Federal Housing Finance Agency
Office of Inspector General

FHFA Oversight of Enterprise Handling of Aged Repurchase Demands

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Synopsis

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Why OIG Did This Report

Various entities such as banks often sell mortgage loans to two Government Sponsored Enterprises – the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac); taxpayers invested heavily to keep these enterprises afloat during the recent housing crisis due to losses on those mortgages. The Federal Housing Finance Agency (FHFA or Agency) oversees the Enterprises as their regulator and conservator, which includes ensuring that loans they purchase are underwritten and serviced effectively and performing a later review to determine if their selling and servicing standards are being met. This report focuses on FHFA's oversight of the Enterprises' programs for encouraging seller-servicers to resolve demands to repurchase defective loans timely, because robust FHFA oversight of harmonizing these programs between the Enterprises and ensuring effective implementation could yield significant benefits to taxpayers.

What OIG Found

In January 2012, as part of its larger effort to harmonize the Enterprises' operations, FHFA directed the Enterprises to develop "consistent timelines and collection standards for fees and penalties and additional types of penalties and remedies." However, the Agency's published guidance for aged repurchase demands essentially let each Enterprise establish its own model for penalizing seller-servicers. As a result, Freddie Mac continued to employ its existing contractual right to assess late fees on seller-servicers for not resolving repurchase demands timely, while Fannie Mae continued to have no equivalent penalty.

FHFA allowed Fannie Mae to continue without any ability to assess repurchase late fees because the Enterprise claimed that setting up such a program could cost up to $5.4 million. However, the Enterprise's analysis did not consider the potential benefits of the program including a continuous stream of penalty fees. As an indication of the program's potential, Freddie Mac could have assessed as much as $284 million from 2009 through 2012 using its existing right to assess late fees. And for much of that time period, Fannie Mae had a larger volume of unresolved repurchase demands than Freddie Mac. Specifically, as of July 2013, more than 10,000 of Fannie Mae's repurchase demands totaling $2.5 billion had been unresolved for at least 120 days.

OIG also concluded that Freddie Mac's assessment of repurchase late fees could benefit from stronger Agency supervision. By inconsistently waiving, enforcing, and excepting late fees through 2012, the Enterprise missed assessing up to $284 million in late fees that are now unlikely to be collected – losses that taxpayers ultimately bore. In part, OIG traced this to the need for robust FHFA oversight. Before its harmonization work, the Agency largely left the assessment of repurchase late fees unsupervised, and it currently does not receive sufficient information from Freddie Mac to oversee and assess this part of the Enterprise's business.

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Finally, FHFA is not including any uncollected repurchase late fees in settlement negotiations with seller-servicers over defective loans that were sold to or serviced for the Enterprises. Such loans contributed to their financial difficulties and placement under FHFA conservatorships. Increased Agency oversight can result in additional future recoveries as repurchases are settled.

What OIG Recommends

FHFA should: (1) promptly quantify the potential benefit of implementing a repurchase late fee program at Fannie Mae, and then determine whether the potential cost outweighs the potential benefit; (2) direct Freddie Mac to develop a repurchase late fee report to be routinely provided to FHFA that expands on information already provided by adding summary information by seller on outstanding repurchases, aging of repurchases, late fees assessed and collected, discretionary late fee waivers, and global late fee exclusions. Such a report would provide Freddie Mac and FHFA management with needed information to manage and assess Freddie Mac's repurchase late fee program more effectively; and (3) direct Freddie Mac to provide FHFA with information on any assessed but uncollected late fees associated with the repurchase claims that are included in the 2013 bulk settlements so that these fees can be considered in the negotiations and documented in accordance with the Office of Conservatorship Operations (OCO)'s Settlement Policy. FHFA agreed with OIG's recommendations.

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ABBREVIATIONS

FHFA or Agency	Federal Housing Finance Agency
Fannie Mae or Enterprise	Federal National Mortgage Association
Freddie Mac or Enterprise	Federal Home Loan Mortgage Corporation
OIG	Federal Housing Finance Agency, Office of Inspector General
REO	Real estate owned
UPB	Unpaid principal balance
OGC	Federal Housing Finance Agency, Office of General Counsel
OCO	Federal Housing Finance Agency, Office of Conservatorship Operations
OHRP	Federal Housing Finance Agency, Office of Housing and Regulatory Policy

PREFACE

The Housing and Economic Recovery Act of 2008 established the FHFA Office of Inspector General (OIG).[1] The OIG is authorized to conduct audits, evaluations, investigations, and other activities pertaining to FHFA's programs and operations. As a result of its work, OIG may recommend policies that promote economy and efficiency in administering FHFA's programs and operations, or that prevent and detect fraud and abuse in them.

Given the risks associated with untimely resolution of aging outstanding repurchase demands, this audit report is part of the OIG's proactive audit and evaluation strategy to assess the Agency's related oversight and conservatorship efforts. One aspect of this strategy focuses on the Enterprises' efforts to resolve aging outstanding repurchase demands and the oversight provided by FHFA to help maximize related financial recoveries.

This report furthers OIG's work by assessing the process and controls over FHFA's oversight of the Enterprises' penalty programs to encourage seller-servicers to resolve repurchase demands timely. The OIG found that FHFA did not sufficiently evaluate whether to implement a repurchase late fee program at Fannie Mae. The OIG also found that FHFA did not examine Freddie Mac's use of its contractual right to assess repurchase late fees, resulting in missed opportunities to minimize losses. This report's recommendations can increase FHFA's assurance that the Enterprises' assets are being preserved and conserved.

The OIG appreciates the cooperation of all those who contributed to this audit, including officials at FHFA, Freddie Mac, and Fannie Mae. This audit was led by Laura Benton, Audit Director, and Bobbi Paulson, Audit Manager, who were assisted by Christopher Sim, Senior Auditor, and Anya Philbert, Auditor.

This audit 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.

Russell A. Rau
Deputy Inspector General for Audits

[1] Housing and Economic Recovery Act of 2008, Pub. L. 110-289 § 1105(a)(5).

CONTEXT

The Repurchase Demand Process

FHFA currently serves as both regulator and conservator of the Enterprises. As regulator, the Agency's mission includes ensuring that the Enterprises operate in a safe and sound manner. As conservator, the Agency seeks to conserve and preserve Enterprise assets.

The Enterprises' resolution of repurchase demands is within the scope of FHFA's oversight, because while aging outstanding repurchase demands remain on the Enterprises' books, the Enterprises must reserve for losses and take write-downs on them. The amount of proceeds the Enterprises collect in resolution of repurchase demands determines whether they incur losses, which ultimately represent losses to U.S. taxpayers.

