Federal Housing Finance Agency
Office of Inspector General

Update on Mortgage Insurers as Enterprise Counterparties

White Paper • WPR-2021-001 • March 8, 2021

WPR-2021-001

March 8, 2021

Executive Summary

Under their charters, Fannie Mae and Freddie Mac (the Enterprises) may only purchase conventional single-family residential mortgages with loan-to-value ratios greater than 80% if these mortgages are supported by one of three types of credit enhancements. The credit enhancement used for the vast majority of these Enterprise mortgage purchases is mortgage insurance. Mortgage insurance transfers a portion of the risk arising from default of a mortgage to an insurer. Counterparty risk arises from the potential that mortgage insurers may fail to pay claims. According to the Federal Housing Finance Agency (FHFA or Agency) and the Enterprises, mortgage insurers represent a significant counterparty exposure to the Enterprises.

We published a white paper in February 2018 explaining the then-current and emerging risks for the Enterprises associated with private mortgage insurers. Over the past three years, the industry landscape has continued to evolve. Additionally, the COVID-19 pandemic represents the first significant challenge mortgage insurers have faced since the financial crisis. We are issuing this white paper to provide an overview of key developments affecting the mortgage insurance industry and an explanation of how those changes affect risks to the Enterprises.

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ABBREVIATIONS

Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General
PMIERs	Private Mortgage Insurer Eligibility Requirements

BACKGROUND

Under their charters, Fannie Mae and Freddie Mac may only purchase conventional single-family residential mortgages with loan-to-value ratios greater than 80% if these mortgages are supported by one of three types of credit enhancements. The credit enhancement used for the vast majority of these Enterprise mortgage purchases is mortgage insurance. Mortgage insurance transfers a portion of the risk arising from default of a mortgage to an insurer in exchange for an insurance premium that is usually paid by the borrower.[1]

According to FHFA and the Enterprises, mortgage insurers represent a significant counterparty exposure. Counterparty risk arises from the potential that mortgage insurers may fail to pay claims, for example, due to insolvency. As an industry, mortgage insurers sustained significant losses during the 2008 financial crisis. Three mortgage insurers were found by their respective state regulators to lack sufficient capital and were placed into "run-off," meaning they were not allowed to write new insurance. These insurers partially deferred claim payments due to the Enterprises. Further, some mortgage insurers rescinded coverage on a greater share of loans, canceling the policies as improperly issued and returning the premiums. In such circumstances, the Enterprises could require that the originating lender repurchase the mortgage.

We published a white paper in February 2018 explaining the then-current and emerging risks for the Enterprises associated with private mortgage insurers.[2] Over the last three years, the industry landscape has continued to evolve, both increasing and decreasing counterparty risk to the Enterprises. The COVID-19 pandemic, beginning in 2020, represents the first significant challenge mortgage insurers have faced since the financial crisis. We are issuing this white paper to provide an overview of key developments affecting the mortgage insurance industry over the past three years and an explanation of how those changes affect risks to the Enterprises.

INDUSTRY COMPOSITION

The mortgage insurance industry is concentrated. Currently, six private mortgage insurers are active: Arch Mortgage Insurance Company; Radian Guaranty Inc.; Mortgage Guaranty

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[1] The mortgage insurer assumes the first-loss position in the event of foreclosure and reimburses the Enterprise for losses up to the level specified in the policy, typically about 5% to 35% of the loan amount.

[2] *See* OIG, *Enterprise Counterparties: Mortgage Insurers* (Feb. 26, 2018) (WPR-2018-002) (online at www.fhfaoig.gov/sites/default/files/WPR-2018-002.pdf).

Insurance Corporation; Essent Guaranty, Inc.; Genworth Mortgage Insurance Corporation;[3] and National Mortgage Insurance Corporation.[4]

TOOLS TO REDUCE RISK……………………………………………………

Over the past three years, a number of tools have been implemented or refined, purportedly to help reduce the Enterprises' mortgage insurance counterparty risk.

