FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America

EVALUATION REPORT: EVL 2011 006 DATED: September 27, 2011

EXPLANATION OF REDACTIONS IN THIS REPORT

This report includes redactions requested by the Federal Housing Finance Agency (FHFA) and the Federal Home Loan Mortgage Corporation (Freddie Mac). According to FHFA and Freddie Mac, the redactions are intended to protect from disclosure material that they consider to be confidential financial, proprietary business, and/or trade secret information, which Freddie Mac claims it would not ordinarily publicly disclose and, if disclosed, could place it at a competitive disadvantage.

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL
AT A GLANCE

Evaluation of FHFA's Oversight of Freddie Mac's Repurchase Settlement with Bank of America

Why FHFA-OIG Did This Evaluation

In the closing days of 2010, the Federal Housing Finance Agency (FHFA or Agency), acting in its capacity as the conservator of the Federal Home Loan Mortgage Corporation (Freddie Mac or the Enterprise) and the Federal National Mortgage Association (Fannie Mae) (collectively the Enterprises), approved two agreements totaling $2.87 billion under which the Enterprises settled mortgage repurchase claims asserted against Bank of America.

Freddie Mac and Fannie Mae have purchased millions of mortgages from loan sellers, such as Bank of America. The contracts under which the Enterprises purchased the mortgages provide them with the right to require the sellers to repurchase mortgages that do not meet the underwriting criteria represented and warranted by them. Freddie Mac's $1.35 billion settlement with Bank of America could serve as a precedent for future repurchase settlements.

The FHFA Office of Inspector General (FHFA-OIG) began a review after Members of Congress and others questioned the adequacy of the settlements. During the review, two individuals independently reported their concerns about the Freddie Mac-Bank of America settlement, and FHFA-OIG commenced this evaluation.

What FHFA-OIG Recommends

FHFA-OIG makes two recommendations. FHFA and its senior management should promptly: (1) act on the specific and significant concerns raised by FHFA staff and Freddie Mac internal auditors about Freddie Mac's loan review process; and (2) initiate reforms to ensure more generally that senior managers are apprised of and timely act on significant concerns brought to their attention.

What FHFA-OIG Found

FHFA-OIG found that FHFA senior management did not timely address significant concerns raised about the loan review process used by Freddie Mac and its ramifications on underlying the settlement. Specifically, FHFA-OIG makes three findings.

First, in mid-2010, prior to the Bank of America settlement, an FHFA senior examiner raised serious concerns about limitations in Freddie Mac's existing loan review process for mortgage repurchase claims, which, according to the senior examiner, could potentially cost Freddie Mac a considerable amount of money. Freddie Mac's internal auditors independently identified concerns about the process at the end of 2010. These concerns merited prompt attention by FHFA because they potentially involve significant recoveries for Freddie Mac and, ultimately, the taxpayers. Further, unless examined and addressed, the underlying problems are susceptible to recurrence.

Second, FHFA did not timely act on or test the ramifications of these concerns prior to the Bank of America settlement. FHFA-OIG did not independently validate Freddie Mac's existing loan review process and, therefore, does not reach any final conclusion about it. Nevertheless, by relying on Freddie Mac's analysis of the settlement without testing the assumptions underlying Freddie Mac's existing loan review process, FHFA senior managers may have inaccurately estimated the risk of loss to Freddie Mac.

Third, following the initiation of FHFA-OIG's evaluation, FHFA, to its credit, suspended future Enterprise mortgage repurchase settlements premised on the Freddie Mac loan review process and set in motion activities to test the assumptions underlying the loan review process. Additionally, other findings tend to support the validity of the concerns about the process. For example, on June 6, 2011, Freddie Mac's internal auditors issued an audit opinion that the Enterprise's internal governance controls over this process were "Unsatisfactory." Furthermore, at the end of 2010 and then again in mid-2011, a Freddie Mac senior manager advised the board of directors that the Enterprise could recover more in the future if it used a more expansive loan review process.

TABLE OF CONTENTS

ABBREVIATIONS

ARM ..... Adjustable Rate Mortgage

Countrywide..... Countrywide Financial

DER..... Division of Enterprise Regulation

Fannie Mae..... Federal National Mortgage Association

FHFA ..... Federal Housing Finance Agency

FHFA-OIG..... Federal Housing Finance Agency Office of Inspector General

Freddie Mac ..... Federal Home Loan Mortgage Corporation

HERA..... Housing and Economic Recovery Act of 2008

MBS ..... Mortgage-Backed Securities

OCO ..... Office of Conservatorship Operations

Federal Housing Finance Agency

Office of Inspector General

Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (Public Law No. 110-289) (HERA), which amended the Inspector General Act of 1978 (Public Law No. 95-452). FHFA-OIG is authorized to conduct audits, investigations, and other activities of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them. This evaluation is one in a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities. It is intended to assess FHFA's review and approval of Freddie Mac's settlement of mortgage repurchase claims with Bank of America.

Fannie Mae and Freddie Mac are government-sponsored enterprises that support the nation's housing finance system through the secondary mortgage market. The Enterprises purchase mortgages from loan sellers, such as banks, which can then use the sales proceeds to originate additional mortgages. The Enterprises either hold the loans in their investment portfolios or pool them into mortgage-backed securities (MBS) that they sell to investors. The proceeds of such sales, in turn, fund additional purchases of loans on the secondary market. In 2010, with the housing crisis continuing, federal government-supported entities collectively controlled 96% of the secondary mortgage market.[1] The Enterprises alone accounted for 70% of the market.

In September 2008, due to mounting mortgage-related losses, the Enterprises were placed into conservatorships overseen by FHFA, pursuant to HERA. At the same time, the Department of the Treasury agreed to provide financial support to the Enterprises and, to date, has invested over $162 billion of public funds in them to offset their losses and prevent their insolvency.[2] As

[1] FHFA, *Conservator's Report on the Enterprises' Financial Performance: Fourth Quarter 2010*, at 5, available at www.fhfa.gov/webfiles/21169/Conservator's Report_4Q_4_20_11.pdf. The Government National Mortgage Association, the other federal government-supported entity, accounted for 26% of the secondary mortgage market.

[2] Federal Housing Finance Agency, "Data as of June 9, 2011, on Treasury and Federal Reserve Purchase Programs for GSE and Mortgage-Related Securities."

conservator, FHFA has assumed responsibility for the conservation and preservation of the assets of each Enterprise.

When a lender or other entity sells a mortgage to either Enterprise, it promises that the loan complies with certain representations and warranties – principally, that the eligibility of the property and the creditworthiness of the borrower are characterized accurately in the loan documents at the time of origination. If the purchasing Enterprise later discovers that the loan contains a defect (for instance, that the value of the property securing the loan was materially lower than described in the loan paperwork, or that the borrower did not have the income stated on the loan application), then the Enterprise has the contractual right to require the seller to repurchase the loan at its full face value or to indemnify the Enterprise for losses incurred. The mortgage repurchase process therefore provides an important means for the Enterprises to mitigate their credit-related losses on foreclosed mortgages and potentially limit taxpayer exposure to losses as well. Moreover, because the Enterprises typically do not examine the mortgages they purchase for such defects prior to purchasing them, their repurchase rights represent their principal defense against defective loans and the risks they pose.

In late December 2010, FHFA's Acting Director, in his capacity as the Enterprises' conservator, approved two repurchase settlement agreements between the Enterprises and Bank of America totaling $2.87 billion ($1.35 billion for Freddie Mac and $1.52 billion for Fannie Mae). Freddie Mac's settlement resolved most past, present, and (with limited exceptions) future repurchase issues associated with 787,000 loans sold to the Enterprise by Countrywide Financial (Countrywide). Bank of America purchased Countrywide in 2008. By contrast, Fannie Mae's settlement with Bank of America covered only past and present claims, not future ones. The Freddie Mac settlement could serve as a precedent for future repurchase settlements involving large financial institutions that sold significant numbers of loans to the Enterprise.

Although the Enterprises' mortgage repurchase settlements initially generated positive publicity for Bank of America, Members of Congress and others soon raised concerns about the settlement's adequacy.[3] Accordingly, FHFA-OIG began to survey the settlements in greater detail. While the survey was under way, two individuals independently provided FHFA-OIG with information raising significant concerns about the Freddie Mac-Bank of America settlement. Based on those concerns, FHFA-OIG prioritized its review and commenced this evaluation.

[3] For example, on January 7, 2011, four Representatives on the House Financial Services Committee wrote to FHFA's Acting Director seeking greater detail on the terms of the settlements.

FHFA-OIG makes three findings:

1. In mid-2010, prior to the Bank of America settlement, an FHFA senior examiner[4] raised significant concerns about limitations in Freddie Mac's existing loan review process for mortgage repurchase claims, which, according to the senior examiner, could potentially cost Freddie Mac "billions of dollars of losses." Freddie Mac's internal auditors independently identified concerns about the process at the end of 2010. These concerns merited prompt attention by FHFA because they potentially involve considerable recoveries for Freddie Mac and, ultimately, the taxpayers. Further, unless examined and addressed, the underlying problems are susceptible to recurrence in future settlements.

2. FHFA did not timely act on or test the ramifications of the senior examiner's concerns prior to the Bank of America settlement. FHFA-OIG did not independently validate Freddie Mac's existing loan review process and, therefore, does not reach any final conclusion about it. Nevertheless, by relying on Freddie Mac's analysis of the settlement without testing the assumptions underlying the Enterprise's existing loan review process, FHFA senior managers may have inaccurately estimated the risk of loss to Freddie Mac.

3. After this evaluation began, FHFA, to its credit, suspended future Enterprise mortgage repurchase settlements premised on the Freddie Mac loan review process and set in motion activities to test the concerns raised about the process. In addition, Freddie Mac's internal auditors continued to review the issue, and on June 6, 2011, issued an audit opinion that the Enterprise's internal corporate governance controls over this process were "Unsatisfactory." Furthermore, at the end of 2010 and then again in mid-2011, a Freddie Mac senior manager advised the board of directors that the Enterprise could recover additional money in the future through a more expansive loan review process. Currently, FHFA and Freddie Mac are analyzing the loan review process to determine whether greater recoveries in the future are possible.

FHFA-OIG believes that the recommendations in this report will result in more economical, effective, and efficient operations. FHFA-OIG appreciates the assistance of all those who contributed to the preparation of this report.

[4] For the purpose of this evaluation, within FHFA: staffers, examiners, and senior examiners report to managers; managers report to senior managers; and senior managers report to the FHFA Acting Director. Within Freddie Mac, senior managers report to the Chief Executive Officer.

