Federal Housing Finance Agency
Office of Inspector General

Interconnectedness of Enterprise Counterparties with a Common Parent Company

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Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) have a large number of counterparties across their business lines. As a result, they are exposed to counterparty credit risk, which, according to the Federal Housing Finance Agency (FHFA or Agency), is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness. In addition, Enterprise counterparties can be interconnected in a variety of ways. Interconnectedness may increase risk to the Enterprises. This white paper focuses on interconnectedness of Enterprise counterparties with a common parent company. For example, a parent company might have a mortgage insurance subsidiary as well as a reinsurance subsidiary.

Fannie Mae considers counterparty interconnectedness 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. Fannie Mae identified several key underlying risks in this area, including the interconnectedness of counterparties with a common parent company. Fannie Mae assessed the risk trend of counterparties with a common parent company as increasing, telling us that contributing factors include trends in the reinsurance and mortgage banking sectors. Freddie Mac told us that it considers its risk associated with interconnectedness of counterparties with a common parent company to be stable because the Enterprise was operating within established risk limits. FHFA told us that interconnectedness risk can be considered in a narrow sense as it relates to the legal and organizational structure of counterparties or more broadly including systemic and concentration risks. The Agency said that it views the risk in the narrow sense as relatively low for both Enterprises and that the trend was stable for both Enterprises.

Both Enterprises expressed that they were not aware of any credit-related losses due to parent company interconnectedness within the past five to seven years. FHFA and both Enterprises provided examples of ways the Enterprises mitigate the risk of interconnectedness of Enterprise counterparties with a common parent company.

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ABBREVIATIONS

Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

As explained in a recent Securities and Exchange Commission staff report, U.S. credit markets are interconnected, and the actions of various entities in one market can affect other markets and the financial system more generally. According to an International Monetary Fund staff report, interconnectedness can arise from direct linkages, such as direct balance sheet exposures, or indirect linkages, such as exposure to common assets.

Interconnectedness in the mortgage market can occur in various ways. For example, FHFA explained to us that complexity of the Enterprises' seller/servicer relationships could be interpreted as including interconnectedness in the context of counterparty risk management, and there is also broader systemic interconnectedness. Interconnectedness can also arise when counterparties have a common parent company. For example, a parent company might have a mortgage insurance subsidiary as well as a reinsurance subsidiary, and a "family" could include both a seller/servicer and a broker/dealer.

Each Enterprise has a large number of counterparties across all business lines. 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. An FHFA official told us that the largest counterparties generally have parent or subsidiary relationships with other entities. Fannie Mae further explained that the largest counterparty families typically engage in activities or transactions across the Enterprise's single-family, multifamily, and capital markets business lines. The failure of a parent company or a large entity within an interconnected family grouping that provides implicit or explicit support for entities across the family could weaken those other entities and increase losses for the Enterprise.

This white paper describes FHFA and Enterprise views of the risks associated with the interconnectedness of Enterprise counterparties with a common parent company, as well as Enterprise actions to mitigate those risks. We did not evaluate the adequacy or implementation of the mitigants.

INTERCONNECTEDNESS RISK: COMMON PARENT COMPANY....

Fannie Mae

Fannie Mae considers counterparty interconnectedness 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. According to Fannie Mae, counterparty interconnectedness risk is the risk that the Enterprise is adversely affected by financial distress at one counterparty or group of counterparties with some degree of economic or control interdependence. Fannie Mae identified several key underlying risks in this area, including the interconnectedness of counterparties with a common parent company, which is the focus of this white paper. Fannie Mae defines this underlying risk as the risk that control, ownership, economic interdependence, or financial and operating relationships of a counterparty grouping or family may result in unexpected credit-related losses as a result of being aggregated to a common legal entity parent or beneficial owner.

Fannie Mae assessed the risk trend for counterparty interconnectedness, including the underlying risks such as counterparties with a common parent company, as increasing. Fannie Mae told us that, in the reinsurance sector, more mortgage credit risk has been ceded to reinsurers in recent years than ever before, which could affect the industry if a major reinsurer went bankrupt.[1] In the mortgage banking sector, Fannie Mae said that large mortgage banks are increasingly relying on external sources to grow their business, making it more challenging to monitor risk in times of financial stress. Fannie Mae used the example that a single parent company could have multiple seller/servicer relationships that need to be managed effectively. Fannie Mae added that interconnectedness risk could arise if one entity under the parent was thriving and another was financially distressed.

Risk Monitoring and Mitigation

Fannie Mae told us that it has not experienced any credit-related losses due to parent company interconnectedness within the past five to seven years. Fannie Mae said that it has mitigated the risk of losses by, for example, setting financial eligibility requirements, requesting collateral or a parental guarantee, and having a priority interest in mortgage servicing rights, along with working with regulators and the counterparty. In addition, Fannie Mae told us that it has risk limit frameworks both for individual counterparties and at the family level. The Enterprise said that these limit frameworks are reviewed annually and the limits are updated annually or, for certain sectors, quarterly. According to FHFA, Fannie Mae's exposure to an

[1] For more information about the Enterprises' counterparty exposure to reinsurers, see OIG, *Enterprise Counterparties: Reinsurers* (September 27, 2021) (WPR-2021-007) (online at www.fhfaoig.gov/sites/default/files/WPR-2021-007.pdf).

entity and a family is measured daily, and exposures are reported daily to management and reported regularly to management committees and to Fannie Mae's board. FHFA also told us that Fannie Mae counterparties are required to submit updated financial profiles to the Enterprise quarterly. Fannie Mae told us that counterparties are required to provide the Enterprise with notification of corporate structure changes and changes in control due to acquisitions or mergers, and in certain cases the changes require approval by FHFA and Fannie Mae. Fannie Mae has internal reports that it can use to monitor interconnectedness risk, such as a monthly counterparty risk management report that shows the share of risk attributed to each of the Enterprise's top 20 counterparties by family and a counterparty watchlist that reflects the Enterprise's parent and affiliated counterparties that are of concern.