As part of their quality control systems, the Enterprises review mortgage loans that they purchase or securitize. The results of these reviews may prompt them to issue repurchase demands to **seller-servicers** to minimize losses caused by the loans' underwriting defects or servicing errors. The Enterprises' ability to issue and enforce repurchase demands is part of their leverage to encourage seller-servicers to adhere to contractual requirements and underwriting standards.

Seller-servicers are financial institutions organized under federal or state jurisdictions that are eligible to sell mortgages to the Enterprises and service mortgages purchased by the Enterprises.

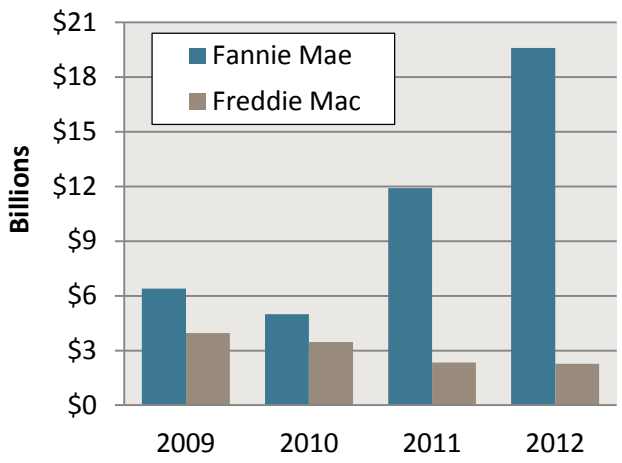
A repurchase demand may be required by the terms under which a loan was purchased or securitized, such as if the mortgage violates a contractual selling representation or warranty or was improperly serviced. However, in certain circumstances, the Enterprises can choose to permit a remedy other than repurchase. Remedies can include requiring the seller to (1) correct a selling warranty violation or inadequate underwriting; (2) remit a "make-whole" payment if the loan had been liquidated; (3) indemnify the Enterprise against any loss, damage, or expense sustained in connection with the loan; (4) provide collateralized recourse; (5) terminate servicing; or (6) share losses with the Enterprise.

Seller-servicers can satisfy a repurchase demand by repurchasing the loan if it remains active or delinquent and reimbursing losses realized by the Enterprise if the loan is in foreclosed or real estate owned (REO) status. Seller-servicers may appeal the repurchase demand and the demand can be rescinded during the appeal process. Seller-servicers historically appealed most repurchase demands, but unsuccessful appeal did not change the due date for resolution of the repurchase demand.

Outstanding Repurchase Demands Rapidly Increased to Substantial Levels by 2009

During the unprecedented growth in the U.S. housing market from 2005 to 2007, the quality of loans originated and sold to the Enterprises deteriorated substantially. As Fannie Mae and Freddie Mac identified defects in these loans, the Enterprises issued thousands of repurchase demands to sellers.

FIGURE 1. THE ENTERPRISES' OUTSTANDING REPURCHASE DEMANDS FROM 2009-2012, BY UNPAID PRINCIPAL BALANCE



Sources: Monthly outstanding repurchase reports provided to the OIG by Fannie Mae and Freddie Mac.

As shown in Figure 1, between 2009 and 2012, outstanding repurchase demands totaled to as much as $19.6 billion for Fannie Mae, and $3.9 billion for Freddie Mac, with significant decreases only due to bulk settlements of aging repurchase demands. As of year-end 2012, more than 65 percent of Fannie Mae's repurchase demands, and more than 40 percent of Freddie Mac's, had been outstanding and unresolved for more than 120 days.

Freddie Mac Began Assessing a Late Fee to Encourage Seller-Servicers to Resolve Aging Outstanding Repurchase Demands, While Fannie Mae Used No Penalties

After issuing a repurchase demand, Fannie Mae and Freddie Mac continued to accrue interest and/or fees on the loan until the seller-servicer resolved the repurchase demand. However, beginning in October 2010, Freddie Mac also began assessing a late fee to penalize some seller-servicers once the repurchase demand had been outstanding for a certain period of time.

Prior to 2009, Freddie Mac had the discretion to charge a late remittance fee equal to the prime rate plus three percent of the unpaid principal balance (UPB)[2] on loans for which a repurchase demand had been outstanding for more than 30 days.[3] However, Freddie Mac did not begin to enforce its right to assess repurchase late fees until October 2010, when it began assessing repurchase late fees on seller-servicers with the largest volume of outstanding repurchase demands.

[2] UPB is the actual balance of the mortgage as of the last paid installment date.

[3] Freddie Mac's Seller/Servicer Guide, Chapter 72, available at http://www.freddiemac.com/singlefamily.

In July 2011, Freddie Mac management began notifying other major seller-servicers that the Enterprise intended to begin enforcing its right to assess repurchase late fees by updating the seller-servicers' contracts with new terms of business stating that late fees may[4] be assessed on all eligible outstanding repurchase demands. Freddie Mac's internal auditors had identified the mortgage repurchase process as a high risk audit area in late 2010, and concluded through audit work in 2011 that Freddie Mac had not been assessing repurchase late fees consistently for delays by seller-servicers in resolving repurchase requests. The audit work contributed to Freddie Mac's decision to add the new terms of business to its largest seller-servicers' contracts and apply them to all seller-servicers through an update to its Selling Guide effective on January 1, 2013.

Freddie Mac began enforcing its right to assess repurchase late fees with its top 15 seller-servicers only because the manual billing process used to assess and collect the fees could not be extended to smaller seller-servicers with the resources available. The contracts of some major seller-servicers still contained "carve-outs" allowing them to avoid late fees on some repurchases aged more than 120 days, and Freddie Mac could still waive assessment of late fees for multiple reasons.[5] The "carve-outs" were removed through updates to seller-servicers' contracts in 2012.

Freddie Mac also assessed no late fees on outstanding repurchase demands subject to various "global exclusions," which included Bank of America T-deals,[6] since there was no provision for late fee assessment in the governing documents for these loans and those with mortgage insurance compliance violations. Freddie Mac determined that the seller-servicer was sometimes not the primary cause of the delay in resolution. Other "global exclusions" that were used but have now been eliminated were for repurchases associated with loans with certain documentation deficiencies.

Fannie Mae did not have a contractual ability to assess late fees or any other penalty to encourage timely resolution of outstanding repurchase demands. However, Fannie Mae could

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[4] An official in Freddie Mac's legal group confirmed for the OIG that the term "may" provided full enforcement rights to Freddie Mac. While the contractual right to assess late fees was in existence since before 2009 but not enforced, Freddie Mac's Remedy Management personnel told OIG that once the decision was made to enforce the contractual right, they intended to start applying it consistently to the Enterprise's top 15 seller-servicers. Late fees in fact were assessed to all top 15 seller-servicers following revision to the contracts.

