Federal Housing Finance Agency
Office of Inspector General

# FHFA's Representation and Warranty Framework

Audit Report • AUD-2014-016 • September 17, 2014

At A Glance

September 17, 2014

# FHFA's Representation and Warranty Framework

## Why OIG Did This Report

In June 2011, FHFA initiated the Contract Harmonization Project to improve the Enterprises' contracts and contracting processes with seller-servicers to maximize seller-servicer performance and, thus, economic return on the Enterprises' loan portfolios. The new representation and warranty framework is a component of the Contract Harmonization Project that FHFA prioritized and was implemented in September 2012. The framework's objective is to clarify seller repurchase exposure and liability on future loans sold to the Enterprises.

The new framework relieves sellers from certain representations and warranties, such as those relating to credit underwriting and eligibility of the borrower and property that were formerly effective for the life of the loan. Under the new framework, repurchase relief is granted to sellers if loans acquired by the Enterprises on or after January 1, 2013, meet specific acceptable payment history criteria of 12, 36, or 60 months, depending on the loan product and when it was acquired.

The financial magnitude of FHFA's mandated changes to the framework represents a sea-change to the Enterprises' risk management programs and quality control processes. The financial magnitude is based on the Enterprises' level of single family business following the implementation of the new framework. For example, in 2013, the first year for the new framework, the Enterprises bought approximately 5.6 million loans from sellers with a total unpaid principal balance exceeding $1.13 trillion.

Before these changes, the Enterprises' risk management model primarily relied on reviewing loans for underwriting deficiencies after they defaulted as the representations and warranties were effective for the life of the loans. In contrast, the new framework transfers responsibility to the Enterprises to review loans upfront for eligible representation and warranty deficiencies that may trigger repurchase requests. If the Enterprises fail to do so within the applicable period, their ability to pursue a repurchase request expires if it is based upon a representation and warranty that qualifies for repurchase relief.

Given this elevated risk from the new framework and the financial magnitude of loans involved, FHFA's Office of Inspector General (OIG) audited FHFA's oversight of the Enterprises' implementation of the new representation and warranty framework.

At A Glance

September 17, 2014

## What OIG Found

OIG found that FHFA mandated a new framework despite significant unresolved operational risks to the Enterprises. Neither Enterprise had implemented the processes, procedures, and systems needed to operate within the new framework before it went into effect in 2013.

Freddie Mac completed a risk analysis in August 2012 that identified two systems that it would need to create, in addition to enhancing multiple existing systems, in order to support the new framework by tracking loan level data, and allowing sellers to receive feedback on mortgage risk and appraisal quality prior to loan delivery. Freddie Mac estimated that full functionality of two of these systems was expected to be delivered over two years.

Likewise, Fannie Mae needed to implement or enhance numerous systems to support the new framework and, as of July 2014, is still in the process of enhancing some of those systems. Completion and full roll-out for certain systems are projected to occur in late 2015. As a result, there is an inherent risk for potential errors and the Enterprises may experience credit losses that otherwise may have been mitigated through use of contractual remedies such as repurchases.

OIG also found that FHFA mandated a 36-month sunset period for representation and warranty relief without validating the Enterprises' analysis or performing sufficient additional analysis to determine whether financial risks were appropriately balanced between the Enterprises and sellers. Freddie Mac, in contrast to Fannie Mae which provided analysis limited to a 36-month period, provided FHFA with the results of an internal analysis of loans that indicated loans with a 48-month clean payment history were significantly less likely to exhibit repurchaseable defects than loans with a 36-month clean payment history. Thus, losses to the Enterprise could be less with a longer sunset period. Therefore, FHFA cannot support that the sunset period selected does not unduly benefit sellers at the Enterprises' expense.

## What OIG Recommends

OIG recommends that: (1) FHFA assess whether the Enterprises' current operational capabilities minimize financial risk that may result from the new framework and (2) FHFA assess whether the financial risks associated with the new framework, including the sunset periods, are balanced between the Enterprises and the sellers. FHFA provided responsive comments to the first recommendation, but not the second. OIG requests FHFA to reconsider its disagreement with the second recommendation.

# TABLE OF CONTENTS ..........................................................

# ABBREVIATIONS

| | |
|---|---|
| ADVS | Appraisal Data Validation System |
| AUM | Appraisal and Underwriting Model |
| AUS | Automated Underwriting Systems |
| CU | Collateral Underwriter |
| DER | FHFA's Division of Enterprise Regulation |
| Enterprises | Fannie Mae and Freddie Mac |
| Fannie Mae | Federal National Mortgage Association |
| FHFA or Agency | Federal Housing Finance Agency |
| Framework | Representation and Warranty Framework |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| IRWTS | Internal Representation and Warranty Tracking System |
| LQA | Loan Quality Advisor |
| NUC | Fannie Mae's National Underwriting Center |
| OHRP | FHFA's Office of Housing and Regulatory Policy |
| OIG | Federal Housing Finance Agency, Office of Inspector General |
| QAS | Quality Assurance System |
| RDW | Relational Data Warehouse |
| UCDP | Uniform Collateral Data Portal |

# PREFACE

OIG was established by the Housing and Economic Recovery Act of 2008. OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations. As a result of its work, OIG 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.

Given the array of risks associated with FHFA's mandated new representation and warranty framework, this audit report is part of OIG's proactive audit and evaluation strategy to assess the Agency's related oversight and conservatorship efforts. One aspect of this strategy focuses on FHFA's oversight of the Enterprises' operations under the new framework to ensure they function safely and soundly, and that they appropriately manage associated operational and financial risks.

OIG appreciates the cooperation of all those who contributed to this audit, including officials at FHFA, Fannie Mae, and Freddie Mac. This audit was led by Laura Benton, Audit Director, and Scott H. Smith, Audit Manager, who were assisted by Christopher Sim, Auditor-in Charge.

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

# CONTEXT

In June 2011, FHFA informed the Enterprises that the contracts employed by the Enterprises with their seller-servicers might benefit from harmonization, affording a stronger position for the Enterprises in light of deficiencies in the servicing and delivery process.[1] FHFA undertook a priority project to identify areas that would improve the Enterprises' contracts and contracting process with seller-servicers to ensure they reflected viable business relationships that were actively managed to maximize seller-servicer and portfolio performance and economic return to the Enterprises.

## FHFA Directed the Enterprises to Work with the Agency on Contract Harmonization and Prioritize Work on the Representation and Warranty Framework

Through their contractual agreements with the Enterprises, sellers represent and warrant that the mortgages sold to the Enterprises comply in all respects with the standards outlined in Fannie Mae's *Selling Guide* and lender contracts and Freddie Mac's purchase documents, including underwriting and documentation standards. Seller representations and warranties generally relate to the underwriting of the borrower, the mortgaged premises and the project in which the mortgaged premises is located. If a mortgage is not compliant, the Enterprises may exercise their respective contractual remedies, including the issuance of a repurchase request. The Enterprises' ability to require sellers to repurchase loans is necessary to minimize losses that can be caused by underwriting defects, which ultimately represent losses to U.S. taxpayers.

