

**REDACTED**

Federal Housing Finance Agency  
Office of Inspector General



**Audit of FHFA's Oversight of  
Freddie Mac's Compliance with the  
Required Risk Mitigants of  
Automated Underwriting, Mortgage  
Insurance, and Homeownership  
Education for its Purchases of  
Mortgages with a 97% LTV**

This report contains redactions of information that is privileged or confidential.

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## Executive Summary

For more than 20 years, successive administrations agreed that a barrier to homeownership for low- and moderate-income people was a significant down payment, and they promoted solutions to reduce that barrier to increase accessibility to homeownership. Numerous studies have found that saving enough cash for a down payment and other up-front closing costs is the greatest barrier that low-income and minority families face when considering homeownership.

The Housing and Economic Recovery Act of 2008 (HERA) established the Federal Housing Finance Agency (FHFA or Agency), an independent agency responsible for the supervision and regulation of Fannie Mae and Freddie Mac (collectively, the Enterprises) and the Federal Home Loan Banks. Using its powers under HERA, FHFA placed the Enterprises into conservatorships on September 6, 2008.

As conservator, FHFA issued an expectation to the Enterprises in May 2014 to “Work to increase access to mortgage credit for creditworthy borrowers, consistent with the full extent of applicable credit requirements and risk-management practices.” Later that year, in October 2014, the FHFA Director announced that FHFA was working with the Enterprises to develop sensible and responsible guidelines for mortgages with loan-to-value (LTV) ratios between 95% and 97% (high LTV mortgages) to increase access for creditworthy but lower-wealth borrowers.

After reviewing proposals received from the Enterprises, FHFA staff prepared a memorandum in early December 2014 (Staff Memorandum) recommending that the FHFA Director approve the high LTV mortgage programs proposed by the Enterprises. The Staff Memorandum acknowledged that “historical performance demonstrates that higher LTV loans can have higher risks than lower LTV loans and can have higher loss severities,” but asserted that these higher risks can be safely offset by thoughtful compensating factors and risk mitigants, including automated underwriting, private mortgage insurance, and pre-purchase homeownership education. The Staff Memorandum identified an additional control: FHFA’s ongoing oversight of Enterprise purchases of high LTV mortgages. The FHFA Director accepted the staff recommendation and approved the programs on December 3, 2014.

We performed this audit to assess FHFA’s oversight of Freddie Mac’s implementation of the 97% LTV mortgage program. As part of assessing FHFA’s oversight, we obtained (through FHFA) and analyzed Freddie Mac data on the mortgages purchased by Freddie Mac under the program and whether those mortgages conformed to three FHFA-required credit terms:



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(1) method of underwriting, (2) mortgage insurance, and (3) homeownership education.

Based on our inquiries to FHFA and Freddie Mac, and our analysis of the data provided by the Enterprise, we found that Freddie Mac purchased 19,628 mortgages from December 3, 2014, to December 31, 2016, under the 97% LTV mortgage program. Of those mortgages purchased, all were underwritten using an approved method of underwriting and contained information from the lender about required mortgage insurance or another credit enhancement. With regard to homeownership education, which was required for 16,074 of the 97% LTV mortgage purchases, we found that 15,730 mortgages met the credit term, which represents a compliance rate of 98%. For the remaining 344 mortgages, Freddie Mac reported that the lenders could not provide evidence that the homeownership education requirement was met for 13 mortgages and was unable to confirm whether the remaining 331 mortgages met the homeownership education requirement because of the number of lenders involved. Freddie Mac advised us that, as a result of our inquiries, the Enterprise is developing and implementing additional business rules to: (1) improve the accuracy of lenders' recording of homeownership education information in its Selling System and (2) enforce the homeownership education requirement.

Our audit also reviewed FHFA's ongoing oversight of Freddie Mac purchases of high LTV mortgages. We found that FHFA engaged in the following oversight activities:

- A briefing by FHFA's Division of Housing Mission and Goals (DHMG), which drafted the Staff Memorandum, to FHFA's Division of Enterprise Regulation (DER) on the programs' parameters to facilitate DER's ability to conduct supervisory activities.
- DHMG-prepared periodic reporting based on Freddie Mac 97% LTV mortgage data, such as average credit scores and debt-to-income (DTI) ratios of borrowers, loan volume, and delinquency rates, which according to DHMG are used to assess whether the goals and objectives of the 97% LTV mortgage programs are being met and to flag potential concerns or issues for FHFA leadership.
- Ongoing monitoring by DER of Freddie Mac's 97% LTV mortgage program during the 2015 to 2017 examination cycles.

These oversight activities focused on Freddie Mac's credit risk management and have not directly addressed compliance with the three risk mitigants that were the scope of this audit.



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We make no recommendations in this report.

We are also issuing today the results of our audit of FHFA's oversight of Fannie Mae's 97% LTV mortgage program, which was also approved by FHFA's December 2014 Staff Memorandum. See *Audit of FHFA's Oversight of Fannie Mae's Compliance with the Required Risk Mitigants of Automated Underwriting, Mortgage Insurance, and Homeownership Education for its Purchases of Mortgages with a 97% LTV* (AUD-2018-003) (available online at [www.fhfaoig.gov/reports/auditsandevaluations](http://www.fhfaoig.gov/reports/auditsandevaluations)).

This report was prepared by: Tara Lewis, Audit Director; Pamela L. Williams, Auditor-in-Charge; Andrew Geger, Auditor; and Terese Blanchard, Auditor; with the assistance of Bob Taylor, Assistant Inspector General for Audits. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, [www.fhfaoig.gov](http://www.fhfaoig.gov).

