



# Credit Risk Transfers as a Catalyst for Affordable Housing Initiatives

*David Brickman*

*April 2022*

Together, Fannie Mae and Freddie Mac are the dominant providers of capital to the residential mortgage market and are in a unique position, given their size and scale, to drive innovation in the US housing market. But while they are in conservatorship, where they are effectively owned by the federal government, it is not appropriate for them to engage in new and ostensibly riskier initiatives that might put taxpayers at risk. Fortunately, powerful and underused tools are available that can help. By leveraging the existing and potential suite of credit risk transfer (CRT) tools and capabilities, the government-sponsored enterprises (GSEs) can boldly address the acute barriers to affordable and equitable homeownership. In this brief, I explain the potential of CRT strategies to assist in those efforts.

This brief begins with an explanation of how credit risk transfers have historically been used and argues for a more expansive approach to promote affordable housing. I provide examples of how a CRT could encourage loans for manufactured and multifamily housing, vital segments of the nation's affordable housing stock. I then suggest steps that need to be taken to facilitate greater CRT activity by the GSEs. I close with an explanation of why now is the right moment to thoughtfully expand the use of CRTs to reduce affordable housing shortages, including the opportunities to narrow racial wealth and homeownership gaps, broaden the pool of potential CRT investors to include those focused on social responsibility, and help the GSEs satisfy their affordable housing mission and promote equity as recently directed by the Federal Housing Finance Agency (FHFA).

# The Case for a More Expansive View of Credit Risk Transfers

The GSEs have a mandate to provide liquidity, stability, and affordability to US housing markets. The primary way they fulfill this mandate is by pooling, managing, and redistributing mortgages and the risks associated with them. By distributing such risks to investors, the GSEs reduce the volatility associated with market shocks and increase liquidity for mortgages and mortgage-related assets.

Historically, Fannie Mae and Freddie Mac guaranteed—and therefore retained the bulk of the credit risk on—the mortgages they purchased, with the most notable exception being private mortgage insurance required on loans with high loan-to-value ratios. In 2006, Freddie Mac introduced an early form of CRT with the first multifamily K-Deal, a senior subordinate securitization. In 2013, Freddie Mac issued its first single-family CRT transaction, and Fannie Mae followed shortly thereafter. These CRTs provided the GSEs vehicles for transferring their credit risk exposure to private investors via an unsecured or unguaranteed obligation issued by the GSEs.

The term “CRT” typically refers to only a narrow set of these sorts of transactions. But these types of CRTs are just one of many ways the GSEs can transfer credit risk to other entities. For example, when a GSE finances loans it does not own, such as in the role of senior debtholder or guarantor, it is transferring at least some portion of the credit risk exposure while providing critical market liquidity. Thus, although financing is not considered CRT, it has the same risk and economic implications.

All the various forms of CRT can help deliver liquidity to the market, provide observable market prices for various types of risk that otherwise might be hard to price, and be a private market check on the credit quality and economic soundness of GSE activities. And in the extreme, CRT enables the GSEs to affect the availability and structure of mortgage credit while retaining only catastrophic or backstop risk. Throughout the remainder of this brief, I define “CRT” as broadly as possible to include any of the many transactions, structures, and executions that result in the transfer of credit risk from the GSEs to the private market. (For a list of other activities that should be considered credit risk transfers, see the appendix.)

Along with widening the definition of a CRT, there is a need to consider additional CRT applications. Most CRT activity has focused on managing the risk of existing GSE business and prototypical loan products. Consequently, one of the chief virtues of CRTs has not yet been fully realized: the ability to enable the GSEs to prudently experiment with new products and catalyze new business activities, key components of their mission.

To understand the role CRTs can play in helping the GSEs achieve their mission, it is useful to review the mission. As instructed in their charters, the GSEs are to strengthen the mortgage market for underserved populations. Specifically, they are tasked with providing “ongoing assistance to the secondary mortgage market for residential mortgages (including activities relating to mortgages on housing for low and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and

improving the distribution of capital available for residential mortgage financing.”<sup>1</sup> They are also required to “promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”<sup>2</sup> Further, last year, the FHFA asked the GSEs to submit plans to sustainably advance equitable housing finance as part of a new Equitable Housing Finance Plan requirement.

CRTs can help the GSEs satisfy these objectives in a manner that avoids the inherent tension between risk and innovation while opening new avenues for investors to participate in the mortgage and housing markets. For example, the GSEs could partner with social impact investors to structure CRTs on mortgage products that satisfy investors’ impact criteria, in turn broadening the pool of CRT investors and drawing more capital into the market. CRTs could also be used to gauge market demand for new products through reverse inquiries from investors and allow for healthy competition among pilot sponsors for new products and executions.

