Federal Housing Finance Agency
Office of Inspector General

CohnReznick LLP's Independent Audit of FHFA's Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers

Audit Report • AUD-2014-013 • May 8, 2014

FEDERAL HOUSING FINANCE AGENCY
FHFA OIG
OFFICE OF INSPECTOR GENERAL

At A Glance

May 8, 2014

FHFA's Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers

Why OIG Had CohnReznick Do This Audit

The Housing and Economic Recovery Act of 2008 created the Federal Housing Finance Agency (FHFA or the Agency) in July 2008. FHFA's mission is to provide effective supervision, regulation, and housing mission oversight of Fannie Mae and Freddie Mac (collectively, the Enterprises) to promote their safety and soundness. Since September 2008, both Enterprises have been in FHFA conservatorships with FHFA assuming management responsibilities to preserve and conserve their assets.

The Enterprises are restricted by their charters to only purchase loans with loan-to-value ratios over 80% if the loans include a form of credit enhancement. The Enterprises typically require mortgage insurance underwritten by private mortgage insurers as a credit enhancement to reduce the amount of losses in the event of borrower default. The Enterprises operate in the secondary mortgage market by purchasing residential mortgage loans from lenders, thus receiving the benefit of mortgage insurance. As of June 30, 2013, the Enterprises held over $587 billion in single-family residential mortgage loans insured by private mortgage insurance companies. FHFA as the regulator for Fannie Mae and Freddie Mac has the responsibility to perform oversight of the Enterprises' monitoring of the financial condition of the mortgage insurers with which they conduct business. Additionally, as conservator for the Enterprises, FHFA has management responsibilities and authorities to operate the Enterprises with a focus on preserving and conserving their assets.

In March 2013, FHFA's Office of Inspector General (OIG) contracted with CohnReznick LLP (CohnReznick) to perform an audit of FHFA's oversight of the financial condition of the mortgage insurers used on loans purchased by the Enterprises and their risk exposure.

What CohnReznick Found

CohnReznick found that FHFA has gone through a number of iterations in its oversight and governance structure regarding Enterprise relationships with mortgage insurers in response to the deteriorating financial condition of certain mortgage insurers and the related loss exposure to the Enterprises. In particular, FHFA has actively pursued implementation of new master policy agreements and eligibility requirements for mortgage insurers. CohnReznick concluded that FHFA has opportunities to further strengthen its oversight of

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the Enterprises' monitoring of the financial condition of mortgage insurers and their related risk exposure. Specifically, CohnReznick identified that:

- FHFA can better coordinate oversight of the risk posed by mortgage insurers in a weakened financial condition through issuance of a formal oversight plan that defines the roles and responsibilities of the various FHFA components and the Enterprises in this area. As of June 30, 2013, these distressed mortgage insurers were potentially responsible for up to $49 billion in the event of borrower defaults – over a third of the coverage to both Enterprises.

- FHFA can improve its oversight of the approval of new mortgage insurers. CohnReznick determined that FHFA delegated the approval decision for a new mortgage insurer to the Enterprises. Such delegated approval is limited to counterparties where there are no reasonably foreseeable material increases in operational risk, which is generally not the case for a new mortgage insurer. Additionally, FHFA does not have a formal process for evaluating new mortgage insurers, including Enterprise risk assessments and justification for conditional approval requirements. Given the importance of mitigating the risk posed by new mortgage insurers, the direct involvement of FHFA in the review and approval process would strengthen governance over these decisions.

What CohnReznick Recommends

While FHFA has performed oversight and monitoring of mortgage insurance related activities, there continue to be opportunities for FHFA to enhance these activities. CohnReznick recommends that FHFA take the following actions: (1) establish policies, procedures, and processes to execute FHFA's oversight of the Enterprises' monitoring of business conducted with mortgage insurers; (2) develop specific criteria, and update the letter of instruction accordingly, that classifies new mortgage insurers as non-delegated activities that require FHFA approval; and (3) develop a methodology for FHFA's review of new mortgage insurers and ensure procedures performed are adequately documented and support the conclusions reached during the review.

FHFA generally agreed with the first recommendation but did not provide responsive comments to the second and third recommendations, which OIG considers unresolved.

PREFACE..

This is one in a series of audits, evaluations, and special reports published as part of the Federal Housing Finance Agency (FHFA or Agency) Office of Inspector General's (OIG) oversight responsibilities to promote economy, effectiveness, and efficiency in the administration of FHFA's programs. The objective of this performance audit was to assess FHFA's oversight of the Enterprises' monitoring of the financial condition of mortgage insurers.

OIG contracted with CohnReznick, an independent certified public accounting firm, to conduct this performance audit. CohnReznick is responsible for the attached auditor's report, dated May 2, 2014, and the findings and conclusions expressed in that report. In connection with the contract, OIG reviewed CohnReznick's report and related audit documentation, inquired of its representatives, and performed other monitoring activities in order to fulfill OIG's responsibility to ensure the firm adhered to Generally Accepted Government Auditing Standards (GAGAS). OIG's review found no instances where the firm did not comply, in all material respects, with GAGAS. OIG's review, as differentiated from an audit in accordance with GAGAS, was not intended to enable OIG to report conclusions based on the audit objective.

CohnReznick's audit report makes three recommendations to FHFA to enhance oversight and monitoring procedures related to the risks posed to the Enterprises from conducting business with mortgage insurers. Refer to Appendix A for OIG's evaluation of FHFA's responses to the CohnReznick recommendations. Questions on this report can be directed to the OIG at (202) 730-0880. OIG appreciates the assistance of all those who contributed to the audit.

