



The Net Present Value Test's Impact on the Home Affordable Modification Program

Special Inspector General for the Troubled Asset Relief Program



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MEMORANDUM FOR: The Honorable Timothy F. Geithner – Secretary of the Treasury

FROM: Ms. Christy L. Romero – Special Inspector General
for the Troubled Asset Relief Program *by J. Romero*

SUBJECT: The Net Present Value Test's Impact on the Home Affordable
Modification Program (SIGTARP 12-003)

We are providing this report for your information and use. It discusses the Home Affordable Modification Program's net present value test.

The Office of the Special Inspector General for the Troubled Asset Relief Program conducted this audit (engagement code 019), under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978, as amended.

We considered comments from the Department of the Treasury when preparing the report. Treasury's comments are addressed in the report, where applicable, and a copy of Treasury's response is included in the Management Comments appendix.

We appreciate the courtesies extended to our staff. For additional information on this report, please contact Mr. Kurt W. Hyde, Deputy Special Inspector General for Audit and Evaluation (Kurt.Hyde@treasury.gov / 202-622-4633), or Ms. Kimberley A. Caprio, Assistant Deputy Special Inspector General for Audit and Evaluation (Kim.Caprio@treasury.gov / 202-927-8978).



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Introduction

Faced with record numbers of foreclosures, Congress intended for the Troubled Asset Relief Program (“TARP”) to help families keep their homes. In February 2009, the U.S. Department of the Treasury (“Treasury”) announced TARP’s signature housing program, the Home Affordable Modification Program (“HAMP”), under which mortgages would be modified to a payment that is “affordable” and “sustainable.” Originally announced as a program that would help as many as 3 million to 4 million homeowners avoid foreclosure, as of March 2012, only 794,748 homeowners were in a permanent mortgage modification, approximately half of which are funded by TARP.¹ According to testimony by Phyllis Caldwell, Treasury’s former Chief of the Homeownership Preservation Office (“HPO”), Treasury designed HAMP on four core principles: affordability, pay for success, a net present value (“NPV”) test, and help for unemployed borrowers.² This report addresses the NPV test.

The NPV test is the gateway through which an otherwise eligible homeowner gets help under HAMP. A mortgage servicer³ first determines a homeowner’s eligibility based on whether the homeowner is in default or at risk of imminent default, and whether the home is an owner-occupied, single-family, one- to four-unit property with a maximum unpaid principal balance of \$729,750 (for one unit).⁴ The mortgage servicer must take several steps⁵ to lower the borrower’s monthly mortgage payment to 31% of the borrower’s monthly gross income. If a homeowner meets these eligibility criteria, the decision of whether a homeowner must be approved for HAMP rests on the results of the NPV test. Based on Treasury data as of March 2012, approximately 5% of 3.2 million homeowners denied for HAMP were denied based on the NPV test. This represents 160,870 homeowners⁶ who did not get help from HAMP.

A key to understanding the NPV test is to know that it estimates whether it is in the best interests of the investor to modify a mortgage under HAMP. Servicers

¹ The rest are funded by the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”).

² Throughout this report, the terms “homeowner” and “borrower” are used interchangeably.

³ A mortgage servicer collects payments from the borrower and administers the loan. The servicer may be the lender or may be a specialized company under contract with the lender or the investor who owns the loan.

⁴ In March 2012, Treasury changed the name of HAMP to HAMP “Tier 1” and announced HAMP “Tier 2” effective June 1, 2012. The described criteria apply to the original HAMP.

⁵ The steps may include adding accrued interest due and late fees to the principal of the mortgage, reducing the interest rate, extending the term of the mortgage, and forbearing principal. For a more complete explanation of the NPV model and test, see Appendix B.

⁶ This number includes private mortgages as well as Fannie Mae and Freddie Mac mortgages.

enter 44 inputs⁷ (39 of which are specific to the NPV decision) into the NPV test.⁸ The NPV test compares the expected cash flow from a modified loan with the expected cash flow from the same loan with no modification to determine which option is likely to be more valuable to the investor. If the NPV test estimates that modifying a mortgage will result in more revenue for the investor than not modifying the mortgage (described as a positive NPV result), the servicer must offer a HAMP mortgage modification to the homeowner.⁹ If the NPV test produces a negative result, a servicer has the option of modifying the mortgage under HAMP if the investor consents.

Because the NPV test is a linchpin in an otherwise eligible homeowner's HAMP application, Treasury guidelines require that servicers maintain documentation on their NPV inputs. If a servicer turns down a homeowner for HAMP, within 10 business days it must send a letter to the homeowner explaining the reason for denial and describing other foreclosure alternatives. If the NPV test was the reason for the denial, the servicer must include 33 specific inputs that were used in its NPV test.¹⁰ Homeowners can request that the servicer rerun the NPV test if they believe one of the inputs is incorrect. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act") required that Treasury make a web-based NPV calculator available to the public, which Treasury did on May 23, 2011, at www.CheckMyNPV.com. Homeowners can enter into the calculator the NPV inputs listed in their denial letter or substitute those with other inputs.

Senator Jeff Merkley and eight other senators requested that the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") review whether servicers are correctly applying NPV to determine which homeowners qualify for HAMP.¹¹ SIGTARP began a review to assess the issues

⁷ The NPV model uses three types of inputs: user inputs such as borrower and loan information; servicer-defined inputs such as risk premium, modification fees, and mortgage insurance partial payment amount; and the terms of the proposed HAMP modification.

⁸ Treasury has given servicers discretion to adjust the value used for three of the variables: (1) modification fees such as notary or property valuation fees; (2) mortgage insurance; and (3) the risk premium. The NPV test also contains 12 assumptions, which are estimates or predictions about various mortgage characteristics that are factored into the NPV calculations. Treasury sets these assumptions based on Fannie Mae's, Freddie Mac's, and the Federal Housing Finance Agency's analysis of mortgage data, including, for example, the probability a homeowner will default using standard redefault rates; home price projections (based on 110 local housing markets); and the time and costs associated with a foreclosure.

⁹ The scenario under which the mortgage is not modified assumes the borrower either becomes current on the mortgage payments without a modification or the borrower goes into foreclosure.

¹⁰ Inputs as specified in the Making Home Affordable Program Handbook for Servicers of Non-GSE Mortgages include information such as gross income and the co-borrower's credit score.

¹¹ The other senators were Richard Durbin, Jack Reed, Herb Kohl, Sherrod Brown, Russell Feingold, Sheldon Whitehouse, Mark Begich, and Maria Cantwell.

surrounding the NPV test that have posed challenges to HAMP's success, as well as the following objectives:

- whether the servicers correctly applied the NPV test under the program;
- the extent to which Treasury ensured that servicers appropriately applied the NPV test per HAMP guidelines when they assessed homeowners for program eligibility; and
- the procedures servicers followed to communicate to homeowners the reasons they were denied HAMP mortgage modifications, as well as to identify the full range of loss mitigation options then available to those homeowners.

In conducting this audit, SIGTARP gathered information from Treasury and its financial agent, the Federal Home Loan Mortgage Corporation ("Freddie Mac"), in its role as compliance agent for HAMP. SIGTARP also examined the application of the NPV test by three of the largest servicers participating in HAMP: Wells Fargo Bank, NA ("Wells Fargo"); GMAC Mortgage, LLC ("GMAC Mortgage"); and Ocwen Loan Servicing, LLC ("Ocwen"). From these servicers, SIGTARP judgmentally selected 149 homeowner applications to determine the impact that the NPV test had on whether these homeowners qualified for HAMP. SIGTARP also asked those three servicers and four additional servicers – Bank of America, NA ("Bank of America"), CCO Mortgage, JPMorgan Chase Bank, NA ("JPMorgan"), and Saxon Mortgage Services, Inc. ("Saxon") – for their rationale or analysis for using the risk premium. SIGTARP conducted the audit from March 2010 through May 2012, and in accordance with generally accepted government auditing standards as prescribed by the Comptroller General of the United States. For a discussion of the audit's scope and methodology, see Appendix A.

Background

Three TARP oversight bodies – the Congressional Oversight Panel (“COP”), the Government Accountability Office (“GAO”), and SIGTARP – previously reported on problems or concerns over the NPV test. This report involves some of the same issues and concerns raised, based in part on SIGTARP’s sample testing.

In October 2009, COP reported evidence of eligible borrowers being denied HAMP modifications incorrectly, misinterpretations of program guidelines, and difficulties encountered by borrowers and housing counselors in understanding the NPV models, as well as the reasons that HAMP applications were being denied. COP examined Treasury’s NPV model and noted that it was highly sensitive to small changes. COP reported that Treasury lets servicers override the default discount rate set by Freddie Mac and add a risk premium up to 250 basis points (2.5%). COP reported that the discount rate impacts the present value of expected cash flows. COP found that only a one basis point change in the risk premium is necessary to change the outcome of the NPV test from NPV positive to NPV negative. COP called on Treasury to provide greater transparency by releasing its NPV model and stated that requiring servicers to give borrowers specific reasons for denials “could help alleviate [lack of transparency].”

