

Federal Housing Finance Agency
Office of Inspector General



Freddie Mac Could Further Reduce Reimbursement Errors by Reviewing More Servicer Claims

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At A Glance

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Why OIG Did This Report

Freddie Mac (along with Fannie Mae) supports the secondary residential mortgage market by purchasing mortgages originated by banks and other financial institutions. When Freddie Mac purchases a mortgage loan, it contracts with mortgage servicers, such as large banks or mortgage companies, to handle routine loan activities, such as collecting and forwarding mortgage payments.

When borrowers become delinquent, a servicer may be required to maintain the property, pay taxes and insurance, and liquidate the loan. After the loan is liquidated, the servicer seeks reimbursement of its expenses from Freddie Mac.

Freddie Mac paid servicers \$1.4 billion in 2013. In this report we discuss the process by which Freddie Mac reimburses its servicers for delinquency expenses, examine the controls it put in place to minimize erroneous payments, and estimate the rate of improper payments made by Freddie Mac in 2013.

What OIG Found

Freddie Mac has a Multi-layered Process for Assessing the Validity of Servicer Reimbursement Claims

Under its multi-layered review, Freddie Mac identified and denied approximately \$126 million in erroneous claims in 2013. The following summarizes the process:

- Freddie Mac's reimbursement system automatically denies any servicer claims for reimbursement that do not meet established cost ceilings;
- Next, Freddie Mac personnel review certain higher-risk claims to determine their reasonableness; and
- Finally, before any reimbursements are made, Freddie Mac selects a random, statistically significant sample of claims for a detailed "pre-payment review." Servicers are required to submit supporting documentation for each expense set forth in the selected claims. If a servicer does not submit documentation by the required date, then the expense in question will be denied, and the servicer may not resubmit a claim for reimbursement of it.



At A Glance

August 27, 2014

Freddie Mac May be Able to Further Reduce Erroneous Servicer Reimbursement Expenses

Freddie Mac's process appears to be generally effective in reducing erroneous servicer reimbursement expenses. However, we estimate that in 2013 Freddie Mac paid about \$70 million to settle erroneous claims for reimbursement that were not subjected to the pre-payment review. Accordingly, we believe that Freddie Mac may achieve additional savings by enlarging the sample of claims that is subjected to the prepayment review.

We acknowledge that Freddie Mac would incur additional expenses, such as personnel costs, if it expanded the size of the prepayment review sample beyond the current percentage of claims reviewed. However, we estimate that doubling the percentage of claims reviewed would result in additional savings of nearly \$7 million at a cost of only about \$1 million in higher Enterprise personnel expenses.

At some point, however, the costs associated with expanding the pre-payment review sample would likely exceed the potential financial benefits.

What OIG Recommends

We recommend that FHFA require Freddie Mac to:

1. Determine, by means of a cost-benefit analysis, whether to increase the size of the sample of reimbursement claims that it subjects to the pre-payment review.
2. If warranted by the result of the cost-benefit analysis, increase the size of the sample of reimbursement claims that it subjects to pre-payment review.

FHFA agreed that by August 31, 2014, it would direct Freddie Mac to complete a cost-benefit analysis and, if warranted, to increase the sample size by October 31, 2014.

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ABBREVIATIONS

Desk Reference	Freddie Mac Expense Reimbursement Desk Reference
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
HERA	Housing and Economic Recovery Act of 2008
IPERA	Improper Payments Elimination and Recovery Act of 2010
OIG	Federal Housing Finance Agency Office of Inspector General
OMB	Office of Management and Budget
REO	Real Estate Owned
Guide	Freddie Mac Single Family Seller/Service Guide

PREFACE.....

Since the 2008 financial crisis, Fannie Mae and Freddie Mac (together, the Enterprises) have paid their servicers billions of dollars to manage the properties that secure their mortgages.

The servicers carry out their management duties in accordance with the Enterprises' servicer guidelines and other applicable documents and agreements. From time to time servicers are required to advance payments on behalf of borrowers who have become delinquent. For the most part, such payments are made to cover property maintenance, insurance, taxes, and loan liquidation costs. Thereafter, the Enterprises reimburse the servicers.

In September 2013, we issued a report on Fannie Mae's servicer reimbursement operations.¹ In it, we made three findings. First, errors made by the contractor that Fannie Mae hired to process its servicers' reimbursement claims caused Fannie Mae to overpay its servicers about \$89 million in 2012. Second, the method by which Fannie Mae oversaw its contractor was not effective in minimizing such overpayments. And third, FHFA's oversight of Fannie Mae's operations was minimal prior to 2013.

