

Federal Housing Finance Agency  
Office of Inspector General



**FHFA's Oversight of Risks  
Associated with the Enterprises  
Relying on Counterparties to  
Comply with Selling and Servicing  
Guidelines**



## OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

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

September 26, 2014

**TO:** Nina Nichols, Deputy Director for Enterprise Regulation

A handwritten signature in blue ink, appearing to read "Russell A. Rau", is positioned above the "FROM:" line.

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

**SUBJECT:** Audit of FHFA's Oversight of Risks Associated with the Enterprises Relying on Counterparties to Comply with Selling and Servicing Guidelines

### Summary

Two government-sponsored Enterprises, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), use a delegated business model to buy and service mortgage loans. In this model, they contract with third-party mortgage loan sellers and/or servicers (e.g., counterparties, such as banks) that are relied on to comply with their requirements for: (1) originating loans that the Enterprises buy; (2) servicing the purchased loans (e.g., collecting payments); and (3) reporting data about the loans. As a result of relying on the counterparties for compliance and reporting, the Enterprises run the risk of their counterparties failing to meet their respective selling and servicing guidelines. Assurance regarding compliance with selling requirements is particularly important in light of new limits on how long Fannie Mae and Freddie Mac have to perform quality control activities on loans being acquired and to make decisions about whether sellers need to repurchase noncompliant loans. As such, increased reliance is being placed on controls at the sellers.

As their conservator and regulator, the Federal Housing Finance Agency (FHFA or Agency) has established prudential standards for identifying, measuring, monitoring, and controlling Enterprise risk, and can act to mitigate risks, including those posed by counterparties. To better assess the operational and financial risks posed by these counterparties, the Office of Inspector General (OIG) reviewed FHFA's oversight of how the Enterprises ensure their counterparties comply with their requirements.

In the mid-1990s, one of the Enterprises required an independent, third-party assurance of counterparties' compliance with some elements of its guidelines, but this requirement was replaced by reliance on counterparties' self-representations of their compliance. Further, the Enterprises have risk-based, internal oversight of their counterparties' compliance with selling and servicing guidelines but most receive no onsite review. In addition, only a portion of loans

purchased are subject to detailed quality reviews. While monitoring controls are important, the lack of independent assurance across the population of Enterprise counterparties can increase the risk of subpar originating and servicing going undetected.

OIG concluded that the Enterprises could require independent assurance that counterparties are complying with their selling and servicing requirements as a complement to other monitoring controls already in place. As examples of best practice, federal agencies involved in the mortgage market, such as the Securities and Exchange Commission (SEC) and the Department of Housing and Urban Development (HUD), and private investors in mortgage-backed securities (MBS) commonly require independent assurance of counterparty compliance. Also, in December 2013, one Enterprise's internal audit function proposed using independent, third-party attestations of compliance with selling and servicing guidelines, but the merits of the proposal were not assessed by either the Enterprise or FHFA.

Accordingly, OIG recommends that FHFA direct the Enterprises to assess a risk-based approach to having their counterparties obtain independent, third-party attestations of their compliance with origination and servicing requirements to increase assurance that the \$4.8 trillion in Enterprise-owned and -guaranteed mortgages are appropriately originated and serviced. Such attestations could complement but not replace Fannie Mae's and Freddie Mac's onsite reviews and other performance monitoring controls. The attestations can be implemented in a manner that considers their cost/benefit based on a given counterparty's size, complexity, performance, and other risk factors.

FHFA did not agree with the OIG recommendation. OIG is requesting that FHFA reconsider its disagreement with the recommendation.

## **Background**

Fannie Mae and Freddie Mac provide liquidity for housing finance by purchasing mortgage loans from primary mortgage sellers and keeping them for their own investment portfolios, or securitizing them for sale to investors in the secondary mortgage market with guaranteed monthly payments. By 2014, the Enterprises owned and guaranteed mortgage loans with outstanding balances totaling \$4.8 trillion that are serviced by their counterparties. Since the Enterprises rely on contracts with these counterparties, oversight in the form of monitoring controls is important to assuring compliance.

The Enterprises' annual reports disclose that their loan underwriting and much of their financial reporting depend on counterparty mortgage loan data required by Enterprise guidance. For example, loan sellers send the Enterprises data about loan characteristics and underwriting information. Loan servicers also send the Enterprises loan-level data each month, including information about payments, delinquencies, and loss mitigation. The Enterprises use this data for various purposes, such as calculating their loan loss reserves.

## **Seller and Servicer Repurchases**

The Enterprises buy mortgage loans from sellers that originate them, which frees up money for the sellers to make more loans. In 2013, the Enterprises purchased over \$1 trillion in mortgages that, in turn, were either securitized and sold or held in their portfolios.

When the Enterprises buy mortgage loans, they contract with companies (counterparties) for day-to-day loan servicing, such as collecting payments and handling defaults. Servicers typically receive a percentage of the monthly interest on the unpaid principal balances of the mortgages they manage. As of March 31, 2014, Freddie Mac had a total of about 1,200 servicing counterparties under contract with unpaid principal balances totaling \$1.7 trillion while Fannie Mae had about 1,400 servicing counterparties with balances totaling \$3.1 trillion.

The Enterprises rely on representations and warranties under which sellers and servicers assert that their origination and servicing work complies with the Enterprises' seller and servicer contract requirements and related guidance. If Fannie Mae and Freddie Mac later find that it did not, the Enterprises can, among other remedies, require their counterparties to repurchase the defective loans or otherwise cover losses.

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. With the implementation of the framework, sellers are relieved of certain repurchase obligations for loan defects after three years. Before the new framework, the Enterprises could demand repurchase over the life of most loans that defaulted and resulted in losses if underwriting defects they caused were evident. With this level of protection from losses, the Enterprises' quality control efforts focused to a greater extent on nonperforming loans. With the new framework and a 3-year limit on repurchase demands, the Enterprises' quality control efforts are now focused more upfront on performing loans. Since the Enterprises already rely on a delegated business model, the reduction in their ability to seek repurchase of nonperforming loans points to increasing focus on the underwriting processes of the sellers to provide assurance of the quality of purchased loans.