Consider manufactured housing, the nation’s largest source of unsubsidized affordable housing and 13 percent of occupied homes in rural communities and small towns. These factory-built homes comply with the national US Department of Housing and Urban Development code, cost significantly less than site-built homes, and primarily serve older homeowners with lower incomes and lower net worth than site-built homeowners. Today, about 17.5 million Americans live in manufactured homes (Russell et al. 2021).

Manufactured homes are placed on land that the homeowner either owns or leases, and this distinction has important implications for the homeowner’s cost. If the homeowner owns both the manufactured home and the underlying land, they can apply for a traditional mortgage loan. But if the homeowner rents the underlying land, they are ineligible for a traditional mortgage loan and instead must apply for a chattel loan, or a loan against personal property that carries a higher interest rate than a traditional mortgage loan. About 42 percent of manufactured housing loans are chattel loans (Russell et al. 2021).

Despite the critical role manufactured housing plays in providing affordable homeownership, the market for manufactured housing lending is more concentrated than that of site-built home lending, especially for chattel loans. According to a Consumer Financial Protection Bureau analysis of Home Mortgage Disclosure Act data, the top 5 lenders active in the manufactured housing market in 2019 originated more than 40 percent of home purchase manufactured housing loans, including nearly 75 percent of chattel loans. Many of the remaining top 15 lenders were banks and nonbank lenders for whom manufactured home loans are a small share of their business, and nonbank lenders are gaining market share as banks have decreased their activity or left the market altogether over the past decade. The result is a market that lacks both the liquidity and competition necessary to bring down interest rates for borrowers, especially among those who rely on chattel loans (Russell et al. 2021).

An opportunity exists here for the GSEs to use CRT tools to enter this market, create liquidity and standardization, and lower homeownership costs for some forms of manufactured housing. To

understand how the GSEs can do this effectively and prudently, it is important to note that even though the secondary market for manufactured home chattel loans is small, there are investors active in that space. The GSEs could leverage the activities of existing lenders and investors through this more expansive and “proactive” view of CRT. Specifically, the GSEs could work with existing lenders to develop a standardized product for manufactured housing chattel loans, including a single set of loan terms and documents, credit parameters, and delivery mechanics, which would create significant value and bring helpful liquidity to an otherwise fragmented market.

The GSEs could leverage this standardization by developing any one of several types of CRT structures with existing and potential investors. To provide liquidity to the market, the GSEs could purchase mortgages directly, thereby ensuring standards are met and providing quality control in loan manufacturing. Additionally, they could hold some degree of backstop or catastrophic risk that would be highly unlikely to ever result in any loss. Possible CRT structures could range from front-end commitments from investors to purchase CRTs to senior subordinate securitizations. A high-yield but unguaranteed subordinate bond would likely appeal to existing market participants, as they invest in the same risk today at lower yields and with greater capital requirements (see the appendix for a stylized example). The lower cost of senior GSE capital would more than likely offset the higher costs of capital on the CRT. It would also add significant liquidity to the market and create greater transparency through the accumulation and disclosure of loan information and performance data over time.

Of course, the GSEs do not today have significant experience doing chattel loans, and the risk on such loans is unquestionably greater than what we see in typical conforming loans. But the GSEs could readily adapt the CRT toolkit to meet these challenges. For example, they could require lenders to initially retain (or work with investment partners to purchase) significant first-loss bonds on such pools and thus ensure skin in the game. Further, the GSEs could set attachment points much higher than what we see today on conventional residential mortgages and higher than historical loss rates. For example, where a typical single-family CRT might have a detachment point (i.e., maximum level of credit support) of 2 to 3 percent, and a multifamily K-Deal might have credit support of 5 to 7.5 percent, a new CRT based on chattel loans might start with credit support of at least 20 percent. Using a conservative severity or loss, given an 80 percent default rate, this level of subordination would be adequate to protect the GSEs against a 25 percent default rate (25 percent default x 80 percent loss severity = 20 percent losses). That said, both the default rate and the loss severity appear higher than recent experience would suggest based on research from Freddie Mac using the National Mortgage Database (Freddie Mac Single-Family, n.d.).

