

REDACTED

Federal Housing Finance Agency
Office of Inspector General



**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**

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

Audit Report • AUD-2018-003 • March 8, 2018



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



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

Based on our inquiries to FHFA and Fannie Mae, and our analysis of the data provided by the Enterprise, we found that Fannie Mae purchased 74,700 mortgages from December 3, 2014, to December 31, 2016, under the 97% LTV mortgage program. Of those mortgages purchased, all were underwritten using an automated underwriting system and all but two loans utilized mortgage insurance or another credit enhancement. With regard to homeownership education, which was required for only about a fourth of the 97% LTV mortgage purchases, we found that Fannie Mae relied on the lenders' representations and warranties to determine whether this requirement was met. Fannie Mae quality control reviews of purchased loans found 20 exceptions with homeownership education, representing 3% of loans sampled where homeownership education was a requirement. During our field work, Fannie Mae advised us that in March 2017, it implemented a "fatal" rule in its Loan Delivery system, requiring lenders to confirm that pre-purchase homeownership education has been completed, when required, or the mortgage will be rejected.

Our audit also reviewed FHFA's ongoing oversight of Fannie Mae 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 Fannie Mae 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.
- Supervisory activities conducted by DER on Fannie Mae's 97% LTV mortgage program that consisted of an ongoing monitoring activity during the 2016 examination cycle and a targeted examination during the 2017 examination cycle.

These oversight activities focused on Fannie Mae'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 Freddie Mac's 97% LTV mortgage program, which was also approved by FHFA's December 2014 Staff Memorandum. See *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* (AUD-2018-004) (available online at www.fhfaog.gov/reports/auditsandevaluations).

This report was prepared by: Tara Lewis, Audit Director; Pamela L. Williams, Auditor-in-Charge; Andrew Gegor, 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.fhfaog.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
DU	Desktop Underwriter
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
HUD	U.S. Department of Housing and Urban Development
LTV	Loan-to-Value
MCM	MyCommunityMortgage
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.”¹ 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.²

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.”³ The Strategy identified specific actions to be taken to lower barriers to homeownership, including working collaboratively to reduce homebuyer down payment requirements.⁴ 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,⁵ he recognized that “[o]ne of the biggest hurdles to homeownership is getting money for a down payment” and explained that the statute would

¹ 12 U.S.C. § 4501.

² 12 U.S.C. § 4561(a); 12 U.S.C. § 4566(a)(1).

³ 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).

⁴ *Id.* at 4-5.

⁵ 42 U.S.C. § 12701.

“help many low-income buyers to overcome that hurdle, and to achieve an important part of the American Dream.”⁶ 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.”⁷

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.⁸

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%

⁶ 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>).

⁷ 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).

⁸ 12 U.S.C. § 1454(a)(2); 12 U.S.C. § 1717(b)(2).

down payment⁹ and that program expanded over time.¹⁰ Freddie Mac introduced a 97% LTV mortgage program in 1998.

The LTV ratio is defined by Fannie Mae as the ratio between the original amount of the first mortgage and the lower of the property's appraised value or sales price. 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.¹¹ 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."¹²

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

⁹ Fannie Mae, Information Statement, at 5 (Mar. 31, 1995) (online at 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).

¹⁰ 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).

¹¹ 12 U.S.C. § 4511(a).

¹² 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.¹³ 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.¹⁴ 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

¹³ 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).

¹⁴ 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).

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.¹⁵

FHFA's Approval of Fannie Mae's Proposed 97% LTV Mortgage Program

Pursuant to FHFA's June 2014 guidance, Fannie Mae submitted its proposal to purchase mortgages with an LTV up to 97% to FHFA on September 30, 2014, and, based on feedback received from FHFA, submitted a revised proposal on November 5, 2014. FHFA staff reviewed Fannie Mae'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.¹⁶ 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."¹⁷

¹⁵ 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).

¹⁶ The Staff Memorandum also emphasizes the relative small scale of the programs.

¹⁷ 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).

The Staff Memorandum explained each of these controls.

