

Federal Housing Finance Agency
Office of Inspector General



Freddie Mac's IMAGIN Pilot



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Executive Summary

Under their charters, Fannie Mae and Freddie Mac (the Enterprises) must obtain credit enhancement to purchase conventional mortgages with loan-to-value ratios (LTVs) greater than 80%. Credit enhancement is a method or tool to reduce the risk of extending credit to a borrower. The charters allow three forms of credit enhancement, with mortgage insurance used most often. Mortgage insurance transfers a portion of the risk of mortgage default to an insurer. At the same time, it exposes the Enterprise to the counterparty risk that the insurer may fail to pay claims. The Enterprises' charters specify that the insurance must be provided by a qualified insurer as determined by the Enterprise. Six mortgage insurance companies are currently approved by Fannie Mae and Freddie Mac for new mortgage acquisitions.

Beginning in 2007, as housing prices fell and defaults skyrocketed, mortgage insurers incurred large losses. As an industry, mortgage insurers sustained significant losses from 2007 through 2012. State regulators placed three mortgage insurers into run-off, prohibiting them from writing new insurance. These mortgage insurers deferred some claim payments to the Enterprises, with two of them still deferring some payments.

According to the Federal Housing Finance Agency (FHFA or Agency), the Agency and the Enterprises have been focused on mitigating the counterparty risk of mortgage insurers. FHFA, as conservator, directed Fannie Mae and Freddie Mac to align and strengthen their requirements for mortgage insurers. As a result, the Enterprises issued revised Private Mortgage Insurer Eligibility Requirements (PMIERs), effective December 31, 2015. Although the financial condition of the Enterprises' mortgage insurance counterparties approved to write new business has improved in recent years, the risk remains that some of them may fail to fully meet their obligations.

The risk areas include:

- Limited ability to select the counterparty and the related concentration risk: Freddie Mac has disclosed potential limitations on its ability to manage its exposure to mortgage insurers since at least its 2013 10-K and disclosed the concentration of its mortgage insurance exposure in a small number of firms before then
- Financial capacity of the counterparty: Freddie Mac also has reported that it continues to acquire mortgages insured by mortgage insurers rated below investment grade



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- Monoline business: mortgage insurers must limit their business to writing mortgage guaranty insurance, which exposes them to downturns in the housing market; mortgage insurers may be least able to pay claims when claims are most likely
- Uncertain coverage: mortgage insurers may deny or rescind coverage based on their assessment of whether mortgages were investment quality

On March 1, 2018, Freddie Mac launched a pilot called Integrated Mortgage Insurance (IMAGINSM), which is intended to mitigate risks such as these. Under the IMAGIN pilot program, simultaneous with purchasing single-family mortgages, Freddie Mac effectively purchases mortgage insurance from a panel of reinsurance companies. Freddie Mac has preapproved each of the reinsurers on this panel and the allocation of risk among them. In addition, the reinsurers post collateral to provide further assurance that claims will be paid, and they essentially cannot deny or rescind coverage.

In light of questions raised by our stakeholders about the IMAGIN pilot, we prepared this white paper to explain how this pilot program works.

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ABBREVIATIONS

ACIS	Agency Credit Insurance Structure
Arch MRT	Arch Mortgage Risk Transfer Holdings Inc.
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
IFR	Interim final regulation
IMAGIN	Integrated Mortgage Insurance
LTV	Loan-to-value
OIG	Federal Housing Finance Agency Office of Inspector General
PMIERS	Private Mortgage Insurer Eligibility Requirements

BACKGROUND.....

Under their charters, Fannie Mae and Freddie Mac (the Enterprises) must obtain credit enhancement to purchase conventional mortgages with loan-to-value ratios (LTVs) greater than 80%. Credit enhancement is a method or tool to reduce the risk of extending credit to a borrower. The charters allow three forms of credit enhancement, with mortgage insurance used most often.¹ Mortgage insurance transfers a portion of the risk of mortgage default to an insurer. At the same time, it exposes the Enterprise to the counterparty risk that the insurer may fail to pay claims. The Enterprises' charters specify that the insurance must be provided by a qualified insurer as determined by the Enterprise. Traditionally, for loans sold to the Enterprises, the lender selects the mortgage insurer from among the companies approved by the Enterprises, and the borrower pays the cost with the monthly mortgage payments. Six mortgage insurance companies are currently approved by Fannie Mae and Freddie Mac for new mortgage acquisitions.

