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RMBS Commentary

Fannie Mae Seeks to Broaden Investor Base by Structuring CAS Deals as Remics

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Morningstar Perspective

In an effort to enhance the structure of its credit-risk transfer securitizations, Fannie Mae proposed allowing the trust issuing the bonds to qualify as a real estate mortgage investment conduit, which should have no negative impact on the credit risk of these deals. The hope is that the Remic structure will boost liquidity by broadening the investor base for the fledging investments, allowing more REITs to buy the bonds. Offered notes backed by Remic cash flows allow REITs to categorize their investment under more favorable REIT eligibility tests. The new structure also calls for the securitization trust to directly pay principal and interest payments on the Remic-eligible securities, whereas under the current structure, Fannie Mae itself remits these payments. There would be little to no change in the collateral quality, bond structure, and payment waterfall. Eligibility criteria for loans that can be included in the deals remain "largely unchanged," Fannie Mae said. Operational details pertaining to loan servicing, reporting, loan pooling, hedging, and delivery remain unchanged.

Pressure to Transfer Credit Risk

Under orders from their federal overseer to reduce U.S. taxpayer exposure to potential losses, Fannie Mae and Freddie Mac in 2013 introduced the credit-risk transfer deals, designed to have investors share some of the credit risk on a portion of their loans. Fannie Mae's program is known as Connecticut Avenue Securities, or CAS, while the program name of its smaller sibling, Freddie Mac, is Structured Agency Credit Risk, or STACR. Washington, D.C.-based Fannie Mae, which has been getting feedback on its proposal, hopes to offer its first deal with the Remic structure in early 2018. Freddie Mac has proposed a similar change for its STACR deals.

For simplification, this paper focuses on Fannie Mae. The agency's CAS deals are sold only to qualified institutional buyers, such as insurance companies, asset managers, and hedge funds.

The credit-risk transfer market is arguably the most liquid market for nongovernment guaranteed residential mortgage credit, but Fannie Mae and Freddie Mac continue to fine tune their credit-risk transfer offerings. Issuance to date has reached $1.586 trillion, with $754.01 billion from STACR and $832.30 billion from CAS transactions. This represents the aggregate principal balance of the reference obligations as of the deal cutoff date. The number of loans securitized in the credit-risk transfer programs tops 6.8 million. Under the proposal, Fannie Mae would subject the mortgage loans deposited into its mortgage-backed security trust to Remic elections. Bonds would be issued in the same manner as before. The Remic structure affects the credit-risk transfer deals and not the MBS trust. The credit-risk transfer deals provide Fannie Mae with credit protection for loans held by the MBS trust.

Proposed Change Would Limit Investor Exposure to Counterparty Risk

Under the proposal, CAS notes would no longer be issued as Fannie Mae corporate debt (that is, as credit-linked notes), and sales proceeds from the notes would no longer be commingled with Fannie Mae corporate funds. Fannie Mae would no longer be obligated, as a corporate credit matter, to make the principal and interest payments to the note holders; that obligation would fall primarily to the bankruptcy-remote trust. Right now, investors in the credit-risk transfer transactions face Fannie Mae or Freddie Mac as direct counterparties, so they likely would be affected by future changes in the agencies' status. Morningstar Credit Ratings, LLC, in our presale for our first credit-risk-transfer ratings for STACR 2017-DNA2, noted that the Federal Housing Finance Agency could terminate the conservatorships, implemented when the U.S. government bailed out the government-sponsored enterprises in 2008, and place Fannie Mae and Freddie Mac into receivership, which could affect the agencies' ability to perform under the current corporate debt, credit-linked note structure. While a change to receivership is unlikely as long as the agencies make a profit and generate cash for the U.S. Treasury Department, we think that this risk could be mitigated or eliminated under Fannie Mae's proposed CAS structural change, as detailed in the Appendix.

In theory, under the Remic structure, the senior CAS notes that meet Morningstar's AAA credit enhancement can get a AAA rating that is delinked from Fannie Mae's corporate rating. AAA ratings for credit-risk transfer transactions are academic, because for all practical purposes Fannie Mae does not need to, and will probably not seek, AAA ratings as long as it is not selling the senior bonds. There is little credit risk to be transferred on notes with a AAA rating.

