Comments on
“Credit Risk Transfer and the Pricing of Mortgage Default Risk”
by
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Summary

- **Research Focus**: Develop analytic framework to evaluate (1) the information content of CRT securities and (2) their cost efficiency as risk transfer tool.

  - A well designed CRT can provide valuable risk price signals.
  - CRT securities may be expensive and provide opaque signal (complex and illiquid).
  - Correlation with BB OAS index raises question about information content.
  - GSEs not using CRTs to set guarantee fees.
  - GSEs face significant CRT issuance costs.
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- Mortgages contain two sources of risk:
  - Interest rate risk
  - Default/credit risk

GSE effectively transmit interest rate risk to investors via mortgage pass-through securities. Traditionally, GSEs retained credit risk.

- Why? What is special about credit risk?
  - Have to foreclose on the collateral.
  - Could create contracts on this – but expensive.

- Used loan underwriting guidelines and mortgage insurance to mitigate idiosyncratic credit risk.

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How do CRTs work?
- CRTs are unsecured debt obligations of GSEs.
- Return tied to performance of underlying reference pool of mortgages.
  - CRT balance written down based on underlying reference mortgage principal (top down).
  - Mortgage losses are allocated from the bottom-up.
  - CRTs exposed to both credit loss and interest rate (prepayment) risk.

Summary

What does this paper do?

- Systematically examines the question of whether CRTs are “expensive”.

- Collects default cost data from GSEs on CRT performance.
  - Default costs correlated with BB OAS index.
  - G-fees are weakly correlated with default costs.
  - GSEs still retain large (40-70%) of default costs.

- Reports secondary marketing trading data.
  - Find significant issuance costs
  - Reflects low trading volume

- Creates CRT valuation model to project expected returns.
  - Top tranches have almost no default risk exposure, but have high yields.
  - Suggests potential structural inefficiency in CRT design?
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Three Comments on CRT Valuation Model

- Model generates expected yield compared to risk-free rate → the risk premium comprising credit risk, liquidity risk, and term risk.
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- Would like more detail on model/suggestions for future refinement:
  - Calibrate model to specific reference pools
  - Calculate risk premiums for non-standard mortgage pools (the greatest risk)
  - Consider advanced simulation techniques, such as weighted Monte Carlo estimators, see e.g. Glasserman and Yu (Operations Research, 2005).
Questions and Comments for future versions:

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Why do CRTs trade infrequently? Is this a design flaw?

What are implications of CRT for total GSE risk exposure?

Note, easiest to price mortgages are in CRT pools, high risk stuff not included!
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- Final comment: what are the effects of CRTs on GSE incentives to minimize losses given default?
Summary

- A very interesting study on an important issue.
- Introduces a framework for evaluating CRT effectiveness.
- Raises very interesting questions about how GSEs should manage credit risk.
- I look forward to reading the next version.
Thank You!