Beginning in 2007, as housing prices fell and defaults skyrocketed, mortgage insurers incurred large losses. As an industry, mortgage insurers sustained significant losses from 2007 through 2012. State regulators placed three mortgage insurers into run-off, prohibiting them from writing new insurance. These mortgage insurers deferred some claim payments to the Enterprises, with two of them still deferring some payments. As of June 30, 2018, Freddie Mac had a total of \$500 million in cumulative unpaid deferred obligations from these two mortgage insurers. Mortgage insurers also rescinded coverage on substantially more loans during the crisis, canceling the policies as improperly issued and returning the premiums.

According to the Federal Housing Finance Agency (FHFA or Agency), since the financial crisis, the Agency and the Enterprises have focused on mitigating the counterparty risk of mortgage insurers. FHFA, as conservator, directed Fannie Mae and Freddie Mac to align and strengthen their requirements for mortgage insurers. As a result, the Enterprises issued revised Private Mortgage Insurer Eligibility Requirements (PMIERS), effective December 31, 2015. According to Moody's Investors Service, PMIERS strengthened the capital adequacy of mortgage insurers. At FHFA's direction, the Enterprises have been evaluating whether further updates to the PMIERS are appropriate.

¹ More specifically, borrower-paid mortgage insurance is by far the most common. Mortgage insurance also can be paid by the lender and, in that case, it is typically paid as an upfront premium. The lender passes the cost on to the borrower. Freddie Mac told OIG that currently approximately 85% of the market is borrower-paid and 15% is lender-paid mortgage insurance. Other allowable forms of credit enhancement are the seller retaining at least a 10% participation interest in the mortgage and the seller agreeing to repurchase or replace the mortgage in the event of default.

Although the financial condition of the Enterprises' mortgage insurance counterparties approved to write new business has improved in recent years, the risk remains that some of them may fail to fully meet their obligations, particularly, as Freddie Mac has noted, under a stress economic scenario. A recent FHFA Office of Inspector General (OIG) white paper summarized risks that Freddie Mac and others have identified related to the Enterprises' use of mortgage insurance as a credit enhancement.²

On March 1, 2018, Freddie Mac launched a pilot called Integrated Mortgage Insurance (IMAGIN), which is intended to mitigate such risks. (Fannie Mae announced a similar pilot, called Enterprise Paid Mortgage Insurance, in July 2018.)

IMAGIN PILOT

Since 2012, FHFA has directed the Enterprises to develop a program of credit risk transfer intended to reduce their overall risk. As part of these efforts, Freddie Mac completed its first Agency Credit Insurance Structure (ACIS) transaction in November 2013. Under ACIS, reinsurance companies cover a portion of the credit risk on existing pools of Freddie Mac single-family mortgages, and they post collateral. Freddie Mac officials told us that the IMAGIN pilot was part of Freddie Mac's evolution of credit risk transfer and used principles from ACIS.

At FHFA's direction, the Enterprises considered the development of new models for mortgage insurance during 2014, and FHFA, in its scorecard assessment, stated that it anticipated further engagement with the Enterprises during 2015. In early November 2015, FHFA directed the Enterprises to coordinate efforts on possible approaches to address concerns related to mortgage insurers, including financial strength as a counterparty, selection processes, and concentration exposures. According to FHFA and Freddie Mac, the Enterprises developed their respective pilots independently.

In mid-November 2015, Freddie Mac first proposed its pilot program, referred to at the time as the "Select MI" pilot program, to FHFA.³ In 2016 and 2017, FHFA set targets for Fannie

² OIG, *Enterprise Counterparties: Mortgage Insurers* (Feb. 16, 2018) (WPR-2018-002) (online at www.fhfaog.gov/Content/Files/WPR-2018-002.pdf).

³ FHFA attributed the delay from Freddie Mac's initial submission in 2015 to FHFA's approval in 2017 largely to its efforts to research details in the IMAGIN pilot proposal. FHFA also explained to us that it prioritized its review of Freddie Mac's proposal for deep mortgage insurance, another form of credit risk transfer, that it approved in September 2016 and Freddie Mac launched in September 2016.

Mae and Freddie Mac to further develop Enterprise-paid mortgage insurance pilots. With Enterprise-paid mortgage insurance, the Enterprises select and pay the insurer.

In August 2017, Freddie Mac again submitted its mortgage insurance pilot program for FHFA’s approval. Section 1102 of the Housing and Economic Recovery Act of 2008 grants the Agency general regulatory power over each Enterprise to make such rules and regulations as shall be necessary and proper to oversee them. Pursuant to this statutory directive, FHFA issued an interim final regulation (IFR) at 12 C.F.R. § 1253. Its IFR directs each Enterprise to submit requests for new activities to FHFA for approval. However, the IFR requires the Agency to seek public comment only for those “new activities” that the FHFA Director determines, in his sole discretion, to be “new products.”

