



**Review of FHFA's Tracking and
Rating of the 2013 Scorecard
Objective for the New Representation
and Warranty Framework Reveals
Opportunities to Strengthen the
Process**



AUD-2016-002

March 28, 2016

Executive Summary

The Federal Housing Finance Agency (FHFA or the Agency) is responsible for the supervision, regulation, and housing mission oversight of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Since 2008, FHFA also has been the conservator of Fannie Mae and Freddie Mac (together, the Enterprises).

During 2012, FHFA announced significant changes to the Enterprises' representation and warranty framework. Historically, the Enterprises had relied on the sellers' representations and warranties when purchasing loans from sellers. In the event of default of a purchased loan, the affected Enterprise reviewed the loan file for possible breach by the seller of its contractual representations and warranties. When a breach was identified, the affected Enterprise could exercise its contractual rights to require the seller to repurchase the loan, mitigating losses caused by underwriting defects. After the housing market collapsed and loan defaults skyrocketed, the Enterprises were placed into conservatorship. At the direction of FHFA, the Enterprises reviewed defaulted loans for evidence of breach of sellers' representations and warranties and the Enterprises demanded repurchase of many such loans from the lenders.

Sellers complained that the Enterprises' open-ended ability to demand loan repurchases was unfair and unpredictable, and caused them to tighten lending standards beyond what the Enterprises required to protect themselves from future exposure from loan repurchases. Concerned by the limitations on the availability of mortgage credit, FHFA directed the Enterprises in 2012 to develop and implement a new representations and warranties framework (new Framework) to provide sellers with greater certainty about their potential future repurchase exposure. That new Framework, which went into effect for loans purchased after January 1, 2013, in many circumstances imposed a three-year deadline after which the Enterprises could no longer demand repurchase of defective loans from sellers of those loans.

FHFA issued its Strategic Plan for Enterprise Conservatorships (Strategic Plan) in February 2012, which identified its strategic goals. Beginning in 2013 and for each year subsequently, FHFA has issued an annual Scorecard in which it sets objectives for each of the three goals in its Strategic Plan and sets specific targets for each objective. FHFA has a formal process to track and rate Enterprise performance against the Scorecard on a quarterly basis and to award an overall annual Scorecard performance for each Enterprise. This annual rating is factored into Enterprise executive compensation for the following year. Tracking Enterprise performance against the annual Scorecard is a valuable internal control to keep Enterprise activities aligned with



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conservatorship strategic goals and to keep Enterprise executives accountable for the Enterprises' performance.

FHFA's 2013 Scorecard, issued on April 1, 2013, and revised on May 1, 2013 (2013 Scorecard), identified 11 measurable objectives with specific targets for the Enterprises to work toward meeting FHFA's strategic goals. One of those 11 objectives was implementation of the new Framework. That objective contained two quarterly targets for both Enterprises. The first target required development of a plan to conduct up-front quality control reviews and the second target required an assessment of the Enterprises' execution of the new model and use of tools to identify defective loans, and an assessment of the effectiveness of the up-front quality control reviews.

In this audit, OIG reviewed the effectiveness of FHFA's efforts to track and rate Enterprise performance on this one objective. We found that FHFA's records of the tracking and rating process were imprecise and unclear. The records contained internal inconsistencies and did not clearly reflect when targets were modified or deferred, or what actions were required to meet the target. We found that these records can create the misimpression that work had been completed when, in fact, it had been modified or delayed. We also found that the Agency did not consistently communicate guidance to the Enterprises in writing. Because of the importance of FHFA's Scorecard tracking and rating process, we make several recommendations regarding FHFA's tracking and rating process to improve clarity and avoid confusion and inconsistencies. FHFA accepted our recommendations and reported that it had taken steps prior to the issuance of this report to address the recommendations included in the report (see Appendix A).

This audit was conducted by Cassandra Ingram, Audit Manager, with support from Moira T. Roberts, Special Counsel. We greatly appreciate the assistance and input provided by FHFA and the Enterprises.

We distributed this report to Congress, the Office of Management and Budget, and others, and posted it at www.fhfaoig.gov.

A handwritten signature in black ink, appearing to read "Stacey Nahrwold".