This evaluation was led by David Z. Seide, Director of Special Projects; Timothy Lee, Senior Financial Advisor; and Bruce McWilliams, Investigative Evaluator. This evaluation report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

Richard Parker
Acting Deputy Inspector General for Evaluations

BACKGROUND

About the Enterprises and FHFA

To fulfill their obligations to provide liquidity to the mortgage finance system, Fannie Mae and Freddie Mac support what is commonly known as the secondary mortgage market. The Enterprises purchase from loan sellers residential mortgages that meet their underwriting criteria. The loan sellers can then use the sales proceeds to originate additional mortgages. The Enterprises can hold the mortgages in their portfolios or package them into MBS that are, in turn, sold to investors. In exchange for a fee, the Enterprises guarantee that investors will receive timely payment of principal and interest on their investments.

HERA provides FHFA with broad authority as the Enterprises' conservator to conserve and preserve Enterprise assets and to control and direct their finances and operations. FHFA has exercised that authority by, among other things, requiring FHFA pre-approval of certain categories of Enterprise business operations such as settlements of claims exceeding $50 million. In this regard, FHFA seeks to ensure that these high-dollar settlements are in the best interests of the Enterprises and the taxpayers.

For the purpose of this evaluation, two offices within FHFA, which report to FHFA's Acting Director, are relevant: the Office of Conservatorship Operations (OCO) and the Division of Enterprise Regulation (DER). OCO coordinates all activities concerning conservatorship issues. In this case, it took the lead in coordinating FHFA's review and approval of the Fannie Mae and Freddie Mac repurchase settlements with Bank of America. DER is an organizational unit comprised of FHFA examiners who have in-depth knowledge of Enterprise operations and credit risk work.

Overview of the Mortgage Repurchase Process

Designed to mitigate potential credit losses, the Enterprises' underwriting standards for loans they purchase are established in their federal charters and company policies. Lenders and other entities that sell mortgages to the Enterprises are contractually required to "represent and warrant" that, at the time of their origination, the loans they sell comply with the Enterprises' underwriting standards.[5]

[5] These representations and warranties are detailed in Freddie Mac's *Single Family Seller/Servicer Guide* and Fannie Mae's *Selling Guide.*

The Enterprises have established ongoing, post-purchase quality review processes to verify that the loans they purchase conform to their underwriting standards. If an Enterprise determines that a loan did not conform to its underwriting standards at the time of the loan's origination, then the Enterprise may require loan seller to repurchase the loan at full face value or to indemnify the Enterprise for any losses incurred. For example, the Enterprises review mortgages (the majority of which have gone into foreclosure) to determine whether the representations and warranties included in them were correct and in compliance with their underwriting standards. Based on such analysis, the Enterprises determine whether to request that loan sellers repurchase defective mortgages.

To date, the Enterprises have recovered billions of dollars through their assertion of repurchase claims. For instance, as of January 2011 Freddie Mac had received repurchase payments from loan sellers on about 8% of approximately one million loans that it had purchased that were then in foreclosure.[6] As of June 30, 2011, Freddie Mac had outstanding repurchase claims on loans with a combined unpaid principal balance of $3.1 billion.[7]

Changes in Mortgage Lending Practices During the Housing Boom

With the unprecedented growth in the United States housing market during the 2005 to 2007 housing boom, the quality of loans originated and sold to the Enterprises deteriorated substantially.[8] Before the boom, the mortgage market largely consisted of fixed rate, amortizing loans, such as 30-year fixed rate mortgages requiring equal payments each month over the life of the loan, and adjustable rate mortgages (ARMs) that incorporated features to protect borrowers from excessive fluctuations in monthly payments (such as "caps" limiting the amount by which the mortgage's interest rate can rise over the life of the loan).

However, from 2005 through 2007 there was a substantial increase in non-traditional mortgage products. These products had significantly enhanced risk profiles compared to more traditional mortgage products. First, they often included inherently risky attributes, such as significantly curtailed verification of borrowers' incomes and assets. Second, non-traditional loans appear to have significant percentages of representations and warranties defects.[9]

---

[6] Freddie Mac QC Disposition of Foreclosures by Funding Year, dated 1/11/11.

[7] Freddie Mac Update August 2011, at 16, available at www.freddiemac.com/investors/pdffiles/investor-presentation.pdf.

[8] Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report* (FCIC Report), at 178-79 (2011).

[9] Freddie Mac data summarizing housing boom era loans eligible for repurchase claims show that for loans originated in 2006, 2007, and 2008, 18.4%, 20.6%, and 23.4% respectively were "ineligible," meaning that Freddie Mac considered these loans potentially good candidates for repurchase claims. Freddie Mac Document, "NPL QC

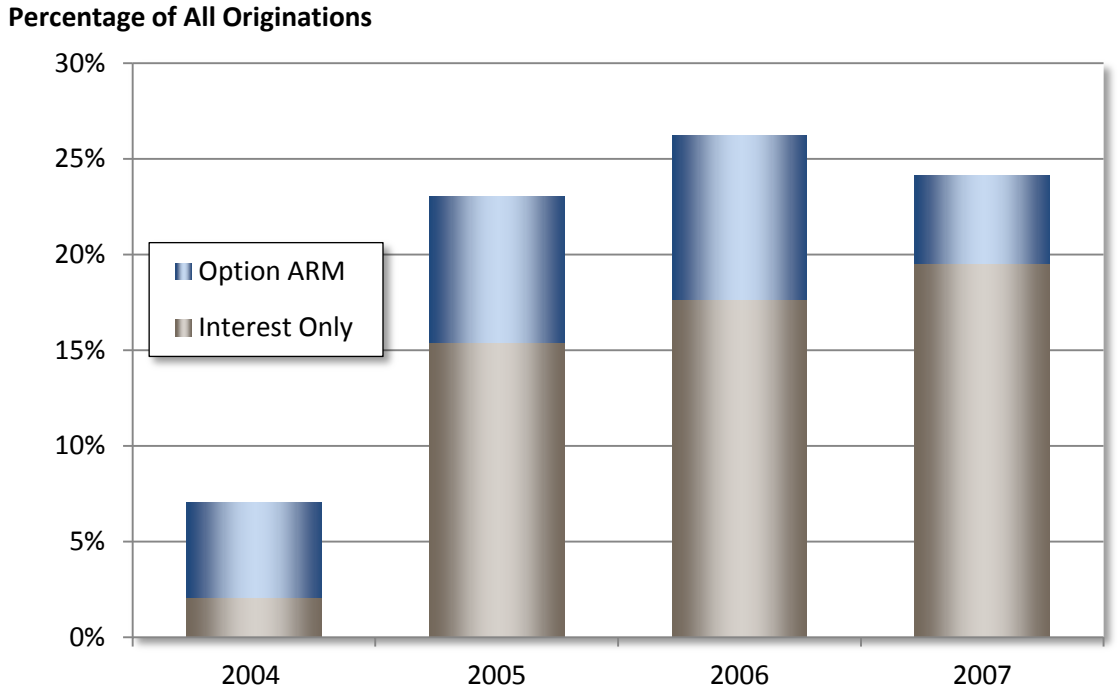
Frequently, the non-traditional loans featured "teaser" rates initially resulting in low payments, but those payments could increase dramatically two, three, or five years after origination when the rates reset and/or the repayment of principal began. Although borrowers with limited incomes and credit histories might be able to afford property purchases using such non-traditional loans during the teaser rate periods, the potential for defaults increased dramatically when the monthly payments on these loans subsequently reset at higher levels. Aggravating these conditions, defaults increased as housing prices began to fall at the end of 2006. The falling prices left many homeowners "underwater" – that is, with mortgage balances exceeding the value of the homes securing them.

Figure 1 illustrates the dramatic increase in two of the more commonly used non-traditional loan types during the housing boom years: Interest Only and Option ARM loans. Interest Only loans permit the borrower to pay only interest on the loan, not principal, for a specified period; Option ARMs are adjustable rate mortgages that permit the borrower, for a specified period, to choose among different payment options each month, ranging from traditional interest and principal payments, to interest only payments, to payments below the amount of interest owed each month.[10]

Review Results By Loan Characteristics Loans Funded January 2006-December 2009 QC Results as of Mar 3, 2011." Moreover, Freddie Mac's internal auditors, in a June 6, 2011, audit opinion report, cited to repurchase rates exceeding 10% among Alt-A loans from 2005 that entered foreclosure. June 6, 2011, Freddie Mac Memorandum, Re: Performing Loans Quality Control and Administration Audit (#2011-010), at 10-11.

[10] Federal Reserve Board, Consumer Handbook on Adjustable Rate Mortgages, available at www.federalreserve.gov/pubs/arms/arms_english.htm.

Figure 1: Significant Growth in Interest Only and Option ARM Loan Originations in the Overall Mortgage Market During 2005-2007 Housing Boom[11]



Although some non-traditional mortgages had interest rate resets within two years after origination, many others reset at a later time. For example, according to Freddie Mac, 80% of its Interest Only loans that originated in 2005 had their first payment adjustment five years after origination.[12]

There was also significant growth during the housing boom in higher-risk Alt-A mortgages as an alternative to lower-risk prime mortgages. Offered to those borrowers with credit profiles approaching those of prime borrowers, Alt-A mortgages often required limited or no documentation of key borrower credit risk characteristics, such as income and assets.[13] For example, borrowers might only have to state their annual income rather than provide verifying documentation, such as W-2 tax forms. Such limited- or no-document loans are also referred to

[11] Source: Inside Mortgage Finance, *2011 Mortgage Market Statistical Annual*, "Alternative Mortgage Originations," at 32.

[12] Sept. 15, 2010, FHFA Analysis Memorandum, at 2.

[13] Government Accountability Office, *Testimony of William B. Shear Before the U.S. Congress Joint Economic Committee on Home Mortgages*, at 1 n.1 (July 28, 2009), available at www.gao.gov/new.items/d09922t.pdf.

as "stated income" (or, more colloquially, "liar") loans. These categories of loans are not mutually exclusive; some Alt-A loans incorporated Interest Only or Option ARM payment structures.

During the housing boom, the Enterprises purchased large volumes of these non-traditional mortgages from large lenders, such as Countrywide. Countrywide was one of the most aggressive originators of limited- or no-document Interest Only and Option ARM loans.[14]

In early 2008, with the collapse of the housing market, Bank of America purchased Countrywide, which was then on the verge of failure.[15] Countrywide loans are the dominant component of the portfolio included within the Freddie Mac-Bank of America settlement and account for a significant number of repurchase claims asserted by Freddie Mac. For example, prior to the Bank of America settlement, Freddie Mac reviewed 58% of all Countrywide loans in foreclosure and made repurchase claims on 24% of them.

Chronology of Key Events and Associated Analysis[16]

a. Nine Months Prior to the Bank of America Settlement, an FHFA Senior Examiner Identifies Changes in Housing Foreclosure Patterns

In March 2010, an FHFA senior examiner, who is assigned to oversee Freddie Mac, noticed in Freddie Mac-supplied housing data an unusual pattern among foreclosures of loans originated during the 2005 to 2007 housing boom years. That pattern, as discussed in detail below, may have significant financial consequences for Freddie Mac and the taxpayers.

