

GAO

Report to the Chairman, Subcommittee  
on Housing and Community Opportunity,  
Committee on Financial Services, House  
of Representatives

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October 2005

# HOUSING FINANCE

## Ginnie Mae Is Meeting Its Mission but Faces Challenges in a Changing Marketplace



G A O

Accountability \* Integrity \* Reliability

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# HOUSING FINANCE

## Ginnie Mae Is Meeting Its Mission but Faces Challenges in a Changing Marketplace

Highlights of [GAO-06-9](#), a report to the Chairman, Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives

### Why GAO Did This Study

The Government National Mortgage Association, commonly known as Ginnie Mae, is a wholly owned government corporation that guarantees mortgage-backed securities (MBS) backed by pools of federally insured or guaranteed mortgage loans. The agency supports federal housing programs by facilitating the securitization of loans backed by the Federal Housing Administration (FHA), Department of Veterans Affairs (VA), Rural Housing Service, and the Office of Public and Indian Housing within the Department of Housing and Urban Development (HUD). Concerned that Ginnie Mae's share of the overall MBS market has declined significantly, you asked us to address (1) the state of Ginnie Mae's market share and guarantee volume, (2) the potential implications of changes in its share and volume, and (3) the challenges Ginnie Mae faces and steps it is taking and could take to address these challenges.

### What GAO Recommends

GAO is making no recommendations. Ginnie Mae agreed with this report's conclusions.

[www.gao.gov/cgi-bin/getrpt?GAO-06-9](http://www.gao.gov/cgi-bin/getrpt?GAO-06-9).

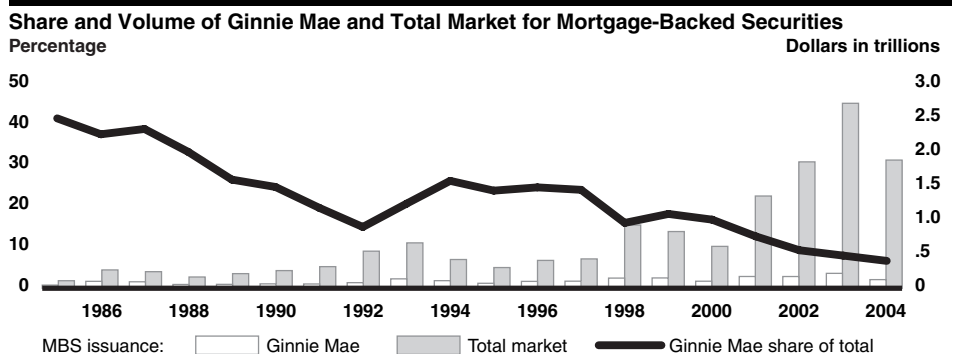
To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov).

### What GAO Found

Despite its declining share of the overall MBS market, Ginnie Mae continues to serve its key public policy goal of providing a strong secondary market outlet for federally insured and guaranteed housing loans. Ginnie Mae MBS financed more than 90 percent of new FHA-insured and VA-guaranteed loans in fiscal year 2004, and the agency appears to face relatively little competition in this market. Ginnie Mae's total volume has declined in recent years, however, and its share of the overall MBS market has fallen from 42 percent of new securities in 1985 to 7 percent in 2004. This drop is largely the result of the decline in the market share of the FHA and VA loan programs and the concurrent rise in the securitization of non-government-backed mortgages.

Further declines in Ginnie Mae's volume could potentially have implications for borrowers, the liquidity of its securities, and federal revenues. For example, Ginnie Mae's securities could become less liquid, although it is unclear at what levels of volume this would occur. In addition, Ginnie Mae's program revenues could decline if its volume decreased. In fiscal year 2004, program revenues exceeded expenses by \$295 million, which helped reduce the federal budget deficit.

Ginnie Mae faces a number of challenges in responding to changes in the marketplace, meeting stakeholders' needs, and managing its operations, and the agency has been taking steps to address these challenges. For example, it has expanded its product mix to reach more borrowers and has begun disclosing more information on loans underlying its securities to help investors better predict risk. GAO and others have identified opportunities for improvement in Ginnie Mae's data integrity and internal controls. The agency has begun addressing these issues, but it contracts out most of its operations, so ensuring that it has sufficient staff capabilities to plan, monitor, and manage its contracts is essential.



Source: GAO analysis of data from the 2005 Mortgage Market Statistical Annual, Volume II: The Secondary Market.

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**Abbreviations**

ARM	adjustable rate mortgage
Fannie Mae	Federal National Mortgage Association
FHA	Federal Housing Administration
FHLBank	Federal Home Loan Bank
Freddie Mac	Federal Home Loan Mortgage Corporation
Ginnie Mae	Government National Mortgage Association
HUD	Department of Housing and Urban Development
MBS	mortgage-backed security
OIG	Office of Inspector General
PIH	Office of Public and Indian Housing
REMIC	Real Estate Mortgage Investment Conduit
RHS	Rural Housing Service
VA	Department of Veterans Affairs

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United States Government Accountability Office  
Washington, D.C. 20548

October 31, 2005

The Honorable Robert W. Ney  
Chairman  
Subcommittee on Housing and  
Community Opportunity  
Committee on Financial Services  
House of Representatives

Dear Mr. Chairman:

The Government National Mortgage Association, commonly known as Ginnie Mae, plays an important role in supporting federal housing initiatives by increasing liquidity in the secondary mortgage market. A wholly owned government corporation, Ginnie Mae guarantees the timely payment of principal and interest on securities issued by private institutions and backed by pools of federally insured or guaranteed mortgage loans. Securities guaranteed by Ginnie Mae finance the vast majority of loans backed by the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA), as well as loans backed by the Rural Housing Service (RHS) and the Office of Public and Indian Housing (PIH) within the Department of Housing and Urban Development (HUD).

Ginnie Mae plays a significant role in the secondary market and to some extent competes directly with private sector entities. However, as a government agency housed within HUD, it has less flexibility than a private sector company in the way it operates.<sup>1</sup> Partly because of that lack of flexibility, Ginnie Mae faces a number of challenges in responding to changes in the marketplace and in managing its operations efficiently and effectively. In particular, Ginnie Mae must determine if and how it should respond to its steadily declining share of the overall market for mortgage-backed securities (MBS).

Concerned about this decline in Ginnie Mae's market prominence, you asked us to address (1) the state of Ginnie Mae's market share and guarantee volume, (2) the potential implications of changes in Ginnie Mae's

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<sup>1</sup>This report refers to Ginnie Mae as an "agency" because it is a government corporation housed within HUD. See 5 U.S.C. § 105.

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market share and guarantee volume, and (3) the challenges Ginnie Mae faces in fulfilling its mission and the steps that have been or could be taken to address these challenges.

To address our objectives, we analyzed data provided by Ginnie Mae and industry sources on Ginnie Mae's guarantee volume and market share, interviewed agency representatives, and reviewed agency documents. We also interviewed representatives of HUD's FHA and PIH programs, and its Office of the Inspector General (OIG), VA, RHS, and the Federal Housing Finance Board and reviewed documents from these entities. In addition, we spoke with and gathered relevant documents from a variety of Ginnie Mae stakeholders and secondary market participants, including issuers of Ginnie Mae securities, institutional investors, investment banks, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Banks of Chicago and Seattle, and trade associations such as the Bond Market Association. Further, we conducted a literature search and reviewed Ginnie Mae's legislative history and relevant laws, regulations, and guidance, as well as reports by HUD's OIG. We conducted our work in Washington, D.C., and Boston from October 2004 through September 2005 in accordance with generally accepted government auditing standards. Appendix I provides additional details on our scope and methodology.

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## Background

Mortgage lenders keep the loans they originate in the primary market or sell them in the secondary, or resale, markets. In turn, purchasers of mortgage loans in the secondary markets either hold the loans in their own portfolios or, most often, pool together a group of loans to back MBS that are sold to investors or held in the originator's portfolio. Secondary loan markets benefit lenders, borrowers, and investors in a number of ways. First, they allow lenders to manage their liquidity needs, reduce interest rate risk, and generate funds for additional lending. Second, they increase the amount of credit available to borrowers and help lower interest rates by fostering competition among lenders. Finally, they allow investors to further diversify their risks and to sell their interests on active secondary markets to other willing investors.

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Ginnie Mae was created in 1968 through an amendment to the National Housing Act.<sup>2</sup> Organizationally, Ginnie Mae operates as a unit of HUD, and its administrative, staffing, and budgetary decisions are coordinated with HUD's. Ginnie Mae defines its mission as expanding affordable housing in America by linking capital markets to the nation's housing markets, largely by serving as the dominant secondary market vehicle for government-backed loan programs.<sup>3</sup> These programs, which insure or guarantee mortgage loans that are originated in the private sector, are administered by a variety of federal agencies, including FHA, VA, RHS, and PIH. The government backing provided by these programs expands opportunities for homeownership to borrowers who may have difficulty obtaining a conventional mortgage.<sup>4</sup>

Ginnie Mae does not buy or sell loans or issue mortgage-backed securities. Rather, it provides guarantees backed by the full faith and credit of the U.S. government that investors will receive timely payments of principal and interest on securities supported by pools of government-backed loans, regardless of whether the borrower makes the underlying mortgage payment or the issuer makes timely payments on the MBS. Figure 1 shows the process of Ginnie Mae securitization. All mortgages in the Ginnie Mae pool must be insured or guaranteed by a government agency and have eligible interest rates and maturities.

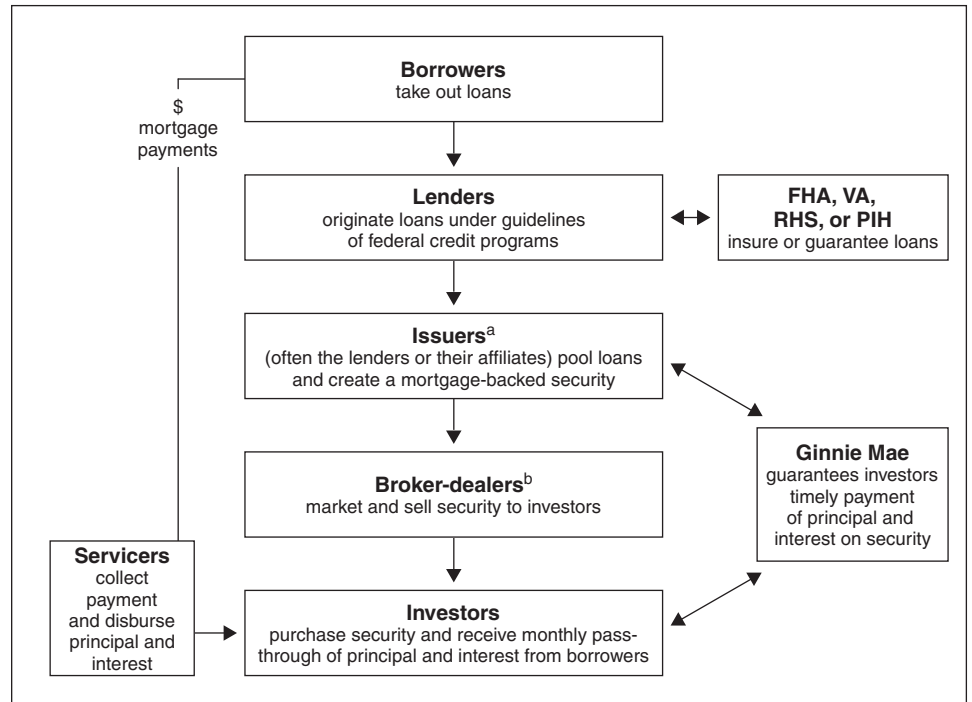
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<sup>2</sup>Housing and Urban Development Act of 1968, Pub. L. No. 90-448; *see* 12 U.S.C. §§ 1716-1723c. Ginnie Mae's charter allows it to conduct three primary activities: (1) implement programs to guarantee the timely payment for securities of pools of federally backed mortgages, (2) conduct certain management and liquidation functions related to mortgages in which federal agencies have a financial interest, and (3) purchase certain federally backed mortgages. According to Ginnie Mae officials, at present Ginnie Mae exercises only the first of these authorities.