[5] Reasons for late fee waiver included if Freddie Mac rescinded the demand; if Freddie Mac and the seller-servicer agreed to a satisfactory resolution; if Freddie Mac determined that its action or inaction impacted the seller-servicer's ability to resolve the repurchase timely; if the loan was included in the Partial Release of Liability Agreement dated March 17, 2010, with GMAC Mortgage, LLC and Residential Funding Company, LLC; or if Freddie Mac and the seller-servicer reached an impasse about the reason for the repurchase demand, the repurchase price, or the "make-whole" amount.

[6] T-deals are structured pass-through certificates, instruments which signify transfer of principal and interest payments to the certificate's holder.

encourage compliance with repurchase demands at the seller-servicer level, rather than at the loan level, by suspending or terminating a lender's right to sell loans to Fannie Mae. Freddie Mac could also take such action.

Freddie Mac's Late Fees Result in Higher Repurchase Proceeds on Some Repurchases

The Enterprises differed in their calculation of the amount due to resolve an outstanding repurchase demand. However, Freddie Mac's calculation generally resulted in a larger repurchase payment from the seller-servicer than Fannie Mae would receive on a comparable loan, unless the repurchase demand remained unresolved when the loan passed into REO status.

After issuing a repurchase demand, both Enterprises would continue accruing interest at the same rate on a comparable loan's UPB; this "pass-through" rate is the loan's interest rate less a 0.25 percent servicing fee. However, the rates subsequently used by the Enterprises, and the total proceeds finally collected, varied according to whether the loan was in active, inactive, or delinquent status[7] (see Scenario 1 below) or in REO status[8] (see Scenario 2 below) when the repurchase demand was resolved.

Scenario 1: Loan is in Active, Inactive, or Delinquent Status When the Repurchase Demand is Resolved

If a loan is in active status when a repurchase demand is issued, Freddie Mac continues to accrue interest at the initial "pass-through" rate. If the repurchase demand is not resolved within 120 days, in addition to the interest accrual, Freddie Mac can also assess a late fee on the latest UPB at the prime rate[9] plus 3 percent[10] until the repurchase demand is resolved. Fannie Mae would also accrue interest at the initial "pass-through" rate for a loan in active status, but would not charge any late fee for the aging repurchase demand.

If an active loan passes into delinquency and remains in delinquency for more than 90 days, the loan becomes inactive. Freddie Mac would continue to accrue interest at the initial "pass-through" rate and also assess a late fee if the repurchase demand remains unresolved after 120

[7] An active status mortgage is a current or delinquent mortgage. A mortgage enters delinquency when principal and interest remain unpaid after the due date. A mortgage enters inactive status when it has been delinquent for 90 days (for Freddie Mac) or when a transaction such as payoff, repurchase, or foreclosure occurs (for Fannie Mae).

[8] A loan passes into REO status when the Enterprise takes possession of the property.

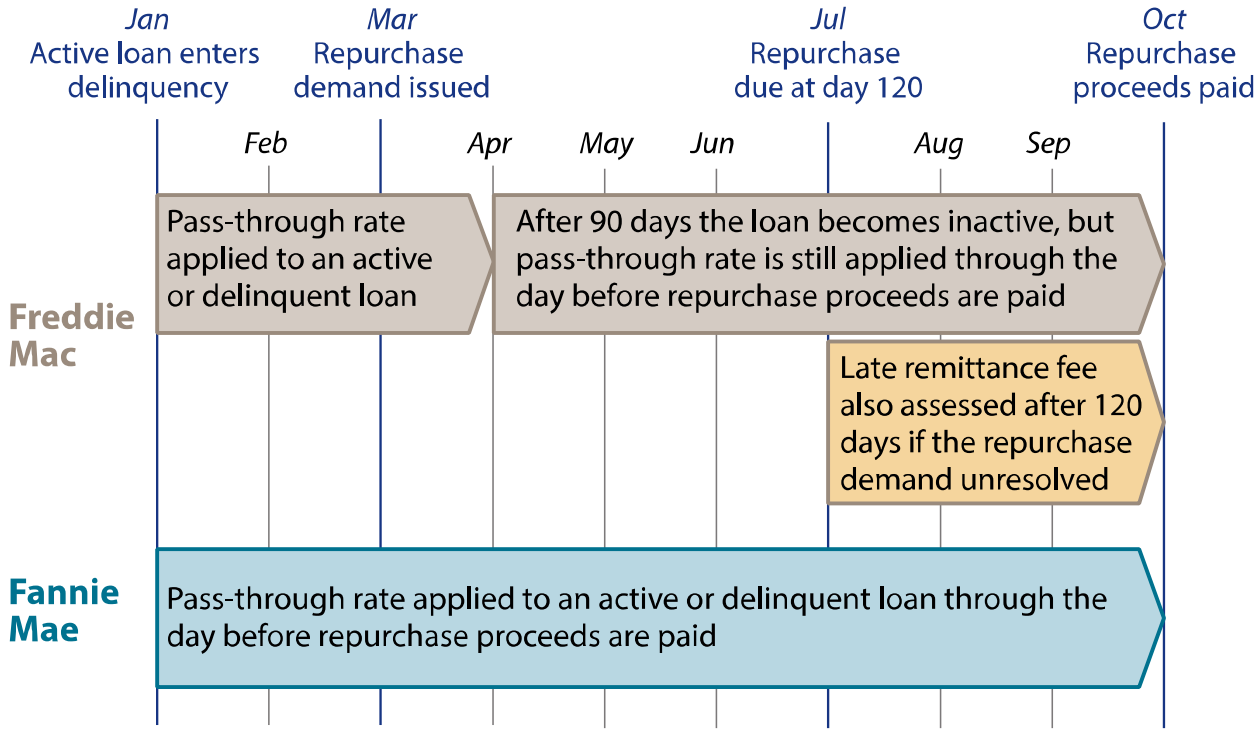
[9] The prime rate has been 3.25 percent since December 16, 2008, according to http://www.federalreserve.gov/releases/h15/data.htm.

[10] Freddie Mac's Seller/Servicer Guide, Chapter 72.3, available at http://www.freddiemac.com/singlefamily.

days. Fannie Mae would also continue to accrue interest at the initial "pass-through" rate, but would not charge any repurchase late fee.

Because of Freddie Mac's ability to assess a late fee in addition to accruing interest, Freddie Mac generally would collect higher proceeds than Fannie Mae on a comparable loan that is in active, inactive, or delinquent status when the repurchase demand is resolved. Figure 2 illustrates this situation.

