



Issue Date: April 30, 2009
Audit Report Number 2009-FO-0005

TO: Joseph J. Murin, President, Government National Mortgage Association, T

FROM: Thomas R. McEnanly, Director of Financial Audit Division, GAF

SUBJECT: Mortgage-Backed Securities Program Document Review

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited Government National Mortgage Association's (Ginnie Mae) Mortgage-Backed Securities (MBS) program's contract documents and other program related representations. Additionally, we reviewed certain business practices related to ensuring that mortgages were insured. We conducted this audit because Office of Inspector General (OIG) senior management officials had concerns about potential internal control weaknesses in Ginnie Mae's MBS program based on past loan origination fraud cases reported in the latter part of 2007. Our objectives were to determine whether Ginnie Mae (1) agreements with the issuers sufficiently protected Ginnie Mae against fraud or other misrepresentation in the MBS program and (2) had implemented sound business practices to ensure that only insured mortgages remained in Ginnie Mae pools.

### **What We Found**

While our audit did not disclose instances in which Ginnie Mae agreements with the issuers were insufficient to protect the agency against losses, we had concerns related to certain Ginnie Mae business practices. Our concerns were related to

controls over business practices for ensuring that loans in Ginnie Mae pools were insured within a reasonable period after issuance.

### **What We Recommend**

We recommend that the President of the Ginnie Mae develop and implement policies and procedures for assessing issuer reasonableness in obtaining FHA mortgage insurance, including those procedures for monitoring and following up on unmatched loan exceptions.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

### **Auditee's Response**

We provided the draft report to Ginnie Mae on February 23, 2009, and held an exit conference on March 4, 2009. On March 20, 2009, Ginnie Mae provided its written response which outlined actions taken during the audit to address the deficiencies noted in the report. Ginnie Mae concurred on all audit recommendations except audit recommendation 1E. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix A of this report.

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## BACKGROUND AND OBJECTIVES

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The Government National Mortgage Association (Ginnie Mae) is a wholly owned corporate instrumentality of the United States within the U.S. Department of Housing and Urban Development (HUD). It was established through a 1968 amendment to Title II of the National Housing Act. Its mission is to support expanded affordable housing by providing an efficient government-guaranteed secondary market vehicle linking the capital markets with federal housing markets. Under section 306(g) of the National Housing Act, Ginnie Mae is authorized to guarantee the timely payment of principal and interest on securities that are based on and backed by pools composed of mortgages which are insured by the Federal Housing Administration (FHA), the U.S. Department of Agriculture (USDA) under the Rural Housing Service Program, or the U.S. Department of Veterans Affairs (VA) or guaranteed by the Secretary of HUD under section 184 of the Housing and Community Development Act of 1992.

Under the Ginnie Mae Mortgage-Backed Securities (MBS) program, only approved issuers are authorized to issue Ginnie Mae securities. Issuers in turn are bound by the terms and conditions of the MBS Guide, which is incorporated by reference into the Ginnie Mae guaranty agreement. Additionally, issuers are required to provide investors with a prospectus, which contains certain disclosures about the quality of the loans that are used as collateral for their investments. The MBS Guide requires that only federally insured mortgage loans be placed in Ginnie Mae pools.

To create a mortgage pool, approved issuers submit their loan pools in electronic format through GinnieNet<sup>1</sup> to the central processing and transfer agent/pool processing agent. Concurrent with the loan submission process, mortgage loan documents for all loans that are used to support the pool as collateral are transferred to a document custodian for safekeeping. A document custodian is typically a banking financial institution approved by Ginnie Mae. At the end of each month, the issuer provides loan level data updates to Ginnie Mae's risk management contractor for analysis and review.

In fiscal year 2007, the Office of Inspector General (OIG) became aware of misrepresentations involving at least two Ginnie Mae issuers. [REDACTED]

[REDACTED] These issuers defaulted in October 2006 and October 2007, respectively. We initiated the audit in connection with these issues. Our objectives were to determine whether Ginnie Mae (1) agreements with the issuers sufficiently protected Ginnie Mae against fraud or other misrepresentation in the MBS program and (2) had implemented sound business practices to ensure that only insured mortgages remained in Ginnie Mae pools after issuance.

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<sup>1</sup> GinnieNet is a proprietary system that is used primarily to transmit MBS pool loan data, final certifications and recertification information, and various monthly MBS forms/reports to Ginnie Mae.