As a result of dialogue between FHFA and the Enterprises regarding possible areas of contract consistency, the Agency determined that contract harmonization was necessary and appropriate in eight areas. On January 19, 2012, FHFA directed the Enterprises to work with it to align their contracts in eight areas. FHFA identified two areas as top priorities to implement within 180 days: (1) "Consistent and precise benchmarks and measureable standards for repurchase requests and other penalties for nonperformance," and (2) "consistent timelines and collection standards for fees and penalties and additional types of penalties and remedies."[2] The first top priority area of the directive initiated the process of changing the Enterprises' representation and warranty framework.

[1] Seller-servicers are financial entities organized under federal or state jurisdiction that are eligible to sell mortgages to the Enterprises and to service mortgages purchased by the Enterprises.

[2] Repurchase of a loan by a seller is a contractual remedy available to the Enterprises for breaches of the representations and warranties concerning loan eligibility made at the time of sale to the Enterprises.

Under the new framework, relief was granted for representations and warranties relating to the credit underwriting or eligibility of the borrower and the property, including its value, once the loan met specific eligibility criteria. Under the new framework, a sunset period is the required number of months that pass with acceptable pay history following the acquisition of a loan that qualifies sellers for representation and warranty relief. The new framework excluded repurchase relief for certain representations and warranties that remain in effect for the life of the loan, such as misstatements, misrepresentations, omissions, charter violations,[3] and noncompliance with state, federal, and local laws and regulations.

## The Enterprises and FHFA Developed the New Representation and Warranty Framework

In response to FHFA requests to prioritize work on the new framework, the Enterprises began providing information and data to FHFA for its consideration in formulating the terms of the new framework. Between February 2012 and May 2012, the Enterprises provided proposals for the new framework and studies concerning the sunset period. During this timeframe, FHFA conducted meetings with large, medium, and small sellers to develop an understanding of their experiences with repurchases and to discuss possible enhancements to the representation and warranty model.[4]

In preparation for a new framework, Freddie Mac also completed a risk analysis and issued a memorandum on May 11, 2012, detailing the results of its review. The risk analysis concluded that the new framework was a fundamental change in its single-family business practices and might increase the company's overall risk profile.[5] This memorandum explained

[3] Sellers are responsible for representations and warranties for the life of the loan for compliance with the Enterprises' charters. In accordance with their charter requirements, a mortgage loan (or any participation interest therein) must meet all of the following requirements to be eligible for sale to the Enterprises: be secured by property that is residential in nature; be secured by a property located within a U.S. state, the District of Columbia, or any U.S. territory or possession; be secured by a property with four or fewer units, unless sold through Fannie Mae's multifamily mortgage business; have an original principal balance not greater than the applicable maximum loan limit in effect at the time of Fannie Mae's acquisition; and have a loan-to-value ratio of 80% or less of the security property's value at the time Fannie Mae acquires the loan, or if the mortgage has a loan-to-value ratio in excess of 80%, the mortgage must meet specific criteria.

[4] The feedback FHFA received from sellers included the following: support for a sunset period ranging from 24 to 48 months, a phase-in of the sunset period to allow sellers to incorporate new rules into their systems and operations, and performance of quality control within a defined window after delivery of the loan (e.g., 6 months) as defects are easier to cure if identified earlier in the process.

[5] Freddie Mac prepared a final risk analysis memo dated August 23, 2012, to supplement its initial risk analysis. According to this final risk analysis, Freddie Mac believed that the key risks identified in the risk analysis memorandum dated May 11, 2012, were still valid and that no significant new risks were discovered. Additional detail regarding some of the previously identified risks was provided, but did not supersede any of the original key risks.

that because the changes to the framework will be mandated by FHFA, Freddie Mac's ability to maintain its franchise value and minimize risk associated with the proposed framework was limited. Further, the aggressive timelines associated with the significant business changes impacted Freddie Mac's ability to consider and propose alternatives and also elevated the risk of implementation errors.

According to Freddie Mac's risk analysis, its initial credit risk may be lower because additional pre-funding and post-funding risk assessments may be performed, and the scope of quality control sampling and review for performing and non-performing loans will expand, potentially resulting in more repurchases. However, after the to-be-determined sunset date, any credit risk on eligible loans that is related to selling representations and warranties will be transferred from the seller to Freddie Mac. Thus, the Enterprise's credit risk would increase as loans moved past the sunset date. Freddie Mac concluded that accurate identification of loan level sunset eligibility, the seller representation and warranty holder at any given time, and the sunset date are critical to monitoring credit risk and accurately enforcing quality control sampling, remedies, and repurchases. Yet, building out the systems to perform these tasks would take time.

Freddie Mac's risk analysis also identified a number of significant operational risks that resulted from the breadth of the proposed changes to the framework and an aggressive implementation timeline in the areas of people, processes and procedures, and technology/systems as follows:

- **People:** This effort will require multiple resources across the company to support the system, policy, and model changes. The aggressive timelines and competing priorities may create stress on existing resources and increase the likelihood of implementation errors. It is likely that additional resources, such as full-time employees to support increased quality control activity, will be necessary to build and support the new infrastructure.

- **Processes and Procedures:** Numerous processes and procedures must be updated or developed to support the initiative. Various reporting processes across the company will need to be adjusted and modified to capture new data and accommodate new data sources.

- **Technology/Systems:** Numerous systems across Freddie Mac must be built, modified, or enhanced to support the concept of a sunset period for certain selling representations and warranties. Various applications must be able to identify the appropriate selling representation and warranty holder of a loan on a historical and prospective view. Six major systems have been identified that require enhancements to accommodate new data or new source systems. Two systems will need to be built: an eligibility assessment tool, and a new representation and warranty tracking system. The implementation of this project will require a high level of effort and coordination among various groups in the organization to minimize or avoid any systemic operation deficiencies.

Fannie Mae did not prepare a similar risk analysis. However, Fannie Mae's Internal Audit completed a pre-implementation review of the new framework and issued its findings on January 2, 2013, one day after the new framework became effective. Internal Audit identified fifteen individual work streams that were related to developing policies consistent with FHFA's directive and communicating the new approach to sellers, refining existing defect definitions and actions for findings, and developing new analytical tools to identify and select a statistically valid sample population. These work streams included fielding Collateral Underwriter (CU) and the Appraisal and Underwriting Model (AUM), and updating the National Underwriting Center (NUC) loan review processes and its supporting Quality Assurance System (QAS).

Most notably, Internal Audit found that although there appears to be a clear definition of the objectives of the work streams, there did not seem to a be a formally documented, integrated vision for the Enterprise on how the redesigned processes and systems will operate in the future, or how other stakeholders in the Enterprise may be affected by the change. Internal Audit concluded that until Fannie Mae management can clearly articulate the Enterprise-wide impacts of the new framework, the full scope of efforts needed to implement the change and effectively manage the associated risks will not be known. Internal Audit also concluded that risk related to the implementation of the framework, such as inadequate loan selection methodology, loan review training, vendor reporting, and system updates, would not be mitigated until after the January 1, 2013, effective date for the new framework.