FIGURE 2. INTEREST ACCRUAL AND LATE FEE ASSESSMENT ON A LOAN IN ACTIVE, INACTIVE, OR DELINQUENT STATUS WHEN THE REPURCHASE DEMAND IS RESOLVED



Sources: The OIG created the chart by applying repurchase late fee policies from Freddie Mac's Seller-Servicer Guide Chapter 72.3 and Fannie Mae's repurchase policies and procedures provided to the OIG.

Scenario 2: Loan is in REO Status When the Repurchase Demand is Resolved

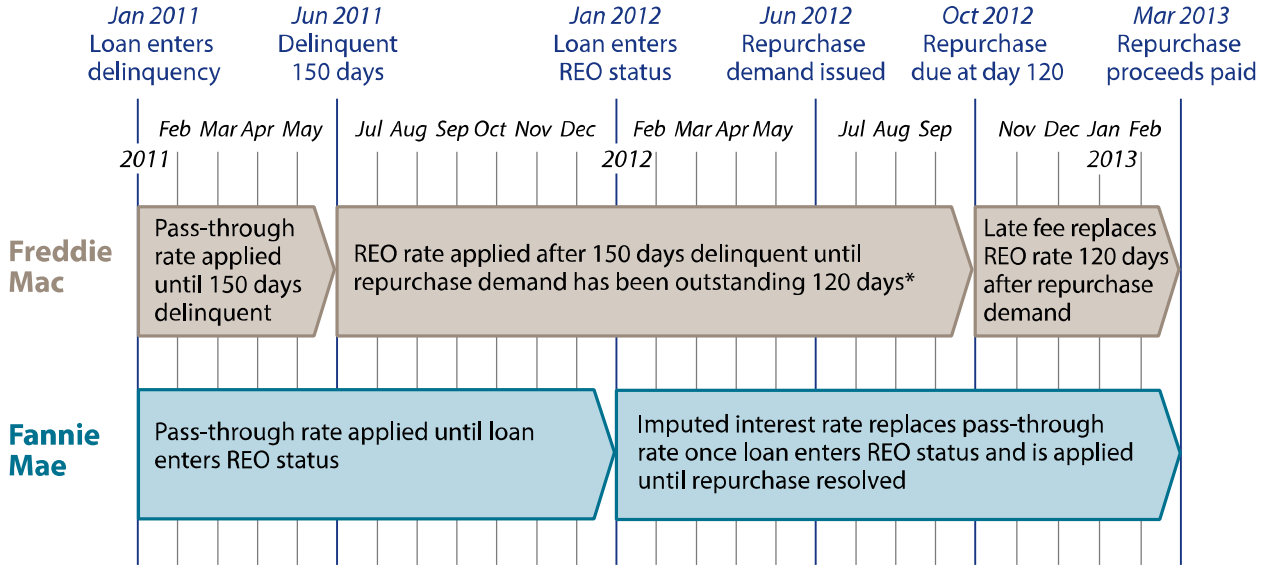
If a delinquent loan later entered REO status, Freddie Mac would begin accruing interest at the prime rate minus 0.5 percent[11] from the time the loan had been delinquent for 150 days through the point when the repurchase demand had been outstanding for 120 days. Freddie Mac can then assess a repurchase late fee of the prime rate plus 3 percent, but it would replace the REO rate of the prime rate minus 0.5 percent being used up to that point.

[11] Freddie Mac's Seller/Servicer Guide, Chapter 72.3, available at http://www.freddiemac.com/singlefamily.

Fannie Mae would continue accruing interest at the initial "pass-through" rate until the loan entered REO status, at which point an "imputed interest" rate of 5.2 percent[12] would be used until the repurchase demand was resolved.

Fannie Mae may collect more than Freddie Mac on a comparable loan that is in REO status when the repurchase demand is resolved. This is because Freddie Mac accrues some interest at a different – and likely lower – rate than the initial "pass-through" rate for loans that enter REO status. Freddie Mac's late fee assessment also replaces rather than augments this interest accrual, while Fannie Mae accrues some interest at a rate higher than Freddie Mac's REO rate. Figure 3 shows an example of this scenario.

FIGURE 3. INTEREST ACCRUAL AND LATE FEE ASSESSMENT ON A LOAN IN REO STATUS WHEN THE REPURCHASE DEMAND IS RESOLVED



* Freddie Mac's REO rate is applied retroactively after 150 days of delinquency *only* if the delinquent loan passes into REO status. If the delinquent loan does not pass into REO status, then Freddie Mac continues to apply the "pass-through" rate until the repurchase demand is resolved (see Scenario 1).

Sources: The OIG created the chart by applying repurchase late fee policies from Freddie Mac's Seller-Servicer Guide Chapter 72.3 and Fannie Mae's repurchase policies and procedures provided to the OIG.

[12] Fannie Mae's Announcement SVC 2012-21 and email communication with Fannie Mae management.

FHFA Intended to Align the Enterprises' Methods for Resolving Aging Repurchase Demands

On January 19, 2012, FHFA issued a Contract Harmonization Directive requiring the Enterprises to work with FHFA to align their contracts, including developing "consistent and precise benchmarks and measurable standards for repurchase requests and other penalties for nonperformance" and "consistent timelines and collection standards for fees and penalties and additional types of penalties and remedies." The contract harmonization initiative was an effort to develop a set of common principles, standards, and requirements and/or tools for contract breaches and remedies, among other items. It followed FHFA's statement to the Enterprises in June 2011 that their contracts with seller-servicers might benefit from harmonization, affording a stronger position for the Enterprises in light of recent deficiencies in the delivery and servicing processes. Contract harmonization was intended to help ensure that seller-servicer contracts reflected viable business relationships that were actively managed to maximize seller-servicer and portfolio performance and economic return to the Enterprises. The process supported FHFA's 2012 Strategic Plan for Enterprise Conservatorships, which stated that through HERA, FHFA may take action to preserve and conserve the assets of the Enterprises. FHFA's strategic plan also stated that FHFA has reported on numerous occasions that HERA's "preserve and conserve" mandate directs FHFA to minimize losses on behalf of taxpayers.

During the contract harmonization discussions, FHFA sought to develop consistent repurchase standards and related penalties to prevent a seller-servicer from selecting its Enterprise business partner based on the most favorable repurchase requirements and enforcement mechanisms. This included discussion of alignment of the Enterprises' penalty programs, including late fee programs. However, while FHFA issued Guiding Principles for Managing Aged Repurchase Requests upon conclusion of contract harmonization discussions, the principles did not reflect harmonization among the Enterprises specific to a repurchase late fee program.