Before the housing boom, when the mortgage market was dominated by more traditional loans, mortgages that defaulted tended to do so during the first three years following origination. Further, the rate of defaults declined over time as the loans seasoned. This is reflected in Figure 2, showing when loans purchased by Freddie Mac in 2001 entered foreclosure.[17]

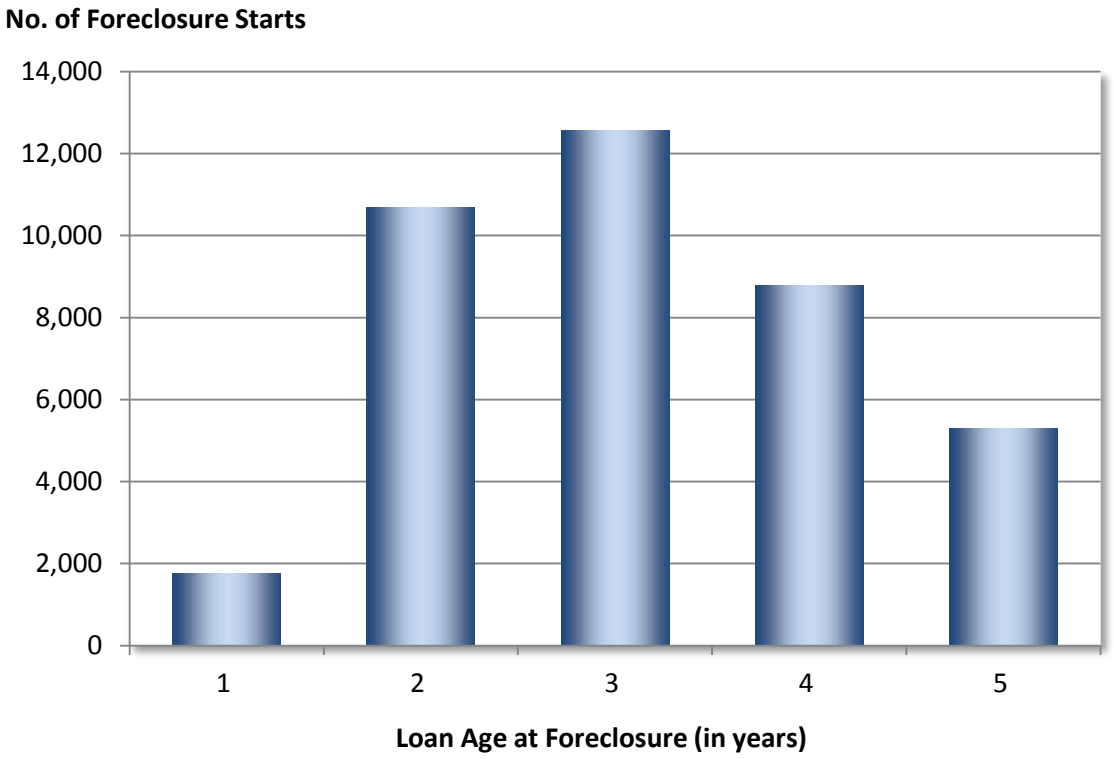
[14] FCIC Report at 105.

[15] FCIC Report at 250.

[16] A chart summarizing a timeline of key events is included at Appendix C.

[17] Freddie Mac purchases the vast majority of its loans shortly after origination.

Figure 2: Loans Purchased in 2001 by Freddie Mac that Entered Foreclosure[18]



But a different pattern exists among loans that Freddie Mac purchased that were originated during the housing boom. Rather than foreclosures declining over time, Freddie Mac-supplied housing data revealed foreclosures increasing, three, four, and five years after purchase, as reflected in Figure 3. It shows that for Freddie Mac-owned mortgages purchased in 2006 there were relatively few foreclosures within the first two years after purchase but there were significantly higher numbers of foreclosures during years three through five.

[18] Source: Freddie Mac QC Disposition of Foreclosures by Funding Year, dated 1/11/11.

Figure 3: Loans Purchased in 2006 by Freddie Mac that Entered Foreclosure[19]

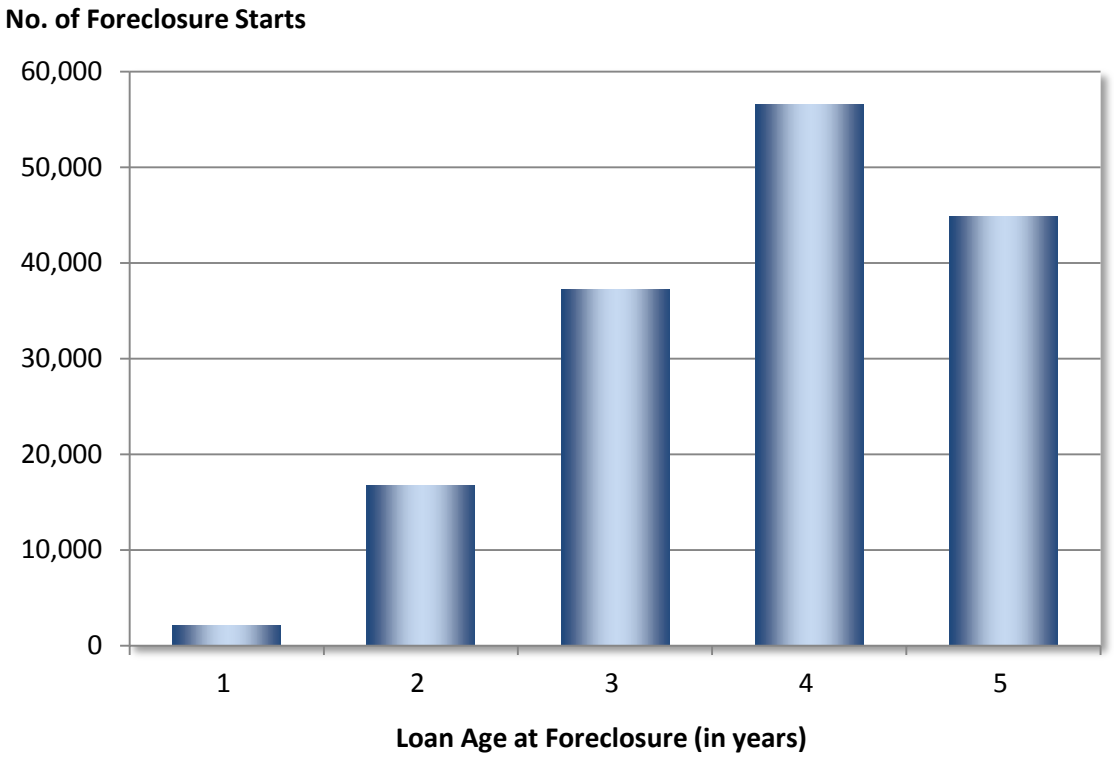


Figure 3 also shows over 100,000 additional loans in default (as compared to 2001-vintage loans), likely the result of the collapsed housing market and the onset of the financial crisis.

The FHFA senior examiner attributed the reversed pattern to the end of the teaser rate period for non-traditional mortgages,[20] and he recommended further study of the issue. An FHFA staff memorandum explained:

> [I]t would be reasonable to assume that many of the borrowers, faced with significantly increasing payments in the near term and very little equity in their home, made the decision to default before their [payments reset to higher levels]. It would also be reasonable to assume that the stated income and stated asset

[19] Source: Freddie Mac QC Disposition of Foreclosures by Funding Year, dated 1/11/11.

[20] Freddie Mac staff advised FHFA-OIG that they disagree with the senior examiner's causation hypothesis. Alternatively, they attribute the reversed pattern of foreclosures shown in Figure 3 to falling home prices leading to negative equity or "underwater" mortgages. However, causation is irrelevant to the issue in controversy. Regardless of the cause of these defaults, the search for representations and warranties defects is the point of the loan review process; and if the search does not begin, then the defects will not be found.

underwriting requirement played a role, but neither assumption can be tested without a review of the loans.[21]

As discussed in more detail below, FHFA did not test the loan review process to validate the senior examiner's concerns prior to its review and approval of the Bank of America settlement.

It should be noted that not all causes of foreclosure will justify a repurchase claim. For example, foreclosures may result from a borrower's subsequent loss of a job or health issues. But repurchase claims are fact-specific and based upon representations and warranties defects, such as missing or erroneous information regarding the quality of a borrower's assets or income.

b. FHFA Senior Examiner Raises Concerns that Freddie Mac Did Not Revise Its Loan Review Process for Repurchase Claims to Account for Foreclosure Pattern Changes Among Housing Boom Mortgages

The FHFA senior examiner also observed that, despite the apparently changed foreclosure patterns associated with housing boom era mortgages, Freddie Mac had not adjusted its process for identifying loans that might be candidates for repurchase claims. Freddie Mac reviews intensively for repurchase claims only those loans that go into foreclosure or experience payment problems during the first two years following origination. Loans that default thereafter are reviewed at dramatically lower rates. Freddie Mac senior management believe that loan underwriting defects such as an undisclosed lien on a property – which may be an indication of a representations and warranties deficiency – are most likely to appear within the first two years following origination.[22] Moreover, Freddie Mac management has advised FHFA-OIG that they also believe that higher rates of loan defaults in later years do not necessarily equate to higher defect rates. In their view, loans that had demonstrated a consistent payment history over the first two years following origination and then defaulted in later years (i.e., years three through five after origination) likely did so for a reason such as loss of employment, which is unrelated to a representations and warranties defect.[23] Based on these assumptions, Freddie Mac does not review most loans that go into foreclosure more than two years after origination. It reviews such loans only if they had already exhibited problems such as missed or late payments during the initial two years after origination or have potential indications of value discrepancies or any indication of fraud.

[21] Sept. 15, 2010, FHFA Analysis Memorandum, at 2-3.

[22] November 2, 2010, FHFA Analysis Memorandum, prepared by the FHFA Division of Enterprise Regulation, at 3.

[23] As discussed later in this report, Freddie Mac's internal auditors requested and Freddie Mac management agreed to test these assertions. Such testing is currently under way.

