Federal Housing Finance Agency
Office of Inspector General

Enterprise Counterparties: Custodial Depository Institutions

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Executive Summary

The Federal Housing Finance Agency (FHFA or Agency) Office of Inspector General (OIG) uses a risk-based approach to our work that enables us to leverage our resources and provide strong oversight of FHFA. We focus our resources on those Agency programs and operations that pose the greatest financial, governance, and/or reputational risks to FHFA, Fannie Mae and Freddie Mac (the Enterprises), and the Federal Home Loan Banks (FHLBanks), which are reflected in our annual Management and Performance Challenges memorandum to FHFA. One of those risks is counterparty risk—the risk created by persons or entities that provide services to Fannie Mae or Freddie Mac. We previously published a white paper on one category of Enterprise counterparties, mortgage insurers.

This white paper discusses another category of Enterprise counterparties known as custodial depository institutions (CDIs), which each month receive and hold on behalf of the Enterprises billions of dollars in mortgage payments that borrowers make on mortgages that the Enterprises own or guarantee. Some of those funds are earmarked to pay investors who have purchased Fannie Mae or Freddie Mac mortgage-backed securities (MBS), and some are earmarked for payment to the Enterprises for mortgages they own or to pay their guarantee fees. Because CDIs hold billions of dollars on behalf of the Enterprises, the Enterprises may be exposed to counterparty risk should one or more CDIs fail to meet their obligations.

We undertook this white paper to understand and explain the counterparty risk associated with CDIs and the mitigants in place to reduce that risk.

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ABBREVIATIONS

CDI	Custodial Depository Institution
Enterprises	Fannie Mae and Freddie Mac
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
Fitch	Fitch Ratings, Ltd.
MBS	Mortgage-Backed Securities
Moody's	Moody's Investors Service, Inc.
NCUSIF	National Credit Union Share Insurance Fund
OIG	Federal Housing Finance Agency Office of Inspector General
S&P	Standard & Poor's Financial Services LLC

BACKGROUND

The Enterprises do not originate mortgages. Rather they purchase mortgages—single-family residential loans and multifamily loans—that banks, other depository institutions, and non-banks[1] underwrite in accordance with Enterprise guidelines. Lenders may sell mortgages to the Enterprises for cash, or they may pool and "swap" mortgages in return for Enterprise MBS. Under either scenario, these mortgages are generally securitized into MBS and sold with an Enterprise guarantee that investors will receive payments. Monthly mortgage payments on the loans that underlie MBS are passed through to the investors (after servicing and other fees are deducted).

Similarly, the Enterprises do not process monthly mortgage payments from the borrowers on the mortgages they have purchased. Instead, they contract with companies known as servicers, which collect and account for each monthly mortgage payment from borrowers, disburse funds according to mortgage terms (e.g., make tax and insurance payments from escrow accounts), manage mortgage delinquencies and defaults, and release funds to the Enterprises pursuant to contractual agreements.

Servicers for Fannie Mae and Freddie Mac collect and aggregate billions of dollars in mortgage payments each month. According to Fannie Mae, monthly collections by its servicers ranged from about $30 billion to $50 billion over the past year, and Freddie Mac's monthly collections by its servicers averaged about $29 billion from October to December 2017. The principal and interest components of these payments are deposited by servicers into custodial accounts in CDIs on behalf of the Enterprises, which may be after deduction of fees owed to the servicers.[2] (Applicable escrows for real estate taxes and insurance are deposited into separate custodial accounts.) Principal and interest payments generally are held in CDI accounts for less than 30 days, according to both Enterprises. Enterprise servicing agreements permit servicers to consolidate funds held in multiple principal and interest custodial accounts into one account at a CDI, prior to disbursement. Monthly mortgage payments held in CDIs are transferred into the Enterprises' custodial accounts, according to a schedule established by each Enterprise.

