Insight

Credit Risk Transfers: A Primer

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Executive Summary

- The 2007-2008 financial crisis demonstrated the enormous risk to economic stability posed by the housing finance giants Fannie Mae and Freddie Mac.
- Since conservatorship, that risk has been assumed entirely by the federal government and the U.S. taxpayer – with one key exception, the credit risk transfer (CRT), through which Fannie and Freddie have transferred over $100 billion of risk from the public to the private sector.
- CRTs decrease the risk borne by the federal government, improve systemic stability, have created a highly liquid secondary market, and have improved the quality and access consumers have to mortgages.
- CRTs therefore represent one of the few available and most effective tools the housing market has against another financial crisis triggered by a collapse in the housing market.

Context

Widespread defaults on home mortgages as a result of the Great Depression led to the creation in 1938 of the Federal National Mortgage Association, known as Fannie Mae. In 1970, the same impetus drove the creation of the Federal Home Loan Mortgage Corporation, known as Freddie Mac. By securitizing mortgages as mortgage-backed securities (MBS), Fannie Mae created a secondary mortgage market, greatly improving the ability of banks to issue home mortgages. The 2007-2008 financial crisis required the U.S. government to rescue Fannie Mae and Freddie Mac, putting them into conservatorship in September 2008, and the two government-sponsored enterprises (GSEs) remain in conservatorship under the Federal Housing Finance Agency (FHFA) to this day. Risks borne by the GSEs are ultimately backed by the taxpayer, and in 2013, the GSEs created the credit

risk transfer (CRT) program to transfer some of the risks held by the GSEs (and by extension, the U.S. government, and thus the taxpayer) to private industry.

This primer sets out the history, function, and role of CRTs in the housing finance market. A robust system of private capital supporting the GSEs minimizes volatility in the housing finance market, improving market stability and helping to ward off another systemic collapse, and introduces a constituency incentivized to monitor the risks taken by the GSEs. CRTs also improve mortgage products' affordability and consumers' access to them.

The American Action Forum has written at length on the need for large-scale housing finance reform and the need to end the conservatorship of the GSEs. In the decade since the GSEs became public wards, CRTs represent the only positive step limiting the risk of the U.S. government and the taxpayer to the hazards posed by the GSEs and the housing market more generally, and the role played by CRTs remains more important than ever.

History

Prior to the housing crisis, the GSEs securitized mortgages as participation certificates and sold only the interest rate risk to investors, a business model that required the GSEs to retain 100 percent of mortgage credit risk. As GSEs, Fannie Mae and Freddie Mac, although privately owned, are publicly chartered with a line of credit from the Department of Treasury (and other preferential features to their charter). As a result, they are viewed as being backed by the taxpayer. The structural weaknesses exposed by the financial crisis, and assumption of these risks by the taxpayer, demonstrated an urgent need to reform the business model of the GSEs to pass on some of the GSEs' mortgage credit risk. In 2013, Freddie Mac created the Structured Agency Credit Risk (STACR) program, the first CRT vehicle enabling private industry to directly purchase credit risk from the enterprise, with Fannie Mae following suit in the same year with its Connecticut Avenue Securities (CAS) program. Although CRT remains the predominant risk-sharing vehicle for the GSEs, it is not the only channel, and the GSEs employ other risk-mitigation mechanisms. These include credit insurance risk transfers including Fannie Mae's Credit Insurance Risk Transfer program, which transfers risk to an insurance provider and usually then a reinsurance provider rather than the GSEs holding the investment themselves.

Function

CRTs are issued by the GSEs as unsecured debt obligations. Unsecured refers to the fact that these debt obligations are not backed by any form of collateral and as such represent a greater threat to the buyer in that they might not be able to recover their investment. To offset this risk, unsecured debt obligations typically carry higher interest rates and are

structured as credit-linked notes (a financial security specifically designed to transfer credit risk). The GSEs pay interest on these notes and repay principal based on the performance of an underlying pool of loans. The GSEs choose the underlying loan pool at their discretion, although the typical choice is fixed-rate single-family loans with a loan-to-value (LTV) ratio exceeding 60 percent. If this loan pool incurs losses, the value of the notes is written down and the GSE is no longer obligated to pay that portion of the principal to its investors, shifting the burden of any loss to the investors. This puts the GSEs in a ”last loss” rather than ”first loss” position with respect to many of the loans that they guarantee. Neither the STACR nor CAS program impacts investors in the more traditional GSE MBS products as the GSE remains the only guarantor, with the role of the GSE being something like a central counterparty.

CRT notes are issued at par (face value), uncapped (without ceiling), and have historically been based off the London Inter-Bank Offered Rate (LIBOR), a benchmark interest rate widely used by the housing finance market due to be replaced by U.S. regulators by the end of 2021. All STACR and CAS bonds are provided a rating by the National Association of Insurance Commissions (NAIC).

Market Size

As of August 2020, the STACR program (unique to Freddie Mac), has transferred $62 billion in credit risk to a wide range of private investors, including money managers, reinsurers, and hedge funds. Similarly, Fannie Mae’s CAS program has transferred $47 billion. The FHFA noted shortly after the commencement of the programs that the GSEs were transferring “significant” amounts of risk on almost 90 percent of all loans representing the GSEs’ credit risk. Passing over $100 billion in credit risk to private industry represents a meaningful reduction in the exposure of the federal government to mortgage credit risk and has created a new financial market that is pricing and trading credit risk. CRTs operate in a highly liquid environment, with STACR notes bought and sold in $2 billion-worth of trades on average a month.

The performance and liquidity of CRT instruments, however, took a serious blow with the onset of the coronavirus pandemic. Fannie Mae has not issued CAS bonds since Q1 2020, the onset of the pandemic, although Freddie Mac did resume STACR offerings after a brief pause. Nevertheless, the damage to the industry shook investor confidence in the viability of CRTs, and rating agencies have followed this by downgrading a number of CRT vehicles.

Prospects for GSE Reform and the CRT

The CRTs represent a real effort to reduce the exposure of taxpayers to the risks of the

housing market, but they are limited in their ultimate impact. What is really needed is congressional action reforming the GSEs, but such action appears as unlikely as ever.

Conversely, the present administration is the first since the financial crisis to test in a serious way the scope of its authority to pursue housing finance reform without Congress, and 2019 saw significant advances by the administration in the direction of housing finance reform. The Treasury and Department of Housing and Urban Development published their recommendations for widescale reform to the housing finance market, the Consumer Financial Protection Bureau announced its intention to allow the Qualified Mortgage rule to expire, and in a joint announcement the FHFA and Treasury amended the net-worth sweep and in so doing allowed the GSEs to retain a portion (up to an aggregate $45 billion) of their earnings. These reforms have de-leveraged Fannie Mae and Freddie Mac from a leverage ratio of 1,000-1 earlier in the year to 500-1 and are therefore necessarily a step in the right direction.

The FHFA is clearly advancing along a path to GSE reform and the newly proposed capital rule is one of the final conceptual steps towards releasing the GSEs from conservatorship. By virtue of the implied Treasury backstop, however, even post-conservatorship the GSEs will likely pose a significant risk to the taxpayer. While GSE reform is important, the manner in which reform is achieved is equally if not more important, and any future in which the usage of the CRT is disincentivized poses enormous risks to financial stability.