Marla A. Freedman, Deputy Inspector General for Audits /s/

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## ABBREVIATIONS .....

DER	Division of Enterprise Regulation
DHMG	Division of Housing Mission and Goals
DTI	Debt-to-Income
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
HERA	Housing and Economic Recovery Act of 2008
HFA	Housing Finance Agency
HUD	U.S. Department of Housing and Urban Development
LPA	Loan Product Advisor
LTV	Loan-to-Value
MIIs	Mortgage Insurance Providers
OIG	Federal Housing Finance Agency Office of Inspector General
Staff Memorandum	Federal Housing Finance Agency Staff Analysis Memorandum
Strategy	<i>The National Homeownership Strategy: Partners in the American Dream</i>
UMDP	Uniform Mortgage Data Program
UPB	Unpaid Principal Balance

## BACKGROUND.....

### Significant Down Payments: An Acknowledged Barrier to Affordable Homeownership

Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which President George H.W. Bush signed into law on October 28, 1992. In that statute, Congress defined the mission of the Enterprises and amended the Enterprise charters to impose “an affirmative obligation to facilitate the financing of 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>1</sup> At the same time, Congress directed the U.S. Department of Housing and Urban Development (HUD) to set and enforce affordable housing goals for the Enterprises to ensure that they met their affirmative obligation.<sup>2</sup>

For more than 20 years, successive administrations agreed that a barrier to homeownership for low- and moderate-income people was a significant down payment, and they promoted solutions to reduce that barrier to increase accessibility to homeownership. In 1994, President Clinton directed the then-HUD Secretary to develop, with leaders of the housing industry, nonprofit organizations, and government leaders, a strategy to increase homeownership. The resulting report, *The National Homeownership Strategy: Partners in the American Dream* (Strategy), recognized that an impediment to homeownership was that “[l]ow- and moderate-income families often cannot become homeowners because they are unable to come up with the required downpayment and closing costs. In many instances, these prospective first-time homebuyers find that developing the proper savings patterns to accumulate sufficient cash for the downpayment is difficult.”<sup>3</sup> The Strategy identified specific actions to be taken to lower barriers to homeownership, including working collaboratively to reduce homebuyer down payment requirements.<sup>4</sup> Eight years later, in October 2002, President George W. Bush recognized that barriers to access persisted. In signing into law the American Dream Downpayment Act the following year,<sup>5</sup> he recognized that “[o]ne of the biggest hurdles to homeownership is getting money for a down payment” and explained that the statute would

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<sup>1</sup> 12 U.S.C. § 4501.

<sup>2</sup> 12 U.S.C. § 4561(a); 12 U.S.C. § 4566(a)(1).

<sup>3</sup> U.S. Department of Housing and Urban Development, *The National Homeownership Strategy: Partners in the American Dream*, at 4-4 (May 1995) (online at [www.globalurban.org/National\\_Homeownership\\_Strategy.pdf](http://www.globalurban.org/National_Homeownership_Strategy.pdf)).

<sup>4</sup> *Id.* at 4-5.

<sup>5</sup> 42 U.S.C. § 12701.



“help many low-income buyers to overcome that hurdle, and to achieve an important part of the American Dream.”<sup>6</sup> That statute authorized \$200 million per year in down payment assistance to at least 40,000 low-income families.

Numerous studies over time have found that “saving enough cash for a down payment and for up-front closing costs is the greatest barrier that low-income and minority families face when considering homeownership.”<sup>7</sup>

### **Historic Efforts by the Enterprises to Overcome the Down Payment Obstacle**

The Enterprises’ amended charters authorize them to purchase a non-federally insured mortgage for more than 80% of a property’s value, provided that the mortgage includes a form of credit enhancement. The charters identify three specific forms of credit enhancements:

- The seller retains a participation of not less than 10% in the mortgage;
- The seller agrees to repurchase or replace a defaulted mortgage upon demand by an Enterprise, for such period and under such circumstances as the Enterprise may require; or
- The portion of the mortgage amount in excess of 80% LTV is guaranteed or insured by a qualified insurer as determined by each Enterprise.<sup>8</sup>

One of a number of initiatives implemented by the Enterprises to meet their affordable housing goals and to reduce the recognized down payment barriers was high LTV mortgage programs for more than 80% of a property’s value, with credit enhancements. Fannie Mae announced a pilot program in 1994 to buy conventional home mortgages with only a 3%

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<sup>6</sup> Press Release, President Bush Signs American Dream Downpayment Act of 2003 (Dec. 16, 2003) (online at <http://georgewbush-whitehouse.archives.gov/news/releases/2003/12/20031216-9.html>).

<sup>7</sup> U.S. Department of Housing and Urban Development, *HUD’s Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005-2008 and Amendments to HUD’s Regulation of Fannie Mae and Freddie Mac*, 69 Fed. Reg. 63655 (at text accompanying note 105) (Nov. 2, 2004) (online at [www.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/FR-2004-11-02.pdf](http://www.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/FR-2004-11-02.pdf)).

<sup>8</sup> 12 U.S.C. § 1717(b)(2); 12 U.S.C. § 1454(a)(2).

down payment<sup>9</sup> and that program expanded over time.<sup>10</sup> Freddie Mac introduced a 97% LTV mortgage program in 1998.

The LTV ratio is defined by Freddie Mac as a ratio obtained by dividing the first lien mortgage amount by the lesser of the property's purchase price or appraised value of the mortgaged premises. For instance, if a borrower seeks to purchase a house worth \$150,000 and is only able to put down \$4,500, the borrower will need a mortgage of \$145,500. The LTV ratio for that mortgage is calculated at 97% (\$145,500/\$150,000).

