davis, vp at Fannie Mae, agrees that transparency is important and that much of the innovation introduced into the CAS programme is designed to facilitate investor understanding and access. "Investors need to be able to understand how loans have performed and who Fannie Mae is as a credit risk manager. Consequently, we published loan level and monthly performance data on 24 million loans going back to 2000, so that investors can analyse the cycle and build credit models specific to our loans."

She adds: "Some investors said that such a large amount of data was difficult to process, so we rolled out a free tool, Data Dynamics, that sits on top of the data to slice and dice it on a historical and loan-level basis. Whenever we bring a new deal, we load it into the system, so that investors can compare it pre-pricing. We've also recently enhanced the data with geographic characteristics at the MSA and zip code levels."

Part of Fannie Mae's aim with CAS was to build a programme that would be repeatable and scalable, in order to create liquidity, according to Davis. "We heard from investors that ratings are important and obtained retroactive ratings on some sub bonds, which facilitated liquidity even further. We've also seen 46 upgrades - reflecting strong performance in the underlying mortgages, HPA in the US and structural deleveraging - and upgrade pressure remains."

As the market increased in liquidity, larger asset managers have become involved. Davis says that each CAS issuance has attracted new investors, with the recent NAIC designations encouraging insurance companies to participate and the opportunity to access diversified geographic exposure to US consumers driving an up-tick in interest from international investors.

Reynolds concurs that the majority of outstanding STACR CUSIPs having a NAIC 1 designation is more attractive to insurance companies. "Equally, we've seen many bonds upgraded from non-investment grade to investment grade, which opens the door to more investors. There is a pick-up in price for the bonds when this occurs."

Both Fannie Mae and Freddie Mac issue CRT deals with high-LTV and regular-LTV reference collateral. CAS transactions initially featured a mixture of both types of collateral, but issuances now alternate between regular- and high-LTV pools. Freddie has always separated the pools, using the 'HQ' moniker for high-LTV assets and 'DN' for regular-LTV assets.

"We found that investors prefer to bid separately on high-LTV pools, so we split the offerings out. The majority of high-LTV loans have mortgage insurance, which Freddie backstops," Reynolds observes.

Davis says that while ratings have been added down the capital stack, Fannie Mae has otherwise tried to keep the CAS structure stable over time, so each deal has featured an investment grade tranche and an unrated sub-investment grade bond. The most significant structural change - for both the CAS and STACR programmes - was the introduction of a split B tranche (SCI passim).

"Beginning in 2017, we began splitting the subordinate-most tranche, the B tranche, into two slices. We typically retain the first loss position, the B2 tranche, and offer the next slice of risk, the B1 tranche, to investors. We found that the new structure appeals to a broader investor base: credit support for the B1 tranche can be 2-3 times expected loss or more, depending on the deal and risk model being used, so investors feel they have decent credit protection while picking up yield," she explains.

Reynolds adds: "As we collated more performance data and strong performance was observed across the STACR programme, the general comfort level among investors improved and they felt able to move down the capital structure. To aid this move, we split the first loss bond into B1 and B2 tranches, where the B1 slice represents 50bp-100bp of protection."

Fannie Mae issued US$7.4bn in CAS bonds across seven deals last year and expects a similar pace of issuance this year, while remaining mindful of balancing supply with demand. "We generally issue larger sized deals when the market is stronger," confirms Davis. "Credit markets continue to be strong and we project US$6bn-US$8bn of issuance in 2017, assuming current conditions continue."

Freddie Mac also expects to issue roughly similar STACR volumes this year to 2016. "We anticipate a drop-off in volume as rates rise and so originations may slow down in the second half by around 25%. Rates are the biggest driver of issuance expectations," Reynolds notes.

Looking ahead, both GSEs are planning to further enhance their CRT programmes by enabling them to issue notes via a REMIC arrangement, which would make them more attractive to REIT investors in particular. They would facilitate this change - potentially by early 2018 - by making a REMIC tax election on a majority of single-family loans that are acquired.

As part of the plans, CRT note proceeds would be put into a REMIC trust that would be used to pay principal and part of the interest on the notes, as well as compensating the GSEs for losses. Morgan Stanley RMBS strategists suggest that this could drastically reduce investor counterparty risk compared to the current model, where the securities are unsecured obligations of Fannie and Freddie. They believe that additional demand from REITs - an investor base with over US$300bn in assets that is a natural buyer of mortgage risk - will be a tailwind for spreads, especially for M2 and B tranches.

Meanwhile, Fannie Mae is exploring the creation of a new benchmark CRT index. Davis confirms that investors have indicated that such an index would be useful.

"The total return performance of CAS has been strong, so some asset managers would like to have a way of benchmarking and to demonstrate performance to their investors. We continue to explore ways of helping investors," she notes.

Aggarwal welcomes both the development of a benchmark CRT index and the potential introduction of REMIC structures. "They are interesting ideas when thinking about optionality: a CDS index will offer an additional way for investors to access mortgage credit, especially when it can be difficult to source the cash bonds; and the recent announcements regarding changes in REIT eligibility will increase the investor universe for the CAS and STACR product."

He concludes: "In the early stages of the programme, the GSEs likely forecasted what the future of their CRT programmes would look like and I think they got it right: we're seeing significant issuance and significant demand for the product."

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