In March 2010, SIGTARP reported that Treasury’s many changes to the HAMP NPV model from March 2009 through November 2009 posed challenges to servicers. Treasury changed or clarified the NPV test eight times in 2009. Some of these changes included updating key parameters in the test, such as the discount rate, the cure rate, and foreclosure costs, and adding a home price decline protection incentive payment to the model.¹² Changes caused problems for the servicers throughout the process. Servicers told SIGTARP that they encountered problems accessing the NPV test early in the process and getting documentation from Treasury concerning the model, and that earlier models had errors and inconsistencies. In addition, servicers complained to SIGTARP that there was a lack of Treasury guidance and there was confusion regarding multiple changes to the model. One servicer told SIGTARP that changing the model made it particularly difficult to manage version control over the model. Another servicer told SIGTARP that there was a short time to comply with significant changes to the model, and servicers were not notified of changes to the model until after they were implemented.

¹² The discount rate is the current Freddie Mac’s Primary Mortgage Market Survey rate for 30-year fixed-rate conforming loans. The cure rate is the percentage of delinquent mortgages that become current because the borrowers remit all of the missed payments or pay off the mortgage in full. Foreclosure costs include pre-foreclosure sales, third-party sales, and other costs associated with foreclosure. Home price decline protection incentive payments are additional incentives for modifications of loans on properties located in areas where home prices have recently declined and where investors are concerned that prices will continue to decline.

In April 2010, COP again reported on problems and concerns regarding the NPV test. COP applauded Treasury's efforts to test its new NPV model, but stated that because Treasury had still not publicly released the model for the benefit of borrowers and counselors, Treasury had not made meaningful progress in addressing concerns about the secrecy of the NPV model. COP also reported that, although Treasury had made significant progress on establishing guidelines for written communications to homeowners regarding the reasons for a HAMP denial, it was unclear whether borrowers were receiving notices in a timely manner. COP stated that it is important for Treasury to monitor the activities of the program participants, audit them, and enforce program rules, guidelines, and requirements.

In June 2010, GAO reported that 15 of the 20 largest servicers were not running the NPV test in compliance with HAMP guidelines. GAO reported, "This lack of compliance likely resulted in differences in how borrowers were evaluated, and could have resulted in the inequitable treatment of similarly situated borrowers." Because servicers linked the NPV model to their own systems, GAO found that values for inputs such as property values and credit scores were erroneously updated during the rerunning of the NPV model. These errors were so severe that Treasury required the servicers to fix the in-house models, and determined that until they did so, the servicers could not deny a HAMP modification based on the NPV test. GAO found that half of the servicers it sampled reported at least a 20% error rate for income calculations. GAO reported, "According to Treasury, the number of borrowers who were denied because of a servicer's NPV errors could range from a handful to thousands, depending on the size of the servicer and the extent of the error." GAO also found that servicers' error rates for calculating borrower income were well above a servicer's own established error thresholds (typically 3% to 5%). GAO reported, "Without accurate income calculations, similarly situated borrowers applying for HAMP may be inequitably evaluated for the program and may be inappropriately deemed eligible or ineligible for the program."

In addition to errors in inputs that servicers were using in the NPV test, GAO also reported concerns, similar to COP's reported concerns, surrounding the risk premium. According to GAO, Treasury allowed some differences in how servicers evaluate borrowers for HAMP, which could result in inconsistent outcomes for borrowers. GAO was referring to Treasury allowing servicers to add up to a 2.5% risk premium to the Freddie Mac rate when inputting the discount rate to the NPV model. GAO explained, "The higher the risk premium a servicer chooses, the fewer the number of loans that are likely to pass the NPV model, because expected future cash flows would have less value." GAO's analysis determined that as of April 17, 2010, 11 servicers (out of more than 100 servicers) used a risk premium, most of them the full 2.5%.

The reported problems surrounding a lack of transparency in the NPV test and servicer errors led to Congressional action. Section 1482 of the Dodd-Frank Act required a publicly available web-based NPV calculator based on the HAMP NPV model to assist borrowers in understanding the NPV evaluation process under HAMP and in conducting an estimated NPV evaluation of their mortgage. Congressman Mike Quigley, who sponsored the amendment to the Dodd-Frank Act that required the NPV calculator, explained, “A homeowner’s fate hinges on the NPV score, so the American dream is literally at stake here.”

In December 2010, COP reported that Treasury had come out with a new model and Dodd-Frank required its public release. COP noted that several factors could affect the success of the model, including the design and implementation of the model, and the accuracy of the data input by the servicers into the model. COP stated that Treasury still allowed servicers to add up to a 2.5% risk premium and added, “The number of loans that will qualify for a HAMP modification will vary depending on the risk premium a servicer uses in its NPV calculations.”

The Discretion Treasury Gave to Servicers To Add a Risk Premium to the Discount Rate Reduced the Number of Homeowners Who Get Help in HAMP, According to SIGTARP's Sample

This section describes how the use of a risk premium results in fewer homeowners getting HAMP modifications.

Despite warnings by COP and GAO that Treasury's practice of allowing servicers to add a risk premium to Freddie Mac's discount rate results in fewer homeowners being approved for HAMP, Treasury has allowed that practice to continue without questioning the servicer's rationale for adding a risk premium as long as it does not exceed 2.5%. According to Treasury, the addition of the risk premium reflects an additional cost that investors may face in modifying and continuing to carry mortgages at risk of default. According to GAO's June 2010 report, only 11 out of more than 100 servicers participating in HAMP added a risk premium. SIGTARP decided to review these warnings by GAO and COP and found that although some servicers initially added a risk premium, only four continue to do so. It is unclear why this small number of servicers should be allowed to take an action that results in fewer HAMP modifications.

With HAMP three years old and any risk in the program presumably known to servicers, Treasury should stop letting servicers add a risk premium to the discount rate used by Freddie Mac. SIGTARP surveyed seven servicers (GMAC Mortgage, Ocwen, Wells Fargo, Bank of America, CCO Mortgage, JPMorgan, and Saxon) to understand their rationale for use of the risk premium. Initially, only GMAC Mortgage did not add a risk premium.¹³ Six servicers added a risk premium – five added the maximum 2.5% (Bank of America, Saxon, Wells Fargo, JPMorgan, and Ocwen), and one, CCO Mortgage, added 0.005%. However, in late 2010 and early 2011, JPMorgan and Ocwen¹⁴ stopped adding any risk premium. JPMorgan explained to SIGTARP that initially it used the maximum risk premium because HAMP was new and had no performance results. JPMorgan told SIGTARP that it no longer used the risk premium because servicers and investors became more comfortable with HAMP over time and it wanted to align its practices with Fannie Mae and Freddie Mac, which do not use a risk premium.

The rationale of one of HAMP's three largest servicers, JPMorgan, may apply to the other servicers that continue to add a risk premium, which supports Treasury's

¹³ GMAC Mortgage told SIGTARP that it did not consider adding a risk premium and that it does not deny homeowners a HAMP modification solely based on the NPV result.

¹⁴ Ocwen did not provide to SIGTARP its rationale for its decisions on how it assigned a risk premium or why it eliminated the use of the risk premium.

discontinuing any use of a risk premium. Bank of America, the largest HAMP servicer in terms of TARP incentives, told SIGTARP that it uses the highest risk premium allowed in part because investors wanted a higher discount rate, and rates that are too low could be costly to investors. Wells Fargo, the second-largest HAMP servicer, told SIGTARP that it uses the maximum risk premium because its “cost of capital” for its largest mortgage portfolio exceeds Treasury’s discount rate with the added 2.5% premium.

In its sample, SIGTARP found that the discretion that Treasury gave to servicers to add a risk premium reduced the number of otherwise qualified homeowners that Treasury helped through HAMP. SIGTARP’s analysis of 51 judgmentally selected HAMP applications¹⁵ evaluated by Ocwen or Wells Fargo found that more than half (27) of the homeowners would have had a positive NPV result if the servicer had not used a risk premium. The following table demonstrates the impact of reducing and removing the risk premium.

TABLE 1

INCREMENTAL RISK PREMIUM CHANGE SUMMARY		
Risk Premium Decrease		*Number of NPV Decisions That Reversed
From	To	
2.5%	2.0%	7
2.0%	1.5%	10
1.5%	1.0%	5
1.0%	0.5%	2
0.5%	0.0%	3
Total		27

*Note: This column shows the number of NPV test results that changed from negative to positive when premium was reduced.

Source: SIGTARP analysis of NPV negative mortgages from the two servicers that elected to use a risk premium.

