

Federal Housing Finance Agency  
Office of Inspector General



# **The Enterprises' Use of Recourse as a Credit Enhancement Under Their Charters**

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## Executive Summary

Under their charters, Fannie Mae and Freddie Mac (the Enterprises) must obtain credit enhancements to purchase single-family conventional mortgages with loan-to-value (LTV) ratios greater than 80%. The Enterprise charters allow three forms of credit enhancement: mortgage insurance, participation, and recourse. Mortgage insurance transfers a portion of the risk of mortgage default to an insurer. An official at the Federal Housing Finance Agency (FHFA or Agency) told us that mortgage insurance has always been the predominant form of credit enhancement for the Enterprises. Participation refers to an agreement by a financial institution to retain an ownership interest in the mortgage that it is selling to an Enterprise. According to a Fannie Mae official, participation as a form of credit enhancement is rarely used in mortgages that the Enterprise purchases.

Recourse is the third form of credit enhancement permitted by the Enterprise charters. Recourse refers to an agreement by the financial institution selling a mortgage to an Enterprise to “repurchase or replace the mortgage upon the demand of the [Enterprise] in the event that the mortgage is in default.” According to an FHFA official, recourse as a credit enhancement was never widely used by the Enterprises.

While Congress provided specific parameters for mortgage insurance and for participation, it did not specify any period of time for which the recourse obligation must remain in effect. The charters state that recourse will be “for such period and under such circumstances as the [Enterprise] may require.” An FHFA official told us that, historically, the length of recourse has varied. Recourse could run for the life of the loan. However, the use of longer-term recourse agreements is challenging for lenders because of the accounting true sale treatment. FHFA regards 12-month recourse when used in conjunction with certain other forms of additional credit enhancement as complying with the credit enhancement requirement in the Enterprise charters.

We have previously explained, in a white paper, the use of mortgage insurance as a credit enhancement. We undertook this project to explain the use of recourse as a credit enhancement for mortgages eligible for purchase by the Enterprises.

Through our work, we have learned that the Enterprises’ use of recourse as a credit enhancement likely amounts to significantly less than 1% of the Enterprises’ business and is largely used as a credit enhancement that assists with meeting affordable housing goals. We also learned that on October 19, 2018, FHFA issued guidance to the Enterprises establishing consistent standards for recourse agreements. According to FHFA, this guidance would



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limit Enterprise discretion in establishing the duration of recourse and commit the Enterprises to placing the vast majority of recourse mortgages into credit risk transfer agreements. It also would eliminate the need for the Enterprises to seek approval for individual recourse agreements. Less than one week later, on October 25, 2018, FHFA advised the Enterprises not to engage in any announcement or communications about its October 19, 2018, recourse directive, stating that it was considering an amendment to this directive. FHFA issued a revised directive on March 19, 2019.

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## ABBREVIATIONS .....

Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
LTV	Loan-to-value
OIG	Federal Housing Finance Agency Office of Inspector General

## BACKGROUND.....

Fannie Mae and Freddie Mac operate under congressional charters to provide liquidity, stability, and affordability to the mortgage market. Under their charters, the Enterprises must obtain credit enhancements to purchase single-family conventional mortgages with LTV ratios greater than 80%. Credit enhancements reduce the risks attendant to mortgages with LTV ratios over 80%. The Enterprise charters allow three forms of credit enhancement: mortgage insurance, participation, and recourse.<sup>1</sup>

An official at FHFA told us that mortgage insurance has always been the predominant form of credit enhancement under the charters for the Enterprises. When mortgage insurance is used, the Enterprises' charters specify that it must cover the portion of the mortgage's unpaid principal balance that is greater than 80% of the value of the property securing the mortgage and be provided by a qualified insurer as determined by the Enterprise. FHFA views mortgage insurance as providing protection for the Enterprises for loan losses incurred when a borrower with a higher LTV mortgage defaults, by transferring a portion of the risk of mortgage default to an insurer.

Participation refers to an agreement by a seller to retain an ownership interest in the mortgage that it is selling to an Enterprise. The Enterprises' charters require that the ownership interest retained by the seller must meet or exceed 10% for this form of credit enhancement. According to a Fannie Mae official, participation as a form of credit enhancement is rarely used in mortgages that the Enterprise purchases.

