Federal Housing Finance Agency
Office of Inspector General

FHFA Can Improve Its Oversight of Fannie Mae's Recoveries from Borrowers Who Possess the Ability to Repay Deficiencies

Audit Report • AUD-2013-011 • September 24, 2013

OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

September 24, 2013

TO: Jon D. Greenlee, Deputy Director for Enterprise Regulation

FROM: Russell A. Rau, Deputy Inspector General for Audits

SUBJECT: FHFA Can Improve Its Oversight of Fannie Mae's Recoveries from Borrowers Who Possess the Ability to Repay Deficiencies (Audit Report AUD-2013-011)

Summary

The Federal Housing Finance Agency (FHFA or agency) Office of Inspector General (OIG) assessed FHFA's oversight of the effectiveness of Fannie Mae's deficiency recovery process for borrowers who possess the ability to repay deficiencies.[1] A deficiency exists when a foreclosure sale's proceeds are less than the borrower's mortgage loan balance. Fannie Mae, as the owner of the mortgage, typically has the right (depending on state law) to pursue collection of that deficiency in order to reduce its credit losses.

The enterprise has been in a conservatorship under FHFA's direction since 2008 due to concerns over its financial condition and has received to date over $116 billion in taxpayer investments. Pursuing deficiency recoveries from those with the ability to repay serves as a deterrent to borrowers who may consider strategically defaulting on their mortgages, despite having the ability to pay their contractual obligations. In addition, improving recoveries from borrowers with the ability to repay deficiencies could help reduce Fannie Mae's foreclosure-related losses, and, in turn, could lead to larger payments to the U.S. Treasury as returns of taxpayers' investments.

[1] In this report, the term borrower also refers to co-borrowers.

In October 2012, OIG issued a report that assessed FHFA's oversight of the enterprises' deficiency management.[2] OIG found that FHFA had an unfulfilled opportunity to provide the enterprises with guidance about effectively pursuing and collecting deficiencies from borrowers who may possess the ability to repay. This audit's objective focuses in more detail on Fannie Mae's deficiency recovery processes for borrowers who possess the ability to pay amounts owed on mortgages owned or guaranteed by the enterprise.

OIG found that Fannie Mae's deficiency collection vendors (vendors) unecessarily limited their pursuit of borrowers with the ability to repay. Specifically, Fannie Mae's vendors generally did not pursue deficiencies on foreclosure sales when, in their view, applicable statutes of limitation for filing deficiency claims against borrowers provided insufficient time to obtain the necessary information from servicers and foreclosure attorneys to evaluate if deficiency balances existed.

From January 2010 to June 2012, Fannie Mae's vendors excluded from pursuit or ceased action on 44,652 foreclosure sales (also referred to as "accounts" in this report) because states' statutes of limitation for pursuing the deficiencies expired or were about to expire. Of the 44,652 foreclosure sales, Fannie Mae's vendors reviewed 14,960 foreclosures and confirmed the existence of deficiency balances, before ceasing action to pursue these deficiencies. It is likely that only a portion of these deficiencies may be recoverable, as many borrowers likely do not possess the ability to repay. Further, the deficiency vendors did not pursue or estimate the total deficiencies on the remaining 29,692 accounts because the statutes of limitation expired before the vendor could gather the necessary information to review the accounts and calculate the deficiency balances.

OIG believes that FHFA and Fannie Mae are in a position to improve vendors' ability to act within the timeframes set by statutes of limitations, even those in the 10 states with the shortest statutes of limitation, by having vendors more quickly assemble documents and information needed (before and after foreclosure) to evaluate and pursue borrowers with the ability to repay deficiencies, particularly strategic defaulters.

Therefore, OIG recommends that FHFA direct Fannie Mae to strengthen controls over deficiency collections by more fully considering timeframes provided by states' statutes of limitation in prioritizing, coordinating, and monitoring collection of deficiencies from borrowers with the ability to repay. FHFA provided comments agreeing with the recommendation in this report.

Background

If a borrower experiences a foreclosure sale and the sale's proceeds are less than the borrower's unpaid mortgage loan balance,[3] the shortfall results in a deficiency.[4] Between October 2008 and

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[2] OIG, *FHFA's Oversight of the Enterprises' Efforts to Recover Losses from Foreclosure Sales* (AUD-2013-001, October 17, 2012); available at http://www.fhfaoig.gov/Content/Files/AUD-2013-001.pdf.