Fannie Mae expects to offer the same class of notes, M-1, M-2, and the subordinate B-1, as shown in Exhibit 1 in the appendix, with a floating rate tied to one-month Libor. Operational details that pertain to loan servicing, reporting, loan pooling, hedging, and delivery would remain unchanged. The Fannie Mae fact sheet contains a description of the items that remain unchanged in the Remic trust structure. Note that under the Remic structure the trust that issues the credit-risk transfer bonds is collateralized (Box 4 from Exhibit 2), meaning that the issuance proceeds are maintained for the life of the deal in a collateral account instead of being commingled with Fannie Mae corporate funds. Also, note under Exhibit 3, Box 4 that the trust now makes principal and interest payments on a collateralized, asset-backed basis to note-holders that were previously paid by Fannie Mae on a corporate-credit basis (Exhibit 1).

Treatment of Loan Modifications

One other possible change under the Remic structure deals with modification-related losses. Under the current non-Remic structures, CAS deals apply modification-related losses in a reverse sequential manner among the mezzanine and subordinate bonds, beginning with a reduction in the interest paid on the lowest class--typically the Class 1B-2H reference tranche--and then a reduction in principal amount. Modification losses are treated slightly differently for the subordinate classes in Freddie Mac's whole loan securities program, another Remic offering. In the whole loan securities program, Freddie Mac uses certain principal payments to cover the difference, if any, between the foregone interest caused by interest-rate modifications and the subordinate certificate accrued interest. This, in turn, allocates realized losses to the principal of the subordinate certificates. In addition, Freddie Mac treats forborne unpaid principal balance as a realized loss at the time of a principal modification. In the STACR and CAS current credit-linked note programs, Fannie Mae and Freddie Mac treat foregone subordinate certificate interest caused by rate modifications as a loss to the subordinate certificates in reverse sequential order, and they distribute forborne unpaid principal balance as a realized loss through a modification-loss waterfall.

Because the proposed Remic structure likely will closely mirror the credit-linked note structure, we assume that modification-related losses will be treated similarly to that structure rather than to the whole loan securities subordinate certificate structure. Practically, though, given the current net mortgage weighted average coupon on the underlying mortgages in credit-risk transfer deals, and given the Fed's medium- to long-term interest-rate increase forecasts, it is unlikely that the borrowers would get any payment relief via a lower interest-rate loan.

Broadening Investor Base for Credit-Risk Transfer Deals

Under pressure to reduce U.S. taxpayers exposure to losses, Fannie Mae and Freddie Mac four years ago introduced credit-risk transfer securitizations, and issuance from both Fannie Mae and Freddie Mac totals some $1.586 trillion. While this asset class is arguably among the most liquid for nongovernment residential mortgage credit, the proposed Remic structure for Fannie Mae's CAS deals and Freddie Mac's comparable STACR deals should have no negative impact on the credit risk of these securitizations or the quality of the collateral. The structure change is designed to further bolster liquidity by expanding the investor base, allowing more REITs to purchase these deals. Morningstar does not anticipate any change in ratings.

Appendix (Source: Fannie Mae)

Exhibits reproduced solely to illustrate and highlight aspects of the structure referenced in our article.