In response to Freddie Mac’s request, FHFA’s Division of Housing Mission and Goals prepared an October 31, 2017, staff analysis memo that was transmitted to (among others) the heads of the Division of Housing Mission and Goals, Division of Enterprise Regulation, and Division of Conservatorship, and to the FHFA Director. This staff analysis memo contained legal advice from FHFA’s Office of General Counsel on whether the new activity should be considered to be a new product, for which public comment would be required, and it described in detail the IMAGIN pilot program. After receipt and review of this staff analysis memo, the FHFA Director, on November 7, 2017, issued a written concurrence with the recommendation in the staff analysis memo that FHFA issue to Freddie Mac a formal non-objection to the new activity. That same day, the FHFA Director stated, in writing, his finding that the new activity of the IMAGIN pilot did not constitute a new product. Two days later, on November 9, 2017, FHFA’s Division of Conservatorship issued a written non-objection to the IMAGIN pilot for up to one year or \$2.5 billion in unpaid principal balance.⁴ Freddie Mac officials reported to us that the volume would represent approximately 2% of its insured business, primarily coming from the portion of its business that would have been lender-paid mortgage insurance. Subsequently, the IMAGIN limit was expanded to \$6 billion.

Mechanics of the IMAGIN Pilot Program

The Enterprises were established to support the secondary mortgage market. In its 2017 10-K, Freddie Mae states that its charter does not permit it to originate loans or lend money directly

⁴ The Mortgage Bankers Association recently commented that pilot programs offered by the Enterprises could have widespread and lasting effects and proposed that FHFA (or the Enterprise offering the pilot) disclose information about the scope and participants in a pilot, and make available to the public market data collected through the pilot. The Mortgage Bankers Association is a national association representing the real estate finance industry and says that it “works to ensure the continued strength of the nation’s residential and commercial real estate markets; to expand homeownership; and to extend access to affordable housing to all Americans.” Its comments pertained to Enterprise pilots generally and not solely to the IMAGIN pilot.

to mortgage borrowers in the primary mortgage market. Traditionally, lenders selected the mortgage insurer for mortgages sold to the Enterprises.

The IMAGIN pilot program somewhat changes the dynamic of mortgage insurer selection. For that pilot program, Freddie Mac selected 22 of its small and large lenders and these 22 lenders, together, represent about 20% of Freddie Mac's purchase volume. These lenders have the option to sell mortgages to Freddie Mac with LTVs above 80% with traditional borrower-paid mortgage insurance, with lender-paid mortgage insurance, or with IMAGIN as the form of insurance. (Figure 1 below compares borrower-paid mortgage insurance, lender-paid mortgage insurance, and the IMAGIN pilot.)

Should the lender select IMAGIN, the lender pays Freddie Mac an upfront fee that covers the cost of insurance and prices the cost of the insurance into the borrower's mortgage. This fee is based on risk characteristics of the loan, such as LTV. Unlike traditional mortgage insurance, for which insurers may offer volume discounts to larger lenders, the fee for IMAGIN does not vary based on the volume delivered by the lender. According to Freddie Mac officials, this element of the fee structure makes the IMAGIN pilot attractive to community lenders.

Simultaneous with buying loans from these 22 lenders if IMAGIN is selected, Freddie Mac buys insurance coverage from a "protected cell" of Arch Mortgage Risk Transfer Holdings Inc. (Arch MRT), and the cell buys coverage for its entire exposure from a panel of reinsurers.⁵ With IMAGIN, Freddie Mac's counterparty exposure is essentially to the reinsurers, not to the cell. Each reinsurer on the panel is approved by Freddie Mac based on a number of factors, including their financial strength. (Freddie Mac also approved the allocation of risk among panel members, taking into account its other exposure to them.) As of mid-July 2018, Freddie Mac had approved seven reinsurance companies for this panel—four U.S.-based and three international—and was in discussions with an eighth company.

Freddie Mac officials reported to us that Freddie Mac considers the reinsurers it selected for this panel to be diversified, well-capitalized, and highly rated. By way of example, the lowest rated reinsurer on the panel had an A- rating. These officials further explained that Freddie Mac can remove reinsurers from the panel in certain circumstances, such as if their credit

⁵ Arch MRT is a new U.S. subsidiary of Arch Capital Group Ltd., a Bermuda-based mortgage and property/casualty insurer and reinsurer. Arch Capital Group Ltd. also is the parent company for Arch Mortgage Insurance Company and Arch Reinsurance Company. A protected cell company is a corporate structure in which a single legal entity is comprised of a core and several cells that have separate assets and liabilities. Each cell is independent of the other cells and of the company's core, but the entire unit is a single legal entity.

rating falls below A-. In the event that a reinsurer is removed from the panel, its portion of the risk is re-allocated to the ones remaining.

