Federal Housing Finance Agency
Office of Inspector General

FHFA Oversight of Enterprise Controls Over Pre-Foreclosure Property Inspections

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Synopsis

March 25, 2014

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Why OIG Did This Report

The Federal Housing Finance Agency (FHFA or Agency) serves as the federal regulator of Fannie Mae and Freddie Mac, collectively the Enterprises, with broad responsibilities for the Enterprises' safety and soundness. Additionally, since September 2008, FHFA has acted as conservator for the Enterprises, with management authority to preserve and conserve their assets. In both of these roles, FHFA has taken action to mitigate losses associated with delinquent single-family residential mortgages purchased by the Enterprises. As of December 31, 2012, the Enterprises together had more than 923,000 mortgages that were more than 90 days past due, with total credit losses over $25 billion in 2012 due to foreclosures and alternative actions to address delinquencies.

When borrowers become delinquent on their mortgage payments, the Enterprises and their servicers use pre-foreclosure property inspections to help protect the Enterprises' interest in the properties securing the mortgages from physical conditions that may pose safety hazards or impair the value of the properties. The inspections' objectives are to help minimize credit losses and identify any apparent safety hazards. The Enterprises reimbursed servicers approximately $91.2 million in 2011-2012 for property inspections performed by contractors related to delinquent loans.

The severity of risk in the property inspection business was recently highlighted by the conviction of a property preservation contractor whose company created and submitted fraudulent property inspection reports to servicers for reimbursement. The possibility of other property inspection vendors engaging in the same practice presents a potential risk to the Enterprises. Therefore, we conducted this audit to determine whether controls exist to prevent similar fraudulent activities from occuring and to detect and minimize risk in the pre-foreclosure inspection process.

The overall objective of this performance audit was to assess FHFA's oversight of the Enterprises' controls over pre-foreclosure property inspections that are performed on delinquent loans.

What OIG Found

The pre-foreclosure property inspection process needs improvement to ensure that pre-foreclosure inspection objectives are achieved in the most effective manner. There is limited assurance that the Enterprises have effective controls in place to ensure the quality of inspections conducted and that inspectors issue reports consistent with contractual requirements. Overall, several servicers reviewed during the audit did not have quality controls in place to ensure contractors provided accurate, complete, and consistent information in property inspection reports.

Specifically, OIG identified inspection reports with inconsistent and inaccurate information; missing or blurry photographs; manipulated date and time stamps on the photographs; and unneccessary inspections that did not provide useful information

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about the properties. Also, the servicers reviewed by OIG inconsistently adopted requirements for inspectors to complete and pass criminal background checks.

These deficiencies in the pre-foreclosure property inspection process occurred, in part, because of: (1) minimal attention and oversight provided by both FHFA and the Enterprises; (2) limited Enterprise quality standards for inspections conducted by inspectors under contract with servicers; and (3) the Enterprises' reliance on servicers to monitor the quality of property inspections. Further, neither FHFA nor the Enterprises have assessed the overall effectiveness of their respective pre-foreclosure property inspection processes in achieving their safety and loss mitigation objectives.

The lack of effective controls related to quality diminishes an inspection report's integrity and casts doubt on whether performing pre-foreclosure property inspections adds value. Further, the minimal attention and oversight to the pre-foreclosure property inspection process presents a control weakness that inspectors may be able to exploit with manipulated inspection reports.

Pre-foreclosure property inspections can assist both servicers and the Enterprises when correctly performed. These inspections can reduce the risk of safety-related incidents and mitigate losses by triggering needed repairs. Further, if a property is determined to be vacant during an inspection, some states allow for an alternative foreclosure process that can accelerate foreclosure proceedings and minimize losses to the Enterprises.

What OIG Recommends

OIG recommends that FHFA direct the Enterprises to jointly assess the effectiveness of their pre-foreclosure property inspection processes. Based on this assessment, FHFA should direct the Enterprises to establish uniform pre-foreclosure inspection quality standards and quality control processes for inspectors. OIG identified several specific areas to review as part of the assessment, including: (a) identifying pre-foreclosure property inspection risks and objectives; (b) identifying cost effective control alternatives for achieving the objective(s); and (c) recommending inspection standards and quality controls with regard to the content and frequency of inspections. FHFA identified corrective actions that address OIG's recommendations.

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ABBREVIATIONS

AMFS	American Mortgage Field Services
CORE	Counterparty Operational Risk Evaluation
COSO	Committee of Sponsoring Organizations
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
OIG	Federal Housing Finance Agency Office of Inspector General
REO	Real Estate Owned
SAI	Servicing Alignment Initiative

PREFACE

OIG issued a report to FHFA in November 2012 related to a previous investigation of a property preservation company that created fraudulent property inspection reports.[1] The report identified that the company submitted $12.7 million in fraudulent property inspection claims to the Enterprises and the Federal Housing Administration. The fraudulent property inspection reports related to these losses were for properties with delinquent loans, as opposed to properties held by the Enterprises as real estate owned (REO).[2] In accordance with Enterprise requirements, servicers are responsible for ensuring that pre-foreclosure property inspections are performed on properties with delinquent loans. OIG conducted this audit to determine whether FHFA had adequate oversight of the Enterprises' controls over the pre-foreclosure property inspection process.

OIG issued an initial report resulting from this audit in January 2014 that addresses FHFA's oversight of Fannie Mae's controls over the reimbursement process for property inspections.[3] This report focuses on the overall quality assurance and controls over pre-foreclosure property inspections.

OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations. As a result of our work, we may recommend policies that promote economy and efficiency in administering FHFA's programs and operations, or that prevent and detect fraud and abuse in them. We believe this report's recommendations (along with those in prior reports) 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, including officials at FHFA, Fannie Mae, Freddie Mac, and selected servicers. This audit was led by Kevin Carson, Audit Director, who was assisted by Rhoda Allen, Audit Manager, Cassandra Ingram, Auditor-in-Charge, Jacob Trewe, Auditor, and Rachael Young, Auditor.

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[1] OIG Systemic Implication Report, *Enterprise Oversight of Property Preservation Inspections,* SIR-2013-0002 (November 26, 2012). Accessed December 23, 2013, at http://fhfaoig.gov/Content/Files/SIR%20FINAL%20Enterprise%20Oversight%20of%20Property%20Preservation_0.pdf.

[2] REO are residential properties that have been foreclosed upon and transferred into an REO inventory for management and ultimately disposition by the Enterprises.

