Federal Housing Finance Agency
Office of Inspector General

Compliance Review of FHFA's Implementation of Its Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances

Compliance Review • COM-2016-001 • December 17, 2015

COM-2016-001

December 17, 2015

Executive Summary

In an audit report issued on March 22, 2012, by the Federal Housing Finance Agency (FHFA/Agency) Office of Inspector General (OIG), *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003) (2012 Audit Report), OIG found that the Agency lacked a formal process to review Fannie Mae's and Freddie Mac's (the Enterprises) single-family mortgage purchase underwriting standards and variances to them. OIG concluded that the lack of a formal process limited the effectiveness of the Agency's oversight of the Enterprises' application of their underwriting standards and award of variances, and recommended that FHFA "…establish a policy for its review process of underwriting standards and variances including escalation of unresolved issues reflecting potential lack of agreement."

FHFA agreed with the recommendation and adopted an internal process called the Single-Family Policy Review and Escalation Process (Process) in early January 2013. The Process establishes three key requirements for oversight of the Enterprises' single-family mortgage purchase underwriting standards, variances to them, and other aspects of their single-family mortgage lines of business by FHFA's Office of Housing and Regulatory Policy (OHRP).

According to OHRP, the oversight demanded by the Process would enable FHFA to develop an understanding of the Enterprises' single-family credit risks and provide it an opportunity to identify, and help ensure the remediation of, any unsafe and unsound practices. After FHFA adopted the Process in January 2013, it asked OIG to close its outstanding recommendation. OIG reviewed the Process, as drafted, and representations by Agency officials that FHFA employees were in place to implement it, and closed the recommendation on March 12, 2013.

In this compliance review, OIG reports on the results of its verification testing of OHRP's implementation of the Process' three key requirements during the period January 2014 through March 2015 (our review period). Based on that verification testing, OIG determined that OHRP did not implement two variance-related requirements, which OHRP acknowledged. OHRP reported to OIG that in light of these deficiencies, in late 2014, it began to "reevaluate and reengineer" these two Process requirements but, as of this writing, no timeline has been established for completing this review.

Regarding the third requirement, we found that OHRP reviewed a total of 57 new and proposed revisions to the Enterprises' single-family credit policies during our review period, of which 52 were submitted by one Enterprise and 5 were submitted by the other Enterprise. The head of OHRP advised OIG that the few submissions from one Enterprise limited OHRP's "visibility" into that

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Enterprise's single-family credit policies and underwriting standards. The official said she had spoken with, and planned to speak further with, officials from that Enterprise to increase its submissions, but OHRP had not provided OIG with a timeline pursuant to which it intended to accomplish this objective at the completion of our review.

The Process was adopted in January 2013 and FHFA committed to OIG shortly thereafter that implementation of the Process was underway. More than two years later, two of the three requirements in the Process have not been implemented and implementation of the third requirement has not been sufficient to provide OHRP with full visibility in the single-family risks of one Enterprise. In light of these significant shortcomings, OIG is reopening the recommendation from its 2012 Audit Report. The recommendation will remain open until FHFA fulfills its commitment to establish and fully implement a formal process for reviewing the Enterprises' underwriting standards and variances to them. FHFA agreed with the recommendation, and reported it plans to complete its review of the Process by June 2016 and implement it by year-end 2016.

This report was led by Karen E. Berry, Senior Investigative Counsel, and Wesley M. Phillips, Senior Policy Advisor, with assistance from Patrice Wilson, Audit Manager, and Andrew Gegor, Jr., Senior Auditor. It has been distributed to Congress, the Office of Management and Budget, and others, and will be published on our website, www.fhfaoig.gov. We appreciate the assistance we received from FHFA in completing this compliance review.

Richard Parker
Deputy Inspector General, Compliance & Special Projects

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ABBREVIATIONS

2012 Audit Report	*FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003)
Enterprises	Fannie Mae and Freddie Mac
FHFA/Agency	Federal Housing Finance Agency
HERA	Housing and Economic Recovery Act of 2008
LOIs	Letters of Instruction
OHRP	Office of Housing and Regulatory Policy
OIG	Federal Housing Finance Agency Office of Inspector General
Process	Single-Family Policy Review and Escalation Process

BACKGROUND ....