### **Finding: FHFA Can Further Mitigate the Risks Associated with the Enterprises Relying on Counterparties to Comply with Selling and Servicing Guidelines**

The Enterprises do not require independent, third-party assurance that their counterparties are complying with their requirements. Such assurance is commonly used in similar lending and servicing arrangements. Instead, the Enterprises rely on counterparties' assertions of compliance and a set of risk-based, monitoring controls that each Enterprise uses to assess compliance with its guidance. The coverage of these monitoring controls is limited, which increases the risk that noncompliance will go undetected. FHFA can potentially achieve greater assurance that Enterprise-owned and -guaranteed mortgages are being properly originated and serviced.

FHFA and the Enterprises could further mitigate these risks by assessing the cost/benefit of a risk-based approach to requiring: (1) counterparties' management to provide representations as

to their companies' compliance with Enterprise requirements, and (2) independent, third-party attestations<sup>1</sup> to provide reasonable assurance of counterparty compliance.

### **Other Federal Agencies and Private MBS Investors Require Third-Party Assurance**

Unlike the Enterprises, federal agencies, such as the SEC and HUD, and private MBS investors involved in the secondary mortgage market require annual, independent assurance of counterparty compliance. Although the requirements vary among federal agencies, the overall concept as well as many of the counterparties are the same.

#### *SEC Requirements*

The SEC's Regulation AB (Reg AB), *Asset-Backed Securities*, sets the rules for registering, disclosing, and reporting publicly registered, asset-backed securities, such as MBS. The regulation's requirements include servicers assessing and asserting their compliance with the regulation's provisions and obtaining reports from registered accounting firms that attest to their self-reported compliance. Item 1122 of Reg AB defines the disclosure-based servicing criteria to be used by the relevant party to the transaction to provide an assertion regarding servicing compliance and also an attestation report by registered public accounting firms in assessing said compliance. The minimum servicing criteria in this section are separated into four categories: general servicing considerations, cash collection and administration, investor remittances and reporting, and pool asset administration. The SEC has adopted a requirement that material instances of noncompliance during the reporting period must be disclosed even if such noncompliance is subsequently corrected during the reporting period.

#### *HUD Requirements*

Similar to the SEC's Reg AB, HUD also requires its sellers and servicers to submit annual, independent attestation reports. Specifically, HUD's *Consolidated Audit Guide for Audits of HUD Programs*<sup>2</sup> (*Audit Guide*) requires sellers and servicers who do business with the Federal Housing Administration (FHA) and the Government National Mortgage Association (Ginnie Mae) to submit an annual audit of financial statements, internal controls, and compliance with their respective program requirements.<sup>3</sup> The compliance audit serves as an independent, third-party attestation.

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<sup>1</sup> These independent, third-party attestations are services typically provided by independent public accountants.

<sup>2</sup> HUD Office of Inspector General, *Consolidated Audit Guide for Audits of HUD Programs*, Handbook 2000.4 REV-2 CHG-17 (May 2013).

<sup>3</sup> **FHA** insures single- and multi-family mortgage loans made by FHA-approved lenders. FHA insures mortgages on single-family and multifamily homes, which reduces lenders' risk because FHA pays if homeowners default. To qualify for insurance, loans must meet certain FHA requirements, such as income verification, remittances, escrow, and loss mitigation. **Ginnie Mae** is a self-financed, wholly-owned, government corporation within HUD. Ginnie Mae guarantees investors the timely payment of principal and interest on MBS backed by federally insured or guaranteed loans—mainly loans insured by FHA or guaranteed by the Department of Veterans Affairs.

According to HUD officials, the objectives of a HUD program-specific audit are to help the program managers in HUD determine whether the auditee has: (a) provided financial data and reports that can be relied on; (b) internal control in place to provide reasonable assurance that it is managing HUD programs in compliance with applicable laws and regulations; and (c) complied with the terms and conditions of federal awards and guarantees, and thus expended federal funds properly and with supporting documentation. HUD program audit reports are primary tools used by program managers to meet their stewardship responsibilities in overseeing these HUD programs and assuring the integrity of funds. Program managers must act on the areas of noncompliance and internal control weaknesses noted in these reports.

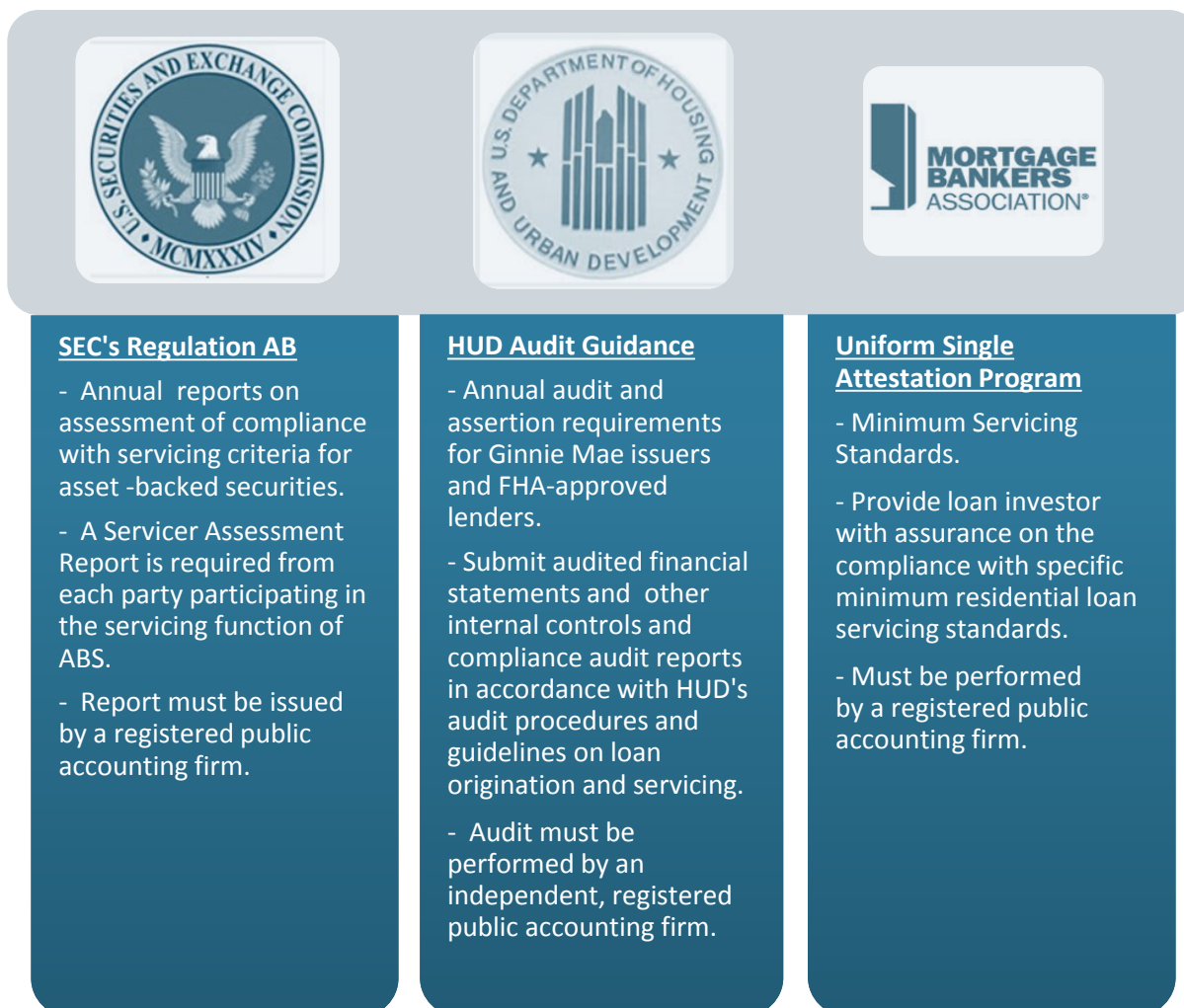
The annual assertions and audits have helped FHA and Ginnie Mae identify problems with their counterparties, including issues relating to serious noncompliance and poor performance. Since many of these counterparties also do business with the Enterprises, similar deficiencies could be identified and corrected if the Enterprises had similar requirements for independent, third-party attestations.

