FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Oversight of the Enterprises' Efforts to Recover Losses from Foreclosure Sales

Audit Report: AUD-2013-001

October 17, 2012

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

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Why FHFA-OIG Did This Audit

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) support the secondary mortgage market by buying residential mortgages and securitizing most of them. Typically, when borrowers default on these mortgages and efforts to cure the defaults fail or do not materialize, the properties are foreclosed upon and eventually sold. The purchase price, though, may not be enough to pay off the entire outstanding mortgage balance on the property and the resulting shortfall is known as a deficiency. The Enterprise that owned or guaranteed the particular mortgage then absorbs the loss.

In 2008, the Enterprises entered conservatorships overseen by the Federal Housing Finance Agency (FHFA or Agency) as a result of their deteriorating financial conditions. Simultaneously, the U.S. Department of the Treasury (Treasury) began investing taxpayer funds—more than $187 billion to date—in the Enterprises to cover their losses.

If the Enterprises can recover mortgage deficiencies, then they can mitigate some of their losses. For example, with respect to borrowers who may currently or in the future possess the ability to repay—such as, but not limited to, owners of investment properties or vacation homes who have defaulted for strategic reasons—pursuing deficiency collections and judgments may provide an added source of revenue for the Enterprises. In addition, pursuit against such borrowers may deter others who are considering default despite being financially able to make their mortgage payments. However, during 2011, the Enterprises recovered only a small fraction of the deficiencies they pursued—approximately $4.7 million collected out of $2.1 billion pursued.

FHFA's Office of Inspector General (FHFA-OIG) undertook this audit to assess FHFA's oversight of the Enterprises' deficiency management. In a future audit, FHFA-OIG plans to assess the Enterprises' different practices and their relative effectiveness in recovering deficiencies.

What FHFA-OIG Found

FHFA has an opportunity to provide the Enterprises with guidance about effectively pursuing and collecting deficiencies from targeted groups of borrowers who may possess the ability to repay. Yet, FHFA does not currently oversee the Enterprises' deficiency management. Further, FHFA does not gather information about the Enterprises' deficiency management practices and does not obtain data about the scope or effectiveness of their deficiency recoveries. Consequently, the Agency is not well positioned to determine the benefit that stronger Agency oversight may provide.

Each Enterprise has developed its own deficiency management approach. For example, Fannie Mae has its vendors pursue deficiencies in more than twice as many states as Freddie Mac does. The Enterprises also take different approaches to determining which deficiencies to pursue. For example, Freddie Mac delegates the decision to its vendors, but Fannie Mae maintains oversight of its vendors' methodology. Also, Freddie Mac does not pursue deficiencies when third parties buy foreclosures, whereas Fannie Mae does. In addition, Fannie Mae has announced an initiative that focuses on borrowers it identifies as having defaulted on their mortgages despite having the ability to pay—i.e., strategic defaulters. FHFA may be able to help the Enterprises recoup future losses through strengthened oversight and guidance.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA obtain information sufficient to analyze how the Enterprises manage deficiencies and issue guidance to them regarding the topic. Based on the results of its analysis, FHFA should incorporate deficiency management into its Enterprise oversight.

FHFA provided comments agreeing with the recommendations in this report.

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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

HAMP ....Home Affordable Modification Program

HUD.. Department of Housing and Urban Development

Treasury .... U.S. Department of the Treasury

PREFACE

The Housing and Economic Recovery Act of 2008 (HERA), which amended the Inspector General Act of 1978, established FHFA-OIG.[1] FHFA-OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations. FHFA-OIG is also authorized to recommend policies that promote economy and efficiency or the prevention and detection of fraud and abuse.

This audit report is part of FHFA-OIG's mission to promote the economy, efficiency, and effectiveness of FHFA's programs and, in accordance with its first strategic goal,[2] adds value by helping the Agency improve the Enterprises' economic health. Specifically, the report is intended to strengthen FHFA's oversight of how the Enterprises manage losses on single-family foreclosure sales. Better management of these losses—focused on those debtors who possess the ability to repay—may lead to opportunities to recover a larger portion of the Enterprises' single-family foreclosure deficiencies. That is important in light of taxpayers having invested over $187 billion to help stabilize the Enterprises and prevent their insolvency.

FHFA-OIG believes that its recommendations for enhancing the Agency's oversight of the Enterprises' deficiency management processes should not be construed as encouragement to aggressively pursue borrowers who do not have the ability to pay their mortgages. Instead, the Agency should obtain information to better understand the Enterprises' deficiency management processes and assess whether further improvements are needed to ensure the Enterprises are efficiently and effectively managing their credit loss mitigation activities.