SIGTARP’s analysis confirms that homeowners in the sample were denied a HAMP modification because of the servicers’ addition of a risk premium. A discount rate set by Freddie Mac is already used by more than 100 servicers in

¹⁵ This sample of 51 loans is a subset of 149 loans that SIGTARP judgmentally selected from Ocwen, Wells Fargo, and GMAC Mortgage for NPV input testing. Of the 149 loans, only loans that were originally evaluated with a risk premium and returned a negative NPV test result were analyzed. The 149 loans were selected to represent a cross section of loans according to factors including geographic location, date the NPV test was run, and amount of unpaid principal balance. Results from a judgmental sample cannot be projected to the universe of data from which the sample was drawn.

HAMP.¹⁶ Only four of the servicers in HAMP use the additional risk premium. If JPMorgan and Ocwen no longer believe there is a need to add a risk premium to the NPV test, it would not seem necessary for others. Treasury should remove this obstacle that prevents otherwise eligible homeowners from getting help from HAMP.

¹⁶ The number of servicers participating in HAMP has changed over the course of the program. As of December 2011, there were 109 servicers participating in HAMP.

Servicers in SIGTARP's Sample Erred Inputting Homeowner Information in the NPV Test and Did Not Maintain Sufficient Documentation of the NPV Inputs

This section describes how three of the largest servicers in HAMP performed in inputting NPV test information, according to SIGTARP's sample.

Any model will be only as good as its inputs. In addition to other Treasury oversight bodies, SIGTARP found in its sample that servicers made errors using NPV inputs and did not properly maintain records of all NPV inputs¹⁷ during the period of our review. Good recordkeeping on NPV inputs is critical for oversight and to protect homeowners' rights. Congress specifically intended that, through the web-based NPV calculator, homeowners have the right to ensure that their personal information was submitted correctly. A servicer's failure to maintain the NPV inputs as required by Treasury guidance thwarts the intention of Congress, the ability for effective compliance and oversight, and the rights of homeowners who have been denied a HAMP modification due to the NPV test.

Within SIGTARP's judgmental sample of 149 applications that were reviewed for HAMP modifications between 2009 and early 2011 by 3 of the largest servicers – Ocwen, Wells Fargo, and GMAC Mortgage – SIGTARP found that the servicers could provide both accurate inputs and documentation for only 2 of the HAMP applications. SIGTARP found instances in which servicers failed to comply with HAMP guidelines on maintaining records on NPV inputs. For 19 HAMP applications, the servicer was not able to provide all of the inputs used to evaluate the homeowner for the NPV test.

For another 19 HAMP applications, the servicer provided all inputs used to perform the NPV test, and provided documentation for all these inputs, but in some cases that documentation did not support the input used. For 109 applications, the servicers either could not provide documentation to support various inputs, or provided inaccurate documentation for various inputs. For the 149 denied HAMP applications, SIGTARP found that approximately 19% of the inputs either were entered incorrectly or could not be supported by the servicers' records. Because of the servicers' failure to maintain documentation of the NPV inputs, SIGTARP was unable to determine how many homeowners from its sample may have been wrongly denied a HAMP modification.

¹⁷ SIGTARP found errors in its sample related to credit scores, principal forgiveness, dates of NPV tests, unpaid principal balance, amortization, principal and interest after modification, and the type of property valuation used.

One of the key inputs in SIGTARP's sample where SIGTARP found errors or lack of documentation was the borrower's gross income. Despite GAO's June 2010 report about servicer errors in calculating gross income, SIGTARP found servicer errors. The extent to which servicers used incorrect data increased the risk of an improper decision to an unacceptable level. When servicers use erroneous information in the NPV test, homeowners may be denied a HAMP modification and may ultimately lose their homes.

Servicers in SIGTARP's Sample Communicated Poorly to Homeowners on the Denial of a HAMP Modification

This section describes servicers' performance in communicating with homeowners in SIGTARP's sample.

SIGTARP reviewed a sample of 26 denial letters sent by GMAC Mortgage, Ocwen, and Wells Fargo, and found that only 2 letters were issued in compliance with HAMP guidelines. HAMP guidelines require that servicers communicate a denial to the homeowner within 10 business days after the decision. SIGTARP found that for 4 homeowners, Wells Fargo sent the denial letter to the homeowner between 32 and 147 business days (69 days on average) after Wells Fargo's decision.¹⁸ Servicers' failure to communicate denial of a HAMP modification to homeowners in a timely manner can have serious consequences because a delay may prevent homeowners from finding other foreclosure alternatives sooner. One homeowner was left in the dark when GMAC Mortgage failed to provide the homeowner with a reason for the denial. GMAC Mortgage later offered that homeowner a non-HAMP mortgage modification.

Of the 12 homeowners sampled who were denied a HAMP modification due to a negative NPV result, 6 denial letters from 1 servicer failed to follow HAMP guidelines of listing certain NPV inputs. This failure to follow HAMP's guidelines can have serious consequences because without these inputs homeowners cannot use the web-based NPV calculator, required by the Dodd-Frank Act, to challenge servicer errors that may have prevented their participation in HAMP.

SIGTARP also found that the servicers failed to provide vital information on foreclosure prevention alternatives to homeowners in 18 of the 26 cases SIGTARP reviewed. Although 17 of the 18 letters from servicers told the homeowner that there may be other loss mitigation options available or that the mortgage was being reviewed for other loss mitigation solutions, the servicer did not give the homeowner any information on those options. In the 18th letter, the servicer did not tell the homeowner that there were other foreclosure alternatives. Treasury told SIGTARP that according to a sample Freddie Mac conducted in December 2011 of four large servicers – Bank of America, Wells Fargo, JPMorgan, and CitiMortgage – Treasury found that those servicers had made improvements to denial letters.

¹⁸ SIGTARP excluded two loans from timeliness testing. One was excluded because of the borrower's bankruptcy proceeding. The other was excluded because, according to the servicer, Treasury was not allowing the servicer to deny modifications because of possible NPV test errors.

Treasury Must Ensure Servicers Appropriately Apply the NPV Test To Assess Homeowners for HAMP

Freddie Mac's Review of HAMP Servicers

Treasury contracts with Freddie Mac as its financial agent to conduct examinations and review servicers' compliance with HAMP's guidelines. Treasury has obligated approximately \$228 million to retain Freddie Mac as the compliance agent for all HAMP servicers except Fannie Mae and Freddie Mac, and has paid Freddie Mac approximately \$152 million as of March 31, 2012. Treasury's former HPO Chief, Phyllis Caldwell, testified before COP in October 2010, "...Freddie Mac, Treasury's compliance agent, conducts periodic audits of servicers' implementation of the [NPV] model."

In addition, Freddie Mac monitors servicers for compliance with program guidelines through a number of reviews, including the second look process. According to Freddie Mac, in second look reviews, Freddie Mac examines the reason why a borrower was denied a HAMP modification and determines whether it agrees, disagrees, or is unable to determine how the servicer made the decision. Freddie Mac told SIGTARP that it examines a sample of at least 100 loans from each servicer in the second look process.

For those in the sample turned down for HAMP because of the NPV test, Freddie Mac requests from the servicer all loan documentation and a list of the NPV inputs the servicer used to run the test. Freddie Mac told SIGTARP that it examines the supporting documentation, determines what it believes the correct inputs to be, and reevaluates the loan using the NPV test.

Treasury's Oversight of Servicers' Performance and Compliance, and Freddie Mac as the HAMP Compliance Agent

Treasury is ultimately responsible for ensuring that servicers comply with HAMP guidelines. However, SIGTARP's findings of servicer errors with the NPV test and failure to comply with HAMP guidelines in SIGTARP's sample of HAMP applications through the beginning of 2011, and the more recent June 2011 poor assessment results, raise serious concerns about the effectiveness of Treasury's oversight. Treasury is responsible for overseeing and monitoring Freddie Mac's compliance activities. Treasury said it approves the design of Freddie Mac's compliance program; reviews the detailed results of the servicer reviews; and engages in additional oversight of a servicer if the servicer is significantly lagging in its efforts to correct identified issues.

Treasury also monitors servicer progress with its Making Home Affordable Compliance Committee meetings. According to Treasury, Freddie Mac briefs the

committee on the status of the servicers in correcting issues identified during Freddie Mac's reviews and significant issues identified as part of NPV test reviews. SIGTARP reviewed committee minutes from September 2009 through March 2012 and found the minutes usually included a list of participants and a few bullet points. The committee's charter states that Treasury "will also be responsible for capturing the notes of the meeting with special emphasis on the rationale behind any decisions ... made ..." Furthermore, the charter states that differing points of view should be documented in instances where there is a lack of consensus on issues discussed by the committee.

