



**U.S Department of Housing and Urban  
Development, Office of Single Family Housing**

**FHA's Loss Mitigation Program**



Issue Date: September 24, 2014

Audit Report Number: 2014-KC-0004

TO: Kathleen Zadareky, Deputy Assistant Secretary for Single Family Housing, HU

//signed//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: Lenders Generated \$428 Million in Gains From Modifying Defaulted FHA Loans

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of lender gains from Federal Housing Administration (FHA) loan modifications.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 913-551-5870.



September 24, 2014

## Lenders Generated \$428 Million in Gains From Modifying Defaulted FHA Loans

# Highlights

Audit Report 2014-KC-0004

### What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) loss mitigation program. We initiated this audit due to our concern that FHA might have incurred costs while allowing lenders to make large amounts of money by modifying defaulted FHA-insured loans. Our audit objective was to determine the extent to which loans modified under the FHA program generated gains for the lenders.

### What We Recommend

We recommend that HUD perform a study of the loan modification program and evaluate whether any changes are needed to strengthen the insurance fund.

### What We Found

Lenders generated an estimated \$428 million in gains from the sale of Government National Mortgage Association securities when modifying defaulted FHA loans in fiscal year 2013. These loan modifications were completed as part of FHA's loss mitigation program. None of these lender generated gains were used to offset FHA's insurance fund costs. As a result, FHA missed opportunities to strengthen its insurance fund.

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## BACKGROUND AND OBJECTIVE

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The U.S. Department of Housing and Urban Development (HUD) initiated its loss mitigation program to provide maximum opportunities for Federal Housing Administration (FHA)-insured borrowers to retain home ownership. The program delegates loss mitigation responsibility and authority to lenders. They must consider the comparative effects of their elective servicing actions and take steps that can reasonably be expected to generate the smallest financial loss to FHA. Such actions include but are not limited to deeds in lieu of foreclosure, preforeclosure sales, partial claims, assumptions, special forbearance, and recasting of mortgages. Regulations at 24 CFR 203.605 require lenders to evaluate all loss mitigation techniques available before four full monthly installments due on the mortgage have gone unpaid. FHA pays lenders an incentive of \$750 for each loan modification they complete.

Lenders are authorized to package FHA loans into securities as mortgage-backed securities and offer them to investors willing to purchase them. The Government National Mortgage Association (Ginnie Mae), through its mortgage-backed securities program, guarantees these securities. Security holders receive a “pass-through” of the principal and interest payments on a pool of mortgages, less amounts required to cover servicing costs and Ginnie Mae guaranty fees. The Ginnie Mae guaranty ensures that the security holder receives the timely payment of scheduled monthly principal and any unscheduled recoveries of principal on the underlying mortgages, plus interest at the rate provided for in the securities. The pools are composed of mortgages that are insured or guaranteed by FHA and other government entities.

Lenders issuing securities must pay security holders on time the full amount specified by the terms of the securities. If pooled loans are delinquent or in foreclosure, lenders must use their own funds to pay security holders when payment is due. For loans backing a Ginnie Mae security which has an issue date on or after January 1, 2003, lenders may repurchase a loan without written permission from Ginnie Mae if the borrower fails to make a payment for 3 consecutive months. Lenders may repurchase any pooled loan for an amount equal to 100 percent of the loan’s outstanding balance and may recover advances from funds remaining after they pay off the security holders.

Modified loans that have successfully completed the modification process and have been permanently modified may be repooled. To be eligible for repooling, the permanently modified loan must be current as of the issuance date of the related security. When a security is sold for a premium, it is sold for more than its face value (unpaid principal balance), and when it is sold at a discount, the lender receives less than the face value. The lenders receive this lump-sum payment at the time of the sale of each mortgage-backed security. Typically, the higher the interest rate of the security, the higher the premium it is sold for. Currently, there is no requirement or restriction on how the lenders use these gains.

Our audit objective was to determine the extent to which loans modified under the FHA program generated gains for the lenders.

