Federal Housing Finance Agency
Office of Inspector General

FHFA Can Improve Its Oversight of Freddie Mac's Recoveries from Borrowers Who Possess the Ability to Repay Deficiencies

Audit Report • AUD-2013-010 • September 24, 2013

Synopsis

September 24, 2013

FHFA Can Improve Its Oversight of Freddie Mac's Recoveries from Borrowers Who Possess the Ability to Repay Deficiencies

Why OIG Did This Report

The Federal Home Loan Mortgage Corporation (Freddie Mac or the enterprise) has been in a conservatorship under direction of the Federal Housing Finance Agency (FHFA or the agency) since September 2008 and has received over $71 billion in taxpayer assistance. Between its placement in conservatorship and December 2012, there have been more than 460,000 foreclosures of single-family residential mortgages owned or guaranteed by Freddie Mac. Further, the enterprise owned 49,071 foreclosed properties with a carrying value of $4.3 billion as of December 2012. As of March 31, 2013, it also owned a substantial shadow inventory: 364,000 mortgages with payments that are 60 days or more delinquent and are likely foreclosure candidates.

If either the foreclosure sale's proceeds or the value at which Freddie Mac records a property in its real estate owned portfolio is less than the borrower's mortgage loan balance, the shortfall (or deficiency) represents a loss to Freddie Mac. Such losses can be reduced if the enterprise recovers deficiencies from borrowers who possess the ability to repay. Enhanced deficiency management practices can also serve as a deterrent to those who would choose to strategically default on their mortgage obligations.

In October 2012, the FHFA Office of Inspector General (OIG) issued a report that assessed the agency's oversight of the deficiency management efforts of Freddie Mac and the Federal National Mortgage Association (Fannie Mae) (collectively, the enterprises). In that audit, OIG found that FHFA had an unfulfilled opportunity to provide the enterprises with guidance about effectively pursuing and collecting deficiencies from borrowers who may possess the ability to repay. In this audit, OIG focused in more detail on Freddie Mac's deficiency recovery practices for borrowers who possess the ability to pay amounts owed on foreclosed mortgages owned or guaranteed by the enterprise.

What OIG Found

OIG concluded that FHFA can improve its oversight of Freddie Mac's deficiency recovery processes. OIG based this conclusion on two facts. First, OIG found that Freddie Mac did not refer nearly 58,000 foreclosures with estimated deficiencies of approximately $4.6 billion to its deficiency collection vendors (vendors) to evaluate the borrowers' ability to repay those deficiencies. Because the deficiencies were not referred for consideration of recovery, the portion of the $4.6 billion that may have been collectible is unknown. Further, Freddie Mac eliminated any possibility of recovery when it did not refer foreclosed mortgages for evaluation of collectibility. Most of these foreclosed mortgages were associated with properties in states where Freddie Mac did not pursue deficiencies but where Fannie Mae did, with some success. The remainder were foreclosure sales to third parties rather than the

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enterprise; these third-party sales can result in deficiencies but as a practice Freddie Mac—unlike Fannie Mae—did not pursue deficiencies arising from third-party sales.

Second, delays in the vendors' evaluation process limited Freddie Mac's opportunity to pursue deficiencies related to more than 6,000 foreclosed mortgages for which state statutes of limitations had expired. The delay was caused by challenges associated with coordinating among Freddie Mac's various foreclosure/deficiency collection counterparties—servicers, attorneys, and vendors. Specifically, the vendors did not timely receive from the servicers and attorneys the information needed to calculate deficiency balances and pursue collection. Without timely evaluating the collectability of deficiencies from borrowers with the ability to repay, Freddie Mac reduces the chance of recoveries and incentivizes "strategic defaulters" (i.e., those who choose not to meet their contractual obligations to make mortgage payments in spite of their ability to do so).

What OIG Recommends

OIG recommends that FHFA: (1) evaluate periodically the efficiency and effectiveness of Freddie Mac's deficiency recovery strategies for pursuit of borrowers with the ability to repay; (2) review Freddie Mac's monitoring controls over its servicers, foreclosure attorneys, and collection vendors involved in deficiency recovery activities to ensure that oversight across these counterparties is maintained; (3) direct Freddie Mac to establish and implement controls for its counterparties to deliver timely documents to deficiency recovery vendors and provide for financial consequences to those counterparties that fail to meet delivery deadlines; and (4) direct Freddie Mac to implement a control to consider timeframes in state statutes of limitations in prioritizing, coordinating, and monitoring deficiency collection activity for borrowers with the ability to repay.

FHFA provided comments agreeing with the recommendations in this report.

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ABBREVIATIONS ....

COSO	Committee of Sponsoring Organizations of the Treadway Commission (COSO)
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or agency	Federal Housing Finance Agency
Freddie Mac or enterprise	Federal Home Loan Mortgage Corporation
OIG	Federal Housing Finance Agency Office of Inspector General
Treasury	U.S. Department of the Treasury
Vendors	Deficiency Collection Vendors

PREFACE

This audit report is part of OIG's mission to promote the economy, efficiency, and effectiveness of FHFA's programs and, in accordance with our first strategic goal, adds value by helping the agency improve the enterprises' economic health. Specifically, the report is intended to strengthen FHFA's oversight of how Freddie Mac manages deficiencies or losses that result when foreclosure sale proceeds are less than the borrower's mortgage loan balance. Better management of these losses—focused on those borrowers who possess the ability to repay—may lead to opportunities to recover a larger portion of the enterprises' single-family foreclosure deficiencies.