On July 1, 2013, Fannie Mae's Internal Audit completed follow-up on the January 2013 pre-implementation review of the new representation and warranty framework. The objective of the follow-up review was to evaluate operational readiness of the new processes and related controls supporting the new framework, and to assess pre-implementation controls over the new technology and models. As part of the review, Fannie Mae's Internal Audit looked at the governance and design for CU and AUM, as well as change management controls over QAS upgrades. Internal Audit found that significant progress had been made related to modeling and tools to support the framework; however, they noted that significant model and application updates were planned, and key resources and tools needed to support the new framework were not fully online. Additionally, while Internal Audit did not test the new models or output from the new applications or the efficacy of controls to support the framework, it identified two control issues for management's attention.[6]

- The Fannie Mae CU application entered production without a completed review by Model Review & Oversight.
- Segregation of duties controls between development, configuration management, and production execution were not adequate for the Fannie Mae AUM Analytics.

## FHFA's Directive Implementing the New Representation and Warranty Framework

FHFA reviewed the proposals, studies, and risk analyses provided by the Enterprises and moved forward with its plans to announce a new framework in September 2012.

With regard to a sunset period, Fannie Mae submitted data and analysis to FHFA supporting a 36-month sunset period that did not include any other alternative sunset periods for comparative purposes. Freddie Mac submitted data and analysis supporting a 48-month sunset period and compared sunset periods of 36 and 48 months. FHFA's Office of Housing and Regulatory Policy (OHRP) acknowledged that the 48-month sunset period inherently posed less risk to the Enterprises than a 36-month sunset period, but decided to place more importance on Fannie Mae data that it believed showed a surprisingly low percentage of underwriting findings and defects for loans that achieved 36 months of on-time payments and subsequently defaulted. Therefore, OHRP did not conduct further analysis of Freddie Mac's proposed 48-month sunset period.

OHRP also solely relied on the representations and data supplied by the Enterprises to inform its decision on the sunset period. For example, OHRP did not independently study the risks associated with each sunset period or ensure the data and analysis submitted by the Enterprises was validated. OHRP also did not elicit the involvement of other FHFA offices or procure outside expertise to help analyze or validate Enterprise data.

OHRP explained that Freddie Mac recommended a 48-month sunset period because it had not made a decision on what tools it was going to use to leverage electronic appraisal and loan delivery information that it was receiving. To address this concern, FHFA asked Fannie Mae to conduct a demonstration of CU for Freddie Mac so it could consider using the same

[6] Fannie Mae's management has addressed these two control issues. Internal Audit has verified the segregation of duties between development, configuration management, and production activities for AUM analytics and closed this issue. Internal Audit is expected to complete its review of management actions resulting from the review of CU by December 2014.

system. CU, however, was only in the initial implementation stage.[7] Ultimately, Freddie Mac opted to use another tool after some preliminary testing. Despite acknowledging Freddie Mac's concerns over the readiness of its systems, OHRP continued to implement the new framework and told OIG that it believed the Enterprises had the necessary data and information to identify loan defects sooner in the process.

OHRP then compiled a concept approval request recommending a new framework to FHFA's Acting Director. A draft term sheet dated May 24, 2012, was included within the concept approval materials. The new framework received approval from FHFA's Acting Director on June 5, 2012. Following this approval, on June 8, 2012, FHFA directed the Enterprises to implement the new framework as defined within a term sheet that included the following broad categories:

- Selling Representation and Warranty Relief
- Loan Level Eligibility Criteria
- Automatic Repurchase Triggers
- Exclusions from Representation and Warranty Relief
- Repurchase Timelines and Remedies
- Additional Requirements and Controls (Pre- and Post-Funding Quality Control and Due Diligence)

The sunset period defined within the "Loan Level Eligibility Criteria" section of the term sheet was 36 months of consecutive on-time payments or 60 months if the loan was current on the 60th month, provided there were no more than two 30-day delinquencies in the first 36 months. OHRP explained that FHFA's then Acting Director and other senior executives were briefed in June 2012 and several key decisions were made, including the decision for this sunset period. Also, the term sheet included a section entitled, "Additional Requirements and Controls (Pre and Post Funding Quality Control and Due Diligence)" that required the use of automated underwriting systems (AUS) or risk assessment tools approved or used by each Enterprise before and after loan delivery, delivery of Uniform Loan Delivery Dataset (ULDD) data and electronic appraisals, collateral valuation checks, enhanced performing loan

[7] Fannie Mae's CU system for underwriting collateral is not broadly available. It is currently used by six seller-servicers. Two seller-servicers began using it in September 2012, one in November 2012, and the other three between March 2014 and May 2014. According to Fannie Mae, this system tool is being upgraded to begin a broader industry roll out.

sampling, and continued sampling of non-performing loans and eligibility checks on settlement statements.

FHFA completed an amended term sheet on September 6, 2012, and four days later directed the Enterprises to replace the existing framework with the amended framework and commence implementation. The amended term sheet included additional details regarding loan level eligibility criteria and exclusions from representation and warranty relief after the relief date. The most significant changes were the addition of three loan level eligibility criteria, including a sunset period of 12 months for a Freddie Mac Relief Refinance Mortgage or a Fannie Mae Refi Plus or Fannie Mae DU Refi Plus mortgage.[8]

On September 11, 2012, FHFA and the Enterprises announced the launch of a new representation and warranty framework for loans sold or delivered on or after January 1, 2013. The announced highlights of the new framework were:

- Sellers were relieved of certain repurchase obligations for loans that met specific payment requirements; for example, representation and warranty relief were provided for loans with 36 months of consecutive, on-time payments.
- Home Affordable Refinance Program (HARP) loans were eligible for representation and warranty relief after an acceptable payment history of only 12 months following the acquisition date.
- Information about exclusions for representation and warranty relief, such as violations of state, federal, and local laws and regulations, were detailed.
- Fannie Mae and Freddie Mac were to continue to make available for sellers a range of tools to help improve loan quality.

FHFA's announcement of the new framework also acknowledged that it moved the focus of quality control reviews from the time a loan defaults up to the time the loan is delivered to Fannie Mae and Freddie Mac. FHFA also directed the Enterprises to:

- Conduct quality control reviews earlier in the loan process, generally between 30 to 120 days after loan purchase.

[8] The Enterprises did not submit any information for FHFA to consider regarding the 12-month sunset period applicable to these refinance mortgages despite these types of loan products accounting for a significant portion of the Enterprises' acquisitions. For example, in 2013, the first year for the new framework, the Enterprises bought approximately 1.6 million refinance mortgages with an unpaid principal balance exceeding $262 billion that were potentially subject to the 12-month sunset period.

