REDACTED

Federal Housing Finance Agency
Office of Inspector General

FHFA's 2015 and 2016 Supervisory Activities, as Planned, Addressed Identified Risks with Freddie Mac's New Representation and Warranty Framework

This report contains redactions of information that is privileged or confidential.

Audit Report • AUD-2017-009 • September 22, 2017

AUD-2017-009

September 22, 2017

Executive Summary

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together, the Enterprises) provide liquidity to the U.S. housing finance system by supporting the secondary mortgage market. The Enterprises purchase residential mortgages from lenders and bundle the purchased mortgages 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 mortgages. To mitigate this risk, the Enterprises require lenders that sell the residential mortgages to make specific contractual representations and warranties in which they represent that the mortgages meet specific underwriting standards.

Historically, the Enterprises relied on the lenders' representations and warranties and conducted limited due diligence at the time the mortgages were purchased. When mortgages defaulted or the borrower missed payments, the Enterprises would review the loan files for evidence of breach of the representations and warranties and exercise their contractual rights to require lenders to repurchase, or buy back, non-compliant loans. The Enterprises' contractual rights to put back non-compliant loans at any point during the term of the loans enabled the Enterprises to reduce losses caused by underwriting defects.

In September 2012, the Federal Housing Finance Agency (FHFA) announced that the Enterprises would launch a new representation and warranty framework (new framework). The objective of the new framework was to enhance transparency and certainty for lenders by clarifying when a mortgage loan may be subject to repurchase. The new framework, designed by the Enterprises to meet FHFA's stated objective, shifted some risk of non-compliance with representations and warranties from the lenders to the Enterprises (and therefore to taxpayers). The new framework also required operational changes at the Enterprises to mitigate the additional risk. FHFA recognized the need to test the adequacy of those operational changes, through its supervisory activities, to ensure that the risks had been mitigated.

FHFA is charged by the Housing and Economic Recovery Act with, among other things, ensuring that the Enterprises and the Federal Home Loan Banks operate in a safe and sound manner. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises. According to the *FHFA Examination Manual*, each year DER assesses the risks of Enterprise operations and plans its supervisory activities to assess the mitigation of those risks. DER summarizes and communicates the results of its supervisory activities in an annual report of examination (ROE) issued to each Enterprise.

AUD-2017-009

September 22, 2017

We performed this audit to assess (1) whether DER's planned supervisory activities relating to Freddie Mac's implementation of the new framework for the 2015 and 2016 examination cycles could be tracked to its risk assessments and supervisiory strategies and (2) whether DER executed these planned supervisory activities during the 2015 and 2016 examination cycles.

For the 2015 examination cycle, the risks identified by DER with respect to Freddie Mac's implementation of the new framework focused on Freddie Mac's [redacted]. To address the identified risks, we found that DER, as planned, performed two ongoing monitoring activities related to ERM issues. For 2015, DER reported [redacted]. For the 2016 examination cycle, DER identified the new framework as a supervisory focus. DER's 2016 Freddie Mac supervisory plan included three framework-related targeted examinations and one ongoing monitoring activity. These supervisory activities tracked to the new framework-related risks identified in the risk assessment. During the examination cycle, DER completed two of the planned targeted examinations, deferred the other targeted examination to 2017, and completed the ongoing monitoring activity. The 2016 supervisory activities identified [redacted]. We make no recommendations in this report.

We are also issuing today the results of our audit of DER's execution and completion of planned supervisory activities for the 2015 and 2016 examination cycles to test the adequacy of Fannie Mae's implementation of the new framework. See *FHFA's 2015 Report of Examination to Fannie Mae Failed to Follow FHFA's Standards Because it Reported on an Incomplete Targeted Examination of the Enterprise's New Representation and Warranty Framework*, AUD-2017-008, available online at www.fhfaoig.gov/reports/auditsandevaluations.

This report was prepared by James Lisle, Audit Director; April Ellison, Auditor-in-Charge; and Brian Maloney, Auditor; with the assistance of Bob Taylor, Assistant Inspector General for Audits. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of the report.

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

Marla A. Freedman, Deputy Inspector General for Audits /s/

TABLE OF CONTENTS

ABBREVIATIONS ....

