Federal Housing Finance Agency
Office of Inspector General

FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages

Audit Report • AUD-2014-014 • July 1, 2014

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

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

July 1, 2014

TO: Nina Nichols, Acting Deputy Director for Enterprise Regulation

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

SUBJECT: Audit of FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages

Summary

Banks that traditionally service mortgage loans backed by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (the Enterprises) have been selling the rights to service troubled loans (e.g., delinquent or in default) in bulk to new companies specialized to handle them. Often, the Enterprises are engaged in such transfers to these nonbank special servicers. Nonbank special servicers currently hold approximately $1.4 trillion in mortgage servicing rights out of a nearly $10 trillion market. The companies' servicing business concentrates on these labor-intensive loans, so the Enterprises have approved such sales to limit resulting losses. However, these new servicers have less stringent regulatory and financial requirements than banks, so, as part of a review of problems identified with one such servicer, the Office of Inspector General (OIG) assessed the Federal Housing Finance Agency's (FHFA or Agency) controls to ensure the Enterprises monitor nonbank special servicer performance and mitigate related risks.

Overall, OIG concluded that while FHFA and the Enterprises have responded well to specific problems at nonbank special servicers, the Agency has not established a risk management process or overall oversight framework to handle some general risks posed by nonbank special servicers. These general risks include:

- Using short-term financing to buy servicing rights for troubled mortgage loans that may only begin to pay out after long-term work to resolve their difficulties. This practice can jeopardize the companies' operations and also the Enterprises' timely payment guarantees and reputation for loans they back; and

- Assuming responsibilities for servicing large volumes of mortgage loans that may be beyond what their infrastructures can handle. For example, of the 30 largest mortgage servicers, those that were not banks held a 17% share of the mortgage servicing

> market at the end of 2013, up from 9% at the end of 2012, and 6% at the end of 2011. This rise in nonbank special servicers has been accompanied by consumer complaints, lawsuits, and other regulatory actions as the servicers' workload outstrips their processing capacity.

As an example of such business practices putting the Enterprises' reputation and credit at risk, one nonbank special servicer has used short-term financing to acquire servicing rights on a large volume of Enterprise-backed, troubled mortgage loans. The servicer, though, lacked adequate infrastructure to handle the loans, which has led to consumer complaints and delayed payments to the Enterprises. In addition, the servicer was operating with limited credit availability, which increased the risk that it would not be able to fund its operations. In such a case, borrowers with Enterprise-backed mortgages may not have their loans properly serviced.

Such risks are amplified by nonbank special servicers operating without the same standards and regulation as banks that service mortgage loans. Specifically, the nonbank special servicers do not have the same capital requirements as a bank, which means they are more susceptible to economic downturns. Such downturns could substantially increase nonperforming loans that require servicer loss mitigation while at the same time impact the ability of the servicer to perform.

Several regulatory agencies, including FHFA, have identified some or all of these factors in raising concerns about the spiking volume of mortgage loans acquired by nonbank special servicers. However, the Agency has responded to issues with these servicers on a case-by-case basis. Going forward, FHFA can further enhance its oversight through a more consistent approach to nonbank special servicers. Therefore, OIG recommended that FHFA issue guidance on a risk management process for nonbank special servicers and develop a comprehensive, formal oversight framework to examine and mitigate the risks these nonbank special servicers pose. FHFA generally agreed with OIG's recommendations and is taking responsive action.

Background

Congress chartered Fannie Mae and Freddie Mac to provide stability and liquidity in the home mortgage loan market. On July 30, 2008, the Housing and Economic Recovery Act of 2008 established FHFA as the Enterprises' regulator. Among its responsibilities, the Agency oversees their safety and soundness, supervises their support of housing finance and affordable housing goals, and facilitates a stable and liquid mortgage market. On September 6, 2008, FHFA became Fannie Mae's and Freddie Mac's conservator to help protect the Enterprises—and therefore the wider financial market—from collapse. In this role, the Agency is charged with preserving and conserving the Enterprises' assets, ensuring the Enterprises' focus on the housing mission, and facilitating their emergence from conservatorship.