<sup>3</sup>For the purposes of this report, the term "government-backed loan" is used to describe a mortgage loan that is either insured or guaranteed by a program of the federal government.

<sup>4</sup>Mortgages without explicit government backing are called conventional mortgages.

**Figure 1: Ginnie Mae Securitization Process**



Source: GAO.

Notes: This chart represents the process for basic Ginnie Mae I and Ginnie Mae II MBS. These securities may serve as collateral for other products, such as Ginnie Mae Real Estate Mortgage Investment Conduits and Platinum Securities.

<sup>a</sup>An issuer is a company or government entity offering securities for sale to investors.

<sup>b</sup>A broker-dealer is an individual or firm in the business of buying and selling securities.

Ginnie Mae has several different products. Ginnie Mae’s original MBS program, Ginnie Mae I, requires that all pools contain similar types of mortgages (e.g., single family) with similar maturities and the same interest rates. The Ginnie Mae II MBS program, which was introduced in 1983, permits pools to contain loans with more heterogeneous loans. For example, the underlying mortgages in a pool can have varying interest rates and a pool can be created using adjustable rate mortgages (ARM).<sup>5</sup> Ginnie Mae’s Multiclass Securities Program, introduced in 1994, includes, among

<sup>5</sup>An adjustable rate mortgage is a loan type that allows the lender to adjust the interest rate during the term of the loan. In contrast, a fixed rate mortgage has an interest rate that does not change during the term of the loan.



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other things, Real Estate Mortgage Investment Conduits (REMIC) and Ginnie Mae Platinum Securities. REMICs are designed to tailor the prepayment and interest rate risks associated with MBS to investors with varying investment goals. These products direct principal and interest payments from underlying MBS to classes, or tranches, with different principal balances, interest rates, and other characteristics. Ginnie Mae Platinum Securities allow investors to aggregate MBS with relatively small remaining principal balances and similar characteristics into new, more liquid securities.

Investors in Ginnie Mae MBS face prepayment risk—that is, the possibility that borrowers will pay off their mortgages early, reducing the amount of interest earned. However, investors do not face credit risk—the possibility of loss from unpaid mortgages—because the underlying mortgages backing the pools are federally insured or guaranteed and Ginnie Mae guarantees timely payment of principal and interest. FHA’s single-family loan program and PIH’s loan guarantee programs insure nearly 100 percent of the loan amount. VA guarantees the lender against losses, subject to a cap equal to 25 percent to 50 percent of the loan amount based on the size of the loan; RHS guarantees up to 90 percent of the loan value. Issuers are responsible for delinquent loans in pools. When a Ginnie Mae issuer defaults in making timely payments of principal and interest to investors, Ginnie Mae makes the payments and takes over the issuer’s entire portfolio of government-backed loans that stand behind the securities that Ginnie Mae has guaranteed.

Ginnie Mae charges issuers a guarantee fee for providing its guarantee of timely payment. The fee varies depending on the product and is six basis points for securities backed by single-family loans, which represent the majority of Ginnie Mae MBS.<sup>6</sup> Issuers also pay a commitment fee that gives them the authority to pool mortgages into Ginnie Mae MBS. Issuers of Ginnie Mae securities may also collect a fee to cover the cost of servicing the underlying mortgages (generally 44 basis points for Ginnie Mae I products and 19 to 69 basis points for the Ginnie Mae II). Ginnie Mae does not receive appropriations or borrow money to finance its credit operations. The agency’s revenues exceed its expenses, which reduces the federal budget deficit.

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<sup>6</sup>A basis point represents one 1/100th of a percentage point (0.01 percent). A guarantee fee of six basis points means that Ginnie Mae charges issuers an annual fee of 6 cents for every \$100 of guaranteed MBS.

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## Results in Brief

The vast majority of loans in FHA's mortgage insurance program and VA's loan guarantee program have historically been pooled into MBS guaranteed by Ginnie Mae. In fiscal year 2004, Ginnie Mae guaranteed \$149.1 billion in MBS, which financed more than 90 percent of new loans issued by FHA's and VA's loan programs. Because the agency's MBS are backed solely by loans supported by FHA, VA, PIH, and RHS programs, its MBS volume is largely a function of the volume of these loan programs. Ginnie Mae appears to face relatively little competition in the market for securitizing government-backed housing loans. Other major participants in the secondary market for mortgages—such as Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and state and local government agencies—have purchased or securitized a relatively small number of government-backed loans in recent years and do not appear to have plans for significant expansion into this market. Ginnie Mae's share of the overall MBS market has declined significantly since the 1980s, dropping from about 42 percent of newly issued securities in 1985 to about 7 percent in 2004. This decline is largely due to two factors: a decline in the number of loans FHA and VA have originated, which has not kept pace with growth in the total market, and the rapid rise in the securitization of conventional mortgages during this period.

Changes in Ginnie Mae's volume of new and existing securities could affect borrowers, the liquidity of the Ginnie Mae securities themselves, and government revenues. Competition from other secondary market players that reduced Ginnie Mae's share of the government-backed loan market would not necessarily harm borrowers because these new players would need to offer products that were competitive with Ginnie Mae's. But a decline in the share of high-quality mortgages included in Ginnie Mae's MBS would lower the securities' credit quality and may increase the default rate of the underlying mortgages, possibly increasing servicing costs and interest rates for new borrowers of government-backed loans. In addition, significant declines in the volume of Ginnie Mae securities could also reduce their liquidity, although it is unclear how low Ginnie Mae's volume would have to be before reduced liquidity became a significant concern. Finally, because Ginnie Mae's program income is based on the principal balance of its securities portfolio, declines in Ginnie Mae's outstanding volume could decrease federal revenues. Ginnie Mae's revenues exceed its expenses—by \$295 million, net of interest income, in fiscal year 2004—helping to reduce the federal budget deficit.

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Ginnie Mae faces a number of challenges in fulfilling its mission of supporting borrowers of government-backed loan programs, and we found that the agency generally has been taking steps likely to help address these challenges:

- Ginnie Mae has responded to a changing mortgage market by improving the efficiency and flexibility of some products and expanding its scope to provide securitization for new types of loans. For example, Ginnie Mae worked with FHA to develop and ensure securitization of new FHA hybrid ARM products, which, as of 2004, have provided FHA borrowers with additional options previously available only in the conventional markets. In 2005, Ginnie Mae began guaranteeing securities that finance RHS multifamily loans, providing a new secondary market outlet for this program. However, the Veterans Benefits Improvement Act of 2004 did not address provisions that have limited investors' interest in securities containing certain VA hybrid ARM products. Similarly, certain FHA hybrid ARM products contained terms that, until modified, were unattractive to investors and thus to lenders. Ginnie Mae and VA officials say that capital market participants may not have been sufficiently consulted during the legislative process to ensure that provisions of the FHA and VA hybrid ARM programs were consistent with Ginnie Mae and conventional secondary market requirements.
- The securities industry has raised concerns for several years that Ginnie Mae does not disclose sufficient information on items such as loan terms and borrower characteristics for the loans in its pools, hindering the ability to predict prepayment rates for Ginnie Mae securities. Ginnie Mae's ongoing MBS Disclosure Initiative, which began in January 2004, is providing investors with substantial additional and more frequent information on its securities' loan pools.
- In 1999, Ginnie Mae was in danger of exhausting the limit of its congressionally authorized commitment authority that was available for 1 year and thus was not able to fully meet commitments it had made to capital market participants. To address this problem, since 2002, Congress has made Ginnie Mae's commitment authority available for 2 years. Other options to address this problem include increasing Ginnie Mae's commitment authority limits or requiring earlier notification to Congress on the amount of commitment authority the agency has used.

In addition to responding to the marketplace, Ginnie Mae faces challenges in managing its internal operations in an efficient and cost-effective manner

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and in ensuring that appropriate internal controls are in place. Following losses due to fraud in 2002, reviews by HUD's OIG of Ginnie Mae's internal controls, as well as our review, identified inconsistencies and inaccuracies in Ginnie Mae's data systems. For example, the agency was initially unable to provide us with accurate data on the composition of the loans backing its portfolio. The agency recently completed a business process improvement plan and has other initiatives under way—but not yet fully implemented—designed to improve its data integrity and streamline its operations. Ginnie Mae operates with a small staff of about 66 people and contracts out most of its operations. A 2004 resource management study by HUD found Ginnie Mae had sufficient staff resources to perform contract administration functions. But given its reliance on contractors, Ginnie Mae should continue to focus on ensuring that these staff have sufficient training, qualifications, and capabilities to ensure that its contracts are planned, monitored, and executed appropriately.

HUD reviewed a draft of this report and concurred with our findings.

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## Ginnie Mae Securities Finance Most Government-Backed Housing Loans, but Represent a Declining Share of the Total MBS Market

Ginnie Mae securities finance the great majority of FHA and VA loans, suggesting that the agency is fulfilling its basic mission, and faces relatively little competition in the market for government-backed mortgage loans. However, Ginnie Mae's share of the total MBS market has declined over the last 20 years, both in terms of new issuances and volume outstanding, largely because FHA and VA loan origination has not kept pace with growth in the overall mortgage market and because securitization of conventional mortgages has become far more prevalent.

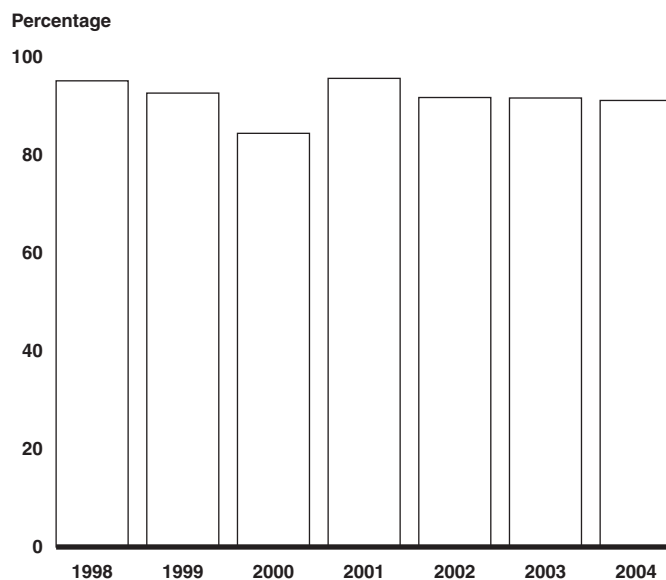
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## Ginnie Mae Guarantees Securities for the Bulk of FHA and VA Single-Family Loans

Historically, the vast majority of government-backed housing loans have been pooled to back MBS for which Ginnie Mae guarantees the timely payment—a trend that continues today. Ginnie Mae issued its first MBS in 1970, and since that time it has guaranteed a cumulative total of more than \$2 trillion of MBS. According to Ginnie Mae, its securities historically have represented roughly 90 percent of the market for FHA and VA loans. For example, between fiscal years 1998 and 2004 Ginnie Mae securities financed between about 84 percent and 96 percent of FHA-insured single-family loans (see fig. 2). In fiscal year 2004, Ginnie Mae issued a total of \$149.1 billion in MBS. These MBS financed 91 percent of all eligible loans insured or guaranteed by FHA and VA. Ginnie Mae securities also have

financed about half of RHS-guaranteed single-family loans since 1999 and financed roughly 40 percent of PIH-backed loans in fiscal year 2004.