Strong Borrower Eligibility Requirements and Low Volume. The Staff Memorandum explained that Fannie Mae’s proposal offered three 97% LTV mortgage products: an affordable lending product limited to first-time homebuyers through its MyCommunityMortgage (MCM) program; a “Standard 97” (non-MCM) product limited to first-time homebuyers; and limited cash-out refinances of existing Fannie Mae mortgages up to 97% LTV. It explained that the volume of 97% LTV mortgages proposed by Fannie Mae (and Freddie Mac) 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 Fannie Mae estimated its volume for purchases of 97% LTV mortgages and refinancings in 2015 to be \$5.6 billion but provided no projection after 2015. It explained that there were several factors contributing to Fannie Mae’s relatively low projected volume in 2015, including roughly three quarters of purchasing activity in 2015 and its limitation on purchases of 97% LTV mortgages to first-time homebuyers.

Automated Underwriting. The Staff Memorandum endorsed Fannie Mae’s proposal to only purchase 97% LTV mortgages processed through its automated underwriting system, Desktop Underwriter (DU), with a minimum credit score of 620 and a maximum DTI index of 45%. According to the memorandum, DU evaluates components of borrower risk profiles such as credit history, delinquent accounts, borrower equity, liquid reserves, DTI, and LTV. Additionally, the DU evaluation considers risk layering; a borrower would be ineligible for a high LTV mortgage if multiple risk factors were present or layered on top of another.¹⁸

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.¹⁹ 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

¹⁸ Fannie Mae defines risk layering as combining multiple higher risk elements on a single mortgage, such as a low credit score with a high debt ratio. According to FHFA, in the period prior to pre-2009, underwriting standards became progressively less rigorous resulting in significant risk layering, which led to significantly increased risk for high LTV programs instead of mitigating that risk.

¹⁹ 12 U.S.C. § 1454(a)(2); 12 U.S.C. § 1717(b)(2).

enhancement.²⁰ 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.²¹

Fannie Mae’s final proposed Term Sheet, which was included in the Staff Memorandum, proposed to require pre-purchase homeownership education only for first-time homebuyers in the MCM program, not for first-time homebuyers with loans delivered through the Standard 97 (non-MCM) program or for borrowers refinancing an existing Fannie Mae mortgage. The Staff Memorandum, which recommends approval of Fannie Mae’s proposal, provides no explanation for the reasons why the “important risk mitigant” of pre-purchase homeownership education was not required for all first-time homebuyers.

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

²⁰ 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).

²¹ For programs requiring homeownership education, Fannie Mae’s *Selling Guide* requires that such education be completed prior to closing, and retention of documentation, such as a certificate of course completion, be in the loan file.

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.

* * * * *

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, 2014.²²

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.

Subsequent Policy Changes to Fannie Mae's 97% LTV Mortgage Program

Where the Enterprises seek significant or material changes to existing selling and servicing guides, they must follow a process established by FHFA to provide notice of the proposed change so that FHFA has sufficient time to analyze the proposal. Pursuant to this process, an Enterprise seeking a significant/material policy change submits its proposal to FHFA, and the Office of Housing and Regulatory Policy, an office within DHMG: researches the policy topic; coordinates with subject matter experts, as needed; and when its review is complete, informs the Enterprise of the policy determination (i.e., no further questions or comments, objection to the implementation of the policy and the grounds, or key comments or concerns.)

²² The Staff Memorandum also discussed Freddie Mac's proposed 97% LTV mortgage program, which the FHFA Director approved on the same date.

Fannie Mae's Request for Policy Change to Redesign MCM

On July 22, 2015, Fannie Mae submitted its proposal to change its MCM program to FHFA. According to Fannie Mae's notice of proposed change, the MCM program had been its affordable lending product since 2001, but that over time, most of the underwriting and eligibility flexibilities had been removed or transitioned into standard policy. To support access to credit for creditworthy borrowers, Fannie Mae proposed to redesign MCM with a new name and change its underwriting and eligibility guidelines, pricing, and homeownership education and counseling requirements. These proposed changes would modify existing underwriting criteria for 97% LTV MCM mortgages in the Director-approved December 2014 Staff Memorandum.

