FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers

EVALUATION REPORT: EVL-2012-008 **DATED: September 18, 2012**

FEDERAL HOUSING FINANCE AGENCY
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AT A GLANCE

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Why FHFA-OIG Did This Evaluation

The Federal Housing Finance Agency (FHFA or Agency) Office of Inspector General (FHFA-OIG) conducted this evaluation to assess FHFA's oversight of a transaction between the Federal National Mortgage Association (Fannie Mae) and Bank of America (BOA). In the summer of 2011, Fannie Mae proposed to purchase from BOA – for $512 million – the mortgage servicing rights (MSR) to approximately 384,000 mortgage loans owned or guaranteed by Fannie Mae. The deal between Fannie Mae and BOA received significant public and media attention; indeed, FHFA-OIG received a request from Congress that it review the transaction.

What FHFA-OIG Found

Fannie Mae's purchase of MSR from BOA was not an isolated event. Rather, it was the most recent of several transactions executed as part of an ongoing initiative. This initiative, the High Touch Servicing Program, utilizes specialty servicers who work with at-risk borrowers to help reduce the number of defaults in mortgages owned or guaranteed by Fannie Mae. In order to transfer MSR from a regular servicer to a specialty servicer, Fannie Mae must first terminate the regular servicer's contract, i.e., purchase or otherwise take away the MSR.

The BOA transaction was the largest of the transfers in the High Touch Servicing Program to date. However, the amount Fannie Mae paid was consistent with the amounts it had paid to other servicers from which it purchased MSR under the program.

An internal audit conducted by Fannie Mae raised questions about the controls surrounding the High Touch Servicing Program, as well as the likelihood that it would achieve the projected savings. Similarly, FHFA-OIG found that Fannie Mae relied on a single consultant to price most of the MSR transactions under the program, and that the terms of Fannie Mae's standard servicing contract appear to constrain its ability to transfer – at no or reduced cost – MSR for reasons related to a portfolio's performance.

Furthermore, FHFA-OIG determined that FHFA can improve its oversight of Fannie Mae's program. Although FHFA reviewed the BOA transaction and allowed it to proceed, it did not conduct similar reviews of other transactions in the High Touch Servicing Program nor did it review the program as a whole.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA: (1) consider revising its Delegation of Authorities to the Enterprises to require FHFA approval of unusual or high cost new initiatives; (2) ensure that Fannie Mae applies additional scrutiny and rigor to pricing significant MSR transactions; (3) review the assumptions underlying the High Touch Servicing Program and, as the program develops, re-evaluate the performance criteria for the program; and (4) ensure that Fannie Mae fully implements earlier FHFA directions on the purchase and transfer of MSR; this could include revising its standard servicing contract to facilitate MSR transfers due to portfolio performance.

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ABBREVIATIONS

Abbreviation	Meaning
BOA	Bank of America
Bps	Basis Points
CEO	Chief Executive Officer
DCF	Discount Cash Flow
ESP	Enhanced Servicing Program
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or the Agency	Federal Housing Finance Agency
FHFA-OIG	Federal Housing Finance Agency, Office of Inspector General
Freddie Mac	Federal Home Loan Mortgage Corporation
The Guide	Fannie Mae's Single Family Servicing Guide
HAMP	Home Affordable Modification Program
HERA	Housing and Economic Recovery Act of 2008
MBS	Mortgage-Backed Securities
MRA	Matter Requiring Attention
MSR	Mortgage Servicing Rights

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 (HERA), which amended the Inspector General Act of 1978. FHFA-OIG is authorized to conduct audits, evaluations, investigations, and other activities of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them.

This evaluation is one in a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities. It furthers FHFA-OIG's first strategic goal: assisting FHFA to improve the economic health of the regulated entities and to understand the causes and costs of the conservatorships. Specifically, it is intended to assess FHFA's supervision of Fannie Mae's acquisition of mortgage servicing rights from BOA and to identify opportunities for improvement generally.

This evaluation was led by Director of Special Projects David Z. Seide. The report was prepared by Assistant Inspector General David Morgan Frost, with assistance from Chief Economist Simon Wu. FHFA-OIG appreciates the assistance of all those who contributed to this report.

George Grob
Deputy Inspector General for Evaluations

BACKGROUND

I. Introduction

In July 2011, Fannie Mae negotiated an agreement to pay $512 million to BOA to acquire the MSR to approximately 384,000 mortgage loans that were owned or guaranteed by the Enterprise. The deal, which ultimately cost $421 million,[1] received significant attention in the media and by Members of Congress. Indeed, within a month of the sale, FHFA-OIG received a letter from Representatives Jackie Speier, George Miller, Brad Miller, and Maxine Waters, requesting that it review the BOA transaction.

In this report, OIG reviews and evaluates Fannie Mae's business rationale for its deal with BOA, the circumstances surrounding that transaction, similar transactions with several other banks, and the supervisory role played by FHFA.

A. FHFA and Its Delegation of Authorities to the Enterprises

HERA established FHFA as the federal safety and soundness and mission regulator for Fannie Mae, the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks.

Since September 2008, FHFA has also acted as the conservator for Fannie Mae and Freddie Mac (collectively, the Enterprises), in which capacity it has plenary authority over all Enterprise operations. FHFA carries out its oversight and conservatorship responsibilities by conducting continuous supervision and targeted examinations and by issuing supervisory or enforcement orders.

On November 24, 2008, FHFA issued orders delegating most Enterprise management functions to the Enterprises' boards of directors. FHFA advised the Enterprises that they "should consult with and obtain approval of the Conservator" before taking action in certain specific areas, including significant settlements; matters relating to the conservatorship; matters involving

[1] The amount initially proposed by Fannie Mae to FHFA for the transaction was $512 million for the MSR to approximately 384,000 loans. At the time of the first transfer, the projected total value was $496.3 million. When all transfers were completed, the total amount paid by Fannie Mae was $421 million. The decrease was the result of a reduction in the number of loans in the portfolio – and the corresponding reduction in the unpaid principal balance of the portfolio – due to early payoffs or refinancings.

reputational risk; and any substantial transaction between an Enterprise and any of its affiliates, except for transactions undertaken in the ordinary course of business.[2]

Matters not specified in the delegations as requiring the conservator's approval are typically handled by the Enterprises without first seeking such approval. FHFA relies on the Enterprises to determine, in light of the delegations, which matters require conservator approval and which may be considered within the ordinary course of business. Because the Enterprises' interpretations of their delegations are not formally reviewed by the conservator, they tend to be final.

B. About Fannie Mae and the Secondary Mortgage Market

Fannie Mae was chartered by Congress to create liquidity and promote affordable housing in the mortgage market (i.e., to provide the ready availability of cash for mortgages). To carry out this mission, Fannie Mae purchases mortgage loans originated by banks and other lenders, enabling those institutions to replenish their funds so they can lend to other homeowners.

Fannie Mae purchases mortgages on single-family homes from mortgage companies, commercial banks, credit unions, and other financial institutions. Fannie Mae generally securitizes these mortgages by bundling them into mortgage-backed securities (MBS), which it then sells to investors. When homeowners make their payments of mortgage principal and interest each month, these payments are ultimately transferred (passed through) to MBS investors.

A significant portion of Fannie Mae's MBS business involves guaranteeing the underlying mortgages securitized by Fannie Mae. In exchange for a "guarantee fee," Fannie Mae assumes the risk for all principal and interest payments on the security. Thus, Fannie Mae bears the credit risk in the event of a borrower's default.