### **FHFA's May 2014 Direction to the Enterprises: Increase Access to Mortgage Credit**

HERA established FHFA, an independent agency responsible for the supervision and regulation of the Enterprises and the Federal Home Loan Banks.<sup>11</sup> Using its powers under HERA, FHFA placed the Enterprises into conservatorships on September 6, 2008. As conservator, FHFA's stated goal is to "[h]elp restore confidence, enhance capacity to fulfill mission, and mitigate systemic risk that contributed directly to instability in financial markets."<sup>12</sup>

Beginning in 2012, FHFA has developed and published formal strategic plans that establish strategic goals for the Enterprises.

FHFA has also issued annual conservatorship scorecards to set specific expectations for each strategic plan goal, which enable FHFA and the Enterprises to track progress toward achieving the goals. Each annual scorecard maps to the strategic plan in place at the time the

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<sup>9</sup> Fannie Mae, Information Statement, at 5 (Mar. 31, 1995) (online at [www.fanniemae.com/resources/file/ir/pdf/info-statements/infostmtmar1995.pdf](http://www.fanniemae.com/resources/file/ir/pdf/info-statements/infostmtmar1995.pdf)); see also J. Linn Allen, *Lenders Try 3% Home Down Payments: 750,000 Could Qualify for Loans*, Chicago Tribune (Feb. 17, 1994) (online at [http://articles.chicagotribune.com/1994-02-17/business/9402170318\\_1\\_mortgage-insurance-gecapital-fannie-mae](http://articles.chicagotribune.com/1994-02-17/business/9402170318_1_mortgage-insurance-gecapital-fannie-mae)).

<sup>10</sup> U.S. Department of Housing and Urban Development, *HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005-2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac*, 69 Fed. Reg. 63655 and 63743 (Nov. 2, 2004) (online at [www.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/FR-2004-11-02.pdf](http://www.gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/FR-2004-11-02.pdf)).

<sup>11</sup> 12 U.S.C. § 4511(a).

<sup>12</sup> Congress vested FHFA with sweeping powers as conservator: FHFA possesses all rights and powers of any stockholder, officer, or director of the Enterprises. See 12 U.S.C. § 4617(b)(2)(A)(i). For reasons of efficiency, concordant goals with the Enterprises, and operational savings, FHFA has determined to (1) delegate authority for general corporate governance and day-to-day matters to the Enterprises' boards of directors and executive management and (2) retain authority for certain significant decisions. FHFA requires the Enterprises to consult with and obtain approval from FHFA, as conservator, on critical matters.

scorecard is issued and describes the activities that further each strategic goal.<sup>13</sup> In May 2014, FHFA issued its 2014 scorecard to the Enterprises. FHFA identified four expectations under the strategic plan goal titled “Maintain in a safe and sound manner, foreclosure prevention activities and credit availability for new and refinanced mortgages to foster liquid, efficient, competitive and resilient national housing finance markets.” One of those expectations was to “Work to increase access to mortgage credit for creditworthy borrowers, consistent with the full extent of applicable credit requirements and risk-management practices.” In June 2014, FHFA issued guidance to the Enterprises to meet this expectation:

- Complete an analysis of existing or historical offering of mortgages with a 97% LTV ratio limit;
- Survey market landscape to identify market and opportunity for 97% LTV lending;
- Submit written proposals to offer 97% LTV ratio, first-time homebuyer programs. Such offerings must include appropriate risk controls and risk management practices, guidelines to ensure approval of creditworthy borrowers, mitigating factors that offset incremental risks to lower down payment (e.g., pricing, mortgage insurance, etc.), any changes needed for combined loan-to-value standards, and any other factors that may help create a sustainable mortgage product; and
- Draft conceptual offerings with term sheet.

In October 2014, the FHFA Director announced that FHFA was working with the Enterprises to develop sensible and responsible guidelines for mortgages with LTV ratios between 95% and 97% to increase access for creditworthy but lower-wealth borrowers.<sup>14</sup> In written testimony presented to the Senate Banking Committee on November 19, 2014, the FHFA Director explained the reasons for the low-down payment initiative:

Part of the Enterprises’ mission is promoting access to mortgage credit for creditworthy borrowers across all market segments. We know that in today’s market, there are creditworthy borrowers who have the income to afford monthly mortgage payments but do not have the money to make a large down payment and

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<sup>13</sup> The 2014 Scorecard reflected the change in the conservator’s goals and priorities outlined in the 2014 Strategic Plan. See FHFA, *2014 Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions* (May 13, 2014) (online at [www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014Scorecard051314FINAL.pdf](http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014Scorecard051314FINAL.pdf)).