Russell A. Rau
Deputy Inspector General for Audits

Independent Audit of FHFA's Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers

Fiscal Years September 2008 to May 2013

May 2, 2014

COHNREZNICK

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TRANSMITTAL LETTER

May 2, 2014

Russell A. Rau
Deputy Inspector General for Audits
Office of Inspector General
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, D.C. 20024

Dear Mr. Rau:

We are pleased to submit to you our final report representing the results of our performance audit of the Federal Housing Finance Agency's (FHFA or Agency) Oversight of Fannie Mae's and Freddie Mac's (collectively referred to as "the Enterprises") Monitoring of the Financial Condition of Mortgage Insurers. The objective of this performance audit was to assess FHFA's oversight of the Enterprises' monitoring of the financial condition of mortgage insurers.

We conducted our performance audit in accordance with *Generally Accepted Government Auditing Standards* (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions, based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions, based on our audit objective.

Overall, we found that, while FHFA has performed certain oversight and monitoring of mortgage insurance related activities, there continue to be opportunities for FHFA to enhance these procedures related to the risks posed to the Enterprises from conducting business with mortgage insurers. Additionally, FHFA has the opportunity to ensure the non-delegated authorities, included in the letter of instruction, are specific and encompass Enterprise activities that require FHFA approval.

On April 18, 2014, FHFA provided comments to a draft of this report. FHFA partially agreed with Recommendations 1 and 3 and disagreed with Recommendation 2. FHFA's full response was considered, where appropriate, in finalizing the report.

This performance audit did not constitute an audit of financial statements in accordance with GAGAS. CohnReznick was not engaged to and did not render an opinion on the FHFA's internal controls over financial reporting or over financial management systems. The information included in this report was obtained from FHFA prior to May 2, 2014. We have no obligations to update our report or to revise the information contained therein to reflect events and transactions occurring subsequent to May 2, 2014.

If you have any questions concerning this report, please contact Frank Banda, Partner, at (301)280-1856. We greatly appreciate the opportunity to have performed this audit, as well as the courtesies extended to CohnReznick during the audit.

Sincerely,

CohnReznick LLP

CohnReznick LLP

Bethesda, MD

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CONTEXT

Background

Mortgage Insurers

As of June 30, 2013, the Enterprises conducted business with seven mortgage insurers.[1] In order to qualify to conduct business with the Enterprises, a mortgage insurer must meet the Enterprises' established operating standards, referred to as eligibility requirements. The current versions of the eligibility requirements were effective in 2005 for Fannie Mae and 2008 for Freddie Mac.[2]

The requirements include standards on the mortgage insurers' risk-to-capital ratios and credit ratings, as assigned by Standard and Poor's, Moody's, and Fitch.[3] Additionally, after a mortgage insurer qualifies to conduct business with the Enterprises, it must submit an annual certification of its compliance with the eligibility requirements.[4] A mortgage insurer that does

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1 The audit scope period covered September 2008 to May 2013; however, June 30, 2013, was used as a consistent benchmark since relevant quarterly information was available as of that date. During the scope period, three mortgage insurers were placed into receivership and a new mortgage insurer was added to the list of qualified mortgage insurers.

2 Fannie Mae, *Qualified Mortgage Insurer Approval Requirements* (December 2003). Accessed: March 18, 2014, at www.fanniemae.com/content/eligibility_information/mortgage-insurers-approval-requirements.pdf. Freddie Mac, *Private Mortgage Insurer Eligibility Requirements* (January 2008). Accessed: March 18, 2014, at www.freddiemac.com/singlefamily/pdf/mireqs.pdf.

3 Risk-to-Capital – The ratio of net risk in force an insurer has relative to its total policyholders' surplus.

Freddie Mac, "Glossary," *Private Mortgage Insurer Eligibility Requirements*, at G-6 (January 2008). Accessed: March 18, 2014, at www.freddiemac.com/singlefamily/pdf/mireqs.pdf.

4 Annual Certification – Requirement in the Enterprises' eligibility requirements that states each approved mortgage insurer must submit a Certificate of Compliance by April 15.

Freddie Mac, "Exhibit 3, Annual Certification," *Private Mortgage Insurer Eligibility Requirements*, at E-3 (January 2008). Accessed: March 18, 2014, at www.freddiemac.com/singlefamily/pdf/mireqs.pdf. Fannie Mae, "Maintaining Approval," *Qualified Mortgage Insurer Approval Requirements*, at 4 (December 2003). Accessed:

not comply with these requirements may be suspended or terminated from doing business with the Enterprises, decisions that are left to the Enterprises' discretion. Mortgage insurers must also execute master policy agreements with each lender. The master policy agreements define the terms and conditions of the mortgage insurance between the mortgage insurer and the insured (typically the lender).

As part of the *Conservatorship Strategic Plan: Performance Goals for 2013* (2013 Conservatorship Scorecard), the Enterprises were required to develop uniform master policy agreements and eligibility requirements.[5] On December 2, 2013, FHFA announced that the master policy agreements were aligned and updated to strengthen requirements over the following areas:

- Loss mitigation;
- Claims;
- Assurance of coverage; and
- Enhanced communication.[6]

The new master policy agreements will be filed with the state insurance regulators for review and approval. Upon completion, the new master policy agreements will be executed and effective for all loans purchased by the Enterprises, which FHFA anticipates will occur by mid-2014.

Additionally, as of December 2013, drafts of the revised eligibility requirements are under review by FHFA and the Enterprises. Once this review is complete, the revised drafts will be available for public comment prior to being issued in final form and implemented.

March 18, 2014, at www.fanniemae.com/content/eligibility_information/mortgage-insurers-approval-requirements.pdf.

5 Federal Housing Finance Agency, "Maintain Foreclosure Prevention Activities and Credit Availability for New and Refinanced Mortgages," *Conservatorship Strategic Plan: Performance Goals for 2013*, at 3. Accessed: February 17, 2014, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2013EnterpriseScorecard_508.pdf.

6 Federal Housing Finance Agency, *FHFA Announces Overhaul of Fannie Mae and Freddie Mac Mortgage Insurance Master Policy Requirements* (December 2, 2013). Accessed: February 17, 2014, at http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Overhaul-of-Fannie-Mae-and-Freddie-Mac-Mortgage-Insurance-Master-Policy-Requirements.aspx.