C. Mortgage Servicing

Regardless of whether a loan is sold, securitized, or retained in a lender's portfolio, the mortgage itself must be "serviced." This means that payments must be collected and disbursed appropriately and the loan must be administered, including the release of the mortgagor's interest

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[2] *See* Letter from James B. Lockhart, III, Director, FHFA, to Chairman of the Board Philip A. Laskawy (Nov. 24, 2008), and Letter from James B. Lockhart III, Director, FHFA, to John A. Koskinen, Chairman of the Board (Nov. 24, 2008). In addition, the Enterprises are required to consult with FHFA on certain other specified matters, including: actions involving capital stock and dividends; the creation of any subsidiary or affiliate; matters involving hiring, compensation, and termination benefits of directors and officers at the executive vice president level and above; the retention and termination of external auditors and law firms serving as board consultants; settlements in excess of $50 million of litigation, claims, regulatory proceedings, or tax-related matters; or mergers or acquisitions of businesses involving consideration in excess of $50 million.

in the borrower's collateral at payoff or, as necessary, the management of defaults and foreclosures.

Although both Enterprises purchase substantial numbers of loans, neither services any of the loans in its portfolio. Rather, the Enterprises rely on third-parties to service their loans; these third parties generally are affiliates of the parties that originated and sold the loans. The following figure illustrates the relationship between servicers, the Enterprises, and homeowners.

Figure 1: The Mortgage Servicing Process

Homeowners

Make monthly payments under terms of mortgage

Servicer

- *Collects payments and calculates balances*
- *Distributes principal and interest to mortgage owner, net of service fees*
- *Loss mitigation or foreclosure, if required*

Enterprise

- *Owns or guarantees mortgages*
- *Receives principal and interest or guarantee fee*

For this work, servicers generally receive an annual loan servicing fee. Typically, the fee is calculated based on the percentage of the unpaid principal balance of a particular loan. Fannie Mae pays regular or standard loan servicers a minimum annual fee of 25 basis points (bps), or one quarter of one percent, on the unpaid principal balance of performing loans, although the actual fee may be higher.[3] Specialty servicers receive a fixed amount (figured in dollars per year

[3] The "net servicing fee" for a loan may exceed 25 bps, depending on a number of factors, such as MBS pass-through (the yield on the particular MBS of which the loan is a part) and Fannie Mae's guarantee fee (which varies). Consider the case of a particular loan with a 6% interest rate, a guarantee fee of 20 bps, and an MBS pass-through of 5.5%. To calculate the net servicing fee, Fannie Mae would take the yield of the loan (6% or 600 bps) and subtract: (1) the yield of the security (5.5% or 550 bps); (2) the guarantee fee (20 bps); and (3) the minimum service fee (25 bps). The remaining sum (5 bps) would then be added to the 25 bps minimum net service fee. Thus, in this case, the annual fee that a servicer would claim for this particular loan would be 30 bps or 0.30%. Fannie Mae's service fees are not negotiated but are calculated based on this fixed formula; a standard servicer's ability to make a profit will vary with its ability to economize on servicing activities.

per loan) that varies depending on the status of the loan. In such cases, fees would typically rise for loans that are delinquent, in light of the additional work that the servicer would have to perform (e.g., working with delinquent borrowers to facilitate payments or managing any foreclosures).

The terms of the loan servicing arrangement between Fannie Mae and its loan servicers are found in the *Fannie Mae Single Family Servicing Guide* (the Guide).[4] Under its terms, Fannie Mae may transfer MSR from one loan servicer to another, with or without cause. If servicers are terminated **for cause**, then Fannie Mae pays no termination fee. On the other hand, if Fannie Mae decides to use the services of another servicer and terminates a servicer **without cause**, then the Guide specifies that Fannie Mae must pay a fee to the terminated servicer equivalent to twice its annual servicing fee on each loan serviced.

In other words, if Fannie Mae wanted to transfer servicing without cause on loans for which the servicer is paid 25 bps, then Fannie Mae could do so provided it paid the servicer a termination fee on each loan to be transferred. In that case, the termination fee would be 50 bps multiplied by the unpaid principal balance of all of the loans serviced. That figure could be significant, especially where, as here, Fannie Mae transferred hundreds of thousands of loans to another servicer.

In addition, when Fannie Mae transfers MSR without cause, the Guide provides the terminated servicer with the opportunity to attempt to find another buyer willing to pay more than the contractual termination fee. Specifically, the servicer is entitled to up to 90 days to sell the MSR to another purchaser.

D. The Housing Crisis

With the collapse of the housing market, default rates on single-family mortgages increased dramatically, particularly for loans originated during the housing boom and shortly thereafter (2005–2008). As reflected in Figure 2 below, by 2011, over 5% of the single-family mortgages originated in 2005 were in default; over 8.5% of mortgages from 2006 and approximately 9% of mortgages from 2007 were also in default. Moreover, the chart reveals that defaults peak several years after origination.

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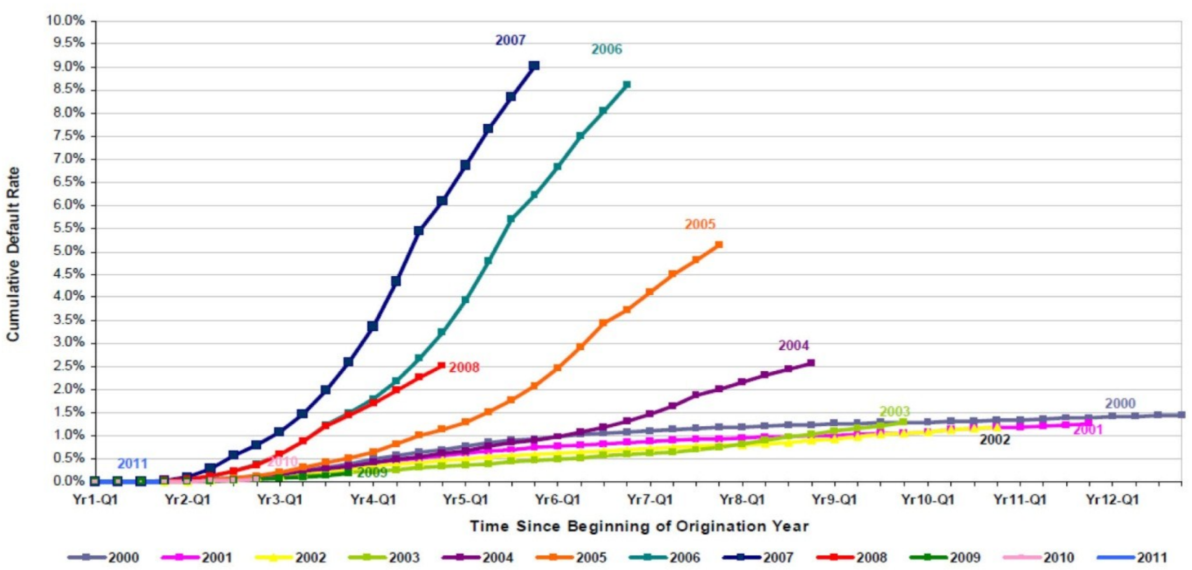
[4] *Fannie Mae Single Family 2012 Servicing Guide* (March 14, 2012) (online at https://www.efanniemae.com/sf/guides/ssg/svcgpdf.jsp).

Figure 2: Fannie Mae Single-Family Cumulative Default Rates[5]

Cumulative Default Rates of Single-Family Conventional Guaranty Book of Business by Origination Year



Note: Defaults include loan liquidations other than through voluntary pay-off or repurchase by lenders and include loan foreclosures, preforeclosure sales, sales to third parties and deeds in lieu of foreclosure. Cumulative Default Rate is the total number of single-family conventional loans in the guaranty book of business originated in the identified year that have defaulted, divided by the total number of single-family conventional loans in the guaranty book of business originated in the identified year.