Stacey Nahrwold
Acting Deputy Inspector General for Audits

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ABBREVIATIONS

2013 Scorecard	FHFA's Scorecard issued on April 1, 2013, and revised on May 1, 2013
DHMG	Division of Housing Mission and Goals
ECB	Executive Compensation Branch
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
New Framework	New Representation and Warranty Framework effective January 1, 2013
OHRP	Office of Housing and Regulatory Policy
OIG	Federal Housing Finance Agency, Office of Inspector General
Strategic Plan	FHFA's Strategic Plan for Enterprise Conservatorships, February 2012

BACKGROUND

FHFA is responsible for the supervision, regulation, and housing mission oversight of the Enterprises and the Federal Home Loan Banks and their Office of Finance. As regulator, FHFA's mission is to ensure that these regulated entities operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Since 2008, FHFA also has acted as conservator of the Enterprises.

FHFA issued its Strategic Plan for the conservatorship in February 2012. This Plan set three broad strategic goals for the conservatorship:

- Build a new infrastructure for the secondary mortgage market;
- Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations; and
- Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

Approximately seven months after adoption of its Strategic Plan, FHFA announced a new initiative aimed at achieving the third strategic goal—maintaining foreclosure prevention activities and credit availability for new and refinanced mortgages. In June 2012, FHFA directed the Enterprises to launch a new Framework for conventional loans sold or delivered on or after January 1, 2013.¹ This new Framework significantly changed when the Enterprises reviewed loans and the methodology they used to identify potentially defective loans.

Historically, the Enterprises Demanded that Sellers Repurchase Defaulted Loans Found in Breach of the Sellers' Representations and Warranties, Regardless of when Default Occurred

The Enterprises provide liquidity to the U.S. housing finance system by purchasing residential mortgages and bundling the purchased loans into securities for which they guarantee principal and interest. In guaranteeing the securities, the Enterprises assume the credit risk from possible default of the underlying loans. To mitigate this risk, the Enterprises purchase loans

¹ We are publishing today a memorandum closing a survey involving FHFA oversight of conservatorship directives. In that memorandum, we note that FHFA relied on the Enterprises to self-report issues with implementation and compliance with conservatorship directives and that the reports the Agency received from the Enterprises were of limited value because of inaccuracies and incomplete information. See "FHFA's Oversight of the Enterprises' Implementation of and Compliance with Conservatorship Directives during an 18-Month Period from January 2013 through June 2014."

only from sellers that make specific contractual representations and warranties that their mortgages meet the specific underwriting standards set forth in the Enterprises' selling guidelines and agreements.

Historically, the Enterprises performed minimal quality control reviews on the loans at the time of purchase. In the event of default of a purchased loan, the affected Enterprise reviewed whether that loan complied with the seller's **representations and warranties** in the **lender contract**. When an Enterprise found that a defaulted loan breached these representations and warranties in any way, the Enterprise could exercise its contractual right to demand that the seller **repurchase** the non-compliant loan at any time during the life of the loan, even if the loan defaulted years after it was made. (Many, but not all, repurchase demands were made for loans that defaulted within three years of purchase by an Enterprise.) This right to demand repurchase of defaulted loans that did not comply with any representation and warranty in the lender contract mitigated the risk of losses to the Enterprises from defaulted loans.

After the housing market collapsed and loan defaults skyrocketed, the Enterprises were placed into conservatorship in September 2008 by FHFA and required a total investment of \$187.5 billion in taxpayer funds to remain viable. At the direction of FHFA, the Enterprises aggressively exercised their right to demand repurchases from sellers of defaulted loans in breach of lenders' representations and warranties.

Uncertainty Over Future Exposure to Repurchase Demands Led Sellers to Impose Credit Overlays

As the number of Enterprise mortgage repurchase demands increased steadily through 2010 and 2011, it was reported that several large financial institutions increased their reserves significantly so they would have sufficient funds to repurchase defaulted loans. Numerous sellers claimed that the Enterprises' repurchase demands were unreasonable because the

Representations and Warranties:

A mortgage lender's assurances that the mortgages it sells to the Enterprises comply with certain standards, such as underwriting and documentation standards. Violations of a representation or warranty entitles the Enterprise that purchased a loan to pursue certain remedies, including having the lender buy back, or repurchase, the loan.

Lender Contract: The lender's obligations to comply with the Enterprises' agreements (i.e., Selling Guides) in their entirety.

Repurchase: A remedy in lender contracts under which the lender must buy back or otherwise make the Enterprise whole for a mortgage it previously sold to the Enterprises.

Credit Overlay: Additional borrower qualification requirements that are more stringent than the minimum requirements set by the Enterprises. Overlays may reduce the ability of some borrowers to obtain loans.

defaults occurred years after the mortgages were originated and were unrelated to breaches of the sellers' representations and warranties. Claiming that they lacked certainty about the size of their future risk exposure for repurchases under the existing representation and warranty framework, sellers imposed more stringent loan criteria than those required by the Enterprises in order to reduce the risks of future defaults and repurchase demands. In May 2012, FHFA officials recognized that sellers had “curbed their appetite” for new risk through **credit overlays**,² ultimately affecting the liquidity and availability of mortgage credit.

