Federal Housing Finance Agency
Office of Inspector General

NPL Sales: Additional Controls Would Increase Compliance with FHFA's Sales Requirements

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Executive Summary

The Federal Housing Finance Agency (FHFA) is charged with supervising Fannie Mae and Freddie Mac (collectively, the Enterprises) to ensure that they operate safely and soundly and serve as a reliable source of liquidity and funding for housing finance. On September 6, 2008, FHFA placed the Enterprises into conservatorship in response to a deterioration in the housing markets that severely impacted the Enterprises' financial condition. A key component of the conservatorship is the commitment of the Department of the Treasury (Treasury) to provide financial support to the Enterprises, through senior preferred stock purchase agreements (PSPAs) with FHFA as conservator, so that they could continue to operate.

The Enterprises provide liquidity to the housing finance system by purchasing residential mortgages. Historically, the Enterprises have either packaged these mortgages into mortgage-backed securities that were, in turn, sold to investors, or held them in a retained portfolio. Also in the retained portfolios are non-performing loans (NPL) that the Enterprises purchase out of mortgage-backed securities to make investors whole and facilitate loss mitigation. The PSPAs, as amended in 2012, require, among other things, the Enterprises to reduce their retained portfolio to no more than $250 billion for each Enterprise by December 31, 2018.

According to FHFA, NPL sales by the Enterprises reduce the number of delinquent loans held in their retained portfolios and transfer credit risk to the private sector. The goal of such sales is to achieve more favorable outcomes for borrowers and neighborhoods than would be achieved if the Enterprises held the NPLs in their portfolios, while at the same time reducing losses to the Enterprises (and taxpayers). After an initial FHFA-approved pilot sale in August 2014, FHFA granted approval to Freddie Mac to sell NPLs on January 15, 2015, and to Fannie Mae on July 2, 2015.

In granting approval, FHFA established sales requirements. Those requirements include bidder qualifications, bidding transparency, loan modification protocols, loss mitigation protocols, handling of sales of foreclosed properties, handling of loans by subsequent servicers, as well as post-sale reporting from the buyer of the loans regarding borrower and neighborhood outcomes and on other NPL sale requirements.

We performed this audit to determine (1) what analyses FHFA performed prior to its decision to approve NPL sales and (2) FHFA's controls over NPL sales to ensure that the Enterprises met FHFA's established requirements.

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We found that FHFA followed prescribed protocols and processes in authorizing the Enterprises to sell NPLs. Additionally, according to Division of Housing Mission and Goals (DHMG) officials, FHFA views NPL sales as the Enterprises' program and that the Enterprises should have controls in place to ensure compliance with FHFA's NPL sales requirements. FHFA monitors loan resolutions and borrower and neighborhood outcomes based on aggregated data provided by the Enterprises, but does not monitor compliance with the specific NPL sales requirements.

In this regard, FHFA requires that NPL buyers/servicers, including subsequent servicers, report on the loan resolution and borrower and neighborhood outcomes to the Enterprises for four years after the NPL sale. The NPL buyers/servicers collect and report this information to the Enterprises by way of a template. We found that the templates used by the Enterprises did not contain some data fields that would be necessary for the Enterprises to determine buyer/servicer compliance with FHFA's sales requirements.

Additionally, it was not until we made inquiries about the monitoring of certain NPL sales requirements that one Enterprise identified five instances of possible violations of the no "walkaways" sales requirement. That Enterprise is currently in the process of determining how best to track loans with possible violations to ensure that NPL buyers do not abandon the liens and "walk away" from the properties.

We make three recommendations to address the findings identified in this report. In its written comments to our draft report, FHFA agreed with the three recommendations. We considered FHFA's planned actions sufficient to resolve these recommendations.

This report was prepared by Bob Taylor, Assistant Inspector General for Audits; Tara Lewis, Director; Jenny Ahn, Auditor-in-Charge; Marco Uribe, Auditor; Andrew Gegor, Auditor; and Pamela L. Williams, Auditor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov.

Marla A. Freedman /s/
Deputy Inspector General for Audits

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ABBREVIATIONS ....

