

Federal Housing Finance Agency
Office of Inspector General



Enterprise Counterparties: Reinsurers



WPR-2021-007

September 27,
2021

Executive Summary

Reinsurance is often colloquially referred to as “insurance for insurance companies.” Fannie Mae and Freddie Mac (the Enterprises) have both direct and indirect single-family counterparty exposure to reinsurers. As part of their credit risk transfer (CRT) programs, the Enterprises purchase insurance from diversified reinsurers. Until recently, both Enterprises also operated pilot programs under which they utilized reinsurers to provide charter-required credit enhancement. Additionally, the Enterprises have indirect exposure to reinsurers to the extent that the reinsurers also provide reinsurance to Enterprise mortgage insurance counterparties.

According to an internal document, Fannie Mae considers the counterparty credit risk associated with mortgage insurers and reinsurers to be one of the top risks to its business, that is, an inherent risk before taking into account the controls the Enterprise has in place to mitigate the risk. In public documents and information provided to us, Fannie Mae described various mitigants in place to reduce the counterparty credit risk posed by reinsurers, including eligibility standards, collateral, and managing exposure. Fannie Mae told us that, after considering mitigants, it would characterize its residual risk as very manageable and very low.

In an internal document, Freddie Mac identified third-party risk, a category that includes reinsurers, as one of its top risks. However, Freddie Mac does not view reinsurance counterparty risk as a primary factor that influences the magnitude of third-party risk. In its 2020 10-K and information provided to us, the Enterprise identified approaches it believes help mitigate counterparty credit risk related to reinsurers, including eligibility standards, collateral, and managing exposure. Overall, Freddie Mac assessed the residual risk of the Enterprise incurring material losses from reinsurance counterparties as low on both an absolute basis and relative to other counterparty types.

Federal Housing Finance Agency (FHFA or Agency) officials explained that the Enterprises’ exposure to reinsurers constitutes only a small fraction compared to their exposure to mortgage insurers, which is a concentrated risk and their largest exposure. In contrast to mortgage insurers, the Agency indicated that the reinsurance market is both broad-based and large enough that it should not pose a high degree of risk to the Enterprises. FHFA expressed that, after application of mitigants, the risk to the Enterprises posed by reinsurers remains relatively low at this point.

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ABBREVIATIONS

ACIS	Freddie Mac’s Agency Credit Insurance Structure
CIRT	Fannie Mae’s Credit Insurance Risk Transfer
CRT	Credit Risk Transfer
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
IMAGIN	Freddie Mac’s Integrated Mortgage Insurance Program
PMIERS	Private Mortgage Insurer Eligibility Requirements

BACKGROUND.....

Reinsurance is a mechanism by which insurance companies manage risks and the amount of capital they must hold to support those risks. As a contract of indemnity between an insurer and reinsurer, reinsurance is often colloquially referred to as “insurance for insurance companies.” According to FHFA, reinsurers often have diversified lines of business, which helps mitigate the risk that they would have increased claims when housing markets are under stress.

In the United States, the insurance industry (including reinsurance) is primarily regulated at the state level. Each state has an insurance department, and laws, regulations, policies, and procedures that regulate virtually every aspect of the operations of insurers and reinsurers. As a result, insurance companies, reinsurance companies, and insurance intermediaries are subject to the laws and regulations of each U.S. jurisdiction in which they transact business. Licensed reinsurers are subject to the same state-based regulation as other licensed insurers. Reinsurers can be domiciled domestically or internationally. The regulation of reinsurance in the United States takes into consideration the domicile of the reinsurer and whether the reinsurer is a licensed reinsurer in a U.S. jurisdiction.

Reinsurers as Enterprise Counterparties

The Enterprises have both direct and indirect counterparty exposure to reinsurers. As part of their CRT programs, the Enterprises purchase insurance from diversified reinsurers. Until recently, both Enterprises also operated pilot programs under which they utilized reinsurers to provide charter-required credit enhancement. Additionally, the Enterprises have indirect exposure to reinsurers to the extent that the reinsurers also provide reinsurance to Enterprise mortgage insurance counterparties. The Enterprises use reinsurance in both their single-family and multifamily business lines. This paper focuses on the single-family business; it does not cover other exposure the Enterprises may have to reinsurers, such as when the Enterprises obtain insurance unrelated to mortgage credit risk.