#### *Mortgage Bankers Association Guidelines*

The Mortgage Bankers Association's (MBA) Uniform Single Attestation Program (USAP) gives private investors in residential mortgage loans guidelines for gaining assurance over management's assertion of a servicing entity's compliance with USAP's minimum servicing standards. Each standard represents a specific minimum requirement with which a servicing entity is expected to be in material compliance. The USAP engagement must be performed by a certified public accountant (CPA) who complies with the applicable provisions of the public accountancy law and the rules of the jurisdiction in which the CPA is licensed. USAP testing provides assurance on servicing operations in the following areas: custodial bank accounts, mortgage payments, disbursements, investor accounting and reporting, mortgagor loan accounting, delinquencies, and insurance policies. Potential users of the USAP report include all parties with an interest in management's assertion about a servicing entity's compliance with the minimum servicing standards and, specifically, those to whom the mortgage servicer is obligated, through contractual agreement, to furnish a copy of the report. For example, a credit rating agency downgraded a large Enterprise seller/servicer late last year due to material problems identified in part as a result of a USAP engagement.

The following figure presents key third-party assurance requirements of the three organizations discussed above with respect to the secondary mortgage market.

**Figure 1: Other Federal Agencies and Mortgage Association Guidelines on Mortgage Origination and Servicing**



Source: MBA's USAP, SEC's Regulation AB, and HUD's Audit Guidance

### **Enterprises' Delegated Business Model**

Much of the Enterprises' business and financial success rests with their counterparties. The Enterprises' single-family mortgage business is operated largely under a delegated business model that relies on counterparties to: (1) originate and deliver qualifying loans for purchase or guarantee; and (2) service the associated mortgages, including reporting timely, accurate data to the Enterprises about borrowers, collateral, credit characteristics, capacity to repay, and loan status. Unless monitoring controls detect and correct the noncompliance, this model results in the Enterprises bearing the risk that their counterparties may fail to meet the requirements of their respective seller and servicing guides.

As presented in their respective SEC annual reports, the Enterprises rely on representations and warranties provided by their counterparties concerning the characteristics of the single-family



mortgage loans they buy. Additionally, both Enterprises have deployed an array of monitoring controls. However, neither Enterprise requires counterparties to have routine, independent verification of counterparty compliance with their guidance as a complement to these monitoring controls. This exposes the Enterprises to the risk that the parties involved could be in noncompliance with Enterprise guidance or even that they could engage in fraud by misrepresenting facts about properties, borrowers, or loans. In fact, one Enterprise's annual report stated that while it reviews a sample of loans after it buys them to determine if such loans comply with its contractual requirements, there can be no assurance that this will detect or deter mortgage fraud, or otherwise reduce exposure to the risk of fraud. In addition, the Enterprise's annual report<sup>4</sup> indicated it is also exposed to fraud by mortgage servicers.

The Enterprises, through the new representation and warranty framework, have substantially limited their opportunity to perform quality control reviews of purchased loans, which could shift considerable risk from sellers to themselves. However, neither Enterprise has established requirements for those sellers to have their loan production processes independently tested by a third-party as part of either annual financial statement audits or separate engagements. Such testing could focus on compliance with Enterprise selling guidance and provide additional assurance that purchased loans comply with that guidance. The testing can serve as an important component of a governance structure to manage the risk assumed by the Enterprises through implementation of the new framework and can serve as an important complement to other monitoring controls.

With respect to mortgage loan servicing, the Enterprises' respective 2013 annual reports state that the Enterprises do not service loans. Instead, they rely on counterparties to service their loans according to their guidelines. As these reports point out, if servicers lack appropriate controls, or experience a failure in their controls or an operating disruption, the Enterprises' business and financial results could be adversely affected. Therefore, consideration of complementary controls to mitigate such risk is an important part of sound risk management.

In summary, obtaining independent, third-party assurance of compliance with selling and servicing guidance could help the Enterprises manage the risks associated with their delegated underwriting business model.