Additionally, this report supplements OIG's prior work in the deficiency management area by assessing the effects of the lack of agency oversight. Specifically, the audit evaluates Freddie Mac's processes for determining the ability of borrowers to repay mortgage deficiencies.

OIG believes that our recommendations for enhancing the agency's oversight of Freddie Mac's deficiency recovery 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 assess whether further improvements are needed to ensure the enterprise is efficiently and effectively managing its credit loss mitigation activities.

OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations. As a result of this work, OIG may recommend policies that promote economy and efficiency in administering FHFA's programs and operations, or that prevent and detect fraud, waste, and abuse in them. OIG believes that this report's recommendations will increase FHFA's assurance that the enterprises are operating safely and soundly and that their assets are preserved and conserved.

OIG appreciates the cooperation of all those who contributed to this audit, which was led by Alisa Davis, Acting Assistant Inspector General for Audits. This report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on OIG's website, www.fhfaoig.gov.

Russell A. Rau
Deputy Inspector General for Audits

CONTEXT

Previous Audit

In an October 2012 report, OIG addressed FHFA's general lack of oversight of the enterprises' processes for recovering deficiencies from borrowers who possess the ability to repay.[1] OIG found that FHFA had an unfulfilled 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. Specifically, FHFA had not examined the enterprises' deficiency management practices, provided guidance to them on the subject, or obtained data about the scope and effectiveness of their deficiency recoveries.

OIG noted that better management of deficiency recoveries—focused on those borrowers who possess the ability to repay, including strategic defaulters[2]—can help mitigate losses and deter strategic defaults.

Deficiency Recovery Process

Foreclosure Overview

A deficiency could stem from a foreclosure, short sale,[3] or deed-in-lieu of foreclosure. For this audit, OIG will outline the deficiency process associated with foreclosure.

A deficiency typically is established based on what occurs during a foreclosure sale. At such a sale, the buyer who is the highest bidder acquires the property. However, if a foreclosure sale's proceeds are less than the borrower's mortgage loan balance, then Freddie Mac absorbs the shortfall, or deficiency, as a loss.[4] From September 2008 through December 2012, there were more than 460,000 foreclosure sales of properties that secured Freddie Mac owned or guaranteed mortgages. These sales resulted in substantial losses to the enterprise.

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[1] OIG, *FHFA's Oversight of the Enterprises' Efforts to Recover Losses from Foreclosure Sales* (AUD-2013-001, October 17, 2012), available at http://www.fhfaoig.gov/Content/Files/AUD-2013-001.pdf.

[2] Strategic defaulters are defined as those who possess the financial means to make their monthly mortgage payments, but do not do so.

[3] A short sale is the sale of a mortgaged property at a price that nets less than the total amount due on the mortgage (e.g., the sum of the unpaid principal balance, accrued interest, advanced escrows, late fees, and delinquency charges). The servicer and borrower negotiate payment of the difference between the net sales price and the total amount due on the mortgage.

[4] Such a loss can be reduced by mortgage insurance proceeds or a repurchase, if either is applicable.

Freddie Mac may acquire a foreclosed property based on its bid, and the property becomes real estate owned. Freddie Mac sends new foreclosures on a monthly basis to its vendors so they can begin evaluating and pursuing any deficiency from borrowers who can repay based on information available at the time of the foreclosure sale.

In an effort to recoup some of these losses, Freddie Mac can direct vendors to pursue voluntary collections from borrowers with the ability to repay or to obtain court-ordered deficiency judgments. Freddie Mac's vendors pursued deficiency recoveries on foreclosure sales when the properties were taken into Freddie Mac's real estate owned inventory, but—until recently—they did not pursue deficiency recoveries on foreclosure sales won by third parties.

Although recovering deficiencies reduces losses, several factors influence the decision to pursue recovery. In particular, state laws dictate the timeline for filing a deficiency claim or may prohibit the collection of deficiencies. The statute of limitations establishes the period during which a creditor can sue a debtor or borrower in this case. Each state has its own statute of limitations. If the statute of limitations has expired, then payment of the debt owed cannot be enforced through the courts.