Receivership (Run-off)[7] and Deferred Payment Obligation[8]

State insurance departments regulate mortgage insurers and usually require them to maintain a risk-to-capital ratio of 25:1.[9] When a mortgage insurer can no longer meet the state's risk-to-capital ratio requirements, they may be placed into receivership, or run-off, by the state regulator and may no longer be eligible to conduct new business.

Because of their financial condition and inability to meet the state's minimum risk-to-capital ratio requirement of 25:1, five of the ten mortgage insurers eligible to conduct business with the Enterprises are considered financially weakened (see Table 2, page 9). Additionally, three of the five financially weakened mortgage insurers—PMI Mortgage Insurance Co. (PMI), Triad Guaranty Insurance Corporation (Triad), and Republic Mortgage Insurance Company (RMIC)—are in run-off and no longer able to issue new mortgage insurance policies. Moreover, these mortgage insurers have established deferred payment obligation (DPO) agreements that require a percentage of their claims obligations, to the Enterprises, to be deferred.

New Mortgage Insurers

In January 2013, Fannie Mae and Freddie Mac submitted requests for approval of a new mortgage insurer. Prior to requesting approval from the Agency, the Enterprises conducted independent six- to nine-month reviews of the operations and financial condition of the proposed new mortgage insurer—National Mortgage Insurance Company (National MI).

The Enterprises' reviews of the proposed new mortgage insurer identified various risks, including:

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[7] Receivership (Run-off) – A court order whereby all the property subject to dispute in a legal action is placed under the control of an independent receiver. In this case, the mortgage insurers who could no longer meet the risk-to-capital ratio requirements were placed into run-off by the state regulator. Mortgage insurers in run-off are prevented from conducting new business with the Enterprises.

[8] Deferred Payment Obligations – For mortgage insurers in receivership, the state regulator delays full payment of all claims to ensure all claims receive a partial payment. The unpaid claim balance is referred to as the deferred payment obligation.

[9] Mortgage insurers are generally required to hold a risk-to-capital ratio of at least 25:1 (i.e., for every $25 of risk in force, the mortgage insurer must hold at least $1 of capital) to cover unexpected losses.

United Guaranty, "Background and Scope of Analysis," *RE: Comment on Building a New Infrastructure for the Secondary Mortgage Market*, at 2 (December 3, 2012). Accessed: March 18, 2014, at http://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/Securitization-Infrastructure/12.03.2012.United_Guaranty_FHFA_Comment_Letter_-_12-3-12.PDF.

- The state of Arizona had filed a lawsuit against the new mortgage insurer citing unfair business practices related to current employees (these employees were formerly at a mortgage insurer domicile in Arizona, which is currently under state receivership);
- The new mortgage insurer had not obtained licensing to insure loans in all 50 states and the District of Columbia; and
- The mortgage insurer had no mortgage insurance industry footprint.

Based on their respective reviews, the Enterprises determined that a conditional approval should be given to National MI, of which a selection of the required provisions is included in the following (see Table 1, below):

TABLE 1: NATIONAL MI'S CONDITIONAL APPROVAL REQUIREMENTS

Fannie Mae's Conditions	Freddie Mac's Conditions
National MI must maintain at all times total statutory capital (i.e., policyholder surplus plus statutory contingency reserves) of at least $150 million.	National MI must maintain at all times a minimum $150 million statutory capital, excluding loss reserves.
National MI will not pay any dividends to affiliates or its holding company until December 31, 2015.	National MI can only be involved in standard "plain-vanilla" mortgage products, i.e., only primary first-lien mortgage insurance.
National MI will maintain a risk-to-capital ratio not to exceed 15:1 through December 31, 2015.	National MI must maintain a maximum risk-to-capital ratio of 15:1 for the first three years. Any changes require Freddie Mac's approval.
National MI must obtain Fannie Mae's prior written approval of any risk novation or commutation until December 31, 2015.	All nonstandard (bulk, pool, etc.) transactions must be reported to Freddie Mac for review and approval.

FHFA Oversight

FHFA's Division of Enterprise Regulation (DER) is responsible for the risk-based Enterprise supervision program and is governed by the *Division of Enterprise Regulation Supervision Handbook* (Handbook), updated July 16, 2009, which is currently in its second edition (2.1).[10] The Handbook defines policies and procedures that DER should implement to perform the

[10] Federal Housing Finance Agency, "Background," *Division of Enterprise Regulation Supervision Handbook 2.1*, at 6 (June 16, 2009). Accessed: March 18, 2014, at http://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Documents/DER_Supervision_Handbook_2.1_508.pdf.

requisite supervision and monitoring activities. DER provides oversight of the Enterprises and ensures coordination among all of the FHFA supervisory functions. DER's oversight function includes the management of mortgage insurers by the Enterprises.

DER also plans and conducts examinations of the Enterprises, prepares and issues reports of the examinations, and seeks preventative and corrective actions as appropriate. Examination procedures are comprised of internal and external activities, including financial safety and soundness monitoring. Special reviews/projects are conducted to focus on specific issues of concern in coordination with other supervision functions upon request.[11]

In addition to the Handbook, FHFA also uses the letter of instruction as an oversight and monitoring tool for the Enterprises in conservatorship.[12] The letter of instruction, written by FHFA's Office of the Director, outlines matters that are not delegated to the Enterprises' Boards of Directors and require FHFA approval, as well as matters that require notice to FHFA. The first letter was issued to the Enterprises on November 24, 2008, and was subsequently updated and re-issued on November 15, 2012.

