FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties

WHITE PAPER: WPR-2012-003 DATED: June 14, 2012

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AT A GLANCE

Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties

Background

The Housing and Economic Recovery Act of 2008 (HERA) established the Federal Housing Finance Agency (FHFA or Agency) as the supervisor and regulator of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises). In September 2008, the Enterprises entered into conservatorships overseen by FHFA out of concern that their deteriorating conditions threatened the stability of financial markets. Simultaneously, the U.S. Treasury Department (Treasury) began providing financial assistance – more than $187 billion to date – to support the Enterprises during the conservatorships.

The Enterprises purchase mortgages from lenders and then keep them as investments or package them into securities that are sold to investors. When borrowers default on such mortgages they may become subject to foreclosure proceedings. In many cases, the Enterprises take possession of foreclosed properties and resell them in an effort to recover some of their losses. The process of securing, maintaining, repairing, and selling foreclosed properties is often referred to as Real Estate Owned (REO) management.

Scope

In this white paper, the FHFA Office of Inspector General (FHFA-OIG) discusses: (1) the basics of the foreclosure and REO management processes; (2) the critical role that Enterprise contractor oversight plays in REO management; (3) key Enterprise REO management challenges; (4) FHFA's oversight of the Enterprises' REO management; and (5) FHFA's and Fannie Mae's development of an REO pilot program under which investors can purchase in bulk foreclosed properties with rental commitments. Given the risks associated with REO management, FHFA-OIG places a high priority on it. Accordingly, this white paper also identifies FHFA-OIG's strategy for assessing FHFA's oversight of the Enterprises' REO management efforts.

Summary

The Enterprises have been dealing with surging foreclosure rates, rising REO inventories, and associated costs since the onset of the U.S. housing and financial crises in 2007 and 2008. By the end of 2011, their REO inventories had more than tripled to nearly 180,000 units and their related expenses totaled $8.5 billion. Further, given the financial distress in which many American homeowners continue to find themselves, the Enterprises are likely to face elevated REO inventories and costs for years to come.

As the Enterprises' conservator and regulator, FHFA has a critical responsibility to oversee their REO management efforts. A failure in Enterprise efforts to secure and maintain foreclosed properties could drive up Enterprise losses and cause damage in affected communities, e.g., foreclosed properties can lower the value of surrounding properties and increase blight and crime.

In recent examinations, FHFA concluded that the Enterprises should significantly improve their REO management efforts. The Agency identified deficiencies in the Enterprises' management of the large contractor networks they employ for many REO tasks, including inadequate property inspections and insufficient controls to detect fraudulent reimbursements. FHFA plans to follow up on these findings in 2012.

Additionally, FHFA is working with Fannie Mae to implement a pilot program under which investors may buy foreclosed properties in bulk if they agree to offer them for rent for specified periods. The intent of the program is to determine whether such an arrangement is a viable means to reduce REO inventories and meet rental demands.

FHFA-OIG REO Strategy

FHFA-OIG has several ongoing audits of key aspects of FHFA's oversight of the Enterprises' REO management, such as property maintenance and contractor reimbursement controls. FHFA-OIG also plans to evaluate the programmatic controls that are intended to prevent fraud in the REO pilot program should it be expanded.

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ABBREVIATIONS

Fannie Mae.. Federal National Mortgage Association

FHFA or Agency...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

HPI ....House Price Index

MBS .... Mortgage-Backed Security(ies)

MRA ....Matter Requiring Attention

REO..Real Estate Owned

Treasury .... U.S. Treasury Department

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

Since the onset of the U.S. financial and housing crises in 2007 and 2008, the Enterprises have faced significant challenges in managing their REO inventories, which, by the end of 2011, tripled to nearly 180,000 units and resulted in total costs of approximately $8.5 billion.[1] Moreover, the Enterprises are likely to face additional REO management challenges due to the fact that more than 1.1 million of the mortgages they presently own or guarantee are seriously delinquent. In these circumstances, FHFA has a critical responsibility to ensure that the Enterprises manage their REO inventories so as to minimize costs and mitigate the negative effects that foreclosed properties can have on the communities in which they are located.

In this white paper, FHFA-OIG provides an overview of Enterprise REO management and FHFA's oversight and conservatorship activities. Specifically, it discusses: (1) the basics of the foreclosure and REO management processes; (2) the critical role that Enterprise contractor oversight plays in REO management; (3) key Enterprise REO management challenges; (4) FHFA's oversight of the Enterprises' REO management; and (5) Fannie Mae's and FHFA's development and implementation of an REO pilot program under which investors are granted the opportunity to purchase foreclosed properties in bulk as long as they agree to offer the properties for rent over specified periods.

In addition, this paper contains a discussion of FHFA-OIG's strategy for future audits and evaluations concerning FHFA's oversight of the Enterprises' management of their REO properties. The strategy includes two ongoing audits of FHFA's oversight of the Enterprises' controls over contractors that are directly responsible for many day-to-day REO management tasks, such as securing and maintaining properties, as well as an audit of FHFA's REO risk assessment process. Further, the strategy includes an evaluation of the controls and monitoring systems that FHFA and Fannie Mae may employ in the REO pilot program currently under development should the pilot be expanded.

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[1] When the Enterprises take titles to properties through the foreclosure process, they realize credit losses on the loans plus certain other expenses. Subsequently, the Enterprises incur specific REO-related costs during the period properties are in their REO inventories. These latter REO costs, which totaled $8.5 billion from 2007 through 2011, represent maintenance and other property expenses, the fair market value gains or losses of a foreclosed property during the time it is in the REO inventory, gains or losses at the time the property is resold to homeowners or investors, and offsets from mortgage insurance or other sources. Although these REO expenses are accounted for separately, they are a component of the Enterprises' overall credit losses.

This FHFA-OIG white paper 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
Director, Office of Policy, Oversight, and Review

BACKGROUND

About FHFA and the Enterprises

On July 30, 2008, HERA established FHFA as the regulator of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. Among its responsibilities, FHFA oversees Fannie Mae's and Freddie Mac's safety and soundness, supervises their efforts to support housing finance and affordable housing goals, and facilitates a stable and liquid mortgage market. HERA also expanded the authority of Treasury to provide financial support to the Enterprises.

On September 6, 2008, FHFA became Fannie Mae's and Freddie Mac's conservator. As such, the Agency is charged with preserving and conserving the Enterprises' assets, ensuring that they focus on their housing mission, and facilitating their emergence from conservatorship. Additionally, pursuant to its authority under HERA, as of March 31, 2012, Treasury had provided $187.5 billion to the Enterprises, thereby enabling them to remain solvent and continue their operations.[2]

The Enterprises support the secondary mortgage market by purchasing residential mortgages from loan originators such as banks and credit unions. The loan originators may then use the proceeds of these transactions to originate more mortgages. The Enterprises may hold mortgages in their investment portfolios or package them into mortgage-backed securities (MBS) that they sell to investors. In exchange for a fee, the Enterprises guarantee that MBS investors will receive timely payment of principal and interest on their MBS investments.

Basics of the Foreclosure and REO Management Processes

The Enterprises retain the credit risk associated both with the mortgages they hold in their investment portfolios as well as those for which they provide guarantees to MBS investors. That is, the Enterprises retain the risks that borrowers will default on their mortgages and may ultimately face foreclosure proceedings. At that point, the Enterprises generally seek to take possession of foreclosed properties and sell them to offset their losses. The process of safeguarding, maintaining and repairing, and marketing and selling foreclosed properties is often referred to as "REO management."

Typically, when a borrower fails to make mortgage payments for 90 days, the borrower is considered to be seriously delinquent. In such cases, the Enterprises, working through their

[2] This includes $41 billion in dividends that the Enterprises are required to pay Treasury under the terms of their Senior Preferred Stock Purchase Agreements with Treasury.

mortgage servicers, will generally initiate workout strategies to assist the borrower.[3] For example, Fannie Mae and Freddie Mac may institute loan modifications intended to lower a borrower's monthly payments, such as those offered through Treasury's Home Affordable Modification Program.[4] But in cases in which these efforts prove unsuccessful, the Enterprises may initiate foreclosure proceedings.