<sup>14</sup> Melvin L. Watt, FHFA Director, Prepared Remarks at the Mortgage Bankers Association Annual Convention, Las Vegas, Nevada (Oct. 20, 2014), (online at [www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt,-Director,-Federal-Housing-Finance-Agency-at-the-MBA-Annual-Convention.aspx](http://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-of-Melvin-L-Watt,-Director,-Federal-Housing-Finance-Agency-at-the-MBA-Annual-Convention.aspx)).

pay closing costs. As a result, Fannie Mae and Freddie Mac will shortly announce purchase guidelines that allow for 3 to 5 percent down payments, which will improve opportunities for access to credit for some of these borrowers.<sup>15</sup>

### **FHFA's Approval of Freddie Mac's Proposed 97% LTV Mortgage Program**

Pursuant to FHFA's June 2014 guidance, Freddie Mac submitted its proposal to purchase mortgages with an LTV up to 97% to FHFA on September 30, 2014, and submitted a revised proposal on November 14, 2014. FHFA staff reviewed Freddie Mac's proposal and prepared a Staff Memorandum in early December 2014 recommending that the FHFA Director approve it. The Staff Memorandum acknowledged that "historical performance demonstrates that higher LTV loans can have higher risks than lower LTV loans and can have higher loss severities," but asserted that these higher risks can be safely offset by thoughtful compensating factors and risk mitigants.<sup>16</sup> According to that Staff Memorandum, those controls were:

- Strong borrower eligibility requirements and low volume;
- Automated underwriting decisions with maximum or minimum parameters for credit terms such as debt-to-income (DTI) ratios, reserves, and credit scores;
- Private mortgage insurance;
- Homebuyer education and counseling (hereafter homeownership education); and
- FHFA supervision of Enterprise implementation of approved high LTV programs.

The Staff Memorandum stated that high LTV programs with these controls would provide, in a safe and sound manner, "access to credit and homeownership opportunities for creditworthy borrowers who have sufficient income and an ability to pay a mortgage but lack the family and household wealth to put down a large down payment and pay closing costs."<sup>17</sup>

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<sup>15</sup> Senate Committee on Banking, Housing, and Urban Affairs, Statement of Melvin L. Watt, FHFA Director, *An Update from the Federal Housing Finance Agency on Fannie Mae, Freddie Mac, and the Federal Home Loan Banks* (Nov. 19, 2014), (online at [www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-Melvin-L-Watt-Before-the-US-Senate-Banking-Committee-11-19-2014.aspx](http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-Melvin-L-Watt-Before-the-US-Senate-Banking-Committee-11-19-2014.aspx)).

<sup>16</sup> The Staff Memorandum also emphasizes the relative small scale of the programs.

<sup>17</sup> In FHFA's Progress Report on its 2014 Scorecard, the Agency noted that the Enterprises' purchase guidelines emphasize strong underwriting standards and do not allow the kind of risk layering that occurred in the years leading up to the housing crisis. See FHFA, *Progress Report on the Implementation of FHFA's Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*, at 7 (Mar. 16, 2015) (online at [www.fhfa.gov/AboutUs/Reports/ReportDocuments/SPEC2014ProgressReport3162015.pdf](http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/SPEC2014ProgressReport3162015.pdf)).

The Staff Memorandum explained each of these controls.

**Strong Borrower Eligibility Requirements and Low Volume.** The Staff Memorandum explained that Freddie Mac’s proposal offered three 97% LTV mortgage products: an affordable lending product through its *Seller/Servicer Guide* (“Home Possible Advantage”); a separate negotiated product that would adapt some of the Home Possible Advantage program’s parameters, including homeownership education requirements, on a case-by-case basis for housing finance agencies (HFAs) (“Home Possible Advantage for HFAs”), and a limited cash-out refinance product. It also noted that Freddie Mac would not limit the Home Possible Advantage products to first-time homebuyers. Furthermore, the Staff Memorandum explained that the volume of 97% LTV mortgages proposed by Freddie Mac (and Fannie Mae) represented “a small portion of their annual single-family 30 year flow business (approximately 1.0% and 1.5%) and an even smaller proportion of their combined credit guarantee books of business (approximately 0.2% to 0.3%)” based upon “FHFA’s assumption of \$1 trillion in combined 30-year flow over two years (\$400 billion and \$600 billion for Freddie Mac and Fannie Mae[,] respectively) and \$4.5 trillion in existing combined total guaranteed portfolios.”

The Staff Memorandum reported that Freddie Mac’s target volume for its 97% LTV mortgage program was \$1 to \$2 billion in 2015 and \$2 to \$6 billion in 2016.

**Method of Underwriting.** The Staff Memorandum endorsed Freddie Mac’s proposal to purchase 97% LTV mortgages underwritten through its automated underwriting system, Loan Product Advisor (LPA), or manually, if identified by LPA as a “caution” loan.<sup>18 19</sup> According to the memorandum, LPA evaluates components of borrower risk profiles such as credit history, delinquent accounts, borrower’s equity, liquid reserves, DTI, and LTV. The Staff Memorandum also endorsed Freddie Mac’s proposal to purchase 97% LTV mortgages

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<sup>18</sup> According to the Staff Memorandum, the maximum DTI index and the minimum credit score varies by mortgage program. The credit terms for purchase programs underwritten through LPA included a maximum DTI of 45%, while the minimum FICO score was to be determined by the system. Regarding the manually underwritten loans delivered through the purchase programs, the terms included a maximum DTI of 43% and a minimum FICO score of 660. For the refinance programs underwritten through LPA, the credit terms included a maximum DTI of 45% and a minimum FICO score of 680. For manually underwritten loans delivered through refinance programs, the terms included a maximum DTI of 43% and a minimum FICO score of 680.

<sup>19</sup> A “caution” loan, excluding those allowed for delivery through LPA if specific requirements are met, is a loan that would not be accepted for delivery, as underwritten, through LPA. The lender is required to evaluate the loan data and make the final determination regarding borrower creditworthiness and excessive layering of risk (i.e., manually underwrite) these caution loans. According to the Staff Memorandum, the proportion of caution loans requiring manual underwriting was expected to be extremely low – under 5% of 97% LTV mortgage deliveries.

underwritten with other automated underwriting systems on a negotiated basis, such as Fannie Mae's proprietary system – Desktop Underwriter.