Freddie Mac

Freddie Mac did not provide, for purposes of this report, a definition of counterparty interconnectedness risk. However, the Enterprise said that it addresses this risk in its risk framework. Freddie Mac told us that it considered its risk associated with interconnectedness of counterparties with a common parent company to be stable because the Enterprise was operating within established risk limits. Freddie Mac noted mortgage insurer holding companies as an area of growing counterparty interconnectedness, in light of increasing credit risk exposure of their reinsurance subsidiaries. As an example, Freddie Mac said that the reinsurance subsidiary might increase its coverage for the holding company's mortgage insurance subsidiary, which would keep the mortgage insurance exposure within the group, rather than being transferred to third parties outside the holding company.

Risk Monitoring and Mitigation

Freddie Mac told us that it did not recall being adversely affected in the past five to seven years due to interconnectedness of a counterparty with a common parent company. FHFA told us that Freddie Mac uses risk limits, risk measurement, reporting, and governance activities to manage and mitigate risk associated with counterparties including counterparty interconnectedness risk. According to Freddie Mac, under its framework, potential stress loss is measured for all entities within a family, that is, entities related by common ownership. Freddie Mac added that exposure to a family is measured daily or monthly and reported daily to management. Freddie Mac's internal risk standard calls for daily internal reporting of exposures consolidated at the family level that are economically interdependent. Exposures also are reported monthly to management risk committees and quarterly to board risk committees, according to Freddie Mac. In addition to reporting, the Enterprise told us that it sets counterparty limits at the family level, and any interconnectedness within a family is managed by having that family-level limit. Under Freddie Mac's risk standard, its internal credit risk reports must include limit usage, availability, and any overages by family. Additionally, Freddie Mac told us that its counterparty records are updated based on notifications from seller/servicers of mergers and acquisitions or the need to update a parent entity.

FHFA

FHFA told us that it does not have its own definition of counterparty interconnectedness risk. The Agency said that it considers interconnectedness risk as a component within counterparty credit risk, rather than as a risk that it assesses independently. FHFA explained that, for single-family seller/servicers, it provides guidance to the Enterprises to consider the complexity of seller/servicer relationships, and that complexity could be interpreted as including interconnectedness. FHFA's guidance notes that individual seller/servicers may present unique risks due to their organizational structure and complexity. FHFA expects the Enterprises to consider, as appropriate, organizational structure, complexity, and ownership, including affiliates, before entering into contractual relationships with seller/servicers.

FHFA's guidance to its examiners advises that the Enterprises should implement procedures for measuring counterparty risk exposures and should establish counterparty risk limits. FHFA told us that Enterprise reports such as counterparty risk exposure, originations, and servicing are in many cases presented both at an individual counterparty level and aggregated so that interconnectedness can be seen. In addition, FHFA said that the Enterprises set risk limits for individual subsidiaries. FHFA added that the Enterprises use a risk-based approach, focusing on high-volume, high-risk counterparties. Regarding FHFA's oversight, the Agency said that it receives Enterprise reports showing counterparty exposure by subsidiary and at the parent level, and that it has reviewed counterparties with common parents. FHFA also said that it assesses the framework used by the Enterprises to calculate exposures.

FHFA told us that interconnectedness risk can be considered in a narrow sense as it relates to the legal and organizational structure of counterparties or more broadly including systemic and concentration risks. The Agency said that it views the risk in the narrow sense as relatively low for both Enterprises and that the trend was stable for both Enterprises.

CONCLUSION

Fannie Mae considers counterparty interconnectedness 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. Fannie Mae identified several key underlying risks in this area, including the interconnectedness of counterparties with a common parent company. Fannie Mae assessed the risk trend of counterparties with a common parent company as increasing, telling us that contributing factors include trends in the reinsurance and mortgage banking sectors. Freddie Mac told us that it considers its risk associated with interconnectedness of counterparties with a common parent company to be stable because the Enterprise was operating within established risk limits. FHFA told us that interconnectedness risk can be considered in a narrow sense as it relates to the legal and organizational structure of counterparties or more broadly including systemic and concentration risks. The Agency said that it views the risk in the narrow sense as relatively low for both Enterprises and that the trend was stable for both Enterprises. Both Enterprises expressed that they were not aware of any credit-related losses due to parent company interconnectedness within the past five to seven years. FHFA and both Enterprises provided examples of ways that the Enterprises mitigate the risk of interconnectedness of Enterprise counterparties with a common parent company.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide background information related to Enterprise counterparty risk, FHFA and Enterprise views of the risks associated with interconnectedness of counterparties, including counterparties with a common parent company, and Enterprise actions taken to mitigate the risks. To achieve this objective, we requested and reviewed information from FHFA and the Enterprises, and we reviewed other internal FHFA and Enterprise documents as well as publicly available documents. We also met with FHFA and Freddie Mac officials.

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

ADDITIONAL INFORMATION AND COPIES.................................

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