[3] The unpaid mortgage balance can include accrued interest and other fees.

[4] A short sale or deed-in-lieu of foreclosure could also result in a deficiency.

December 2012, Fannie Mae acquired 802,868 foreclosed properties that were secured by loans it owned or guaranteed. As of December 2012, Fannie Mae owned 105,666 foreclosed properties with a carrying value of $9.5 billion. At that time, it also had substantial shadow inventory: over 576,000 seriously delinquent mortgages with payments that were 90 days or more delinquent—many of which are likely foreclosure candidates.

Deficiency Recovery Overview

Although a deficiency can stem from a foreclosure, short sale,[5] or a deed-in-lieu of foreclosure,[6] for purposes of this report, OIG will outline the deficiency process associated with foreclosures.

A deficiency typically is established based on what occurs during a foreclosure sale. At such a sale, the highest bidder acquires the property. If a foreclosure sale's proceeds are less than the borrower's mortgage loan balance, Fannie Mae absorbs the shortfall, or deficiency, as a loss. Fannie Mae sends new foreclosures on a monthly basis to its vendors so they can begin evaluating and pursuing such deficiencies from borrowers who can repay based on information available at the time of the foreclosure sale.

In an effort to recoup some of these losses, Fannie Mae can direct vendors to pursue voluntary collections from borrowers with the ability to repay or to obtain court-ordered deficiency judgments. Fannie Mae's vendors pursue deficiency recoveries on foreclosure sales whether the property was taken into Fannie Mae's real estate owned inventory or sold to other buyers.

Several factors influence the decision to pursue deficiency recoveries. In particular, state laws dictate the timeline for filing a deficiency claim or may prohibit the collection of deficiencies. The statute of limitations establishes the period during which a creditor can sue a debtor or borrower in this case. Each state has its own statute of limitations. If the statute of limitation has expired, then the payment of the debt owed cannot be enforced through the courts.

Deficiency Recovery Practices

There are multiple players and steps in the deficiency recovery process. They include:

- Servicers, who collect monthly mortgage payments from borrowers;
- Attorneys, who assist servicers with the foreclosure process;
- The enterprise, who owned or guaranteed the mortgage on the foreclosed property and oversees vendors performing recovery services; and
- Vendors, who evaluate the collectability of the deficiencies and pursue recoveries.

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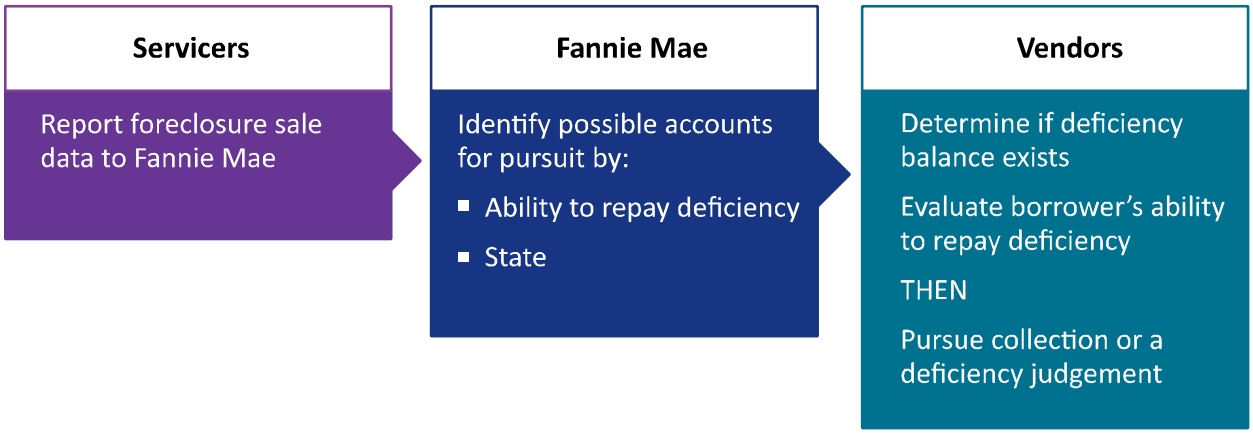
[5] A short sale is the sale of a mortgaged property at a price that nets less than the total amount due on the mortgage (e.g., the sum of the unpaid principal balance, accrued interest, advanced escrows, late fees, and delinquency charges). The servicer and borrower negotiate payment of the difference between the net sales price and the total amount due on the mortgage.