Foreclosure proceedings are the means by which the owner of a defaulted mortgage loan, such as one of the Enterprises, may recover amounts due and owing by taking ownership of, or repossessing, the property that secures a loan. In general, foreclosure proceedings begin when the mortgage servicer files a lawsuit against the homeowner or notifies the homeowner of the initiation of foreclosure proceedings. If the homeowner cannot "cure" the default, i.e., pay what is due and owing, then the process may culminate in a public auction known as a foreclosure sale.[5] At the foreclosure sale the owner of the mortgage, e.g., an Enterprise via its servicer, may buy the property and take possession of it. Alternatively, a third party, such as an investor, may buy the property at the foreclosure sale.[6]

When an Enterprise takes possession of a foreclosed property, the effectiveness of its REO management program may affect the value of the property and influence the Enterprise's ultimate associated credit loss. To keep its credit loss as low as possible, the Enterprise must maximize its resale proceeds, among other means, by minimizing the expenses associated with managing and reselling the property. The expenses associated with an REO property include taxes, maintenance, repair, and upkeep – all of which tend to increase the longer it takes to resell a foreclosed property – and marketing and sales.

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[3] A mortgage servicer, such as a commercial bank subsidiary or affiliate, may perform a variety of functions for an Enterprise. These include collecting principal and interest payments from borrowers, forwarding the mortgage payments to the owners of the loans, maintaining escrow accounts, and default-related services including notifications to delinquent borrowers and, if necessary, initiating foreclosure proceedings.

[4] *See generally*, FHFA-OIG, *Evaluation of FHFA's Role in Negotiating Fannie Mae's and Freddie Mac's Responsibilities in Treasury's Making Home Affordable Program* (EVL-2011-003, August 12, 2011), available at http://www.fhfaoig.gov/Content/Files/EVL-2011-003.pdf.

[5] Lenders may also agree to a "short sale." In a short sale scenario the homeowner conducts a private sale of the house and the lender releases its lien in exchange for the proceeds of the sale despite the fact that they are insufficient to pay off the debt. However, the lender may require the borrower to repay some or all of the remaining mortgage debt at a later time. Alternatively, on some occasions a lender will accept a "deed in lieu of foreclosure." In such situations the homeowner will surrender title to the property voluntarily rather than require the lender to initiate foreclosure proceedings.

[6] For more information regarding foreclosure, *see* FHFA-OIG, *An Overview of the Home Foreclosure Process*, available at http://www.fhfaoig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process.pdf.

The key steps in the REO management process are intended to ensure that foreclosed properties are:

1. *Secured* to avoid theft, vandalism, and unauthorized use;

2. *Maintained and repaired*, e.g., lawns cut, plumbing winterized, hazards removed or mitigated, leaking roofs fixed, etc. Ensuring that a property is maintained in good repair helps to protect its value and ensure its marketability. Beyond protecting its investment, an Enterprise's efforts in this regard minimize the **negative impacts of foreclosures** on the communities in which they are located;[7]

3. *Priced appropriately* through broker price opinions or appraisals and satisfactory promotional efforts; and

4. *Sold* to homeowners or investors within a reasonable period.

Negative Impacts of Foreclosures
Foreclosed and vacant properties can have profoundly negative consequences in the neighborhoods and communities in which they are located. These consequences include reduced property values. According to the U.S. Government Accountability Office, recent research has found that vacant foreclosed properties may reduce prices of nearby homes by $8,600 to $17,000 per property in specific cities. Additionally, vacant and unattended residential properties can attract crime, cause blight, and pose a threat to public safety.

Effective Contractor Oversight Is a Critical Component of the Enterprises' REO Management Processes

The Enterprises' REO inventories, which totaled nearly 180,000 properties at the end of 2011, are located across the nation (see Figure 1).[8]

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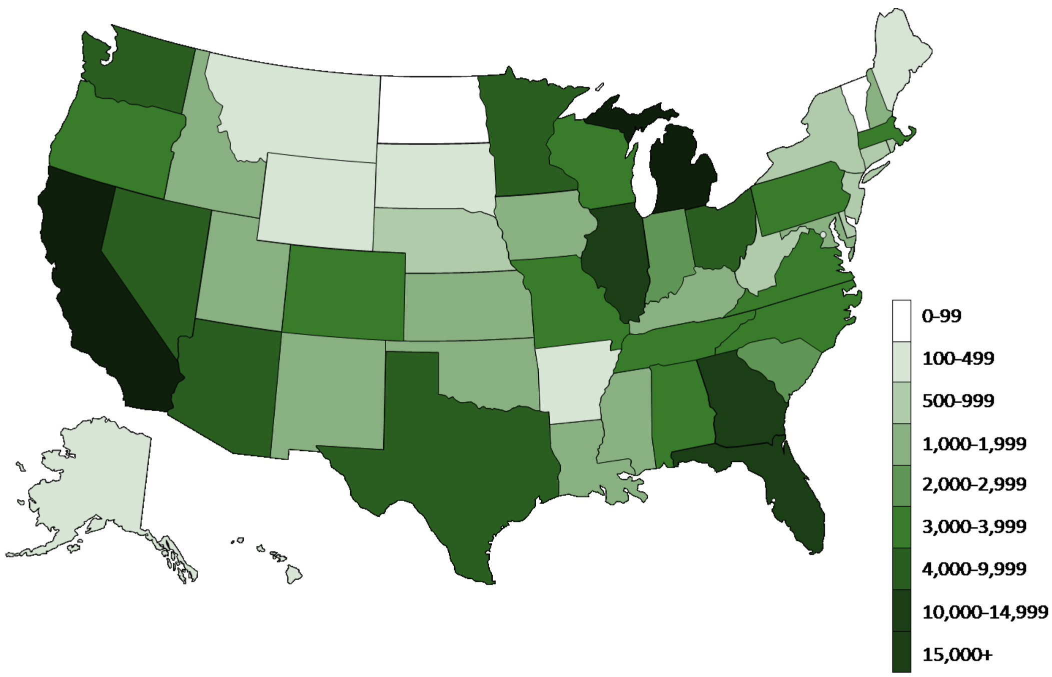
[7] *See* Government Accountability Office, *Vacant Properties: Growing Number Increases Communities Costs and Challenges* (GAO-12-34, November 4, 2011), available at http://www.gao.gov/products/GAO-12-34.

[8] As discussed in more detail below, over 40% of the inventory is concentrated in five states: Michigan, California, Florida, Illinois, and Georgia.

Figure 1: Number of Enterprise REO Properties by State as of December 31, 2011[9]



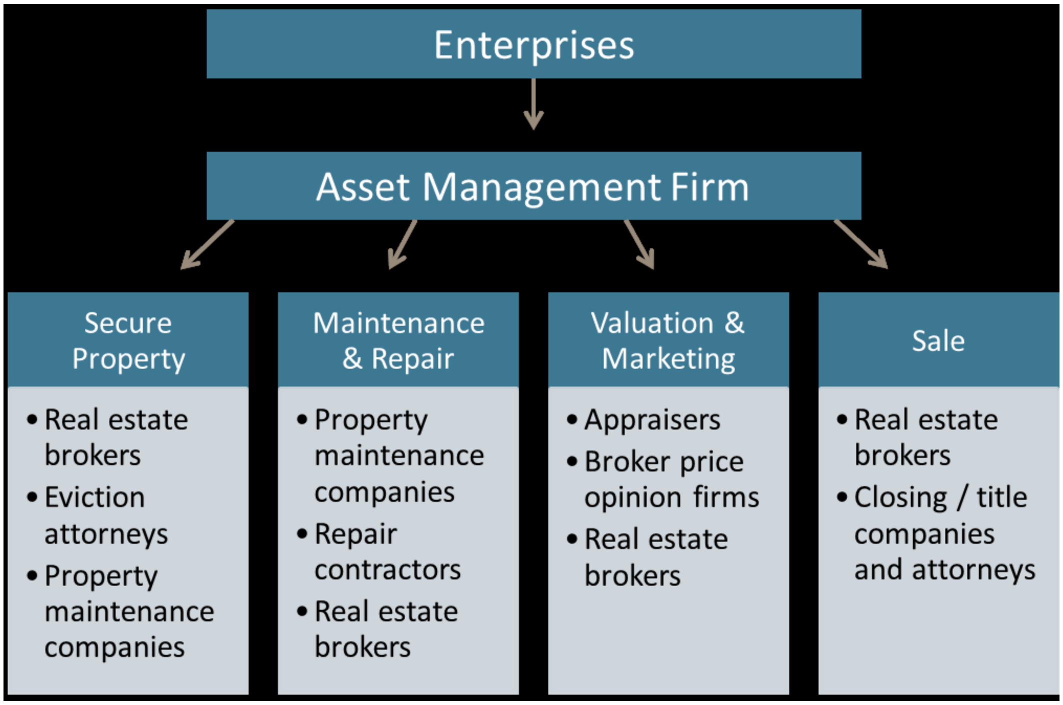
Rather than employing large staffs to manage their nationwide REO inventories directly, the Enterprises generally rely on networks of thousands of contractors and subcontractors[10] to perform the day-to-day tasks associated with maintaining and selling foreclosed properties (see Figure 2).[11] Accordingly, it is critical that the Enterprises effectively oversee their contractors to ensure that they mitigate REO-related expenses and the negative effects of foreclosures.