OIG's 2012 Audit Found that FHFA Lacked a Formal Process for Reviewing Enterprise Single-Family Mortgage Underwriting Standards and Variances

In our 2012 Audit Report, we explained that single-family **underwriting standards** were critical in managing the credit risks associated with Enterprise mortgage purchases. The report stated that underwriting standards included both charter-based and traditional risk-based criteria. Traditional risk-based underwriting criteria consisted of minimum borrower **credit score** requirements and maximum **debt-to-income ratios**.

We reported that more than 11,000 **variances** from risk-based criteria were granted by Fannie Mae during the housing boom. We showed that some variances granted by Fannie Mae contained features far riskier than its traditional risk-based criteria, such as loans made with unverified income or assets, or little or no down payments. The report further stated that the variances and purchases of riskier mortgages were major factors in Fannie Mae's credit losses and credit-related expenses. Subsequently, Fannie Mae dramatically decreased its inventory of underwriting variances: as of September 2011, Fannie Mae had reduced outstanding variances from 11,718 for 857 lenders in January 2005, to 638 variances for 188 lenders, and many of the canceled variances related to higher-risk loans. Freddie Mac also substantially enhanced its underwriting standards in the wake of the financial crisis.

Underwriting standards, known as eligibility criteria, establish the characteristics that a loan must possess to be eligible for purchase.

A **credit score** is a statistically derived expression of a person's creditworthiness used to assess the likelihood that a person will repay his or her debts.

A **debt-to-income ratio** is a financial measure that compares an individual's indebtedness to his or her overall income.

A **variance** is an Enterprise-approved exception to its eligibility criteria (underwriting standards) granted to an individual lender or group of lenders.

In our 2012 Audit Report, we credited FHFA for conducting informal reviews of Fannie Mae's credit policies during 2010 and 2011. Because credit policy changes are high-level issues and may not involve underwriting standards and variances, we recognized the significant risk that FHFA's informal review of credit policies might not reach review of the Enterprises' underwriting standards and variances. For that reason, we looked to see whether FHFA conducted regular, formalized reviews of the Enterprises' underwriting standards and found it did not.

As a consequence, we concluded FHFA could take steps to increase its assurance that the Enterprises were operating in a safe and sound manner and we recommended that FHFA "…formally establish a policy for its review process of underwriting standards and variances including escalation of unresolved issues reflecting potential lack of agreement."[1] FHFA agreed with our recommendation and committed to adopt formalized procedures by September 30, 2012, and to provide OIG with a status report on their implementation by March 1, 2013.[2]

FHFA's Establishment of the Process

In response to the 2012 Audit Report recommendation, FHFA developed the Process in late 2012 and adopted it in early January 2013. The current head of OHRP, who has served in OHRP leadership capacities since OIG issued its 2012 Audit Report, reported to OIG that she was responsible for drafting the Process. She advised us that the Process was designed to provide FHFA, acting in its conservatorship capacity, with an understanding of the Enterprises' single-family credit risks, through its oversight and monitoring of: variances granted by each Enterprise; their bulk and negotiated transactions with mortgage sellers; and proposed changes to their mortgage selling policies.[3] The specific elements of each of the three categories of oversight and monitoring required by the Process follow.

Review of the Enterprises' Variances by OHRP[4]

- Monthly:[5]
    - An OHRP employee shall: review key Enterprise management reports related to variance activities and meet with the responsible Enterprise officials.
    - This OHRP employee shall document each monthly meeting using an established checklist and prepare a monthly variance analysis memorandum.

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[1] The 2012 Audit Report contained a second recommendation regarding FHFA's procedures for conducting examinations of the Enterprises' mortgage underwriting standards and variances. That recommendation was not within the scope of this compliance review.

[2] The 2012 Audit Report's conclusions and recommendation applied to FHFA's oversight of both Enterprises.

[3] The OHRP official was an Associate Director and solely focused on managing OHRP's mortgage servicing team from the third quarter of 2013 until September 2014. Starting on October 1, 2014, the official served as the acting Senior Associate Director for OHRP and was named Senior Associate Director for OHRP in March 2015.