[3] OIG Audit Report, *FHFA Oversight of Fannie Mae's Reimbursement Process for Pre-Foreclosure Property Inspections,* AUD-2014-005 (January 15, 2014). Accessed January 31, 2014, at http://www.fhfaoig.gov/Content/Files/AUD%202014-005.pdf.

This audit 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

BACKGROUND ....

Introduction to Property Inspections

In performing duties related to servicing delinquent mortgage loans, servicers should take action necessary to protect the Enterprises' interest in the properties securing the loans as authorized by servicing guidance and the loans' terms.[4] Among other duties, this includes periodically inspecting the properties to ensure that: (1) physical conditions are satisfactory; (2) no apparent hazardous conditions affect occupants or others; and (3) no apparent violations of applicable law might result in the properties' seizure or forfeiture.

On April 28, 2011, FHFA announced a Servicing Alignment Initiative (SAI) directed at the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to align their respective guidelines for servicing delinquent mortgages that the Enterprises either own or guarantee. The SAI required the Enterprises to align servicing requirements in four key areas, including: (1) borrower contact, (2) delinquency management practices, (3) loan modifications, and (4) foreclosure timelines. Included in the delinquency management practices section, the directive required the Enterprises to align standards for property inspections.[5]

In response, the Enterprises changed their existing standards for conducting pre-foreclosure property inspections on delinquent loans to align the following:[6]

1. **Ordering Inspections**. The servicer must generally order the first property inspection no later than the 45th day of delinquency and complete the property inspection no later than the 60th day of delinquency.

2. **Subsequent Inspections**. The servicer must generally continue to obtain property inspections every 30 days as long as the mortgage loan remains 45 days or more delinquent.

3. **Bankruptcy**. Inspections are not required for loans under a bankruptcy plan.[7]

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[4] Mortgage servicers typically collect and deliver principal and interest payments, administer escrow accounts, monitor and report delinquencies, perform default prevention activities, evaluate transfers of ownership interests, respond to requests for partial releases of security, and handle proceeds from casualty and condemnation losses.

[5] FHFA, "Frequently Asked Questions – Servicing Alignment Initiative." Accessed December 23, 2013, at http://www.fhfa.gov/webfiles/21191/faqs42811final.pdf.

[6] We refer to property inspections on delinquent loans (as opposed to property inspections on REO) as "pre-foreclosure property inspections" throughout this report.

4. **Interior Inspections**. An interior property inspection must be performed after confirmation that a property has been abandoned and within 30 days of a foreclosure sale.[8]

The Fannie Mae *Single Family 2012 Servicing Guide* and the Freddie Mac *Single-Family Seller/Servicer Guide* are consistent with these standards and require servicers to perform monthly property inspections on all properties when borrowers have become delinquent on their mortgage loans. The servicing guides require that once a loan becomes 30 days delinquent, the servicer must order a property inspection by the 45th day of delinquency. The initial inspection must be performed by the 60th day. After the initial inspection, the guides require that a subsequent inspection of the property be performed every 30 days.

When the decision is made to start foreclosure, the Enterprises require the servicer to schedule its property inspections in a way that will ensure that the final, comprehensive property inspection is completed within 30 days of the foreclosure sale.

Ordering Property Inspections

During the financial crisis, which started in 2007, there was a surge in the number of borrowers who became delinquent on mortgages owned or guaranteed by the Enterprises. Serious delinquency rates remain very high for mortgage loans originated between 2005 and 2008, which now account for approximately 20 percent of the Enterprises' single-family portfolios.[9]

A consequence of the high volume of delinquent mortgage loans is the increased demand for property preservation services, including property inspections. Most servicers reviewed during this audit contract with property preservation companies to conduct these inspections.[10] In turn, these companies often hire subcontractors to do the inspections.[11] Figure 1 provides a chronology of the typical property inspection ordering process.

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[7] A property inspection is not required for mortgage loans in which the borrower has filed bankruptcy, provided that the borrower is performing under the applicable bankruptcy plan.

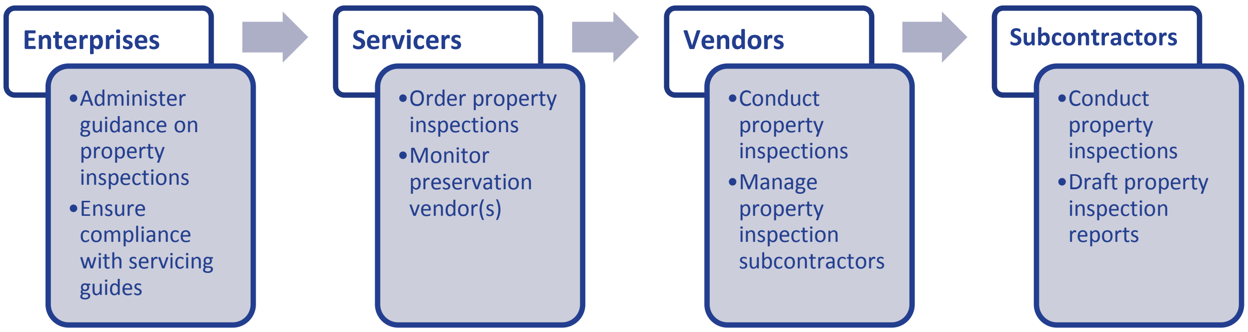
[8] As of November 1, 2013, Freddie Mac no longer limits the timeframe for interior inspections to the period after abandonment and the 30 days preceding the foreclosure sale. Rather, servicers are required to order the monthly property inspection as an interior inspection.

[9] FHFA, *Conservator's Report on the Enterprises' Financial Performance* (First Quarter 2013). The serious delinquency rate measures the percentage of mortgages in the Enterprises' portfolios that are three or more payments delinquent, including those mortgages that are in foreclosure and subject to disposition pursuant to bankruptcy proceedings.

[10] Servicers generally hire between one and four property preservation companies to conduct inspections.

[11] Vendors contracted by all servicers included in this audit hired subcontractors to perform the property inspections.

FIGURE 1. CHRONOLOGY OF THE PROCESS TO ORDER A PROPERTY INSPECTION



Source: OIG Analysis

The Property Preservation Industry

Property preservation companies perform a variety of services including property inspections (e.g., exterior and interior inspections). The companies also provide property preservation (e.g., securing, winterization, and lawn maintenance), REO, and utility management services. During 2011 and 2012, the 12 servicers reviewed as part of this audit ordered over 15 million pre-foreclosure property inspections.[12] On average, inspectors receive less than $20 to conduct pre-foreclosure property inspections. Of the 12 servicers OIG reviewed, six contracted with Safeguard Properties LLC (Safeguard) to perform pre-foreclosure property inspections between 2011 and 2012. Safeguard is the country's largest privately held mortgage field services property preservation company.

