Semper On GSE Credit Risk Transfers (CRTs)

Summary:

Semper believes that the Credit Risk Transfer (CRT) market continues to be a compelling investment vehicle that offers RMBS investors an opportunity to achieve attractive risk-adjusted returns, while accessing various parts of post-crisis mortgage credit and origination.

Market Overview:

Following the mortgage crisis, the Federal Housing Finance Agency (FHFA) has mandated a number of changes affecting the government-sponsored enterprises (GSEs), mainly Fannie Mae and Freddie Mac. This mandate centers on reducing the risk of losses that the GSEs may pose to taxpayers. The first CRT transactions were issued in 2013 by both Freddie Mac and Fannie Mae in efforts to convey portions of their previously retained credit risk for the Agency mortgages they guarantee to the private sector. The collateral is newly issued (post-crisis) and incorporates significant reform in origination standards. Further, the reference collateral can vary in coupon and LTV, but is primarily conventional 30-yr fixed rate mortgages.

Key Components:

- CRT issuance primarily comes in 2 series: Connecticut Avenue Securities (CAS) by Fannie Mae, and Structured Agency Credit Risk (STACR) by Freddie Mac.
- As of May 2017, 47 CRT deals with combined security balances of $45B have been issued since the program's inception in 2013. This represents exposure to over $1.3 trillion of residential single-family mortgages.
- Unlike traditional RMBS securities, payments made to investors are not directly from the underlying mortgage cashflows, but are instead remitted by Fannie/Freddie to CRT investors. The prepayments and the defaults incurred on the underlying reference pools are then reflected in payments by the GSEs to bondholders.

The structural benefits are significant:

- The coupons paid by the GSEs are uncapped Libor floaters and carry various attachment points of credit enhancement.
- The GSE oversight and review of originator and servicer performance provides an additional layer of surveillance which represents a further positive to underlying fundamentals.
- The CRT program offers a uniform and standardized investment vehicle for investors to access post-crisis mortgage credit. Also, the CRT program issuance has dwarfed the size of the RMBS 2.0 market (i.e., post-crisis non-QM mortgage securitizations) through today. This is in part due to the lack of standardization of the RMBS 2.0 market. CRT has become one of the few investment areas where investors can access this post-crisis mortgage credit.
- The deal structures have been evolving since 2013. Initially only a first pay (M1) and last cashflow (LCF) were originated. Since then, these securities have evolved into anywhere from 3-5 tranches per transaction collateral pool. The deals now also offer exchangeable securities (MAC) where bondholders can split holdings into various access points of credit tranching or interest rates.

Market is garnering much attention:

- Investors have many options to express views within housing:
  - relative value to other US structured products and broader fixed income; and,
  - views on the path of home prices and the path of interest rates going forward; and, technical factors arising from the declining outstanding float in legacy RMBS sectors.
- Dealers are heavily involved in making markets on the various tranches due to the synergies in primary issuance and trading this sector in secondary markets.

- Rating agencies have taken positive actions on many of the tranches due to the credit performance of the assets, issuing several upgrades and positive rating outlooks.
- Depth of the market continues to grow. Given that the CRT market is one of the only sizeable sectors available to investors in post-crisis mortgage credit and underwriting today, the GSEs continue to work on expanding the investor base. An example: they are working on the REIT eligibility of the product, and once implemented, should further improve the size and depth of the investor base.

Semper Position:

The CRT market remains well supported, while the collateral and structural benefits are high. We believe different parts of the capital structure add relative value in our portfolio construction. Here are some of the areas we find beneficial within our portfolios:

- Front Cash Flows (M1s) are front sequentials which pay atop the cashflow waterfall. They shorten as rates rally, but don't extend significantly in an interest rate selloff (to clarify, mortgage rates are pegged to the on-the-run 10yr US Treasury note and with higher rates, mortgage rates increase, slowing principal prepayments and therefore these bonds slow down/extend). The uncapped Libor floater offers additional protection against rising rates enhancing the risk-adjusted return profile. They are low beta and stable carry, and we have added these positions in many of our Funds.
- Last Cash Flows (LCFs) are generally the second or third payer in the sequential waterfall. They are longer in spread duration and carry thick coupon spreads. Similar to the M1, the LCF's are also uncapped floaters that may increase in value in scenarios of higher rates and cashflow extension (explained previously). Performance thus far remains strong and offers relative value versus the traditional legacy space and we have added across the deal seasoning curve for many of our Funds.
- Modifiable and Combinable (MACs): These options allow a framework for investors to exchange tranches to express differing credit or interest rate views, for example by splitting off the interest-only portion or increasing/decreasing loss support. In recent weeks, we have taken advantage of these MACs to create profiles which we believe add additional value and optionality to certain portfolios.

Home prices have continued their steady improvement and today, coupled with new post-crisis underwriting guidelines, we view the underlying sector outlook as strong. Continued enhancements to the program, structure, and the growing depth of the investor base, all while housing and market fundamentals remain robust, are reasons for our focus and positioning within the CRT sectors.

Semper Capital Management, L.P.

Semper Capital is an independent investment management firm specializing in structured product investments with a focus on mortgage-backed securities. Semper Capital offers clients access to multiple investment products ranging from private absolute return funds and custom managed accounts to public mutual funds. Semper Capital has been an SEC-registered investment advisor since 1992, and is an MBE certified and veteran owned business.

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