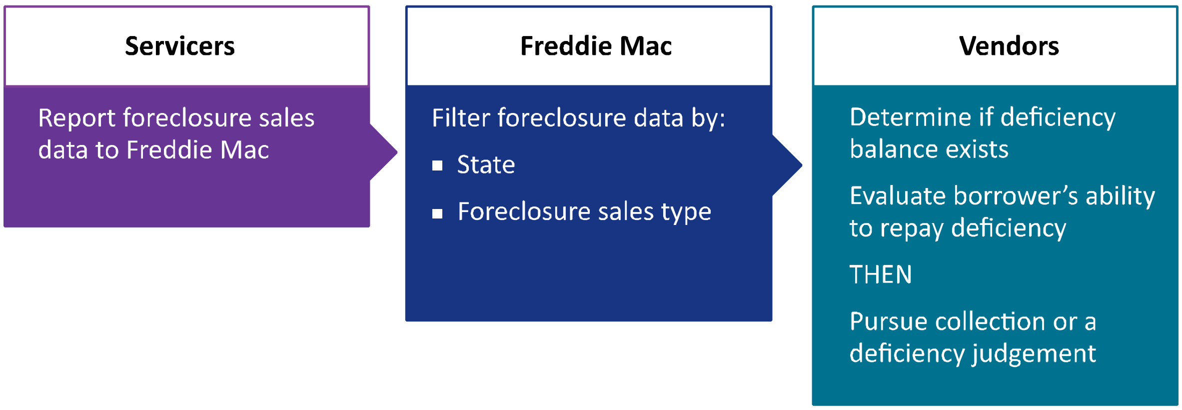
Deficiency Recovery Process Overview

There are multiple players and steps in the deficiency recovery process. The key players include:

- Servicers, which collect monthly mortgage payments from borrowers;
- Attorneys, who initiate foreclosure proceedings on behalf of Freddie Mac;
- Freddie Mac, which owns or guarantees the mortgages on the foreclosed properties and oversees vendors performing recovery services; and
- Vendors, which evaluate the collectability of the deficiencies and pursue recoveries.

Figure 1 summarizes the deficiency recovery process, and the following paragraphs provide further details.

FIGURE 1: DEFICIENCY RECOVERY OVERVIEW



Source: OIG analysis of Freddie Mac's and its vendors' policies and practices.

The first two steps in Freddie Mac's deficiency recovery process involve obtaining and analyzing monthly foreclosure data. First, Freddie Mac receives from its servicers data on foreclosure sales that occurred during the month. Second, the enterprise compiles a list of the foreclosure sales. To prepare this file to send to its collection vendors, Freddie Mac applies its deficiency management criteria to the foreclosures. These criteria enabled the enterprise to filter out third-party sales[5] and foreclosures in states in which its servicers were not required to preserve the enterprise's rights to pursue deficiencies.[6] Freddie Mac then allocates the foreclosures to the vendors to evaluate whether a deficiency exists and should be pursued.[7] Freddie Mac sends new foreclosures to its vendors on a monthly basis.

The vendors, in turn, request from Freddie Mac's servicers and foreclosure attorneys information that enables them to calculate whether any deficiency balances exist in the loan files they receive. Next, the vendors evaluate the files, excluding those that they are

[5] 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 (known as a third-party sale). If there is no potential buyer, the enterprise takes possession of the property.

[6] Before June 1, 2013, Freddie Mac's servicing guide required preservation of deficiency rights in 17 states plus the District of Columbia. Preservation of deficiency rights requires the foreclosure attorney to file the legal documents (perfect its rights) in accordance with applicable state statutes where the foreclosure occurred, which allows pursuit of the deficiency for a certain period of time. See the following report section that discusses changes Freddie Mac made in 2013 to its criteria concerning inclusion of third-party sales and preserving deficiency rights in all states.

[7] In January 2011, as Freddie Mac explored adding vendors to manage its deficiencies, it stopped sending the foreclosure listing to the vendor that had managed Freddie Mac's deficiencies since 1993. Freddie Mac sent the foreclosures that occurred between January 2011 and March 2012 to its new vendors once the parties signed the contracts in March 2012.

precluded from pursuing under state law. Each vendor then uses its own criteria to determine whether the remaining borrowers are able to repay the deficiencies, because Freddie Mac has not provided guidance in this regard. As a general matter, vendors consider borrower attributes, such as death, employment status, and bankruptcy filings, as screening criteria.

Vendors may purchase the right to collect deficiencies from Freddie Mac, and then remit a portion of the recovered amount to the enterprise in accordance with its contract. Freddie Mac applies such recoveries towards its losses on the foreclosed properties.

According to Freddie Mac's vendors, it may take months or even years to collect on a deficiency.

Evolution of Freddie Mac's Deficiency Management Program

Freddie Mac's deficiency management program has evolved over time. After 2008, Freddie Mac focused on foreclosure prevention and loss mitigation, rather than pursuing deficiencies, because of the financial crisis and housing market downturn. However, the enterprise more recently has enhanced its recovery efforts by revising its vendor relationships, improving guidance to servicers, and re-emphasizing deficiency management processes.

Freddie Mac began its deficiency management program in 1993, with a single recovery vendor. In 2010, Freddie Mac solicited other vendors to provide these services. In March 2012, Freddie Mac selected and signed agreements with two new vendors.[8] During the period January 2011 to March 2012, the enterprise did not send foreclosure sales to its vendors for evaluation and pursuit of deficiencies. As a result, in the spring of 2012, the vendors confronted a backlog of 39,655 foreclosures to evaluate for collectability. Their task was made even more difficult by the lack of required documentation from servicers and foreclosure attorneys. As a result, by the end of 2012, Freddie Mac's newest vendors had yet to calculate and confirm a deficiency for pursuit on any foreclosures referred by Freddie Mac since signing their contracts in March 2012.

