FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned

Audit Report: AUD 2012 005

July 19, 2012

OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

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

July 19, 2012

TO: Jon Greenlee, Deputy Director of Enterprise Regulation

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

SUBJECT: FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned (Audit Report No. AUD-2012-005)

Summary

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) buy and sell mortgages. Typically, when borrowers default on these mortgages and efforts to cure the defaults fail or do not materialize, the mortgages are foreclosed upon. Through foreclosure, properties that secure the defaulted mortgages revert back to Fannie Mae and Freddie Mac (collectively, the Enterprises) as real estate owned (REO).[1]

Since the onset of the financial crisis in 2007, the Enterprises have incurred substantial losses on the mortgages they own or guarantee, and their inventories of single-family REO have grown substantially.[2] In September 2008, the Enterprises entered into conservatorships overseen by the Federal Housing Finance Agency (FHFA or Agency). Since then, taxpayers have invested approximately $187.5 billion to ensure the Enterprises' solvency.[3] Through 2010, there was steady growth of the Enterprises' REO inventories and no clear signs of price escalation in the real estate market. As a consequence, the Enterprises are at risk of losing additional amounts on

[1] The Enterprises obtain REO properties when they are the highest bidder at foreclosure sales of properties that collateralize mortgages that they own.

[2] From here forward, REO refers to single-family REO for simplicity and readability. Single-family properties include those with one to four units.

[3] The Department of the Treasury provides financial support to the Enterprises by purchasing their preferred stock pursuant to Senior Preferred Stock Purchase Agreements.

foreclosed properties and taxpayers may be called upon to provide additional money to support them.

Since 2008, FHFA, which supervises and regulates the Enterprises and acts as their conservator, has consistently listed their large inventories of REO as contributing to "critical concern" ratings in their quarterly risk assessments. However, in spite of FHFA's identification of REO as a prominent and ascending risk, FHFA did not conduct targeted examinations or similar focused reviews of REO until 2011.

In the second quarter of 2011, FHFA began examination planning and risk assessment work in preparation for a supervisory review of REO management activity of the Enterprises. In June 2011, FHFA's Office of Inspector General (FHFA-OIG) announced an audit of FHFA's oversight of the Enterprises' REO. Subsequently, in July 2011, FHFA announced plans to conduct targeted examinations of REO risks arising from the Enterprises' use of contractors to manage REO (e.g., appraise, maintain, sell) and their efforts to mitigate losses from problematic properties (e.g., unmarketable homes, cancelled foreclosures). The Agency asserted that one of the factors that prompted the targeted examinations was the Enterprises' high-risk inventories noted on prior risk assessments.

Completed in 2012, FHFA's targeted examinations are positive supervisory steps that the Agency can supplement in the future by closely assessing other REO risk areas that need focused supervision. For example, the Enterprises also have hundreds of thousands of properties that are in or near foreclosure (the "shadow inventory"), which may stress their systems for cost-effectively managing, marketing, and disposing of REO. Because FHFA's underlying risk assessments drive the Agency's targeted examinations, expanding the scope of the assessments to evaluate more risks can help the Agency more comprehensively design its supervisory planning activities for REO. In turn, gaining a more fulsome understanding of all of the risks confronting Enterprise REO and the relative impact of such risks can help FHFA protect the taxpayers' investment in the Enterprises by ensuring that the Agency focuses its supervisory resources where they may best mitigate the Enterprises' REO-related losses.

Background

Overview of Enterprises' REO

The Enterprises support the secondary mortgage market by purchasing residential mortgage loans from sellers that can then use the proceeds to make more loans. They may hold the purchased mortgages as their own investments or bundle them into mortgage-backed securities (MBS) in which the underlying loans are guaranteed in the event they default. MBS are then sold to other investors. The Enterprises suffer losses when inadequately collateralized mortgages go into default and they either own the loans or they have guaranteed them as part of an MBS transaction. The Enterprises try to minimize these losses by taking ownership (through foreclosure and other means) of the properties securing the defaulted mortgages and then disposing of them cost effectively.[4] These foreclosed properties are referred to as REO.

In recent years, REO has grown substantially. From 2007 through 2011, the Enterprises went from acquiring nearly 72,000 REO properties per year to over 298,000, and inventory (i.e., the number of REO properties on hand at the end of the year) rose from over 48,000 to over 179,000.[5] At the same time, the Enterprises recorded $649 million in REO-related expenses in 2007, which more than doubled to $1.4 billion in 2011. (These expenses include costs to repair, maintain, manage, and dispose of the properties.) Although FHFA expects the risk of loss to be mitigated to some degree by decreased REO inventory, continued steady disposition rates, and cost efficiencies in the scale of REO operations, the Enterprises have substantial assets at risk with such large REO inventories and associated expenses.