However, given the lack of detail in the minutes, SIGTARP could not find evidence that the requirements of the committee's charter were fulfilled. At the meetings, Freddie Mac presents details of its reviews of servicers, including results of second look reviews. Treasury told SIGTARP that it determines the appropriate course of action if there are significant delays or issues with a servicer's remediation efforts. However, Treasury was unable to provide documentation confirming its oversight of servicers. Treasury did not provide SIGTARP documentation of actions that Treasury took as a result of Freddie Mac's review. Treasury failed to document its oversight, stating that some of its oversight is conducted in such a way that there would be no formal documentation. Accordingly, SIGTARP was unable to verify Treasury's role in the oversight of servicers or Freddie Mac.

SIGTARP and COP have called for transparency of servicer performance. In March 2010, SIGTARP recommended that Treasury set performance benchmarks and publicly report on them to measure over time the implementation and success of HAMP. In April 2010, COP also recommended that Treasury release performance metrics, the results by servicer, and appropriate, meaningful sanctions or procedures to address noncompliance.

However, despite these calls for accountability, Treasury did not publicly release information on Freddie Mac's review of servicers until June 2011, more than 2 years after HAMP started, and then released information only on the reviews of the 10 largest servicers.¹⁹ Treasury reported that 4 of the 10 largest servicers needed substantial improvement and six needed moderate improvement. In findings similar to those from GAO and SIGTARP, Treasury found that all 10 of the largest HAMP servicers used erroneous gross income amounts when evaluating borrowers for HAMP, with gross income calculation errors that ranged from 6% to 33%.

Treasury's first published assessment of the servicers raises concerns about Treasury's compliance and remediation efforts. In June 2011, for the first quarter of 2011, 3 of the 10 largest HAMP servicers ranked poorly on the second look

¹⁹ Treasury defined the 10 largest servicers as the 10 largest servicers based on HAMP activity volume.

metric. That is, borrowers who should have received a permanent mortgage modification were wrongly denied. Four servicers had an unacceptably high number of cases where, in the second look process, Freddie Mac was unable to determine, based on the documentation provided, how the servicer reached the decision not to offer a permanent modification. Treasury withheld incentives from three servicers, but later released the funds. It is unclear why Treasury allowed large servicers to not follow HAMP guidelines without significant lasting consequences.

Greater transparency over HAMP servicers' failure to follow program guidelines since the June 2011 servicer assessments has led to some improvements from servicers. For example, seven servicers still need moderate improvement according to Treasury's most recent assessment published in March 2012, which reported results for the fourth quarter of 2011. According to this most recent servicer assessment, as of the fourth quarter of 2011, some servicers are showing signs of improvement, but three servicers still have gross income error rates, ranging from 6% to 10% of Freddie Mac's sample, above Treasury's established benchmark of 5% and well above those servicers' internal benchmarks as reported by GAO as often set at 3% to 5%.²⁰ Gross income is a crucial input in the NPV test. Treasury's failure to establish benchmarks and publicly report on them earlier represents a lost opportunity to make these improvements earlier in servicer compliance.

Treasury's oversight since June 2011 appears to be focused on using the results of Freddie Mac's review of servicers to rate the servicer and determining whether to temporarily withhold incentives. The most Treasury has done has been to withhold TARP funds from servicers temporarily for one to three quarters. Despite finding (in the June 2011 assessment) that all of the 10 largest servicers required either moderate or substantial improvement more than two years after HAMP started, Treasury has never permanently withheld any TARP payments or clawed back any TARP funds paid to servicers for servicers' noncompliance with HAMP guidelines.

²⁰ GAO-10-634, "Troubled Asset Relief Program: Further Actions Needed to Fully and Equitably Implement Foreclosure Mitigation Programs," June 24, 2010, p. 21.

Conclusions

The Troubled Asset Relief Program's ("TARP") signature program, the Home Affordable Modification Program ("HAMP"), was designed around four core principles, one of which was a net present value test ("NPV test") that estimates whether a mortgage modification is in the best interest of the investor. The NPV test is the gateway through which an otherwise eligible homeowner gets into HAMP. More than 160,000 HAMP-eligible homeowners have been turned down for a HAMP mortgage modification by their mortgage servicer based on the results of the NPV test.

In 2009 and 2010, three TARP oversight bodies – the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), the Government Accountability Office ("GAO"), and the Congressional Oversight Panel ("COP") – reported several problems with the NPV test. These problems included servicers failing to follow HAMP guidelines, servicers making errors in implementing Treasury's NPV model, servicers inputting the wrong data, such as a borrower's income, into the test, and concerns about Treasury's monitoring of its compliance agent for HAMP, the Federal Home Loan Mortgage Corporation ("Freddie Mac"). GAO reported that half of the servicers it sampled had a 20% error rate in listing borrowers' income. COP characterized problems with the NPV test as evidence of eligible borrowers incorrectly being denied HAMP modifications. GAO similarly reported that "this lack of compliance likely resulted in differences in how borrowers were evaluated, and could have resulted in the inequitable treatment of similarly situated borrowers."

SIGTARP's most recent analysis from its sample identified concerns with the NPV test that may stand as barriers to homeowners getting much-needed help from HAMP. One concern can be easily fixed, though others require greater compliance and enforcement by Treasury:

- Treasury's practice of protecting investors by allowing them to add a "risk premium" to the NPV test calculation: SIGTARP found in its sample that the discretion that Treasury gave to servicers to override the baseline discount rate in the NPV test by adding a risk premium (of up to 2.5%) reduces the number of otherwise qualified homeowners Treasury helps through HAMP. According to Treasury, the addition of the risk premium reflects an additional cost that investors may face in modifying and continuing to carry mortgages at risk of default. Only 4 servicers add a risk premium, down from 11 in 2010. More than 100 servicers do not add a risk premium. In a SIGTARP analysis of a sample of 51 denied HAMP applications, SIGTARP found that if the servicer had not used a risk premium, more than half (27) of the homeowners in SIGTARP's sample would have tested positive in the NPV test (which would require the servicer to offer a HAMP modification).

The fact that more than 100 servicers do not find it necessary to add a risk premium suggests that the four servicers that do can put an end to this practice, which protects the investors at the expense of homeowners. Of the three largest HAMP servicers, only Bank of America, NA (“Bank of America”) and Wells Fargo Bank, NA (“Wells Fargo”) use a risk premium, both choosing to use the maximum 2.5%. Bank of America justified its risk premium to SIGTARP by saying that investors wanted a higher discount rate. The third-largest servicer, JPMorgan Chase Bank, NA (“JPMorgan”), told SIGTARP that it initially used the maximum risk premium because HAMP was new and had no performance results, but discontinued it because servicers and investors became more comfortable with HAMP over time and it wanted to align its practices with the Federal National Mortgage Association (“Fannie Mae”) and Freddie Mac, which do not use a risk premium. There is a simple fix for Treasury to remove this obstacle to homeowners getting into HAMP – tell servicers that risk premiums are no longer allowed.

- Errors Inputting Homeowner Information and Failure To Maintain Documentation in SIGTARP’s Sample: Any model will be only as good as its inputs. SIGTARP found in its sample that servicers made errors using NPV inputs and did not properly maintain records of all NPV inputs during the period of our review. Within SIGTARP’s judgmental sample of 149 HAMP applications, SIGTARP found that the servicers could provide both accurate inputs and documentation for only two HAMP applications.²¹ SIGTARP found that servicers failed to comply with HAMP guidelines on maintaining records on NPV inputs, which is crucial for compliance and to protect homeowners’ rights to challenge servicer error. For 19 denied HAMP applicants, the servicer was not able to provide all of the inputs used in the NPV test. In some instances where there was documentation, it did not support the NPV inputs the servicer used. For 149 denied HAMP applications, SIGTARP found that approximately 19% of the inputs were either entered incorrectly or could not be supported by the servicers’ records. Because of the servicers’ failure to maintain documentation of the NPV inputs, SIGTARP was unable to determine how many homeowners from its sample may have been wrongly denied a HAMP modification.
- Errors in Calculating Homeowner Gross Income and in Other Areas in SIGTARP’s Sample: In 2010, GAO found that servicers’ error rates for calculating gross income were well above the servicers’ own established error rate thresholds, which were typically 3% to 5%. In 2010 and 2011, SIGTARP also found servicer errors or lack of documentation in calculating the homeowner’s gross income, which is a key input in the NPV test. SIGTARP also found errors in its sample related to credit scores, principal forgiveness,

²¹ SIGTARP’s sample consisted of 149 HAMP applications reviewed by 3 of the 10 largest servicers: Ocwen, Wells Fargo, and GMAC Mortgage.

dates of NPV tests, unpaid principal balance, amortization, principal and interest after modification, and the type of property valuation used. The extent to which servicers use incorrect data increases the risk of an improper decision to an unacceptable level. When servicers use erroneous information in the NPV test, homeowners may pay the price by being denied help under HAMP and ultimately may lose their homes.