3LOD	Three Lines of Defense
DER	Division of Enterprise Regulation
ERM	Enterprise Risk Management
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
MRA	Matter Requiring Attention
New framework	Representation and Warranty Framework
OIG	Office of Inspector General
PSPA	Preferred Stock Purchase Agreement
ROE	Report of Examination
Treasury	Department of the Treasury
UPB	Unpaid Principal Balance

BACKGROUND

DER Supervisory Process

Created by Congress in 2008, FHFA is charged by the Housing and Economic Recovery Act of 2008 with, among other things, the supervision of the Enterprises. Its mission as a federal financial regulator includes ensuring the safety and soundness of the Enterprises so that they serve as a reliable source of liquidity and funding for housing finance and community investment. FHFA exercises its supervision of the Enterprises through DER. Like other federal financial regulators, FHFA maintains that it uses a risk-based approach to carry out its supervisory activities.

In a number of recently issued reports, we have explained in detail the different elements of DER's supervision program for the Enterprises.[1] According to FHFA, DER's examinations of the Enterprises are risk-based and rely on an understanding of the Enterprise, risk assessments, the development of a supervisory strategy and supervisory plan, and examination procedures tailored to the Enterprise's risk profile. The specific elements of DER's supervisory program include:

- DER's written assessment of risks at the Enterprises, which serves as a platform for developing an annual supervisory strategy and supervisory plan;
- DER's annual supervisory strategy is intended to form a bridge between the risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. The supervisory strategy should include, among other things, the planned supervisory approach (extent of ongoing monitoring or targeted examination activity) and planned objectives that address the significant risks and the principal supervisory priorities for the year;
- DER's supervisory plan for each annual examination cycle sets forth the planned supervisory activities, prioritized based on level of risk identified in DER's risk assessments. The supervisory plan is supposed to clearly link to the supervisory strategy. Because supervisory planning is a continuous process, supervisory plans may need to be adjusted during each year to address newly emerging risks that require attention during the current examination cycle; adjustments to the supervisory plans must be risk-based and documented. Supervisory activities include ongoing

[1] We have issued a number of reports addressing DER's supervisory process, which are summarized in *Safe and Sound Operation of the Enterprises Cannot Be Assumed Because of Significant Shortcomings in FHFA's Supervision Program for the Enterprises* (Dec. 15, 2016) (OIG-2017-003) (online at www.fhfaoig.gov/Content/Files/OIG-2017-003.pdf).

monitoring and targeted examinations. According to FHFA, ongoing monitoring and targeted examinations serve complementary purposes. The purpose of ongoing monitoring is to analyze real-time information and to use those analyses to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant increased supervisory attention. According to the *FHFA Examination Manual*, ongoing monitoring is also "used to determine the status of the Enterprise's compliance with supervisory guidance, MRAs, and conservatorship directives[.]"[2] Targeted examinations complement ongoing monitoring; further, the *FHFA Examination Manual* notes that they enable examiners to conduct "a deep or comprehensive assessment" of the areas found to be of high importance or risk;

- DER's planned examination procedures for its supervisory activities, which are designed to identify the objectives of the activity and describe the examination steps to be performed, including sampling and testing;

- DER's quality control processes for its targeted examinations and for ongoing monitoring activities with findings, which assess whether such activities comply with FHFA examination standards and procedural requirements in the *FHFA Examination Manual*, supplemental modules, supervision directives, and DER operating procedures bulletins, which DER requires must be completed before DER communicates the results of such activities to an Enterprise;

- DER's communication of its findings from its supervisory activities, including its supervisory concerns, to each Enterprise;

- DER follow-up on efforts by each Enterprise to correct identified deficiencies throughout the remediation period to ensure that remediation is timely and adequate; and

- DER's communication of its examination conclusions, findings, and composite/ component examination ratings after the end of each annual examination cycle to each Enterprise board of directors in an annual ROE to assist Enterprise directors in executing their oversight responsibilities.

[2] As discussed in AB-2017-01 *Classifications of Adverse Examination Findings*, MRAs are adverse examination findings that fall into one of the following categories: (1) critical supervisory matters (the highest priority) that pose substantial risk to the safety and soundness of the Enterprise and (2) deficiencies that are supervisory concerns, which FHFA believes could, if not corrected, escalate and potentially negatively affect the condition, financial performance, risk profile, operations, or reputation of the Enterprise.

The New Framework Sought to Provide Greater Certainty to the Seller, Shifting Some Risk to the Enterprises

The Enterprises provide liquidity to the U.S. housing finance system by purchasing residential mortgages and bundling the purchased mortgages into securities for which they guarantee principal and interest. In guaranteeing the securities, the Enterprises assume the credit risk[3] from possible default of the underlying mortgages. To mitigate this risk, the Enterprises require lenders that sell the residential mortgages to make specific contractual representations and warranties in which they represent that their mortgages meet the specific underwriting standards set forth in Fannie Mae's *Selling Guide* or Freddie Mac's *Single-Family Seller/Servicer Guide*.