Data as of December 31, 2011 are not necessarily indicative of the ultimate performance of the loans and performance is likely to change, perhaps materially, in future periods.

Fannie Mae has sustained – and continues to sustain – significant losses on defaulting mortgages. From the third quarter of 2008 (the quarter in which Fannie Mae was placed in conservatorship) through the end of 2011, Fannie Mae lost more than $157 billion; most of these losses were attributable to mortgage losses in the Enterprise's retained and guaranteed mortgage portfolios.

II. Fannie Mae's Mortgage Servicing Strategy

In late 2008, as a result of Fannie Mae's review of its mortgage servicing processes, the Enterprise began a project to manage servicing differently in an effort to mitigate the credit losses impacting its portfolio of mortgage investments. One of the ideas the Enterprise contemplated was the acquisition of a company through which it could conduct its own mortgage servicing (effectively saving costs by eliminating the "middle man"). Fannie Mae proposed this idea to FHFA; however, the idea was not implemented. Accordingly, with continuing concerns as to servicing issues, Fannie Mae sought other means of realizing credit loss savings on its troubled mortgage portfolio.

[5] Source: Fannie Mae 2011 Credit Supplement (Feb. 29, 2012).

As part of this effort, Fannie Mae established the Enhanced Servicing Program (ESP). Enhanced servicing involves closer and more frequent contact between a delinquent mortgagor and the servicer; it is the business model utilized by so-called "specialty" or "high touch" servicers.

A. Potential Limitations in the Standard Servicing Arrangement

Prior to the inception of ESP, Fannie Mae may have had (what one of its executives described as) a "misalignment of interests" with its servicers. As guarantor or loan holder, Fannie Mae could face significant losses from a default. However, a servicer earns only a fraction of a percent of the unpaid balance of a mortgage it services and, thus, the fees derived from any particular loan may not – at least for the servicer – provide adequate incentive to undertake anything more than the bare minimum of effort in order to prevent a default. This will typically include sending out delinquency notices to borrowers who have not made timely payments, telephoning delinquent borrowers, and, ultimately, initiating foreclosure proceedings.

B. The High Touch Servicing Advantage

Fannie Mae determined that specialty servicers might be able to improve outcomes for mortgages at risk of default. These servicers intensively contact borrowers, educate them on the impact of not paying, and explain options to avoid foreclosure. A specialty servicer will often have a single point of contact for a delinquent borrower; this individual is responsible for outreach services. Moreover, Fannie Mae mandates certain staffing levels for high touch servicers, limiting the number of cases any staffer can handle.

As an incentive for providing an enhanced level of attention to high risk loans, specialty servicers have a different compensation structure from the one applicable to standard servicers. As indicated above, a standard servicer's compensation is based on a fraction of a percent of the unpaid balance of a particular loan – the fraction is small enough that it may not be cost-effective for the servicer to expend significant resources to prevent default. A specialty servicer's compensation, however, generally comes in three forms: first, the specialty servicer receives base fees; second, it receives incentive payments for mortgage modifications; and, finally, it receives a performance payment based on its success as contrasted with that of a comparable (or "benchmark") portfolio established by Fannie Mae. Accordingly, a specialty servicer's compensation varies far more directly and significantly with its ability to prevent defaults. This may reduce the "misalignment of interests" the Fannie Mae executive noted with its standard servicers.

The High Touch Servicing Program

The Origin of the High Touch Servicing Program

Fannie Mae's High Touch Servicing Program originated with the consolidation of various servicing-related initiatives, including ESP. The team responsible for ESP had determined that approximately 70% of Fannie Mae's mortgage losses were coming from a specific portfolio of mortgages with a combined principal balance of approximately $300-$400 billion.

Having pinpointed the source of so large a portion of its losses, Fannie Mae concluded that transferring the MSR for this portfolio of mortgage investments to specialty servicers could potentially help avoid substantial anticipated credit losses. Under the plan, Fannie Mae would terminate its contracts with the servicers who held MSR associated with the problematic portfolio and select specialty servicers whose efforts, Fannie Mae anticipated, would generate substantial cost savings. According to Fannie Mae, the High Touch Servicing Program could result in credit loss savings in the range of 20% – a potentially significant amount given the credit losses Fannie Mae expected to sustain on its higher risk mortgages.

According to a Fannie Mae executive, prior to 2009, Fannie Mae occasionally had transferred MSR; however, this was generally done as a result of poor financial practices on the part of a servicer or some impairment to a servicer's financial ability or its likely capacity to continue servicing the mortgages. Fannie Mae typically had not transferred MSR as a strategic move to improve the return on its investments. Thus, although the notion of an MSR transaction was not new to Fannie Mae, the basic concept of the High Touch Servicing Program – a planned series of MSR transactions designed to reduce credit losses through specialty servicing – was a novel concept.

In light of this, in early to mid-2009, the executives responsible for the High Touch Servicing Program presented the business case for the program to Fannie Mae's Chief Executive Officer (CEO), who approved it.[6] Fannie Mae provided briefings to FHFA on the High Touch Servicing Program; however, Fannie Mae did not seek FHFA's approval to undertake the program prior to its initiation, nor did it seek such approval after the program was initiated, apparently concluding that the program did not fall within any category of activity requiring prior approval from FHFA in its role as conservator. Fannie Mae has asserted that the program itself and the individual transactions fell within Fannie Mae's ordinary course of business, and thus remained within the authority FHFA had delegated to Fannie Mae in November of 2008.

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[6] The first transaction in the program actually was completed on November 30, 2008, months prior to the CEO formally approving the program.

The High Touch Servicing Program Gets Underway

Initial activities under Fannie Mae's new program involved the Enterprise's financing a portion of MSR acquisitions by specialty servicers, who acquired the MSR on specified numbers of loans from standard servicers. Later, Fannie Mae paid a portion of the purchase price directly to the terminated servicers and contracted with specialty servicers to manage servicing activities.

Prior to the BOA transaction in August 2011, Fannie Mae had conducted or facilitated MSR transactions with about twelve other standard servicers pursuant to the High Touch Servicing Program. With these transactions, Fannie Mae transferred to specialty servicers MSR for over 700,000 higher-risk loans with an unpaid balance in excess of $130 billion. Fannie Mae paid, or financed the payment of, approximately $1.5 billion in termination fees (including the BOA transaction) for the MSR it transferred.

FHFA Examiners Question the Amounts Paid by Fannie Mae to Transfer MSR

Beginning in October 2010 and continuing through early 2011, FHFA, in its capacity as regulator of Fannie Mae, reviewed the Enterprise's administration of the Home Affordable Modification Program (HAMP).[7] During the course of that review, the examination staff learned that Fannie Mae was paying "significantly more than the contractual or going rate" to transfer MSR.

On June 13, 2011, following its review, FHFA issued a report expressing serious concerns about HAMP generally. With respect to MSR specifically, FHFA found that "Fannie Mae's approach to transferring non-performing loans from servicers for poor performance is inadequate."[8] FHFA's report included a matter requiring attention (MRA), in which FHFA observed that Fannie Mae had facilitated the transfer of MSR through negotiated transactions and had routinely paid more than the contractually specified fee for terminations without cause. Specifically, the MRA stated that Fannie Mae's third-party sales of servicing rights in 2008 through 2010 revealed a flawed approach to servicing transfers and indicated that Fannie Mae was paying a premium to transfer MSR from servicers who failed to service the loans at an acceptable level.