[6] A deed-in-lieu of foreclosure is a transaction in which the borrower surrenders the deed to the property associated with the mortgage agreement. As implied by the title, a deed-in-lieu of foreclosure does just that – it avoids foreclosure.

Figure 1 summarizes the deficiency recovery process, and the following paragraphs provide further details.

Figure 1: Deficiency Recovery Overview



Source: OIG analysis of Fannie Mae's and its vendors' policies and practices.

The first two steps in Fannie Mae's deficiency recovery process involve obtaining and analyzing foreclosure data. First, servicers send foreclosure data to Fannie Mae monthly. This data reflects the work of the servicers and foreclosure attorneys when foreclosing mortgages on which borrowers have defaulted. They collect and maintain documentation on the property, borrower financial condition, and cause of the default. Second, Fannie Mae filters this data to identify borrowers who may have the ability to repay deficiencies, and it also considers factors such as applicable state laws, foreclosure timeframes, and costs to pursue recovery. Based on that analysis, Fannie Mae has its vendors pursue deficiency recoveries in 38 states and the District of Columbia; the remaining states are excluded due to state laws restricting deficiency recoveries. Fannie Mae established deficiency collection procedures to filter this monthly data and to provide direction to vendors specifically to target potential strategic defaulters whom Fannie Mae believes have the ability to repay.[7]

The last two steps in the deficiency recovery process are driven by Fannie Mae's vendors. First, the vendor must determine if a deficiency balance exists. Determining the amount of the deficiency balance requires the vendor to obtain information from the servicer and foreclosure attorney, such as the amount that was bid at the foreclosure sale, the unpaid mortgage balance, and the amount of mortgage insurance coverage, among other things. Based on OIG's analysis of data from Fannie Mae's vendors, from January 2010 through June 2012, over 26,000 borrowers were determined to owe deficiency amounts averaging approximately $79,000 per mortgage. Second, if a deficiency exists, the vendor evaluates the borrower's ability to repay the deficiency by reviewing the borrower's specific circumstances, including assessing open credit lines and assets, analyzing income and expenses, and interacting and negotiating with the borrower. The

[7] Fannie Mae's strategic default methodology uses a borrower's credit history and the characteristics of the loan and property to determine if a borrower is a potential strategic defaulter.

vendor also considers other factors such as state antideficiency laws that preclude collection, death or imprisonment of the borrower, presence of guarantors, and the borrower filing for bankruptcy.

In light of several of the reasons noted above, the vendors' recoveries on Fannie Mae's deficiencies have historically been low. Further, successfully recovering deficiencies takes time. Between state requirements and individual borrower circumstances, the timeframe it takes to recover a deficiency typically ranges from months to years, according to Fannie Mae's vendors.

In some states, deficiencies are allowed but are subject to short statutes of limitation ranging from 30 to 180 days after a foreclosure sale. According to Fannie Mae's vendors, these short statutes of limitation exist in 10 states and are a factor considered when deciding whether to pursue recovery. OIG believes that assembling this information early in the process and upfront coordination (before and after foreclosure) among servicers, foreclosure attorneys, and collection vendors may improve their ability to pursue borrowers with the ability to repay, particularly in the 10 states that have short statutes of limitations, and thus may serve as a deterrent effect to those considering strategic default. One way Fannie Mae has identified to increase the potential for recovery from strategic defaulters in such states is to enhance upfront coordination among servicers, foreclosure attorneys, and collection vendors. Fannie Mae has relationships with the servicers and foreclosure attorneys who initiate and complete the foreclosures, as well as with the vendors who evaluate and pursue recoveries of deficiencies. Leveraging the relationships among the parties, and monitoring their coordinated efforts, can contribute to collection efforts.

Objective

This audit's objective was to assess FHFA's oversight of the effectiveness of Fannie Mae's deficiency recovery process for borrowers who possess the ability to repay their deficiencies.