In 2011, FHFA established the Mortgage Insurance Working Group (MIWG) to coordinate information sharing among the various divisions within the Agency involved in mortgage insurance, though the individual divisions continued to work with the Enterprises.[13] MIWG held weekly, monthly, and ad hoc meetings with the Enterprises to discuss mortgage insurance activities and events. MIWG, which was disbanded during July 2013, was not designed to issue directives to the Enterprises or create an oversight plan to address the financial condition of mortgage insurers. Subsequent to the disbandment of MIWG, mortgage

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[11] Federal Housing Finance Agency, "Examination," *Division of Enterprise Regulation Supervision Handbook 2.1*, at 9 (June 16, 2009). Accessed: March 18, 2014, at http://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Documents/DER_Supervision_Handbook_2.1_508.pdf.

[12] Letter of instruction, FHFA Office of the Director, November 15, 2012 – The letter of instruction defines the roles and responsibilities of the Agency, the board of directors, and management at the Enterprises. The first letter was provided to the Enterprises on November 24, 2008; this letter was subsequently updated on November 15, 2012.

[13] MIWG included representatives from the following FHFA divisions: the Office of Strategic Initiatives, Office of Conservator Operations, Office of General Counsel (OGC), Division of Housing Mission and Goals (DHMG), DER, Division of Supervision Policy and Support (DSPS), and Office of Systemic Risk and Market Surveillance.

insurance oversight activities continued with individual divisions within the Agency and the executive Mortgage Insurance Steering Committee.[14]

[14] Established in January 2013, the Mortgage Insurance Steering Committee is responsible for providing guidance to the FHFA divisions for mortgage insurance related matters.

OBJECTIVES

The overall objective of this audit was to assess FHFA's oversight of the Enterprises' monitoring of the financial condition of mortgage insurers. The specific objectives were to assess:

- whether FHFA has evaluated the risks associated with mortgage insurers' financial condition;
- FHFA's oversight efforts regarding the new master policy agreements and eligibility requirements;
- whether FHFA evaluated the Enterprises' requirements for conducting business with new mortgage insurers; and
- whether FHFA assessed whether the Enterprises should be conducting business with mortgage insurers in a weakened financial condition.

FINDINGS ....

1. FHFA Can Further Strengthen Its Oversight of the Risks Posed by Mortgage Insurers to the Enterprises

During the period September 2008 to May 2013, FHFA's annual supervisory plans did not include the risk exposure to the Enterprises from conducting business with financially weakened mortgage insurers. Although FHFA was performing ongoing mortgage insurance related oversight procedures, including targeted examinations and special projects, FHFA should have documented and reported their evaluation of the financial risks to the Enterprises for doing business with mortgage insurers in a weakened financial condition. In addition, FHFA should have issued formal guidance, directives, and/or instructions to the Enterprises for conducting business with mortgage insurers in a weakened financial condition.

FHFA's coordinated oversight of the risks posed by mortgage insurers in weakened financial condition could have been strengthened through the issuance of a formal oversight plan that includes defining roles and responsibilities of the various components of FHFA and the Enterprises. Such an oversight plan should clearly define the policies and procedures used to achieve FHFA objectives concerning Enterprise use of mortgage insurance as a credit enhancement and risk management tool. Well-defined policies and procedures are particularly important as FHFA and the Enterprises proceed with the implementation of new master policy agreements and eligibility requirements for mortgage insurers.

As illustrated in Table 2 (below), as of June 30, 2013, the five financially weakened mortgage insurers represented $202 billion of the $587 billion in Enterprise exposure (about 34%).[15] In addition, the maximum amount of loss recovery from the five financially weakened insurers is

[15] In this case, the exposure relates to insurance in force, which represents the unpaid principal balance of single-family loans in the Enterprises' guaranty books of business covered under the applicable mortgage insurance policies. The five financially weakened mortgage insurers are PMI, RMIC, Triad, Genworth, and CMG.

Fannie Mae "Table 45: Mortgage Insurance Coverage," *Form 10-Q for the Quarterly Period Ended June 30, 2013*, at 72. Accessed: February 17, 2014, at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2013/q22013.pdf. Freddie Mac, "Table 50 — Mortgage Insurance by Counterparty," *Form 10-Q for the Quarterly Period Ended June 30, 2013*, at 83. Accessed: February 17, 2014, at http://api40.10kwizard.com/cgi/convert/pdf/FEDERALHOMELOANMORTGAGECORP-20130807-10Q-20130630.pdf?ipage=9066647&xml=1&quest=1&rid=23&section=1&sequence=-1&pdf=1&dn=1.

$49 billion of a total of $144 billion, which is also about 34%.[16] Given the amount of exposure to mortgage insurers, the Enterprises have identified that they may incur losses as a result of mortgage insurance claims not being paid in full or at all and that there is increased concentration risk due to the smaller pool of financially sound insurers. [17]

TABLE 2. ENTERPRISE RISK EXPOSURE FOR EACH MORTGAGE INSURER AS OF JUNE 30, 2013

Counterparty	Financial Condition[18]	Insurance in Force ($ in billions)[19]	Risk in Force ($ in billions)[20]
PMI Mortgage Insurance Co. (PMI)	Run-off (managed by the court since 8/4/11)	$49.10	$12.00
Republic Mortgage Insurance Company (RMIC)	Run-off (managed by the state since 1/19/12)	$40.40	$9.60
Triad Guaranty Insurance Corporation (Triad)	Filed for bankruptcy[21]	$14.70	$3.60
Genworth Mortgage Insurance Corporation (Genworth)	Financially weakened	$83.50	$20.70

[16] In this case, the maximum amount of loss recovery relates to risk in force.

Fannie Mae, "Table 45: Mortgage Insurance Coverage," *Form 10-Q for the Quarterly Period Ended June 30, 2013*, at 72. Accessed: February 17, 2014, at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2013/q22013.pdf.
Freddie Mac, "Table 50 — Mortgage Insurance by Counterparty," *Form 10-Q for the Quarterly Period Ended June 30, 2013*, at 83. Accessed: February 17, 2014, at http://api40.10kwizard.com/cgi/convert/pdf/FEDERALHOMELOANMORTGAGECORP-20130807-10Q-20130630.pdf?ipage=9066647&xml=1&quest=1&rid=23&section=1&sequence=-1&pdf=1&dn=1.