Exhibit 1: Current CAS structure

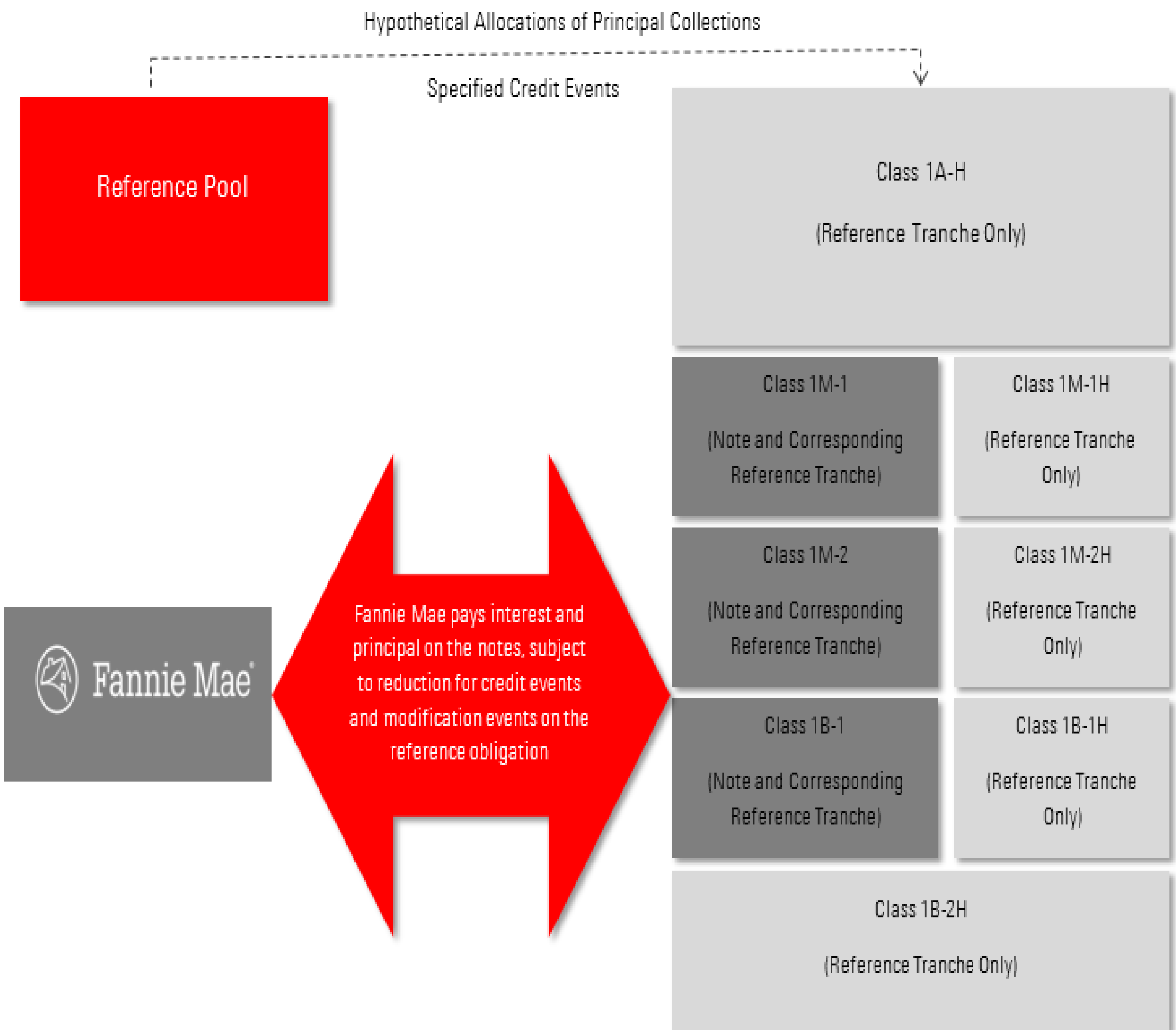
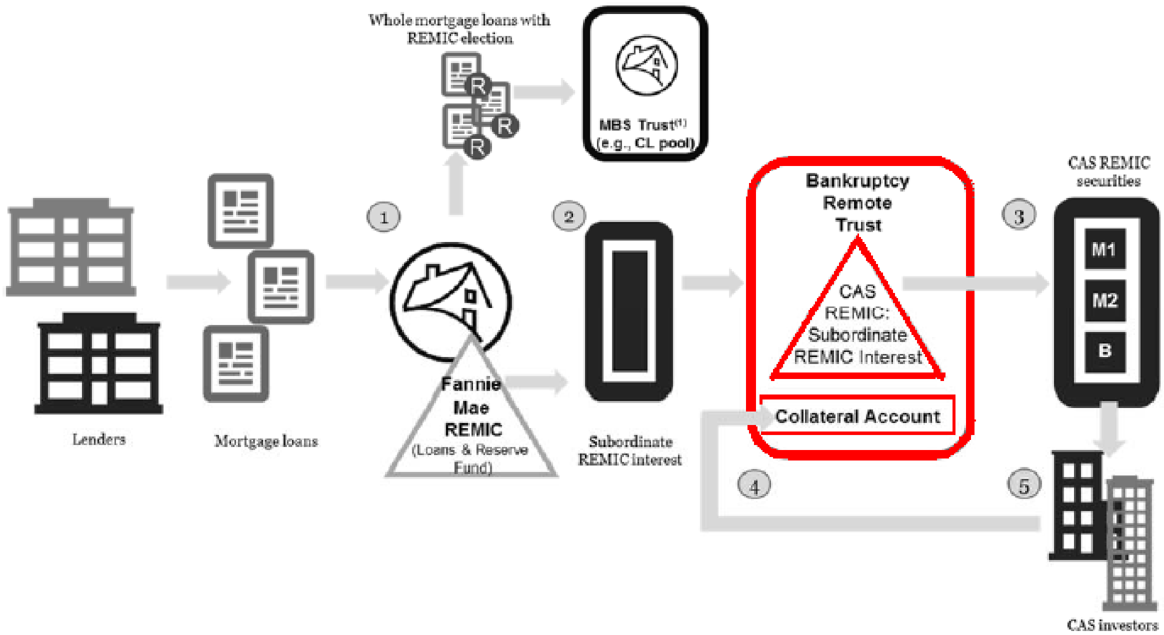


Exhibit 2: Proposed CAS structure



1 Fannie Mae takes Remic election on loans and creates a reserve fund.

2 Fannie Mae internal Remic creates a subordinate Remic interest, which is contributed to the CAS Remic trust. The subordinate Remic interest is supported by assets in the reserve fund and excess mortgage interest.