### **Independent Assurance of Counterparty Data Was Previously Required**

In the mid-1990s, one Enterprise required counterparties to engage independent auditors to test their compliance with some elements of origination and servicing requirements and to issue related reports. This gave the Enterprise reasonable assurance about whether counterparties were complying with elements of its selling and servicing requirements, but the requirement was discontinued. When asked about the rationale for dropping the requirement, officials from the

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<sup>4</sup> The annual report referred to here was the Enterprise's SEC Form 10-K for 2013. Federal securities laws require publicly traded companies to disclose information on an ongoing basis. The annual report on Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements.



Enterprise were unable to explain or provide documents describing why the Enterprise had done so.

In December 2013, one Enterprise's internal audit function analyzed the significant risks posed by its sellers and servicers. The analysis noted that the Enterprise placed considerable reliance on sellers and servicers to originate and deliver qualifying loans for purchase or guarantee, to service mortgages, and to report timely, accurate data about borrowers, collateral, credit, repayment, and loan status. The Enterprise's internal audit function recommended:

Under FHFA's guidance and direction, Freddie Mac and Fannie Mae should consider jointly adopting a risk management program that would require Seller/Servicers to provide annual independent third-party attestation reports of compliance with significant origination and servicing standards. Regulation AB and the Seller/Servicer Guide may serve as useful platforms on which to build this assurance program in a manner that is most cost-effective for Seller/Servicers. As part of such program, the GSEs [Government-Sponsored Enterprises] can focus their on-going efforts on monitoring the attestation reports and responding to identified compliance deficiencies.

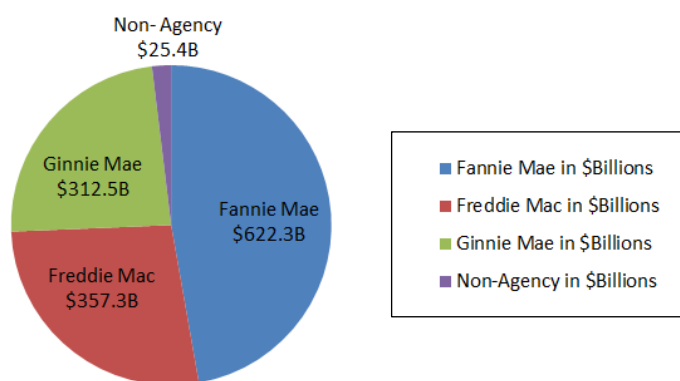
The analysis was shared with senior management at the Enterprise that did not provide any formal response. The analysis was also shared with FHFA but no formal actions have yet been taken by the Agency to assess the merits of independent, third-party attestations.

## Enterprises and Ginnie Mae

The Enterprises are currently the largest issuers of MBS. For example, in 2013, the Enterprises' MBS market share was nearly \$980 billion, or triple that of Ginnie Mae, which issued about \$313 billion of MBS as shown in Figure 2.

Despite their dominance of the MBS market, the lack of independent, third-party attestation requirements by the Enterprises contrasts with Ginnie Mae, which has such requirements.<sup>5</sup> As noted earlier, Ginnie Mae requires its mortgage loan issuers to engage independent auditors to test their compliance with origination and servicing requirements. Although the compliance requirements vary between Ginnie Mae and the Enterprises, many of their counterparties are the same. Importantly, Ginnie Mae's efforts have identified matters requiring

**Figure 2: MBS Market Shares 2013**



Source: Ginnie Mae Annual Report to Congress

<sup>5</sup> OIG did not assess the overall governance structure used by Ginnie Mae in comparison to that of the Enterprises. Such an assessment could be a part of FHFA's consideration of this approach to ensuring the Agency and Enterprises have reasonable assurance regarding counterparty compliance with selling and servicing guidance.

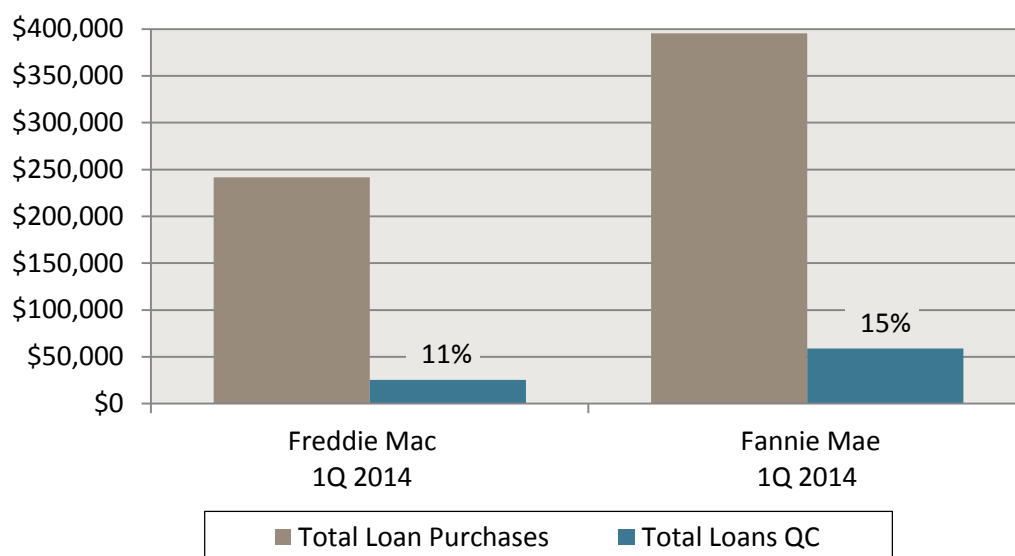
attention by those counterparties, which indicates the value to be derived from such an approach. Independent, third-party assurance of compliance with origination and servicing requirements could similarly aid the Enterprises in mitigating underwriting and servicing risks related to compliance with their guidance. However, the cost/benefit of obtaining this added assurance has not been assessed by FHFA or the Enterprises, including risk-based alternatives for ensuring the value of this monitoring control. Such alternatives could include establishing third-party assurance requirements based on counterparties' business volume, performance data, size, and complexity.

## Enterprises' Oversight of Counterparties

In lieu of requiring independent, third-party assurance on all counterparties, the Enterprises have monitoring controls for sellers and servicers, including loan quality control (QC) reviews, servicer performance reviews, and operational reviews.<sup>6</sup> These controls are risk-based, covering in depth a small percentage of loans and counterparties.