## RESULTS OF AUDIT

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### Finding 1: Ginnie Mae Did Not Ensure That MBS Pools Were Insured within a Reasonable Period after Pool Issuance

Ginnie Mae did not design or implement effective controls over [REDACTED]

This condition occurred because of the [REDACTED]

[REDACTED] Consequently, the control gaps in the MBS program could leave Ginnie Mae vulnerable to fraud.

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#### **Business Practices on Loans in Ginnie Mae Mortgage-Backed Securities Pools**

Ginnie Mae is authorized, in accordance with section 306(g) of the National Housing Act, to guarantee timely payment of principal and interest on Ginnie Mae mortgage-backed securities. These securities are backed by pools of federally insured mortgages.<sup>3</sup> Under the Ginnie Mae MBS program, approved issuers create Ginnie Mae mortgage-backed securities by submitting pools of insured mortgage loans to Ginnie Mae through a pool processing agent. Once processed, the pool securities are delivered to the investors through the Federal Reserve Bank of New York.

For many years, Ginnie Mae has allowed the issuance of Ginnie Mae securities collateralized by single-family mortgage loans that were in the process of being insured but not yet insured. OIG questioned this practice in February 1975 and again in May 2008. On both occasions, HUD's Office of General Counsel (OGC)

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<sup>2</sup> For purposes of this review, we used four months from the pool issuance date as a baseline for determining a reasonable period, which is consistent with the requirements for defective loans under section 14-8(D) of the MBS Guide. The MBS Guide defines defective loans as a mortgage (1) that cannot be insured or guaranteed by an agency of the federal government, (2) that has been refused by the insuring or guaranteeing agency, (3) for which federal agency insurance or guaranty has been withdrawn, or (4) that does not comply with the terms of the related securities. If a single-family mortgage or manufactured home loan is found to be defective within four months after the issue date of the securities, the issuer must cure the defect or replace the mortgage or loan in the pool or loan package with a substitute mortgage or loan. After the four-month period, replacement is not allowed, and the issuer must either cure the defect or repurchase the mortgage or loan out of the pool or loan package in an amount equal to the remaining principal balance of the loan less the principal payments advanced by the issuer on the loan.

<sup>3</sup> The loans in Ginnie Mae pools are insured by FHA, VA, USDA, or HUD.

opined to OIG that “for practical business necessities of the program,” it had no legal objections to Ginnie Mae’s business practice. OGC’s opinion went on to state that Ginnie Mae possesses broad authority under its Charter Act to exercise its business judgment to determine the appropriate means to implement its MBS program to achieve its statutory purposes. It is OGC’s opinion that this practice is permissible even when there is technical noncompliance with the statute for a “short period of time.”

As of January 2009, Ginnie Mae had not formally established a policy that defined that “short period of time.” Further, it had retained uninsured loans and/or loans with undetermined mortgage insurance in the Ginnie Mae MBS portfolio for extended periods. For example, a majority of the loans in the portfolio for one defaulted issuer were uninsured for significantly unreasonable periods. Additionally, \$2.1 billion in loans that were more than four months old had undetermined mortgage insurance status, and 64 percent of the loans were more than a year old as of March 2008. The causes of the undetermined mortgage insurance were unresolved as of January 2009. Detailed discussions of these issues are provided in the succeeding paragraphs.

**A Significant Portion of Loans for a Single Issuer Were Uninsured**



The issuer defaulted in October 2006. As of September 30, 2006, 123 of its 305 active single-family FHA loans (or 40 percent) with \$17.8 million in remaining principal balance were uninsured. Of the 123 uninsured loans, 71 (58 percent) had been uninsured for more than four months and in some cases up to 16 months after issuance of the securities.

Below is the aging analysis of the 123 uninsured single-family FHA loans.

**Exhibit 1. Aging of uninsured [REDACTED] loans as of September 30, 2006**

Days	Loan count	Percentage of loan count	Remaining principal balance	Percentage of remaining principal balance
0 - 29	18	14.63%	\$ 3,030,047.25	16.97%
30 - 60	12	9.76%	1,823,479.60	10.21%
61 - 91	17	13.82%	2,328,267.88	13.04%
92 - 121	5	4.07%	804,519.28	4.51%
122 - 152	4	3.25%	679,378.37	3.80%
153 - 182	4	3.25%	430,980.30	2.41%
183 - 365	44	35.77%	6,464,532.77	36.20%
>365	19	15.45%	2,295,190.27	12.85%
<b>Totals</b>	<b>123</b>	<b>100%</b>	<b>\$ 17,856,395.72</b>	<b>100%</b>

Source: Aging analysis prepared by OIG.