Recourse is the third form of credit enhancement permitted by the Enterprise charters. The charters refer to this form of credit enhancement as one in which the entity selling a mortgage to an Enterprise agrees to "repurchase or replace the mortgage upon the demand of the [Enterprise] in the event that the mortgage is in default."<sup>2</sup> While Congress provided specific parameters for mortgage insurance (required on the portion of the loan over 80% LTV by qualified insurers) and for participation (at least 10% retention), it did not specify any period of time for which the recourse obligation must remain in effect.

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<sup>1</sup> See 12 U.S.C. §§ 1454(a)(2), 1717(b)(2) (codifying the credit enhancement requirements in Freddie Mac's and Fannie Mae's charter acts, respectively).

<sup>2</sup> The Enterprises typically refer to this as recourse, and this white paper adopts that terminology. In more general usage, however, recourse can refer to other types of arrangements, such as seller indemnification for losses, which are not within the charter language and therefore cannot be used by themselves to meet the charter requirement for credit enhancement for mortgages with LTV ratios exceeding 80%. With indemnification, the lender reimburses the Enterprise for certain losses instead of repurchasing the mortgage if it defaults.

We have previously explained, in a white paper, the use of mortgage insurance as a credit enhancement.<sup>3</sup> We undertook this project to explain the use of recourse as a credit enhancement for mortgages eligible for purchase by the Enterprises.

## USE OF RECOURSE AS A CREDIT ENHANCEMENT

### Historical Use of Recourse as a Credit Enhancement

According to an FHFA official, the Enterprises used recourse as a credit enhancement more frequently in the 1990s than in recent times, but recourse was never widely used. In 1999, FHFA’s predecessor agency noted that “recourse represents a small percentage of the credit enhancements used by the Enterprises.” A Freddie Mac official told us that 12-month or shorter term recourse has never been a meaningful part of Freddie Mac’s business, and estimated that recourse and indemnification had been used as a credit enhancement for about 0.2-0.3% of Freddie Mac’s single-family mortgage volume.

### Recent Use of Recourse as a Credit Enhancement

According to an FHFA official, use of recourse as a credit enhancement likely amounts to significantly less than 1% of the Enterprises’ business. In their 2018 Form 10-Ks, both Enterprises acknowledged that they are permitted to use recourse as a credit enhancement under their charters for mortgages they acquire. Freddie Mac reported, in its 2018 Form 10-K, a total of \$2.6 billion of unpaid principal balance in its single-family mortgage portfolio with a credit enhancement of recourse, indemnification, integrated mortgage insurance (IMAGIN), or pool insurance, amounting to 0.14% of its \$1.9 trillion single-family mortgage portfolio. In comparison, it reported that 20% of its \$1.9 trillion portfolio used mortgage insurance as a credit enhancement. Fannie Mae did not report comparable information in its 2018 Form 10-K. Fannie Mae reported a combined total for mortgages with mortgage insurance and mortgages with “other” credit enhancements in its single-family portfolio, and stated that it generally achieved the charter requirement through mortgage insurance. Officials from FHFA and both Enterprises told us that a limited number of sellers use recourse agreements.

### ***Affordable Housing***

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 amended the Enterprise charters to impose “an affirmative obligation to facilitate the financing of

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<sup>3</sup> For more information about mortgage insurance, see OIG, *Enterprise Counterparties: Mortgage Insurers* (Feb. 16, 2018) (WPR-2018-002) (online at [www.fhfaig.gov/Content/Files/WPR-2018-002.pdf](http://www.fhfaig.gov/Content/Files/WPR-2018-002.pdf)).

affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return.”<sup>4</sup> In that statute, Congress directed the U.S. Department of Housing and Urban Development to set and enforce affordable housing goals for the Enterprises to ensure that they met these affirmative obligations.<sup>5</sup> The Housing and Economic Recovery Act of 2008, which amended the 1992 statute, shifted to FHFA the establishment and enforcement of annual affordable housing goals. FHFA assesses the Enterprises’ performance against these annual housing goals.<sup>6</sup>

