Federal Housing Finance Agency
Office of Inspector General

Recent Trends in the Enterprises' Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies

Evaluation Report • EVL-2014-010 • July 17, 2014

At A Glance

July 17, 2014

Recent Trends in the Enterprises' Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies

Why OIG Did This Report

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) provide liquidity for housing finance by purchasing mortgage loans from primary mortgage lenders and securitizing them for sale in the secondary mortgage market. In recent years, the Enterprises have seen a shift in the composition of their mortgage sellers, with relatively fewer sales from large depository institutions and more sales from smaller lenders and nonbank mortgage companies.

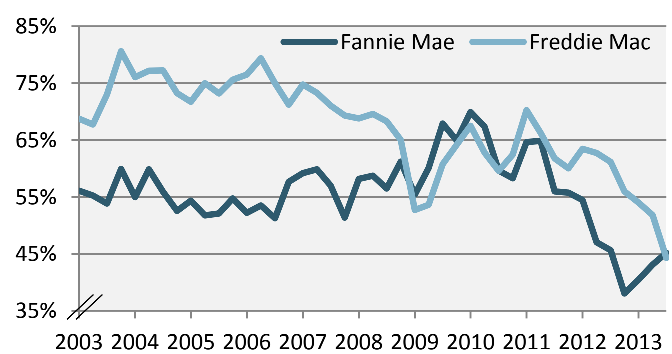
This evaluation report documents the increase in sales to the Enterprises by smaller lenders and nonbank mortgage companies, discusses the reasons behind this trend, and assesses the Federal Housing Finance Agency's (FHFA or Agency) oversight of the Enterprises' risk management controls.

OIG Analysis

Traditionally, the Enterprises bought most of their loans from the largest commercial banks and mortgage companies. These entities sold the Enterprises mortgages that they originated or purchased from smaller, independent lenders. Since 2011, however, the largest commercial banks and mortgage companies have reduced their purchases from smaller lenders and, therefore, sold fewer loans to the Enterprises. The figure below shows the decline in the market share of the Enterprises' respective top five mortgage sellers.

Smaller mortgage originators and nonbank mortgage companies have responded to the changing market by developing direct sales relationships with the Enterprises, thereby increasing their market share.

FIGURE 5. MARKET SHARE OF THE ENTERPRISES' TOP FIVE SELLERS (2003 Q1–2013 Q3)



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Counterparty Risks Presented by Some Small and Nonbank Sellers

The increase in mortgage sales to the Enterprises by smaller lenders and nonbank mortgage companies presents the Enterprises with certain potential benefits and risks. For example, the shift in market share among the Enterprises' sellers reduces the Enterprises' highly concentrated financial exposure to their largest counterparties. However, the shift may also increase their exposure to certain risks and raises their costs for counterparty risk management. For example:

- Smaller and nonbank lenders may have relatively limited financial capacity, and the latter are not subject to federal safety and soundness oversight. Thus, the Enterprises face an increase in the risk that those counterparties could default on their financial obligations;

- Such lenders may lack the sophisticated systems and expertise necessary to manage high volumes of mortgage sales to the Enterprises, thereby increasing the risk that the Enterprises will suffer losses on such transactions; and,

- Some nonbank lenders may present the Enterprises with an elevated risk of reputational harm. For example, we identified one such institution that was sanctioned by state regulators for engaging in abusive lending practices.

FHFA's Oversight of the Enterprises' Risk Controls for Small and Nonbank Lenders

During 2013, FHFA conducted high-level examinations of the Enterprises' counterparty risk management controls and reviewed the risks associated with specialized mortgage servicers. However, we concluded that, due to other examination priorities, FHFA did not test and validate the effectiveness of the controls put in place by the Enterprises to address the recent increase in mortgage sales from smaller and nonbank lenders.

The Agency's 2014 planning documents indicate that it has scheduled several examinations of the Enterprises' management of the risks associated with their smaller lenders and nonbank mortgage companies. Further, FHFA officials said that the Agency is developing guidance intended to strengthen the Enterprises' counterparty risk management.

We will continue monitoring the effectiveness of the Agency's efforts to oversee this critical issue.

FHFA and the Enterprises provided us with technical comments on this report.

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ABBREVIATIONS

DER	Division of Enterprise Regulation
DHMG	Division of Housing Mission and Goals
DSPS	Division of Supervision Policy and Support
EIC	Examiner in Charge
Enterprises	Fannie Mae and Freddie Mac
FDIC	Federal Deposit Insurance Corporation
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
FHFA or Agency	Federal Housing Finance Agency
FSOC	Financial Stability Oversight Council
MBS	Mortgage-Backed Security
OCA	Office of the Chief Accountant
OCC	Office of the Comptroller of the Currency
OFAMS	Office of Financial Analysis, Modeling and Simulations
OIG	Federal Housing Finance Agency Office of Inspector General
UPB	Unpaid Principal Balance

PREFACE

Fannie Mae's and Freddie Mac's statutory mission is to provide stability, affordability, and liquidity to the secondary market for residential mortgages.[1] The Enterprises carry out this mission by purchasing qualifying mortgage loans from the banks and other lenders that originate them. The Enterprises then bundle the loans into mortgage-backed securities (MBS) that may be purchased by investors.[2]

Historically, large commercial banks and other financial companies often acted as loan "aggregators," purchasing mortgages originated by smaller lenders and selling them to the Enterprises along with loans they originated through their own lending operations.[3] The aggregators were responsible for ensuring that the loans they sold to the Enterprises met their underwriting standards.

This system benefitted both the smaller lenders and the Enterprises. The smaller lenders received favorable compensation for their mortgage loans, and the Enterprises were able to focus their counterparty risk oversight on the performance of the relatively few large aggregators from which they bought the majority of their mortgage loans.

Since the financial crisis of 2007, many of the surviving large aggregators have reduced the amount of loans they purchase from other lenders, and they sell fewer loans to the Enterprises. Consequently, smaller lenders sell substantially more loans directly to the Enterprises, as do a class of financial institutions known as nonbank mortgage companies.[4]

The increase in purchases directly from smaller financial institutions and nonbank mortgage companies offers the Enterprises some potential benefits, such as lower concentration risk.[5] On the other hand, it may increase counterparty credit risk, which stems primarily from two sources. First, some smaller lenders and nonbank mortgage companies have limited financial capacity; second, in some instances, they are subject to less comprehensive federal oversight

[1] *See* Federal National Mortgage Charter Act (12 U.S.C. 1716) and Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1451 Note).

[2] The Enterprises' contribution to the secondary mortgage market is substantial. During 2013, Fannie Mae and Freddie Mac securities accounted for 76% of all new MBS issuances.

[3] In this report, we define small lenders based on their quarterly mortgage sales volume to the Enterprises.

[4] See page 10 for a definition of, and additional information about, nonbank mortgage companies.

[5] The highly concentrated nature of the Enterprises' business with several large financial institutions places the Enterprises at risk that their financial condition and operations could be significantly affected if one of their large counterparties fails, defaults on its contractual obligations, or ceases doing business with an Enterprise. Thus, diversification of mortgage sales among a broader pool of smaller sellers has reduced the Enterprises' concentration risk.

than larger financial institutions. Consequently, some may pose a heightened risk of financial loss to the Enterprises.

In this report, we discuss the recent rise in direct sales to the Enterprises by smaller financial institutions and nonbank mortgage companies and several of the reasons behind this trend. We also identify the risks and challenges associated with it, and discuss FHFA's and the Enterprises' risk management and oversight efforts.

This report was prepared by Simon Z. Wu, Ph.D., Chief Economist; Jon Anders, Program Analyst; and Wesley M. Phillips, Director of the Division of Oversight and Review. We appreciate the cooperation of all those who contributed to this effort.

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

Richard Parker
Deputy Inspector General for Evaluations

CONTEXT ....

The Enterprises Purchase Mortgages Primarily from Depository Institutions and Nonbank Mortgage Companies

The majority of the Enterprises' mortgage lender counterparties are depository institutions, their subsidiaries, and nonbank mortgage companies.[6] Depository institutions and nonbank mortgage companies both contribute substantially to housing finance. However, as described below, there are distinct differences in their business models and the degree to which they are regulated.

Depository Institutions

Depository institutions, referred to in this report as banks, are financial firms whose primary business is taking deposits and making loans. A governmental entity at the national or state level charters them, and their deposits are insured, in part, against loss. In addition, depository institutions are subject to federal supervision, including examinations of their financial safety and soundness. Depository institutions are:

- *Commercial banks*, which are chartered at the state or national level and subject to state or federal regulatory supervision. On the federal level, supervision may be provided by the Office of the Comptroller of the Currency (OCC), the Federal Reserve System, or the Federal Deposit Insurance Corporation (FDIC).[7] The FDIC also insures deposits in commercial banks for at least $250,000. In addition to taking deposits and lending, commercial banks may operate other business lines, including investment banking and credit card operations. Commercial banks vary in size from small community lenders to the largest national bank holding companies.[8] As a general matter, large commercial banks have better access to financing and capital than other financial institutions.