FHFA Directed the Enterprises to Adopt and Implement a New Representations and Warranties Framework in an Effort to Reduce Credit Overlays

In June 2012, FHFA instructed the Enterprises to implement an agreed-upon representation and warranty framework in their seller-servicer contracts. In September 2012, FHFA Acting Director DeMarco publicly announced the new framework for conventional loans sold or delivered on or after January 1, 2013. He explained that the “objective of the new framework is to clarify lenders' repurchase exposure and liability on future deliveries. Under this framework, lenders will be relieved of certain repurchase obligations for loans that meet specific payment requirements.”³ For this new Framework to be effective, FHFA recognized that quality control reviews would need to be improved and would need to occur soon after purchase of the loans. In announcing this new Framework, Acting Director DeMarco stated that “the focus of the Enterprises' quality control reviews will be shifted earlier in the loan process, generally between 30 to 120 days after loan purchase.”⁴ In his view, “better quality loan originations and underwriting, along with consistent quality control, will help maintain liquidity in the mortgage market while protecting the Enterprises from loans not underwritten to prescribed standards.”⁵

In its 2012 Report to Congress, published in June 2013, FHFA reported that it had directed the Enterprises to adopt the new Framework in order to provide more certainty to lenders and to improve the Enterprises' credit risk management practices. FHFA recognized that the success of the new Framework turned on the Enterprises' ability to conduct quality control reviews earlier in the process and, as part of those reviews, evaluate loan files on a more

² FHFA OHRP, *Concept Approval Request [for Representations and Warranties Prospective New Framework]*, at 1 (May 25, 2012).

³ Remarks as Delivered by Edward J. DeMarco, FHFA Acting Director, *The Conservatorships of Fannie Mae and Freddie Mac: An Update on Current and Future Operations*, at 5 (Sept. 10, 2012), online at www.fhfa.gov/Media/PublicAffairs/Pages/Remarks-as-Delivered-Edward-J-DeMarco-Acting-Director-FHFA-American-Mortgage-Conference.aspx.

⁴ *Id.*

⁵ *Id.*

comprehensive basis to identify significant deficiencies. FHFA did not quantify the additional credit risk associated with the new Framework.⁶

Implementation of the New Representation and Warranty Framework

On January 1, 2013, the Enterprises launched the new Framework for loans purchased on or after that date. Under the new Framework, the time period for repurchase demands for one kind of loan concludes one year after purchase by the Enterprise, assuming an acceptable 12-month payment history, and subject to certain exceptions. For most other loans, repurchase was unavailable upon completion of 36 months of acceptable payment history, also subject to certain exceptions.⁷ Because the new Framework limited the time periods in which the Enterprises could make repurchase demands, it compelled the Enterprises to conduct quality control reviews soon after the loans were delivered to the Enterprises.

The 2013 Conservatorship Scorecard Included the New Framework as an Enterprise Objective

FHFA issues annual guidance to the Enterprises about specific actions expected from them to achieve the goals of the Strategic Plan for the conservatorships. The annual guidance, called the Scorecard, sets objectives for each of the three goals in the plan and specific targets for each objective. The targets are actions or deliverables with due dates and provide metrics used by FHFA to rate each Enterprise's performance to determine whether it has achieved the objective during the year. The Enterprise's annual performance rating factors into Enterprise executive compensation levels for the following year.

⁶ OIG recommended in a 2014 audit that FHFA perform an analysis of the risks and benefits of the new Framework. FHFA disagreed with the recommendation and declined to do the analysis. See OIG, *FHFA's Representation and Warranty Framework*, at 28, 32-37 (Sept. 17, 2014) (AUD-2014-016).

⁷ Certain loan defects, such as those involving fraud, were exempt from repurchase deadlines. Beginning in mid-2014, the time period for making a repurchase demand expired immediately after a loan successfully passed an Enterprise's quality control review. See FHFA, *A Progress Report on the Implementation of FHFA's Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac*, at 4-5 (Mar. 16, 2015).

The 2013 Scorecard listed 11 objectives for the Enterprises in 2013. One objective addressed implementation of the new Framework and included two specific targets, as follows:

2013 New Framework Objective	First Quarter Target	Second Quarter Target	Third Quarter Target	Fourth Quarter Target
Enhance Post Delivery Quality Control— Enhance post-delivery quality control practices and transparency associated with new representation and warranty framework	None	None	Provide a plan to FHFA that outlines how we will meet the objective.	Assess GSE execution of the new model, including up-front quality control reviews and use of tools to identify defective loans. Evaluate effectiveness.