Although using such high levels of credit support might lower the pricing benefit initially, it would likely be economically feasible and nominally profitable for the GSEs based on current mortgage rates (see the appendix). Also, economic returns would likely tighten as liquidity, standardization, and loan data become more widely available, drawing additional lenders and investors into the market. By offering this type of structure, the GSEs could bring much-needed liquidity to the market and help lower mortgage rates on chattel loans to the benefit of millions of low-income Americans living in

manufactured homes. These lower rates could also make homeownership more accessible to many low-income households and possibly increase product demand.<sup>3</sup>

Manufactured housing is just one of many products that could benefit from this sort of CRT pilot. Another pilot could be construction-to-permanent loans to single-family and multifamily developers. Numerous developers and investors would be willing to participate in such a CRT, and the transactions could give developers incentives to build more affordable homes or projects. The incentives could be provided both through attractive pricing and through reduced risk associated with the conversion from a construction to a permanent loan; such products would also reduce the transaction costs associated with interim or bridge financing. CRT pilots could also prove valuable for mortgage products that use alternative credit scores, small-balance single-family loans, and shared appreciation and rent-to-own products, among others.

To illustrate how this could work, consider the K-G (green) CRT transactions Freddie Mac has issued to finance energy or water efficiency improvements in multifamily projects that comprise workforce housing. The subordinate (unguaranteed) bonds in those securitizations have generally been purchased by socially oriented or ESG (environmental, social, and governance) investors at yields lower than would have been expected based on their risk characteristics. What Freddie Mac or Fannie Mae can do in these types of transactions is to define the “box”—the credit and loan parameters that are acceptable—and to offer price (spread) concessions based on the expected back-end execution. These price concessions can induce a sponsor to undertake a project or renovation or a mortgage lender to make a loan they might not have otherwise made.

A related example of this is a separate program Freddie Mac offered that worked directly with a sponsor of low-income housing to aggregate and sell subordinate bonds on a pool of loans (tax-exempt bonds) that financed affordable housing made possible by the Low-Income Housing Tax Credit program. By participating in the CRT, the owners of the developments lowered their up-front costs of capital, making possible affordable projects that might otherwise have been difficult to finance. In both of these programs, the investors in the bonds (the CRT investments) had not previously invested in CRTs, and their participation represented a noteworthy expansion of the CRT market.

## Next Steps in Expanding the GSEs’ Use of CRTs

To capitalize on these and other opportunities, there must be a broadening of how CRTs are conceptualized and used. There must be a shift away from the tendency to view CRTs exclusively as a tool to reduce risk exposure on existing GSE business activities toward considering a wider range of CRT applications, including incubating pilots and initiatives that address challenges in affordable housing issues related to cost, access, and supply.

In the CRT context, the GSEs are the appropriate drivers of innovation for several reasons. They possess an unparalleled ability to conduct research and develop pilots. This is not only because of their size but because of their demonstrated success in creating and imposing underwriting standards that enjoy broad market confidence. Additionally, the GSEs have the proven ability to create operational

scale across a range of important activities, including the aggregation and distribution of capital, products, risk, and information. Finally, the GSEs are highly regulated, providing investors and taxpayers a crucial layer of additional protection and accountability.

Despite their many advantages, the GSEs would nevertheless face obstacles to innovating CRT pilots. Among other things, the GSEs would need to resolve operational challenges to buying new types of mortgages. Also, because product development is inherently nonlinear, the GSEs and their conservator would need to embrace the negotiations, market testing, and product modifications that are required to successfully launch and develop a pilot. This process does not necessarily comport with the existing and somewhat regimented processes the FHFA uses to approve new products or executions.

Crucially, this approach is not intended or expected to increase the GSEs' retained risk. Instead, the strategy would be to do more business with a wider range of products but retain less risk. The GSEs can innovate CRT initiatives while continuing to prudently limit their capital and risk exposures, as is appropriate for institutions so critical to the stability and vitality of the housing system. Initiating CRT pilots would not meaningfully increase the GSEs' exposure to definable credit or interest rate risk, nor would the pilots meaningfully affect their retained portfolios as long as the focus is on retaining only catastrophic or backstop risk and distributing most first-loss risk. Under the more expansive definition, where CRTs may be seen as financing a co-investment, expanded CRT offerings could reduce GSE risk exposure and possibly their capital requirements, too, depending upon the specific structures and capital treatment.

Several steps must be taken for the GSEs to effectively innovate CRT initiatives. First, there must be clarity around whether various CRT pilots would be subject to the new product rules put in place in 2021 that require the GSEs to provide advance notice of new activities to the FHFA and obtain approval before launching new products. Second, GSE risk limits on pre-CRT risk or "untested" products would need to be relaxed. This change would not enable the GSEs to hold more risk but rather to enable them to buy and then sell more risk. And third, a host of limitations, largely in the form of regulatory directives or charter interpretations provided or issued to the GSEs that broadly preclude certain activities, would need to be revisited, as they may strictly limit certain types of loan products, financing activities, or investments.