For example, OIG found that the percentage of loans selected for quality control review in comparison to total loan purchases as of March 31, 2014, is less than 15% at each Enterprise as shown in the following figure.

**Figure 3: Enterprises' Mortgage Loans Selected for Quality Control Reviews**



Source: Enterprises' Reports

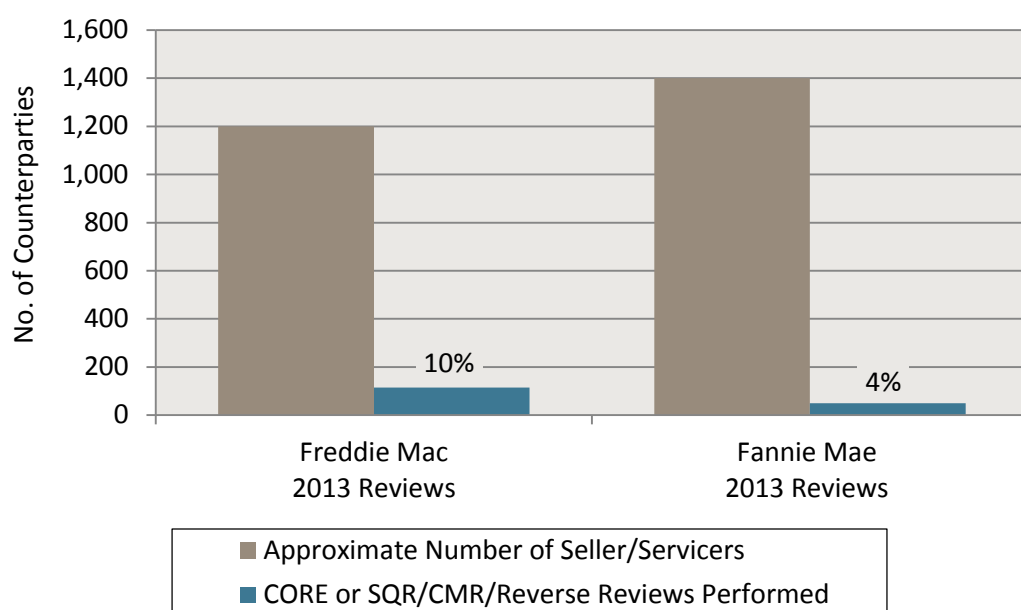
Despite the small sample of loans selected for risk-based, quality control review, the results of the sampling indicated a number of underwriting defects, which subsequently resulted in repurchase requests being made to the sellers. Most of the repurchases issued and collected due

<sup>6</sup> Both Enterprises noted that they perform risk-based seller reviews that result in many of the largest volume sellers being reviewed. Although these efforts contribute to overall assessments of seller compliance, they focus on controls and thus differ from quality control reviews of compliance for individual loans. Further, the risk-based approach results in a large number of sellers not being reviewed on a regular basis.

to underwriting defects were identified through the quality control review of nonperforming loan files. With the shift in emphasis to upfront quality control on performing loans, additional attention to counterparty underwriting practices could be critical in protecting the Enterprises' interests through the use of its repurchase ability, which is now limited to three years.

Each Enterprise currently has over 1,200 sellers and servicers. The Enterprises' counterparty operational risk evaluation (CORE) function and servicer quality review (SQR) function have performed risk-based reviews on a small number (less than 10%) of seller and servicers annually. For example, in 2013, Freddie Mac and Fannie Mae reviewed approximately 120 and 50 counterparties, respectively, or approximately 10% and 4% of the respective Enterprise's population as shown in the following figure.

**Figure 4: Enterprises 2013 Counterparty Operational Risk Evaluation and Servicer Quality Reviews**



Source: Enterprises' Reports

Although limited to a small sample, the Enterprises' CORE and SQR reviews, which are risk-based, have identified numerous operational and compliance issues at the counterparties, including those related to loss mitigation, delinquency, escrow, and foreclosure. Default management, fraud, quality control, and governance were the most recurring issues identified in their risk evaluations for 2013 and 2014. Since these reviews are risk-based, those counterparties that present greater risk may receive more focus, but the remainder of the counterparties could also receive compliance testing under an independent, third-party attestation model.

### Issues Identified with Enterprise Oversight

Although the Enterprises have implemented various internal functions to oversee counterparty compliance with their respective origination and servicing standards, FHFA's Division of Enterprise Regulation's examination teams as well as each Enterprise's internal audit function have identified weaknesses.

For example, a recent FHFA review of one Enterprise's operational review function noted an inadequate process in place to identify and report significant high-risk issues to senior management. One seller/servicer was identified in the report as having multiple years of report findings that were not raised to senior management for resolution. The examination also indicated that the Enterprise's operational review process did not monitor counterparty compliance with consumer protection laws and regulations.

Another FHFA review in 2014 of one Enterprise's counterparty risk management function noted concerns with the risk management of counterparties and the governance of credit risk. Further, FHFA expressed concern with the effectiveness of counterparty risk management's capabilities at the Enterprise to challenge the business units that deal with counterparties.

In a 2013 Enterprise internal audit report, issues were noted in the performing loan quality control function and administration. Specifically, there were issues with the quality control infrastructure and processes to resolve discrepancies. The quality control function is critical to the Enterprise with the implementation of the new representation and warranty framework. In another 2013 Enterprise internal audit report, controls weaknesses were identified in the seller/servicer eligibility function. Specifically, the Enterprise's internal audit noted issues with seller/servicer eligibility and compliance monitoring processes.

OIG has also noted a number of issues with counterparty compliance and associated FHFA and Enterprise oversight in the past two years. For example, in a recent OIG report, a seller/servicer lacked adequate infrastructure to handle its increased loan volume, which led to consumer complaints and delayed payments to the Enterprises.<sup>7</sup> Moreover, this breakdown in the seller/servicer infrastructure was not disclosed in its annual report. As such, borrowers with Enterprise-backed mortgages may not have their loans properly serviced.

In another report, OIG also identified shortcomings with FHFA's monitoring of the Enterprises' oversight of their counterparties' compliance with consumer protection laws.<sup>8</sup> OIG determined that the Enterprises do not ensure counterparties' business practices follow all federal and state laws and regulations designed to protect consumers from unlawful activities such as discrimination. In addition, OIG identified that the Enterprises do not have a formal monitoring program in place to review their counterparties' compliance with the federal and state laws that govern originating and servicing mortgage loans. Instead, both Enterprises rely primarily on counterparty self-certifications of contractual compliance along with federal regulators' supervisory and enforcement activities.