- Establish consistent timelines for sellers to submit requested loan files for review.
- Evaluate loan files on a more comprehensive basis to ensure a focus on identifying significant deficiencies.
- Leverage data from the tools currently used by Fannie Mae and Freddie Mac to enable earlier identification of potentially defective loans.
- Make available more transparent appeals processes for sellers to appeal repurchase requests.

### FHFA Modifications to the New Representation and Warranty Framework

On May 12, 2014, the Enterprises announced that, at the direction of FHFA, a number of significant enhancements to the framework that became effective on January 1, 2013, were being made for loans delivered to the Enterprises on and after July 1, 2014. These changes included:

- Relaxing the acceptable payment history requirement for determining when a mortgage was eligible for relief from the selling representations and warranties. For mortgages other than certain refinance mortgages, relief requirements were relaxed so that mortgages that would have previously obtained relief upon the borrower's 60th monthly payment would receive relief upon the borrower's 36th monthly payment.
- Introducing an additional path for eligible mortgages to obtain relief from selling the representations and warranties. In addition to the payment history path, sellers would also obtain relief from the representations and warranties if there were a satisfactory conclusion of an Enterprise quality control review of the mortgage.
- Providing sellers with written notices of mortgages that met the eligibility requirements for relief from the selling representations and warranties.
- Implementing an alternative to repurchase that might allow a seller to "stand in" in lieu of repurchasing the mortgage. The Enterprises would not automatically require a repurchase when notified that primary mortgage insurance had been rescinded on a mortgage.

Figure 1 below illustrates the changes to the new framework for loans acquired by the Enterprises after July 1, 2014.

**FIGURE 1**. DIFFERENCES BETWEEN VERSION 1 AND VERSION 2 OF THE NEW FRAMEWORK FOR NON-REFINANCED LOANS

| Relief Criteria | Version 1 – Announced on September 11, 2012 | Version 2 – Announced on May 12, 2014 |
|---|---|---|
| Effective Dates | Effective for mortgages sold on and after January 1, 2013, and before July 1, 2014 | Effective for mortgages sold on and after July 1, 2014 |
| Number of required consecutive monthly payments after the Enterprise settlement date | 36 | 36 |
| Number of delinquencies permitted during the first 36 monthly payments after the Enterprise settlement date in order to be eligible for relief after the 36th monthly payment | No delinquencies permitted | Two delinquencies of 30 days or less and the 36th monthly payment is not delinquent |
| Opportunity to re-establish acceptable payment history if there were delinquencies in the first 36 monthly payments after the Enterprise settlement date? | Yes, as of the 60th monthly payment, provided there were no more than two delinquencies of 30 days or less with the first 36 months and the 60th monthly payment is not delinquent | Not applicable |
| Eligible for relief after satisfactory conclusion of quality control review? | No | Yes |

Source: Freddie Mac Seller-Servicer Bulletin 2014-8 (May 12, 2014).

On May 13, 2014, FHFA released its *2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*. Coinciding with the modifications to the framework announced the day before, FHFA's strategic plan indicated that in an effort to provide greater market certainty, FHFA would evaluate and act, where appropriate, on changes to the framework. Also, a component of the first strategic goal provided clarity concerning the Enterprises' framework: "Maintain, in a safe and sound manner, foreclosure prevention activities and credit availability for new and refinanced mortgages to foster liquid, efficient, competitive and resilient national housing finance markets."[9] Further, the strategic plan stated that lack of clarity about representation and warranty requirements can contribute to decisions by sellers to add credit overlays that can unnecessarily limit access to credit.[10] Greater certainty regarding both origination and servicing obligations should help increase sellers' willingness to more fully provide credit within the Enterprises' underwriting standards.

FHFA is planning future changes to the new framework and is addressing the scope of life of loan exemptions. FHFA recognizes lenders' concerns about how these exemptions apply to loans that have passed quality control reviews or have met the 36-month sunset period and will work toward clarity on this issue. During the next year, FHFA will also explore:

- Establishing an independent dispute resolution program when lenders believe a repurchase is unwarranted;
- Developing cure mechanisms for loan defects rather than relying solely on repurchases; and
- Providing additional clarity on Fannie Mae and Freddie Mac underwriting rules.

[9] This strategic goal is also a major component [40%] of FHFA's 2014 Scorecard For Fannie Mae, Freddie Mac, and Common Securitization Solutions. With respect to the representation and warranty framework, the Enterprises are to continue to improve the framework for originations and provide additional clarity regarding servicing representations and warranties and remedies for poor performance, including compensatory fees.

[10] A credit overlay is terminology that describes a condition where sellers' underwriting standards are more stringent than those of the Enterprises. For example, a lender may place additional conditions, such as higher credit score requirements, on top of the acceptable credit standards of each Enterprise.

# FINDINGS ........................................................................

## 1. FHFA Mandated a New Representation and Warranty Framework Despite Significant Unresolved Operational Risks to the Enterprises

FHFA directed the Enterprises to implement the new framework without allowing sufficient time for them to fully implement and test pre- and post-loan delivery risk assessment tools, systems used to track loan information related to the new framework, and systems that support the Enterprises' quality control processes. As a result, there is potentially unmitigated risk of errors in the new loan review framework and the Enterprises may experience credit losses that otherwise could have been avoided both by the structure of the framework and the systems and processes employed to implement it. Nonetheless, FHFA officials have informed OIG that the Enterprises have adequate time to prepare for supporting the new framework that went into effect in January 2013 and have until January 2016 to prepare since that is the earliest point at which relief could be granted for the vast majority of loans.

### *Enterprise System Enhancements*

Freddie Mac acknowledged in its August 2012 internal risk analysis memorandum provided to FHFA that in order to reduce purchases of non-compliant loans with a goal of reducing credit losses, robust pre- and post-delivery risk assessment tools and processes were critical. In the months following, Freddie Mac continued to develop three key systems in addition to enhancing various other systems and processes to help support the framework (see Figure 2).

**FIGURE 2.** FREDDIE MAC SYSTEMS DEVELOPED TO SUPPORT NEW FRAMEWORK

| System Name/Description | Implementation Date/Status |
|---|---|
| Loan Quality Advisor (LQA): Evaluates loan data and provides feedback to sellers on Freddie Mac's assessment of mortgage risk prior to loan delivery. | New application that was and is still being implemented over a series of releases. The latest release (#3) was deployed in March 2014. |
| Appraisal Data Validation System (ADVS): Receives appraisals from the Uniform Collateral Data Portal (UCDP) and provides feedback on appraisal quality to sellers prior to loan delivery. | New application/portal/tool that was implemented over a series of releases. The latest release (#4) was deployed in June 2014 with additional releases planned for 2014 and 2015. |
| Internal Representation and Warranty Tracking System (IRWTS): Tracks representation and warranty loan level information including the representation and warranty holder and releases of liability. | New application that was and is still being implemented over a series of releases. The latest release was deployed in June 2014 with future releases scheduled for 2014 and early 2015. |

Source: Internally generated based on information provided to OIG by Freddie Mac.

