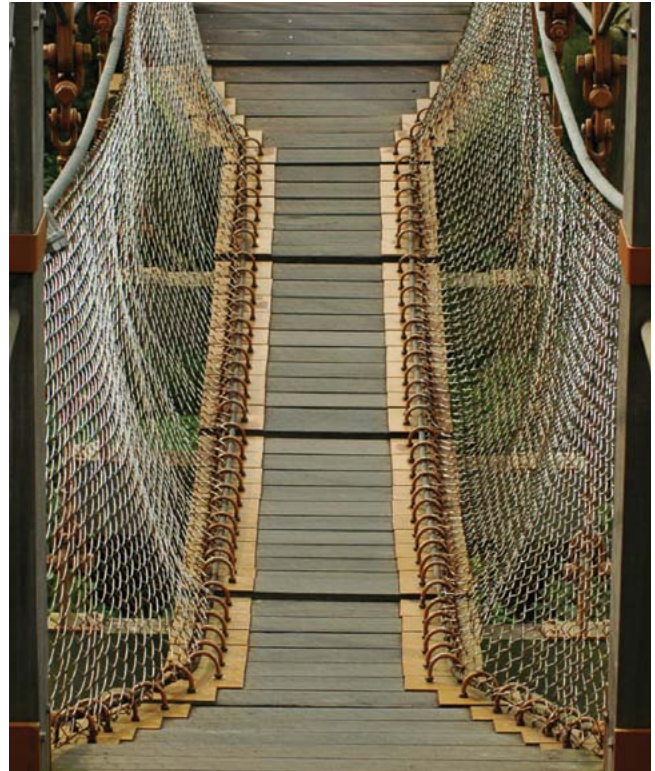


By Laurie S. Goodman and Landon D. Parsons

A private solution to a very public problem

The future of Fannie Mae and Freddie Mac remains uncertain. While we wait for clarity from lawmakers and the White House, though, a struggling mortgage insurance industry leaves the government-sponsored agencies with a more pressing issue: how to devise alternative ways to cover mortgages with high loan-to-value ratios. That presents a perfect opportunity for the private market to help shoulder more of the burden of financing the U.S. housing market — an idea already promoted by FHFA director Ed DeMarco. Our guest authors from Amherst Securities and Moelis & Co lay out three options.



Private capital: a safe bridge for GSE mortgage credit enhancement

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The long-term future of Fannie Mae and Freddie Mac is far from being decided. The combination of the tough political environment in Washington D.C. and the slow pace of introducing complex changes to the financial system means that any fundamental changes are unlikely before 2017. No one doubts, in the meantime, that the private sector could and should take on more of the burden of financing the U.S. housing market, and while we wait for direction from policy-makers, there are various initiatives that can help promote this objective.

Encouragingly, Edward DeMarco, acting director of the Federal Housing Finance Administration (FHFA), recently took the unusual step for a regulator of embracing new ways to share GSE risk with the private sector. In a speech to the American Mortgage Conference in September last year DeMarco gave a nod to alternative methods of doing that beyond the traditional reliance on mortgage insurance.

“Another way to allow for greater private sector risk sharing is to develop security structures that allow for a portion

of the credit risk currently undertaken by the Enterprises to be sold off,” he said. “There are numerous securities structures that could be considered in this space, and we will be evaluating some of those in the coming months.”

Following such a path would be beneficial on several fronts. First, it would diversify the GSEs’ sources for risk management. That, in turn, ought to be reassuring for the federal government and for taxpayers who have already handed over US\$180 billion in rescue money and would be on the hook for any future bailout, too. Third, broadening the number of providers of credit would help determine a more accurate price for mortgage risk that the private sector is willing to pay. And it would, of course, allow the private sector to return to the mortgage market in greater volume than the few non-agency deals of the past two years have allowed.