In this report we focus upon Freddie Mac's reimbursement operations, i.e., how Freddie Mac reimburses its servicers for delinquency expenses. We also estimate the rate of improper payments made by Freddie Mac in 2013.²

This evaluation was led by Bruce G. McWilliams, Senior Investigative Evaluator, and Omolola Anderson, Senior Statistician, with assistance from Desiree I-Ping Yang, Financial Analyst, and overseen by Angela Choy, Director. We appreciate the cooperation of all those who contributed to this effort, especially members of the Default Fees and Claims Department at Freddie Mac.

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



Richard Parker
Deputy Inspector General for Evaluations

¹ See *Evaluation of Fannie Mae's Servicer Reimbursement Operations for Delinquency Expenses* (EVL-2013-012) (September 18, 2013), <http://www.fhfa.ig.gov/Content/Files/EVL-2013-012.pdf>.

² We define the term "improper payments" to refer to the combination of payments in excess of what is required, i.e., an "overpayment," and less than what is required, i.e., an "underpayment."

CONTEXT

The Servicers' Role in Protecting Freddie Mac's Financial Interests

Freddie Mac (along with Fannie Mae) supports the secondary residential mortgage market by purchasing mortgages originated by banks and other financial institutions. The Enterprises either hold the mortgages in their investment portfolios or pool them into mortgage-backed securities (MBS), the performance of which the issuing Enterprise guarantees. In either case, when Freddie Mac purchases a mortgage, it has a financial interest in maintaining the value of the home that secures its mortgage.

Freddie Mac goes about maintaining the value of the mortgages that it owns or guarantees by contracting with servicers to perform a variety of duties, including:

- Collecting mortgage payments and processing late payments;
- Forwarding payments from the homeowners to Freddie Mac;
- Maintaining escrow accounts to pay property taxes and insurance; and
- Handling default proceedings and foreclosures as necessary.

As long as a borrower is current on his or her loan, then the servicer merely collects mortgage payments and forwards them to Freddie Mac.³ The servicer's responsibility increases when the borrower defaults on the loan. Then the servicer must assist the borrower in finding a solution to the delinquency problem in a manner that protects Freddie Mac's financial interest. For example, the servicer may help the borrower obtain an appropriate foreclosure alternative, such as a loan modification or a short sale.⁴

If, however, a borrower cannot repay the mortgage or obtain a foreclosure alternative, then the servicer is required to liquidate the mortgage through foreclosure. After the loan is liquidated

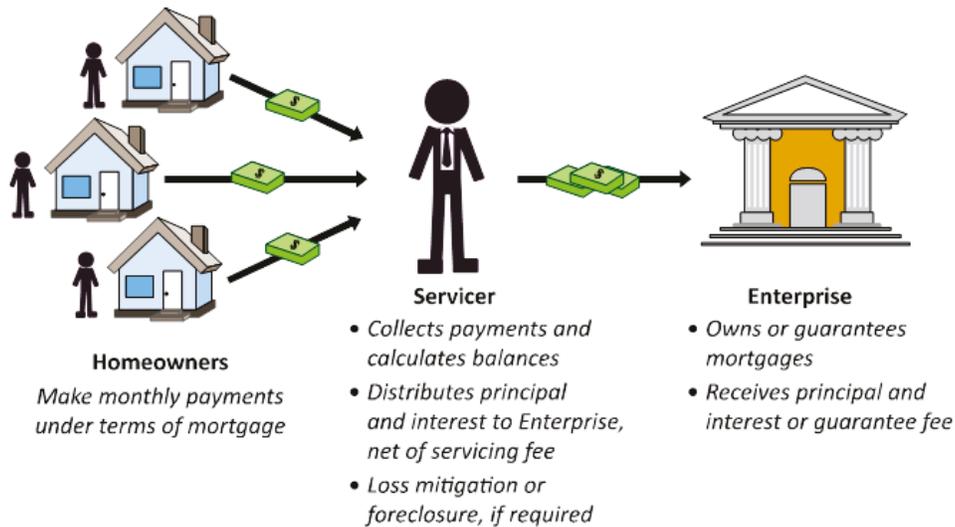
³ The servicer may also collect escrow funds for taxes, insurance, or homeowner association (HOA) dues and make payments in furtherance of such expenses.

The servicer retains a small percentage of the payment as a servicing fee. See *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* (AUD-2012-001) (March 07, 2012), http://www.fhfaog.gov/Content/Files/AUD%202012-001_0.pdf.

