Investment Insights
What are GSE Credit Risk Transfer securities?

Introduction
Credit Risk Transfer (CRT) securities are general obligations of the US Federal National Mortgage Association, commonly known as Fannie Mae, and the US Federal Home Loan Mortgage Corporation, commonly known as Freddie Mac. These Government Sponsored Enterprises (GSEs) are mandated to expand the secondary market for residential mortgage loans through securitization. Fannie Mae and Freddie Mac purchase and securitize loans and sell the resulting mortgage-backed securities (Agency MBS) in the secondary market. Agency MBS are guaranteed by the GSEs, meaning that these entities are responsible for the timely payment of principal and interest on the bonds and bear the risk of credit losses on the underlying loans.

CRT securities were created in 2013 to effectively transfer a portion of the risk associated with credit losses within pools of conventional residential mortgage loans from the GSEs to the private sector. Unlike Agency MBS, full repayment of the original principal balance of the CRT securities is not guaranteed by the GSEs; rather, “credit risk transfer” is achieved by writing down the outstanding principal balance of the CRT securities if credit losses on the related loans exceed certain thresholds. By reducing the amount that they are obligated to repay to holders of CRT securities, Fannie Mae and Freddie Mac are able to offset credit losses on the related loans.

Background
The CRT market is a product of the efforts of Fannie and Freddie’s regulator, the Federal Housing Finance Agency, to accelerate the return of private capital to the residential mortgage loan market following the financial crisis. As home prices started to decline in 2007 and the US subsequently entered a recession, defaults on guaranteed loans escalated dramatically and the GSEs suffered significant losses. In September 2008, the GSEs were placed under the conservatorship of the US Treasury and received financial support in the form of lines of credit — effectively a bailout funded by US taxpayers. The credit risk transfer initiative seeks to reduce the exposure of taxpayers to such an event in the future by placing the GSEs in a last loss position rather than a first loss position with respect to most of the loans that they guarantee.

Growth
The CRT market has grown rapidly since its debut in July of 2013. Investor reception has been robust as it has become increasingly difficult to source exposure to credit risk linked to the residential mortgage loan market. As of May 2018, the GSEs had issued USD 58.8 billion CRT securities. These transactions have provided the GSEs with credit loss protection on nearly USD 2.0 trillion of loans to date.

Today
CRT securities have come to represent the predominant form of non-guaranteed debt issuance related to recently originated residential mortgage loans in the US. They have enabled a wide range of investors to gain credit exposure to the ongoing recovery of the residential real estate market. We expect total issuance in 2018 of approximately USD14 billion, compared with USD14.3 billion in 2017, as higher mortgage rates and tight housing supply may result in lower conforming loan origination volumes.
Why consider CRTs?
CRT securities can help diversify the risk profile of a fixed income strategy by providing credit exposure to the US residential mortgage market. We believe this sector offers a potentially compelling opportunity due to the strength of US residential real estate fundamentals and the high quality of loans that Fannie and Freddie have acquired in recent years. Additionally, floating rate LIBOR-based coupons could help to mitigate uncertainty related to the future path of interest rates and allow investors to benefit from increases in LIBOR that have resulted from regulatory reforms.

The loans underlying CRT have performed well in recent years as home prices increased and the labor market improved. In contrast to many other asset classes, we believe that tight supply and low mortgage rates will continue to drive sustainable home price gains. Rating agencies have recently been active in upgrading CRT securities, and we expect this cycle to persist. Looking forward, we believe an expanding investor base is likely to improve liquidity in the CRT market, and relative credit risk premiums may contract as the sector continues to mature.

How IFI is different
Invesco Fixed Income (IFI) employs a balanced top-down, bottom-up approach in our portfolio construction process. Our top-down analysis examines factors in the broader economy such as GDP growth, interest rates, labor market dynamics, consumer data and corporate earnings. Our analysis then defines fundamental trends in residential real estate such as housing stock, mortgage originations, delinquency rates, loan origination conditions and housing performance across distinct geographical areas, which, in turn, shape our outlook for the residential market and the performance of housing-related debt. Robust bottom-up credit analysis also plays an important role.

For any potential investment, our analysis begins at the loan level. Key collateral and borrower characteristics including delinquency status, loan type, balance, geographic location, property type, documentation type, occupancy status, current loan-to-value ratio and credit scores are reviewed to determine appropriate assumptions for prepayment and default expectations. Property level assessments and geographically detailed home price indices are utilized to update collateral value estimates. Where appropriate for the type of security, the team formulates assumptions for variables that are influenced by transaction parties, such as the servicers that collect payments from borrowers and manage property liquidations. Once base case assumptions have been established, we perform structural analysis under multiple scenarios to determine likely cash flow profiles and to quantify the amount of projected loan loss relative to the credit protection provided by the transaction structure.

1 Derived using Intex data, 31 May 2018.
2 Derived using Intex data, 31 May 2018.
3 Invesco Fixed Income (IFI) is a unit comprising Invesco Advisers, Inc. of Atlanta, Georgia; Invesco Asset Management Limited, of London, U.K.; and Invesco Canada Ltd. of Canada.
How CRTs work

Each CRT transaction generally includes several tranches that cover a range of cash flows, credit risk and potential return profiles. Historically, tranches with the highest credit quality have been rated A and feature a relatively short expected cash flow window and a large amount of credit protection in the form of a higher level of subordination. BBB rated tranches feature longer expected cash flow windows and lower levels of subordination. Finally, below investment grade tranches represent the longest expected cash flows and have the least credit protection, but typically offer the highest potential returns. Tranche prepayments and write-downs are based on the performance of the reference mortgage loan pool. As loans are prepaid, the most senior tranche is first in line to receive the proceeds, followed by lower-rated tranches as outstanding balances are paid off. As defaults occur, losses are allocated sequentially from the tranches with the lowest rating to the highest. Thus, below investment grade tranches experience write-downs first, and if they are written down entirely, BBB rated tranches begin to take write downs, and so on.

Typical CRT Transaction Structure

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The issuer of CRT instruments may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer’s credit rating. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. Mortgage- and asset-backed securities are subject to prepayment or call risk, which is the risk that the borrower’s payments may be received earlier or later than expected due to changes in prepayment rates on underlying loans. Securities may be prepaid at a price less than the original purchase value.