Mortgage Insurance

Under their charters, conventional mortgages acquired by Fannie Mae and Freddie Mac that have loan-to-value ratios above 80% are required to have loan-level credit enhancement in the form of mortgage insurance, a repurchase agreement, or seller-retained participation in the loan. According to FHFA, mortgage insurance is the form of charter-eligible credit enhancement used most often, with six active private mortgage insurers serving both

Enterprises.¹ When losses occur on covered loans, mortgage insurers provide credit loss coverage. All six active mortgage insurers currently use reinsurance and other credit-risk transfer tools to transfer risk and diversify their capital strategy.² Nevertheless, as explained by Freddie Mac, the mortgage insurers are the direct Enterprise counterparties and remain legally bound for their entire claim obligation independent of whether they transfer any of that risk through reinsurance.

Enterprise Pilot Programs

In 2018, the Enterprises launched pilot programs under which, simultaneous with purchasing single-family mortgages, they could effectively purchase mortgage insurance from a panel including preapproved reinsurance companies. Freddie Mac implemented the Integrated Mortgage Insurance program, also known as IMAGIN, and Fannie Mae implemented the Enterprise Paid Mortgage Insurance program. Instead of lenders choosing the counterparties taking on this risk, these programs allowed each Enterprise to choose the counterparties. At FHFA's direction, the Enterprises ended these relatively small pilots in June 2021, with a wind-down period to accommodate delivery of loans in the pipeline.³

Credit Risk Transfers

In 2013, the Enterprises launched CRT programs that are separate from the Enterprises' charter requirements applicable to loans with loan-to-value ratios greater than 80%, according to FHFA. Across the different types of CRT, the basic transaction is the same: the Enterprises pay private market participants to assume a portion of the credit risk on particular pools of mortgages that the Enterprises guarantee, according to an FHFA report. The Agency explained that instead of providing coverage on individual loans as with loan-level primary mortgage insurance, these pool-level policies cover a specified percentage of aggregate credit risk for a pool that includes thousands of loans.

¹ By contrast to the six active mortgage insurers, the Enterprises have more than two dozen reinsurance counterparties. Enterprise mortgage insurance and reinsurance counterparties may be connected through a common parent company.

² For more information regarding mortgage insurers, see OIG, *Update on Mortgage Insurers as Enterprise Counterparties* (Mar. 8, 2021) (WPR-2021-001) (online at www.fhfaig.gov/sites/default/files/WPR-2021-001.pdf).

³ For more information regarding these pilot programs, see OIG, *Freddie Mac's IMAGIN Pilot* (Sept. 12, 2018) (WPR-2018-005) (online at www.fhfaig.gov/sites/default/files/WPR-2018-005.pdf).

Insurance/reinsurance transactions are one of the Enterprises' key single-family CRT vehicles.⁴ At Fannie Mae, they are known as Credit Insurance Risk Transfer (CIRT); at Freddie Mac, they are referred to as the Agency Credit Insurance Structure (ACIS). Through CIRT and ACIS, the Enterprises purchase insurance primarily from diversified reinsurers. According to FHFA's May 2021 report on the performance of Enterprise CRT, "[i]nsurance/reinsurance transactions are underwritten primarily to the financial strength of the counterparties, and as a result these transactions are not fully collateralized."⁵ FHFA told us that these transactions are partially collateralized and distributed among a variety of entities, including reinsurers and reinsurer affiliates of mortgage insurers. According to an FHFA report, reinsurance transactions represented 23% of the single-family risk transferred under the Enterprises' CRT programs from 2013 through the end of 2020.

Counterparty Credit Risk

According to FHFA, counterparty credit risk is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction's cash flows. A Fannie Mae report explains that an Enterprise faces this risk from entities that could impact financial results through:

- Failure of a credit enhancement provider, such as a reinsurer, to satisfy its contractual obligations to cover losses, as well as
- Inability of a counterparty to sufficiently cover losses through payment or collateral.