The pre-foreclosure property inspection industry is largely unregulated. Currently, there are no specific federal or state laws that govern property inspections of homes securing mortgage loans in default.[13] Specifically, universal standards do not exist for servicers to require their inspectors to maintain minimum education requirements, experience level, or qualifications. As a result, it is the responsibility of each individual servicer to provide the primary oversight of the property preservation vendors and inspectors that the servicer contracts with to conduct these inspections.

[12] Property inspections conducted by these 12 servicers made up over 80% of the Enterprises' expenditures for pre-foreclosure property inspections in 2012.

[13] In accordance with Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the Enterprises should require lenders to use appraisers who are state-licensed or certified. Pre-foreclosure property inspections are not the same as conducting a home appraisal. As such, the property inspection industry is not required to adhere to this provision.

Property Preservation Complaints

The Illinois Attorney General recently filed a lawsuit against Safeguard Properties, claiming that the company has unlawfully removed legal occupants from their homes by breaking into occupied houses, locking the occupants out of their homes, removing their personal property, and shutting off utilities in the home—often in spite of evidence that the properties remain legally occupied.[14] The lawsuit further asserts that Safeguard does not adequately train or supervise its subcontractors who determine the occupancy status of properties during inspections. Safeguard has denied the claims. Nonetheless, the lawsuit points to the type of problems that could occur absent oversight of inspector performance.

FHFA's Actions Related to Property Inspections

Prior to 2013, FHFA conducted examinations focusing on the Enterprises' REO inventory and property preservation as opposed to pre-foreclosure property inspections performed by servicers. Since that time, the scope of FHFA's ongoing monitoring at the Enterprises has been expanded to include a limited focus on pre-foreclosure property inspections.[15] While FHFA continues to monitor Fannie Mae's REO inventory and property preservation, the Agency has also reviewed Freddie Mac's *Seller/Servicer Guide's* section on pre-foreclosure property inspections and interviewed Freddie Mac officials about REO property preservation. Regardless of these activities, FHFA's ongoing monitoring has not resulted in a recommendation for a targeted examination at either Enterprise.[16]

The Enterprises' Oversight and Quality Control

The scope of Fannie Mae's oversight of its servicers' controls over pre-foreclosure property inspections is limited to determining whether the required inspections were appropriately ordered. Fannie Mae conducts Servicer Quality Reviews to ensure servicers comply with the ordering requirements outlined in its servicing guide. These requirements include ensuring that servicers order property inspections when mortgage loans become delinquent. After

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[14] Attorney General of the State of Illinois, *The People of the State of Illinois vs. Safeguard Properties, LLC*, 2013CH20715 (September 9, 2013). Accessed January 31, 2014, at http://www.illinoisattorneygeneral.gov/pressroom/2013_09/SAFEGUARD_PROPERTIES_COMPLAINT_09-09-2013_15-51-37.pdf.

[15] Ongoing monitoring generally involves broad assessments of Enterprise business practices and risks including activities such as meetings with Enterprise officials, reviews of reports, and in-depth analyses of specific risk management practices.

[16] Targeted examinations typically involve in-depth transactional testing of a specific risk area or program. Transaction testing associated with targeted examinations can provide FHFA with an independent basis for assessing government sponsored enterprises' financial operations, performance, and risk management. (These enterprises include Fannie Mae, Freddie Mac, and 12 Federal Home Loan Banks.)

ordering the inspections, Fannie Mae relies on its servicers to ensure that controls are in place to minimize the risk of inconsistent, inaccurate, and incomplete property inspections and reports, and to ensure that inspections are useable for their intended purposes.

At Freddie Mac, the Counterparty Operational Risk Evaluation (CORE) team reviews servicers' overall performance. However, before September 2013, with respect to pre-foreclosure property inspections, these reviews only determined if the inspections were ordered appropriately. In September 2013, Freddie Mac's CORE team revised its servicer review program to include a new procedure to validate the effectiveness of controls over conducting property inspections. However, according to Freddie Mac officials, the new procedure does not include ensuring that servicers conduct procedures to determine whether property inspection reports are accurate and complete.

Principles of Internal Control

Internal control is an "integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations." An organization's internal control includes the plans, methods, and procedures used to meet missions, goals, and objectives. Internal control is not a single event, but a series of activities that occurs throughout the entity's operations and on an ongoing basis.[17]

Control activities can work either to prevent or detect, with the main difference being when the control activity occurs. A control activity can *prevent* an entity from failing to achieve an objective or addressing a risk, or a control activity can *detect* when an entity is not achieving an objective or addressing a risk before the entity's operation has concluded and corrects the actions so that the entity achieves the objective or addresses the risk.

In a recent white paper by the American Institute of Certified Public Accountants on updates to the Committee of Sponsoring Organizations (COSO),[18] the authors explain that while both preventive and detective controls have their place in an internal control structure, the importance and value of preventive controls has grown significantly.[19] Regarding inspections,

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[17] The Government Accountability Office, "Definition and Objectives," S*tandards for Internal Control in the Federal Government* (November 1999). Accessed January 31, 2014, at http://www.gao.gov/assets/80/76455.pdf.

[18] COSO provides a framework for internal control that is followed by professionals worldwide.

[19] "Changes to COSO in 2012," *White Paper: COSO 2012—Updated, Principles-Based, and More Guidance* (March 2012). Accessed January 31, 2014, at http://www.aicpa.org/InterestAreas/FRC/AuditAttest/DownloadableDocuments/COSO/COSO-2012_Whitepaper.pdf.

preventive controls can include clear inspection objectives and standards, properly structured contractual terms and conditions, and sound quality controls.

Repurchase is an Incentive for Seller/Servicers to Conduct Quality Property Inspections

The Enterprises' right to request that a seller/servicer repurchase a loan due to inadequate property inspections serves as an incentive for servicers to conduct quality property inspections. A typical repurchase means that a **seller** violated representations and warranties provided to the Enterprise at the time of the loan sale. In this case, the Enterprise would identify the defective mortgage and issue a repurchase letter to the seller explaining the errors or failures that would have resulted in the Enterprise's refusal to purchase the loan.

Seller/Servicer: An institution approved to sell mortgages to, and to service mortgages purchased by the Enterprises. A **seller** is an institution approved to sell mortgages to the Enterprises. A **servicer** collects and delivers principal and interest payments, administers escrow accounts, and monitors and reports delinquencies, among other activities. An institution could be a seller, servicer, or both (i.e., a seller/servicer).