This practice meant that most pre-housing boom loans in foreclosure were reviewed for repurchase claims.[24] However, the shift in foreclosure patterns among housing boom loans (loans foreclosed three through five years after origination) meant most of them were not being reviewed, regardless of their potential viability for repurchase claims. Yet, later payment resets common among housing boom loans may have temporarily hidden the impact of representations and warranties defects (e.g., erroneous information about borrower income may not have come to light until their loan payment resets if the borrowers had sufficient income to satisfy the "teaser" rate payments but not the later permanent payments). The FHFA senior examiner shared his concerns with Freddie Mac management in June 2010 at a meeting attended by three FHFA examiners and an FHFA manager. A June 9, 2010, FHFA memorandum summarized the issue as follows:

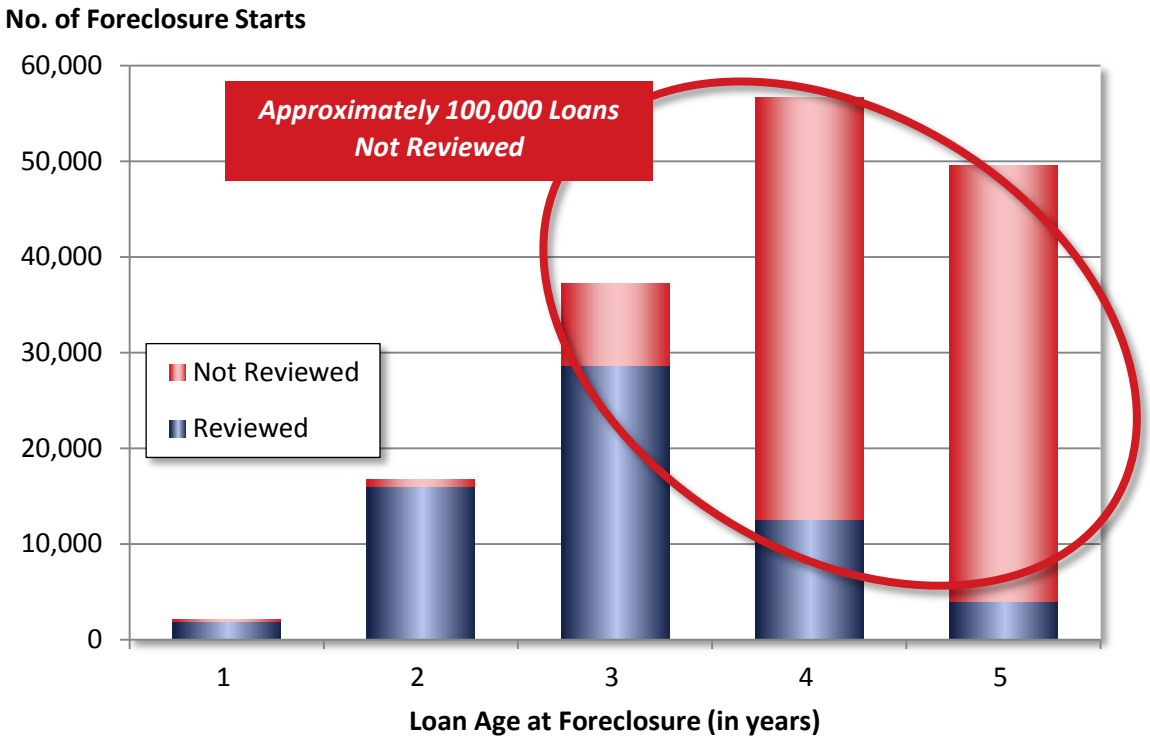
> It was pointed out to [Freddie Mac] that over 93% of the year-to-date [loan] foreclosures [(as of June 2010)] from the 2005 and 2006 [loan] vintages have been excluded from [loan repurchase] review, eliminating any chance to put ineligible loans back to the lenders from those years.[25]

Figure 4 demonstrates the extent to which Freddie Mac has not reviewed housing boom era mortgages that went into foreclosure during the third through fifth years after their origination. It shows that by choosing to review intensively only those loans that defaulted within two years of origination, Freddie Mac did not examine close to 100,000 2006 vintage loans.

[24] For example, from 2000 through 2004 Freddie Mac reviewed 62% of the 191,853 loans in foreclosure. Freddie Mac QC Disposition of Foreclosures by Funding Year, dated 1/11/11.

[25] July 9, 2010, FHFA Meeting Notes, at 2.

Figure 4: Loans Purchased in 2006 by Freddie Mac that Entered Foreclosure[26]



Freddie Mac data further show that for all Enterprise-owned foreclosed loans originated between 2004 and 2007, Freddie Mac has not reviewed over 300,000 loans for possible repurchase claims.[27] Those loans that were not reviewed (hereafter referred to as "out-of-sample" loans) have a combined unpaid principal balance exceeding $50 billion. Many of these loans are likely not candidates for repurchase. For instance, a portion of the loans not reviewed are lower-risk prime loans, which probably have a lower incidence of representation and warranty defects. On the other hand, Freddie Mac's portfolio of housing boom loans includes a substantial number of Interest Only and Alt-A mortgages, which have a high incidence of defects.[28]

[26] Source: Freddie Mac QC Disposition of Foreclosures by Funding Year, dated 1/11/11.

[27] Id.

[28] For example, Freddie Mac's internal auditors have observed that Interest Only and Alt-A loans respectively comprise 24% and 35% of all 2006 vintage loans in foreclosure, and 38% and 36% of all 2007 vintage loans in foreclosure. Freddie Mac 2011-010 PL Quality Control & Administration Audit Draft Audit Report Findings (05/05/11) (Draft Version 4.0), Fig. 3 and supporting data.

c. FHFA Senior Examiner Views Freddie Mac's Continued Use of Its Loan Review Process as Potentially Costing Freddie Mac "Billions of Dollars"

Throughout 2010, the FHFA senior examiner discussed with Freddie Mac managers his concerns about the Enterprise's continued reliance on its current loan review process. In his view, by not reviewing intensively the mortgages foreclosed upon more than two years after origination for repurchase claims, Freddie Mac could potentially lose "billions of dollars" that could be used to mitigate taxpayer losses.[29]

On June 9, 2010, during a regular monthly meeting involving four FHFA examination staff members and Freddie Mac senior managers, referenced above, the concerns about Freddie Mac's continuing use of its loan review process were discussed ("It was pointed out … that over 93% of the year-to-date [loan] foreclosures from the 2005 and 2006 [loan] vintages have been excluded from [loan repurchase] review."). A Freddie Mac senior manager said he had analyzed data on "loans defaulting 3-5 years out and concluded that [repurchase] reviews would not prove fruitful." But the manager agreed to conduct testing and "acknowledged that looking at the actual loan files would improve his analysis and so [he] agreed to call in a sample of those loans" to review.[30]

However, Freddie Mac officials ultimately did not review such a sample in 2010 or otherwise test issues related to the senior examiner's hypothesis. Moreover, FHFA did not require Freddie Mac to do so or to conduct independent testing. According to an FHFA examination staff description of a July 26, 2010, meeting of Freddie Mac's Credit Risk Subcommittee, a Freddie Mac manager told FHFA staff that loan repurchase review "was 'resource constrained' and sampling older defaults was 'not the highest and best use of his limited resources.'"[31] Weeks later, the FHFA senior examiner reported to FHFA senior managers that a Freddie Mac manager had informed him that another Freddie Mac senior manager was "vehemently against looking at more loans" but had offered "no cogent argument" explaining his resistance.[32]

---

[29] As discussed herein, the senior examiner's concerns were not confined to the Bank of America settlement, but covered all loan sellers and all potential future settlements. The issue is currently under review by FHFA and Freddie Mac.

[30] June 9, 2010, FHFA Meeting Notes, at 2.

[31] Sept. 15, 2010, FHFA Analysis Memorandum, at 3.

[32] Sept. 29, 2010, FHFA e-mail, Re: IO and OA defaults.

In a September 23, 2010, internal e-mail chain, the Freddie Mac senior manager told the Freddie Mac manager, "[w]e have spent a fair amount of time trying to help sellers forecast loan samples and repurchase request[s]. We have laid out a pretty clear sampling strategy." Sept. 23, 2010, Freddie Mac e-mail (11:04 AM), Re: NPL Sample on Older IO ARMs and Options Arms. Later in the same email chain, the senior manager told the manager, who suggested a temporary review of additional loans for two to three months, that "given the visibility and sensitivity

Senior Freddie Mac managers disagreed with the FHFA senior examiner's concerns, at least partly because they believed a change to a more aggressive approach to repurchase claims would adversely affect Freddie Mac's business relationships with Bank of America and other large loan sellers. During the course of this evaluation, FHFA-OIG staff interviewed the relevant Freddie Mac senior managers, who asserted that the existing loan review process was appropriate and that changing the process could potentially cost Freddie Mac business. One senior manager, who confirmed that he had recommended against further study of the default-timing anomaly, said he did not believe Freddie Mac would recover enough from a more expansive loan review process to offset losses of business from Bank of America and other loan sellers. Another Freddie Mac senior manager also talked about the potential loss of business and emphasized that he did not believe that the number of repurchase claims would increase appreciably.

d. FHFA Senior Examiner Alerts FHFA Staff, Managers, and Senior Managers to the Concerns About Freddie Mac's Loan Review Process

Between June and December 2010, approximately one dozen FHFA staffers, managers, and senior managers were alerted to the FHFA senior examiner's concerns about Freddie Mac's loan review process. See Appendix D for a timeline showing when each staffer, manager, and senior manager was first alerted. Nonetheless, FHFA did not timely act on or test the data underlying these concerns prior to approval of the Bank of America settlement. FHFA has advised FHFA-OIG that the senior examiner did not raise his concerns in the context of the normal FHFA examination process. However, the record is clear that his concerns were known to FHFA senior management well in advance of the completion of the settlement.

On September 15, 2010, the FHFA senior examiner prepared and circulated to FHFA managers an Analysis Memorandum describing the concerns. The memorandum recommended that Freddie Mac change its loan review process to analyze greater numbers of housing boom loans in foreclosure for repurchase claims. The memorandum also disputed Freddie Mac's argument that limited resources undermined its capacity to review a larger sample of loans and concluded by noting that the Enterprise was potentially losing out on significant potential mortgage repurchase recoveries.

> By not taking a good look at these defaulted [Interest Only and Alt-A] loans over the next 2-3 years, … with a loss severity rate above 40%, Freddie [M]ac could be passively absorbing billions of dollars of losses. Since the savings in credit losses would dwarf the incremental expenses incurred in reviewing additional loan files,

---

around [loan reviews] and repurchases, I view any change, even temporary as material. I would prefer we lay out a proposal here, with clear goals and objectives, then do at least a rough cost benefit." Sept. 23, 2010, Freddie Mac e-mail (11:44 AM), Re: NPL Sample on Older IO ARMs and Options Arms.

