MEMORANDUM

To: File No. S7-38-11

From: Elizabeth Sandoe
Senior Special Counsel
Office of Trading Practices
Division of Trading and Markets

Date: March 24, 2015

Re: Meeting with Representatives of the FHFA, Fannie Mae, and Freddie Mac


Attachment
GSE Credit Risk Transfer ("CRT")

Meeting at the Securities and Exchange Commission
Tuesday, March 24, 2015
Agenda

1. Overview of Current CRT Issuance Program and Goals
2. Overview of Proposed Alternative CRT Structure
3. Additional Considerations

Appendix

1. Additional details on CRT Issuance Programs to date
2. Additional details on Proposed Alternative CRT Structure
Goals for Credit Risk Transfer

Goals for a credit risk transfer program are to:

- Create an additional method to manage the credit risk of the guaranty book of business
- Develop risk sharing structures that are scalable and sustainable over time
- Preserve the “To Be Announced” (TBA) market
- Minimize disturbance/changes required of lenders and servicers
- Connect lenders and investors through an intermediary who sets standards and provides stability through the cycle
- Fulfill Conservatorship goals of increasing private capital participation in mortgage credit risk

- 2015 FHFA Scorecard Goal: transact credit risk transfers on single-family mortgages with unpaid principal balance (UPB) of at least: $150 billion (Fannie Mae) and $120 billion (Freddie Mac)
Overview of Current CRT Issuance Program

- Reference Loan Pool
  No sale/transfer of underlying loans; used for reference purposes only
  All loans have been securitized in MBS/PC pools
  Underlying loan processes unchanged (quality control, servicing, etc.)
  Large, diversified pool of 30-year fixed-rate mortgage loans underwritten to GSE guidelines
  Each reference pool is a random and representative sample of total eligible loans
  Each deal references a portion of a certain period of recent loan acquisitions

- CRT Securities
  Unguaranteed, unsecured debt securities issued by each GSE, generally with 10 year terms
  Accrued interest on securities paid to investors by GSEs on a monthly basis
  As loans in reference pool paid, principal balance of the securities is repaid, so securities mirror payment and prepayment behavior of mortgage loans in reference pool
  If loans in reference pool experience credit defaults, CRT investors may bear losses
  Each GSE retains vertical slice of transaction to ensure aligned interest with CRT investors
Fannie Mae/Freddie Mac Credit Guaranty Business Model

When Fannie Mae issues fully guaranteed MBS or Freddie Mac issues fully guaranteed PCs, they retain all of the credit (mortgage default) risk associated with losses on the underlying mortgage loans. In return for taking on that risk, they receive a guaranty fee paid from a portion of the loans’ interest payments, which is passed through by the lender that delivered the loan. When the GSEs issue credit risk transfer securities, they transfer some of the retained credit risk to private market investors. However, the purchasers of the credit-linked debt do not own the underlying loans. Such ownership interest belongs to the MBS or PC investor.

Funding loans through *issuance* of Fannie Mae MBS or Freddie Mac PC (TBA Market)
**Current CRT Structure**

Reference Pool

(Loans backing fully guaranteed MBS/PCs)

Hypothetical Allocations of Principal Collections

Specified Credit Events

- Class A – H
  (Reference Tranche Only)

  - Class M-1
    (Note and Corresponding Reference Tranche)

  - Class M-2
    (Note and Corresponding Reference Tranche)

  - Class A – H
    (Reference Tranche Only)

  - Class M – 1 H
    (Reference Tranche Only)

  - Class M – 2 H
    (Reference Tranche Only)

  - Class B-H
    (Reference Tranche Only)

Applicable GSE pays coupon on Notes, and its obligation to repay principal on the Notes is reduced for credit events on the Reference Pool.

First loss position may be retained or sold.

**Note:** Tranches labeled “H” are not issued or sold; risk retained by applicable GSE.
Proposed Alternative CRT Structure - Overview

Reference Pool
(Loans backing fully guaranteed MBS/PCs)

Specified Credit Events

Hypothetical Allocations of Principal Collections

SPV/Trust

Swap Agreement*

Amount needed to pay monthly interest on bonds

Trust issues bonds

Class A-H
(Reference Tranche Only)

Class M-1
(Note and Corresponding Reference Tranche)

Class M – 2
(Vote and Corresponding Reference Tranche)

First loss position
May be retained or sold

Class M – 2H
(Reference Tranche Only)

Class B-H
First loss position
(Reference Tranche Only)

Payment for specified credit events

Class M -1 H
(Reference Tranche Only)
Legal Structure. Each GSE will establish a special purpose vehicle (SPV), which may be an LLC, a corporation or a trust. GSE retains ownership interest in the SPV. SPV will issue securities (Notes) to capital market investors. GSE pays transaction-related expenses, including underwriting discounts and commissions.

Collateral. Proceeds of Notes will be used to buy US Treasuries or cash equivalents (Collateral) to be assigned to the indenture trustee and held in trust for the benefit of Noteholders and the GSE as swap counterparty. SPV will grant to indenture trustee a first-priority perfected security interest in Collateral.

The Swap. SPV will enter into a credit default swap (CDS) by which Notes will be linked to performance of a specified reference pool of single-family residential mortgages held or guaranteed by the GSE (Reference Pool). Although the notional amount of the swap will equal the principal amount of Collateral, the Reference Pool will be significantly larger than the swap notional amount. If specified credit events occur in the Reference Pool, SPV will make a payment to the GSE funded from the partial liquidation of Collateral. In return for credit protection, the GSE will pay SPV a credit premium under the CDS.
**Cash Flow Allocation Priorities.** Payment of specified SPV expenses, including ongoing administrative expenses and any extraordinary expenses (such as indemnification payments owed to transaction parties under the indenture), are expected to be the responsibility of the GSE. However, if future transactions provide for payment of such expenses from SPV cash flows, such payments would be expected to have first priority under SPV cash flow allocations (subject to a cap). Interest payments to Noteholders will be funded by a combination of (i) investment income on Collateral and (ii) periodic fee payments by the GSE under the CDS.