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[6] The Enterprises also purchase single-family mortgage loans from state and local housing finance agencies, insurance companies, and investment banks, among others. According to data provided by the Enterprises, depository institutions, their subsidiaries, and nonbank mortgage companies supplied nearly 100% of their mortgages in the third quarter of 2013.

[7] The Federal Reserve, FDIC, and state bank regulators oversee state chartered commercial banks.

[8] According to the FDIC, community banks are often privately owned, operate within a limited market area, and are more likely to engage in mortgage lending based on specialized knowledge of their community rather than the model-based underwriting employed by larger banks. *See* FDIC, *FDIC Community Banking Study*, "Chapter 1 – Defining the Community Bank," at 1-1, 1-5 (December 2012) (online at: http://fdic.gov/regulations/resources/cbi/report/CBSI-1.pdf).

- *Credit unions*, which are member-owned, not-for-profit financial cooperatives that provide savings, credit, and other financial services to their members. Credit unions pool their members' savings deposits and shares to finance their own loan portfolios rather than rely on outside capital. Members may benefit from higher returns on savings, lower rates on loans, and fewer fees on average. The National Credit Union Administration charters and supervises federal credit unions and insures deposits in federal and most state-charted credit unions through the National Credit Union Share Insurance Fund.[9]

- *Thrifts*, which are financial institutions that generally possess the same depository, credit, and account transactional functions as commercial banks. However, they are organized and operate primarily to promote savings and home mortgage lending as opposed to commercial lending. In 2011, the OCC assumed supervisory responsibility for federal thrifts from the now-defunct Office of Thrift Supervision. The FDIC insures thrift deposits.

Mortgage Companies

Mortgage companies specialize in the origination, sale, and/or servicing of real-estate mortgage loans. Included in this group are independent nonbank mortgage companies and subsidiaries of commercial banks that specialize in mortgage lending. In this report we discuss primarily the growth of and risks associated with a subset of the above—nonbank mortgage companies that are unaffiliated with commercial banks. In general, nonbank mortgage companies:

- Are monoline businesses that rely largely upon short-term funding sources, such as lines of credit from commercial banks, which may be threatened during periods of financial stress. Some nonbank firms also obtain funding through the issuance of long-term debt;

- Vary in size from small, local mortgage lenders to large, nationwide lending firms; and

- Are typically capitalized to a lesser extent than large commercial banks and are not subject to the same degree of federal regulatory oversight that chartered commercial banks receive.[10]

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[9] State governments may also charter credit unions.

[10] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 created the Consumer Financial Protection Bureau (CFPB) and authorized it to supervise and examine compliance with consumer protection laws by mortgage lenders, consumer and student loan providers, and certain larger nonbank market

Overview of the Enterprises' Mortgage Sale Processes

The Enterprises Set Loan Quality Standards for the Mortgages they Purchase from Lenders

Lenders, including banks and mortgage companies, must ensure that the single-family mortgages they plan to sell to Fannie Mae and Freddie Mac meet the Enterprises' standards. For example, the maximum principal balance of a mortgage offered for sale to an Enterprise may not exceed the "conforming loan limit" which, in most locations, is now $417,000.[11] Moreover, the underwriting associated with such loans must meet the Enterprises' guidelines on matters such as a borrower's credit score and debt-to-income ratio.[12] Furthermore, lenders are contractually required to represent and warrant to the Enterprises that, at the time of their origination, the mortgage loans they sell to the Enterprises comply with their underwriting standards.

Lenders Swap their Mortgages for MBS or Sell them for Cash

> In a **swap** transaction the lender exchanges mortgages for Enterprise MBS backed by the same mortgages.

Lenders with mortgage loans that meet the Enterprises' standards may sell them in two ways. First, as depicted in Figure 1A, the lender **swaps** the loans for Enterprise MBS backed by those same mortgages, which the lender then sells to investors. Second, as depicted in Figure 1B, the lender sells the mortgages to the Enterprise for cash, and the Enterprise securitizes the mortgages and sells the resulting MBS to investors.[13] In both cases, the mortgages end-up as part of an Enterprise MBS, and lenders obtain cash they can use to make additional loans, thereby creating liquidity for the housing finance market.[14]

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participants. However, the CFPB does not conduct financial safety and soundness examinations of these companies. *See* 12 U.S.C. 5514. "Larger participants of certain consumer financial product and services markets" are defined at 12 C.F.R. Part 1090.

[11] *See* Federal National Mortgage Charter Act (12 U.S.C. 1717(b)(2)), the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1454(a)(2)), and the Housing and Economic Recovery Act of 2008 (Pub. L. No. 110-289 § 1124).

[12] These underwriting standards serve to mitigate potential credit losses on the loans that comprise the MBS guaranteed by the Enterprises. For more information on underwriting standards, *see* OIG, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards*, at 2 (March 22, 2012) (AUD-2012-003) (online at: www.fhfaoig.gov/Content/Files/AUD-2012-003_0.pdf).

[13] Each Enterprise may also purchase mortgage loans or MBS and hold them in its retained mortgage portfolio.

[14] As described later in this report, larger lenders generally prefer to swap their mortgages for MBS whereas smaller lenders typically sell their mortgages to the Enterprises for cash.

FIGURE 1A. LENDER SWAPS MORTGAGES FOR ENTERPRISE MBS

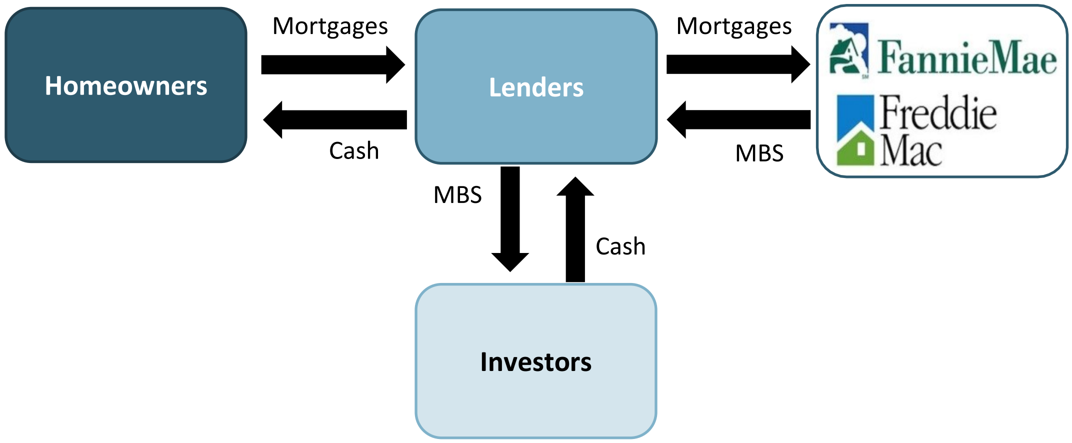
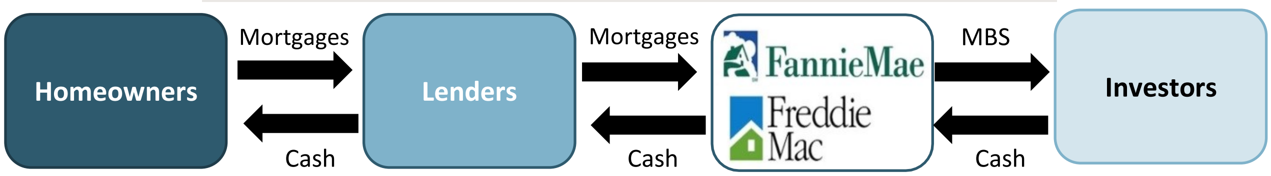


FIGURE 1B. LENDER SELLS MORTGAGES TO AN ENTERPRISE FOR CASH



In exchange for a fee, known as "the guarantee fee," the Enterprises guarantee that investors will continue to receive the timely payment of principal and interest on their MBS regardless of the credit performance of the underlying mortgages.[15]

The Enterprises May Require Sellers to Repurchase Mortgages that Do Not Comply with their Underwriting Standards

The Enterprises have established ongoing, post-purchase quality review processes to verify that the mortgages they purchase conform to their underwriting standards. If an Enterprise determines that a mortgage does not conform to its underwriting standards at the time of the loan's origination, then the Enterprise may require the mortgage seller to repurchase the mortgage at full face value or indemnify the Enterprise for any losses incurred.[16] As shown in Figure 2 below, since the financial crisis the Enterprises have recovered nearly $100 billion through their assertion of repurchase claims.

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[15] For more information about the Enterprises' guarantees and the fees associated with them, see OIG, *FHFA's Initiative to Reduce the Enterprises' Dominant Position in the Housing Finance System by Raising Gradually Their Guarantee Fees* (July 16, 2013) (EVL-2013-005) (online at: www.fhfaoig.gov/Content/Files/EVL-2013-005_4.pdf) (hereinafter, *OIG Guarantee Fee Report*).