3 CAS Remic issues CAS Remic securities.

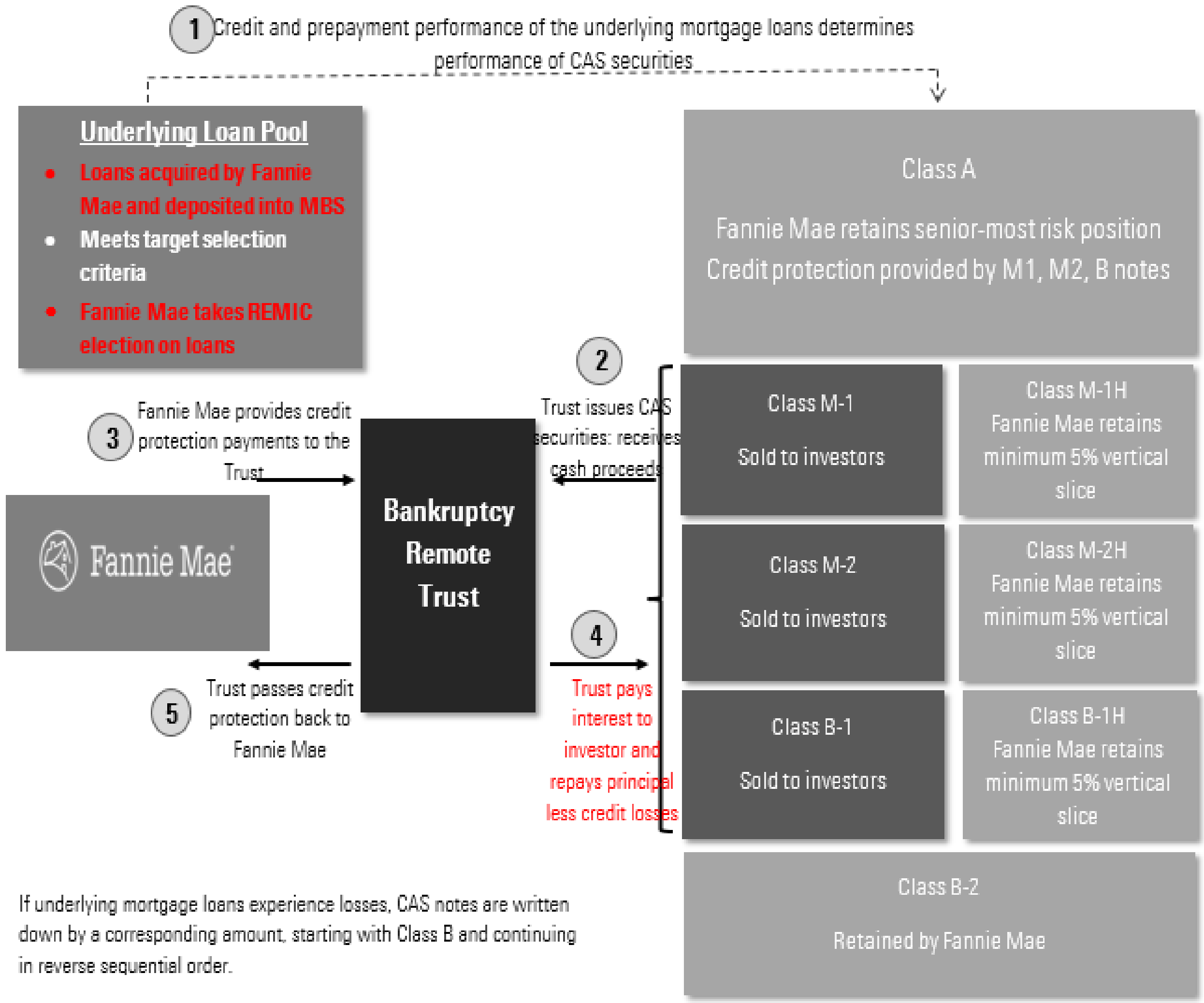
4 Issuance proceeds are deposited into the collateral account.

5 The CAS investor receives Remic-eligible credit securities tied to performance of mortgage loans.

Proposed CAS Remic structure

- This enhancement to the CAS offerings would limit investor exposure to Fannie Mae counterparty risk.
- The structure of the CAS deals, including the capital structure, cash flows, and loss calculations, would largely remain unchanged.

Exhibit 3: Proposed CAS Structure



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