In addition to adding new vendors to pursue recoveries on deficiencies, Freddie Mac recently modified its deficiency management guidance. Freddie Mac originally required its servicers to preserve the right to pursue a deficiency in 17 states and the District of Columbia.[9] Consequently, Freddie Mac referred foreclosures only in those jurisdictions to

[8] Although Freddie Mac's original vendor still evaluates and pursues the foreclosures it received from Freddie Mac prior to January 2011, Freddie Mac sends foreclosure sales occurring since January 2011 to its two newer vendors.

[9] The servicer had the option to preserve the right to pursue a deficiency in other states if it believed it was in Freddie Mac's best interest, but Freddie Mac had to approve the servicer's written request in such instances.

its vendors for evaluation and pursuit. Based on recommendations from its vendors in October 2012, Freddie Mac revised its guidance so that effective June 1, 2013, servicers must preserve deficiency rights in all states where it (1) is legally allowed to pursue deficiencies and (2) does not result in additional foreclosure-related losses for Freddie Mac.[10] Consistent with its new guidance, Freddie Mac said it has started referring new foreclosures in all 50 states and the District of Columbia to its vendors for their evaluation and pursuit.[11] However, Freddie Mac has not referred to its vendors existing foreclosures that occurred prior to June 2013 from these additional states.

Freddie Mac has also been working to change its deficiency management processes. For example, the enterprise historically did not refer third-party sales, but referred foreclosures to its vendors only when it acquired the property in the foreclosure sale. Beginning in January 2013, Freddie Mac officials stated they started referring new third-party sales to the enterprise's vendors. However, Freddie Mac officials said that the enterprise had not referred to its vendors deficiencies associated with third-party sales that occurred prior to January 2013.

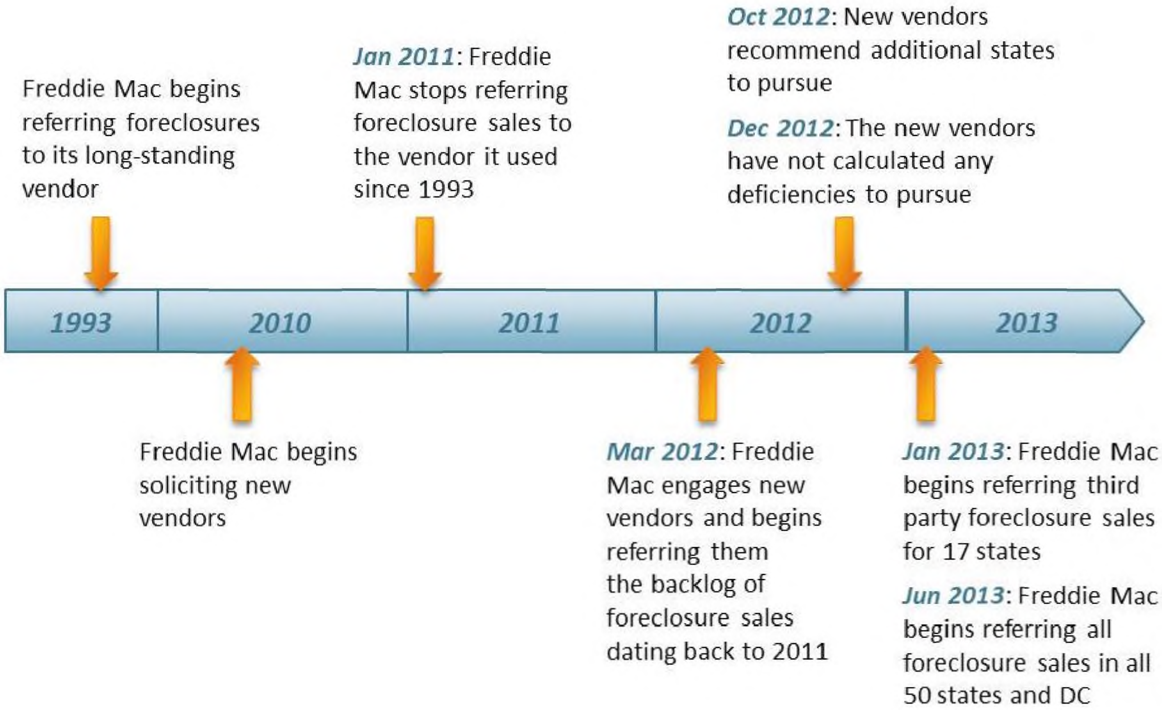
Similarly, although Freddie Mac received summary and detail spreadsheets from its vendors regarding collections they pursued, the enterprise historically did not have the ability to track the thousands of foreclosures it sent to its vendors. As a process improvement, Freddie Mac stated that in January 2013 it implemented a new deficiency management database, which will facilitate the tracking of the vendors' progress on each foreclosure the vendors evaluate.

Figure 2 depicts the key events in Freddie Mac's deficiency management vendor relationships.