FHFA's New Representation and Warranty Framework Likely Will Result in Earlier Issuance of Repurchase Demands

As part of FHFA's seller-servicer contract harmonization initiative, Fannie Mae and Freddie Mac implemented a new representation and warranty framework on January 1, 2013, to clarify sellers' repurchase exposure and liability on loans sold to the Enterprises beginning in 2013.

The new representation and warranty framework changes the focus of the Enterprises' quality control reviews from the time a loan defaults to the time the loan is delivered to Fannie Mae or Freddie Mac, and directs the Enterprises to conduct earlier quality control reviews of loans

in order to identify underwriting deficiencies more quickly than in previous years. FHFA also directed the Enterprises to establish more consistent and transparent processes for lenders to use in responding to repurchase demands. These changes are likely to result in repurchase demands being issued sooner than in previous years, while a loan remains active or delinquent and before it passes into REO status.

FHFA Has Encouraged Bulk Settlements to Resolve Outstanding Repurchase Demands

FHFA required the Enterprises to complete the process of issuing repurchase demands for representation and warranty defects on loans sold to the Enterprises before they entered conservatorship in September 2008 (legacy loans), or complete negotiations for bulk settlements with seller-servicers on outstanding repurchase demands for legacy loans by the end of 2013. FHFA's 2013 Conservatorship Scorecard for the Enterprises provided the implementation roadmap for this process, including specific milestones for Fannie Mae and Freddie Mac to achieve each quarter in 2013 toward this goal. FHFA has actively encouraged the Enterprises to negotiate such settlements with seller-servicers to close out credit exposures related to legacy loans, according to a discussion with FHFA's OCO in April 2013.

In anticipation of the Enterprises concluding multiple bulk settlements in 2013, FHFA issued a Settlement Policy on June 27, 2012, to begin to establish consistent settlement procedures. The policy requires Enterprise management to provide valuation of the proposed settlement to FHFA based on the Enterprise's internal data, business judgment, interpretation of relevant contractual terms, and customary business practices. The Enterprises' documentation for settlement valuation should clearly show the scope of the settlement, including information such as loans covered, conditions and exclusions, payments, and financial consequences for non-performance. According to the policy, FHFA's OCO is responsible for ensuring comprehensive FHFA analysis and assessment of the settlement information provided by the Enterprises, and maintaining official records associated with the settlements, including documents and data to substantiate the settlement value and comparisons to related settlements.

The Enterprises have completed several bulk settlements of repurchase demands with seller-servicers since 2010, the largest with Bank of America; Freddie Mac settled $1.35 billion of outstanding repurchase demands in October 2010, and Fannie Mae settled $10.26 billion of outstanding repurchase demands in January 2013. These settlements reduced the volume of repurchase demands that had been outstanding for more than 120 days for both Enterprises. The Enterprises and FHFA have also negotiated settlements with several other sellers.

FINDINGS

1. FHFA Did Not Sufficiently Evaluate Whether to Implement a Repurchase Late Fee Program at Fannie Mae by Not Quantifying the Potential Benefits

FHFA did not enforce its own mandate by providing Fannie Mae relief from establishing a repurchase late fee program similar to Freddie Mac's existing contractual right to assess such fees. The absence of a late fee program potentially eliminates the opportunity to collect repurchase late fees on Fannie Mae's aged outstanding repurchase demands from 2013 forward, and allows continued inconsistency and potential competition between the Enterprises regarding repurchase late fees. FHFA also based its decision on incomplete data by considering only the possible costs of the action, although evidence existed of significant potential benefits.

In accordance with FHFA's Contract Harmonization Directive issued in January 2012, Fannie Mae and Freddie Mac participated in discussions with FHFA that included consideration of potentially implementing a repurchase late fee program at Fannie Mae. Documentation from the contract harmonization discussions showed that FHFA's Office of Housing and Regulatory Policy (OHRP) intended to address the issue of possible competitive disadvantage connected with inconsistency in repurchase related penalties:

> Inconsistent and less than precise benchmarks for repurchase requests and associated penalties may lead to disadvantaged competition for one of the GSEs. [13] OHRP leans toward harmonizing repurchase penalties because we would not want a seller-servicer to select its GSE business partner based on the most favorable repurchase requirements and enforcement.

In the course of contract harmonization discussions, FHFA asked Fannie Mae to provide information on the cost impact of implementing a late fee program similar to Freddie Mac. In April 2012, Fannie Mae provided an estimated cost of $500,000 to use an existing system to bill for late fees or an estimated cost of up to $5.4 million to upgrade its systems to track repurchase requests within specified timelines, and generate, track, and receive fees for aged repurchases. The estimated costs included the cost to implement a separate fee under consideration for excessive lender appeals. The estimated completion dates for these projects were September 2012 and January 2014, respectively.

[13] Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs).

Neither FHFA's request nor Fannie Mae's analysis contained information on potential benefits of implementing a late fee policy. Fannie Mae's cost analysis also indicated its desire not to implement a late fee policy: the analysis included the statement "Fannie Mae's strong preference is to manage lender performance overall… In the event a lender is not performing according to the designated timelines, remedies at a lender level, including termination or suspension should be pursued."

As contract harmonization discussions ended, in June 2012, OHRP issued guidance to the Enterprises titled Guiding Principles for Managing Aged Repurchase Requests. The stated objective of the principles was to develop a harmonized approach for managing aged repurchase requests that prevents the Enterprises from competing on aged repurchases, allows FHFA examination teams to assess compliance, and accommodates Enterprise operational and systems differences.

However, rather than preventing Enterprise competition with regard to repurchase late fees, the principles essentially allowed Fannie Mae and Freddie Mac to continue to develop and use their own methods for managing aged repurchases. The principle most applicable to repurchase late fees stated "Each enterprise will develop policies and procedures regarding the application of escalated remedies appropriate for the level of noncompliance."

The principles also showed that FHFA's decision was based on data that did not take into account the benefits of implementing a late fee policy at Fannie Mae. The principles included a statement that "OHRP is aware of systems differences in the application of aged repurchase remedies that would be costly to modify, particularly in proportion to the benefit of harmonization in this area." The "cost to modify" was a reference to Fannie Mae's estimated cost of from $500,000 to $5.4 million to implement a repurchase late fee program. OHRP and Fannie Mae had informed the OIG that the potential "benefit of harmonization in this area" was never quantified for comparison against the $500,000 or $5.4 million.