Enterprises' REO Risks

In terms of costs and community impact, REO is a high-risk area.[6]

One measure of the Enterprises' financial risk derives from estimates of the size of the expected loss on each REO property (referred to as the severity rate).[7] As REO inventories have climbed, so have the severity rates and loss estimates. For instance, from 2007 through 2011, Fannie Mae's reported severity rate estimates more than tripled from 11% to 35%. That is, at the end of 2007, the Enterprise expected to lose on average $22,000 on a $200,000 defaulted mortgage loan balance, but, at the end of 2011, it expected to lose approximately $70,000 on the same loan balance. Over the same time, Freddie Mac's estimated severity rate similarly increased from 18% to 41%.[8]

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[4] Foreclosure is the legal process by which the owner of a debt secured by real property can exercise his/her rights against the property to satisfy the debt. For more information, *see* FHFA-OIG, *An Overview of the Home Foreclosure Process*, available at http://www.fhfaoig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process.pdf.

[5] The Enterprises' strategies for keeping people in their homes include home retention solutions and foreclosure alternatives (*e.g.*, loan modifications). Their strategies for disposing of REO properties consist primarily of standard retail sales but also include alternative sale channels, such as auction sales, bulk sales to investors, public entity sales, and rent and hold.

[6] For a more detailed discussion of the risks posed by the Enterprises' REO inventories, including fraud, management, and maintenance and Fannie Mae's pilot program to sell investors foreclosed properties in bulk for rentals, *see* FHFA-OIG, *Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties*, available at http://www.fhfaoig.gov/Content/Files/WPR-2012-003.pdf.

[7] Other factors determining severity rates include price depreciation, state redemption laws, mortgage insurance curtailments, and market-related holding periods.

[8] Percentage is based on quarterly averages for the fourth quarter of 2007 and the fourth quarter of 2011.

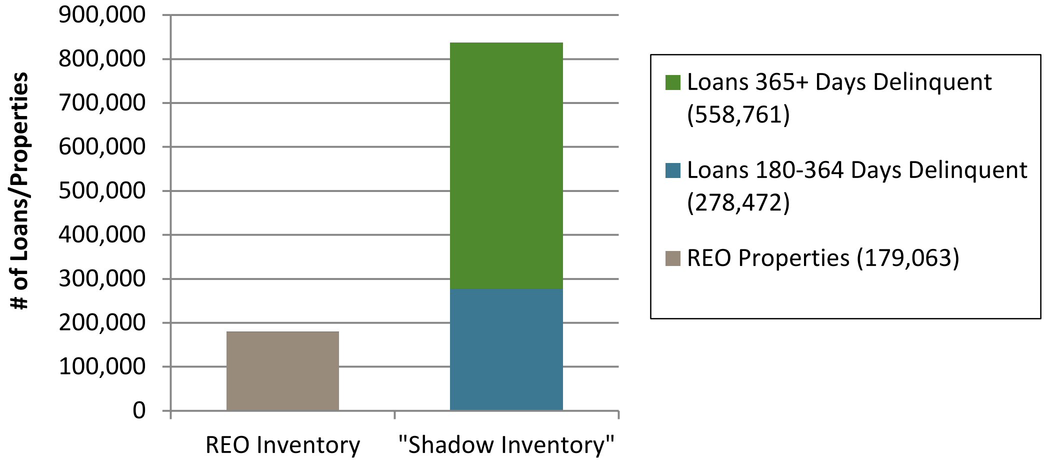
Aggravating the increased severity rates, the Enterprises risk having to acquire even more REO inventory than they currently manage. Currently, the Enterprises own or guarantee over one million seriously delinquent loans—loans for which payments have ceased but a foreclosure action has not been completed. Fannie Mae recently noted that: (1) in the third quarter of 2011, approximately 11 million, or 22%, of all residential properties with mortgages were underwater (i.e., a property is worth less than the balance of the mortgage it secures); and (2) despite signs of stabilization and improvement, 1 out of 13 borrowers was delinquent or in foreclosure during the fourth quarter of 2011.[9] These facts point to the likelihood of continued high REO inventories.

Beginning in 2007, the housing crisis flooded the Enterprises' servicers with defaulted mortgages, which led to flawed foreclosure practices. Correcting these practices was a factor that lengthened the time between mortgages going into default and becoming Enterprise REO. For example, between 2009 and 2011, Freddie Mac's nationwide average for completing a foreclosure rose from 370 days to 506 days. This increase has led to an unprecedented level of severely delinquent mortgages (e.g., mortgages that have not had a mortgage payment for over six months).

As shown in Figure 1 on the next page, there were over 837,000 mortgages as of December 31, 2011, on which payments had not been made for more than 6 months—over 4.5 times more than the Enterprises' REO inventory for 2011. Properties securing such severely delinquent mortgages are known as "shadow inventory" because, although they do not belong to the Enterprises yet, they are likely to become REO as the Enterprises' servicers foreclose on them. Further, counting only mortgages that have not been paid for over a year (i.e., 558,761), the Enterprises still face tripling their 2011 inventory (i.e., 179,063).