[9] Source: REO inventory data for the period ending December 31, 2011, as provided by Fannie Mae and Freddie Mac.

[10] According to FHFA examinations, the Enterprises use approximately 10,000 contractors to perform REO-related activities. FHFA-OIG cannot provide a reliable, comprehensive count of Enterprise contractors because some may be employed by both Fannie Mae and Freddie Mac.

[11] Contractors may be compensated for their work through various methods, such as direct reimbursements by the Enterprises for maintenance and repair activities.

Figure 2: Enterprises' General Oversight Structure for Their REO Contractors



The following summarizes the responsibilities of some key Enterprise REO contractors:

- **Asset management firms:** Each Enterprise has managers and staff members whose job it is to oversee the company's REO contractors. In addition to their internal staffs, Fannie Mae and Freddie Mac also employ asset management firms to direct certain REO contractors in the performance of day-to-day property management responsibilities. However, the ultimate responsibility for the management and oversight of the contractor networks rests with the Enterprises' senior managers;

- **Real estate brokers:** Instead of, or in addition to, hiring asset management firms, the Enterprises may place brokers under contract to manage selected portions of their inventory all through the REO process, i.e., from inspecting and securing a property to disposing of it by sale. Their contractual duties may include identifying and mitigating hazardous conditions at the properties, developing and implementing marketing plans, listing properties, and evaluating offers;

- **Attorneys:** The Enterprises contract with attorneys in the states in which their properties are located to accomplish a variety of legal tasks.[12] For example, attorneys may manage the eviction process when necessary. Further, designated attorneys and national title companies are employed to ensure that the Enterprises obtain title to properties incident to foreclosure sales and to manage the closing process upon resale;

- **Property maintenance companies and repair contractors:** These contractors secure and maintain properties by, among other things, removing interior and exterior debris, cleaning houses, cutting lawns, inspecting and repairing plumbing, and winterizing structures. They also make repairs, such as fixing leaking roofs, repairing or replacing appliances, and installing major systems, such as heating and air conditioning units; and

- **Appraisers and broker price opinion firms:** These contractors help the Enterprises determine the value and listing prices of foreclosed properties by reviewing comparable sales and conducting appraisal reviews.

The Enterprises can employ a variety of controls and systems to help ensure effective contractor performance and minimize the costs associated with their contractor networks. These measures include the following:[13]

1. Hiring qualified REO contractors, such as law firms, property maintenance companies, real estate brokers, and others to secure, maintain, market, and sell REO properties.

2. Providing contractor training as necessary or appropriate.

3. Establishing standard policies and procedures for key REO maintenance activities, such as the number of times per month lawns must be cut.

4. Establishing budgets and reimbursement schedules for routine property maintenance activities.

5. Requiring multiple bids and/or reviews for proposed repairs that exceed pre-established dollar thresholds.

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[12] For a discussion of FHFA's oversight of the attorneys Fannie Mae uses in the foreclosure and related processes, *see FHFA-OIG, FHFA's Oversight of Fannie Mae's Default Related Legal Services* (AUD-2011-004, September 30, 2011), available at http://www.fhfaoig.gov/Content/Files/AUD-2011-004.pdf.

[13] The procedures employed by the two Enterprises may not be identical.

6. Conducting on-site inspections of selected properties to ensure that they are secured, maintained, and repaired according to established standards.

7. Requiring multiple broker price opinions or appraisals to establish listing prices and reviewing proposed prices as appropriate.

8. Conducting audits of bills submitted by contractors to ensure their appropriateness and screen for potential fraud.

9. Conducting account reviews and performance management audits and monitoring contractors using established metrics, including contractual obligations.

10. Withholding payments to contractors for services rendered until such services have been completed satisfactorily and suspending or terminating unsatisfactory contractors.

An Enterprise's failure to effectively manage its contractors' implementation of basic REO responsibilities, i.e., securing, maintaining, repairing, and marketing properties, would place it at considerable financial risk. It could also endanger the stability of the communities in which the properties are located. For example, if a contractor fails to secure properties for which it is contractually responsible, then the properties may be broken into, looted, and used for illegal activities. Similarly, a contractor's failure to maintain a property, e.g., remove debris, cut lawns, fix broken windows, etc., can reduce its value and detract from its marketability, as well as the marketability of near-by homes. The deteriorated condition of an REO property may cause it to remain on the market and in an Enterprise's inventory for an extended period, thereby increasing the Enterprise's total carrying costs. This, in turn, will reduce the Enterprise's returns on the sale of such properties and, ultimately, increase the taxpayer costs associated with the conservatorships.

The Enterprises also must implement REO management controls and strategies to ensure that:

- **The fair market values of their foreclosed properties are established.** If fair market values are not established effectively, then properties may be sold at unreasonably low prices that expose the Enterprises and taxpayers to unnecessary losses;

- **Foreclosed properties located in economically distressed areas are managed and marketed in a cost-effective manner.** It may be particularly difficult to sell properties located in such areas given potentially weak real estate markets. In some cases, it may not be cost-effective for an Enterprise to maintain, repair, and sell a deteriorated foreclosed property in such areas. Indeed, it may be more cost-effective in some cases to demolish such properties; and

- **Foreclosed property repairs are cost-effective.** In some cases, repairs may enhance a property's value and thereby maximize returns. However, without an effective means to make determinations about whether repairs will enhance property value, the Enterprises could potentially reimburse contractors for repairs that are unnecessary and increase their property management costs.

Finally, there is also the risk of considerable fraud and abuse associated with the failure to manage Enterprise REO contractors effectively. Under the best of circumstances it may be challenging for the Enterprises to verify that certain types of maintenance and repairs, such as interior painting and plumbing, are being completed in accordance with quality standards and within established timeframes for thousands of foreclosed properties across the nation. Therefore, it is important for the Enterprises to establish effective property inspection procedures and controls to prevent fraudulent contractor reimbursements.

FHFA-OIG Hotline
FHFA-OIG investigates allegations of fraud and other misconduct involving the operations of FHFA and the GSEs, including REO-related matters. FHFA-OIG's Hotline allows concerned parties to report allegations of fraud, waste, or abuse to FHFA-OIG directly and confidentially. The FHFA-OIG Hotline can be reached at 1 (800) 793-7724 or via email at oighotline@fhfaoig.gov.

The Enterprises Face Significant Challenges and Risks in Managing Their REO Inventories

The Enterprises have experienced extraordinary increases in their REO inventories and the costs associated with them since the onset of the U.S. housing and financial crises starting in 2007 and 2008. Further, given ongoing delays in the foreclosure process and the financial distress in which millions of American homeowners continue to find themselves, the Enterprises are likely to face elevated REO inventories and costs for years to come.