In addition to their financial capacity to pay claims, reinsurers participating on the panel post collateral for the IMAGIN pilot. This collateral is held in a trust that Freddie Mac can access if the reinsurer fails to pay. The amount of collateral required depends on the rating of the reinsurer. According to Freddie Mac officials, Freddie Mac selected for the panel reinsurers that had an equivalent, if not better, ability to pay than mortgage insurers meeting the PMIERS standards.

Unlike mortgage insurers that offer insurance for mortgages with LTVs above 80%, reinsurers participating in the IMAGIN pilot do not underwrite the covered loans nor do they perform quality control re-underwriting.⁶ Instead, reinsurers rely on Enterprise underwriting guidelines, lender origination quality, and Enterprise quality control reviews. (These reinsurers can assess the sufficiency of these quality control processes.) By the same token, these reinsurers, unlike traditional mortgage insurers, generally may not deny or rescind coverage.

According to Freddie Mac, eliminating multiple underwriting processes provides the Enterprise with certain mortgage insurance coverage and contributes to potential cost savings for borrowers. Combined with other efficiencies that Freddie Mac expects from IMAGIN, Freddie Mac officials project that borrowers could save as much as \$6,000 over 10 years when compared to the costs of traditional mortgage insurance.

A trade association for active U.S. mortgage insurance companies, U.S. Mortgage Insurers, maintains that the IMAGIN pilot violates the spirit of Freddie Mac's charter and blurs the bright line between primary and secondary market activities. It argues that the IMAGIN pilot represents greater vertical integration of private-sector activities into Freddie Mac.

FHFA defines the primary and secondary markets differently from one another. According to FHFA, the primary mortgage market is the market in which financial institutions provide mortgages to homebuyers, and the secondary mortgage market is the market in which mortgages or mortgage-backed securities are acquired by the Enterprises and traded. FHFA officials reported to us that FHFA does not consider the IMAGIN pilot program to constitute primary market activity because Freddie Mac is not originating loans under this pilot program.

⁶ The mortgage insurer may underwrite the loan itself or may delegate this function to the lender, meaning rely on the lender's initial underwriting.

FIGURE 1. BORROWER-PAID MORTGAGE INSURANCE. LENDER-PAID MORTGAGE INSURANCE. AND THE IMAGIN PILOT

	Borrower-Paid Mortgage Insurance	Lender-Paid Mortgage Insurance	IMAGIN Pilot (Enterprise-Paid Mortgage Insurance)
Premium Paid By	Borrower	Lender (ultimately by the borrower)	Enterprise (ultimately by the borrower)
Insurer Selection	Lender	Lender	Enterprise
Insurance Provided By	Mortgage insurance company (which may reinsure some risk)	Mortgage insurance company (which may reinsure some risk)	Panel of reinsurers, which may include reinsurance affiliates of mortgage insurance companies (via a protected cell)
Enterprise Approval	Enterprise approves mortgage insurance companies using PMIERS	Enterprise approves mortgage insurance companies using PMIERS	Enterprise approves reinsurers and the allocation among them
Number of Approved Insurance/Reinsurance Companies	Six	Six	Seven with potential additions
Insurer Business Model	Monoline	Monoline	Diversified
Collateral	No	No	Yes
Borrower Cancellation	Yes: For mortgages that are current on payments, automatic when loan is scheduled to reach 78% LTV; by request at 80% LTV based on loan paydowns and property appreciation	No	No
Length of Coverage	Cancellation	Life of loan	10 years
Insurer Underwriting and Loan Quality Control Reviews	Yes (underwriting may be delegated to the lender)	Yes (underwriting may be delegated to the lender)	No

Source: FHFA, Fannie Mae, and Freddie Mac.

RISK CONSIDERATIONS.....

Concentration

With traditional mortgage insurance, the lender selects the mortgage insurer from the list of counterparties approved by the Enterprises. According to Freddie Mac, the Enterprises have very limited ability to control concentration risk, such as suspending the mortgage insurer or imposing volume limits. Freddie Mac holds the view that there should be an incentive for the insurer to hold more capital than the minimum required and the Enterprise should be able to adjust the allocations based on the financial strength of the mortgage insurer counterparty because it bears the risk in the event the counterparty fails to honor its obligations. Under the IMAGIN pilot program, Freddie Mac selects the counterparty.