RISKS RELATED TO REINSURERS AS ENTERPRISE COUNTERPARTIES

According to the Enterprises, reinsurers represent a primary counterparty exposure. FHFA and the Enterprises have identified various risk mitigants that they assert reduce the risk posed by reinsurers. We did not independently verify the efficacy of such mitigants as part of this white paper.

⁴ The Enterprises' other key single-family CRT vehicle is securities issuances, also known as capital markets CRT, and is beyond the scope of this white paper. Together these two vehicles account for the vast majority of all the Enterprises' CRT issuance.

⁵ Counterparties post collateral (cash and non-cash assets) that is held in trusts for the ultimate benefit of the Enterprises. The Enterprises recover covered credit losses via reimbursements from insurance/reinsurance counterparties, and if needed, from posted collateral.

Fannie Mae

According to an internal document, Fannie Mae considers the counterparty credit risk associated with mortgage insurers and reinsurers to be one of the top risks to its business, that is, an inherent risk before taking into account the controls the Enterprise has in place to mitigate the risk. As discussed further below, FHFA told us that the exposure to reinsurers is significantly less than the exposure to mortgage insurers. The key underlying risks Fannie Mae identified include the failure of a reinsurer to meet its obligations, which, according to the Enterprise, could result in higher than expected credit losses. Fannie Mae also identified a related risk due to the interconnectedness of its counterparties.⁶ According to Fannie Mae, even if its exposure to a failed reinsurer was collateralized, Fannie Mae's other counterparties could have exposure to that reinsurer that was not collateralized.

Fannie Mae told us that more mortgage credit risk has been transferred in the reinsurer counterparty sector in the past few years than ever before by both mortgage insurers and the Enterprises. The Enterprise also noted the interconnectedness of its mortgage insurance and reinsurance counterparties. Some of Fannie Mae's active reinsurers are affiliates of mortgage insurers, and mortgage insurers may transfer risk to many of the same reinsurers that participate in Enterprise transactions.

CRT is one of the ways that Fannie Mae has counterparty exposure to reinsurers. However, Fannie Mae has not entered into any new CRT transactions since the first quarter of 2020, as discussed further below. According to FHFA, fewer CRT transactions means less exposure to reinsurers but more credit risk retention.

Risk Monitoring and Mitigation

In public documents and information provided to us, Fannie Mae described various mitigants in place to reduce the counterparty credit risk posed by reinsurers:

- **Eligibility Standards:** Although mortgage insurers select the reinsurers that write their reinsurance coverage, the Enterprises' Private Mortgage Insurer Eligibility Requirements (PMIERS) permit Fannie Mae to review the mortgage insurers' proposed reinsurers.⁷ The Enterprise can ask for a reinsurer to be excluded or its proposed allocation reduced. Additionally, Fannie Mae reported to us that the Enterprise selects and allocates risk to reinsurers under its CIRT transactions. In

⁶ For more information about the interconnectedness of Enterprise counterparties, see OIG, *Interconnectedness of Enterprise Counterparties with a Common Parent Company* (Sept. 27, 2021) (WPR-2021-006) (online at www.fhfa.ig.gov/sites/default/files/WPR-2021-006.pdf).

⁷ PMIERS establishes the requirements an approved insurer must meet and maintain in order to provide mortgage guaranty insurance on mortgages acquired by the Enterprises.

its 2020 10-K, the Enterprise said that as part of this process it reviews reinsurers' financial strength and concentration risk.

- **Collateral:** Fannie Mae told us that it considers collateral requirements to be one of its most critical risk mitigants. Concerning mortgage insurance, PMIERS mandates mortgage insurers to require collateral from reinsurers. Based on its reinsurer reviews noted above, Fannie Mae can establish higher collateral requirements for reinsurers when warranted. As described in the Enterprise's 2020 10-K, for CIRT, collateral from reinsurers consists of highly rated liquid assets held in an irrevocable trust account. Initial collateral levels are determined by a reinsurer's rating, among other factors, and contractual provisions require additional collateral in the event of adverse events, such as a ratings downgrade.
- **Managing Exposure:** Besides collateral requirements, Fannie Mae cited its Counterparty Limit Framework as its other most critical risk mitigant. The framework applies board-approved limits to reinsurers, depending on whether a company is a diversified reinsurer or a monoline reinsurer with high mortgage credit risk concentration. According to internal documents, Fannie Mae monitors the risk through various actions, such as collateral monitoring, operational assessments, exposure monitoring, and reinsurance industry sector analyses.