The Rise of Servicers Specializing in Troubled Loans

Fannie Mae and Freddie Mac buy mortgage loans, which they may hold as their own investments or bundle for sale typically with guaranteed principal and interest payments. In either case, the

Enterprises rely on other companies to service the loans, which includes collecting payments, managing escrow accounts, and handling mortgage modifications, defaults, and foreclosures.

Historically, financial institutions, such as banks that originated loans for borrowers and sold the loans to the Enterprises, also serviced them. In recent years, though, many large bank mortgage lenders have sold some of their mortgage servicing rights to companies that are not banks.

Given the growth in the volume of delinquencies and defaults after the housing crisis in 2007, these new servicers have come to specialize in acquiring troubled (i.e., nonperforming) loans. Servicing these loans can be labor-intensive. For example, in the case of delinquent loans, the servicer may need to contact the borrowers to learn about their financial situation, educate them about the impact of not paying a mortgage, explain options for avoiding foreclosure such as loan modifications and short sales, and ultimately initiate foreclosure proceedings if necessary.

Although troubled mortgage loans require more work and involve vulnerable borrowers, companies that specialize in servicing such loans do so under less stringent capital requirements than banks. Specifically, rules by federal banking regulators have increased the amount of capital that federally insured depositories must hold against mortgage servicing rights under certain circumstances.[1] As such, nonbanks are not subject to these capital requirements, which raises concern in a stressed environment as these servicers can be heavily concentrated in a single business line.

Some banks have been willing to part with the risky, labor intensive work involved in servicing troubled mortgage loans. As a result, mortgage servicing rights at U.S. commercial banks (and thrifts) have declined by more than half since their peak in mid-2008, or from $84 billion to $40 billion. In turn, FHFA and the Enterprises have been supportive of banks, as evidenced by their approvals of selling these rights to nonbank special servicers that can provide specialized support to homeowners and thereby protect Enterprise investments.

Consequently, 9 of Fannie Mae's top 20 servicers are not banks, and they account for 28% of the overall group's loan volume, or 3.6 million mortgage loans with approximately $600 billion in unpaid principal balances. Similarly, nonbank servicers represent 7 of Freddie Mac's top 20 servicers and account for 15% of the group's loan volume, or 1.3 million loans with approximately $230 billion in unpaid principal balances. For example, of the 30 largest mortgage servicers, those that were not banks held a 17% share of the mortgage servicing market at the end of 2013, up from 9% at the end of 2012, and 6% at the end of 2011.

[1] The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation approved final regulatory capital rules in July 2013 to overhaul the regulatory capital framework for the U.S. banking sector. Regulated banks are required to maintain higher capital levels to hedge against financial crisis by increasing liquidity and decreasing leverage. As such, the final rules require banks to hold more capital on hand for mortgage servicing rights. See Board of Governors of the Federal Reserve System, *Press Release* (July 2, 2013) (online at www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm); Office of the Comptroller of the Currency, *Press Release* (July 9, 2013) (online at www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-110.html); and Federal Deposit Insurance Corporation, *Press Release* (July 9, 2013) (online at fdic.gov/news/news/financial/2013/fil13031.html).

Transferring Mortgage Servicing Rights

In order to acquire servicing rights, first the Enterprises (and in some instances, FHFA) must approve transferring the rights to mortgage loans they own or guarantee. In general, according to their respective servicing guides, when the Enterprises approve a transfer, they evaluate the servicer in various areas, including:

- Overall servicing performance;
- Capacity to service the number and types of mortgage loans to be transferred;
- Delinquency ratios;
- Status of unresolved issues related to repurchase requests, claim denials, or other outstanding claims; and
- Financial condition.

After the Enterprises' review, FHFA must approve transferring the right to service their mortgage loans if the portfolio transferred exceeds 25,000 loans.

General Warning Signs of Nonbank Special Servicer Risks

As the volume of loans handled by nonbank special servicers has climbed, there have been signs of financial and operational strain at the companies. Federal and state regulatory warnings on rising risk, consumer complaints of shoddy servicing, and lawsuits about systemwide misconduct have accompanied nonbank special servicers' surging growth.