[16] For example, a loan may not comply with the Enterprises' underwriting standards if borrowers did not earn the amount of income stated on their mortgage application.

FIGURE 2. ENTERPRISE REPURCHASE REQUEST RECOVERIES, IN $ BILLIONS

	2009	2010	2011	2012	2013	Total
Fannie Mae	$4.6	$8.8	$11.5	$17.1	$32.2	**$74.2**
Freddie Mac	$4.3	$6.4	$4.5	$3.5	$5.6	**$24.3**
Total	**$8.9**	**$15.2**	**$16.0**	**$20.6**	**$37.9**	**$98.5**

Source: Fannie Mae: *Form 10-K for the Fiscal Year Ended December 31, 2010*, at 172; *Form 10-K for the Fiscal Year Ended December 31, 2011*, at 175; *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 143. Freddie Mac: *Form 10-K for the Fiscal Year Ended December 31, 2010*, at 108, and *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 138. The figure may include some recoveries based upon violations of Enterprise servicing guidelines. Numbers may not add to total shown due to rounding.

Lenders Often Service the Mortgages They Sell to the Enterprises

Many banks and mortgage companies serve as **mortgage servicers** for the loans they sell to Fannie Mae and Freddie Mac. That is, they act as points of contact between borrowers and the Enterprises that own the mortgage loans. Servicers typically receive a percentage of the unpaid principal balance (UPB) of the mortgages they manage as a fee for their services.

On the Enterprises' behalf, **mortgage servicers** collect payments from borrowers; maintain escrow accounts for property taxes and insurance; and handle mortgage modifications, defaults, and foreclosures.

Large Financial Institutions May Aggregate and Sell Smaller Lenders' Mortgage Loans to the Enterprises

Large commercial banks and mortgage companies may act as aggregators for smaller lenders, i.e., smaller commercial banks, credit unions, thrifts, and mortgage companies. They do so by purchasing mortgages originated by smaller institutions and selling the loans to the Enterprises. Figure 3, below, depicts the relationship between loan-aggregating lenders and smaller lenders.[17] Typically, the aggregators perform the following functions:

- Verify that the loans meet the Enterprises' underwriting standards. To do so, the aggregators may "re-underwrite" the mortgages; that is, they review the loan documentation to ensure compliance with the Enterprises' requirements.

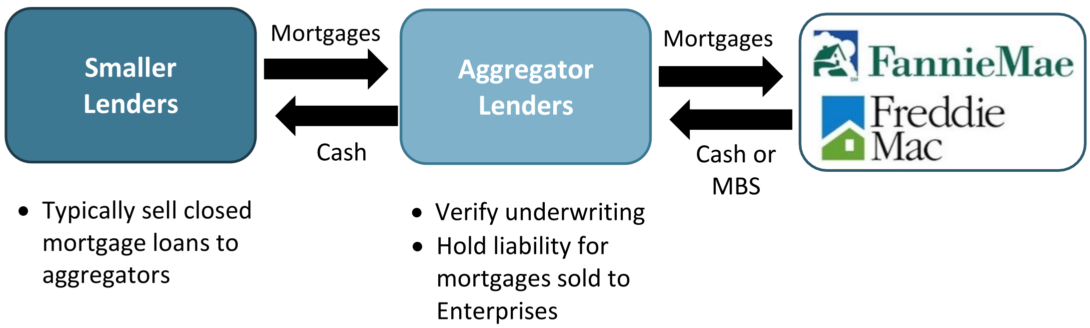
- Assume responsibility for the representations and warranties on the mortgage loans originated by smaller lenders. Accordingly, the Enterprises may seek repurchases

[17] The type of lending described in this section is commonly known as correspondent lending. Generally, correspondent lenders complete loan processing and underwriting, fund loans in their name, and then sell closed loans to other banks and mortgage companies, which we refer to as "aggregators."

directly from the aggregators for any mortgage loans originated by smaller lenders that do not meet their underwriting standards or other requirements.

As explained below, the role played by large institutional aggregators has diminished since the financial crisis of 2008.

FIGURE 3. LOAN SALES TO THE ENTERPRISES THROUGH AGGREGATORS



Source: OIG analysis of information provided by Fannie Mae and Freddie Mac, and Mortgage Bankers Association, *33 Hour SAFE Comprehensive School of Mortgage Banking I, Introduction to Real Estate Finance Industry, Book 1* (2012).

The Aggregation System Offered Financial and Other Benefits to the Participants

The aggregation system provided financial benefits to both the aggregators and smaller lenders. Aggregators benefitted because the Enterprises have historically provided guarantee fee discounts to them based upon the volume of loans that they delivered. By combining their own mortgages with those originated by smaller lenders, the aggregators received larger guarantee fee discounts from the Enterprises.[18] In turn, the aggregators passed along a portion of their discounted guarantee fees to smaller lenders in the form of better prices than the Enterprises could offer them. This arrangement provided many smaller lenders with financial incentives to sell their mortgages to aggregators rather than directly to the Enterprises.

Aggregators also purchased the **mortgage servicing rights** associated with the loans they bought from smaller lenders. According to representatives of Fannie Mae, this provided the primary financial incentive for smaller lenders to participate in the aggregation system. The mortgage servicing rights provided the aggregators with ongoing fee income and

> **Mortgage Servicing Rights** are the contractual rights to service a mortgage and receive fees for those services. They may be bought and sold among servicers.

[18] For more information on the guarantee fees that lenders pay and the Enterprises' historic practice of providing volume-based discounts, *see OIG Guarantee Fee Report*, at 18.

the opportunity to market their other financial services directly to the mortgage borrowers whose loans they serviced.

The Enterprises also benefitted from purchasing mortgages from aggregator sellers. Specifically:

- The aggregators performed an additional layer of review by ensuring that mortgages originated by smaller lenders met the Enterprises' underwriting standards;[19]
- The Enterprises did not have to track potentially hundreds of smaller lenders' financial condition and compliance with their selling and servicing guidelines; and
- Large aggregators may have had more ability to honor the Enterprises' mortgage loan repurchase demands because they often had greater financial resources than smaller lenders.

Many Aggregators Have Failed or Withdrawn from the Business Since the Financial Crisis Due to Changing Economic Circumstances and Regulatory Initiatives

The role played by aggregators in the sales of mortgage loans to the Enterprises prior to the financial crisis of 2008 was quite significant, but since then it has declined due to the failure of some aggregators, changing economic circumstances, and new regulatory requirements.

Fannie Mae recently reported that only 5 of the top 20 mortgage originators of 2006 remain active in the mortgage market today.[20] The firms that failed or were absorbed by other lenders include some of the Enterprises' top sellers and aggregators. For example, according to data obtained from Fannie Mae, Countrywide Financial, which was later purchased by Bank of America, was responsible for nearly a third of Fannie Mae's mortgage purchases in the second quarter of 2007.

Moreover, during the past three years several large aggregators, including Bank of America, have stopped purchasing mortgages originated by other lenders. Other large lenders, including Wells Fargo and CitiMortgage, have also reduced their aggregation activities.

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[19] In recent years, aggregators generally have employed stricter underwriting standards—beyond the Enterprises' requirements—on loans purchased from smaller lenders. This has ensured the sale of high quality loans to the Enterprises.

[20] *See* Fannie Mae, *Deconsolidation in the Primary Mortgage Market: A Temporary or Structural Trend?*, Fannie Mae Housing Insights, Volume 3, Issue 10, at 1 (December 5, 2013) (online at http://www.fanniemae.com/resources/file/research/datanotes/pdf/housing-insights-120513.pdf).

Our discussions with FHFA and Enterprise officials led us to identify several apparent causes of this trend, which are detailed below.[21]

- *Repurchase Requests:* In recent years, the largest commercial banks have been faced with a high volume of repurchase requests from the Enterprises for legacy mortgages sold to them between 2005 and 2008.[22] For example, as shown in Figure 2 above, the Enterprises resolved $37.9 billion in outstanding repurchase requests in 2013 alone. Enterprise officials said that large sellers have attempted to reduce their future repurchase risk by limiting acquisitions of mortgages originated by other lenders and increasing their scrutiny of the third-party mortgages they acquire.[23]

- *Guarantee Fee Increases:* In 2012, FHFA announced an average increase of 10 basis points in the Enterprises' guarantee fees. The increase was intended, in part, to reduce the disparity in guarantee fee pricing between large and small sellers.[24] An official from one Enterprise said that the fee increase caused large banks to realize less compensation for assuming the representation and warranty liability associated with mortgages originated by smaller lenders.[25]

- *New Financial Regulations:* Under U.S. financial regulations instituted in the wake of the Basel III accord, mortgage servicing assets are treated as riskier assets that require the banks that hold them to have significantly higher levels of capitalization.[26] Enterprise officials said that large banks have responded to the regulations by

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[21] Fannie Mae has argued that this shift is the result of the cyclical nature of the secondary market as opposed to a structural change. See *id,* at 4.

