Government National Mortgage Association, Washington, DC

Nonbank Oversight

Office of Audit, Region 7
Kansas City, KS

Audit Report Number: 2017-KC-0008
September 21, 2017

To: Michael Drayne, Senior Vice President, Office of Issuer and Portfolio Management, TS

//**signed**//

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

Subject: Ginnie Mae Did Not Adequately Respond to Changes in Its Issuer Base

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Ginnie Mae's oversight of nonbank issuers.

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 website. 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.

Audit Report Number: 2017-KC-0008
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Ginnie Mae Did Not Adequately Respond to Changes in Its Issuer Base

Highlights

What We Audited and Why

We audited the Government National Mortgage Association's (Ginnie Mae) oversight of nonbank issuers. We initiated this audit due to the growth of nonbank issuers in the mortgage servicing industry. Our audit objective was to determine whether Ginnie Mae responded adequately to changes in its issuer base.

What We Found

Ginnie Mae did not adequately respond to changes in its issuer base. Specifically, it did not implement policies and procedures in a timely manner for its account executives to follow in managing issuers, did not develop a written default strategy, and did not assess and address the risks posed by nonbanks in a timely manner.

What We Recommend

We recommend that Ginnie Mae develop and implement controls to (1) ensure that policies and procedures for account executives are continually reviewed and updated to reflect changes in Ginnie Mae's operations; (2) determine the total impact of a large or multiple-issuer default, the maximize-size default Ginnie Mae can adequately execute, and individual issuers' ability to adapt to changing market conditions; (3) continually assess skills required to meet organizational goals; and (4) ensure that employee skill levels are developed to meet changing organizational needs.

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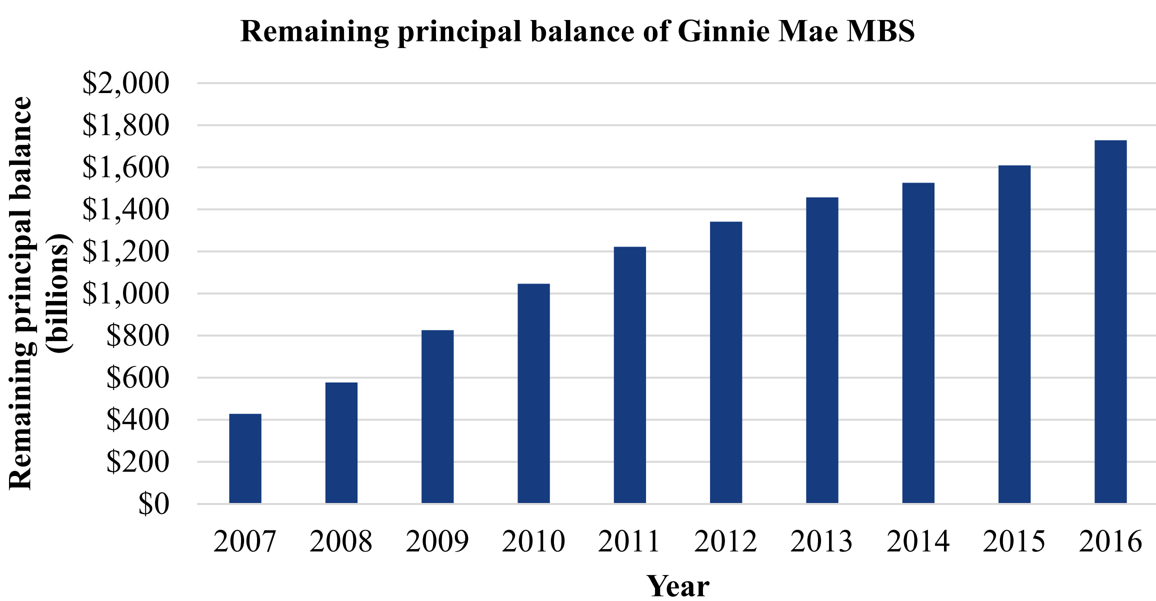
Background and Objective

The Housing and Urban Development Act of 1968 created the Government National Mortgage Association (Ginnie Mae), a wholly owned U.S. Government corporation within the U.S. Department of Housing and Urban Development, to pursue the creation of a mortgage-backed security market for government-insured loans. Through its mortgage-backed securities programs, Ginnie Mae guarantees securities backed by pools of mortgages and issued by mortgage lenders approved by Ginnie Mae. Ginnie Mae refers to these mortgage lenders as Ginnie Mae issuers.