However, FHFA had evidence that Freddie Mac's implementation of its late fee policy had expedited resolution of outstanding repurchase demands, and this information should have been considered in determining the potential benefit of aligning repurchase late fee programs between the Enterprises. In a memorandum to Freddie Mac's Chief Executive Officer in December 2010 that was shared with OCO, Freddie Mac senior officials pointed out that implementing the late fee policy for Bank of America in 2010 had contributed directly to faster resolution of outstanding repurchase demands:

> The addition of a new repurchase late fee to Bank of America's new master agreement mid-year provided increased incentives for Bank of America to work through the large volume of outstanding repurchases on an expedited basis. Evidence of this trend can be seen in the increased resolutions and funds

received on the overall outstanding repurchase demands between June and October 2010.

Freddie Mac reported that after it added the terms of business to Bank of America's master agreement indicating its intention to assess late fees, it began receiving $26 million more in repurchase-related remittances each month and achieving resolution of 500 more outstanding repurchase demands each month.

Moreover, FHFA should have considered that the changes the Enterprises implement in accordance with the new representation and warranty framework are likely to result in repurchase demands being issued sooner beginning in 2013 than in previous years, while a loan remains active or delinquent before it passes into REO status. According to the Enterprises' procedures for calculating the amount to resolve an outstanding repurchase demand, Freddie Mac generally would collect a larger amount than Fannie Mae in the resolution of a repurchase demand on an active loan, because Freddie Mac can assess a late fee on this type of loan. Fannie Mae has no equivalent penalty.

OHRP officials told the OIG that while potential harmonization of repurchase late fees was discussed, OHRP allowed inconsistency to remain between Fannie Mae and Freddie Mac regarding repurchase late fees because Fannie Mae preferred not to assess any fees or penalties. Fannie Mae did not want to assess late fees or penalties, since (1) Fannie Mae considered its existing "make-whole" policy adequate to recover costs associated with aged repurchases, with enforcement of other remedies for delinquent lenders at the lender level; and (2) Fannie Mae considered the benefits of harmonization with Freddie Mac on repurchase late fees uncertain, whereas Fannie Mae had estimated specific costs that might be required to implement a repurchase late fee program.

Fannie Mae officials told the OIG that they did not think there was a need to put in place a repurchase late fee program because:

1. Fannie Mae's existing remedies were effective;
2. Taxpayers were made whole under Fannie Mae's existing process, including collection of interest from lenders for delays;
3. Fannie Mae's interest calculation process would result in the same or a higher remittance amount than Freddie Mac's process;
4. Freddie Mac's repurchase late fee did not result in better performance, since as of June 30, 2013, 45 percent of Freddie Mac's repurchase demands had been outstanding

longer than 120 days, while 38 percent of Fannie's Mae's repurchase demands had been outstanding that long;[14]

5. Fannie Mae's contracts do not authorize any type of penalty that exceeds Fannie Mae's damages or loss; and
6. Fannie Mae preferred a holistic approach to lender management, at the lender level, not the loan level.

Through the decision – based on inadequate analysis – to allow continued inconsistency between the Enterprises regarding repurchase late fees, FHFA may potentially have eliminated an opportunity to collect repurchase late fees on Fannie Mae's aged outstanding repurchase demands from 2013 forward. According to information provided to the OIG, outstanding repurchase demands totaled $4.4 billion as of July 2013, of which 56% – $2.5 billion – are aged at least 120 days. None of these are currently subject to any monetary penalty to encourage their timely resolution.

Further, contrary to its January 2012 directive and June 2012 Guiding Principles, FHFA has allowed continued inconsistency and continued potential competition between the Enterprises regarding repurchase late fees. Freddie Mac continues to assess late fees on aged outstanding repurchase demands, while Fannie Mae continues to have no monetary penalties to encourage their resolution.

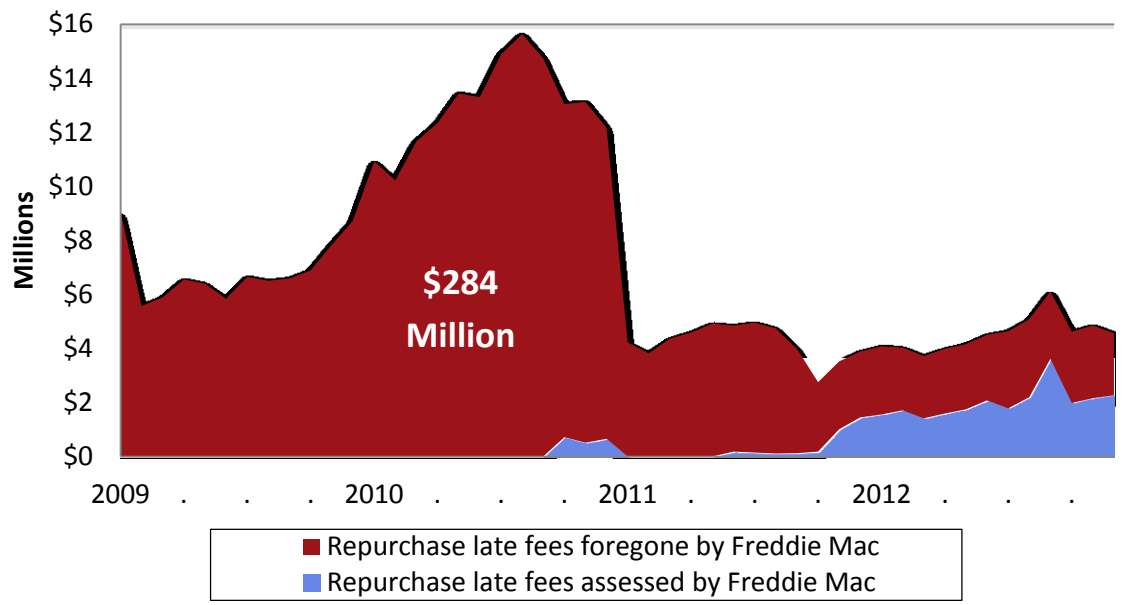
2. FHFA Did Not Examine Freddie Mac's Use of its Contractual Right to Assess Late Fees on Repurchase Demands Resulting in Missed Opportunities to Minimize Losses

The Enterprises' outstanding repurchase demands increased significantly beginning in 2007. Although Freddie Mac had a contractual right to assess late fees on repurchase demands prior to 2009, the Enterprise only began assessing late fees in late 2010, and only for Bank of America, which had approximately $1.5 billion in outstanding repurchase demands at that time. Although Wells Fargo had more than $1.1 billion in outstanding repurchase demands at that time and other seller-servicers also had significant volumes of aged repurchase requests, Freddie Mac did not begin to enforce its right to assess late fees for these seller-servicers until mid-2011. Had the existing contractual right to assess late fees been enforced for other major seller-servicers, the OIG determined that Freddie Mac potentially could have assessed $264 million more in late fees from 2009 to early 2011 (see Figure 4).

