NEW YORK--(BUSINESS WIRE)--Fitch Ratings expects to assign the following rating and Rating Outlook to Fannie Mae's fourth risk transfer transaction, Connecticut Avenue Securities, series 2014-C03:

--$555,000,000 class 1M-1 notes 'BBB-sf'; Outlook Stable.

--$239,500,000 class 2M-1 notes 'BBBsf'; Outlook Stable.

The following classes will not be rated by Fitch:

--$ 57,437,785,171 class 1A-H reference tranche;

--$ 37,142,115 class 1M-1H reference tranche;

--$ 945,000,000 class 1M-2 notes;

--$ 61,641,596 class 1M-2H reference tranche;

--$ 177,642,635 class 1B-H reference tranche;

--$ 18,296,659,144 class 2A-H reference tranche;

--$ 17,128,465 class 2M-1H reference tranche;

--$ 310,500,000 class 2M-2 notes;

--$ 22,166,530 class 2M-2H reference tranche;

--$ 123,561,855 class 2B-H reference tranche.

The 'BBB-sf' rating for the 1M-1 notes reflects the 2.00% subordination provided by the 1.70% class 1M-2 notes and the non-offered 0.30% 1B-H reference tranche. The 'BBBsf' rating for the 2M-1 notes reflects the 2.40% subordination provided by the 1.75% class 2M-2 notes and the non-offered 0.65% 2B-H reference tranche. The notes are general senior unsecured obligations of Fannie Mae (rated 'AAA' on Rating Outlook Stable by Fitch) subject to the credit and principal payment risk of a pool of certain residential mortgage loans held in various Fannie Mae-guaranteed MBS.

The reference pool of mortgages will be divided into two loan groups. Group 1 will consist of mortgage loans with loan-to-values (LTVs) of less than or equal to 80% while group 2 will consist of mortgage loans with LTVs greater than 80% and less than or equal to 97%. Each loan group has its own loss severity schedule and issued notes. There will be no cross-collateralization. Aside from distinct loss severity schedules, each group's structure will be identical.

Connecticut Avenue Securities, series 2014-C03 (CAS 2014-C03) is Fannie Mae's fourth risk transfer transaction issued as part of the Federal Housing Finance Agency's Conservatorship Strategic Plan for 2013 - 2017 for each of the government sponsored enterprises (GSEs) to demonstrate the viability of multiple types of risk transfer transactions involving single family mortgages.

The objective of the transaction is to transfer credit risk from Fannie Mae to private investors with respect to a $78 billion pool of mortgage loans currently held in previously issued MBS guaranteed by Fannie Mae where principal repayment of the notes are subject to the performance of a reference pool of mortgage loans. As loans become 180 day delinquent or other credit events occur, the outstanding principal balance of the debt notes will be reduced by a pre-defined, tiered loss severity percentage related to those credit events.

While the transaction structure simulates the behavior and credit risk of traditional RMBS mezzanine and subordinate securities, Fannie Mae will be responsible for making monthly payments of interest and principal to investors. Because of the counterparty dependence on Fannie Mae, Fitch's expected rating on the 1M-1 and 2M-1 notes will be based on the lower of: the quality of the mortgage loan reference pool and credit enhancement available through subordination; and Fannie Mae's Issuer Default Rating. The 1M-1 and 2M-1 notes will be issued as uncapped LIBOR-based floaters and will carry a 10-year legal final maturity.

KEY RATING DRIVERS

Inclusion of Loans with Prior 1x30 Delinquency: Approximately 1% of Group 1 loans and 0.9% of Group 2 loans have experienced a 1x30 days delinquency over the past 12 months. All loans were current as of the cutoff date and have been current for at least the past three consecutive payments. Loans with delinquencies in the prior 12 months are applied a higher probability of default (PD) relative to those that have clean histories to reflect their higher default potential, as evidenced by historical performance.

Higher Loan-to-Value Loans: As with Fannie Mae's prior transaction, eligibility criteria include loans with loan-to-value ratios (LTVs) of up to 97%. These loans are included in this transaction as Group 2. All higher LTV loans were subject to the same underwriting, quality control (QC) and servicing practices as those loans with original LTVs below 80%. Fitch's analysis of these loans resulted in a PD that was approximately 1.4x higher than the lower LTV loans.