**Private Mortgage Insurance.** The Enterprises' charters require mortgage-level credit enhancement for residential mortgages where the unpaid principal balance (UPB) exceeds 80%. Mortgage insurance is a "credit enhancement" that provides first loss protection to the Enterprises.<sup>20</sup> According to the Promontory Financial Group, LLC, the "vast majority of loans over 80% LTV purchased" by the Enterprises use private mortgage insurance as the credit enhancement.<sup>21</sup> The Staff Memorandum reported that the final proposals from each Enterprise required private mortgage insurance for the 97% mortgages that they purchased, as reflected on the final Term Sheets submitted by the Enterprises. It stated that implementation of eligibility requirements for Mortgage Insurance providers (MIs) "should reduce the counterparty risk of the MIs and ensure the availability of the credit enhancement. Further, as an industry, the MIs are currently stronger than they have been in the past."

**Pre-Purchase Homeownership Education.** The Staff Memorandum reported that research indicated that pre-purchase homeownership education can improve borrower performance and that "housing counseling and education for first-time homebuyers participating in the programs [will] serve as an important risk mitigant for the proposed 97% LTV products." Pursuant to the Staff Memorandum, "[t]he lender must retain a record of the independent counseling in the loan file" but the Staff Memorandum does not require the Enterprise to obtain and retain records of such counseling.<sup>22</sup> Freddie Mac's final proposed Term Sheet, which was included in the Staff Memorandum, proposed to require pre-purchase homeownership education for first-time home buyers.

**FHFA Supervision.** The Staff Memorandum identified one additional control not proposed by the Enterprises: FHFA's ongoing oversight of Enterprise purchases of mortgages with 97% LTVs. It explained:

FHFA's ongoing monitoring of the implementation and performance of Enterprise initiatives, in addition to Enterprise quality control findings, is an important oversight control. The Enterprises will provide regular reports to FHFA on loan delivery volumes, loan performance, and average credit parameters. In

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<sup>20</sup> 12 U.S.C. § 1717(b)(2); 12 U.S.C. § 1454(a)(2).

<sup>21</sup> Promontory Financial Group LLC, *The Role of Private Mortgage Insurance in the U.S. Housing Finance System*, at 8 (Jan. 2011) (online at [www.usmi.org/wp-content/uploads/2014/11/Promontory-study-I-Role-of-PMI.pdf](http://www.usmi.org/wp-content/uploads/2014/11/Promontory-study-I-Role-of-PMI.pdf)).

<sup>22</sup> For loans requiring homeownership education, Freddie Mac's *Seller/Servicer Guide* requires that such education be completed before the note date, and retention of documentation, such as a certificate of completion, be in the loan file.

addition to serving as a monitoring tool, these reports will help FHFA develop future policy adjustments, as needed.

The Staff Memorandum did not define the timing or contents of the Enterprises' required reports.

According to the Staff Memorandum, FHFA would review information in these regular reports and "take steps as appropriate as part of the agency's ongoing oversight and conservatorship responsibilities." It recommended that DHMG, which drafted the Staff Memorandum, brief DER on the programs' parameters, to facilitate DER's ability to conduct appropriate supervisory activities.

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The Staff Memorandum opined that 97% LTV mortgage programs with these controls would provide, in a safe and sound manner, "access to credit and homeownership opportunities for creditworthy borrowers who have sufficient income and an ability to pay a mortgage but lack the family and household wealth to put down a large down payment and pay closing costs" and recommended approval of the Enterprises' 97% LTV mortgage programs with these controls. The FHFA Director accepted the staff recommendation and approved the programs on December 3, 2014.<sup>23</sup>

On December 8, 2014, the FHFA Director released a written statement that the Enterprises' 97% LTV mortgage programs provide a responsible approach to improving access to credit for creditworthy borrowers who can afford a mortgage but lack the resources to pay a substantial down payment plus closing costs, while also ensuring safe and sound lending practices.

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<sup>23</sup> The Staff Memorandum also discussed Fannie Mae's proposed 97% LTV mortgage program, which the FHFA Director approved on the same date.



## **Subsequent Variances (Credit Policy Exceptions) Reported by Freddie Mac to its 97% LTV Mortgage Program**

Variances, referred to as credit policy exceptions by Freddie Mac, are negotiated terms with individual lenders that are exceptions to the Enterprises' selling and servicing guides contained within each individual lender's Master Agreement.<sup>24</sup>

For variances within individual Master Agreements, FHFA requires the Enterprises to submit written reports on a regular basis that show their variance activities.<sup>25</sup> To implement this requirement, Freddie Mac submits monthly management reports to FHFA detailing credit policy exceptions within individual Master Agreements.

In its December 2015 monthly variance report to FHFA, Freddie Mac included a credit policy exception that allowed one lender, in partnership with a nonprofit organization, to deliver 97% LTV mortgages to Freddie Mac with a credit enhancement that replaced traditional mortgage insurance for these mortgages. This variance provided that the nonprofit organization would serve as the credit guarantor for that portion of the mortgage over 80% LTV, thereby acting as a credit enhancement.

## **Continued Purchases of 97% LTV Mortgage Purchases Were Contingent on a Credit Risk Review and Approval by Freddie Mac after Certain Delivery Limits Were Reached**

The Staff Memorandum stated that Freddie Mac's proposal incorporated a delivery limit for its 97% LTV mortgage program that included a credit risk review. For mortgages originated under the HFA program, the program was to expire on the earlier of April 1, 2017, or once volume reached \$1.5 billion. For non-HFA related 97% LTV mortgages, the program was to expire on the earlier of April 1, 2016, or once volume reached \$2.5 billion. To continue the 97% LTV mortgage program after these dates, Freddie Mac would need to perform an analysis on the population of loans received and could approve a new policy for going forward only after the approval of its Chief Risk Officer.

