Fannie Mae's Controls Over Short Sale Eligibility Determinations Should be Strengthened

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FEDERAL HOUSING FINANCE AGENCY
FHFA OIG
OFFICE OF INSPECTOR GENERAL

Synopsis

November 20, 2013

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Why OIG Did This Report

The Federal Housing Finance Agency (FHFA or Agency) currently serves as both regulator and conservator of the Federal National Mortgage Association (Fannie Mae or Enterprise) and the Federal Home Loan Mortgage Corporation (Freddie Mac). As conservator, FHFA's responsibilities are to preserve and conserve Fannie Mae's assets. Short sales are part of Fannie Mae's loss mitigation strategy to pursue foreclosure alternatives in order to help minimize the severity of losses it incurs as a result of loan defaults. Fannie Mae depends upon its servicers to collect financial information from borrowers and utilize that information to consider whether borrowers are eligible for a short sale. During 2012, Fannie Mae and its servicers approved over 73,000 short sales.

The objective of this performance audit was to assess FHFA's oversight of Fannie Mae's controls over borrower eligibility requirements applicable to its short sale program.

What OIG Found

A short sale of real estate occurs when the proceeds from a property sale fall short of the amount owed on mortgages secured by the property. As part of the selling process, lenders typically release borrowers from the full amount of liens on the property. For loans owned or guaranteed by Fannie Mae, the Enterprise requires approval of the short sale since it incurs any resulting loss.

Borrowers may be eligible for a short sale if they are experiencing a financial hardship that prevents them from making their mortgage payments and can be expected to have difficulty in selling their homes because the current value is less than the amount owed on the mortgage. Fannie Mae relies on its servicers – those entities contractually required to perform servicing functions such as collection of payments and responding to loan delinquencies on behalf of Fannie Mae – to obtain the information needed to determine whether a borrower is eligible for a short sale. The servicers request that potentially distressed borrowers complete the Uniform Borrower Assistance Form (UBAF) identifying their financial hardship and provide supporting documentation for all income, expenses, and assets. Furthermore, Fannie Mae relies on its servicers to review this documentation. Depending on the level of authority delegated by Fannie Mae, servicers will either make the borrower eligibility determination for Fannie Mae or collect and review the required information and forward this information to the Enterprise for further consideration.

Based on a review of 41 short sale transactions involving multiple Fannie Mae servicers, OIG found that five servicers, which accounted for 34% of Fannie Mae's short sales during 2012, were not always collecting all of the required documentation before making borrower eligibility determinations or forwarding the information to Fannie Mae when seeking required approvals. Also, servicers did not always conduct

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adequate reviews supporting borrower eligibility determinations. For example, servicers identified but did not pursue missing documentation and therefore, could not perform a complete borrower eligibility review. In other cases, discrepancies between financial information reported on the borrower's UBAF and supporting documentation identified in the course of servicer reviews were left unresolved. Regardless of these circumstances, the short sales were approved. Further, Fannie Mae and its servicers did not ensure that borrower eligibility information stored within Fannie Mae's system of record, the Distressed Assets Reporting and Tracking System (DARTS), was accurate. This system is intended to provide Fannie Mae key information to make borrower eligibility decisions or evaluate decisions made by its servicers.

OIG also found that borrowers with potentially significant financial resources sold multiple non-owner occupied properties through Fannie Mae's Low FICO Program (now called the Streamlined Documentation Program). This program allows servicers to approve short sales without collecting or reviewing any further eligibility information about the borrower, including a UBAF and supporting documentation, if the borrower has a FICO score of less than 620 and is at least 90 days delinquent on the subject loan. OIG concluded that this policy should be reviewed by FHFA to determine whether it should apply to borrowers with mortgage loans secured by non-owner occupied properties, who may not experience the requisite financial hardship that would justify a short sale.

What OIG Recommends

FHFA should direct Fannie Mae to take the following actions to strengthen controls over short sales: (1) enforce the requirement that all borrowers not eligible for the Streamlined Documentation Program provide a borrower-certified UBAF and supporting documentation in order to make eligibility determinations and assess borrower contributions; (2) establish controls to identify and resolve inconsistencies between the UBAF and supporting information used in making short sale eligibility determinations; (3) assess its servicer compensation structure to determine if it should consider the quality of borrower eligibility determinations for short sales and success in limiting losses, including through contributions by borrowers with the ability to pay; and (4) enhance controls over collection and use of electronic information from servicers on the financial condition of borrowers to ensure data is reliable and effectively used in both borrower eligibility and servicer performance evaluation processes.

Additionally, FHFA should (1) review the Streamlined Documentation Program to determine whether the program should be available to borrowers seeking approval to short sell non-owner occupied properties; and (2) provide examination coverage of Fannie Mae's short sale activities with particular emphasis on identifying systemic deficiencies related to borrower submissions, Enterprise eligibility determinations, servicer compensation structure, and reliability of electronic information used in managing short sales.

FHFA provided comments agreeing with these recommendations.

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ABBREVIATIONS ....

DARTS	Distressed Assets Reporting and Tracking System
Fannie Mae or Enterprise	Federal National Mortgage Association
FICO	Fair Isaac Corporation
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
HSSN	Home Saver Solutions Network
LMQC	Loss Mitigation Quality Control Review
MANP	Minimum Acceptable Net Proceeds
OIG	Federal Housing Finance Agency Office of Inspector General
REO	Real Estate Owned
SQR	Servicer Quality and Risk Review
UBAF	Uniform Borrower Assistance Form (Form 710)

PREFACE

The Housing and Economic Recovery Act of 2008 established the FHFA Office of Inspector General (OIG). OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations. As a result of OIG's work, it may recommend policies that promote economy and efficiency in administering FHFA's programs and operations, or that prevent and detect fraud and abuse in them.

Short sales are Fannie Mae's primary foreclosure alternative to mitigate losses, and this audit report is a part of OIG's proactive audit and evaluation strategy to assess the Agency's related oversight and conservatorship efforts. This audit focused on whether short sale eligibility determinations made by Fannie Mae and its servicers were sufficient to deter potential abuse by borrowers with the ability to continue making mortgage payments or make cash contributions to reduce losses on the sale.