As discussed earlier, Fannie Mae's final proposed Term Sheet for its 97% LTV mortgage program, which was included in the Staff Memorandum, required pre-purchase homeownership education only for first-time homebuyers in the MCM program. Its July 2015 notice proposed, in part, two changes: (1) to eliminate the first-time homebuyer requirement for the MCM redesigned program; and (2) to require pre-purchase homeownership education for at least one borrower in all MCM redesign transactions. Fannie Mae proposed that its policy changes would become effective in December 2015.

DHMG staff reviewed Fannie Mae's proposal and prepared a "Review Memo" dated August 18, 2015, in which it analyzed the proposed changes and their impact and recommended that no objection be interposed to the proposed policy changes. The following day, the FHFA Director and FHFA's Acting Deputy Director, Division of Conservatorship, met with Fannie Mae's Chief Executive Officer and other Fannie Mae executives to review the proposed policy changes. Fannie Mae representatives briefed the Director on the proposed policy changes using a PowerPoint entitled "Access to Credit and Affordable Housing," which explained proposed changes to underwriting criteria. On August 20, 2015, DHMG informed Fannie Mae that FHFA had no objections to the policy changes sought in its MCM redesign request.²³

²³ On September 29, 2015, Fannie Mae announced the rebranded MCM program as HomeReady.

Subsequent Variances Reported by Fannie Mae to its 97% LTV Mortgage Program

Variances are negotiated terms with individual lenders that are exceptions to the Enterprises' selling and servicing guides contained within each individual lender's Master Agreement.²⁴

For variances within individual Master Agreements, the Enterprises are not required to follow the same process they must follow for proposed significant or material policy changes to selling and servicing guides. Specifically, FHFA requires the Enterprises to submit written reports on a regular basis that show their variance activities.²⁵ To implement this requirement, Fannie Mae submits monthly management reports to FHFA detailing variances within individual Master Agreements.

In its June 2016 monthly variance report to FHFA, Fannie Mae included a variance that allowed one lender, in partnership with a nonprofit organization, to deliver 97% LTV mortgages to Fannie Mae with a repurchase obligation that replaced traditional mortgage insurance.²⁶ In addition, this variance provided that the nonprofit organization would serve as the credit guarantor for a portion of the credit losses, thereby acting as an additional credit enhancement.

²⁴ A Master Agreement is an "umbrella" document that supplements the general guidelines and requirements of the Fannie Mae *Selling Guide* and *Servicing Guide* and sets forth the additional terms under which Fannie Mae does business with lenders. Each lender must have a Master Agreement for mortgage-backed securities and for any loans originated or delivered under negotiated terms.

²⁵ 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).

²⁶ According to the terms of the variance, Fannie Mae has the right to require the non-profit organization to repurchase loans under certain circumstances.

FACTS AND ANALYSIS

We performed this audit to assess FHFA’s oversight of Fannie Mae’s implementation of the 97% LTV mortgage program. As part of assessing FHFA’s oversight, we obtained, through FHFA, and analyzed Fannie Mae data on the mortgages purchased by Fannie Mae 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: (1) automated underwriting; (2) mortgage insurance; and (3) homeownership education. There were other risk mitigants associated with Fannie Mae’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 Fannie Mae 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 Fannie Mae, lenders report these data elements through Fannie Mae’s web-based Loan Delivery system. These data elements include, but are not limited to, automated underwriting, mortgage insurance, and homeownership education.

The Required Risk Mitigants of Automated Underwriting and Mortgage Insurance Were Utilized, With Few Exceptions Reported, in Connection with Fannie Mae’s Purchases of 97% LTV Mortgages and, for the Risk Mitigant of Homeownership Education, Fannie Mae Relied on the Lenders’ Representations and Warranties that the Credit Term Was Met

Our audit covered the high LTV mortgages purchased by Fannie Mae from December 3, 2014, to December 31, 2016, (review period) under the program approved by the Director in the Staff Memorandum, as revised in 2015.²⁷ In response to our inquiries, Fannie Mae reported that it purchased 74,700 single-family 97% LTV mortgages with a UPB of

²⁷ Fannie Mae reported that the first loan delivery for loans included in the scope of this audit was December 30, 2014.