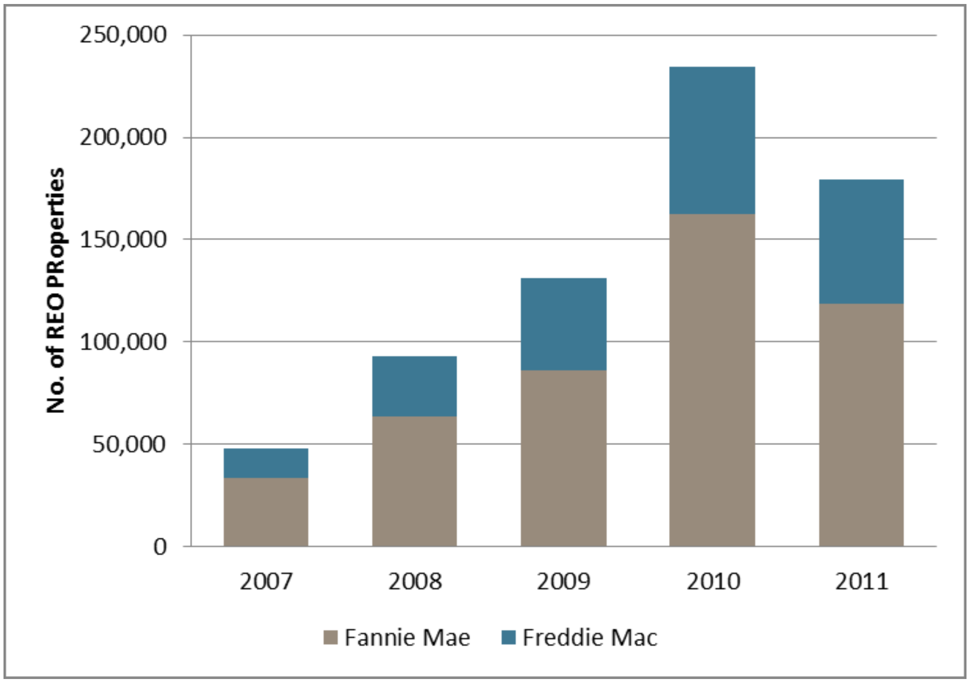
The following highlights some of the REO-related risks facing the Enterprises.

Managing the Ongoing and Expected Surge in Foreclosed Property Inventories

Foreclosed property inventories have grown rapidly since 2007. According to Enterprise data, Fannie Mae's and Freddie Mac's combined REO inventory nearly quintupled from about 48,100 units at the end of 2007 to 234,582 units at the end of 2010 (see Figure 3). In 2011, the Enterprises' combined REO inventory declined by 25% to more than 179,000 units, which was still more than three times higher than the 2007 level.[14]

[14] This decline continued in the first quarter of 2012 with the Enterprises' combined REO inventories falling by approximately 3% from 179,083 properties to 173,480 properties.

Figure 3: Enterprises' REO Inventories, 2007-2011[15]



By some measures, Fannie Mae and Freddie Mac responded effectively to the surge in foreclosures by successfully augmenting their disposition capacities, but the recent decrease in REO inventory is also influenced by lagging acquisitions in late 2010 and 2011. The Enterprises' rate of disposition of foreclosed properties, which generally refers to sales, appears to have largely kept up with the surge in foreclosures as shown in Figure 4.[16] Specifically, the Enterprises disposed of 353,851 properties in 2011 as compared to 57,748 in 2007. This represents a nearly six-fold increase in the total number of dispositions. Further, FHFA-OIG's analysis indicates that the rate at which the Enterprises disposed of REO properties increased from about 52% in 2008 to 66% in 2011. In other words, the Enterprises disposed of the equivalent of slightly more than half of their annual foreclosed property inventories in 2008, but

[15] *See* Fannie Mae, *2008 10-K Report*, at 187, available at www.fanniemae.com/portal/about-us/investor-relations/sec-filings.html, and 2011 10-K Report, at 168, available at www.fanniemae.com/portal/about-us/investor-relations/sec-filings.html; Freddie Mac, *2008 10-K Report*, at 160, available at www.freddiemac.com/investors/sec_filings/index.html, and *2011 10-K Report*, at 167, available at www.freddiemac.com/investors/sec_filings/index.html. Freddie Mac did not publish a breakdown of its multifamily inventory data in its annual filings for 2007 and 2008. For consistency across the years, FHFA-OIG has included Freddie Mac's multifamily inventory in this data. The impact upon Freddie Mac's total REO volume is likely to be negligible: for the years 2009 to 2011, the multifamily inventory comprised less than 0.05% of all REO units and never exceeded 20 properties.

[16] The Enterprises also dispose of distressed properties through sales to cities, municipalities, and other public entities; bulk sales and public auctions; and direct sales to Neighborhood Stabilization Program grant recipients.

by 2011 they had successfully increased their sales to about two-thirds of their inventory. This is significant because, absent this increase in their REO dispositions, Enterprise REO inventories would be much higher than they are now.[17] FHFA-OIG also observes, though, that the rate at which the Enterprises acquired foreclosed properties into their REO inventories declined by 23% in 2011, and that this may have facilitated the increase in their disposition performance from 55% in 2010 to 66% in 2011.

Figure 4: Enterprises' REO Acquisition and Disposition Performance, 2007-2011[18]

REO Inventory	2007	2008	2009	2010	2011
Acquisitions	71,961	145,183	230,729	388,994	298,352
Dispositions	57,748	100,422	192,406	286,959	353,851
Year-end Inventory	48,123	92,884	131,207	234,582	179,083
Disposition Rate	54.5%	51.9%	59.5%	55.2%	66.4%

Fannie Mae attributed delays in its acquisition of REO properties in 2011 to new legislative, regulatory, and judicial requirements pertaining to foreclosures. Additionally, Fannie Mae noted that it is contributing to the delay by directing its servicers to defer foreclosure sales until they verify that the borrowers are ineligible to participate in Treasury's Home Affordable Mortgage Program and that all other home retention and foreclosure prevention alternatives have been exhausted. In addition, Freddie Mac stated that in late 2010 several large mortgage seller/servicers temporarily suspended foreclosure proceedings in several states due to potential legal deficiencies in such proceedings.[19] Freddie Mac added that, although the larger

[17] FHFA-OIG estimates that if the Enterprises' disposition rate had remained constant at the 2008 rate of 51.9%, then their combined REO inventories would have reached 269,072 properties in 2011 rather than the actual amount of 179,083. This is significant because larger REO inventories can result in increased Enterprise REO costs.

[18] *See* Fannie Mae, *2008 10-K Report*, at 187, available at www.fanniemae.com/portal/about-us/investor-relations/sec-filings.html, and *2011 10-K Report*, at 168, available at www.fanniemae.com/portal/about-us/investor-relations/sec-filings.html; Freddie Mac, *2008 10-K Report*, at 160, available at www.freddiemac.com/investors/sec_filings/index.html, and *2011 10-K Report*, at 167, available at www.freddiemac.com/investors/sec_filings/index.html. *See* footnote 15 for an explanation of the inclusion of Freddie Mac multifamily REO properties.

The disposition rate is the proportion of the Enterprise's annual REO inventory that is disposed of in the given year. The ratio – calculated as the current year dispositions divided by the sum of the inventory at the end of the previous year and the current year acquisitions – provides a rough measure of REO performance but it has limitations. For example, the metric does not account for factors that may slow the turnover rate, such as state-mandated redemption periods, tenant protections laws, properties requiring eviction, or other constraints to marketing the properties.

[19] For example, some law firms that process foreclosures under contract with the Enterprises appear to have filed false affidavits or documents with forged signatures in foreclosure proceedings.

seller/servicers generally resumed foreclosure proceedings in early 2011, the foreclosure process continued to experience delays throughout 2011.

Further, general distress in the housing sector will likely continue to result in elevated REO inventories. For example, the Enterprises' financial data indicate that, as of the end of 2011, more than 1.1 million mortgages held or guaranteed by the Enterprises were "seriously delinquent," i.e., were 90 or more days past due. At that time, the volume of seriously delinquent mortgages was more than six times the size of the Enterprises' REO inventories (see Figure 5).

