GSE Activity Report

Friday, July 31, 2020

Curtains Rise Again for CRT?

Summary

When we looked at the GSEs 1Q earnings, we asked if it was "curtains for CRT." The question came then because of the sudden rout in CRT counterparties caused by March's market madness. Since then of course has come FHFA's capital proposal along with it its tough stand on CRT. Now in their 2Q earnings statements, Fannie has essentially abjured CRT but Freddie thinks deals can be done as long as current capital rules prevail. Indeed, it did one single-family deal earlier this month. Based on Fannie's CRT assessment, it could well join in, but only if FHFA's capital rule is postponed or its CRT construct becomes less expensive.

Impact

In its 2Q report, Fannie states that it did no CRTs in the second quarter due in part to market disruption as well as the capital costs imposed on CRT under FHFA's proposal. As Fannie readily recognizes, CRT abstention means that near-term credit losses will rise in the absence of anyone to share them on newly-originated loans plowing into the pandemic. Further, Fannie's capital needs will go up over time because its loss exposure on all of its guarantees will be higher than it would in the presence of CRT. This might seem a capital consequence devoutly to be avoided, but Fannie appears to be redesigning its purchases to anticipate a world without CRT.

As we noted in our assessment of first-quarter CRT considerations, this means as large a book of low-risk mortgages as it can accumulate, backing as much risk wherever it's unavoidable (e.g., high LTVs) with MIs or other credit-enhancement constructs not penalized by the CRT restrictions. As we noted, the NPR provides considerable scope for alternative credit-enhancement options that would not be deemed synthetic securitizations.

Fannie doesn't say so, but the liquidity directive we assessed yesterday may also be a factor here. We know little about the details of FHFA's directive, including the critical question here of how inflows from synthetic securitization payments factor into cash-flow projections over the 30- and 365-day scenarios included in the new standards. Does FHFA assume a sudden cessation of all payments due to the GSEs much as the banking rules anticipate a shut-down for banks of all external credit lines? What about CRT repayment flows for structures that aren't pre-funded? When is funding recognized for cash-flow purposes? Tough liquidity standards combined with leverage rules for the GSEs' remaining balance sheets could be very costly.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

Outlook

Or maybe not. Freddie seems unbowed. Fannie's CRT stand appears premised on expectations that FHFA's capital rule will come quickly into effect, forcing near-term recognition of CRT capital costs. Buoyed by calls as recently as Wednesday from top House Democrats, Freddie may instead count on business as usual for as long as counterparties are to be found.

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