\$14.1 billion during this review period.²⁸ For this universe of mortgages, we asked Fannie Mae to provide data on the automated underwriting, mortgage insurance, and pre-purchase homeownership education.

Data from Fannie Mae Showed that All 74,700 of the 97% LTV Mortgages Were Underwritten Using an Automated Underwriting System

Based on our analysis of the data provided by Fannie Mae, we found that all 74,700 of the 97% LTV mortgages purchased by it were underwritten using an automated underwriting system.²⁹

Fannie Mae initially reported that its Loan Delivery system showed 5 of the 74,700 mortgages (0.007%) were underwritten using a proprietary automated underwriting system other than DU or Loan Product Advisor. Although proprietary automated underwriting was not permitted under the terms of FHFA's approval of Fannie Mae's 97% LTV mortgage program, Fannie Mae's Loan Delivery system did not identify these mortgages as ineligible or otherwise prevent their purchase by Fannie Mae.

In response to our follow-up requests, Fannie Mae reported to us that the lenders for these 5 mortgages represented to Fannie Mae that each of the 5 were underwritten using DU but had incorrectly recorded a different method of underwriting in the Loan Delivery system. Fannie Mae also stated to us that, as of November 2016, its Loan Delivery system no longer allows a lender to report use of a proprietary underwriting system in connection with 97% LTV mortgages, unless there is a specific lender variance in place at the time of purchase.³⁰

Data from Fannie Mae Showed that All But 2 of the 74,700 Mortgages Contained Mortgage Insurance or Another Credit Enhancement

Based on our analysis of the data provided by Fannie Mae, of the 74,700 mortgages, we found that 2 of the 97% LTV mortgages purchased (0.003%) lacked information from the lender

²⁸ In addition to the 74,700 97% LTV mortgages purchased under the program approved by the Staff Memorandum that are the scope of this audit, Fannie Mae purchased 84,226 mortgages with LTVs between 95% and 97% and a combined UPB of \$14.6 billion between December 3, 2014, and December 31, 2016, delivered under continuing programs offered by Fannie Mae prior to conservatorship. The mortgage purchases through these continuing programs are not included in the scope of this audit.

²⁹ Fannie Mae reported that, during the scope of our audit, lenders delivered 74,674 of the 74,700 97% LTV mortgages underwritten using DU. Eight lenders delivered, through variances (i.e., negotiated terms), the remaining 26 loans underwritten using Freddie Mac's automated underwriting system, Loan Product Advisor.

³⁰ Fannie Mae also reported that for another 47 mortgages, the lender had recorded in the Loan Delivery system that both DU and Loan Product Advisor were used to underwrite that loan. In following up on our inquiry about these loans, Fannie Mae reported that the lenders had incorrectly recorded both underwriting methods in the Loan Delivery system; for these 47 mortgages, the lenders represented to Fannie Mae that DU was used, not both.

about required mortgage insurance or another credit enhancement. For these two mortgages, Fannie Mae subsequently reported that one was paid in full and one was repurchased by the lender.

As part of determining whether the 97% LTV mortgages included mortgage insurance or another credit enhancement as required, we found that Fannie Mae's Loan Delivery controls did not prevent mortgages from being purchased where the lender did not provide information about mortgage insurance or another credit enhancement. In addition to the two exceptions explained above, Fannie Mae officials found, in the course of responding to our requests, that lenders for 24 mortgages did not provide mortgage insurance information upon delivery. For these mortgages, Fannie Mae contacted the lenders to obtain the mortgage insurance information. We compared the date Fannie Mae purchased the mortgages to the date the lender provided the mortgage insurance information and found that the lag in receipt of the information was up to 28 months.

During our field work, Fannie Mae reported that it implemented a "fatal" rule in its Loan Delivery system for any loans in which the lender did not provide information about mortgage insurance or another credit enhancement. This "fatal" rule means that, at the discretion of Fannie Mae, a mortgage may be rejected if the lender does not provide the mortgage insurance or other credit enhancement information.