[4] The OHRP review requirements discussed in this section apply to what the Process refers to as "variances, waivers and exceptions." For purposes of this compliance review, the term "variances" refers to departures from the Enterprises' single-family underwriting standards.

[5] This description of Process requirements has been summarized for presentational purposes in this section.

- Senior OHRP personnel shall: review the monthly variance analysis memorandum; and provide guidance to the responsible OHRP employee on revisions to the monthly analysis memo, if needed.

- The responsible OHRP employee shall: revise the monthly memorandum as required and notify the Enterprise of the results of OHRP's monthly variance analyses, including any related concerns.

- The OHRP employee shall refer any OHRP concerns about the Enterprises' variances to the Division of Enterprise Regulation for potential follow-up, as needed.

- Annually:

  - An OHRP employee shall: meet with each Enterprise's Single-Family Risk Officer to understand business unit risk limits that exceed established standards; and prepare a memorandum on this subject for consideration by senior OHRP personnel.

Review of the Enterprises' Bulk and Negotiated Transactions by OHRP

The Process defines a bulk or negotiated transaction as a sale of a set of loans to an Enterprise in which guarantee fees and other contract terms are negotiated individually for each transaction.[6] OHRP reported to OIG that bulk and negotiated transactions, which relaxed prevailing underwriting standards, had exposed the Enterprises to credit risks in the past. The Process' requirements for monitoring bulk and negotiated transactions mirror the monitoring requirements for the Enterprises' variances set forth above.

Review of the Enterprises' Mortgage Selling Policies by OHRP

FHFA, acting as conservator, has delegated to the Enterprises responsibility for establishing their single-family credit and underwriting standards. Among its responsibilities, OHRP is tasked with monitoring the Enterprises' exercise of this delegated responsibility. The Process requires OHRP to review and comment upon new and proposed revisions to the Enterprises' mortgage selling policies, which it defines as "…selling and servicing policies that are presented at the Enterprise business and risks committees…[because] they generally represent higher credit, operational, and/or headline risk…."

The Process requires OHRP's review of mortgage selling policies and includes the following elements:

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[6] The Enterprises charge a fee (guarantee fee) to guarantee the timely payment of principal and interest on their mortgage-backed securities.

- OHRP must assign one OHRP employee to review each mortgage policy submitted by the Enterprises.

- According to OHRP officials, the assigned OHRP employee is tasked with reviewing Enterprise documentation that identifies the reasons for the changes to the existing mortgage selling policy or new policy, details the actual changes to the underwriting standards wrought by the revised or new policy, and identifies the level of risk associated with such changes as well as the Enterprise's plans to manage the risk. As appropriate, the assigned OHRP employee confers with other OHRP and Agency staff, and prepares a recommendation memorandum.

- The senior OHRP staff review the recommendation memorandum, and the assigned OHRP employee revises the memorandum to include the views of senior OHRP staff.

- Where OHRP has no objections to or questions about the revised or new mortgage selling policy, OHRP so advises the Enterprise within a target of 15 days.

- Where OHRP has comments, questions, or concerns about the revised or new mortgage selling policy, it must seek to resolve those issues with the affected Enterprise.

- In the event that OHRP cannot resolve those issues with the affected Enterprise, OHRP escalates those issues to FHFA's Division of Conservatorship, which is authorized to approve or disapprove any mortgage selling policy.

During our review period, one Enterprise submitted to OHRP 52 mortgage selling policies and the other submitted 5.

COMPLIANCE REVIEW RESULTS ....

FHFA informed OIG that it had adopted the Process as of early January 2013, communicated its requirements to the Enterprises, and begun implementing it. FHFA further advised OIG that FHFA employees were in place to implement key provisions of the Process. OIG closed the audit recommendation on March 12, 2013, based on our determination that the Process was consistent with the recommendation in the 2012 Audit Report and our review of other information provided by the Agency. During this compliance review, OIG conducted verification testing to assess OHRP's implementation of the Process' three key oversight and monitoring requirements during the period January 2014 through March 2015.[7] As set forth below, OHRP did not implement two of the three key requirements relating to variances and bulk and negotiated transactions requirements. OHRP's less than forceful implementation of the third requirement, relating to review of new and proposed revisions to the Enterprises' mortgage selling policies, has limited its oversight of one Enterprise's single-family business risks.