In addition, it would be critical for the GSEs to be able to use a small portion of their retained portfolio capacity—say, \$10 billion per GSE—to fund and incubate some of these pilots and make commensurate allowances to hold the less liquid products or residuals that would support the underlying assets for the CRTs. Restrictions on the strict retained portfolio limits and liquidity requirements would likely need to be granted to make this possible.

Naturally, with GSE innovation, there are concerns around potential creep regarding scope and scale. These fears overestimate the degree of discretion available to the GSEs and underestimate the many and extensive levels of oversight federal conservatorship has introduced. That said, it will be important for the GSEs to establish clear goals and boundaries for each CRT pilot, including explicit risk

and capital thresholds, as well as both financial and mission-focused performance standards and benchmarks. Strict volume limits have been, and could continue to be, used to effectively constrain new products. And any changes to GSE policies and practices should be made only to facilitate CRT activities that strengthen the GSEs' ability to meet their affordable housing mission and equity objectives. Doing so could also help the GSEs better address climate vulnerabilities.

Although CRT initiatives are not a panacea for the nation's housing woes, they are a powerful and underused tool the GSEs can use to help address affordable housing issues related to cost, access, and supply. Doing so will not only help the GSEs meet their affordable housing goals but potentially expand the market for CRTs by attracting impact investors interested in affordable housing or mission-oriented investments more broadly. Additionally, given the well-documented history of racial inequities in housing, increasing the availability of affordable housing will help the GSEs promote equity, as recently directed by the FHFA, and help close the nation's ever-widening racial wealth and homeownership gaps.

## Appendix

### Additional CRT Models

Examples of other transactions, structures, and activities that should be considered credit risk transfer strategies include the following:

- **Synthetic, derivative-like contracts or instruments that transfer risk in return for premiums.** These back-end transactions are the most commonly used CRTs.
- **Reinsurance contracts.** These are similar to synthetic, derivative-like contracts or instruments that transfer risk in return for premiums, except that they are designed as an insurance contract to enable reinsurers to participate. Premiums are paid based on a pool of mortgages, and claim payments to the GSEs are effectively prompted by credit losses.
- **Structured sale of a pool of mortgages for specific products with front-end CRT.** In this arrangement, the seller or sponsor (or a related party) agrees to purchase or retain a CRT bond based on a specific pool of mortgages or types of financing. These were a widely used and successful tool on conventional deliveries in the past.
- **Structured securitizations in which a portion of the capital structure is not guaranteed (e.g., senior subordinate securitization).** This is the typical structure used in Freddie Mac's K-Deal program.
- **GSE purchase and then sale of a highly specified type of mortgage to precommitted investors (or investor vehicles) with the GSE's commitment to provide warehouse or term repurchase agreement financing subject to strict conditions and narrow eligibility limited to that mortgage type.** This is a little-used but highly effective structure for encouraging new, less liquid mortgages that may not be as readily securitized (e.g., construction loans).

- **Creation of bankruptcy remote special purpose entity vehicles that are primarily capitalized and financed privately, with only partial capitalization or financing by the GSEs.** These investment vehicles would be constrained to a narrow class of mortgage or investment eligibility standards and would not be guaranteed by a GSE. This approach has not been used but represents a viable mechanism for capitalizing and ringfencing the risk of a GSE-sponsored initiative.
- **Mortgage purchase with recourse.** Perhaps the oldest form of CRT, this strategy continues to be used successfully and is an effective mechanism for managing risk when the GSEs purchase mortgages from well-capitalized “rated” institutions, such as large commercial banks or mortgage sellers who retain GSE servicing. That said, the accounting and capital treatment for these types of transactions is generally unfavorable for the selling institution, particularly for new products where the risk retention may be expected to be more significant and the counterparty risk management by the GSEs more challenging.

## Theoretical CRT for the Manufactured Housing Chattel Sector

To understand how a CRT-based strategy can help the GSEs extend credit to a new sector in a prudent and economically sustainable way, consider the hypothetical example below, based loosely on what we might expect in the manufactured housing chattel sector.