2014 Plan	FHFA's *The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*
DHMG	Division of Housing Mission and Goals
Enterprises	Fannie Mae and Freddie Mac
FHFA	Federal Housing Finance Agency
HAMP	Home Affordable Modification Program
HERA	Housing and Economic Recovery Act of 2008
MWOB	Minority- and Women-Owned Business
NPL	Non-Performing Loan
PSPA	Senior Preferred Stock Purchase Agreement
REO	Real Estate Owned
Treasury	Department of the Treasury
UPB	Unpaid Principal Balance

BACKGROUND

FHFA, created by the Housing and Economic Recovery Act of 2008 (HERA), is an independent regulatory agency responsible for, among other things, supervision of the Enterprises. On September 6, 2008, FHFA used its authority under HERA to place the Enterprises into conservatorship in response to a deterioration in the housing markets that severely impacted the Enterprises' financial condition and left them unable to fulfill their missions without government intervention. At the time the Enterprises were placed into conservatorship, FHFA, as conservator of the Enterprises, executed the PSPAs with Treasury with two critical provisions.[1]

- First, in any quarter in which an Enterprise's net worth becomes negative during the conservatorship, Treasury is obligated to purchase enough senior preferred stock (subject to specified limits) from that Enterprise to restore it to positive net worth. For the period from 2008 through 2011, the Enterprises incurred combined losses exceeding $200 billion and required $187.5 billion in investment from Treasury. Treasury's continuing obligations to purchase senior preferred stock from the Enterprises ensures that the Enterprises "can pay their debt obligations as they become due and that they can continue to borrow in the capital market to fund their operations," which provides liquidity and stability to the secondary mortgage market.[2] The Enterprises returned to profitability in 2012 and have not needed to draw on additional federal funds since then. As of March 31, 2017, $258 billion of Treasury funding remains available under the PSPAs. As a result of the PSPAs, Treasury maintains effective ownership of the Enterprises through its senior preferred stock holdings.

- Second, in exchange for this investment, each Enterprise agreed to pay Treasury a quarterly dividend and these dividend payments do not reduce the outstanding amount of stock held by Treasury. In 2012, the PSPAs were amended to require the Enterprises to make quarterly dividend payments in the amount of the positive net worth reported on their balance sheets minus a specified capital reserve amount (set to decline to zero in 2018). For the period 2008 through March 31, 2017, the Enterprises have paid about $265.8 billion in dividends to Treasury. Pursuant to the PSPAs, the

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[1] The PSPAs were entered into contemporaneously with the appointment of the conservator and have been amended three times since then. For additional information regarding the PSPAs, see OIG, *Analysis of the 2012 Amendments to the Senior Preferred Stock Purchase Agreements* (Mar. 20, 2013) (online at www.fhfaoig.gov/Content/Files/WPR-2013-002_2.pdf).

[2] Congressional Budget Office, *The Effects of Increasing Fannie Mae's and Freddie Mac's Capital*, at 4-5 (Oct. 20, 2016) (online at www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52089-gse-report.pdf).

Enterprises' quarterly payments to Treasury are dividends on the government's investment in senior preferred stock and do not serve to repay Treasury for its past financial support or to buy back its senior preferred stock.

Retained Portfolio Reduction Requirements and the Related Role of Non-Performing Loan Sales

Fannie Mae and Freddie Mac provide liquidity to the housing finance system by purchasing residential mortgages. Historically, the Enterprises have either packaged these mortgages into mortgage-backed securities that were, in turn, sold to investors, or held them in a retained portfolio. The Enterprises' retained portfolios consist of mortgage loans and mortgage-related securities owned by the Enterprises.

For many years, net interest income[3] from the Enterprises' retained portfolios had been their primary source of revenue.[4] The Enterprises' retained portfolios grew over 700% between 1992 and 2008, and net interest income became the largest source of earnings. The Enterprises' combined retained portfolios were $192 billion as of the end of 1992, and $1.6 trillion as of the end of 2008. Beyond leveraging their retained portfolios for investment purposes, the Enterprises have used assets in their portfolios to purchase single-family loans delinquent for 90 or more days (non-performing loans) to make investors whole and facilitate loss mitigation. The purchases of NPLs have added to the Enterprises' retained portfolios.

Treasury and FHFA Retained Portfolio Reduction Requirements

According to FHFA, the Enterprises' retained portfolios exposed them to significant credit, asset, liquidity, and interest rate risks. Among other things, the PSPAs, as amended, require the Enterprises to reduce the size of their retained portfolios of single-family mortgage loans in accordance with a designated schedule, to no more than $250 billion for each Enterprise, by December 31, 2018. To date, both Enterprises have met the annual reduction requirements for their retained portfolios.