We conducted this audit to assess FHFA’s tracking and rating of the Enterprises’ performance under this Scorecard objective.

FACTS AND ANALYSIS

FHFA's Scorecard Tracking and Rating Process

FHFA's annual Scorecard sets objectives for each of the three goals in FHFA's Strategic Plan and sets specific targets for each objective. FHFA tracks Enterprise performance against the Scorecard and gives each Enterprise an annual performance rating score, which becomes a factor in setting compensation levels for Enterprise executives.

FHFA's Executive Compensation Branch (ECB) and Office of Strategic Initiatives manage FHFA's Scorecard tracking and rating process. The process is set out in an internal procedures document, augmented by written instructions from ECB's manager of Executive Compensation. FHFA's procedure to track and rate Enterprise performance against the Scorecard includes the following steps:

- **Quarterly Tracking on Rating Sheets**

Every objective in the annual Scorecard is assigned to a "Project Lead" in a specific FHFA office or division who is charged with responsibility for tracking Enterprise performance against the targets of that objective. Each objective and its targets are identified on an FHFA rating sheet for each Enterprise. At the end of every quarter, each Enterprise assesses its performance against that quarter's target(s), using the standard rating terms "Complete," "On Schedule," "Off Track," "Ahead of Schedule," or "At Risk," and enters its self-rating and any further comments on the rating sheet. The Project Lead reviews the entries of the Enterprises and enters his or her own quarterly rating and comments.

FHFA's rating sheet template defines the standard rating terms. It states:

[U]se the following ratings to describe progress toward quarterly metrics:

- **OS** – "On Schedule" – Met quarterly milestones and on schedule to meet the annual goal.
- **OT** – "Off Track" – Did not meet quarterly milestones, but will meet the annual goal.
- **AoS** – "Ahead of Schedule" – Met quarterly milestones, began working next quarter milestones, and will meet the annual goal.

- **At Risk** – Expect that the annual goal will not be met.
 - If assessment is considered at risk, provide an addendum explaining the factors contributing to the metric not being met and steps to alleviate the risk.
- **Complete** – Enterprise has completed the measure.

[FHFA] Quarterly Scorecard Assessment Instructions, Aug. 2, 2013 (emphasis in original).

If an Enterprise misses a target, the Project Lead is tasked with establishing a revised target date and a process for tracking Enterprise performance against that date. As needed, the Project Lead confers with each Enterprise during the year to assess its progress against the Scorecard.

At year-end, the Enterprises may submit self-assessments for the entire year, in addition to their fourth-quarter rating sheet entries. After reviewing the Enterprises' rating sheet entries and other submissions, the Project Lead enters final ratings and comments on the rating sheets.

- **Senior Level Review and Year-End Analysis Memo**

Senior officials in the same office or division as the Project Lead are responsible for submitting a year-end written analysis of Enterprise performance in meeting the specified objective identified in the Scorecard guidance. Using the rating sheets completed by the Enterprises and Project Lead, these officials compile a written narrative and analysis of Enterprise performance on the objective to which the relevant rating sheet is attached. The officials send the year-end analysis and attachments to ECB.

- **ECB Review, Summary, and Recommendation**

ECB receives and reviews a year-end analysis of Enterprise performance for every Scorecard objective. After its review and discussions as needed with the drafting offices, ECB proposes numerical ratings for each Enterprise—a rating on each objective. ECB prepares a summary chart of ratings for the Enterprises and forwards it to the FHFA Director, along with all of the year-end written analysis memos and ratings sheets.

- **Final Scorecard Rating Submission by the FHFA Director**

As needed, the Director meets with ECB and other FHFA officials to discuss the ECB summary memorandum and attached material, including the proposed ratings. The FHFA Director reviews and submits the final Scorecard rating to each Enterprise.

FHFA's Tracking and Rating of Enterprise Performance for the New Framework Objective in the 2013 Scorecard

FHFA's Division of Housing Mission and Goals (DHMG), Office of Housing and Regulatory Policy (OHRP), was charged with responsibility for tracking and rating the Enterprises' performance against the new Framework objective in the 2013 Scorecard Guidance. DHMG's ratings sheets (one for each Enterprise) contain ratings and comments for each quarter containing a target.