OIG found that these systems were not expected to be fully implemented prior to January 1, 2013, the effective date of the framework as mandated by FHFA, and they are still being implemented. As of August 2012, Freddie Mac reported in its risk analysis provided to FHFA that the Eligibility Assessment Confirmation tool (LQA) and the Appraisal Data Validation System (ADVS) tools were not available. However, projects were under way to deliver some functionality during the first quarter of 2013, and full functionality was expected to be delivered over the following two years. Freddie Mac also reported that a new tracking system (IRWTS) had to be built to support the new framework. The importance of this system is highlighted by Freddie Mac's assessment that its most significant process risk is associated with accurately capturing the representation warranty holder throughout the life of the loan. Further, this assessment indicates that a tracking system must be built to support the representation and warranty sunset period to mitigate operational risk.

In addition, FHFA was aware that Freddie Mac did not have a system tool to assess electronic appraisal information and had not made a decision regarding such a tool as of September 2012. Accordingly, in conjunction with Fannie Mae, FHFA arranged a demonstration of Fannie Mae's CU system (Fannie Mae's appraisal system) for Freddie Mac to consider. At the time, FHFA was aware that this system was only being tested among three of Fannie Mae's seller-servicers and was not a proven solution.[11] Due to Freddie Mac's concerns regarding CU, including its ability to connect with other commercially available tools/applications and

[11] See footnote 7, *supra*.

its suitability for business processes, Freddie Mac developed a new system to fulfill this critical function. This new system, ADVS, was initially deployed in June 2014 to include functionality to evaluate appraisal quality.

Despite FHFA's awareness that Freddie Mac would not have the systems and tools in place it deemed necessary to help identify non-compliant loans and reduce credit losses, FHFA continued with its January 1, 2013, implementation for the new framework. Consequently, FHFA did not determine the impact of system implementation delays on Freddie Mac's ability to identify loan defects prior to the applicable sunset period (12 or 36 months) for loans purchased after January 1, 2013, or ensure that mitigating controls were in place. Further, based on information OIG obtained from Freddie Mac in July 2014, its systems still may not have the necessary functionality to fully support the new framework.[12]

As shown in Figure 2, LQA, ADVS, and IRWTS are still being implemented through a series of releases. For example, IRWTS was initially deployed in October 2013 to include functionality to internally establish and monitor framework sunset dates. In November 2013 and June 2014, additional releases were deployed to add functionality to fulfill and support additional framework requirements such as new data control reports and establishing rules for bifurcated servicing transfers. Further releases are planned for late 2014 and early 2015 to implement capabilities to comply with the new framework mandate to provide record of relief to seller/servicers that satisfy applicable sunset eligibility requirements.

Likewise, FHFA did not determine whether Fannie Mae had the necessary systems in place to support the framework. Based on information provided to OIG in July 2014, Fannie Mae had to implement or enhance numerous systems to support the new framework and is still enhancing CU and Relational Data Warehouse (RDW) to leverage their full functionality (see Figure 3).

[12] FHFA's analysis supporting its enhancements to the new framework that were announced in May 2014 also did not address whether the Enterprises had appropriate systems, tools, and processes in place to support the new framework as well as the enhancements that were to be effective on July 1, 2014, only two months later.

**FIGURE 3.** FANNIE MAE SYSTEMS DEVELOPED TO SUPPORT NEW FRAMEWORK

| System Name/Description | Implementation Date/Status |
|---|---|
| Early Check: Provides feedback on loan eligibility to sellers prior to loan delivery. | June 2013 – Fannie Mae enhanced Early Check to include additional loan delivery edits for loan quality purposes, helping sellers to ensure that loans are eligible for delivery to Fannie Mae from a credit/data perspective earlier in the loan manufacturing process. |
| Quality Assurance System (QAS): Tracks the status of loan reviews for loans that Fannie Mae has selected for quality assurance reviews. | July 2014 – Fannie Mae completed enhancements to incorporate new quality control workflows and the new loan defect framework. |
| Collateral Underwriter: Evaluates the quality of appraisal information and is expected to play a central role in post purchase reviews to detect appraisal data errors and inconsistencies among appraisers and appraisals, among other things. | Initial implementation June 2013 – As of July 2014, CU was piloted with six Fannie Mae seller-servicers. Broader industry rollout is expected with a future release. |
| Appraisal and Underwriting Model: Performs a risk assessment of all new loans by measuring the likelihood of loan defects. | June 2013 |
| Relational Data Warehouse: RDW is the current system of record for tracking the representation and warranty status for all loans at the individual loan level. The RDW solution tracks status by payment history (implemented in February 2014), but does not currently interface with QAS. | Third Quarter of 2015 – Full integration of the representation and warrant implications of QC review results and corresponding remedial actions with RDW will provide a central system of record. |

Source: Internally generated based on data provided to OIG by Fannie Mae.

### *FHFA Examination Coverage*

OIG also found that despite significant changes to the Enterprises' systems and processes, FHFA has performed limited work to ensure that necessary controls are in place and operating effectively prior to the applicable sunset periods. The Enterprises needed to shift the primary focus of their quality control efforts from nonperforming loans where underwriting defects may be more obvious to the larger population of performing loans within the sunset period. Yet, the Division of Enterprise Regulation (DER) has performed limited work with respect to the quality control processes that Freddie Mac implemented to accommodate the new framework.[13] Aside from an evaluation of Relief Refinance Mortgage Performance following the sunset period during the third quarter of 2014, FHFA does not intend to conduct further reviews specific to the new framework quality control processes within the scope of the 2014 examination plan, but will consider incorporating this activity into the 2015 plan.[14] Furthermore, DER has not examined any of the systems that Freddie Mac identified in its risk analysis that it needed to establish or enhance to support the new framework.

As for Fannie Mae, DER has no scheduled exams that cover the new framework or the quality control processes and systems needed by the Enterprise to accommodate the framework. The Agency indicated that there was coverage from ongoing monitoring of the NUC through attending executive meetings, but there was no targeted monitoring or specific examinations of the framework.

FHFA's implementation of the framework in January 2013 did not adequately consider operational risks related to implementation of an appropriate infrastructure to support the new framework through upfront monitoring of loan quality and post-purchase quality control prior to the sunset period. This lack of due diligence on FHFA's part is significant since the implications of not having the necessary systems, tools, and processes in place impacts the Enterprises' ability to: (1) conduct quality control reviews earlier in the loan process, generally between 30 to 120 days after loan purchase; (2) evaluate loan files on a more comprehensive basis to ensure a focus on identifying significant deficiencies, and (3) leverage data from the tools currently used by Fannie Mae and Freddie Mac to enable earlier identification of potentially defective loans as mandated by FHFA. Without adequate systems and processes, achieving a positive economic outcome for the Enterprises through implementation of the new framework is uncertain. Conversely, the sellers stand to benefit from the lack of preparation as loans start to pass the sunset dates without thorough screening of their quality.