[9] Fannie Mae, "Residential Mortgage Market," *Fannie Mae 2011 10K*.

Figure 1: Enterprises' REO Properties and Shadow Inventory at December 31, 2011[10]



At the end of 2011, the Enterprises expected that they could suffer additional losses of over $110 billion due largely to high severity rates and the volume of seriously delinquent loans that may transform into foreclosures.[11] And, if the housing market weakens, the Enterprises could be exposed to larger losses. For example, 2011 ended with the Enterprises estimating that a 5% decline in nationwide home prices could increase their losses by over $28 billion.[12]

Communities also face risks as the Enterprises foreclose on and then sell REO properties. For example, the Government Accountability Office (GAO) recently cited a study estimating that foreclosures could bring down neighboring home values by up to 8.7%.[13] GAO has also noted that the longer a foreclosure takes, the more likely a property is to be vacant during and after the process, which leaves it open to being vandalized or used for criminal activity.[14] Thus, the

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

[11] The $110 billion here is included in the $187.5 billion Treasury investment to support the Enterprises. The figure is drawn from the Enterprises' single-family loan loss reserves, which are an estimate of future losses required by accounting principles. *See Fannie Mae 2011 10K*, available at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2011/10k_2011.pdf; *see also Freddie Mac 2011 10K*, available at http://www.freddiemac.com/investors/er/pdf/10k_030912.pdf.

[12] Fannie Mae, "Regulatory Hypothetical Stress Test Scenario," *Fannie Mae 2011 10K*; and Freddie Mac, "Credit Risk Sensitivity," *Freddie Mac 2011 10K.*

[13] GAO, *Vacant Properties: Growing Number Increases Communities' Costs and Challenges* (November 2011); and Frame, Scott W., "Estimating the Effect of Mortgage Foreclosures on Nearby Property Values: A Critical Review of the Literature," *Federal Reserve Board Bank of Atlanta Economic Review*, vol. 95, no. 3, 2010.

[14] GAO, *Vacant Properties: Growing Number Increases Communities' Costs and Challenges*.

average foreclosure timeline of over a year sets the stage for property deterioration and community blight.[15]

Overall, the Enterprises' effectiveness in acquiring, maintaining, and disposing of REO properties can help to mitigate risks of deterioration of vacant properties after foreclosure sale. To support Enterprise efforts, FHFA conducts a regular cycle of risk assessment, supervisory planning, and supervision activities.

FHFA's Supervision Framework

The Housing and Economic Recovery Act of 2008 established FHFA as the Enterprises' prudential regulator to ensure that they operate in a safe and sound manner. Starting in September 2008, Treasury began to invest taxpayer dollars in the Enterprises to prevent their insolvency, and it has invested $187.5 billion through March 31, 2012. Concurrent with Treasury's support, FHFA became the conservator of the Enterprises and in that capacity it oversees Enterprise operations with the goal of conserving and preserving assets.

To meet its mandated missions, FHFA has developed a supervision process that lays out how it assesses the quantity of the Enterprises' risk and the quality of their systems to manage it. In total, FHFA's review is intended to determine how effectively the Enterprises identify, measure, monitor, and control risk. Each step in the supervisory process has a corresponding deliverable.

Figure 2: FHFA's Supervision Steps and Resulting Products[16]

Supervisory Process Step	Supervision Product
Understanding the Enterprise	• Business Profile
Planning	• Supervision Workplan
Performing Supervisory Activities	• Continuous Supervision • Targeted Examination • Supervisory Analysis • Remediation Activities

[15] Recently, several localities have adopted ordinances to expand the responsibilities and liability for maintaining vacant properties. The Enterprises and FHFA have reported that these ordinances could significantly increase their costs, and the Agency has challenged at least one of them. *See, e.g.*, FHFA, *FHFA Sues the City of Chicago Over Vacant Buildings Ordinance*, available at http://www.fhfa.gov/webfiles/22832/Chicago_Lawsuit_121211.pdf.

[16] Source: FHFA Division of Enterprise Regulation's *Supervision Handbook 2.1*, "The Supervision Process and Products," ch. 4, pgs. 35-43.

Communicating	• Mid-Year Letter • Conclusion Letter • Matters Requiring Attention • Supervisory Letter • Report of Examination • Report to Congress
Assigning Ratings	• Risk Assessment

As shown in Figure 2 above, FHFA's risk-based supervision begins with understanding each Enterprise's characteristics and condition by identifying and concentrating on its major risk areas; this includes developing a business profile to capture the Enterprise's structure, culture, risk tolerance, etc.[17] FHFA's supervision process then requires that it plan how it will supervise the Enterprise generally. This workplan is intended to guide Agency examiners to create detailed supervision strategies (i.e., workplans) that outline comprehensive supervisory activities to be conducted over 12 months.