Third Quarter Target: Provide a Plan for Enhancing Quality Control

Freddie Mac. Freddie Mac rated its performance for the third quarter as "On Schedule." It explained that it had presented a plan to FHFA in August 2013 and would continue to update the plan as it continued to implement the new Framework. The Project Lead concurred and rated Freddie's Mac's performance as "On Schedule."

Fannie Mae. Fannie Mae rated its own performance for the third quarter as "Complete", reporting that it submitted to FHFA a comprehensive plan to meet the objective on July 3, 2013. The Project Lead entered "Disagree; not complete" on the rating sheet. In rating sheet comments, the lead wrote that Fannie Mae had submitted a PowerPoint presentation and an attached spreadsheet, but that "the project continues at this stage." The Project Lead went on to request that Fannie Mae submit a "comprehensive project plan," if available, "that provides in narrative form the scope of the overall project plan, describes all planned activities and deliverables, etc." Notwithstanding these written entries, the Project Lead rated Fannie Mae's third quarter performance as "On Schedule," without any explanation. The rating sheet instructions state that the rating "On Schedule" means that the Enterprise has met quarterly milestones, and the rating "Off Track" should be used when quarterly milestones are missed.

The reason for the inconsistency between the Project Lead's comments and the Project Lead's rating cannot be determined from the Scorecard rating and tracking records. During this audit, DHMG reported to us that Fannie Mae met the third quarter 2013 target at some point in time because the totality of its submissions constituted an adequate plan. DHMG produced two Fannie Mae Power Point presentations, from August and November 2013, which updated the July 2013 presentation figures on sampling reports and reviews issued in 2013. Because the third quarter rating sheet entries were undated, it is possible that the "On Schedule" rating

was entered sometime later, after Fannie Mae had submitted an adequate plan, but on its face the document is inconsistent in that it claims that the status is both “not complete” yet “On Schedule.”

Fourth Quarter Target: Assess the Execution of Enhanced Quality Control Reviews and Evaluate Effectiveness

According to FHFA, the Agency informed both Enterprises in November 2013 what would be required of them for a fourth quarter deliverable.⁸ FHFA told us that the Agency delivered this guidance in writing to Fannie Mae and in phone conversations with Freddie Mac personnel.

In a November 2013 email to Fannie Mae, DHMG provided guidance on what FHFA expected from it to satisfy the fourth quarter target. The email began by repeating the initial Scorecard target:

[P]lease assess your execution of the new model, including upfront quality control reviews and use of tools to identify defective loans, and evaluate effectiveness.

The email then added additional guidance:

What we would like to see is a summary narrative report that discusses the extent to which the objectives were met for this scorecard item, as well as the factors that hindered and facilitated in meeting them. We’d like to see impacts, key findings and how they will inform future changes or modifications to your quality control practices and transparency associated with the new framework.

During this audit, FHFA stated that this guidance set the expectations of what would be required of the Enterprises. Under this guidance, the Enterprises were required to give a narrative report on what work had been done toward meeting the target, including hindering and facilitating factors, impacts, key findings, and implications for future changes to quality control practices. However, neither the rating sheets nor the 2013 Scorecard Guidance reflects any modification of the fourth quarter target.

Freddie Mac. Freddie Mac rated its fourth quarter performance as “Complete,” and described its efforts to implement the new Framework, including improvements to its quality control reviews and tools. Freddie Mac submitted a separate year-end self-assessment memo in

⁸ As discussed further below, a later FHFA document states that quality control effectiveness could not yet be determined in 2013 due to insufficient data.

which it provided greater detail about its implementation activities. The memo summarized its efforts to put into place up-front quality control reviews for the new Framework, its tools to identify defective loans, lessons learned, and implications for further implementation. This memo also discussed Freddie Mac's efforts to update existing quality control practices and principles, develop marketing tactics to support the Framework execution activities, update systems, and monitor loan performance. The memo reported that Freddie Mac's implementation activities, including loan performance monitoring, was ongoing. The Project Lead rated Freddie Mac's fourth quarter performance as "Complete" and supported the rating with broad statements about attitude and effort.

The Agency reported to us that it determined that Freddie Mac met its fourth quarter target from information provided by Freddie Mac in its periodic status reports, and that the Enterprise provided summaries of the evaluations it had been able to conduct with the limited data available. However, in reviewing the Enterprise submission, it is difficult to identify information that could be construed as a meaningful assessment of the effectiveness of the new quality control reviews.