Fannie Mae told us that, after considering mitigants, it would characterize its residual risk as very manageable and very low. The Enterprise further said that it believes using reinsurance provides effective risk management and reduces risk by spreading risk to reinsurers.

Freddie Mac

In an internal document, Freddie Mac identified third-party risk as one of its top risks. The Enterprise clarified for us that the risk is a combination of relevant risks from all counterparties, including reinsurers. However, Freddie Mac does not view reinsurance counterparty risk as a primary factor that influences the magnitude of third-party risk. The Enterprise believes that counterparty credit risk is an inherent part of doing business with reinsurers.

Freddie Mac also reported to us an increase in counterparty interconnectedness due to mortgage insurer holding companies increasing the mortgage credit risk exposure of their reinsurance subsidiaries, including by growing their CRT participation.

According to Freddie Mac, its exposure to reinsurers varies from month to month depending on whether business from new transactions is added faster or slower than the run-off rate for existing transactions. However, the Enterprise reported to us that overall, its reinsurer counterparty credit risk is increasing gradually.

Risk Monitoring and Mitigation

In an internal document Freddie Mac identified various elements common to reinsurers that, in its view, make them attractive counterparties to assume a portion of Freddie Mac's credit risk. First, reinsurers tend to have a small amount of mortgage credit risk in their portfolios, so their financial results are typically not highly correlated to the performance of the U.S. housing market. Second, reinsurers generally have large balance sheets with a considerable amount of excess capital. Finally, they are heavily monitored by the credit rating agencies as well as by insurance regulators.

Freddie Mac told us that such factors are supplemental to the Enterprise's own monitoring and management of reinsurer counterparty risk. In its 2020 10-K and information provided to us, the Enterprise identified approaches it believes help mitigate counterparty credit risk related to reinsurers, including:

- **Eligibility standards:** Although the Enterprise does not have authority to determine mortgage insurers' reinsurance counterparties, under PMIERS Freddie Mac has the right to evaluate the strength of those reinsurers and may take subsequent action, discussed further below. For CRT, Freddie Mac said that the approval of reinsurers and the allocation of risk to each is solely in the Enterprise's discretion. Freddie Mac reported that it conducts due diligence for CRT reinsurer counterparties prior to onboarding and maintains eligibility standards, including risk-based financial requirements. According to Freddie Mac, contract provisions allow the Enterprise to terminate business with a reinsurer if external ratings reach a specified level.
- **Collateral:** As noted above, under PMIERS Freddie Mac has the right to evaluate the strength of reinsurers and the Enterprise may set collateral levels based on those evaluations. For CRT transactions, Freddie Mac requires reinsurers to post collateral covering a portion of their exposure. Freddie Mac reported that it ensures the amount is adequate monthly. According to the Enterprise, contract provisions increase collateral requirements for existing transactions if a reinsurer experiences an external ratings decline.
- **Managing exposure:** Freddie Mac maintains a management limit constraining the amount of business any individual entity can write. The Enterprise also measures the overall level of concentration for reinsurance counterparties monthly and monitors the direction of concentration over time.

Freddie Mac told us it believes the mitigants reduce the probability of default and the magnitude of losses that would occur should a reinsurer default. Overall, Freddie Mac assessed the residual risk of the Enterprise incurring material losses from reinsurance counterparties as low on both an absolute basis and relative to other counterparty types.