- Poor Communication with Homeowners on Denial of HAMP Modifications in SIGTARP's Sample: In its sample, SIGTARP also found that servicers had poor communication with homeowners on the denial of a HAMP modification due to the NPV test. SIGTARP reviewed a sample of 26 denial letters sent by GMAC Mortgage, LLC ("GMAC Mortgage"), Ocwen Loan Servicing, LLC ("Ocwen"), and Wells Fargo, and found that all but 2 of the letters failed to comply with at least 1 requirement of HAMP guidelines. Wells Fargo sent denial letters to 4 homeowners between 32 and 147 business days (69 days on average) after its decision, well past the 10-day requirement. Six denial letters failed to list certain NPV inputs, which has serious consequences because without the inputs, homeowners cannot use the web-based NPV calculator required by Congress and specifically designed to allow homeowners to challenge their servicer about errors. Treasury told SIGTARP that it has recently made improvements in that area, according to a December 2011 sample of four large servicers.

SIGTARP's findings of servicer errors with the NPV test and failure to comply with HAMP guidelines in its sample raise serious questions about the effectiveness of Treasury's oversight of servicers. In March 2010, SIGTARP recommended that Treasury set performance benchmarks and publicly report on them to measure HAMP implementation and success. Despite this call for accountability on the part of servicers, Treasury did not release information on reviews of the 10 largest servicers until June 2011, more than 2 years after HAMP was launched. The results showed that four needed substantial improvement and the other six needed moderate improvement.

Treasury also monitors servicer progress through its Making Home Affordable Compliance Committee meetings. According to Treasury, Freddie Mac briefs the committee on the status of the servicers in correcting issues. However, Treasury was unable to provide documentation of determination of appropriate action on significant delays or issues with a servicer's remediation efforts.

There were also issues with seven servicers in Freddie Mac's second look reviews. For a sample of at least 100 loans per servicer, Freddie Mac examines the reason why a borrower was denied a HAMP modification and determines whether it agrees. In June 2011, Treasury published first quarter 2011 data showing that 3 of the 10 largest HAMP servicers ranked poorly in the second look reviews, meaning that homeowners were wrongly denied modifications, and 4 servicers had an unacceptable number of cases where Freddie Mac was unable

to determine how the servicer reached the decision not to offer a permanent modification. Treasury also found that all 10 of the largest servicers used erroneous gross income amounts when evaluating borrowers for HAMP, with 6% error rates to 33% error rates.

Despite the poor servicer assessments announced in June 2011, more than two years into HAMP, Treasury has never permanently withheld any TARP payments or clawed back any TARP payments to servicers. Greater transparency over HAMP servicers since the June 2011 servicer assessments has led to some improvements, although more transparency is needed. For example, according to the most recent assessments, three servicers still have gross income error rates of 6% to 10%, exceeding both Treasury's benchmark of 5% and the servicers' own benchmarks. Gross income is a crucial input in the NPV test. Treasury's failure to establish benchmarks and publicly report on them prior to June 2011 represents a lost opportunity to make improvements earlier in servicer compliance. Greater improvement in servicers' compliance is a key to homeowners getting help through HAMP. Treasury must be more rigorous in its compliance and enforcement (including permanently withholding TARP payments) against servicers that fail to follow HAMP guidelines.

Recommendations

1. Treasury should stop allowing servicers to add a risk premium to Freddie Mac's discount rate in HAMP's net present value test.
2. Treasury should ensure that servicers use accurate information when evaluating net present value test results for homeowners applying to HAMP and should ensure that servicers maintain documentation of all net present value test inputs. To the extent that a servicer does not follow Treasury's guidelines on input accuracy and documentation maintenance, Treasury should permanently withhold incentives from that servicer.
3. Treasury should require servicers to improve their communication with homeowners regarding denial of a HAMP modification so that homeowners can move forward with other foreclosure alternatives in a timely and fully informed manner. To the extent that a servicer does not follow Treasury's guidelines on these communications, Treasury should permanently withhold incentives from that servicer.
4. Treasury should ensure that more detail is captured by the Making Home Affordable Compliance Committee meeting minutes regarding the substance of discussions related to compliance efforts on servicers in HAMP. Treasury should make sure that minutes clearly outline the specific problems encountered by servicers, remedial options discussed, and any requisite actions taken to remedy the situation.

Management Comments and SIGTARP's Response

Treasury provided an official written response to this report in a letter dated June 15, 2012, which is reproduced in full in Appendix E. Treasury disagreed with the findings in our report. Treasury responded that SIGTARP's sample of 149 HAMP applications was too small, from too few servicers, and not recent enough to be representative of current operations. Treasury stated that use of a risk premium is traditional in expected cash flow modeling. Treasury said it would discuss the recommendations with SIGTARP.

SIGTARP's audit was conducted in accordance with Generally Accepted Government Auditing Standards ("GAGAS"). GAGAS 7.63 provides that "when sampling is used, the method of selection that is appropriate will depend on the audit objectives" and that "a targeted selection may be effective if the auditors have isolated certain risk factors or other criteria to target the selection." As required by GAGAS 7.63, SIGTARP made a targeted selection after isolating certain risk factors and other criteria. As stated in the report, SIGTARP selected its judgmental sample from 3 of the 10 largest servicers, based on servicing portfolio size, SIGTARP Hotline complaints, amount of eligible incentives available to each servicer through HAMP, and other factors. SIGTARP validated more than 5,000 inputs that were used for the loans to determine the potential impact on the NPV decision. SIGTARP's report is not based solely on the targeted sample, but on all information gathered. Sampling serves to validate information and conclusions reached by SIGTARP during interviews and other research as clearly set forth in detail in Appendix A. This includes that SIGTARP compared its targeted sample results to information found in Treasury's service assessments, including one from March 2012, that found that some servicers are showing signs of improvement, but seven servicers still need moderate improvement in their compliance and that three servicers continue to have unacceptable gross income error rates. As such, SIGTARP recommended that to the extent a servicer does not comply with Treasury's guidelines, Treasury should permanently withhold incentives from that servicer.

As to the risk premium, 96% of the servicers do not add a risk premium. Only four servicers add a risk premium. The third-largest servicer, JPMorgan, discontinued the practice because investors became comfortable with HAMP. SIGTARP recommended that, based on this and other data, and the potential that this risk premium could result in negative NPV scores, Treasury should discontinue allowing a risk premium.

Appendix A – Scope and Methodology

We performed this audit under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978, as amended. The Office of the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”) initiated this audit in response to a letter dated March 10, 2010, from Senator Jeff Merkley and eight other senators.²² Our audit objectives were to determine:

- whether the mortgage servicers correctly applied the net present value (“NPV”) test²³ under the Home Affordable Modification Program (“HAMP”);
- the extent to which the U.S. Department of the Treasury (“Treasury”) ensured that servicers appropriately applied the NPV test per HAMP guidelines when they assessed homeowners for program eligibility; and
- the procedures servicers followed to communicate to homeowners the reasons they were denied HAMP mortgage modifications, as well as to identify the full range of loss mitigation options then available to those homeowners.

We conducted our audit work at Treasury’s Office of Financial Stability in Washington, D.C., Fannie Mae headquarters in Washington, D.C., Freddie Mac headquarters in McLean, Virginia, and the offices of three mortgage servicers: Ocwen, in West Palm Beach, Florida; Wells Fargo in Des Moines, Iowa; and GMAC Mortgage in Waterloo, Iowa. The scope of this audit covered both privately owned mortgages and Fannie Mae- and Freddie Mac-owned mortgages that were serviced by HAMP servicers.

To determine the extent to which servicers correctly applied the NPV test, we assessed the accuracy of the servicers’ decisions to grant or deny HAMP mortgage modifications by verifying the accuracy of information servicers entered into the NPV model²⁴ (“NPV inputs”) and re-performed the NPV test, but we did not validate the NPV model directly. We judgmentally selected the sample of three servicers based on servicing portfolio size; amount of eligible incentives available to each servicer through HAMP, SIGTARP Hotline complaints, and other factors.²⁵ We then judgmentally sampled a total of 50 mortgages from each servicer based on a cross section of loans according to factors including geographic location, date the NPV test was run, and amount of unpaid principal balance. In addition, we reviewed eight Congressional constituent complaints. Our sample totaled 158 mortgages that were evaluated for HAMP by these servicers between August 4, 2009, and January 13, 2011. We tested 149 of the 158 sampled mortgages because necessary documentation was not available for 5, 3 of the constituents referred to us were not eligible under the program, and the servicers never evaluated the HAMP eligibility of 1 constituent’s mortgage (but the constituent later received a proprietary mortgage modification).

²² The other senators were Richard Durbin, Jack Reed, Herb Kohl, Sherrod Brown, Russell Feingold, Sheldon Whitehouse, Mark Begich, and Maria Cantwell.

²³ A full explanation of the NPV test and its importance in determining homeowner eligibility for HAMP mortgage modifications is included in the Introduction of this report, on p. 1.

²⁴ For more information on the NPV model and NPV test, see Appendix B – The Home Affordable Modification Program’s Net Present Value Model.