Fannie Mae. Fannie Mae rated its fourth quarter performance as "Complete" and supported that rating by referring to a year-end self-assessment memo to FHFA in December 2013. The memo summarized its efforts to put into place up-front quality control reviews for the new Framework, its tools to identify defective loans, lessons learned, and implications for further implementation. This memo discussed Fannie Mae's efforts to assess up-front quality control effectiveness and stated that this assessment was ongoing. The Project Lead rated Fannie Mae's performance for this quarter as "Complete," and supported the rating with the same broad statements about attitude and effort, without specifically addressing the elements of the target. The Project Lead reported:

[Fannie Mae/Freddie Mac] successfully completed the 2013 Scorecard objectives related to the implementation of the new Representation and Warranty framework.

[Fannie Mae/Freddie Mac] staff was engaged in and devoted significant resources to implementing the new Representation and Warranty framework and enhancing their respective quality control practices and tools to support it.

Although both Fannie Mae and Freddie Mac reported that their assessments were ongoing and the Agency reported that there was insufficient data available at the time, the 2013 Scorecard rating records show no action to establish a revised target date for the original objective

requirements and a means for tracking Enterprise performance against a revised date.⁹ We note that the 2015 Scorecard Guidance, issued on March 31, 2015, instructs the Enterprises to “[b]egin an analysis of the effectiveness of the current quality control process” during the first quarter.

- **Senior Level Review and Year-End Analysis Memo**

DHMG prepared a 2013 year-end analysis memo discussing both Enterprises’ performances on the new Framework objective in the Scorecard. That memo rated the performance of each Enterprise as “Complete” and described each Enterprise’s relevant activities and achievements. In language that echoed the Project Lead’s comments, the year-end memo reported:

Fannie Mae and Freddie Mac were engaged in and devoted significant resources to implementing the new Representation and Warranty framework and enhancing their respective quality control practices and tools to support it.

This year-end analysis memo, which attached the completed rating sheets, did not explain the inconsistency between the Project Lead’s comments and the rating for Fannie Mae’s third quarter performance. For the fourth quarter target, the memo recognized that quality control effectiveness could not yet be determined for either Enterprise and attributed the delay to insufficient data – which is inconsistent with the fourth quarter stated target of assessing the effectiveness of the execution of the new model, including up-front quality control reviews.

- **ECB Review, Summary, and Recommendation**

ECB received a year-end memo for each of the eleven objectives in the 2013 Scorecard, including the DHMG memo for the new Framework objective, and developed its overall rating recommendation for the 2013 Scorecard and ratings for each of the Scorecard’s 11 objectives. For the new Framework objective, ECB concluded that the third and fourth quarter ratings for each Enterprise were “Complete.” ECB’s comments on the two targets were high-level and brief: “Both achieved. Good feedback for [Enterprise].”

ECB sent its rating recommendation to the Director on January 24, 2014, with a cover memo in which it reported that its scoring was “based not only on ultimate accomplishment of results but cooperation, relative contribution, and collaboration with the board, FHFA, the other Enterprise, and market participants, as appropriate to the particular measure.” Attached to ECB’s recommendations memo were supporting materials, including the year-end analysis

⁹ ECB’s guidance to FHFA states, “[f]or objectives assessed as incomplete, Project Leads must describe how and when the Enterprises will meet the objectives and the process for tracking progress.” However, the fourth quarter target was deemed “Complete” and DHMG thus apparently did not conduct the procedures to ensure that “incomplete” objectives are met and tracked in the future.

memo prepared by DHMG and a summary table showing year-end ratings by both the FHFA offices and the Enterprises against each objective.

At the time of ECB's review, the fourth quarter target for FHFA's 2013 Scorecard continued to state that the fourth quarter target required the Enterprises to assess its execution of up-front quality control reviews and tools to identify defective loans, and evaluate effectiveness. Nothing in ECB's cover memo or summary chart reflected that DHMG had revised or rescheduled a component of the representations and warranties objective.

FINDING

FHFA's Records in Support of Its Quarterly and Year-End Ratings for the Representation and Warranty Objective in the 2013 Scorecard Are Imprecise and Inconsistent

One of the 11 objectives in FHFA's 2013 Scorecard was implementation of the new Framework. Pursuant to established FHFA procedure, each Enterprise assessed its performance in meeting the quarterly targets for that objective, as did the assigned Project Lead, and the Enterprises and the Project Lead awarded a quarterly rating for that performance. We found that one third-quarter rating assigned by the Project Lead for one of the Enterprises was inconsistent with the Project Lead's written performance assessment. The written comments describe the Enterprise's performance as "not complete" yet the Enterprise performance was rated as "On Schedule," indicating it had met the milestones for the quarter.

