Freddie Mac Single-Family Home Starts Here Podcast Episode Transcript:

Freddie Mac
Single-Family

CRTcast E4: CRT Then and Now, A Conversation with Don Layton

Announcer [00:00:01] Welcome to the "Freddie Mac Single-Family CRTcast," a series under the "Home Starts Here Podcast." Now, investors have a front row seat to conversations discussing economic and housing markets, portfolio management and analytics, servicing policy, and credit risk management from Freddie Mac leaders and other industry experts.

Mike Reynolds [00:00:28] Hello and welcome to Freddie Mac's CRTcast. This is the first year that we're doing it and today's episode is our planned last one for the year, and I'm so happy to wrap up the year with Don Layton, who is our Freddie Mac's former CEO and really drove the creation of the CRT market. And Don, thank you so much for taking the time to be here.

Don Layton [00:00:56] Happy to do it, Mike. Always, it's always good to revisit successes from one's career when you're retired.

Mike Reynolds [00:01:05] So, let's go back. Why CRT, Don? You are a strong proponent of it. But why?

Don Layton [00:01:14] Well, CRT delivers quite a few benefits to a large financial institution like the two GSEs. I wrote an article about it a few years ago at Harvard's Joint Center for Housing Studies, for those who are interested in it and in depth. But let me just pick two major benefits it gives to running an FI like Freddie Mac. Number one, it reduces systemic risk. We all learned in 2008 about systemic risk, and there have been tons of reforms of the financial system since then. But the GSEs are stuck in a box. Their mission requires them to become just this giant glob of trillions of dollars of single-family mortgage credit risk, and that is a systemic risk all by itself. It, of course, didn't work very well in 2008. The companies fell into conservatorship. CRT is the only known method proven cost effective, that means we can do our mission and take all this credit risk in, but not have it sit – have it go out into the broad marketplace diversified at a reasonable cost. This is the solution to the GSE systemic risk, and so that's a great advantage. It also means the company doesn't get in such trouble when there is a downturn in the market.

The second benefit, I'll mention is that it provides market discipline to the GSE in their providing of mortgage credit risk. I'm going to have to return to a theme in our talk today, I suspect, about how much everything the GSEs do gets politicized because it lives in the world of Washington politics. One topic like that is their credit box. The GSEs are never endingly second guessed on the credit box, simultaneously being accused of being too tight and too loose, too cheap and too expensive – and that's just the way the politics work. Before CRT, all the companies could do, all Freddie could do and Fannie, was say, "Hey, we know what we're doing." Unfortunately, given what happened in 2005 and 6 and 7 where that was said, it didn't work so well, so the credibility of the companies is not great on that aspect. With CRT, that's no longer the case. It's not just the opinions of the GSEs. The marketplace, over 100 large financial institution investors, are deciding what is an acceptable credit and what they'll pay for it, putting hard cash on the line with their views – and that provides a lot of market discipline to the whole process and makes us make sure we're getting the best possible information to make our credit decisions.

Mike Reynolds [00:04:00] I completely agree Don, and the independent views make Freddie Mac better. So we have due diligence firms, we have rating agencies. We have broker dealers, and then, of course, all of the investors. And we spend tremendous energy and effort into improving our disclosures. We have loan-level disclosures, pool-level disclosures, historical data. We're constantly updating that to keep pace with the times. So, we very much want to give the market that insight and it is a healthy process. But that back-and-forth Don, I mean Freddie Mac is a mission driven company. How does CRT, in your mind, impact the mission? Does it help it? Does it hinder it?

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Don Layton [00:04:42] It absolutely helps the mission. It makes it easier to accomplish our mission, as I'll explain. First of all, all the GSC activities with our primary market lenders go on pretty much as before. CRT is a back-end, overwhelmingly a back-end process. We buy their loans as before, we put them on the company's balance sheet as before. Historically, however, it ended there, and, of course, we used to call that the buy and hold business model. What is different via CRTs, is now the GSEs after the fact, after the loans are purchased, lay off much of that risk, usually in quarterly packages to reflect the entire nationwide origination of the two companies, which avoids issues of adverse selection. This is not at all how like a Wall Street PLS bond underwriter works, where the origination can't happen unless they have investors. In our case, we can take it on and hold it if we need to. So, the Wall Street business model is known as 'originate to distribute.' That's not what we're doing here; that would hurt our mission.