OHRP Did Not Implement the Process' Variance Review Requirements

To assess OHRP's implementation of the variance monitoring requirements of the Process, we requested that OHRP provide the completed OHRP checklist[8] for each monthly meeting with Enterprise officials and memoranda of each required annual meeting with Enterprise officials. OHRP did not provide us with any such documentation, and OHRP reported to OIG that OHRP staff could not locate any variance checklists for the period of our review. OHRP produced cursory notes of two meetings between OHRP employees and Fannie Mae held during the 15 months of our review period in which variances were discussed. Even if it were possible to assess whether the participants in these two meetings covered the matters specified in the OHRP checklist, there is no evidence that the required meetings were held during each of the remaining 13 months. OHRP did not produce notes of any meetings between OHRP and Freddie Mac during the 15-month review period in which variance activity was discussed.

We also requested that OHRP provide documentation of the monthly and annual variance analysis memoranda required by the Process. OHRP provided no such documentation and reported to OIG that it could not locate any written memoranda required by the Process.

The head of OHRP reported to OIG that she became aware of OHRP's failure to implement the Process' variance review requirements shortly after her appointment on October 1, 2014. At that time, OHRP began to "reevaluate and reengineer" the Process focusing on the Enterprises' variances, given the potential risks they pose to the Enterprises' financial soundness. As of October 1, 2015, nearly a year into the project, OHRP had not established a timeline for its completion.

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7 OIG limited the testing to this period in light of the document production demands that a longer period would have imposed on the Agency.

8 The form, titled "Selling Variance, Waivers and Exceptions Checklist," is reproduced in its entirety in Appendix B to this compliance review.

OHRP Did Not Implement the Process' Bulk and Negotiated Transactions Review Requirements

To assess OHRP's implementation of the Process' annual and monthly bulk and negotiated transaction review requirements, we requested that OHRP provide documentation of its reviews during the period January 2014 to March 2015. OHRP did not provide us with any of these documents. OHRP reported to OIG that OHRP staff never met with Enterprise officials to discuss bulk and negotiated transactions during the review period, nor did they prepare any of the required annual or monthly memoranda analyzing these transactions.

As was the case with the Process' variance review requirements, the head of OHRP advised us that she learned of OHRP's failure to implement the bulk and negotiated transactions review requirements shortly after her appointment in October 2014, and included these requirements in the ongoing review and reengineering of the Process.

OHRP Reports that Its Oversight of Single-Family Risks of One Enterprise Is Limited by the Relatively Small Number of Mortgage Selling Policies Submitted to FHFA by that Enterprise

To assess OHRP's implementation of the requirement that it review changes to, as well as new, mortgage selling policies, we obtained from OHRP the policies submitted by the Enterprises during our review period and records of OHRP's review of them. Our testing of the 57 policies received by OHRP revealed that OHRP followed the Process' review requirements: recommendation memoranda were drafted and reviewed by senior OHRP personnel and OHRP notified the Enterprises of the outcomes of OHRP's reviews in a timely manner. [9]

We also found a wide disparity in the number of mortgage selling policies submitted by the Enterprises, which OHRP acknowledged. Specifically, one Enterprise submitted 52 mortgage selling policies during our 15-month review period while the other submitted only 5. According to OHRP's records, a wide disparity in submissions was evident by August 2014: at that time, one Enterprise had submitted 33 policies to OHRP while the other had submitted only 4.

Based on information learned during our compliance review, we determined the cause of the disparity, which we now explain. On November 15, 2012, FHFA issued revised Letters of Instruction (LOIs) to the Enterprises. Among other provisions, the revised LOIs require the Enterprises to provide to FHFA "any planned changes in business processes or operations, including changes to Enterprise single- and multi-family credit policies and loss mitigation

[9] An evaluation of the content of these memoranda was beyond the scope of this compliance review.

strategies that management has determined in its reasonable business judgment to be significant....” On November 16 and 19, 2012, OHRP officials met with employees of the Enterprises to brief them on the Agency’s efforts to enhance its oversight of mortgage selling policies in the wake of OIG’s 2012 audit. OHRP advised the Enterprises that they were required to submit for review as mortgage selling policies those items that were escalated to the Enterprises’ business and risk committees. OHRP reinforced that requirement in a February 5, 2013, memorandum to the Enterprises’ single-family risk officials.