For example, the Financial Stability Oversight Council (FSOC)—established in part to identify and respond to national, systemic financial risk—noted concern about financial institutions other than banks using short-term funding to secure long-term assets (e.g., mortgage loans) without appropriately managing the associated risks.[2] FSOC, which includes FHFA as a voting member, specifically mentioned servicers that have bought mortgage servicing rights from banks, but do not have the same requirements to maintain capital to mitigate those risks. In other words, if market conditions deteriorate, nonbank special servicers may not have the same reserves as banks to meet those challenges and continue servicing the loans without interruption.

In addition, New York State banking regulators stopped a servicer's plan to buy 184,000 loans worth $39 billion from Wells Fargo because they were concerned about the acquiring servicer's

[2] Public Law 111-203, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), established FSOC to identify risks to U.S. financial stability that could arise from the activities, material financial distress, or failure of "large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace[.]" 12 U.S.C. § 5322(a)(1)(A). FSOC also promotes market discipline and responds to emerging threats to the nation's financial system. *Id*. § 5322(a)(1)(B). FSOC is chaired by the Secretary of the Treasury, and brings together federal and state financial regulators, and a Presidentially appointed independent insurance expert. *Id*. § 5321(b).

aggressive growth rate. The New York regulators have also asked another servicer for information related to its policies, procedures, pipeline, staffing, and capacity related to servicing right transfers because of its rapid growth accompanied by increased consumer complaints.

The Consumer Financial Protection Bureau (CFPB) has also warned about the risk of nonbank special servicers' expanding role.[3] While these specialized servicers claim to have helped save millions of homes from foreclosure, the CFPB has received thousands of complaints about servicing interruptions and failures to honor loan modifications. With one nonbank special servicer that services approximately 2.8 million residential loans as of year-end with $465 billion in unpaid principal balances—CFPB settled a lawsuit to compensate homeowners over $2 billion for years of systemic servicing misconduct.

Enterprise-Specific Warning Signs with Nonbank Special Servicer Risks

Both OIG and FHFA have expressed concerns about the Enterprises having servicing rights transferred from highly regulated institutions such as banks to less regulated institutions such as servicers specializing in troubled mortgage loans.

As detailed in OIG's 2012 report on the transfer of troubled, Fannie Mae-backed mortgages from Bank of America to nonbank special servicers, FHFA had raised concerns about such transfers as early as June 2011, and the Agency's Division of Enterprise Regulation (DER) noted a year later that this issue remained a concern for the Enterprise.[4] According to DER, the rapid growth of nonbank servicers increased Fannie Mae's operational risk. Given this rising risk, OIG recommended that FHFA engage in closer oversight of Fannie Mae's efforts to transfer mortgage loans to nonbank special servicers.

In response, the Agency stated that it intended to ensure that Fannie Mae was adequately managing its internal processes to mitigate the risk of these transfers. In addition, FHFA stated that it would continue to follow up on these issues throughout the 2013 examination cycle, which FHFA has done through various exams and supervisory actions that focused on individual servicers and transfers.

One Enterprise's internal audit reports have also noted a lack of controls over specialized servicers. A January 2013 report highlighted weaknesses in the Enterprise's monitoring of the servicers' capacity to handle their volume of business. The report noted that the servicers might not be equipped to execute the Enterprise's loss mitigation programs (e.g., offering alternatives to foreclosure such as modifying loans to make them more affordable), which could lead to financial losses.

[3] The Dodd-Frank Act created CFPB to "regulate the offering and provision of financial products and services under the Federal consumer financial laws." 12 U.S.C. § 5491(a).

[4] OIG, *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* (Sept. 18, 2012) (EVL-2012-008). Accessed April 10, 2014, at: www.fhfaoig.gov/Content/Files/EVL-2012-008.pdf.

