

REDACTED

Federal Housing Finance Agency
Office of Inspector General



**FHFA Completed its Planned Procedures
for a 2015 Representation and Warranty
Framework Targeted Examination at
Fannie Mae,
but Did Not Document a Change to Planned
Testing**

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

Audit Report • AUD-2018-005 • March 13, 2018



AUD-2018-005

March 13, 2018

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 either hold these mortgages in their portfolios or 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 from whom they purchase residential mortgages to make contractual representations and warranties wherein the lenders represent that the mortgages meet specific underwriting requirements.

Historically, the Enterprises have relied on the lenders' representations and warranties that underwriting requirements were met and conducted limited due diligence at the time the mortgages were purchased. When mortgages defaulted or the borrower missed payments, the Enterprises would then 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 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 additional risk had been mitigated.

FHFA is charged by the Housing and Economic Recovery Act of 2008 (HERA) 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. We recently issued the results of a completed audit, *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,



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available online at <https://www.fhfaog.gov/reports/auditsandevaluations>. In that audit, we found that DER failed to follow FHFA standards when it reported on the results of a 2015 new framework-related targeted examination before that targeted examination had been subjected to a mandatory internal quality control review.

This audit follows on that work. In this audit, we sought to determine whether DER performed its planned procedures and sufficiently supported its conclusions for this same targeted examination. We found that DER performed its planned procedures and the conclusions presented in the Conclusion Letter to Fannie Mae were consistent with those detailed in the workpapers. We also found that the workpapers sufficiently supported DER's conclusions regarding the [REDACTED]. However, we also found one instance in which DER did not document the reasons for a reduction in the number of [REDACTED] it planned to test in compliance with established guidance. We make no recommendations in this report.

We are also issuing today the results of our audit of DER's execution of a targeted examination of Freddie Mac's risk management activities related to the new framework. See *FHFA Completed its Planned Procedures for a 2016 Representation and Warranty Framework Targeted Examination at Freddie Mac, but the Supporting Workpapers Did Not Sufficiently Document the Examination Work*, AUD-2018-006, available online at www.fhfaog.gov/reports/auditsandevaluations.

This report was prepared by James Lisle, Audit Director; Marco Uribe, 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.fhfaog.gov.

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

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ABBREVIATIONS

| | |
|---------------|--|
| CU | Collateral Underwriter |
| DER | Division of Enterprise Regulation |
| EIC | Examiner-in-Charge |
| EPB | Examination Practices Bulletin |
| Enterprises | Fannie Mae and Freddie Mac |
| Fannie Mae | Federal National Mortgage Association |
| FHFA | Federal Housing Finance Agency |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| HERA | Housing and Economic Recovery Act of 2008 |
| LQC | Loan Quality Center |
| New framework | Representation and Warranty Framework |
| OIG | Federal Housing Finance Agency Office of Inspector General |
| OPB | Operating Procedures Bulletin |
| QC | Quality Control |
| TAU | Trusted Appraisal and Underwriting |

BACKGROUND.....

DER Supervisory Process

Created by Congress in 2008, FHFA is charged by HERA 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.

DER executes supervisory activities, which consist of ongoing monitoring and targeted examinations conducted in accordance with a supervisory plan. The *FHFA Examination Manual* explains that targeted examinations are a critical component of supervision and will be undertaken, as needed, based on risk. The purpose of targeted examinations is to allow for a deep or comprehensive assessment of the area under review.

According to DER's Operating Procedures Bulletin (OPB) 2013-DER-OPB-04, *DER Supervisory Activities* (September 19, 2013), targeted examinations are designed to assess a particular area, product, risk, or activity of the Enterprise and by definition are narrow in scope. This OPB directs DER examiners to conduct detailed analysis and testing in order to develop specific conclusions. With regard to testing, FHFA issued Examination Practice Bulletin (EPB), EPB 2014-01, *Sampling Practices in Examinations* (February 2014). The stated purpose of the EPB is to provide examiners with guidance on sampling practices to aid them in the performance of mandatory testing in accordance with FHFA examination work programs.

The *FHFA Examination Manual* and DER's OPBs define expectations and approval requirements for examiner workpapers. According to 2013-DER-OPB-04 and 2014-DER-OPB-01, *Guidelines for Preparing Supervisory Products and Examination Workpapers* (January 27, 2014), required documents for targeted examinations are:

- Procedures Document – sets forth the steps performed to achieve the objective of the supervisory activity, and provides the official agency record of evidence to support the execution of the targeted examination. The Procedures Document must be approved by the Lead Examiner and Examination Manager.
- Request Letter – announces the objective and scope of the targeted examination to the Enterprise, requests the Enterprise to schedule a kickoff and subsequent meetings with management, and requests timely delivery of documentation to be produced by the Enterprise. The Request Letter must be approved by the Lead Examiner, Examination Manager, and Examiner-in-Charge (EIC).