⁴ Foreclosure alternatives include payment plans, forbearance agreements, loan modifications, short sales, or deeds-in-lieu of foreclosure. When a mortgage loan is modified its terms are adjusted to create a more affordable monthly payment for the borrower. Upon completion of the modification, the mortgage is brought current. In a short sale the borrower is permitted to sell the property for an amount that is less than the balance of the mortgage, and, thus, avoid foreclosure.

the servicer seeks reimbursement from Freddie Mac for the various expenses it incurred during the foreclosure process. The mortgage servicing process is illustrated in Figure 1, below.

FIGURE 1. ENTERPRISE MORTGAGE SERVICING PROCESS



Freddie Mac’s Servicer Reimbursement Operations

Freddie Mac’s Claims Department manages its servicer reimbursement operations. Once a loan has been liquidated, the servicer⁵ submits an electronic claim to the Claims Department through Freddie Mac’s Reimbursement System.⁶ A claim consists of various line items that correlate to the expenses the servicer incurred in attending to Freddie Mac’s mortgage loan. Typical expense line items include attorney fees and legal costs incurred during the foreclosure process, property taxes, insurance, and property maintenance. In 2013, Freddie Mac paid \$1.4 billion to 460 servicers for such expenses. Although Freddie Mac has many servicers, its top 10 servicers – relative to total reimbursements – accounted for 87 percent of all reimbursement payments made by Freddie Mac in 2013. See Figure 2.

⁵ In some instances, parties other than servicers submit reimbursement claims to Freddie Mac through the Reimbursement System. Throughout this report the term “servicer” is used to mean all those entities that engage in default management services and submit claims through Freddie Mac’s Reimbursement System.

⁶ The Claims Department uses VendorScape software developed by CoreLogic, Inc., a real estate data provider. CoreLogic manages Freddie Mac’s software and houses its database.

FIGURE 2. SERVICER COMPOSITION OF FREDDIE MAC’S REIMBURSEMENTS IN 2013

Rank	Servicer	Percent of Total
1	JP Morgan Chase Bank	21%
2	Wells Fargo Home Mortgage Inc	21%
3	Bank of America	12%
4	Nationstar Mortgage, LLC	11%
5	Citimortgage Inc	8%
	Top Five Servicers	72%
6	Ocwen Loan Servicing, LLC	6%
7	US Bank	3%
8	PNC BANK, NA	2%
9	Cenlar FSB	2%
10	Fifth Third Bank	2%
	Top Ten Servicers	87%
	Other 450 Servicers	13%
Total		100%

Source: Freddie Mac. Numbers may not add due to rounding.

Freddie Mac Employs a Three Tier Process to Determine Whether to Pay a Claim

Freddie Mac’s Reimbursement System is comprised of three parts: business rules, queues, and pre-payment review. These parts are defined and described below.

Business Rules

Generally, Freddie Mac reimburses a servicer after ensuring that its claim falls within the parameters specified in its Single Family Seller/Servicer Guide (Guide).⁷ These parameters, known as business rules, set forth how much and how frequently Freddie Mac will pay for certain items.⁸

Freddie Mac employs the business rules to approve, adjust, or deny claims based upon established expense limits and the date upon which the expense was incurred. If a servicer expects to incur an expense that will exceed the limits set by Freddie Mac, then it must submit a request for pre-approval (RPA) prior to submitting the claim. If Freddie Mac approves the

⁷ Freddie Mac does not require a servicer to submit supporting documentation at the time the servicer submits its expense reimbursement claim. However, Freddie Mac may require a servicer to submit supporting documents at another point in the reimbursement process. For example, documentation is required if a claim is subjected to pre-payment review, which is discussed later in this report.

⁸ The business rules are programmed into the reimbursement system’s software.

exception in the RPA, then it will be programmed into the reimbursement system as an acceptable expense. Otherwise, the request for reimbursement will be automatically reduced or denied if it exceeds the limits or is not reimbursable.

Queues

The Reimbursement System targets higher risk claims for additional review by the Claims Department. These claims are identified by the business rules and are routed to workflow queues for further analysis. Although the claims are reviewed for reasonableness, the claimants are generally not asked to provide documentary evidence of the expenses underlying the claims.

The Pre-Payment Review Process – an Additional Level of Scrutiny

After all adjustments from the business rules and queues have been applied, but before reimbursement is paid, a random, statistically significant sample of the claims is selected for a pre-payment review.⁹ The servicers that submitted the affected claims are required to submit documentation supporting each line item within seven business days.¹⁰ If a servicer fails to submit documentation by the required date, then the line item in question will be denied, and the servicer may not resubmit a claim in connection with it.