In its quarterly filings with the Securities and Exchange Commission (SEC) as of June 30, 2013, Freddie Mac noted that it continues to face challenges with respect to the performance of certain servicers in managing seriously delinquent loans. As part of its efforts to address this issue and mitigate credit losses, the Enterprise was facilitating the transfer of servicing from certain underperforming servicers to other servicers that specialize in workouts of problem loans. Freddie Mac concluded that some of these specialized servicers have grown rapidly in the last two years and now service an increasing number of loans.[5]

In June 2013, FHFA stated in its Annual Report to Congress that Fannie Mae had begun transferring large servicing assignments to rapidly growing nonbank companies that introduce a new level of risk. FHFA noted that the Enterprise had a number of efforts underway to address its operational shortcomings including with regard to nonbank special servicers, but these projects would take several years to complete and the level of operational risk would remain a concern throughout the transition. The report did not lay out actions FHFA would take regarding the risks posed by nonbank special servicers or the servicer capacity issues to be considered in transfers of mortgage servicing rights that were identified by both Enterprises.

Safety and Soundness Regulation

CFPB has regulatory responsibilities related to consumer protection for mortgage servicing activities by banks and nonbanks. Additionally, the nonbank special servicers are subject to certain state level standards and regulation. However, nonbank special servicers do not have a prudential safety and soundness regulator at the federal level for their mortgage servicing operations.[6] In contrast, banks performing mortgage servicing are subject to safety and soundness oversight by federal banking agencies such as the Federal Deposit Insurance

[5] Fannie Mae, in its 2013 annual SEC filings, mentions servicing transfers and a general risk that if a significant mortgage servicer counterparty fails and its mortgage servicing obligations are not transferred to a company with the ability and intent to fulfill all of these obligations, it could incur penalties for late payment of taxes and insurance on the properties that secure the mortgage loans serviced by that mortgage servicer. Fannie Mae, *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 141 (online at www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2013/10k_2013.pdf). Similarly, Freddie Mac in its 2013 SEC filings stated that it faces the risk that the Enterprise might not receive a sufficient price for the mortgage servicing rights or that they may be unable to find buyers who are willing to assume the representations and warranties of the former servicer and have sufficient capacity to service the affected mortgages. Freddie Mac concluded this option may be difficult to accomplish with respect to larger servicers due to operational and capacity challenges of transferring a large servicing portfolio. Freddie Mac, *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 43 (online at www.freddiemac.com/investors/er/pdf/10k_022714.pdf).

[6] In its 2014 Annual Report released on May 7, 2014, FSOC reported that mortgage servicing rights are increasingly being transferred to nonbank mortgage servicing companies. FSOC stated that, while the CFPB and state regulators have some authority over these companies, many of them are not currently subject to prudential standards such as capital, liquidity, or risk management oversight. Further, FSOC concluded that, in many cases, mortgage investors' ability to collect on mortgages is dependent on a single mortgage servicing company, where failure could have significant negative consequences for market participants. FSOC recommended that, in addition to continued monitoring, state regulators work together with CFPB and FHFA to collaborate on prudential and corporate governance standards to strengthen nonbank servicers. See FSOC, *2014 Annual Report*, at 114 (online at www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf).

Corporation and Office of the Comptroller of the Currency (OCC).[7] These regulators focus on key risk components at regulated institutions including risks related to capital, assets, liquidity, management, earnings, and market activities, as well as compliance with mortgage servicing regulations.

The Enterprises oversee their servicing contracts with both bank and nonbank special servicers and, in turn, FHFA regulates the Enterprises. However, in the case of nonbank special servicers, there is not the additional regulatory regimen provided by federal banking agencies upon which FHFA and the Enterprises can place a level of reliance in structuring their oversight.