## RESULTS OF AUDIT

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### Lenders Generated \$428 Million in Gains From Modifying Defaulted FHA Loans

Lenders generated an estimated \$428 million in gains from the sale of Ginnie Mae securities when modifying defaulted FHA loans in 2013. These loan modifications were completed as part of FHA's loss mitigation program. FHA does not have requirements governing the use of these lender gains and it does not receive information on the amounts of the gains generated. As a result, FHA missed opportunities to strengthen its insurance fund.

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#### Lenders Generated Gains

Lenders generated an estimated \$428 million in gains from the sale of Ginnie Mae securities related to modified FHA loans. These loan modifications were completed as part of FHA's loss mitigation program. Lenders received these gains from modifying 67,048 defaulted FHA loans during fiscal year 2013 and packaging them into Ginnie Mae securities between September 2012 and April 2014. The sale of these securities was made possible by the FHA loss mitigation program. When the original loans became delinquent, Ginnie Mae allowed the lenders to repurchase the loans for an amount equal to 100 percent of the loans' principal balance (that is, at face value or par). After successfully undergoing loan modifications, these repurchased loans were eligible to be repooled in mortgage-backed securities. The lenders were able to obtain these gains as a result of the loan modifications completed as part of the FHA program.

#### FHA Lacked Requirements and Data Access

FHA does not have requirements governing the use of the lender gains from the sale of Ginnie Mae securities nor does it have access to the details of these transactions.

Specifically, FHA does not impose any limitations on how the lenders use the gains from the sale of these securities or how much they can generate in gains. Lenders are free to sell the securities at a price the market will bear and are unencumbered in their use of these gains.

In addition, FHA does not have a mechanism to record or track Ginnie Mae securities sales data as lenders do not currently share that information with it and there is no central repository for this information.

## **FHA Missed Opportunities**

FHA may have missed opportunities to strengthen its insurance fund. Lenders could be required to offset gains they obtained from the sale of securities for incentive fees and claims for modified loans that redefault.

At a minimum, FHA could have reduced or eliminated the incentive fees paid to lenders for modifying loans. For the 67,048 loans modified in fiscal year 2013 and repooled, FHA paid about \$50 million in loan modification incentives to the lenders.

Lenders could be required to utilize the gains to offset the losses realized when the modified loans became nonperforming and the associated property was foreclosed upon. If FHA required lenders to apply the gains against its claims for FHA insurance on failed loans, the insurance fund would pay out smaller claim amounts on the loans that fail.

Another opportunity to strengthen the insurance fund would be to decrease the allowable interest rate for modified loans. While such a decrease would reduce the lenders' gains from repooling the loans, it should assist some homeowners in maintaining their modified loan in good standing by lowering their payments, and/or reducing the deferred principal amount in the form of a Partial Claim, which is a subordinate lien that does not have to be repaid unless the modified loan is sold or refinanced.

## **Conclusion**

Lenders generated an estimated \$428 million in gains from the sale of Ginnie Mae securities related to modified defaulted FHA loans in 2013 and FHA did not seek a portion of the gains to offset its incentive fees for loan modifications or claims of modified loans that redefaulted. Therefore, it missed opportunities to strengthen its insurance fund and should explore potential program modifications to reduce future payments.

## **Recommendation**

We recommend that the Deputy Assistant Secretary for Single Family Housing

- 1A. Perform a study of the loan modification program and evaluate whether any changes are needed, such as (1) developing procedures to offset lender gains from insurance fund payments, (2) reducing the allowable interest rate for loan modifications, and (3) examining the incentives paid to lenders modifying loans, to put \$50 million to better use.

## SCOPE AND METHODOLOGY

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To accomplish our objective, we

- Interviewed HUD staff,
- Reviewed Federal regulations and mortgagee letters,
- Reviewed the Ginnie Mae mortgage-backed securities guide, and
- Selected and reviewed a statistical sample of successfully completed loan modifications.

We performed our audit between March and August 2014. Our audit generally covered October 1, 2012, through September 30, 2013.