Fannie Mae Relied on the Lenders' Representations and Warranties that the Pre-Purchase Homeownership Education Requirement Was Met

As discussed earlier, Fannie Mae's final proposed Term Sheet required homeownership education for only one category of 97% LTV mortgages – first-time homebuyers in the MCM program – which the FHFA Director approved. In July 2015, Fannie Mae proposed to expand the homeownership education requirement to at least one borrower in all MCM redesign transactions, to which FHFA did not object. Of the 74,700 mortgages, Fannie Mae reported that 18,769 (25%) of the 97% LTV mortgages purchased were subject to the pre-purchase homeownership education requirement.

Fannie Mae reported to us that its Loan Delivery system contained fields for lenders to report at the time of loan delivery: (a) whether pre-purchase homeownership education was required and (b) whether such education requirement was satisfied; however, Fannie Mae did not use this information.³¹ As a consequence, Fannie Mae did not make use of a front-end (preventive) control at the time of purchase to determine whether the homeownership education requirement was met. Instead, Fannie Mae relied on representations and warranties

³¹ According to Fannie Mae, when lenders provided this information, it flowed into a system that was not one from which Fannie Mae ran reports. So, while Fannie Mae had the information, it did not make use of it.

by lenders – a back-end (detective) control – that all requirements of the 97% LTV mortgage program were met, including pre-purchase homeownership education, when required.

Based on our analysis of the data provided by Fannie Mae, we found that, as part of its quality control program, Fannie Mae completed quality control reviews of 716 of the 18,769 mortgages requiring pre-purchase homeownership education. Those reviews identified 20 exceptions (3% of the sample).³² For one of the exceptions, Fannie Mae cited a significant defect and reported that the lender would repurchase the mortgage. For the other 19 exceptions, Fannie Mae cited the lender with a finding for missing homeownership education.

During our field work, Fannie Mae reported that it implemented a “fatal” rule in its Loan Delivery system in March 2017, requiring lenders to confirm that homebuyers have completed pre-purchase homeownership education, when required. This “fatal” rule means that a mortgage will be rejected if the lender does not confirm that homebuyers have completed pre-purchase homeownership education when it is required. Fannie Mae also reported that, as of June 15, 2017, the absence of homeownership education documentation will be considered a significant defect if found during a quality control review.

FHFA’s Oversight of Fannie Mae’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 Fannie Mae’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 Fannie Mae’s 97% LTV mortgage program data from May 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: automated underwriting, mortgage insurance, and pre-purchase homeownership education requirements. These

³² Fannie Mae defines a “significant defect” as “one or more defects that either necessitates a change to the price on which the loan was acquired or result in the loan being unacceptable for purchase had the true and accurate information about the loan been known at the time of purchase.” A finding is defined as “one or more defects that, when considered with other loan features, does not necessitate a change in the price of the loan or result in the loan being unacceptable even if the true and accurate facts about the loan had been known at the time Fannie Mae purchased or securitized the loan.”

reports also did not contain information about Fannie Mae'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 Fannie Mae had acquired a total of 123,753 of the 97% LTV mortgages under its Standard 97 product.³³ That same DHMG report noted that the 90-day delinquency rate for 97% LTV mortgages was 0.22%, 8 basis points higher than its conventional mortgages, which had a 90-day delinquency rate of 0.14%.

- During the 2016 examination cycle, DER performed an ongoing monitoring activity of Fannie Mae's Single-Family Mortgage Business.³⁴ The ongoing monitoring activity included a procedure to review monthly acquisition metrics for 97% LTV mortgages. The 2016 ongoing monitoring activity [REDACTED] However, DER examiners observed in the closeout memorandum that [REDACTED]
- During the 2017 examination cycle, DER initiated a targeted examination [REDACTED] The targeted examination was in progress as of March 2018.

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

³³ According to Fannie Mae's Annual SEC 10-K filings, it reported that it acquired approximately 24,000 97% LTV mortgages during 2015 and that these loans represented 1% of the single-family loans acquired during the year. For 2016, Fannie Mae reported that it acquired approximately 50,000 97% LTV mortgages, representing 2% of the single-family loans acquired during the year.

³⁴ 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.

CONCLUSION.....