Several other FHFA-OIG audits and evaluations also demonstrate the benefit of FHFA proactively supervising the Enterprises. These include FHFA-OIG's separate assessments of the Agency's oversight of Enterprise activities related to loan repurchase settlements, mortgage servicing contractors, and single-family underwriting standards.[3] Further, FHFA-OIG plans to assess in a future audit the effect that the Enterprises' different practices have on their effectiveness in recovering deficiencies.

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[1] HERA: Public Law No. 110-289; Inspector General Act of 1978: Public Law No. 95-452.

[2] See FHFA-OIG, *Strategic Plan: Fiscal Years 2012 – 2014*, available at http://www.fhfaoig.gov/Content/Files/Strategic%20Plan_0.pdf.

[3] See FHFA-OIG, *Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America* (EVL-2011-006, September 27, 2011); FHFA-OIG, *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* (AUD-2012-001, March 7, 2012); and FHFA-OIG, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003, March 22, 2012).

FHFA-OIG appreciates the cooperation of everyone who contributed to the audit, including officials at Fannie Mae, Freddie Mac, and FHFA. This audit was led by Heath Wolfe, Assistant Inspector General for Audits, and Alisa Davis, Audit Manager.

Russell A. Rau
Deputy Inspector General for Audits

BACKGROUND

The Enterprises support the secondary mortgage market by purchasing residential mortgage loans from sellers that can then use the proceeds to make more loans. The Enterprises may hold the mortgages they purchase as their own investments or bundle them into mortgage-backed securities in which the underlying loans are guaranteed against default. The securities are then sold to other investors.

In 2007 and 2008, the U.S. housing market suffered its worst downturn since the Great Depression, and the Enterprises lost billions of dollars. In the midst of this financial crisis, FHFA was established by HERA and was authorized to oversee the Enterprises by, among other means, conducting examinations and developing regulations. HERA also expanded the authority of Treasury to provide financial support to the Enterprises.

In September 2008, as the Enterprises' losses mounted, they entered into conservatorships overseen by FHFA. As conservator, FHFA is responsible for preserving and conserving the Enterprises' assets and restoring them to a sound financial condition. Accordingly, FHFA's purview includes Enterprise loss mitigation activities such as recovering deficiencies—i.e., the difference between the proceeds of foreclosure sales and the higher balances of the foreclosed mortgages. Additionally, as of June 30, 2012, Treasury has invested over $187 billion in the Enterprises to offset their losses and prevent their insolvency.[4]

In what follows, FHFA-OIG discusses how the Enterprises manage their deficiencies. After presenting a general overview of mortgage defaults and foreclosures, this Background section describes how deficiencies can be collected, focuses on the differences between how the Enterprises manage their deficiencies, and then summarizes FHFA's oversight activities. The Finding section considers the potential for improvements in the Enterprises' deficiency management activities and highlights the importance of FHFA's oversight.

Default and Foreclosure Overview

When borrowers take out mortgages, they make contractual commitments to pay them on time and in full. Typically, borrowers continue to honor their commitments—if they are financially able to do so—even when they owe more than their properties are worth (i.e., they are

[4] Specifically, pursuant to Senior Preferred Stock Purchase Agreements, the Enterprises request and obtain funds from Treasury, which owns preferred stock in each Enterprise. Under the agreements, the liquidation value of Treasury's stock increases as the Enterprises obtain additional Treasury funds, and—in exchange for Treasury's investment—the Enterprises must consult with Treasury concerning a variety of significant business activities, capital stock issuance and dividend payments, ending the conservatorships, transferring assets, and awarding executive compensation.

"underwater").[5] However, when borrowers miss a payment, their mortgage loans are considered delinquent.

Ordinarily, when borrowers fail to make mortgage payments for 90 days they are considered seriously delinquent. In such cases, the Enterprises, acting through their mortgage servicers, may work with borrowers to resolve the delinquency.[6] For example, the Enterprises may offer loan modifications to lower borrowers' monthly payments through programs such as Treasury's Home Affordable Modification Program (HAMP).[7]

If these efforts prove unsuccessful, the Enterprises may initiate foreclosure proceedings. 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 an auction known as a foreclosure sale.