[17] Fannie Mae, "Risks Relating to Our Business," *Form 10-K for the Fiscal Year Ended December 31, 2011*, at 67, 68. Accessed: February 17, 2014, at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2011/10k_2011.pdf.

[18] Per Fannie Mae's June 30, 2013 financial statements, the mortgage insurers listed as financially weakened were in need of capital infusions to meet the regulatory capital in their domicile states.

[19] Insurance in force represents the unpaid principal balance of single-family loans in the Enterprises' guaranty books of business covered by the respective mortgage insurer.

[20] Risk in force is the maximum coverage on single-family loans in the Enterprises' guaranty books of business and represents the maximum potential loss recoverable from the applicable mortgage insurer.

[21] Phil Milford, Bloomberg, *Insurer Triad Guaranty Files for Bankruptcy Protection* (June 4, 2013). Accessed: March 18, 2014, at www.bloomberg.com/news/2013-06-04/insurer-triad-guaranty-files-for-bankruptcy-protection.html.

Counterparty	Financial Condition	Insurance in Force ($ in billions)	Risk in Force ($ in billions)
CMG Mortgage Insurance Company (CMG)	Financially weakened - Undergoing acquisition[22]	$13.80	$3.30
Radian Guaranty, Inc. (Radian)	Better financial standing[23]	$126.10	$31.00
Mortgage Guaranty Insurance Corporation (MGIC)	Better financial standing[21]	$125.80	$31.10
United Guaranty Residential Insurance Company (UGIC)[24]	Better financial standing	$113.00	$28.20
Essent Guaranty, Inc. (Essent)	Better financial standing	$19.20	$4.60
National Mortgage Insurance Corporation (National MI)	Newly approved (January 2013)	$0.00	0.00
Other		$1.00	$0.20
Total		**$586.60**	**$144.30**

The failure of mortgage insurers to meet contractual requirements can result in substantial risk of loss to the Enterprises. Recent FHFA experience in efforts to mitigate this risk have included the implementation of an array of additional safeguards in the Enterprises' selection of and continuing relationships with mortgage insurers. Clearly established and enforced policies, procedures, and processes can help ensure the success of these oversight procedures.

[22] PMI and CUNA Mutual Group jointly own CMG. As of February 2013, Arch U.S. Mortgage Insurance, a U.S. subsidiary of the Bermuda-based Arch Capital Ltd., is working on an agreement to acquire all equity interest in CMG from PMI and CUNA Mutual Group. On January 30, 2014, Arch Capital completed the acquisition of CMG; the new company is Arch Mortgage Insurance Company.

Arch Mortgage Insurance, *Arch Capital Group Ltd. Announces Closing of Acquisition of CMG MI and PMI's Operating Platform*. Accessed: March 18, 2014, available at http://phx.corporate-ir.net/phoenix.zhtml?c=74599&p=irol-newsArticle&ID=1895458&highlight.

[23] As of December 2012, Radian and MGIC were deemed financially distressed; however, as per Fannie Mae's June 2013 quarterly financial statements, Radian and MGIC were able to secure enough capital to meet the state's risk-to-capital requirements and are no longer considered financially distressed.

[24] Per FHFA, UGIC losses were covered by agreements with its parent company (AIG) who received Troubled Asset Relief Program funds.

2. FHFA Should Establish Criteria Defining the Review and Approval of New Mortgage Insurers

Although Fannie Mae rated the approval of the new mortgage insurer, National MI, as a high-risk event, FHFA delegated approval of the new mortgage insurer to the Enterprises. This was based upon the letter of instruction clause stating conservator approval is not required for matters deemed to be within the Enterprises' delegated authority.

Although the letter of instruction allows delegation of authority for the approval of new counterparties, it also includes the following provision that requires FHFA approval: "Increases in Board [of Directors] risk limits, material changes in accounting policy, and reasonably foreseeable material increases in operational risk."[25] FHFA contends that their review process was performed in conjunction with the Enterprises and was adequate to ensure all risks were controlled, including operational risk. FHFA has not clearly defined which Enterprise activities constitute a "reasonably foreseeable material increase in operational risk."

Further, FHFA's Single-Family Credit Risk Management Module states, "the failure of any significant counterparty to meet its obligations to an enterprise could have a material adverse effect on an enterprise's results of operations, financial condition, and ability to conduct future business. … A failure by an enterprise to manage exposure to financially weakened counterparties could further increase credit risk and losses."

Despite the initial concerns identified by the Enterprises, which resulted in the conditional approval requirements, FHFA did not document their comprehensive evaluation to determine whether the Enterprises' review processes identified all potential risks or whether the conditional approval requirements mitigated those risks.

The Enterprises may engage in transactions that increase their insurance risk exposure. For example, FHFA's 2013 Conservatorship Scorecard includes as Goal Two, with a 50% weight, that "each enterprise will demonstrate the viability of multiple types of risk transfer transactions involving single family mortgages with at least $30 billion of unpaid principal balances in 2013."[26] National MI and Fannie Mae entered into a risk-sharing transaction, which involves over $5 billion in unpaid principal balances on single-family loans.

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[25] Letter of Instruction, FHFA Office of the Director, November 15, 2012 –The letter of instruction defines the roles and responsibilities of the Agency, the board of directors, and management at the Enterprises. The first letter was provided to the Enterprises on November 24, 2008, and was subsequently updated and re-issued on November 15, 2012.

[26] Federal Housing Finance Agency, "Contract the Enterprises Dominant Presence in the Marketplace While Simplifying and Shrinking Certain Operations," *Conservatorship*

As conservator, FHFA has the responsibility for ensuring significant Enterprise business decisions are adequately reviewed and approved. Due to the volatile nature of the mortgage insurance industry and financial stability concerns throughout the financial crisis, FHFA should consider evaluating whether the risks posed to the Enterprises by mortgage insurers is significant enough to require FHFA approval over new mortgage insurers.