Instead, the new business model is the GSEs use their big balance sheets, allowing them to leave the primary market lenders operating just as before – analogous to how the GSEs enable primary market lenders to redeploy their capital to make new mortgage loans rather than get full up from their originations. The GSEs similarly get to need less capital, which can be redeployed over and over by laying off risk through CRT to the institutional market. And because we get that helpful market discipline on the flows, we can fine tune them to make the secondary market more efficient and accurate for primary lenders. This is a new hybrid business model. It's not buy and hold, which has its problems in terms of concentration of credit risks, nor origination to distribute, when we couldn't originate if the market wasn't there to buy. It's now a buy as if to hold, but then lay the risk off when it's economically advantageous to do so. If the cost of laying the risk off is too high, we'll keep it. Fortunately, it's almost always been advantageous to lay it off, and so we're set up to be completely a shock absorber to the system, keeping it going and yet redeploying the capital and reducing systemic risk. So, I think it makes the mission easier.

Mike Reynolds [00:07:09] I agree, and I would point out with the COVID crisis, which is still here affecting the nation, but very specifically in the way the financial markets seized up in March/April of 2020, the CRT markets did suffer significant losses, but they stayed open. And they actually were a source of liquidity for investors that were looking for that cash. And then, really by May/June timeframe the markets were signaling, this both on the capital market side/reinsurance side, that they were ready to take down new risk. So, I think given the, the size of that and unforeseen nature of COVID and how it impacted so much of our lives, including financial markets, and then the market was able to, to be resilient, be available and be that outlay to help supplement our capital position definitely made our business safer throughout the balance of the year.

Don Layton [00:08:05] Mike, that period also proved my point. You didn't stop buying loans when the CRT market kind of closed for the six or eight weeks it was. We kept doing business, we kept providing liquidity to the primary markets to help keep the economy going. And then the markets opened, and we got back to business and things went on as before. Worked perfectly well.

Mike Reynolds [00:08:27] So Don I joined Freddie Mac a few months after you back in 2012, and I joined specifically for CRT. It was all a very new project to that point in time. How did it get going? I think it was going for probably a year or so before I joined. How did it get going? What can you share leading up to Freddie Mac issuing the first CRT transaction in 2013?

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Don Layton [00:08:50] This is actually an interesting story. I arrived at Freddie as the new CEO in May of 2012. The FHFA had just two months earlier put out their first conservatorship scorecard, which means they stop just fighting the financial crisis and started to tell us to do things moving forward. One of those things they had in there was to do credit risk transfer. That was an idea that apparently had been kicking around the GSEs for many years, even pre-2008, but never, nothing ever came it really. The FHFA's instincts were very right in saying we should look at this, although they thought it was somehow going to help the PLS market get started, which obviously was not relevant it turned out. But again, the right instincts. So, they had told, even before the scorecard came out, the two GSEs "start working on credit risk transfer." So, I get on this when I arrive, and I found at Freddie Mac there was a small team devoted to it. It's, of course, run by your boss, Kevin Palmer, at the time a Vice President, but otherwise it was just going around in circles. Top management and the board didn't know what to make of it. Some people liked the idea, some people didn't like the idea through innate conservatism and concerns about all sorts of things. And, it kind of was going nowhere. I also learned via the FHFA that Fannie Mae had no interest in doing this and basically had done almost nothing. But I came in with a very different background than everyone else. What was unusual to me, was I was the only person with a large FI background, financial institution background. Everyone else was a GSE person at the top or, or a government person, and that gave me a different perspective. I came in knowing that starting 20 plus years earlier, 30 years in many ways, that the buy and hold business model was not a winner. It wasn't for, for a financial intermediary like a GSE or a bank. It means you have too much concentration of risk, we acquired too much capital and usually was low return, all not good things to happen. So, some kind of risk distribution was a smart thing to do.