At the foreclosure sale, the owner of the mortgage, such as an Enterprise via its servicer, may make an offer on the property and take possession if it is the highest bidder. Alternatively, a third party, such as an investor, may win the bid and take ownership. In 2011, there were 341,738 foreclosure sales of properties that secured Enterprise-owned or -guaranteed mortgages. The Enterprises bought 298,327 of those foreclosures (about 87%) and third parties bought the remaining 44,247 (about 13%).[8]

Some borrowers default because they no longer possess the ability to repay their mortgage loans. However, there is a group of borrowers who may continue to possess the ability to repay but who elect to default for strategic reasons. These borrowers are commonly referred to as "strategic defaulters." For purposes of this report, strategic defaulters have the financial means to make

[5] For example, according to FHFA, approximately 80% of the Enterprises' underwater borrowers are current on their loans. See FHFA, *Review of Options Available for Underwater Borrowers and Principal Forgiveness*, p. 3 (July 31, 2012).

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

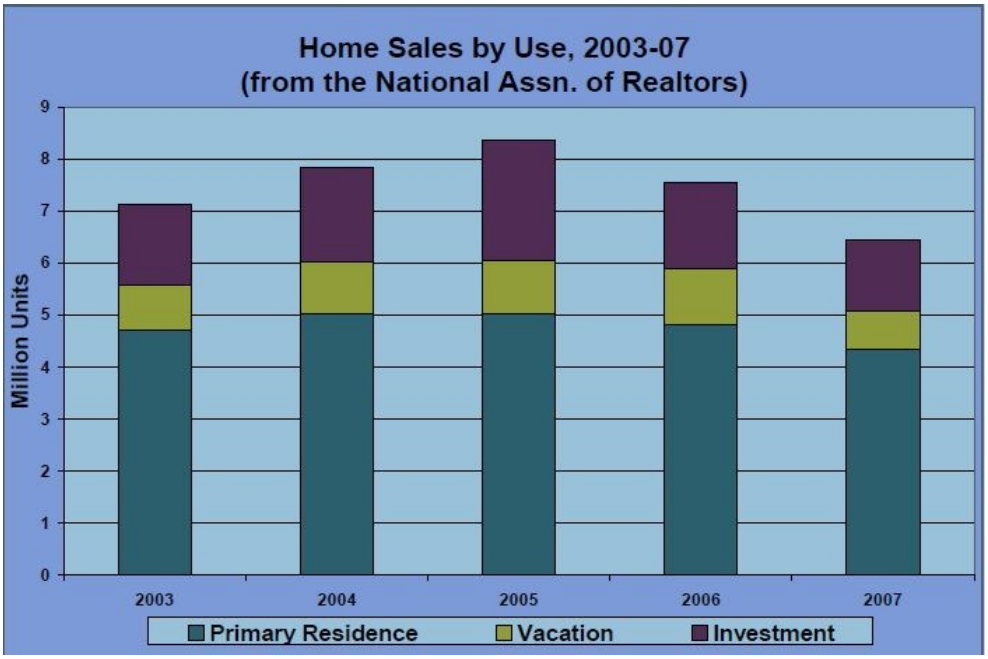
[7] See generally, FHFA-OIG, *Evaluation of FHFA's Role in Negotiating Fannie Mae's and Freddie Mac's Responsibilities in Treasury's Making Home Affordable Program* (EVL-2011-003, August 12, 2011).

[8] According to an FHFA official, the difference (i.e., 44,247 vs. 43,411) is due to the timing of different data sets.

their monthly mortgage payments, but choose not to and walk away from their contractual commitments to pay.[9]

One potential class of strategic defaulter—i.e., borrowers who purchased vacation homes or purchased residential real estate for investment purposes—appears to be significant. As reflected in Figure 1 below, between 2003 and 2007, approximately two million or more vacation/investment homes were purchased each year.

Figure 1: Home Sales by Use, 2003-2007[10]



Foreclosure Sale Deficiencies and State Deficiency Judgments

There are times when the proceeds from a foreclosure sale may be less than the borrower's mortgage loan balance.[11] For example, a home's current value/sales price may fall below the borrower's mortgage loan balance, so that the foreclosure sale does not make the lender

[9] The definition of "strategic defaulter" may vary. For example, FHFA defines "strategic defaulters" in its *Review of Options Available for Underwater Borrowers and Principal Forgiveness* as borrowers who default on their underwater mortgages "without apparent disruption to their other financial obligation" (p. 3).

[10] Source: *The Role of Non-Owner-Occupied Homes in the Current Housing and Foreclosure Cycle*, The Federal Reserve Bank of Richmond (WP 10-11), available at http://www.richmondfed.org/publications/research/working-_papers/2010/pdf/wp10-11.pdf (accessed September 4, 2012).