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<sup>24</sup> A Master Agreement is an agreement between Freddie Mac and the Seller providing the terms for origination, underwriting, delivery, and any other relevant terms under which Freddie Mac will purchase eligible mortgages over a fixed period of time. The Master Agreement sets forth terms related to the purchase and sale of mortgages, including, among other things, any negotiated provisions that vary from the provisions of Freddie Mac's *Seller/Servicer Guide*.

<sup>25</sup> For a discussion of FHFA's review of variance activities over the period January 2014 through March 2015, see OIG, *Compliance Review of FHFA's Implementation of Its Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Dec. 17, 2015) (COM-2016-001) (online at [www.fhfa.gov/Content/Files/COM-2016-001\\_1.pdf](http://www.fhfa.gov/Content/Files/COM-2016-001_1.pdf)).



Freddie Mac completed an analysis of volume and available performance data of its 97% LTV mortgage purchases for 2015. According to the analysis, Freddie Mac concluded that its risk exposure was limited for its 97% LTV mortgage program and the Enterprise removed the delivery limits. The analysis was approved by Freddie Mac's Chief Risk Officer of Single-Family on March 31, 2016.

## FACTS AND ANALYSIS .....

We performed this audit to assess FHFA's oversight of Freddie Mac's implementation of the 97% LTV mortgage program. As part of assessing FHFA's oversight, we obtained, through FHFA, and analyzed Freddie Mac data on the mortgages purchased by Freddie Mac under the program approved by FHFA's December 2014 Staff Memorandum and whether those mortgages conformed to three FHFA-required credit terms: (1) method of underwriting; (2) mortgage insurance; and (3) homeownership education. There were other risk mitigants associated with Freddie Mac's purchases of high LTV mortgages that were not included within the scope of this audit, such as maximum or minimum parameters for credit terms like DTI ratios and credit scores.

In conducting this audit, we obtained and reviewed data reported to Freddie Mac under the Uniform Mortgage Data Program (UMDP). Established jointly by the Enterprises at the direction of FHFA, the UMDP requires lenders to report a common set of data elements for single-family mortgages purchased by the Enterprises. The UMDP was intended to provide the Enterprises with consistent lender mortgage data and facilitate their ability to reduce risk (and decrease costs) by focusing on the quality of the mortgage prior to its purchase. For Freddie Mac, lenders report these data elements through Freddie Mac's web-based Selling System. These data elements include, but are not limited to, method of underwriting, mortgage insurance, and homeownership education.

### **The Required Risk Mitigants of an Approved Method of Underwriting and Mortgage Insurance Were Utilized in Connection with Freddie Mac's Purchases of 97% LTV Mortgages and, when Required, the Risk Mitigant of Homeownership Education Was Utilized for 98% of the 97% LTV Mortgages Purchased by Freddie Mac**

Our audit covered the high LTV mortgages purchased by Freddie Mac from December 3, 2014, to December 31, 2016, (review period) under the program approved by the Director in the Staff Memorandum.<sup>26</sup> In response to our inquiries, Freddie Mac reported that it purchased 19,628 single-family 97% LTV mortgages with a UPB of \$3 billion during this review period. For this universe of mortgages, we asked Freddie Mac to provide data on the method of underwriting, mortgage insurance, and pre-purchase homeownership education.

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<sup>26</sup> Freddie Mac reported that the first loan delivery for loans included in the scope of this audit was March 25, 2015.

***Data from Freddie Mac Showed that All 19,628 of the 97% LTV Mortgages Were Underwritten Using an Approved Method of Underwriting***

Based on our analysis of the data provided by Freddie Mac, we found that all 19,628 of the 97% LTV mortgages purchased by it were underwritten using an approved method of underwriting: automated underwriting (LPA or Desktop Underwriter)<sup>27</sup> – 19,191 mortgages (98%); and manual underwriting – 437 mortgages (2%). At 2%, the proportion of 97% LTV mortgages that were manually underwritten and purchased by Freddie Mac during our review period was consistent with the expectation expressed in the Staff Memorandum that mortgages requiring manual underwriting was expected to be low, under 5% of 97% LTV mortgage deliveries.

***Data from Freddie Mac Showed that All 19,628 Mortgages Contained Mortgage Insurance or Another Credit Enhancement***

According to the Enterprise, Freddie Mac's Selling System requires lenders to report whether a 97% LTV mortgage contains mortgage insurance or another credit enhancement. Based on our analysis of the data provided by Freddie Mac, we found that all 19,628 of the 97% LTV mortgages purchased by the Enterprise contained information from the lender about required mortgage insurance or another credit enhancement.

***Data from Freddie Mac Showed that 15,730 of the 16,074 Mortgages (98%) Subject to the Homeownership Education Requirement Complied with this Risk Mitigant; Freddie Mac Does Not Consider Noncompliance with this Requirement to Be a Defect***

Based on our analysis of the data provided by Freddie Mac, of the 19,628 mortgages, we found that 16,074 of the 97% LTV mortgages purchased by it were subject to the pre-purchase homeownership education requirement. Of these 16,074 mortgages, 15,730 mortgages met the credit term, which represents a compliance rate of 98%. For the remaining 344 mortgages, Freddie Mac reported, in response to our inquiry, that the lenders could not provide evidence that the homeownership education requirement was met for 13 mortgages and was unable to confirm whether the remaining 331 mortgages met the homeownership education requirement because of the multiple lenders involved.