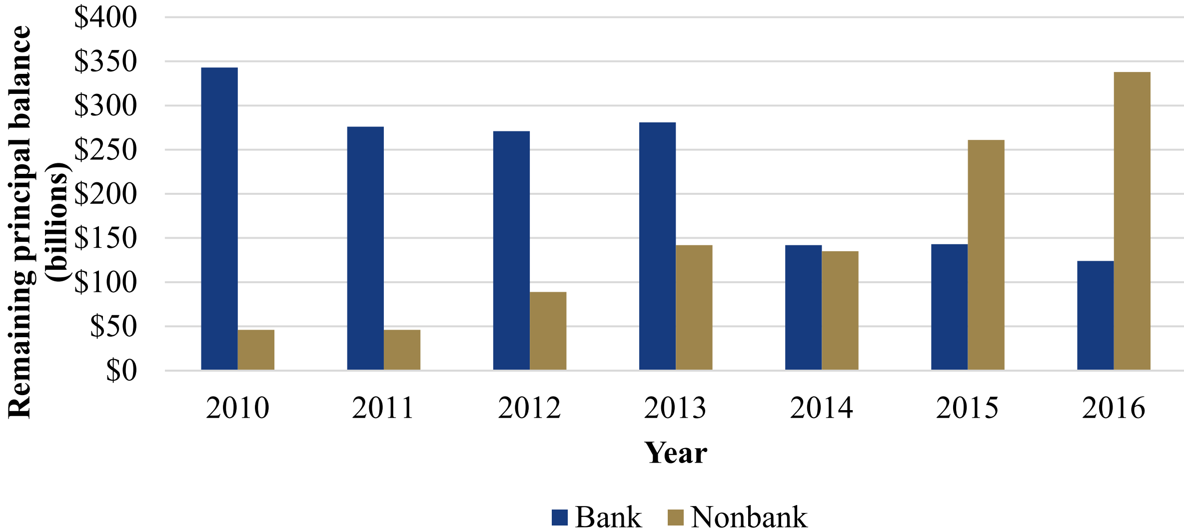
Ginnie Mae depends on its issuers to take full responsibility for servicing, remitting, and reporting activities for the mortgages in every pool. If the borrower fails to make a timely payment on its mortgage, the issuer must use its own funds to ensure that the investors receive timely payment. If an issuer cannot ensure the timely payment of principal and interest to investors, Ginnie Mae, in accordance with its guaranty, defaults the issuer, acquires the servicing of the loans, and uses its own funds to manage the portfolio and make any necessary advances to investors. Ginnie Mae's risk for loss occurs almost entirely at the point of issuer default, when Ginnie Mae must step in and exercise its guaranty. Counterparty risk refers to the risk of issuer default.

Following the financial crisis, the demand for government-insured loans increased, which created an increased demand for Ginnie Mae's product. Ginnie Mae's total remaining principal outstanding increased from $427.6 billion in 2007 to $1.7 trillion in 2016. This represents a 300 percent increase. The chart below shows the growth of the outstanding remaining principal balance of Ginnie Mae's mortgage-backed securities programs from 2007 to 2016.