[22] Repurchase requests may decline in future years. Fannie Mae reported that, as of the end of 2013, it requested repurchases for less than 0.25% of the mortgages it acquired between 2009 and 2012. By way of comparison, the repurchase rate for mortgages it acquired between 2005 and 2008 was 3.7%. *See* Fannie Mae, *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 143.

[23] Fannie Mae officials said that the delay in funding caused by longer underwriting review times has been one of the factors driving smaller lenders to sell directly to the Enterprises.

[24] *See* FHFA, *FHFA Announces Increase in Guarantee Fees* (August 31, 2012) (online at http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Increase-in-Guarantee-Fees.aspx).

[25] Officials from the other Enterprise discounted this explanation and cited other factors.

[26] The Federal Reserve System, the OCC, and the FDIC issued rules in 2013 that overhauled the regulatory capital framework of the U.S. banking sector. Under the U.S.'s implementation of Basel III, mortgage servicing assets that exceed 10% of a bank's common equity tier 1 capital will now be deducted from the bank's regulatory capital; and mortgage servicing assets held below the 10% threshold will be treated with a 100% risk weight, which will increase to a 250% risk weight by 2018. In addition, the combined holding of mortgage servicing assets, tax deferred assets, and certain other investments are limited to 15% of regulatory capital. These capital requirements went into effect for large financial institutions on January 1, 2014, and will go into effect for smaller banks in 2015.

prioritizing lending through their own mortgage origination operations over purchasing mortgages from third parties.[27]

Smaller Lenders and Nonbank Mortgage Companies Have Increased Their Direct Sales of Mortgages to the Enterprises

Since 2011, smaller lenders, including smaller commercial banks, credit unions, thrifts, and mortgage companies, have increased dramatically their sales of mortgages to the Enterprises. FHFA and Enterprise officials told us that this trend is due, in part, to the fact that some large financial institutions no longer act as aggregators for the smaller lenders. Several of the larger financial institutions have failed, and others have reduced their aggregation of third-party originated loans. Smaller lenders have applied in increasing numbers to become Enterprise sellers in order to continue selling their mortgages into the secondary market.

In the aggregate, nonbank mortgage companies have increased their sales to the Enterprises. According to Enterprise officials, they have done so, in part, by expanding their operations more aggressively than commercial banks in response to the recent boom in residential mortgage refinancing. Recently, nonbank specialty servicers have also begun originating mortgages and selling them to the Enterprises.

The Number of Active Seller Counterparties Has Increased at Both Enterprises

As shown in Figure 4 below, the Enterprises have seen a steady increase in their active mortgage seller counterparties since the 2007 to 2008 financial crisis.[28] For example, between the first quarter of 2011 and the third quarter of 2013, Fannie Mae's total seller count increased by 14%, and Freddie Mac's increased by 7%. Moreover, between late 2007 and late 2013 the number of each Enterprise's active mortgage sellers grew by an average of about 30%.

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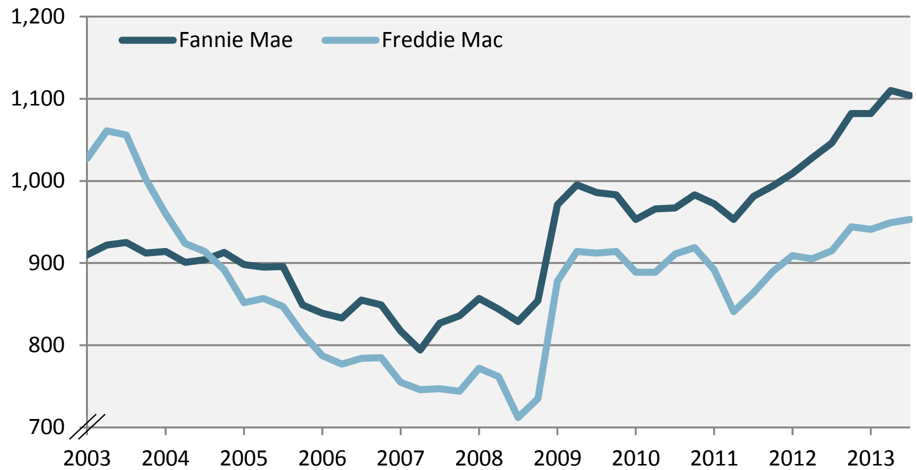
[27] Large commercial banks have also sold significant amounts of their mortgage servicing assets, also known as mortgage servicing rights, to nonbank servicers. The nonbank servicers are not covered by the Basel III regulations. For more information on this trend, *see* Financial Stability Oversight Council, *2014 Annual Report*, at 54 (accessed May 12, 2014) (online at: http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf).

[28] Much of the analysis in this report section was informed by an internal FHFA presentation on risks presented by nonbanks and smaller lenders, which is discussed later in this report. However, our analysis uses a separate data set independently requested from the Enterprises. The data extend back 10 years to 2003 and present information on lenders who sold conventional single-family mortgage loans to the Enterprises.

FIGURE 4. QUARTERLY NUMBER OF ACTIVE SINGLE-FAMILY SELLER COUNTERPARTIES (2003 Q1 – 2013 Q3)



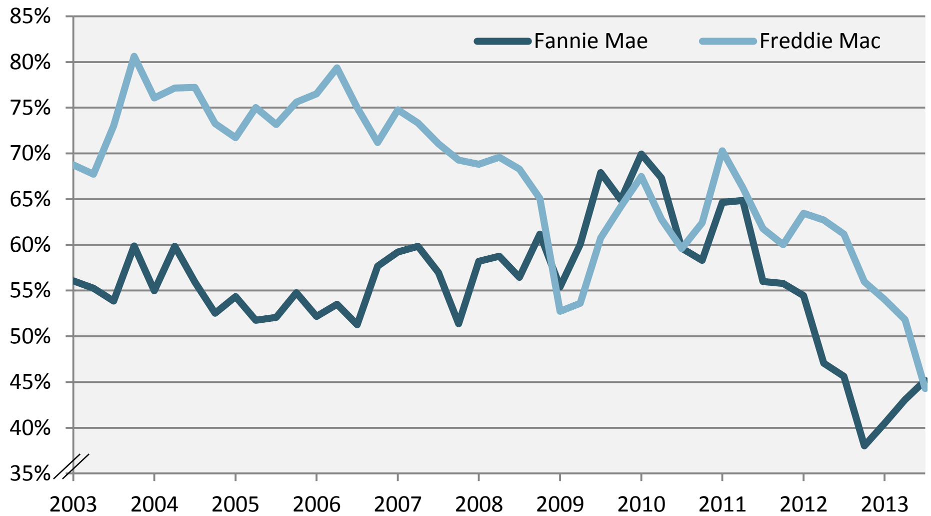
Source: OIG analysis of data provided by Fannie Mae and Freddie Mac. The chart presents a total count of all counterparties that sold conventional single-family mortgage loans to the Enterprises in each quarter.

The Market Share of the Enterprises' Largest Mortgage Sellers Has Declined Significantly

The decline in market share among the Enterprises' respective top five sellers provides evidence of the shift in the composition of their mortgage seller counterparties. In early 2011, their top five sellers delivered between 65% and 70% of the mortgages purchased by each Enterprise.[29] Since then, there has been a pronounced decline in the market share of the Enterprises' largest mortgage seller counterparties. As depicted in Figure 5 below, this has resulted in the top five sellers contributing less than half of the Enterprises' mortgages by the third quarter of 2013.

[29] For most top sellers to the Enterprises, loans originated by other lenders, e.g., correspondent lenders, made up a significant portion of their sales volume. For example, according to data collected by the trade publication *Inside Mortgage Finance*, in the fourth quarter of 2011, for the top five sellers to both Enterprises, the share of mortgages originated by correspondent lenders ranged between 33% and 74% of their total mortgage deliveries. *See* Inside Mortgage Finance, *2012 Mortgage Annual Statistical*, "GSE Business Profile of Top Mortgage Sellers in 4Q11."

FIGURE 5. MARKET SHARE OF THE ENTERPRISES' TOP-FIVE SELLERS, BY UPB (2003 Q1 – 2013 Q3)



Source: OIG analysis of data provided by Fannie Mae and Freddie Mac.

FIGURE 6. MARKET SHARE OF MORTGAGE SALES TO THE ENTERPRISES BY SELLER SALES VOLUME

	Fannie Mae		Freddie Mac	
	2011 Q1	2013 Q3	2011 Q1	2013 Q3
Sellers 1-5	**65%**	**45%**	**70%**	**44%**
Sellers 6-50	**27%**	**33%**	**24%**	**43%**
Sellers 51-900+	**8%**	**22%**	**5%**	**13%**

Source: OIG analysis of data provided by Fannie Mae and Freddie Mac.

