

Federal Housing Finance Agency
Office of Inspector General



FHFA's Oversight of Fannie Mae's 2013 Settlement with Bank of America

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Synopsis

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Why OIG Did This Report

Between 2000 and 2008, the Federal National Mortgage Association (Fannie Mae or the Enterprise) purchased millions of mortgages from Bank of America (and from Countrywide, which Bank of America acquired in 2008). Bank of America continued to service the mortgages (i.e., collect and disburse principal and interest payments and manage defaults and foreclosures).

Fannie Mae claimed that Bank of America had breached its representations and warranties at the time it sold Fannie Mae many of the mortgages, and that Bank of America had to either repurchase the mortgages or compensate Fannie Mae for its losses. In addition, Fannie Mae assessed certain compensatory fees against Bank of America for failures to properly manage defaults on these mortgages.

In September 2011, at the direction of the Federal Housing Finance Agency (FHFA or the Agency), Fannie Mae and Bank of America met to negotiate a comprehensive settlement of the Enterprise's claims. Negotiations continued for more than a year, concluding with FHFA's January 2013 approval of an \$11.6 billion settlement between the parties.

The \$11.6 billion settlement resolved Fannie Mae's long-standing claims that Bank of America sold it defective mortgages and mishandled various mortgages it was servicing for the Enterprise. In addition, FHFA allowed the transfer of the servicing rights to approximately 1.1 million mortgages from Bank of America to other servicers.

In September 2011, the Office of Inspector General (OIG) recommended that FHFA "issue internal guidance regarding its handling of future repurchase settlements, should they arise." In June 2012, the Agency issued such guidance. The January 2013 Bank of America settlement provided the first opportunity for OIG to review FHFA's implementation of its new settlement policy. Moreover, because FHFA's policy applied to one, but not all, portions of the settlement, the 2013 settlement enabled OIG to contrast FHFA's oversight under its settlement policy with its oversight of matters that fell outside of that policy. Accordingly, OIG evaluated FHFA's oversight of Fannie Mae's 2013 settlement with Bank of America.

Conclusions

FHFA, to its credit, adhered to its established policy in reviewing the representation and warranty settlement between Fannie Mae and Bank of America. Its policy did not apply, however, to the resolution of compensatory fees and the transfer of mortgage servicing. Consequently, FHFA's review of these aspects of the settlement did not benefit from such an established process.

Recommendation

FHFA should establish a formal review process for compensatory fee settlements and significant mortgage servicing rights transfers.

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ABBREVIATIONS

DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae or the Enterprise	Federal National Mortgage Association
FHFA or the Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
MSR	Mortgage Servicing Rights
OCO	Office of Conservatorship Operations
OHRP	Office of Housing and Regulatory Policy
OIG	Federal Housing Finance Agency Office of Inspector General
PLMBS	Private-Label Mortgage-Backed Securities
Settlement Policy	FHFA Settlement Policy and FHFA Settlement Procedural Guide

PREFACE.....

OIG was established by the Housing and Economic Recovery Act of 2008, which amended the Inspector General Act of 1978. OIG is authorized to conduct audits, investigations, and other studies of FHFA’s programs and operations. As a result of our work, we may recommend policies that promote economy and efficiency in the administration of FHFA’s programs and operations or that prevent and detect fraud and abuse in them.

This report was initiated in the wake of an \$11.6 billion comprehensive settlement of disputes between Fannie Mae and Bank of America that was concluded in January 2013. Moreover, the report was designed to follow up on a recommendation issued by OIG in 2011 in *Evaluation of the Federal Housing Finance Agency’s Oversight of Freddie Mac’s Repurchase Settlement with Bank of America*.¹

In that evaluation, OIG recommended that FHFA “issue internal guidance regarding its handling of future repurchase settlements, should they arise.” Subsequently, on June 27, 2012, the Agency issued the *FHFA Settlement Policy* and the *FHFA Settlement Procedural Guide* (together, the “Settlement Policy”) and distributed them to the chief executive officers of Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mae) (collectively, the Enterprises). The Bank of America settlement that is the subject of this report provided the first opportunity for OIG to test the effectiveness of the Settlement Policy.

This report was prepared by Bruce McWilliams, Senior Investigative Evaluator; Simon Wu, Chief Economist; Beth Preiss, Program Analyst; and David M. Frost, Assistant Inspector General for Evaluations. OIG appreciates the cooperation of all those who contributed to this evaluation.