In addition to an increase in demand for Ginnie Mae's products, Ginnie Mae's issuer base had shifted dramatically since the financial crisis. Banks retreated from mortgage lending, causing a shift in Ginnie Mae's issuer base from banks to nonbanks. For the purpose of this report, a bank refers to an institution licensed to receive deposits and make loans, whereas a nonbank refers to institutions that offer only mortgage-related services. In 2014, Ginnie Mae reported that 6 of its top 10 issuers were nonbanks. The chart below illustrates the shift in Ginnie Mae's issuer base since 2010.

Changing issuer base: nonbank vs. bank issuances (single family)



When banks dominated Ginnie Mae's issuer base, Ginnie Mae outsourced a significant portion of its risk management to bank regulators, such as the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, and the National Credit Union Association. While the Consumer Financial Protections Bureau regulates nonbanks for consumer-related issues, nonbanks are not subject to the same safety and soundness regulation as banks. No equivalent regulator exists for nonbanks. Therefore, Ginnie Mae must function as the first line of defense to evaluate nonbank institutions for financial and operational soundness. Ginnie Mae's Office of Issuer and Portfolio Management is responsible for overseeing Ginnie Mae issuers concerning all matters related to participation in its mortgage-backed security programs, including monitoring issuer participation and executing issuer defaults.

Unlike banking institutions, nonbanks tend to have complex financial and operating structures and frequently use subservicers instead of servicing the loans in their portfolios. Additionally, nonbanks rely on credit lines for funding, which may limit a nonbank's access to liquidity to meet the financial obligations of being a Ginnie Mae issuer. Banking institutions have standardized corporate ownership and lines of business, substantial liquidity, and the ability to service the loans in their portfolios.

Our audit objective was to determine whether Ginnie Mae responded adequately to changes in its issuer base.

Results of Audit

Finding: Ginnie Mae Did Not Adequately Respond to Changes in Its Issuer Base

Ginnie Mae did not implement policies and procedures in a timely manner for its account executives to follow in managing issuers, develop a written default strategy, or assess and address the risks posed by nonbanks in a timely manner. This condition occurred because Ginnie Mae was not prepared for the rapid growth and shift in issuer base and its staff lacked the skills necessary to immediately respond to increased risks posed by these changes. As a result, Ginnie Mae may not identify problems with issuers in time to prevent default. Additionally, it may not be able to properly service loans absorbed in a default and may require additional funds from the United States Treasury to pay investors in the event of a large issuer default.

Ginnie Mae's Issuer Base Had Changed Dramatically

As of September 2016, 6 of Ginnie Mae's top 10 issuers for its single-family mortgage-backed securities program were nonbanks. The total remaining principal balance for these top nonbank issuers was more than $392 billion. At that time, nonbanks accounted for 73 percent of Ginnie Mae's single-family issuances. Ginnie Mae had not seen nonbank issuers of this size in its history, nor had nonbanks made up such a large portion of its issuer base. In 2011, only 1 of Ginnie Mae's top 10 issuers was a nonbank, and its remaining principal balance totaled approximately $24 million. Ginnie Mae reported that only 14 percent of its single-family issuances were from nonbanks in 2011. See the Background and Objective section of this report for more information on the shift of Ginnie Mae's issuer base.

Ginnie Mae Did Not Adequately Respond to Changes in Its Issuer Base

Ginnie Mae did not adequately respond to changes in its issuer base. Specifically, Ginnie Mae did not implement policies and procedures in a timely manner for its account executives to follow in managing issuers, did not develop a written default strategy, and did not assess and address the risks posed by nonbanks in a timely manner.

<u>Ginnie Mae Did Not Implement Policies and Procedures for Its Account Executives in a Timely Manner</u>

In 2011, Ginnie Mae determined that its desk manual, which included its operating procedures, no longer reflected its current operation and stopped requiring its use. In late 2014, Ginnie Mae hired a contractor to review its current state. The contractor completed the review in 2015, and began working with Ginnie Mae to develop policies and procedures to replace the desk manual. Ginnie Mae began implementing the policies and procedures that resulted from this review in July 2017. Several account executives told us they did not have adequate policies and procedures to manage issuers. They said they learned how to perform tasks from one another.