Finding: Fannie Mae Needs to Establish Monitoring Controls to Prioritize Its Vendors' Collection Efforts

In June 2010, Fannie Mae announced it would take action to recover deficiencies, where allowed, from strategic defaulters who have the ability to pay their mortgages but default anyway.[8] According to a Fannie Mae official, the main driver for focusing on strategic defaulters is achieving greater recoveries and avoiding the reputational risk associated with pursuing those without the means to repay deficiencies. OIG found that there is opportunity for improvement in FHFA's oversight and the enterprise's procedures.

From an oversight standpoint, recovering deficiencies from borrowers who have the ability to repay is consistent with FHFA's conservatorship mandate. As conservator of the enterprises, FHFA is responsible for taking actions both to put the enterprises in a sound and solvent condition and to preserve and conserve their assets and property. Maximizing deficiency

[8] Fannie Mae, News Release, "Fannie Mae Increases Penalties for Borrowers Who Walk Away: Seven-Year Lockout Policy for Strategic Defaulters" (June 23, 2010); accessed July 17, 2013, at: http://www.fanniemae.com/portal/about-us/media/corporate-news/2010/5071.html.

recoveries from borrowers with the ability to repay such deficiencies is one means of potentially conserving and preserving Fannie Mae's assets.

Additionally, from Fannie Mae's standpoint, having the proper internal controls helps mitigate risks. The Committee of Sponsoring Organizations of the Treadway Commission (COSO)[9] established an internal control framework that is widely used in publicly traded corporations, such as Fannie Mae.[10] This framework applies to deficiency recoveries because collections are revenue that offset recorded losses and impact financial reporting.

Monitoring is one of five control standards within the control framework. COSO requires that management monitor internal controls, whether through ongoing monitoring activities, separate evaluations, or a combination of the two. Through monitoring, an entity can ensure internal controls are properly designed and operating effectively as intended. FHFA needs to ensure Fannie Mae establishes additional monitoring controls to pursue deficiency recoveries from borrowers with the ability to repay, taking into consideration the timeframes in states' statutes of limitation.

Although Fannie Mae started taking steps in 2010 to improve its deficiency recovery processes, OIG still found opportunity for improvement. For example, Fannie Mae monitored the general status of the vendors' recovery processes by relying on high-level summary reports and periodic status calls to obtain information about its vendors' recovery efforts. However, Fannie Mae did not have adequate monitoring controls to ensure that it prioritized collection efforts in those cases where borrowers have the ability to repay and where states' statutes of limitation for pursuing claims against the borrowers require prompt action. Prompt, coordinated action among servicers, foreclosure attorneys, and vendors pursuing collection can enhance deterrence and increase opportunities to reduce losses on foreclosed mortgages.

One of the primary reasons vendors were unable to pursue deficiency collections for 44,652 foreclosure sales from borrowers who may have had the ability to repay was delay in receipt of required information from servicers and foreclosure attorneys. In order to address problems caused by delay in vendor receipt of documentation, Fannie Mae should establish monitoring controls to ensure possible strategic defaulters are identified and priority is placed on providing vendors the necessary information to pursue collection and provide overall visibility to the foreclosure process.

Additionally, Fannie Mae did not issue a servicer directive on pursuit of strategic defaulters until August 2012, and the directive only went to selected servicers. In particular, the directive makes clear the responsibilities of the servicer to support the deficiency recovery process and

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[9] COSO was organized in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent, private-sector initiative that studied the causal factors that can lead to fraudulent financial reporting. It also developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.

[10] According to its 2012 annual filings with the SEC, Fannie Mae's management assessed the effectiveness of internal controls over financial reporting as of December 31, 2012. In making its assessment, management used the criteria established in the Internal Control-Integrated Framework issued by COSO.

specifically to flag potential strategic default loans at the time of referral for foreclosure. However, the directive did not fully address the level of servicer coordination needed with other parties in the foreclosure process or prioritize potential foreclosures in consideration of factors such as ability to repay and state statutes of limitation.