> the fundamental question that Freddie Mac and FHFA should be addressing is this: How many of the **ineligible** loans sold to Freddie Mac in the 2005-2007 origination years should Freddie Mac accept the loss on? (Emphasis in the original.)[33]

FHFA recipients of the memorandum offered differing responses to its contents. One senior manager told FHFA-OIG that he never read the memorandum because he had never opened the e-mail attachment containing it. Two managers (a senior manager and a manager) acknowledged that they had reviewed the memorandum, but they did not remember that the issue could potentially involve substantial losses to Freddie Mac. Another recipient noted that "this [issue] is important" and observed that "[o]ver time, I have consistently been concerned about sampling size. [Freddie Mac] appears to define sample size by the # of [full time employees] it has or wants, rather than by the true risk in the portfolio."[34] The senior examiner, in a reply e-mail that also copied the senior manager – who never read the memorandum – said:

> [S]taffing [for Freddie Mac] isn't an issue because [Freddie Mac] can hire or use vendors, or both. As I said yesterday, if you hire more underwriters, they will pay for themselves in the first week. This all goes away in about 2 years, but $billions will be lost if nothing is done.[35]

Additional e-mails describing the FHFA senior examiner's concerns were also sent to other FHFA staff, managers, and senior managers before FHFA approved the Freddie Mac-Bank of America settlement on December 29, 2010. In a November 23, 2010, e-mail another FHFA senior manager was advised by the FHFA senior examiner that the concerns involved "billions of dollars."[36] A December 9, 2010, e-mail commenting on the then-proposed Freddie Mac-Bank of America settlement observed that "if the agreement goes as is, those losses [on loans not reviewed] will be Freddie's and the discussion is over," and concluded that "the settlement number is too low …."[37] And, on the eve of the settlement's approval, a December 28, 2010, e-mail from the FHFA senior examiner to an OCO staffer again made the same point. It said that

[33] Sept. 15, 2010, FHFA Analysis Memorandum, at 4.

[34] Sept. 30, 2010, FHFA e-mail (8:12 AM), Re: IO and OA defaults.

[35] Sept. 30, 2010, FHFA e-mail (9:12 AM), Re: IO and OA defaults.

[36] Nov. 23, 2010, FHFA e-mail, Re: FW: FHFA AM NEWS SUMMARY 11 22 10. That senior manager told FHFA-OIG that he did not recall knowing that the issue potentially concerned billions of dollars of losses.

[37] Dec. 9, 2010, FHFA e-mail, Re: BoA settlement with Freddie.

Freddie Mac's continued use of its loan review process was a "huge" error, and the resulting losses would be "Freddie's losses, and of course, yours and mine as taxpayers."[38]

e. Freddie Mac Reaches a Tentative Repurchase Settlement with Bank of America; Freddie Mac's Internal Auditors Independently Raise Concerns About Freddie Mac's Loan Review Process

In early December 2010, Freddie Mac management agreed to a tentative settlement of repurchase claim issues with Bank of America. The tentative settlement was subject to approval by Freddie Mac's board of directors and FHFA. The settlement, which Bank of America wanted to finalize before the end of the year, required the bank to pay Freddie Mac $1.35 billion in exchange for relinquishment (with limited exceptions) of all pending and future repurchase claims related to 787,000 mortgage loans previously sold to Freddie Mac by Bank of America and Countrywide.

Enterprise management advised Freddie Mac's board of directors that the $1.35 billion figure was a reasonable settlement amount. The figure was premised on the assumption that Freddie Mac would in the "expected case" likely recover about [redacted][39] in repurchase claims from Bank of America from the specified portfolio of mortgage loans.[40] Freddie Mac management further explained, however, that there was "significant uncertainty" (or significant margin of error) in this figure and that it could vary positively or negatively by [redacted]. Thus, according to Freddie Mac management, a reasonable recovery in the expected case could range from about [redacted].[41] The proposed settlement of $1.35 billion was at the high end of the expected case range. These calculations incorporated the assumptions underlying Freddie Mac's existing loan review process, as well as revisions to a financial model Freddie Mac developed to estimate repurchase claims exposure.

[38] Dec. 28, 2010, FHFA e-mail (12:35 PM), Re: FYI--CW I/Os.

[39] Red text signifies content that FHFA and Freddie Mac claim is confidential financial, proprietary business, or trade secret information that is redacted in the publicly available version of this report.

[40] *Bank of America Repurchase Settlement Proposal* (Dec. 17, 2010), at 3. The precise figure given to the board of directors was [redacted].

[41] Id. The board was further informed that the possible recovery from Bank of America in a "stress case" was [redacted], and that a reasonable recovery in the stress case could range from about [redacted]. The "stress case" assumed, among other things, a worsening economy to a greater extent than the "expected case," leading to greater numbers of foreclosed loans and greater losses on repurchase claims.

Freddie Mac's board of directors was also told that the settlement had a number of benefits, as follows: [42]

- Because of "uncertainty around estimates," Freddie Mac stood to recover less money if it did not settle and instead continued to pursue repurchase claims;
- The settlement would reduce Freddie Mac's counterparty exposure to Bank of America, which was consistently greater than Freddie Mac's internal risk management policy permitted;
- Lower levels of potential Bank of America counterparty exposure could permit Freddie Mac to do more "capital markets" business with Bank of America (such as issuing MBS and corporate debt);
- "If the counterparty fails," Freddie Mac would have already been paid and the "benefit of representations and warranties [payments would have been] realized before failure;"
- The settlement "[i]mproves [Freddie Mac's] ongoing relationship with Bank of America;"
- The settlement would reduce Freddie Mac's costs associated with reviewing loans for repurchase claims;
- The settlement would be "positive [for Freddie Mac's] current financial results;" and
- The settlement would reduce Freddie Mac's "ongoing litigation [expense] risk of a loan-by-loan enforcement strategy."

In late November and early December 2010, Freddie Mac's internal auditors evaluated the settlement for reasons related to Freddie Mac's counterparty exposure to Bank of America and unrelated to the issues raised by the FHFA senior examiner. During the course of their review,

[42] Id. at 5. The board was also told of four risks or "cons" associated with the settlement:

- "Uncertainty about [the internal] estimates could result in losses beyond [the] settlement amount;"
- The "[t]ransfer of credit risk (beyond [the] settlement amount) from Bank of America to Freddie Mac [on settled loans would be] ultimately transferred to the taxpayer;"
- "Low probability of counterparty failure;" and
- Freddie Mac would have to change its internal models to account for the settlement.

the auditors independently questioned Freddie Mac's existing loan review process and documented their questions in a December 14, 2010, memorandum. The memorandum made two recommendations concerning the effect of the loan review process on loans not being reviewed for repurchase claims. Specifically, the internal auditors recommended that Freddie Mac management should:

1. Provide an overview of [Freddie Mac's] current sampling methodology, including a description of the portion of the portfolio that is not sampled; and

2. Quantify the potential risk of loss that is not or was not the subject of sampling pursuant to current and past sampling strategies.[43]

f. Freddie Mac Management Responds

In response to the internal auditors, Freddie Mac management prepared a memorandum (also dated December 14, 2010), which attempted to calculate how much money Freddie Mac would lose by not pursuing repurchase claims on loans that went into foreclosure three to five years after funding. In other words, Freddie Mac attempted to calculate how much it would be "leaving on the table" by not changing its existing loan review process to adjust for the changed circumstances brought about by the housing boom. Freddie Mac management calculated that figure to be in the range of [redacted] in the "expected case."[44] However, Freddie Mac's chief internal auditor observed that a potential [redacted] loss, which is at the low end of that range, left little if any of the [redacted] margin of error cushion associated with the settlement negotiations discussed above. Any amount greater than [redacted] would exceed the margin of error.

In making their calculation, Freddie Mac management did not have time to undertake a fresh study based on a representative sample of the "out-of-sample" loans, as requested by the FHFA senior examiner in June 2010, given the goal of closing the settlement by year-end. Instead, management used existing data collected for another purpose. It relied on a sample of about 2,200 loans drawn from all loan seller/servicers from which Freddie Mac purchased mortgages that had gone through repurchase claim review after having gone into foreclosure more than two

[43] Id. at 3.

[44] Dec. 14, 2010, Memorandum from Freddie Mac Senior Management to Freddie Mac's Internal Auditors, at 3. The "expected case" assumed that the economy would worsen slightly. Management further assumed that, in a "stress case," Freddie Mac could expect to recover larger amounts, specifically [redacted] – more than double the margin of error.

years after origination.[45] However, as Freddie Mac internal auditors have acknowledged, the loan sample used by management was not representative.[46] Among other things, the loans in the Freddie Mac management sample were drawn from all loan sellers, not only the loans found within the Bank of America settlement population. This represents a significant difference because most of the Bank of America loans in foreclosure were originated by Countrywide, which was among the most aggressive originators of higher-risk, non-traditional loans and whose loans had significantly above-average numbers of defects subject to repurchase claims.[47]

Freddie Mac management also justified its current loan review process under a "business practices" rationale. Freddie Mac management said that maintaining stable customer relationships that might lead to additional business with loan sellers like Bank of America justified the existing loan review process. The December 14 memorandum states:

> [T]he sample size is also impacted by our overall business strategy. Our sampling strategy is considering several goals, including put-backs of defective loans that create losses for the firm, providing incentives for sellers to produce well-underwritten loans, and maintaining stable customer relationships. For the settlement negotiations with Bank of America, management made a deliberate decision not to consider changes to our sampling procedures. Hence, the model was built on the assumption that past sampling practices are the best guide for future policies. While there is always the possibility that sampling policies will change going forward to be either more or less stringent, we did not adjust for these explicitly in evaluating the Bank of America settlement. However, we do have assumptions in the model that we believe account for potential risk in our valuation, in particular, our capital costs.[48]

In other words, Freddie Mac management asserted that the need to maintain relationships with loan sellers such as Bank of America was a factor weighing against implementing more expansive loan review and repurchase policies.

---

[45] These loans were purportedly a "proxy" for a random sample. In fact, the loans in question had defaulted three, four, or five years after origination and had good pay histories in the first two post-origination years. Ordinarily such loans would not be reviewed using Freddie Mac's current loan review process. This group had been reviewed because Freddie Mac suspected that the loans might be defective (insofar as their values significantly exceeded local averages), but further research had found no evidence of defects.

[46] Freddie Mac notes that this fact was disclosed to its board of directors.

[47] Freddie Mac staff has advised FHFA-OIG that before 2010, Countrywide loans had 50% more representations and warranties violations than the average.

[48] Dec. 14, 2010, Memorandum from Freddie Mac's Senior Management to Freddie Mac's Internal Auditors, at 4.

Freddie Mac's board of directors approved the Bank of America settlement on December 14, 2010.