The Single Family Data Warehouse is a large and extensive collection of database tables organized and dedicated to support the analysis, verification, and publication of Single Family Housing data. Using this system, we identified loans with loss mitigation claims in the “loss\_mitigation” table by a code of “32” (loan modification) in the “clm\_typ” field. We included only claims that had been paid, indicated by a value of “1” (claims paid without corrections required) or “2” (claims suspended then paid) in the “clm\_sts\_cd” field. Using this process, we identified 107,689 loan modification claims processed between October 1, 2012, and September 30, 2013. We matched these loans against the system’s monthly transaction table for Ginnie Mae, known as “gnma\_loan\_level.” This match identified 67,048 loan modifications that had resold on the secondary market as Ginnie Mae mortgage-backed securities between September 2012 and April 2014. Because our universe was determined based on claim dates rather than the date the loan was actually modified, some loans repooled before their loan modification claims were processed; therefore some loans were repooled in September 2012 even though the claims were processed in fiscal year 2013.

We used a sampling frame to represent the universe. Our sampling frame consisted of the 56,504 loan modifications that were handled by the top 9 servicers of FHA loans and were resold as mortgage-backed securities. The single, first occurrence of a sale to a secondary market mortgage-backed security between September 2012 and April 2014 was the sampling unit. In the event that a loan was pulled from a pool and sold again on the secondary market as sometimes occurred, we did not include the second sale in our universe as that sale might have occurred with or without the loan modification.

For the purpose of stratifying the sample and testing the viability of the design, we estimated the amount of gain on resale for each loan. We did so by applying the published market value of the mortgage-backed security for the coupon rate that was closest to the yield of the associated Ginnie Mae pool during the month when the loan entered that pool.

Resale rates can vary, and for the purposes of stratification, we used the published rates for the end of each month based on common coupon rates of 3.0, 3.5, 4.0, 4.5, 5.0, and 5.5 percent. For coupon rates between published rates, such as 3.75 percent, we used prorated resale values, averaging the values above and below. For pools with yield rates below 3.0 percent, we applied

the resale value of 3.0 percent pools for that month. Similarly, for yield rates above 5.5 percent, we used the 5.5 percent resale value for that month.

For the purposes of stratification, each sampling unit was given a valuation equal to the outstanding principal at the time of pooling times the resale markup value in accordance with the estimated markup values mentioned above.

The sample was designed as a stratified, optimized sample with seven strata. The strata are designed to control for the variable amounts of income that result from applying changing resale values to varied mortgage amounts. Modified loans were sorted and ranked by the sample unit valuation calculated above and then stratified by percentile points along this ranking to control for variance in dollar amounts.

To control variance and minimize effects from random selections within influential strata, we used an optimized Neyman sample to assign samples to each stratum. A Neyman sample distributes the selection of sampling units according to how much uncertainty an area has and how much it will affect the final projection, thereby making the most effective use of samples. Optimized samples require some basic knowledge of the relative variance between strata. Because Neyman samples respond to relative variance between strata rather than exact variance amounts, we can model a variance profile that is sufficient to design the sample without knowing the exact rate of error that will be found during the execution of the audit. The sample valuation method mentioned above is sufficient for establishing relative variance. The sample design was stratified as shown in the table below.

<b>Sample design and results</b>						
<b>Stratum</b>	<b>lower boundary</b>	<b>Sample size</b>	<b>Loans in sampling frame</b>	<b>Loans in universe</b>	<b>Sampling weights</b>	<b>Estimated resale</b>
net_loss	Neg. \$	2	1,145	1,164	582.000	Loss on resale
0-10pct	\$0	3	5,533	6,339	2,113.000	\$0
10-30pct	\$8,192	6	11,074	12,915	2,152.500	\$2,780
30-50pct	\$11,986	7	11,068	13,079	1,868.429	\$5,490
50-70pct	\$15,334	9	11,077	13,201	1,466.778	\$8,178
70-90pct	\$22,592	16	11,070	13,351	834.438	\$1,1672
90-100pct	\$30,654	27	5,537	6,999	259.222	\$18,350
Total	n/a	70	56,504	67,048	n/a	n/a

We selected a sample of 70 pooled loans. We used computer-replicated sampling (audit simulations) to test the performance of the sample design, with sample counts ranging from 60 to 150. Because the markup rate found will vary some from the reference rates used to design the sample, our testing randomly varied the markup rate found in our simulated audits by +/- 30 percent to ensure that the sample design can accommodate that level of uncertainty.