**Figure 2: FHA-Insured Single-Family Loans Guaranteed by Ginnie Mae Securities, Fiscal Years 1998–2004**



Source: GAO analysis of Ginnie Mae data.

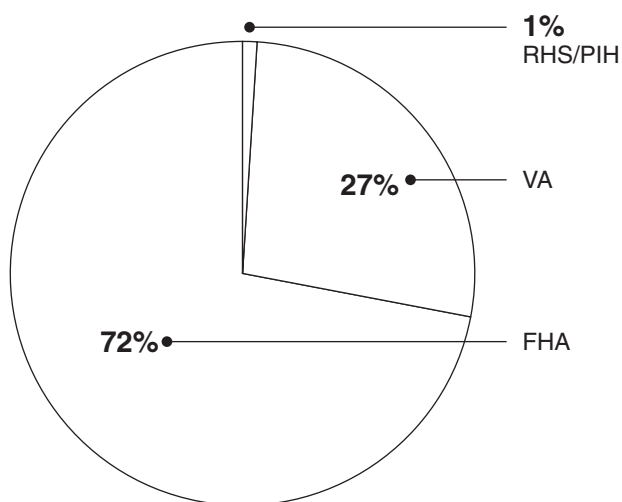
Note: Ginnie Mae's MBS issuance and the FHA loan endorsement do not occur simultaneously, resulting in a lag between the year an FHA loan is endorsed and the year that Ginnie Mae is recorded as guaranteeing its securitization. To improve the accuracy of the data, Ginnie Mae recently matched most of the FHA loans with the Ginnie Mae MBS in which they were pooled from 1998 until the present. Data for Ginnie Mae's share of VA originations is not presented here because Ginnie Mae is still in the process of completing the matching process for its VA portfolio.

In 2004, newly issued Ginnie Mae securities financed \$83.8 billion in FHA-insured loans, \$31.4 billion in VA-guaranteed loans, and \$1.6 billion in loans guaranteed by RHS and PIH. As shown in figure 3, FHA and VA loans represented 72 percent and 27 percent, respectively, of Ginnie Mae's portfolio of new issuances that year, with RHS and PIH representing about 1 percent. About 92 percent of the loans backing Ginnie Mae MBS were single-family loans; the remainder were multifamily loans. Because Ginnie Mae's charter keeps it focused on a discrete portion of the MBS market—specifically, that of loans made under FHA, VA, RHS, and PIH programs—the volume of Ginnie Mae's new MBS issuance is linked directly to the origination volume of these programs. Changes in Ginnie Mae's market volume over the years are thus largely a reflection of changes in the

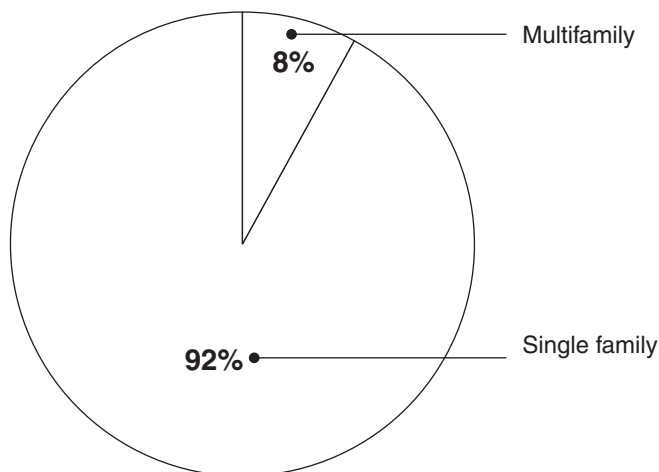
volume of FHA and VA loans, which represent 99 percent of Ginnie Mae's portfolio.

**Figure 3: Composition of Ginnie Mae's Newly Issued MBS, 2004**

Type of loan



Type of housing



Source: GAO analysis of Ginnie Mae data.

### Ginnie Mae Faces Relatively Little Competition in the Secondary Market for Government-Backed Loans

Although Ginnie Mae securities finance the great majority of the government-backed loans it is authorized to support, it does face potential competition from other secondary market entities. Federally insured and guaranteed loans can be expected to appeal to conventional securitizers because these loans carry little to no credit risk. However, Ginnie Mae has consistently captured 90 percent or more of the market for FHA and VA loans. Market participants told us that Ginnie Mae captured most of the market because of the difficulty of competing with the government guarantee of timely payment. This guarantee helps Ginnie Mae securities

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command a higher price and, correspondingly, offer a lower yield than other MBS of government-backed loans.<sup>7</sup>

We spoke with a number of secondary market participants that have or could become active in the market for government-backed loans, including the Federal Home Loan Banks, Fannie Mae, Freddie Mac, state and local government agencies, and private label issuers.<sup>8</sup> In general, they have had limited or no involvement in Ginnie Mae's market. Moreover, for a variety of reasons, they do not appear to have plans to encroach on Ginnie Mae's market to any substantial degree, as the following examples illustrate:

- The Federal Home Loan Banks (FHLBank) have mortgage programs under which they purchase pools of conventional and federally insured or guaranteed mortgage loans from member banks.<sup>9</sup> First authorized in 1998, the programs go by the names of the Mortgage Partnership Finance® program and the Mortgage Purchase Program.<sup>10</sup> The programs were attractive to lenders in part because lenders could use them to sell their mortgages without paying guarantee fees. In 2000, FHLBanks took over a significant amount of Ginnie Mae's market share and purchased \$12.7 billion in FHA and VA loans, representing about 11 percent of the combined market for those loans. However, the Federal Housing Finance Board, which oversees the FHLBanks, became concerned because the program was intended to focus on conventional rather than FHA loans. The board took measures to encourage the FHLBanks to limit their purchase of FHA loans to no more than one-third of their

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<sup>7</sup>"Price" refers to the dollar amount to be paid for a security and "yield" to the rate of return it earns. As a security's price rises, its yield falls because strong demand for a given security raises its price for the seller and the return to the investor (yield) declines. Conversely, as a security's price declines, its yield rises.

<sup>8</sup>"Private label issuer" is the term commonly used to describe a securities issuer that is an entity other than a U.S. government agency or U.S. government-sponsored enterprise. Such issuers may include subsidiaries of investment banks or other financial institutions.

<sup>9</sup>The Federal Home Loan Bank System is a government-sponsored enterprise that consists of 12 Federal Home Loan Banks, which are cooperatively owned by member financial institutions—typically commercial banks and thrifts (or savings and loans). The primary mission of the FHLBank System is to promote housing and community development, generally by making loans, also known as advances, to member financial institutions. See GAO, *Federal Home Loan Bank System: An Overview of Changes and Current Issues Affecting the System*, [GAO-05-489T](#) (Washington, D.C.: Apr. 13, 2005).

<sup>10</sup>Mortgage Partnership Finance is a registered trademark of the Federal Home Loan Bank of Chicago.

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mortgage purchase program portfolio. After 2000, FHLBanks greatly reduced their purchases of FHA loans. From 2001 to 2003, they purchased loans representing about 4 percent to 5 percent of the FHA market, which then declined further to about 2 percent in 2004.

- In fiscal year 2004, Fannie Mae purchased 4 percent of all FHA and VA originations.<sup>11</sup> Its share of FHA and VA originations has varied over time, ranging from 1 percent to 6 percent between 1990 and 2004, or just 0.3 percent to 3 percent of Fannie Mae's total purchase activity. According to Fannie Mae officials, these purchases of government loans consist largely of repurchases of delinquent loans. A Fannie Mae official told us the company did not systematically purchase FHA loans and in its normal course of business did not consider itself a competitor with Ginnie Mae. Fannie Mae does not receive credit from HUD toward its affordable housing goals by purchasing government-backed loans.<sup>12</sup>
- Freddie Mac has purchased less than 1 percent of the market of FHA and VA loans each year since 1990. Freddie Mac officials said that its competition with Ginnie Mae is largely indirect, by encouraging conventional lending to the most creditworthy low- and moderate-income borrowers who might otherwise receive a mortgage through FHA or VA. Freddie Mac officials also said they do not compete with Ginnie Mae in the secondary market directly because it is hard to compete with Ginnie Mae's government guarantee. In addition, as with Fannie Mae, government-backed loans do not count toward Freddie Mac's required affordable housing goals. Freddie Mac does purchase some mortgage revenue bonds that are collateralized by FHA and VA loans and directly purchases some FHA and VA loans that Ginnie Mae does not securitize.
- State and local government entities, including housing finance agencies, issue mortgage revenue bonds to raise funds in the capital markets for mortgage lending. Because these bonds are tax exempt, investors are

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<sup>11</sup>Fannie Mae and Freddie Mac are government-sponsored enterprises—congressionally chartered, private corporations that are publicly owned—that help ensure that funds are available to home buyers by buying mortgages from mortgage originators, such as savings and loan associations, commercial banks, and mortgage bankers.

<sup>12</sup>The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires Freddie Mac and Fannie Mae to meet housing goals established by HUD for serving certain categories of borrowers, including those who are underserved and have low or moderate incomes. Pub. L. No. 102-550 §§ 1331-1334; see 12 U.S.C. §§ 4561-4565 (2000 & Supp. 2004).



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willing to accept a lower interest rate for them. This interest savings is passed on through lenders to lower-income families in the form of loans with interest rates below the market average. These bonds often finance government-backed mortgages. As of 2003, 71 percent of the mortgages that revenue bonds financed were insured or guaranteed by a federal program—58 percent by FHA, 10 percent by RHS, and 3 percent by VA. The overall volume of mortgage revenue bonds issued was \$10.7 billion in 2003.<sup>13</sup>

- Private label issuers purchased an estimated 3 percent of FHA and VA loans in 2004. These issuers account for an increasingly large share of the overall MBS market, but most of their market consists of loans not offered by FHA and VA programs, such as jumbo nonconforming loans and home equity lines of credit.<sup>14</sup> According to RHS officials, private label issuers do currently securitize the majority of Section 538 multifamily loans guaranteed by RHS, but these loans account for less than 1 percent of Ginnie Mae's portfolio.

Most of the competition for Ginnie Mae's market share does not come directly—that is, secondary market participants are not seeking to purchase or securitize significant numbers of government-backed loans. Rather, lenders compete with Ginnie Mae indirectly by seeking greater market share at the origination level by making conventional loans to borrowers who might otherwise use FHA and VA loan programs. Fannie Mae and Freddie Mac have an incentive to serve this market because lower-income borrowers who might otherwise turn to a government-backed loan program can help them meet their housing goals established by HUD. In addition, subprime mortgage originations have grown

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<sup>13</sup>Measuring the secondary market share of government-backed loans that these bonds represent is difficult because the bonds are often purchased by other secondary market entities. For example, Freddie Mac's reported purchases of FHA loans include loans collateralizing mortgage revenue bonds that it holds.

<sup>14</sup>A jumbo nonconforming loan provides financing for those borrowers who are purchasing or refinancing properties that require larger loan amounts than Fannie Mae and Freddie Mac will allow—\$359,650 for a single-family mortgage in 2005. Home equity lines of credit provide a revolving line of credit based on the equity available in a home.