FHFA noted that Fannie Mae had facilitated third-party sales of servicing rights in 2008 and 2009, and transferred servicing rights in 2010. The cumulative effect of these actions was to

[7] HAMP is a federal government-sponsored program designed to provide homeowners an opportunity to modify their loans to more affordable monthly payments.

[8] FHFA-OIG notes that insofar as "performance" is concerned, although BOA's performance was below average among its peer group, it was never alleged to have been in breach of its contract with Fannie Mae. Rather, in the wake of the financial crisis, it appears that Fannie Mae realized that the standard servicing model contracted for between BOA and Fannie Mae no longer met Fannie Mae's requirements for a high risk portfolio.

transfer the servicing of 741,000 loans with $131.45 billion in unpaid principal balance. FHFA stated, however, that in each instance Fannie Mae made the servicer whole for loans transferred, thus eliminating any punitive effect of the transfer.

According to FHFA, in instances where Fannie Mae had opportunities to move loans "without cause" at a lower rate, this option was not exercised. For example, FHFA noted a transaction in which Fannie Mae had the opportunity to transfer servicing at twice the net service fee, but settled at 2.77 to 2.87 times the net service fee. FHFA stated that such transactions not only failed to encourage improved servicer performance, but actually encouraged and even rewarded poor performance. FHFA concluded:

> We expect Fannie Mae to structure its portfolio transfers in a manner that reflects the performance deficiencies of the transferring servicer. Specifically, if the transfer is a result of poor servicer performance, the transaction will not make the servicer that failed to perform whole.

By letter dated July 13, 2011, Fannie Mae disagreed with FHFA's conclusion and argued that, in most instances, it had paid for MSR transfers at an appropriate rate. It also stated that, in light of the:

> high risk nature of the portfolios and disproportionate share of expected future losses relative to the entire Single Family portfolio … it was in Fannie Mae's best interest to negotiate mutually beneficial terms in order to gain control of servicing and therefore, credit performance of the assets.

Fannie Mae added that any attempt to transfer MSR without proper compensation would have resulted in litigation as well as unnecessary and costly delays. Finally, Fannie Mae asserted that, from a business perspective, a negotiated settlement was a better choice, as follows.

> Servicing transfers are operationally intensive. Cooperation and coordination between the existing and new servicer therefore is critical. If we had not negotiated on price, the existing servicers would have not cooperated, thereby impacting credit losses, the borrower, and the new servicer's ability to service.

FHFA examiners, however, were not persuaded by Fannie Mae's response, as discussed in further detail below. Meanwhile, as discussions on the MRA continued between Fannie Mae and

FHFA,[9] the High Touch Servicing Program continued apace and Fannie Mae negotiated the BOA transaction, the largest transaction in the history of the program.

III. The Bank of America Transaction

Fannie Mae had identified within the portfolio of loans that it owned or guaranteed approximately 384,000 higher risk loans serviced by BOA with a combined unpaid principal balance of approximately $73.6 billion. The portfolio's delinquency rate was approximately 11%, and Fannie Mae had calculated that, under BOA's servicing paradigm, defaults on mortgages in the portfolio would result in credit losses of approximately $10.9 billion.[10]

Conversely, Fannie Mae, as part of its High Touch Servicing Program, had also projected that were this portfolio to be transferred to specialty servicers, the Enterprise could realize credit loss savings ranging from approximately $1.7 billion to $2.7 billion over the subsequent five years. Accordingly, around January of 2011, Fannie Mae commenced discussions with BOA with the intention of purchasing the MSR from BOA and transferring them to a specialty servicer.[11]

A. Fannie Mae and BOA Negotiate the Price of the MSR

As indicated above, Fannie Mae's servicing contract provides two primary methods of terminating a servicer's MSR in order to transfer them to another servicer – "for cause" or "without cause." Fannie Mae could transfer MSR "for cause" without any termination fee; should it elect to transfer MSR "without cause," however, its servicing contract calls for payment to the servicer of an amount equal to twice the annualized servicing fee. Additionally, in the event that MSR were to be transferred "without cause," the servicer would have the opportunity, for 90 days, to attempt to find another buyer for the MSR.

BOA received a net servicing fee of 29 bps on the portfolio in question. Thus, according to the Guide, termination of BOA's servicing contract "without cause" should have resulted in a payment in the amount of 58 bps (0.58%) of the $73.6 billion unpaid principal balance of the loans. If Fannie Mae had chosen this option, the transfer fee would have been about $427 million, $85 million less than the actual negotiated price. As detailed below, the parties

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[9] Subsequently, by letter dated October 26, 2011, Fannie Mae agreed to update internal policies regarding servicing transfers and other aspects of the Guide.

[10] Fannie Mae reviewed BOA's overall servicing performance and concluded that it was below average in relation to BOA's servicer peer group, but the Enterprise never determined the servicer to be in breach of its contract. Fannie Mae also noted that BOA had brought in new management to handle servicing, but improvements in the process were likely to take some time.

[11] Fannie Mae had initially broached the subject with BOA in early 2010; however, the parties were too far apart on the price of the termination fee.

ultimately reached an agreement to transfer the portfolio for $512 million, a sum equal to 2.4 times the annualized servicing fee.

Initially, BOA demanded a fee of 84 bps (about $621 million). Under the servicing contract, BOA had the right to delay a "without cause" transfer for up to 90 days while it sought another buyer. BOA may or may not have been able to find a buyer willing to pay more than 58 bps for its MSR; nonetheless, BOA may well have recognized that the prospect of a three month delay in the transaction (and the attendant additional delay and expenses that it would cause Fannie Mae) provided it some leverage in the negotiations.

In preparation for the proposed transaction – as for most other transactions in the High Touch Servicing Program – Fannie Mae engaged an independent valuation firm (the "independent valuator") to provide an assessment of the value of the BOA portfolio. Fannie Mae did not seek any other independent valuations of the portfolio.

B. Fannie Mae's Independent Valuation

At Fannie Mae's direction, the independent valuator produced a valuation analysis of the BOA MSR portfolio. The independent valuator arrived at its market valuation through a common valuation technique, discounted cash flow (DCF) analysis.

The DCF analysis calculates the value of an asset today, based on projections of how much money the asset is going to make in the future. A key element of DCF analysis is the discount rate, which is the interest rate used to estimate the present value of future cash flows. In the case of a portfolio of mortgages, for example, the greater the risk of defaults, refinancings, or other diminutions of future payments (i.e., decreases in the unpaid principal balance of the mortgage portfolio and, consequentially, reduction of annual payments for servicing), the higher the discount rate; alternatively, the lower the risk of diminutions of future payments, the lower the discount rate.

The independent valuator concluded that the weighted average discount rate for its market analysis was 15.3%. That figure produced a market value of 63 bps, or $464 million, for the BOA portfolio – $37 million more than what the contract specified the fee would be had BOA been terminated without cause (i.e., 58 bps, or $427 million).[12] Had the discount rate been

[12] The independent valuator also provided several additional value measures: the contract termination fee of twice the annual servicing fee (58 bps, or $427 million); BOA's publicly stated value for this portfolio (80-90 bps, or $589 million to $663 million); the estimated value that BOA assigned to this MSR on its own books and records (around 84 bps, or $621 million); the intrinsic value of the portfolio to Fannie Mae, meaning the amount it internally valued the portfolio (61.5 bps, or $453 million); and the range of values negotiated between Fannie Mae and BOA (66-69.5 bps, or $486 million to $512 million). Thus, the range of values the independent valuator presented went from a low

higher, then the valuation would have been lower; conversely a lower and less risky discount rate would have resulted in higher valuation.