Historically, the Enterprises performed limited due diligence on the loans at the time of purchase. In the event of default, the affected Enterprise reviewed whether the defaulted loan complied with the lender's representations and warranties in the lender contract. If an Enterprise found that a defaulted loan breached these representations and warranties in any way, the Enterprise could exercise its contractual right to require the lender to repurchase the non-compliant loan, even if the loan defaulted years after it was made. This right to demand repurchase of defaulted loans that did not comply with the representations and warranties in the lender contract mitigated the risk of losses to the Enterprises from defaulted loans.

In September 2012, FHFA announced that the Enterprises would launch the new framework for conventional loans sold or delivered on or after January 1, 2013.[4] The objective of the new framework was to enhance transparency and certainty for lenders by clarifying when a mortgage loan may be subject to repurchase. The new framework provides relief for lenders from the requirement to remedy (e.g., repurchase) a loan due to breaches of certain underwriting and property valuation representations and warranties when a loan meets certain payment history requirements or the satisfactory conclusion of a quality control review by the Enterprise.[5] The new framework does not change the underlying representations and

[3] Credit risk is the potential that a borrower or counterparty will fail to meet its obligation in accordance with agreed terms.

[4] On September 10, 2012, then-acting FHFA Director DeMarco explained that "there has been much discussion that the uncertainty with representation and warranty exposure may be affecting the willingness of lenders to extend credit" and that this uncertainty warranted a change in the representation and warranty framework. Edward J. Demarco, FHFA Acting Director, Remarks as Delivered – American Mortgage Conference, Raleigh, NC (Sept. 10, 2012) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Remarks-as-Delivered-Edward-J-DeMarco-Acting-Director-FHFA-American-Mortgage-Conference.aspx).

[5] A quality control program defines the standards for loan quality, establishes processes designed to achieve those standards, and mitigates risks associated with the origination processes. A quality control program includes a documented quality control plan that outlines requirements for validating that loans are originated in accordance with the Enterprise's established policies and procedures.

warranties the lender makes to the Enterprises when selling mortgages; it changes whether and how the Enterprises will enforce breaches of those representations.[6] As Director Watt testified in January 2015:

> FHFA's supervision function evaluates the safety and soundness of the Enterprises' operations. Safety and soundness is a top priority in meeting FHFA's statutory obligations, in execution of Enterprise strategic initiatives and in all business and control functions. . . . In updating and clarifying the Framework, FHFA's objectives are to continue to support safe and sound Enterprise operations, encourage lenders to reduce their credit overlays, and complement the agency's efforts to strengthen the Enterprises' quality control process.[7]

As Freddie Mac recognized in its December 31, 2013, Form 10-K,[8] "We may face greater exposure to credit and other losses under this new framework since it relieves lenders of certain repurchase obligations in specific cases[.]" The increased exposure under this new framework could pass through to the taxpayers as the Enterprises continue to operate under FHFA's conservatorship.[9]

Freddie Mac reported to us that, as of April 30, 2017, it has acquired more than 5.6 million loans, with an unpaid principal balance (UPB) of $1.12 trillion, that are subject to the new framework. More than 2 million of those loans, with a UPB of nearly $347 billion, have either demonstrated acceptable payment histories, passed Freddie Mac quality control review, or met other requirements. Pursuant to the new framework, Freddie Mac will not exercise its remedies, including a demand to repurchase those loans, except in limited situations. More than 3.5 million loans, with a UPB of approximately $758 billion, have not completed Freddie Mac quality control review and are still within the sunset period. Pursuant to the new

---

[6] Lenders remain responsible for the life of the loan in the event of misstatements, misrepresentations and omissions, and certain other situations.

[7] Statement of Melvin L. Watt before the U.S. House of Representatives Committee on Financial Services, "Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency" (Jan. 27, 2015) (online at www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-Melvin-L-Watt-Director-FHFA-Before-the-US-House-of-Representatives-Committee-on-Financial-Services-1272015.aspx).

[8] Securities laws require publicly traded companies to disclose information on an ongoing basis. Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements.