Similarly, the Enterprises can require a **servicer** to repurchase a mortgage loan or can impose alternative remedies due to improper servicing.[20] Servicing violations include inadequately maintaining a property during the pre-foreclosure period that may result in a material adverse effect on the value of the mortgage loan. Repurchase of a loan by a servicer can be an effective tool to incentivize servicers to conduct quality inspections. However, as of February 2014, inadequate pre-foreclosure property inspections have not resulted in the Enterprises exercising their right to require seller/servicers to repurchase the mortgage loan. According to Enterprise officials, inadequate inspections exclusively have not warranted such actions.

The Enterprises have procedures in place to follow up with a servicer if property damages are severe enough to question the adequacy of that servicer's inspections of the properties during the loan's delinquency. However, the repurchase option is not effective if potential violations are not appropriately detected. Therefore, the repurchase option or alternative remedies due to improper servicing are merely *incentives* for seller/servicers to conduct quality inspections rather than a preventive control for the property inspection process.

[20] Alternative remedies include, but are not limited to, the responsible party paying the Enterprises the funds to make whole or indemnify the Enterprises for the servicing violations. A make whole payment is the amount a party responsible for a breach in a selling representation or warranty or a servicing breach must pay so that the Enterprises do not incur a loss on the mortgage or the property. Indemnification requires a responsible party that sells mortgages to the Enterprises and/or services a mortgage loan to hold the Enterprises harmless against all losses, damages, judgments, claims, costs, expenses, legal actions, and legal fees that are based on, or result from, a breach in its origination, selling, or servicing activities.

FINDING ....

Pre-Foreclosure Property Inspections Can Be Enhanced by Strengthening Quality Assurance and Controls

The Enterprises' pre-foreclosure property inspection processes need improvement to ensure that their programs' objectives are achieved in the most effective manner. While the Enterprises paid in excess of $91.2 million for pre-foreclosure property inspections during 2011 and 2012, there is limited assurance that either Enterprise had effective controls in place to ensure the quality of inspections conducted or that inspectors submitted reports consistent with the existing requirements. Specifically, OIG found that:

- Property inspection reports contain inaccurate information which conflicts with corresponding photographs;
- Property inspection reports include missing, manipulated, and blurry photographs;
- Property inspectors conduct inspections outside of gated communities instead of waiting to obtain access to restricted properties;
- Servicers neither consistently conduct oversight procedures to evaluate vendors' property inspection performance, nor validate inspection reports to ensure the information is accurate, complete, and consistent;
- Property inspection reports do not include the names or signatures of those who conducted the inspections; and
- Servicers inconsistently adopted requirements for inspectors to complete and pass criminal background checks.

Figure 2 illustrates the number of property inspection reports OIG reviewed that contained these inconsistencies. As the figure illustrates, the majority of these files contains an inspection report with one or more area of concern.

FIGURE 2. INCONSISTENCIES IN PROPERTY INSPECTION REPORTS[21]

Source: Servicer Property Inspection Reports

Both Enterprises have servicing guides governing their property inspection process for delinquent loans. The guides require servicers to maintain copies of all property inspection reports with the mortgage loan files. Fannie Mae's *Single Family Servicing Guide* requires that inspection reports include information from its *Property Inspection Reports*, such as:

- Occupancy status;
- Property condition;
- General property description;
- Required repairs and estimated cost;
- Security status; and
- Vandalism assessment.

Similarly, Freddie Mac's *Seller/Servicer Guide* prescribes guidance requiring servicers to disclose similar information.

Inappropriate Property Inspection Reports and Photographs

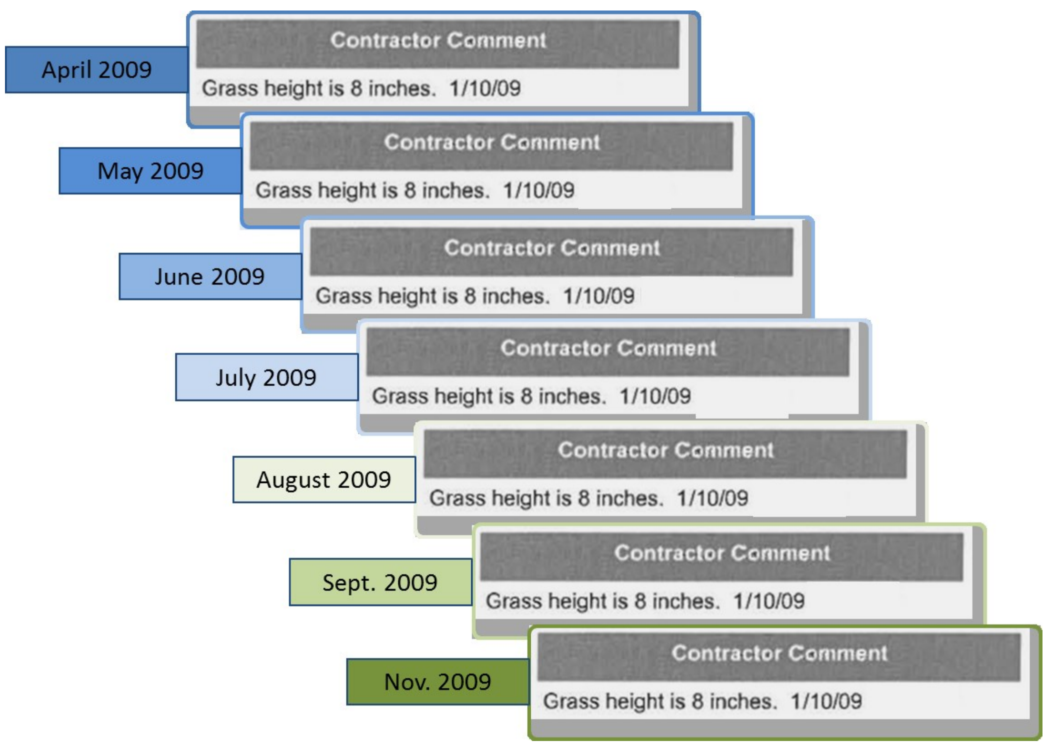
OIG identified property inspection reports with inconsistent and inaccurate information. For example, in one inspection report, an inspector was able to establish the property's occupancy

[21] OIG evaluated servicers' quality control files from the servicers' oversight of property inspection vendors. Along with other internal records and supporting documents, OIG reviewed 84 property inspection reports.

status based on observing the homeowner's personal property, decorations, and cars. However, neither cars nor decorations are visible in the pictures accompanying the report. Further, the pictures showed that the shades on the house were drawn, which obstructs the view inside of the home. Another inspection report asserted that the homeowner's yard was in good condition, but the property was a condominium unit in a medium-rise, multi-unit structure that lacked a separate yard.