According to FHFA's *Supervision Handbook*, workplans are dynamic and should respond to internal factors (e.g., business profile) and external ones (e.g., economic circumstances). As supervision progresses over time, workplans also link FHFA's overall risk assessment for each Enterprise, including significant risks and supervisory concerns, to the supervisory activities that follow. In other words, if the assessment identifies a risk or concern, the workplan must indicate what supervisory activities will address it.

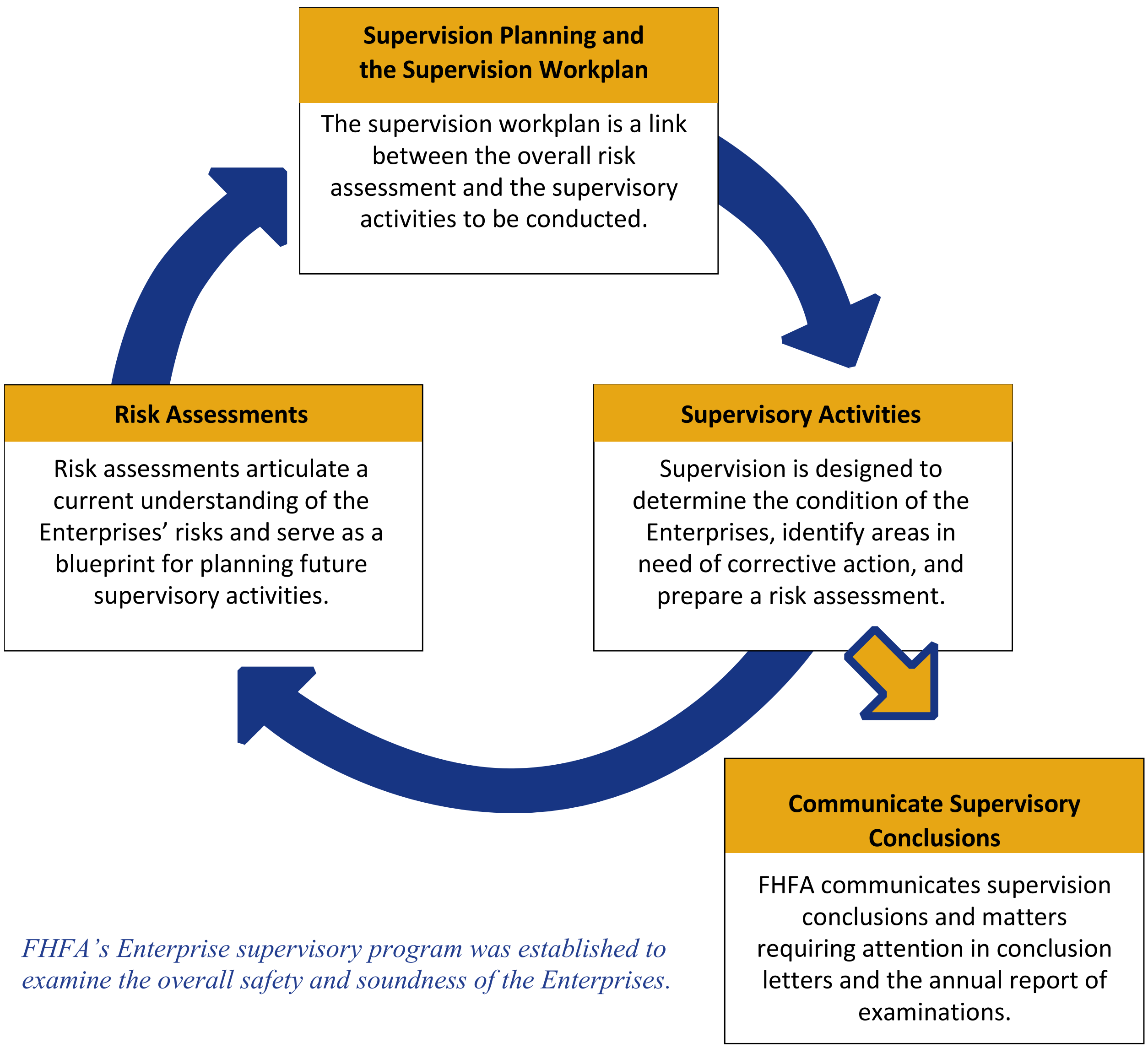
In turn, the Agency's supervisory activities contribute to assessing an Enterprise's risks. For example, targeted examinations offer detailed evaluations of specific risks or risk management systems particular to a single area, certain supervisory concern, etc. Similarly, continuous supervision encompasses a wide range of ongoing activities to monitor and analyze emerging trends and associated risks. Thus, along with supervisory analyses (i.e., research to improve FHFA's risk assessment) and remediation (i.e., oversight of an Enterprise's corrective action), all supervisory activities proceed through a continuous cycle of risk assessment and planning. In particular, they share the function of discovery in which they focus extensively on risk in order

[17] Figure 2 is a linear depiction that is intended to illustrate the variety of products that comprise FHFA's supervisory process. It does not, however, reflect the circular nature of the supervision products and process. Figure 3 on the next page and the text that follows Figure 2 describe how—as time progresses—supervisory products from a prior year inform planning and products in subsequent years. Accordingly, FHFA's *Supervision Handbook* specifies that a comprehensive risk assessment—the final item of Figure 2's linear depiction—of an Enterprise should be used as a blueprint for planning supervisory activities—the second item of Figure 2's linear depiction. *See* FHFA Division of Enterprise Regulation's *Supervision Handbook 2.1*, "Assigning Ratings," ch. 4, pg. 40.

to help Agency examiners identify, quantify, and evaluate it as the basis for planning future supervisory activities.