Enhanced QC Process: Starting with the 2013 acquisitions, Fannie Mae implemented further enhancements to its performing loan QC framework, which Fitch found to be robust and should reduce the risk of credit events arising from faulty loan-origination practices and sunset provisions. Fitch believes that Fannie Mae is an above-average aggregator for 2013 acquisitions. As a result, Fitch applied a reduction to its default expectations to account for the lower risk associated with the recent acquisitions.

Market Value Decline Sensitivity: Fitch considered further market value decline (MVD) sensitivities, in addition to those generated by its sustainable home price (SHP) model. These scenarios align Fitch's 'Asf' sustainable MVD (sMVD) assumptions with peak-to-trough MVDs experienced during the housing crisis through 2009. The sensitivity analysis, which was factored into Fitch's loss expectations, resulted in applying a base case sMVD of 14% from 16% for Group 1 and an sMVD of 10% from 11% for Group 2.

Few Due Diligence Findings: The due diligence review resulted in minimal findings. The findings are reflective of the improvements made to Fannie Mae's risk management and QC processes, which have evolved over time, with the majority of the processes developed following the crisis and implemented prior to 2013. The findings also reflect the scope of the due diligence review to better indicate Fannie Mae's QC process.

Fixed Loss Severity: One of the unique structural features of the transaction is a fixed loss severity (LS) schedule tied to cumulative net credit events. If actual loan LS is above the set schedule, Fannie Mae absorbs the higher losses. Fitch views the fixed LS positively, as it reduces the uncertainty that may arise due to future changes in Fannie Mae's loss mitigation or loan modification policies. The fixed severity also offers investors greater protection against natural disaster events where properties are severely damaged, as well as in cases of limited or no recourse to insurance.

Advantageous Payment Priority: The payment priority of M-1 notes will result in a shorter life and more stable CE than mezzanine classes in private-label (PL) RMBS, providing a relative credit advantage. Unlike PL mezzanine RMBS, which often do not receive a full pro-rata share of the pool's unscheduled principal payment until year 10, the M-1 notes can receive a full pro-rata share of unscheduled principal immediately, as long as a minimum CE level is maintained. Additionally, unlike PL mezzanine classes, which lose subordination over time due to scheduled principal payments to more junior classes, the M-2 and B-H classes in each group will not receive any scheduled or unscheduled allocations until their M-1 classes are paid in full. The B-H classes will not receive any scheduled or unscheduled principal allocations until the M-2 classes are paid in full.

10-Year Hard Maturity: The 1M-1, 1M-2, 2M-1 and 2M-2 notes benefit from a 10-year legal final maturity. As a result, any collateral losses on the reference pool that occur beyond year 10 are borne by Fannie Mae and do not affect the transaction. Fitch accounted for the 10-year hard maturity in its default analysis and applied a 10% reduction to its lifetime default expectations.

Rep and Warranty Gaps: While the loan defect risk for 2014-C03 is notably lower than for agency and non-agency mortgage pools securitized prior to 2009, Fitch believes the risk is greater for this transaction than for recently issued U.S. PL RMBS. Notably, neither Fannie Mae nor an independent third party will conduct loan file reviews for credit events, and Fannie Mae will not conduct any reviews of loans from a seller once it has filed for bankruptcy. Fitch incorporated this risk into its analysis by treating all historical repurchases as if they were defaulted loans that were not repurchased. Consequently, the rating analysis includes an assumption that the loans will experience defect rates consistent with historical rates, and that those defects will not be repurchased.

Solid Alignment of Interests: While the transaction is designed to transfer credit risk to private investors, Fitch believes the transaction benefits from a solid alignment of interests. Fannie Mae will be retaining credit risk in the transaction by holding the A-H senior reference tranches, which have a loss protection of 3% in Group 1 and 3.75% in Group 2, as well as the first loss B-H reference tranches, sized at 30 bps and 65 bps, respectively. Fannie Mae is also retaining an approximately 6% and 7% vertical slice/interest in the M-1 and M-2 tranches for Group 1 and Group 2, respectively.