OIG also identified a series of inspection reports for a single property that claimed the property's grass height was exactly eight inches for seven months. In this example, further illustrated in Figure 3, it appears the inspector copied old inspection report information onto each subsequent month's inspection form. From April through November, each inspection report contained the identical comment the inspector originally made in January, including the same original date. These reports did not include photographs to validate the inspector's claim.

FIGURE 3. IDENTICAL INSPECTOR COMMENTS IN SEVEN CONSECUTIVE INSPECTION REPORTS



Source: Servicer Property Inspection Reports

The audit also identified that property inspectors either manipulated or inserted the dates and times on photographs. For example, OIG observed inspection reports where the inspectors took pictures to capture various angles of the house, including the front, back, side, and inside, but the date and time remained the same so that it appears as if the pictures were taken simultaneously. As shown in Figure 4, the date and time for each photograph is "12/8/2012 9:21:00 AM."

FIGURE 4. MANIPULATED INSPECTION PHOTOGRAPHS—THE SAME DATE AND TIME STAMP

Source: Servicer Property Inspection Reports

OIG found that inspectors conducted unnecessary inspections that did not report useful information to the servicer. In one case, the inspector conducted inspections of a property in a gated community—closed to the public. For 12 consecutive months, the inspector did not obtain access to the restricted property and billed the servicer for 12 property inspections conducted from outside the gated community. None of these inspection reports contained useful information—e.g., occupancy and security status, condition, and description—which prevented the servicer from properly monitoring the status of the delinquent property for an entire year.

In another example, an inspector submitted photographs that were dated April 2007 for an inspection report submitted in December 2012. We also observed inspection reports with two separate dates on each photograph. Figure 5 provides additional examples of inspection reports with blurry or manipulated pictures.

FIGURE 5. BLURRY AND MANIPULATED INSPECTION PHOTOGRAPHS

Source: Servicer Property Inspection Reports

Servicers Neither Consistently Conduct Oversight Procedures to Evaluate Vendors' Property Inspection Performance Nor Validate Inspection Reports to Ensure the Information is Accurate, Complete, and Consistent

Several of the 12 servicers reviewed during the audit did not have controls in place to ensure vendors provided accurate, complete, and consistent information related to pre-foreclosure property inspections. Specifically, several servicers stated that they have either not finished implementing or simply did not have quality control procedures in place to evaluate vendors' performance on property inspections. Other servicers asserted that they used their existing vendor scorecard system[22] to evaluate the quality and completeness of property inspections. Despite this claim, the audit identified that the criteria included in the vendor scorecard systems did not address property inspection quality but instead primarily focused on whether

[22] Many servicers use a scorecard approach to evaluate a vendor's performance. The comprehensiveness of these scorecards varies with each servicer.

the inspections were ordered timely. Servicer officials also stated that they relied on the vendors to ensure the inspection reports were accurate, complete, and consistent.

The audit also showed that servicers do not require inspection reports to include the name of the individual who conducted the inspection. As a result, servicers were unable to trace and identify inspectors who appeared to submit consistently inaccurate or incomplete information. In other cases, inspectors signed the report with either untraceable initials or their last names.

Servicers were also unable to confirm whether inspectors passed criminal background checks. Servicers asserted that some property preservation vendors might have their own policies addressing this area. However, these servicers also acknowledged that they do not require vendors to ensure inspectors go through criminal background checks before inspecting homes. In addition, servicers were unable to confirm whether subcontractors hired by vendors to conduct inspections undergo such checks. OIG found that property preservation vendors typically hire subcontractors to conduct most property inspections.

OIG did identify one servicer with strong quality controls over its vendors' property inspection performance and reporting. Unlike the other servicers observed during the audit, we identified fewer inconsistencies on its vendors' property inspection reports. We attributed these results to the servicer's quality control activities for monitoring property inspections. For example, this servicer conducts ghost inspections whereby an independent vendor inspects a property a few days after the primary vendor inspects the same property. Once these inspections are complete, the servicer compares both inspections to identify anomalies. The purpose of the ghost inspection is to evaluate a vendor's performance and identify potential areas that require improvement.

As part of its quality process, this same servicer also conducts several weekly and monthly reviews to validate the information inspectors disclose on inspection reports. In most cases, analysts performing these reviews compared the inspectors' disclosures to independent sources (e.g., borrowers' appraisal records) to validate the data's integrity. In addition, the servicer is in the process of implementing an inspector-tracking program whereby each report will include the inspector's identification code. This code will also confirm whether the inspector has passed a criminal background check. Although criminal background checks are not required criteria to conduct inspections on delinquent mortgage loans, OIG believes this best practice enhances transparency and quality control over the inspector's performance.