¹ EVL-2011-006 (Sept. 27, 2011). The report, in part, detailed limitations of Freddie Mac’s process for selecting loan candidates for repurchase review (see page 18). In particular, Freddie Mac focused mainly on loans that defaulted in the first two years after origination or had a spotty payment history during the first two years. For its Bank of America settlement, Fannie Mae, by contrast, employed a more holistic approach that used a model to determine which loans to review considering payment history during the first five years with a focus on the first three; Fannie Mae’s process also considered a wide range of variables, such as whether the loan was risky to begin with and the likely value to be recovered if the loan was to be repurchased.

This evaluation report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on OIG's website, www.fhfa.ig.gov.

A handwritten signature in cursive script that reads "George Grob".

George Grob
Deputy Inspector General for Evaluations

CONTEXT

The Dispute and Settlement Between Fannie Mae and Bank of America

Overview of Settlement

On January 6, 2013, FHFA approved agreements between Fannie Mae and Bank of America to resolve certain claims related to mortgages sold to Fannie Mae between 2000 and 2008. Many of these mortgages were originated by Countrywide Home Loans, which Bank of America had purchased during that time. The agreements were approved by the Fannie Mae board of directors, and—taken as a whole—reflected the resolution of large and long-standing disputes between Bank of America and Fannie Mae.²

There were three agreements between the parties: (1) the settlement of representation and warranty claims for defective loans; (2) the payment of compensatory fees for Bank of America’s failure to meet foreclosure timelines; and (3) a transaction in which Bank of America, with Fannie Mae’s approval, sold to **specialty servicers** mortgage servicing rights (MSR) for approximately 1.1 million loans.

Specialty Servicers (also known as High Touch Servicers) are companies capable of providing more contact with troubled borrowers than existing bank servicers. The aim of using a specialty servicer is to reduce the likelihood of foreclosure and ultimately to reduce costs to the Enterprises.

The representation and warranty settlement involved \$10.26 billion in cash proceeds to Fannie Mae. The compensatory fee payment of \$1.30 billion (subject to subsequent adjustment) by Bank of America to Fannie Mae was for failure to meet timeline requirements related to handling delinquencies. Together, these settlements resulted in a payment of \$11.56 billion to Fannie Mae. The transfer of MSR from Bank of America to specialty servicers did not involve any direct payments to or from Fannie Mae. Figure 1 summarizes these three agreements.

² The parties to the representation and warranty and compensatory fee agreements included Bank of America, N.A., Countrywide Home Loans, and other parties affiliated with Bank of America Corporation. For convenience, these parties are referred to, collectively, throughout this report as “Bank of America.”

FIGURE 1. THREE AGREEMENTS BETWEEN FANNIE MAE AND BANK OF AMERICA

Agreement	Settlement Cash Proceeds
Representation and Warranty Settlement	
Cash “Make-Whole” Payment	\$ 3.55 billion
Repurchases	<u>\$ 6.71 billion</u>
Total Representation and Warranty Settlement	\$10.26 billion
Compensatory Fees for Failure to Meet Delinquency Timelines	<u>\$ 1.30 billion</u>
Transfer of Mortgage Servicing Rights	No funds to or from Fannie Mae
Total	\$11.56 billion

The agreements resolved the majority of Fannie Mae’s outstanding repurchase claims against Bank of America for the years 2000 through 2008. The Agency, which was instrumental in facilitating this settlement, believes that the settlement is a reasonable way to resolve the disputes between Bank of America and Fannie Mae without the risks and costs associated with litigation.

The Dispute and Negotiations

The disputes between Fannie Mae and Bank of America revolved around a large portfolio of mortgages that Bank of America sold to Fannie Mae, and for which it conducted the servicing. Fannie Mae claimed that many of these mortgages were defective at the time they were sold and demanded that Bank of America repurchase them. Fannie Mae cited its representation and warranty arrangement that required Bank of America to repurchase such mortgages. Bank of America claimed that it was exempt from the repurchase requirement based upon another agreement that the bank asserted superseded Fannie Mae’s claims. In addition, Fannie Mae claimed that Bank of America had not lived up to its contractual obligations to pay compensatory fees associated with delays in delinquent borrower resolution timelines.

At the suggestion of FHFA, in September 2011, Fannie Mae, Bank of America, and FHFA met to discuss the possibility of a comprehensive settlement relating to Bank of America’s legacy book of business.³ As the parties continued to meet, however, there were substantial differences of opinion about the value of the loans in question and the possibility of litigation

³ Freddie Mac attended the first meeting. Subsequently, however, FHFA directed the Enterprises to pursue their own settlements.

was raised. By February 2012, Fannie Mae ceased purchasing Bank of America mortgages, except those tied to the Home Affordable Refinance Program.⁴ The two sides spent many hours discussing their valuation models.