After replicating the audit findings that would occur with this number set at various sample sizes, we compared these typical audit results with the dollar amounts underlying our tests. The recommended sample size was found to be extremely effective in preventing errors, and the accuracy of probabilistic statements made with this sample design exceeded the stated confidence interval – a one-sided confidence interval of 95 percent.

Sample records were randomly selected with the number of samples in each stratum being optimized to get the most accurate dollar estimate for a given sample size. The audit sample was selected by means of computer routines written in SAS<sup>®</sup>, using the surveyselect procedure and a seed of 7.

To quantify the earnings that loan servicers accrue from reselling loans that have undergone loss mitigation, we sampled the universe of 67,048 modified loans that underwent HUD's loss mitigation refinance process during HUD's fiscal year 2013 and were successfully resold to the secondary market during this period or during the 6 months that followed it. Using the loan modifications originated by the top nine servicers as a sampling frame, we pulled a stratified, optimized, statistical sample of 70 loans from this frame and then projected the results to the entire universe of loans. The top nine frame we sampled from represented 84.2 percent of the universe.

The sample was stratified according to the expected markup on the loan (in dollars) when it was resold to a mortgage-backed security. Expected markup value of the resale was established by applying the published, end-of-the-month market value for Ginnie Mae mortgage-backed security pools with the coupon rate closest to that of the Ginnie Mae pool that bought the loan. The coupon rate of the pool that bought the loan was calculated specifically for the month when the loan was purchased. Later analysis showed that the expected resale value calculated in this manner had a correlation coefficient of .91 when compared with the resale value found during the audit, thereby showing a very strong correlation between the estimated value used to group the sample and the mortgage-backed security resale value of the loan.

Samples were then randomly selected in accordance with a 70-count, optimized sample design, using the surveyselect procedure in SAS<sup>®</sup>. The sample count was verified extensively, using replicated sampling, and the design was found to be more than sufficient for making these projections.

The audit team acquired records pertaining to resale on the secondary market, computed the dollar amount of the resale gain, calculated a margin of error, and made a final projection on that basis. This was done by computing the mean and standard error of the resale amounts, using the means estimating procedure (surveymeans) in SAS<sup>®</sup>. Variances were calculated by using a Taylor series.

Regarding the 67,048 loss-mitigated loans in our universe, we can say, with a one-sided confidence interval of 95 percent that servicers earned at least \$428 million for the loans that had been restored by loan modification in fiscal year 2013 and resold on the secondary market to a mortgage-backed security.

We relied in part on data maintained by HUD in its Single Family Data Warehouse database. Specifically, we relied on the data to identify loans that were successfully modified during our audit period. Although we did not perform a detailed assessment of the reliability of the data, we corroborated the fields used to determine our sample universe against documentary evidence supplied by the lenders for our 70 sample loans. Based on the work performed, we determined that the computer-processed data were sufficiently reliable for the purposes of this report.

We conducted the audit 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(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

# INTERNAL CONTROLS

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Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

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## Relevant Internal Controls

We determined that internal controls were not relevant to the audit objective because this audit addressed an area without established rules or guidance. HUD could not be reasonably expected to have controls limiting lender gains since it did not have requirements limiting these gains.

## Significant Deficiencies

We did not identify internal controls related to the audit objective to evaluate in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of FHA's internal control.

## APPENDIXES

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### Appendix A

#### SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

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Recommendation number	Funds to be put to better use 1/
1A	\$50,286,000

- 1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

In this instance, if HUD implements our recommendations, it will ensure that FHA will reduce payments from its insurance funds due to modified loans as it will be able to recapture incentive payments made to lenders or use them to offset future claims. In fiscal year 2013, we determined that FHA made more than \$50.2 million in incentive payments to lenders processing loan modifications that were sold as Ginnie Mae securities (\$750 per loan modification times 67,048 loans in our universe). We expect a similar payment next year if FHA does not take advantage of opportunities to strengthen its insurance fund as loan modification volumes in fiscal 2014 are similar to fiscal year 2013 levels. This amount is conservative as it does not take into account FHA's capturing all the gains of the lenders.

## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

### Ref to OIG Evaluation

### Auditee Comments

 OFFICE OF HOUSING	U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT WASHINGTON, DC 20410-8000
	SEP 11 2014
MEMORANDUM FOR:	Ronald J. Hosking, Regional Inspector General for Audit, 7AGA
FROM:	 Kathleen A. Zadareky, Deputy Assistant Secretary for Single Family Housing, HU
SUBJECT:	Auditee Response Lenders Generated \$428 Million in Gains From Modifying Defaulted FHA Loans Audit Report No.: 2014-KC-XXXX
	<p>The Federal Housing Administration (FHA) strives to establish policies that lead to the long-term solvency of its Mutual Mortgage Insurance (MMI) fund while continuing to meet its mission of strengthening the nation's housing market, and to bolster the economy. The Office of Housing's response to the Office of Inspector General's (OIG) recommendation and methodology for calculating the gain on the sale of modified mortgages is as follows:</p>
	<p><b><u>Recommendation 1A:</u></b></p>
	<p>We recommend that the Deputy Assistant Secretary for Single Family Housing perform a study of the loan modification program and evaluate whether any changes are needed, such as (1) developing procedures to offset lender gains from insurance fund payments, (2) reducing the allowable interest rate for loan modifications, and (3) examining the incentives paid to lenders modifying loans, to put \$50 million to better use.</p>
	<p><b><u>Single Family Housing's Response:</u></b></p>
Comment 1	<p>The Office of Housing acknowledges that \$50 million was paid in incentive fees to lenders for the 67,048 modified loans subject to the audit. However, the audit report fails to emphasize that had the loans not been modified, the alternative would have been foreclosure and the eviction of 67,048 homeowners and losses to FHA's Mortgage Mutual Insurance Fund in excess of \$5.2 billion from insurance claims filed by lenders.</p>
Comment 2	<p>It is important to note that FHA does not originate, buy, package, sell or invest in FHA single-family loans or Ginnie Mae Mortgage-Backed Securities (MBS) as part of its normal operations. Those lenders who are also Ginnie Mae issuers perform these tasks and assume balance sheet risk, hedging risk, etc., and realize gains and losses that result from these activities. Without receipt of a legal opinion that supports OIG's inference that FHA can "offset lender gains (on secondary marketing from modified loans) insurance fund payments", establishing such a policy would result in disrupting the mortgage market and tighten access to mortgage credit.</p>

**Ref to OIG Evaluation**

**Auditee Comments**

**Comment 3**

FHA made significant changes in 2009 and also in 2013 pertaining to interest rates on modified loans that enabled modified loans to receive favorable rates. Prior to the publication of Lender Letter 2009-35, *FHA Loss Mitigation Incentives - Update* (<http://www.hud.gov/offices/adm/hudclips/letters/Lender/2009ml.cfm>) on September 23, 2009, the maximum interest rate on loan modifications was 200 basis points above the monthly average yield on United States Treasury Securities, adjusted to a constant maturity of 10 years as specified in Lender Letter 2008-21.

Mortgagee Letter 2009-35, reduced the maximum interest rate on loan modification by defining the Market Rate on loan modifications to be “no more than 50 basis points greater than the most recent Freddie Mac Weekly Primary Mortgage Market Survey Rate<sup>1</sup> for 30-year fixed-rate conforming mortgages (US average), rounded to the nearest one-eighth of one percent (0.125%), as of the date the permanent modification is executed. Mortgagee Letter 2011-28 modifies this definition by applying the Market Rate for a permanent modification as of the time a trial payment is approved by the servicer. This change was necessary to avoid a change in the borrower’s mortgage payment between the time the borrower successfully completed the trial payment plan and when the lender completed the permanent modification documents.