The Enterprises' mid-tier and smallest sellers have gained the market share ceded by the largest mortgage sellers. Figure 6, right, illustrates this trend through snapshots of mortgage sales to the Enterprises in the first quarter of 2011 and the third quarter of 2013. While both Enterprises saw a decline in sales from their top five sellers, different segments of their mortgage sellers benefited most from this trend. At Fannie Mae, the smallest sellers—those outside the top 50—gained the most market share, increasing from 8% to 22%, while mid-tier sellers gained the most ground at Freddie Mac, expanding market share from 24% to 43%.

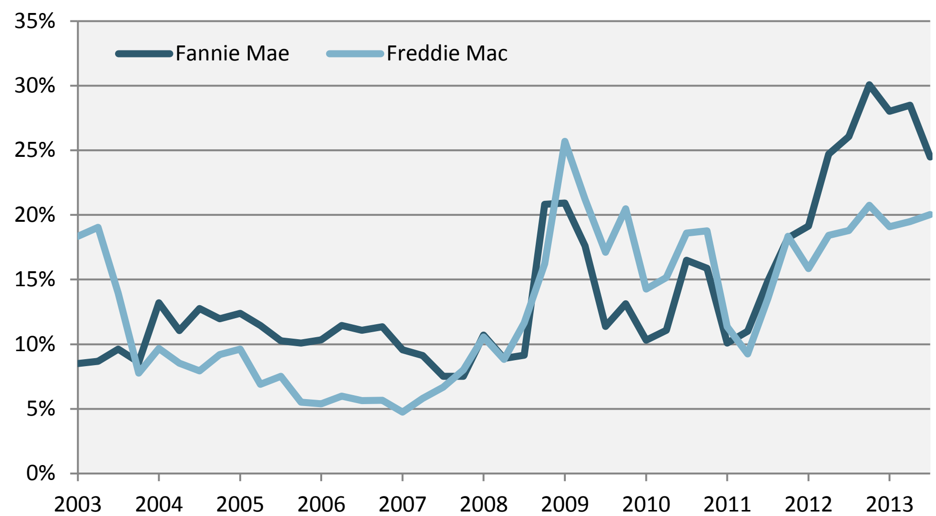
Significant Increase in Mortgage Lender Cash Sales to the Enterprises

As discussed previously, lenders may either swap their mortgages for MBS or sell them to the Enterprises for cash. Traditionally, smaller lenders have sold their mortgages to the Enterprises for cash because such sales are less operationally challenging than MBS swaps.[30]

[30] Fannie Mae officials told us that cash window sales require less loan volume; pay sellers relatively quickly; and have a wider tolerance for loan credit characteristics relative to MBS deliveries.

With smaller lenders contributing a bigger portion of the Enterprises' mortgages, it is not surprising that the market share of cash-window sales has increased significantly over the past few years. As shown in Figure 7 below, cash window sales grew to between 20% and 25% of each Enterprise's total mortgage purchase volume by late 2013. Enterprise data indicate that Fannie Mae's cash window sales have increased at a faster rate than Freddie Mac's cash sales.[31]

FIGURE 7. MARKET SHARE OF CASH WINDOW SALES TO THE ENTERPRISES. BY UPB (2003 Q1 – 2013 Q3)



Source: OIG analysis of data provided by Fannie Mae and Freddie Mac.

Increased Sales Percentages from Nonbank Mortgage Companies

Enterprise data also indicate that sales from nonbank mortgage companies, i.e., those unaffiliated with commercial banks, represent a growing percentage of their mortgage purchases.[32] According to a Fannie Mae document, 46.6% of its mortgages were purchased

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A Fannie Mae official also suggested that even large banks may rely on cash windows more now due to the simplicity of the cost structure and shortened time delays for cash window sales. However, we were unable to confirm this from the data provided by the Enterprises.

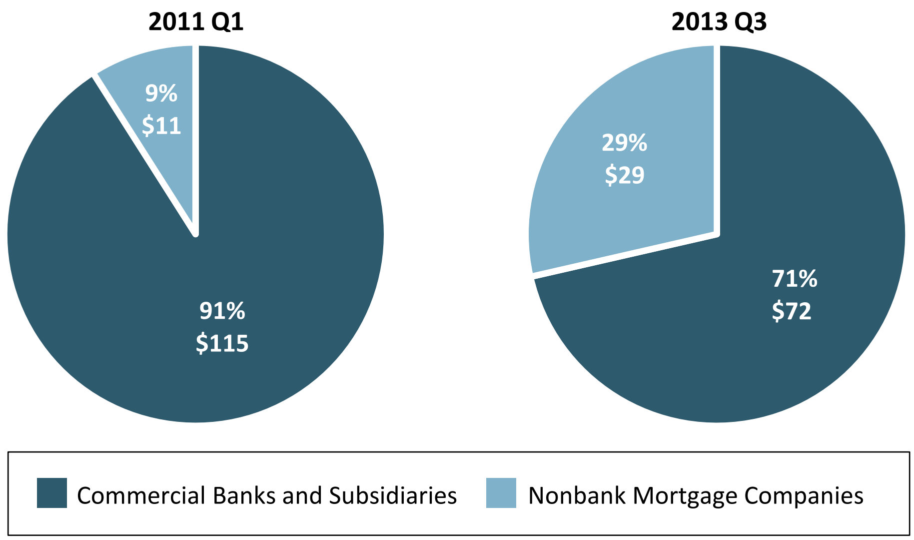
[31] In the first quarter of 2011, cash window sales to Fannie Mae and Freddie Mac amounted to $16.3 billion and $10.8 billion, respectively. By the third quarter of 2013, cash window sales had increased to $44.5 billion at Fannie Mae and $18.8 billion at Freddie Mac.

[32] Nonbank lenders have increased their share of overall mortgage originations. *Inside Mortgage Finance* recently estimated that nonbank lenders accounted for 37.7% of mortgage originations in the first quarter of 2014, which was up from 26% in the same quarter of the prior year. *See* John Bancroft, *Nonbanks Continue to Gain Production Share; Biggest Losers Among the Top 30: Fifth Third, Citi*, IMF news (May 1, 2014) (online at: http://www.insidemortgagefinance.com/imfnews/1_343/daily/nonbank-mortgage-lenders-continue-to-gain-market-share-1000027109-1.html).

from nonbank mortgage companies in the first three quarters of 2013, which was up from 33.2% in 2011. Freddie Mac data shows that its share of mortage purchases from nonbank mortgage companies more than doubled from 8.4% to 20.5% over that same period, but its share remains significantly lower than Fannie Mae's share.

As depicted in Figure 8 below, this trend is particularly prevalent among Fannie Mae's largest mortgage sellers. Sales from nonbank mortgage companies within Fannie Mae's top ten sellers more than doubled between the first quarter of 2011 and the third quarter of 2013, rising from $11 billion to $29 billion, as measured in UPB, and representing almost 30% of the mortgage deliveries made by that group.[33]

FIGURE 8. MORTGAGE SALES BY FANNIE MAE'S TOP 10 SELLERS (2011 Q1 AND 2013 Q3). UPB IN $ BILLIONS



Source: OIG analysis of data provided by Fannie Mae.

Apart from the decline in mortgage aggregation among the top sellers, FHFA and Enterprise officials generally attributed the increase in direct sales from nonbank mortgage companies to the refinance boom of 2012 and early 2013. The record low interest rates during that period provided an incentive for many homeowners to reduce their interest rates by refinancing their mortgages. During this period the lending industry sometimes lacked the capacity to meet the refinancing demand. This, in turn, caused many nonbank mortgage companies to quickly expand their operations. Additionally, new lenders formed what FHFA and Enterprise officials have termed "niche" refinance companies.

[33] Freddie Mac saw similar, but less pronounced, gains by nonbank mortgage companies among its top ten mortgage sellers during this period. Such lenders provided 3% ($2.4 billion in UPB) of the mortgages sold by Freddie Mac's top ten sellers in the first quarter of 2011 and 11% ($6.5 billion in UPB) in the third quarter of 2013.

Nonbank Specialty Servicers Have Initiated Mortgage Sales to the Enterprises

Specialty servicers, also known as high-touch servicers, are nonbank firms that specialize in servicing troubled loans.

The Enterprises have experienced significant growth in mortgage sales from nonbank companies commonly referred to as **specialty servicers**. According to FHFA and Enterprise officials, specialty servicers grew in the wake of the housing crisis. They did so, in part, by acquiring the mortgage servicing rights to large banks' portfolios of troubled mortgage loans, including loans that were serviced on behalf of the Enterprises.[34] The officials said that specialty servicers entered into mortgage lending to recapture business from distressed borrowers who were newly able to refinance into more affordable mortgages in the low-rate environment.[35]

Some of these nonbank specialty servicers are now among the Enterprises' fastest growing mortgage sellers due, in part, to their attempts to provide refinance loans to distressed borrowers. According to data obtained from the Enterprises:

- Mortgage sales from Nationstar Mortgage and its parent company, Fortress Investment Group, grew from $441.7 million in the first quarter of 2011 to $7.7 billion in the third quarter of 2013. Fortress Investment Group was the sixth largest seller to Fannie Mae in the third quarter of 2013, and Nationstar Mortgage was the ninth largest seller to Freddie Mac that quarter.