1. Possible Issues with Using a Single Valuation

The independent valuator calculated the 15.3% discount rate by assigning varying discount rates to different groups of loans in the BOA portfolio. The independent valuator assigned discount rates based on a variety of factors that contribute in different ways to the risks inherent in any particular loan.[13] However, independent assessments of the valuation, one commissioned by FHFA-OIG and another conducted by FHFA-OIG's Chief Economist, raise two questions about the 15.3% discount rate: first, whether the valuation adequately accounted for regional variation and negative equity severity, given the heavy concentration of severely underwater loans originated in the states hardest hit by the housing crisis; and second, whether the valuation adequately accounted for recent MSR transactions, a number at levels noticeably lower than the Fannie Mae-BOA negotiated price.

Regional Variation

Of the 384,000 loans covered by the BOA transaction, about 60% are concentrated in the five states hardest hit by the housing crisis: California, Florida, Arizona, Nevada, and Michigan. The drop in property values in those states was precipitous – by May 2011, property values in Los Angeles, California, had dropped 38.1% from their June 2006 peak value; property values in Las Vegas, Nevada, had dropped 59.1%, and property values in Miami, Florida, had dropped 50.2%. Contrast this with property values in Dallas, Texas, which dropped only 8.2% between June 2006 and May 2011, or Denver, Colorado, where properties dropped 11.1% in that time period.

Figure 3: Regional Variation in Home Values[14]

City	June 2006–May 2011 Drop in Price
Chicago, IL	33.0%
Dallas, TX	8.2%
Denver, CO	11.1%
Las Vegas, NV	59.1%
Los Angeles, CA	38.1%

of 58 bps ($427 million, the contractually specified termination fee) to a high of 90 bps ($663 million, BOA's estimated public carry value).

[13] Those factors included: length of loan maturity; whether the loans were fixed-rate or adjustable-rate mortgages; whether the borrowers were delinquent and, if so, the extent of delinquency; whether the loans were "interest-rate only;" FICO credit scores; and loan-to-value ratio of the mortgage.

[14] Source: S&P Case-Shiller Home Price Indices.

Miami, FL	50.2%
New York, NY	23.5%
Washington, DC	28.1%

Given this very wide variation, it is likely that two similarly-situated homes – one in Las Vegas and the other in Dallas – would present different levels of risk to lenders, and therefore different discount rates. The valuation model utilized by the independent valuator, however, appears not to have considered the likely impact of geography on the discount rate – a particularly important consideration in light of the high concentration of BOA loans in hardest hit states, like California, Nevada, and Florida.[15]

Regional variation may also have had a significant effect on risk because the foreclosure process varies from state to state. Some states require court action on a foreclosed home, while other states allow foreclosure without judicial action.[16] Variations in state foreclosure processes are significant in that some processes are faster and more efficient than others. Since efficiency varies by state, the timeline for receiving expected future cash flows also varies and the discount rate used in the DCF may vary. It appears that the independent valuator may not have considered the possible impact of state foreclosure law on the value of the BOA portfolio.

Severity of Loans Underwater

The independent valuator attempted to account for the severity of underwater loans somewhat by dividing the 384,000 BOA loans into two groups: (1) loans not underwater (i.e., loans with loan-to-value ratios of less than 100%) or barely underwater (i.e., loans with loan-to-value ratios of greater than 100% and less than 110%); and (2) all other underwater loans (i.e., loans with loan-to-value ratios of greater than 110%). However, this loan population had a substantial number of loans that were severely underwater. Indeed, over 203,000 loans – more than half of the loans – had loan-to-value ratios of greater than 120% and, thus, entirely within the upper threshold of the independent valuator. These loans were likely more risky (relative to loans that were not or barely underwater), which would have been reflected in higher discount rates. Moreover, the valuation may not have adequately accounted for this concentrated risk because it did not

[15] For example, an independent contractor retained by FHFA-OIG determined that the implied discount rate in the Texas real estate market was 15%, while in the more volatile Nevada market it was 23%.

[16] In states that require judicial foreclosures, a lender must prove in court that the borrower is in default before initiating foreclosure. Non-judicial foreclosures are based on deeds of trust that enable the trustee to initiate a mortgage foreclosure sale without having to go to court.

differentiate among the classes of underwater loans in the independent valuator's upper threshold.[17]

Other MSR Transactions

FHFA-OIG also considered several other transactions between 2010 and 2012 in which high touch servicers acquired portfolios of MSR. These transactions ranged in price from a low of 35 bps to a high of 68 bps. Although Fannie Mae's transaction with BOA was slightly above the upper end of this range, FHFA-OIG recognizes the limitations inherent in any comparison of the transaction between Fannie Mae and BOA with "arm's length" transactions between other parties. Fannie Mae, as guarantor of the mortgages in the BOA portfolio, faced the prospect of significant losses were it not to purchase the MSR; thus, the value of the MSR to Fannie Mae might well have exceeded the value to a purchaser with no such liability.

2. Fannie Mae's Reliance on the Independent Valuator

It appears that Fannie Mae relied exclusively on the independent valuator's valuation of the MSR portfolio in its negotiations with BOA. Furthermore, as noted by Fannie Mae's internal audit of the High Touch Servicing Program, the Enterprise did not avail itself of its internal Model Risk Oversight Group to assess the independent valuator's process or conclusions. An FHFA examiner familiar with the transaction opined that, in light of the size of the BOA transaction, Fannie Mae should have done this, as well as obtain a second valuation.

Further, FHFA-OIG ventures no findings as to the validity of the independent valuator's valuation model or the accuracy of its valuation of the BOA portfolio, as such.[18] However, valuation models may vary. For example, FHFA-OIG's independent contractor considered the BOA portfolio and suggested bases for a different (lower) valuation, in light of factors like those discussed above. Without attempting to decide the precise model that ought to be used in any given transaction, FHFA-OIG is persuaded that Fannie Mae could benefit by a more rigorous examination of the methods employed by MSR valuators in order to determine best practices.

C. FHFA Reviews and Approves the BOA MSR Transaction

Fannie Mae and BOA reached a tentative agreement for the purchase of the portfolio of MSR at a price of 69.5 bps, or $511,665,515. Although this sum is squarely within the independent valuator's valuation range, it represents a premium of 11.5 bps (more than $80 million) over the

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[17] According to FHFA-OIG's contractor, the implied discount rate for loans with a loan-to-value ratio of 110% is 21%, and for loans with a ratio of 180% the discount rate is 30%.

[18] As suggested above, an objective valuation of a particular portfolio may not capture the potential value of the portfolio to Fannie Mae. Ultimately, the amount that a disinterested buyer might give a willing seller for a particular portfolio may not be the same as the amount that Fannie Mae might be willing to pay.

58 bps price specified for a without cause termination under Fannie Mae's servicing contract. In essence, the premium gave Fannie Mae the ability to avoid a possible 90 day delay in the transaction and to utilize a specialty servicer of its choice.

Having reached this tentative agreement for the purchase of MSR, Fannie Mae's High Touch Servicing Program team prepared an internal memorandum setting forth projected losses on the BOA portfolio, as well as anticipated credit loss savings from special servicing. The memorandum, which also presented the independent valuator's conclusions as to the value of the MSR, sought internal approval to purchase the BOA MSR at the negotiated price.