Strategic Plan: Performance Goals for 2013, at 2. Accessed: February 17, 2014, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2013EnterpriseScorecard_508.pdf.

CONCLUSIONS

While FHFA has performed certain oversight and monitoring of mortgage insurance related activities, there continue to be opportunities for FHFA to enhance these procedures related to the risks posed to the Enterprises from conducting business with mortgage insurers. Additionally, FHFA has the opportunity to ensure the non-delegated authorities, included in the letter of instruction, are specific and encompass Enterprise activities that require FHFA approval.

RECOMMENDATIONS

CohnReznick recommends that FHFA take the following actions:

1. Establish policies, procedures, and processes to execute FHFA's oversight of the Enterprises' monitoring of business conducted with mortgage insurers. These policies should provide for the coordinated involvement of necessary FHFA divisions and define their roles and responsibilities in matters pertaining to managing risks to the Enterprises associated with mortgage insurers;

2. Develop specific criteria, and update the letter of instruction accordingly, that classifies new mortgage insurers as non-delegated activities that require FHFA approval; and

3. Develop a methodology for FHFA's review of new mortgage insurers and ensure procedures performed are adequately documented and support the conclusions reached during the review.

SCOPE AND METHODOLOGY ....

Scope

The period covered by CohnReznick's audit was from September 2008 through May 2013. CohnReznick performed fieldwork from April 2013 through January 2014 at FHFA's offices in Washington, DC; Fannie Mae's headquarters in Washington, DC; and Freddie Mac's headquarters in McLean, Virginia.

General Methodology

To achieve its objectives, CohnReznick performed the following procedures:

- Interviewed FHFA and Enterprise personnel to gain an understanding of the oversight and evaluation procedures in place and of the financial condition of mortgage insurers;

- Reviewed Enterprise documentation submitted to FHFA regarding the financial condition of mortgage insurers;

- Reviewed FHFA examinations procedures and results, including remediation activities, related to the financial condition of the mortgage insurers and risk exposure to the Enterprises; and

- Evaluated FHFA's activities related to interaction with state regulators for the mortgage insurers in run-off/receivership, mitigation of Enterprise risk exposure, and identification of opportunities where DPOs could be improved.

CohnReznick assessed the reliability of data received for this audit as determined necessary by corroborating the information with other source data and considered the risk of fraud as it relates to the audit objective.

CohnReznick assessed the internal controls related to the audit objective. Specifically, CohnReznick evaluated the control standards that were significant to the audit objective, including control activities and monitoring.

CohnReznick conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed such that sufficient, appropriate evidence is obtained to provide a reasonable basis for the findings and conclusions, based on the audit objective. CohnReznick believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on the audit objectives.

APPENDIX A ....

OIG's Response to FHFA's Comments

On April 18, 2014, FHFA provided comments to a draft of this report. FHFA partially agreed with recommendations 1 and 3 and disagreed with recommendation 2. Regarding recommendation 1, FHFA identified responsive corrective action sufficient to resolve the recommendation. FHFA actions regarding recommendations 2 and 3 are not sufficient to resolve these recommendations. OIG requests that FHFA reconsider its position on recommendations 2 and 3 and provide additional comments within 30 days of the issuance of this report. OIG has attached FHFA's full response as Appendix B and CohnReznick considered it where appropriate in finalizing this report. Appendix C provides a summary of the Agency's response to CohnReznick's recommendations and the status of corrective actions.

With respect to recommendation 1, FHFA responded that it will enhance inter-divisional coordination on issues related to Enterprise engagement with mortgage insurers through existing forums used by FHFA's supervision and conservatorship divisions. Specifically, by November 15, 2014, FHFA agreed to establish processes to incorporate mortgage insurance issues into the proceedings of existing senior-level Agency forums to ensure sharing and review of mortgage insurance information on a regular basis. OIG considers FHFA's response to recommendation 1 to be sufficient to resolve the recommendation, which will remain open until OIG reviews the new processes and proceedings.

Recommendation 2 requested that FHFA classify the use of new mortgage insurers as non-delegated activities that require FHFA approval and that it update its letters of instruction to the Enterprises accordingly. FHFA responded that it continues to believe that the responsibility to assess, manage, and approve counterparties, including new mortgage insurers, rests with the Enterprises. FHFA stated that, as conservator, it has provided the Enterprises with broad delegated authority to conduct day-to-day operations although it continually assesses changes that may be necessary to those delegations. FHFA further stated that oversight and monitoring of mortgage insurers occurs throughout FHFA even though approval authority is delegated.

In response to FHFA's comments, OIG points out that applying to mortgage insurers the "one size fits all" approach used in FHFA's current delegation of counterparty approval authority to the Enterprises does not take into consideration such key factors as: (1) the combined financial and operational risk to both Enterprises associated with the addition of a new mortgage insurer that could in turn be doing business on a nationwide basis with numerous

Enterprise sellers,[27] (2) the potential for inconsistent approval conditions being required by each Enterprise in the course of its separate approval processes for new mortgage insurers,[28] and (3) possible concerns of other federal and state regulators regarding the prospective mortgage insurer under consideration.[29] Additionally, FHFA has in other instances established thresholds for approval of certain transactions and revisited its conservator delegations to the Enterprises to help ensure proper oversight of Enterprise operations.[30]