In addition, we found that the Scorecard target defined in the tracking and rating records was inconsistent with other documentation indicating that the target could not be met at that time due to insufficient data. The Enterprises' performance for that quarter was rated "Complete." FHFA told OIG that DHMG's subsequent guidance to the Enterprises set the expectations for a summary narrative and the guidance did not set specific requirements to include data analysis or metrics. According to the 2013 Scorecard guidance, the fourth quarter target requires the Enterprises to assess the execution of their up-front quality control reviews and use of tools to identify defective loans and evaluate effectiveness. We found that FHFA did not revise the original 2013 Scorecard document to reflect that the Enterprises were unable to assess the effectiveness of their quality control reviews because of insufficient data. The Scorecard did not state that the target had been suspended or modified. Instead, the quarterly rating sheet declared that both Enterprises completed the original target of:

Assess[ing] GSE execution of new model, including up-front quality control reviews and use of tools to identify defective loans. Evaluat[ing] effectiveness.

Moreover, FHFA was not consistent in providing written guidance to the Enterprises, alerting them of the expectations for the fourth quarter target. FHFA explained to OIG that the Agency provided additional guidance on the fourth quarter target near the end of the quarter. DHMG sent an email to one Enterprise and conducted oral discussions with the other Enterprise. Because DHMG did not provide guidance in writing, we are unable to confirm whether DHMG provided consistent guidance to both Enterprises.

In this audit, we identified internal inconsistencies in Agency documentation regarding the Scorecard ratings and requirements and found that they did not clearly reflect when targets

were modified or deferred. These inconsistencies and gaps, if not confined to this one instance, have the potential to create the misimpression that Scorecard objectives have been met when, in fact, they have been modified or delayed by staff.

CONCLUSIONS

FHFA issued its Strategic Plan in 2012 for the Enterprises. Beginning in 2013 and for each year subsequently, FHFA has issued an annual Scorecard in which it sets objectives for each goal in its Strategic Plan and sets specific targets for each objective. FHFA has a formal process to track and rate Enterprise performance against the Scorecard on a quarterly basis and to award an overall annual Scorecard performance for each Enterprise. This annual rating is factored into Enterprise executive compensation for the following year. Tracking Enterprise performance against each Scorecard is a valuable internal control to keep Enterprise activities aligned with conservatorship strategic goals and to keep Enterprise executives accountable for Enterprise performance.

During 2012, FHFA announced significant changes to the Enterprises' representation and warranty framework. Historically, the Enterprises relied on the sellers' representations and warranties when purchasing loans from sellers. In the event of default of a purchased loan, the affected Enterprise reviewed the loan file for possible breach by the seller of its contractual representations and warranties and could exercise its contractual rights to require the seller to repurchase the loan upon a breach of a representation or warranty. In the wake of the collapse of the housing market and soaring loan defaults, Enterprise repurchase demands on sellers mounted. In response, sellers tightened lending standards beyond what the Enterprises required to protect themselves from future uncertain exposure from loan repurchase demands. In an effort to ease these restrictions on the availability of mortgage credit, FHFA directed the Enterprises in 2012 to develop and implement a new Framework. That new Framework, which went into effect for loans purchased after January 1, 2013, in many circumstances imposed a three-year deadline after which the Enterprises could no longer demand repurchase of defective loans from sellers of those loans. One objective in FHFA's 2013 Scorecard was implementation of the new Framework.

In this audit, we reviewed FHFA's efforts to track and rate Enterprise performance on this one objective in the 2013 Scorecard. We found that the fourth quarter target – deemed “Complete” by the Agency – was inconsistent with other documentation indicating that the deliverables for the target had been revised and that the original target could not be met due to insufficient data. We also found that the Agency did not always communicate its expectations to the Enterprises in writing. Because of the importance of FHFA's Scorecard tracking and rating process, we recommend enhancements to require greater clarity and minimize the risk of misimpressions.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Establish standards requiring that modifications or suspensions of Scorecard targets must be documented in writing;
2. Require that FHFA comments and ratings on quarterly rating sheets be dated; and
3. Establish standards to address missed or partially missed quarterly targets, including requiring that every quarterly rating sheet record when any target was missed and the reset target date.

On March 2, 2016, FHFA provided comments to a draft of this report, agreeing with all recommendations and identifying FHFA actions which it believes have addressed each recommendation. OIG has not yet assessed the Agency's actions and will hold open its recommendations until it determines that the corrective actions reported by FHFA are completed and responsive to the recommendations.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this performance audit was to assess FHFA's oversight of the Enterprises' implementation of the new representation and warranty framework through the conservator's Scorecard tracking system. Specifically, we assessed FHFA's tracking and reporting of the Enterprises' performance against the 2013 Scorecard targets related to implementation of the new Framework.