Required payments to the GSE under the CDS will be made in respect of credit events in the Reference Pool at regular intervals as described above. Noteholders will receive regular principal payments based on the Reference Pool amortization and subject to any payments made to the GSE. Principal payments will be funded from partial liquidation of Collateral. The same payment priorities—payments to GSE of amounts owed under CDS and then payments to Noteholders—are expected to apply upon specified events of default, including a payment default on the Notes, commencement of insolvency or similar proceedings for SPV, or early termination of CDS. Moreover, it is expected that transaction parties will agree that, subject to any necessary provision for expenses, claims by such parties to payment or to Collateral will be subordinated to payment entitlements of the GSE under the CDS.
Additional Considerations

- CRT is the subject of FHFA mandate and oversight.
  Stated objectives include increasing private capital participation in residential mortgage credit risk, mitigating ongoing GSE risk exposure and preserving the TBA market for fully guaranteed MBS /PCs.

- CRT offsets a portion of existing GSE guaranty exposure.
  GSE guaranty of MBS/PC payments continues throughout life of CRT securities; CRT securities amortize in relation to reference assets underlying guaranteed MBS/PCs.

- Retained GSE guaranty exposure assures alignment of interests.
  Based on guidance from FHFA, GSEs committed to retain a minimum level of unhedged pro rata exposure to credit risk on reference assets.

- MBS/PC issuance programs longstanding and continuous.
  Customary MBS/PC program policies determined without regard to CRT; reference assets are characteristic of GSE acquisitions of comparable vintage.
• CRT designed to reduce guaranty exposure

Credit events (actual or stated losses) on loans in the CRT reference pool trigger losses under the GSE’s guaranty obligation to MBS investors and corresponding CDS protection payments to GSE.

• Programmatic context and transaction details fully disclosed to CRT investors.

Market standard offering materials and procedures are applied and ongoing disclosure is provided electronically; sales limited to sophisticated institutional investors.

• CRT replicates the economics of traditional private label senior-sub securitization.

MBS/PC investors assume interest rate and market risk only; CRT investors assume a portion of related credit risk.
Disclosure and Transparency

- Historical loan-level performance data is provided as part of an effort to increase transparency and help investors build more accurate credit performance models in support of the risk-sharing initiatives
  - Fannie Mae data set: 19 million loan records dating back to 2000
  - Freddie Mac data set: 17 million loan records dating back to 1999

- Loan-level data is provided on the reference pools as part of the initial transaction disclosure; ongoing performance is updated monthly as part of the bondholder reporting provided by the trustee
[1] A reference pool is created, which generally includes recently-originated loans
[2] A securitization trust, the CRT SPV/Trust, is created
[3] GSE enters into swap agreement with the CRT SPV/Trust, buying credit protection on loans in the reference pool and paying for the protection via a monthly credit premium to the CRT SPV/Trust.
[4] The CRT SPV/Trust issues s bonds, which may or may not be explicitly rated. The bonds may be issued with floating or fixed rate coupons based on investor demands. The CRT SPV/trust pays monthly P&I to these bonds based in part on reference pool paydowns.
[5] The CRT SPV/Trustee invests and reinvests proceeds from the bond issuance in cash equivalents / high quality short-term assets that will be held in a collateral account.
[6] Swap Agreement Payments: Each month, (i) as certain credit events occur in the reference pool, the CRT SPV/trust compensates the GSE with funds from the collateral account and (ii) the GSE pays the amount, if any, needed to pay monthly interest on the bonds
### Participant Functions

**GSE:**
1. Develop and design deal and structure.
2. Create Reference Pool.
3. Pursuant to Swap Agreement with CRT SPV/Trust: (i) make monthly payments to Trust in amount needed to pay interest on bonds (in excess of what trust collateral produces) and (ii) receive payments (protection) from Trust based on credit events in Reference Pool.
4. Prepare and provide to Trustee monthly loan-level data file for Reference Pool loans, including info re: credit events.
5. Publish monthly disclosure on reference pool loans.
6. Prepare prospectus for bonds.

**Trustee:**
1. Manage monthly payments to bond investors of P&I and reinvestment proceeds.
2. Manage monthly swap payments between GSE and Trust.
3. Prepare and distribute monthly remittance reports for bonds.
4. Prepare and distribute monthly reports related to swap payments between GSE and Trust.
5. Invest trust collateral in qualified investments pursuant to trust documents.
6. Prepare and file all compliance statements required by the trust agreement.
7. Cause the preparation and filing of all required tax returns on behalf of the Trust.

**Underwriters / Placement Agents:**
1. Assist in development and design of deal and preparation of offering document.
2. Market the Bonds to qualified investors via pre-issuance road shows and distribution of offering document.
3. Pay proceeds of sale of bonds to trustee.

**Investors**

**Reference Pool created by GSE**

**Chooses loans for Reference Pool**

**GSE**

**Swap Agreement**

**CRT SPV/Trust administered by Trustee**

**Trust issues bonds**

**CRT Bonds**

**Sold to underwriters/placement agents**

**Underwriters/Placement Agents**

**Proceeds from sale of bonds**

**Solicit & sell bonds to market**

**Investors**