During the period of January 2010 through June 2012, Fannie Mae properties were subject to 595,128 foreclosures totaling $410 billion in unpaid principal balance. Of this number, Fannie Mae did not send its vendors 301,994 foreclosures for various reasons, including state laws that prohibit pursuit and borrowers who did not meet Fannie Mae's strategic default criteria. For the same time period, Fannie Mae sent the remaining 293,134 foreclosures to its vendors. However, Fannie Mae's vendors did not pursue any portion of the deficiencies on 14,960 vendor-reviewed accounts or on another 29,692 accounts for which no action was taken because the statutes of limitation expired or were about to expire. Only a portion of these deficiencies may be recoverable, as many borrowers likely do not possess the ability to repay.

According to Fannie Mae's vendors, they generally did not pursue deficiency recoveries in the 10 states that had short statutes of limitation because of insufficient time to obtain the necessary information from servicers and foreclosure attorneys to evaluate if a deficiency balance existed. If servicers actively monitor and refer to the foreclosure attorneys delinquent loans with patterns indicative of strategic defaulters, this additional information could assist Fannie Mae in prioritizing such cases that proceed to foreclosure sale. OIG believes greater information sharing and improved coordination among the parties before and after a foreclosure sale could provide the vendors more time—in consideration of states' statutes of limitation—to evaluate and initiate pursuit of deficiencies.

Conclusion

By not implementing adequate monitoring controls to identify deficiency accounts that require special attention because of short statutes of limitation, Fannie Mae lost opportunities to pursue deficiencies on accounts referred to vendors. Absent prioritization by Fannie Mae, vendors did not collect the necessary information to determine deficiency balances on 29,692 accounts and were not successful in pursuing recoveries on another 14,960 accounts before statutes of limitation expired. Fannie Mae can potentially achieve additional recoveries on foreclosures and further deter those who might otherwise consider strategic default by (1) flagging potential strategic defaulters early in the foreclosure process; (2) coordinating and prioritizing collection action among the servicers, foreclosure attorneys, and collection vendors; and (3) monitoring the overall foreclosure process.

Recommendation

OIG recommends that FHFA direct Fannie Mae to strengthen controls over deficiency collections by more fully considering timeframes provided by states' statutes of limitation in prioritizing, coordinating, and monitoring collection of deficiencies from borrowers with the ability to repay.

Scope and Methodology

In order to accomplish our objective, OIG:

- Surveyed federal agencies and private financial services institutions for best practices in deficiency recoveries;
- Interviewed enterprise officials and reviewed enterprise deficiency management processes, procedures, servicing guides, and related documents;
- Analyzed the enterprise's deficiency loan data and other mortgage data associated with borrowers who had deficiencies; and
- Interviewed the enterprise's collection vendors and reviewed their deficiency management documents and reports.

OIG conducted its fieldwork at FHFA's offices in Washington, D.C., and Fannie Mae's corporate offices in Washington, D.C. The scope of the audit was January 2010 through June 2012, and was expanded as necessary to obtain more current data for reporting purposes.

We assessed the reliability of data received for this audit as determined necessary by corroborating the information with publicly available reports and with other source data.

OIG assessed the internal controls related to the audit objective. Specifically, OIG evaluated the following control standards that were significant to the audit objective: control activities, information and communication, and monitoring. Based on the work completed on this performance audit, OIG considers its finding regarding the lack of Fannie Mae's monitoring of foreclosed loans in consideration of state statutes of limitation to be significant in the context of the audit objective. Additionally, other less significant matters that came to OIG's attention during the audit will be communicated separately to FHFA in an audit memorandum.

OIG performed fieldwork for this audit from September 2012 through June 2013 in accordance with generally accepted government auditing standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusions included herein, based on the audit objective.

Attachments: Attachment A, FHFA's Comments
Attachment B, OIG's Response to FHFA's Comments
Attachment C, Summary of Management's Comments on the Recommendation

Attachment A

FHFA's Comments

Federal Housing Finance Agency

MEMORANDUM

TO: Russell A. Rau, Deputy Inspector General for Audits

FROM: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation

SUBJECT: Audit Report: FHFA's Oversight of Fannie Mae's Recoveries from Defaulting Borrowers Who Possess the Ability to Repay Their Deficiencies (Assignment No. AUD-2012-019)

DATE: August 9, 2013

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendation in the report prepared by FHFA-OIG, *FHFA's Oversight of Fannie Mae's Recoveries from Defaulting Borrowers Who Possess the Ability to Repay Their Deficiencies (Assignment No. AUD-2012-019).* We appreciate the opportunity to provide feedback on this draft report and the FHFA-OIG findings.