²⁵ Results from a judgmental sample cannot be projected to the universe of data from which the sample was drawn.

We examined supporting documentation for the selected NPV inputs for all mortgages tested to ensure that the inputs used by the servicers in the NPV test were accurate. We validated 36 of the 44 inputs for each mortgage tested, resulting in a total of 5,364 inputs tested. These inputs were judgmentally selected based on the potential impact that they would have on the NPV decision. The remaining inputs such as “HAMP servicer number” and “remaining term” were not validated because they have a lesser impact on the NPV decision. For the gross income NPV input, we recalculated each borrower's monthly gross income based on supporting documentation in accordance with program guidance and servicers' own policies and procedures for calculating gross income. We also consulted with Freddie Mac for guidance on the gross income calculations.

To analyze how a reduction in the discount risk rate premium from 2.5% to 0% (in increments of 0.5%) would affect each borrower's NPV result, we submitted for testing all private loans in our sample using inputs based on servicer documentation to Treasury's online NPV test, holding constant all inputs other than the risk premium. No GMAC Mortgage-serviced mortgages were retested because GMAC Mortgage does not add a risk premium. From the original sample of 50 Ocwen mortgages, 8 were excluded from testing because necessary documentation was missing from the servicer's files, 2 were excluded because they were owned by Fannie Mae or Freddie Mac, 4 failed to return an NPV value, and 1 loan returned a positive NPV value, leaving 35 Ocwen mortgages that were tested. In addition to the original sample of 50 mortgages serviced by Wells Fargo, all constituent mortgages we reviewed were also serviced by Wells Fargo. From the 58 mortgages we sampled, 18 were excluded from testing because necessary documentation was missing from the servicer's files, 13 were excluded because they were owned by Fannie Mae or Freddie Mac, 5 failed to return an NPV value, and 6 returned a positive NPV value, leaving 16 Wells Fargo mortgages that were tested. In total we tested all 51 loans that returned a negative NPV result – 35 from Ocwen and 16 from Wells Fargo – and all 51 were analyzed at each risk premium increment. We also surveyed seven servicers for their rationale for choosing a risk premium, as well as their analysis to support their decision. The seven servicers were GMAC Mortgage, Ocwen, Wells Fargo, Bank of America, CCO Mortgage, JPMorgan, and Saxon Mortgage Services, Inc. (“Saxon”).

To gain an understanding of the NPV model and its proper application, we interviewed officials from Treasury, the mortgage servicers, industry groups, Fannie Mae, Freddie Mac, the Federal Deposit Insurance Corporation, and the Federal Housing Finance Agency, and we received a demonstration of Treasury's base model from Fannie Mae. We interviewed Fannie Mae on its role in the creation of the NPV model and the NPV model's mechanics. We also collected Treasury's HAMP guidance, policies and procedures from the three sampled servicers, the Emergency Economic Stabilization Act of 2008, the Helping Families Save Their Homes Act of 2009, and relevant Treasury white papers providing additional guidance to servicers on the NPV test. We also obtained from Treasury feedback that it had received from servicers and industry groups on the NPV model, version 4.0.

To determine the extent to which Treasury ensures that servicers are appropriately applying the NPV test per HAMP guidelines when assessing borrower program eligibility, we conducted interviews with Treasury officials, Fannie Mae, Freddie Mac, and three servicers. We also reviewed Treasury's policies and procedures as well as the audit program that Freddie Mac uses to assess servicer compliance and associated workpapers, servicer participation agreements, Treasury guidance on HAMP, Treasury's financial agent oversight policy, and sections of the Financial Agency Agreement between Treasury and Freddie Mac that were pertinent to the NPV test. In addition, we reviewed communications sent by Freddie Mac to servicers notifying them of issues that Freddie Mac had identified, as well as Treasury's Making Home Affordable

Compliance Committee meeting minutes for October 2009 to March 2012, showing what actions, if any, have been taken to address these issues.

To determine the procedures used by servicers to communicate to borrowers the reasons they were denied HAMP mortgage modifications and their full range of loss mitigation options, we selected half of the original sample of 50 loans from each servicer for further detailed testing. In total, we tested 26 mortgages after excluding loans owned by Fannie Mae and Freddie Mac and those loans that were evaluated for HAMP by the sampled servicers before January 1, 2010, when Treasury issued guidance on denial communications. Our scope for this objective focused on whether servicer denial communications to borrowers complied with Treasury's guidance. In addition, we reviewed Treasury's guidance, discussed with servicers their policies and procedures for handling HAMP denials, and reviewed servicers' mortgage documentation supporting foreclosure alternatives.

We conducted this performance audit from March 2010 through May 2012, and in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides reasonable basis for our findings and conclusions based on our audit objectives.

Limitations on Data

We obtained servicer populations of mortgages that were evaluated for HAMP, and the NPV test date and final NPV decision for each mortgage. We also obtained data provided by Fannie Mae to report on the status of modifications and the NPV inputs used. While we validated the accuracy of the NPV inputs in our sample using the steps described in the scope and methodology outlined above, we could not verify the completeness of the data provided by the servicers or Fannie Mae because we did not have direct access to extract the data from their systems. In addition, we could not independently confirm the total number of mortgages evaluated for HAMP by each servicer.

Use of Computer-Processed Data

To perform this audit, we used data provided by Fannie Mae and the servicers on the status of modifications and the NPV inputs used. While we could not validate the completeness of the data (see explanation in the "Limitations on Data" section), we verified the accuracy of the data in our sample by obtaining related mortgage documentation. In addition, the NPV model has edits to prevent servicers from submitting data outside the range limit of the model. Those edits provide some assurance of the reasonableness of the data, but do not attest to the accuracy of the data submitted to the model. Accordingly, we did not rely on the model's edits.

Internal Controls

We reviewed internal controls over the accuracy of data used in the NPV test by comparing servicers' inputs to mortgage-related source documentation. We also reviewed Treasury and the sampled servicers' controls over communications to borrowers by assessing Treasury guidelines and testing servicer compliance with those guidelines, specifically on timeliness, reason for denial, description of foreclosure alternatives and, if the loan was denied for a negative NPV, did each letter include a list of inputs and a statement that the borrower may request the date the NPV calculation was completed and values used for those inputs.

Prior Coverage

Government Accountability Office, Report No. 11-288, "Troubled Asset Relief Program: Treasury Continues to Face Implementation Challenges and Data Weaknesses in Its Making Home Affordable Program," March 17, 2011

Congressional Oversight Panel, "Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation," November 16, 2010

Government Accountability Office, Report No. 10-634, "Troubled Asset Relief Program: Further Actions Needed to Fully and Equitably Implement Foreclosure Mitigation Programs," June 24, 2010

Congressional Oversight Panel, "Evaluating Progress on TARP Foreclosure Mitigation Programs," April 14, 2010

SIGTARP, Report No. 10-005, "Factors Affecting Implementation of the Home Affordable Modification Program," March 25, 2010

Congressional Oversight Panel, "Taking Stock: What Has the Troubled Asset Relief Program Achieved?," December 9, 2009

Government Accountability Office, Report No. 10-301, "Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements," December 9, 2009

Congressional Oversight Panel, "An Assessment of Foreclosure Mitigation Efforts after Six Months," October 9, 2009

Government Accountability Office, Report No. 10-16, "Troubled Asset Relief Program: One Year Later, Actions Are Needed to Address Remaining Transparency and Accountability Challenges," October 8, 2009

Government Accountability Office, Report No. 09-837, "Troubled Asset Relief Program: Treasury Actions Needed to Make the Home Affordable Modification Program More Transparent and Accountable," July 23, 2009

Congressional Oversight Panel, "Foreclosure Crisis: Working Toward a Solution," March 6, 2009

Appendix B – The Home Affordable Modification Program's Net Present Value Model

On March 4, 2009, Treasury issued guidelines that introduced its NPV model and explained how the model should be used to evaluate borrowers requesting a modification to their mortgage under HAMP. The model includes both a net present value test component (“NPV test”) and a tool that checks the reasonableness of the terms the servicer used when applying the HAMP modification waterfall (“waterfall check”).

For privately owned mortgages, the NPV test determines whether a servicer participating in HAMP is required to offer the borrower a HAMP mortgage modification. The model compares the net present value of cash flows expected from a modified mortgage to the net present value of cash flows expected if the mortgage is not modified. If the value of the cash flows is greater with a mortgage modification than without, the servicer is required to offer a HAMP modification to the borrower. Otherwise, a HAMP modification is optional.

For mortgages owned or guaranteed by Fannie Mae and Freddie Mac, servicers are required to offer a trial modification under HAMP when the difference in the cash flows is positive as well as when the difference in net present values of cash flows is negative – as long as the difference is negative by less than \$5,000.²⁶ In other words, even if the NPV test indicates that a modified mortgage would cost Fannie Mae or Freddie Mac up to \$5,000 more than foreclosure, the servicer must still offer the modification.