Finding: FHFA Can Help Mitigate Nonbank Special Servicer Risk with Additional Guidance and Oversight

FHFA has not established a risk management process or overall oversight framework to handle some risks posed by nonbank special servicers. While FHFA identified in its Annual Report to Congress issued in June 2013 that counterparty risk was a concern given the greater prominence of nonbank special servicers, it approved transferring troubled loans to these servicers.[8] Risks associated with nonbank special servicers are reflected in concerns expressed by financial regulators and in a recent case where FHFA and the Enterprises were confronted with significant risks at a nonbank special servicer. Specifically, over the last three years, the Enterprises have taken remedial steps to address operational deficiencies discovered at one mortgage loan servicer specializing in troubled loans. They have identified major risks with this nonbank special servicer's ability to handle the volume of troubled mortgages the company has acquired, and, accordingly, have focused monitoring resources on the company and taken or directed corrective action. While these steps were intended to address the identified risks, FHFA has not established a risk management process unique to nonbank special servicers to better oversee how the Enterprises control inherent risks in transferring mortgage servicing rights and performing large scale servicing operations. Additionally, FHFA would benefit from structuring its oversight of these nonbank special servicers and the controls employed by the Enterprises under a formal oversight framework. These actions are particularly important given the growth in use of nonbank special servicers and the more limited regulatory oversight of these servicers as compared to banks performing servicing functions.

A Case of Nonbank Special Servicer Risk

Warnings about one nonbank special servicer emerged in 2011 and 2012 when Freddie Mac determined that the servicer warranted increased oversight because of concerns (among other things) about how fast the company was acquiring mortgage loan servicing rights. Fannie Mae's

---

[7] Federal banking agencies regulate federally-insured depository institutions. For ease of reference, this report refers to all such institutions as "banks."

[8] See FHFA 2012 Annual Report to Congress (June 13, 2013) (online at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2012_AnnualReportToCongress_508.pdf)

overlapping concerns in 2012 and 2013 focused on this nonbank special servicer's failure to provide sufficient documentation to allow the Enterprise to assess its capacity to service the loans it had or planned to acquire. For example, this nonbank special servicer bought the right to service large amounts of mortgage loans from several banks. Additionally, the servicer already had billions of dollars in servicing right acquisitions in its pipeline. FHFA approved these large transfers of Enterprise loan servicing under the condition of increased Enterprise surveillance and review of this company's servicing operations given its considerable growth.

Despite being subjected to increased oversight, this nonbank special servicer's infrastructure proved insufficient to properly service some Enterprise-backed mortgage loans. Freddie Mac became aware of operational problems initially because of Enterprise-backed loans for which there were remittance delays. The Enterprise notified FHFA, which in turn alerted Fannie Mae. Both Enterprises separately sent their respective review teams to this servicer and found operational risks related to weak infrastructure such as poor practices for handling borrower complaints.

Fannie Mae found the servicer had breached the Enterprise's minimum capital requirements. According to Fannie Mae's servicing guide, this violation constituted a breach of contract and presented an unacceptable risk to the Enterprise. Failure by the company to resolve this issue could result in a suspension of the contract, meaning Fannie Mae would cease all commitments on loan purchases and the servicer would not be able to service any more of the Enterprise's loans.

Subsequently, Freddie Mac suspended any further bulk sales of servicing rights to this company. Fannie Mae then informed the company in early 2013 that it would not approve material transfers until the company met certain requirements. In January 2014, at FHFA's request, Fannie Mae detailed actions the servicer must take to address operational issues. Also at the Agency's request, Freddie Mac required similar remediation from the servicer.

For its part, FHFA had previously identified the potential for this nonbank special servicer to encounter liquidity problems given the servicer's reliance on short-term debt (borrowing) to pay for long-term assets (servicing). FHFA concluded that the company's current problems resulted from inadequate operations and a weak infrastructure. In part to address liquidity concerns, the servicer subsequently sold some mortgage servicing rights to other companies.

Opportunity to Mitigate Specialized Servicer Risks

FHFA and the Enterprises have worked to mitigate the specific problems identified with the nonbank special servicer discussed above. The roots of those problems, though, are shared by other nonbank special servicers that have rapidly bought large volumes of mortgage loan servicing rights, including where short-term financing is used, which can strain their operations and finances. Since the Enterprises back these loans, such strains can increase credit risk. In addition, poor or interrupted servicing—particularly for vulnerable homeowners with troubled mortgage loans—can risk the Enterprises' reputation.