From a limited sample of closed short sales reviewed, OIG found that Fannie Mae's controls over short sale eligibility determinations should be strengthened. OIG also found that borrowers with potentially significant financial resources sold multiple non-owner occupied properties through Fannie Mae's Low FICO Program (now called the Streamlined Documentation Program) without having to disclose their financial situation. This report's recommendations (along with those in prior reports) can increase FHFA's assurance that the Enterprises are operating safely and soundly, and that their assets are being preserved and conserved.

OIG appreciates the cooperation of everyone who contributed to this audit, including officials at Fannie Mae and FHFA. This audit was led by Laura Benton, Audit Director, and Scott Smith, Audit Manager, who were assisted by Cairo Carr, Auditor-in-Charge, Chris Sim, Senior Auditor, Monica Graves, Senior Auditor, and Mendy Breitkopf, Auditor.

This audit report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on OIG's website, www.fhfaoig.gov.

Russell A. Rau
Deputy Inspector General for Audits

CONTEXT

Introduction to Short Sales

Short sales, also known as pre-foreclosure sales, are a part of Fannie Mae's strategy to pursue foreclosure alternatives in order to help minimize the severity of the losses it incurs as a result of loan defaults. Fannie Mae relies on its mortgage servicers to identify problem loans and offer appropriate workout options to distressed borrowers. Servicers first look at available home retention solutions, such as loan modifications and forbearance plans, and then foreclosure alternatives, such as short sales and deed-in-lieu of foreclosure transactions, before proceeding with foreclosure. Fannie Mae's primary foreclosure alternative is a short sale, accounting for 73,528 (83 percent) of the total completed foreclosure alternative transactions of 88,732 in 2012.[1]

In short sales, Fannie Mae's servicers work with borrowers to sell their homes prior to foreclosure. Even though the proceeds received from the sale fall short of the amount of debt secured by liens against the property, a short sale may be mutually beneficial to the borrower and Fannie Mae. For example, while a short sale most often results in a loss to Fannie Mae, the Enterprise has estimated the amount of loss in a short sale to generally be less than the losses associated with the foreclosure process.[2] Additionally, borrowers can benefit because while short sales are likely to adversely affect their credit ratings, the duration of credit impairment can be shorter.[3]

Regarding short sales, Fannie Mae has two categories of servicers – non-delegated and delegated. Non-delegated servicers have no authority to make short sale decisions on behalf of Fannie Mae. Their role is limited to collecting the information needed to determine whether the borrower is eligible for the program and forwarding it to Fannie Mae for consideration. Delegated servicers also collect needed information from the borrower but have been delegated authority by the Enterprise to make borrower eligibility determinations on behalf of Fannie Mae and complete short sales if the proceeds from the transaction meet Fannie Mae's

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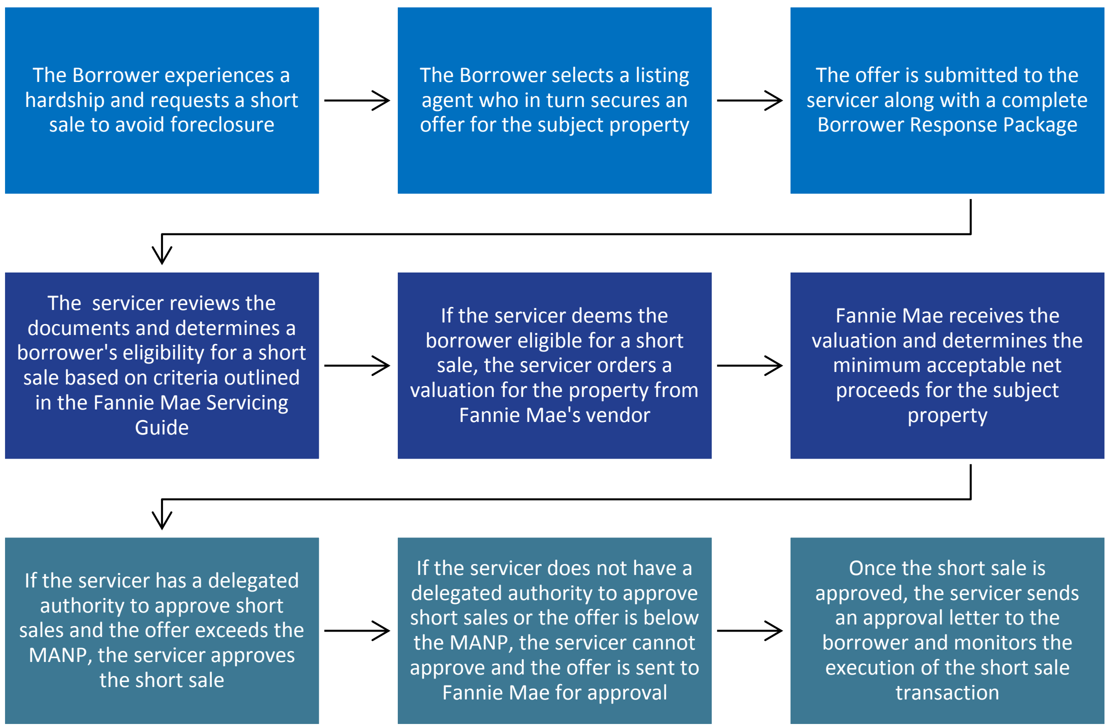
[1] See Table 47: Statistics of Single-Family Loan Workouts on pg. 135 of Fannie Mae's 2012 10-K http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/10k_2012.pdf. Further, this table indicates that the unpaid principal balance on Fannie Mae's completed short sales in 2012 was $15.9 billion.

[2] According to Fannie Mae, the average loss severity it experienced from short sales during 2012 was 38.7% of unpaid principal balance and 45% for real estate owned, which suggests a savings of 6.3% for properties liquidated through a short sale.

[3] Fannie Mae's Selling Guide provides that borrowers are not eligible for a Fannie Mae loan for at least two years after a short sale; by contrast, borrowers are required to meet a seven-year waiting period after a prior foreclosure to be eligible for a new mortgage loan eligible for sale to Fannie Mae.

Minimum Acceptable Net Proceeds (MANP).[4] However, delegated servicers must obtain Fannie Mae's approval for any short sale that does not meet the MANP requirement. See Figure 1 which depicts the process for a typical Fannie Mae short sale.

FIGURE 1. FANNIE MAE'S SHORT SALE APPROVAL PROCESS



Source: Figure 1 was derived from a Fannie Mae document that described its short sale process.