I had first been exposed to that back in the early 1990s, when one of the predecessors to JP Morgan Chase, where I had retired from previously, had led the development of the loan syndication business, which hadn't existed prior to that time, for the exact same reasons the GSEs we're going to look at CRT – get rid of the concentration of risk, get market discipline, be a pass through and returns would be higher if you did it right. I also had been involved, by nature of my positions in banking over the years, in the evolution of bank capital concepts from the pre-quant days of the seventies and eighties through Basel 1 and its heavy statistical driven quantification since then. And I understood that CRT was about capital reduction, because it was about risk reduction. So, I had this looked up. I arrived at Freddie Mac as new CEO on Monday, and by Thursday of that same week I was deep diving into CRT. I overrode all the management and board ambivalence about it, just told them this was something we had to do and why, and we went full steam ahead. The first big decision being to release the data to the markets, so they could actually analyze a deal we might bring. It also meant I had to develop a capital system, an updated and modernized capital system inside Freddie Mac, to figure out if the pricing of a CRT deal was attractive or not. It was not worth doing if it was unattractive economically. And so, this all came into place, took a while to get through, and that resulted in the first GSE CRT deal 'STACR' in early 2013, and we were well on our way to a business, new business model. Interestingly, we were told then to take our documents and give them to Fannie Mae, because the FHFA did not want them to take so much time to reinvent the wheel so they could follow with their CAS bonds. And away we went, and that's the history.

Mike Reynolds [00:13:09] That's a great history. And certainly, the CRT market has benefited with the similarities in the programs between Freddie Mac and Fannie Mae. And at differing times since 2013 the shelves have had slight differences, but they've been largely the same. And I think that's always been a focus for us. I remember hearing conversations that some leaders at the company, obviously we know just as you described how you pushed it through, but how some leaders in the company were so concerned that if we did that data release we were giving away, like, Freddie Mac's secret sauce or something like that.

Don Layton [00:13:48] Yah, they thought it was our franchise. It was not. Our franchise is the fact of all the powers we have as a, from our charter as a, we're the two GSEs. And of course, it was absolutely necessary to get out of this box of way too much concentration of risk, which means low returns and a very unstable company through the mortgage credit cycles. And yes, the FHFA was smart in saying, let's have the program between the two companies be about the same. So, you had one bigger, efficient market rather than two smaller kind of inefficient markets, and it definitely helped.

Mike Reynolds [00:14:28] And so, you know, I touched on COVID for a second, but one of the concerns that a critic of CRT or critics of CRT have had is they're worried about the availability of a CRT market that will only be there in good times, not available in bad times. What's your view on that issue?

Don Layton [00:14:46] Yah. Well, a CRT is a capital markets product. In this case, I'll focus on our version of STACR, easiest to focus on. It will not be available in some times when the market is disrupted. Since we started in 2013, however, up until the pandemic hit, I kind of estimate it was available, and I'm not exaggerating here, 99% of the time. I only remember it stopping for a very short period of time when, with the surprise vote on Brexit, which obviously has nothing to do with mortgages in the US. When the pandemic came, the markets closed for about six to eight weeks. And they reopened, stayed open. Pricing could bounce around, of course. Now again, everything about the GSEs tends to be politicized, and so some people who don't like the GSEs have pushed a narrative that really says the following, "If you can't do CRT 100% of the time, you should do it 0% of the time." This makes no sense. We're not running an originate to distribute model, as I explained already, where if there's no CRT market we have to stop buying mortgages, that's not it. We have the giant balance sheet, so we just keep going. And so, we buy the loans regardless of CRT market and lay the risk off when we can. When this argument came up, I used to have conversations with the senior people at the FHFA and along the theoretical line of "what kind of capital should a GSE have around to hold those loans in case the CRT market closes?" And we used to think of it closing for a year or two, it ends up closing for weeks. So, I would say it's a good business model, there is absolutely nothing wrong with a CRT being capital markets based. And if it's not there 100% of the time, we're set up to handle it regardless, and we've now proven that.