Regarding quality control reviews, Freddie Mac explained that its quality control department does not check whether homeownership education requirements were met when a mortgage is selected for review. Freddie Mac's rationale is that the homeownership education

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<sup>27</sup> Of the 97% LTV mortgages underwritten by an approved automated underwriting system, Freddie Mac reported purchasing 19,099 mortgages underwritten by LPA and 92 mortgages underwritten by Desktop Underwriter.

requirements are flexible (e.g., different types of firms can provide the education, the education can be completed online or in person). Furthermore, according to Freddie Mac officials, a loan file lacking homeownership education documentation is not considered by the Enterprise to be a significant defect.<sup>28</sup>

In responding to our requests for information regarding homeownership education, Freddie Mac officials also informed us that, as a result of our inquiries, they are developing and implementing additional business rules to: (1) improve the accuracy of lenders' recording of homeownership education information in its Selling System and (2) enforce the homeownership education requirement.

### **FHFA's Oversight of Freddie Mac's 97% LTV Mortgage Program**

As discussed earlier, the Staff Memorandum considered FHFA's ongoing oversight of Enterprise implementation of their 97% LTV mortgage program to be a risk mitigant. We reviewed FHFA's oversight of Freddie Mac's implementation of its 97% LTV mortgage program during the review period and identified the following activities:

- DHMG briefed DER on the parameters of the Enterprises' 97% LTV mortgage programs in December 2014.
- DHMG staff prepared review reports based on Freddie Mac's 97% LTV mortgage program data from June 2015 to September 2017. According to DHMG, it uses the information in these reports to assess whether the goals and objectives of the 97% LTV mortgage program were being met and to flag potential concerns or issues for FHFA leadership. We reviewed these reports and found that none reported on the three credit terms that were the subject of this audit: method of underwriting, mortgage insurance, and pre-purchase homeownership education requirements. These reports also did not contain information about Freddie Mac's quality control reviews. The reports did include information on homebuyers (such as average credit scores and average DTI ratios), loan volume, delinquency rates, and the Enterprises' return on capital/equity. DHMG's report, as of September 2017, also showed that Freddie Mac had acquired a total of 47,497 of the 97% LTV mortgages under its Home Possible

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<sup>28</sup> Freddie Mac defines defect as a loan-level deficiency that breaches a term contained in the Purchase Documents in effect at the time of mortgage purchase. Freddie Mac categorizes defects depending on their severity (e.g., a "significant defect" would require the repurchase of the mortgage or possibly an offer of a repurchase alternative; a "finding" would not require a correction or a remedy from the seller).

Advantage product.<sup>29</sup> That same DHMG report noted that the 120-day delinquency rate for 97% LTV mortgages was 0.08%, 4 basis points higher than its conventional mortgages, which had a 120-day delinquency rate of 0.04%.

- During the 2015 examination cycle, DER performed an ongoing monitoring activity of Freddie Mac's 97% LTV mortgage program.<sup>30</sup> The objective of the supervisory activity was [REDACTED] [REDACTED] DER acknowledged that this activity will be a continuation of the monitoring and analysis of the 97% loan program included in the Staff Memorandum. DER [REDACTED]
- During the 2016 examination cycle, DER performed an ongoing monitoring activity of Freddie Mac's Single-Family Credit Risk Management to include single-family affordable lending. The objective of the supervisory activity was [REDACTED] [REDACTED] This ongoing monitoring activity [REDACTED] However, the DER examiners did observe in the Analysis Memorandum for the ongoing monitoring activity that [REDACTED] [REDACTED] The Analysis Memorandum also described a targeted examination performed in 2016 that focused on [REDACTED] [REDACTED]
- During the 2017 examination cycle, DER initiated an ongoing monitoring activity of Freddie Mac's Single-Family Credit Risk. The objective for this supervisory activity was [REDACTED] [REDACTED] In a mid-year memorandum

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<sup>29</sup> According to officials, Freddie Mac acquired 3,570 97% LTV mortgages during 2015 and that these loans represented 0.3% of the single-family loans acquired during the year. For 2016, Freddie Mac reported that it acquired 16,058 97% LTV mortgages, representing 1% of the single-family loans acquired during the year.

<sup>30</sup> FHFA's supervisory activities include ongoing monitoring and targeted examinations. According to the *FHFA Examination Manual*, the purpose of ongoing monitoring is to analyze real-time information and to use those analyses to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention, while targeted examinations allow for a deep or comprehensive assessment of the area under review.

on the ongoing monitoring activity dated July 27, 2017, DER noted [REDACTED]

[REDACTED] As a  
result, DER noted that [REDACTED]

[REDACTED]

The focus of the oversight activities described above was on Freddie Mac's credit risk management and did not directly address compliance with the three risk mitigants that were the scope of this audit.

## CONCLUSION.....

We performed this audit to assess FHFA’s oversight of Freddie Mac’s implementation of the 97% LTV mortgage program. As part of assessing FHFA’s oversight, we obtained (through FHFA) and analyzed Freddie Mac data on the mortgages purchased by Freddie Mac under the 97% LTV mortgage program approved by FHFA’s December 2014 Staff Memorandum and whether those mortgages conformed to three FHFA-required credit terms. The FHFA-required credit terms that we focused on for this audit were: (1) method of underwriting; (2) mortgage insurance; and (3) homeownership education. Our analysis of data provided by Freddie Mac, through FHFA, found a high rate of compliance for the 19,628 mortgages purchased by Freddie Mac under its 97% LTV mortgage program.