Eventually, the parties decided to divide the representation and warranty settlement into two parts: (1) a cash payment for the loans upon which Fannie Mae and Bank of America agreed on the “make-whole” amount that would compensate Fannie Mae for the losses it had incurred and will incur in the future, and (2) a repurchase of approximately 30,000 loans for which Bank of America would pay Fannie Mae the unpaid principal balance (and any delinquent interest) and would take the risk of future losses. This change helped break the stalemate.

The two sides finally reached agreement in December 2012, more than a year after the first meeting. FHFA approved the settlement, and Fannie Mae and Bank of America completed the transactions in January 2013.

Representation and Warranty Settlement

Overview of Agreement

On January 6, 2013, following protracted negotiations and final approval by FHFA, Fannie Mae and Bank of America agreed to a resolution of outstanding repurchase requests arising from contractual breaches of representations and warranties made when the loans were sold. The settlement resolved a long-standing dispute between Bank of America and Fannie Mae and resulted in the payment of \$10.26 billion to the Enterprise.

The agreement covered a population of 2.88 million active and inactive loans originated from 2000 to 2008 with an unpaid principal balance of \$414 billion as of July 31, 2012. The original loan count for these vintage years was 8.2 million with an unpaid principal balance of \$1.38 trillion; the difference results from pay downs, liquidations, and refinances.

As mentioned above, the parties used different methodologies to project likely losses on the mortgages. To reach resolution, Bank of America and Fannie Mae agreed to a framework that included both a make-whole cash component for loans Fannie Mae kept and a repurchase component. Bank of America repurchased approximately 30,000 mortgages for their unpaid

⁴ The Home Affordable Refinance Program aims to refinance loans owned or guaranteed by Fannie Mae or Freddie Mac and was designed to assist borrowers who are current on their loans but have not been able to refinance because they have little or no equity in their homes.

principal balance and accrued interest of \$6.71 billion.⁵ Fannie Mae gave up the stream of payments from these mortgages, and Bank of America assumed any future credit losses.⁶

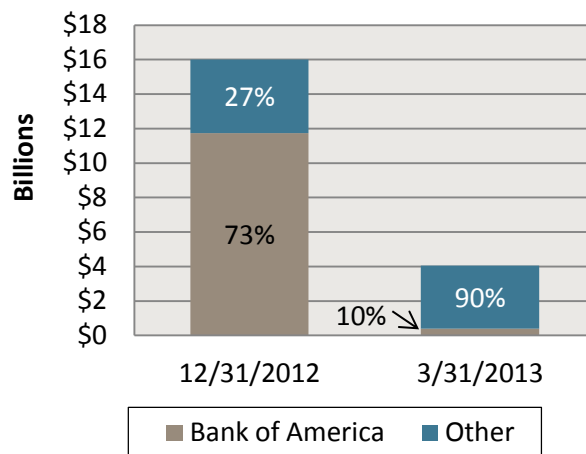
The agreement resolved 97% of Fannie Mae’s outstanding repurchase requests made to Bank of America as of December 31, 2012. Further, as detailed in Figure 2, because Fannie Mae’s repurchase requests to Bank of America represented 73% of its total repurchase requests outstanding as of December 31, 2012, the settlement drastically reduced the total number of repurchase requests in Fannie Mae’s portfolio.

On January 4, 2013, citing compliance with the FHFA Settlement Policy of June 27, 2012, FHFA staff recommended that the FHFA Acting Director approve the settlement. The Acting Director approved the settlement on January 6, 2013.

FHFA’s Settlement Policy

In June 2012, FHFA established the Settlement Policy for settlements of Enterprise claims against counterparties related to mortgage repurchases, mortgage insurance, or private-label mortgage-backed securities (PLMBS). The Settlement Policy calls for FHFA to direct and approve settlements that satisfy the goals of conservatorship and exceed \$50 million, and notes that FHFA could choose to review smaller transactions. The Settlement Policy was designed to ensure that relevant parties within FHFA had the opportunity to provide their views to the conservator on a proposed settlement. It defines the respective roles of FHFA officials, the Enterprise’s management, and the Enterprise’s board in negotiating and approving settlements.