[11] The mortgage balance may include accrued interest as well.

financially whole. Such deficiencies may also arise when the costs associated with the foreclosure process, including attorney's fees, exceed the foreclosure recovery amount. If foreclosure sale proceeds are not sufficient to cover the borrower's debt, the mortgage owner, such as an Enterprise, is left either to absorb the deficiency as a loss or to try to collect it from the borrower.

Rules governing foreclosure processes and attempts to collect deficiency amounts vary by state. These state laws govern whether the foreclosure process is handled through the courts (i.e., judicial foreclosure) or without a court order (i.e., non-judicial foreclosure). State laws also dictate whether a mortgage owner has recourse to pursue collection of a deficiency.[12] The Enterprises can pursue deficiencies via voluntary debt collection efforts or through the legal system; however, the Enterprises generally must obtain judgments in court to make borrowers pay the deficiencies.

Some states restrict deficiency judgments and may be considered to be non-recourse states. For example, one state does not permit deficiency judgments if the foreclosed property is residential, on less than 2.5 acres, and intended as a home for one or two families. Further, in states where lenders have recourse against delinquent borrowers, lenders typically must credit borrowers for at least their properties' fair market values, which may be higher than foreclosure sale prices. This variance among state laws influences the Enterprises' approaches to managing their deficiencies.

Enterprises' Deficiency Management

Neither Enterprise pursues recoveries on deficiencies as a primary loss mitigation strategy. Instead, the Enterprises assert that they focus on foreclosure alternatives to minimize losses. These alternatives include avoiding foreclosures through loan modifications (e.g., HAMP).[13] However, when these efforts fail and foreclosure sale proceeds are not enough to pay off mortgage balances, the Enterprises may either absorb the deficiencies as losses; direct collection

[12] Here and below, details are drawn from Andra C. Ghent and Marianna Kudlyak, *Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States*, Federal Reserve Bank of Richmond Working Paper No. 09-10 (July 7, 2009).

[13] For more information on the foreclosure process, see FHFA-OIG, *An Overview of the Home Foreclosure Process*, available at http://www.fhfaoig.gov//Content/Files/SAR%20Home%20Foreclosure%20Process.pdf. For more information on the Enterprises' real estate owned process and activity, see FHFA-OIG, *Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties* (WPR-2012-003, June 14, 2012).

vendors to pursue voluntary collections from borrowers; or obtain court-ordered deficiency judgments.[14]

Officials at both Enterprises note that, among other factors, state laws, foreclosure timeframes, and costs influence their decisions to pursue deficiencies. Although external factors impact the Enterprises the same, their strategies for recouping their losses differ. For example, the Enterprises differ with respect to the states in which they pursue deficiencies. Fannie Mae has its vendors pursue deficiency collections and judgments in 38 states and the District of Columbia, but Freddie Mac's vendors limit their pursuit to 17 states and the District of Columbia.

The Enterprises also take different approaches in determining which deficiencies to pursue. For example, Freddie Mac delegates the decision to its vendors, but Fannie Mae maintains oversight of its vendors' decision-making methodologies. Also, Freddie Mac does not pursue deficiencies when third parties buy at foreclosure sales the properties underlying its defaulted mortgages. Conversely, Fannie Mae pursues deficiencies regardless of whether it or a third party is the purchaser at a foreclosure sale.

The Enterprises have also adopted different approaches to targeting borrowers who strategically default yet still have the ability to repay. Fannie Mae has articulated its intention to focus on strategic defaulters.[15] Accordingly, the Enterprise has developed a methodology to identify potential strategic defaulters and to send this information to its vendors to pursue collection. On the other hand, Freddie Mac has not established a policy with regard to pursuing deficiency collections from strategic defaulters.

In 2011, the Enterprises' vendors pursued 35,231 deficiency accounts, with a combined value of about $2.1 billion. Of this amount, vendors recouped approximately $4.7 million—about 0.22%. In a future audit, FHFA-OIG plans to assess the Enterprises' different practices and their relative effectiveness in recovering deficiencies.

[14] The Enterprises' losses on deficiencies may potentially be offset by, among other things, repurchases and mortgage insurance.