FHFA concurs with the importance the report accords to minimizing the impact to credit losses from foreclosures, with a focus on borrowers engaging in strategic default. The report recognizes the impact of the legal prohibition against deficiency judgments in twelve states, the short statutes of limitations in ten states, and the resulting limitations on Fannie Mae's ability to fully recover of mortgage principal and other owed amounts. Current deficiency recovery processes in the remaining states present further challenges because the majority of borrowers do not have the financial ability to repay the deficiency balance and there is inherent reputation risk of a collection activity following a home foreclosure.

The report indicates the potential for an additional $1B in deficiency balances in the ten states with short statutes of limitations. However, historical recovery experience indicates that potential additional recoveries would be substantially less than that amount. In addition, Fannie Mae may have limited ability to make future operational changes necessary to collect deficiency judgments in the ten states after taking into full consideration the cost/benefit constraint.

FHFA-OIG recommends that FHFA: Direct Fannie Mae to strengthen controls over the deficiency collections by more fully considering timeframes provided by states' statutes of limitation in prioritizing, coordinating and monitoring collection of deficiencies from borrowers with ability to repay.

Management Response: Agree. FHFA is already in discussions with Fannie Mae to identify ways to improve the deficiency recovery process. We anticipate these efforts will be completed by January 31, 2014. The focus of FHFA's efforts will be on requesting Fannie Mae to develop a plan that identifies ways to attempt deficiency recoveries and prioritize efforts in a way that (i) considers states' statutes of limitations; recognizes that potential economic benefits should exceed anticipated costs of any additional efforts; (iii) is consistent with practices utilized throughout the financial services industry; and (iv) takes into account potential reputational risks associated with recoveries following foreclosures.

cc: Richard Hornsby, Chief Operating Officer
Mark Kinsey, Chief Financial Officer
John Major, Internal Controls and Audit Follow-Up Manager

Attachment B

OIG's Response to FHFA's Comments

FHFA provided comments to a draft of this report, agreeing with our recommendation and identifying specific actions it would take to address the recommendation. FHFA stated that it concurs with the importance this report places on minimizing credit losses from borrowers engaging in strategic default. OIG considers the proposed actions sufficient to resolve the recommendation, which will remain open until OIG determines that the agreed actions are completed and responsive to the recommendation. OIG considered the agency's full response (attached as Appendix A), along with technical comments, in finalizing this report. Appendix C provides a summary of management's comments on the recommendation and the status of agreed-upon corrective actions.

Importantly, in its response to a related OIG audit report on FHFA's oversight of Freddie Mac's deficiency recoveries, FHFA agreed to issue an Advisory Bulletin regarding deficiency balances including requirements for both enterprises to (a) maintain formal policies and procedures for managing their deficiency collection processes for borrowers that strategically default on their mortgage obligations; (b) establish controls to monitor the activities of all counterparties involved in deficiency balance management to ensure that deficiency balance management processes are timely, effective, and efficient; and (c) comply with the applicable state statute of limitations in order to preserve the ability to pursue collection. This Advisory Bulletin was issued on September 16, 2013.

FHFA also agreed in response to the other audit report that the Division of Enterprise Regulation will develop and implement ongoing monitoring procedures to assess the effectiveness of the enterprises' deficiency judgment process on a periodic basis, including (a) evaluation of efficient and effective deficiency recovery strategies; (b) enterprise monitoring controls over its servicers, foreclosure attorneys, and collection vendors; and (c) assessment of implementation by the enterprises of the Advisory Bulletin provisions relating to timely document handling and other provisions. This action will also strengthen oversight at Fannie Mae.

Attachment C

Summary of Management's Comments on the Recommendation

This table presents the management response to the recommendation in OIG's report and the status of the recommendation as of when the report was issued.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits ($ Millions)	Resolved: Yes or No [a]	Open or Closed[b]
1	Develop a plan to prioritize the pursuit of deficiency recoveries, considering (1) state statutes of limitation; (2) costs and benefits of such pursuit; (3) financial services industry practices; and (4) reputational risk.	01/31/2014	$0	Yes	Open

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to the OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

[b] Once OIG determines that the agreed-upon corrective actions have been completed and are responsive, the recommendation can be closed.

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