As illustrated in Figure 3 below, risk assessments, supervisory planning, and supervisory activities answer and inform each other on FHFA's ongoing supervision program.

Figure 3: FHFA's Risk-Based Supervisory Program[18]



[18] Source: FHFA-OIG's analysis of FHFA Division of Enterprise Regulation, *Supervision Handbook 2.1*, "The Supervision Process and Products," ch. 4, pgs. 35-43.

FHFA's Supervision of Enterprises' REO Risk

FHFA has not effectively employed its supervision process in the REO context. As FHFA conducted risk assessments of the Enterprises between 2008 and 2011, the Agency noted their large inventories of REO as contributing to a "critical concern" rating—the Agency's most severe.[19] Until 2011, however, the Agency's supervisory planning did not include targeted oversight activities to examine REO-related risks (but FHFA's supervision included general ongoing monitoring). Specifically, FHFA did not perform any targeted examinations of the Enterprises' management and marketing of REO until 2011.[20]

In the second quarter of 2011, FHFA incorporated REO into its preliminary scoping project to identify the need and begin planning for targeted examinations. The Enterprises use vendors for a variety of their principal business activities, such as underwriting (i.e., determining eligibility for mortgage loans), servicing Enterprise mortgage loans (e.g., collecting payments), information technology (e.g., accounting software), and REO management (e.g., maintenance, real estate sales). The preliminary scoping project's analysis reviewed these various business activities to identify risks specific to each area's vendors. REO was a component, not the focus, of the overall analysis.

Later, in the second quarter of 2011—shortly after FHFA-OIG announced this review, the Agency's supervisory strategy listed REO among a number of risk elements that required monitoring.[21] Afterwards, FHFA conducted four targeted examinations that were completed in 2012: two of the examinations focused on REO risks arising from the Enterprises' use of vendors to manage REO (e.g., appraise, maintain, sell, etc.); and two of the examinations looked at their efforts to mitigate losses from problematic properties (e.g., unmarketable homes, cancelled foreclosures, etc.).

Although these targeted examinations focused on some risks associated with REO, FHFA-OIG found that FHFA's risk assessments, which serve as the blueprint for future examination activities, could be improved to provide coverage of additional REO risk areas. The Office of

[19] Other factors contributing to the critical concern risk rating included the high number of seriously delinquent loans, home value depreciation, and losses relative to past performance.

[20] In 2007, FHFA's predecessor agency, the Office of Federal Housing Enterprise Oversight, followed up on REO-related issues identified during an earlier examination in 2005, but FHFA did not conduct a targeted examination until 2011.

FHFA did not perform REO examinations prior to 2011 due to examiner shortfalls. Further, two of FHFA's four targeted examinations in 2011 were contracted out.

[21] FHFA's Division of Enterprise Regulation, *2011 Supervisory Strategy for Fannie Mae and Freddie Mac*, pg. 4 (July 2011).

the Comptroller of the Currency has published a handbook, *Other Real Estate Owned*, that identifies various factors that impact bank REO holdings.[22] These factors include:

- The property's carrying value relative to its appraised value, asking price, and offers received;
- The length of time the property has been on the market and local market conditions for the type of property involved (e.g., recent sales trends and histories for comparable properties);
- Past performance in liquidating assets acquired in satisfaction of debts previously contracted;
- Income generated by the property and other economic factors affecting the probability of loss exposure;
- The manner in which the entity intends to dispose of the property;
- The source and quality of the appraisal; and
- Other pertinent factors, including the title, statutory redemption privileges, zoning, other liens, tax status, and insurance.

FHFA's four targeted examinations have not addressed all of the risk factors included in the Office of the Comptroller of the Currency's handbook.

FHFA-OIG's Audit and Evaluation Strategy for FHFA's Supervision of REO

In June 2011, FHFA-OIG announced this audit to examine the general supervisory system underlying FHFA's supervision of the Enterprises' REO. This report is part of FHFA-OIG's multi-pronged audit and evaluation strategy for REO that includes:

- Contract audits to evaluate in more detail the Enterprises' management of REO and FHFA's oversight;
- An evaluation of FHFA's and Fannie Mae's REO pilot program to sell foreclosed properties in bulk for rentals, if it is permanently implemented; and
- A potential evaluation of specific phases of REO management, such as the Enterprises' REO performance measures (e.g., length of time to sell) and how their handling of REO affects communities.[23]

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[22] Available at http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/oreo1.pdf, section 219. Similar guidance has been issued by the Federal Reserve, *see Commercial Bank Manual*, Section 2200 (April 2010), available at http://www.federalreserve.gov/boarddocs/supmanual/cbem/2000.pdf.