Ginnie Mae Did Not Develop a Default Strategy

Ginnie Mae did not develop a written default strategy, which included identifying, analyzing, and planning for all default scenarios and determining whether its staff and master subservicers had the capacity to default and absorb large issuers (issuer with more than 100,000 loans). Ginnie Mae operates with a small staff and relies heavily on contractors to perform its core responsibilities, including servicing loans absorbed from defaulted issuers. Ginnie Mae officials told us that they recognized the challenges Ginnie Mae faced and had ideas on how they would execute large or multiple-issuer defaults, but Ginnie Mae did not begin to implement a written strategy to address large issuers or all default scenarios until July 2017. Ginnie Mae recently finalized its single-family default strategy handbook and was working on implementing the procedures. Next, Ginnie Mae planned to work on the default strategy for home equity conversion mortgages (also known as reverse mortgages), followed by the multifamily default strategy. During our review, these policies were still in draft. We reviewed the draft policies and noted that the draft strategy addressed our concerns about multiple default scenarios. As of June 2017, both of Ginnie Mae's master subservicers had provided Ginnie Mae with a plan on how they would obtain the resources necessary to default a mega issuer (issuer with more than 400,000 loans). We did not review the recently finalized policy to determine whether it addressed our concern regarding Ginnie Mae's staffing capacity.

Ginnie Mae Did Not Assess and Address the Risks Posed by Nonbanks in a Timely Manner

Ginnie Mae did not assess and address the risks posed by nonbanks in a timely manner. Ginnie Mae did not consider the impact the growth of nonbanks could have on its organization. Specifically, it did not consider strategic issues, such as determining the maximum-size issuer default Ginnie Mae could adequately manage, and operational issues, such as determining the total impact of a large or multiple-issuer default and determining individual issuers' ability to adapt to changing market conditions, such as rising interest and delinquency rates.

Until December 2016, Ginnie Mae had not determined whether its master subservicers could absorb a large issuer portfolio. In an internal memorandum, dated March 2017, Ginnie Mae stated that it would be difficult to absorb portfolios greater than 100,000 loans or with high levels of delinquency without impacting servicing standards. Ginnie Mae acknowledged that it faced operational constraints when dealing with a very large or mega-issuer default. As of July 2017, Ginnie Mae had 13 nonbank issuers with more than 100,000 loans. Of these, 4 nonbank issuers had more than 400,000 loans. Ginnie Mae started addressing these issues while we were performing our audit work.

In Ginnie Mae's 2014 financial statement audit, HUD's Office of Inspector General (OIG) issued a finding stating that it was unable to obtain sufficient, appropriate evidence to express an opinion on the fairness of the $6.6 billion in nonpooled loan assets from Ginnie Mae's defaulted issuers' portfolio. (See the Followup on Prior Audits section of this report for more detail.) This finding recurred in fiscal years 2015 and 2016. As a result of this finding, Ginnie Mae began a comprehensive review of its default strategy. In July 2017, Ginnie Mae was finalizing and implementing a more robust default strategy, which included policies and procedures for default, termination, and master subservicer portfolio seizure. Additionally, Ginnie Mae now requires its master subservicers to submit a semiannual plan on how they would obtain the resources necessary to absorb a mega-issuer default.

Ginnie Mae Was Not Prepared for Growth and Its Staff Lacked Skills

Ginnie Mae was not prepared for rapid growth, and its staff lacked secondary market experience needed to properly assess the risks associated with the growth and shift in issuer base. Ginnie Mae did not plan for the growth it experienced after the financial crisis. Its management explained that it had not budgeted for increased staff numbers to support the growth.

In addition, Ginnie Mae's small staff at the time did not have sufficient secondary mortgage market experience to properly assess and address the risks of the growth or shift in issuer base. The secondary mortgage market refers to the market created for the sale of securities that are backed by the value of mortgage loans. Ginnie Mae's management had not predicted that the banks would leave the mortgage market to the degree that they did. Ginnie Mae's entire model had been built around the idea that the predominant issuers were regulated banking institutions, and it took time for Ginnie Mae to assess and address the risks associated with this dramatic shift.