The pilot also addresses concentration by expanding the choice of counterparties. Currently, only six mortgage insurance companies are approved by both Enterprises, and Freddie Mac reports that the majority of its exposure is concentrated with three of them. The IMAGIN pilot program includes reinsurers approved by Freddie Mac, which approves the allocation of risk among them.

Financial Capacity

According to FHFA, PMIERS are designed to reduce risk to the Enterprises and ensure that qualified mortgage insurers maintain sufficient financial strength to withstand a significant economic stress. The Enterprises and Moody's Investors Service have acknowledged the strengthened condition of mortgage insurers in recent years. Although Enterprise-approved mortgage insurance companies meet PMIERS, they are not all rated as investment grade. Of the five mortgage insurers that each provided 10% or more of Freddie Mac's overall coverage as of June 30, 2018, one was rated A-, one was rated BBB+, one was rated BBB, one was rated BBB-, and one was rated BB+, based on the lower of the Moody's and Standard & Poor's ratings (expressed as the Standard & Poor's equivalent), according to the Enterprise.

U.S. Mortgage Insurers has publicly taken the position that the IMAGIN pilot circumvents the high capital and regulatory standards applicable to U.S. mortgage insurers and creates the potential for an unlevel playing field for entities taking the same risks. Participating reinsurers on the IMAGIN pilot panel are not subject to PMIERS. According to Freddie Mac officials, the participating reinsurers on the IMAGIN pilot panel are all well capitalized, highly rated (with ratings of at least A-), and post collateral. Of the seven reinsurers currently approved by Freddie Mac for the IMAGIN pilot panel, three are international and may be subject to different regulation and taxation than the four participating U.S. reinsurers. Freddie Mac

officials stated to us that Freddie Mac takes regulatory risk into consideration in its counterparty reviews.

Monoline Business

The Enterprises and the mortgage insurers are monoline businesses with exposure to mortgage credit risk. As a result, downturns in the housing market will affect both, which can make mortgage insurers least able to pay claims when they are most needed. U.S. Mortgage Insurers asserts that the monoline nature of the mortgage insurance industry is a benefit, maintaining that mortgage insurers provide capital that is more permanent and committed to taking U.S. housing risk, while the IMAGIN panel of reinsurers does not have that commitment. Freddie Mac, however, holds a different perspective: in its view, the diversification offered by participating reinsurers on the IMAGIN panel provides it with greater confidence that claims will get honored during a mortgage crisis and better protects taxpayers.

According to FHFA, reinsurers play some role in traditional mortgage insurance because mortgage insurers reinsure approximately 25% of their exposure. Reinsurers also cover a portion of Enterprise risks through transactions such as Freddie Mac's ACIS (and Fannie Mae's similar Credit Insurance Risk Transfer transactions).

Certainty of Coverage

Reinsurers in the IMAGIN pilot do not underwrite loans, and they generally cannot deny or rescind coverage. By contrast, traditional mortgage insurance includes some mortgage insurer underwriting and quality control re-underwriting, as described above. Some may view the second look as beneficial to risk management while others may see it as duplicative adding to costs. According to think tank American Action Forum, eliminating the mortgage insurer's second look increases risk. However, this potential for increased risk is generally limited because, according to Freddie Mac, most mortgage insurance currently is not re-underwritten as mortgage insurers rely on delegating the underwriting to the lender. When mortgage insurers take a second look, that look, in Freddie Mac's view, creates the risk that the insurers could deny coverage. Eliminating the second look, according to Freddie Mac, provides it with greater certainty of coverage and also may reduce costs to borrowers.

CONCLUSION.....

The Enterprises acknowledge that, although the financial condition of their mortgage insurer counterparties approved to write new business has improved in recent years, the risk remains that some of them may fail to fully meet their obligations. As discussed in our previous white paper on mortgage insurance, there are positive emerging trends, such as stronger mortgage insurer capital, compliance with PMIERS, the ongoing effort to consider whether PMIERS should be updated, and the strength of the housing market.

According to FHFA, it and the Enterprises have been focused on mitigating the counterparty risk of mortgage insurers. On March 1, 2018, Freddie Mac launched a pilot called IMAGIN, which is intended to mitigate these risks. In light of questions raised by our stakeholders about the IMAGIN pilot, we prepared this white paper to explain how this pilot program works.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this white paper was to provide background information on Freddie Mac’s IMAGIN pilot. To achieve this objective, we reviewed internal FHFA and Freddie Mac documents as well as publicly available documents. We also interviewed FHFA and Freddie Mac officials.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

ADDITIONAL INFORMATION AND COPIES.....

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