[10] There are 16 states where the state laws extremely limit or otherwise prevent vendors from pursuing deficiencies against borrowers, as well as scenarios in which the vendors have determined pursuit not to be economically feasible. Therefore, there are 35 states, including the District of Columbia, where deficiencies can be pursued by Freddie Mac. Until June 2013, Freddie Mac referred foreclosures in only 18 of those 35 states, including the District of Columbia, leaving 17 states where deficiencies could be pursued and were not.

[11] Freddie Mac stated that it started referring deficiencies in all states because it does not attempt to interpret state or local law, so it instructs its servicers to preserve its rights where legally allowed through the traditional foreclosure process.

FIGURE 2: TIMELINE OF KEY EVENTS IN FREDDIE MAC'S DEFICIENCY MANAGEMENT VENDOR RELATIONSHIPS



Sources: Interviews with Freddie Mac management and information from the vendor contracts.

Strategic Defaulters

Each of Freddie Mac's three collection vendors has methodologies to identify potential strategic defaulters when considering which deficiency balances to attempt to collect. However, the vendors stated they do not apply their methodologies to Freddie Mac's potential deficiencies because Freddie Mac has not instructed them to target strategic defaulters. In contrast, Fannie Mae specifically targets potential strategic defaulters in an effort to recover from those borrowers with the ability to repay a deficiency.

Freddie Mac's Evaluation of Its Vendors' Performance

Freddie Mac evaluates its vendors' performance through regular reporting and status communications. On a monthly basis, Freddie Mac obtains summary and detail reports from its vendors. Freddie Mac utilizes this information to compare the vendors' performance based on the number of foreclosures sent to them, gross collections, and the collection amount remitted to Freddie Mac. In addition, Freddie Mac also obtains further detail about each vendor's collection efforts, including the number of uncollectible deficiencies, the number of deficiencies that were closed due to full or partial settlements, and the number of deficiencies in which borrowers were on a repayment plan. Beyond this reporting, Freddie Mac and the vendors characterize their status communications as frequent.

FINDINGS ....

1. Freddie Mac Did Not Refer Nearly 58,000 Foreclosures to Its Vendors to Evaluate Borrowers' Ability to Repay

During the period January 2010 through June 2012, Freddie Mac experienced 220,000 foreclosures resulting in estimated deficiencies of $19.6 billion.[12] Almost half of these foreclosures, about 103,000 with estimated deficiencies of $11.3 billion, could not be pursued due to state laws. Of the remaining 117,000 foreclosures, Freddie Mac did not refer nearly 58,000—all in states that allow pursuit of deficiency judgments—to its vendors to evaluate collectability.[13] This occurred primarily because Freddie Mac employed inadequate policies that did not maximize referrals to vendors or ensure prioritization, coordination, and monitoring of deficiency collection activity among servicers, foreclosure attorneys, and collection vendors. As a result, Freddie Mac's vendors missed the opportunity to evaluate the collectability of $4.6 billion in estimated deficiencies. Although only a fraction of these deficiencies may have been recoverable, pursuing deficiencies could have mitigated some credit losses and served as a deterrent to borrowers who may consider strategically defaulting. Accordingly, during the course of OIG's audit, Freddie Mac began to strengthen the controls over its deficiency recovery practices, but neither FHFA nor Freddie Mac have formally evaluated the efficiency and effectiveness of the enterprise's overall recovery strategies.

The 58,000 foreclosures that were not referred for evaluation and pursuit of deficiencies included: (1) 43,742 foreclosure sales with $2.7 billion in estimated deficiencies in states where Freddie Mac did not pursue deficiencies but one of its vendors had recovered deficiencies on behalf of Fannie Mae; and (2) 14,160 foreclosure sales with $1.9 billion in estimated deficiencies related to third-party sales.[14]

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[12] The 220,000 foreclosures between January 2010 and the end of June 2012 are part of the total of 460,000 foreclosures that occurred between the start of Freddie Mac's conservatorship in September 2008 and the end of December 2012. Also, because Freddie Mac's vendors had not calculated the deficiency balances for the majority of the foreclosure sales during this audit's scope period, OIG calculated estimated deficiency balances for the audit based on Freddie Mac data detailing the unpaid principal balance at foreclosure sale, delinquent interest, charge-offs, foreclosure sale bid amount, repurchase (if applicable), and mortgage insurance coverage percent (if applicable). As this is an estimate, it could vary from the vendors' official deficiency calculation.

[13] There were another approximately 7,000 foreclosure sales that Freddie Mac did not refer to its vendors that occurred in states in which Freddie Mac's largest collection vendor historically had negligible collections.

[14] The $1.9 billion in estimated deficiencies on 14,160 foreclosures represents only those third-party sales in states where one of Freddie Mac's vendors had recovered deficiencies on behalf of Fannie Mae.