**Comment 4**

On May 14, 2013, FHA published Mortgagee Letter 2013-17, *Interest Rates for Loss Mitigation Options* which further reduced the maximum interest rate on modified loans by 25 basis points. The orderly reduction in the maximum interest rate on modified loans resulted in reduced premiums that lenders would have otherwise received on Ginnie Mae MBSs and enabled FHA to establish a 20 percent targeted payment reduction for its Home Affordable Modification Program (FHA-HAMP) as detailed in Lender Letter 2013-32.

FHA elected not to reduce the \$750 incentive fee for modified loans because the level of effort to complete purchase or refinance loans is less than the level of effort required to complete modified mortgages. The basis for this decision is that the incentive payment of \$750 is usually less than the one percent origination fee (plus other fees) that lenders are permitted to charge borrowers on purchase and refinancing transactions. This decision is bolstered by an article entitled “Mortgage Banking Profits Hit Hard in 2<sup>nd</sup> Half of 2013” by Jan Swanson on May 22, 2014, that stated “Commissions, compensation, occupancy, equipment, and other production expenses and corporate allocations increased to \$5,948 per loan in 2013 compared to \$5,137 in 2012.”

**Comment 5**

The Office of Single Family Housing will continue to monitor the pricing of Ginnie Mae MBS to determine if its market interest rate definition for modified loans should be amended in the projected rising interest rate environment.

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<sup>1</sup> The weekly survey results are published on the Freddie Mac website at <http://www.freddiemac.com/pmms/> and the Federal Reserve Board includes the average 30-year survey rate in the list of Selected Interest Rates that it publishes weekly in its Statistical Release H.15 at <http://www.federalreserve.gov/releases/h15/>.

**OIG's Finding:**

Lenders generated an estimated \$428 million in gains from the sale of Ginnie Mae securities related to modified FHA loans. These loan modifications were completed as part of FHA's loss mitigation program. Lenders received these gains from modifying 67,048 defaulted FHA loans during fiscal year 2013 and packaging them into Ginnie Mae securities between September 2012 and April 2014. The sale of these securities was made possible by the FHA loss mitigation program. When the original loans became delinquent, Ginnie Mae allowed the lenders to repurchase the loans for an amount equal to 100 percent of the loans' principal balance (that is, at face value or par). After successfully undergoing loan modifications, these repurchased loans were eligible to be repooled in mortgage-backed securities. The lenders were able to obtain these gains as a result of the loan modifications completed as part of the FHA program.

**Single Family Housing's Response:**

OIG's methodology for estimating the \$428 million gain lenders generated from the sale of modified FHA-insured loans sold into Ginnie Mae guaranteed mortgage securities materially misrepresents the actual gain on sale that lenders generated for the following reasons:

- The OIG estimated resale profit by applying the published market value of the mortgage backed security for the coupon rate closest to the yield of the associated Ginnie Mae pool for the end of the month that the loan entered that pool. That represents an approximation of the secondary market price that a lender could have obtained in the month of settlement of the mortgage-backed security if it did not hedge interest rate risk on the modified loans (i.e., the risk that interest rates will rise and the secondary market price fall from the time the interest rate on the modified loan is set (locked-in) to when the loan is eventually sold in the secondary market).
- Prudent lenders hedge interest rate risk on their mortgage pipeline and most do that for FHA-insured loans by advance sale of loans expected to close in the to-be-announced (TBA) forward market. In a TBA trade, the two parties agree upon a trade day price for delivering a given volume of TBA eligible loans into a Ginnie Mae security at a specified future date. The available prices for loans pre-sold in this manner are significantly below those available in the future month of settlement because of the increased delay before the investor (purchaser) starts to receive mortgage cash flows on the pooled loans.
- For purchase and refinance loans, lenders typically offer mortgage applicants the option to lock in a mortgage rate for a period of 30-90 days and they hedge the interest rate risk through forward sale of the loans with delivery at a future date that accommodates the estimated time the lender needs to close the loan and deliver it into a pass-through mortgage security. Loans modified through FHA's Loss Mitigation program require a minimum three month Trial Payment period with the interest rate locked-in prior to the start of the plan. Lenders must manage interest rate risk over a much longer period on those loans (typically a minimum of six months) and prices obtainable through forward

Comment 6

**Ref to OIG Evaluation**

**Auditee Comments**

**Comment 7**

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mortgage sales are further reduced as a result.