Figure 5: Enterprise Single-Family REO Inventories and Mortgages More Than 90 Days Delinquent, December 31, 2011[20]

Enterprise	Mortgages More Than 90 Days Delinquent[21]	Properties in REO Inventory	Ratio of Mortgages More Than 90 Days Delinquent to REO Inventory
Fannie Mae	690,139	118,528	582%
Freddie Mac	412,988	60,535	682%
Combined	1,103,127	179,063	616%

FHFA-OIG did not independently estimate the extent to which the level of seriously delinquent mortgages could increase the Enterprises' REO inventories over time. Nevertheless, the Enterprises' data suggest that the numbers could be significant given the extent to which many borrowers are behind on their mortgage payments. For example, there were 558,761 mortgages either owned or guaranteed by the Enterprises that were a year or more delinquent at the end of 2011 (see Figure 6). Indeed, Fannie Mae has stated that, due to elevated numbers of delinquent borrowers among other challenges in the housing sector, it does not expect its REO inventory to return to pre-financial crisis levels for "years."[22]

[20] *See* FHFA, *Foreclosure Prevention & Refinance Report, Fourth Quarter 2011*, at 43-45, available at http://www.fhfa.gov/webfiles/23522/4q11_fpr_finalv2i.pdf.

[21] FHFA-OIG calculation based on Federal Housing Finance Agency, *Foreclosure Prevention & Refinance Report, Fourth Quarter 2011*, at 43-45.

[22] *See* Fannie Mae, *2011 10-K Report*, at 17, available at www.fanniemae.com/portal/about-us/investor-relations/sec-filings.html.

Figure 6: Enterprise Single-Family Mortgages, by Length of Delinquency, December 31, 2011[23]

Enterprise	365+ Days Delinquent	180-364 Days Delinquent	90-179 Days Delinquent	Total Mortgages More Than 90 Days Delinquent[24]
Fannie Mae	351,612	173,462	165,065	690,139
Freddie Mac	207,149	105,010	100,829	412,988
Combined	558,761	278,472	265,894	1,103,127

Managing Concentrations of Foreclosed Properties in States with Particularly Distressed Real Estate Markets

The Enterprises also face significant challenges in mitigating their REO-related losses in states with large concentrations of foreclosed properties. The five states with the largest concentrations of Enterprise REO all experienced double-digit declines in overall house prices from 2007 through 2011. According to FHFA's House Price Index (HPI) both California and Florida experienced declines of 44% (see Figure 7).[25] Other states with relatively large percentages of the Enterprises' REO inventories that have experienced substantial declines in house prices include Arizona at 48% and Nevada at 59%. With large concentrations of their REO inventories located in states with such dramatic house price declines, it is reasonable to expect that the Enterprises may face challenges in selling foreclosed properties in them as compared to other regions. Further, depressed real estate markets in these states could limit the Enterprises' capacity to mitigate their overall credit losses.[26]

[23] *See* FHFA, *Foreclosure Prevention & Refinance Report, Fourth Quarter 2011*, at 44 and 45, available at http://www.fhfa.gov/webfiles/23522/4q11_fpr_finalv2i.pdf.

[24] FHFA-OIG calculation based on FHFA, *Foreclosure Prevention & Refinance Report, Fourth Quarter 2011*, at 43-45.

[25] FHFA produces quarterly house price indexes using Enterprise data for conventional conforming loans for single-family detached properties. The indexes are based on a modified weighted-repeat sales methodology developed by Case and Shiller**.** *See OFHEO House Price Indexes: HPI Technical Description*, available at http://www.fhfa.gov/webfiles/896/hpi_tech.pdf.

[26] As discussed previously, the Enterprises recognize mortgage loan losses at the foreclosure sale, but there are also costs involved in REO management such as maintenance expenses. In states with distressed markets, the Enterprises may face further declines in the values of foreclosed properties in their REO inventories that would increase their overall credit losses.

Figure 7: States with the Highest Number and Percentage of Enterprise Single-Family REO Properties[27]

State	REO Properties	Percentage of National Inventory	Change in House Prices from 2007-2011
Michigan	22,605	12.6%	-26.5%
California	19,972	11.2%	-44.2%
Florida	12,618	7.0%	-44.8%
Illinois	12,471	7.0%	-20.3%
Georgia	11,962	6.7%	-25.1%
Minnesota	8,765	4.9%	-20.9%
Ohio	7,503	4.2%	-13.8%
Texas [(a)]	6,782	3.8%	3.5%
Arizona	6,070	3.4%	-47.9%
Washington	4,854	2.7%	-23.9%
Nevada	4,206	2.3%	-59.0%
Wisconsin	3,955	2.2%	-12.3%
Missouri	3,937	2.2%	-12.2%
North Carolina	3,887	2.2%	-10.5%
Virginia	3,550	2.0%	-16.3%
Total [(b)]	133,137	74.4%	-24.9%

To illustrate further the risks associated with the Enterprises' REO inventories in these states, Figure 8 shows the locations of their 22,534 foreclosed properties in Michigan at the end of 2011.[28] These properties were generally located in the lower half of the state, with the bulk

[27] Source: FHFA, *State HPI Summary*, available at www.fhfa.gov/Default.aspx?Page=215&Type=summary; and FHFA, *Foreclosure Prevention & Refinance Report, Fourth Quarter 2011*, at 43, available at http://www.fhfa.gov/webfiles/23522/4q11_fpr_finalv2i.pdf.

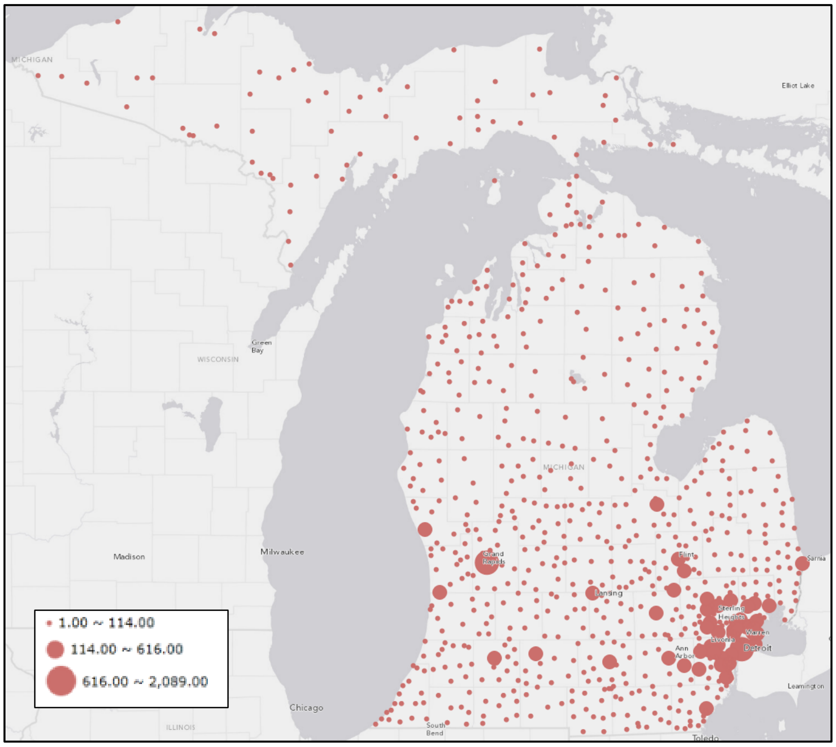
[(a)] REO properties in Texas comprise a relatively large percentage of the Enterprises' national REO inventory given the large number of Enterprise-owned mortgages in the state. However, the percentage of Enterprise-owned mortgage loans in Texas that actually entered into foreclosure and became REO properties is relatively small compared to other states, i.e., Texas ranks 36th out of the 50 states in terms of the percentage of Enterprise-owned mortgage loans that have entered into the Enterprises' REO inventories.

[(b)] The "Total" row is comprised of the total REO properties in the selected states, their percentage of the Enterprises' national REO inventory, and the average of the five-year change in the FHFA HPI for those states.

[28] This figure was derived from loan-level data for REO properties provided to FHFA-OIG by the Enterprises. Publicly available sources, such as FHFA's *Foreclosure Prevention & Refinance Report for the Fourth Quarter of*

concentrated in southeast Michigan in and around Detroit. In recent years, the Detroit area has faced significant economic challenges, such as relatively high unemployment, due to weakness in the auto sector.