Assume lenders are originating chattel loans with an 8.25 percent interest rate. The GSEs could offer to buy such loans, with, for example, a forward commitment from a well-capitalized investor to purchase a subordinate bond representing 20 percent of the first-loss risk for a (non-loss-adjusted) yield of, say, 20 percent. Let us further imagine that the GSEs could sell a GSE-guaranteed mortgage-backed security for approximately 1 percent over where current single-family to-be-announced securities trade—or, approximately 4 percent today. Then, the GSEs could purchase a pool of the 8 percent mortgages for par (\$100) and sell the two tranches: a senior bond representing 80 percent of the principal for a 4 percent return and a subordinate bond (the first-loss risk) representing 20 percent of the principal for a 20 percent return. The total interest paid by the mortgages and the bonds (all based on an illustrative \$100 balance) would be as follows:

Interest paid on mortgage: \$8.25

Servicing fee retained by servicer: \$0.50

Net interest advanced to GSEs: \$7.75

Interest paid by GSEs on senior bond: \$3.20 (4 percent of \$80 in senior bonds)

Interest paid by GSEs on subordinate bonds: \$4 (20 percent of \$20 in subordinate bonds)

Total interest paid by GSEs: \$7.20

Residual interest or cash flow available to pay a GSE guarantee fee would be \$0.55 (or 55 basis points). For guaranteeing a highly credit-enhanced bond, this would be a reasonable guarantee fee. Of course, all these numbers are stylized and simplified. Actual execution would differ and could be



significantly enhanced through structuring and would also be reasonably expected to compress over time.

## Notes

- <sup>1</sup> 12 U.S.C § 1716–Declaration of Purposes of Subchapter.
- <sup>2</sup> Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351, 84 Stat. 450 (2010).
- <sup>3</sup> The production of manufactured housing has been largely on the decline since the US Department of Housing and Urban Development implemented the Manufactured Housing Code in 1977. From 1977 to 1994, 240,000 units of manufactured housing were produced annually. In the late 1990s, production increased rapidly, peaking at 373,000 in 1998, before crashing to less than 50,000 units in 2009 and 2010. Production has since recovered to around 100,000 units shipped annually from 2018 to 2021, despite a larger population than in the 1970s, 1980s, and early 1990s.

## References

Freddie Mac Single-Family. n.d. *Manufactured Home Loan Performance (for Originations between 2009 and 2019)*. McLean, VA: Freddie Mac Single-Family.

Russell, Jessica, Nora O'Reilly, Karl Schneider, Nicolas Melton, Nick Schwartz, and Sam Leitner. 2021. *Manufactured Housing Finance: New Insights from the Home Mortgage Disclosure Act Data*. Washington, DC: Consumer Financial Protection Bureau, Offices of Research and Mortgage Markets.

## About the Author

**David Brickman** is chief executive officer of NewPoint Real Estate Capital and executive chairman of Meridian Capital Group. Through January 2021, he was chief executive officer, previously president, of Freddie Mac, one of the nation's largest providers of mortgage financing. He also served on the company's board of directors. During his tenure, Brickman led the more than \$2 trillion company through a period of significant growth, change, and disruption as a result of the COVID-19 crisis and associated recession. Brickman spent most of his career at Freddie Mac working in and leading the multifamily business, presiding over a remarkable period of growth, raising annual production from \$16 billion in 2010 to almost \$80 billion in 2018. He established the company's flagship K-Deal securitization program as one of the leading securitized products in the structured finance markets. Brickman also drove significant innovation and expansion in Freddie Mac's products and offerings, particularly those serving the increasing need for affordable and workforce housing. Brickman holds a bachelor's degree from the University of Pennsylvania and a master's degree in public policy from Harvard University. He completed all doctoral coursework for the PhD program in economics and real estate at the Massachusetts Institute of Technology. He is a senior adviser to Stone Point Capital and has held appointments as a professorial lecturer at the George Washington University and as an adjunct professor at Johns Hopkins University. He holds a US patent for a novel type of mortgage-backed security structure.

# Acknowledgments

The Housing Finance Policy Center (HFPC) was launched with generous support at the leadership level from the Citi Foundation and John D. and Catherine T. MacArthur Foundation. Additional support was provided by The Ford Foundation and The Open Society Foundations.

Ongoing support for HFPC is also provided by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. Funds raised through the Forum provide flexible resources, allowing HFPC to anticipate and respond to emerging policy issues with timely analysis. This funding supports HFPC's research, outreach and engagement, and general operating activities.

This brief was funded by these combined sources. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at [urban.org/fundingprinciples](https://urban.org/fundingprinciples).



500 L'Enfant Plaza SW  
Washington, DC 20024

[www.urban.org](https://www.urban.org)

## ABOUT THE URBAN INSTITUTE

The nonprofit Urban Institute is a leading research organization dedicated to developing evidence-based insights that improve people's lives and strengthen communities. For 50 years, Urban has been the trusted source for rigorous analysis of complex social and economic issues; strategic advice to policymakers, philanthropists, and practitioners; and new, promising ideas that expand opportunities for all. Our work inspires effective decisions that advance fairness and enhance the well-being of people and places.

Copyright © April 2022. Urban Institute. Permission is granted for reproduction of this file, with attribution to the Urban Institute.