[14] These percentages take into account Fannie Mae and Freddie Mac's bulk settlements on legacy loans.

While it was a positive step when Freddie Mac began to enforce its existing contractual rights in mid-2011 with its top seller-servicers, Freddie Mac could have more effectively enforced its contractual right. Based on data the OIG collected from Freddie Mac on outstanding repurchases and fees actually assessed and collected from mid-2011 through 2012, the OIG found that Freddie Mac missed the opportunity to assess as much as another $20 million in late fees over that time, because the contractual right to assess late fees was not consistently enforced (see Figure 4).

FIGURE 4. REPURCHASE LATE FEES FORGONE VERSUS ASSESSED BY FREDDIE MAC, 2009–2012



Sources: Repurchase late fees calculated by the OIG using Freddie Mac's monthly outstanding repurchase reports from Jan. 2009 through Dec. 2012 and applying repurchase late fee policies from Freddie Mac's Seller-Servicer Guide Chapter 72.3.

Freddie Mac's Remedy Management personnel told the OIG that Freddie Mac did not consider there to be a need to charge late fees until the volume of outstanding repurchase demands increased substantially from the level of preceding years and they wanted to attempt to shift the carrying cost for the increasing volume of repurchases to seller-servicers. They began assessing late fees in 2010 on only Bank of America because that seller-servicer had the largest volume of outstanding repurchase demands at that time. They did not apply the existing contractual right to assess late fees to all eligible aged outstanding repurchase demands because the management in place at the time, who are no longer at Freddie Mac, did not strictly enforce the contractual right.

Freddie Mac officials generally agreed with the OIG's assessment of forgone late fees from 2009 through 2012, although they believe that $6 million of the $20 million represents late

fees that were waived by Freddie Mac for some of its major seller-servicers. However, Freddie Mac was unable to provide information to substantiate this position, because the Enterprise does not track waivers in a way that allows for comprehensive reporting to either Freddie Mac management or FHFA, even though waivers were used extensively for the first time in 2012 and continue to be used in 2013. The only way to determine whether a waiver was issued and for what reason was to view comments entered manually in individual loan files.

Freddie Mac does provide a monthly management reporting package to FHFA containing information on repurchase demands issued and resolved and aging of repurchase demands, and FHFA has access to Freddie Mac's information on global late fee exclusions. However, Freddie Mac does not report to FHFA on late fees assessed and collected and discretionary late fee waivers, although this information would allow FHFA to assess whether Freddie Mac is managing its repurchase late fee program effectively to minimize losses on behalf of taxpayers.

In addition to not properly enforcing Freddie Mac's existing contractual right to assess late fees, the OIG found that FHFA and Freddie Mac had not considered the impact of this contractual right on planned 2013 Enterprise legacy loan settlements. FHFA directed the Enterprises to resolve outstanding representation and warranty demands for all pre-conservatorship loans by the end of 2013 through repurchase demands or legacy settlements.

The OIG informed FHFA's Office of General Counsel (OGC) that there may be assessed but uncollected late fees on aged repurchase demands for Freddie Mac's legacy loans that should be included in the negotiations for the 2013 legacy loan settlements. OGC told the OIG that because the late fees are not expected to be disputed by seller-servicers, uncollected late fees will not be considered during settlement negotiations. This leaves outstanding the risk that any uncollected late fees likely would be unrecoverable once outstanding repurchases are settled.

CONCLUSIONS

FHFA took action to direct the Enterprises to work through and clear the significant accumulation of aging outstanding repurchase demands on legacy loans by the end of 2013. However, FHFA's actions in the contract harmonization process regarding repurchase late fees were not consistent with the goals of avoiding inconsistency and potential competitive disadvantage between the Enterprises and maximizing economic return to the Enterprises on future repurchase demands. Moreover, as discussed previously, Fannie Mae historically has had a significantly larger volume of outstanding repurchase demands than Freddie Mac. FHFA needs to reevaluate whether a late fee program similar to Freddie Mac's should be implemented at Fannie Mae by determining the potential benefits of the program and then assessing whether the benefits are likely to exceed the cost.

Freddie Mac began implementing its contractual right to assess late fees on all larger seller-servicers' aging repurchase demands by late 2011, and then took action to apply the program more consistently to all of its seller-servicers beginning in 2013. However, active FHFA oversight in prior years, when the volume of aging outstanding repurchase demands was increasing rapidly, could have expedited Freddie Mac's response to the situation and resulted in collection of significantly more late fees and greater return to taxpayers. FHFA needs to ensure that Freddie Mac is providing sufficient information to allow FHFA to assess more effectively Freddie Mac's management of repurchase late fees going forward, particularly on topics such as discretionary waivers of late fees.

FHFA also needs to ensure that any outstanding repurchase late fees that remain unpaid by seller-servicers pursuing bulk settlements are included at least in the settlement negotiation process, as any uncollected late fees likely would be unrecoverable once settlement terms are finalized.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Promptly quantify the potential benefit of implementing a repurchase late fee program at Fannie Mae, and then determine whether the potential cost of from $500,000 to $5.4 million still outweighs the potential benefit.

2. Direct Freddie Mac to develop a repurchase late fee report to be given routinely to FHFA that expands on information already provided by adding summary information by seller on outstanding repurchases, aging of repurchases, late fees assessed and collected, discretionary late fee waivers, and global late fee exclusions. Such a report would provide Freddie Mac and FHFA management with needed information to manage and assess Freddie Mac's repurchase late fee program more effectively.

3. Direct Freddie Mac to provide FHFA with information on any assessed but uncollected late fees associated with the repurchase claims that are included in the 2013 bulk settlements so that these fees can be considered in the negotiations and documented in accordance with OCO's Settlement Policy.

OBJECTIVES, SCOPE, AND METHODOLOGY .....

The objective of this performance audit was to assess FHFA's oversight of the Enterprises' penalty programs to encourage seller-servicers to resolve repurchase demands timely.

The OIG performed fieldwork for this audit from April 2013 through September 2013. The OIG conducted this audit in Washington, D.C., at the headquarters of FHFA, Fannie Mae, and Freddie Mac.

The scope of the OIG's audit involved repurchase demands issued from January 1, 2009, through December 31, 2012, from the point of the repurchase demand to the point of resolution. The OIG relied on computer-processed and hard-copy data from FHFA, Fannie Mae, and Freddie Mac.