[REDACTED] while the remaining 182 of the 305 active single-family FHA loans had been insured, 67 of these loans (37 percent) were insured between 123 to 345 days after issuance of the securities. Ginnie Mae was aware of these issues because its MBS Monitoring Division staff received monthly loan origination match exception reports, which are generated as a result of a loan-matching process.<sup>4</sup> All 123 uninsured loans identified in this finding were reported to Ginnie Mae in the exception reports, initially after four months of its pool issuance date and consistently each month thereafter. However, more than half of the mortgage insurance on these loans remained unresolved for several months. [REDACTED]

[REDACTED]

The serious delays in obtaining mortgage insurance for the loans and the varying degrees of late mortgage insurance exceptions identified in the report should have raised concerns about the loans' insurability. [REDACTED]

[REDACTED]

[REDACTED]

**Thousands of Single-Family  
FHA Loans Had Undetermined  
Mortgage Insurance Status**

As of March 2008, mortgage insurance status for 19,483<sup>5</sup> (of 2.7 million in FHA's active loan portfolio) single-family FHA loans in Ginnie Mae's portfolio

<sup>4</sup> On January 2003, Ginnie Mae implemented new procedures for verifying mortgage insurance with FHA by way of electronic loan data matching. To accomplish this task, specific data elements such as FHA case number, original principal balance, interest rate, etc., from Ginnie Mae's loan level data are matched to FHA's insurance loan level data (i.e., a two-string or five-string match).

<sup>5</sup> Ginnie Mae MBS Guide, section 4-8 (D). See footnote 2

[REDACTED]

with \$2.1 billion in remaining principal balance was undetermined for more than four months after their applicable pool issuance date. [REDACTED]

[REDACTED]

As indicated earlier, Ginnie Mae's MBS Monitoring Division staffs received monthly loan matching exception reports and were fully aware of the above issues. [REDACTED]

[REDACTED]

This condition was partly due to [REDACTED]

[REDACTED]

Below is the summary of the aging for 19,483 loans in the Ginnie Mae single-family FHA loan portfolio as of March 2008, according to the exception reports prepared by Ginnie Mae's contractor. This aging analysis showed a wide range of exceptions related to mortgages with undetermined mortgage insurance status as noted below.

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[REDACTED]

<sup>7</sup> Ginnie Mae's risk management contractor performs the loan-matching process for Ginnie Mae.

**Exhibit 2. Loan aging of Ginnie Mae single-family unmatched FHA loan portfolio as of March 2008**

<b>Aging in days</b>	<b>Unmatched loans</b>	<b>Percentage of unmatched loans</b>	<b>Remaining principal balance</b>	<b>Percentage of remaining principal balance</b>
122 - 151	1,315	6.75%	\$ 176,606,871	8.38%
152 - 182	1,596	8.19%	\$ 211,402,631	10.03%
183 - 365	2,663	13.67%	\$ 383,550,270	18.20%
>365	13,909*	71.39%	\$1,335,541,244	63.38%
<b>Totals</b>	<b>19,483</b>	<b>100.00%</b>	<b>\$2,107,101,016</b>	<b>100.00%</b>

Source: Data provided by Ginnie Mae's risk management contractor.

\*Note: Of 13,909 unmatched loans, 4,403 loans totaling \$240,588,872 were issued before January 2003.

Ginnie Mae indicated that it was developing new procedures to strengthen the controls and monitoring of the unmatched loans. [REDACTED]

Additionally, the APM 08-21 (Changes to Ginnie Mae's Loan Matching Process) dated October 2, 2008, was issued in connection with this plan. We commend Ginnie Mae for taking proactive steps in this APM to address some of the issues or concerns noted in this report but more improvements are needed to refine the timeframes (i.e., timeframes before taking appropriate corrective action by Ginnie Mae against an issuer) established in the monitoring plan.

The noninsured loans placed in Ginnie Mae pools represented a technical noncompliance with section 306(g) of the National Housing Act because the underlying mortgages from the securities that constituted the pools had not fully met all statutory requirements. Although, we acknowledge Ginnie Mae's business decision to allow issuance of certain securities when some of the underlying loans had pending mortgage insurance, Ginnie Mae needs to ensure that its business processes support the statute's language or request a statutory revision from Congress to reflect current practices.

**Conclusions**

The above conditions resulted from [REDACTED]

- **Program policy regarding timing for mortgage insurance** – [REDACTED]

- [REDACTED] – Although there has been a process in place since January 2003 for identifying unmatched loans, [REDACTED]  
[REDACTED]
- [REDACTED]  
[REDACTED]

These risks are threats to Ginnie Mae’s MBS program and without proper corrective actions, the gap in the MBS program policies and procedures will continue to make Ginnie Mae susceptible to program risks, including fraud risks, which could undermine the overall integrity of the program.