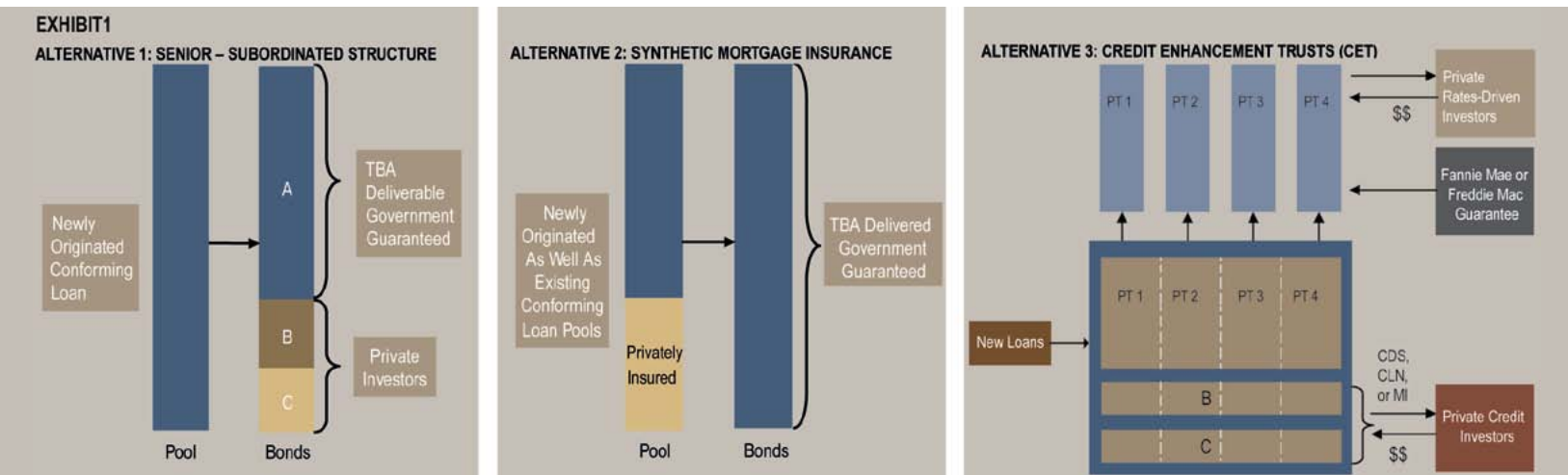
So, with DeMarco’s words ringing in our ears, we have devised three securities structures that could fit the bill. We summarize them in Exhibit 1 and outline them below. But before we do, let’s quickly recap why such structures are more necessary than before.

32.4% of the loans that are seriously delinquent by 90 days or more.

Meanwhile, more borrowers are taking conventional loans with insurance. That’s the result of the Federal Housing Administration increasing insurance premiums from a maximum 55 basis points in early 2010 to 115bp in April 2011. That has made a conventional loan with mortgage insurance a more competitive product for many borrowers. For the period August-October 2011, 22% of the Freddie Mac-insured loans used for home purchase came with mortgage insurance, up from 15% in the second quarter of 2010. With insurance on the rise, the GSEs clearly need the other options DeMarco has hinted at.

So Where Do We Go From Here?

The first alternative to mortgage insurance on our list is a simple senior subordinated structure, with a pool of loans as collateral. The senior bond has a GSE guarantee. The subordinate bond would be sold directly to investors seeking to purchase mortgage credit risk for cash and does not have a guarantee. This is the simplest structure, but it has the disadvantage that



Insurance In A Bind

The reason lies in the weakened financial state the credit crisis has left the mortgage insurance industry in. That’s a crucial point as the GSEs are prohibited by law from taking the first loss position on any mortgage loans that are worth 80% or more of the value of the property. As a result, they have relied on mortgage insurers to cover the first loss on these loans.

Until a couple of years ago, seven mortgage insurers did business with the GSEs. Since then, three have stopped writing insurance and two of the remaining four carry junk bond ratings — and one of those still rated investment grade is perilously close to breaching its risk-to-capital ratio [see box and exhibit 2].

As shown in Exhibit 2 on page 23, some \$641 billion of the GSEs’ \$4.5 trillion book of single-family loan guarantees is covered by insurance. On average, the mortgage insurers cover the first 22.8% of the unpaid principal balance on these loans, making the maximum coverage \$146 billion. This coverage is very important: even though loans with mortgage insurance comprise only 14.1% of the total book of business, they comprise

the senior bond would not be TBA eligible, and is hence likely to trade at a price concession to the TBA market. This is very similar to Freddie’s K Series for multifamily loans.