Eligibility Requirements

At FHFA's direction, the Enterprises published Private Mortgage Insurer Eligibility Requirements (PMIERs), which became effective in December 2015.[5] Among other things, PMIERs established a minimum level of available assets, or PMIERs capital, for private mortgage insurers to do business with the Enterprises. In 2018, FHFA directed the Enterprises to modify PMIERs to address changes in Enterprise counterparty risk management as well as in the mortgage insurance industry and economy. The revision, known as PMIERs 2.0, became effective in March 2019. The Enterprises have provided additional guidance to mortgage insurers since then.

An FHFA official told us that PMIERs 2.0 strengthened the financial requirements for mortgage insurers that do business with the Enterprises. However, a Fannie Mae official noted that the change was somewhat modest, increasing required assets by 5 to 10%.[6] Nevertheless, another official said that mortgage insurers are much stronger counterparties for Fannie Mae under PMIERs 2.0. A Freddie Mac official said that the change to PMIERs 2.0

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[3] Our 2018 white paper noted a pending acquisition of Genworth Financial, Inc. by China Oceanwide Holdings Group Co., Ltd. However, as of February 2021, that transaction faces uncertainty. Genworth announced that in the interim it will focus on executing a contingency plan, including a potential initial public offering of the mortgage insurance business. Although a Fannie Mae official told us that the potential failure of the transaction represents more risk in the short term, officials from both Enterprises told us that the concern is with the parent company, not the mortgage insurance counterparty.

[4] Arch Capital owns both Arch Mortgage Insurance Company and United Guaranty Residential Insurance Company, which technically also is approved as a mortgage insurer. MassHousing, a state housing finance agency, also is approved by the Enterprises. PMI Mortgage Insurance Co., Republic Mortgage Insurance Company, and Triad Guaranty Insurance Corporation remain in run-off and unable to write new policies. The mortgage volume backed by these three companies and the proportion of their payments being deferred have declined.

[5] Before the financial crisis, a minimum credit rating was part of the criteria the Enterprises used to approve mortgage insurers. Over the past three years, a number of mortgage insurers have received credit rating upgrades. A Freddie Mac official confirmed to us that Genworth is the only mortgage insurer rated below investment grade at this time. According to FHFA, PMIERs now drive eligibility standards instead of ratings.

[6] Together the 2015 PMIERs and PMIERs 2.0 nearly doubled the mortgage insurers' capital requirement.

served to increase the quality and liquidity of mortgage insurer assets, and PMIERs help mitigate risk. FHFA and the Enterprises said that they believe PMIERs 2.0 are sufficient to protect the Enterprises in a stress scenario generally. (See section on Use of Risk Mitigation Tools in Response to Pandemic and Economic Environment for additional information about capital adequacy relative to the ongoing pandemic.)

As of year-end 2020, all six active private mortgage insurers comply with PMIERs. The mortgage insurers have generally been operating profitably and adding to their PMIERs capital. According to Fannie Mae, as of December 2020, the industry's collective surplus over the total PMIERs required assets stood at $6.5 billion, which is approximately 145% of the requirement.[7] A surplus can help a mortgage insurer weather stress.

Rescission Relief and Master Policies

FHFA directed the Enterprises to align and implement rescission relief principles, which specify conditions that must be met before a mortgage insurer can rescind coverage. The most recent major revision was in December 2017. The principles generally align with the Enterprises' representation and warranty framework, providing automatic relief from rescission after specified periods of timely payments and also after a mortgage insurer has completed a full review of the loan and its underwriting that does not identify any significant defect. At FHFA's direction, the Enterprises also developed and implemented aligned mortgage insurance master policy provisions, with the most recent versions becoming effective in March 2020. The March 2020 master policies incorporated the December 2017 rescission relief principles and included a few other provisions.

Credit-Risk Transfer Tools

All six active private mortgage insurers currently use reinsurance and other credit-risk transfer tools to transfer risk and diversify their capital strategy. Over the last three years, use of these tools has grown substantially. As of October 2020, private mortgage insurers had transferred nearly $41.4 billion in risk on approximately $1.8 trillion of insurance-in-force since 2015 according to U.S. Mortgage Insurers, a mortgage insurance trade association. A white paper issued by that insurance trade association described the use of reinsurance and credit-risk transfers as changing the mortgage insurance business model from "buy-and-hold" to "aggregate-manage-distribute."