Although FHFA stated it continually assesses the need for changes in its delegated approval authority to the Enterprises, it has not indicated a willingness to do so with regard to the approval of new mortgage insurers. OIG does not consider approval of a new mortgage insurer to be part of the routine day-to-day operations of the Enterprises—there are less than a dozen mortgage insurers in business with the Enterprises and only one has been approved in recent history. As noted in the audit report, the Enterprises' financial exposure to mortgage insurers is over $145 billion and some of the insurers are financially stressed. OIG considers it important for FHFA as conservator to ensure appropriate due diligence on the part of each Enterprise in the assessment of new mortgage insurers. However, individual Enterprise analyses should be complemented by FHFA assessment of the risk across both Enterprises that collectively provide well over half of the liquidity available in the secondary mortgage market and rely on mortgage insurance to mitigate some of the associated credit risk. FHFA, rather than each Enterprise, is best-positioned to assess the industry-wide and cross-Enterprise risks because of its insight into both Enterprises, which remain entirely separate corporate

[27] OIG's view is that each Enterprise individually cannot thoroughly assess the overall financial and operational risk posed to both Enterprises collectively by the addition of a new mortgage insurer. FHFA involvement is needed to facilitate analysis across both Enterprises of such factors as the impact of conditional approval requirements established by the Enterprises, potential insurance in force, projected claims volume and settlement amounts, and capital and liquidity sufficiency.

[28] As shown in the audit report, each Enterprise established different conditions in some cases.

[29] As noted in the audit report, mortgage insurers are approved and regulated by state authorities that may be in possession of information directly related to consideration of a new mortgage insurer. Additionally, federal banking agencies that supervise and regulate insured depository institutions perform examinations that can identify adverse conditions regarding third-party relationships, including those with mortgage insurers that pose risk to the institution. FHFA has worked to establish relationships with these other regulators to facilitate information sharing.

[30] In OIG's audit report, *FHFA's Conservator Approval Process for Fannie Mae and Freddie Mac Business Decisions*, OIG found that FHFA did not require conservator approval for various major business such as transfers of mortgage servicing rights for over 700,000 loans and increases in counterparty risk limits exceeding $500 billion (AUD-2012-008, September 27, 2012). Additionally, the report noted that the Enterprises were not requesting approvals even where required, including with regard to mortgage insurance settlements in excess of $50 million. Among other things, OIG recommended FHFA revisit its delegations of authority to ensure significant business decisions receive conservator approval and strengthen controls in the approval process. FHFA generally agreed with OIG's recommendations.

entities even in conservatorship.[31] As a result, OIG considers FHFA's comments to recommendation 2 to be nonresponsive and the recommendation unresolved.

Concerning recommendation 3, FHFA cited work on the establishment of new minimum eligibility standards for private mortgage insurers that intend to do business with the Enterprises. FHFA stated that these standards will be made available for public comment this summer. FHFA also stated it will remain informed of approvals of prospective mortgage insurance entrants through Enterprise notification and FHFA review of Enterprise approvals to ensure consistent application of the new standards.

OIG agrees that new industry standards for private mortgage insurer eligibility are needed and that FHFA should be reviewing implementation of the new standards. However, OIG believes additional action is necessary to develop a methodology for FHFA review of new mortgage insurers. Such a methodology should: (1) enforce the new standards, (2) include steps to help ensure compliance with new master policy agreements, (3) define the roles and responsibilities of FHFA and the Enterprises in assessing prospective mortgage insurers, and (4) provide for monitoring of mortgage insurers' compliance, and determining the need for remedial actions if needed.

In response to recommendation 3, FHFA indicated that it would be relying on after-the-fact reviews of Enterprise approval decisions for mortgage insurers to ensure consistent application of the new standards rather than also performing upfront reviews using a standard methodology. Given the dollar magnitude of decisions regarding new mortgage insurers, OIG considers both upfront and after-the-fact reviews to be essential components of a sound internal control structure for these decisions. Because FHFA did not agree to develop a methodology governing review of new mortgage insurers inclusive of documentation requirements or propose sufficient alternative corrective actions (including estimated completion dates), OIG considers FHFA's comments to be nonresponsive and recommendation 3 to be unresolved.

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[31] OIG has previously reported on a general theme it has observed of FHFA as conservator deferring key decisions to the Enterprises rather than proactively engaging in the review and approval process. In OIG's sixth *Semiannual Report to the Congress*, OIG stated that it has repeatedly found significant instances in which FHFA, in its capacity as conservator, displayed undue deference to enterprise decision-making (October 31, 2013). OIG noted that some matters are sufficiently important to warrant greater FHFA involvement.

APPENDIX B……………………………………………………………………

FHFA's Comments on the Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Russell A. Rau, Deputy Inspector General for Audits

FROM: Nina A. Nichols, Acting Deputy Director, Division of Enterprise Regulation
Wanda DeLeo, Deputy Director, Division of Conservatorship

SUBJECT: Audit Report: *FHFA's Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers* (Audit Assignment AUD-2013-011)

DATE: April 18, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations resulting from the Audit Report prepared for FHFA-OIG under contract with an outside firm: *FHFA's Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers* (Audit Assignment AUD-2013-011). The audit report discusses OIG contractor findings regarding opportunities for FHFA to strengthen its oversight procedures of Enterprise monitoring of the financial condition of current mortgage insurers and consideration of new mortgage insurers.

This memorandum: (1) identifies FHFA management's agreement and/or disagreement with the recommendations; and (2) identifies the actions that FHFA will take in response to the recommendations.

General

FHFA concurs that this is an important topic, and consequently, FHFA has devoted substantial attention to addressing the risks that financial weakness in the mortgage insurance industry could present to the Enterprises. FHFA welcomes FHFA-OIG's feedback on opportunities to strengthen our internal processes for addressing these risks.

Recommendation 1: Establish policies, procedures, and processes to execute FHFA's oversight of the Enterprises' monitoring of business conducted with mortgage insurers. These policies should provide for the coordinated involvement of necessary FHFA divisions and define their roles and responsibilities in matters pertaining to managing risks to the Enterprises associated with mortgage insurers.

Management Response to Recommendation 1: Partially Agree. Several divisions are engaged in aspects of FHFA's oversight of the Enterprises' business engagement with mortgage insurers. While each division has established policies and procedures for its activities, there is opportunity to improve coordination and information sharing among the FHFA divisions engaged in different functions with respect to the Enterprises' engagement with mortgage insurers.