These previous examples of issues identified regarding the Enterprises' counterparty oversight structure further highlight the need for independent, third-party assurance of counterparty compliance with Enterprise requirements set forth in their guidance.

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<sup>7</sup> *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages* (AUD-2014-014, July 1, 2014). Accessed August 24, 2014, at <http://www.fhfaoig.gov/Content/Files/AUD-2014-014.pdf>.

<sup>8</sup> *FHFA Should Develop and Implement a Risk-Based Plan to Monitor the Enterprises' Oversight of Their Counterparties' Compliance with Contractual Requirements Including Consumer Protection Laws* (AUD-2013-008, March 26, 2013). Accessed August 24, 2014, at [http://www.fhfaoig.gov/Content/Files/AUD-2013-008\\_0.pdf](http://www.fhfaoig.gov/Content/Files/AUD-2013-008_0.pdf).

## **Recent Issues with Servicers**

Experience since the financial crisis has shown that independent oversight of compliance with seller and servicer guidelines is essential at some organizations. In 2012, for example, the Department of Justice, HUD, and state attorneys general announced a settlement with the five leading bank mortgage servicers to address mortgage loan servicing and foreclosure abuses, resulting in \$25 billion in monetary sanctions and relief. The settlement requires testing of compliance with mortgage servicing requirements and oversight by an independent monitor that will report to the attorneys general and the court. The independent monitor has filed a number of compliance reports with the court, most recently covering testing for the third and fourth quarters of 2013. To validate servicer compliance efforts, the independent monitor has engaged professional firms to review servicer work papers and test a sub-sample of servicer compliance work.

## **Conclusion**

FHFA can further mitigate the risks posed by the Enterprises' reliance on their counterparties' information on origination and servicing compliance by directing them to assess the cost/benefit of whether counterparties should obtain independent, third-party attestations on a risk-focused basis that considers such things as counterparty size, product line, and other characteristics. Through such robust attestations and independent oversight, FHFA can increase its assurance that Enterprise-owned and -guaranteed loans are originated and serviced in compliance with requirements. Such a control can complement existing risk-based controls and provide broad compliance coverage to those counterparties that would otherwise not receive oversight. In this regard, one Enterprise prepared and FHFA received a proposal to consider independent, third-party attestations of counterparty compliance but has not acted on the proposal.

Compliance with selling requirements is particularly important in light of FHFA's new representation and warranties framework that now limits to three years the length of time the Enterprises have to perform quality control activities on loans being acquired. As such, increased reliance is being placed on controls at the sellers. Obtaining independent, third-party assurance could not only help provide the Enterprises with more reliable evidence about the accuracy and timeliness of data that counterparties report, but also help manage the risks associated with their delegated underwriting business model.

Finally, other federal agencies require annual assertions and independent, third-party attestations that allow them to identify problems with counterparty compliance. Since many of these counterparties also do business with the Enterprises, similar deficiencies could have been identified if the Enterprises had similar requirements for independent compliance attestations.

## **Recommendation**

OIG recommends that FHFA:

1. Direct Fannie Mae and Freddie Mac to assess the cost/benefit of a risk-based approach to requiring their sellers and servicers to provide independent, third-party attestation reports on compliance with Enterprise origination and servicing guidance.

FHFA provided comments (see Attachment A) disagreeing with OIG's recommendation. Attachments B and C contain OIG's evaluation of FHFA's comments.

## **Objective, Scope, and Methodology**

The overall objective of this performance audit was to assess FHFA's oversight of Enterprise information reporting used to oversee compliance with origination and servicing standards. To accomplish this objective, in part, OIG reviewed FHFA's oversight and the Enterprises' controls and processes to monitor seller/servicers' compliance with key standards, including risk management practices used to ensure compliance with the Enterprises' mortgage origination and servicing guidance.

OIG conducted its fieldwork at FHFA's headquarters, Fannie Mae's corporate offices in Washington, DC, and Freddie Mac's corporate offices in McLean, VA.

In order to accomplish its objective, OIG:

- Analyzed FHFA examination results related to Fannie Mae's and Freddie Mac's counterparty reviews, specifically, the Enterprise functions responsible for counterparty compliance;
- Reviewed internal audit reports from the Enterprises related to counterparty oversight and/or compliance;
- Reviewed other federal agencies' regulations and industry best practices related to independent audit/attestation on mortgage origination and servicing requirements, i.e., HUD, FHA, Ginnie Mae, and the SEC;
- Reviewed counterparty compliance issues and problems identified by other federal agencies;
- Discussed with FHFA officials the Agency's oversight and guidance on independent, third-party attestation of counterparty compliance with mortgage origination and servicing requirements; and
- Discussed with Enterprise officials the processes to validate counterparty compliance with the Enterprises' respective origination and servicing requirements.

OIG conducted fieldwork for this performance audit from April 2014 through August 2014 in accordance with generally accepted government auditing standards. Those standards require

that OIG plan and perform audits 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 finding and conclusions included herein based on the audit objective. OIG considers its finding to be significant in the context of the audit objective.

OIG appreciates the cooperation of everyone who contributed to this audit, including officials at FHFA, Fannie Mae, and Freddie Mac. This audit was led by Kevin Carson, Audit Director, who was assisted by Damon Jackson, Audit Manager, and Crystal Tsang, Auditor-in-Charge.

cc: Melvin L. Watt, Director  
Eric Stein, Chief of Staff  
Larry Stauffer, Acting Chief Operating Officer  
Sandra Thompson, Deputy Director for Housing Mission and Goals  
Robert Ryan, Special Advisor  
Mark Kinsey, Chief Financial Officer  
John Major, Internal Controls and Audit Follow-up Manager

Appendices: Appendix A: FHFA's Comments on OIG's Finding and Recommendation  
Appendix B: OIG's Response to FHFA's Comments  
Appendix C: Summary of FHFA's Comments on the Recommendation



## Appendix A

### *FHFA's Comments on OIG's Finding 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 *nan*

SUBJECT: Audit Report: *FHFA's Oversight of Risks Associated with the Enterprises Relying on Counterparties to Comply with Selling and Servicing Guidelines, Audit Assignment AUD-2014-011*

DATE: September 16, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendation in the FHFA-OIG draft audit report, *FHFA's Oversight of Risks Associated with the Enterprises Relying on Counterparties to Comply with Selling and Servicing Guidelines, Audit Assignment AUD-2014-011* (Report). The Report discusses use of independent third-party attestations of compliance by mortgage loan sellers and servicers with Enterprise origination and servicing requirements. The report recommends that FHFA direct the Enterprises to assess the feasibility and benefit of requiring such attestations.