During the internal approval process, Fannie Mae determined that it should seek FHFA's review and approval of the BOA transaction. The Enterprise's reason for seeking the Conservator's approval for this transaction was based on the potential appearance of the transaction, the attendant reputational risk, and the MRA discussed above.[19]

On July 19, 2011, Fannie Mae alerted FHFA staff to the BOA transaction and requested FHFA approval. FHFA's initial reaction appears to have been generally supportive insofar as the transaction itself was concerned. However, several FHFA personnel were concerned by the $80 million price premium being offered. In one internal e-mail, dated July 22, 2011, an FHFA senior manager, who was asked to review the proposed transaction, wrote:

> if the threshold question is whether or not to do the transfer, the answer is probably yes. But the analysis probably understates the gain to [BOA] from getting this stuff off their books, so we might question if they have squeezed [BOA] hard enough on the pricing. It looks like doing the deal is better than not doing the deal, but there may be room to push for a better price.

In a July 26, 2011, e-mail to an FHFA executive, who was also reviewing the transaction, Fannie Mae provided four reasons for its decision to pay a premium over the contractually specified price:

- Operational impacts (BOA might slow the transaction);
- BOA would be given time to seek a better price for the portfolio;

[19] At the end of 2010, Fannie Mae had received approximately $1.3 billion from BOA in settlement of outstanding repurchase claims over faulty mortgages. Fannie Mae feared that its payment of nearly half a billion dollars to BOA for MSR would be perceived as taxpayer-funded relief to BOA. In fact, CNN Money, Forbes, and other publications raised questions as to Fannie Mae's motivation for the transaction.

- Insisting on the contractual price of twice the annualized servicing fee might erode liquidity in Fannie Mae MSRs (presumably by placing a ceiling on the sale price of such MSRs, thus limiting their value to a potential purchaser); and

- There was a potential litigation risk if Fannie Mae were to enforce a contractual provision that it had not enforced in the past.

Notwithstanding these arguments, FHFA officials remained skeptical about the price of the transaction. On July 29, 2011, FHFA officials directed Fannie Mae to attempt to negotiate a transfer payment that was no more than twice the annual servicing fee of 58 bps. Fannie Mae complied. However, on August 1, 2011, BOA informed Fannie Mae that it would not go forward with the transaction on such terms, and that it would attempt to sell the portfolio to another servicer.

Fannie Mae's CEO then proposed a compromise to allow the deal to proceed. Under this so-called "clawback" agreement, Fannie Mae would pay 69.5 bps for the MSR, but BOA would agree to refund up to 9.5 bps of the purchase price (about $70 million) if Fannie Mae did not realize credit loss savings of at least 5% from high touch servicing after 5 years.[20] BOA accepted the proposal, and FHFA's review of the transaction concluded with the Acting Director's issuance of a "no objection" letter on August 3, 2011. The Acting Director's letter also imposed several conditions for allowing the transaction to proceed, including the following:

- Fannie Mae and BOA would agree on a formula to measure the credit loss savings;

- Fannie Mae would report periodically to its Board of Directors and FHFA on performance versus expectations; and

- Fannie Mae would continue to address the MRA.

Having received its conservator's approval, Fannie Mae proceeded with the transaction.

IV. Fannie Mae's Internal Audit of the High Touch Servicing Program

The Fannie Mae-BOA transaction became public knowledge in early August 2011. Soon thereafter, on August 26, 2011, Fannie Mae's internal auditors announced an audit of the High Touch Servicing Program.

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[20] The determination as to whether the credit loss savings had been realized was to be based on a "shadow" pool of mortgages (not all of which were serviced by BOA). The default rate of this pool of mortgages would be compared to the BOA portfolio to be purchased by Fannie Mae and transferred to specialty servicers.

The audit of the High Touch Servicing Program had originated as a "review" (a survey in less detail than an audit) in 2010, and was added to the 2011 Fannie Mae internal audit plan as a more comprehensive, full audit. The audit covered the period from July 1, 2010, through September 30, 2011.[21] The report on the High Touch Servicing Program, issued on January 13, 2012, concludes that the program is in a "high risk" area, and that the controls governing the program are in need of improvement.

A. Preliminary Assessment of the High Touch Servicing Program

At the time of the report, Fannie Mae had contracted for the transfer of 15 portfolios under the High Touch Servicing Program (including the BOA portfolio). By the end of 2011, Fannie Mae had invested approximately $1.5 billion in the program.

For Fannie Mae's internal auditors, a key question about the High Touch Servicing Program was the extent to which it was achieving – or is likely to achieve – its goals. The earliest transfer in the program took place in November 2008; two others took place in the autumn of 2009. All the rest, including the BOA transaction, took place in 2010 and 2011. As the credit loss savings were projected to take place over a five year period that has not yet concluded, no final assessment of the program may be ventured.

However, according to the audit report, the "overall performance of the portfolios" was considered favorable. Although only one transfer had achieved the anticipated 20% savings, program management stated that greater savings were likely to come "as portfolios season," with "lower or negative credit loss performance" occurring in earlier months.[22] The report notes, nonetheless, that there was insufficient documentation within Fannie Mae's files from which auditors could assess the reasonableness of the credit loss savings assumptions. Specifically, the report found there was "limited documentation and analysis to support the likelihood that the expected credit loss savings will be achieved based on historical and current performance of the special servicers."

B. The Internal Audit's Findings

The audit report concludes that the controls governing the High Touch Servicing Program are in need of improvement. Specifically, it notes the following issues as the most significant:

- Documentation and analysis supporting the projections about credit loss savings is inadequate. In particular, the report noted that the Guide lacks clarity on the issue of

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[21] Thus, it included the BOA transaction.

[22] It should be noted that the "breakeven" point for the transactions in the High Touch Servicing Program was well under 20%. In most cases, the cost of the MSR transactions could be justified with less than 5% savings.

when it was appropriate to terminate a servicer's contract with cause or pursue a negotiated transaction.

- Fannie Mae's internal reporting regarding the High Touch Servicing Program is inconsistent and does not include a comparison of portfolio performance to management's expectation of performance at specific points in time.
- The independent valuator's valuation model has not been reviewed by Fannie Mae's Model Risk Oversight Group.
- Fannie Mae does not have processes or procedures in place to oversee the specialty servicers' implementation of policies relating to property preservation, quality assurance, and internal controls.

Based on those findings, Fannie Mae management agreed to submit the independent valuator's model to Fannie Mae's Model Risk Oversight Group for further evaluation. FHFA-OIG notes that a similar analysis by this group of the methods used by other MSR valuators could lead to the discovery of best practices that could improve Fannie Mae's negotiating position in future transactions.

C. Projected Credit Loss Savings

Regarding the essence of the High Touch Servicing Program – the projected 20% credit loss savings – as stated above, Fannie Mae's internal auditor's report states that Fannie Mae presented "limited documentation and analysis to support the likelihood that expected credit loss savings will be achieved based on historical and current performance of the special servicers." FHFA-OIG also identified confusion regarding the basis for the High Touch Servicing Program team's savings projection.

Some officials at Fannie Mae stated that the program was intended and expected to achieve a 20% savings for the Enterprise. Consistently, documentation prepared by Fannie Mae makes it clear that program management had conveyed an understanding to Fannie Mae senior leadership – and in the case of the BOA transaction to FHFA – that a minimum 20% credit loss savings was the intended result of the program. Further, Fannie Mae's internal auditor's report on the High Touch Servicing Program explains that Fannie Mae's goal is to reduce expected credit losses on transferred portfolios by 20% over a 5-year period. Moreover, documentation submitted to FHFA in support of the BOA transaction states:

> As part of our credit expense reduction strategies, the net benefit ranges from approximately $1.7 billion to $2.7 billion for the high risk portfolio under the

proposed structure depending on Credit Save Percentage (20%–30%). Targeted Credit Save is at least 20%.

On the other hand, at least one Fannie Mae executive directly connected with the program stated that the projected 20% credit loss savings was merely one of several "scenarios," and that other projections – both higher and lower – were provided as well.