FIGURE 2. FANNIE MAE’S OUTSTANDING REPURCHASE REQUESTS



⁵ When FHFA submitted the transaction for the Acting Director’s approval on January 4, 2013, the numbers were to repurchase 30,024 mortgages for \$6.71 billion including unpaid principal balance and accrued interest on the loans. These numbers were subject to reconciliation. Fannie Mae’s 2012 Annual Report on Form 10-K, issued April 2, 2013, said that Bank of America repurchased approximately 29,500 loans for \$6.6 billion, subject to a reconciliation process.

⁶ Because Fannie Mae gave up the future payments on the loans, the value of the repurchase transaction to Fannie Mae was less than the \$6.71 billion received in cash. From Fannie Mae’s perspective, the value was equivalent to what it would have sought as a cash payment had it settled the representation and warranty claims for these loans with a make-whole payment instead of repurchases.

The representation and warranty settlement between Fannie Mae and Bank of America resolved claims related to mortgage repurchases and was well above the \$50 million threshold. Therefore, the Settlement Policy applied. FHFA's Settlement Policy did not, however, apply to the resolution of compensatory fees or to the mortgage servicing transfer, regardless of how large they were, because those agreements did not involve mortgage repurchases, mortgage insurance, or PLMBS.

OIG analyzed the Settlement Policy and divided its provisions into more than 50 elements. OIG then reviewed whether FHFA and Fannie Mae applied each of the 50 elements to the resolution of the representation and warranty dispute. OIG determined that the elements of the Settlement Policy were followed. Some of the main elements are discussed below.

Settlement Value and Commercial Reasonableness

The Settlement Policy sets several standards for FHFA to approve a settlement. A key standard is that the “value of the proposed settlement exceeds the estimated value of achieving a resolution absent a settlement (such as through litigation).” In addition, the settlement must be “commercially reasonable.”

Analysis by Fannie Mae, supported by the calculations of an independent consultant retained by the Enterprise, led Fannie Mae to conclude that it likely achieved a more favorable resolution than it would have without the settlement. FHFA also concluded that the value of the representation and warranty settlement exceeded the value absent a settlement and that the settlement was commercially reasonable.

The repurchase component allows both parties to realize a settlement value consistent with their own loss expectations. Fannie Mae projected losses would be greater than those projected by Bank of America. Fannie Mae received the unpaid principal balance, and the risk of loss was transferred back to Bank of America.

Independent Third-Party Review

As set forth in the Settlement Policy, for settlements valued in excess of \$500 million (not involving PLMBS), a knowledgeable third-party must review and attest that the proposed settlement is a commercially reasonable resolution. Because this settlement exceeded \$500 million, Fannie Mae obtained the services of a recognized independent consulting firm, which attested that the representation and warranty settlement was a commercially reasonable settlement of Fannie Mae's claims.

Goals of Conservatorship

In addition, for FHFA to approve a settlement, it must satisfy “one or more goals of conservatorship.” The Settlement Policy lists reasons that “justify the use of settlements in furtherance of the goals of conservatorship and the statutory purposes of the Enterprises.” These reasons include that the settlement will: reduce costs of pursuing claims through lengthier and more costly processes such as litigation; speed the timeline for restoring stability to company operations by bringing certainty and final resolution to outstanding claims; and bring certainty to and restore confidence in marketplace norms and practices. FHFA stated in announcing the settlement that it was “a major step forward in resolving issues from the past and providing greater certainty in the marketplace, which remain critical FHFA goals as conservator.”

Settlement Documentation

Another standard for FHFA to approve a settlement is that the settlement is “properly documented.” OIG’s review of the transaction records showed that the documents required by the Settlement Policy were included in the records. In one case, Fannie Mae did not provide the necessary information in FHFA’s specified format, but this did not affect the information available to FHFA to approve the transaction.

Coordination Within FHFA

The Settlement Policy requires FHFA’s Office of Conservatorship Operations (OCO) to coordinate with FHFA’s legal, policy, and supervision staff to analyze and assess the claims at issue. Additionally, supervision staff must ensure that OCO is aware of issues arising from its examinations that may be relevant to the proposed settlement.

FHFA legal officials were involved from the beginning in the settlement process and signed the final recommendation to approve the transaction. The Office of Housing and Regulatory Policy (OHRP) was not involved in the representation and warranty settlement. However, its recommendation supporting the MSR transfer included the condition that outstanding representation and warranty claims, as well as compensatory fees, be resolved (see below, Transfer of Mortgage Servicing Rights). In addition, OHRP had the opportunity to comment while the announcement of the representation and warranty settlement was under review.