As discussed, the FSOC, CFPB, federal and state banking regulators, and FHFA have noted the escalating risks posed by the rapid rise of nonbank special servicers taking over servicing from traditional financial institutions such as banks. The case with the nonbank special servicer discussed above highlights FHFA's opportunity to implement a formal, comprehensive plan to supervise Enterprise oversight of nonbank special servicers and take advantage of the lessons already learned in assessing FHFA and Enterprise controls.

FHFA's regulatory peers have been active in issuing mortgage servicing guidance relevant to the rising risk posed by nonbank special servicers. Such directives can serve as examples of best practices for FHFA to consult in formulating its own guidance. For example:

- In February 2013, the CFPB issued guidance to residential mortgage servicers to address potential risks to consumers that may arise in connection with transfers of servicing.[9] As appropriate, the CFPB will require servicers engaged in significant servicing transfers to submit written plans detailing how they will manage the associated consumer risks. The CFPB will use the plans to assess consumer risks and inform its examination planning.

- In October 2013, OCC published risk management guidance for assessing and managing risks associated with third-party relationships.[10] A third-party relationship is defined as any business arrangement between a bank and another entity, by contract or otherwise. This guidance provides a framework for managing third-party risk that could be applied by FHFA to Enterprise oversight of nonbank special servicers that perform servicing functions on contract with the Enterprises. Specifically, the OCC guidance calls for a risk management process throughout the life cycle of the relationship including:

    - Plans that outline the bank's strategy, identify the inherent risks of the activity, and detail how the bank selects, assesses, and oversees the third party.

    - Proper due diligence in selecting a third party.

    - Written contracts that outline the rights and responsibilities of all parties.

    - Ongoing monitoring of the third party's activities and performance.

    - Contingency plans for terminating the relationship in an effective manner.

    - Clear roles and responsibilities for overseeing and managing the relationship and risk management process.

[9] CFPB Bulletin 2013-01 – Mortgage Servicing Transfers (February 11, 2013) (online at files.consumerfinance.gov/f/201302_cfpb_bulletin-on-servicing-transfers.pdf).

[10] OCC is the primary federal regulator for national banks and federal savings associations. OCC Bulletin 2013-29 – Third Party Relationships: Risk Management Guidance (October 30, 2013) (online at occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html).

- Documentation and reporting that facilitates oversight, accountability, monitoring, and risk management.

- Independent reviews of third party activities.

As the Enterprises' conservator, FHFA is positioned to confront nonbank special servicer risks that it and its partner agencies have identified by directing the Enterprises to identify and mitigate those risks through a formal risk management process. Additionally, FHFA would benefit from a formal, comprehensive, supervision and examination framework for Enterprise oversight of contracts with nonbank special servicers—steps that can help FHFA better protect both the Enterprises and borrowers. Additional Enterprise controls and FHFA oversight are important since these nonbank special servicers do not have a dedicated federal regulator similar to banks that perform servicing.

Recommendations

OIG recommends that FHFA:

1. Issue guidance to the Enterprises on the risk management process that should be employed to identify and mitigate risks related to nonperformance under Enterprise contracts with nonbank special servicers.

2. Develop a comprehensive, formal framework to mitigate the risks nonbank special servicers pose to the Enterprises that includes routine FHFA examinations, Enterprise reviews, and capacity testing before acquisition of servicing rights to ensure these servicers can continue to fulfill their servicing requirements.

FHFA provided comments (see Attachment A) generally agreeing with OIG's recommendations. Attachments B and C contain OIG's evaluation of FHFA's comments.

Objective, Scope, and Methodology

The overall objective of this performance audit was to assess FHFA's controls to ensure the Enterprises monitor nonbank special servicer performance and mitigate related risks. To accomplish this objective, in part, OIG reviewed FHFA's response to concerns raised with one nonbank special servicer that experienced operational issues. During the course of OIG's audit, those concerns raised more comprehensive issues related to FHFA's general risk management approach to nonbank special servicers and related internal control.

OIG conducted its fieldwork at FHFA's headquarters and Fannie Mae's corporate office in Washington, DC, and Freddie Mac's corporate offices in McLean, VA.