- Walter Investment Management Corporation, the parent company of specialty servicer Green Tree Servicing, initiated mortgage sales to Fannie Mae in the fourth quarter of 2012. Its mortgage sales to Fannie Mae grew from just $15.4 million in the fourth

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[34] In the past, the Enterprises have encouraged sales of mortgage servicing rights from large commercial banks to specialty servicers because their business model involved closer and more frequent contact with distressed borrowers that resulted generally in better outcomes for borrowers and creditors. For more information see 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) (EVL-2012-008) (online at http://www.fhfaoig.gov/Content/Files/EVL-2012-008.pdf).

According to Enterprise officials, a number of the large servicing portfolios acquired by specialty servicers from banks were acquired without the selling representations and warranties, indicating the higher-capitalized, regulated depository institutions often retained the repurchase risk on the loans.

[35] An FHFA official also said that rising home prices and the shrinking population of homeowners with seriously delinquent mortgages has contributed to specialty servicers initiating or acquiring their own mortgage origination operations.

quarter of 2012 to $6.3 billion in the third quarter of 2013, making the firm Fannie Mae's fifth largest seller that quarter.[36]

Risks and Challenges Associated with the Increase in Mortgage Sales by Smaller Lenders and Nonbank Mortgage Companies

The increase in mortgage sales to the Enterprises by smaller lenders and nonbank mortgage companies presents the Enterprises with certain potential benefits, such as a reduction in their high concentration risk—a product of their financial exposure to a few large commercial banks. Enterprise officials also said that purchasing mortgages from smaller lenders and nonbank mortgage companies helps them to provide liquidity to the secondary mortgage market.

However, we have identified new risks and challenges associated with the shift in the composition of lenders that sell mortgages to the Enterprises. Specifically, and as described below, the trend towards smaller sellers and nonbank mortgage companies may present the Enterprises with elevated credit, operational, and reputational risks.[37] Our conclusion in this regard is based upon our discussions with FHFA and Enterprise officials, as well as our review of their records and other relevant documents.

Elevated Counterparty Credit Risks

The Enterprises' increase in mortgage purchases from smaller lenders and nonbank mortgage sellers may elevate their exposure to counterparty credit risk—the risk that a counterparty will default on financial obligations to the Enterprises, e.g., their representation and warranty obligations.[38] The Enterprises' traditional top sellers—large commercial banks—are

[36] Mortgage sales to the Enterprises from Fortress Investment Group and Walter Investment Management may include acquisitions from other subsidiaries aside from Nationstar Mortgage and Green Tree Servicing. In addition, Walter Investment Management saw its volume of mortgage sales increase after acquiring an existing mortgage-lending platform in early 2013.

[37] These risks are not mutually exclusive. For example, a counterparty that represents high reputational risk may also present heightened credit and operational risks.

[38] Our report is not intended to suggest that, as a class, small or nonbank lenders pose higher credit risks to the Enterprises. Indeed, community banks, for example, may originate mortgages with lower default and other risks than larger institutions. Our intent is to represent what FHFA and the Enterprises have identified as risks associated with some smaller lenders and nonbank mortgage companies.

For example, Fannie Mae's regulatory filings indicate that the decrease of its concentration with large depository institutions may increase its counterparty credit risk and mortgage credit risk, and may have an adverse effect on its financial condition. The Enterprise further disclosed that the smaller and nonbank counterparties with which is it conducting a greater proportion of business may lack the same financial strength, liquidity, or operating capacity as larger depository institutions. *See* Fannie Mae, *Form 10-K for the Fiscal Year Ended December 31, 2013*, at 38, 54 (February 21, 2014) (online at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2013/10k_2013.pdf).

generally well-capitalized financial firms that benefit from broad access to funding and maintain diversified business lines. Their financial strength has allowed such counterparties to fulfill their responsibilities for Enterprise mortgage repurchase requests. Furthermore, the Federal Reserve, OCC, and FDIC enforce prudential standards for capital and liquidity at commercial banks and oversee their financial safety and soundness by examining their operations.[39]

In contrast, some smaller and nonbank lenders have relatively limited financial capacity, and the latter are not subject to federal safety and soundness oversight.[40] According to FHFA officials and records, some of the Enterprises' emerging sellers may not have the financial capacity necessary to honor their representation and warranty commitments on the mortgages they sell to the Enterprises.[41] Consequently, the Enterprises could incur financial losses on mortgages purchased from such lenders if they do not comply with established underwriting guidelines.[42]

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[39] We observe that federal financial regulators did not always effectively supervise large commercial bank and other financial institution risk management practices during the housing boom of 2005 through 2007. Thus, federal supervision unto itself does not necessarily mitigate the Enterprises' credit risks from counterparties.

[40] As noted above, the CFPB may supervise and examine mortgage companies' compliance with consumer protection laws. However, a senior FHFA official said that this level of review was not equivalent to the financial safety and soundness oversight performed by other federal regulators.

In its 2014 Annual Report, the Financial Stability Oversight Council (FSOC) observed that state financial regulators provide some oversight of nonbank servicers, including the imposition of bonding and minimum net worth requirements. However, many nonbank servicers are not subject to prudential standards, such as those associated with capital, liquidity, and risk management oversight. FSOC also recommended that state regulators collaborate with the CFPB and FHFA to establish prudential and governance standards for nonbank servicers. *See* FSOC, *2014 Annual Report*, at 10, 114 (accessed May 12, 2014) (online at: http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf).

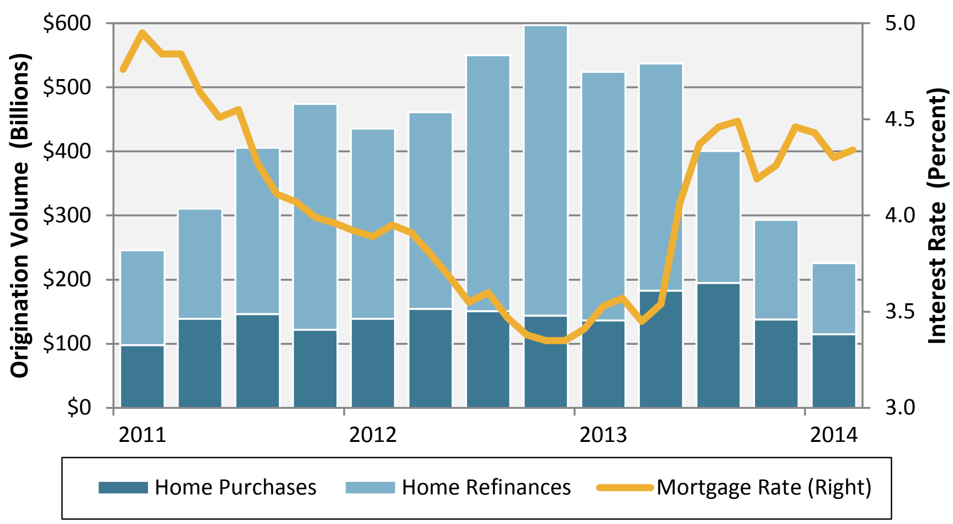
[41] According to Freddie Mac officials, smaller sellers frequently provide credit enhancements, such as collateral, against representations and warranties exposures. These enhancements partially offset the risks and uncertainties that the Enterprises take on when doing business with them.

In addition, the Enterprises revised their representation and warranty frameworks effective January 1, 2013. These revisions may reduce the magnitude of claims made against lender counterparties. In general, the Enterprises will not pursue repurchase requests for mortgages on which the borrower remained current in payments for the first 36 months of the loan, with certain exceptions, such as if the mortgage does not comply with laws or contains misstatements or omissions and data inaccuracies. In conjunction with the new framework, the Enterprises announced expansions of their quality control and enforcement processes for recently purchased loans. Enterprise officials project that these changes will reduce the number of future repurchases.

[42] The high quality of the loans delivered to the Enterprises in recent years mitigates some of the counterparty credit risks presented by emerging sellers. High quality mortgage loans carry a lower probability of borrower default and are less likely to result in repurchase requests. So long as the purchased mortgages maintain low default rates, the Enterprises have the performance and collateral of the mortgages as their first line of defense against credit losses.