**Recommendations**

We recommend that the President of the Ginnie Mae

- 1A. Design and implement a program policy [REDACTED] consistent with current FHA direct endorsement and lender insurance program endorsement policies and procedures.
- 1B. Develop and implement formal written policies, procedures, and systems for monitoring and/or following up on unmatched loan exceptions and identify those who will be accountable for ensuring that proper follow-up actions are taken according to an established protocol.
- 1C. Review the 19,483 loans with undetermined mortgage insurance identified in this finding to determine whether these loans are defective. If loans are defective, Ginnie Mae should require the issuer to buy the loans out of the pools to ensure full compliance with MBS program requirements.
- 1D. Pursue appropriate legal actions available to Ginnie Mae against the defaulted issuer to recover any remaining losses for the 123 uninsured loans identified in this finding, [REDACTED] to ensure that Ginnie Mae will be indemnified for any losses incurred or to be incurred from these defective loans.

- 1E. Request a legislative proposal to amend the statute to align with the current practice of allowing uninsured mortgages to remain in a noncompliant status for a short period.

## SCOPE AND METHODOLOGY

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We conducted our review from January through November 2008 at HUD headquarters in Washington, DC. Initially, we selected for review the loan portfolio of two most recent defaulted Ginnie Mae issuers as of January 2008. We then further narrow our review focus on the loan portfolio of only one defaulted issuer based on the results of our survey. To accomplish our audit objectives, we

- Reviewed Ginnie Mae's internal operating procedures and the MBS Guide (HUD Handbook 5500.3, REV-1) to gain a basic understanding of the rules, policies, and procedures that govern the program. We also conducted walkthroughs with Ginnie Mae management officials and contractors to confirm our understanding of their processes, controls, and risk management approaches.
- Reviewed issuer representations in the Ginnie Mae guaranty agreement and other MBS legal documents. Additionally, we reviewed correspondence and loan level data files for one defaulted issuer.
- Interviewed Ginnie Mae management officials and its contractors to follow up on issues and/or observations noted during the course of our review.
- Performed 100 percent data analysis using Audit Command Language for one defaulted issuer by comparing electronic data of monthly pool and loan level data against the loan level data in FHA's Single Family Data Warehouse to identify anomalies or inconsistencies in the data. Our loan level data analysis was limited to FHA loans only.

We performed our review 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# INTERNAL CONTROLS

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Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 the following internal controls were relevant to our audit objectives:

Program policies and procedures that management has implemented to reasonably ensure that

- Guaranty programs meet their objectives;
- Valid and reliable data are obtained, maintained, and fairly disclosed in reports;
- Resource use is consistent with laws and regulations; and
- Resources are safeguarded against fraud, waste, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weaknesses

Based on our review, we believe that the following item is a significant weakness:

- [REDACTED]

[REDACTED]

## APPENDIX A

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### AUDITEE COMMENTS AND OIG'S EVALUATION

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Ref to OIG Evaluation

Auditee Comments

See next page for auditee comments.

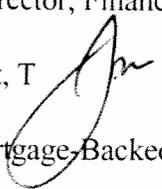


U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-9000

GOVERNMENT NATIONAL  
MORTGAGE ASSOCIATION

March 20, 2009

MEMORANDUM FOR: Thomas R. McEnanly, Director, Financial Audits Division, GAA

FROM: Joseph J. Murin, President, T 

SUBJECT: Draft Audit Report of Mortgage-Backed Securities Program Document Review

Thank you for giving me an opportunity to comment on the draft audit report regarding Ginnie Mae's mortgage-backed securities program documents. As you know, Ginnie Mae has implemented a number of important improvements to our risk management environment during 2008, and I am committed to working collaboratively with the Office of the Inspector General (OIG) as we continue to make further changes. Ginnie Mae's responses to specific recommendations follow.

**Recommendation 1A:** Design and implement a program policy that [REDACTED] consistent with current FHA direct endorsement and lender insurance program endorsement policies and procedures.

**Response:** Ginnie Mae agrees with this recommendation. On June 6, 2008, Ginnie Mae's Risk Committee approved a recommendation from the Office of Mortgage-Backed Securities to make a number of significant improvements to the matching program to leverage Ginnie Mae's limited resources [REDACTED]

[REDACTED] On September 26, 2008, Ginnie Mae's Risk Committee approved a more detailed implementation plan for these improvements. On October 28, 2008, Ginnie Mae issued an All Participants Memorandum (APM) to issuers describing the three major components of these changes, as well as the schedule for their implementation.

