The affordability conundrum

The GSEs are under considerable political pressure to extend credit to the underserved. But what does this mean for CRT investors, issuers and rating agencies? **Simon Boughey** investigates.

In October of last year, Sandra Thompson, director of the FHFA, unveiled potentially far-reaching policy changes with the aim of making US homes more affordable. All involve a radical reordering of how creditworthiness of potential borrowers is assessed.

Under the changes, the FICO 10T and VantageScore 4.0 scoring systems replace classic FICO, both of which Thompson said at the time are not only "more accurate" than classic FICO, but also "more inclusive." In addition, she announced that henceforth mortgage originators would require two credit reports from national consumer reporting agencies, such as Experian and Equifax, rather than three.

Finally, upfront fees – or loan level price adjustments (LLPAs) in certain categories of loans, for which the credit threshold is lower – will be abolished. To compensate for the loss of income, upfront fees for cash-out refinance loans were increased.

The categories of borrowers for whom fees would no longer be applied include Housing Finance Agency (HFA) Advantage and Preferred loans, as well as first-time borrowers at or below 100% of the area median income (AMI) or below 120% AMI in high-cost areas.

The fee elimination will benefit "borrowers with limited income, borrowers with limited resources for down payments and borrowers in underserved communities," Thompson stated.

Fee changes were further amplified on January 19, when, in essence, LLPAs were decreased for low credit borrowers and increased for better credit borrowers. The industry has not responded with unalloyed enthusiasm (*SCI 26 January*).

The GSEs have announced changes to their underwriting processes to align with the FHFA's ▶

Susan Hosterman, Fitch

priorities. Fannie Mae further unveiled "innovative enhancements" to "simplify the borrowing process for loans where homebuyers do not have a credit score", adding that "millions of people in the US are credit invisible, with Black and Latino/Hispanic people disproportionately represented."

As such, Fannie Mae's automated underwriting mechanism Desktop Underwriter would update its eligibility criteria for borrowers without any credit score. Other forms of assessment will be used, such as an evaluation of a monthly cashflow over a 12-month period using bank statements.

One issue that these new measures have precipitated is accurate assessment from credit rating agencies, whose methodologies for rating MBS are centered around traditional FICO scores. "The issue that the industry is running into is that our models are based on the classic FICO, which is also what prior GSE data is based on. So now we're introduced to these new FICO scores and we need to find a new mapping system that says, for example, 'Vantage score X equates to FICO score Y.' No one in the industry has come out and said 'This is the mapping,'" says Susan Hosterman, senior analyst in North American RMBS at Fitch in New York.

There appears to be no straightforward way to establish an equivalence between one method of credit scoring and traditional FICOs. "We have looked into this, but there is not a simple method of mapping between FICO and other scoring methodologies. It's a completely new scoring set. You can't just say that 700 Vantage is equal to 750 FICO," says another analyst.

Fitch has asked originators that want to use non-classic FICO scores to provide data for both non-classic FICO and FICO, says Hosterman. The differences are alarming.

"We're seeing differences of up to 200 points between classic FICO and non-classic FICO," she says.

Calculating a blended credit score between numbers as divergent as this raises a whole new vista for the MBS industry. The agencies have their work cut out, as indeed do investors.

Beyond the technical difficulties of credit assessment is the elephant in the room: by widening – or at least – redefining the credit box, could US regulators be courting the same type of financial hurricane seen in 2008/2009? Through the National Homeownership Strategy of 1994, the Bill Clinton administration took more than 100 executive orders to relax bank lending and also enlisted federal agencies to enforce new underwriting guidelines to help low-income borrowers. In this context, Fannie Mae and Freddie Mac were enjoined to double the underwriting quota of 'affordable loans'.

Products designed to help borrowers have always featured in the GSEs' books and from Q3 onwards last year have made a resurgence. This includes such products as 40-year loans when years 10 to 20 are interest rate only (IO), 30-year loans with a 10-year IO period and short-term adjustable-rate mortgages (ARMs) with balloon payments at the end.

"Our losses on these products are significantly higher than they were before and during the financial crisis. For example, for a 30-year IO, the losses are 1.15 times higher than for our basic 30-year mortgage; for a 40-year IO, the losses are 1.5 times higher and for a short-term ARM, the losses have increased by around two times," says Hosterman.

Roelof Slump, Fitch

risk a repeat of 2008 and a government bailout. No losses have ever occurred to CAS or STACR bonds, but could the new underwriting standards poison the well?

In its credit report on CAS 2023-R01, for instance, KBRA notes that the borrowers had a weighted average (WA) credit score of 747, a WA debt to income ratio of 36.3% and a WA loan to value of 74.4%. "I do think CRTs are very credit levered, particularly comparing them to other triple-A RMBS without government guarantees. There are few credit enhancements and adding

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The MBS market has, of course, changed a lot since the pre-financial crisis days. Underwriting standards and due diligence are markedly better and more rigorous, stress sources.

The market has changed in another key respect, with the emergence of credit risk transfer products. For the last almost 10 years, Fannie Mae has issued CAS transactions and Freddie Mac has issued STACR transactions, alongside reinsurance products – the express purpose of which has been to cover the GSEs from losses they may incur on triple-A rated government-backed TBA issuance.