Recent market trends already raise questions about the long-term viability of some of the Enterprises' seller counterparties. The refinancing boom that spurred the growth of many lenders began to recede in 2013 when mortgage rates rose from record low positions. As depicted in Figure 9 below, mortgage refinances are estimated to have fallen by over 75% since their peak in the fourth quarter of 2012. The corresponding reduction in business has hurt mortgage company profits and resulted in lay-offs across the sector.[43]

FIGURE 9. QUARTERLY ESTIMATED SINGLE-FAMILY MORTGAGE ORIGINATION VOLUMES AND MONTHLY AVERAGE COMMITMENT RATES ON 30-YEAR FIXED-RATE MORTGAGES



Source: Mortgage Bankers Association Quarterly Mortgage Originations Estimates as of May 2014 and the Freddie Mac Primary Mortgage Market Survey, historical monthly data for conventional, conforming 30-year fixed-rate mortgages.

In addition, officials from the Enterprises told us that the relatively low, though growing, levels of mortgage loan deliveries from smaller sellers mitigate their counterparty credit risks due to the relatively small degree of financial exposure to any one of these counterparties. For example, 96% of Freddie Mac's projected potential losses from counterparties during a stress event come from its top 200 counterparties. We note that many nonbank mortgage companies are among the Enterprise's top sellers.

[43] The Mortgage Bankers Association reported that, in the fourth quarter of 2013, mortgage company origination profits were at their lowest level, and production expenses were at their highest level, since it began surveying mortgage companies in 2008. *See* Mortgage Bankers Association, *Independent Mortgage Banker Profits Reach New Lows in the Fourth Quarter of 2013* (March 26, 2014) (online at: http://www.mba.org/NewsandMedia/PressCenter/87759.htm).

Elevated Operational Risks

> **Operational risk** is the exposure to loss from inadequate or failed internal processes, people, and systems, or from external events, including legal events.

The increasing trend of smaller and nonbank mortgage lenders selling loans directly to the Enterprises may also present heightened **operational risks**. One Enterprise official told us that, relative to large commercial banks, the operations of some smaller lenders may lack sophistication, resulting in potential quality control and fraud management problems. For example, small lenders may lack access to experts in increasingly complex subject areas, such as regulatory compliance.

FHFA officials also told us that the rapidity that characterizes the specialty servicers' mortgage origination and sales business growth also presents increased operational risks for the Enterprises. Specifically, the officials said that the increased pace of the specialty servicers' business could cause them to stretch their operational capacity or overrun their quality control procedures. We observe that this, in turn, could increase the potential for representation and warranty claims and credit losses on the mortgages they sell to the Enterprises. We have reported on problems that the Enterprises discovered in the servicing operations of a specialty servicer and the need for increased oversight.[44] Similar oversight is needed with respect to the operations by which the Enterprises' specialty servicers originate residential mortgages.

Finally, we note that the change in the composition of the Enterprises' mortgage sellers may increase the Enterprises' operational risks and costs. Specifically, and as detailed in the next section of this report,[45] the change requires the Enterprises to monitor the financial strength and operational capacity of their many new lenders and nonbank mortgage companies as well as that of their traditional large bank sellers. This, in turn, requires the Enterprises to expend additional resources to develop the added operational capacity necessary for this task.

Elevated Reputational Risk

According to FHFA, Enterprise officials, and the documents that we have obtained, buying loans from some nonbanks could damage the Enterprises' reputations.[46] This could occur if,

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[44] *See*, OIG, *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages*, at 7-8 (AUD-2014-014, July 1, 2014) (online at: http://www.fhfaoig.gov/Content/Files/AUD-2014-014.pdf).

[45] The next report section summarizes some of the controls that the Enterprises have established to mitigate the risks associated with the change in the composition of their mortgage sellers.

[46] We observe that reputational risk is not confined to, for example, some nonbank mortgage companies. Several large commercial bank counterparties of the Enterprises, such as Bank of America and JPMorgan

for example, an Enterprise bought loans from a lender that harmed consumers by engaging in fraud or other misconduct.[47] Moreover, the Enterprises' reputations could be damaged if several of these entities failed while the Enterprises had financial exposure to them, as could occur under adverse market conditions.

FHFA identified a nonbank lender that exemplifies the reputational risks discussed above. This particular lender became a top 20 seller to one Enterprise during the refinance boom of 2012 to 2013. In 2013, one of the lender's businesses engaged in abusive lending practices causing it to be subjected to regulatory and enforcement actions by several state authorities.[48] Representatives of the affected Enterprise told us that it assessed the lender's mortgage-lending operations during the period of its rapid growth.[49] In the third quarter of 2013, the Enterprise became increasingly concerned with the heightened reputational risk caused by the regulatory enforcement actions and civil litigation that had been filed against the lender and accepted the lender's voluntary suspension from doing further business with the Enterprise.[50]

The Risk Management Controls Put in Place by the Enterprises to Address the Increase in Direct Sales from Smaller Lenders and Nonbank Mortgage Lenders

Fannie Mae and Freddie Mac officials told us that the Enterprises have modified their existing counterparty risk management controls in response to increased direct mortgage sales from smaller and nonbank lenders. According to these officials and documents that we have reviewed, some of their modified risk management controls include:[51]

Chase, have reached significant financial settlements with the Department of Justice, federal regulators, and states' Attorneys General for misrepresenting the risks associated with mortgage securities and poor mortgage servicing, among other deficiencies and violations.

[47] A senior FHFA examiner said that nonbank lenders can pose relatively greater reputational risks to the Enterprises than traditional banks. The examiner said that this is due to the lack of federal oversight of nonbank lenders and lower barriers to entry into the business relative to the chartering process for banks.

[48] The business engaged in consumer lending.

[49] Specifically, the Enterprise conducted operational and loan file reviews as well as other ongoing monitoring activities. It also lowered the lender's mortgage loan delivery limit and required it to post collateral against potential future losses from representation and warranty risks.

[50] The lender sold a nominal amount of mortgage loans to the other Enterprise during 2013. An onsite operational review by that Enterprise found deficiencies in the lender's processes for fraud prevention and quality control. It terminated its relationship with the lender in 2013.

[51] We did not independently verify the Enterprises' claims about the reported improvements in their risk management practices. We observe that the Agency is directly responsible for assessing these controls, and its efforts in this regard are discussed in the final section of this report.

- *Additional and Stricter Financial Requirements for New Mortgage Seller Applicants:*[52] The Enterprises have strengthened their financial standards for potential counterparties by increasing the minimum net worth requirement from $250,000 to $2.5 million. New applicants must undergo financial assessments and key personnel background checks prior to approval. Additionally, the Enterprises recently instituted onsite operational reviews of new nonbank seller applicants that are intended to allow the Enterprises to assess whether nonbank lenders possess the systems and controls necessary to comply with the Enterprises' seller/servicer guides.[53]

- *Limits on Mortgage Sales from Sellers that May Represent Elevated Risks:*[54] Fannie Mae officials told us that they have instituted restrictive loan delivery limits for new and smaller sellers, i.e., limits on the notional dollar value of monthly or annual loan sales. Fannie Mae staff members can assign such delivery limits to existing seller counterparties in response to rapid growth, concerns about performance, or operational deficiencies.[55] Freddie Mac officials said that the Enterprise has established internal risk-based exposure limits for its counterparties. However, the Enterprise has not established stated delivery limits for new mortgage sellers as Fannie Mae has done.

- *Operational Reviews for Current Mortgage Sellers:* Teams from each Enterprise are to perform on-site and off-site reviews to identify their current sellers' operational risks, including assessments of the effectiveness of their controls and compliance with Enterprise requirements.[56] Further, a Freddie Mac official said that in 2013 the

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[52] The Enterprises' counterparty application process seeks to ensure that potential sellers have the financial, management, and operational readiness required to be effective counterparties.

[53] Representatives from one Enterprise said that it initiated onsite reviews of nonbank mortgage company applicants due, in part, to the lack of federal safety and soundness oversight of such lenders.

[54] Additionally, the Boards of Directors of the Enterprises approve absolute limits on the amount of financial exposure that they may have to counterparties. Within these absolute limits, their Enterprise Risk Management groups administer internal operating limits that are set in accordance with their counterparties' creditworthiness, net worth, and pledges of collateral, among other factors. Finally, Fannie Mae enforces limits on the notional value of mortgage sales from new sellers and certain existing counterparties, as described in the text above.

[55] In 2012, Fannie Mae began monitoring mortgage deliveries on a monthly basis, searching for lender volume spikes, increases in third-party origination volumes, and new deliveries from dormant lenders. According to Fannie Mae documents, identifying such lenders can lead to further review of their operations, controls, and loan quality. A Freddie Mac Enterprise Risk Management official told us that the Enterprise does not monitor its exposures to the mortgage loans that lenders deliver through its cash window. The official said that such monitoring would soon be in place under a new risk management system.

[56] Fannie Mae's operational risk review team is known as the Mortgage Origination Risk Assessment team and Freddie Mac's is referred to as the Counterparty Operational Risk Evaluation team.