Ginnie Mae Had Made Progress on Nonbank Oversight

Since 2012, Ginnie Mae had implemented several items to address the increased counterparty risk posed by nonbanks. It had created the Office of Enterprise Risk and developed a robust watch list, which serves as a formal compilation of issuers identified as needing a higher degree of scrutiny. Additionally, Ginnie Mae had implemented operational and desktop reviews, during which Ginnie Mae staff requests and reviews more indepth documentation of an issuer's operations. Ginnie Mae had also created a Spotlight program, which identifies issuers with size, growth, complexity, or nontraditional structures that warrant a more intensive level of ongoing engagement. These items, however, did not address the operational challenges that Ginnie Mae would face if default occurs.

Ginnie Mae May Not Identify Problems With Issuers in Time To Prevent Default and May Not Be Able To Absorb Loans Without Disrupting Servicing

Ginnie Mae may not identify problems with issuers in time to prevent default. Ginnie Mae's account executives manage and maintain the relationship between Ginnie Mae and its issuers. Ginnie Mae's shift in issuer base also required the account executives to act as risk managers in addition to their other responsibilities. The account executives act as the main points of contact for the issuer and are responsible for being familiar with the performance and status of each issuer they manage. They receive and review issuer requests, including requests for commitment authority, which an issuer must have to issue Ginnie Mae securities. Additionally, the account executives review a variety of reports to ensure that issuers meet program requirements. Early detection is key for early intervention to correct problems before they become too severe. Without policies and procedures that provide guidance for account executives to perform responsibilities, account executives may not identify problems in time to prevent issuer defaults.

In the event of default, Ginnie Mae must react quickly to absorb the portfolio without disruption in servicing. If disruption in servicing occurs, Ginnie Mae may need to request additional funds from the U.S. Treasury to pay investors. Further, Ginnie Mae may not comply with servicing standards and may miss important deadlines to receive proper payment of claims from the government loan-insuring agencies.

Recommendations

We recommend that Ginnie Mae's Senior Vice President, Office of Issuer and Portfolio Management,

1A. Develop and implement controls to ensure that policies and procedures for account executives are continually reviewed and updated to reflect changes in Ginnie Mae's operations.

1B. Develop and implement controls to review issuers to determine the total impact of a large or multiple-issuer default, the maximize-size default Ginnie Mae can adequately execute, and an issuer's ability to adapt to changing market conditions.

1C. Develop and implement controls to continually assess skills required to meet organizational goals to include a plan to prioritize resources to accommodate changing organizational needs.

1D. Develop and implement training programs to ensure that employee skill levels are developed to meet changing organizational needs to include secondary market training.

Scope and Methodology

Our audit generally covered the period October 1, 2014, through September 30, 2016. However, we expanded our review through July 2017 to review the results of Ginnie Mae's meeting with its master subservicers and draft policies and procedures. We performed our audit work between November 2016 and July 2017, primarily at our office in Kansas City, KS. We conducted some fieldwork at Ginnie Mae's office in Washington, DC.