[15] Over two years ago, Fannie Mae announced that it would "take legal action to recoup the outstanding mortgage debt from borrowers who strategically default on their loans in jurisdictions that allow for deficiency judgments." See "Fannie Mae Increases Penalties for Borrowers Who Walk Away; Seven-Year Lockout Policy for Strategic Defaulters," Fannie Mae News Release (June 23, 2010), available at http://www.fanniemae.com/portal/about-us/media/corporate-news/2010/5071.html (accessed August 23, 2012). Fannie Mae also indicated that strategic defaulters henceforth would be ineligible for a Fannie Mae-owned or -guaranteed loans for seven years.

The Enterprises' current recovery rate and the potential increase in foreclosures[16] present FHFA, as conservator, with an opportunity to ensure through its oversight that the Enterprises are benefitting from effective deficiency management.

FHFA's Oversight of Enterprises' Deficiency Management

FHFA has not issued comprehensive guidance to the Enterprises regarding deficiency management. However, the Agency has considered questions related to deficiencies in connection with other issues. For example, the Agency recently announced changes to short sale policies that include a prohibition against the Enterprises pursuing deficiency judgments against military personnel, who own homes purchased before June 30, 2012, and are ordered to change duty stations.[17] FHFA has also considered the impact of deficiency judgments on the default risk associated with residential mortgage loans.[18] Specifically, FHFA agreed with research concluding: "Even if lenders seldom (or never) pursue deficiency judgments in court, losses are lower when the threat of recourse can be exercised credibly."[19] Nonetheless, FHFA has not conducted an overall assessment of the Enterprises' deficiency judgment practices to determine if guidance for the Enterprises is warranted.

In contrast, other federal agencies with national housing responsibilities have issued guidance on deficiencies for lenders under their jurisdiction. The guidance covers areas such as which borrowers to pursue and what cost-benefit rationales to consider. For example, the U.S. Department of Agriculture, which administers rural housing development programs, advises that deficiency judgments should only be pursued (in allowable states) when borrowers have sufficient assets for recovery.[20] Similarly, the Department of Housing and Urban Development (HUD) issued guidance about pursuing mortgage deficiencies;[21] HUD emphasized seeking

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[16] FHFA-OIG recently reported that as of December 31, 2011, the Enterprises owned or guaranteed over 1.1 million seriously delinquent mortgages. See FHFA-OIG, *Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties* (WPR-2012-003, June 14, 2012).

[17] "FHFA Announces Short Sale Assistance for Military Homeowners with Fannie Mae or Freddie Mac Loans," FHFA News Release (June 21, 2012), available at http://www.fhfa.gov/webfiles/24026/CFPBFinalw-FS.pdf (accessed August 9, 2012).

[18] FHFA, *Default Risk Evaluation in the Single-Family Mortgage Market* (October 2009), available at http://www.fhfa.gov/webfiles/15151/10-30-09_FHFA_Default_Risk_Evaluation_Report.pdf%20uses%20October%2030 (accessed September 9, 2012).

[19] Id., p. 6.

[20] USDA Handbook HB-1-3550, available at http://www.rurdev.usda.gov/SupportDocuments/3550-1chapter13.pdf (accessed on June 29, 2012).

[21] HUD guidance is available from the following sources: HUD Mortgagee Letter 89-14, available at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/89-14ml.txt (accessed on April 9, 2012); HUD Mortgage Notice H-94-89, available at http://www.hud.gov/offices/adm/hudclips/notices/hsg/files/94-89HSGN.doc (accessed on June 29, 2012); and HUD Mortgage Letter 90-15, available at http://www.hud.gov/offices/adm/hud-clips/letters/mortgagee/files/90-15ml.txt (accessed on August 15, 2012).

deficiency judgments against strategic defaulters who abandon their mortgage payment obligations despite their apparent continued ability to repay.

In general, FHFA performs supervisory reviews, including offsite monitoring and targeted examinations. In the finding that follows, FHFA-OIG outlines the Agency's opportunity to incorporate deficiency management into its supervisory review process.

FINDING

FHFA Can Better Supervise the Enterprises' Deficiency Management by Obtaining Deficiency Data and Providing Guidance

Recovering losses from strategic defaulters and others who have the ability to repay their financial obligations—e.g., real estate investors and vacation home owners—presents an opportunity for the Enterprises to strengthen their financial positions and to reduce the need for future taxpayer support. As conservator, FHFA is responsible for preserving and conserving the Enterprises' assets and restoring them to a sound financial condition. Accordingly, FHFA should obtain information necessary to better understand the Enterprises' deficiency activities and to determine where improvements can be made.