[23] *See also* FHFA-OIG, *Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties*, available at http://www.fhfaoig.gov/Content/Files/WPR-2012-003.pdf .

Altogether, FHFA-OIG believes this strategy will put it in position to determine if FHFA is ensuring the Enterprises are effectively minimizing REO's costs and community impact. In context of FHFA-OIG's overall strategy, this report focuses on the main precursor that drives FHFA's specific supervisory activities for REO: a comprehensive risk assessment.

Audit Objective

This performance audit's objective was to assess FHFA's supervision of the Enterprises' management and marketing of REO properties. To accomplish this, FHFA-OIG conducted a broad review of FHFA's general supervision of the Enterprises' REO.

Finding: FHFA's Supervision of Enterprise REO Can Be Strengthened by More Comprehensive Risk Assessments

FHFA will benefit from a more comprehensive REO risk assessment and from using the assessment to enhance its planning of supervisory activities. According to FHFA's *Supervision Handbook*, risk assessment is the process of developing a comprehensive, risk-focused view of an Enterprise that presents a current look at its emerging and existing risk characteristics. The handbook specifies that the comprehensive, risk-focused view of an Enterprise should be used as a blueprint for planning supervisory activities.[24] And, thorough planning should help Agency examiners develop detailed strategies to supervise the Enterprises.[25]

However, until early in 2011, FHFA's supervisory planning did not focus on the significant and increasing risks associated with the Enterprises' REO.[26] Moreover, although FHFA announced targeted examinations in July 2011, the Agency's prior risk assessments were not sufficiently detailed to provide a blueprint for developing subsequent supervisory activities covering the full range of risks associated with REO beyond vendor management.[27]

For instance, FHFA followed up on its preliminary scoping of Enterprise-wide vendor management risk by examining risks related to REO vendors.

- Two of FHFA's four targeted examinations looked at the Enterprises' management of their REO contractors and included reviewing REO contractors' roles in loss mitigation

[24] FHFA Division of Enterprise Regulation, *Supervision Handbook 2.1*, "Assigning Ratings," ch. 4, pg. 40.

[25] FHFA Division of Enterprise Regulation, *Supervision Handbook 2.1*, "Planning," ch. 4, pg. 37.

[26] FHFA staff responsible for REO supervision emphasized that they had been tasked with analyzing proposals to stabilize the Enterprises after the housing market crisis in 2007, which left them without time and staff to conduct granular REO oversight activities such as targeted examinations.

[27] The Agency stated it introduced new ongoing monitoring in May 2012 that will cover foreclosure sales and REO acquisition, as well as inventory.

and evaluating policies and procedures governing REO. FHFA found deficiencies at the Enterprises, including decentralized complaint tracking, insufficient quality assurance reviews, and limited background checks of listing brokers.

- The other two examinations evaluated the Enterprises' overall REO operations with respect to loss mitigation; specifically, unable-to-market inventory, aged evictions, and cancelled foreclosures. One Enterprise's examination found concerns, such as insufficient documentation for inventory it could not market. And the complementary examination found key deficiencies at the other Enterprise, such as the absence of a comprehensive framework for managing unmarketable inventory.

Although the Agency's efforts to examine REO contractor performance are noteworthy, broadening the scope of its risk assessments can further enhance its supervision by ensuring that it has accounted for other types of risk particular to REO when it plans future supervisory activities such as targeted examinations. For example, the Office of the Comptroller of the Currency's guidance offers several critical risk factors beyond inventory level to consider in coming to a comprehensive assessment of REO risk, including:

- Sales and insurance proceeds and rental income generated by the property and other economic factors affecting the probability of loss exposure. As discussed above, the Enterprises expect severity rates to remain high. Freddie Mac's expected loss per REO property more than doubled while Fannie Mae's more than tripled. At the same time, the Enterprises are threatened by a large shadow inventory (up to four and a half times their current REO inventory), which can escalate their losses even more. These potential losses may mount given the Federal Reserve Board's analysis of foreclosed properties pulling down housing prices, which means that the Enterprises may generate less per property—the severity rates may increase even more as they list more foreclosed properties for sale.[28]

- The length of time the property has been on the market and local market conditions for the type of property involved (e.g., recent sales trends and histories for comparable properties). The Enterprises' REO risks may not be distributed evenly throughout the nation. In 2011, over half of the Enterprises' total credit losses (largely associated with disposing of single-family REO) were concentrated in four states (Arizona, California, Florida, and Nevada). Moreover, although Florida accounted for 12,618 REO properties, or 7% (i.e., 12,618 of 179,063) of the Enterprises' total REO inventory through 2011, the State had 30% (i.e., 166,443 of 558,761) of the Enterprises' loans that were 365 or more

[28] Federal Reserve Board, *The U.S. Housing Market: Current Conditions and Policy Considerations*, available at http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf.

days seriously delinquent at the end of 2011. In other words, the Enterprises could nearly double their current REO inventory from Florida alone as foreclosures proceed there. Regional risks such as these may warrant assessment to determine if they should be subject to particular supervisory planning and activities.