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[7] As of the third quarter of 2020, each mortgage insurance company had a surplus above its requirement, based on OIG calculations of information reported in their 10-Qs, as follows: Arch Mortgage Insurance Company, 158%; Radian Guaranty Inc., 129%; Mortgage Guaranty Insurance Corporation, 138%; Essent Guaranty, Inc., 156%; Genworth Mortgage Insurance Corporation, 132%; and National Mortgage Insurance Corporation, 167%.

By engaging in risk transfers and utilizing reinsurance, mortgage insurers can reduce their PMIERs-required asset requirements. An internal Enterprise document credits the mortgage insurance industry's strong asset surpluses in large part to reinsurance utilization.

Risk-Based Pricing

By 2019, the entire mortgage insurance sector had shifted to use of dynamic, risk-based pricing engines incorporating a multitude of variables specific to each loan. Risk-based pricing engines enable mortgage insurers to respond quickly to changing market conditions. According to a mortgage insurance CEO, approximately 75% of new insurance written is now through pricing engines, with the expectation that the proportion will increase to nearly 100%.

The change to risk-based pricing has allowed mortgage insurers to tailor pricing in a granular manner. An FHFA official explained that it provided mortgage insurers with the ability to manage and reduce risk in a way that was not previously possible. A Freddie Mac official agreed that risk-based pricing allowed better management of risk exposures, underscoring its efficiency.

Pilots to Address Industry Concentration

According to FHFA, the limited number of mortgage insurers results in concentration risk. During the past three years, each Enterprise launched a relatively small pilot program under which, simultaneous with purchasing single-family mortgages, the Enterprises effectively purchase mortgage insurance from a panel including preapproved reinsurance companies.[8] Freddie Mac adopted its pilot program, called IMAGIN, in an effort to reduce concentration risk from mortgage insurers. Fannie Mae told us that it is not overly concerned about concentration right now, but the Enterprise also is testing its pilot program, Enterprise Paid Mortgage Insurance. An FHFA official indicated that other Enterprise tools including credit-risk transfers also lower concentration risk.

CHALLENGES ....

Pandemic and Economic Environment

While FHFA and the Enterprises have taken steps to reduce mortgage insurer counterparty risk, the pandemic and economic environment present challenges.

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[8] For additional information, see OIG, *Freddie Mac's IMAGIN Pilot* (Sept. 12, 2018) (WPR-2018-005) (online at www.fhfaoig.gov/sites/default/files/WPR-2018-005.pdf). Since that white paper, Freddie Mac has entered into IMAGIN transactions in which a mortgage insurer directly insures the risk without reinsurance.

Under the Coronavirus Aid, Relief, and Economic Security Act, the Enterprises provided forbearance options for borrowers affected by the pandemic.[9] Borrowers were eligible for up to one year of forbearance and then have various repayment, loan modification, or deferral options.[10] On February 25, 2021, FHFA announced that borrowers with Enterprise mortgages meeting certain conditions would be eligible for up to a total of 18 months of pandemic-related forbearance. According to data from mortgage software and analytics firm Black Knight, the number of Enterprise mortgages in forbearance peaked around mid-2020. Even with the subsequent decline, FHFA reported that more than 900,000 Enterprise mortgages remained in forbearance as of October 2020, representing more than 3% of Enterprise mortgages.

FHFA officials told us that it was too early to know the outcome for mortgages in forbearance. Moody's Investors Service reported in November 2020 that the impact of the pandemic-related downturn on the mortgage insurance sector would take at least a year to play out, with the caveat that insurers entered the downturn from a relatively strong position.

