Integrated Mortgage Insurance (IMAGIN) Pilot

Over the last few months, Freddie Mac has provided briefings on IMAGIN to industry groups, media and congressional staff. Arch Mortgage Risk Transfer (MRT), our partner in this pilot, also has provided briefings and other materials to inform interested parties. This factsheet captures and expands on the information Freddie Mac has shared to date, further explaining the purpose of IMAGIN and the benefits it can provide to lenders, borrowers and taxpayers.

Summary of IMAGIN

Freddie Mac's Integrated Mortgage Insurance (IMAGIN) pilot features **an enhanced form of mortgage insurance** (MI) designed to attract additional sources of private capital to support low down payment lending, while enabling better management of taxpayer exposure to our mortgage and counterparty risks. We are offering IMAGIN in partnership with Arch Mortgage Risk Transfer (MRT), an affiliate of Arch Capital Group, which is currently the largest MI provider.

Participating lenders can choose IMAGIN or traditional MI at their discretion.

Under IMAGIN, Arch MRT initially provides Charter-compliant MI on high-LTV loans. In turn, each loan is reinsured by a panel of Freddie Mac-chosen and -approved insurers/reinsurers. The allocation of risk among panel members is determined by Freddie Mac, which also has the contractual right to seek reimbursement for unpaid claims directly from panel members. In this way, Freddie Mac can fully manage the counterparty risk of MI coverage.

Other key features of this enhanced design are:

- Panel members must meet stringent standards that include: (1) counterparty creditworthiness superior to the minimum requirements of the Private Mortgage Insurer Eligibility Requirements (PMIERs), plus (2) partial collateralization of exposure (with the level of collateralization tiered to reflect counterparty creditworthiness), plus (3) minimum diversification requirements.

- The panel members agree to use Freddie Mac credit guidelines and approvals and have no ability to separately rescind coverage or deny claims. As a result, they do not have additional and duplicative requirements of their own, and Freddie Mac no longer has any risk that the insurance on individual loans it has guaranteed can be rescinded or denied. Moreover, due diligence by panel members provides broad market discipline to help ensure Freddie Mac's credit box and policies are well designed and operated.

- Affiliates of traditional MI companies can qualify to be included on the panel as they have an exemption from the diversification requirements applied to other panel members.

Pilot participants: We expect the pilot to include a broad range of Freddie Mac sellers, with most participants to be regional and community lenders. Should IMAGIN be approved by the Federal Housing Finance Agency (FHFA) as a standard offering, it would be available to all Freddie Mac sellers.

Review and Approval: IMAGIN was reviewed and approved by FHFA.

Scope: The pilot is subject to further FHFA review after 12 months. FHFA also will monitor volume. And, as conservator, FHFA has ongoing review authority over all GSE activities.

Policy Background

FHFA has prioritized reducing taxpayers' exposure to GSE risks, which are concentrated in residential mortgages. For example, each FHFA Scorecard since 2013 has set credit risk transfer (CRT) targets and instructed the GSEs to explore additional methods of risk transfer. IMAGIN is one such additional form of CRT.

The experience of the financial crisis led to a review of the traditional MI business model that identified key structural opportunities for improvement, as identified further below.

- PMIERs, issued in 2015, was a first step in improving the safety and soundness of traditional MI. It did this by requiring somewhat improved creditworthiness levels and stronger contract terms. FHFA is in the process of developing enhancements to PMIERs.

- IMAGIN is an additional and complementary approach that improves upon traditional MI by using a redesigned structure that reduces counterparty and concentration risks and delivers other benefits, discussed more below. It also expands and diversifies the sources of private capital supporting low down payment lending.

As background, Freddie Mac's Charter requires it to use one of three types of credit enhancements on loans with less than a 20 percent down payment.[1] Insurance is one such type of credit enhancement, and traditional MI is simply one type or structure of such insurance.

Traditional MI became the market standard in an earlier regulatory era and emerged prior to the financial crisis as nearly the sole credit enhancement Freddie Mac used to satisfy Charter requirements for low down payment lending. IMAGIN provides an additional structure for Charter-compliant MI, increasing stability and affordability.

Freddie Mac first introduced the enhanced design structure of IMAGIN in our Agency Credit Insurance Structure (ACIS) CRT offering, which has been used extensively across all down payment levels. We have completed 38 ACIS transactions since 2013, transferring more than $10.2 billion of credit risk on approximately $1.1 trillion of unpaid principal balance (UPB). As a result, the enhanced design structure is well-tested.

Benefits

IMAGIN cuts costs, levels the playing field for lenders and expands access to credit. It also reduces risk to Freddie Mac, taxpayers and the broader housing finance system.