Freddie Mac provided two reasons for not referring the 58,000 foreclosures to its vendors.[15] First, under its then-current guidance, Freddie Mac's vendors only pursued deficiencies in 17 states and the District of Columbia. Although the servicers could recommend that Freddie Mac permit them to preserve the enterprise's rights in other states, Freddie Mac stated it had not received such requests during the period January 2010 through June 2012. Consequently, it could not refer deficiencies occurring in the additional jurisdictions to its vendors.[16] Second, Freddie Mac explained that its third-party sales exclusion was an internal, informal practice that resulted from a mistake by Freddie Mac staff.

Pursuing deficiencies in additional states where it is lawful to do so and on third-party foreclosure sales—practices its competitor, Fannie Mae, follows—can result in additional recoveries for Freddie Mac and provide an appropriate deterrent to strategic defaulters. And, indeed, during the OIG audit Freddie Mac took action to require servicers to preserve deficiency rights for pending foreclosures in all 50 states plus the District of Columbia and began referring third-party sales to its vendors.

Moreover, although Freddie Mac has monitoring controls in place for its vendors, it has not implemented overall oversight of its deficiency recovery activities across its servicers, foreclosure attorneys, and collection vendors. As discussed in Finding 2 below, coordination among Freddie Mac's foreclosure and deficiency collection counterparties is key to ensuring the enterprise's deficiency management program achieves intended results.

FHFA can increase its assurance that Freddie Mac is consistently and prudently pursuing deficiencies by requiring the enterprise to pursue deficiencies from borrowers with the ability to repay, where allowed by state law and regardless of the foreclosure sale type (i.e., real estate owned and third-party sales). Additionally, FHFA should periodically assess the enterprise's recovery strategies and monitoring controls within its deficiency management program. Freddie Mac may expose itself to reputational risk by allowing borrowers with the ability to repay—for example, investors owing amounts on non-owner occupied properties—to avoid repayment of deficiencies. Further, Freddie Mac may encourage strategic default if it does not pursue deficiencies from those borrowers who possess the ability to repay.

[15] Freddie Mac also stated that its recoveries were likely impacted to some extent by its decision to suspend referral of 39,655 foreclosures during the period January 2011 to March 2012, while it was in the process of selecting additional collection vendors.

[16] See footnote 10.

2. Delays in the Vendors' Evaluation Process Limited Their Opportunity to Pursue Borrowers Who Can Repay

Of the 52,000 foreclosures referred for collection, Freddie Mac's vendors were unable to evaluate approximately 6,000 foreclosures (with estimated unpaid principal balances of $1.4 billion) because they could not timely obtain foreclosure-related documentation from other Freddie Mac counterparties, such as servicers and foreclosure attorneys.[17] These delays precluded the vendors from (1) identifying and estimating potential deficiency amounts and (2) initiating deficiency collection activities in states that have statutes of limitations of a year or less.

Proper internal control helps mitigate risks. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) established an internal control framework that is widely used by publicly traded corporations, such as Freddie Mac. This framework applies to deficiency recoveries because collections are revenue that offset recorded losses and impact financial reporting.

Monitoring is one of five control standards within the control framework. COSO requires that management monitor internal controls, whether through ongoing monitoring activities, separate evaluations, or a combination of the two.

Among Freddie Mac's controls, it contractually requires its vendors to complete their evaluation of referred foreclosure sales within 5 to 15 days of receipt of data from the enterprise. However, according to Freddie Mac, this contract requirement was seldom enforced due to extended delays in obtaining the necessary documents from servicers and foreclosure attorneys. For example, Freddie Mac sent to one vendor over 8,000 foreclosure sales for evaluation during 2012. Of that number, foreclosure documentation was obtained for only 400 sales as of December 31, 2012, and that documentation took more than six months to receive from the date the foreclosure sales were referred. As to the remaining 7,600 foreclosure sales that were referred, the vendor was still awaiting information as of the end of OIG's audit fieldwork, and thus it could not evaluate these deficiencies for collection let alone initiate collection activities.

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[17] In order to estimate the unpaid principal balance for the 6,000 foreclosures, OIG utilized Freddie Mac's average original unpaid principal balance as reported in its May 2013 "Single Family Loan Summary Statistics" for the years 2010 and 2011, and multiplied it by the number of liquidated mortgages whose statute of limitations expired as of December 31, 2012. Data for 2012 were not available in the referenced Freddie Mac report.

OIG also observes that the number of foreclosed mortgages not pursued or closed because of document delays is likely greater than 6,000. Only one of Freddie Mac's vendors assigns a code to foreclosures for which it cannot calculate a deficiency because of a lack of documents. The other vendors do not collect such data.

The most recent third-party review conducted at Freddie Mac's largest collection vendor also identified documentation delays as a problem. The resulting report stated that there were 12,465 potential deficiencies that the vendor could not completely evaluate because it was awaiting documents for the subject foreclosures. OIG confirmed with each of Freddie Mac's three vendors that timely receipt of documentation remains a key issue.

Although Freddie Mac is aware of the delays, the enterprise had not specified a timeframe for counterparties to provide foreclosure-related documents to its vendors. Nor has Freddie Mac implemented monitoring controls to prioritize deficiency collection activities (including delivery of required foreclosure-related documents) in states with brief statutes of limitations. Similarly, FHFA has not directed Freddie Mac to establish such controls. As such, the enterprise's vendors may expend significant time and effort trying to obtain the documentation.