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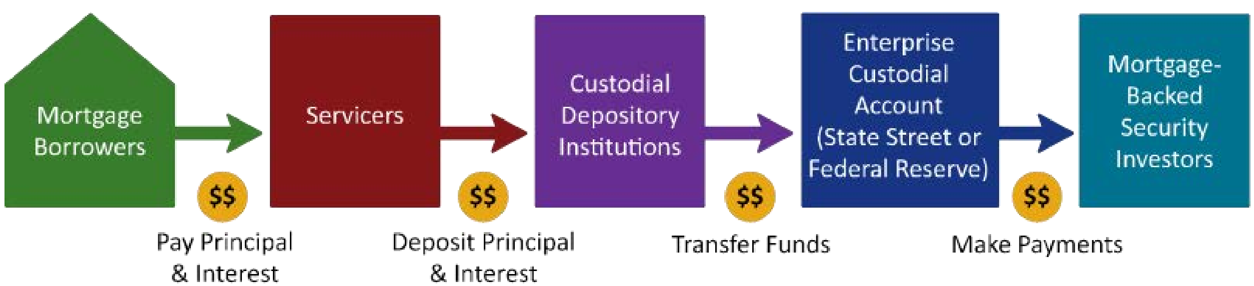
[1] Non-banks are non-depository firms unaffiliated with commercial banks.

[2] In addition to depository institutions, servicers can use custodial accounts at Federal Reserve Banks or FHLBanks to hold principal and interest payments on behalf of the Enterprises. However, according to the Enterprises, servicers are not using Federal Reserve Banks for this purpose. They are using FHLBanks, but Fannie Mae told us that the amount held in servicer custodial deposits on its behalf at FHLBanks was immaterial. (Freddie Mac did not have the amount held in FHLBanks on its behalf readily available.)

Fannie Mae holds its MBS trust custodial account at State Street Bank and Trust Company. Generally, monthly mortgage payments for mortgages purchased by Fannie Mae are held in the account at State Street for approximately one week from the date received from the servicers, though payments in full of the remaining principal balance of single-family mortgages could be held for an additional month. Freddie Mac holds its custodial account at the Federal Reserve Bank of New York, which is part of the U.S. central banking system.[3] Freddie Mac's monthly mortgage payments generally are held in the account at the Federal Reserve Bank of New York for less than 30 days from the date received from CDIs.

Figure 1 illustrates how monthly borrower mortgage payments (for mortgages guaranteed by Fannie Mae or Freddie Mac) move upon receipt by mortgage servicers, to CDIs, to the Enterprises' custodial accounts, and then ultimately to investors who have purchased Enterprise MBS.

FIGURE 1. CASH FLOWS THROUGH CUSTODIAL DEPOSITORY INSTITUTIONS



COUNTERPARTY RISK

Because CDIs hold billions of dollars on behalf of the Enterprises, each Enterprise may be exposed to the risk that these counterparties could fail to meet their obligations. In Fannie Mae's 2016 10-K, Fannie Mae disclosed that CDIs were a primary source of counterparty risk because the insolvency of a principal CDI "could result in significant financial losses." Freddie Mac did not address potential CDI counterparty risk in its 2016 10-K. In February 2018, Fannie Mae released its 2017 10-K, in which it changed its classification of CDIs from a primary counterparty exposure to an "other" counterparty exposure.

[3] The Enterprises are permitted to invest funds held in custodial accounts in eligible investments. Freddie Mac told us that it may move funds out of its Federal Reserve Bank custodial account temporarily to invest them.

MAGNITUDE OF EXPOSURE

According to Fannie Mae, the average monthly balance in its custodial account at State Street ranges between $35 billion and $50 billion, and it monitors State Street and looks at quality on a monthly basis. For 2016, Fannie Mae reported the extent of its exposure to CDIs in its 2016 10-K. See Figure 2.

FIGURE 2. FANNIE MAE EXPOSURE TO CUSTODIAL DEPOSITORY INSTITUTIONS

Fannie Mae	Single-Family	Multifamily
Deposits received and held by custodial depository institutions during December 2016	$42 billion	$3 billion
Number of institutions holding the deposits	258	27
Percent of the deposits held by institutions rated as investment grade by S&P, Moody's, and Fitch as of year-end 2016	91%	98%
Percent of deposits held by the Enterprise's six largest custodial depository institutions as of year-end 2016	80%	91%

Freddie Mac did not report similar information in its 2016 10-K. Freddie Mac explained that it did not report the information because it has a long-standing process of monitoring the eligibility of depository institutions to hold custodial accounts. Freddie Mac is developing a template report that will include the dollar amount of remittances, by depository institution.

Neither Enterprise reported such information in its 2017 10-K.