OIG conducted this performance audit from April 2015 through November 2015. OIG conducted this audit in Washington, D.C. at FHFA and Fannie Mae headquarters, and in McLean, VA at Freddie Mac headquarters.

The scope of OIG's audit involved FHFA's process for, and record of, tracking and rating the Enterprises' targeted deliverables under the 2013 Scorecard objective relating to the new Framework. For purposes of this audit, OIG did not assess controls over computer-processed data. To achieve the audit objective, OIG:

- Reviewed FHFA's directives, guidelines, announcements, Scorecards, analyses, and other internal and external communications and documents concerning the new Framework that became effective in January 2013;
- Interviewed some of the FHFA officials responsible for tracking Enterprise performance against the 2013 Scorecard new Framework deliverables, for giving guidance to the Enterprises on those deliverables, for rating Enterprise performance on those deliverables, and for reporting Enterprise Scorecard performance and ratings to the conservator;
- Interviewed some of the Fannie Mae and Freddie Mac officials responsible for implementing changes in their quality control processes to comply with the new Framework; and
- Reviewed Enterprise guidelines, announcements, annual reports, analyses, internal and external reports, and documents associated with their new Framework quality control processes.

OIG also assessed the internal controls related to the audit objective. Internal controls are an integral component of an organization's management that provide reasonable assurance 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 evaluating, reporting, and monitoring program performance.

OIG conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for OIG's findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on the audit objective.

APPENDIX A

FHFA's Comments on OIG's Finding and Recommendations



Federal Housing Finance Agency

MEMORANDUM

TO: Stacey Nahrwold, Senior Attorney Advisor, Acting Deputy Inspector General for Audits

FROM: Bob Ryan, Acting Deputy Director, Division of Conservatorship *BR*

SUBJECT: Audit Report: *Review of FHFA's Tracking and Rating of the 2013 Scorecard Objective for the New Representation and Warranty Framework Reveals Opportunities to Strengthen the Process*

DATE: March 2, 2016

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the draft report prepared by FHFA OIG, *Review of FHFA's Tracking and Rating of the 2013 Scorecard Objective for the New Representation and Warranty Framework Reveals Opportunities to Strengthen the Process* (Report).

FHFA reviewed the Report and accepts the recommendations. However, FHFA had already taken steps prior to the issuance of this report to address the recommendations included in the report. These steps are described below.

Recommendation 1:

Establish standards requiring that modifications or suspensions of Scorecard targets must be documented in writing.

FHFA updated its Scorecard guidance process in 2014 in light of lessons learned in 2013 to include several new processes and standards, including the establishment of standards requiring that modifications or suspensions of Scorecard targets must be documented in writing. FHFA leads¹ must propose in writing any suggested modifications to Scorecard targets, including suspending those targets, as the year progresses. Memos justifying changes to Scorecard targets must include an explanation of the proposed change(s), recommended action(s), as well as a red-lined document to capture specific wording adjustments. Written justifications are then cleared through an executive review process that includes approval by executive FHFA stakeholders.

¹ Every objective in the annual Scorecard is assigned to an FHFA "lead" that is charged with the responsibility for tracking Enterprise performance against the targets of that objective.

Recommendation 2:

Require that FHFA comments and ratings on quarterly rating sheets be dated.

An additional standard implemented in 2014 requires that FHFA comments and ratings on quarterly rating sheets be dated. Currently, all written comments in the Scorecard assessment quarterly files are finalized on a date certain (at an internal working group meeting) and approved on a date certain (at a governance committee² meeting). Additionally, all Scorecard assessment entries (comments) are date stamped through an FHFA collaboration site.

Recommendation 3:

Establish standards to address missed or partially missed quarterly targets, including requiring that every quarterly rating sheet record when any target was missed and the reset target date.

FHFA has implemented standards by which quarterly targets missed and partially missed are documented in FHFA's quarterly rating sheet, in year-end Scorecard assessment memos, and in meeting minutes that record verbal discussions among FHFA stakeholders on Scorecard targets and describe feedback provided to the Enterprises. Also, as noted in Management Response to Recommendation 1, FHFA has a process for recording the reset dates for quarterly targets.

In light of actions taken by FHFA as outlined above to address the recommendations of this report, we request that the Inspector General close these recommendations.

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

² FHFA's Conservatorship Committee, which provides senior executive review, direction and oversight of the exercise of FHFA's conservatorship authority.

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