Figure 8: Enterprises' Combined Single-Family REO Inventories in Michigan (Number of Properties by City), December 31, 2011[29]



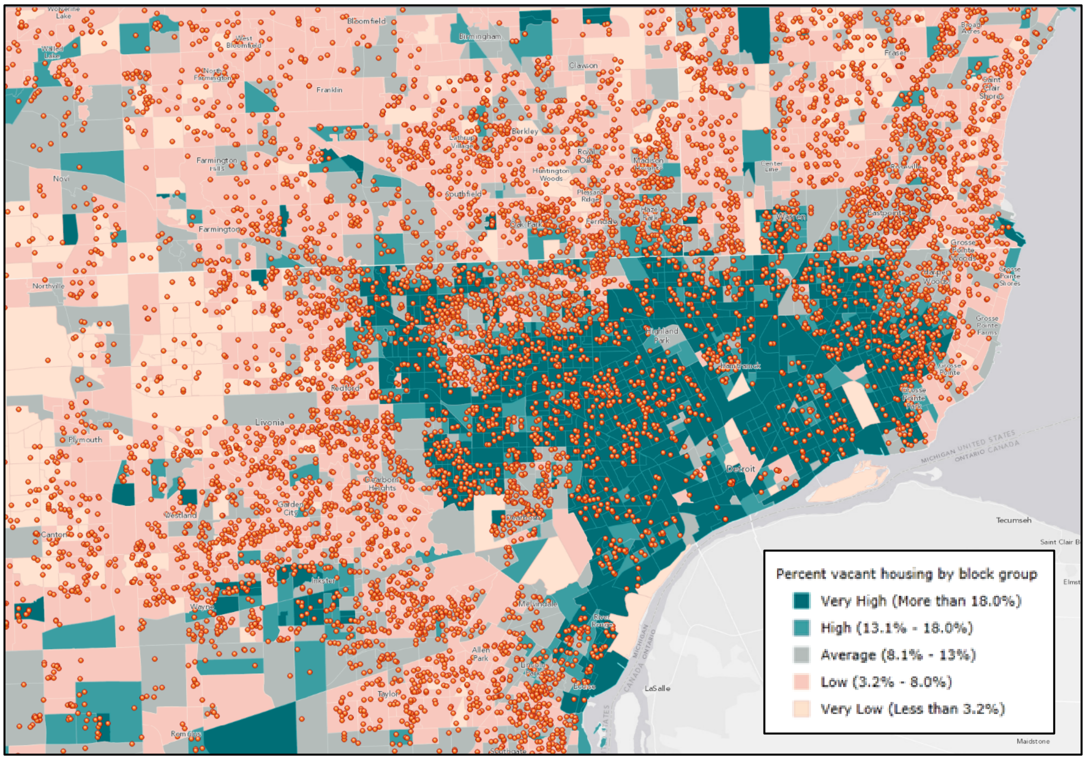
As of the end of 2011, Enterprise REO properties within Detroit were concentrated in areas with vacancy rates at or exceeding 18% (see dark shaded areas in Figure 9). When vacant properties are inadequately secured they become particularly vulnerable to unauthorized entry and vandalism, and contribute to urban blight. Further, they can serve as a focus for illegal activities.[30] This, in turn, further hurts the housing market and can adversely affect the values of nearby properties.

2011, indicate that the Enterprises REO inventory in the state of Michigan consisted of 22,605 properties at the end of 2011.

[29] Figures 8 and 9 were developed using the ArcGIS online tool. FHFA-OIG normalized and validated Enterprise-provided loan-level REO data for the period ending December 31, 2011. The REO data is displayed on the maps using a combination of property addresses, zip codes, city locations, and latitudinal and longitudinal coordinates.

[30] *See* Government Accountability Office, *Vacant Properties: Growing Number Increases Communities' Costs and Challenges* (GAO-12-34, November 4, 2011), available at http://www.gao.gov/products/GAO-12-34.

Figure 9: Enterprises' Combined REO Inventory Concentrations by Property Vacancy Rates in Detroit, Michigan, December 31, 2011[31]



Managing REO Inventories in States with Redemption Laws

Another challenge facing the Enterprises is the effect that some states' redemption laws may have on their ability to maintain and market their foreclosed properties. As FHFA-OIG recently noted, 29 states and the District of Columbia have redemption laws. These laws permit borrowers to remain in foreclosed properties for a specified time after the foreclosure sale has been completed (generally ranging from 5 days up to 3 years, depending on the state).[32] The intent of these laws is to provide former homeowners who have been foreclosed upon with an opportunity to redeem the property by paying the loan debt and the cost of the foreclosure sale or an amount specified in state statute. During these redemption periods the former homeowners generally may remain in the properties, and the Enterprises may not evict them and secure the

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[31] Figure 9 displays individual REO properties from the Enterprises' inventories as of December 31, 2011, and property vacancy rates by census block group from the 2010 census. Housing vacancy rates are publicly available from the U.S. Census Bureau at http://www.census.gov/hhes/www/housing/hvs/hvs.html. Aggregate data for Enterprise REO properties by census block group were not available at the time of publication.

[32] *See* FHFA-OIG, *An Overview of the Home Foreclosure Process*, at 19-21, available at http://www.fhfaoig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process.pdf.

properties.[33] Thus, the Enterprises may place properties that are subject to redemption in what is known as "unable to market for sale" status.

State redemption laws can have a significant impact on the Enterprises' ability to maintain and market their foreclosed properties.[34] Fannie Mae has said that, as of the end of 2011, 12% – nearly 15,000 of 118,528 – of its inventory of foreclosed properties were occupied as a result of redemption laws. Fannie Mae has also said that state redemption laws increase the time that a property remains in its REO inventory by an average of two to six months.

In spite of the adverse impact of such laws, FHFA has not challenged their application to the Enterprises. In contrast, on December 12, 2011, FHFA filed a lawsuit in the U.S. District Court for the Northern District of Illinois, challenging the impact of the City of Chicago's "Vacant Buildings Ordinance" as enforced against the Enterprises. The ordinance seeks to address the problem of vacant properties by requiring mortgage owners to inspect mortgaged properties monthly in order to determine whether they are vacant, in which case the mortgage owners must pay fees of $500 per property to register them as such. FHFA contends that the ordinance subjects the Enterprises to regulation and supervision by the Chicago Department of Buildings.

Managing REO-Related Costs and Expenses

The surge in REO inventories during the period of 2007 through 2011 produced a dramatic increase in the Enterprises' REO-related costs, which cumulatively total $8.5 billion (see Figure 10). These costs, which include maintenance and other property management expenses, jumped from $649 million in 2007 to nearly $3 billion in 2008. Subsequently, these expenses have fluctuated, falling to $1.1 billion in 2009, rising to $2.4 billion in 2010, and falling to $1.4 billion in 2011. The Enterprises' REO expenses in 2011 were offset, in part, by recoveries on mortgage repurchase settlements with certain seller/servicers and other recoveries.[35]

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[33] It is uncommon for foreclosed property owners to come up with the cash necessary to redeem their properties during the redemption period, but the right is exercised from time to time. *See* FHFA-OIG, *An Overview of the Home Foreclosure Process*, at 15, available at http://www.fhfaoig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process.pdf.

[34] There are steps that the Enterprises can take to mitigate the risks associated with foreclosed properties subject to redemption laws. For example, Freddie Mac said it monitors properties during redemption periods and attempts to shorten such periods by offering cash for redemption and monitoring for vacancy. If the property becomes vacant, Freddie Mac may file an affidavit of abandonment or execute other applicable processes within a state.

[35] Under the terms of their mortgage purchase contracts, the Enterprises may require mortgage sellers to repurchase mortgages that contain certain defects, such as inadequate documentation of borrower income. Such repurchase claims may be used to offset credit losses.

