GSE Activity Report

Tuesday, June 2, 2020

Cracking CRT Capital

Summary

As promised in our last in-depth analysis, we turn now to another strategy-critical capital question: the future of credit risk transfer (CRT). FHFA has proposed an extraordinarily-complex CRT framework designed at once to reduce reliance on pool-insurance CRT and still favor it over like-kind structures under the U.S. banking rules. The paradox of the NPR is that, after a lengthy description of all the hazards of CRT, FHFA still goes relatively easy on it. Its preferred approach – equity financing – could be counter-cyclical, but the new framework still allows some CRTs and thus offers considerable scope for regulatory-capital arbitrage between CRT and equity increases and within the CRT and CRM frameworks. The new approach seeks to buttress CRT against current risks resulting from highly-leveraged counterparties, but does not or indeed could not solve for ongoing capital and operational constraints that keep big banks out of the GSE-CRT arena. As a result, this section of the new capital framework, if finalized as proposed, would be a dealmaker's dream if – and it's a big if – market appetite for CRT returns and risk tolerances can be satisfied under the new framework in a near-term post-conservatorship construct. As we have noted, CRT have effectively collapsed under COVID.

Impact

CRT has been the crux of FHFA's foot-print shrinking plan for the GSEs since it first mandated that Fannie and Freddie do these deals in 2013. Seeing itself as a capital-markets company, Freddie was happy to comply; Fannie has also done as bidden even though its predilection appeared to be to remain both a guarantor and securitizer across the single- and multi-family spectrum.

Under the NPR, CRT structures are separated into structured debt issues (e.g., STACRs and CAS) considered synthetic notes, not CRT, thus posing no counterparty risk as long as the note is fully collateralized. CRT per se in the new taxonomy are pool-level reinsurance transactions. Here, the GSEs usually take risk of first loss along with counterparty risk, although diversification reduces this along with wrong-way peril. Front-end CRT is mentioned but discounted due to its imminent end.

Much in the NPR slams CRT on structural grounds. FHFA says it's potentially procyclical and thus a threat to the GSEs' mission as well as an encouragement to systemic leverage because the GSEs are more leveraged in the wake of CRT even as they also rely on highly-leveraged counterparties (presumably the leveraged hedge funds also slammed in the Fed's latest financial-stability report).

However, after castigating CRT, FHFA then goes on to enable it, albeit less enthusiastically then under current rules or even the 2018 NPR. The NPR works its anti-CRT constructs through a new capital

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

© 2020 Federal Financial Analytics. All Rights Reserved.

framework that is said to be similar to the banking-agency securitization standards but at the same time all FHFA's own. The new CRT construct bows to comments on the 2018 round complaining that CRT had less risk absorbency than an equivalent amount of "equity financing." FHFA does not define what is meant by equity financing, but it appears to mean more equity capital because it cites equity financing's benefit to covering credit risk across a portfolio, not just a designated slice thereof, with equity enhancing also protecting against operational and market risk. Equity financing also permits a capital-distribution pause while CRT requires continuing debt-service or other payments.

FHFA is now also concerned by structural complexity and legal uncertainty, proposing new operational restrictions (e.g., contractual irrevocability) akin to those demanded by the banking agencies. New disclosures on CRT terms are proposed, but these do not go as far as the banking agencies in terms of limiting CRT terms that go beyond traditional or synthetic securitizations. Most notably, FHFA would not require that financial guarantees come only from companies in the business of making these guarantees, opening the market very considerably despite all its other CRT cautions.

Like both the Basel and U.S. rules, the FHFA approach is not capital neutral – that is, a securitization must generally have more capital than the sum applied to its underlying exposures – an option maintained to prevent a strong capital disincentive from securitizing only higher-risk assets. The NPR includes a challenging formula in the midst of many other conditions for CRT capital requirements along with a 10% minimum risk weight for all retained CRT exposures, less than the 20% banking-agency minimum. However, comment is sought on whether to align the CRT framework with the "Basel and U.S." frameworks which, since these are different, appears to invite any comparison commenters prefer. Despite the calculator released today, the overall CRT construct is very complex, which FHFA readily acknowledges even as it also seeks comment on whether to conform it to the banking agencies' standardized securitization formula. Yet another alternative simpler to the proposal but different from either Basel or the banking agencies is also proposed for comment. Here, FHFA posits a supervisory-adjustment factor to set risk weightings.

Outlook

In addition to its new capital framework, FHFA now suggests that it will institute broader safety-and-soundness standards for going-forward CRT. A new construct in which FHFA categorizes CRT for loss-absorbency capacity and approves only some is mentioned, but not built out beyond mention of future restrictions such as a ban on CRT termination due to deteriorating market conditions. How FHFA proceeds on these add-on standards along with how it wends its way through all the options on which comment is sought is simply impossible to predict, meaning that the only forecast we can confidently advance after reviewing the NPR is that CRT will be different under the new capital regime, likely less important than it is now, but yet still a significant opportunity for some GSEs with some counterparties under some market and credit-risk scenarios.

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

© 2020 Federal Financial Analytics. All Rights Reserved.