

# GSE-CRT investor rift develops over forbearances; boycott threat darkens outlook for new deals

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*[This story has been edited since publication to clarify in paragraph four that the bonds are subject to write-downs after a credit event, instead of having principal diverted to senior notes, as originally reported.]*

CRT bond investors are crossing sabers with Fannie Mae and Freddie Mac over what will likely be their largest losses since the market was formed to lay off risks of residential mortgages to private markets, according to three investors and a trader. The row brings the foundation of the USD 51bn market into question, two analysts said.

Some investors are planning to boycott new issues as a result, according to the trader and an investor.

Investor angst over how the losses will be applied to USD 4bn of bonds from several 2013 and 2014 deals has deepened in the last two weeks as it became clearer that the GSEs wouldn't be making any exceptions to how forbearances are treated under special circumstances such as the borrower relief program made possible by the CARES Act in March. The stance of the GSEs — and the Federal Housing Finance Agency — has surprised investors who recall how the GSEs have softened the forbearance-related blows in the past.

Investors in eight of the GSE's earliest CRTs are now anticipating that their bonds will suffer unnecessarily, as homeowners stop their payments for six months or more, said a trader. Governing documents for deals such as **CAS 2014-C01** require that loans delinquent for more than 180 days trigger a "credit event" that results in immediate write-downs on the bonds. Governing documents for newer deals are more forgiving.

In 2018, Fannie told bondholders that loans granted temporary forbearance as a result of Hurricane Harvey wouldn't be deemed to have experienced a credit event at 180 days of delinquency. Fannie would determine a credit event after 20 months or three months after the end of the forbearance, it said at the time.

As hopes for a similar GSE intervention this time faded, bondholders have taken action.

First, bonds seen as most susceptible to losses plunged despite the overall rebound in the market. A USD 280,000 **CAS 2014-C02** 1M2 dropped to 60 on 24 April from 91.25 at the end of March, when the bond was recovering from the chaotic selling earlier that month, according to Finra's TRACE. Several larger than USD 5m **STACR 2014-DN1** M3s last week traded as low as 62.875, down from 87 in early April when the bond was trying to form a floor, TRACE data show.

"The market is totally spooked," said the trader. Bonds "could get wiped out because of this," and it makes little sense since the deeply seasoned loans are among the most likely to become current after forbearance, preventing the GSE's from realizing the losses that will be passed on to bondholders, he said.

Not everyone shares that dire view. Losses may not be harsh as the bonds have built substantial credit support over time and the applied loss severity of the "fixed-severity" deals would be relatively modest, according to Alex Levin, a financial engineer at Andrew Davidson & Co. **STACR 2014-DN1** M2 and M3 classes, and **STACR 2014-DN2** M3s would begin losing principal at about 3% 180-day delinquency rates, and loss severity would be slightly above 20% on a blended basis, Levin said.

However, if 180-day delinquency rates climb to 13%–20%, the picture changes dramatically. In that case, most M2s and M3s from early fixed-severity deals would see large losses with severities of about 30%, according to his study.

Bondholders frustrated with the GSE response are voting with their feet. They're planning to boycott future deals, including a Freddie Mac **STACR** deal in the pipeline, said the trader, citing conversations with investors. Another investor whose firm oversees more than USD 300bn in fixed income said "we also won't buy any new deals until they fix the old fixed-severity deals."

Fannie and Freddie spokespeople pointed to language clarifying CRT forbearance policy on later CAS deals but declined to comment on their early CRT issues. While two of the sources suggested the FHFA was the decider of the policy, a spokesperson for the agency flipped questioning back to the GSEs.

Speculation of the regulator's involvement in the decision comes after a yearlong push by new FHFA director Mark Calabria to reduce the taxpayer risk to GSE programs. Credit risk transfer bonds have been cited as an important way to achieve the goal, including in most plans floated to extricate the GSEs from government conservatorship.

So to analysts, the apparent decision to hold bondholders to the contractual relationships to which they agreed comes as no surprise.

“FHFA has made clear its priority to look out for Fannie and Freddie,” said Eric Kaplan, director of the housing finance program at the Milken Institute’s Center for Financial Markets “The risks are clearly disclosed to investors – and they’ve been warned many times – that Fannie and Freddie can administer CRT to serve their own interests.”

The GSEs over the years have been consumed with the task of selling their wares to investors. They’ve made structural changes to attract certain investors, such as converting deals into real estate mortgage investment conduits (REMICs). They’ve released more granular information and offered a free database to help investors manage their portfolios. They’ve pressured capital-constrained dealers to support a secondary market where investors can always trade and liquidate, if needed.

Their efforts were working. Until February, some CAS and STACR bonds drew so much demand that the GSEs could have sold 10 times the offered amounts.

But an investor boycott raises questions about the viability of CRT as a risk management tool for the GSEs, said Kaplan and Mark Goldhaber, an industry consultant who has worked as a Freddie public affairs executive and in regulatory positions with the US Department of Housing and Urban Development.

“There’s a real question from a policy point of view,” Goldhaber said. “As you think about the GSEs going forward, what is going to be the appetite for investors to invest as aggressively as they have in CRTs.”

The argument comes down to a philosophical one, the sources agreed. As noted by the trader, the “spirit” of the programs is to protect the GSEs from losses on the loans. But that flies in the face of the “letter of the law,” which in the case of the early CRTs means investors will be taking losses even though there’s good reason to believe the GSEs will suffer little harm in the longer run.

Investors who’ve avoided CRT for the binary risks they present had little sympathy for holders of the eight deals facing losses.

“Some investors would still view this as ‘housing,’ and housing being too systematically important to not support (under) the belief that if the government lets investors take losses, the market will be forever impaired,” one investor said. “This said, CRT is writing insurance ... if (forbearances) weren’t specifically carved out, then losses should be passed along.”

“What is the whole stupid point of the CRT market if the GSEs are just going to prevent losses,” another investor asked.

In terms of risk sharing, the scope of losses caused by the COVID-19 pandemic may be far too large for GSEs not to utilize CRT programs as designed, said Mark Fontanilla, who founded the CRTx indexes and has worked at Fannie Mae. The number of daily forbearance requests as of Monday was easing but, based on the current pace, more than 8m homeowners could enter into plans by mid-June, representing 16% of all US mortgages, according to Black Knight.

“The hurricanes exposed a geographic percentage of reference pools in the low single-digits,” Fontanilla said. “Now, it’s a much wider geographic breadth of pools that are exposed, which is a big difference.”

by [Al Yoon](#)