Freddie Mac's chief internal auditor advised the board of directors that management had "highlighted and quantified the enumerated key risks."[49] At a December 17, 2010, board meeting, the chief auditor noted that management's estimate of [redacted] (which, as discussed above, was the amount Freddie Mac could lose in the settlement by not changing its loan review process) was "significant." Given that the proposed settlement allowed only for a [redacted] margin of error in the "expected case," or low range, the auditor told the board that "[f]rom this perspective there was little, if any, cushion, left for model uncertainty, further house price declines or higher severities." In other words, the auditor regarded management's low estimate to be at or very near the margin of error cushion. Any estimated amount greater than [redacted] would exceed the margin of error.

g. FHFA Staff Reviews and Recommends Approval of the Freddie Mac-Bank of America Settlement

Starting in early December 2010, FHFA staffers, managers, and senior managers also began to review the proposed settlement. FHFA senior management summarized their review in a December 28, 2010, memorandum to the Acting Director that recommended he approve the settlement. The memorandum provided significant detail about the settlement and included the package of materials supplied to the Freddie Mac board of directors prior to their approval of the settlement. The FHFA memorandum discussed Freddie Mac's and Bank of America's motivations to settle, explained the analysis and corporate governance process conducted by Freddie Mac management, reviewed risk factors, and compared the settlement to other repurchase settlements. Additionally, one paragraph in the memorandum identified the FHFA senior examiner's concerns about Freddie Mac's loan review process.[50] The paragraph described the process and noted that the Freddie Mac management had estimated the risk associated with the process to be "quantified in the range of [redacted] in recoveries." But, as discussed above, Freddie Mac's estimate had been premised on an unrepresentative sample of 2,200 loans, and it effectively equaled or offset the settlement's margin of error.[51]

[49] Dec. 14, 2010, Memorandum from Freddie Mac's internal auditor to the board of directors, at 4. FHFA believed that the auditors had considered Freddie Mac's current loan review process and found it to be "appropriate and reasonable." Dec. 28, 2010, Memorandum to the Acting Director, Re: Bank of America Recommended Settlement, at 5. However, according to Freddie Mac's chief internal auditor, the internal auditors did not endorse or disapprove the terms of the settlement. Rather, they raised concerns about risks associated with the settlement and advised the board of directors that Enterprise management had "highlighted and quantified the enumerated key risks."

[50] Dec. 28, 2010, Memorandum to the Acting Director, Re: Bank of America Recommended Settlement, at 5.

[51] Dec. 28, 2010, Memorandum to the Acting Director, Re: Bank of America Recommended Settlement, at 5.

Prior to conducting the settlement review, FHFA did not test the examiner's concerns (for instance, FHFA did not insist that Freddie Mac management follow through on the promise made in June 2010 to test a representative sample of loans in order to validate the senior examiner's concerns). Instead, the Agency relied on Freddie Mac's loan review process and its analysis of the settlement.

FHFA staff also faced time limitations in light of the goal of closing the settlement by the end of the month.[52] The short timetable affected what could be accomplished. For instance, FHFA staff suggested bringing in an outside expert to assist staff in their review, but FHFA senior management declined to do so because of the goal to finalize the deal by year-end.[53]

h. FHFA's Acting Director Suspends All Future Enterprise Repurchase Settlements Pending Further Review; Freddie Mac's Internal Auditors Issue an "Unsatisfactory" Audit Opinion

FHFA's Acting Director approved the settlement on December 29, 2010. However, after this evaluation began, and on the basis of concerns raised by FHFA-OIG and others about Freddie Mac's loan review process and its impact on repurchase settlements, FHFA suspended, pending further review, all future Enterprise repurchase settlements affected by the methodology underlying Freddie Mac's current loan review process.

Additionally, Freddie Mac's internal auditors continued to examine Freddie Mac's loan review process and, on June 6, 2011, they delivered to Freddie Mac's senior management an opinion that the Enterprise's internal controls associated with its loan review process were "Unsatisfactory."[54] The auditors' report explained that their opinion was "primarily driven by deficiencies noted with the governance, business rationale, and objectives of the [loan review process] and oversight of the … process."

As part of their work, the internal auditors analyzed Freddie Mac-owned loans that were funded in 2005 and were in foreclosure and – like the FHFA senior examiner – observed a sharp

[52] For example, a December 24, 2010, e-mail from Freddie Mac to FHFA senior management reiterated:

> BofA wants certainty and we will need your [(FHFA's)] sign-off so we can proceed to finalize everything on Tuesday and sign docs on Tuesday or Wednesday with the settlement, payment and disclosure on Friday the 31st.

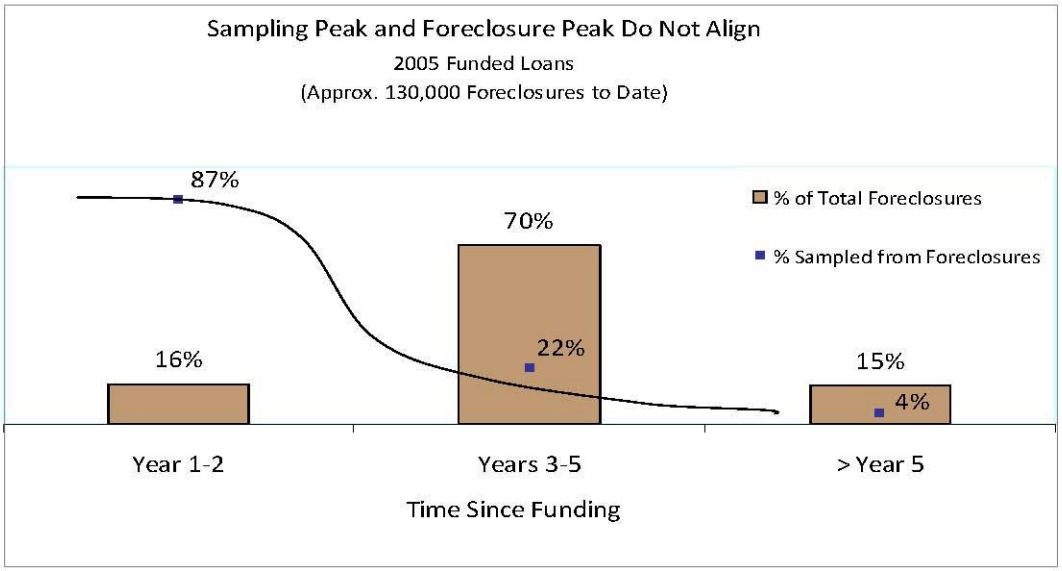
Dec. 24, 2010, Freddie Mac e-mail to FHFA (18:55), Re: BofA settlement.

[53] One senior manager told FHFA-OIG that he felt no time pressure to complete the review. However, others have told FHFA-OIG that they believed time pressure had an effect.

[54] June 6, 2011, Freddie Mac Memorandum, Re: Performing Loans Quality Control and Administration Audit (#2011-010), at 1. The opinion addressed the loan review process in general, not the Bank of America settlement in particular.

increase in foreclosures more than two years after origination, along with an equally dramatic fall-off in loan reviews after the second year, as shown in Figure 5 below.

Figure 5: Freddie Mac Internal Auditors' Depiction of Default Timing Anomaly[55]



This observation led the internal auditors (in a June 2011 presentation to the Freddie Mac board of directors) to assert that "[o]pportunities for increasing the repurchase benefit justify an expansion of our sampling approach after year two."[56]

The auditors recommended and management agreed to put additional emphasis on tying loan review methodologies to the volume of foreclosures (to examine larger numbers of currently unreviewed loans) and to "place more emphasis on balancing the customer relationship with the ultimate cost to the company."[57]

Consistent with the internal auditors' findings, the same Freddie Mac senior manager who prepared the Freddie Mac management estimate at the end of 2010 informed the Enterprise's board of directors that he believed Freddie Mac could recover several billion additional dollars by changing its current loan review process. On May 26, 2011, the senior manager advised the

[55] Id. at 9, Fig. 2.

[56] June 3, 2011, Presentation to the Freddie Mac Board of Directors, re: "Repurchase Sampling Strategy," at 3.

[57] June 6, 2011, Freddie Mac Memorandum, Re: Performing Loans Quality Control and Administration Audit (#2011-010), at 1.

board that Freddie Mac may be able to recover from [redacted] more in future repurchase efforts through the use of a more expansive loan review process.[58]

In addition, at the continued urging of the FHFA senior examiner, Freddie Mac management initiated a more statistically rigorous "out-of-sample" test in February 2011. Management agreed to sample approximately 1,000 "out-of-sample" Interest Only foreclosed loans originated during the housing boom era to estimate potential recoveries if a broader loan review process were employed. On August 31, 2011, Freddie Mac disclosed to FHFA the draft results from this study, which indicate that at least 15% of the sample loans – a higher percentage than anticipated by Freddie Mac management in connection with the Bank of America settlement – contain apparent representation or warranty defects and therefore are subject to repurchase claim to loan sellers.[59] The figure may fall to the extent that loan sellers ultimately cure the defects identified in some of these loans. Freddie Mac expects to receive final results from that review in about three months.

[58] May 26, 2011, Freddie Mac Memorandum to Board of Directors, Re: Single-Family Quality Control Process, at 8. On that day, the senior manager also informed the board that he believes Freddie Mac could lose from [redacted] in new business were it to adopt a more aggressive loan review procedure. In other words, according to Freddie Mac's rationale and as a cost-benefit exercise, the senior manager now believes that after deducting those possible losses from an estimated [redacted] gain, a change in the loan review strategy would leave Freddie Mac with $500 million to $1 billion in additional revenue.

[59] August 31, 2011, Freddie Mac Memorandum, Bank of America Settlement Loan Process Assumptions Review, at 6.

FINDINGS

On the basis of the foregoing record, FHFA-OIG finds that:

1. An FHFA Senior Examiner Raised Significant Concerns About Freddie Mac's Loan Review Process for Mortgage Repurchase Claims

As early as June 2010, prior to the Bank of America settlement, an FHFA senior examiner began to raise significant concerns about Freddie Mac's loan review process. Specifically, he noted that loans that Freddie Mac purchased that were originated during the housing boom defaulted at higher than expected rates during the third through fifth years after origination. However, Freddie Mac reviewed intensively only those loans that went into foreclosure or experienced payment problems during the first and second years following origination. As a result, Freddie Mac did not review over 300,000 loans for possible repurchase claims. According to the senior examiner, this could be costing Freddie Mac "billions of dollars of losses." These concerns merited further review of the loan review process in 2010, which was not forthcoming. In support of this finding, FHFA-OIG makes two initial observations.

- First, the concerns raised came from an FHFA senior examiner who had been reviewing Freddie Mac's financial and operational soundness for an extended period and continues to do so. Similar concerns were later independently raised by Freddie Mac's internal auditors.

- Second, the concerns relate to a significant risk (potentially involving substantial monetary losses) that is susceptible to recurrence in the event the Enterprise enters into future repurchase settlements.

FHFA-OIG further notes that the FHFA senior examiner's concerns were consistent with Enterprise data provided to FHFA, both before and after the Bank of America settlement. Specifically, as shown at Figures 2, 3, and 4 above, data indicate a significant shift in the mortgage default patterns on which the Enterprise's traditional loan review process was premised. That is, rather than foreclosures declining two years following their origination, mortgages originated during the housing boom era showed increasing rates of foreclosure during the third through fifth years after origination. In other words, the trend data upon which Freddie Mac's loan review process is premised appear to be at odds with actual foreclosure patterns associated with the 2005 to 2007 vintage loans included in the settlement.

