The puzzling case of the disappearance of Fannie Mae

Fannie Mae has not issued a CRT deal since 1Q20. **Simon Boughey** investigates the circumstances behind the GSE's disappearance from the market and what might make it come back.

Fannie Mae, one of the co-founders of the ground-breaking GSE credit risk transfer market, has not issued a CAS or CIRT transaction since 1Q20. There is no knowing when it might return to the market, but there is some reason to believe that Fannie's non-attendance will not continue for much longer, given the sea-change in policy under the Biden administration.

Fannie began issuing CAS bonds in 2013 and by the end of 1Q20 had sold a total of US$47bn, transferring risk on US$1.5trn of unpaid principal balance of mortgage loans. In 2018 and 2019 – the last two full years of issuance – it sold around US$7bn a year to investors.

The great majority of disinterested observers would agree that the CRT schemes unveiled by Freddie Mac and then Fannie Mae in 2013 have been a great success. The two GSEs created a whole new asset class that proved very popular with investors and one which successfully helped reposition Fannie and Freddie as careful, prudent organisations that would not again endanger the wallet of the taxpayer.

Although it declined to comment for this article, Fannie explained why it had stepped away from the market in its Q2 10-Q, released on 3 August 2020. "We did not enter into new credit risk transfer transactions in the second quarter of 2020, due to adverse market conditions resulting from the Covid-19 pandemic. Market conditions improved in the second half of 2020, but we have not entered into any new transactions as we evaluate their costs and benefits, including a reduction in the capital relief these transactions provide under FHFA's enterprise regulatory capital framework. We may engage in credit risk transfer transactions in the future, which could help us manage capital and manage within our risk appetite, particularly given the growth and turnover in our book in 2020," the GSE said.

Since then, it has offered no update or embellishment to this statement. As the market has now recovered substantially, it seems that the FHFA's enterprise regulatory capital rules – released at the end of May 2020 – are now entirely responsible for Fannie Mae's continued absence from the CRT market.

These rules are considerably less friendly to CRT mechanisms than the previous 2018 rules. The GSEs are required to use the more binding of either a risk-based capital formula or a leverage ratio, but the latter affords much less capital benefit than the former. Indeed, according to some calculations, there is zero capital benefit derived from CRT if a leverage ratio is applied.

The rules also applied the Simplified Supervisory Formula Approach (SSFA) for capital to be held against retained tranches under risk-based capital rules. Using this approach, CRT schemes cut required capital by only 40%, at the most, rather than 75% as under the 2018 rules. This ▶

brought the GSEs more into line with the capital treatment meted out to banks, which was one of the FHFA's objectives.

The adjustment also reflected the fact that the regulator did not regard CRT as anything like the equal of common equity in absorbing unexpected losses. And this, it might be argued, is fair enough as common equity can be used to plug any holes, while CRT can only ameliorate losses in a specific reference pool of assets.

And that, as far as Fannie Mae is concerned, is that. It hasn't been back to the CRT market in 18 months and there is no indication of it reappearing.

"It's just Fannie Mae that has been on pause. So far, origination volumes – in both the purchase and refinance market – have been very strong and enough to make up for the slack in demand that would have otherwise been seen in the CRT market," says Tim Armstrong, an md at Guy Carpenter. The latter is one of the two big names in the CRT reinsurance space, alongside Aon.

Indeed, Freddie Mac's combined STACR and ACIS programmes attained record half-yearly issuance of US$9.9bn in the first six months of 2021, it was announced in early August. The GSE sold five STACR deals and seven ACIS deals in this period, which included the two largest STACR transactions ever sold. The first quarter was particularly lively, with a total of US$6.4bn issued.

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However, the overall market appears to be functioning just fine without one of its founders. While Fannie Mae has not been around, Freddie Mac has stepped up the pace of its STACR issuance.

In 2019, for example, there was US$7bn of issuance under the CAS programme and US$8bn under STACR for a combined total of US$15bn of CRT new debt. In 2020, while there was only US$2bn of issuance under the CAS programme, there was US$11bn under STACR for a combined US$13bn – only US$2bn less than in 2019.

At the end of July, Freddie issued its sixth STACR of 2021 – designated STACR 2021-DNA5 – and has now issued US$6.2bn under the programme this year. There were some notable firsts in this deal as well: the class B1 and B2 tranches were the largest yet seen for this part of the capital structure, while the B1 drew 39 investors – the most in programme history. Spreads for the M1 and M2 tranches were also the narrowest seen for two years.

So, there is no shortage of investor interest in the asset class and no real shortage of product either. Fannie Mae has been away from the CIRT market as well, but there hasn't been much impact in this arena either.

That Freddie Mac should have had a very different response from Fannie Mae to the capital rules appears at first sight puzzling. The two institutions are, after all, very similar. But there are differences between them as well.

First, Fannie Mae is much older than Freddie Mac. It was established as the Federal National Mortgage Association in 1938 by Congressional decree through amendments to the National Housing Act, as part of President Roosevelt's wide-ranging and far-reaching interventions into the US economy.

Mike Reynolds, Freddie Mac

The Federal Home Loan Mortgage Association was founded by Congress in 1970 to further increase the availability of funds to finance mortgages, but also – specifically – to provide competition for the newly privatised Fannie Mae.

Both GSEs were received into conservatorship in September 2008, wherein they have remained ever since, but differences in culture and attitude remain. Fannie sees itself as a government agency, while Freddie sees itself as a street firm, say market sources.

"I would say that Freddie is more market sensitive and Fannie is more programme sensitive," says another source. In other words, Freddie appears to find current spread levels too good to turn down, while Fannie seemingly is worried about the long-term effects of the capital rules upon the entire CRT programme.