Fannie Mae's servicers are bound by the requirements detailed within Fannie Mae's Servicing Guide for processing short sale transactions. This guide also details the information that servicers are required to collect from borrowers to determine whether they are eligible for the short sale program.

Information Fannie Mae Requires its Servicers to Collect from Borrowers to Determine Eligibility

Part VII, Section 604 of Fannie Mae's 2012 Servicing Guide states that the servicer must identify those borrowers who are experiencing a financial hardship that prevents them from making their mortgage payments and who can be expected to have difficulty in selling their

[4] The servicer must obtain a Broker Price Opinion or appraisal through Fannie Mae's vendor list in order to obtain the Minimum Acceptable Net Proceeds (MANP) from Fannie Mae. MANP is the baseline value to be used by the servicer to establish a list price that is reflective of current market conditions. See Fannie Mae's Servicing Guide https://www.fanniemae.com/content/guide/svc031412.pdf, pg.706-118.

homes because the current value is probably less than the amount owed on the mortgage. Servicers are required to exhaust all other available means before discussing a pre-foreclosure sale with borrowers. After a potential candidate is identified, servicers must obtain and review a complete Borrower Response Package to determine if the borrower's financial hardship is the result of an involuntary reduction in income or an unavoidable increase in expenses.[5]

A Borrower Response Package includes a UBAF, also known as Form 710, and documentation that supports disclosures made within the UBAF. The UBAF requires that borrowers identify their hardship and provide information for <u>all</u> of their income, expenses, and assets. Required supporting documents include borrowers' most recent pay stubs, bank statements, and investment account statements. Also, depending upon borrowers' identified sources of income, a copy of a complete, signed individual federal income tax return may be required. Furthermore, the UBAF requires borrowers to make important certifications, representations, and agreements, including certifying that all of the information in the submission is truthful. However, borrowers do not need to meet these requirements if they qualify for the Low FICO Program (now called the Streamlined Documentation Program).[6]

To help ensure that its servicers comply with its Servicing Guide and evaluate workout decisions, annual reviews are performed under Fannie Mae's Servicer Quality and Risk Program (SQR) that were previously included in the Loss Mitigation Quality Control (LMQC) review programs. SQR is designed to evaluate servicers' compliance with the Fannie Mae Servicing Guide and loss mitigation program directives through a combination of loan level testing and a review of documented procedures. Prior to SQR, LMQC was established to evaluate the quality and control of workout decisions made by Fannie Mae servicers, and all workout solution compliance testing has since been incorporated into the SQR program. SQR and LMQC reviews of short sales typically include a review of all servicer and borrower documentation that is compared to information retrieved from Fannie Mae's systems.[7] The results of these reviews are used to identify process gaps that require further evaluation by the

[5] According to Fannie Mae's Servicing Guide, hardships can include death or long-term disability of a borrower, unemployment, divorce or separation, natural or man-made disaster, and other reductions in income or increases in expenses.

[6] The Fannie Mae Low FICO Program, which is targeted at borrowers with Low FICO scores, exempts qualified borrowers from having to provide financial information, including a UBAF and supporting documentation. See Finding 2 on page 18 for a discussion of the Low FICO Program within the context of short sales.

[7] Fannie Mae's servicers enter this information into Fannie Mae's Home Saver Solutions Network System (HSSN), a data entry portal that populates another Fannie Mae system, the Distressed Assets Reporting and Tracking System (DARTS).

servicer and apply appropriate corrective action for adherence to the stated guidance. Fannie Mae's top servicers were included within the scope of the SQR reviews.[8]

Changes to Fannie Mae's Short Sale Program that Resulted from the Implementation of FHFA's Directive

FHFA issued a directive dated April 17, 2012, that required the Enterprises to work together to align policies and practices in the area of liquidation alternatives, including short sales. This directive is broad and identifies the areas of alignment as eligibility, solicitation, documentation simplification, improved listing guidance, evaluation, response time frames, payments to subordinate lien holders, mortgage insurance delegations, and fraud prevention.

Fannie Mae's implementation of this directive included a number of changes to the short sale program. In particular, Fannie Mae's guidance directed servicers to release the borrower from liability for any deficiency associated with the Fannie Mae mortgage upon successful completion of the short sale. However, servicers were required to evaluate certain borrowers for a cash contribution as part of approving the short sale.[9] Fannie Mae's guidance also excluded certain borrowers from consideration for cash contributions to short sale transactions where: (1) applicable law prohibits borrower contributions; (2) the borrower qualifies for streamlined documentation; or (3) the borrower is an active duty military service member and meets certain requirements.

Additionally, Fannie Mae's guidance provided that all servicers, not just those with delegated authority to make eligibility determinations, were permitted to process short sales for borrowers considered to be in imminent default (defined as less than 31 days delinquent) with the following hardships: (1) death of a borrower or co-borrower; (2) long-term or permanent illness or disability of a borrower or co-borrower or dependent family member; (3) divorce or legal separation of a borrower or co-borrower; and (4) distant employment transfer/relocation. If one of these hardships occurred, no additional approval was needed from Fannie Mae, even if the borrowers were current on their mortgage payments. The mortgaged property had to be the borrower's principal residence, thus non-owner occupied properties were excluded from the imminent default procedures.

[8] During 2013, Fannie Mae selected its top 46 servicers. At a minimum, the top 15 servicers as defined by loan volume will have an SQR review performed annually.

[9] Fannie Mae required its servicers to evaluate whether borrowers requesting approval for a short sale were able to provide a cash contribution when their cash reserves were in excess of the greater of $10,000 or six times their monthly mortgage payment (including principal, interest, and tax and insurance). If servicers determined that borrowers had the capacity to make a cash contribution, they were required to initially request a contribution of 20% of borrowers' cash reserves. If borrowers had cash reserves of more than $50,000, servicers were required to forward the short sale request to Fannie Mae to determine the contribution amount and receive written approval of the amount determined by Fannie Mae.

Short Sales of Non-Owner Occupied Properties Is an Area of Heightened Risk for Fannie Mae

Fannie Mae has recognized the risk associated with borrowers who request approval to short sell non-owner occupied properties. In January 2011, Fannie Mae issued supplemental guidance to its servicers stating that, "Fannie Mae's approval is required to close a short sale without a contribution on an investment property or second home."[10] Nonetheless, until Fannie Mae implemented changes to its short sale program in November 2012, there were no controls in place to require servicers to determine an appropriate contribution amount based on a borrower's cash reserves or prevent a servicer from collecting a nominal cash contribution from a borrower to avoid securing approval from Fannie Mae on an investment property or second home.