We performed this audit to assess FHFA’s oversight of Fannie Mae’s implementation of the 97% LTV mortgage program. As part of assessing FHFA’s oversight, we obtained (through FHFA) and analyzed Fannie Mae data on the mortgages purchased by Fannie Mae 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) automated underwriting; (2) mortgage insurance; and (3) homeownership education. Our analysis of data provided by Fannie Mae, through FHFA, found a high rate of compliance with these credit terms for the 74,700 mortgages purchased by Fannie Mae under its 97% LTV mortgage program.

Fannie Mae reported during our field work that it made changes to its systems and quality control reviews that, if implemented as described, should enhance controls over all three credit terms. Specifically, Fannie Mae stated that, as of November 2016, its Loan Delivery system no longer allows a lender to report use of a proprietary underwriting system in connection with 97% LTV mortgages, unless there is a specific lender variance in place at the time of purchase. Fannie Mae also reported that it implemented a “fatal” rule in its Loan Delivery system for any loans in which the lender did not provide information about mortgage insurance or another credit enhancement. And, for homeownership education, Fannie Mae reported that it implemented a “fatal” rule in its Loan Delivery system in March 2017, requiring lenders to confirm that homebuyers have completed pre-purchase homeownership education, when required. Lastly, Fannie Mae reported that, as of June 15, 2017, the absence of homeownership education documentation will be considered a significant defect if found during a quality control review.

We also found that FHFA conducted oversight of Fannie Mae’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.

Fannie Mae’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%. In the closeout memorandum for a 2016 ongoing monitoring activity, DER examiners observed that [REDACTED]. In view of the increasing volume of 97% LTV mortgages purchased by Fannie Mae, it is prudent for FHFA to conduct supervisory activities over Fannie Mae’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 Fannie Mae’s implementation of the 97% LTV mortgage program. As part of assessing FHFA’s oversight, we obtained, through FHFA, and analyzed Fannie Mae data on the mortgages purchased by Fannie Mae 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.³⁵ The FHFA-required credit terms that we focused on for this audit were: (1) automated underwriting; (2) mortgage insurance; and (3) homeownership education. There were other risk mitigants associated with Fannie Mae’s purchases of high LTV mortgages that were not included within the scope of this audit.

To address our objective, we:

- Researched and identified applicable laws, regulations, and other guidance that relate to FHFA’s oversight of Fannie Mae’s 97% LTV mortgage program;
- Obtained and reviewed FHFA and/or Fannie Mae documentation and correspondence related to FHFA’s assessment and approval(s) related to Fannie Mae’s 97% LTV mortgage program along with changes to the program;
- Obtained and analyzed information provided by Fannie Mae related to the universe of 97% LTV mortgages purchased from December 3, 2014, through December 31, 2016, to determine whether Fannie Mae 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 Fannie Mae’s 97% LTV mortgage program, such as review reports and ongoing monitoring and targeted examination results;
- Interviewed FHFA and Fannie Mae officials to gain an understanding of Fannie Mae’s 97% LTV mortgage program (and applicable credit terms);
- Observed and reviewed Fannie Mae’s updates to its loan tracking system in response to our audit inquiries related to the automated underwriting and mortgage insurance for 97% LTV mortgages purchased during the scope of our audit (for example, Fannie

³⁵ The mortgages with LTVs between 95% and 97% delivered between December 3, 2014, and December 31, 2016, under continuing programs offered by Fannie Mae prior to conservatorship are not included in the scope of this audit.

Mae updated its loan tracking system after it received mortgage insurance information during our audit); 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 Fannie Mae from December 3, 2014, through December 31, 2016, provided for our audit on behalf of Fannie Mae.

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 *STh*

SUBJECT: Draft Report: *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 Purchase of Mortgages with a 97% LTV*

DATE: March 1, 2018

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 Fannie Mae's Compliance with the Required Risk Mitigants of Automated Underwriting, Mortgage Insurance, and Homeownership Education for Its Purchase of Mortgages with a 97% LTV* (Report). The audit reviewed FHFA's oversight of Fannie Mae's 97% LTV mortgage program and whether the 97% LTV mortgages purchased by Fannie Mae 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 Fannie Mae. 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

ADDITIONAL INFORMATION AND COPIES.....

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