Mike Reynolds [00:16:42] Yes, and I think Don your experience at Freddie Mac and at other massive FI companies, and continuing, your super active at Harvard Housing Studies. So just over the past year, I say that because I think your perspective is so valuable, that's why I brought that up again. So, over the past year, there seems to be a pretty wide variety of views on CRT, from some being quite supportive to some being quite skeptical, even anti-CRT. How do you see that and what's driving those differences in your view?

Don Layton [00:17:17] Well, I'd have to come back to politics. CRT, interestingly, was developed kind of quietly and then just done. There was no regulatory approval required, it was all a conservatorship thing, there was no public comment period – all those things. No opportunity for all the political types to have views. And no one knew what it really was when it started, other than a few specialists inside the two GSEs and FHFA. And it got going; everybody was supportive of CRT. The phrase that got everyone supportive was that 'it reduced taxpayer exposure to the GSEs while they were in conservatorship,' or even after, which because they do get support from the government. So, they love this. Then, only much later in 2009, I believe it was, it got politicized. A very small group, we're not talking about the investment community, the underwriting community, the primary lenders, we're not, we're just talking about an inside the beltway group of people who don't like the GSEs started to say, "it doesn't work."

I first ran into this when someone from one of the think tanks told me, and this is almost a quote, "CRT is just CDS, meaning a credit default swap, and AIG's collapse proved that CDS doesn't work." I was stunned. This is factually wrong. It's completely wrong-headed. And let me tell you my background for saying that against this person who is a think tank policy person. In my career, which was mainly in the capital market side, I ended up running the largest derivatives business in the world, including, of course, after mergers produced JP Morgan Chase, where I came from, the place that had invented credit default swaps. I also, later, was put on the board as part of the rescue by U.S. Treasury of AIG. So, I've seen this from all sides and know the facts. CRT transactions are not CDS. They don't have the same defects CDS has that helped drive AIG down. For the record, although we never advertised this, CRT transactions are actually patterned, whether intentionally or not, on CAT bonds – that is catastrophe bonds, which now has the fancy name insurance link notes. These have worked for multiple decades for multiple natural disasters; it's a proven technique to handle risk transfer. But that never stopped the politics. People don't like the GSEs, don't like CRT because, quite honestly, for all the reasons I mentioned, it makes our business model better, which means they're more durable. And so, we're just caught up in the politics there. But it's a very small group, and otherwise overwhelmingly supported throughout the financial community and even the government community.

Mike Reynolds [00:20:11] That's how I view it. You know, I'm biased. I'm running the program for the Single-Family business, but I definitely think the CRT is making Freddie Mac run at a better business model. We are reducing capital. The transactions reduce capital at a faster rate than the income give up, and thus your return on capital at the end of the transaction is improved.

Don Layton [00:20:35] That's if the pricing is good in the marketplace and acceptable, and the answer is it has proven to be that way. But I want come back to the comment about running a better company. I will tell you, having worked through the evolution in banking, I mean I'm getting pretty old now. When it was, banking was a buy and hold business model, even the money center banks as they used to be called back in the seventies when I started, you could be a little bit fat, dumb and happy when you just put the loans on the books. And the whole risk distribution market discipline requirement has resulted in a much sharper, fine-tuned understanding of risk – where it belongs, who's the best holder of that risk in terms of liquidity or timeframes. It's more sophisticated, yes. The GSEs run better businesses because they use CRT, much better businesses.

Mike Reynolds [00:21:26] And I think one of the biggest criticisms is it's a one-way transaction. Is the CRT, does it really transfer risk? Is it just really a waste of money? We're paying all these premiums, billions and billions in premiums out, but we're not collecting, you know, billions of payouts back from CRT transactions. So that's been raised as a criticism. I definitely have a view, but what's your view of that criticism?

Don Layton [00:21:53] Mike, actually, I've heard those arguments. Actually, there are two very different arguments in what you said. One, it's a sham, it doesn't really transfer risk. The other is different, it says you transfer risk, but it's not worth doing. Let's do the first one – It's a sham. Those accusations do not come from risk management experts at banks or researchers at Wall Street securities firms or anything like that. It comes back to the same political group inside the beltway who don't like the GSEs. It really transfers risk. The entire financial community knows it transfers risk. There it is. It works. I don't know what to say about that. The facts are the facts.