[10] Short sales under the Low FICO Program were excluded from the contribution approval requirement.

FINDINGS ....

1. FHFA and Fannie Mae Controls Over Borrowers Seeking Approval for Short Sales Should be Strengthened

FHFA and Fannie Mae have taken action to shorten the timelines for processing short sales and create a standard short sale process to expedite assistance to borrowers. However, based on its assessment of controls and detailed reviews of a limited number of short sale transactions, OIG found that Fannie Mae's servicers were not:

- Collecting all of the required borrower eligibility documentation;
- Conducting adequate reviews supporting borrower eligibility determinations; or
- Ensuring the accuracy of borrower eligibility information stored in Fannie Mae's system of record, DARTS, which is the Distressed Assets Reporting and Tracking System.

During 2012, Fannie Mae closed over 73,000 short sales. OIG examined 41 short sales closed in 2012 by 10 borrowers who sold multiple non-owner occupied properties. [11] Eight Fannie Mae servicers, including three of its five largest, processed these short sales.

To conduct the review, OIG obtained copies of the servicers' files and reviewed the borrowers' financial information pertinent to making a borrower eligibility determination. After reviewing the servicers' files, OIG interviewed seven of the eight servicers with Fannie Mae's participation to obtain an understanding of their controls over determining borrower eligibility.[12] Furthermore, OIG accessed borrower eligibility data stored in Fannie Mae's DARTS system and compared that information to the borrower eligibility information in the servicers' files.

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[11] This group of 10 borrowers does not represent a statistically significant sample, and therefore, the results were not projected across the universe of short sales closed by the Enterprise in 2012. However, the results of OIG's testing of the 41 short sales (40 are of non-owner occupied properties) has resonance beyond these sampled transactions because the overall controls for borrower eligibility applicable to all short sales, including those in the OIG sample, were identical.

[12] Two of these servicers were subject to SQR reviews during 2012 and two additional servicers were subject to LMQC reviews during November 2011. The sample size for each of these reviews was 30 for three servicers and 15 for the remaining servicer. Pursuant to these reviews, Fannie Mae identified issues that were consistent with OIG's findings such as missing documentation including, but not limited to, the borrower's UBAF, income documentation, and tax return. Furthermore, Fannie Mae found that required information was either not uploaded to its system of record (DARTS) or that such information was not consistent with data in the servicer's system. Holistically, OIG notes that Fannie Mae identified issues related to making borrower eligibility determinations in 24 out of 29 servicer reviews, which suggests that the control deficiencies identified by OIG are not limited to the servicers responsible for the short sale transactions reviewed by OIG.

Figure 2 summarizes OIG's findings. For the 41 short sale loans reviewed:

- 8 were missing required supporting documentation from Borrower Response Packages in servicer files;
- 19 showed evidence of potential understatement of financial assets; and
- 21 had inconsistencies between borrower eligibility information communicated to Fannie Mae that is stored in DARTS and information supplied by the borrower.

FIGURE 2. RESULTS OF OIG'S REVIEW OF SHORT SALES FOR 10 BORROWERS WITH MULTIPLE SHORT SALES DURING 2012

Borrower No.	No. of Loans	Missing Required Documents	Potential Understatement of Financial Assets	Inconsistency Between Information Supplied by the Borrower and Received by Fannie Mae
Borrower 1	10		6	6
Borrower 2	7	2	2	2
Borrower 3	4			2
Borrower 4	3	3	3	3
Borrower 5	3		3	3
Borrower 6	2		2	2
Borrower 7	4			
Borrower 8	2			
Borrower 9	3			
Borrower 10	3	3	3	3
Totals	**41**	**8**	**19**	**21**

Source: OIG Analysis

The examples that follow were derived from OIG's review of 41 short sales identified in Figure 2 above.

Servicers' Files Were Missing Required Supporting Documentation for Borrower Eligibility Determinations

The key control utilized by Fannie Mae and its servicers to gather the information needed to make informed borrower eligibility determinations for short sales was the UBAF and supporting documentation. While Fannie Mae's Servicing Guide requires its servicers to obtain complete Borrower Response Packages to enable an assessment of borrowers' financial hardships and eligibility for short sales, servicers were not exercising due diligence in carrying out their responsibility to gather sufficient information to make sound eligibility determinations for certain short sales of non-owner occupied properties. In particular, for three borrowers with a total of eight short sales, servicers did not obtain all required financial information, including monthly income and expenses, financial and other assets, liabilities, and supporting documentation such as tax returns and bank statements. When financial information is missing or incomplete, it cannot be factored into the eligibility determination process or considered for the purpose of requesting a borrower contribution. When supporting documentation is missing, servicers are unable to assess whether borrowers have disclosed current, accurate, and complete information regarding their financial condition. In addition to incomplete financial information, OIG found that one borrower did not provide a UBAF or an acceptable equivalent that included required financial information and borrower certification that all of the information provided was accurate and complete.

Fannie Mae stated that as part of the information gathering process it expects servicers will follow up on missing documentation and any inconsistencies with information provided by the borrowers, but this is not always being done. Fannie Mae focuses primarily on the price negotiations in short sale transactions and does not thoroughly review its servicers' eligibility determinations prior to approval in cases where a delegated servicer makes the initial eligibility determination.

Potential Understatement of Borrowers' Financial Assets

Fannie Mae's servicers did not exercise prudent judgment and conduct necessary follow-up with borrowers when assessing whether the information in the Borrower Response Package fairly presented the borrower's financial condition. Specifically, for 6 borrowers approved for a total of 19 short sales, the UBAF and required supporting documentation contained information indicating that the borrower had considerable assets that were not pursued by Fannie Mae's servicers in the course of determining whether the borrower was eligible. For example, the borrowers claimed they had minimal assets or income, yet their tax returns reflected significant taxable interest income, dividends, and capital gains. Also, multiple transfers between bank accounts that in total significantly exceeded the borrower's stated income and assets did not receive the attention of some of Fannie Mae's servicers during the borrower eligibility determination process. This activity is problematic from a risk perspective because it suggests borrowers understated their income or financial assets. Additionally, although not required, these cases provide examples where it may be prudent for Fannie Mae's servicers to perform independent research to confirm the accuracy and completeness of the financial information provided by borrowers since it is what servicers rely upon to determine borrower eligibility.