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dramatically in recent years, as many lenders market to less creditworthy borrowers who in the past may have received a government-backed loan.<sup>15</sup>

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### Ginnie Mae's Share of the Total MBS Market Has Declined

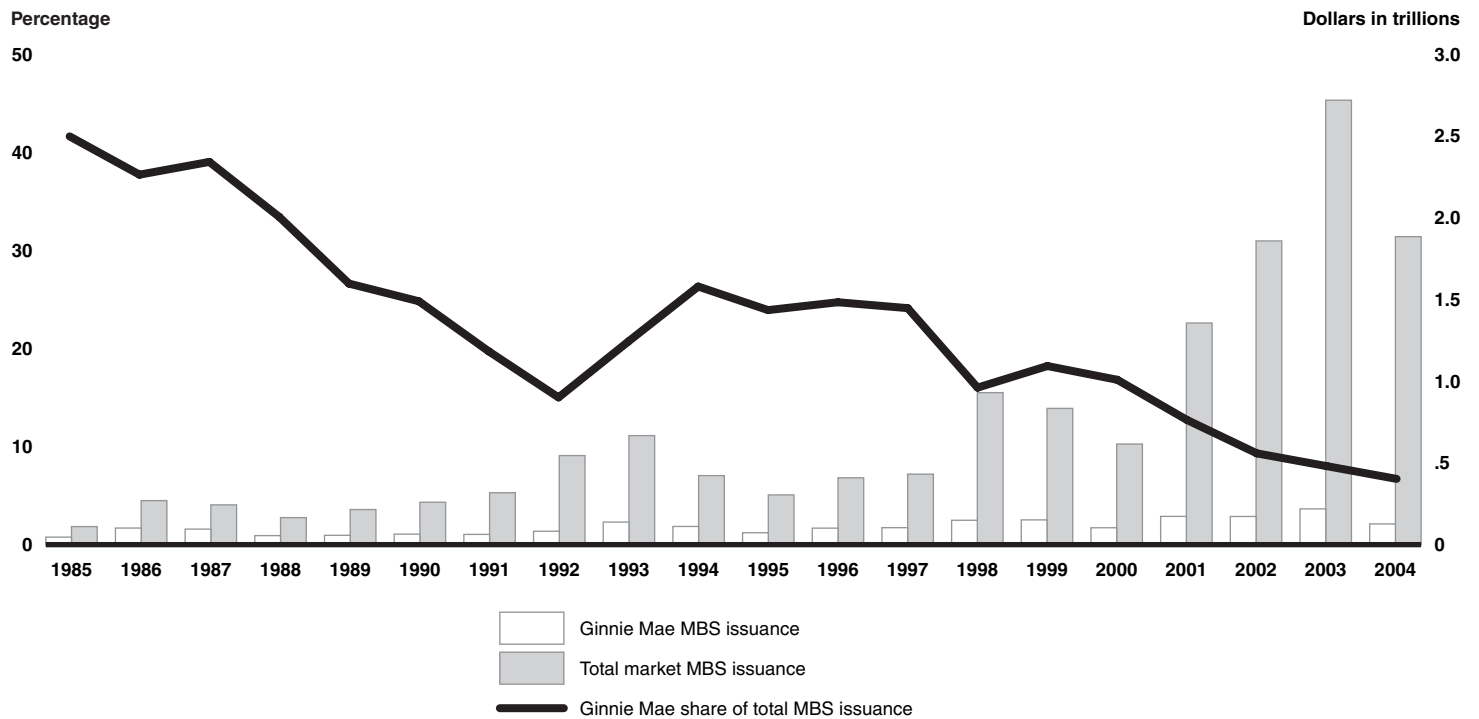
Although Ginnie Mae continues to finance the bulk of government-backed loans, its share of the overall MBS market has declined substantially over the past 20 years. As shown in figure 4, Ginnie Mae securities represented 42 percent of all new MBS issued in 1985, but only 7 percent in 2004.<sup>16</sup> This drop in market share of new issuance is due not to a significant decline in Ginnie Mae's MBS issuance, but rather to rapid growth in the rest of the market—Fannie Mae, Freddie Mac, and private label issuers, which we refer to as the “conventional” market for MBS. In 1985, Ginnie Mae MBS issuance was \$46 billion, while the conventional market issued \$64 billion. By 2004, Ginnie Mae issuance had grown to \$127 billion, but issuance of conventional MBS had grown to \$1.8 trillion. MBS issuance has risen among all segments of the conventional market. The rise in private label MBS issuance has been particularly steep in the last few years, rising from \$136 billion in 2000 to \$864 billion in 2004.

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<sup>15</sup>The subprime market serves borrowers who have poor or no credit histories or limited incomes who cannot meet the credit standards for obtaining loans in the prime market. Many borrowers of government-backed loan programs, which are designed to serve lower-income or underserved populations, have those characteristics.

<sup>16</sup>For the purposes of this report, issuance refers to new MBS issued in a given year and outstanding refers to the cumulative amount of existing MBS issued in the past years and still held by investors.

**Figure 4: MBS Market Volume and Ginnie Mae's Market Share, Fiscal Years 1985-2004**



Source: GAO analysis of data from the 2005 Mortgage Market Statistical Annual, Volume II: The Secondary Market.

Note: Total market includes Ginnie Mae, Fannie Mae, Freddie Mac, and private label issuers.

Two factors have spurred the growth of the conventional MBS market: the increasing number of conventional mortgage originations and the growing proportion of these mortgages that are securitized. Mortgage lending in the conventional market has grown much more rapidly over the last 20 years than lending through FHA and VA programs.<sup>17</sup> Conventional mortgage originations rose from an estimated \$243 billion in 1985 to an estimated \$2.8 trillion in 2004. In contrast, originations of FHA and VA loans rose from \$42 billion to \$129 billion during that period. In addition, the rate of

<sup>17</sup>Market participants cite several reasons for recent declines in FHA and VA loan volume. Among them are (1) increased competition from private mortgage insurers and other housing finance institutions; (2) administrative and regulatory requirements that may serve as a disincentive to lenders to originate FHA and VA loans; (3) rising home prices, which reduce the proportion of homes that can stay within FHA's and VA's mortgage limits; and (4) a decline in the veteran population that has reduced the number of potential VA borrowers.

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securitization of conventional mortgages has risen rapidly over the last 20 years; by the end of 2004, almost half of outstanding mortgage debt was financed through securitization, according to the Bond Market Association.

Ginnie Mae's market share of outstanding MBS has also declined significantly over the last 20 years, falling from 54 percent in 1985 to 10 percent in 2004. Since 2000, Ginnie Mae's volume of MBS outstanding has fallen from \$612 billion to \$453 billion in 2004, a drop of approximately 26 percent. The primary factor contributing to this decline has been the increase in borrowers who have refinanced out of FHA and VA loan programs into conventional loans. Falling interest rates and rising home prices have led to a boom in refinancing over the last 10 years, particularly from 1997 to 1999 and 2001 to 2004. At the peak of the refinancing boom in 2003, refinancings represented about 65 percent of mortgage originations. As some borrowers with mortgages insured by FHA and guaranteed by VA have built up equity in their homes, they have been able to refinance out of these programs into conventional loans that may offer more favorable and flexible terms and interest rates. This trend may have been facilitated to some extent by the increased availability of loans to borrowers who are less creditworthy. This has allowed some borrowers who would not otherwise have been able to borrow in the conventional market to do so rather than using FHA-insured and VA-guaranteed mortgage programs. The decline in the outstanding volume of FHA and VA loans has led to a corresponding decline in the outstanding volume of Ginnie Mae securities, which are mostly composed of those loans.

To a lesser extent, lender repurchases of delinquent FHA-insured and VA-guaranteed loans in Ginnie Mae pools have also contributed to the decline in Ginnie Mae's volume of outstanding MBS. Ginnie Mae's policy prior to 2003 allowed lenders and servicers to repurchase loans that were in their Ginnie Mae pools if the borrower missed just one payment that remained unpaid for 4 consecutive months. According to Ginnie Mae, these loans often had a low risk of default; the loan may have had only one missed payment followed by resumption of loan servicing by the borrower. However, lenders were able to profit by repurchasing these loans for the remaining balance because, during an era of falling interest rates, the market value of the loans was more than the remaining balance. Data obtained from Ginnie Mae officials show that these repurchases of delinquent loans reached a peak in 2002, when they totaled \$22 billion, and that they contributed to the decline in Ginnie Mae's outstanding volume. To address this problem, Ginnie Mae announced a revision to its loan repurchase policy in November 2002. Under the new policy, for pools

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issued on or after January 1, 2003, servicers can repurchase delinquent loans only when no payment has been made for 3 consecutive months.<sup>18</sup> Ginnie Mae officials as well as issuers we talked with said that these new policies appear to have curtailed repurchase activity.

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## Changes in Ginnie Mae's Share and Volume Could Have Implications for Borrowers, the Liquidity of Its Securities, and Federal Revenue

Ginnie Mae's share of the government-backed mortgage market has been fairly constant. If other secondary market players substantially increased their market share of government-backed mortgages, borrowers would be unlikely to see higher interest rates or tighter credit immediately, because such players would need to offer products that were competitive with Ginnie Mae's. However, a decline in the proportion of high-quality mortgages included in Ginnie Mae's MBS could lower their overall credit quality, potentially raising the cost of servicing the underlying mortgages and thus interest rates paid by borrowers. In addition, any decline in the volume of Ginnie Mae's MBS could potentially reduce their liquidity, although it is unclear whether reduced liquidity is likely to be a significant concern in the foreseeable future. Finally, declines in Ginnie Mae's outstanding volume would reduce its fee revenue from its MBS programs. Because Ginnie Mae's program income exceeds its expenses, a drop in income could affect its contribution to reducing the federal budget deficit.

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## Ginnie Mae's Benefits to Borrowers of Government-Backed Loans May Not Be Dependent on Its Market Share

As noted earlier, Ginnie Mae has consistently guaranteed MBS for the great majority of FHA and VA loans, but its share of the total MBS market has declined significantly since 1985. Borrowers of government-backed loan programs have benefited from the Ginnie Mae guarantee because it helps make such loans more accessible and keep borrowers' interest rates down. New issuance of Ginnie Mae MBS has remained fairly constant, generally ranging from \$150 billion to \$200 billion annually from 1998 to 2004. Ginnie Mae's share of the MBS market for government-backed loans would likely decline only if other secondary market players such as the Federal Home Loan Banks, Fannie Mae, Freddie Mac, state and local government entities,

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<sup>18</sup>Under the new policy, repurchases of loans issued on or before December 1, 2002, are permitted where for 4 consecutive months at least one missed payment remains uncured (a "rolling" delinquency) or else a consecutive 3 month delinquency warranted repurchase consideration. For pools issued on or after January 1, 2003, loans to be repurchased must be delinquent for 3 consecutive months. Loans with rolling delinquencies issued in pools on or after January 1, 2003, are not eligible for repurchase. See HUD, *Ginnie Mae MBS Guide*, Ginnie Mae 5500.3, Rev. 1 (Washington, D.C.; July 1, 2003), ch. 18.

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and private label issuers chose to become more active in the securitization of these loans. In such a scenario, interest rates would probably not rise or credit tighten for borrowers because such players would need to offer products that were competitive with Ginnie Mae's, thus benefiting borrowers to a similar degree. As noted earlier, however, such a scenario is unlikely in the near future, as other secondary market participants generally appear to have chosen not to directly compete with Ginnie Mae because of the government guarantee.

As we have seen, Ginnie Mae's outstanding volume of MBS has declined in recent years because the outstanding volume of FHA and VA loans has fallen as growing numbers of borrowers refinance in the conventional market. However, those FHA and VA borrowers who are able to take advantage of refinancing options are generally the most creditworthy of the programs' borrowers. The result has been a decline in the overall credit quality of FHA and VA loans in recent years indicated by increased default and foreclosure rates in government mortgage insurance and guarantee programs. As a result, the loan quality underlying Ginnie Mae's securities has declined. Thus far, investors have not been directly affected by this development because of the government guarantee.

However, the cost of servicing the government-backed loans in Ginnie Mae's pools could rise in such a scenario, since managing delinquencies and the foreclosure process is the most costly component of servicing. According to Ginnie Mae, the servicing fees issuers are allowed to charge are sufficient to cover any significant increase in servicing costs resulting from declines in credit quality. However, increased servicing costs could result in smaller profits for Ginnie Mae issuers, potentially reducing lenders' willingness to make government-backed loans and increasing borrowers' interest rates. In addition, any increase in prepayment rates due to borrower defaults could reduce the price investors are willing to pay for Ginnie Mae MBS, which could also act to raise interest rates for borrowers.