We found no exceptions for the credit terms of method of underwriting and mortgage insurance (or other credit enhancement). For the credit term of homeownership education, we found a compliance rate of 98%. As a result of our inquiries about this credit term, Freddie Mac represented that it is developing and implementing additional business rules to: (1) improve the accuracy of lenders’ recording of homeownership education information in its Selling System and (2) enforce the homeownership education requirement.

We also found that FHFA conducted oversight of Freddie Mac’s implementation of the 97% LTV mortgage program. While FHFA’s supervisory activities [REDACTED], our review of the workpapers for those activities found that none focused directly on the three credit terms that were the subject of this audit.

Freddie Mac’s 97% LTV mortgage program approved by FHFA in December 2014 has not experienced a time of economic stress. As of this writing, the U.S. economy has been stable, gross domestic product growth has been positive every quarter since the second quarter of 2014, and the unemployment rate currently stands at 4.1%. DER’s supervisory activities [REDACTED]

[REDACTED] In view of the increasing volume of 97% LTV mortgages purchased by Freddie Mac, it is prudent for FHFA to conduct supervisory activities over Freddie Mac’s 97% LTV mortgage program, consistent with the recognition in the Staff Memorandum that such activities are “an important oversight control.”

## FHFA COMMENTS AND OIG RESPONSE.....

We provided FHFA an opportunity to respond to a draft of this audit report. FHFA provided technical comments on the draft report, and those comments were incorporated as appropriate.

FHFA also provided a management response which is reprinted in its entirety in the Appendix to this report.



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

The objective of our audit was to assess FHFA’s oversight of Freddie Mac’s implementation of the 97% LTV mortgage program. As part of assessing FHFA’s oversight, we obtained, through FHFA, and analyzed Freddie Mac data on the mortgages purchased by Freddie Mac under the program approved by FHFA’s December 2014 Staff Memorandum and whether those mortgages conformed to certain FHFA-required credit terms. The FHFA-required credit terms that we focused on for this audit were: (1) method of underwriting; (2) mortgage insurance; and (3) homeownership education. There were other risk mitigants associated with Freddie Mac’s purchases of high LTV mortgages that were not included within the scope of this audit, such as maximum or minimum parameters for credit terms like DTI ratios and credit scores.

To address our objective, we:

- Researched and identified applicable laws, regulations, and other guidance that relate to FHFA’s oversight of Freddie Mac’s 97% LTV mortgage program;
- Obtained and reviewed FHFA and/or Freddie Mac documentation and correspondence related to FHFA’s assessment and approval(s) related to Freddie Mac’s 97% LTV mortgage program along with changes to the program;
- Obtained and analyzed information provided by Freddie Mac related to the universe of 97% LTV mortgages purchased from December 3, 2014, through December 31, 2016, to determine whether Freddie Mac purchased mortgages conforming with the three credit terms in the scope of our audit as approved by FHFA’s Staff Memorandum;
- Obtained and analyzed documentation regarding FHFA’s oversight of Freddie Mac’s 97% LTV mortgage program, such as review reports and ongoing monitoring and targeted examination results;
- Interviewed FHFA and Freddie Mac officials to gain an understanding of Freddie Mac’s 97% LTV mortgage program (and applicable credit terms);
- Observed and reviewed some of Freddie Mac’s controls in place to ensure that it implemented FHFA’s requirements related to the three credit terms included in the scope of our audit (for example, Freddie Mac officials demonstrated messages within its Selling System related to compliance with mortgage insurance requirements); and
- Obtained a written representation by the Acting Deputy Director, Division of Conservatorship, that FHFA, as part of its oversight and conservatorship

responsibilities, has taken the appropriate actions that provide a reasonable assurance of the completeness, accuracy, and reliability of the information (program-related data) related to the universe of 97% LTV mortgages purchased by Freddie Mac from December 3, 2014, through December 31, 2016, provided for our audit on behalf of Freddie Mac.

We conducted this performance audit between March 2017 and March 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our 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.


## APPENDIX: FHFA MANAGEMENT RESPONSE.....



### Federal Housing Finance Agency

#### MEMORANDUM

TO: Marla Freedman, Deputy Inspector General for Audits

FROM: Sandra Thompson, Deputy Director, Division of Housing Mission and Goals 

SUBJECT: Draft Report: *Audit of FHFA's Oversight of Freddie Mac's Compliance with the Required Risk Mitigants of Automated Underwriting, Mortgage Insurance, and Homeownership Education for Its Purchase of Mortgages with a 97% LTV*

DATE: March 1, 2018

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Thank you for the opportunity to respond to the Federal Housing Finance Agency Office of Inspector General's (FHFA OIG) draft report, *Audit of FHFA's Oversight of Freddie Mac's Compliance with the Required Risk Mitigants of Automated Underwriting, Mortgage Insurance, and Homeownership Education for Its Purchase of Mortgages with a 97% LTV*. The audit reviewed FHFA's oversight of Freddie Mac's 97% LTV mortgage program and whether the 97% LTV mortgages purchased by Freddie Mac conformed to credit terms for (1) automated underwriting, (2) mortgage insurance, and (3) homeownership education.

I am pleased the audit found a high rate of compliance for the 97% LTV mortgages purchased by Freddie Mac. Please feel free to contact me with any questions.

cc: Larry Stauffer, Acting Chief Operating Officer  
John Major, Internal Controls and Audit Follow-up Manager

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