Despite these instructions from OHRP to the Enterprises that they submit for review those items that were escalated to the Enterprises’ business and risk committees, both Enterprises did not follow that instruction. Rather, each Enterprise advised us that it submitted to OHRP those materials that the revised LOIs require for consideration by the conservator. However, each Enterprise interpreted this LOI requirement differently: one Enterprise decided to submit all mortgage selling policies to OHRP rather than make individual determinations as to which policies were significant, and the other Enterprise provided only those policies it deemed “significant.”

OHRP officials said they were aware that the Enterprises were using the LOIs rather than the Process definition to determine what to submit for review. OHRP reported to us that it was aware that one Enterprise only submitted those selling policies that it deemed “significant” under its interpretation of the LOIs, causing it to submit few mortgage selling policies for OHRP’s review.

The head of OHRP advised us that, as a result of the relatively few submissions from one Enterprise, OHRP’s “visibility” into its single-family credit policy, selling, and underwriting standards is limited. OHRP’s records reflected a wide disparity in the Enterprises’ submission of mortgage selling policies as of August 2014.[10] Although the new head of OHRP was promoted into that position in October 2014, she reported to us that she first began a series of monthly discussions with the Enterprise that submitted fewer mortgage selling policies in June or July 2015 in an effort to get more visibility and ultimately persuade that Enterprise to increase the number of mortgage selling policies it submits to OHRP.

In September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorships pursuant to its authority under the Housing and Economic Recovery Act of 2008 (HERA).[11] HERA vested FHFA, as the Enterprises’ conservator, with sweeping powers; the Agency is empowered to operate the Enterprises “with all the powers of the shareholders, the directors, and the officers” and possesses broad authority to take any action appropriate to preserve and

[10] From January through August 2014, one Enterprise submitted 33 policies while the other submitted only 4.

[11] Pub. L. No. 110-289, 122 Stat. 2654 (2008). HERA extensively amended the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §§ 4501-4642.

conserve Enterprise assets. As long as the Enterprises remain in conservatorships, FHFA is authorized by statute to operate them.

While FHFA has delegated to the Enterprises the responsibility to create and revise mortgage selling policies, it recognized in its establishment of the Process, which was in response to our 2012 Audit Report recommendation, that its oversight of the Enterprises' mortgage selling policies was critical to fulfilling its responsibilities as conservator. We were not able to determine the reason(s) why OHRP waited almost a year, that is, until June or July 2015, before it raised its concerns with the affected Enterprise about the lack of visibility caused by its submission of relatively few mortgage selling policies. At that time, OHRP could have improved its visibility into the Enterprise's single-family credit policy, selling, and underwriting standards by directing it to immediately increase its submissions or setting a time frame within which the Enterprise must do so, but OHRP did neither. Instead, it began a dialogue with the affected Enterprise in an effort to increase its submissions over time.

CONCLUSION...

In March 2013, OIG reviewed the written Process and relied on FHFA's representations that implementation of the Process was underway when it determined to close an outstanding recommendation in its 2012 Audit Report. More than two years later, two of the three requirements in the Process have not been implemented and implementation of the third requirement has not been sufficient to provide OHRP with full visibility into the single-family credit policy, selling, and underwriting standards of one Enterprise. In light of these significant shortcomings, we are reopening the recommendation in our 2012 Audit Report. We will hold open our recommendation until FHFA demonstrates that it has fully implemented a formal process to review the Enterprises' underwriting standards and variances from them.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

Our objective for this compliance review was to determine whether OHRP implemented the three key requirements of the Process over the period January 1, 2014, through March 31, 2015.

To address our objective, we asked OHRP to provide documentation of meetings held with the Enterprises as well as annual and monthly memoranda prepared as required by the variances and bulk and negotiated transactions requirements of the Process.