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## Changes in Ginnie Mae's Volume Could Potentially Affect the Liquidity of Its Securities

A market is said to be liquid if the instruments it trades can be bought by investors or sold in the markets quickly and easily with little impact on market prices. Liquid assets have relatively lower yields and higher prices than illiquid assets.<sup>19</sup> One key factor affecting the liquidity of MBS is the size of the market in which they are traded—all other things being equal, larger markets are generally more liquid than smaller markets. In addition, standardized pools—that is, pools of mortgages with similar interest rates and terms—are generally more liquid than pools of mixed mortgage products, which cannot be traded as readily because they are more difficult to value and thus riskier. For this reason, Ginnie Mae I securities are more liquid than Ginnie Mae II securities (whose pools consist of loans with more variability).

Market participants we spoke with provided mixed opinions about the current liquidity of Ginnie Mae securities. Some dealers said that Ginnie Mae securities were quite liquid and traded easily, while others noted that they were less liquid than other MBS, such as those issued by Fannie Mae and Freddie Mac. One institutional investor told us that Ginnie Mae securities that are traded in smaller volumes—such as those backed by hybrid ARMs—could face liquidity issues. Another noted that the liquidity of Ginnie Mae securities could be a concern for very large trades, such as those of more than \$1 billion.

Any reduced liquidity resulting from a continued decline in Ginnie Mae's market share could have some effect on the costs to borrowers of government-backed loans. However, it is not clear how significant the decline would have to be before liquidity became a significant concern that materially affected the pricing of Ginnie Mae securities and thus interest rates for borrowers of government-backed loans. Ginnie Mae officials told us that their securities had at least adequate liquidity. They noted, for example, that the bid-ask spread on Ginnie Mae securities was comparable with the spread for Fannie Mae securities, one indication that liquidity is not currently an issue.<sup>20</sup> The officials said that if volume continued to

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<sup>19</sup>The less risky an asset, the more investors will pay for it and the lower the interest rate, or yield, that they will require from it.

<sup>20</sup>Bid-ask spreads represent the difference between the price at which an investor can buy a bond and can sell the same bond. Bid-ask spreads are sometimes used as an indicator of liquidity, since small spreads can suggest active trading and efficient pricing.

decline, liquidity could become a significant concern in the future, although it is unknown at what levels of volume this would occur.

### Changes in Ginnie Mae's Outstanding Volume Could Affect Its Contribution to Reducing the Federal Budget Deficit

Revenues from Ginnie Mae's MBS guarantee programs exceed the cost of operating them. Since fiscal year 1985, the agency has not had to borrow from the U.S. government to finance its operations and its excess funds go into a receipt account held as capital reserves. As shown in table 1, in fiscal year 2004 Ginnie Mae had total revenues of \$815.5 million and expenses of \$77.8 million. The excess of its revenues over expenses, net of interest income, is invested in U.S. government securities and reduces the amount that the Treasury must borrow from the public to finance government programs—that is, it reduces the deficit.<sup>21</sup> In fiscal year 2004, this amount was \$295 million.

**Table 1: Ginnie Mae's Revenues and Expenses, Fiscal Years 1998-2004**

Dollars in millions

Ginnie Mae revenues and expenses	Fiscal Year						
	1998	1999	2000	2001	2002	2003	2004
Interest income	\$362.7	\$380.3	\$415.8	\$430.3	\$398.9	\$389.3	\$442.7
MBS program income	392.3	405.0	408.2	438.7	446.0	406.1	372.8
Other income	12.4	13.3	8.0	9.5	6.2	4.2	—
<b>Total revenues</b>	<b>767.4</b>	<b>798.6</b>	<b>832.0</b>	<b>878.5</b>	<b>851.1</b>	<b>799.6</b>	<b>815.5</b>
<b>Total expenses</b>	<b>45.6</b>	<b>51.8</b>	<b>47.2</b>	<b>49.4</b>	<b>56.8</b>	<b>68.1</b>	<b>77.8</b>
Excess of revenues over expenses	674.7	746.8	762.8	805.3	794.3	731.5	737.7
Excess of revenues over expenses, net of interest income	312.0	366.5	347.0	375.0	395.4	342.2	295.0

Source: Ginnie Mae.

Most of Ginnie Mae's revenue comes from MBS program income, which totaled \$372.8 million in fiscal year 2004. Ginnie Mae charges issuers a guarantee fee that is based on the aggregate principal balance of an issuer's

<sup>21</sup>Ginnie Mae's interest income does not have a direct effect on its contribution to offsetting the federal budget deficit. Interest income that Ginnie Mae receives is, from the Treasury's point of view, offset by the Treasury's cost of paying it.



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outstanding MBS, and collects commitment fees for the authority to pool mortgages into Ginnie Mae MBS.<sup>22</sup>

Ginnie Mae's program income allows it to cover the expenses it incurs in carrying out its programs and initiatives, including the cost of hiring contractors, paying staff salaries and benefits, printing, and performing other administrative functions. Ginnie Mae also incurs credit-related expenses—for example, it must maintain reserves against losses and issuer defaults in order to ensure a ready source of funds to meet its guarantee of timely payment. At the end of fiscal year 2004, Ginnie Mae had reserves of about \$10.4 billion.

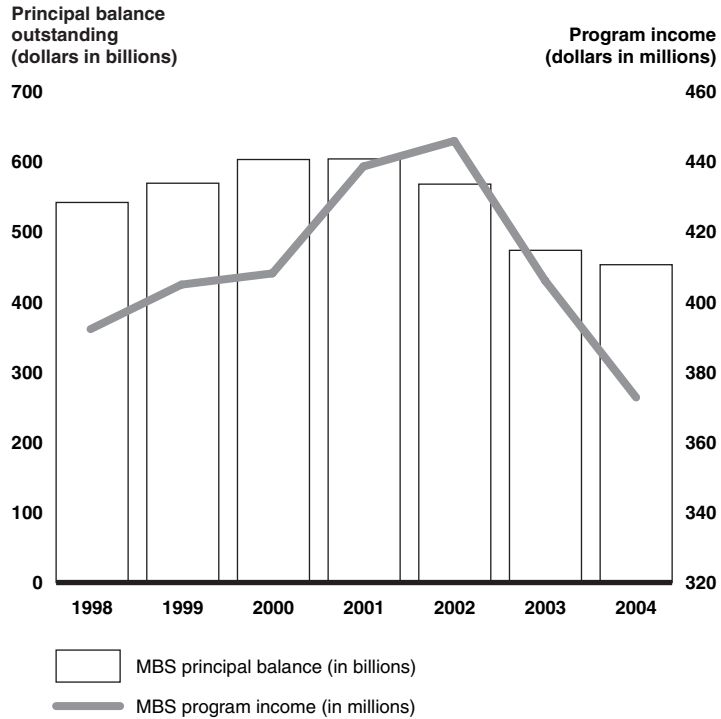
Ginnie Mae's fee income is based on the principal balance of its securities portfolio, so the agency's revenues largely depend on the volume of its outstanding securities. As we have seen, Ginnie Mae's share of the MBS market has declined in the last 20 years. In fiscal years 2000 through 2004, Ginnie Mae's principal balance outstanding also declined, falling from \$603.4 billion to \$453.4 billion and reducing program income from \$408.2 million to \$372.8 million (see fig. 5). As a result, during that period, the agency's excess of revenues over expenses (net of interest), which reduces the federal budget deficit, declined from \$347 million to \$295 million.<sup>23</sup> Ginnie Mae's program income continues to exceed its expenses and, according to Ginnie Mae officials, is likely to do so for the foreseeable future. However, if its outstanding volume continued to decline, program income and excess revenues, which reduce the federal budget deficit, could also be expected to continue falling.

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<sup>22</sup>Other fees charged by Ginnie Mae include new issuer fees, handling fees, multiclass fees, and fees for transferring servicing to Ginnie Mae when issuers default on their securities.

<sup>23</sup>The amount of Ginnie Mae's excess of revenues over expenses is also affected, of course, by changes in its expenses. Ginnie Mae's expenses rose from \$47.2 million to \$77.8 million from fiscal years 2000 to 2004.

**Figure 5: Ginnie Mae MBS: Outstanding Balances and Income**



Source: GAO analysis of Ginnie Mae data.

## Ginnie Mae Faces a Changing Marketplace and Management Challenges

Ginnie Mae faces challenges in a number of areas. First, it must respond to changes in the marketplace and meet the needs of its stakeholders. To meet this challenge, the agency has expanded its product offerings and taken other initiatives to maintain its viability. Second, Ginnie Mae must adequately disclose loan information that MBS investors need to assess prepayment risk. The agency has recently improved this disclosure, though these improvements are not yet complete. Third, Ginnie Mae must work within the limits of its commitment authority. In 1999, it instituted procedures to ration its commitment authority when the agency faced the possibility of reaching the limit of its authority by year's end. To help prevent the problem from recurring, Congress changed Ginnie Mae's commitment authority cycle from 1 year to 2 years and could consider further steps. Fourth, inconsistencies and inaccuracies exist in some aspects of Ginnie Mae's data systems, although measures to improve these systems are under way. Finally, given Ginnie Mae's small staff and reliance

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on contractors, the agency faces the challenge of ensuring that its capacity to plan, manage, and oversee contractors is adequate.

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## Ginnie Mae's Activities Have Responded to a Changing Market Environment

Ginnie Mae has faced and continues to face the challenge of fulfilling its mission of supporting government-backed loan programs in a changing market environment. Among the significant market changes over the last 20 years have been the growing availability of private mortgage insurance and subprime loans, rapid development of the conventional secondary mortgage market, alterations in the volume and characteristics of government-backed loan programs, and the proliferation of new mortgage loan products, such as hybrid ARMs. Ginnie Mae recently completed or has under way several initiatives that are likely to help respond to the needs of its stakeholders in a changing marketplace, although additional efforts may be needed in some areas. Among the steps Ginnie Mae has taken are the following:

- As part of its Business Improvement Initiative, in October 2004 Ginnie Mae began a formal process of soliciting recommendations from business partners and other stakeholders to improve its MBS and Multiclass Securities programs. In March 2005, the agency publicly released the suggestions it had received, including, among others, changing technological processes and developing new securitization products. Ginnie Mae officials say they are currently in the process of evaluating the suggestions.
- Ginnie Mae played a role in developing FHA's hybrid ARM products.<sup>24</sup> Ginnie Mae and FHA officials say that they worked together to encourage Congress to permit FHA to insure hybrid ARMs, in large part because the agency wanted to remain competitive with conventional markets, in which such products had become increasingly popular. Ginnie Mae developed a securitization program, as Ginnie Mae II securities, for these products, and in 2004 FHA began offering 3-, 5-, 7-, and 10-year hybrid ARM products in addition to its standard 1-year ARM.

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<sup>24</sup>Hybrid ARMs offer a fixed interest rate for a set period of time. After this period—say, 5 years—the rate is adjusted periodically. These products were authorized by the fiscal year 2002 VA/HUD Appropriations bill. Pub. L. No. 107-73 § 206; see 12 U.S.C. § 1715z-16, as amended.