The NPV model also has a waterfall check. HAMP servicers are required to modify certain aspects of a borrower's mortgage in the order outlined below, called a waterfall, until the borrower's debt-to-income ratio reaches 31% without going below 31%.²⁷ The reasonableness of the data used by the servicer to apply the waterfall is assessed by the model, although the model's guidance states that the servicer is responsible for verifying a borrower's program eligibility and modification terms. The waterfall steps are:

- First, the servicer calculates the current debt-to-income ratio based on the current mortgage payment and gross monthly income.
- Second, the servicer capitalizes any unpaid interest and fees²⁸ (that is, the servicer adds them to the outstanding principal balance).
- Third, the servicer reduces the interest rate in incremental steps to as low as 2%.
- Fourth, if the 31% threshold has still not been reached, the servicer extends the term of the mortgage to a maximum of 40 years from the modification date.

If the four steps do not reduce the borrower's debt-to-income ratio to the 31% threshold, the servicer may allow a borrower to defer, or forbear, principal payments, subject to certain limits. The forbearance amount

²⁶ According to Fannie Mae, the mandatory mortgage modification threshold of \$5,000 in negative cash flows went into effect on December 1, 2009.

²⁷ Under Treasury guidelines, there is no restriction on reducing the debt-to-income ratio below 31%, but the portion of the reduction below 31% will not be reimbursed by Treasury. The 31% debt-to-income ratio level was chosen because Treasury considers it to be the standard across the industry for an affordable and sustainable modification. This standard is also a Federal Housing Administration underwriting target.

²⁸ Late fees are not capitalized.

is not interest bearing and results in a lump-sum payment due upon the earliest of the sale date of the property, the payoff date of the interest-bearing mortgage balance, or the maturity date of the mortgage.

Servicers are not required to forgive principal under HAMP. However, servicers may forgive principal in order to lower the borrower's monthly payment to achieve the debt-to-income ratio goal of 31% on a stand-alone basis or before any of the other HAMP modification steps described above.

Appendix C – Acronyms and Abbreviations

Acronym or Abbreviation	Definition
Bank of America	Bank of America, NA
CCO Mortgage	CCO Mortgage, a division of RBS Citizens, NA
COP	Congressional Oversight Panel
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
GAO	Government Accountability Office
GMAC Mortgage	GMAC Mortgage, LLC
HAMP	Home Affordable Modification Program
HPO	Homeownership Preservation Office
JPMorgan	JPMorgan Chase Bank, NA
LLC	Limited Liability Corporation
NA	National Association
NPV	Net present value
Ocwen	Ocwen Loan Servicing, LLC
Saxon	Saxon Mortgage Services, Inc.
SIGTARP	Office of the Special Inspector General for the Troubled Asset Relief Program
TARP	Troubled Asset Relief Program
Treasury	U.S. Department of the Treasury
Wells Fargo	Wells Fargo Bank, NA

Appendix D – Audit Team Members

This audit was conducted and the report was prepared under the direction of Kurt W. Hyde, Deputy Special Inspector General for Audit and Evaluation, and Kimberley A. Caprio, Assistant Deputy Special Inspector General for Audit and Evaluation, Office of the Special Inspector General for the Troubled Asset Relief Program.

Staff members who conducted the audit and contributed to the report include Patrice Wilson, Lindsay Steward, Philip Mastandrea, Andrew Lopresti, Clayton Boyce, and Cynthia Broome.

Appendix E – Management Comments



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 15, 2012

Christy L. Romero
Special Inspector General
for the Troubled Asset Relief Program
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

RE: Response to SIGTARP's Final Audit Report on The Net Present Value Test's Impact on the Home Affordable Modification Program

Dear Ms. Romero:

Thank you for the opportunity to review your draft final audit report entitled, *The Net Present Value Test's Impact on the Home Affordable Modification Program*, dated June 1, 2012 (the Report). The Department of the Treasury (Treasury) appreciates the efforts of the Office of the Special Inspector General (SIGTARP) in preparing the Report. This letter provides Treasury's official response.

The Treasury Department is committed to making sure that qualified homeowners receive assistance through the Home Affordable Modification Program (HAMP) in order to help prevent avoidable foreclosures. Over the course of the last three years, we have taken significant steps to expand the reach of our programs and strengthen oversight of servicers. However, we strongly disagree with the findings of the Report, and we believe it has significant methodological flaws, inadequate analysis, and outdated information.

As an initial matter, over one million families have now received permanent modifications under HAMP, and tens of thousands of additional families enter the program each month. These homeowners are benefitting from some of the deepest and most sustainable assistance available to prevent foreclosure, and they continue to demonstrate a high likelihood of long-term success in the program. Additionally, the program has developed standards that have helped to transform industry practices and have contributed to nearly 2.9 million additional modifications completed outside of the program.

The Net Present Value (NPV) model has been an important tool in evaluating whether to modify a homeowner's mortgage. It is an economic model designed by an interagency NPV development group¹, which is part of a process that makes sure the modification makes economic sense for the homeowner and the owner of the mortgage, and therefore whether the

¹ The NPV model was designed by an interagency group comprised of economists from the Treasury, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Fannie Mae, and Freddie Mac. It has been refined with the experience gained in administering the program.

modification is likely to be sustainable. It is administered by over 100 servicers who participate in the program. Only about five percent of HAMP denials are related to NPV results and almost two million homeowners who have received trial modifications under HAMP “passed” the NPV test. Therefore, we disagree with the characterization of the NPV model as “the gateway” to a HAMP modification, as the Report implies.

Since the beginning of the program, Treasury has conducted compliance reviews of servicer performance, including servicer administration of the NPV model. We appreciate SIGTARP’s acknowledgment in the section titled, “Treasury’s Oversight of Servicers’ Performance and Compliance, and Freddie Mac as the HAMP Compliance Agent,” that servicer performance has improved due to these compliance efforts. However, the rest of the Report conflicts with this acknowledgment and implies that there has been little improvement.

As you know, we previously submitted extensive comments and technical corrections to a draft of the Report, and discussed these with your staff. These comments raised our concerns regarding the methodology, scope, and conclusions reached in the Report. As it appears that SIGTARP did not address a large number of those comments and corrections, we reiterate our key concerns below.

1. SIGTARP’s Use of a Flawed Loan Sample

Our main concern with the Report is that SIGTARP appears to have done very little substantive investigation of servicer performance in applying the NPV model. As noted in the Report, SIGTARP used a “judgmental” sample of only 149 loans from three servicers taken from 2009 to early 2011. As you are aware, an auditor’s “judgmental” sample is selected with specific criteria in mind. SIGTARP’s selection criteria are not explained in the Report, and thus we are unable to comment on the sample other than to say it is clearly not statistically representative of the entire population of loans evaluated for MHA.² We also note that, under generally accepted government auditing standards (GAGAS), auditors are required to disclose if they cannot apply the results from their testing across the entire population of loans that is the subject of the audit.³ This small “judgmental” sample appears to be the only evidence SIGTARP relied on for much of its analysis, other than reports issued by the Government Accountability Office and the Congressional Oversight Panel in 2009 and 2010.

We believe that this sample is simply too small, from too few servicers, and not recent enough to be representative of current operations. Over 100 servicers administer the program and apply the NPV model. A “judgmental,” unrepresentative sample of 149 loans is too small in relation to the

² The size of the relevant sample of loans is likely even smaller as it appears from the Report in that an indeterminate number of these 149 loans owned or guaranteed the GSEs. At the inception of HAMP, Treasury agreed with FHFA that the GSEs themselves are responsible for compliance activities with respect to GSE loans, not the Treasury. Treasury’s compliance program pertains only to non-GSE loans. The inclusion of loans that are not subject to the Treasury compliance program further reduces the validity of the sample as a basis for evaluating Treasury’s compliance efforts.

³ Section 7.13 of GAGAS requires auditors to disclose if their results can be applied to the entire population. Government Auditing Standards, 7. Reporting Standards for Performance Audits, Section 7.13, GAO-12-331G (Dec. 2011) (Yellow Book Standards).

scale of the program, and a sample that consists of only three servicers cannot be extrapolated to all servicers.

Second, the outdated nature of the sample makes the results less useful in evaluating servicer performance today. Although the sample period is described as 2009 to 2011, no mention is made of when the loans sampled were actually evaluated for MHA, an important factor as servicer performance improved over that time period. Loans could have been evaluated almost three years ago; at best, they were evaluated at least 15 months ago. Nevertheless the Report implies that the results are representative of current servicer performance. It would be more appropriate to examine larger, more diverse samples of loans taken from different points in time, including some sampled much more recently, to be able to measure changes in servicer performance.