Servicer interviews provided insight into why additional effort was not expended to follow up on indications of incomplete or inaccurate financial disclosures. One Fannie Mae servicer stated that it viewed every customer as being eligible for a short sale regardless of the eligibility determination process. Another servicer stated that borrowers were determined to be eligible based on the value of the property and offers submitted. Therefore, even high net worth individuals are eligible and the borrower financial information is only required to determine whether a borrower can make a contribution. Yet another servicer stated that if a borrower is seriously delinquent, only liquid assets are considered for the purpose of determining the need for a contribution and its amount.

Inconsistency Between Information Supplied by the Borrower and Received by Fannie Mae

Fannie Mae required its servicers to supply it with borrower eligibility information by entering data into HSSN, a data entry portal that populates DARTS with the information entered by servicers. Fannie Mae has not put in place adequate controls over these systems used to gather short sale data and support borrower eligibility decisions. Specifically, for 7 borrowers approved for a total of 21 short sales, borrower eligibility information provided by servicers to Fannie Mae to enable an assessment of the accuracy of the servicers' eligibility determinations (in delegated cases) or to make the eligibility determinations (in non-delegated cases) was not always accurate, complete, or reconcilable. The only borrower eligibility information that Fannie Mae typically received from its servicers was data entered into HSSN such as borrowers' hardships and information about their finances identified on the UBAF (e.g., income, expenses, assets, and liabilities). Supporting documents that borrowers supply to servicers, such as tax returns and bank statements that may be used to verify income and assets, are not provided to Fannie Mae unless it requests this documentation.

In certain instances, the information entered by the servicers into HSSN to populate the various data fields within DARTS was inconsistent with the supporting documentation in the servicers' files because different approaches were used to populate the various data fields (e.g., assets, income). For example, one servicer used an online tool to project borrowers' income and used discretion in deciding what information to enter into HSSN. Another servicer indicated that it gets borrower eligibility information verbally, which is then entered directly into Fannie Mae's system. In order to routinely validate borrower eligibility determinations and recommendations made by its servicers, Fannie Mae needs to establish additional controls to ensure data accuracy and completeness, including the identification and resolution of inconsistencies with supporting documentation.

Examples of Borrowers Approved for Short Sales of Non-Owner Occupied Properties

The following examples demonstrate the effect of a lack of due diligence on the part of Fannie Mae's servicers to obtain complete financial information in order to qualify borrowers.

Borrower 4 and a co-borrower were approved for three short sales within one year although the borrower failed to provide the required UBAF and report all financial information including bank accounts and investments. Also, the co-borrower provided tax returns that did not include pertinent pages and supporting schedules. Moreover, the borrower's reported financial hardship was based only on declines in property values, not an inability to repay the loans. The servicer did not follow up to obtain all missing documentation or establish the borrower’s eligibility based on his stated financial hardship. Based on an analysis of tax returns for 2008, 2009, and 2010, the borrowers appeared to have substantial assets and income. Losses on the three short sales totaled approximately $258,000.

Borrower 10, self-employed and owner of three real estate investing and property management companies, was approved for three short sales at the same time. The financial information included in the borrower’s UBAF and profit and loss statement, which reflected negative cash flow and monthly losses, could not be reconciled to the borrower’s substantial adjusted gross income reported in his individual federal tax return. Also, the borrower did not provide the servicer with required bank and securities account statements. Nonetheless, based on the servicer’s comments in DARTS, Fannie Mae advised the servicer to submit the three short sales for preforeclosure approval because of time constraints and not wanting to lose an all cash buyer for all three properties. In turn, Fannie Mae approved all three short sales. Fannie Mae explained that since the information submitted by the servicer showed the borrower had a monthly deficit and the loan was over 60 days delinquent at the time of submission, it agreed to move forward with the short sale without requesting a contribution from the borrower. Subsequent OIG analysis of publicly available information showed the borrower appeared to have significant unreported assets and had engaged in a number of recent real estate transactions including the sale and transfer of properties in Hawaii valued at over $3 million. Losses on the three short sales totaled approximately $874,000.

Lack of Incentives for Servicers to Exercise Due Diligence

Fannie Mae structures fees paid to servicers in a manner that encourages short sales. However, FHFA and Fannie Mae can enhance the servicer incentive structure to encourage servicers to exercise greater due diligence in carrying out their responsibilities to review and approve short sale requests. The servicers interviewed stated that the compensation received for closing short sales was about the same, regardless of whether a borrower contribution was collected. In fact, one Fannie Mae servicer indicated that it considered every borrower who requested a short sale to be eligible for the program and would not spend time trying to determine if a borrower had additional assets.

According to Fannie Mae’s Servicing Guide, the incentive fee is paid to non-delegated servicers based on the net proceeds from the short sale, which considers both contributions and promissory notes, but does not incentivize servicers to pursue more than 92 percent of those proceeds to the value of the property. At the 92 percent level, the maximum incentive fee of $1,500 is reached. For short sales with net proceeds to value less than 90 percent, a flat incentive fee of $1,000 is paid. The $500 spread between the incentive for top and bottom tier performance may not provide sufficient reward compared to the cost of analyzing borrower eligibility and pursuing contributions or promissory notes in short sales. For delegated servicers, there was a flat fee of $1,700 through June 2012 when a tiered structure was put in place based on the delinquency period. Shorter periods receive higher fees as an incentive to reduce losses by timely action on delinquent loans. Neither FHFA nor Fannie Mae has completed an assessment of these incentive structures, or the need for financial penalties, to determine whether these incentives are operating as intended, including deterring potential abuse of the short sale program. FHFA has commenced a Scorecard project reviewing incentives for both retention and liquidation solutions that will inform consideration of changes in 2014. Nonetheless, Fannie Mae may benefit from assessing its short sale compensation structure for servicers, including the need to focus on conducting thorough reviews as part of the eligibility determination and contribution assessment processes.

Lack of FHFA Oversight

FHFA has not performed any supervisory activities over Fannie Mae's short sale program. The Agency plans to look at collateral valuations used in single-family REO, foreclosure bidding, and short sale transactions along with associated fraud prevention processes. FHFA also plans to review the modeling methodology and procedures used in the valuation of distressed properties, including short sales, to ensure that they are reasonable. Nonetheless, there are no current plans to review Fannie Mae's borrower eligibility determination process for its short sale program.