Additionally, according to Freddie Mac officials, servicers and foreclosure attorneys have not faced financial or other consequences for not sending documents to the vendors. Rather than impose financial penalties, Freddie Mac officials stated that they have preferred to work with the counterparties to get the necessary documents to its vendors faster. For example, the enterprise has provided the vendors with a template letter to assist them in obtaining the documents from the servicers and foreclosure attorneys in a more timely fashion. The template authorizes and directs the servicers and foreclosure attorneys to share the requested deficiency-related information with the vendors. Nonetheless, according to the vendors, the template has not had an appreciable effect on reducing delays in receipt of required documentation.

CONCLUSIONS

As conservator of Freddie Mac, FHFA is responsible for ensuring the enterprise conserves and preserves its assets. Pursuing deficiency recoveries from those with the ability to repay may help reduce Freddie Mac's foreclosure-related losses. In addition, it could serve as a deterrent to borrowers who may consider strategically defaulting on their mortgages, despite having the ability to pay their contractual obligations. However, Freddie Mac did not have sufficient controls in place to achieve these objectives.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Evaluate periodically the efficiency and effectiveness of Freddie Mac's deficiency recovery strategies for the pursuit of borrowers with the ability to repay.

2. Review Freddie Mac's monitoring controls over its servicers, foreclosure attorneys, and collection vendors involved in deficiency recovery activities to ensure that oversight across these counterparties is maintained.

3. Direct Freddie Mac to enforce controls for its counterparties to deliver timely documents to deficiency recovery vendors necessary to calculate and pursue deficiencies, and provide for financial consequences for counterparties that fail to meet delivery deadlines.

4. Direct Freddie Mac to implement a control to consider timeframes in state statutes of limitations when prioritizing, coordinating, and monitoring deficiency collection activity for borrowers with the ability to repay.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this performance audit was to assess FHFA's oversight of the effectiveness of Freddie Mac's deficiency recovery processes for borrowers who possess the ability to repay deficiencies. The scope of the audit was January 2010 through June 2012 and was expanded as necessary to obtain more current data for reporting purposes.

OIG performed fieldwork for this audit from September 2012 through May 2013. OIG conducted fieldwork at FHFA's office in Washington, D.C., and Freddie Mac's office in McLean, Virginia.

To achieve this audit objective, OIG:

- Researched the performance metrics and best practices used by the deficiency recovery industry, Freddie Mac, and its deficiency vendors to evaluate their respective deficiency recovery processes;
- Reviewed Freddie Mac deficiency recovery processes, procedures, servicing guides, and related documents;
- Reviewed vendor deficiency management policies, procedures, reports, and related documents;
- Interviewed Freddie Mac officials and personnel from all of Freddie Mac's deficiency collection vendors concerning their deficiency recovery policies and procedures;
- Reviewed the compliance audit review conducted by a third-party firm on behalf of Freddie Mac; and
- Analyzed foreclosure sale data and active loans related to the enterprises from January 1, 2010, through June 30, 2012.

OIG assessed the reliability of data received for this audit, as deemed necessary, by corroborating the information with publicly available reports and other source data.

OIG also assessed the internal controls related to the audit objective. Based on the work completed on this performance audit, OIG considers weaknesses in FHFA's supervisory oversight of Freddie Mac's controls over its deficiency recovery processes to be significant in the context of the audit's objective. Additionally, other less significant matters that came to OIG's attention during the audit will be communicated separately to FHFA in an audit memorandum.

OIG conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that OIG plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the audit findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on the audit objective.

APPENDIX A ……………………………………………………………………

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

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

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

SUBJECT: Audit Report: FHFA's Oversight of Freddie Mac's Recoveries from Defaulting Borrowers Who Possess the Ability to Repay Their Deficiencies (Assignment No. AUD-2012-019)

DATE: September 4, 2013

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses to the recommendations in the report prepared by FHFA-OIG, *FHFA's Oversight of Freddie Mac's Recoveries from Defaulting Borrowers Who Possess the Ability to Repay Their Deficiencies (Assignment No. AUD-2012-019).* We appreciate the opportunity to provide feedback on this draft report and the FHFA-OIG findings.

FHFA appreciates and concurs in the importance the report accords to strengthening controls over deficiency collections and that Freddie Mac's processes should continue to improve. The Enterprise has already taken steps to correct many of the issues outlined in the report including system enhancements and FHFA will review the improvements as part of its supervisory review. It is important to note that even with improved processes, there is a critical cost/benefit analysis that must be done in determining whether or not to pursue deficiency judgments, and that the likelihood of significant recoveries is minimal.

FHFA-OIG recommends that FHFA:

1. Evaluate periodically the efficiency and effectiveness of Freddie Mac's deficiency recovery strategies for pursuit of borrowers with the ability to repay.

2. Review Freddie Mac's monitoring controls over its servicers, foreclosure attorneys, and collection vendors involved in deficiency recovery activities to ensure oversight across these counterparties is maintained.