[13] FHFA completed a targeted examination of Freddie Mac's quality control sampling methodologies for credit risk management on March 31, 2014, and concluded that performing and non-performing sampling methodologies were adequate.

[14] Freddie Mac Relief Refinance mortgages, Fannie Mae Refi Plus, and Fannie Mae DU Refi Plus mortgages have a sunset period of either: (a) 12 consecutive months of on-time payments in accordance with the refinanced loan's terms following acquisition, or (b) following acquisition, current on the 60th month in accordance with the refinanced loans terms, provided that there are no more than two 30-day delinquencies and no 60-day delinquencies in the first 36 months.

## 2. FHFA Mandated a 36-Month Sunset Period for Representation and Warranty Relief Without Validating the Enterprises' Analyses or Performing Sufficient Analysis Needed to Appropriately Balance Financial Risk Between the Enterprises and Sellers

FHFA mandated a 36-month sunset period for representation and warranty relief using inconsistent and incomplete analyses from the Enterprises that were not validated or independently tested. As a result, the cost/benefit of this approach has not been clearly demonstrated. Further, FHFA understood from analysis provided by Freddie Mac that a 48-month sunset period might carry less risk to the Enterprises, but selected the 36-month sunset period in the absence of any quantifiable benefit to the Enterprises. Accordingly, the 36-month sunset period may not appropriately balance financial risk between the Enterprises and sellers.

### *Enterprise Analyses*

FHFA's decision-making process concerning the new framework was not supported by complete, thorough, and consistent analysis. FHFA asked each Enterprise to provide their recommendation for a sunset period in the new framework, accompanied by supporting data, but did not require each Enterprise to perform consistent analyses using comparable data. As a result, the analyses and recommendation received from each Enterprise were inconsistent. Fannie Mae recommended a 36-month sunset period and Freddie Mac recommended a 48-month sunset period.[15] As reflected in Figure 4 below, the analyses supporting each recommendation were not uniform and therefore not comparable across each Enterprise. Nonetheless, FHFA did not perform any procedures to validate the underlying mortgage data, test the results furnished by the Enterprises, or direct the Enterprises to re-work their analysis using the same criteria, such as consistent sampling methodologies and vintages of the mortgages selected for review. FHFA also did not develop an understanding of any measures taken by the Enterprises to validate this data. FHFA informed OIG that due to differences in data availability and systems at each Enterprise, it is impossible to receive analyses with identical data and characteristics. FHFA also stated that it is not possible to independently validate specific GSE data.

[15] FHFA's frequently asked questions document that was attached to its September 11, 2012, news release concerning the launch of the new representation and warranty framework stated: "Among industry members consulted, there were various suggestions on the timing of the relief, the most prevalent being 36 months. Freddie Mac and Fannie Mae, in consultation with FHFA, concluded that 36 months would enable Fannie Mae and Freddie Mac to conduct sampling and analyses needed to confirm eligibility of the mortgage loans acquired, and would show the borrower's ability to repay the loan according to its terms."

In addition, FHFA did not require Fannie Mae to prepare any analyses to assess a 48-month sunset period, which Freddie Mac's analysis indicated carried less risk than a 36-month sunset period. Furthermore, FHFA did not require the Enterprises to provide data that would show whether the new framework was cost beneficial over the existing framework. FHFA informed OIG that cost/benefit considerations, such as determining if the new framework had economic advantages over the existing framework, were not relevant to the purpose of revising the representation and warranty framework. Rather, the focus was on ensuring broader access to credit.

**FIGURE 4.** INCONSISTENCIES BETWEEN THE ENTERPRISES' SUNSET PERIOD ANALYSIS AND RECOMMENDATIONS

| Fannie Mae | Freddie Mac |
|---|---|
| Analysis performed for 36-month sunset period | Analysis performed for 36- and 48-month sunset periods |
| Sampled loans acquired from 2003 through 2010 | Sampled loans funded during 2004, 2005, and 2006 |
| Sample size of 43,103 loans | Sample size of approximately 8,000 loans |
| No information for defaults after year 5 | Includes information for lifetime defaults for loans with 36- and 48-month clean pay history |
| Recommendation: 36-Month Sunset Period | Recommendation: 48-Month Sunset Period |

Source: FHFA OHRP *Concept Approval Request* (May 25, 2012).

According to FHFA's *Concept Approval Request*, data provided by Fannie Mae indicates that for 2003-2010 acquisitions with 36 consecutive on time payments, approximately 6.1% of the loans defaulted in years 4 and 5 and subsequently had defects. FHFA concluded that for those loans with a clean payment history in the first 36 months that default in the subsequent two years, there is a very small percentage with a defect so a repurchase or some other remedy could be requested.[16]

Freddie Mac's scenario analysis data from 2004-2006 acquisitions indicates that the percentage of the first 5-year defaults found in mortgages with 36 months of clean pay history that subsequently defaulted in years 4 and 5 that could have a repurchaseable defect was approximately 3.7%; meanwhile, loans with 48 months of clean pay history that subsequently

[16] The very small percentage referred to by FHFA is 6.1%. According to Fannie Mae's analysis, this percentage was derived by dividing the number of reviewed loans with 36-month clean pay histories that defaulted in years 4 and 5 with findings (2,634) by the total number of those loans that defaulted (43,103), which yields a finding rate of 6.11%.

defaulted in year 5 and could have had repurchaseable defects was approximately 1.3%.[17] FHFA concluded that given the improved quality of underwriting practices and standards, these percentages should be smaller in more recent book years, as well as in prospective business. Analytics, according to FHFA, also reveal that a very high percentage of acquisitions do in fact achieve 36 months of consecutive on-time payments following acquisition—approximately 90% of Freddie Mac's fixed-rate mortgages in funding years 2004-2006. Therefore, the majority of acquisitions should meet the clean pay history eligibility criteria.[18]

#### *FHFA Independent Validation*

FHFA did not independently analyze financial risks posed to the Enterprises by the sunset periods or ask either Enterprise to perform any further analysis. Neither Enterprise provided information that detailed the years in which each loan defaulted over the life of the loan and Fannie Mae provided no information about lifetime defects for loans with a 36-month clean payment history that defaulted after year 5. This is significant since the defect rate on a defaulted loan is higher over the life of the loan than for defaults in years 4 and 5.

For example, according to Freddie Mac's analysis, defects on loans with 36 months of clean pay history within five years is 3.7%, but increased to 12.3% for the lifetime of the loan.[19] Consequently, most of the risk of foregoing potential recoveries appears to occur after year 5. Although Freddie Mac did not quantify the percentages in dollars, this difference is the risk being borne by the Enterprises that no longer have the repurchase remedy available to them if underwriting quality problems exist. Moreover, this increased defect risk cannot be further analyzed or quantified without default rate information that could help identify peak default years beyond year 5 and resulting credit loss risk. For example, Freddie Mac reported in its May 2014 *Credit Results Management Summary* that for its loan portfolio as of May 31, 2014, 96% of its credit losses resulted from loans originated in 2010 or prior. While OIG

---

[17] The analysis provided by Freddie Mac also provided comparable lifetime of loan defects that averaged 12.3% (36 months of clean pay history) and 8.3% (48 months of clean pay history). In the process of validating this information pursuant to its review of OIG's report, Freddie Mac identified an error and issued a disclaimer. Freddie Mac's disclaimer states in part that this information has been assembled on an expedited basis in order to provide FHFA with information responsive to its request. As such, it reflects preliminary information, and it has not been subjected to the rigorous review to which Freddie Mac typically subjects information prior to dissemination and that the expedited nature of the production should be kept in mind as this information is reviewed.