Speaking to SCI, Mike Reynolds, vp of single-family CRT at Freddie Mac, elaborated on Freddie's attitude to the CRT market. "We evaluate and update our CRT strategy as needed, depending on our overall business strategy, regulatory requirements and market conditions. We receive capital relief as a result of our CRT transactions and, by transferring credit risk on a portion of our single-family mortgage portfolio to the private market, we reduce the risk of future losses to us when borrowers default. CRT has been one of our biggest success stories since Freddie Mac pioneered the asset class in 2013," he says.

So, it would seem, from Freddie's perspective, the capital relief afforded is still sufficient to make the CRT market worthwhile. This is a different perspective to that of Fannie Mae.

At the moment, then, Fannie's absenteeism has not had a marked effect on prices or availability of investment opportunities. However, notes Krohn: "Fannie Mae's absence has not made all that much difference so far, but it will if they stay out of the market long term. Then it will have an impact."

While the GSE CRT sector has continued to operate relatively smoothly over the last 18 months without Fannie Mae, there is no doubt that it would be better if the elder GSE returned to the market. And there is some reason to believe that Fannie's non-attendance will not continue for much longer.

In June, Mark Calabria was fired as director of the FHFA and a sea-change in policy is under way. Sandra Thompson, the new acting director of the agency, has very different objectives to her predecessor and it would be a surprise if a speedy exit from conservatorship is one of them.

Sam Dunlap, Angel Oak Capital Advisors

Under Calabria, the FHFA was openly sceptical of the value of the CRT market. In a now notorious paper published in May, entitled 'Performance of the Enterprises' Single Family CRT', the FHFA suggested that the CRT market is an expensive waste of money. This attitude is likely to become a thing of the past under the new administration, say sources.

"The FHFA supports CRT as a valuable tool to mitigate credit risk at the Enterprises," a spokesman for the FHFA told SCI.

However, it is worth noting that there are unlikely to be any penalties for Fannie Mae if it continues to abjure the CRT market. The GSE's 2021 scorecard, released by the FHFA in February, was a little woollier than in the past.

The scorecard adumbrates three specific areas of focus for the GSEs: the fostering of competitive, liquid, efficient and resilient housing markets; ensuring safety and soundness; and preparing for exit from conservatorship. Under the second of those targets, the GSEs were told to "continue to transfer credit risk to private markets in a commercially reasonable and safe and sound manner."

But, unlike previous years, it did not designate an amount of CRT that the GSEs should complete. For example, the 2019 scorecard said the GSEs should "transfer a meaningful portion of credit risk on at least 90% of the unpaid principal balance of newly acquired single-family mortgages in loan categories targeted for credit risk transfer."

Moreover, the scorecard's recommendations on risk transfer are not limited to CRT. It also encourages the sale of less liquid assets, such as non-performing loans and re-performing loans, which Fannie has continued to do.

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Calabria, moreover, was a notorious regulatory capital hawk. In the words of Larry Platt, a partner at Mayer Brown who specialises in housing finance: "Calabria had a love affair with regulatory capital." The new leadership of the FHFA perhaps does not share that affection.

Consequently, some investors believe that a return to the CRT market for Fannie Mae is on the cards. "In our view, given the recent change in the FHFA, it will be the status quo from here on out. I would think that the resumption of the programme from Fannie Mae makes a lot of sense, particularly as they hopefully want to continue to provide homeownership opportunities for the US in an increasingly complex housing market," says Sam Dunlap, cio of public strategies at Angel Oak Capital Advisors. Angel Oak is a long-time investor in agency CRT securities.

The 2021 scorecard is also considered contradictory by critics of the FHFA under Calabria. While it encourages CRT, it also enjoins the GSEs to "ensure the efficient utilisation of capital targeted to support the core guaranty business with adequate returns to attract the private capital necessary to enable an exit from conservatorship."

Yet the new capital rules do not provide the capital relief to make CRT deals as economically beneficial as they once were. In effect, say the critics, the scorecard asks the GSEs to face both ways at once and it is no surprise that the result is confusion.

Even if Fannie were to be considered in breach of the scorecard, it is not clear what action the FHFA might take anyway. As one source with long experience of the GSE CRT programme asks: "What could really happen; the GSEs are in conservatorship under the FHFA?"

Jeff Krohn, Guy Carpenter

There are unlikely then to be any repercussions for Fannie if it stays out of the market. It can, moreover, legitimately claim that it is following the spirit of the new capital rules by continuing to stay out of the market.

So, we're back to the capital rules unveiled in May of last year. These need to change before Fannie Mae returns. But they haven't been changed yet, and there are perhaps other items in Sandra Thompson's in-tray requiring more pressing attention than capital rules.

"My feeling is that reversing the capital rule is not high on the interim director's to-do list. She will likely focus more on expanding the credit box on loans eligible for purchase and furthering the public mission of entity. The capital rule is done for now, I think," says Larry Platt of Mayer Brown.

However, there are strong rumours in the market that a succession of interested parties has been through the doors of the FHFA in recent weeks to make strenuous representation to the new acting director that Calabria's capital rules will be ditched. The agency is listening to a new set of voices.

"We are hopeful the new acting director of the FHFA and current administration make some changes to the Enterprise Capital Rule that are reflective of the true economic benefits of CRT," says Jeff Krohn, the head of Guy Carpenter's mortgage credit segment.

It seems public policy action is needed before investors can feast upon CAS and CIRT once again, and that action is perhaps not that far away.

As one leading participant in the CRT market says: "Under the prior director, the now current capital rule was written in a way that was not reasonable and impairs the future viability of CRT."

For Fannie Mae to come back, the rules have to change.■

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