Both Enterprises have in place internal controls to manage various types of counterparty risks and have recently made significant changes and enhancements to their counterparty risk management programs in connection with the revised representation and warranty framework. As the regulator and supervisor of the Enterprises, FHFA is responsible for reviewing and evaluating the effectiveness of internal controls, and that supervisory work is underway. The Report references practices of other agencies and argues that attestations would prove beneficial for the Enterprises, despite the limitations of attestations as a risk management tool; however, neither supervisory findings nor internal audit conclusions provide concrete support for this approach.

**Recommendation 1:** OIG recommends that FHFA direct Fannie Mae and Freddie Mac to assess the cost-benefit of a risk-based approach to requiring their sellers and servicers to provide independent, third-party attestation reports on compliance with Enterprise origination and servicing guidance.

**Management Response to Recommendation 1:** FHFA disagrees with this recommendation. FHFA does not find that the information and arguments in the Report warrant supervisory

direction to the Enterprises to dedicate management and other resources to conduct a cost-benefit analysis of risk-based attestations of compliance by sellers and servicers.

FHFA does, however, agree with the Report's position that effective counterparty risk management is critical to the safety and soundness of Enterprise operations. DER will continue to treat counterparty risk management as a high priority and conduct thorough supervisory review of Enterprise internal controls. DER will include in its 2015 examination plan for each Enterprise a review of internal controls relating to counterparty risk management for sellers and servicers, particularly changes made in connection with the adoption of the revised representation and warranty framework. DER will communicate to Enterprise management findings and any recommendations for consideration of additional or improved controls.

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

## Appendix B

### *OIG's Response to FHFA's Comments*

On September 16, 2014, FHFA provided comments to a draft of this report. FHFA disagreed with the recommendation. 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. As discussed below, OIG considers the recommendation to be unresolved and requests that within 30 days of the issuance of this report, FHFA reconsider its position and provide OIG with a further response.

FHFA agreed that effective counterparty risk management is critical to the safety and soundness of Enterprise operations and indicated it would continue to treat counterparty risk management as a high priority. Additionally, the Agency stated that it would include a review of internal controls relating to counterparty risk management for sellers and servicers in its 2015 examination plan for each Enterprise. FHFA further stated its review of internal controls related to counterparty risk management would focus on changes to controls made in connection with the Enterprises' adoption of the revised representation and warranty framework. OIG considers these to be positive steps.

FHFA broadly commented that as regulator and supervisor of the Enterprises it is responsible for reviewing and evaluating the effectiveness of internal controls. However, the Agency stated that it did not find that the information and arguments in the draft report warrant direction to the Enterprises to dedicate management and other resources to conduct a cost-benefit analysis of risk-based attestations of compliance by sellers and servicers to complement and enhance other counterparty risk management controls. OIG provides the following discussion related to these two points.

#### *Reviewing and Evaluating Internal Controls for Managing Counterparty Risk*

OIG identified that, in some instances, the Enterprises already make use of independent, third-party attestations. Thus, the Agency's planned examination to review internal controls relating to counterparty risk management for sellers and servicers at each Enterprise could lead to examination of independent, third-party attestations as an internal control. However, FHFA neither acknowledged the use of independent third-party attestations by the Enterprises in its response nor stated that the Agency would specifically review this control in its planned examination work.

There are at least several cases of limited Enterprise use of independent, third-party compliance attestations. For example, on December 10, 2013, Freddie Mac issued Bulletin Number M2013-7 to multifamily sellers and servicers that provides an option for servicers to have Freddie Mac consider the results from a Seller/Servicer's Regulation AB audit when the Enterprise conducts its own audit of servicer compliance. Specifically, the Bulletin allows servicers of multifamily loans preparing for a compliance audit to provide Freddie Mac with the servicer's annual Regulation AB assertion and related attestation report prepared by an independent public accountant on its assessment of compliance with the Regulation AB servicing criteria. While

the Bulletin applies only to servicing of multifamily loans, it clearly indicates that Freddie Mac recognizes that independent, third-party attestations can reduce the burden on servicers in some cases, especially if the attestation is already being performed in response to other requirements.

Further reliance on the use of independent, third-party attestations by Freddie Mac included the Enterprise identifying in certain offering circulars for the sale of interests in multifamily mortgage-backed securities that servicers of the underlying mortgages must provide independent, third-party attestations of compliance with the minimum servicing standards identified in the Uniform Single Attestation Program (USAP) for Mortgage Bankers. Such requirements are intended to, among other things, increase investor confidence in the performance of servicing functions in order to protect investor interests. Freddie Mac also disclosed in its 2013 annual report the audit fees billed by PricewaterhouseCoopers LLP for the performance of a compliance evaluation of the minimum servicing standards as set forth in USAP and the provision of an attestation report. These USAP fees were approved by FHFA as conservator of Freddie Mac.

OIG also noted that some prospectuses issued by Fannie Mae for single family mortgage-backed securities had servicer attestation requirements. For example, one prospectus stated that servicers must annually provide a report on the assessment of compliance with servicing criteria for asset-backed securities, together with a copy of an attestation report from a registered public accounting firm regarding such party's assessment of compliance.

Despite what appears to be use of independent, third-party attestation as an internal control in some cases, neither Enterprise pointed out in the course of the audit that third party attestations had in fact been used under certain circumstances or the justification for doing so. Such information would be directly relevant to OIG's recommended assessment of a risk-based approach to managing counterparty and other risks through a process of management assertions regarding compliance with origination and servicing requirements and independent testing and attestation to those assertions.