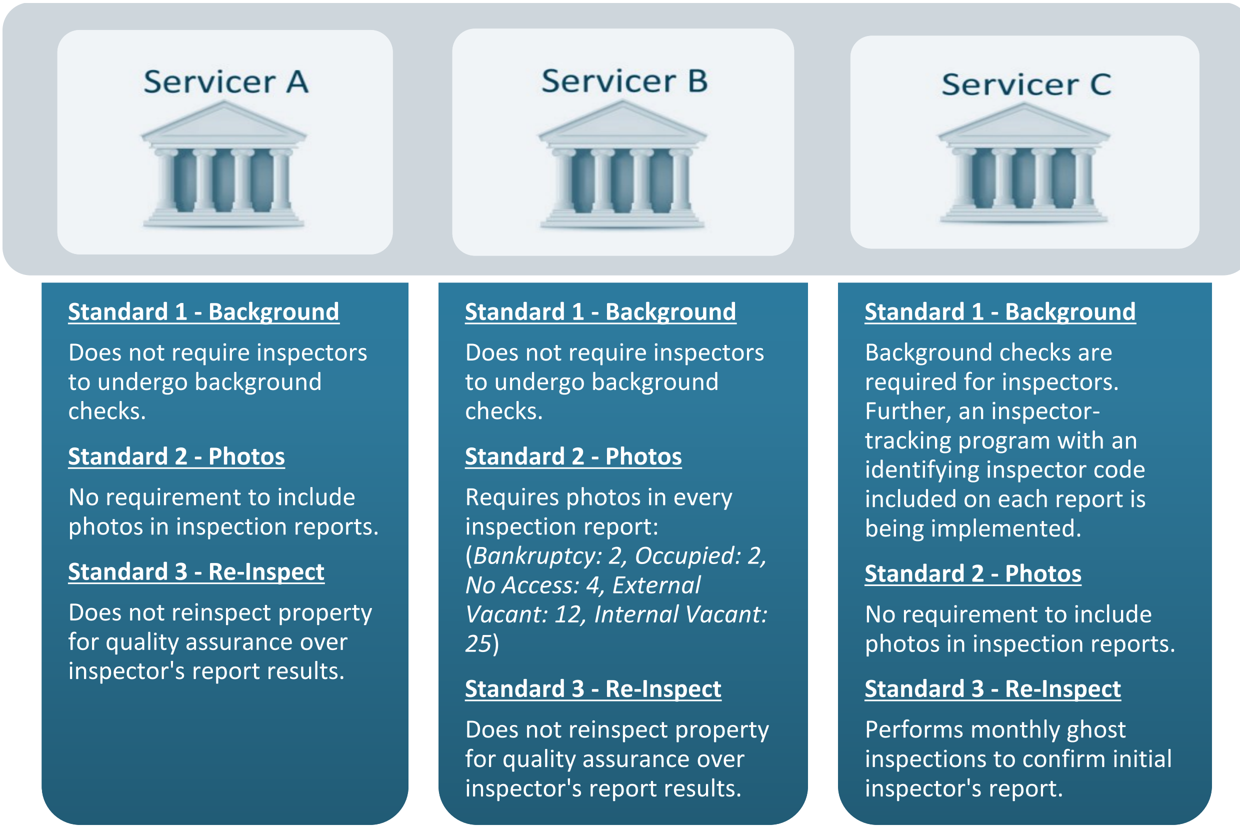
Pre-Foreclosure Property Inspections Receive Minimal Attention and Oversight

There has been little attention provided to pre-foreclosure property inspections by both FHFA and the Enterprises. FHFA has not issued guidance to the Enterprises related to the quality of pre-foreclosure property inspections and the Agency has not conducted any targeted examinations of the Enterprises' pre-foreclosure property inspection processes. FHFA's examination coverage has been limited to property inspections for REO single-family homes, and its ongoing reviews have been limited to evaluating Freddie Mac's *Single-Family Seller/Servicer Guide*.

In addition to limited FHFA oversight, the Enterprises have limited quality standards for inspections conducted by servicers. For example, Enterprise standards do not consistently require that all inspection reports include information such as the inspector's full name, signature, and digital photographs.[23] The Enterprises rely on servicers to draft quality standards for pre-foreclosure property inspections. Accordingly, these standards varied among servicers, as illustrated in Figure 6. For example, while some servicers have contractual agreements with their vendors to provide a specific number of photographs with each inspection, other servicers have no such requirements.

[23] The Enterprises provide servicers with suggestive property inspection reports they can use during inspections. While Freddie Mac's sample report includes a section for inspectors to sign their name but has no section for uploading pictures, Fannie Mae's sample report has an area where inspectors can upload pictures but excludes a section for the inspector's signature. In addition, both Enterprises allow servicers to use their own report or an alternative report with equivalent information.

FIGURE 6. DIFFERENCES IN SERVICERS' PROPERTY INSPECTION STANDARDS



Source: Servicer Property Inspection Reports

OIG found that servicers dedicated most of their control efforts to ensuring that inspections were ordered timely and little effort was spent on actual inspection performance and quality. Servicers also have varying levels of controls in place related to property inspection oversight, quality control, record retention, and inspector qualifications. Enterprise officials explained to OIG that they rely on servicers to monitor inspection quality and assurance. However, the Enterprises do not first ascertain whether adequate controls even exist among these servicers. Several servicers acknowledged to OIG that they then rely on hired vendors to conduct inspections and to validate inspection quality and performance.

Thus, OIG concludes that standards for performing inspections and the responsibility for inspection quality are highly decentralized and widely inconsistent across servicers and inspectors. In turn, this diminishes the inspections' value in achieving Enterprise objectives regarding safety and loss mitigation.

Additionally, neither FHFA nor the Enterprises have assessed the overall effectiveness of pre-foreclosure property inspection processes in achieving their respective safety and loss mitigation objectives. Such assessments of the design and implementation of inspection controls can include comparing inspection report results to objectives, identifying costs and benefits, and finding alternative ways to achieve inspection goals. Specifically, this analysis could include the following:

1. Determining whether pre-foreclosure property inspections operate effectively at the current level of minimum quality assurances and controls;
2. Identifying the objective(s), purpose, and intended use of pre-foreclosure property inspection information;
3. Recognizing cost effective alternatives for achieving the objective(s);
4. Ensuring that the program is necessary at the current frequency level;
5. Identifying pre-foreclosure property inspection risk;
6. Developing control measures to mitigate potential risk; and
7. Factoring control measures against potential program costs and benefits.

Under the Servicing Alignment Initiative (SAI), FHFA instructed the Enterprises to work together to develop consistent, standardized policies for servicing nonperforming loans and joint standards for evaluating servicer performance. In accordance with this directive, FHFA specifically required the Enterprises to align their property inspection standards with a focus on ordering inspections within certain timeframes. Similarly, a joint assessment of the property inspection process could allow Fannie Mae and Freddie Mac to build on the best practices developed by each Enterprise as they determine the best course of action for the program. Developing uniform standards to evaluate servicer performance (and thereby, vendor performance) could also result in a more effective Enterprise loss mitigation program.

The Lack of Quality Controls Reduces Pre-Foreclosure Property Inspection Effectiveness

The lack of effective quality controls in place over the pre-foreclosure property inspection process reduces the effectiveness of the inspections. Effective controls to ensure that inspection reports are accurate, complete, and consistent could include selecting a sample of inspection reports for audit/review, sampling other reports to re-inspect properties to verify the initial inspector's results (i.e., ghost inspections), ensuring that all inspection reports include unaltered digital photographs, and requiring inspectors to undergo criminal background checks.

Among other information, the Enterprises require servicers to report a home's occupancy status, security status, and damage in their pre-foreclosure property inspection reports. In the absence of controls to confirm the inspection report's integrity, it is difficult to conclude whether these disclosures are either accurate or achieving the inspections' intended objective, which is to act upon conditions that present safety hazards or increase losses.

This overall lack of controls has already resulted in one breakdown of significant consequence when a property inspection company, American Mortgage Field Services (AMFS), fraudulently submitted over $12.7 million in claims for reimbursement of property inspections. Over a five-year period between 2007 and 2012, AMFS[24] created fraudulent and false property inspection reports that they electronically submitted to various servicers, including primarily Bank of America.

