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Hurricanes Take Toll on Risk-Transfer Bonds

Fearing losses from Hurricane Harvey and Hurricane Irma, investors are attempting to reduce their exposures to agency risk-transfer bonds.

The concerns have been evident in the secondary market, as holders of Class B-1 and B-2 securities issued by **Fannie Mae** and **Freddie Mac** increasingly have sought bids for their positions in the past two weeks. The upshot has been a slide in values.

The activity initially stemmed from reports of widespread flooding in the Houston area from Hurricane Harvey. With an estimated 185,000 homes destroyed or damaged in Texas, and some 75% of them lacking flood insurance, the worry for risk-transfer bonds has been that payments could either pause or stop altogether for affected properties in the deals' reference pools.

Hurricane Irma, meanwhile, is projected to strike South Florida on Saturday. And with recovery efforts likely to be prolonged, payment interruptions could drag on for some time.

The effect on bond values has been pronounced. Take a 12-year class of unrated B-1 securities from a $1.4 billion deal that priced on July 18 under Fannie's Connecticut Avenue Securities label. That paper was trading at 92 cents on the dollar on Aug. 31, down from 97 cents on Aug. 24 — the day before Harvey made landfall.

The bonds then recouped about half of their losses amid assertions from some investors that they were over-sold, only to begin sliding again as Irma approached.

The reductions coincided with heavy offering volume. Consider that **Empirasign** tracked bid lists totaling $136.1 million in the sector on Aug. 31 and $95.8 million on Sept. 6, with a light period in between surrounding the Labor Day holiday.

"Most of this is the price of risk and uncertainty," said **Alex Levin,** who oversees financial engineering at **Andrew Davidson & Co.** "How much of this will be covered by flood insurance? How much of the bill does [the **Federal Emergency Management Agency]** pick up? And that only happens if Congress approves it."

The concerns also extend to other types of bonds with exposures to residential properties. Prices fell among rental-home securities, for example, and sources warned that certain private-label mortgage deals with large concentrations of loans in Texas or Florida could be vulnerable.

The risk appears to be greatest for holders of risk-transfer bonds, however, because investors' positions in the deals typically represent subordinate or mezzanine stakes — as opposed to the senior interests they more often would take in jumbo-mortgage offerings. "These bonds are designed with a very thin slice of credit enhancement," one trader said. "I'm not sure they factored in a catastrophe of this magnitude."

Sales of risk-transfer bonds also have outpaced production of jumbo-mortgage securities of late. And loans in Texas have accounted for growing percentages of the reference pools for both Fannie and Freddie deals. Texas mortgages made up 6.4% of the assets for Freddie's Structured Agency Credit Risk securities on Aug. 1, up from 3.7% on July 1, 2013, according to data company **Recursion.**

That said, Levin doubts that the long-term impact on bond performance will be severe. In studying how the securities would have fared during other natural disasters, Davidson observed only minimal changes in borrower behavior over time. After Hurricane Katrina flooded New Orleans in 2005, for example, delinquencies initially rose but then tapered off as borrowers received federal aid.

Following that pattern, Levin said it appears a disaster on par with Harvey should bring only a modest increase in losses — even though the storm represented a worst-case scenario. It also helps that the reference pools for risk-transfer bonds are spread nationwide.

On the other hand, the bonds' market values still could suffer in the near term. "If we see a notable increase in delinquencies coming out of Texas in the October remittance reports, then you will have a second round of selling," one trader predicted. ❖