The more interesting one is this issue about, "Well, isn't it a waste? You pay away all this money and you don't get anything back." I have two responses for that. One, of course, is kind of the flawed logic of insurance, the analogy they use. This would say that since the vast, vast majority of people have never put in a claim for a fire at their house, they should stop buying fire insurance because it's a waste of money. And you go, that doesn't seem to make sense. Ok. But let me get a little more technical here. There is an issue of: you're paying this money away, you don't get anything back, maybe you're better off self-insuring. That would be the more sophisticated version of this argument – you're better off self-insured. Leaving aside the systemic risk issue, what's the economic benefit of all this? And the answer is capital. It comes back to capital. CRT is a capital-related transaction. Fundamentally, in CRT, we take part of the G-fee and pay away to investors to take the risk. That means they need capital to support the risk, we don't. We have less. In our economics, as you mentioned in an earlier set of comments, what happens is we have lower income, but we have a lower regulatory requirement for capital. And, if you do it right when the pricing is right, your net revenue goes down, but your net capital requirement goes down proportionately and even more than proportionally. So, the return and equity of the company goes up. That's value creation. That's the economics behind it. That's why it's not a waste, even in a technical sense, because you're paying away money to reduce the capital burden that you need to have to run the organization. And FIs run on ROE, and with ROE being good you're in great shape, and if ROEs are bad you have problems. So, it's still a great thing to do.

Mike Reynolds [00:24:28] Thanks for sharing that, Don. I think the only other thing I would add to that is it addresses the runway risk. The times that we're paying out those premiums are at times where the economy is good and the companies are profitable, and we would only receive the money when we need it most, when our net income would be down. Like you said, from a capital perspective. So, I really don't think anybody wants to have massive losses. It's a great thing, it's a great thing that we're not collecting off of the CRT transactions.

Don Layton [00:24:58] And actually, as you and I know, the way CRT is done, it's really aimed heavily at unexpectedly large losses being taken by the investors. Not the everyday few dollars here and there that the GSEs can handle in the ordinary course of business, and anyone, no one hardly notices. It's there for the big downturns. If the, if the pandemic had turned into a housing debacle instead of the opposite where prices were skyrocketing, CRT would have absolutely been regarded as a hero of the story.

Mike Reynolds [00:25:32] Yes. So, Don we're out of time, is there any closing statements, last thoughts that you have that you want our listeners to hear?

Don Layton [00:25:40] Yah, I am optimistic about CRT, not just at the GSEs, but as a growing tool by which more financial institutions dealing in mortgages realize there's better ways to do things. It's a very traditional business in many ways. CRT spread, by the way, from the two GSEs and now is broadly used heavily by the mortgage insurers, who of course, had the same problem – all this concentration of risk. And they had high-risk type situations, because they're, they're only doing the high-risk part of mortgages. And they've used it and have higher ROEs and more stable companies. I'm even aware that some of the banks have started to do it with respect to their mortgage assets, although they require a lot of custom negotiation with bank regulators about capital relief because it's such a specialty area. So, I see it becoming a core part of the financial system. And yah, it was really great to be there. There's a history book written a long time ago called "Present at the Creation." That was the title. That's what I feel like I had, and you had, coming in early days. We were present at the creation of something big and new. It's going to make the financial markets better in the future.

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Mike Reynolds [00:26:53] I very much feel like that, being part of a small piece of history. Very proud of the work and thank you, Don, for your time today, and much more so for all of the great accomplishments that Freddie Mac has been able to do under your leadership. And again, really appreciate you taking the time to talk with us here on today's podcast.

Don Layton [00:27:12] Happy to do it. I'm proud of what Freddie's done in my time there, and so I'm happy to do it even again if you want to Mike.

Mike Reynolds [00:27:20] Well, all right, we might take you up on that. And to all of our listeners, if you enjoyed today's show, please check out our earlier podcasts in the CRTcast series. All under the Freddie Mac "Home Starts Here", wherever you get your podcasts from. Thank you and have a good day.

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