Risk-Transfer Buyers Wary of Loan Erosion

Investors in risk-transfer bonds from **Fannie Mae** and **Freddie Mac** are trying to measure the effects of deteriorating credit quality among the deals' weakest obligors.

While average credit scores have fallen across the transactions' underlying borrowers, the trend has been particularly pronounced among those with the spottiest histories. Consider that the average collateral scores for offerings conducted via Fannie's Connecticut Avenue Securities program initially stood at 766 in 2013, but had dropped to 749 for an issue completed Jan. 18.

That works out to a 2% weakening. At the same time, average scores for the bottom 2.5% of borrowers fell by 6%, from 695 to 653, according to data company **Recursion.**

Some investors are viewing the shift as a sign that Fannie and Freddie purposely are trying to lay off more risk on bond buyers amid moves to relax their loan-underwriting standards. Others suspect that the overall universe of borrowers has grown, leading to a natural increase in exposures to those with particularly low scores.

At the same time, certain investors would welcome more risk if it meant a larger return — in part because strong housing-market conditions offer some insulation from borrower defaults. Strong demand for risk-transfer securities typically has meant shrinking returns, however, with spreads remaining on a tightening trajectory over the past several months. "People want to be cognizant of what spreads are paying versus what the average pool looks like," one source said.

Even with the decline in credit scores, meanwhile, many industry participants are playing down the risk to investors. Bondholders on the mezzanine levels have benefitted from a slight increase in subordination, for example.

Falling loan-to-value ratios and rising home prices also have added to investor protections, as has a brighter economic outlook. That helps explain one analyst's view that a Dec. 1 transaction from Fannie wasn't measurably riskier than its predecessors despite a 12.3% exposure to borrowers with scores of 690 or lower, versus 4% for the earliest transactions.

He added that some weakening of credit scores would be expected because the first risk-transfer pools formed when post-credit-crisis caution led to unusually strict underwriting standards. Fannie and Freddie also saw a need to assemble particularly pristine pools at the outset, given buysiders' unfamiliarity with the product. "It would be normal to see some FICO drift remembering that the pools being referenced date back to 2012 to 2013 . . . but it hasn't been too significant," the analyst said.

Risk-transfer bonds are structured as credit-linked notes in which the reference loans remain on the issuers' books. The agencies typically retain the deals' top pieces while selling the mezzanine and junior classes, with those at the bottom absorbing losses as soon as the underlying loans default.

Alex Levin, who oversees financial engineering at **Andrew Davidson & Co.,** said actual losses for subordinate investors have been miniscule, while secondary-market prices for their holdings have climbed to about 120 cents on the dollar from par since mid-2016.

"We had pretty tight spreads on our recent deal, which we view as broad market acceptance of the strong credit fundamentals," a Freddie spokeswoman said, referring to a transaction completed on Jan. 31 (see Initial Pricings on Page 10).

Along with falling credit scores, Fannie and Freddie have tweaked characteristics of their asset pools. For example, the percentage of collateral loans from California has varied from 6% to 30% across the agencies' deals, according to Recursion. The New York analytics shop is led by founder **Li Chang.**

Counting only unguaranteed securities, Fannie and Freddie have issued a combined 45 risk-transfer deals totaling $32.7 billion, according to **Asset-Backed Alert's** ABS Database. Both agencies are expected to increase their outputs this year. ❖