FHFA's Strategic Plan for the Enterprises' Sales of Less Liquid Assets

In May 2014, FHFA issued *The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac* (2014 Plan). One of the strategic goals in the 2014 Plan was: "Reduce Taxpayer Risk through Increasing the Role of Private Capital in the Mortgage Market." FHFA identified several objectives for the Enterprises to meet this goal, one of which was

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[3] Net interest income is the difference, or spread, between the interest income earned on the assets in the retained portfolio and the interest expense associated with the debt that funds those assets.

[4] OIG, *The Continued Profitability of Fannie Mae and Freddie Mac Is Not Assured*, at 10-11 (Mar. 18, 2015) (WPR-2015-001) (online at www.fhfaoig.gov/Content/Files/WPR-2015-001.pdf).

“Shrink the Enterprises’ Retained Portfolios with Focus on Less Liquid Assets.” Within this objective, FHFA directed the Enterprises to submit plans to reduce the assets in their retained portfolios and improve the composition of the retained portfolio assets so that the remaining retained portfolio is “highly liquid.” According to FHFA, the plans to be submitted by the Enterprises were to prioritize the sale of their less liquid portfolio assets while taking into account how the sale of less liquid assets would impact both the overall housing market and neighborhood stability.

FHFA’s Enterprise Scorecard Requirements for Portfolio Reduction

FHFA establishes its yearly priorities and expectations for the Enterprises in its annual Conservatorship Scorecard. One of the priorities in the 2014 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions (2014 Scorecard) was reducing taxpayer risk through increasing the role of private capital. Included in this priority was the same direction in the 2014 Plan: the Enterprises were directed to submit retained portfolio plans to FHFA to reduce the size of the retained portfolios. The plans were to focus on reducing less liquid assets and consider the impact that sales would have on the housing market and neighborhood stability. A requirement to execute the approved retained portfolio plans, to include consideration for better borrower outcomes and neighborhood stabilization, was also included in the scorecards for 2015 and 2016.

Non-Performing Loan Sales

Both Enterprises submitted plans as required by the 2014 Scorecard and proposed to reduce the less liquid assets in their retained portfolios. With FHFA’s approval, Freddie Mac conducted a pilot sale of NPLs in August 2014.

Based on the experience with the NPL pilot sale, FHFA developed requirements for future NPL sales by the Enterprises, which it announced in March 2015. According to FHFA, it expected that NPL sales by the Enterprises would achieve more favorable outcomes for the Enterprises, borrowers, and neighborhoods by providing alternatives to foreclosure, wherever possible. Included in this set of requirements were instructions on bidder qualifications, bidding transparency, and handling of sales of foreclosed properties as well as protocols for loan modification and loss mitigation. FHFA also required that servicers report to the Enterprises on borrower outcomes after the NPL sales closed so that (1) the Enterprises would be able to quantify whether the desired outcomes had been achieved and (2) FHFA would be able to publicly report on the outcomes.[5] The following year, FHFA added additional requirements that (1) direct NPL buyers to evaluate underwater borrowers for modifications

[5] For an example, see FHFA, *Enterprise Non-Performing Loan Sales Report –August 2016* (Nov. 16, 2016) (online at www.fhfa.gov/AboutUs/Reports/Pages/Enterprise-Non-Performing-Loan-Sales-Report-August-2016.aspx (accessed Apr. 13, 2017).

that include principal and/or arrearage forgiveness, (2) forbid buyers from walking away from vacant homes, and (3) establish more specific proprietary loan modification standards for NPL buyers. The reporting requirement was continued in the additional sales requirements announcement, stating that "This will allow FHFA, the Enterprises and the public to evaluate outcomes." (See Appendix A for a detailed description of FHFA's published NPL sales requirements.) FHFA's requirements apply to all NPL sales by the Enterprises.

As of December 31, 2016, the Enterprises have sold a combined 72,502 NPLs with an unpaid principal balance (UPB) of $14.1 billion as of the time of settlement.[6] These loans, on average, were delinquent for 3.4 years and had an average loan-to-value ratio of 97 percent.[7] As of that date, the Enterprises received a total of $10.3 billion from the NPL sales, amounting to 73 percent of the $14.1 billion UPB at settlement for the NPL loans sold. As of December 31, 2016, according to the Enterprises, the NPL sales program has cost approximately $60.5 million to administer (Freddie Mac has spent $31.2 million and Fannie Mae has spent $29.3 million).[8]

We performed this audit to determine (1) what analyses FHFA performed prior to its decision to approve NPL sales and (2) FHFA's controls over NPL sales to ensure that the Enterprises met FHFA's established requirements.