Although not exhaustive, the Office of the Comptroller of the Currency's guidance offers a more comprehensive approach to assessing REO risk than merely identifying the overall level of the Enterprises' inventories.[29]

To recap, by the end of 2011, the Enterprises held over 179,000 single-family REO properties, which were valued at over $15 billion. The losses to date on these properties and the Enterprises' other operations have required a taxpayer investment of $187.5 billion. Additionally, over one million Enterprise-owned and -guaranteed mortgages are in the foreclosure process or seriously delinquent and in danger of foreclosure. A more comprehensive assessment of the risks associated with this real and shadow REO inventory can help FHFA provide for the Enterprises' safety and soundness and help protect the taxpayers from undue losses by ensuring the Agency focuses its supervision where it can best mitigate risks.

Recommendation

FHFA-OIG recommends that FHFA's Deputy Director of Enterprise Regulation implement the performance of risk assessments of REO that are more comprehensive and link the results to supervisory plans that address those risks through specific supervisory activities.

FHFA Comments

As shown in the attached appendices, FHFA agreed with FHFA-OIG's recommendation and is planning to take responsive corrective action.

Scope and Methodology

The audit scope was June 1, 2009, through May 31, 2011, and was expanded as necessary.

To understand how FHFA supervised the Enterprises' REO management and marketing, FHFA-OIG reviewed the Agency's and the Enterprises' relevant policies and procedures and interviewed officials at:

- FHFA's offices in Washington, D.C.;

[29] Additional procedures for assessing REO risk factors have also been issued by: the Federal Deposit Insurance Corporation (*Risk Management Manual of Examination Policies*, sec. 3.6 "Other Real Estate," March 2012); and the Federal Reserve Board (*Commercial Bank Examination Manual*, sec. 2200.1 "Other Real Estate Owned," April 2010).

- Fannie Mae's corporate office in Washington, D.C.;
- Freddie Mac's corporate office in McLean, Virginia; and
- Fannie Mae's and Freddie Mac's REO offices in Dallas, Texas.[30]

FHFA-OIG also reviewed computer-processed and hardcopy data from FHFA and the Enterprises. This included: (1) FHFA's data in its document repository and emails; and (2) the Enterprises' data that was electronically transmitted to FHFA-OIG via a secure website or email. FHFA-OIG assessed the validity of the electronic and hardcopy data and found it to be generally accurate, but could not conclude on its completeness. FHFA-OIG used this data for informational purposes and did not rely on it to achieve the audit's objective.

FHFA-OIG assessed the internal controls related to the audit's objective. Internal controls are an integral component of an organization's management. They provide reasonable assurance of: (1) effective and efficient operations; (2) reliable financial reporting; and (3) compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures for meeting its mission, goals, and objectives. They include the processes and procedures for planning, organizing, directing, and controlling program operations along with the systems for measuring, reporting, and monitoring program performance. Based on the work completed in this performance audit, FHFA-OIG considers its finding on FHFA's supervision of the Enterprises' REO to be significant within the context of the audit's objective. Additionally, other less significant matters that came to FHFA-OIG's attention during the audit were communicated separately to FHFA in an audit memorandum.

FHFA-OIG conducted this performance audit from June 2011 through September 2011 in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for FHFA-OIG's finding and conclusion based on the audit objective. FHFA-OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusion included herein, based on the audit objective.

[30] This audit was not intended or designed to assess the effectiveness of the Enterprises' oversight of REO. FHFA-OIG visited the Enterprises' REO offices in Dallas, Texas for further understanding of their REO processes.

cc: Edward DeMarco, Acting Director
John Major, Internal Controls and Audit Follow-Up Manager
Bruce Crandlemire, Senior Advisor for IG Operations

Attachments: Appendix A, FHFA's Comments on the Finding and Recommendation
Appendix B, FHFA-OIG's Response to FHFA's Comments
Appendix C, Summary of Management's Comments on the Recommendation

Appendix A: FHFA's Comments on the Finding and Recommendation

Federal Housing Finance Agency

MEMORANDUM

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

FROM: Jon D. Greenlee, Deputy Director for Enterprise Regulation

SUBJECT: Audit Report: FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned (Assignment Number: AUD-2011-010)