These trends could be unrelated to the higher incidence of mortgage origination defects that might support repurchase claims if, for example, rising unemployment rates related to the

lingering recession caused more borrowers to default on their prime loans and led to increased home foreclosure rates. On the other hand, data demonstrate that many of the foreclosures of loans originated during the housing boom era appear to involve non-traditional loans, which appear to contain significant percentages of underwriting defects supporting repurchase claims. In any event, FHFA did not test issues related to the senior examiner's concerns prior to approving the Freddie Mac-Bank of America settlement.

Freddie Mac's internal auditors independently raised concerns in late 2010. In late November and early December 2010, Freddie Mac's internal auditors evaluated the Bank of America settlement for reasons unrelated to the senior examiner's actions, and, in connection with their evaluation, they too raised questions about the loan review process.

2. FHFA Did Not Timely Act on or Test the Ramifications of the Senior Examiner's Concerns; Consequently, FHFA May Have Incorrectly Estimated the Risk of Loss to Freddie Mac Before Approving the Bank of America Settlement

FHFA, acting as the conservator of the Enterprises, has established a procedure under which it reviews all Enterprise settlements of more than $50 million to ensure that they preserve and conserve Enterprise assets and are in the best interests of taxpayers. FHFA-OIG finds that senior FHFA management did not timely act on or test the ramifications of the FHFA senior examiner's concerns prior to approving the settlement, even though one dozen FHFA staffers, managers, and senior managers were aware of the concerns over a six-month period, as detailed below and as reflected in Appendix D. FHFA has advised FHFA-OIG that the senior examiner did not raise his concerns in the context of the normal FHFA examination process. However, the record is clear that his concerns were known to FHFA management and senior management well in advance of the completion of the settlement. For example:

- The FHFA senior examiner repeatedly raised concerns about Freddie Mac's loan review process with his direct supervisors (two managers who report to a senior manager) within DER in regular meetings throughout 2010. These direct supervisors did not follow up on or provide organizational support to substantiate these concerns.

- The FHFA senior examiner alerted two FHFA senior managers to the inaction of his direct supervisors.

- Two managers (a senior manager and a manager) acknowledged that they had reviewed the September 15, 2011, Analysis Memorandum, but they did not remember that the issue could potentially involve substantial losses to Freddie Mac.

FHFA-OIG did not independently validate Freddie Mac's existing loan review process and therefore does not reach any final conclusion about it. Nevertheless, by relying on Freddie Mac's analysis of the settlement without testing the assumptions underlying Freddie Mac's existing loan review process, FHFA senior managers may have inaccurately estimated the risk of loss to Freddie Mac. FHFA relied on a Freddie Mac management estimate that the Enterprise was forgoing no more than [redacted] by continuing to employ its current loan review process. That estimate was open to question because, among other reasons – and as Freddie Mac's internal auditors acknowledged, the [redacted] projected loss, which was at the low end of that estimate, left little if any cushion or margin of error, and the estimate itself was based on an unrepresentative sample of loans.

3. FHFA's Decision to Suspend Approval of Additional Repurchase Settlements and Freddie Mac's Continuing Efforts to Address the Concerns Are Positive Steps

After FHFA-OIG initiated this evaluation, FHFA suspended further Enterprise mortgage repurchase settlements that are premised on Freddie Mac's current loan review process. That is a positive step, and it may help FHFA better assure that any future repurchase claim settlements benefit the Enterprises and taxpayers.

In addition, since the close of the Bank of America settlement, Freddie Mac's internal auditors have continued to examine the matter and on June 6, 2011, issued an "Unsatisfactory" audit opinion concerning the internal corporate governance controls involving the loan review process. In response to that opinion, Freddie Mac management agreed to perform "out-of-sample" testing of loans not currently reviewed for repurchase claims. Freddie Mac management commenced such testing before the opinion was issued. In February 2011, at the urging of the FHFA senior examiner, management agreed to review a sample of 1,000 Interest Only loans originated during the housing boom that went into foreclosure more than two years after origination. The draft results from that sample were disclosed to FHFA on August 31, 2011, and they revealed that at least 15% of such loans – a higher percentage than anticipated by Freddie Mac management in connection with the Bank of America settlement – include representations and warranties defects and are subject to repurchase claims to loan sellers. However, the final repurchase rate may be lower. Final results are expected in about three months.

Moreover, as discussed in footnote 58 and accompanying text, on May 26, 2011, a Freddie Mac senior manager – who provided management estimates to the Freddie Mac board of directors in late 2010 – advised the board of directors that the Enterprise could recover from $500 million to $1 billion net in additional revenue through the use of a more expansive loan review process.

CONCLUSIONS

FHFA-OIG encourages FHFA and Freddie Mac to continue their efforts to gauge the impact of the default anomaly associated with housing boom loans and to take remedial actions to address problems identified. This evaluation reveals a lack of independent action by FHFA senior management, which may have led and could lead to significant losses by Freddie Mac. Had FHFA senior management required testing of the concerns raised by an FHFA senior examiner, FHFA may have been in a better position to evaluate Freddie Mac's repurchase claim settlement with Bank of America.

In the aftermath of the settlement, FHFA has suspended approving similar Enterprise repurchase claim settlements pending further review. Moreover, Freddie Mac's internal auditors continue to assess the issue, and Freddie Mac management has agreed to actions to resolve the concerns.

RECOMMENDATIONS

FHFA-OIG makes two recommendations:

1. **FHFA and its senior management must promptly act on the significant concerns raised about the loan review process.**

To ensure that Freddie Mac is maximizing its repurchase claim recoveries:

- FHFA should continue to withhold approval of Freddie Mac repurchase settlements until such time as it is confident that the concerns about the Enterprise's loan review process have been resolved.
- FHFA senior management should ensure that Freddie Mac management resolves the concerns that prompted their internal auditors to issue an "Unsatisfactory" audit opinion.
- FHFA senior management should oversee Freddie Mac's "out-of-sample" loan testing and consider independently validating the testing.
- FHFA should evaluate whether Fannie Mae and Freddie Mac should adopt consistent review practices for repurchase claims.

- FHFA senior management should initiate an independent assessment of Enterprise repurchase practices in order to ensure that they are maximizing their repurchase claim recoveries.

- FHFA should issue internal guidance regarding its handling of future repurchase settlements, should they arise.

2. FHFA must promptly initiate management reforms to ensure more generally that senior management is apprised of and timely acts on significant concerns brought to its attention.

FHFA senior management must immediately initiate reforms to avoid the kind of management process shortcomings identified in this evaluation. In particular:

- Direct supervisors must properly and timely address and act upon significant concerns brought to their attention (i.e., resolve or elevate issues that pose significant potential risks or document decisions not to do so).

- Senior managers, regardless of their position within FHFA, must timely address and act on significant concerns, particularly when they receive reports that the normal reporting and supervisory process is not working properly.

FHFA's Acting Director must establish appropriate goals, principles, and procedures at the top of the FHFA organization to guarantee that significant concerns are properly and timely addressed and acted upon.

SCOPE AND METHODOLOGY

To conduct this evaluation FHFA-OIG staff requested and reviewed FHFA and Freddie Mac documents, including e-mails associated with Freddie Mac's settlement with Bank of America. In addition, FHFA-OIG interviewed FHFA senior management and staff, as well as current and former Freddie Mac senior managers.

FHFA-OIG reviewed HERA, FHFA regulations, and internal policies. FHFA-OIG also obtained and reviewed publicly available data.

This evaluation was conducted under the authority of the Inspector General Act of 1978, as amended, and in accordance with the Quality Standards for Inspection and Evaluation (January 2011), which have been promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards, which are generally adopted by federal agencies, require FHFA-OIG to plan and perform evaluations so as to obtain evidence sufficient to provide reasonable bases to support findings and conclusions.

The performance period for this evaluation was from January 1, 2011, to August 30, 2011.

FHFA-OIG provided the Acting Director and FHFA senior management with briefings on this evaluation, as well as the opportunity to comment officially on the draft version of this report.

FHFA-OIG appreciates the efforts of FHFA and Freddie Mac management and staff in providing the information necessary to complete this evaluation.

APPENDIX A

FHFA Management Comments

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker
Deputy Inspector General for Evaluations (Acting)

FROM: Jeffrey S. Spohn
Senior Associate Director, Conservatorship Operations

SUBJECT: FHFA Comments on Draft Report "Evaluation of FHFA's Oversight of Freddie Mac's Repurchase Settlement with Bank of America"

DATE: September 19, 2011

Thank you for the opportunity to provide formal agency comments on the subject report. After months of review regarding this particular transaction, FHFA has not changed its view that the settlement reached in late December was appropriate and reasonable.

FHFA and Freddie Mac have previously provided numerous technical comments, corrections, and additional documentation to the Office of Inspector General (OIG) during the report review process. While we appreciate the opportunity afforded by these exchanges, FHFA does not concur with all the inferences made and concerns raised in the report.

Given the extensive feedback provided by FHFA during the development of this report, in this formal comment letter FHFA limits its response to providing the agency's comments on the findings and recommendations contained in the report.

Finding One: *An FHFA Senior Examiner Raised Significant Concerns About Freddie Mac's Loan Review Process for Mortgage Repurchase Claims*

There is no disagreement that a senior examiner in charge of examination activity involving Freddie Mac's loan review process for non-performing loans expressed concerns regarding the adequacy of that process for two types of mortgages. As part of regular examination activity, about six months before the repurchase agreements were finalized and before they were being negotiated, that FHFA senior examiner questioned Freddie Mac on a specific aspect of its loan review process for non-performing loans and outlined a hypothesis that, if proven correct, would suggest that the review process was inadequate for these two mortgage types. The follow-up (or lack thereof) that ensued, and the implications of this series of events for the completeness of the information available to FHFA and Freddie Mac at the time of the repurchase agreement with Bank of America is the principal subject of this report.

Freddie Mac (like Fannie Mae) has had a long-standing business practice built on past experience of sampling defaulted mortgages. The business objective of the loan review process for non-performing loans is primarily to understand why loans go into default (particularly early payment defaults) and secondarily, to assess whether the loan sold to Freddie Mac complied with contractual requirements at the time the loan was originated. Defects related to non-compliance with contractual terms may be grounds under Freddie Mac's contract to request the loan seller to repurchase the mortgage at par, which has the effect of shifting the loss on the defaulted loan from Freddie Mac to the loan seller.

Long-standing business practice has been that reviews of non-performing loans focus principally, but not exclusively, on mortgages that default in the first few years. This business practice stems from the belief that defaults that occur in the first few years provide the best opportunity to learn why loans go into default, while most later defaults are likely to be unrelated to manufacturing defects (they more typically reflect life events of the borrower such as unemployment, divorce, or health issues) and manufacturing defects become harder to prove with the passage of time.