[6] UPB represents a loan's actual principal balance owed to the Enterprise. The UPB does not include past due amounts on delinquent loans, such as property taxes, interest, homeowners' insurance, and any fees paid by the servicer to protect the lienholder's lien.

[7] The loan-to-value ratio represents the ratio of the loan amount of the first mortgage to the property value.

[8] The Enterprises' NPL sales expenses include advisory fees, legal fees, and costs associated with setting up electronic data rooms for potential bidders to review loan information included in the loan pools. Expenses also include broker price opinions on the properties included in the loan pools, lien searches, and general and administrative expenses for the Enterprises' employees who work on NPL sales activities.

FACTS AND ANALYSIS ....

FHFA's Decision to Authorize Enterprise NPL Sales Followed its Established Process

Pursuant to FHFA's direction, in its 2014 Plan and 2014 Scorecard, the Enterprises submitted plans to reduce the size of their retained portfolios, which prioritized the sales of non-liquid assets. Subsequently, each Enterprise submitted written requests to FHFA to approve the proposed sales of NPLs. We reviewed the documents provided to us by FHFA and found that employees in FHFA's DHMG, Division of Conservatorship, and Division of Enterprise Regulation reviewed the Enterprises' written requests to engage in the sale of NPLs. FHFA's Retained Portfolio Governance Committee (comprised of senior officials from the above divisions) and its Conservatorship Committee (also comprised of senior officials from the above divisions) discussed the Enterprises' written requests and reviewed supporting documentation from the Enterprises during committee meetings. A written staff analysis of both requests was prepared in which the staff recommended that the FHFA Director approve each request. The Director granted Freddie Mac approval to engage in NPL sales on January 15, 2015, and granted Fannie Mae approval on July 2, 2015. FHFA followed its internal processes in authorizing the Enterprises' NPL sales programs.

FHFA Relies on the Enterprises to Ensure Compliance with FHFA's NPL Sales Requirements

According to DHMG officials, FHFA views NPL sales as the Enterprises' program and that the Enterprises should have controls in place to ensure compliance with FHFA's NPL sales requirements. FHFA reports on loan resolutions[9] and borrower and neighborhood outcomes based on aggregated data provided by the Enterprises, but does not monitor compliance with the specific NPL sales requirements.

FHFA requires that the Enterprises collect quarterly, for four years after the sale, loan-level data from the NPL buyers/servicers, including subsequent servicers, on the status and resolution of sold NPLs. The Enterprises use FHFA-required templates to collect this information from the NPL buyers/servicers. According to FHFA, the templates are designed to support public reporting, not compliance testing.

We reviewed the data fields included in these templates to understand what information was being collected by the Enterprises. We found that the templates, as designed, do not seek all

[9] For purposes of this audit, the term loan resolution means either modification to the terms of the loan, a short sale, a deed-in-lieu of foreclosure, or foreclosure.

the information that would be necessary to determine whether all of FHFA's NPL sales requirements were met. For example:

- FHFA's reporting templates do not contain any fields to determine whether the "loss mitigation waterfall" sales requirement was met by the buyers/servicers. The loss mitigation waterfall sales requirement is intended to ensure that servicers apply a waterfall of resolution tactics that includes: first, evaluating borrower eligibility for a loan modification; second, a short sale; third, a deed-in-lieu of foreclosure; and last, foreclosure. While the templates sought information about actions completed by the servicer such as short sale or foreclosure sale, there was no data field to collect information to enable FHFA to determine if its waterfall of resolution tactics had been applied (improve borrower outcome).

- FHFA's reporting templates lacked all of the data fields necessary to determine whether the "REO" sales requirement was met by the buyers/servicers. REO, or real estate owned, is real estate that the NPL buyer has acquired through foreclosure or a deed-in-lieu of foreclosure. Under FHFA's REO sales requirement for NPL sales, for the first 20 days that an REO property is marketed, that property may be sold only to buyers who intend to occupy the property as their primary residence or to a nonprofit (improve neighborhood outcome).

Enterprise Controls Over FHFA's NPL Sale Requirements

Because FHFA officials reported that they relied on the Enterprises to ensure that FHFA's NPL sales requirements are met, we asked each Enterprise to explain how it ensures compliance with these requirements. We found both Enterprises developed controls that, if implemented as described, would be sufficient to ensure compliance with FHFA's pre-sale requirements.[10] For example, the Enterprises require bidders to submit a qualification package that includes the bidder's financial information and a completed servicer questionnaire that demonstrates a record of successful resolution of loans through alternatives to foreclosure. Bidders are reviewed and approved by the Enterprises before they are permitted to participate in the NPL sales auction.