According to Freddie Mac, supporting documentation includes, among other things, copies of original bills or invoices for expenses such as legal fees and costs, property inspections, property preservation costs, primary mortgage insurance premiums, and condominium/HOA/Planned Unit Development.¹¹

After receiving an automated confirmation that documentation has been received on a claim, the pre-payment reviewer assigned to the claim must manually confirm that documentation exists for each line item within the claim. After reviewing the documents, the reviewer approves, denies, or adjusts the amount in each line item.

⁹ The Claims Department refers to the review as a “pre-audit review.” Since this review occurs prior to payment, for presentational purposes we refer to the process as the “pre-payment review.”

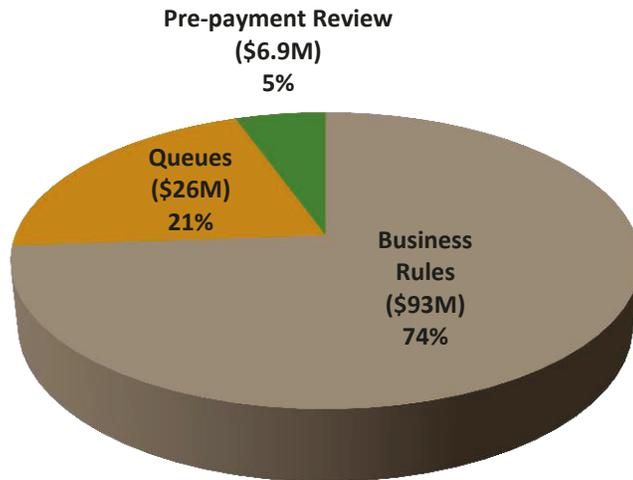
¹⁰ A servicer that requests an extension may be provided with up to five additional business days to submit required documentation.

¹¹ Less frequently submitted standard documentation includes: copies of loan histories for the twelve months prior to the due date of the last paid installment up to the date upon which the history was requested, and information concerning tax payments. In some cases in which taxes are paid as a lump sum, the claimant must provide a breakdown from the taxing authority that specifies the tax amount, including late charges, penalties, and interest paid, if any.

The Claims Department noted that some smaller servicers with lower claim volumes may not consistently adhere to the documentation submission requirements and has proposed additional training as a remedy.

Although the pre-payment review results in additional adjustments in reimbursement payments, the majority of payment adjustments are made as a result of Freddie Mac’s application of its business rules. See Figure 3.

FIGURE 3. DISTRIBUTION OF CLAIM REIMBURSEMENT ADJUSTMENTS IN 2013 (\$ MILLIONS)¹²



Source: Freddie Mac.

In 2013, through all three levels of claim review, Freddie Mac reduced reimbursement payments by \$126 million. The pre-payment review accounted for \$6.9 million of these reductions.¹³

There were over 200 line item codes in Freddie Mac’s 2013 pre-payment review sample. We aggregated these codes into the following seven categories: (1) taxes; (2) attorney fees and legal costs; (3) lender-placed¹⁴ and property insurance; (4) maintenance; (5) mortgage insurance; (6) Home Affordable Modification Program (HAMP) costs;¹⁵ and (7) other

¹² We note that only a portion of reimbursement claims are subjected to a Pre-Payment Review, whereas all claims are subjected to reviews under the business rules and the queues processes.

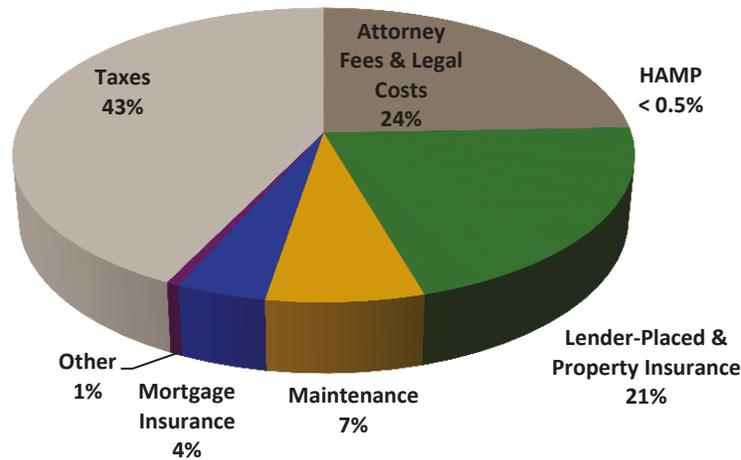
¹³ An adjustment can result in either an increase or a reduction in a claim for reimbursement, although the large majority of adjustments result in reductions. Thus, the net impact of adjustments made under the Reimbursement System has been a reduction in the amount of reimbursements made by Freddie Mac.

