Expanding the GSE Credit Risk Transfer

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There is near unanimous agreement that the government still plays too large a role in the mortgage market and that we won’t have a normal market again until the government’s role shrinks significantly. An effective way to quickly decrease the government’s risk exposure is to increase Fannie Mae and Freddie Mac’s (the government-sponsored enterprises, or GSEs) risk-transfer deals with private investors. Accordingly, the GSEs’ regulator, the Federal Housing Finance Agency, requires the GSEs to transfer credit risk on at least 90 percent of newly acquired single-family loans in 2016. The agency also requires the GSEs to explore ways to expand the scope of these credit risk transfer (CRT) transactions by increasing the investor base for back-end capital markets transactions such as Freddie Mac’s Structured Agency Credit Risk (STACR) and Fannie Mae’s Connecticut Avenue Securities (CAS) securities, under which risk is transferred after the GSEs acquire the loans. The agency also requires them to assess the viability of front-end risk transfer structures, where risk is transferred before GSE loan acquisition. A recent panel cohosted by the Urban Institute and CoreLogic, moderated by CoreLogic’s Faith Schwartz, concluded that while these may be viable options for expanding CRTs, important issues still need to be resolved.

According to Andy Davidson, president of Andrew Davidson & Co. Inc., CRT volume “could be as much as $20 to $30 billion a year.” This is roughly double the current combined STACR and CAS issuance of $10 to $15 billion a year. There are two ways to expand these deals: (1) transfer more credit risk on the back end under STACR and CAS, or (2) transfer credit risk on the front end through deeper private mortgage insurance (PMI) or lender recourse transactions, where risk is shared with the lender.

Scaling up back-end credit risk transfer
Most back-end CRT transactions have used STACR and CAS, with reinsurance deals accounting for a small portion. However, these transactions have mostly transferred the risk present in the mezzanine tranches, with the GSEs still retaining most first loss and all of the catastrophic loss risk. According to Laurie Goodman, director of the Urban Institute’s Housing Finance Policy Center, “an expansion of back-end risk transfer would require the GSEs to shed greater amounts of these two types of risks.” But because the probability of taking a catastrophic loss is remote and liquidity of such bonds is likely to be very low, the returns on these bonds may not be high enough to cover the liquidity risk, dampening investor interest. This leaves the GSEs no viable option but to transfer a greater amount of first-loss risk on the back end.
There are obstacles to this method. Mortgage real estate investment trusts (mREITs) have been major investors in mortgage-backed securities for decades. “Both STACR and CAS offer attractive returns and a significant opportunity for mREITs to invest in mortgage credit risk,” said Bill Roth, chief investment officer at Two Harbors Investment Corp. In spite of this, mREITs have been unable to invest meaningfully in STACR and CAS securities. Howard Altarescu, partner at law firm Orrick, Herrington & Sutcliffe LLP, attributed this to “statutory and regulatory issues rooted in the Investment Company Act of 1940, which restricts the types of assets mREITs can invest in, as well as in tax law which does not consider CAS and STACR bonds to be ‘real estate assets.’” Additionally, there are concerns about CAS and STACR liquidity, although that is not unusual for a nascent asset class.

Experimenting with front-end structures
The deeper PMI approach would require the GSEs to increase their mortgage insurance coverage in exchange for some reduction in the g-fees paid by borrowers. Lender recourse transactions would follow a similar structure, but lenders would take on the risk. Under both approaches, if the g-fee reduction is greater than what the PMIs or lenders might charge, borrowers would save money. Rohit Gupta, president and CEO of Genworth US Mortgage Insurance, observed that deeper PMI would “improve borrower economics and better protect taxpayers in a more sustainable housing finance system.” The concern here is that the GSEs would want to limit further risk exposure to PMIs since both are monoline institutions exposed to the same risk, the newly strengthened PMI capital requirements notwithstanding. The risk with lender recourse is that it could end up giving larger lenders an advantage because their scale would offer GSEs a more meaningful opportunity for risk transfer than smaller lenders would.

There are trade-offs, too. STACR and CAS can minimize GSEs’ (and hence taxpayers’) counterparty risk exposure because the GSEs collect payments from investors up front (i.e., at the time the bonds are issued). In comparison, under PMI and lender recourse, the GSEs are exposed to greater counterparty risk. On the other hand, STACR and CAS—because of their heavy reliance on well-functioning capital markets—are likely to be much more volatile than mortgage insurance or lender recourse.

Indeed, each of these alternatives has its own pros and cons, and none is necessarily more effective than the others. This seems one of those problems that might need an “all of the above” solution.

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