To accomplish our objective, we

- Reviewed the Code of Federal Regulations, Standards for Internal Control in the Federal Government, Office of Management and Budget (OMB) Circular A-123, and the Consolidated Audit Guide for Audits of HUD Programs.
- Reviewed Ginnie Mae's statutory authority, the Ginnie Mae Mortgage-Backed Securities Guide, Ginnie Mae's all participant memorandums, Ginnie Mae's bylaws, and Ginnie Mae's A-123 Memorandum and Assessment Report.
- Reviewed Ginnie Mae's Default Manual, Default Playbook, and draft Standard Operating Procedures for Ginnie Mae's Office of Issuer and Portfolio Management.
- Reviewed the Ginnie Mae guaranty agreement, which is the contract between Ginnie Mae and the issuers of securities.
- Reviewed the Ginnie Mae contracts listing, compliance review contract, and financial statement review services contract.
- Reviewed the study, entitled "Ginnie Mae's Operations and Staffing Analysis."
- Reviewed documentation related to Ginnie Mae's level of effort to default First American Mortgage Trust and Doral Bank.
- Reviewed Ginnie Mae's budget requests and staffing information.
- Reviewed documentation supporting Ginnie Mae's hiring and attrition.
- Reviewed documentation supporting Ginnie Mae's timeline for risk management.
- Prepared and summarized the results of a questionnaire that account executives and mortgage banking analysts completed.
- Interviewed HUD's Budget Officer and Ginnie Mae personnel and their contractors.
- Reviewed Ginnie Mae's audited financial statements.

We did not conduct sampling in our audit. We did not use automated systems data during the audit and relied primarily on such source documents as Ginnie Mae's policies and procedures, questionnaires, and reviews conducted of Ginnie Mae issuers to determine our audit conclusions.

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

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.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Controls over issuer management.
- Controls over default planning.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- Ginnie Mae did not have adequate controls for its account executives for managing issuers or a written default strategy to include its or its master subservicers' capacity to default a large issuer or be prepared for all default scenarios.
- Ginnie Mae did not have adequate controls to determine the total impact of a large or multiple-issuer default, the maximum-size default Ginnie Mae can adequately execute, the size to which an issuer should be allowed to grow before being considered too big to fail, or an issuer's ability to adapt to changing market conditions.

Followup on Prior Audits

Audit of the Government National Mortgage Association's Financial Statements for Fiscal Years 2014 and 2013, 2015-FO-0003

We reviewed the recommendations related to Finding 1, Material Asset Balances Related to Nonpooled Loans Were Not Auditable, from Audit Report 2015-FO-0003, Audit of the Government National Mortgage Association's Financial Statements for Fiscal Year 2014 and 2013. As of August 2017, the following recommendations remained open:

Recommendation number	Recommendation	Status
1A	Establish and implement policies and procedures to demonstrate how Ginnie Mae provides appropriate accounting and financial reporting oversight of the master-subservicers to ensure that the master-subservicers are capable of producing accurate and reliable accounting records and reports.	Open
1B	Establish and implement policies and procedures to properly account for and track at a loan level all of the accounting transactions and events in the life cycle of the loans. This measure is intended to compensate for the servicing system's inability to perform loan level transaction accounting.	Open

This finding was a repeat finding in fiscal years 2015 (Audit Report 2016-FO-0001, issued on November 13, 2015) and 2016 (Audit Report 2017-FO-0001, issued on November 13, 2015). In the audit of Ginnie Mae's 2016 financial statements, HUD OIG stated that full implementation of the corrective action plan was not expected until fiscal year 2017.

Appendixes

Appendix A

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation	Auditee Comments

Ginnie Mae — Our Guaranty Matters

425 3rd Street, SW, Fifth Floor
Washington, DC 20024
(202) 708-1535

September 11, 2017

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

FROM: Michael R. Drayne, Senior Vice President, Office of Issuer and Portfolio Management, TS

SUBJECT: Office of Issuer and Portfolio Management Response to Draft Audit Report

As is detailed in the Report and elsewhere, the changing composition of the participants in the residential finance industry has had a significant impact on Ginnie Mae's administration of its mortgage-backed securities (MBS) program.

Comment 1

Given the dramatic expansion of demands on its resources over a very short period of time – and the challenge, as a governmental organization, of shifting course nimbly and expeditiously – Ginnie Mae has done a more than credible job adapting to the changed environment. The changing counterparty landscape became apparent in 2012 and 2013 as servicing transfers and changing origination patterns began to shift the balance toward non-depository institutions. By September of 2014 Ginnie Mae had published a comprehensive white paper explaining in detail the changes that were occurring, and how Ginnie Mae was responding – this was among the very first treatments of this topic. One year later we had completed a thorough examination of the Office of Issuer and Portfolio Management (OIPM), which manages this aspect of the MBS Program, and laid out an internal plan for re-engineering our approach. It was understood that this plan would take several years to accomplish, and would not itself constitute a sufficient approach to the situation if additional resources were not forthcoming. Though the Report gives the opposite impression, we have successfully made the case for a modest number of additional staff, and were able to add personnel with appropriate experience.