Nonetheless, regardless of whether credit loss savings were adequately documented, FHFA-OIG's analysis confirmed that the "breakeven" points for the transactions to date in the High Touch Servicing Program were well under 20%.[23] In most cases, the cost of the MSR transactions would have been justified with credit loss savings of less than 5%. Time will tell whether the savings realized overall (i.e., savings accrued on historic and future transactions) will justify Fannie Mae's investment in the program.

V. The High-Touch Servicing Program to Date

In September 2011 (shortly after having approved the BOA transaction), FHFA advised Fannie Mae that its response to the MRA discussed above failed to address the Agency's concerns. Pending resolution of these concerns, FHFA stated that "Fannie Mae should not undertake any further [MSR] transfers until further notice." Since the BOA transaction, Fannie Mae has not paid to transfer MSR, pending resolution of this issue.[24]

However, as indicated above, the High Touch Servicing Program has been operating formally since late-2009. To date, Fannie Mae has paid approximately $1.5 billion in order to transfer to specialty servicers the MSR of over 1.1 million mortgages with an unpaid balance of over $200 billion. Fannie Mae has also paid a premium to transfer these loans to high touch servicers. The average transaction was at 2.3 times the annualized servicing fee for each transaction, which represents a premium of 15% over the contractually specified fee of twice the annual servicing fee. The BOA transaction, which was at 2.4 times the annualized servicing fee, was thus not significantly different from the "typical" High Touch Servicing Program transaction.

As reflected in Fannie Mae's internal audit report of the program, some early transfers have proved successful – others, it may be hoped, will prove similarly successful.

[23] Additionally, FHFA-OIG's independent contractor determined that Fannie Mae's 20% credit loss savings projection is reasonable.

[24] FHFA has subsequently interpreted its directive to mean that Fannie Mae may continue to transfer MSR provided it does not pay a fee.

However, whether the program's projected savings will ever be realized remains an open question. The concerns expressed by FHFA and Fannie Mae's own auditors as to various aspects of the program – including the price paid for MSR, the legitimacy of projected savings, and lack of quality control at specialized servicers – make the question about credit loss savings all the more pointed.

FINDINGS

FHFA-OIG finds that:

1. The BOA Transaction Was Part of a Larger, Essentially Sound Initiative

Fannie Mae's purchase of mortgage servicing rights from BOA was not an isolated deal related to the well-known $1.3 billion settlement between BOA and Fannie Mae. Rather, it was the most recent of several transactions that were part of an ongoing initiative – the High Touch Servicing Program – to mitigate Fannie Mae's own losses by reducing mortgage defaults and foreclosures. FHFA-OIG finds that the concept underlying this program is a sound one.

2. The BOA Portfolio Purchase Was Consistent with Similar Transactions

Although the BOA transaction was the largest of the transfers in the High Touch Servicing Program, the amount Fannie Mae paid was consistent with the amounts it had paid to other servicers from which it purchased MSR under the program.

3. Fannie Mae's Ability to Transfer MSR on Favorable Terms Is Constrained by Its Servicing Contract

The terms of Fannie Mae's standard servicing contract appear to constrain its ability to transfer – for no or reduced cost – MSR due to poor portfolio performance.

4. The High Touch Servicing Program Would Benefit from a More Rigorous Valuation Process

Fannie Mae's internal audit of the High Touch Servicing Program raised questions as to the controls surrounding the program. Furthermore, Fannie Mae relied on a single consultant to price most of the MSR transactions under the program. FHFA-OIG's contractor noted aspects of the BOA portfolio that were, it appears, not considered in Fannie Mae's valuation and that could have impacted the overall value of the portfolio.

5. FHFA's Oversight of the High Touch Servicing Program Was Limited

FHFA was consulted in the BOA transfer (due to the high visibility of the transaction and the potential reputational risk); however, it had no involvement in approving the broader initiative of which the BOA transaction was a part, nor did it approve any of the other transactions in the High Touch Servicing Program.

CONCLUSION

The High Touch Servicing Program itself is a fundamentally promising initiative with the potential to reduce Fannie Mae's – and, by extension, the taxpayers' – losses on mortgage guarantees, and may also serve to reduce the number of foreclosures. However, because the program was new, large, and complex, it should have been carefully monitored by FHFA from its inception. FHFA-OIG believes that implementing the recommendations set forth below could help reduce the cost of transferring additional loans under the High Touch Servicing Program from the current average of 2.3 times the annualized servicing fee to an amount closer to 2 times the annualized servicing fee, as specified in the existing contract.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA take the following actions:

1. **Delegated Authorities.** FHFA should consider revising FHFA's Delegation of Authorities to require FHFA approval of unusual, high-cost, new initiatives, like the High Touch Servicing Program**.**

2. **Performance Contracting.** FHFA should ensure that Fannie Mae does not have to pay a premium to transfer inadequately performing portfolios.

   This is consistent with the Agency's finding in the MRA. For example, this might be achieved through: the reduction or elimination of the 90 day period during which servicers are able to seek other potential buyers for a portfolio; contract provisions that would allow the Enterprise to purchase the servicing rights at a pre-established rate based on contractually established portfolio performance criteria; or some combination of these or other criteria. In addition, Fannie Mae could retain the right to approve the sale of MSR to any other servicer in order to ensure MSR can only be transferred to high performing servicers.

3. **Valuation.** Consistent with the control issues found in Fannie Mae's internal audit report on the High Touch Servicing Program, FHFA should ensure that Fannie Mae applies additional scrutiny and rigor to pricing significant MSR transactions.

   FHFA should consider requiring Fannie Mae to assess the valuation methods of multiple MSR valuators in order to discern best practices. In the case of larger MSR transactions

(at a threshold to be determined by FHFA), FHFA should consider requiring two independent valuations.

4. **Program Assessment.** FHFA should assess the efficacy of the program and direct any necessary modifications.

   As the portfolios purchased under the program approach the five-year mark, FHFA should review both the underlying assumptions and the performance criteria for the High Touch Servicing Program.

FHFA-OIG is pleased that FHFA has accepted all the recommendations in this report. FHFA's formal response is set forth in Appendix A.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this evaluation was to assess FHFA's oversight of Fannie Mae's High Touch Servicing Program, particularly insofar as it concerned Fannie Mae's purchase from BOA, for nearly $500 million, of MSR on a portfolio of approximately 384,000 loans.

To address this objective, FHFA-OIG reviewed extensive documents prepared by or on behalf of Fannie Mae pertaining to the High Touch Servicing Program, as well as to individual transactions within the program. Among these was the valuation prepared for the BOA MSR by Fannie Mae's independent valuator.

FHFA-OIG reviewed documentation and correspondence created in connection with examinations of Fannie Mae by FHFA, including correspondence pertaining to the High Touch Servicing Program in general and BOA transaction in particular. FHFA-OIG also reviewed an internal audit of the High Touch Servicing Program conducted by Fannie Mae.

In support of this evaluation, FHFA-OIG's Chief Economist prepared an independent analysis of the BOA MSR valuation.

In addition, FHFA-OIG retained an independent contractor, Beyondbond, Inc., to assist with the assessment process; in particular, the contractor helped FHFA-OIG gather market intelligence surrounding similar MSR transactions during the relevant time period and also evaluated assumptions and techniques used by the independent valuator in the valuation models.

This evaluation was conducted under the authority of the Inspector General Act and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support the findings and recommendations made herein. FHFA-OIG trusts that the findings and recommendations discussed in this report meet these standards.