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- In February 2005, Ginnie Mae began guaranteeing securities backed by RHS multifamily loans, which support affordable multifamily housing in rural areas.<sup>25</sup> RHS officials told us that this created the first consistent secondary market for these loans and that Ginnie Mae's involvement would increase access to these loans and would lower borrower costs by increasing lenders' liquidity. The officials also noted that Ginnie Mae had actively supported RHS by ensuring that the multifamily loan program could be securitized as Ginnie Mae I securities.
  - The Ginnie Mae II Program was created to provide issuers and investors with more flexibility in pooling different kinds of loans—such as adjustable rate mortgages—into Ginnie Mae securities. By their nature, Ginnie Mae II securities are less homogeneous than Ginnie Mae I securities. As a result, they are considered less predictable and investors demand a higher yield from these securities. In 2003, the Ginnie Mae II product was restructured to make it more competitive. Among other changes, the agency narrowed the spread on the note rates that could be included in the pools, so that the loans backing the securities would be more homogenous.<sup>26</sup> In addition, the range of servicing fees that issuers could charge was widened to provide more flexibility. As a result, Ginnie Mae says there is now a smaller gap in pricing between Ginnie Mae I and Ginnie Mae II securities. But one broker-dealer we spoke with complained that to ensure sufficient loan volume for a Ginnie Mae II pool, issuers sometimes must include mortgages that would otherwise qualify for a Ginnie Mae I.
  - In July 2004, Ginnie Mae expanded its Targeted Lending Initiative, which was created to provide financial incentives for lenders to increase loan volumes and raise homeownership levels in underserved areas. Under the program, which began in 1996, Ginnie Mae reduced its guarantee fee by up to 50 percent for approved issuers that originate or purchase eligible loans in designated communities and place them in Ginnie Mae pools. The expansion brought additional areas into the program,

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<sup>25</sup>In January 2004, Congress amended Ginnie Mae's charter legislation to specify that Ginnie Mae has the authority to guarantee securities backed by loans made under the Section 538 Rural Rental Housing Guaranteed Loan Program. Consolidated Appropriations Act, 2004, Pub. L. No. 108-199 § 774.

<sup>26</sup>For example, under the old policy, a Ginnie Mae II pool could include mortgage loans with both 5-1/2 percent and 6-1/2 percent coupon rates (a spread of 100 basis points). Under the new policy, the spread in a given pool can be no greater than 50 basis points.

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including “colonias” along the Southwest border region and additional Renewal Communities and Urban Enterprise Zones designated by HUD.<sup>27</sup> In September 2005, Ginnie Mae announced it was temporarily expanding the Targeted Lending Initiative further to include counties in the states of Alabama, Louisiana, and Mississippi that were declared federal disaster areas as a result of Hurricane Katrina.<sup>28</sup>

Ginnie Mae still faces certain barriers to financing government-backed loan programs. For example, VA and Ginnie Mae officials have expressed concern that recently enacted changes in the law authorizing certain hybrid ARM products in VA’s loan guarantee program did not address a limitation that has made these products difficult to securitize. Although the Veterans Benefits Act of 2004 made certain modifications to the program’s provisions for adjusting interest rates for VA’s 5-, 7-, and 10-year hybrid ARM products, the act continued a restriction on annual rate adjustments (those made after the initial rate adjustment) to a maximum increase or decrease of 1 percentage point.<sup>29</sup> While this restriction may benefit borrowers by limiting interest rate increases, Ginnie Mae and VA officials said that a 1 percentage point annual cap was inadequate to attract interest from investors who purchased such products. Further, the terms of VA’s hybrid ARM products are no longer the same as the corresponding hybrid ARMs offered by FHA, bifurcating the market and making securities containing these types of loans less liquid. According to Ginnie Mae, this lack of liquidity results in higher interest rates for veterans and nonveterans alike. VA officials said that the capital markets and Ginnie Mae

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<sup>27</sup>The underserved areas under the expanded Targeted Lending Initiative include urban and rural Empowerment Zones and Enterprise Communities (distressed communities eligible for certain tax benefits designed to attract or retain jobs or businesses); Renewal Communities (distressed areas in need of economic and social renewal); adjacent eligible central city areas; areas with a majority population of Native Americans; and “colonias” (rural communities along the U.S.-Mexico border that lack adequate infrastructure and other basic services).

<sup>28</sup>Loans backing Ginnie Mae securities, where the property is located in a designated county, are being given Targeted Lending Initiative status, effective for securities with an issue date of October 1, 2005, through September 1, 2009.

<sup>29</sup>Pub. L. No. 108-454 § 405(b); *see* 12 U.S.C. § 3703A(c), as amended. In a hybrid ARM mortgage loan, the interest rate is fixed for an initial multiyear period, and then is adjusted, based on market rates, on an annual basis. Prior to enactment of the 2004 act, the annual adjustment rate for VA hybrid ARM loans was limited to a maximum increase or decrease of 1 percentage point. Under the act, the initial adjustment rate for VA’s 5-, 7-, and 10-year hybrid ARM products can be prescribed by the VA Secretary, but annual adjustments after that are limited to an increase or decrease of 1 percentage point.

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may not have been sufficiently consulted on this adjustment during the legislative process to ensure that provisions in the VA hybrid ARM program were consistent with the requirements of Ginnie Mae and conventional secondary markets.

A similar situation occurred with respect to an FHA single-family insured ARM product. The fiscal year 2002 VA/HUD appropriations bill limited annual interest rate adjustments on FHA's hybrid ARMs to 1 percentage point if the initial interest rate term was fixed for 5 years or less and imposed a lifetime cap of 5 percentage points.<sup>30</sup> These caps were intended to assist FHA borrowers, but lenders and capital market participants expressed concern that Ginnie Mae securities backed by these ARMs would be unattractive to investors—and thus lenders—since equivalent products in the conventional market typically included annual caps of 2 percent and lifetime caps of 6 percent. In response, an amendment to the authorizing legislation, enacted in December 2003, made the annual cap applicable only to loans having a fixed term for the first three or fewer years<sup>31</sup>—a change that FHA said was needed to meet the needs of home buyers, lenders, and the secondary mortgage market. Following the 2003 amendment, FHA issued an interim final rule in March 2005 that raised the cap on adjustments to annual interest rates for 5-year ARMs from 1 to 2 percentage points and raised the lifetime cap on interest rate adjustments for those loans to 6 percentage points.<sup>32</sup> Ginnie Mae officials noted that these problems could have been avoided had Congress initially consulted more closely with capital market participants.

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<sup>30</sup>Pub. L. No. 107-73 § 206 (2001).

<sup>31</sup>The amendment changed the annual cap by applying the 1 percent annual adjustment limitation only to ARMs having a fixed term for the first 3 or fewer years. As a result, annual adjustments for FHA's 5-year hybrid ARMs could exceed 1 percent. *See* Pub. L. 108-186 § 301 (2003).

<sup>32</sup>70 FR 16080 (Mar. 29, 2005).

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## Ginnie Mae Is in the Process of Expanding Disclosure on Loan Information to Help Investors Better Predict Prepayment

Investors in Ginnie Mae securities do not face credit risk, since the mortgages underlying these securities are federally insured or guaranteed and because Ginnie Mae guarantees timely payment of principal and interest. However, MBS investors do face prepayment risk, because they are purchasing cash flows that can stop when borrowers pay their loans in full early. Mortgage loans are prepaid for several reasons, most commonly when the house is refinanced, sold, or destroyed, or when the borrower goes into foreclosure. Prepayment rates tend to increase in periods of declining interest rates, when borrowers have the opportunity to lower their interest payments by refinancing.<sup>33</sup> When mortgages are prepaid, voluntarily or involuntarily, investors receive their principal, but not further interest payments. In an environment of declining interest rates, prepayments may force investors to reinvest prematurely at a lower interest rate and to incur transaction costs.<sup>34</sup>

Historically, the rate of prepayment for Ginnie Mae securities has been lower than for other MBS because borrowers of government-backed mortgages are generally first-time or low- to moderate-income home buyers who are less likely to be able to incur the cost of refinancing or relocating. According to research by securities trading firms, between 1980 and 1990 Ginnie Mae securities consistently prepaid at lower rates than their conventional counterparts. However, since that time, prepayment rates for conventional MBS have changed relative to those for Ginnie Mae MBS.<sup>35</sup> Since 1990, Ginnie Mae's prepayment rates have been slower than those of their conventional equivalents in the initial 18 months to 2 years after loan origination. But after this initial period, as the loans seasoned, Ginnie Mae's prepayment rates have generally risen compared with conventional MBS. Ginnie Mae securities backed by seasoned loans are currently prepaying at a much faster rate than did similar securities during the 1990s.

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<sup>33</sup>As noted earlier, some investors use REMICs to reduce prepayment risk by investing in tranches that absorb less of a security's prepayment variability.

<sup>34</sup>Conversely, prepayments can benefit investors during a period of rising interest rates because investors can then redirect their cash to investments that offer higher returns.

<sup>35</sup>This rate is often expressed as the "conditional prepayment rate," which measures prepayments in a given year as a percentage of the current outstanding loan balance. For example, a conditional prepayment rate of 10 percent means that 10 percent of the pool's current loan balance pool is likely to prepay over the next year.

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Three factors in particular seem to have influenced the increase in Ginnie Mae's rate of prepayment—refinancings, delinquencies, and repurchases. As explained earlier, expanded access to credit, rising home prices, and falling interest rates have allowed more FHA and VA borrowers to refinance into conventional loans.<sup>36</sup> With the added equity built up in their homes, borrowers have been able to reduce their monthly costs by refinancing without paying the federal programs' insurance premiums. In addition, delinquency and default rates for FHA and VA loans—which have traditionally been higher than those for conventional loans—have been steadily increasing in recent years.<sup>37</sup> The delinquency rate on all FHA mortgages increased from 6.7 percent in 1990 to 12.2 percent in 2004. By contrast, the delinquency rate for conventional mortgages has remained relatively stable and stood at 1.6 percent in 2003. Finally, as noted earlier, before July 2003 Ginnie Mae's policy allowed loan servicers to repurchase loans from Ginnie Mae's pools if a borrower missed only one payment and left it unpaid for 4 months. These repurchases, which peaked in 2002, caused a temporary acceleration in the prepayment rates of Ginnie Mae's MBS.

Market participants we met with expressed concerns about the accelerated rate of prepayment on Ginnie Mae securities in recent years. Institutional investors often employ complex models—which rely in part on detailed information about the underlying loan pools—to forecast prepayment rates and help price MBS. Investors we spoke with noted that predicting prepayment risk on Ginnie Mae securities had become increasingly difficult because of rapid shifts in the marketplace, such as the expansion in the availability of conventional credit and increases in FHA and VA delinquencies, and uncertainty about future developments.<sup>38</sup>

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<sup>36</sup>Falling interest rates resulted in a rapid rate of refinancings in the entire mortgage market, and prepayment rates of both conventional MBS and Ginnie Mae MBS rose as a result.

<sup>37</sup>Loans are considered in default when they are delinquent for more than 90 days.

<sup>38</sup>Economists make a distinction between risk and uncertainty. Risk refers to variation in potential outcomes to which an associated probability can be assigned. For example, MBS investors can estimate the probability of prepayment on underlying loans based on the prepayment rates of similar loans in the past. Uncertainty, by contrast, is the lack of knowledge concerning the probability distribution of future events. When market conditions are uncertain and contain unknown variables, predicting prepayment rates can be difficult because the past behavior of loans may not be an accurate guide to the future.



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In the past, the securities industry has also expressed concerns that developing models to predict prepayment of Ginnie Mae MBS has been particularly difficult because Ginnie Mae has not always provided the same degree of detail on its loans as conventional securitizers. In written comments to Ginnie Mae, the Bond Market Association—a trade association representing securities dealers—said that while Ginnie Mae had begun providing more information than ever before about the mortgages backing its securities, there was still “significant room for improvement.” One broker-dealer noted to us that information was particularly lacking on hybrid ARM products in Ginnie Mae pools. A second broker-dealer said that additional information on geography and occupancy rates for multifamily loans would help better estimate the risk of delinquency—and thus prepayment—of securities backing those loans. Market participants also noted that having information on borrower credit scores would be useful.