According to FHFA, OCO and supervision staff were present at several meetings during which the settlement was discussed throughout the negotiation process. OIG has no record of specific advice rendered by them at these meetings. However, on December 26, 2012, as the representation and warranty settlement was concluding, supervision officials received an email asking whether they were aware of any impediments to the proposed settlement or had concerns with the models or methodology used. They responded that day, indicating that—

based on a quick review—the dollar amount was in the “ballpark” and the methodology did not raise concerns. Additionally, FHFA’s supervision staff had conducted a prior review of Fannie Mae’s model for valuing representation and warranty claims, the results of which were noted by FHFA in its deliberations regarding the settlement.

OIG observes that the Settlement Policy does not specify when the policy and supervision staff must be provided with information by which to analyze claims. In fact, with regard to supervision staff, it states: “The role of FHFA supervision staff most often will be limited to providing technical expertise upon request.” Seeking advice from these groups earlier in the process might be beneficial for future settlements.

Consistency with Other Settlements

Under the Settlement Policy, OCO must—to the extent practicable and appropriate—ensure reasonable consistency with other Enterprise settlements with specific counterparties across similar types of claims.

FHFA stated that it is difficult to draw precise conclusions regarding comparability between representation and warranty settlement transactions because each transaction is negotiated separately and is based upon the existing contract, historical performance, business practices, litigation risks, and other factors. Notwithstanding this, Fannie Mae presented FHFA with information regarding several other representation and warranty settlements from recent years.

Checklists

Though not required under the Settlement Policy, the FHFA officials recommending the transaction provided the Acting Director with a checklist that covers the procedures OCO is required to carry out under the Settlement Policy. Each box was checked, indicating OCO’s self-assessment that it had followed those procedures for which it was responsible.⁷

The Settlement Policy requires the Enterprise to use a submission checklist when providing transaction documentation to FHFA. Such a Fannie Mae checklist—covering the Enterprise’s responsibilities—also was included in the supporting materials for the Acting Director’s decision. In this case, instead of checkmarks, specific documentation that had been submitted was listed. However, the items in the Enterprise’s checklist were broad categories that did not

⁷ However, the checkmarks were not linked to documentation showing that the requirements were indeed satisfied. The OCO checklist also was not signed or dated.

mirror the items the Enterprise was responsible for in the Settlement Policy. Further, some items required by the procedures were not included in the checklist.⁸

Checklists that mirror the policies and procedures and link to supporting documentation might enhance FHFA’s implementation of its Settlement Policy.

Compensatory Fees Resolution

Overview of Agreement

Under its contract with Bank of America, Fannie Mae regularly submitted invoices to the bank for “compensatory fees” owed by Bank of America for deficiencies in foreclosure management. In particular, Bank of America was required to meet certain deadlines in the foreclosure process—which it did not—and Fannie Mae was entitled to assess compensatory fees for Bank of America’s failure to meet those deadlines. Bank of America did not honor Fannie Mae’s demands. Almost all of the compensatory fees assessed to Bank of America under its contract with Fannie Mae from 2010 through September 2012 remained outstanding until the date of the settlement. As of September 30, 2012, assessed but unpaid compensatory fees amounted to \$664 million.

According to Fannie Mae’s usual practice with its servicers, Bank of America would have been able to challenge or “rebut” any of the compensatory fees assessed by Fannie Mae through a review process agreed upon by both parties. However, as indicated above, Bank of America had not made most of the payments since 2010.

Nonetheless, Fannie Mae was able to bring Bank of America to the negotiating table due to the bank’s interest in completing a significant sale of MSR to third-party servicers. The proposed sale was part of a special project designed to transfer substantial amounts of MSR from Bank of America to specialty servicers. Because Bank of America needed Fannie Mae’s approval for the sale, it agreed to negotiate a resolution of all compensatory fee claims in exchange for Fannie Mae’s consent.

During the negotiations, Fannie Mae and Bank of America agreed to address not only the \$664 million of outstanding claims assessed by Fannie Mae for servicing deficiencies as of September 2012, but also claims for loans to be foreclosed from October 2012 through December 2012. Further, the parties agreed to resolve projected claims for the large number of mortgages associated with the MSR that Bank of America intended to transfer in

⁸ Fannie Mae’s checklist did not include, for example, the requirement in the procedures for the Enterprise to provide FHFA with a standard briefing book applicable to settlements generally or the requirement in the policy for the Enterprise to have internal procedures for settlements.

connection with the special project, but that were already in delinquency as of December 2012. This resolution of the compensatory fees was intended to represent the amount that would be due if both entities reviewed the entire portfolio of mortgage loans on a loan-by-loan basis.