In addition to counterparty risk, the transfer of billions of dollars of principal and interest can pose operational risk to the Enterprises. In its 2016 10-K, Freddie Mac reported that it had insufficient operational procedures related to its custodial account at the Federal Reserve Bank of New York that led to a build-up of funds due to the Enterprise and stated that it had withdrawn more than $22 billion of its funds from this account. Freddie Mac said that it had made significant progress to correct the deficiencies during 2016 and was continuing its efforts to improve its procedures. Recent Fannie Mae custodial account matters have led the Enterprise to consider possible additional internal controls for custodial accounts.

CONCENTRATION RISK

Concentration risk exists when the Enterprises rely on a small number of counterparties, increasing the exposure to any individual counterparty. Fannie Mae and Freddie Mac do not place limits on the amount of principal and interest custodial funds that can be kept at a single institution.

Fannie Mae reported in its 2016 10-K that its "transactions with custodial depository institutions are concentrated." As shown in Figure 2, its six largest CDIs held 80% of deposits for single-family mortgages at year-end 2016. Fannie Mae told us that one institution accounted for $12 billion (27%) of principal and interest custodial deposits.

Freddie Mac did not have similar information readily available. However, Freddie Mac told us that the template report under development will provide aggregate dollar amounts by depository institution.

Additionally, the Enterprises may have multiple types of exposures to one counterparty. Fannie Mae noted in its 2016 10-K that many of its counterparties provide several different services to the Enterprise, such as acting as the mortgage seller, mortgage servicer, or CDI.

FACTORS MITIGATING COUNTERPARTY RISK TO THE ENTERPRISES

Risks posed by the potential insolvency or failure of a CDI are mitigated by federal deposit insurance, agreements with servicers, and requirements that CDIs meet certain minimum eligibility requirements.

Deposit Insurance

For single-family residential mortgage payments, the Enterprises require CDIs to have accounts insured by the Federal Deposit Insurance Corporation (FDIC), or if the CDI is a credit union, the National Credit Union Share Insurance Fund (NCUSIF).[4] Under FDIC and NCUSIF rules for mortgage-servicing principal and interest custodial accounts, deposit

[4] For its multifamily business, Fannie Mae requires CDIs to have accounts insured by the FDIC, NCUSIF, or other such governmental insurer acceptable to the Enterprise. (However, Fannie Mae told us that it did not have any credit union CDIs for its multifamily business.) Freddie Mac requires multifamily CDIs to be FDIC-insured or to be a Federal Reserve Bank or FHLBank.

insurance coverage of $250,000 exists per borrower whose funds are held in the account.[5] Fannie Mae explained to us, for example, that payments of mortgage principal and interest on a single-family mortgage with two co-borrowers would be covered by insurance up to $500,000. FHFA data reflect that, for 2016, roughly half of Enterprise purchases of single-family owner-occupied mortgages had co-borrowers. For multifamily mortgages, the Enterprises reported to us that the entity receiving the loan typically would be considered one borrower with $250,000 worth of insurance coverage.

Given that the Enterprises do not purchase single-family loans that exceed specified loan limits, scheduled monthly payments will be less than $250,000,[6] so that the standard scheduled monthly mortgage payment would be covered by deposit insurance. In those instances when a mortgage is paid off in full before the end of the loan term (prepayment), that prepayment could exceed the insured amount. Freddie Mac told us that approximately 125,000 of its single-family mortgages are prepaid each month of which roughly 16,000 mortgages had prepayments greater than $250,000. (We recognize that a number of these mortgages may have had two co-borrowers, which would raise the insured amount to $500,000.)

Fannie Mae advised us that its internal estimate of potential exposure to CDI counterparties in a stress scenario accounted for the availability of deposit insurance. According to Fannie Mae, its potential exposure to CDIs was a small portion of its exposure to all counterparties.

The Enterprises' multifamily businesses are not subject to statutory loan limits. There is some risk that a multifamily mortgage purchased by the Enterprises could have scheduled monthly payments greater than $250,000, but the Enterprises' average size multifamily mortgage has a monthly payment below $250,000, assuming typical loan terms.[7]

Unlike single-family mortgages, multifamily mortgages typically have short terms (five, seven, or ten years), with a balloon payment due at maturity, which can be sizable. If the loan balance is not refinanced at maturity by the same lender, a payment well above $250,000

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[5] For example, if a mortgage servicer collects $2,000 of principal and interest from each of 1,000 borrowers in a custodial account, the full $2 million would be covered by insurance if recordkeeping and other requirements are met. According to Fannie Mae, deposit insurance coverage also applies to borrower principal and interest payments held in its custodial account at State Street. Freddie Mac's custodial account is held at the Federal Reserve Bank of New York, which is part of the U.S. central banking system.