[10] FHFA's "pre-sale" requirements relate to the qualifications of bidders, the transparency of the bid process, and the packaging of small pools of loans for purchase by nonprofit organizations and minority- and women-owned businesses.

We also found that the Enterprises developed controls that, if implemented as described, would be sufficient to ensure compliance with some, but not all, post-sale requirements.[11] For example, both Enterprises performed quality checks of post-sale data received from NPL buyers/servicers. Freddie Mac demonstrated for us its data validation and reporting system that performed key data quality checks on the electronic data submissions provided by the NPL buyers/servicers. These data quality checks included identifying fields with missing or invalid data. Fannie Mae showed us an example of how they performed data validity reviews of the data received from the NPL buyers/servicers, which involved ensuring that all data fields are complete and values included in the data fields are valid. According to Enterprise officials, when questions arose during this review process, each Enterprise contacted the buyers/servicers for answers. We reviewed email communications that showed that the Enterprises interacted with the buyers/servicers when there were questions around the submitted data.

We found, however, that Fannie Mae was not monitoring for the FHFA sales requirement of no "walkaways." The no walkaways sales requirement is intended to ensure that if a property is vacant, buyers do not abandon the lien and "walk away" from the property. Instead, if a foreclosure alternative is not possible, the servicer must complete a foreclosure, sell, or donate the loan, including to a government or nonprofit entity (improve neighborhood outcomes).

On June 2, 2017, FHFA provided technical comments to a draft of this report. In those comments, FHFA stated "The post-sale reporting templates contain two fields to address this [no walkaways sales requirement]: Vacancy and a loan resolution type of Charge-Off. In order to violate the 'no walkaway' requirement, a servicer would need to do a charge-off on a vacant property, so both fields would need to be filled in. The Enterprises have had no instances of simultaneous Vacancy and Charge-Off reported since the institution of this requirement in v2.0 [April 2016] of the NPL Sales Requirements."

In follow-up on FHFA's technical comment, we sought further information regarding the reporting of the two fields (charge-off and vacant property) simultaneously as a way to monitor for no walkaways. Fannie Mae officials informed us that during the week of June 5, 2017, (the week after FHFA provided technical comments to a draft of this report) it identified five loans where charge-off and vacant property were simultaneously reported, indicating possible violations of the no walkaways NPL sales requirement. (The NPL buyer initially reported this information to Fannie Mae on January 26, 2017.) When we inquired about actions being taken regarding these five loans, Fannie Mae wrote "…we are in the process of determining how best to track the loans that have been charged-off and are

[11] FHFA's "post-sale" requirements focus on the buyer and new servicer of NPLs and include requirements for the evaluation of borrowers for mortgage loan modifications, application of a specific waterfall of loan resolution tactics, instructions for handling vacant and real estate owned properties, and reporting loan results to the Enterprises.

vacant…Since the investor still has the lien after the charge-off, they will continue to report on these loans. We will likely ask for additional information quarterly on these loans going forward to determine how they plan to resolve the delinquency. The most likely outcomes include a foreclosure, an appropriate foreclosure alternative, loan sale, or donation."

We also found that while the Enterprises review the borrower outcome data for completeness and consistency, officials of both Enterprises told us that they rely on the buyers/servicers to provide accurate data, and neither Enterprise verified the data provided against source documentation, such as loan files and servicer records. According to an official of one Enterprise, the Enterprise lacked authority to review loan files once the loan is sold. At our request, FHFA's Office of General Counsel reviewed the Enterprises' sales agreements and advised us that the Enterprises' NPL sales agreements do provide the Enterprises, and FHFA, the right to access the loan files of the buyers and their servicers.

Enterprises' Internal Audits of NPL Sales

The Enterprises' internal audit departments conducted reviews of NPL sales by their respective Enterprise.

Freddie Mac's Internal Audit Department performed an audit in 2015 on internal processes related to NPL sales and issued six findings on those processes. The findings and recommendations related to the need for Freddie Mac to: establish a process to receive feedback from various NPL stakeholders; review inconsistencies between NPL sales models; track information related to post-sale data to inform results for future decision making; establish clear roles and responsibilities for the NPL sales process; enhance the process to identify and remove loans included in the NPL sales; and establish thresholds for monitoring the NPL valuation model used to establish the reserve price for NPL sales. Enterprise management took actions to address the report's findings and the recommendations were closed by the Internal Audit Department as of December 2016.