To address concerns about its disclosures, in January 2004 Ginnie Mae began its MBS Disclosure Initiative, which was designed to provide investors with additional information that would allow them to better forecast prepayment rates. Prior to the initiative, Ginnie Mae’s disclosures on the loans underlying its securities included such things as the weighted average age of the loan, the number of loans in the pool, the unpaid principal balance, and the average original loan size. With the initiative, the agency began providing expanded disclosures—at issuance—of loan data that it was already collecting and began disclosing new data items about FHA and VA single-family loan pools, including original loan-to-value ratios, loan purpose, property type, average original loan size, and year of origination. In addition, in September 2004 Ginnie Mae began updating its MBS disclosures every month instead of quarterly. Ginnie Mae said that in December 2005 it would begin disclosing additional details on the reasons for prepayments of the loans backing Ginnie Mae MBS, including the number of loans that were paid off in full by borrowers, repurchased by issuers because of delinquency, and liquidated due to foreclosure. Ginnie Mae officials told us that the recent changes made disclosures on Ginnie Mae securities comparable with those for Fannie Mae’s and Freddie Mac’s.

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## Caps on Ginnie Mae’s Commitment Authority Have Created Potential Constraints

In developing its annual budget, Ginnie Mae officials told us they must estimate the amount of the agency’s commitment authority—the limit on the total dollar volume of securities that the agency can guarantee. The Office of Management and Budget reviews Ginnie Mae’s commitment authority estimates before they are finalized and included in the President’s

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budget request to Congress. Ginnie Mae estimates the amount of the commitment authority it will need for future years based on the actual authority used by the federal guarantee programs it served in the previous year. The agency also considers commitment authority allocations it actually made to issuers in the previous year and includes them as part of the estimate, adding an additional percentage to that estimate to cover unanticipated events in the marketplace. The Secretary of HUD is required by statute to notify Congress when Ginnie Mae has utilized 75 percent of its commitment authority and when HUD estimates that the agency will exhaust this authority before the end of a fiscal year.<sup>39</sup> If Ginnie Mae exhausts the limit placed on its commitment authority, it must suspend issuance of new MBS until Congress provides additional authority. Under these circumstances, an issuer may either have its request returned or leave it with Ginnie Mae to be processed on a first-come, first-served basis after additional commitment authority is restored.

In 1999, fearing it would reach the limit before the end of the year, Ginnie Mae instituted procedures to ration its commitment authority. It temporarily limited the approval of commitment requests to the amount estimated to cover issuer needs for no more than a 60-day period. According to industry participants we spoke with, this step was disruptive to lenders and issuers and caused concern that Ginnie Mae would not have the authority it needed to honor commitments it had already made. One trade association told us that that this situation had resulted in some loss of credibility for Ginnie Mae.

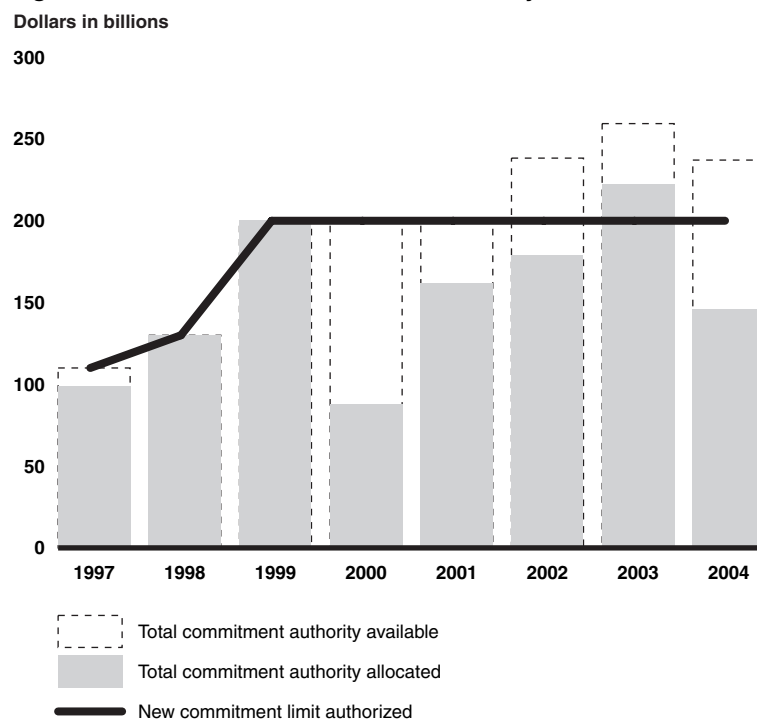
According to Ginnie Mae, the agency had not adequately estimated the demand for its guarantee in 1999, in part because of unexpectedly high levels of new construction and mortgage refinancing activity that year. Since that time, the agency has taken steps to help ensure that it is no longer in danger of reaching the limit of its commitment authority. Since 2002, the commitment authority Ginnie Mae has received as part of HUD's annual appropriations is available for 2 years. Congress annually provides commitment authority but the authority is available for two years. This means Ginnie Mae can use "carryover" authority from the prior year to make current year commitments. According to agency officials, this change from a 1- to a 2-year cycle has given Ginnie Mae more flexibility in planning how to use its commitment authority and should reduce the need to ration it again in the future. In addition, the actual commitment authority

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<sup>39</sup>Pub. L. No. 99-289, 100 Stat. 412; codified at 12 U.S.C. § 1721 Note.

available to Ginnie Mae at any given time may be above the additional amount authorized annually, because since fiscal year 2002, the agency has carried over unused authority from the prior year. Thus, as shown in figure 6, although Ginnie Mae's new commitment authority limit has been \$200 billion each year since fiscal year 1999, the actual authority available for Ginnie Mae to use has been higher beginning in 2002. In fact, in fiscal year 2003, Ginnie Mae was able to meet program demands. Having the ability to rely on unused authority carried over from prior years has meant that the agency has not had to ration or suspend issuer commitments since 1999. Thus, if Ginnie Mae exceeds its annual commitment limit, for a particular year, it has the authority to do so but only to the extent of its carryover authority. However, given uncertainty of demand in the marketplace, carryover authority still may not be enough.

**Figure 6: Ginnie Mae's Commitment Authority Used, Fiscal Years 1997-2004**



Source: GAO analysis of U.S. Department of Housing and Urban Development Congressional Budget Justifications, 1998-2005.

Note: Ginnie Mae has been able to carry over unused commitment authority since fiscal year 2002.

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Federal agencies often face difficulties estimating potential demand for loan guarantees, in part because the budget process requires them to forecast demand nearly 2 years in advance. Our 2005 report on the FHA and RHS loan guarantee programs discussed options that Congress could consider to prevent suspensions of those programs related to exhaustion of their commitment authority.<sup>40</sup> Some of the options discussed in that report could be applicable to Ginnie Mae. For example, Congress could establish a higher limit on Ginnie Mae's commitment authority, although such a step could increase the government's exposure to risk. Congress could also require Ginnie Mae to provide more frequent updates on the amount of commitment authority it has used. This would involve little additional administrative burden and would provide additional and timelier information for determining whether to provide supplemental commitment authority before the end of a fiscal year. Because both of these options could have various implications, their specific impacts would depend on how the changes were structured and implemented.

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### Ginnie Mae Has Taken Steps to Improve Its Data Integrity, but Improvements Are Not Yet Complete

In November 2002, officials of First Beneficial Mortgage Corporation, one of Ginnie Mae's approved issuers, were convicted of engaging in fraudulent pooling practices. According to information from HUD's Office of the Inspector General (OIG) the company used forged documents to pool loans that were collateralized with nonexistent properties and that were not insured or guaranteed by a federal agency, as required of Ginnie Mae securities.<sup>41</sup> Ginnie Mae declared First Beneficial in default and incurred a loss of approximately \$20 million. HUD's OIG, among others, investigated the First Beneficial case and subsequently audited Ginnie Mae's internal controls, completing its report in March 2003. The investigation and audit identified inconsistencies and inaccuracies in Ginnie Mae's data systems and other internal control weaknesses.<sup>42</sup> Most notably, the OIG found that Ginnie Mae, its issuers, and the agencies it serves did not all use a single common and unique case number as the primary management control for identifying and tracking loans in the MBS pools. Instead, each entity assigned its own tracking number, making comparisons of loan data

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<sup>40</sup>GAO, *Housing Finance: Options to Help Prevent Suspensions of FHA and RHS Loan Guarantee Programs*, GAO-05-227 (Washington, D.C.: Mar. 15, 2005).

<sup>41</sup>See *United States v. McLean*, 131 Fed. Appx. 34, 2005 U.S. App. Lexis 7564 (2005).

<sup>42</sup>HUD, OIG, *Government National Mortgage Association Review of Internal Controls, Audit 2003-AT-0001* (Washington, D.C.; Mar. 5, 2003).

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difficult and hindering efforts to ensure that the loans in Ginnie Mae's pools were federally insured or guaranteed. The OIG's report also found that Ginnie Mae did not have adequate controls in place to ensure the reliability of its data—for example, it could not ensure the accuracy of its data entry procedures, had not sufficiently verified all loans to ensure they were federally insured or guaranteed, and did not make sure that all issuers were in fact eligible to issue Ginnie Mae securities. As a result, Ginnie Mae potentially could not identify ineligible loans in its pools.

Ginnie Mae has taken several measures to address many of the internal control and data weaknesses identified in the HUD OIG's reports. For example, the agency has developed and implemented policies, controls, and training designed to make data entry more accurate and is working to better integrate its multiple data systems. Further, 99 percent of Ginnie Mae's portfolio is made up of loans backed by FHA and VA, and the agency now matches the loans in its data systems against those in FHA's and VA's databases. However, Ginnie Mae, FHA, and VA still do not use the same case numbers, which would eliminate the need for time-consuming matching. Ginnie Mae officials told us that they are analyzing aligning case numbers as part of an ongoing Business Process Improvement Initiative. However, such a change would be difficult because it would require systems changes for both Ginnie Mae and its issuers.

OIG officials told us that Ginnie Mae had largely addressed the deficiencies they had observed in the loan data and that that the OIG was generally satisfied with the agency's efforts to address internal control weaknesses. However, we identified additional data integrity issues during our review. For example, Ginnie Mae was initially unable to provide us with a breakdown of loans in its portfolio—that is, percentages of FHA, VA, RHS, and PIH loans. This basic data could not be provided, the agency said, because a programming error had resulted in the underreporting of FHA loans and the overreporting of VA loans. Ginnie Mae officials acknowledged that their data systems should be improved and that they do not have easy access to as much of their information as they should.

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## Adequate Contract Management and Oversight Is Essential for Ginnie Mae

Ginnie Mae operates with a small staff—in fiscal year 2004, the agency had about 66 employees—and contracts out most of its transactional and support work. Ginnie Mae has stated that this centralized management model is designed to allow a relatively small group of agency employees to manage a large number of outsourced projects, improving the quality, timeliness, and consistency of their work. In fiscal year 2004,

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approximately 81 percent of Ginnie Mae's activities were contracted out, including key operations such as accounting and technical support, Ginnie Mae servicing of defaulted loans, internal control reviews, preparation of assessment rating tools, issuer compliance reviews, and information systems management.

Concerns about Ginnie Mae's oversight of its contractors have existed for several years. Our 1993 review of Ginnie Mae's staffing found that the agency was not adequately monitoring its contractors' activities.<sup>43</sup> At that time, the largest contractor told us the agency did not have the resources to adequately review its contractors' work, and Ginnie Mae itself acknowledged that it did not. Similarly, in a 1997 review of HUD's contracting activity, HUD's OIG found that Ginnie Mae was not in compliance with contracting and procurement procedures.<sup>44</sup> The review found that in some instances Ginnie Mae contractors were performing tasks that were inherently governmental functions and that aspects of the bidding process hindered competition.<sup>45</sup> At that time, Ginnie Mae had its own contracting officer; however, as of January 1999, Ginnie Mae began using HUD's contracting officer and its staff to award contracts.