¹⁴ Lender-placed insurance (LPI) is hazard insurance placed upon a home by a servicer at the borrower’s expense when the borrower’s privately procured insurance has lapsed. Under Freddie Mac’s guidelines, its servicers must secure LPI as part of their duty to protect the value of the homes securing the mortgages that Freddie Mac owns or guarantees. Servicers pay the initial LPI premiums and submit claims for reimbursement through Freddie Mac’s Reimbursement System. See *FHFA’s Oversight of the Enterprises’ Lender-Placed Insurance Costs* (EVL-2014-009) June 25, 2014, <http://www.fhfaog.gov/Content/Files/EVL-2014-009.pdf>.

¹⁵ The Home Affordable Modification Program (HAMP) is part of the Making Home Affordable Program. Under HAMP, mortgage servicers work with eligible homeowners to lower their monthly mortgage payments.

expenses. The pre-payment review sample included 308,067 line items totaling \$127.3 million in reimbursement claims. As depicted in Figure 4, below, taxes accounted for the majority of the claims at \$60.5 million (43%). The second largest reimbursement category was attorney fees and legal costs at \$34.5 million (25%).

FIGURE 4. DISTRIBUTION OF SERVICER EXPENSE REIMBURSEMENT CLAIMS IN 2013 PRE-PAYMENT REVIEW



Source: OIG Categorization of Freddie Mac Data.

Although the pre-payment review is a critical reimbursement cost control, we observe that its effectiveness is limited to the sample of claims actually reviewed. The Claims Department does not take any steps to verify the legitimacy of the claims that are not subjected to the pre-payment review.¹⁶ In the Findings section, below, we discuss how expanding the pre-payment sample could provide Freddie Mac with greater assurance as to the validity of the reimbursement process, as well as achieve considerable cost savings.

Freddie Mac Enhanced its Reimbursement System in Response to Internal Audit Reports

Freddie Mac’s Internal Audit Department (Internal Audit) examined the Claims Department in 2010 and 2012. On both occasions, Internal Audit found weaknesses in Freddie Mac’s controls over its Reimbursement System. In its 2010 report, Internal Audit found that the Reimbursement System provided opportunities for servicers and vendors to be overpaid.

¹⁶ Freddie Mac’s Guide requires each servicer to review periodically the costs its vendors incur on behalf of the servicer. However, a Freddie Mac official said that the Enterprise does not generally review servicers’ compliance with this requirement beyond the reimbursement controls discussed in this evaluation report.

In 2012, Internal Audit observed similar flaws and noted weaknesses in both the system's design as well as the sampling methodology employed by Freddie Mac's Claims Department. Specifically, Internal Audit identified the risk of duplicate payments to servicers and inadequate targeting of the sample for expenses known to present higher risks.

After the audits, the Claims Department made several adjustments to the pre-payment portion of the Reimbursement System. Specifically it:

- No longer permits servicers to resubmit claims for line items that have once been denied.
- Twice increased the sample rate it employs in its pre-payment review. These increases were intended to mitigate the risk occasioned by Freddie Mac's decision not to require its servicers to document all of the expenses underlying their claims for reimbursement.
- Doubled the sample size for two servicers that consistently used incorrect codes when seeking reimbursement for default-related legal services. The errors would have resulted in reimbursements in excess of Freddie Mac's limits.

Freddie Mac officials told us that during the third quarter of 2014 the Claims Department will begin targeting specific expense codes that are subject to greater risk.

FHFA's Oversight of Freddie Mac's Reimbursement System

On January 8, 2014, DER issued a report on Freddie Mac's expense reimbursement process. In it, DER found that the Enterprise's procedures for processing expense claims were adequate and that management was taking appropriate steps to address concerns regarding duplicate claims. However, DER did not specifically address the adequacy of Freddie Mac's sampling rate, nor did it offer any standards by which an appropriate rate might be established.

FINDING

Freddie Mac May Be Able to Reduce Servicer Reimbursement Errors by Further Expanding its Prepayment Review Sample

Freddie Mac’s Reimbursement System is multi-layered and designed to mitigate the risks inherent in paying its servicers’ claims for reimbursement. Although Freddie Mac’s system is generally effective in reducing erroneous reimbursements, we estimate that in 2013 Freddie Mac made about \$70 million in net overpayments to its servicers.¹⁷ Accordingly, we conclude that Freddie Mac’s Reimbursement System could be strengthened. Specifically, we believe that Freddie Mac may be able to achieve additional cost savings by further expanding the sample that it employs in its pre-payment reviews.