Fannie Mae's Internal Audit Department performed an audit in 2015 on the execution of the NPL sales process and controls as part of the Enterprise's first NPL sale transaction. The audit found that management needed to take action to ensure appropriate controls were established regarding the use of product codes related to loans used in the NPL sales. Fannie Mae took action to address the report's findings and the recommendations were closed by its Internal Audit Department as of March 2016. The Internal Audit Department completed another audit of NPL sales in December 2016 that found the control environment to be satisfactory.

FINDINGS ....

1. FHFA followed its internal processes in authorizing the Enterprises' NPL sales programs

FHFA's decision to authorize the Enterprises to engage in NPL sales followed its established process. Specifically, we reviewed the documents provided to us and found that FHFA officials reviewed the Enterprises' written requests to engage in the sale of NPLs. FHFA's Retained Portfolio Governance Committee and its Conservatorship Committee discussed the Enterprises' written requests and reviewed supporting documentation from the Enterprises during committee meetings. A written staff analysis of both requests was prepared in which the staff recommended that the FHFA Director approve each request, and the Director granted approval to both Enterprises.

2. FHFA established NPL sales requirements to improve borrower and neighborhood outcomes; however, the current reporting template does not collect all the information necessary to determine buyer/servicer compliance with the waterfall and REO sales requirements

The Enterprises did not collect all information necessary to determine whether NPL buyers and servicers adhered to FHFA's NPL sales requirements. For example, FHFA's reporting templates used by the Enterprises to collect information did not contain any fields to determine whether the loss mitigation waterfall sales requirement (important for improved borrower outcomes) was met by the buyers/servicers. Additionally, FHFA's reporting templates lacked data fields to determine whether the REO sales requirement (important for improved neighborhood outcomes) was met by the buyers/servicers.

3. Fannie Mae has not ensured buyers and servicers comply with the no walkaways sales requirement

During our audit Fannie Mae identified five loans that were simultaneously reported as charged-off and vacant, which according to FHFA and the Enterprises are an indicator of a possible walkaway. Fannie Mae told us that they were in the process of determining how best to track loans that have been charged-off and vacant. They also informed us that they will likely ask for additional information on these loans going forward to determine how the buyer/servicer plans to resolve the delinquency. Such tracking and follow-up is essential to ensure that such loans are resolved through foreclosure, or sale or donation of the loan in accordance with the NPL sales requirement and to achieve more favorable neighborhood outcomes.

4. FHFA and the Enterprises have the right to access loan files to review borrower and neighborhood outcomes

We found that the Enterprises review borrower and neighborhood outcome data collected in support of FHFA's reporting templates for completeness and consistency. However, officials of both Enterprises told us they rely on the buyers/servicers to provide accurate data. Further, neither Enterprise verified the data provided against source documentation, such as loan files and servicer records. An official of one Enterprise told us that the Enterprise lacked the authority to review loan files once the loan is sold. At our request, FHFA's Office of General Counsel reviewed the Enterprises' sales agreements and confirmed that the Enterprises, as well as FHFA, have the right to access the loan files.

CONCLUSION

FHFA's decision to authorize the Enterprises to engage in NPL sales followed its established process.

FHFA expected that NPL sales by the Enterprises would achieve more favorable outcomes for the Enterprises, borrowers, and neighborhoods by providing alternatives to foreclosure, whenever possible. Among FHFA's requirements for NPL sales, servicers must report on borrower and neighborhood outcomes after the NPL sales close so that the Enterprises are able to quantify borrower and neighborhood outcomes and FHFA is able to report on these outcomes. We found, however, that the FHFA-required templates used by the Enterprises to collect this information from the NPL buyers/servicers do not seek all the information that would be necessary for the Enterprises to report to FHFA and for FHFA to assess whether all NPL sales requirements are being met.

Specifically, our analyses showed that FHFA's reporting templates did not include all of the data fields that would be necessary to determine whether the loss mitigation waterfall (borrower outcome) and REO (neighborhood outcome) sales requirements were met. The loss mitigation waterfall sales requirement is intended to ensure that the servicers apply a waterfall of resolution tactics that includes: first, evaluating borrower eligibility for a loan modification; second, a short-sale; third, a deed-in-lieu of foreclosure; and last, foreclosure. Under the REO sales requirement, for the first 20 days that an REO property is marketed, that property may be sold only to buyers who intend to occupy the property as their primary residence or to a nonprofit.