2. The Low FICO Program May Not be Appropriate for Borrowers Seeking Approval for Short Sales of Non-Owner Occupied Properties

Fannie Mae's Low FICO Program was designed to exempt borrowers with poor credit from having to provide additional information on their financial condition and hardships in order to determine eligibility for short sales.[13] In the case of non-owner occupied properties, however, there may be greater potential that borrowers in fact have the ability to repay or make a contribution where allowed by applicable law to reduce the loss amount on the short sale. In such cases, the program may not be achieving its intended purpose.

Specifically, 6 of the 10 judgmentally selected borrowers had 20 short sales approved under the Low FICO Program. As discussed below, some of these borrowers appeared to have significant financial resources. There is sound justification as to why many distressed delinquent borrowers with low credit scores should be spared the burden of submitting extensive financial information for a short sale eligibility determination. Conversely, there is also justification for looking at those borrowers with greater potential for making

[13] Credit scores were determined by FICO and are numerical values that rank individuals according to their credit risk at a given point in time, as derived from a statistical evaluation of information in individuals' credit files.

contributions, such as those with loans secured by non-owner occupied properties, to deter strategic default and other abuses of the Low FICO Program and ensure borrower contributions are obtained where borrowers have the capacity to do so and it is not otherwise prohibited.

Fannie Mae's Low FICO Program and Streamlined Documentation Requirements

Fannie Mae initiated the Low FICO Program during January 2011. Under this program, servicers were authorized to approve short sale transactions where it may be difficult or time consuming to obtain all of the required financial documentation when the short sale otherwise met all other Fannie Mae requirements. For borrowers with FICO scores less than or equal to 620, the servicer was permitted to approve short sales of all properties, including non-owner occupied, without any further collection of financial documentation and without efforts to obtain a cash contribution or promissory note from the borrower as long as the borrower had a delinquency on the mortgage loan on the subject property and a delinquency on at least one other trade line. This program was initially available to Fannie Mae's delegated servicers and was documented through a supplement to their Delegations of Authority applicable to pre-foreclosure sale requirements, rather than within Fannie Mae's Servicing Guide.

As a control, Fannie Mae required servicers to check a monthly list of loans that are not eligible for the Low FICO Program before proceeding to qualify borrowers. One reason why loans would be on the list is that borrower credit utilization practices may indicate strategic default. Mortgage loans on the list that are not eligible for the Low FICO Program must go through the normal borrower financial and contribution reviews. However, none of the loans OIG reviewed were excluded from the Low FICO Program as a result of this control.

As a result of a directive from FHFA dated April 17, 2012, Fannie Mae expanded its Low FICO Program and relabeled it as the Streamlined Documentation Program. On August 22, 2012, Fannie Mae issued Servicing Guide Announcement SVC-2012-19, effective November 1, 2012, stating that all servicers, not just delegated servicers as previously authorized, may approve a borrower for a short sale without verifying the borrower's hardship or obtaining a complete Borrower Response Package if the borrower is 90 or more days delinquent as of the date of the servicer evaluation and the borrower's FICO credit score is less than 620. There is no exception to qualification for the Streamlined Documentation Program for borrowers who are requesting approval of short sales of non-owner occupied properties. As demonstrated by the examples below, servicers were not required to collect financial information from borrowers of non-owner occupied properties who may have had the means to continue making payments or provide borrower contributions. Additionally, in one case, the servicer had financial information indicating the borrower may have had financial resources, but did not inquire further since the borrower qualified for the Streamlined Documentation Program.

Examples of Borrowers Approved for Short Sales of Non-Owner Occupied Properties Under Fannie Mae's Low FICO Program

Borrower 2 [see Figure 2], a non-resident alien, was approved for seven short sales within one year based only on his income, expenses, and assets within the United States. The information provided by the borrower, through his attorney in fact, to support his financial hardship clearly stated "The owner does not derive any income in the United States, other than the rental revenue on his rental properties. This is a revenue statement for the subject property only." Five of these seven short sales qualified for the Low FICO Program and no documentation was required. For the remaining two short sales, the servicer did not inquire further to determine the individual's other sources of income and assets outside of the United States and reported to Fannie Mae in the DARTS system that the individual had no income and assets. OIG's research found that the subject borrower potentially could have considerable income and assets from financial interests outside the United States, yet approval was given for all seven short sales with losses totaling approximately $1.1 million.

Borrower 8 was approved for two short sales under Fannie Mae's Low FICO Program during 2012. Accordingly, this borrower was not required to provide any financial information to the servicer or Fannie Mae to secure approval for his short sales. However, OIG independently identified information that suggests this borrower had financial resources. Borrower 8 reported in his 2012 federal individual tax return proceeds of approximately $1.2 million from the purchase and sale of securities between June and October 2012. Losses to Fannie Mae on the two short sales totaled approximately $1,000,000.

Borrower 9 was approved for three short sales within one year, all under Fannie Mae's Low FICO Program. However, the borrower had provided the servicer with financial information that showed the borrower potentially had financial resources. Most notably, the borrower's reported annual income on his personal financial statement and bank deposits during a single month significantly exceeded the borrower's annual income reported on his UBAF. Although the servicer had this financial information, under the Low FICO Program the servicer was not required to follow up on the inconsistency. In fact, the servicer informed the OIG that it had identified the discrepancy, but due to withdrawals shown on the bank statements and the fact that it was under the Low FICO Program, they did not pursue the discrepancy any further. Losses on the three short sales totaled approximately $978,000.[14]

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[14] Fannie Mae has expressed concern over its ability to mitigate losses on properties located in California where the subject properties of Borrower 9 and Borrower 2 are located. Under California law, the collection of borrower contributions on short sales is prohibited. Fannie Mae could decline the short sales and pursue deficiency judgments under California state law by requiring the servicer to pursue judicial foreclosures. However, according to Fannie Mae, this would add significant delays by adding 270 days to the non-judicial foreclosure process and create a one year right of redemption for the homeowner. Through pursuing this course

Based on the above, FHFA should reassess its policy to determine whether the Streamlined Documentation Program should be available to borrowers seeking approval to short sell non-owner occupied properties.

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of action, Fannie Mae is not guaranteed a successful recovery as the judgment may not be collectible if the homeowner does not have any assets or declares bankruptcy. Nonetheless, 8 of these borrowers' 10 short sales qualified for the Low FICO Program and borrower contributions for such short sales are not collected, regardless of the state where the property is located.

CONCLUSION..