Figure 10: Enterprise Single-Family REO Operations Expenses (in Millions), 2007-2011[36]

Enterprise	2007	2008	2009	2010	2011	Total
Fannie Mae	$444	$1,844	$857	$1,680	$765	**$5,590**
Freddie Mac	$205	$1,097	$287	$676	$596	**$2,861**
Total	**$649**	**$2,941**	**$1,144**	**$2,356**	**$1,361**	**$8,451**

FHFA Oversight of Enterprise REO Management

The Agency did not conduct targeted examinations of REO management from 2008 to early 2011, despite the surge in Enterprise REO inventories during this critical period. In a previous evaluation report, FHFA-OIG noted that FHFA recognized that the Enterprises' growing inventories of REO represent an important risk, but the Agency suffered from a shortage of examiners which limited its capacity to examine the Enterprises' REO management controls.[37]

In early 2011, FHFA reorganized its examination program and initiated a process to hire additional examiners. In its 2011 examination planning, the Agency included the Enterprises' management and oversight of their REO contractors, as well as other REO management issues as examination topics.[38] FHFA completed its examination work at both Enterprises by March 2012.

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[36] Source: Fannie Mae 10-K (Annual Report) for Year Ended December 31, 2011 and Fannie Mae 10-K (Annual Report) for Year Ended December 31, 2009; Freddie Mac 10-K (Annual Report) for Year Ended December 31, 2011 and Freddie Mac 10-K (Annual Report) for Year Ended December 31, 2009.

The expenses denoted in the figure above contain the following elements:

- Maintenance, repair, and other costs;
- Valuation allowances, i.e., increase or decrease in the fair market value of properties in REO inventory;
- Disposition gains or losses; and
- Recoveries from mortgage insurance, pool insurance, or seller/servicer repurchases (Freddie Mac reported $634 million in such recoveries in 2011, but Fannie Mae did not report any).

[37] *See* FHFA-OIG, *Evaluation of Whether FHFA Has Sufficient Capacity to Examine the GSEs* (EVL-2011-05, September 22, 2011), available at http://www.fhfaoig.gov/Content/Files/EVL-2011-005.pdf.

[38] FHFA-OIG is currently conducting an audit of FHFA's supervisory risk-assessment for REO.

FHFA's examinations identified deficiencies in key REO contractor management controls at both Enterprises. These included, among others, deficiencies in controls relating to:

- The selection of REO contractors, e.g., one Enterprise did not perform comprehensive background checks on its contractors;
- The compensation of REO contractors that exposes the Enterprises to improper reimbursement of contractors. For example, the Enterprises lacked controls to protect adequately against duplicative reimbursements for REO-related work; and
- REO contractor performance, such as tracking complaints and corrective actions. For example, one Enterprise did not inspect a sufficient number of properties to determine how well its contractors maintain its REO inventory, and the other lacked adequate REO contractor oversight processes to protect it against inappropriate property maintenance and unnecessary repairs.

As a result of these REO examinations, FHFA issued what are known as Matters Requiring Attention (MRA) to the Enterprises to remediate certain identified deficiencies. MRAs require the Enterprises to remediate such deficiencies within specified periods.

FHFA officials said that they plan to monitor the Enterprises' REO management during 2012. In particular, they plan to verify the Enterprises' implementation of the MRAs instituted pursuant to the recently completed examinations discussed above. Additionally, FHFA plans to conduct supplemental REO examinations of the Enterprises to determine the adequacy of their procedures and controls for determining the fair value of foreclosed properties prior to their disposition.

FHFA's and Fannie Mae's Pilot Program Is Testing the Concept of Selling in Bulk Foreclosed Properties with Rental Commitments

In its role as the Enterprises' conservator, FHFA has been working with them to develop and test alternative approaches to addressing the ongoing risks and costs associated with the surge in REO inventories. In particular, FHFA is overseeing Fannie Mae's development and implementation of a pilot program under which investors will have the opportunity to purchase nearly 2,500 foreclosed properties in bulk, conditioned on their agreement to operate the properties as rentals for a period of years. FHFA and Fannie Mae consider the REO pilot program to be an opportunity to:

- Assess investor interest in purchasing a new type of foreclosed property asset, i.e., scattered site single-family rental housing.

- Determine whether the disposition of foreclosed properties in bulk, as opposed to individual retail sales, presents an opportunity to improve housing market conditions.

- Determine whether selling foreclosed properties in bulk as rental units can be replicated by the Enterprises and other financial institutions.

Fannie Mae's approximately 2,500 properties, which will be included in the first phase of the program, are located in metropolitan areas as well as regions of states with particularly distressed real estate and housing markets (see Figure 11).[39] As discussed earlier, Michigan, California, Florida, Illinois, Georgia, Arizona, and Nevada have large concentrations of Enterprise REO properties and, according to FHFA's HPI, experienced double-digit declines in overall house prices from 2007 through 2011. FHFA officials said that the pilot program will be focused on such distressed areas and that they seek to determine whether bulk sales of properties can be used to complement traditional retail sales.

Figure 11: Preliminary Summary of Fannie Mae REO Assets Available Through the REO Pilot Program, as of February 27, 2012[40]

Location of REO Properties in Fannie Mae Pilot Transaction	Property Count	Percentage of Pilot Transaction Total
Atlanta, GA	572	23.0%
Chicago, IL	99	4.0%
Florida - Central and Northeast	190	7.6%
Florida - Southeast	418	16.8%
Florida - West Coast	167	6.7%
Las Vegas, NV	219	8.8%
Los Angeles / Riverside, CA	484	19.4%
Phoenix, AZ	341	13.7%
Total	2,490	100.0%

[39] FHFA announced the initiation of the pilot program in February 2012. *See* FHFA, *FHFA Announces Interested Investors May Pre-Qualify For REO Initiative* (Feb. 1, 2012), available at www.fhfa.gov/webfiles/23196/REO2112F.pdf; and FHFA, *FHFA Announces Pilot REO Property Sales in Hardest-Hit Areas* (Feb. 27, 2012), available at www.fhfa.gov/webfiles/23403/REOPR22712F.pdf.

[40] *See* FHFA, *Preliminary Summary of Assets: REO Initiative Fannie Mae Pilot Transaction* (SFR REO 2012), available at www.fhfa.gov/webfiles/23402/FNMASFRREO2012-1SummaryofAssets.pdf.

FHFA and Fannie Mae officials said that the REO properties offered for sale under the pilot program have been pooled so that the bidders can place one of two permissible types of offers on them:

- An outright purchase of 100% of the properties in the pool; or
- Joint ventures between the bidder and Fannie Mae that include equity sharing arrangements.[41]

A senior Fannie Mae official also said that FHFA would compare the bids made through the pilot program with those made on similar properties through the traditional retail sales route to determine which approach is the most cost-effective. This process is expected to be completed in the summer of 2012.

Potential Risks Associated with the Pilot Program

Although the REO pilot program may demonstrate that there are benefits to selling in bulk foreclosed properties with rental commitments, FHFA-OIG notes that there also appear to be potential risks associated with it that must be addressed. These include the risks that:

- Fannie Mae and FHFA may not have sufficient data or, in some cases, the technical capacity to appropriately determine whether proceeding with bulk property sales with rental commitments is a workable, cost-effective strategy for disposing of REO that is consistent with the objectives of the conservatorship. For example, there is a risk that Fannie Mae and FHFA may lack the capacity to determine generally whether or not such bulk sales maximize financial returns as compared to traditional individual sales of foreclosed properties;
- FHFA and Fannie Mae may not have selected appropriate regions or housing markets in which to operate the program. For example, the regions or specific housing markets selected may be in the process of recovering, and therefore, traditional property sales with or without rental commitments may be more cost-effective than bulk sales with rental commitments;
- Investors may engage in misconduct, or even fraud, in order to participate in the program. For example, investors may misrepresent their financial or technical capacity to manage scattered rental units. Thus, Fannie Mae's joint venture partners

[41] Under Fannie Mae's joint venture structures, including equity sharing arrangements, the investor and Fannie Mae will share a financial ownership interest in the properties. However, the investor, or joint venture partner or member, assumes responsibility for all aspects of the properties, including their maintenance and management as rental units. Fannie Mae will receive a portion of the rental income for its interest in the joint venture arrangement.

could prove ineffective in managing rental units, or otherwise default on their commitments under the program;

- Fannie Mae may lack the infrastructure necessary to monitor the program's implementation. For example, Fannie Mae does not typically involve itself with foreclosed properties after they are sold through its traditional REO management processes. However, the REO pilot program requires Fannie Mae to monitor properties after their sale for, among other things, compliance with established rental commitments and the treatment being afforded to tenants; and

- FHFA may lack the resources to conduct adequate oversight to ensure that Fannie Mae manages the program effectively.