In this instance, the various servicers hired AMFS to conduct inspections on properties with delinquent mortgage loans. Along with preserving the property, these inspections were to prevent potential safety hazards, such as uncovered swimming pools and exposed electrical wires. AMFS agreed to accept payment to inspect as many as 100,000 properties a month in Florida and other states. AMFS subsequently submitted inspection reports for numerous properties that AMFS employees never inspected. In addition, AMFS employees were directed to create false inspection reports by inserting photographs from previous reports and changing the dates to create the perception that new inspections had been conducted when no such inspections had been performed. OIG's investigation disclosed that between 2007 and 2012, AMFS falsified up to 70% of its property inspections and fraudulently received approximately $12.7 million for property inspections never actually performed.

Pre-Foreclosure Property Inspections Are Beneficial When Done Correctly

Performing pre-foreclosure property inspections in an effective manner and in accordance with uniform quality control standards would ensure that these inspections are used for their intended purpose and can preclude a fraudulent situation like that which happened with AMFS.

When performed effectively, inspections, in some cases, can accelerate the foreclosure process by identifying the borrower's occupancy status. Further, depending on the state where the property is located, property designated as unoccupied or abandoned could support the respective state's case to allow the servicer to shorten the redemption period. Shortening the redemption period may accelerate foreclosure proceedings, in instances where the property is abandoned, and clears the path for sale of the property sooner—thus minimizing losses to the Enterprises.

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[24] From 2007 to 2009, AMFS was called Mid-Florida Home Securing, LLC. While the company name changed to AMFS in 2009, the principals, employees, and mission of the company remained the same. For purposes of this report, AMFS refers to Mid-Florida Home Securing, LLC and American Mortgage Field Services.

Effective inspections may also prevent instances in which property preservation vendors secure the wrong property or inappropriately remove homeowners' personal property. Although claims detailing these alleged incidents have been minimal, the hardship and inconvenience they have caused homeowners may be prevented with the use of strong quality controls over reportable inspection information.

In addition, effective inspections would also ensure that annual reimbursements paid by the Enterprises for pre-foreclosure property inspection claims are used in the most cost efficient and effective manner. We anticipate that the Enterprises will incur additional expenses to pay for property inspections, thus warranting oversight. Specifically, Fannie Mae issued Servicing Guide Announcement SVC-2013-22 (October 30, 2013) that updated property inspection reimbursements and requirements. Effective January 1, 2014, SVC-2013-22 eliminates the $60 and $200 tolerance limits placed on the life of a loan in Fannie Mae's *571 Servicer Processing Guide* and reimburses servicers for all required inspections.

On August 15, 2013, Freddie Mac also issued Single-Family Seller/Servicer Guide Bulletin 2013-15 revising its property inspection requirements. Effective November 1, 2013, Bulletin 2013-15 removes the limit on reimbursement of property inspections to those conducted within the applicable State foreclosure timelines. Specifically, the bulletin provides that any Guide-required monthly inspection completed outside of the State foreclosure timelines will be reimbursable.

CONCLUSION

The Enterprises do not have quality controls in place to obtain reasonable assurance that pre-foreclosure property inspection information is accurate, consistent, and complete. OIG identified several examples demonstrating that servicers do not maintain consistent oversight over their vendors. The lack of quality controls diminishes the inspection report's integrity and casts doubt on whether these inspections are working and necessary. Further, the minimum attention to and oversight of pre-foreclosure property inspections poses a control weakness that vendors may be able to exploit with manipulated or fraudulent inspection reports.

Recently, both Enterprises revised their servicing policies and removed previous limits placed on claims reimbursed to servicers for property inspections. By removing these limits, the Enterprises may experience a significant increase in their property inspection expense. As a result, they may also face greater risk from reimbursing servicers for inadequate inspection reports.

RECOMMENDATIONS

OIG recommends that FHFA direct the Enterprises to:

(1) Jointly assess the effectiveness of their pre-foreclosure property inspection processes. OIG identified several specific areas to review as part of the assessment, including: (a) identifying pre-foreclosure property inspection risk and objectives; (b) identifying cost effective control alternatives for achieving the objective(s); and (c) recommending inspection standards and quality controls with regard to the content and frequency of inspections.

Based on this assessment, FHFA should direct the Enterprises to:

(2) Establish uniform pre-foreclosure inspection quality standards and quality control processes for inspectors.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

Objective

The objective of this performance audit was to assess FHFA's oversight of the Enterprises' controls over pre-foreclosure property inspections that are performed on delinquent loans. OIG assessed: (1) the extent to which the Enterprises have adequate controls over ordering, conducting, documenting, and reimbursing pre-foreclosure property inspections; and, (2) the extent to which servicers have policies and programs necessary to ensure property inspectors perform complete and accurate pre-foreclosure property inspections.

Scope

OIG conducted its fieldwork for this audit from May 2013 through February 2014 at FHFA's and Fannie Mae's offices in Washington, DC, and at Freddie Mac's offices in McLean, VA. OIG also conducted fieldwork at the offices of several servicers. The scope of the audit included a review of Enterprise monitoring activities and gaining an understanding of controls at 12 of the Enterprises' top servicers that received over 80% of property inspection payments reimbursed during 2012.

Methodology

In order to achieve its audit objective, OIG:

- Surveyed servicers to obtain information pertaining to property inspections conducted on delinquent Enterprise mortgage loans;
- Interviewed FHFA officials and reviewed guidance related to findings resulting from examinations and ongoing reviews;
- Interviewed Enterprise officials and reviewed property inspection reimbursement and monitoring processes, procedures, servicing guidance, and internal reports;
- Obtained live demonstrations of Enterprise systems used to process property inspection reimbursement to the servicers;
- Interviewed servicer personnel and reviewed property inspection reports, vendor contracts, procedures, and other documents pertinent to their property inspection oversight and controls; and
- Analyzed servicers' quality control procedures and supporting files associated with property inspections.

OIG assessed the internal controls related to the audit objective. Specifically, OIG evaluated the following control standards that were significant to the audit objective: control activities, information and communication, and monitoring. Based on the work completed on this performance audit, OIG considers its finding regarding the Enterprises and servicers' quality control processes over pre-foreclosure property inspections to be significant in the context of the audit objective. Interviews were conducted in the course of this audit to consider the risk of fraud as it relates to the audit objective.