3. Direct Freddie Mac to enforce controls for its counterparties to deliver timely documents to deficiency recovery vendors necessary to calculate and pursue deficiencies and provide for financial consequences for counterparties that fail to meet delivery deadlines.

4. Direct Freddie Mac to implement a control to consider timeframes in state statutes of limitation in prioritizing, coordinating, and monitoring deficiency collection activity from borrowers with the ability to repay.

Management Response: Agree with all recommendations. In terms of specific actions, by November 30, 2013, FHFA will issue an Advisory Bulletin regarding Deficiency Balances, in fulfillment of Recommendation #3 of OIG's Report AUD-2013-001, *Oversight of Enterprises' Efforts to Recover Losses from Foreclosure Sales*. This Advisory Bulletin will address Recommendations #1, #3, and #4 above by establishing supervisory expectations for deficiency balance management at the Enterprises, including (a) maintaining formal policies and procedures for managing their deficiency collection processes for borrowers that strategically default on their mortgage obligations, (b) establishing controls to monitor the activities of all counterparties involved in deficiency balances management to ensure that deficiency balance management processes are timely, effective, and efficient, and (c) complying with the applicable state statute of limitations in order to preserve the ability to pursue collection .

Secondly, by January 31, 2014, FHFA's Division of Enterprise Regulation will develop and implement ongoing monitoring procedures to assess the effectiveness of the Enterprises' deficiency judgment process on a periodic basis, including (a) evaluation of efficient and effective deficiency recovery strategies, (b) Enterprise monitoring controls over its servicers, foreclosure attorneys, and collection vendors, and (c) assessment of implementation by the Enterprises of the Advisory Bulletin provisions relating to timely document handling and other provisions.

FHFA ongoing monitoring procedures will also provide for the assessment of the Enterprises' possible use of existing provisions of the Seller/Servicer Guides to enforce and receive indemnification for losses associated with failure to adequately recover deficiency balances.

cc: Richard Hornsby, Chief Operating Officer
Mark Kinsey, Chief Financial Officer
John Major, Manager, Internal Controls and Audit Follow-Up

APPENDIX B..

OIG's Response to FHFA's Comments

On September 4, 2013, FHFA provided comments to a draft of this report, agreeing with the recommendations and identifying FHFA actions to address them. Importantly, FHFA issued an Advisory Bulletin on September 16, 2013, regarding deficiency balances including requirements for both enterprises to (a) maintain formal policies and procedures for managing their deficiency collection processes for borrowers who strategically default on their mortgage obligations, (b) establish controls to monitor the activities of all counterparties involved in deficiency balance management to ensure that deficiency balance management processes are timely, effective, and efficient, and (c) comply with the applicable state statutes of limitations in order to preserve the ability to pursue collection of deficiencies.

FHFA also agreed that, by January 31, 2014, the Division of Enterprise Regulation will develop and implement ongoing monitoring procedures to assess the effectiveness of the enterprises' deficiency judgment process on a periodic basis, including (a) evaluation of efficient and effective deficiency recovery strategies, (b) enterprise monitoring controls over its servicers, foreclosure attorneys, and collection vendors, and (c) assessment of implementation by the enterprises of the Advisory Bulletin provisions relating to timely document handling and other provisions. OIG considers FHFA's planned actions to be sufficient to resolve the recommendations, which will remain open until OIG determines that the agreed-upon corrective actions are completed and responsive to the recommendations. OIG considered the agency's full response (attached as Appendix A), along with technical comments, in finalizing this report. Appendix C provides a summary of management's comments on the recommendations and the status of agreed-upon corrective actions.

OIG has also issued a related report on FHFA's oversight of Fannie Mae's deficiency recoveries.

APPENDIX C..

Status of Agreed-Upon Corrective Actions

This table presents the management response to the recommendations in OIG's report and the status of the recommendations 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 issue an Advisory Bulletin on deficiency balances that will require the enterprises to maintain formal policies and procedures for managing deficiency collection processes for strategic defaulters. In addition, FHFA will perform ongoing monitoring to assess the effectiveness of the enterprises' deficiency judgment processes.	1/31/2014	$0	Yes	Open
2	FHFA will perform ongoing monitoring to assess the effectiveness of the enterprises' monitoring controls over its servicers, foreclosure attorneys, and collection vendors, as well as the possible use of indemnification for counterparties' failure to recover adequately on deficiency balances.	1/31/2014	$0	Yes	Open
3	FHFA will issue an Advisory Bulletin on deficiency balances that will require the enterprises to establish controls to monitor the timeliness, effectiveness, and efficiency of counterparties involved in managing their deficiencies. In addition, FHFA will assess how the enterprises have implemented the Advisory Bulletin provisions, including those related to timely document handling.	1/31/2014	$0	Yes	Open
4	FHFA will issue an Advisory Bulletin on deficiency balances that will require the enterprises to comply with applicable state statutes of limitations	1/31/2014	$0	Yes	Open

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved[a] Yes or No	Open or Closed[b]
	to preserve the ability to pursue collections. In addition, FHFA will perform ongoing monitoring to assess the effectiveness of the enterprises' deficiency judgment processes.				

[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 OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

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

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