Freddie Mac’s Estimated Net Overpayments Were Nearly \$70 Million in 2013

In 2013, the three layers of Freddie Mac’s Reimbursement System – business rules, queues, and pre-payment reviews – reduced servicer reimbursement payments by \$126 million. The pre-payment reviews accounted for \$6.9 million of these reductions. Figure 5, below, shows how pre-payment review reductions were distributed among the eight expense categories we identified.¹⁸

¹⁷ This is the net overpayment as it was calculated, i.e., overpayments less underpayments. For a full discussion of methodology we employed, see the Objective, Scope, and Methodology section at the end of this report.

¹⁸ The Claims Department tracks reimbursements using over 200 line item codes; OIG collapsed these codes into seven categories that reflect the maintenance and management of the properties that secure Freddie Mac’s mortgages during their default and the eventual liquidation. We added an eighth category to capture escrow amounts still held by the servicer. These escrow amounts typically offset – and thus reduce – the total expense claim made by the servicer.

FIGURE 5. ADJUSTMENT RATES IN THE 2013 PRE-PAYMENT REVIEW BY EXPENSE CATEGORY
(\$ MILLIONS)

Reimbursement Category	Net Amount Requested [†]	Net Amount Adjusted	Net Adjustment Rate ¹⁹
Taxes	\$60.45	-\$2.56	-4.24%
Attorney Fees & Legal Costs	\$34.51	-\$1.71	-4.95%
Lender-Placed & Property Insurance	\$29.73	-\$2.18	-7.32%
Maintenance	\$10.05	-\$0.53	-5.31%
Mortgage Insurance	\$5.75	-\$0.20	-3.45%
Other Expenses	\$0.82	\$0.04	5.21%
HAMP	\$0.06	-\$0.02	-42.15%
Escrow & Other Income ²⁰	-\$14.07	\$0.26	-1.84%
Total	\$127.31	-\$6.90	-5.42%

[†] This is the outstanding requested amount after business rules are automatically applied and the “queues” check is completed.

Source: OIG categorization and analysis of Freddie Mac data. Numbers may not add due to rounding.

We can extrapolate these pre-payment review results to the approximately \$1.3 billion of expense items that were not subjected to the prepayment review. Thus, we estimate that on a net basis, Freddie Mac overpaid about \$70 million (a 5.4% error rate) of the \$1.3 billion in claims for reimbursement that were not subjected to a pre-payment review.²¹

Expanding the Prepayment Review Sample Could Increase Reimbursement Savings

As previously noted, two Freddie Mac internal audit reports – one issued in 2010 and another in 2012 – identified weaknesses in the sampling methodology employed in the pre-payment review process. Thereafter, Freddie Mac increased the size of its sample and targeted certain servicers for heightened scrutiny. According to Freddie Mac officials, both the expanded

¹⁹ A negative adjustment rate indicates that payments for the respective category were a reduction of the amount requested; a positive rate indicates that the payment was an increase in the amount requested. Net Adjustment Rate equals Net Amount Adjusted divided by Net Amount Requested. The rates were calculated using actual figures. The figures presented in the table are rounded.

²⁰ The amount requested for Escrow & Other Income is a negative value because the category includes items for which the servicer files a claim for money owed to Freddie Mac. Consequently, the amount claimed offsets the expenses incurred by the servicer.

²¹ Details are provided in Figure 6, which is located in the Objective, Scope, and Methodology section of this report.

samples and adverse sampling strategy have served to strengthen the Enterprise's capacity to manage the risks associated with its reimbursement of its servicers.

It is clear, however, that these two changes will not serve to identify all of the errors in the \$1.3 billion of servicer claims for reimbursement that were not subjected to the pre-payment review process. Further, given our estimate of net overpayments of \$70 million in 2013, we can reasonably presume that expanding the sample beyond the current rate would result in further savings.²²

We acknowledge that expanding the size of the pre-payment review sample would increase Freddie Mac's operational costs. For example, we estimate that by doubling the amount of reimbursement claims Freddie Mac reviews could require it to double the size of its pre-payment review staff at a cost of about \$1 million.²³ However, we estimate that this increase in the sample size would likely reduce erroneous payments by somewhere between \$6.80 million and \$7.01 million.²⁴

²² The existing sample size is large enough to produce results that may be extrapolated with an acceptable degree of confidence and precision to the balance of the claims for reimbursement, i.e., those that were not subjected to Pre-Payment Review.

²³ We obtained staffing, salary, and overhead figures for the Claims Department. However, we recommend that Freddie Mac complete a cost/benefit analysis to determine financial benefits that may be achieved by increasing the size of this staff. See "Recommendations" below.

²⁴ This is a statistical 95% confidence interval for an overpayment rate interval of 5.34% and 5.50%. This estimate assumes that the additional sample, of the same proportion, will follow the same distribution as the initial sample in the prepayment review. We recognize, however, that, at some point, increasing the sample size further would produce fewer benefits, until the costs overcame them.