To achieve the audit objective, the OIG:

- Reviewed directives, guidelines, and other communication that FHFA conducted internally or issued to the Enterprises to obtain an understanding of the repurchase process, settlement process, and contract harmonization initiative;
- Reviewed the Enterprises' policies and procedures, contracts with seller-servicers, risk assessments, and reports to obtain an understanding of the repurchase process;
- Interviewed management and staff at FHFA, Freddie Mac, and Fannie Mae to understand and corroborate oversight, supervision, and guidance related to the repurchase process, settlement process, and contract harmonization initiative; and
- Calculated the amount of late fees that Freddie Mac could have assessed and compared it with the amount of late fees that Freddie Mac actually assessed within the scope period.

OIG also assessed the internal controls related to the audit objective. Internal controls are an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed on

this performance audit, OIG considers deficiencies in FHFA's oversight of the Enterprises' penalty programs to encourage seller-servicers to resolve repurchase demands timely to be significant in the context of the audit's objective.

OIG conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that OIG plan and perform audits to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusions included herein, based on the audit objective.

APPENDIX A .....

FHFA's Comments on the OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Rus Rau, Deputy Inspector General for Audits

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

Wanda DeLeo, Deputy Director, Division of Conservatorship

SUBJECT: Response to Recommendations in Audit Report: *FHFA Oversight of Enterprise Handling of Aged Repurchase Demands*

DATE: January 29, 2014

This memorandum communicates the FHFA's management responses to the recommendation in the FHFA-OIG's draft audit report titled, *FHFA Oversight of Enterprise Handling of Aged Repurchase Demands*, dated December 31, 2013. As stated in the report, the audit was conducted by your staff from April 2013 through September 2013 and the scope of the OIG's audit involved repurchase demands issued from January 1, 2009, through December 31, 2012.

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

FHFA-OIG Recommendations:

1. Promptly quantify the potential benefit of implementing a repurchase late fee program at Fannie Mae, and then determine whether the potential cost of from $500,000 to $5.4 million still outweighs the potential benefit.

   Management Response

   FHFA agrees to document the rationale for not pursuing implementation of a late fee program at Fannie Mae by June 30, 2014. Additionally, FHFA will identify and evaluate, by January 29, 2015, potential programmatic enhancements to the Selling Representations and Warranties Framework launched on January 1, 2013 to further minimize the likelihood of future aged outstanding repurchases.

2. Direct Freddie Mac to develop a repurchase late fee report to be given routinely to FHFA that expands on information already provided by adding summary information by seller on outstanding repurchases, aging of repurchases, late fees assessed and collected, discretionary late fee waivers, and global late fee exclusions. Such a report would provide

Freddie Mac and FHFA management with needed information to manage and assess Freddie Mac's repurchase late fee program more effectively.

Management Response

FHFA agrees with this recommendation and will direct Freddie Mac to provide additional periodic reports that expands on the information already provided to FHFA by June 30, 2014. The additional reporting will include summary information by seller on outstanding repurchases; aging of repurchases, late fees assessed and collected, discretionary late fee waivers, and global late fee exclusions.

3. Direct Freddie Mac to provide FHFA with information on any assessed but uncollected late fees associated with the repurchase claims that are included in the 2013 bulk settlements so that these fees can be considered in the negotiations and documented in accordance with OCO's Settlement Policy.

Management Response

FHFA agrees with the recommendation and has confirmed with Freddie Mac that uncollected late fee assessments were made current and included with the 2013 bulk settlements. We should note that legacy Rep and Warrant claims are complete; however, FHFA will insure that any uncollected late fees will be taken into account for any future settlements. FHFA plans to respond to and implement this recommendation by June 30, 2014.

APPENDIX B.....

The OIG's Response to FHFA's Comments

On January 29, 2014, FHFA provided comments to a draft of this report, agreeing with OIG's recommendations and identifying actions it would take to address the recommendations.

FHFA agreed with recommendation 1 and its planned actions are potentially responsive. FHFA stated that it would document the rationale for not pursuing implementation of a late fee program at Fannie Mae. FHFA also stated that it will identify and evaluate potential enhancements to the new representation and warranty framework in order to help minimize the likelihood of future aged outstanding repurchases. This action can help prevent an accumulation of outstanding repurchase demands similar to what occurred in recent years.

FHFA's documentation of its rationale for not pursuing implementation of a late fee program at Fannie Mae should include quantification and comparison of the estimated cost of implementing a repurchase late fee program and the potential benefits. This is necessary because FHFA did not complete its analysis during contract harmonization discussions, although FHFA had evidence at that time that Freddie Mac's application of late fees had yielded significant monetary benefits.

Further, FHFA's evaluation of potential enhancements to the representation and warranty framework to minimize future aged repurchases should also consider the costs and benefits to taxpayers of such enhancements, as well as the contract harmonization goals, to avoid inconsistency and potential competitive disadvantage between the Enterprises.

FHFA agreed with recommendation 2 and its planned actions are responsive. FHFA will direct Freddie Mac to provide it with additional information on seller-servicers' outstanding repurchases, assessed and collected late fees, and waivers and exclusions of late fees, which will improve the Agency's ability to manage and assess Freddie Mac's late fee program.

FHFA agreed with recommendation 3 and its planned actions are responsive. FHFA confirmed with Freddie Mac that uncollected repurchase late fees were included in the recent bulk settlements with seller-servicers, and FHFA will ensure that uncollected late fees are included in future settlements, mitigating the risk that uncollected late fees would be unrecoverable once settlements are concluded. OIG requests that FHFA provide Freddie Mac's confirmation and underlying support regarding inclusion of uncollected repurchase late fees in bulk settlements.

The OIG considers the planned actions sufficient to resolve the recommendations, which will remain open until the OIG determines that the agreed-upon corrective actions are completed

and responsive to the recommendations. The OIG considered the Agency's full response (attached as Appendix A) along with technical comments in finalizing this report. Appendix C provides a summary of management's comments on the recommendations and the status of agreed-upon corrective actions.

APPENDIX C

Summary of FHFA's Comments on the Recommendations

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

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved[a] Yes or No	Open or Closed[b]
1	FHFA will document the rationale for not pursuing implementation of a late fee program at Fannie Mae. FHFA will identify and evaluate potential programmatic enhancements to the representation and warranty framework launched on January 1, 2013.	06/30/2014 01/29/2015	$0	Yes	Open
2	FHFA will direct Freddie Mac to provide additional periodic reports to include summary information by seller on outstanding repurchases, aging of repurchases, late fees assessed and collected, discretionary late fee waivers, and global late fee exclusions.	06/30/2014	$0	Yes	Open
3	FHFA confirmed with Freddie Mac that uncollected late fee assessments were made current and included with the 2013 bulk settlements. FHFA will ensure that uncollected late fees are taken into account in future settlements.	06/30/2014	$0	Yes	Open

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to the OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

[b] Once OIG determines that the agreed-upon corrective actions have been completed and are responsive, the recommendations can be closed.

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