The Enterprises manage their foreclosure deficiencies in a challenging environment. For example, the Enterprises must navigate diverse legal regimes to pursue deficiencies. Although borrowers make contractual commitments to repay their mortgage loans, individual state laws can diminish or effectively eliminate the Enterprises' ability to recover any shortfalls arising from such commitments, even when borrowers can repay the balance of their mortgage loans.

FHFA has not taken a proactive approach to its oversight of the Enterprises' deficiency management practices to maximize recoveries when appropriate. For example, the Agency has not published guidance for the Enterprises on the subject and has not conducted any continuous supervision to monitor and analyze trends and risks associated with deficiencies. The Agency also has not conducted targeted examinations of deficiency management that could offer detailed information about specific risks, supervisory concerns, etc. Further, FHFA does not require the Enterprises to provide deficiency data. For instance, the Agency does not solicit information about the scope of the Enterprises' deficiencies, the number or amount of their collection referrals, or their recovery rate. As a result, the Agency cannot track or evaluate their collection practices and recovery rates, and thus FHFA cannot readily conclude whether the Enterprises' low recovery rate—0.22%—is reasonable, or if their deficiency recoveries could be improved.

FHFA has not devoted particular attention to the Enterprises' deficiency management practices because it does not view the area as high-risk. In contrast, other Federal agencies with national housing responsibilities have issued guidance that standardizes how lenders under their jurisdiction should handle deficiencies—e.g., identifying which borrowers to pursue and what cost-benefit rationales to consider.

In the absence of meaningful FHFA oversight, each Enterprise has developed its own deficiency management approach. Yet, without specific supervision and guidance from FHFA, the Enterprises may not fully realize their recovery potential or ensure that they are meeting their obligations to mitigate losses using all available tools.

CONCLUSION

Given a recovery rate of 0.22%, the Enterprises appear to have room for improvement in how they manage their deficiencies. Further, with 1.1 million seriously delinquent mortgages looming on the foreclosure horizon—triple the Enterprises' foreclosures in 2011—FHFA's timely guidance on deficiency management processes may help the Enterprises recoup future losses and protect taxpayers' investment in their financial health.[22]

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

1. Routinely obtain deficiency-related information, such as the size of the Enterprises' deficiencies, their effectiveness in targeting for deficiency collection defaulting borrowers who continue to have the ability to repay their loans, the number or amount of their collection referrals, and their recovery rate.
2. Based on an analysis of deficiency data from Recommendation 1, incorporate deficiency management into FHFA's supervisory review process.
3. Issue written guidance to the Enterprises on managing their deficiency collection processes, including at a minimum whether they should be pursuing the same type of defaulted borrowers and pursuing collections in the same states.

[22] For more detailed discussion of foreclosure related risks, see FHFA-OIG, *Overview of the Risks and Challenges the Enterprises Face in Managing Their Inventories of Foreclosed Properties* (WPR-2012-003, June 14, 2012).

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this performance audit was to assess FHFA's oversight of the Enterprises' management of deficiency recoveries related to foreclosed, single-family residential mortgages. Specifically, FHFA-OIG sought to review the extent and effectiveness of FHFA's oversight of the Enterprises' deficiency management processes.

In March 2012, FHFA-OIG initiated a survey to assess FHFA's oversight of the Enterprises' management of deficiency judgments. In June 2012, FHFA-OIG completed the survey and announced an audit with the modified objective set forth above. The scope of the audit was January 2010 through June 2012, and was expanded as necessary.

FHFA-OIG performed fieldwork for this audit from June 2012 through August 2012. FHFA-OIG conducted its fieldwork at FHFA's offices in Washington, D.C., Fannie Mae's corporate offices in Washington, D.C., and Freddie Mac's corporate offices in McLean, Virginia. To achieve the objective, FHFA-OIG identified deficiency management guidance used by federal banking/lending regulatory agencies or applicable to government-insured mortgages; interviewed FHFA and Enterprise officials; reviewed FHFA supervision and examination policies, plans, and results; and reviewed Enterprise deficiency management processes, procedures, servicing guides, and related documents.[23]

FHFA-OIG assessed the internal controls related to the audit objective. Specifically, FHFA-OIG evaluated the following control standards that were significant to the audit objective: risk assessment, information and communication, and monitoring. Internal controls are an integral component of an organization's management that provide reasonable assurance that the following objectives are achieved: (1) effectiveness and efficiency of operations; (2) reliability of financial reports; and (3) compliance with applicable laws and regulations. Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed on this performance audit, FHFA-OIG considers its finding on FHFA's oversight of the Enterprises' deficiency management to be significant in context of the audit objective.