Synthetic mortgage insurance is our second alternative. As in our first example, private capital takes the credit risk on a pool of loans. Credit protection can be provided through either a credit linked note (CLN) or a credit default swap (CDS). The underlying securities would be fully GSE guaranteed and TBA eligibility would not be impacted. When the trade is executed in CLN form, the return on the principal on the note is tied to the ultimate performance of the pool of loans. The GSEs have no counterparty credit risk, as the maximum protection that is available is set aside at the outset. If the trade is executed in CDS form, the GSEs would assume the credit risk of the party providing the credit enhancement. To help alleviate the risk, the contract would be both margined and marked-to-market daily. If the counterparty is unable to respond to the margin call, they can be replaced.

The CDS version has two disadvantages. First, even with

frequent margining and the ability to replace the counterparty, the GSEs are assuming counterparty credit risk. Second, the GSEs may face derivative accounting issues by eliminating risk in this manner. The advantage, however, of the CDS is that investors would not be required to tie up the large amount of cash that a CLN would require, providing for much better execution.

The CDS/CLN decision does not have to be a case of choosing only either one or the other; the GSEs should think about a hybrid approach.

So, rather than a \$100 million CLN, an investor could provide a \$25 million CLN and a \$75 million CDS. This is essentially the equivalent of providing financing on the CLN. However it is much more efficient: if an investor were to try to fund a CLN, the funding costs would likely be higher than the yields on permitted uses of the cash portion of the CLN. This

would generate a negative arbitrage. The CDS would be subject to margin calls only to the extent losses exceed the CLN balance.

Another decision to make is what would constitute a credit event. The CLN or CDS could be triggered either by a liquidation, with the loss dictated by the actual severity, or by a delinquency of more than a certain number of months, with the

loss determined by a pre-set severity factor. If the GSEs use delinquency triggers to define a credit event, this would allow for the creation of credit enhancement with legal final maturities far shorter than the maturity

of the underlying collateral. For example, it would be logical to construct a security with a 10-year final maturity as most of the ultimate liquidations would have triggered the delinquency credit event by then and the GSE would have collected on those loans.

In addition to the TBA eligibility, this structure has two other

Broadening the number of providers of credit would help determine a more accurate price for mortgage risk that the private sector is willing to pay.

State of the mortgage insurance industry

The government-backed mortgage agencies lost another insurer towards the end of last year. In November, PMI filed for bankruptcy. A month earlier, Arizona's Department of Insurance had taken possession of the company's mortgage insurance unit after it breached minimum state capital requirements.

That brings to three the number of insurers that are no longer writing business with the GSEs. Triad Guaranty stopped in 2008, also as a result of being unable to meet capital requirements. And Republic Mortgage Insurance closed to new business in August last year after its waivers expired — the GSEs

historically have required at least a double-A rating for firms to qualify as an insurance provider; they will waive that if there is a credible capital rehabilitation plan in place.

The GSEs' two largest mortgage insurers by volume are both experiencing financial challenges. Both have ratings well below investment grade: MGIC is single-B, while Radian at least has a double-B minus equivalent rating from one of the ratings agencies. Their parents' five-year credit default swap spreads are in severely distressed territory: in mid-December MGIC traded above 1,800 basis points and Radian above 3,500bp. And both are close to the 25-1 risk-to-capital ratios state insurance regulators usually demand: MGIC stands at

22.2, Radian at 21.4.

The final two legacy insurance companies are both part of larger organizations. Genworth writes a variety of insurance policies as well as selling annuities. And United Guaranty is a subsidiary of AIG. But both are rated triple-B — though AIG has a single-A rating, too. And Genworth's risk-to capital ratio is above most state limits at 30.7-1.

Take United Guaranty out of the equation and it's easy to see just how much the GSEs rely on shuttered or troubled insurers. As Fannie Mae pointed out in its third-quarter report: "These six mortgage insurers provided...81% of our risk-in-force mortgage insurance of our single-family book of business as of September, 30, 2011." ▼