[9] Fannie Mae and Freddie Mac continue to operate under conservatorship, as they have since 2008. At the time the Enterprises were placed into conservatorship, the Department of the Treasury (Treasury) and FHFA, as conservator of the Enterprises, executed senior preferred stock purchase agreements (PSPAs) to ensure that the Enterprises could continue to operate. The PSPAs, among other things, obligated Treasury to provide funds (subject to specified limits) to an Enterprise to restore it to positive net worth in any quarter in which the Enterprise's net worth becomes negative. Under these PSPAs, U.S. taxpayers, through Treasury, have invested a total of $187.5 billion into the Enterprises since 2008.

framework, Freddie Mac can exercise its remedies, including a demand to repurchase those loans. Almost 99,000 loans, with a UPB of nearly $17 billion, did not demonstrate acceptable payment histories within the sunset period or did not pass Freddie Mac quality control review. For those loans, Freddie Mac retains the right to exercise its remedies, including a demand to repurchase by the loan sellers.

Implementation of the New Framework Required Operational Changes at Freddie Mac

Implementation of the new framework shifted some risk of non-compliance with representations and warranties from the lenders to the Enterprises. As a result, the Enterprises' quality control programs became increasingly important to mitigate origination quality and credit risks since the Enterprises would no longer be able to seek repurchase from a loan seller for the life of the loan. For loans acquired under the new framework, both Enterprises represented that they would conduct most quality control reviews within 30 to 120 days after delivery of the loan to assess whether the specific representations and warranties were satisfied. According to the Enterprises, they would employ new technologies and data gathering tools to identify loans that are not originated in accordance with applicable underwriting and eligibility requirements.

FACTS AND ANALYSIS ....

DER Planned and Executed Supervisory Activities for Freddie Mac to Address the Risks it Identified with the New Framework in the 2015 and 2016 Examination Cycles

2015 Examination Cycle

Risk Assessment – DER identified new framework-related risks in the credit and governance areas[10] of the risk assessment for the 2015 examination cycle. For credit risk, DER noted that Freddie Mac's [redacted][11] For governance risk, DER noted [redacted][12] [redacted].

Supervisory Strategy – The 2015 supervisory strategy did not explicitly mention the new framework but discussed [redacted] as significant risks. The supervisory strategy included Freddie Mac's [redacted], which impacted the new framework, as a focus of supervision.

DER's Supervisory Activities for the 2015 Examination Cycle

DER's 2015 supervisory plan did not include any new framework-related targeted examinations but included ongoing monitoring activities focused on the overall governance

[10] According to the *FHFA Examination Manual*, risk assessments should describe the types of risk as follows: credit, market, liquidity, reputational, operational, model, and legal.

[11] Enterprise risk management is a risk management concept with the primary objective to identify, measure, monitor, and report on risk exposures on an ongoing basis; it should encompass all on- and off-balance sheet risks at entity-wide, portfolio, and business-line levels.

[12] The three lines of defense is a risk management and control model promulgated by the Institute of Internal Auditors (IIA) in its *IIA Position Paper – The Three Lines of Defense in Effective Risk Management and Control* (Jan. 2013) (online at https://na.theiia.org/standards-guidance/Public%20Documents/PP%20The%20Three%20Lines%20of%20Defense%20in%20Effective%20Risk%20Management%20and%20Control.pdf). The model defines operational management as the first line of defense, risk management and compliance functions as the second, and internal audit as the third. The *FHFA Examination Manual* states, "Sound operational risk management practices include a three line[s] of defense approach – business line management, an independent enterprise-level operational risk management function, and an independent review...."

of Freddie Mac's ERM process along with two specific ERM-related ongoing monitoring activities of Freddie Mac's single-family business unit, responsible for the single-family quality control function under the new framework. These ongoing monitoring activities and their objectives were:

- **ERM –** [redacted][13] [redacted]
- **3LOD –** [redacted].

DER performed the two new framework-related ongoing monitoring activities during the 2015 examination cycle. In a year-end summary memorandum, which included these two supervisory activities, DER stated that [redacted].

Report of Examination – DER did not discuss the new framework in the ROE issued for the 2015 examination cycle. It reported on Freddie Mac's [redacted]

2016 Examination Cycle

Risk Assessment – DER identified new framework-related risks in the Freddie Mac risk assessment for the 2016 examination cycle. The risk assessment noted that the Enterprise was [redacted] In addition, the risk assessment noted that [redacted]

---

[13] OIG, *FHFA's Representation and Warranty Framework* (Sept. 17, 2014) (AUD-2014-016) (online at www.fhfaoig.gov/Content/Files/AUD-2014-016.pdf). This report concluded that neither Enterprise had implemented the processes, procedures, and systems needed to operate within the new framework before it went into effect in 2013. Among other things, OIG recommended that FHFA "assess the current state of the Enterprises' critical risk assessment tools, representations and warranties tracking systems, and any other systems, processes, or infrastructure to determine whether the Enterprises [were] in a position to minimize financial risk that might result from the new framework."