[23] The federal banking/lending regulatory agencies include the Office of the Comptroller of the Currency (inclusive of the Office of Thrift Supervision), the Federal Deposit Insurance Corporation, and the Federal Reserve Board of Governors. Agencies with authorities related to government-insured mortgages include the Federal Housing Administration, the Department of Veterans Affairs, and the U.S. Department of Agriculture's Rural Housing Service.

FHFA-OIG conducted this performance audit 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 conclusions based on the audit objective. FHFA-OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusions included herein, based on the audit objective.

APPENDIX A:

FHFA's Comments on Finding and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Russell Rau, Deputy Inspector General for Audit, FHFA-OIG

FROM: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation

SUBJECT: FHFA Response – OIG Audit 2012-007, *FHFA's Oversight of Enterprises' Efforts to Recover Losses from Foreclosure Sales*

DATE: September 20, 2012

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses to the recommendations in the draft report prepared by FHFA-OIG on Audit 2012-007, *FHFA's Oversight of Enterprises' Efforts to Recover Losses from Foreclosure Sales*. We appreciate the opportunity to provide feedback on this report and the FHFA-OIG findings. As these findings and recommendations primarily impact FHFA's supervision function, the responses are being provided by the Division of Enterprise Regulation (DER), in coordination as described below with the Division of Supervisory Policy and Support (DSPS), Office of Conservatorship Operations (OCO) and the Division of Housing Mission and Goals (DHMG).

As noted in the report, FHFA's risk-based approach to supervision has resulted in limited oversight and lack of guidance for deficiency collections. We do recognize, however, that some financial benefit might be realized through post-foreclosure loss recoveries, although there can be significant challenges and complexities to collection, which are identified in your report. FHFA agrees with the FHFA-OIG regarding the difficulty of estimating the financial impact of loss recoveries, as the ability to pursue deficiency collections varies by state and, within some states, also varies by type of property.

We agree with your view that the Agency should not direct the Enterprises to aggressively pursue borrowers without the ability to pay. However, the difficulty in gathering reliable data and assessing borrowers' circumstances complicates the cost-benefit analysis necessary to enable the Enterprises to determine the instances where likely deficiency recoveries will justify the outlay of expense to obtain them. Nevertheless, FHFA agrees with the FHFA-OIG's recommendation that relevant data can be obtained and reviewed as background for an assessment of Enterprise processes, and FHFA proposes several actions in response to your recommendations, as described below.

We want to be clear that the assessment of risk referenced above is confined to the narrow issue of deficiency recoveries, and does not apply to the much broader issue of reducing foreclosure losses, which we have consistently viewed as critical to the Enterprises' safety and soundness. While there is value in estimating and maximizing post-foreclosure recoveries, the Agency's primary focus has been to work to reduce the volume and value of foreclosure losses (some of these efforts are referenced in the report). Agency and Enterprise efforts are currently underway targeting various points in the process, including underwriting, addressing delinquencies, and resolving defaults without foreclosure. For example, a recent FHFA policy initiative aims to facilitate pre-foreclosure, or "short," sales of properties in the Enterprises' portfolios, reducing the volume of properties that go to foreclosure and the resulting volume of deficiencies. FHFA, Fannie Mae and Freddie Mac announced new, aligned guidance for servicers effective November 1, 2012. Under the new guidance, borrowers eligible for a short sale will be evaluated for their ability to contribute towards the shortage, or deficiency. For the first time, servicers have been provided detailed, written guidance on when and how to calculate and request a reasonable, collectible cash and/or promissory note contribution from the borrower. To facilitate a short sale or deed-in-lieu of foreclosure, borrowers acting in good faith will receive an affirmative waiver of any remaining deficiency at the closing table. We believe that this should improve overall collections and loss recoveries on short sales. We also believe this will provide more incentive for borrowers to engage in short sale transactions. This will benefit the Enterprises and the taxpayers, since short sale transactions result in less severe losses than those experienced on foreclosed properties.

FHFA-OIG recommends that FHFA:

1. Routinely obtain deficiency-related information, such as the size of the Enterprises' deficiencies, their effectiveness in targeting for deficiency collection defaulting borrowers who continue to have the ability to repay their loans, the number or amount of their collection referrals, and their recovery rate.