EXHIBIT 2

Mortgage Insurers' GSE Exposure

Mortgage Insurers	Fannie Mae			Freddie Mac			Combined		
	Max Coverage, Sep 2011 (\$bn)	Total UPB, Sep 2011 (\$bn)	Coverage (%)	Max Coverage, Sep 2011 (\$bn)	Total UPB, Sep 2011 (\$bn)	Coverage (%)	Max Coverage, Sep 2011 (\$bn)	Total UPB, Sep 2011 (\$bn)	Coverage (%)
Mortgage Guaranty Insurance	\$22.0	\$94.6	23.3%	\$13.1	\$79.9	16.4%	\$35.1	\$174.5	20.1%
Radian Guaranty	15.1	62.1	24.4%	10.6	49.0	21.6%	25.7	111.1	23.2%
Genworth Mortgage Insurance	13.7	55.2	24.9%	8.1	32.6	24.8%	21.8	87.8	24.9%
United Guaranty Residential Insurance	14.1	58.3	24.2%	7.1	29.2	24.3%	21.2	87.5	24.2%
PMI Mortgage Insurance	11.7	50.1	23.2%	6.5	27.1	24.0%	18.2	77.2	23.5%
Republic Mortgage Insurance	9.7	41.2	23.4%	5.3	23.2	22.8%	15.0	64.4	23.2%
Triad Guaranty Insurance	3.5	14.6	24.0%	2.2	9.8	22.4%	5.7	24.4	23.4%
Essent and Others	2.4	10.3	23.0%	0.8	3.5	22.9%	3.2	13.8	23.0%
Total (\$ in billion)	\$92.2	\$386.5	23.8%	\$53.7	\$254.3	21.1%	\$145.9	\$640.8	22.8%
Total as % of Single-Family Guaranty Book	3.4%	14.2%		3.0%	14.0%		3.2%	14.1%	
Total Book of Business (\$ in billion)		\$2,721.6			\$1,816.4			\$4,538.0	
Total Reported DQ %		4.0%			3.5%			3.8%	
Total Reported Non MI DQ %		3.1%			2.8%			3.0%	
Total Reported MI DQ %		9.4%			7.7%			8.7%	
Total DQ Balance (\$ in billion)		\$108.9			\$63.8			\$172.6	
Total MI DQ Balance (\$ in billion)		\$36.4			\$19.6			\$56.0	
Total DQ MI Loans as % of Seriously Delinquent Loans		33.5%			30.7%			32.4%	

Source: Fannie Mae, Freddie Mac, Amherst Securities
Source Documents: 10-Q Quarterly Filing, Quarterly Credit Supplement, Monthly Volume Summary

advantages. First, unlike the senior subordinated structure, this form of credit enhancement would be available for both existing, as well as newly originated, loans. Second, the number of investors would be larger, as the credit enhancement could be taken in CLN or CDS form. This is very similar to Freddie's MODERNs program, which used a CLN execution.

Last, But Not Least ...

Our third alternative is a credit-enhancement trust (CET), similar to a credit card trust. A revolving master trust is established to purchase loans directly from the GSEs. Loans purchased by the trust must conform to an established set of criteria, such as a given range for FICO scores, LTV and origination dates as well as all criteria of the GSE automated underwriting model. The CET sells the pass-through certificates, which have either an implicit or explicit guarantee. Their TBA eligibility is not impacted in this structure. The CET also sells credit enhancement in the form of a CDS contract, a CLN or additional mortgage insurance. All loans are co-mingled.

One advantage of this structure is that it allows for the substitution of qualifying loans for loans that have prepaid or defaulted. This co-mingling should expand the number of investors who would provide credit enhancement because the broader mix of assets means they would not be exposed to the loans supporting one pass-through, but would be able to offset potential losses from one TBA's pool with better performance from another pool.

Another advantage is that this structure also allows for the growth of the deal given that more pass-throughs mean more subordinate positions. Additionally, this structure would also be advantageous to the GSEs because they can arbitrage the private credit enhancement market by buying credit enhancement in different forms, depending on which represents the most advantageous execution. Lastly, by using the CET for loans that are less than 80% of the value of the home, the CET could provide a programmatic solution for transferring credit risk from the GSEs to the private markets, thereby reducing taxpayer risk.

As in the second option, it must be decided if the credit event is liquidation or a given delinquency trigger. If a delinquency trigger is selected, a pre-set severity must be used. This opens the door for "soft bullet" type structures.

We are not advocating for any one of these three structures over another — and other structures are possible, too. Nor are we advocating that the mortgage insurers be replaced: they provide an important source of credit enhancement. We are arguing instead that it makes sense to diversify credit enhancement sources. Diversification would also bring additional benefits, from gauging the appetite for mortgage risk among the private sector to improving pricing information. That should foster a more intelligent debate on GSE reform — and perhaps even help speed up its implementation.▼

The views expressed are those of the author and do not necessarily represent the views of ASE.

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