In summary, the Enterprises are making selected use of independent, third-party attestations that should be considered in planning examination coverage related to counterparty risk management. FHFA indicates in its response that it is placing a high priority on this area particularly in connection with the adoption of the revised representation and warranty framework. Yet, without performing an underlying assessment, FHFA reached a conclusion that independent, third-party attestations have limitations as a risk management tool. OIG considers it important that FHFA assess the full range of controls in place and not exclude the use of independent, third-party attestation from further consideration if further risk mitigation is deemed necessary.

#### *Additional Support for Assessing Independent Third-Party Attestations as an Internal Control*

In its efforts to assess counterparty risk management, FHFA should consider the potential risks impacting the pricing of Enterprise mortgage-backed securities (MBS) that may be mitigated by strengthened controls such as independent third-party attestations.<sup>9</sup> The Enterprises provide a

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<sup>9</sup> Independence is relative to both the sellers and servicers being reviewed and, in this context, can also apply to the Enterprises.



guarantee to investors related to principal and interest payments on MBS, the cost of which can be impacted by seller and servicer compliance with Enterprise guidance. These risks can affect the pricing of MBS and thus the return to the Enterprises. For example, Fannie Mae points out in its Prospectus for Guaranteed Mortgage Pass-Through Certificates for Single-Family Residential Mortgage Loans that if loans become delinquent, the Enterprise may purchase the loan from the pool, resulting in an early return of principal and potentially reduced earnings to the investor. Factors identified as affecting the likelihood of a borrower default on a mortgage loan include borrower creditworthiness, uninsured natural disasters, and borrower bankruptcy or other insolvency, all of which can relate to selling and servicing activities required of counterparties. The prospectus also points out that, as a result of the new representation and warranty framework, the Enterprise may determine much earlier in the life of a loan that there has been a breach of a representation and warranty related to the loan, which may lead to purchases of loans from pools earlier in their terms. Such action poses similar repurchase risk to investors that can impact pricing decisions for Enterprise MBS.

Regarding servicing, Fannie Mae points out that if a servicer experiences financial difficulties or becomes insolvent, that servicer's ability to effectively service mortgage loans may become impaired as its focus is more directed toward rebuilding financial strength through measures such as staff reductions. In some cases it may become necessary to transfer servicing to another more effective servicer. Less robust servicing practices before, during, or after the transition to a new servicer can exacerbate loan delinquencies and borrower defaults. Although the Enterprises' guaranty of timely payment of principal and interest covers borrower delinquencies and defaults, an increase in borrower delinquencies and defaults could result in acceleration of prepayments on investor certificates if delinquent loans are repurchased from a pool. As previously stated, this can result in reduced earnings to investors that could in turn demand higher returns on future MBS, thus adversely impacting the net income of the Enterprises.

Given the prepayment risks associated with selling and servicing, FHFA should consider providing additional depth in the internal control structure regarding seller and servicer compliance with Enterprise requirements, including independent third-party review of compliance.

Moreover, it is essential to monitor continuously the performance of counterparties and evaluate the risks associated with continuing business relations with them. As OIG's work shows, the Enterprises are only able to conduct detailed reviews of a limited number of counterparties. In a recent OIG report on lessons learned from the fraud scheme perpetrated by the officers and employees of Taylor, Bean & Whitaker Mortgage Corporation (TBW),<sup>10</sup> OIG noted counterparty monitoring as an area for improvement, particularly so-called non-regulated counterparties that do not have a primary Federal regulator as was the case with TBW. Moreover, the report concluded that FHFA and the Enterprises could improve the quality of their

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<sup>10</sup> *Systemic Implication Report: Taylor Bean and Whitaker (TBW)-Colonial Investigation Lessons Learned* (SIR-2014-0013, August 21, 2014) accessed September 17, 2014, at [http://www.fhfaig.gov/Content/Files/SIR\\_TBW\\_Colonial%20Investigation%20Lessons%20Learned%20August%202014.pdf](http://www.fhfaig.gov/Content/Files/SIR_TBW_Colonial%20Investigation%20Lessons%20Learned%20August%202014.pdf).

monitoring with compliance testing by independent firms. Freddie Mac suffered significant losses when TBW failed and no longer had the capacity to fulfill its repurchase obligations.

As part of our audit, we also noted that FHFA had similar concerns with counterparty risk management. In a 2014 review at one Enterprise, FHFA noted concerns with the lack of compliance with FHFA Advisory Bulletin, AB 2013-01, *Contingency Planning for High-Risks or High-Volume Counterparties*, implemented in 2013. This bulletin was issued in response to control weaknesses in counterparty risk management noted in a 2012 OIG audit.<sup>11</sup> FHFA also noted that implementation of the guidance is important with the rise of non-regulated counterparties, because they are large, critically important servicers for which replacement counterparties may be more difficult to identify. The Agency expressed particular concern with the effectiveness of Enterprise's capabilities to deal with counterparties.

FHFA could increase its assurance that counterparty risks are being effectively mitigated by completing the agreed-to examination coverage and assessing whether additional Enterprise counterparties need to obtain independent, third-party attestations of their compliance with the Enterprises origination and servicing guidelines. Such attestations, if warranted based on the results of the OIG-recommended assessment, could complement but not replace FHFA and the Enterprises reviews and other monitoring controls. As such, and also as a result of the findings in this report, we are requesting that FHFA reconsider its position on the recommendation.

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<sup>11</sup> *FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers* (AUD-2012-007, September 18, 2012) accessed September 17, 2014, at <http://www.fhfa.gov/Content/Files/AUD-2012-007.pdf>.

## Appendix C

### *Summary of FHFA's Comments on the Recommendation*

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

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits (\$ Millions)	Resolved: Yes or No <sup>a</sup>	Open or Closed <sup>b</sup>
1.	FHFA disagrees with this recommendation and does not find that the information and arguments in the report warrant supervisory direction to the Enterprises to dedicate management and other resources to conduct a cost-benefit analysis of risk-based attestations of compliance by sellers and servicers.	N/A	\$0	No	Open

<sup>a</sup> 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.

<sup>b</sup> Once OIG determines that the agreed-upon corrective actions have been completed and are responsive, the recommendation can be closed.



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