As demonstrated by the lack of controls and examples in this report, borrowers are completing short sales even though they may have the ability to continue making mortgage payments or make cash contributions to reduce losses on the sale. These borrowers should not have been deemed eligible for the program without further analysis by Fannie Mae's servicers and Fannie Mae. Deficiencies in controls regarding the Borrower Response Package (including a borrower-certified UBAF and supporting documentation), servicer incentive compensation, and data reliability collectively contributed to weaknesses in the overall borrower eligibility process. As a result, in 19 instances (46% of the 41 loans sampled), incomplete and inaccurate information was relied upon in qualifying the borrowers for short sales. Additionally, in 20 instances (49% of the loans sampled), Fannie Mae and its servicers did not require the borrower to supply any financial information and approved the short sales given that these loans qualified for the Low FICO Program, now referred to as the Streamlined Documentation Program. Fannie Mae estimated that the losses for the subject 39 loans total approximately \$5.3 million.[15]

Furthermore, Fannie Mae estimated that it incurred losses from short sales of the 10,310 non-owner occupied properties for 2012 totaling approximately \$953.5 million and losses of approximately \$6.392 billion for all 73,000 short sales closed during 2012. In particular, this suggests an even greater savings potential by strengthening borrower eligibility controls over short sales. Also, Fannie Mae can provide a stronger deterrent to borrowers looking to abuse the short sale program by focusing additional attention on borrowers seeking approval for short sales of non-owner occupied properties through the Streamlined Documentation Program. While short sales of non-owner occupied properties present heightened risk and were a focus of this audit, most borrower eligibility controls are common across all short sales. Thus, the deficiencies in controls identified can also relate to the remainder of Fannie Mae's short sale population. In this regard, additional FHFA oversight through its examination program is warranted.

OIG is planning targeted work related to other facets of the Enterprises' short sale process. The results of this work will help the Agency supervise this important area of loss mitigation.

[15] This estimate does not factor in potential losses that Fannie Mae could incur if the subject properties had gone into foreclosure.

RECOMMENDATIONS

OIG recommends that FHFA direct Fannie Mae to take the following actions to strengthen controls over short sales:

1. Enforce the requirement that all borrowers not eligible for the Streamlined Documentation Program provide a borrower-certified UBAF and supporting documentation in order to make eligibility determinations and assess borrower contributions.

2. Establish controls to identify and resolve inconsistencies between the UBAF and supporting information used in making short sale eligibility determinations.

3. Assess its servicer compensation structure to determine if it should consider the quality of borrower eligibility determinations for short sales and success in limiting losses including through contributions by borrowers with the ability to pay.

4. Enhance controls over collection and use of electronic information from servicers on the financial condition of borrowers to ensure data is reliable and effectively used in both borrower eligibility and servicer performance evaluation processes.

Finally, OIG recommends that FHFA:

5. Review the Streamlined Documentation Program to determine whether the program should be available to borrowers seeking approval to short sell non-owner occupied properties.

6. Provide examination coverage of Fannie Mae's short sale activities with particular emphasis on identifying systemic deficiencies related to borrower submissions, Enterprise eligibility determinations, servicer compensation structure, and reliability of electronic information used in managing short sales.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this performance audit was to assess FHFA's oversight of Fannie Mae's controls over borrower eligibility requirements applicable to its short sale program. The scope of this audit was FHFA's oversight of Fannie Mae's controls over making borrower eligibility determinations for short sales closed during 2012 and testing those controls against a limited, judgmentally selected sample of short sale transactions closed during 2012. OIG performed fieldwork for this audit from January 2013 through August 2013 in Washington, D.C., at FHFA's and Fannie Mae's headquarters, and in Dallas, TX at Fannie Mae's National Servicing Organization.

In order to achieve its audit objective, OIG:

- Reviewed FHFA's guidance to the Enterprises related to the short sale program;
- Reviewed Fannie Mae's policies and procedures related to the short sale process;
- Interviewed FHFA and Fannie Mae officials to further OIG's understanding of the short sale process, how borrower eligibility is determined, and the controls over the process;
- Selected a judgmental sample of 10 borrowers who had 41 short sales closed during 2012 that resulted in significant losses to Fannie Mae to test the process of determining borrower eligibility; selection was based on borrowers who closed multiple short sales of non-owner occupied properties and a diversity of property locations and servicers; and
- Interviewed seven Fannie Mae servicers to gain an understanding of their overall controls over borrower eligibility determinations as well as the process followed by each servicer in determining borrower eligibility for the judgmentally sampled short sales.

OIG also assessed the internal controls related to the audit objective. Internal controls are an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed on this performance audit, OIG considers deficiencies in FHFA's oversight of Fannie Mae's policies, procedures, and practices with respect to determining borrower eligibility for short sales to be significant in the context of the audit's objective.

OIG conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that OIG plan audits and obtain sufficient, appropriate evidence to provide a reasonable basis for audit findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on OIG's audit objective.

APPENDIX A ....

FHFA's Comments on FHFA-OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

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

FROM: Jon Greenlee, Deputy Director, Division of Enterprise Regulation
Sandra Thompson, Deputy Director, Division of Housing Mission and Goals

SUBJECT: Audit Report: Fannie Mae Controls Over Short Sales Eligibility Determination Should be Strengthened (Audit Assignment: AUD-2012-015)

DATE: Nov 1, 2013

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendation in the report prepared by FHFA-OIG, *Fannie Mae Controls Over Short Sales Eligibility Determination Should be Strengthened (Audit Assignment: AUD-2012-015)* We appreciate the opportunity to provide feedback on this draft report and the FHFA-OIG findings.

FHFA views short sales as an important alternative to foreclosure that often benefits both the homeowner and Fannie Mae. Short sales represent an important loss mitigation option for Fannie Mae with respect to borrowers who are not eligible for a home retention solution. Although a short sale represents a loss to Fannie Mae, the amount of the loss is less than would be incurred if the property went to foreclosure. Fannie Mae has established the Streamlined Documentation Program to assist with the management of a large volume of short sales and to ensure that eligibility determinations to participate in short sales are appropriate and fully documented. Fannie Mae also uses a Servicer Quality and Risk (SQR) review as its primary tool for evaluating servicer compliance with the Fannie Mae Servicing Guide requirements, including those related to short sales. As part of that process, loans are selected and reviewed to assess the level of compliance, and findings are evaluated and may require remediation on the part of the servicer to improve the level of compliance.