Officials from both Enterprises, as well as from FHFA, explained that a mortgage with a recourse agreement can be less expensive for the borrower than a mortgage with mortgage insurance. In recent years recourse has predominantly been used as a credit enhancement for mortgages purchased by the Enterprises to meet their affordable housing goals.<sup>7</sup>

## LENGTH OF RECOURSE AGREEMENTS

According to the Enterprises’ congressionally adopted charters, recourse will be “for such period and under such circumstances as the [Enterprise] may require.” An FHFA official told us that, historically, the length of recourse has varied. In the past, recourse could run from as short as four months to as long as the life of the loan.

Enterprise officials explained to us that recourse agreements have objective standards to determine when a lender is obligated to repurchase the mortgage, and each agreement sets a defined period during which, if the borrower is delinquent for a specified length of time, the lender must repurchase the mortgage. According to transaction documents, recent recourse agreements have provided that four consecutive payments (120 days) missed by a borrower during a specified time period trigger a lender’s repurchase obligation. Since they entered conservatorship in September 2008, the Enterprises have submitted some requests to enter into recourse agreements as a credit enhancement to FHFA for approval and submitted some

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<sup>4</sup> 12 U.S.C. § 4501(7).

<sup>5</sup> Pub. L. 102-550 §§ 1331, 1336.

<sup>6</sup> Pub. L. 110-289 §§ 1228, 1230; codified at 12 U.S.C. §§ 4561, 4566.

<sup>7</sup> According to Enterprise officials, their housing goals align with some of their counterparties’ obligations under the Community Reinvestment Act, and transactions with recourse as a credit enhancement can help fulfill both objectives. The Community Reinvestment Act is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods. State housing finance agencies are also significant Enterprise counterparties for transactions with recourse. These agencies are state-chartered, nonprofit organizations that provide financing and services for affordable housing and related community development activities.



other transactions as a notification to FHFA. FHFA has addressed each request on a case-by-case basis.

## Challenges Created by Accounting Treatment

Agency officials told us that lenders were concerned with accounting treatment that determined when a lender could remove a mortgage from its balance sheet after selling that mortgage. Under that accounting treatment, a true sale must occur before the mortgage can be removed. According to an FHFA official, the accounting treatment is complex, and some audit firms interpret the accounting standards to mean that a true sale for accounting purposes has not occurred because of the length of the recourse. As a result, with lengthy recourse periods, the mortgages would remain on the lender's books even after the loans have been sold to an Enterprise and packaged into securities. An FHFA official told us that it would be challenging for lenders to get a true sale opinion for longer-term recourse. FHFA came to the view that a 12-month recourse period would more likely be considered a true sale than a recourse period of several years. FHFA officials advised us that they viewed 12-month recourse agreements when used in conjunction with certain other forms of additional credit enhancement as compliant with the credit enhancement term in Enterprise charters.

## FHFA RECOURSE DIRECTIVE

In 2018, FHFA recognized that it had not provided the Enterprises with “guidance on a consistent set of parameters for recourse transactions that achieved a meaningful level of credit enhancement.” Through its activities as conservator and supervisor, FHFA had become aware of recourse agreements that had not been submitted for FHFA approval, including agreements with a recourse period shorter than 12 months.

On October 19, 2018, FHFA issued guidance to the Enterprises establishing consistent standards for recourse agreements. According to FHFA, this guidance would limit Enterprise discretion in establishing the duration of recourse and commit the Enterprises to placing the vast majority of recourse mortgages into credit risk transfer agreements. It also would eliminate the need for the Enterprises to seek approval for individual recourse agreements. Less than one week later, on October 25, 2018, FHFA advised the Enterprises not to engage in any announcement or communications about its just-issued recourse directive, stating that it was “considering an amendment to this directive to focus this guidance on housing goal-oriented transactions....” According to FHFA, in the interim, recourse agreements that would have been covered by the directive instead required discussion with FHFA on a case-by-case basis. FHFA issued its revised directive on March 19, 2019. Agreements that the Enterprises enter into on or after March 19, 2019, must comply with the terms of the revised directive.