[redacted].

Supervisory Strategy – Consistent with the risk assessment, DER's 2016 supervisory strategy identified Freddie Mac's implementation of the new framework as an area of supervisory focus.

DER's Supervisory Activities for the 2016 Examination Cycle

DER's 2016 Freddie Mac supervisory plan included three new framework-related targeted examinations and one ongoing monitoring activity. These supervisory activities tracked to the new framework-related risks identified in the risk assessment. The supervisory activities and their objectives were:

- **Rep and Warrant Framework (Targeted Examination) –** [redacted].
- **Single-family Loan Level Credit Quality (Targeted Examination) –** [redacted]
- **Single-family Loan Acquisition Quality Control Program (Targeted Examination) –** [redacted].
- **Single-family Credit Risk Management (Ongoing Monitoring Activity) –** [redacted]

DER completed two of the planned targeted examinations, deferred the other targeted examination to 2017 for risk-based reasons, and completed the ongoing monitoring activity. As a result of the supervisory activities conducted during the examination cycle, DER [redacted][14]

Report of Examination – DER did not discuss the new framework in Freddie Mac's 2016 ROE. Overall, DER concluded that [redacted]

[14] Caution loans are loans that are on the margin of acceptability.

CONCLUSION……………………………………………………………

We found that DER's planned supervisory activities relating to Freddie Mac's implementation of the new framework for the 2015 and 2016 examination cycles could be tracked to its risk assessments and supervisory strategies. We also found that DER executed both planned supervisory activities for the 2015 examination cycle and three of the four planned supervisory activities for the 2016 examination cycle. For the one planned supervisory activity that was not performed, DER deferred the examination to 2017 for risk-based reasons. Accordingly, we make no recommendations in this report.

FHFA COMMENTS AND OIG RESPONSE………………………………

We provided FHFA an opportunity to respond to a draft of this audit report. FHFA provided technical comments on the draft report, and those comments were incorporated as appropriate. FHFA informed us that they had no further comments on the report and, therefore, did not provide a written management response.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this audit to assess (1) whether DER's planned supervisory activities relating to Freddie Mac's implementation of the new framework for the 2015 and 2016 examination cycles could be tracked to its risk assessments and supervisory strategies and (2) whether DER executed and completed these planned supervisory activities during the 2015 and 2016 examination cycles.

To accomplish our objective, we reviewed the *FHFA Examination Manual* (December 2013) and the related Credit Risk Management examination module (July 2013); guidance issued by FHFA and DER related to supervisory planning, execution, and quality control; and supervisory planning and examination documentation supporting the supervisory activities conducted of Freddie Mac related to the new framework.

Specifically, for Freddie Mac, we:

- Reviewed DER's risk assessments for the 2015 and 2016 examination cycles to identify risks related to the new framework.
- Reviewed DER's supervisory strategy documents for the 2015 and 2016 examination cycles to identify risks related to the new framework.
- Reviewed DER supervisory plan documents for the 2015 and 2016 examination cycles to identify whether planned supervisory activities addressed the risks related to the new framework DER identified in the risk assessments and supervisory strategies.
- Interviewed DER personnel to gain an understanding of the supervision process and examination approach used to supervise Freddie Mac's implementation of the new framework.
- Reviewed DER's workpapers for the targeted examinations and ongoing monitoring related to the new framework performed during the 2015 and 2016 examination cycles to determine whether:
    - Required documents for each type of examination performed were completed and included in examination documentation in accordance with FHFA guidelines, and
    - The scope and conclusions of each of the supervisory activities' conclusion documents addressed the associated supervisory activity objectives.

- Reviewed the 2015 and 2016 ROEs to determine whether the results and conclusions of the new framework related supervisory activity were discussed.

We conducted this performance audit from March 2017 through September 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

ADDITIONAL INFORMATION AND COPIES................................

For additional copies of this report:

- Call: 202-730-0880
- Fax: 202-318-0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1-800-793-7724
- Fax: 202-318-0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

  FHFA Office of Inspector General
  Attn: Office of Investigations – Hotline
  400 Seventh Street SW
  Washington, DC 20219