In order to accomplish its objective, OIG:

- Interviewed Fannie Mae and Freddie Mac Single-Family Business Unit and Enterprise Risk Management personnel; specifically, the Enterprise staff responsible for servicers' performance reviews, oversight and remediation, and counterparty credit risk management and oversight;

- Obtained information from FHFA staff in the divisions of Enterprise Regulation, and Housing Mission and Goals about the Agency's oversight, supervision, and guidance of servicers;

- Reviewed the past two years of the nonbank special servicer's counterparty credit risk evaluation and servicer performance reviews, including remediation, corrective action, and escalation from the Enterprises;

- Discussed with FHFA and the Enterprises their servicer review and validation process;

- Discussed potential fraud issues and/or complaints with the Enterprises and FHFA;

- Assessed internal control within FHFA's oversight process; and

- Interviewed the Enterprises' internal audit staff about the Enterprises' respective processes for reviewing servicer performance.

OIG conducted fieldwork for this performance audit from November 2013 through April 2014 in accordance with generally accepted government auditing standards. Those standards require that OIG plan and perform audits 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.

OIG appreciates the cooperation of everyone who contributed to this audit, including officials at FHFA, Fannie Mae, and Freddie Mac. This audit was led by Kevin Carson, Audit Director, who was assisted by Damon Jackson, Audit Manager, and Crystal Tsang, Senior Auditor.

cc: Melvin L. Watt, Director
Eric Stein, Acting Chief Operating Officer
Sandra Thompson, Deputy Director for Housing Mission and Goals
Robert Ryan, Special Advisor
Mark Kinsey, Chief Financial Officer
John Major, Internal Controls and Audit Follow-up Manager

Appendices: Appendix A: FHFA's Comments on OIG's Findings and Recommendations
Appendix B: OIG's Response to FHFA's Comments
Appendix C: Summary of FHFA's Comments on the Recommendations

Appendix A

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

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

FROM: Nina A. Nichols, Acting Deputy Director, Division of Enterprise Regulation nan

SUBJECT: Audit Report: *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages* (Audit Assignment AUD-2014-001)

DATE: June 10, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the FHFA-OIG draft audit report, *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages* (Audit Assignment AUD-2014-001) (Report). The Report discusses the increased servicing of troubled loans by nonbank institutions and notes there are risks associated with these operations. The Report recommends that FHFA issue guidance to the Enterprises on the risk management process that should be employed to identify and mitigate risks at nonbank servicers and that FHFA develop a comprehensive, formal framework to mitigate risks to the Enterprises posed by nonbank servicers.

FHFA concurs that servicing of troubled loans by nonbank servicers may entail operational and financial risks for the Enterprises. Consequently, FHFA has given significant supervisory attention to servicing operations performed by nonbank institutions and will continue to focus examination work on the Enterprises' risk management. This memorandum identifies FHFA's agreement or disagreement with the recommendations and the actions that FHFA will take in response to the recommendations.

<u>Recommendation 1:</u> OIG recommends that FHFA issue guidance to the Enterprises on the risk management process that should be employed to identify and mitigate risks at nonbank servicers.

Management Response to Recommendations 1: FHFA agrees with this recommendation. FHFA is in the process of developing additional supervisory guidance on counterparty risk management. This guidance will set forth supervisory expectations for how the Enterprises manage risks associated with servicing of troubled loans, including by nonbank servicers. This guidance will be issued by December 1, 2014.

<u>Recommendation 2:</u> OIG recommends that FHFA develop a comprehensive, formal framework to mitigate the risks nonbank servicers pose to the Enterprises that includes routine FHFA examinations, Enterprise reviews, and capacity testing before acquisition of servicing rights to ensure these servicers can continue to fulfill their servicing requirements.

Management Response to Recommendations 2: FHFA partially agrees with this recommendation. FHFA does not agree that FHFA's supervision function should develop a framework for mitigating risk to the Enterprises. The Enterprises are responsible for developing policies and procedures for mitigating risks posed by counterparties, including servicers. Policies and procedures should be developed and implemented consistent with supervisory expectations for safe and sound operation. FHFA supervision will carefully assess the policies and procedures and their implementation by each Enterprise.