This market has been remarkably successful. When Fannie Mae's CAS 2023-R01 was priced in the second week of January, it represented the fifty-fourth deal of this kind, with total volume of US$59bn and total risk transfer of US$1.98bn.

There is seemingly some incentive for the GSEs to push loans acquired with the new underwriting standards into the CRT market or in potentially risky collateral is going to be of concern to investors. The credit enhancement in these deals is so low that it doesn't take a high percentage of loans to create a problem," says a credit analyst.

Roelof Slump, md and senior RMBS analyst at Fitch, agrees: "The CRT market is highly sensitive. There could be a major impact felt depending on the magnitude of inclusion of this."

So, how might investors react? "The CRT market should refuse to accept paper with these loans in them and they should require the agencies to keep them on-balance sheet and require taxpayers to observe them. I bet most investors express a similar view to me off-the-record," says one investor.

It is, as everyone concedes, a very politicised topic. At the very least, pricing in the CRT market should provide a clear signal to the GSEs whether CRT trades incorporating these types of credits are economically viable.

Tim Armstrong, Guy Carpenter

The changes to the fee structure that the FHFA announced in October are likely to drive a greater proportion of low FICO credits away from the FHA and towards the GSEs. In the past, as the GSEs charged fees for these categories of borrowers – which were included in monthly mortgage payments – they would invariably choose FHA loans. This was positive for GSE loan quality, but the incentive to take an FHA loan has been reduced.

"The pricing dynamic that drove the weakest credits to FHA loans and away from GSE loans is changing as result of recent FHFA actions. The GSEs will be more competitive for lower FICO borrowers, but less competitive for higher DTI. What this means to portfolio credit quality is uncertain," says Tim Armstrong, an md for mortgages and structured credit at Guy Carpenter.

There are caveats to be made, however. When the impact of the changes take effect is at some point in the future. The most recently issued CAS 2023-R01 securitised loans that were put on in January and February of last year, so it will likely be at least a year until any impacts manifest themselves.

Nor is it clear how much and how many of these new loans will actually be originated. It could be that they will represent a small portion of loans that the GSEs buy.

The GSEs have always been mandated to increase affordability and currently CRT transactions include a small amount of loans without FICO scores, but they are too few to have any bearing on the overall performance of a bond. A credit analyst points out that the recently issued CAS 2023-R01 contained 21 loans without FICO scores, but this was only 21 out of 67,000 loans in the reference portfolio – a small enough sample to register as a data error.

"The GSES have always allowed underwriting to borrowers who don't have FICO scores or when no FICO scores are provided and in those we make assumptions. But it is a very small proportion and doesn't move the needle much," he says.

Freddie Mac has also begun retaining the bottom 200bp of CRT deals, rather than 25bp as in the past. This move is solely related to the affordability of CRT transactions to the issuer rather than to increase affordability, but it does have the effect of creating an extra layer of buffering between CRT buyers and troubled loans.

Others wonder if the GSEs are currently making all the right noises about extending a hand to less creditworthy borrowers, but in the end what they actually do won't make much difference to the credit profile of their debt. "We are seeing a lot of headlines, but we haven't seen an impact on portfolio credit quality," says Armstrong.

Slump suggests that the material inclusion of this type of debt in a CRT deal is many months away. "If it is going to happen, we need to think about these things more deeply, what concentration it represents, what our comfort level is and how we calculate default risk. We may need to come up with something new," he says.

> "THE GSES HAVE ALWAYS ALLOWED UNDERWRITING TO BORROWERS WHO DON'T HAVE FICO SCORES"

There is also another wrinkle to be considered. As a result of the November 2022 elections, there have been changes to the leadership and composition of committees in the House of Representatives and the GOP is now in the driving seat.

The new chairman of the House Committee on Financial Services is Patrick McHenry, Republican Representative for the tenth district of North Carolina, while the Sub-Committee for Housing and Insurance – which oversees the FHFA – is headed by Warren Davidson for the eighth district of Ohio.

So far, neither have said anything about the GSEs and in his initial comments upon taking up his new role, McHenry safely covered all the bases, saying that the mandate was to increase economic prosperity for all Americans: "Whether that is increasing opportunities for all investors, expanding access to innovative financial products, or ensuring the safety and soundness of our financial system…"

However, some sources suspect that the safety and soundness aspect of the governance of the GSEs will loom rather larger than affordability to the new personnel.

He adds that the GSEs are such a big and influential part of the market that these practices may slip into the non-agency space. "Because of the size and dominance of the GSEs, as they take a certain position, it becomes an industry fact that the non-agency market decides to adopt or not, depending on if they see an opportunity."

If it is to become a bigger part of CRT debt, then it might appeal to impact funds, which have a mandate to invest in assets that align with ESG priorities. Whether they will earn a decent enough return alongside social objectives remains to be seen.

Other close watchers of the CRT space also speculate whether this new generation of products will achieve the desired result, as it will increase demand for mortgages and thus elevate prices. "This is the wrong solution. The solution to affordability is to lower prices, not credit. And it is the worst time to do it," one source concludes.

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