- The report improperly classifies the difference between the modified loan balance and the estimated selling price as a “gain from sale” and lender profit. Lenders have costs to modify a loan. Expenses for secondary marketing cost centers, including but not limited to operational cost (hedging costs, salaries, depreciation, general and administrative, etc.) and interest expenses must be deducted from sales proceeds to properly calculate net income from sale of loans that are securitized in MBS.

## OIG Evaluation of Auditee Comments

- Comment 1** Regulations at 24 CFR 203.605 require lenders to evaluate all loss mitigation techniques available before four full monthly installments due on the mortgage have gone unpaid and take the appropriate loss mitigation action. Further, 24 CFR 203.501 requires that lenders must consider the comparative effects of their elective servicing actions and take steps that can reasonably be expected to generate the smallest financial loss to FHA. Therefore, lenders cannot just decide to avoid all loss mitigation procedures and file a claim for the loss even if there were no incentive payments. Once participating in the FHA program, they are bound by its rules and regulations.
- Comment 2** The National Housing Act, 12 USC § 1701, et seq, (the Act) imposes an affirmative obligation upon the Secretary to ensure that the insurance fund remains financially sound. 12 USC § 1708(a)(3). To accomplish this, among other obligations, the Secretary is specifically authorized and directed to make such rules and regulations as may be necessary to carry out the provisions of the Act. 12 USC § 1715b. Regarding the payment of insurance benefits, the Secretary is specifically authorized to pay insurance benefits that “shall be equal to the original principal obligation of the mortgage **(with such additions and deductions as the Secretary determines are appropriate)**...” (emphasis added). 12 USC § 1710 (a)(5). HUD has already implemented this authority through regulations specifying additions and deductions to the claim amount. See 24 CFR 203.400 et seq. Moreover, in the area of loss mitigation, “[t]he Secretary **may** pay insurance benefits to the mortgagee to recompense the mortgagee for all *or part* of any costs of the mortgagee for taking loss mitigation actions....” 12 USC § 1710 (a)(2). Therefore, the Secretary is authorized to determine what additions to and *subtractions* from insurance claims are appropriate, as well as what part of any loss mitigations costs to reimburse. Therefore, HUD can decide if it is appropriate or necessary to deduct the lender gains from the sale of Ginnie Mae securities on the secondary market from such claims.
- Comment 3** While it is good that FHA reduced the maximum interest rate on modified loans by 25 basis points last year, it needs to constantly monitor trends in the industry to ensure that it is minimizing insurance fund costs.
- Comment 4** FHA’s decision to reduce the incentive fee should not be based on the comparison of the incentive fee with the one percent origination fee but on the actual costs of the lenders and of the insurance fund. FHA needs to conduct its own study to determine the actual costs of the lender and to determine if its loss mitigation efforts are done with the least payout from the insurance fund. The National Housing Act authorizes the Secretary to “pay insurance benefits to the mortgagee to recompense the mortgagee for all *or part* of any costs of the mortgagee for taking loss mitigation actions....” 42 USC § 1710(a)(2). Therefore, FHA is not obliged to cover all lender costs.

**Comment 5** We agree that this is a required step.

**Comment 6** We only used published mortgage backed securities coupon rates for preliminary grouping of loans into statistical strata. This allowed us to compute and blend similarly sized amounts to further tighten our accuracy and to prevent wide margins of error. The projected earnings from reselling loans modified in fiscal year 2013 are based on actual, final resale amounts received from the lenders.

**Comment 7** We did not classify the gains as “profit” because we do not know the costs of the lenders. The objective of the audit was to identify the amount of the gains lenders are obtaining from modifying the loans and the costs FHA incurs to enable these gains so that it can determine if there are any changes needed for its loss mitigation program.