Management Response: Agree

DER agrees with the recommendation and will work with other FHFA staff and the Enterprises to develop a framework for the type of information that would be most useful in estimating potentially recoverable amounts. DER has undertaken preliminary reviews of current reporting procedures at the Enterprises, and will build on that work in crafting a useful template. Some information is readily available to the Enterprises, for example, foreclosure losses in states where deficiencies may be legally pursued, the types of proceedings necessary in each state, and information about collection vendors needed for the recovery process in each state. Other information, such as indicators of whether a borrower has available assets to pay a deficiency judgment, would have to be obtained by the Enterprises from servicers.

Some of the work mentioned in the report relating to strategic defaulters (that is, identifying them early in the process to avoid those loans becoming seriously delinquent or moving to foreclosure) may be adapted to management of deficiency collections. FHFA will consult with the Enterprises and consider those efforts in determining the data set that should be gathered with respect to previously foreclosed properties.

Information the Enterprises obtain as a result of these efforts would be made available to DER through the examination process, as well as to OCO in its oversight role and HMG as it continues development of market-related strategies and initiatives.

DER will work with other stakeholders to develop a workable, uniform framework for gathering relevant information by April 13, 2013.

2. Based on analysis of deficiency data from Recommendation 1, incorporate deficiency management into FHFA's supervisory review process.

Management Response: Agree

FHFA will include in its supervision strategy more review of whether the Enterprises are identifying and pursuing opportunities to strengthen their financial positions, such as deficiency collections. In determining whether the Enterprises' approach is sound, supervisory staff would consider any cost-benefit analysis performed by the Enterprises relating to potential deficiency collections and likely costs to be incurred. The data set referenced in Recommendation 1 would be the starting point for that analysis. FHFA Supervision would also review the Enterprises' internal processes and management information systems for analyzing the data and for reaching business decisions on when to pursue different types of deficiency collections.

Once the reporting information for post-foreclosure deficiency collections is identified, FHFA Supervision will incorporate reviews of deficiency management into examination work by July 15, 2013.

3. Issue written guidance to the Enterprises on managing their deficiency collection processes, including at a minimum whether they should be pursuing the same type of defaulted borrowers and collections in the same states.

Management Response: Agree

With the benefit of deficiency collection data and analysis, FHFA will be able to outline supervisory expectations for a safe and sound approach to recovering losses from foreclosure deficiencies. FHFA Supervision would not make specific business decisions relating to foreclosure deficiencies, but will work with other staff and the Enterprises to develop a risk framework and identify key parameters for determining when deficiencies should be pursued. As noted above, FHFA would not encourage the Enterprises to pursue all borrowers including those unable to pay, but through guidance would direct the Enterprises to maximize financial benefits of deficiency management by ensuring that business decisions take into account relevant factors. These factors could include:

- Jurisdiction of foreclosure;
- Type of property foreclosed;
- Amount of deficiency;
- Applicability of exclusion from deficiency under other FHFA guidance or programs;
- Availability and cost of qualified collection vendor(s);
- Information about the borrower and estimated likelihood of collection;
- Estimated costs of recovery; and
- Potential impact on deficiencies or delinquencies in the same or comparable markets.

Guidance setting forth supervisory expectations would lead the Enterprises toward a consistent approach and should reduce variation in the Enterprises' overall processes for deficiency management. DER and DSPS will prepare written guidance by September 20, 2013.

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

On September 20, 2012, FHFA provided comments to a draft of this report, agreeing with all recommendations and identifying FHFA actions to address them. FHFA-OIG considers the actions sufficient to resolve the recommendations, which will remain open until FHFA-OIG determines that agreed-upon corrective actions are completed and responsive to the recommendations. 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 recommendations and the status of agreed-to corrective actions.

APPENDIX C:

Summary of Management's Comments on the Recommendations

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

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: Yes or No[a]	Open or Closed[b]
1.	FHFA will develop a framework for the type of deficiency-related information that would be most useful in estimating potentially recoverable amounts and work with the Enterprises to define the type of information that they will routinely gather. FHFA has undertaken reviews of current deficiency reporting procedures at the Enterprises and will build on that work in creating a useful reporting template. FHFA will also share information received among its regulatory, conservator, and strategy divisions.	4/13/2013	$0	Yes	**Open**
2.	FHFA will include the Enterprises' deficiency collections in its supervisory strategy.	7/15/2013	$0	Yes	**Open**
3.	FHFA will issue guidance to the Enterprises on deficiency management.	9/20/2013	$0	Yes	**Open**
Total			$0		

[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 agreed-upon corrective actions have been completed and are responsive, the recommendations can be closed.

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