Internal control issues continue to be a potential concern at Ginnie Mae, as evidenced by losses due to fraud in the First Beneficial case, the HUD OIG's 2003 report, and our own findings of problems with some aspects of the agency's management information systems. Because Ginnie Mae has a small staff and contracts out most of its operations, appropriate contract management and oversight are inherently key components in improving the agency's data systems and internal controls. Unlike the time of the 1997 OIG report, Ginnie Mae's contracting staff are now supplemented by assistance from HUD's contracting staff. In addition, the agency has initiatives under way to improve its information technology infrastructure and to streamline its business processes, some of which involve contract management. For example, Ginnie Mae officials told us that in 2002 the agency created the Procurement Management Division to more stringently

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<sup>43</sup>GAO, *Government National Mortgage Association: Greater Staffing Flexibility Needed to Improve Management*, [GAO/RCEID-93-100](#) (Washington, D.C.: June 30, 1993).

<sup>44</sup>HUD, OIG, *HUD Contracting*, 97-PH-163-0001 (Washington, D.C.; Sept. 30, 1997).

<sup>45</sup>"Inherently governmental functions" are intimately related to the public interest and thus must be performed only by government employees. Examples include such things as determining whether contract costs are reasonable and collecting and disbursing public funds.

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oversee existing contracting and procurement procedures and to provide additional training for staff in contract planning and development. In addition, Ginnie Mae officials say they have built incentives into their performance rating system to increase staff accountability for contract planning and oversight and to provide incentives designed to foster effective contract planning and monitoring.

Ginnie Mae's staff of about 66 are responsible for performing inherently governmental functions and for overseeing the contractors that perform most of the agency's operations. Based on a 2004 HUD resource management study that found that Ginnie Mae had sufficient staff to perform contract administration functions, Ginnie Mae officials told us they believe that their staffing levels are adequate.<sup>46</sup> But given its reliance on contractors, Ginnie Mae should continue to focus on ensuring that staff have the training, qualifications, and capabilities they need to ensure that contracts are planned, monitored, and executed appropriately.

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## Observations

Despite its declining share of the overall MBS market, Ginnie Mae continues to serve its key public policy goal of providing a strong secondary market outlet for federally insured and guaranteed housing programs, helping to improve their access and affordability for low- to moderate-income borrowers. The decline in Ginnie Mae's share of the overall MBS market should not necessarily be a major source of concern, since it is largely a function of the rapid growth in the conventional MBS market. Unlike firms in the conventional market, however, Ginnie Mae has relatively little control over the volume of its securities, which depends on the volume of FHA and VA loan programs. Changes in the volume and market share of government-backed housing loans are largely the result of policies and decisions made by Congress and the agencies themselves. Improvements to Ginnie Mae's product line benefit government-backed loan programs by making them more liquid, but the impact on these programs' volume is relatively marginal. A further decline in Ginnie Mae's volume could have certain implications related to credit quality, liquidity, and the agency's contribution to offsetting the federal budget deficit. But just how much Ginnie Mae's volume could decline in the near future is unclear, as is the magnitude of any potential effects on the market or federal budget.

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<sup>46</sup>We did not assess HUD's resource management study or verify its findings.

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Ginnie Mae faces the challenge of adjusting its product mix and policies to address changes in the marketplace while continuing to meet the needs of both borrowers who rely on affordable housing programs and of industry stakeholders such as issuers and investors. Ginnie Mae has added a number of new products over the years, has made a serious effort to solicit feedback from its business partners, and has expanded its disclosures for investors. The agency has also expanded the types of loans that Ginnie Mae securities can finance, and RHS and PIH officials have commended Ginnie Mae's proactive efforts to assist their loan programs. But some changes remain beyond its scope—for instance, conditions in FHA and VA hybrid ARM products that have limited investor interest. Closer consultation by lawmakers with Ginnie Mae and capital market participants could help ensure that congressionally mandated provisions of loan programs are consistent with Ginnie Mae and conventional secondary market requirements.

Ginnie Mae also faces the challenge of avoiding the need to ration its commitment authority, which can cause disruption among secondary market participants and harm Ginnie Mae's credibility. Beginning in 2002, Congress made the agency's commitment authority available for 2 years rather than 1 year to provide more flexibility, but Ginnie Mae could again bump up against its commitment level cap in the future. Other options to address this problem include raising Ginnie Mae's commitment authority or requiring the agency to notify Congress when it appears the agency may reach its cap. Each of these measures could have various implications that would need to be considered.

Like any agency, Ginnie Mae faces challenges in managing its internal operations in an efficient and cost-effective manner, and in ensuring that appropriate internal controls are in place. This may be especially challenging for Ginnie Mae because it operates with a small staff of about 66 and contracts out most of its operations. Certain weaknesses in Ginnie Mae's data integrity, along with losses resulting from fraudulent activity in the First Beneficial case, indicate the need for continued improvements in data systems and internal controls. Ginnie Mae has taken some important steps on these issues and has ongoing initiatives, such as its Business Process Improvement Plan. However, given certain data integrity issues we identified, the recency of the First Beneficial case, and that Ginnie Mae's business plan was only recently approved, it is too early to assess the results of Ginnie Mae's recent efforts. Finally, given its reliance on contractors to carry out most of its operations, Ginnie Mae will need to pay particular attention to ensuring that its staff have sufficient resources,



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training, and qualifications to ensure that the agency's contracts are planned, monitored, and executed appropriately.

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## Agency Comments

On behalf of HUD, Ginnie Mae provided written comments on a draft of this report, which are reprinted in appendix II. Ginnie Mae agreed with the report's analysis of the challenges it faces and with the report's findings on initiatives Ginnie Mae has taken to address these challenges. It also agreed with our observations related to the importance of improving Ginnie Mae's data systems and maintaining effective contract management. In addition, Ginnie Mae provided us with technical comments, which we have incorporated where appropriate.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the report date. At that time, we will send copies to the Secretary of Housing and Urban Development. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you have any questions about this report, please contact me at (202) 512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

Sincerely yours,



William B. Shear  
Director, Financial Markets and  
Community Investment

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# Objectives, Scope and Methodology

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Our report objectives were to evaluate (1) the state of Ginnie Mae's market share and guarantee volume, (2) the potential implications of changes in Ginnie Mae's market share and guarantee volume, and (3) challenges Ginnie Mae faces in fulfilling its mission and the steps that have been or could be taken to address these challenges.

To assess the state of Ginnie Mae's market share and guarantee volume, we obtained data on issued and outstanding mortgage-backed securities (MBS) from the agency's Integrated Pool Management System and Portfolio Analysis Display System, which obtains its source data from Ginnie Mae's Mortgage-Backed Securities Information System. We tested the reliability of these data by comparing them within the two data systems and with data from the 2005 Mortgage Market Statistical Annual and the Bond Market Association—sources used widely in the industry to analyze MBS activity. We also compared loan data provided by Ginnie Mae with data maintained by the Department of Veterans Affairs (VA), Rural Housing Service (RHS), and the Office of Public and Indian Housing (PIH) within the Department of Housing and Urban Development (HUD).

Our initial comparisons showed significant discrepancies between Ginnie Mae's source data and that of industry sources. Because Ginnie Mae's MBS issuance and agency loan endorsement do not occur simultaneously, a lag exists between the date that the loan is endorsed and the date Ginnie Mae is recorded as guaranteeing its securitization. Thus, to provide accurate information on Ginnie Mae's market share and volume for a given point in time, individual loans must be matched to the Ginnie Mae MBS in which they were pooled. When we began our review, no data for VA, RHS, or PIH loans had been matched with their pool, and data for Federal Housing Administration (FHA) loans had been matched only since 2001. At our request, Ginnie Mae completed the matching of FHA data from 1998 to 2004.

Our initial comparison of the portion of Ginnie Mae's MBS portfolio collateralized by each loan program—that is, by FHA, VA, RHS, and PIH—showed discrepancies as well. As previously discussed, Ginnie Mae could provide us only with estimated percentages because a programming error in the system resulted in the underreporting of FHA loans and the overreporting of VA loans. Because of our request, Ginnie Mae noticed the error and corrected it, and we were able to obtain accurate data on the percentage of loans from each program that were used to collateralize Ginnie Mae MBS. With the corrections Ginnie Mae made, we found the data to be reliable for our purposes.

To address all of the objectives, we spoke with and gathered relevant documents from secondary market participants, including five Ginnie Mae-approved issuers and five dealers/institutional investors in Ginnie Mae securities. Among other things, we discussed with them their perceptions of Ginnie Mae and its products and their reasons for investing in or issuing Ginnie Mae securities rather than other MBS products. The issuers were judgmentally selected and represented more than 46 percent of the MBS Ginnie Mae issued in 2003. Three of the issuers focused on single-family FHA loans and the remaining two on multifamily and VA loans. Dealers/institutional investors were also judgmentally selected; among them were the largest broker-dealers of Ginnie Mae MBS, Real Estate Mortgage Investment Conduits, and Platinum securities. We also interviewed and obtained documentation from representatives of secondary market participants that may compete with Ginnie Mae, including Fannie Mae, Freddie Mac, the National Council for State Housing Finance Agencies, and the Federal Home Loan Banks of Chicago and Seattle. We also interviewed representatives of and reviewed documents from Ginnie Mae, HUD's FHA and PIH programs and its Office of the Inspector General (OIG), VA, RHS, and the Federal Housing Finance Board. In addition, we spoke with relevant trade associations, including the Bond Market Association, National Association of Home Builders, Mortgage Bankers Association, and National Association of Realtors. We conducted a literature search and reviewed Ginnie Mae's legislative history, relevant laws, regulations, budget documents, performance, and annual reports and guidance, and studies and reports by HUD's OIG and others. We conducted our work in Washington, D.C., and Boston from October 2004 through September 2005 in accordance with generally accepted government auditing standards.

# Comments from the Department of Housing and Urban Development



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

GOVERNMENT NATIONAL  
MORTGAGE ASSOCIATION

October 6, 2005

Mr. William Shear  
Director, Financial Markets and  
Community Investment  
Government Accountability Office  
441 G Street, NW, Room 2440B  
Washington, DC 20548

Dear Mr. Shear:

Thank you for the opportunity to review and comment on GAO's draft report entitled *Ginnie Mae is Meeting Its Mission but Faces Challenges in a Changing Marketplace*.

We appreciate GAO's acknowledgement that Ginnie Mae is meeting its mission, which is to expand access to affordable housing by supporting an efficient secondary market for federally insured and guaranteed mortgages. We agree with the report's analysis of a number of challenges facing Ginnie Mae, and appreciate GAO's acknowledgement of the initiatives that Ginnie Mae has undertaken in order to address these challenges, such as developing new products and improving disclosures to investors. We also agree with GAO's observations with respect to the importance of improving our data systems and the need to continue to effectively manage Ginnie Mae's critical contracts.

As your report points out, Ginnie Mae has begun a business process improvement initiative that we believe will result in a systems environment comparable to best practices in the industry, and we have improved our contract oversight by creating a Procurement Management Division to increase staff accountability for effective contract planning and monitoring.

At Ginnie Mae, we are committed to being an open and transparent organization. We enjoyed working with GAO on this report, because we believe that subjecting ourselves to the analysis and criticism of an objective third party provides an excellent opportunity for Ginnie Mae to improve.

Thank you, again, for the opportunity to comment on the draft report.

Sincerely,

Michael J. Frenz  
Executive Vice President

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# GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Staff Acknowledgments

In addition to the contact named above, Jason Bromberg, Assistant Director; Heather Atkins; Daniel Blair; Christine Bonham; Diane Brooks; Emily Chalmers; William Chatlos; Carlos Diz; Austin J. Kelly; Marc Molino; Mitchell B. Rachlis; Paul Thompson; and Franklyn Yao made key contributions to this report.

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