As a part of the process, the parties negotiated a presumed rebuttal success rate derived from a statistical sample of liquidated loans as of September 30, 2012. The rebuttal success rate represents the portion of mortgages that Bank of America would successfully demonstrate should not have been charged compensatory fees due to the circumstances of the foreclosure. Based on the total fees assessed and the presumed rebuttal success rate, Bank of America agreed to make an initial payment of \$1.3 billion to Fannie Mae.

Following Bank of America's initial \$1.3 billion payment, the parties initiated a "true-up" process based on a revised rebuttal success rate calculated from a statistical sample of both liquidated loans and transferred loans. As detailed in the agreement between the parties, the revised rebuttal success rate is to be the basis for a final adjustment to Bank of America's \$1.3 billion payment.

Depending on the outcome of the true-up process, Bank of America might remit additional sums; a second possibility is that Fannie Mae might be required to reimburse some portion of the monies paid by Bank of America. Finally, it is possible that the process would leave Bank of America's initial payment unchanged. The entire process of sampling, reconciliation, and final payments is to be completed by September 15, 2013.

Lack of an Established Policy Regarding Compensatory Fees

Although FHFA's Settlement Policy states that mortgage repurchase settlements in excess of \$50 million are subject to review by FHFA, and those in excess of \$500 million are subject to third party review, FHFA viewed the resolution of compensatory fees as not directly related to mortgage repurchases generally or the representation and warranty settlement specifically. Thus, in its review of the compensatory fee settlement, FHFA did not follow the same procedures it applied to the review of the representation and warranty settlement.

In addition, although Freddie Mac also had both a substantial compensatory fee claim against Bank of America and a pool of mortgages for which Bank of America wished to transfer the MSR, Freddie Mac did not wish to pursue a resolution along the same lines as the one being finalized with Fannie Mae. Yet, there is no indication that, in the course of its review of Fannie Mae's proposed transaction, FHFA weighed the possible merits of Freddie Mac's divergent approach to the issue.

OIG ventures no conclusions regarding whether Freddie Mac's approach was superior to Fannie Mae's, or vice-versa, or, indeed, whether both were reasonable business decisions.

However, the process that FHFA used to review the compensatory fee resolution was not on par with the process it had established for representation and warranty settlements, which, if applicable, would have required consideration of the comparable situation at Freddie Mac.

Transfer of Mortgage Servicing Rights

As indicated above, Fannie Mae approved Bank of America's proposed sale of MSR to certain specialty servicers contemporaneously with the resolution of the compensatory fee dispute. Fannie Mae's approval of Bank of America's MSR sale was not formally a part of the settlement agreements. However, FHFA recognized that the negotiation of the compensatory fee exposure was directly linked to the MSR transfer and was structured to provide greater leverage in the negotiation and resultant recovery of funds owed to Fannie Mae. Specifically, Fannie Mae would not consent to Bank of America's proposed transfer of the MSR until Bank of America agreed to a resolution of Fannie Mae's claims for compensatory fees (see the previous section).

Issues Regarding Servicing Transfers

Both OIG and FHFA have, in the past, expressed concerns regarding Enterprise servicing transfer activities. In a report issued in September 2012, OIG recommended that FHFA engage in closer oversight of Fannie Mae's efforts to transfer MSR to high touch servicers.⁹ In response, FHFA stated that it intended to ensure that Fannie Mae was adequately managing its internal processes to ensure that risk controls were in place relating to MSR transfers. In addition, FHFA stated that it would continue to follow up on MSR transfer issues throughout the 2013 examination cycle.

The Agency's examiners have continued to monitor issues arising from the Enterprises' handling of MSR. As detailed in OIG's September 2012 report referenced above, FHFA had raised concerns about Fannie Mae's transfer of MSR as early as June 2011. A year later, in July 2012, the Agency's Division of Enterprise Regulation (DER) noted that MSR transfer issues remained a concern at Fannie Mae. The rapid growth of specialty servicers in the market increased Fannie Mae's operational risk, particularly in light of the fact that Bank of America had plans to transfer significant servicing portfolios to these entities. DER

⁹ OIG, *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* (September 18, 2012). In the case addressed in the September 2012 report, Fannie Mae repurchased MSR from Bank of America and then transferred the MSR to specialty servicers. While the instant case involves a transaction between Bank of America and the specialty servicers without any payments to or from Fannie Mae, the MSR transfer was still quite substantial, involving approximately 1.1 million loans, with a combined unpaid principal balance of approximately \$164 billion.

emphasized the need for Fannie Mae to consider the special servicers' ability to adapt to a changing business landscape.