The report notes that the processes established by Fannie Mae are effective, with the exception of those investor owned properties identified during the FHFA-OIG review. FHFA is concerned that investors who own properties may have the ability to repay from sources other than the property, questioning the appropriateness of approving a short sale. As such, FHFA is working with the Enterprises to terminate the eligibility of investor owned properties from the Streamlined Short Sale option, which will substantially address the FHFA-OIG's findings and recommendations.

FHFA-OIG recommends that FHFA direct Fannie Mae to take the following actions to strengthen controls over short sales:

Recommendation 1: *Enforce the requirement that all borrowers not eligible for the Streamlined Documentation Program provide a borrower-certified UBAF and supporting documentation in order to make eligibility determinations and assess borrower contributions.*

Recommendation 2: *Establish controls to identify and resolve inconsistencies between the UBAF and supporting information used in making short sale eligibility determinations.*

Recommendation 4: *Enhance controls over collection and use of electronic information from servicers on the financial condition of borrowers to ensure data is reliable and effectively used in both borrower eligibility and servicer performance evaluation processes.*

Recommendation 6: *Provide examination coverage of Fannie Mae's short sales activities with particular emphasis on identifying systemic deficiencies related to borrower submissions, enterprise eligibility determinations, servicer compensation structure, and reliability of electronic information used in managing short sales.*

FHFA agrees with Recommendations 1, 2, 4, and 6, which all relate to the accurate and timely submission, maintenance, and controls over documentation and information used to administer the short sales program. FHFA views the SQR process as Fannie Mae's primary tool for determining servicer compliance as a first step in enforcing Servicing Guide requirements, which includes assessing servicer compliance with all requirements for the short sales program. DER is currently in the process of formulating its 2014 Supervision Strategy and examination plans, which includes considering examination of the SQR process. By January 1, 2014, DER will provide OIG with its plans for reviewing the SQR process as part of its 2014 Supervision Strategy and examination plans.

Recommendation 3: *Assess its servicer compensation structure to determine if it should consider the quality of borrower eligibility determinations for short sales and success in limiting losses including through contributions by borrowers with the ability to pay.*

FHFA agrees with Recommendation 3. FHFA already has underway a Scorecard project reviewing incentives for both retention and liquidation solutions. The current analysis will inform consideration of changes to liquidation incentives in 2014. FHFA will provide a list of incentive changes to be made as a result of that review, if any.

Recommendation 5: *Review the Low FICO Program (now called Streamlined Documentation Program) to determine whether the program should be available to borrowers seeking approval to short sell non-owner occupied properties.*

FHFA agrees with Recommendation 5. FHFA is working with the Enterprises to announce, by the end of this year, the termination of eligibility of investment property for the Streamline Short Sale option and anticipates this change will become effective during the first quarter of 2014.

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

APPENDIX B...

FHFA-OIG's Response to FHFA's Comments

On November 1, 2013, FHFA provided comments to a draft of this report, agreeing with OIG's recommendations and identifying actions it would take to address the recommendations.

FHFA provided a single response to recommendations 1, 2, 4, and 6 that it will consider an examination of Fannie Mae's SQR review process as it formulates the 2014 Supervisory Strategy and examination plan. FHFA views the SQR process as Fannie Mae's primary tool for determining servicer compliance with all requirements for the short sale program. Through conducting an examination of the SQR process or taking other appropriate measures if an examination is not planned, this action is responsive to recommendations 1 and 6, which call for enforcing the requirement that all borrowers not eligible for the Streamlined Documentation Program provide a borrower-certified UBAF and for providing examination coverage of Fannie Mae's short sale activities, respectively.

FHFA's response to recommendations 2 and 4 is potentially responsive. The SQR process is applied to servicers identified by Fannie Mae. Short sale transactions are selected after the fact and reviewed for compliance with the requirements of the short sale program. The SQR process in its current form does not focus on enhancing controls over the short sale process called for in recommendations 2 and 4. Recommendations 2 and 4 focus on establishing stronger controls during the eligibility determination process to identify and resolve inconsistent borrower information and ensure the reliability and effective use of electronic information on borrowers' financial condition. Therefore, FHFA's corrective actions should ensure controls over Fannie Mae's short sale eligibility determinations process are thoroughly reviewed to be fully responsive to recommendations 2 and 4. For example, feedback from SQR reviews could be used to design and implement needed borrower eligibility controls.

FHFA's response to recommendation 3 is responsive. FHFA will utilize analysis from its Scorecard project review currently underway to inform consideration of changes to liquidation incentives in 2014 and will provide OIG a list of any changes made as a result of its review.

In response to recommendation 5, FHFA and the Enterprises are working to announce, by year end, the termination of eligibility of investment property for the Streamline Short Sale option. FHFA anticipates this change to become effective during the first quarter of 2014. This action is responsive to recommendation 5 as it called for the Agency to review the

Streamlined Documentation Program to determine whether the program should be available to borrowers seeking approval to sell non-owner occupied properties.

OIG considers the planned actions sufficient to resolve the recommendations, which will remain open until OIG determines that the agreed-upon corrective actions are completed and responsive to the recommendations. 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 recommendations and the status of agreed-upon corrective actions.

APPENDIX C...

Summary of FHFA's Comments on the Recommendations

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

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved[a] Yes or No	Open or Closed[b]
1	DER is in the process of formulating its 2014 Supervisory Strategy and examination plans, which includes considering examination of the SQR process. DER will provide OIG with its plans for reviewing the SQR process as part of its 2014 Supervisory Strategy and examination plans by January 1, 2014.	01/01/2014	$0	Yes	Open
2	See corrective action for Recommendation 1.	01/01/2014	$0	Yes	Open
3	FHFA has underway a Scorecard project reviewing incentives for both retention and liquidation solutions. The current analysis will inform consideration of changes to liquidation incentives in 2014. FHFA will provide a list of incentive changes to be made as a result of that review if there are any.	09/30/2014	$0	Yes	Open
4	See corrective action for Recommendation 1.	01/01/2014	$0	Yes	Open
5	FHFA is working with the Enterprises to announce, by the end of this year, the termination of eligibility of investment property for the Streamline Short Sale option and anticipates this change will become effective during the first quarter of 2014.	03/31/2014	$0	Yes	Open
6	See corrective action for Recommendation 1.	01/01/2014	$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 recommendations can be closed.

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