OIG performed fieldwork for this audit from May 2013 through February 2014 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 the 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 FHFA-OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

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

FROM: Nina A. Nichols, Acting Deputy Director, Division of Enterprise Regulation

SUBJECT: Audit Report: *FHFA Oversight of Controls Over Pre-Foreclosure Property Inspections* (Audit Assignment AUD-2013-002)

DATE: March 14, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations resulting from the Audit Report: *FHFA Oversight of Controls over Pre-Foreclosure Property Inspections* (Audit Assignment AUD-2013-002). The audit report discusses OIG findings regarding deficiencies in pre-foreclosure property inspections of properties that collateralize delinquent loans held or guaranteed by Fannie Mae or Freddie Mac. The report recommends that FHFA direct the Enterprises to (1) jointly assess the effectiveness of Enterprise pre-foreclosure property inspection processes and (2) establish uniform pre-foreclosure inspection quality standards and quality control processes for inspectors.

This memorandum identifies management's agreement and/or disagreement with the recommendations and identifies the actions that FHFA will take in response to the recommendations.

Background

The FHFA-OIG report's principal finding is that servicers of loans held or guaranteed by the Enterprises do not ensure that their property inspection contractors and sub-contractors provide accurate, complete, and consistent information in property inspection reports.[1] Based on the sample of inspection reports reviewed, the FHFA-OIG finds that the unreliability of pre-foreclosure property inspections rises to a level that casts doubt on the value added by performing pre-foreclosure property inspections.

[1] The report's findings are based on a review of 84 property inspection reports from a universe of 15 million pre-foreclosure property inspections ordered with respect to properties associated with loans guaranteed or owned by the Enterprises during 2011 and 2012.

<u>Recommendation 1:</u> OIG recommends that FHFA direct the Enterprises to jointly assess the effectiveness of their pre-foreclosure property inspection processes. OIG identified several specific areas to review as part of the assessment including: (a) identifying pre-foreclosure property inspection risk and objectives; (b) identifying cost effective control alternatives for achieving the objective(s); and (c) recommending inspection standards and quality controls with regard to the content and frequency of inspections.

Management Response to Recommendation 1: FHFA partially agrees. FHFA concurs with the FHFA-OIG that the Enterprises should assess and manage risks relating to relationships with third parties, including mortgage loan servicers, including any risks associated with pre-foreclosure property inspection activities performed for servicers pursuant to contractual arrangements between the servicers and property inspection firms.

FHFA does not believe, however, that this risk management function must be performed on a joint basis by the Enterprises. Accordingly, FHFA will issue supervisory direction to each Enterprise to perform and document by January 31, 2015, an assessment of risks relating to pre-foreclosure property inspections, as well as a determination whether standards for pre-foreclosure property inspections should be incorporated into the Enterprise's program for management of third-party relationships, based on consideration of the likely costs and benefits of any specific standards the Enterprises identify that should be included.

<u>Recommendation 2:</u> Based on this assessment, OIG recommends that FHFA direct the Enterprises to establish uniform pre-foreclosure inspection quality standards and quality control processes for inspectors.

Management Response to Recommendation 2: FHFA disagrees on two grounds. First, OIG's recommendation pre-supposes the results and recommendations of the assessment that the Enterprises will perform that is described in Recommendation 1. Second, based on the sampling and analysis presented, FHFA does not believe that the report findings and the examples of deficiencies provide compelling support for the imposition of uniform standards and processes for all pre-foreclosure inspections of properties that collateralize delinquent loans held or guaranteed by the Enterprises.

cc: Rick Hornsby
Eric Stein
John Major

APPENDIX B...

FHFA-OIG's Response to FHFA's Comments

On March 14, 2014, FHFA provided comments to a draft of this report. FHFA partially agreed with recommendation 1 and identified responsive corrective actions. FHFA disagreed with recommendation 2. OIG has attached FHFA's full response as Appendix A and considered it where appropriate in finalizing this report. Appendix C provides a summary of the agency's response to OIG's recommendations and the status of any agreed-upon corrective actions remaining open. In summary, although disagreeing with recommendation 2, FHFA's actions are potentially sufficient to resolve the issue – pending the results of the Enterprises' assessment agreed to in recommendation 1 to determine the effectiveness of their pre-foreclosure property inspection processes.

With respect to recommendation 1, FHFA agreed to issue supervisory direction to each Enterprise to perform and document by January 31, 2015, their assessment of risks relating to pre-foreclosure property inspections as well as a determination on whether standards for pre-foreclosure property inspections should be incorporated into the Enterprise's program for management of third-party relationships. OIG considers FHFA's response to recommendation 1 to be sufficient to resolve the recommendation, which will remain open until OIG receives and reviews the results from the Enterprises' assessments.

OIG's recommendation 2 requested FHFA use the results from the Enterprise assessments to establish quality standards and control processes for inspectors. Given that FHFA has agreed to direct the Enterprises to make a determination on whether standards for pre-foreclosure property inspections should be incorporated into the Enterprise's program for management of third-party relationships, OIG considers FHFA's response to recommendation 2 to be potentially responsive to resolve the recommendation. The recommendation will remain open until the Enterprises have completed their assessments.

In a footnote to FHFA's response, FHFA asserts that the OIG report findings are based on a review of property inspection reports. In fact, the OIG conducted a comprehensive audit on quality controls for the pre-foreclosure property inspection process, including gaining an understanding of controls at 12 of the Enterprises' top servicers that received over 80% of property inspection payments. FHFA's assertion diminishes these efforts by referring only to OIG's review of the inspection reports. Further, the assertion is inconsistent with FHFA's interest in managing risk in third-party relationships, including ensuring the Enterprises have effective controls in place to receive maximum value for the inspections performed and helping to prevent their exposure to fraudulent activities.

Finally, FHFA stated that the report findings do not provide support for the imposition of uniform standards and processes for all pre-foreclosure inspections of properties. At the same time, FHFA cautioned against presupposing the results of the Enterprises' assessments. OIG believes all options, including uniform standards and processes, should remain on the table until the Enterprises have completed the assessments FHFA agreed to in response to recommendation 1.

APPENDIX C...

Summary of Management's Comments on the Recommendations

This table presents management's 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 ($ Millions)	Resolved: Yes or No [a]	Open or Closed [b]
1.	FHFA will issue supervisory direction to each Enterprise to perform and document an assessment of risks and standards related to pre-foreclosure property inspections.	01/31/2015	$0	Yes	Open
2.	FHFA provided a management decision disagreeing with the Enterprises establishing uniform pre-foreclosure inspection quality standards and quality control processes for inspectors. However, action in response to recommendation 1 can result in responsive action to this recommendation.		$0	Yes	Open
Total			$0		

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, and 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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