The senior examiner asserted a hypothesis that a certain class of higher risk mortgages – namely interest-only mortgages and pay-option adjustable rate mortgages – had loan repayment characteristics that differed from traditional mortgages, which could increase the likelihood of discovering contractual violations resulting in defaults occurring later in the life of the mortgage. Therefore, the examiner believed that Freddie Mac should alter its sampling methodology for these specific loans by reviewing more loans that default in later years.

Mortgage defaults do not equate to a basis for repurchase requests, but they may be a reason to examine a loan for possible contractual violations. This is not about the riskiness of the loans but about contractual violations at the time of loan origination.

Finding Two: *FHFA Did Not Timely Act on and Did No Testing of the Senior Examiner's Concerns; Consequently FHFA May Have Incorrectly Calculated the Risk of Loss to Freddie Mac Before Approving the Bank of America Settlement*

OIG concludes that Freddie Mac did not timely agree to fully test its loan review process regarding the two loan types at the request of the senior examiner and that FHFA managers were slow to support the senior examiner's request for such testing. FHFA does not share this interpretation, but we agree that there are areas for improvement for FHFA.

FHFA has determined from the issues raised by OIG that the agency lacks sufficient policies and procedures guiding examiners and managers in situations where an examiner has a safety and soundness concern but perceives resistance from a regulated entity in pursuing such concerns. FHFA has also concluded that it needs to instruct its managers on working with examiners to bring such issues to closure. As a result of OIG's work on this report and our self-identification of this as a matter to be addressed, the FHFA Acting Director has instructed that such policies and procedures be developed and implemented quickly. This is in harmony with OIG's second recommendation and the agency's work to implement this remediation is nearly complete.

Finding Three: *FHFA's Decision to Suspend Approval of Additional Repurchase Settlements and Freddie Mac's Continuing Efforts to Address the Concerns Are Positive Steps*

The topics and events covered under this finding, including actions by FHFA and Freddie Mac and internal audit work at Freddie Mac, reflect activities that took place in 2011 and thus are not associated with the repurchase agreement with Bank of America in late 2010. Rather, they involve continued and additional questions involving loan quality reviews by Freddie Mac.

Discussions between FHFA and Freddie Mac following the Bank of America agreement turned to broader questions of Freddie Mac's loan purchase review practices, beyond interest-only and pay-option mortgages that had been the concern of the senior examiner. Freddie Mac agreed to undertake a broader review of its sampling methodology and FHFA suspended certain future repurchase agreements pending the outcome of this review. In June 2011, nearly six months after the agreement with Bank of America, Freddie Mac's internal audit department issued an audit opinion that raised issues with the governance process employed by Freddie Mac in its sampling methodology (not the sampling methodology itself) and the company is addressing those issues now under FHFA oversight. Of course, FHFA had already taken its action to suspend certain future agreements several months earlier and Freddie Mac had already been studying the issue. That work continues today.

OIG Draft Recommendations

OIG makes two recommendations in the draft report.

1. *FHFA and its senior management must promptly act on the significant concerns raised about the loan review process.*

FHFA agrees in principle with the recommendation but not with each of the specific action steps outlined in the report. Specifically, given the considerable amount of ongoing review regarding loan sampling, FHFA believes that action in support of this recommendation is already well underway. This work involves both the original issue raised by the senior examiner – unique sampling issues involving interest-only loans and pay-option mortgages – and a broader set of policy questions regarding loan sampling raised earlier in 2011 by FHFA and by Freddie Mac.

2. *FHFA must promptly initiate management reforms to ensure more generally that senior management is apprised of and timely acts on significant concerns brought to its attention.*

FHFA agrees with the recommendation. As indicated above, FHFA is developing and will soon issue policies and procedures to its examiners and managers regarding the agency's expectations for how to raise and resolve critical safety and soundness concerns that arise in the course of examination work. The goal is to establish greater clarity regarding the agency's expectations for both examiners and managers when an examiner or manager believes there is a critical safety and soundness issue that has not been, and cannot be, resolved through normal examination and supervision procedures.

APPENDIX B

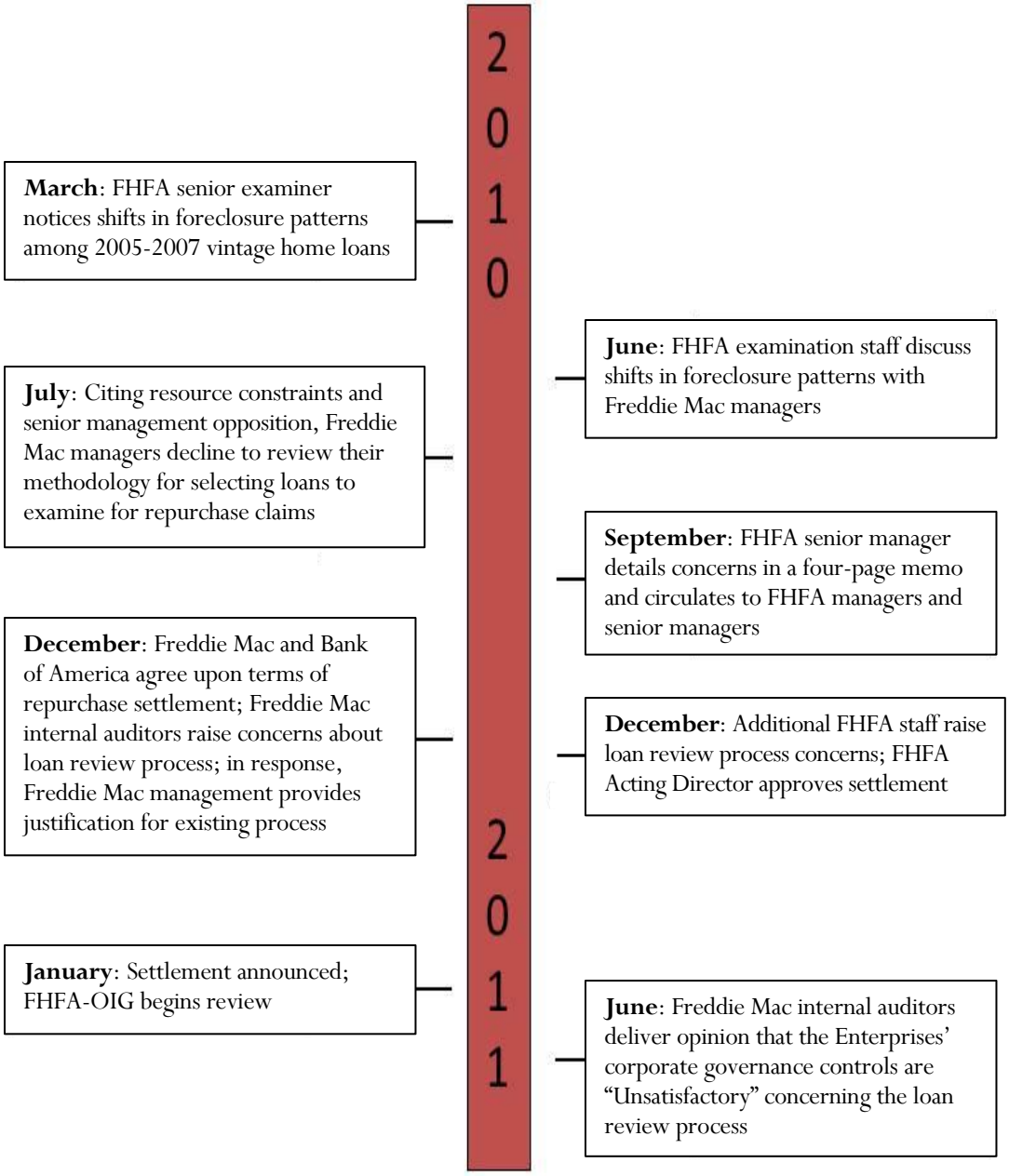
FHFA-OIG Responses to FHFA Management Comments

FHFA-OIG is pleased that FHFA has agreed to its recommendations and is already taking actions to address them.

With respect to the first recommendation on the loan review process, although FHFA accepts it in principle, it does not agree with each of the specific action steps outlined in the report. At the same time, FHFA has not proposed a specific action plan of its own. Under the circumstances, FHFA-OIG will continue to monitor the issues discussed in this report and the actions that FHFA is taking.

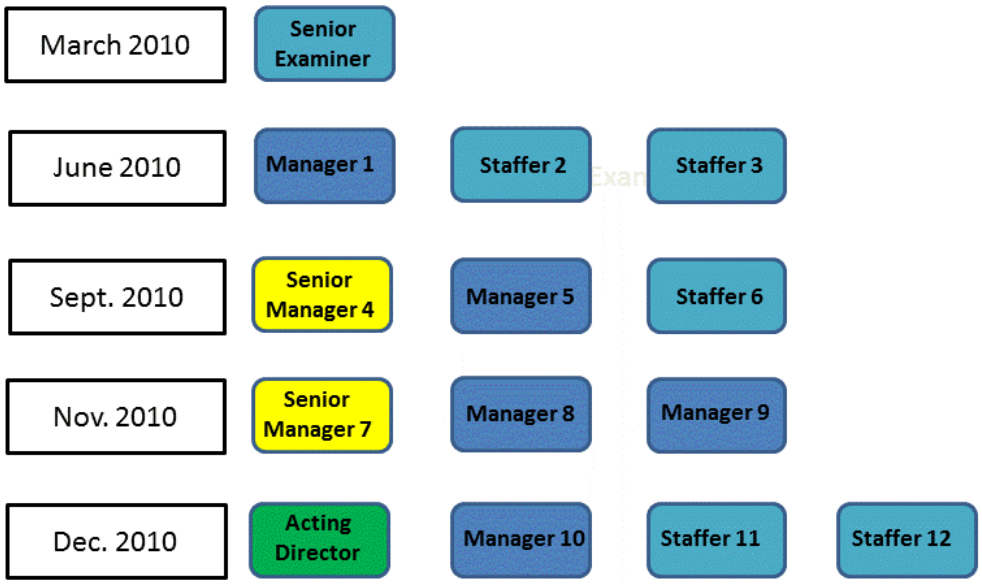
APPENDIX C

Timeline of Relevant Events



APPENDIX D

Timeline of When FHFA Staff Were Alerted to Concerns[61]



[61] For the purpose of this timeline and evaluation, FHFA staffers and senior examiners report to managers; managers report to senior managers; and senior managers report to the FHFA Acting Director.

ADDITIONAL INFORMATION AND COPIES

For additional copies of this report:

- Call the Office of Inspector General (OIG) at: 202-408-2544
- Fax your request to: 202-445-2075
- Visit the OIG website at: www.fhfaoig.gov

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

- Call our Hotline at: 1-800-793-7724
- Fax the complaint directly to: 202-445-2075
- E-mail us at: oighotline@fhfa.gov
- Write to us at: FHFA Office of Inspector General
  Attn: Office of Investigation – Hotline
  1625 Eye Street, NW
  Washington, DC 20006-4001