Comment 2

As is mentioned, our business process re-engineering has included an extensive examination of issues arising from issuer failures. It is not the case that Ginnie Mae had not previously done this; a comprehensive manual governing issuer extinguishment procedures has been utilized and updated for many years. The purpose of the current project, referenced in the Report, is to broaden the scope covered by the defined policies and procedures. Furthermore, while there would indeed be significant challenges associated with the failure of the largest non-depository issuers, the government is not wholly without the ability to manage such a situation. The Report implies a deficiency on the part of Ginnie Mae that non-depository issuers have grown to the scale they have. But that this has occurred is a function of the housing finance system's adaptation to a variety of factors and policy actions. It would arguably have been beyond Ginnie

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Mae's purview to have constrained the provision of housing credit based purely on its own ability to efficiently resolve issuer failures.

Comment 3

The Report asserts repeatedly that Ginnie Mae's overall organizational response to the changing environment was not sufficiently timely, but nowhere is it explained how Ginnie Mae could reasonably have been expected to make substantial organizational changes more rapidly than it has been able to do, given the need to develop skills and procedures during this time merely to cope with day-to-day program management needs that did not previously exist. Our view, in fact, is that Ginnie Mae and OIPM staff in particular have displayed an unusual degree of vision, persistence and skill in re-organizing in the face of extraordinary change over a five-year period, without the occurrence of any significant lapses in the management of the MBS program.

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OIG Evaluation of Auditee Comments

Comment 1 We acknowledge that Ginnie Mae did make efforts beginning in 2014 to take a comprehensive review of the Office of Issuer Portfolio Management to respond to risks posed by nonbanks. However, the Government Accountability Office's Standards for Internal Control for Government Agencies and the Office of Management and Budget's Circular A-123 state that management needs to comprehensively identify risk and should consider all significant interactions between the entity and other parties as well as internal factors at both the entity wide and activity level. Additionally, management should design control activities such as policies, procedures, techniques, and mechanisms that help ensure action are taken to address risks. Further, monitoring the effectiveness of internal controls should occur in the normal course of business. If an effective continuous monitoring program was in place, Ginnie Mae could have identified deficiencies and evaluated and corrected them more timely. In 2011, Ginnie Mae identified that its policies and procedures for account executives no longer reflected Ginnie Mae's organization and stopped enforcing its use. It did not, however, update these controls until 2017. We also acknowledge that Ginnie Mae is currently implementing its Enterprise Risk Management system that will assist in prevention of recurrence. Additionally, Ginnie Mae has made a considerable effort to hire staff with the appropriate experience.

Comment 2 We acknowledge that Ginnie Mae did have a default manual, but it did not contain policies and procedures for all default scenarios including the default of multiple issuers and large issuers. Nor did it contain policies and procedures for determining the level of effort required to default multiple issuers and large issuers. Further, we reviewed two issuer defaults that took place during our audit period and found that Ginnie Mae did not use the default manual to execute the defaults. In addition, Ginnie Mae could not provide sufficient documentation to support the level of effort required to default the issuers reviewed. The report did not take issue with growth of the nonbanks, only Ginnie Mae's readiness in response to that growth. Ginnie Mae did not timely implement policies and procedures reflective of the changing landscape.

Comment 3 Our audit objective was to determine whether Ginnie Mae responded adequately to changes in its issuer base. As such, our report only points out where we believe the response was not adequate. We believe it would have been reasonable for Ginnie Mae to have addressed each of the reported issues more timely.