Prior existing agreements must be amended by no later than June 30, 2019, and mortgage purchases under them must comply with the revised directive by no later than September 30, 2019.

## Terms of the Directive

Under the revised directive, the Enterprises may acquire mortgages using recourse as a credit enhancement provided that, on an annual basis, at least 65% of such mortgages in the aggregate either (a) qualify for one of the single-family annual housing goals or (b) are purchased through Fannie Mae’s HomeReady or Freddie Mac’s HomePossible products and the borrowers’ incomes are no greater than 100% of the area median income. The Enterprises will be required to provide quarterly reporting to FHFA.

FHFA identified four options for the Enterprises to use recourse as a credit enhancement under the charters that did not require FHFA approval for individual agreements. Each of those four options required a minimum 12-month recourse period. Each of those options required an additional credit enhancement or backstop beyond 12 months to reduce Enterprise exposure in the event of borrower default:

- Either a recourse period of at least 48 months or a recourse period for 12 months followed by 36 months of lender indemnification requiring reimbursement of credit losses (instead of repurchase) in the event of default; these periods may be reduced for Enterprise purchases of aged performing mortgages;<sup>8</sup>
- Recourse period for at least 12 months with risk transferred before the end of the recourse period to a third-party investor;<sup>9</sup>
- Recourse period for at least 12 months with risk transferred before the end of the recourse period through pool-level insurance or reinsurance;<sup>10</sup> and
- Recourse period for at least 12 months with risk transferred before the end of the recourse period through another credit-risk transfer structure.

For the three options using credit risk transfer transactions, a “meaningful portion” of the credit risk (as defined in FHFA’s conservatorship scorecard for the Enterprises) must be

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<sup>8</sup> Agreements with only recourse (48 months or for seasoned loans less) are not subject to the annual 65% requirement.

<sup>9</sup> The risk would be transferred through a security issuance, specifically a Connecticut Avenue Securities transaction for Fannie Mae and a Structured Agency Credit Risk transaction for Freddie Mac.

<sup>10</sup> The pool-level transaction would be a Credit Insurance Risk Transfer transaction for Fannie Mae and an Agency Credit Insurance Structure transaction for Freddie Mac.

transferred. Under FHFA’s directive, to secure the true sale characterization, the seller’s repurchase obligation may be capped.

The Enterprises must submit proposed recourse agreements that do not materially comply with the terms of the directive to FHFA for review. In addition, an FHFA official informed us that the Agency will not allow the Enterprises to have recourse agreements that are less than 12 months.

## CONCLUSION.....

Recourse is one of the three credit enhancements permitted by the Enterprise charters; however, it amounts to significantly less than 1% of the Enterprises’ business. When used in these limited circumstances, it has primarily been for mortgages purchased by the Enterprises to meet their affordable housing goals. According to FHFA, lender concerns with complex accounting treatment made the use of longer-term recourse agreements challenging. FHFA regards 12-month recourse when used in conjunction with certain other forms of additional credit enhancement as complying with the credit enhancement requirement in the Enterprise charters.

On March 19, 2019, FHFA issued guidance to the Enterprises that established consistent standards for the Enterprises to use recourse as a credit enhancement under the charters. FHFA eliminated the need for the Enterprises to seek approval for individual recourse agreements that met one of four options. Each option required a minimum 12-month recourse period, with an additional credit enhancement or backstop beyond 12 months to reduce Enterprise exposure in the event of borrower default. On an annual basis, at least 65% of the recourse mortgages, other than recourse-only agreements, must fulfill specified affordable housing purposes.

## OBJECTIVE, SCOPE, AND METHODOLOGY .....

The objective of this white paper was to provide information on the Enterprises' use of recourse as a credit enhancement under their charters and related guidance FHFA provided to them. To achieve this objective, we reviewed internal and publicly available FHFA, Fannie Mae, and Freddie Mac documents. We also interviewed FHFA, Fannie Mae, and Freddie Mac officials. This white paper focused on the use of recourse as a credit enhancement under the Enterprise charters. The Enterprises' use of recourse and repurchases for other purposes, including under the representation and warranty framework, were outside the scope of this white paper.

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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