We also asked OHRP to provide documentation of its reviews of the mortgage selling policies that the Enterprises submitted during the period covered by our review. We tested OHRP's compliance with the Process' requirements for reviewing mortgage selling policies by comparing the analysis memoranda and approvals thereof against the requirements of the Process. We also checked OHRP's records and other documents to determine whether policy determinations were sent to the Enterprises within the Process' 15-day target date.

During the course of our analysis, we also identified the disparity in the number of mortgage selling policies submitted by the Enterprises that is discussed in this compliance review. Our analysis of this topic included reviews of publicly available information on the Enterprises' periodic revisions to their seller/servicer guides.

We also interviewed the head of OHRP and OHRP's Supervisory Policy Analyst, as well as staff members responsible for implementing the Process' requirements. Additionally, we interviewed Fannie Mae's Senior Vice President & Chief Credit Officer for Single-Family – Single-Family Mortgage Business and Freddie Mac's Vice President & Division Chief Credit Risk Officer, Single Family.

We conducted our compliance review during the period June to October 2015 under the authority of The Inspector General Act of 1978, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council for the Inspectors General on Integrity and Efficiency.

FHFA's response to this report is reproduced in its entirety in Appendix A.

APPENDIX A ....

FHFA's Comments on OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Deputy Inspector General for Compliance and Special Audits

FROM: Sandra L. Thompson, Deputy Director, Division of Housing Mission and Goals

SUBJECT: Compliance Review of FHFA's Implementation of its Procedures for Overseeing the Enterprises Single-Family Mortgage Underwriting Standards and Variance

DATE: December 14, 2015

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the Office of the Inspector General's (OIG) draft *Compliance Review of FHFA's Implementation of Its Procedures for Overseeing the Enterprises' Single-Family Mortgage Underwriting Standards and Variances* (Compliance Review). The Compliance Review discusses FHFA's implementation of its *Single Family Policy Review and Escalation Process*. As a result of the Compliance Review, OIG decided to reopen Recommendation #1 from the 2012 Audit Report, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003).

Recommendation:

Division of Housing Mission and Goals formally establish a policy for its review process of underwriting standards and variance including escalation of unresolved issues reflecting potential lack of agreement.

Management Response to OIG Decision to Reopen the Recommendation:

FHFA agrees with the recommendation. FHFA has various other means to monitor policy changes and underwriting standards in addition to the *Single-Family Policy Review and Escalation Process,* including conference calls with the Enterprises and reviewing Enterprise presentations and submissions through the FHFA portal. However, management was aware of some implementation challenges and the Division of Housing Mission and Goals had begun revising the *Single-Family Policy Review and Escalation Process* prior to the Compliance Review.

FHFA will complete the *Single-Family Policy Review and Escalation Process* update by June 30, 2016, and implement the updated process by year-end 2016.

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

APPENDIX B...

Selling Variance, Waivers and Exceptions Checklist

Date:	
SAL/Policy Analyst Name:	
Enterprise:	Fannie Mae ☐ Freddie Mac ☐
Enterprise Owner:	

The questions below are meant to serve as basic guidance for the monthly discussions; SALs should use their judgment and expertise to augment this this list. Provide volume detail by count and UPB.

1. Volume and Type (both monthly and year-to-date)
   - What is the aggregate level of variances, waivers and exceptions (VWE)?
   - Describe the type of VWE offered and how it differs from the Selling Guide?
     - What is the aggregate volume?
     - What is the volume by lender?
     - Does the VWE use boilerplate or custom language?
2. Approval and Oversight
   - How are lenders approved for VWE – differentiate by type if necessary?
   - How are lender VWE monitored?
   - Can lender VWE be suspended and/or terminated?
   - Are lenders assessed for continuing eligibility?
   - How is lender VWE performance communicated?
3. Variance, Waiver and Exception Requests
   - What VWE requests were received this month, by type?
     - How many were approved?
     - How many were rejected?
   - Were any new VWE approved? If yes, please describe the following:
     - VWE language, including volume limits and other conditions
     - Rationale for approval and approval chain
     - Reporting/monitoring plan

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