DER also noted that it had previously expressed concerns about inadequate policies and procedures governing Fannie Mae's transfer of MSR. DER acknowledged that the Enterprise had developed a new transfer of servicing procedure in late 2012,¹⁰ but stated that, due to the high volume of servicing transfers, the rapid growth of specialty servicers, and Fannie Mae's prior lack of internal procedures, MSR transfers would be a high priority for FHFA risk oversight in the coming year.

Based on the OIG and DER studies, FHFA was aware of the complexity of, and risk associated with, large MSR transfers to specialty servicers. Thus, FHFA was aware of the significance of its own review of the specific transfers proposed.

FHFA's Review of Bank of America's Sale of Mortgage Servicing to Specialty Servicers

Although FHFA, in its capacity as conservator, has revised and refined its delegations of authority to the Enterprises, it continues to consider servicing transfers (regardless of size) to be matters within the Enterprises' regular business activities and therefore included within the discretion allowed to Enterprise management.

Nonetheless, as detailed above, FHFA was actively involved in most aspects of the settlement between Fannie Mae and Bank of America. Further, FHFA reviewed the MSR transfer and, ultimately, decided to allow it to proceed.

OCO, which was responsible for facilitating FHFA's approval of Fannie Mae's representation and warranty and compensatory fee settlements with Bank of America, was not the office within FHFA primarily responsible for review of the MSR transaction. OCO requested that OHRP review the transaction. Additionally, DER was consulted on the transaction.

OHRP's Review

OHRP was asked on or about December 14, 2012, to conduct a review of the proposed MSR transaction. OHRP did not ordinarily review transactions. Nonetheless, on January 3, 2013, OHRP issued its final memorandum to the Acting Director; in this memorandum, OHRP discussed various aspects of the proposed sale including risks and mitigating factors. Among other risks, OHRP noted its concern with servicer capacity and performance and made some recommendations (ultimately accepted) to mitigate these concerns. On January 4, 2013, the Acting Director approved OHRP's recommendation.

¹⁰ According to information provided by DER staff in May 2013, Fannie Mae has implemented its new policy; FHFA continues to monitor implementation of the policy and to work with Fannie Mae on this issue.

DER's Review

During the course of OHRP's review of the contemplated MSR transactions, the Acting Director sent an email to DER in which he asked for DER's review (but not approval) of the settlements, including the MSR transaction.

An executive from DER responded on the same day that his advice was requested, expressing some concern regarding the operational risk associated with the specialty servicers. Specifically, he questioned the servicers' ability to take on the volume of loans involved and to manage the relationship with Bank of America and Fannie Mae going forward. The DER executive strongly recommended that FHFA be contractually authorized to conduct onsite examinations at the specialty servicers and noted that, should the transaction go badly, the Agency would bear most of the reputational risk for having approved it. Finally, he suggested that DER could review and monitor the servicing after the transaction was complete.¹¹ It does not appear that DER provided any further feedback regarding the transaction or that it was asked to do so.

Nonetheless, the review of the MSR transfer did not reflect the depth of analysis that likely would have been accorded had FHFA followed a process comparable to that used in its newly established process for reviewing mortgage repurchase, mortgage insurance, and PLMBS settlements.

¹¹ In fact, FHFA examiners have access to all the larger specialty servicers as a result of the regulatory clause in Fannie Mae's contracts, and they conduct onsite reviews. Moreover, after the settlement, in May 2013, DER issued a "Supervisory Expectation Letter" to Fannie Mae, informing the Enterprise that the Agency expected that it would maintain "robust policies and procedures to ensure strong counterparty risk management for all existing and proposed holders of MSRs, both before and after a transfer of MSRs occurs."

CONCLUSIONS

FHFA approved a significant settlement between Fannie Mae and Bank of America. The settlement resolved the majority of Fannie Mae’s outstanding representation and warranty claims. In reviewing the settlement, FHFA followed the settlement review policy and procedures it had established with regard to mortgage repurchase, mortgage insurance, and PLMBS claims. However, that policy did not apply to resolution of compensatory fee claims or to agreements regarding the transfer of mortgage servicing. Consequently, FHFA’s review of these aspects of the settlement did not benefit from such an established process.