Controls Being Developed to Mitigate Potential Risks

FHFA and Fannie Mae officials said that they recognize the potential risks associated with their bulk sale with rental commitment approach. However, they also said that they either have implemented or are developing a number of controls to mitigate such risks. According to these officials and Fannie Mae's program documentation, these controls include:

- **Stringent investor requirements pertaining to their financial and operational expertise and technical qualifications to acquire and manage rental properties:** FHFA officials said they developed an extensive investor application form in connection with this pilot program. Bidders are required to pass a rigorous evaluation process in order to bid. A deposit of $250,000, along with signed non-disclosure agreements, is required to view the property-level information. Fannie Mae has also hired a financial firm to advise it on the structure of the REO pilot program, and a firm to review investor bidder applications;

- **Extensive monitoring of investors' management of purchased properties and compliance with their rental commitments:** Fannie Mae plans to require joint venture partners to provide it with extensive financial data, including consolidated income and expense statements; information concerning their tenants; and their rent rolls. A Fannie Mae official said that the Enterprise also may conduct inspections of properties that have been sold through bulk sales to ensure that the investors are meeting their rental commitments and maintaining the properties appropriately; and

- **Ongoing oversight:** FHFA plans to review Fannie Mae's implementation and oversight of the REO pilot program and any additional bulk sales with rental commitments on an ongoing basis. This oversight will include consideration of appropriate enforcement actions and applicable legal remedies for contract non-compliance or default.

Although FHFA and Fannie Mae are developing or implementing such controls, their effectiveness remains to be seen. As described in the next section of this report, FHFA-OIG plans to evaluate the controls and other issues associated with the REO pilot program if it is expanded over time.

FHFA-OIG'S STRATEGY FOR ASSESSING FHFA'S OVERSIGHT OF THE ENTERPRISES' REO MANAGEMENT

Given the risks associated with the Enterprises' REO management, FHFA-OIG is implementing a proactive audit and evaluation strategy under which it will assess the Agency's related oversight and conservatorship efforts. It is intended to determine whether the Agency and the Enterprises manage REO to maximize financial recoveries and minimize the negative effects of foreclosures on affected communities. FHFA-OIG also plans to assess the effectiveness of the REO pilot program should the Agency and the Enterprises decide to implement it on a wider scale. In this regard, FHFA-OIG will analyze its potential effectiveness and determine whether proper risk management controls are in place to prevent fraud and abuse.

FHFA-OIG's REO strategy consists of the following:

1. **Several Ongoing Audits of FHFA's Oversight of the Enterprises' REO Management Programs**

FHFA-OIG is presently conducting two audits of FHFA's oversight of the Enterprises' REO management programs.[42] The audits are focused on the Enterprises' oversight of basic REO management functions, including acquisition, valuation, maintenance, marketing, and disposition.

The specific objectives of these REO audits are to:

- Assess FHFA's oversight of the performance of the Enterprises' REO contractors, including compliance with Enterprise guidelines, and property management and marketing policies and procedures;
- Conduct tests on a sample of properties to determine error rates, e.g., the rate of erroneous, duplicative, and otherwise unnecessary payments; and
- Determine the risk of fraud associated with payments for services rendered and property management associated with the foreclosure process.

FHFA-OIG also is conducting an audit of FHFA's REO risk assessment processes.

[42] One audit covers FHFA's REO management oversight efforts at Fannie Mae and the other at Freddie Mac. FHFA-OIG will issue a separate report for each of these audits, and it will issue an additional report that summarizes FHFA-OIG's overall findings.

2. **Potential Evaluations Related to Impacts of FHFA's Oversight of the Enterprises' REO Management Programs**

In planning evaluations, FHFA-OIG intends to cover the key steps in the REO management process, including matters such as securing the property, maintenance and repair, valuation and marketing, and sale. FHFA-OIG is considering several evaluations of FHFA's oversight of the Enterprises' planning, monitoring, and management of REO, with a focus on their ability to handle future workloads and mitigate adverse impacts on homeowners and communities.

The specific objectives of these REO evaluations would be to assess FHFA's oversight of the Enterprises':

- Management systems, risk controls, and capacity to deal with any surge of foreclosures in the Enterprises' REO inventories due to seriously delinquent mortgages;
- Efforts to mitigate the effects of concentrations of REO inventories and abandoned or vacant foreclosed properties in economically distressed areas of the country; and
- Initiatives to manage foreclosed properties occupied under state or local redemption and homesteading laws or regulations.

3. **Evaluation of Any Expanded Bulk Sale REO Program**

FHFA-OIG also plans to evaluate FHFA's and Fannie Mae's REO pilot program should FHFA decide to implement the bulk sale/rental commitment model on a wider scale.

The areas that FHFA-OIG may cover in such an evaluation include:

- Whether the program is achieving key expected outcomes and the quality of the data and analytics FHFA and Fannie Mae use to make such determinations. For example, the evaluation could cover FHFA's and Fannie Mae's basis for determining whether, in certain cases, it is more cost-effective to proceed with the bulk sale with rental commitment model than to make sales through the traditional retail channel;
- The quality of the controls that are established to ensure that investors have sufficient expertise and financial resources to meet their rental commitments, as well as Fannie Mae's and FHFA's efforts to ensure compliance with these controls;
- The quality of the processes by which Fannie Mae monitors investor compliance with their rental commitments and the restrictions on the number of properties that may be sold annually, as well as FHFA's oversight of the Enterprises' processes;

- FHFA's and Fannie Mae's program enforcement efforts to ensure compliance with program requirements and, where necessary, their efforts to penalize or sanction investors for non-compliance; and

- FHFA's general oversight of Fannie Mae's efforts to implement the program, as well as its technical expertise and the sufficiency of the resources allocated to these efforts.

With this audit and evaluation strategy, FHFA-OIG believes that it will be well-positioned to: (1) determine whether FHFA is ensuring that the Enterprises are effectively mitigating REO risks and costs and the negative impacts of foreclosures on communities; and (2) evaluate the effectiveness of the controls associated with selling in bulk foreclosed properties with rental commitments. Further, FHFA-OIG will be in a position to make recommendations, as necessary, to strengthen the Agency's REO-related oversight and conservatorship efforts.

SCOPE AND METHODOLOGY

The objective of this white paper was to provide an overview of the growth in the Enterprises' REO inventories and their associated risks and costs, FHFA's oversight of the Enterprises' management of their REO inventories and risks, and FHFA-OIG's plans to assess the Agency's REO oversight efforts going forward.

To address its objective, FHFA-OIG interviewed senior FHFA officials who were responsible for monitoring and examining the Enterprises' management of their REO inventories and associated risks and costs. FHFA-OIG also interviewed senior FHFA and Fannie Mae officials who were responsible for the development and implementation of the REO pilot.

FHFA-OIG also reviewed FHFA's 2012 examinations of the Enterprises' REO management and oversight functions as well as examination planning materials. Further, FHFA-OIG reviewed FHFA financial data on REO management[43] and FHFA documents pertaining to the development of the REO pilot. FHFA-OIG appreciates the cooperation of FHFA and Fannie Mae management and staff in providing information and access to necessary documents to accomplish this study.

The preparation of this white paper was conducted under the authority of the Inspector General Act and is in accordance with the Quality Standards for Inspection and Evaluation (January 2011), which was promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform evaluations that, among other things, result in evidence sufficient to provide reasonable bases for its findings and recommendations. FHFA-OIG believes that the analysis and conclusions contained in this report meet these standards.

The performance period for this white paper was from March 2012 to May 2012.

FHFA-OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork and provided FHFA and the Enterprises with an opportunity to respond to a draft of this white paper. FHFA and the Enterprises provided technical comments which were incorporated as appropriate.

[43] FHFA-OIG generally used publicly available data, such as data from the Enterprises' securities filings, after determining it was reliable for the purposes of this white paper.

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