[18] This percentage indicates that completing quality control reviews within 36 months of acquisition is critical for the Enterprise since 90% of the loans in the sample would qualify for representation and warranty relief under the new framework.

[19] See footnote 17, *supra*.

recognizes that this percentage includes losses on legacy loans still on Freddie Mac's books, the data suggests that default and credit loss risk is highest after three years from loan origination, not before.[20]

In addition, FHFA did not follow up with Fannie Mae on defect rates on defaulted loans with 48 months of clean pay history or assess the financial impact that either sunset period would have on the Enterprises. Instead, FHFA mandated a 36-month sunset period knowing that it exposed the Enterprises to increased financial risk over a longer sunset period without measurable benefits.

[20] Many loan products, for example, have adjustable rates and borrowers can experience payment shock resulting from increasing interest rates.

# CONCLUSION

The new representation and warranty framework is a component of FHFA's Contract Harmonization Project that was designed to improve the Enterprises' contracts with sellers, maximizing both seller performance and economic return on the Enterprises' loan portfolios. The operational and financial risks of implementing the new framework should be appropriately balanced between the Enterprises and sellers and include consideration of the Agency's goals and objectives including those related to credit availability. OIG's work demonstrates that strengthening the Agency's oversight will help FHFA achieve its goals and assist the Enterprises with operating safely and soundly under the new framework.

# RECOMMENDATIONS

OIG recommends that FHFA:

1. Assess the current state of the Enterprises' critical risk assessment tools, representations and warranties tracking systems, and any other systems, processes, or infrastructure to determine whether the Enterprises are in a position to minimize financial risk that may result from the new framework. The results of this assessment should document any areas of identified risk, planned actions, and corresponding timelines to mitigate each area of identified risk. Further, this assessment should provide an estimate of when each Enterprise will be reasonably equipped to work safely and soundly within the new framework.

2. Perform a comprehensive analysis to assess whether financial risks associated with the new representation and warranty framework, including with regard to sunset periods, are appropriately balanced between the Enterprises and sellers. This analysis should be based on consistent transactional data across both Enterprises, identify potential costs and benefits to the Enterprises, and document consideration of the Agency's objectives.

# OBJECTIVES, SCOPE, AND METHODOLOGY ..............................

The objective of this performance audit was to assess FHFA's oversight of Fannie Mae's and Freddie Mac's implementation of the new representation and warranty framework that began in January 2013.

OIG conducted this performance audit from January 2014 through June 2014. OIG conducted this audit in Washington, D.C., at the headquarters of FHFA and Fannie Mae, and in McLean, VA, at Freddie Mac's headquarters.

The scope of OIG's audit involved FHFA's new representation and warranty framework, the Enterprises' ability to function in a safe and sound manner under the new framework, and whether operational and financial risks were appropriately balanced between the Enterprises and their sellers. For purposes of this audit, OIG did not assess controls over computer-processed data.

To achieve the audit objective, OIG:

- Reviewed FHFA directives, guidelines, announcements, analyses, and other internal and external communications and documents concerning the new representation and warranty framework that became effective in January 2013;
- Interviewed Fannie Mae and Freddie Mac officials responsible for providing information to FHFA in response to requests for research and analysis regarding potential changes to the representation and warranty framework; and
- Interviewed FHFA officials responsible for developing elements of the new representation and warranty framework and providing guidance to the Enterprises on implementation of the new framework.

OIG also assessed the internal controls related to the audit objective. Internal controls are an integral component of an organization's management that provide reasonable assurance the following objectives are achieved:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed on this performance audit, OIG considers its findings on FHFA's new representation and warranty framework to be significant deficiencies within the context of the audit objective.

OIG conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for OIG's 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: Sandra Thompson, Deputy Director, Division of Housing Mission and Goals
Nina A. Nichols, Acting Deputy Director, Division of Enterprise Regulation

SUBJECT: Audit Report: *FHFA's Representations and Warranties Framework* (AUD-2014-006)

DATE: September 3, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the Federal Housing Finance Agency, Office of the Inspector General (OIG) draft audit report, *FHFA's Representation and Warranties Framework*. FHFA-OIG conducted this audit for two purposes. First, the OIG evaluated FHFA's assessment of risks of the new representation and warranty framework. Second, the OIG assessed FHFA's oversight of the implementation at the Enterprises.

The Report describes the Representation and Warranties Framework (RAWF) that was issued September 2012 and it describes the sunset period for loan repurchases, and the quality control and review processes conducted at the Enterprises. The Report focuses on the 36 month loan sunset time period, and compares it to a proposed analysis of a 48 month sunset period. Within the Report, the OIG expressed concerns regarding the level of analysis conducted to identify and address risks to the Enterprises in establishing and implementing a 36-month sunset period. Fannie Mae and Freddie Mac both participated in the development of the framework and identified areas of risk and/or policies that needed to be strengthened during the implementation phase. The Report recommends: (1) assessment of the Enterprises' risk and framework implementation tools; (2) analysis of the financial risks associated with representation and warranty framework. Division of Enterprise Regulation (DER) will address the first recommendation, and Division of Housing Mission and Goals (DHMG) will address the second recommendation in this management response.

In May 2014, the Enterprises significantly changed the sunset period of the RAWF in the following two ways: (1) allowing two delinquent payments in the first 36 months after acquisition and (2) providing lenders with a written notice of relief for underwriting the borrower property, while eliminating automatic loan repurchases for rescinded mortgage insurance policies. These decisions were made in collaboration with FHFA and the lending community. Future revisions to the framework are expected, with the goal of clarifying lender repurchase exposure and liability to ease credit overlays and improve access to mortgage credit for consumers consistent with the safety and soundness of Enterprise operations.

Going forward, DHMG agrees to enhance the documentation and analysis, including identifying and addressing Enterprise risks, surrounding the decisions that will impact the Representation and Warranties Framework.

**Recommendation #1:**
OIG recommends that FHFA assess the current state of Enterprises' critical risk assessment tools, representations and warranties tracking systems, and any other systems, processes, or infrastructure to determine whether the Enterprises are in a position to minimize financial risk that may result from the new framework. The results of this assessment should document any areas of identified risk, planned actions, and corresponding timelines to mitigate each area of identified risk. Further, this assessment should provide an estimate of when each Enterprise will be reasonably equipped to work safely and soundly within the new framework.