The Division of Enterprise Regulation (DER) has responsibility for monitoring the safety and soundness of the Enterprises, consistent with supervisory guidance issued by the Division of Supervision Policy and Support. DER and DSPS do not manage risks to the Enterprises; rather, they provide independent oversight and evaluation of the Enterprises' own risk management relating to engagement with mortgage insurers. FHFA's Division of Conservatorship supports the authority of the Conservator in reviewing and approving Enterprise business and risk decisions relating to mortgage insurers, pursuant to the letter of instruction. The Division of Housing Mission and Goals has responsibility for setting broad policies for how the Enterprises must manage risk relating to mortgage insurers; these may be issued as directives to the Enterprises under Conservatorship authority.

In response to this recommendation, FHFA will enhance inter-divisional coordination on issues relating to Enterprise engagement with mortgage insurers by utilizing existing forums for communication. FHFA will incorporate mortgage insurer issues as a regular topic at senior-level meetings for both Supervision and Conservatorship to ensure coordination and information sharing within FHFA. Mortgage insurer issues will be included regularly on the agenda of the Supervision Committee, as well as Conservatorship Governance Committee. By November 15, 2014, both of these forums will have established processes to incorporate mortgage insurer issues into their proceedings to ensure executive-level information sharing and review on a regular basis.

Recommendation 2: Develop specific criteria, and update the letter of instruction accordingly, that classifies new mortgage insurers as non-delegated activities that require FHFA approval.

Management Response to Recommendation 2: Disagree. FHFA, as Conservator, has consistently articulated to the FHFA-OIG that the Board of Directors, standing Committees of the Board, and senior management of the Enterprises are provided broad delegated authority to operate the day-to-day operations of the business. FHFA, as Conservator, has clearly articulated those items that are excepted from this delegated authority, where the Enterprises' Boards and management must seek FHFA Conservator approval, through the Letter of Instruction dated November 15, 2012 (original version November 2008). While FHFA continues to assess changes to the excepted delegations, we continue to believe that the responsibility to assess, manage, and approve counterparties is the direct responsibility of the Enterprises.

FHFA further believes that appropriate oversight and monitoring of mortgage insurers occurs throughout FHFA, regardless of whether this is an excepted delegation or not. As communicated to the FHFA-OIG, FHFA is actively involved in transactions involving mortgage insurance counterparties. The existing notification processes for these types of transactions serve to bring these issues before senior executives across divisions through the Conservatorship Governance Committee. This process further allows FHFA to alter oversight practices, as warranted by changing conditions with particular mortgage insurers or in the industry. As is the case of financially constrained mortgage insurers, FHFA's ongoing discussions with the Enterprises of MI emerging issues, our review and assessment of the Enterprise's decision processes for individual transactions, and our establishment of future standards for the MI industry all demonstrate heightened and appropriate oversight of this delegated decision authority. Further, FHFA's supervisory examination of counterparty practices at the Enterprises further informs FHFA of Enterprise decisions and oversight of mortgage insurers.

Recommendation 3: Develop a methodology for FHFA's review over new mortgage insurers and ensure procedures performed are adequately documented and support the conclusions reached during the review.

Management Response to Recommendation 3: Partially Agree. As communicated to the FHFA-OIG throughout the course of this audit, FHFA is working with the Enterprises to establish clear new industry standards, "Private Mortgage Insurer Eligibility Requirements" (PMIERs) that prescribe minimum eligibility requirements for mortgage insurers who wish to do business with the Enterprises, including prospective mortgage insurer entrants. FHFA will remain informed through notification and review of these approvals to ensure consistent application. A draft of the PMIERs is complete and is under pre-review by state insurance regulators. FHFA plans to seek public input on the PMIERs by early summer.

For other types of mortgage insurance transaction undertaken by the Enterprises, FHFA will continue to review, discuss and assess the Enterprise's decisions to assess risks and determine whether or not additional Conservator action is needed. As is our current practice, documentation of FHFA's review and assessment will be maintained. The extent of the documentation will remain consistent with the complexity of the transaction and the determination of additional Conservator action, if needed.

APPENDIX C..

Summary of Management's Comments on the Recommendations

This table presents management's response to the recommendations in the OIG report and the status of the recommendations as of when the report was issued.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved Yes or No[a]	Open or Closed[b]
1.	FHFA partially agreed with the establishment of policies, procedures, and processes to execute its monitoring of mortgage insurers. However, FHFA stated that it will enhance its existing coordination among divisions responsible for mortgage insurance oversight. This action, in response to recommendation 1, can result in responsive action to this recommendation.	11/15/2014	$0	Yes	Open
2	FHFA disagreed with the revision of its letters of instruction to classify the approval of new mortgage insurers as a non-delegated activity. FHFA's response did not provide actions that address the substance of this recommendation, or propose alternative correction actions, with estimated completion dates. Therefore, OIG considers FHFA's response to recommendation 2 to be nonresponsive and unresolved.	Not Provided	$0	No	Open
3	FHFA partially agreed with the development of a methodology to review new mortgage insurers and ensure that procedures performed and conclusions reached are adequately documented. FHFA stated it will continue to review Enterprise decisions with regard to mortgage insurers in the context of its existing practices and maintain its current documentation standards. As FHFA did not agree to develop a methodology governing review of new mortgage insurers inclusive of documentation requirements or propose sufficient alternative corrective actions (including estimated completion dates),	Not Provided	$0	No	Open

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved Yes or No[a]	Open or Closed[b]
	OIG considers FHFA's comments to be nonresponsive and recommendation 3 is unresolved.				

[a] Resolved means: (1) management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) management agrees to the OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

[b] Once OIG determines that agreed-upon corrective actions have been completed and are responsive, the recommendations can be closed.

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