[6] FHFA established baseline Enterprise loan limits for 2018 of $453,100 for one-unit properties (up to $871,450 for four-unit properties). Loan limits increase in certain high-cost locations up to 150% of the baseline (and the baseline is higher for Alaska, Hawaii, Guam, and the U.S. Virgin Islands).

[7] Fannie Mae reported that the average loan size for its multifamily book of business was $10 million as of the end of 2017. Freddie Mac reported in 2013 that its average loan size for multifamily mortgages was $17 million.

could flow through the CDIs and the Enterprises' custodial accounts. In those cases, the borrower's payment held in the CDI would not be fully covered by deposit insurance.

Servicer Responsibility

According to Fannie Mae, its mortgage servicers would be responsible for any loss of funds deposited in a custodial account as well as any losses sustained by Fannie Mae because of delays in obtaining the funds from the custodial account. In contrast, Freddie Mac reported to us that, for single-family mortgages, liability would depend on the facts of the situation. For its multifamily business, Freddie Mac reported to us that the servicer would be responsible for any loss of funds deposited in custodial accounts and for damages due to delays in obtaining funds. However, if the servicer is serving as the CDI and fails on its CDI obligations, it also might fail on these servicer obligations.

Eligibility Requirements

According to their guidelines for single-family mortgage servicers, both Enterprises have eligibility requirements for CDIs. These guidelines include:

- Funds must be held at institutions with accounts insured by the FDIC or the NCUSIF.
- Institutions must have ratings from certain rating services meeting specified thresholds.
- Servicers must monitor the ratings over time.

Fannie Mae also requires institutions to be rated "well capitalized" by their federal or state regulator. Fannie Mae or Freddie Mac may deem an institution ineligible even if it meets the minimum rating requirements.

Fannie Mae and Freddie Mac also have eligibility requirements for CDIs for their multifamily servicers, such as requiring CDIs to be insured institutions and requiring ratings meeting specified thresholds. Fannie Mae again requires the CDI to be well capitalized by its primary regulator. Generally, the Enterprises set higher eligibility requirements for multifamily than single-family CDIs.[8]

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[8] Fannie Mae explained that it has slightly higher eligibility requirements for multifamily CDIs compared to single-family because of the larger size of multifamily mortgages. Some of Fannie Mae's rating thresholds are higher for its multifamily business than its single-family business. Freddie Mac's eligibility standards for multifamily CDIs require two ratings by "Tier 1" rating services and higher ratings thresholds.

Freddie Mac reported to us that it monitors the eligibility of the CDIs its servicers are using on a quarterly basis for single-family mortgages and a monthly basis for multifamily mortgages.

Fannie Mae reported that 91% of deposits for single-family mortgages were held in institutions rated investment grade by S&P, Moody's, and Fitch as of year-end 2016, as shown in Figure 2. FHFA told us that the remaining 9% of deposits were rated by other rating agencies.

COUNTERPARTY PERFORMANCE

Fannie Mae and Freddie Mac reported to us that they have not suffered losses due to nonperformance of CDIs related to principal and interest custodial accounts. The Enterprises also advised that they have not experienced any significant delays of principal and interest payments due to nonperformance of CDIs.

According to Fannie Mae, it has not exercised remedies, such as transferring funds to another CDI or requiring more frequent remittances. Freddie Mac reported to us that, in the recent past, one CDI became ineligible because of a rating downgrade and the account was moved elsewhere.

CONCLUSION...

Each month, CDIs receive and hold on behalf of the Enterprises billions of dollars in mortgage payments from borrowers. As a result, the Enterprises may be exposed to risk should one or more CDIs fail to meet their obligations. This exposure may be concentrated in a small number of institutions.

The counterparty risk from CDIs is mitigated by deposit insurance up to $250,000 per borrower, servicer responsibilities, and Enterprise eligibility requirements for CDIs. According to the Enterprises, they regularly monitor the risks from CDIs and take action, as warranted. Both Enterprises also continue to consider additional internal controls and best practices for management and oversight of custodial accounts.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to understand and explain the counterparty risk associated with CDIs and the mitigants in place to reduce that risk. To achieve this objective, we reviewed publicly available documents from FHFA, the Enterprises, FDIC, and other institutions as well as documents provided by FHFA and the Enterprises. We also had discussions with FHFA, Fannie Mae, 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.

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