Limited Size/Scope of Third-Party Diligence: Only 608 loans of those eligible to be included in the reference pool were selected for a full review (credit, property valuation and compliance) by a third-party diligence provider. Of the 608 loans, 572 were part of this transaction's reference pool (432 in Group 1 and 140 in Group 2). The sample selection was limited to a population of 5,071 loans that were previously reviewed by Fannie Mae and met the reference pool's eligibility criteria. Furthermore, the third-party due diligence scope was limited to reflect Fannie Mae's post-close loan review for compliance. Fitch's review of Fannie Mae's risk management and QC process/infrastructure, which has been significantly improved over the past several years, indicates a robust control environment that should minimize loan quality risk.

Special Hazard Leakage: Fitch believes the structure is vulnerable to special hazard risk, as there is no consideration for payment disruptions related to natural disaster events in the credit event definition. As such, credit protection in the transaction may be eroded by natural disasters that may cause extended delinquencies (which may, in part, be allowed by disaster relief programs) but of which borrowers ultimately cure. Fitch considered this risk in its analysis, conducted sensitivity analysis and found, based on prior observed performance in post-natural disaster events (including Hurricane Katrina and the Northridge Earthquake), that the risk exposure is relatively low.

Receivership Risk Considered: Under the Federal Housing Finance Regulatory Reform Act, FHFA must place Fannie Mae into receivership if it determines that Fannie Mae's assets are less than its obligations for more than 60 days following the deadline of its SEC filing, as well as for other reasons. As receiver, FHFA could repudiate any contract entered into by Fannie Mae if it is determined that the termination of such contract would promote an orderly administration of Fannie Mae's affairs. Fitch believes that the U.S. government will continue to support Fannie Mae, which is reflected in its current rating of Fannie Mae. However, if at some point Fitch views the support as being reduced and receivership likely, the ratings of Fannie Mae could be downgraded, and the M-1 notes' ratings affected.

RATING SENSITIVITIES

Fitch's analysis incorporates sensitivity analyses to demonstrate how the ratings would react to steeper market value declines (MVDs) than assumed at both the metropolitan statistical area (MSA) and national levels. The implied rating sensitivities are only an indication of some of the potential outcomes and do not consider other risk factors that the transaction may become exposed to or be considered in the surveillance of the transaction.

This defined stress sensitivity analysis demonstrates how the ratings would react to steeper market value declines at the national level. The analysis assumes market value declines of 10%, 20%, and 30%, in addition to the model projected 31% at the 'BBB-sf' level and 29% at the 'BBBsf' level. The analysis indicates that there is some potential rating migration with higher MVDs, compared with the model projection.

Fitch also conducted defined rating sensitivities which determine the stresses to MVDs that would reduce a rating by one full category, to non-investment grade, and to 'CCCsf'. For example, additional MVDs of 10%, 9% and 24% would potentially reduce the 'BBB-sf' rated class down one rating category, to non-investment grade, and to 'CCCsf', respectively.

Key Rating Drivers and Rating Sensitivities are further detailed in Fitch's accompanying presale report, available at ' www.fitchratings.com ' or by clicking on the above link.

Additional information is available at ' www.fitchratings.com '.

Applicable Criteria and Related Research

--'Global Rating Criteria for Single- and Multi-Name Credit-Linked Notes' (February 2014);

--'Global Structured Finance Rating Criteria' (May 2014);

--'Counterparty Criteria for Structured Finance and Covered Bonds' (May 2014);

--'U.S. RMBS Master Rating Criteria' (July 2014);

--'U.S. RMBS Loan Loss Model Criteria' (December 2013);

--'U.S. RMBS Cash Flow Analysis Criteria' (April 2014);

--'Rating Criteria for U.S. Residential and Small Balance Commercial Mortgage Servicers' (January 2014);

--'U.S. RMBS Surveillance and Re-Remic Criteria' (June 2014);

--'Connecticut Avenue Securities Series 2014-C03 Representations and Warranties Presale Appendix' (July 2014).

Applicable Criteria and Related Research: Connecticut Avenue Securities, Series 2014-C03 (US RMBS)

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=752219

Global Rating Criteria for Single- and Multi-Name Credit-Linked Notes

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=729785

Global Structured Finance Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=748821

Counterparty Criteria for Structured Finance and Covered Bonds

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=744158

U.S. RMBS Master Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750719

U.S. RMBS Loan Loss Model Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=727095

U.S. RMBS Cash Flow Analysis Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=746027

U.S. RMBS Surveillance and Re-REMIC Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750110

Additional Disclosure

Solicitation Status

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