During the conduct of this audit, we found that Fannie Mae was not monitoring for the FHFA sales requirement of no walkaways. The no walkaways sales requirement is intended to ensure that if a property is vacant, buyers do not abandon the lien and walk away from the property. Instead, if a foreclosure alternative is not possible, the buyer/servicer must complete a foreclosure, or sell or donate the loan (neighborhood outcome). However, after we made additional inquiries, Fannie Mae self-identified five instances of possible violations of the no walkaways NPL sales requirement.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Based on the goals and requirements of NPL sales, as established by FHFA:
    a. Determine the information necessary to assess whether all of the goals and requirements are being met;
    b. Update/modify the NPL sales reporting requirements as necessary to obtain that information; and
    c. Update/modify the templates the Enterprises use to collect loan-level data from NPL buyers and servicers, as necessary.
2. Direct the Enterprises to:
    a. Put controls in place to identify and track the simultaneous reporting of charge-off and vacant property, as indicating a possible walk away violation; and
    b. Take action, as necessary, to ensure that servicers resolve possible walk away violations through foreclosure, or sale or donation of the loan.
3. Communicate to the Enterprises that they have the authority to review loan files to verify the accuracy of data provided by NPL buyers and servicers, in support of compliance with FHFA's sales requirements.

We provided FHFA an opportunity to respond to a draft report of this audit. In its management response, which is reprinted in its entirety in appendix B, FHFA agreed with the recommendations. FHFA also provided technical comments that we incorporated into the report, as appropriate.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this audit to determine (1) what analyses FHFA performed in support of its decision to implement NPL sales and (2) FHFA's controls over NPL sales to ensure that the FHFA's requirements were complied with by the Enterprises.

We assessed FHFA's oversight of NPL sales from 2014 through December 31, 2016.

To address our objectives, we:

- Obtained from FHFA and analyzed its legal authorities to authorize NPL sales;
- Interviewed FHFA officials regarding the goals and operation of the NPL sales;
- Reviewed FHFA's approval process that was followed in support of the decision to implement the NPL sales;
- Reviewed FHFA's NPL sales reports and gained an understanding of the metrics that were used to report on the sales as well as the source of the underlying data supporting those metrics;
- Compared the NPL sales reporting templates provided to the NPL buyers/servicers to FHFA's sales requirements to determine whether that data would address the sales requirements;
- Interviewed Fannie Mae and Freddie Mac officials regarding their controls over the NPL sales, and observed demonstrations of selected controls; and
- Reviewed the Enterprises' Internal Audit Reports and related resolution of recommendations related to NPL sales.

We conducted this performance audit between October 2016 and July 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX A ....

On March 2, 2015, FHFA announced the following enhanced NPL requirements for sales of NPLs by the Enterprises. According to FHFA, the sales requirements drew upon the experience of Freddie Mac's pilot sales of NPLs.

NPL Sales Requirements

- Bidder qualifications: Bidders will be required to identify their servicing partners at the time of qualification and must complete a servicing questionnaire to determine a record of successful resolution of loans through alternatives to foreclosure.

- Modification requirements: The new servicer will be required to evaluate all borrowers whose loans were originated on or before January 1, 2009, (other than those whose foreclosure sale date is imminent or whose property is vacant) for the Department of the Treasury's Making Home Affordable programs, including the Home Affordable Modification Program (HAMP). All post January 1, 2009, borrowers (other than those with an imminent foreclosure sale date or vacant property) must be evaluated for a proprietary modification. Proprietary modifications must not include an upfront fee or require prepayment of any amount of mortgage debt, and must provide a benefit to the borrower with the potential for a sustainable modification.

- Loss mitigation waterfall requirements: Servicers must apply a waterfall of resolution tactics that includes evaluating borrower eligibility for a loan modification (HAMP and/or proprietary modification), a short sale, and a deed-in-lieu of foreclosure. Foreclosure must be the last option in the waterfall. The waterfall may consider net present value to the investor.

- REO sale requirements: Servicers are encouraged to sell properties that have gone through foreclosure and entered Real Estate Owned (REO) status to individuals who occupy the property as their primary residence or to nonprofits. For the first 20 days after any NPL that becomes an REO property is marketed, the property may be sold only to buyers who intend to occupy the property as their primary residence or to nonprofits.

- Subsequent servicer requirements: Subsequent servicers must assume the responsibilities of the initial servicer.

- Bidding transparency: To facilitate transparency of the NPL sales program and encourage robust participation by all interested participants, each Enterprise will develop a process for announcing upcoming NPL sale offerings. This will include an

NPL webpage on the Enterprise's website, email distribution to small, nonprofit and minority- and women-owned business (MWOB) investors, and proactive outreach to potential bidders. Additionally, each Enterprise will host training sessions for interested nonprofit and MWOB investors to facilitate better understanding of the NPL sales process. The Enterprises will also offer small pools of NPLs, where feasible.