FHFA

FHFA told us that it considers the risk reinsurers present to the Enterprise as part of assessing each Enterprise's overall counterparty credit risk management framework, along with monitoring Enterprise exposure to different counterparties. Officials explained that the Enterprises' exposure to reinsurers constitutes only a small fraction compared to their exposure to mortgage insurers, which is a concentrated risk and their largest exposure. In contrast to mortgage insurers, the Agency indicated that the reinsurance market is both broad-based and large enough that it should not pose a high degree of risk to the Enterprises.

FHFA explained that the Enterprises' cumulative exposure to reinsurers increases as the Enterprises complete more CRT transactions. The Agency noted, however, that the Enterprises' risk from reinsurers is relatively stable at this time because of market dynamics, such as home price appreciation and lower loan-to-value ratios, as well as the reinsurers' strong financial metrics.

In a May 2021 report FHFA noted the concern that CRT markets may be easily disrupted during periods of market stress, requiring the Enterprises to retain credit risk they had prepared to transfer. In its CRT progress report released in August 2021, the Agency stated that, "as a result of adverse market conditions stemming from the COVID-19 pandemic, neither Enterprise entered into any new single-family CRT transactions during the second quarter of 2020."⁸ However, despite improved market conditions in the second half of 2020, Fannie Mae continued to pause issuance of new CRT transactions to evaluate the potential impact of FHFA's Enterprise Regulatory Capital Framework, while Freddie Mac returned to the single-family CRT market in the third quarter of 2020.⁹ FHFA officials confirmed that because the CRT volume was down, not as much reinsurance exposure was added. Instead, the Enterprises were retaining credit risk that would have otherwise been transferred. An official explained that if the Enterprises do not view CRT as beneficial from a risk transfer standpoint, then they can decide not to execute that CRT.

Risk Monitoring and Mitigation

According to an FHFA report, the Enterprises' approaches to mitigating the counterparty risk posed by insurance/reinsurance CRT include counterparty eligibility restrictions, counterparty ratings, counterparty limits, collateral requirements and adequacy under stress, cross-collateralization, and conducting transactions with large, diversified counterparties. However,

⁸ While no new single-family CRT transactions were entered into during the second quarter of 2020, FHFA told us that Freddie Mac closed the SAP-3 and SAP-5 deals in April 2020.

⁹ On September 20, 2021, Fannie Mae announced its intention to enter into new CRT transactions beginning in October 2021.

the report notes that research and analysis are needed to better understand the related costs and benefits and potential risks to the Enterprises. The Agency told us that, of the various mitigants, it considers collateral a key component to minimize losses to the Enterprises because an Enterprise can draw on it if a reinsurer cannot meet its obligations. FHFA expressed that, after application of mitigants, the risk to the Enterprises posed by reinsurers remains relatively low at this point.

CONCLUSION.....

The Enterprises have both direct and indirect counterparty exposure to reinsurers. According to an internal document, Fannie Mae considers the counterparty credit risk associated with mortgage insurers and reinsurers to be one of the top risks to its business before taking into account the controls the Enterprise has in place to mitigate the risk. In an internal document, Freddie Mac identified third-party risk, a category that includes reinsurers, as one of its top risks. However, Freddie Mac does not view reinsurance counterparty risk as a primary factor that influences the magnitude of third-party risk.

Both Enterprises identified reinsurer-related counterparty risk mitigants, including eligibility standards, collateral, and managing exposure. Fannie Mae told us that, after considering mitigants, it would characterize its residual risk as very manageable and very low. Freddie Mac assessed the residual risk of the Enterprise incurring material losses from reinsurance counterparties as low on both an absolute basis and relative to other counterparty types. FHFA expressed that, after application of mitigants, the risk to the Enterprises posed by reinsurers remains relatively low at this point.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this white paper was to provide information on reinsurers and the reinsurance industry and their role in the Enterprises' business as well as Enterprise and FHFA views regarding risks related to reinsurers and corresponding mitigants of those risks. To achieve this objective, we reviewed FHFA and Enterprise documents as well as publicly available documents. The Enterprises use reinsurance in both their single-family and multifamily business lines. This paper focuses on the single-family business; it does not cover other exposure the Enterprises may have to reinsurers, such as when the Enterprises obtain insurance unrelated to mortgage credit risk.

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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