APPENDIX A

FHFA Management Comments

MEMORANDUM

TO: George Grob, Deputy Inspector General for Evaluations, FHFA OIG

FROM: Jon Greenlee, Deputy Director, Division of Enterprise Regulation
Jeffrey Spohn, Senior Associate Director, Office of Conservatorship Operations

SUBJECT: FHFA Response to the Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers (SUR-2011-023)

DATE: September 7, 2012

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses for the recommendations resulting from the evaluation performed by your staff from September 2011 to August 2012, to assess FHFA's oversight of Fannie Mae's High-Touch Servicing Program, particularly the transaction between Fannie Mae and Bank of America (BofA). As agreed among our offices, this memorandum supersedes the management response submitted to you on August 30, 2012.

The responsibility for taking action to address the report's recommendations rests with different divisions within FHFA. The Office of Conservatorship Operations (OCO) is responding to Recommendation 1, and the Division of Enterprise Regulation (DER) is responding to Recommendations 2, 3, and 4. In addition to providing specific responses to the recommendations, FHFA also offers several general comments on the report and its findings.

FHFA notes, and agrees with, the OIG's conclusions that the BofA transaction was part of an ongoing initiative that is conceptually sound, that the particular transaction in question was consistent with other similar transactions, and that the transaction is expected to save money for Fannie Mae, and hence taxpayers, over a wide range of anticipated outcomes. This is also true across the range of uncertainty posited with the valuation methods used.

While it receives only a passing mention in the report, FHFA would emphasize that the transaction was not just about saving money, it was about helping homeowners at risk. The reason servicing transfer transactions such as the one at issue are expected to save money is that the new servicer is better equipped to work with troubled borrowers. The goal is to meet our statutory mandate to minimize foreclosures in a cost-effective way, and improved servicing increases the likelihood that a successful foreclosure alternative may be found and thus default losses will be reduced.

Finally, the report finds that FHFA's oversight was limited, yet the report has extensive documentation indicating that FHFA's supervision program reviewed, and recommended improvements to, Fannie Mae's servicing transfer activities. As the report also shows, FHFA actively reviewed the proposed BofA transfer, expressed certain reservations, and worked with Fannie Mae management to improve the terms of the transaction.

The FHFA-OIG characterizes servicing transfers as unusual, high cost, and new. Mortgage servicing right transfers, while not frequent, are reflective of long-standing business practices at both Enterprises. The nuance of transferring to a servicer with a specialty focus does not alter the basic transaction. Further, since 2010 the Enterprises have not been allowed to enter into new products, per a directive from the Acting Director. FHFA asserts these transfers are not unusual, high cost, or new.

Response to FHFA-OIG Recommendation 1 by OCO

Recommendation 1: Delegated Authorities. FHFA should consider revising FHFA's Delegation of Authorities to require FHFA approval of unusual, high cost new initiatives, like the High Touch Servicing Program.

Management Response*:* FHFA agrees with the recommendation to consider revisions to the delegated authorities. In early 2011, FHFA began a process of re-evaluating the items in the Letter of Instruction to assess potential changes in non-delegated items. During that process, FHFA considered the inclusion of transactions such as high touch servicing or other new or recurring initiatives. The process recommended by the OIG – consider revising the delegation of authorities – was initiated prior to the OIG recommendation and is nearly complete. FHFA currently is finalizing a set of updates to the letters of instruction, and expects to issue them shortly. Thus, we agree with the recommendation and it will be completed upon issuance of the updated letters of instruction.

While we agree with the recommendation, we believe it is also important to highlight that the letters of instruction are not the sole means that FHFA uses to manage and oversee the conservatorships. FHFA believes the language in the letters of instruction do indeed cover items of this nature without limitation. The current letters of instructions are intentionally broad in scope, with language specifically carved out for items of high reputational or operational risk that require Conservator approval. Although FHFA reviewed the transaction, these triggers for Conservatorship approval were not met as this type of activity was determined to be reflective of normal business practices.

Response to FHFA-OIG Recommendations 2, 3, and 4 by DER

Recommendation 2: Performance Contracting. FHFA should ensure that Fannie Mae does not have to pay a premium to transfer inadequately performing portfolios.

Management Response: FHFA agrees with the goal stated by FHFA-OIG that Fannie Mae should not pay excessive consideration for poor performance. FHFA has two separate authorities for improving the safety and soundness of Fannie Mae's business practice in this instance, and DER and OCO will continue to coordinate the exercise of these authorities.

- As supervisor, DER reviews and evaluates the processes at Fannie Mae that provide input to business decisions on compensation to counterparties. These processes include various facets of vendor selection and management, risk controls, management information systems and governance. FHFA's supervisory communications to Fannie Mae include recommendations regarding remediation of any gaps and weaknesses in the processes reviewed. In this case, process improvements could help to assure accurate and consistent portfolio pricing.

- As conservator, OCO can give Fannie Mae direction to make specific business decisions and changes in business practices, consistent with delegations in place. For example, OCO could direct Fannie Mae to include particular provisions in contracts with MSR purchasers or set specific portfolio performance criteria as a means to improve portfolio pricing.

During the time period covered by the report, DER's supervisory reviews of Fannie Mae's MSR portfolio pricing gave rise to communication of supervisory expectations for how contracts should be developed and executed to best protect the safe and sound operation of the Enterprise. DER will continue its focus on vendor selection and management and the internal processes within Fannie Mae to ensure that risk control functions have appropriate input into business decisions relating to MSR portfolio transfers. Examination work to follow up on previous supervisory direction will continue throughout the 2013 examination cycle.

Recommendation 3: Valuation. Consistent with the recommendations found in Fannie Mae's internal audit report on the High Touch Servicing Program, FHFA should ensure that Fannie Mae applies additional scrutiny and rigor to pricing significant MSR transactions.

FHFA should consider requiring Fannie Mae to assess the valuation methods of multiple MSR valuators in order to discern best practices. In the case of larger MSR transactions (at a threshold to be determined by FHFA), FHFA should consider requiring two independent valuations, or an independent valuation along with an indicative price, rather than one independent valuation.

Management Response: FHFA agrees that strong risk controls include careful scrutiny of pricing of MSR transactions. FHFA should consider whether assessment by Fannie Mae of different valuation methods would strengthen pricing determinations, taking into account that larger MSR transactions should receive additional attention. As noted above, the Agency's two authorities can both address business processes that impact the safety and soundness of Fannie Mae's operations.

DER's reviews of Fannie Mae's risk management have and will continue to include reviews of the process for determining pricing of significant portfolio transfers. In the case of transfers of MSRs, FHFA as supervisor will not define "significant" for Fannie Mae's business purposes, but will evaluate whether Fannie Mae takes a risk-based approach with appropriately enhanced controls for larger transactions that involve greater risk to the Enterprise. Reviews of the Enterprise's approach to vendor management will be included in the Fannie Mae examination plan for the 2013 cycle.

Recommendation 4: Program Assessment. FHFA should assess the efficacy of the program, and direct any necessary modifications.

As the portfolios purchased under the program approach the five-year mark, FHFA should review both the underlying assumptions and the performance criteria for the High Touch Servicing Program.

Management Response: As discussed above, FHFA agrees with the need to review the program from a supervisory standpoint and will, in the course of regular, risk-based supervisory activities under the direction of the Fannie Mae Examiner-in-Charge, evaluate Fannie Mae's process for managing transfers of portfolios of MSRs and the controls Fannie Mae has in place to ensure that such transfers are effected in a safe and sound manner. Supervisory assessment in the 2013 examination cycle will include a review of underlying assumptions that inform the terms of portfolio transfers and a review of performance criteria and the processes for setting those criteria. As noted above, it will also take into account relevant prior supervisory observations and criticisms, as well as measures taken by Fannie Mae to address supervisory concerns.

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