No homeowner should be improperly evaluated for a HAMP modification, no matter how long ago. But because SIGTARP has apparently relied solely on this limited sample to evaluate servicer performance today, we are unclear how SIGTARP determined that the Report satisfies relevant government auditing standards with respect to having appropriate and sufficient evidence,⁴ providing sufficient context for findings,⁵ and disclosing any limitations or qualifications for samples used in testing.⁶

By comparison, Treasury's compliance agent, Making Home Affordable-Compliance (MHA-C), the entity under MHA dedicated to overseeing servicer conduct, has reviewed over 60,000 loans since late 2009 in the First Look and Second Look processes, and has found significant improvement in performance over time. These tests are performed through statistically valid sampling procedures, with Second Look sampling for the nine largest servicers every other month and for the next four servicers every quarter. These 13 servicers account for more than 95 percent of MHA volume. Smaller servicers are sampled for Second Look semi-annually.

⁴ Section 7.03 of GAGAS maintains that performance audits in compliance with GAGAS provide reasonable assurance that [the auditor's] evidence is sufficient and appropriate to support the auditors' findings and conclusions. Government Auditing Standards, 7. Reporting Standards for Performance Audits, Section 7.03, GAO-12-331G (Dec. 2011) (Yellow Book Standards). Part of measuring the appropriateness of the evidence is validity. Section 6.60(b) of GAGAS states that in order to be valid, the evidence [supporting the audit findings] must be what it purports to represent. Government Auditing Standards, 6. Field Work Standards for Performance Audits, Section 6.60(b), GAO-12-331G (Dec. 2011) (Yellow Book Standards).

⁵ Section 7.16 of GAGAS requires that auditors put their findings in perspective. For internal controls deemed significant within the context of audit objects, the auditors should determine whether the internal control has been designed and implemented properly. If the internal controls are deemed significant within the context of the audit objectives, auditors should obtain sufficient, appropriate evidence to support their position about the effectiveness of the control. Government Auditing Standards, 7. Reporting Standards for Performance Audits, Section 7.16, GAO-12-331G (Dec. 2011) (Yellow Book Standards).

⁶ An auditor, in their audit methodology, should explain how the completed audit work [the Report] supports the audit objective. In part, when sampling significantly supports the auditor's findings, conclusions, or recommendations, describe the sample design and state why the design was chosen including whether the results can be projected to the intended population." GAGAS Section 7.13. Government Auditing Standards 7. Reporting Standards for Performance Audits, Section 7.13, GAO 12-331G (Dec. 2011) (Yellow Book Standards).

Second Look is a process in which MHA-C reviews loans not in a permanent modification, to assess the accuracy of the servicer's determination of whether the homeowner is eligible for a modification. During Second Look reviews, MHA-C fully re-evaluates the loans against MHA guidelines, including re-calculating income and running the NPV test, if necessary. From these tests, we derive among other important results the Second Look Disagree and Second Look Unable to Determine rates.

Our findings show a dramatic decline in the error rates for both measures. For example, consider our findings from reviews conducted from Q4 2010 to Q1 2012 of several thousand loan files for the three servicers represented in your sample of 149 loans. For the "Second Look Disagree" category, the error rates in the samples declined from as high as 6.3 percent to 1.0 percent or less for all three. For the Second Look Unable to Determine category, the rate in the sample dropped from as high as 24.7 percent to 0.0 percent for all three. Through its compliance efforts, Treasury requires servicers to correct outstanding issues. We enclosed a summary of these findings, covering the top nine servicers, with this letter.

2. Use of the Discount Rate Risk Premium is Traditional in Expected Cash Flow Modeling

Our prior comments also questioned the Report's methodology and analysis on the use of the discount rate risk premium. It is common in expected cash flow modeling to use risk premiums to address differences in risk of assets.⁷ The NPV test allows this use only on a limited basis (that is, a servicer can use a risk premium for its or an investor's entire portfolio but not for individual loans or groups of loans within the portfolio) and only in a capped amount. The interagency NPV development group believes that this was an appropriate way to design a model that could work for the entire market, given that it is comprised of many different investors. The Report does not provide a rationale for not permitting the use of limited risk premiums except to focus solely on the impact the premium may have on pass rates (although again based on an unrepresentative sample of loans). We would be happy to discuss this issue further.

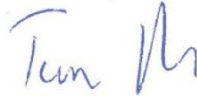
3. Conclusion

The Report makes four recommendations related to the need for the discount rate risk premium in the NPV model and to what SIGTARP contends is both poor servicer performance and Treasury compliance and enforcement. We would be happy to discuss your recommendations as we share your desire to see that servicer performance continually improves. In light of our concerns about the methodology followed for the Report, we think that discussion should also take into account the more detailed and more current information we collect on servicer performance. We believe this is the best way to design effective strategies for continuing to improve performance.

Thank you once again for the opportunity to respond to the Report. We look forward to continuing to work with SIGTARP as we move forward.

⁷ See, for example: Brealey, R., Myers, S., and Marcus, A. 2011. *Fundamentals of Corporate Finance* (7th ed.). McGraw-Hill/Irwin Ross, S. Westerfield, R. and Jaffe, J. 2009. *Corporate Finance* (9th ed.). McGraw-Hill/Irwin.

Sincerely,

A handwritten signature in blue ink, appearing to read "Tim M", is positioned above the printed name.

Timothy G. Massad
Assistant Secretary for Financial Stability

Enclosure:

MHA Servicer Assessment Overview

MHA Compliance Results, Loan File Review: 4th Quarter 2010 - 1st Quarter 2012

Servicer	Second Look % Disagree ¹					Second Look % Unable to Determine ²					Income Calculation Error Rate ³							
	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012		
Bank of America, NA	2.4%	1.5%	0.8%	1.0%	1.0%	2.0%	19.6%	18.8%	8.2%	1.5%	1.0%	1.0%	22.0%	22.0%	13.2%	6.0%	6.0%	5.0%
CitiMortgage, Inc.	4.0%	2.0%	0.5%	1.5%	1.0%	1.0%	12.3%	13.3%	5.5%	0.5%	1.0%	0.5%	8.0%	10.0%	12.0%	6.0%	3.0%	4.0%
GMAC Mortgage, LLC	4.0%	4.7%	1.7%	1.0%	0.5%	0.0%	22.7%	8.3%	0.7%	0.0%	0.0%	0.0%	29.0%	6.0%	4.2%	4.2%	6.5%	4.0%
Homeward Residential	5.3%	1.0%	0.7%	0.0%	1.5%	1.0%	29.3%	5.3%	1.0%	0.0%	0.0%	1.0%	30.0%	14.0%	5.3%	2.0%	1.0%	2.0%
JPMorgan Chase Bank, NA	3.9%	1.6%	1.2%	0.0%	0.7%	0.2%	16.0%	11.3%	3.2%	0.9%	1.0%	0.7%	31.0%	31.0%	20.6%	6.0%	10.0%	9.0%
Litton Loan Servicing, LP ⁴	6.0%	3.7%	3.3%	1.0%	N/A	N/A	5.7%	6.3%	2.7%	2.0%	N/A	N/A	6.0%	6.0%	2.0%	1.0%	N/A	N/A
Ocwen Loan Servicing, LLC	6.3%	6.7%	2.7%	0.0%	0.7%	1.0%	24.7%	10.3%	3.0%	2.4%	0.0%	0.0%	18.0%	33.0%	2.0%	2.0%	2.0%	3.0%
OneWest Bank	4.7%	6.7%	0.7%	0.0%	0.0%	0.0%	12.3%	3.7%	1.0%	0.0%	0.0%	0.0%	11.0%	11.0%	2.0%	2.0%	0.0%	3.0%
Select Portfolio Servicing	2.0%	0.0%	0.0%	0.8%	0.0%	0.0%	17.0%	2.3%	0.3%	0.8%	0.0%	3.0%	22.0%	15.0%	10.0%	3.2%	1.0%	3.0%
Wells Fargo Bank, NA ⁸	1.7%	1.2%	0.4%	0.4%	0.0%	0.3%	6.8%	6.0%	1.3%	1.3%	0.0%	0.0%	27.0%	27.0%	4.4%	5.5%	4.0%	2.0%

¹ Second Look % Disagree: Percentage of loans reviewed where MHA-C did not concur with the servicer's MHA determination.

² Second Look % Unable to Determine: Percentage of loans reviewed where MHA-C was not able to conclude on the servicer's MHA determination.

³ Income Calculation Error %: Percentage of loans for which MHA-C's income calculation differs from the servicer's by more than 5%. Correctly calculating homeowner monthly income is a critical component of evaluating eligibility for MHA, as well as establishing an accurate modification payment.

⁴ Effective November 1, 2011 Litton Loan Servicing, LP transferred its loan portfolio to Ocwen Loan Servicing, LLC.

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By *Fax*: (202) 622-4559

By *Mail*:

**Hotline: Office of the Special Inspector General
for the Troubled Asset Relief Program**
1801 L Street., NW, 3rd Floor
Washington, D.C. 20220

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