**FHFA Management Response:**
FHFA partially agrees with this recommendation. FHFA's risk-based supervision program includes examination of operations, controls, and processes associated with loan purchases by the Enterprises. DER performs targeted examinations and ongoing monitoring at each Enterprise in accordance with an annual examination plan and adjusts the plan as needed to address changing conditions and risk profiles.

FHFA examination staff will continue to examine and review the Enterprises' loan purchase operations, including those affected by the representations and warranties framework. DER examination staff will request the Enterprises to provide information about operational changes needed at each Enterprise for safe and sound implementation of the new framework, and DER will take this information into account in developing its examination plans for 2015. DER will provide its 2015 examination plans to OIG by January 31, 2015.

**Recommendation #2:**
OIG recommends that FHFA perform a comprehensive analysis to assess whether financial risks associated with the new representation and warranty framework, including with regard to sunset periods, are appropriately balanced between the Enterprises and sellers. This analysis should be based on consistent transactional data across both Enterprises, identify potential costs and benefits to the Enterprises, and document consideration of the Agency's objectives.

**FHFA Management Response:**
FHFA disagrees with this recommendation. FHFA will continue to evaluate, document, and revise the RAWF, taking into account stakeholder comments and various market factors in order to improve credit access for consumers, consistent with Enterprise safety and soundness. FHFA, the Enterprises, and the relevant stakeholders have already revised the RAWF, including the sunset period and the related payment history requirement. Revisiting those decisions to prepare an analysis of the financial risks associated with a previous release of the framework may have adverse market effects on future revisions to the framework, and may not align with the FHFA objective of increased lending to consumers, consistent with Enterprise safety and soundness. In addition, adaptation and implementation of the revised RAWF have begun at the Enterprises,

and the level of effort involved to produce an analysis on a previous framework may not yield an economic benefit to either the Enterprises or stakeholders as revisions to the RAWF continue.

cc: John Major, Manager, Internal Controls & Audit Follow-up

# APPENDIX B...............................................................

## OIG's Response to FHFA's Comments

On September 3, 2014, FHFA provided comments to a draft of this report. FHFA partially agreed with recommendation 1 and 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 agreed-upon corrective actions.

With respect to recommendation 1, DER will request and review information from the Enterprises about operational changes needed at each Enterprise for safe and sound implementation of the new framework and will take this into account in developing its examination plans for 2015. Although FHFA's planned corrective action is potentially responsive to OIG's recommendation, it is not clear what specific steps FHFA plans to take or how it plans to document the results of the recommended assessment, including areas of identified risk, planned actions, timelines to mitigate each area of identified risk, and estimates of when each Enterprise will be reasonably equipped to perform loan quality review safely and soundly within the new framework. Accordingly, the content of FHFA's assessment and examination coverage will determine whether the Agency's planned corrective action is responsive to this recommendation. OIG considers FHFA's answer to be potentially responsive to resolve this recommendation, which will remain open until OIG determines that agreed-upon corrective actions are completed and responsive to this recommendation.

OIG's recommendation 2 requested FHFA to perform a comprehensive analysis to assess whether financial risks associated with the new framework, including the sunset periods, are appropriately balanced between the Enterprises and sellers. OIG further requested that this analysis be based on consistent transactional data across both Enterprises, identify potential costs and benefits to the Enterprises, and document consideration of the Agency's objectives.

In response to recommendation 2, FHFA asserts that revisiting its decisions regarding the new framework sunset periods and related payment history requirements to prepare an analysis of the financial risks associated with a previous release of the framework may have adverse market effects on future revisions to the framework, and may not align with the FHFA objective of increased lending to consumers consistent with Enterprise safety and soundness. FHFA also stated that adaptation and implementation of the revised framework have begun at the Enterprises and the level of effort involved to produce an analysis on a previous framework may not yield any economic benefit to either the Enterprises or stakeholders as revisions to the framework continue.

Importantly, FHFA did agree going forward to enhance the documentation and analysis, including identifying and addressing Enterprise risks, surrounding decisions that will impact the representation and warranty framework. Further, FHFA stated it will continue to evaluate, document, and revise the framework, taking into account stakeholder comments and various market factors in order to improve credit access for consumers, consistent with Enterprise safety and soundness. In this regard, OIG did not see that FHFA fully considered the economic impact and in turn the safety and soundness of the Enterprises in the analysis supporting the initial release of the framework in September 2012. Thus, the actions identified by FHFA are positive steps and can go a long way toward meeting the intent of OIG's recommendation.

FHFA announced the objective of the new framework was to clarify lenders' repurchase exposure and liability on future deliveries. OIG remains concerned that FHFA has not fully developed the economic impact to the Enterprises, and in turn taxpayers that have been called upon to financially support them, associated with the limits on lender liability in the framework. The potential consequences of continued implementation of the new framework are substantial and warrant more careful consideration by FHFA. OIG did not intend for FHFA to construct the support for its past decisions regarding the framework although such support was deemed lacking. Rather, OIG intended for FHFA to assess the results of implementation of the framework and in particular whether risks are appropriately balanced between the Enterprises and lenders based on current and projected loan performance, market information, and other relevant factors. Without a comprehensive analysis to assess potential economic impacts on the Enterprises associated with the framework and its revisions in order to establish a baseline to measure performance, FHFA is unable to make fully informed decisions regarding the need for and financial risks associated with further updates to the framework as the agency stated it would do.

Currently, FHFA does not have a full understanding of how such risks, including those associated with the sunset periods, are balanced between the Enterprises and lenders. Furthermore, FHFA has not determined whether its other objective of increased lending to consumers is being achieved through the new framework and at what cost or whether the Enterprises are operating in a safe and sound manner under the new framework. Consequently, OIG considers recommendation 2 to be unresolved and requests that within 30 days of the issuance of this report, FHFA reconsider its position and provide OIG with a revised response.

# APPENDIX C...................................................................

## Summary of FHFA'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 | Resolved[a] Yes or No | Open or Closed[b] |
|---|---|---|---|---|---|
| 1 | FHFA partially agrees with this recommendation. DER examination staff will request the Enterprises to provide information about operational changes needed at each Enterprise for safe and sound implementation of the new framework, and DER will take this information into account in developing its examination plans for 2015. | 01/31/2015 | $0 | Yes | Open |
| 2 | FHFA disagrees with this recommendation and will not perform an analysis of the financial risks associated with the new framework as revisiting decisions regarding the representation and warranty framework sunset periods and the related payment history requirements may have adverse market impact on future revisions to the framework and may not align with the FHFA objective of increased lending to consumers, consistent with Enterprise safety and soundness. | N/A | $0 | No | Open |

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to the 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.

# ADDITIONAL INFORMATION AND COPIES................................

For additional copies of this report:

- Call: 202–730–0880
- Fax: 202–318–0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1–800–793–7724
- Fax: 202–318–0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

  FHFA Office of Inspector General
  Attn: Office of Investigation – Hotline
  400 Seventh Street, S.W.
  Washington, DC 20024