As indicated throughout this report, there are several opportunities for improvement that FHFA might wish to consider. The most important would be the development of procedures for settlements (along the lines of those applicable to mortgage repurchases) of compensatory fee claims and significant MSR transactions, and possibly other matters that exceed the monetary thresholds in the current Settlement Policy. In addition, FHFA might consider engaging policy and supervision staff earlier in the approval process and linking checklists to documentation showing that applicable requirements were satisfied.

RECOMMENDATION.....

FHFA should establish a formal review process for compensatory fee settlements and significant MSR transfers.

Agency Response to Recommendation: After the evaluation was complete, the Agency had the opportunity to review the report and recommendation. (Its response is included as Appendix A.) In sum, the Agency concurred with our recommendation, committing to establish guidelines for both compensatory fee claims in excess of \$50 million and significant MSR transfers by January 31, 2014.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this report was to review FHFA’s oversight of the January 2013 dispute resolution between Fannie Mae and Bank of America. The resolution had three parts: an agreement on the representation and warranty dispute, an agreement on the compensatory fee dispute, and an agreement approving the transfer of MSR.

To review FHFA’s oversight of these agreements, we:

1. Reviewed FHFA and Fannie Mae documents;
2. Conducted a targeted review of email to/from FHFA officials involved in analyzing and approving the transactions;
3. Conducted interviews of FHFA and Fannie Mae officials; and
4. Reviewed financial data provided by Fannie Mae and the independent third party that FHFA retained to attest to the commercial reasonableness of the representation and warranty settlement.

FHFA had implemented policies and procedures that applied to the settlement of the representation and warranty dispute. OIG divided these policies and procedures into more than 50 elements, and then determined whether FHFA’s approval of the settlement was in compliance with each applicable element.

FHFA did not have policies and procedures to guide its decision to approve the settlement of the compensatory fee dispute or to allow the transfer of MSR. Instead, FHFA relied on its own expertise to guide its judgment. Therefore, in order to assess FHFA’s oversight of the settlement of the compensatory fee dispute and the transfer of MSR, OIG compared FHFA’s process for approving these matters to the process it established for representation and warranty settlements.

This report was prepared under the authority of the Inspector General Act and in accordance with the *Quality Standards for Inspection and Evaluation*, which were promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform an evaluation that obtains evidence sufficient to provide a reasonable basis to support the conclusion made herein. OIG believes that the analysis and conclusion discussed in this report meet these standards.

The performance period for this study was from January 2013 through June 2013.

APPENDIX A


FHFA's Comments on OIG's Recommendation



Federal Housing Finance Agency

MEMORANDUM

TO: George Grob, Deputy Inspector General for Evaluations

FROM: Jeffrey Spohn, Deputy Director for Conservator Operations 

SUBJECT: Response to Recommendations in Evaluation Report: *FHFA's Oversight of Fannie Mae's 2013 Settlement with Bank of America*

DATE: August 6, 2013

This memorandum communicates the FHFA's management responses to the recommendation in the FHFA-OIG's draft evaluation report titled, *FHFA's Oversight of Fannie Mae's 2013 Settlement with Bank of America* dated July 29, 2013. As stated in the report, the evaluation was conducted by your staff from January 2013 to June 2013 and reviewed FHFA's oversight of the January 2013 settlement between Fannie Mae and Bank of America.

FHFA appreciates the opportunity to provide feedback on this report and the recommendation.

FHFA-OIG Recommendations:

1. FHFA should establish a formal review process for compensatory fee settlements and significant MSR transfers.

Management Response

FHFA agrees with the recommendation to develop a formal review process for compensatory fee resolutions and significant MSR transfers. More specifically, FHFA will develop guidelines to assess significant agreements to resolve outstanding compensatory fee claims. Within the process, FHFA will define the required documentation, as well as respective responsibilities of management, the Board, and FHFA. The process will define the necessary steps for resolution of compensatory fee claims over \$50 million. The guidelines will be developed by January 31, 2014.

FHFA will also develop guidelines for significant MSR transfers. The guidelines will define the required documentation, as well as respective responsibilities of management, the Board, and FHFA. Significant MSR transactions will be defined in the guidance to ensure the specific transactions are consistently reviewed and documented. The guidelines will be developed by January 31, 2014.

ADDITIONAL INFORMATION AND COPIES.....

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