CONCLUSION.....

Freddie Mac's Reimbursement System contains controls designed to mitigate the risks inherent in reimbursing its servicers for managing defaulted loans. Although the system results in significant cost savings due to the identification of erroneous claims, we estimate that Freddie Mac overpaid servicers approximately \$70 million in 2013. We believe that Freddie Mac and its conservator, FHFA, are responsible for assessing potential opportunities to reduce such erroneous reimbursements and thereby mitigate the Enterprise's financial losses.

RECOMMENDATIONS

Based upon our findings, we recommend that FHFA require Freddie Mac to:

1. Determine, by means of a cost-benefit analysis, whether to increase the size of the sample of reimbursement claims that it subjects to the pre-payment review.
2. If warranted by the result of the cost-benefit analysis, increase the size of the sample of reimbursement claims that it subjects to pre-payment review.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objectives

The objective of this report was to evaluate Freddie Mac’s servicer reimbursement operations for delinquency expenses and FHFA’s oversight of those operations.

When possible, OIG attempts to identify questioned and unsupported costs as well as to estimate any funds that can be put to better use.²⁵ This includes any reduction in outlays that results from our recommendations. The recommendations outlined above would help Freddie Mac reduce overpayments to servicers.

Scope

Our study was based on Freddie Mac’s expense reimbursements to servicers in 2013 for loans in default; we did not review reimbursements made to REO contractors for already-foreclosed loans.

Methodology

To achieve our objectives, we interviewed various Freddie Mac personnel to gather information about the servicer reimbursement operations. We also interviewed FHFA personnel to assess the extent of its oversight. Additionally, we requested, received, and reviewed numerous internal documents from Freddie Mac and FHFA.

This evaluation was conducted under the authority of the Inspector General Act in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform an evaluation that obtains sufficient evidence to provide a reasonable basis to support the findings and recommendations made herein. We believe that the findings and recommendation discussed in this report meet these standards.

FHFA and the Enterprises provided technical comments on a draft of this report, which were incorporated as appropriate. In response to our recommendations, FHFA agreed that by August 31, 2014, it would direct Freddie Mac to complete a cost-benefit analysis, and, if warranted, to increase the sample size of claims subject to Freddie Mac’s pre-payment review by October 31, 2014.

²⁵ Inspector General Act of 1978, 5 U.S.C. App. 3 § 5(a)(6).

The performance period for this evaluation was August 2013 and June 2014.

Methodology for Estimating Potential Overpayments in Population of Claims Not Reviewed by Freddie Mac

To estimate potential overpayments in the population of claims not reviewed by Freddie Mac, we extrapolated the results of the 308,067 expense items (\$127.3 million in reimbursements) that underwent Freddie Mac’s pre-payment review in 2013. Specifically, we performed the following three steps:

1. **Separate negative adjustments (reductions) from positive adjustments (increases):** We received a list of Freddie Mac’s expense items that were adjusted through the pre-payment review process. We classified negative value adjustments as reductions and positive value adjustments as increases.
2. **Calculate the rates of reduction, increase, and overall adjustments:** The rates for all adjustment types were calculated as a ratio of the sum of the adjustments relative to the total dollars in the pre-payment review. Figure 8 illustrates the details of these calculations.

FIGURE 8. CALCULATING THE ADJUSTMENT RATES IN THE PRE-PAYMENT REVIEW SAMPLE²⁶

Reduction Rate (%)	=	$\frac{\text{Sum of all reduction adjustments (\$)}}{\text{Total expense dollars in pre-payment review (\$)}}$	=	$\frac{-\$8.5 \text{ mil}}{\$127.3 \text{ mil}}$		-6.7%
Increase Rate (%)	=	$\frac{\text{Sum of all increase adjustments (\$)}}{\text{Total expense dollars in pre-payment review (\$)}}$	=	$\frac{\$1.6 \text{ mil}}{\$127.3 \text{ mil}}$		1.3%

²⁶ In the report we also present adjustment rates at the expense category level. In those instances, adjustment rates were calculated in the same manner within the respective expense category.

$$\text{Overall (Net) Adjustment Rate (\%)} = \frac{\text{Sum of all adjustments (\$)}}{\text{Total expense dollars in pre-payment review (\$)}} = \frac{-\$6.9 \text{ mil}}{\$127.3 \text{ mil}} \rightarrow -5.4\%$$

Source: OIG analysis.