Enterprise officials and documents indicate that, in general, the teams prioritize operational reviews according to the degree of financial exposure that the Enterprises have to particular counterparties. Further, the operations of the largest counterparties are reviewed on site at least once annually. The Enterprises also

Enterprise initiated a pilot project intended to assess how well its nonbank counterparties would weather the decline in refinance business. The official also told us that Freddie Mac would conduct bi-monthly operational reviews of certain top specialty servicers in 2014. Fannie Mae documents indicate that the Enterprise is supposed to conduct operational reviews once counterparties reach a certain mortgage loan delivery threshold.

FHFA's Oversight of the Enterprises' Risk Management Controls for Mortgage Sales from Smaller Lenders and Nonbank Mortgage Companies

FHFA examination officials stated, and Agency documents confirm, that since at least 2012 the Agency has been aware of the risks associated with increasing sales to the Enterprises by smaller lenders and nonbank mortgage companies. In June 2013, FHFA's Division of Housing Mission and Goals (DHMG) completed an analysis of mortgage sellers that highlighted the growth of nonbank sellers, the changing nature of the Enterprises' counterparty risk, and the reputational risk associated with the nonbank lender discussed earlier in this report.[57]

Our work reveals that, although the Agency conducted examinations pertaining to general counterparty credit risk management and specialized nonbank servicers in 2013, its examiners did not specifically test and validate the Enterprises' controls over the risks associated with direct mortgage sales from small lenders and nonbank mortgage companies. We note that, according to the Agency's 2014 planning documents, it plans to conduct several examinations of the Enterprises' management of the risks associated with their smaller lenders and nonbank mortgage companies. Further, FHFA officials said that the Agency is developing guidance intended to strengthen the Enterprises' counterparty risk management.

FHFA's Examiners Assessed the Enterprises' General Counterparty and Specialized Mortgage Servicer Risk Management in 2013, but Did Not Focus on their Controls for Smaller and Nonbank Lenders

In 2013, Division of Enterprise Regulation (DER) and Division of Supervision Policy and Support (DSPS) examination teams initiated Enterprise counterparty credit risk examinations,

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schedule examinations of counterparty operations based on key risk indicators, such as rapid growth or referrals from other business units.

[57] DHMG is responsible for the oversight of the housing mission of the entities regulated by FHFA. DHMG's Office of Financial Analysis, Modeling and Simulations (OFAMS) is responsible for offsite monitoring of financial performance and risk exposure for all the entities regulated by FHFA. OFAMS assesses the Enterprises' counterparty risk exposure by completing routine, standard reports and periodic in-depth presentations.

as well as examinations of specialty servicers. The following summarizes some of these examination activities:

- One DER core team conducted a high-level examination of an Enterprise's governance of its counterparty credit risk management practices. The examination, which was completed in May 2014, resulted in supervisory directives to the Enterprise to correct certain risk management deficiencies;
- DSPS's Office of the Chief Accountant (OCA) completed a review of the process by which the other Enterprise analyzed the counterparty credit risks associated with its mortgage insurer and seller/servicer counterparties; and
- DER conducted examination activities pertaining to the Enterprises' management of operational and other risks associated with specialized mortgage servicers, which were discussed earlier in the report. For example, DER core team members conducted on-site inspections of multiple specialty servicers. DER also issued several recommendations to the Enterprises to strengthen their risk management controls for these companies' mortgage servicing operations.[58]

Thus, as stated above, we determined that in 2013, the Agency did not specifically test and validate the Enterprises' controls over the risks associated with the recent shift in direct mortgage sales by smaller and nonbank lenders. For example, the examiners did not validate the effectiveness of the Enterprises' operational reviews of new and current mortgage sellers.[59]

DER Plans to Conduct Examination Activities in 2014

DER planning materials for 2014 indicate that the Enterprises' controls for smaller and nonbank sellers will be a focus of the core teams' examination activities.[60] Indeed, one of

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[58] Our review indicates that FHFA examination activities focused largely on the Enterprises' risk management controls over the mortgage servicing aspects of these companies. However, on the basis of one such review, DER examiners recommended that an Enterprise ensure that it has plans in place to manage the risks associated with specialty servicers that are expanding into mortgage originations. Based on our review of Agency documentation and discussions with examiners, we concluded that DER did not specifically test and validate the Enterprise's existing controls, which are described, in part, earlier in this report.

[59] The 2013 DHMG presentation identified the Enterprises' operational reviews as a control meriting supervisory attention.

[60] DER's 2014 examination activities are not within the scope of this report, and many were pending completion at the conclusion of our fieldwork. However, we have previously cited concerns about FHFA's capacity to fulfill its annual Enterprise examination plans. *See*, OIG, *Update on FHFA's Efforts to Strengthen its Capacity to Examine the Enterprises* (December 19, 2013) (EVL-2014-002) (online at: http://www.fhfaoig.gov/Content/Files/EVL-2014-002.pdf). We continue to conduct evaluations in this important area.

DER's four key supervisory priorities includes an assessment of the possible effects of "the increased presence of nonbank and nontraditional seller/servicers" on the Enterprises' business activities.

The following summarizes these planned core team examination activities:

- One core team's planned activities include assessments of the Enterprise's mortgage loan delivery limits and lender eligibility standards.
- The other core team plans to follow up on the OCA special project on the Enterprise's counterparty risk analysis. Its 2014 examination plan for the Enterprise includes assessment of the counterparty approval process and counterparty credit risk resulting from cash window originations.

DSPS Has Issued, and Is Developing, Guidance for the Enterprises on Counterparty Risk Management

In addition to assisting with supervision and examination of the Enterprises in 2013, DSPS staff issued supervisory guidance to the Enterprises on counterparty credit risk management. DSPS released what is known as an advisory bulletin recommending that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks identify high-risk and high-volume counterparties based on internal exposure limits, and produce written contingency plans for those counterparties in the event that internal limits are breached.[61] The advisory bulletin provided additional guidance on effective counterparty risk management under the Agency's Prudential Management and Operating Standards.

A DSPS manager told us that the Division plans to issue several related advisory bulletins on counterparty risk management in 2014. The manager said that one of the bulletins would likely focus on risk management and the approval process for seller counterparties.

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[61] *See* FHFA, *Advisory Bulletin AB 2013-01 "Contingency Planning for High-Risk or High-Volume Counterparties"* (April 1, 2013) (online at: http://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/20130401_AB_2013-01_Contingency-Planning-for-High-Risk-or-High-Volume-Counterparties_508.pdf).

The Advisory Bulletin states that examiners will review the Enterprises' "policies, procedures and practices related to credit and counterparty risk management, including [their] contingency plans for high-risk and high-volume counterparties." We observe that both DER core teams include examination activities related to contingency planning in their 2014 examination plans.

CONCLUSIONS

The recent shift in direct mortgage sales by smaller and nonbank mortgage company lenders reduces the Enterprises' concentration risks. However, the trend appears to increase other Enterprise risks, particularly counterparty credit risk. Specifically, some of the new sellers have limited financial capacity relative to the Enterprises' traditional large bank counterparties, and they are subject to less regulatory oversight. Consequently, some of the new sellers, particularly nonbank mortgage companies, may lack the capacity to honor their representation and warranty commitments to the Enterprises. As a result, the Enterprises could incur financial losses on mortgages purchased from such lenders if they do not comply with established underwriting guidelines.

The Enterprises have reportedly taken a number of steps recently to mitigate these risks. However, due to other examination priorities, FHFA did not specifically test and validate their effectiveness during its 2013 examination activities. The Agency has scheduled a number of relevant examination activities during its 2014 examination cycle, and it plans to issue related guidance on risk management practices. We will continue monitoring the effectiveness of the Agency's efforts to oversee this critical issue.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The primary objectives of this report were to document the increase in sales to the Enterprises by smaller lenders and nonbank mortgage companies, discuss the reasons behind this trend, and assess FHFA's oversight of the Enterprises' risk management controls.

To address these objectives, we interviewed officials in DER, DSPS, and DHMG as well as members of the Enterprises' single-family business and enterprise risk management groups.

To accomplish our quantitative analysis, we requested quarterly selling volume data from the Enterprises. The data capture the total quarterly sale volume, as measured by the number of mortgage loans and their total unpaid principal balance, to the Enterprises by each seller. It also includes each seller's industry classification code, as well as a breakdown of sale volume by selling channels (e.g., cash window and swap transactions) for each individual seller. The data used in this report cover the period from the first quarter of 2003 through the third quarter of 2013. We shared the preliminary results of our analysis with FHFA and Enterprise officials, who generally agreed with our analysis. However, we did not independently test the reliability of the Enterprises' data.

Finally, we also reviewed Enterprise policies and procedures for counterparty risk management, Enterprise internal audit reports, DER examination plans, and planning and findings memoranda associated with Enterprise examinations.

This study 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 OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support its findings and recommendations. We believe this report meets these standards.

FHFA and the Enterprises provided technical comments on a draft of this report, which were incorporated as appropriate.

The performance period for this evaluation was between October 2013 and May 2014.

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