FHFA agrees that examinations of the Enterprises should address significant and emerging risks. FHFA will conduct examinations and ongoing monitoring as set forth in the 2014 Supervisory Plan for each Enterprise. Examination work will be undertaken consistent with the Supervisory Plans to assess each Enterprise's identification and management of risks posed by nonbank servicers. Examination work under the 2014 Supervisory Plans will be documented by April 30, 2015.

FHFA further agrees with the importance of articulating supervisory expectations for the Enterprises to guide their risk management activities. By July 31, 2014, FHFA will issue guidance describing supervisory expectations for the Enterprises' risk management for mortgage servicing transfers.

cc: John Major, Manager, Internal Controls and Audit Follow-up

Appendix B

OIG's Response to FHFA's Comments

On June 10, 2014, FHFA provided comments to a draft of this report, generally agreeing with OIG's recommendations and identifying specific actions it would take to address the recommendations. With respect to Recommendation 1, FHFA stated that the Agency is in the process of developing additional supervisory guidance on counterparty risk management that will set forth supervisory expectations for how the Enterprises manage risks associated with servicing of troubled loans, including by nonbank special servicers. This guidance will be issued by December 1, 2014. OIG considers FHFA's response to Recommendation 1 to be sufficient to resolve the recommendation, which will remain open until OIG receives and reviews the guidance.

FHFA partially agreed with Recommendation 2. Recommendation 2 requested that FHFA develop a comprehensive, formal framework to mitigate the risks nonbank special servicers pose to the Enterprises. In response, FHFA stated that it does not agree that FHFA's supervision function should develop a framework for mitigating risk to the Enterprises and that the Enterprises are responsible for developing policies and procedures for mitigating risks posed by counterparties, including servicers. However, the policies and procedures should be developed and implemented consistent with supervisory expectations for safe and sound operation. FHFA stated that it would carefully assess the policies and procedures and their implementation by each Enterprise. FHFA examination work in the 2014 Supervisory Plans will assess each Enterprise's identification and management of risks posed by nonbank special servicers. This examination work will be documented by April 30, 2015.

In addition to these proposed actions for Recommendation 2, FHFA stated that it would issue guidance describing supervisory expectations for the Enterprises' risk management for mortgage servicing transfers. On June 11, 2014, FHFA issued Advisory Bulletin, 2014-06, Mortgage Servicing Transfers. The bulletin communicates supervisory expectations for risk management practices in conjunction with the sale and transfer of mortgage servicing rights or the transfer of the operational responsibilities of servicing mortgage loans owned or guaranteed by the Enterprises. Consistent with OIG's recommendation, the bulletin requires consideration of servicer capacity, including staffing, facilities, information technology systems, and any sub-servicing arrangements, as part of the analysis of mortgage servicing transfers. OIG commends FHFA for attention to this matter. OIG considers the actions already taken or planned sufficient to resolve Recommendation 2. The recommendation will remain open until OIG determines that the agreed-upon actions are completed.

OIG considered the Agency's full response (attached as Appendix A) in finalizing this report. Appendix C provides a summary of management's comments on the recommendations and the status of agreed-upon 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 ($ Millions)	Resolved: Yes or No [a]	Open or Closed [b]
1.	FHFA will develop additional supervisory guidance on how the Enterprises manage risks associated with servicing troubled loans, including by nonbank special servicers.	December 1, 2014	$0	Yes	Open
2.	FHFA examination work in the 2014 Supervisory Plan will assess each Enterprise's identification and management of risks posed by nonbank special servicers.	April 30, 2015	$0	Yes	Open

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, and 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.

Additional Information and Copies

For additional copies of this report:

- Call: 202-730-0880
- Fax: 202-318-0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1-800-793-7724
- Fax: 202-318-0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

  FHFA Office of Inspector General
  Attn: Office of Investigation – Hotline
  400 Seventh Street, S.W.
  Washington, DC 20024