- Small pools: The Enterprises will offer small, geographically concentrated pools of NPLs, where feasible, to maximize opportunities for nonprofit organizations and MWOBs to purchase NPLs. The Enterprises will actively market such offerings to nonprofits and MWOBs and provide additional time for buyers to complete the transaction.

- Reporting requirements: NPL buyers and servicers, including subsequent servicers, are required to report loan resolution results and borrower outcomes to the Enterprises for four years after the NPL sale. These reports will help inform whether to make future changes to NPL sales requirements and determine whether an NPL buyer and NPL servicer continue to be eligible for future sales based on pool level borrower outcomes, adjusted for subsequent market events. Consistent with applicable law, FHFA and/or the Enterprises will provide public reports on aggregate borrower outcomes at the pool level.

On April 14, 2016, FHFA announced the following additional enhancements to its requirements for sales of NPLs.

- Modification requirements:

    - For borrowers with a mark-to-market loan-to-value ratio above 115 percent, servicers will be required to evaluate these borrowers for loan modifications (HAMP or proprietary) that include principal and/or arrearage forgiveness. Servicers may consider net present value to the investor in establishing the waterfall for implementation.

    - Proprietary modifications must either be fixed rate for the term of the modification or offer an initial period of reduced payments with limits on subsequent increases consistent with HAMP requirements – the initial period must last for at least 5 years and interest rate increases may not exceed 1 percent per year thereafter.

- No walkaways: If a property securing a loan is vacant, buyers may not abandon the lien and walk away from the property. Instead, if a foreclosure alternative is not possible, the servicer must complete a foreclosure or must sell or donate the loan, including to a government or nonprofit entity.

APPENDIX B...

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Marla A. Freedman, Deputy Inspector General for Audit

FROM: Sandra Thompson, Deputy Director for Housing Mission and Goals

SUBJECT: Draft Report: *NPL Sales: Additional Controls Would Increase Compliance with FHFA's Sales Requirements*

DATE: July 19, 2017

This Memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the FHFA OIG draft report, *NPL Sales: Additional Controls Would Increase Compliance with FHFA's Sales Requirements.*

FHFA management's responses to the FHFA OIG's recommendations are below.

Recommendation 1:

Based on the goals and requirements of NPL sales, as established by FHFA:

a. *Determine the information necessary to assess whether all of the goals and requirements are being met;*
b. *Update/modify the NPL sales reporting requirements as necessary to obtain that information; and*
c. *Update/modify the templates the Enterprises use to collect loan-level data from NPL buyers and servicers, as necessary.*

Management Response to Recommendation 1:

FHFA agrees with the recommendation and will review the current information collected to determine if changes are necessary in order to assess whether the NPL Sales goals and requirements are being met. FHFA will make a determination by February 15, 2018. If FHFA

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determines that changes are necessary, FHFA will update the reporting requirements and work with the Enterprises to modify the templates in a reasonable timeframe.

Recommendation 2:

Direct the Enterprises to:

a. *Put controls in place to identify and track simultaneous reporting of charge-off and vacant property, as indicating a possible walk away violation; and*
b. *Take action, as necessary, to ensure that servicers resolve possible walk away violations through foreclosure, or sale or donation of the loan.*

Management Response to Recommendation 2:

While some controls are in place, FHFA will work with the Enterprises to determine if additional controls are needed to address simultaneous reporting of charge-offs and vacant properties and if the Enterprises should take action to ensure that servicers resolve possible walk away violations. FHFA will make its determinations by February 15, 2018.

Recommendation 3:

Communicate to the Enterprises that they have the authority to review loan files to verify the accuracy of data provided by NPL buyers and servicers, in support of compliance with FHFA's sales requirements.

Management Response to Recommendation 3:

FHFA agrees with the recommendation and believes that the recommendation has already been addressed during the audit fieldwork and technical review of the draft Report.

cc: John Major, Internal Controls and Audit Follow-up Manager
Larry Stauffer, Acting Chief Operating Officer

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Auditor's Note: Regarding the Management Response to Recommendation 3, an FHFA official affirmed to us on July 20, 2017, that when issued, FHFA will forward this audit report to the Enterprises to reiterate FHFA's Office of General Counsel position that the Enterprises' NPL sales agreements provide the Enterprises the right to access the loan files of the buyers and their servicers.

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

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