Use of Risk Mitigation Tools in Response to Pandemic and Economic Environment

In response to pandemic-related stresses, the Enterprises and mortgage insurers took a number of steps to mitigate risk. Officials at both Enterprises told us that the mortgage insurers took action to proactively raise capital. According to the mortgage insurance trade association, the industry has secured more than $2.2 billion in new capital during the pandemic through equity and debt offerings.[11] PMIERs also required mortgage insurers to have capital plans should it become necessary to access new sources. At FHFA's direction, the Enterprises took steps to prevent mortgage insurance companies from extracting capital through dividends or asset transfers without Enterprise approval until June 30, 2021, thereby locking down capital within the mortgage insurance counterparty. According to a Fannie Mae document, mortgage insurer asset surpluses were enhanced by freezing dividends to the parent companies at the

[9] For more information about pandemic-related forbearance for Enterprise mortgages, see OIG, *Oversight by Fannie Mae and Freddie Mac of Compliance with Forbearance Requirements Under the CARES Act and Implementing Guidance by Mortgage Servicers* (July 27, 2020) (OIG-2020-004) (online at www.fhfaoig.gov/sites/default/files/OIG-2020-004.pdf) and OIG, *Impact of Pandemic-Related Forbearance and Foreclosure Relief for Single-Family Mortgages on the Enterprises' Implementation of CECL* (Sept. 3, 2020) (WPR-2020-007) (online at www.fhfaoig.gov/sites/default/files/WPR-2020-007.pdf).

[10] The Enterprises use forbearance for major natural disasters. In that event, the amount of capital that mortgage insurers are required to hold for the non-performing loans is reduced, because loans in forbearance due to disasters are considered more likely to return to on-time payments than other delinquent loans. The same treatment was used by the Enterprises for pandemic-related forbearance. Fitch Ratings has noted that the current situation is unprecedented, and the historical tendency for the cure rate of loans in forbearance to be better than average may not hold. In November 2020, however, mortgage insurer Essent called the cure pattern of COVID defaults encouraging.

[11] Most of the new capital was retained at the parent company but available for contribution to the mortgage insurer if needed.

pandemic onset. Fannie Mae and Freddie Mac conducted stress testing and found that, even with anticipated stress losses, the mortgage insurers have sufficient capital to weather the crisis.

According to FHFA, mortgage insurers were able to utilize their risk-based pricing engines to respond quickly to pandemic-related risk and uncertainty. During the early stage of the pandemic, all six active mortgage insurers increased pricing, with some firms now lowering those increases.

In March 2020, the pandemic disrupted the reinsurance and credit-risk transfer markets, raising questions about whether the mortgage insurers would be able to continue executing such transactions. Subsequently, the market thawed and all six private mortgage insurers have come back to the market for additional transactions.

Volume

Typically, mortgage production falls in a stress environment. Despite the pandemic environment, however, the six private mortgage insurers wrote $558 billion of primary coverage on loans sold to the Enterprises in 2020, an increase of 65% from 2019 and a record volume, according to Inside Mortgage Finance. Fannie Mae explained to us that much of this increase was attributed to refinancings.

RISK IMPLICATIONS

Over the past three years, the mortgage insurance industry and economic environment have changed in ways that both theoretically increase and decrease counterparty risk to the Enterprises. FHFA cautioned, however, that it could not say whether the counterparty risk that mortgage insurers pose to the Enterprises increased or decreased overall. Risk exposure is viewed as tied to volume, and when volume increases, risk theoretically increases. As FHFA and the Enterprises caution, risk exposure must be considered against the quality of the mortgages purchased by the Enterprises and, in their view, the current books of mortgages carry less risk.

According to FHFA officials, various policy initiatives have decreased the probability of failure by a mortgage insurer counterparty. These officials identified updated PMIERs capital requirements as well as transfer of risks by mortgage insurers onto investors. Both Enterprises concurred with those observations.

CONCLUSION..

According to FHFA and the Enterprises, mortgage insurers represent a significant counterparty exposure to the Enterprises. Over the past three years, the mortgage insurance industry and economic environment have changed in ways that both theoretically increase and decrease their counterparty risk. FHFA cautioned, however, that it could not say whether the counterparty risk that mortgage insurers pose to the Enterprises increased or decreased overall.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide updated information on the mortgage insurance industry and to provide FHFA and Enterprise views of how developments over the past three years have affected risks to the Enterprises. To achieve this objective, we reviewed FHFA and Enterprise documents as well as publicly available documents. We also interviewed FHFA and Enterprise 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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