3. **Apply the adjustment rates to the population of claim items excluded from pre-payment review:** To calculate the value of claims not reviewed, we subtracted the expenses reviewed in the pre-payment process from the total 2013 expense population, \$1.4 billion. To this result, we multiplied the net adjustment rate (5.4%). The resulting amount is the projected net overpayments in the population of claim items for which Freddie Mac does not review documentation. Specifically, we estimated that \$69.5 million of the \$1.3 billion in expense claims not selected for pre-payment review were overpayments. See Figure 10.

FIGURE 9. CALCULATING POTENTIAL OVERPAYMENTS IN REIMBURSEMENT CLAIMS THAT WERE NOT REVIEWED (\$MILLIONS)

$$\begin{aligned} \text{Claim items not in Pre-Payment Review (\$)} &= \text{Total claim population} - \text{Claim items in Pre-Payment Review} = \$1,414 - \$127.3 \rightarrow \$1,287 \\ \text{Estimated Net Overpayments (\$)} &= \text{Claim items not in Pre-Payment Review} \times \text{Net Reduction Rate Observed in Pre-Payment Review} = \$1,287 \times 5.4\% \rightarrow \$69.5 \end{aligned}$$

Source: OIG analysis of Freddie Mac data.

Finally, based on the above analysis, we detail overpayments, underpayments, and net underpayments and relative error rates in Figure 10, below.

FIGURE 10. PROJECTED OVERPAYMENTS AND UNDERPAYMENTS FROM FREDDIE MAC'S REIMBURSEMENTS, 2013 (\$ MILLIONS)

	Overpayments	Underpayments	Net Financial Loss to Freddie Mac
Projection	\$86.2	\$16.7	\$69.5
Error Rate	6.7%	1.3%	5.4%

Source: OIG extrapolation of Freddie Mac data.

APPENDIX A

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



Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Deputy Inspector General for Evaluations

FROM: Wanda DeLeo, Deputy Director, Division of Conservatorship *Wanda DeLeo*

SUBJECT: FHFA-OIG Evaluation Report: *Freddie Mac's Process for Reimbursing Servicers for Expenses Related to Defaulted Loans (SUR-2013-016)*.

DATE: August 6, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the FHFA-OIG draft evaluation report, *Freddie Mac's Process for Reimbursing Servicers for Expenses Related to Defaulted Loans (SUR-2013-016)* (Report). This memorandum identifies FHFA's agreement or disagreement with the specific recommendations in the Report and actions that FHFA will take to address the recommendations.

The Report discusses the process by which Freddie Mac reimburses servicers for delinquency expenses and examines the controls employed for minimizing erroneous overpayment of claims. Although the OIG found Freddie Mac's control system to be generally effective in reducing erroneous reimbursements, the Report concluded that the reimbursement system could be strengthened. Specifically, the OIG believes that Freddie Mac may be able to achieve additional cost savings by further increasing the sample size used in its pre-payment reviews.

FHFA agrees that Enterprise controls over servicer reimbursement processes should be continually reviewed for possible enhancement. FHFA believes that once such enhancements are identified and documented as economically prudent, they should be implemented as soon as practical in a safe and sound manner.

Recommendation 1: Determine, by means of a cost-benefit analysis, whether to increase the size of the sample of reimbursement claims that are subject to pre-payment review.

Management Response to Recommendation 1:

FHFA agrees with this recommendation. By August 31, 2014, FHFA will direct Freddie Mac in writing to perform an economic cost-benefit analysis of its servicer reimbursement claims review processes. Specifically, Freddie Mac should examine whether increasing the proportion of

claims selected for pre-payment review is likely to generate additional net economic gains. This analysis is to compare the projected savings associated with a reduction in erroneous payment claims against the estimated incremental cost of conducting various staged increases in the number of such reviews.

Recommendation 2: If warranted by the result of the cost-benefit analysis, increase the size of the sample of reimbursement claims that are subject to pre-payment review.

Management Response to Recommendation 2: FHFA agrees with this recommendation if FHFA's review of Freddie Mac's cost-benefit analysis confirms that the expansion of Freddie Mac's servicer reimbursement sampling processes is likely to result in significant economic benefit. Given such a determination, FHFA will direct Freddie Mac to undertake steps to allow for cost effective increases in sample size by October 31, 2014.

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

APPENDIX B.....

Summary of Questioned Costs

Rec	Description	Amount ^{27*}	Category
1	Improve reimbursement operations	TBD	Funds Put to Better Use because of reduction in outlays

The table above summarizes monetary results by recommendations. The table illustrates the anticipated monetary results based on statistical projections of overpayments.

²⁷ This amount will be determined by results from FHFA cost-benefit analysis and subsequent increase, if warranted, in pre-payment sample rate.

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