IMAGIN cuts costs and levels the playing field for lenders

- By eliminating selective traditional MI pricing discounts via discounted monthly and single premium policies, IMAGIN supports a level playing field among lenders of all sizes. Combined with Freddie Mac's previous elimination of pricing by lender size or volume, IMAGIN may improve the competitive position of participating smaller lenders.

- IMAGIN eliminates duplicative processes that require lenders to submit individual loan documents and data to mortgage insurers for underwriting and quality control reviews. It also reduces the costs of mortgage insurers associated with their marketing directly to lenders. As a result, it can save time and lower costs for lenders.

[1] "No conventional mortgage secured by a property comprising one-to-four-family dwelling units shall be purchased under this section if the outstanding principal balance of the mortgage at the time of purchase exceeds 80 per centum of the value of the property securing the mortgage, unless (A) the seller retains a participation of not less than 10 per centum in the mortgage; (B) for such period and under such circumstances as the Corporation may require, the seller agrees to repurchase or replace the mortgage upon demand of the Corporation in the event that the mortgage is in default; or (C) **that portion of the unpaid principal balance of the mortgage which is in excess of such 80 per centum is guaranteed or insured by a qualified insurer as determined by the Corporation.**" (12 USC § 1454(a)(2)) (Emphasis added)

IMAGIN expands <u>access to credit</u>

- By reducing lender costs, IMAGIN can enable lenders to lower mortgage costs for borrowers. That will particularly help first-time homebuyers and some borrowers who do not readily qualify for credit approval.

- IMAGIN eliminates independent MI rescissions and denials, thereby increasing certainty of coverage. This should make lenders more willing to lend to low down payment borrowers.

- IMAGIN attracts additional, diverse and more efficient sources of private capital to low down payment lending, increasing stability and affordability in that market segment.

IMAGIN <u>reduces risk to Freddie Mac, taxpayers and the broader housing finance system</u>

- IMAGIN distributes credit risk away from Freddie Mac, mainly to diversified entities. This helps protect the company, taxpayers and the housing finance system.

- IMAGIN is specifically designed to address structural issues related to the stability of traditional MI that were revealed in the financial crisis and caused Freddie Mac, and thus taxpayer, losses. Those issues include:

  "Wrong-way" risk. IMAGIN helps Freddie Mac manage the risk associated with a mortgage monoline GSE being insured by a mortgage monoline insurer. Specifically, both the GSEs and mortgage insurers are exposed to residential mortgage credit risk. As a result, the insurers are likely to suffer from capital stress at precisely the moment the GSEs need them most to fulfill their obligations – exactly what happened in the financial crisis.

  U.S. financial regulators have expressed significant concerns about wrong-way risk and seek to limit it. For this reason, bank capital rules do not recognize insurance policies issued by private mortgage insurers as eligible credit risk mitigation tools for purposes of determining risk-based capital requirements.[2]

  Counterparty reimbursement risk. IMAGIN reduces the risk that MI claims will not be paid in full and on time by requiring: (1) counterparty creditworthiness stronger than the minimum required by PMIERs (as reflected in public credit ratings and also Freddie Mac's own counterparty review); plus (2) partial collateralization of risk exposure (tiered by counterparty creditworthiness), which traditional MI does not have; plus (3) requirements that counterparties be diversified rather than monolines (excepting affiliates of mortgage insurers); plus (4) alignment of MI approvals, rescissions and denials with Freddie Mac's processes. As one example of the latter, traditional MI policies need not, and usually do not, cover borrower defaults when homes are damaged by hurricanes and other natural disasters. In contrast, after deducting disaster-related losses to the properties, insurers under IMAGIN are obligated to pay those claims.

  Safety-and-soundness. IMAGIN allows Freddie Mac to fully control with whom and in what amount it has counterparty risk, a standard safety-and-soundness requirement. Having this flexibility is critical in avoiding excessive concentration of risk in any one mortgage insurer. In contrast, traditional MI only permits minimal and binary counterparty risk management for new loans, with either potentially unlimited exposure (if the insurer is qualified under PMIERs) or zero exposure (if not).

  Reduced implied subsidy. Under FHFA's proposed capital requirements, the GSEs would be required to hold capital against their large counterparty credit exposure to traditional MI providers. As Freddie Mac would receive no compensation for this exposure, it generates an implied subsidy to mortgage insurers. IMAGIN, with its significantly better counterparty creditworthiness, mostly diversified counterparties and partial collateralization, produces a much lower implied subsidy.

We hope this information is helpful to those seeking to understand the IMAGIN pilot.

[2] See Regulatory Capital Rules (Federal Reserve and OCC), 78 Fed. Reg. 62018, 62104 (Oct. 11, 2013)