DATE: June 21, 2012

The purpose of this memorandum is to provide you with FHFA's response to your recommendation outlined in the Inspector General's Report on FHFA's Supervisory Risk Assessment for Single-Family Real Estate Owned (the "Report"). FHFA appreciates the opportunity to provide its response and values the feedback the Agency receives from the Inspector General. FHFA agrees that real estate owned ("REO") is an important area of risk for the Enterprises, and that the effective management of the large volume of foreclosed properties is critical to reducing taxpayer losses and stabilizing the nation's housing markets. As part of FHFA's efforts, we announced in February an REO rental initiative to help reduce the volume of foreclosed properties for sale in the marketplace. REO has been and continues to be a key supervisory focus for FHFA with regard to the Enterprises and FHFA agrees that there are numerous and varied risk factors for consideration in overseeing through ongoing monitoring and examinations the Enterprises' controls with respect to their portfolios of real estate owned. It is a priority of FHFA to ensure a solid understanding of the risks associated with real estate owned and to assess the effectiveness of the Enterprises' efforts to address those diverse risks.

FHFA's response to the FHFA-OIG recommendation is as follows:

Recommendation: FHFA-OIG recommends that FHFA's Deputy Director of Enterprise Regulation direct the performance of risk assessments of REO that are more comprehensive and link the results to supervisory plans that address those risks through specific supervisory activities.

Management Response:

FHFA agrees with this recommendation and, as discussed in more detail below, FHFA will address the recommendation by enhancing the program for supervision of the Enterprises in the following ways:

(1) Clarify the risk factors to be considered by examiners in reviewing REO-related risks and preparing risk assessments; and
(2) Ensure that REO risk assessments are more explicitly incorporated into the supervisory planning process, as set forth in revised supervisory planning procedures.

(1) Risk Factors for Preparation of Risk Assessments. As described in the Report, REO remains a significant source of risk for the Enterprises, although the Enterprises have experienced reductions in both foreclosures and delinquencies since the first quarter of 2011. Various REO risk factors have been considered in prior supervisory activity of FHFA and will continue to be carefully reviewed, both in targeted examinations as noted in the Report, and also through ongoing monitoring processes that were recently expanded.

In the course of FHFA's supervisory coverage of REO issues in the past three years, primary risk factors identified included, among others, REO disposition process, appraisal, and vendor management. FHFA did complete examination work to review the Enterprises' management of these risks, including through onsite visits and offsite monitoring. As suggested in the Report, however, there is an opportunity to improve the documentation of how particular factors should be considered in reaching conclusions regarding REO risk management.

For example, FHFA examination procedures do not reference the OCC and Federal Reserve guidance for examiners that is referenced in the Report and enumerates a number of risk factors relating to REO. While the federal banking agency guidance provides a framework for determining risk associated with individual properties, rather than for large REO portfolios like those maintained by the Enterprises, the guidance nevertheless reflects supervisory sound practices for REO risk assessment and could be referenced as such by FHFA's supervision program. FHFA will continue to address REO risk factors on an aggregate basis across the Enterprises' portfolios, but can leverage sound practices set forth in other contexts in developing a written framework for risk assessments.

DER and DEPS staff will coordinate to ensure that relevant risk factors are clearly and consistently communicated in writing and incorporated into Agency examination guidance. The target date for revised documentation of risk factors is the second quarter of 2013.

(2) Incorporation of Risk Factors in Supervisory Planning Process. In addition to clarifying the risk factors for inclusion in REO risk assessments, FHFA will improve the process and documentation for ensuring that REO risk assessments inform and guide FHFA examination work. The Division of Enterprise Regulation and Division of Examination Programs and Support are currently developing a revised written framework for the supervisory planning process, which will more clearly set for the appropriate use of risk assessments. The supervisory planning guidance should be completed in the second quarter of 2013.

Appendix B: FHFA-OIG's Response to FHFA's Comments

On June 21, 2012, FHFA provided comments to a draft of this report, agreeing with the recommendation and identifying FHFA actions to address it. FHFA-OIG considers the Agency's proposed actions sufficient to resolve the recommendation, which will remain open until FHFA-OIG determines that agreed upon corrective actions are completed and responsive to the recommendation. FHFA-OIG has attached the Agency's full response (see Appendix A), which was considered in finalizing this report. Appendix C provides a summary of management's comments on the recommendation and the status of agreed-to corrective actions.

Appendix C: Summary of Management's Comments on the Recommendation

This table presents the management response to the recommendation in FHFA-OIG's report and the status of the recommendation as of when the report was issued.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1.	FHFA will address the recommendation by enhancing the program for supervision of the Enterprises in the following ways: (A) Clarify the risk factors to be considered by examiners in reviewing REO-related risks and preparing risk assessments; and (B) Ensure that REO risk assessments are more explicitly incorporated into the supervisory planning process, as set forth in revised supervisory planning procedures.	6/30/2013	$0	Yes	Open

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to the FHFA-OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

[b] Once FHFA-OIG determines that the agreed-upon corrective actions have been completed and are responsive, the recommendation can be closed.

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