The first component, the "Origination Non-Match Notification Process," is a new monthly process that began on October 29, 2008. [REDACTED]

[REDACTED] As shown in the table below, Ginnie Mae has already seen significant improvement in the six months that these notices have been sent:

**Ginnie Mae Average Origination Non-Match Percentage**

September '08	October '08	November '08	December '08	January '09	February '09
21.6%	18.5%	18.5%	15.0%	12.3%	13.6%

The second component, the "Aged MC Process," is a new quarterly process that began on December 30, 2008. [REDACTED]

[REDACTED] Any issuer that receives this E-Notification in two consecutive quarters will be required to correct the problems or buy the loans out within 30 days. The first round of these letters will be issued in April 2009.

The third component, the "Terminated Loan Notification Process," is a new process that began on December 1, 2008. On a monthly basis, every issuer with a loan reported as terminated by the FHA ("MT") receives an E-Notification identifying the loans and instructing them to address the issue. Every quarter, any issuer with an MT loan in a pool for 90 days or more will be required to resolve the issue within 30 days or face possible disciplinary action. The first round of these quarterly letters will be issued in March 2009.

**Recommendation 1B:** Develop and implement formal written policies, procedures, and systems for monitoring and/or following up on unmatched loan exceptions and identify those who will be accountable for ensuring that proper follow-up actions are taken according to an established protocol.

**Response:** Ginnie Mae agrees with this recommendation. See response to Recommendation 1A above. Ginnie Mae has implemented significant improvements to its loan matching program, and has documented the changes through formal cases presented to its Risk Committee and an APM to Ginnie Mae issuers.

In addition, Ginnie Mae's Risk Analysis contractor has drafted updates to its procedures manual [REDACTED]

Separately, and in that same timeframe, Ginnie Mae also expects to update the loan matching section of its desk manual to reflect these changes.

**Recommendation 1C:** Review the 19,483 loans with undetermined mortgage insurance identified in this finding to determine whether these loans are defective. If loans are defective, Ginnie Mae should require the issuer to buy the loans out of the pools to ensure full compliance with MBS program requirements.

Comment 1 **Response:** Over 99 percent of the 19,483 loans referenced above match on FHA case number, [REDACTED]

[REDACTED]

Comment 1

As shown in the table below, this change decreased the number of unmatched loans from 19,483 to 5,946. Ginnie Mae sampled 252 loans to validate this approach; a manual query was performed on each loan in the FHA A-43i active file to confirm case number, property address and first payment date to verify that they represented the same loans as shown in Ginnie Mae's records.

[REDACTED]

Comment 1

[REDACTED]

[REDACTED]

**Recommendation 1D:** Pursue legal actions available to Ginnie Mae against the default issuer to recover any remaining losses for the 123 uninsured loans identified in this finding, [REDACTED] to ensure that Ginnie Mae will be indemnified for any losses incurred or to be incurred from these defective loans.

**Response:** [REDACTED]

**Recommendation 1E:** Request a legislative proposal to amend the statute to align with the current practice of allowing uninsured mortgages to remain in a noncompliant status for a short period.

Comment 2 **Response:** [REDACTED]

As you can see, we agree with many of the recommendations contained in the report, and we will continue enhancing our risk management practices, including strengthening specific policies and procedures to follow up on high risk issuers and loans. In conclusion, I want to reemphasize our commitment to a healthy, collaborative relationship with the OIG. I would be happy to meet with you to discuss this further.

## OIG's Evaluation of Auditee Comments

**Comment 1** Ginnie Mae stated that over 99 percent of the 19,483 loans with undetermined mortgage insurance identified in the draft report matched the FHA case number and that a significant portion of these loans do not appear to have mortgage insurance problems based on the results of a non-statistical sample of 252 loans. [REDACTED]

Our recommendation for Ginnie Mae to review 19,483 unmatched loans is geared towards resolving the status of those loans that have been in suspense for extended periods to ensure their efforts were primarily focused up on truly high risks loans. [REDACTED]

[REDACTED]

weaknesses in the internal control system and if not corrected timely can create opportunities for others to perpetrate fraud similar to what happened to one defaulted issuer that we identified in this report.

**Comment 2** Ginnie Mae stated that no legislative change is necessary based [REDACTED]

[REDACTED] For this reason, we continue to believe that Ginnie Mae needs to ensure that its business processes support the statute's language or request a statutory revision from Congress to conform to their current practices. Therefore, our recommendation or position on this matter did not change.