- Meeting Notes – document the periodic status meetings with management that are conducted throughout the targeted examination to ensure that management is kept apprised of any preliminary findings or emerging concerns. Meeting Notes must be approved by the Lead Examiner and Examination Manager.
- Analysis Memorandum – constitutes the main work product from the supervisory activity that supports the Conclusion Letter, and provides the complete record of the work performed, findings, and conclusions. The Analysis Memorandum should include hyperlinks or references to supporting workpapers and must be approved by the Lead Examiner, Examination Manager, and EIC.¹
- Conclusion Letter – communicates conclusions from targeted examinations to the Enterprise. Conclusion Letters must be approved by the Lead Examiner, Examination Manager, EIC, and DER Deputy Director.

The *FHFA Examination Manual* directs that examiner workpapers, on which the Analysis Memorandum is based, must be prepared in sufficient detail to provide a clear understanding of the examination work performed. Further, 2014-DER-OPB-01 directs DER examiners to prepare workpapers with sufficient detail and explanation so that they can provide a third-party with a clear understanding of the examination work performed, the examination findings, conclusions, and ratings reached, and any implications of the findings, conclusions, and ratings.

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

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 (QC) programs² became increasingly important to mitigate origination quality risk and credit risk since, for loans covered by the new framework, the Enterprises would no longer be able to seek repurchase from a lender for the life of the loan as a result of some representation and warranty breaches. 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 specific

¹ 2014-DER-OPB-01 directs that Examination Managers must ensure examination findings are fully supported by workpapers and hyperlinked or referenced in the Analysis Memorandum.

² A QC program defines the standards for loan quality, establishes processes designed to achieve those standards, and mitigates risks associated with the origination processes. A QC program includes a documented QC plan that outlines requirements for validating that loans are originated in accordance with the Enterprise's established policies and procedures.

representations and warranties were satisfied.³ In addition, the Enterprises stated that they were going to use new technologies and data gathering tools to identify loans that were not originated in accordance with applicable underwriting and eligibility requirements. Fannie Mae implemented new tools to enhance the focus of its post-purchase quality control reviews of performing loans. For example, the Trusted Appraisal and Underwriting (TAU) tool was developed to assist Fannie Mae in identifying underwriting defects by looking for discrepancies, incentives, and trends across many different internal and external data sources, and the Collateral Underwriter (CU) tool was developed to assist Fannie Mae in evaluating the quality of appraisals submitted with loan applications.

Prior OIG Work on the New Framework

A 2014 OIG audit found that FHFA mandated the new framework despite significant unresolved operational risks to the Enterprises. The audit also found that neither Enterprise had implemented the processes, procedures, nor systems needed to operate within the new framework before it went into effect in 2013. The 2014 audit report made two recommendations to FHFA, of which one is relevant to the scope of this audit:

[A]ssess 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 are in a position to minimize financial risk that may result from the new framework. The results of this assessment should document any areas of identified risk, planned actions, and corresponding timelines to mitigate each area of identified risk. Further, this assessment should provide an estimate of when each Enterprise will be reasonably equipped to work safely and soundly within the new framework.⁴

In its written response, FHFA partially agreed with this recommendation, stating that:

FHFA examination staff will continue to examine and review the Enterprises' loan purchase operations, including those affected by the representations and warranties framework. DER examination staff will request the Enterprises to provide information about operational changes needed at each Enterprise for

³ For example, Fannie Mae QC reviews assess representations and warranties related to the underwriting of the borrower, including the seller's assessment of borrower's loan terms, credit history employment, income, assets, and other information used for qualifying the borrower for the mortgage; the assessment also includes the underwriting of the mortgaged premises, which is the analysis of the description and valuation of the mortgaged premises to determine its adequacy as collateral for the mortgage.

⁴ See OIG, *FHFA's Representation and Warranty Framework* (Sept. 17, 2014) (AUD-2014-016) (online at www.fhfa.ig.gov/Content/Files/AUD-2014-016.pdf).

safe and sound implementation of the new framework, and DER will take this information into account in developing its examination plans for 2015.

More recently, a September 2017 OIG audit assessed (1) whether DER’s planned supervisory activities relating to Fannie Mae’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 these planned supervisory activities during the 2015 and 2016 examination cycles.⁵ As detailed in the 2017 audit report, we found that DER identified three risks relating to Fannie Mae’s implementation of the new framework for the 2015 examination cycle: a risk associated with actions taken to [REDACTED]

[REDACTED]

We found that DER planned and performed one targeted examination, entitled Single-Family Loan Quality Center. We also found that DER reported on the results of that targeted examination in the 2015 report of examination before the supervisory activity had been subjected to an internal quality control review, as required by FHFA and DER. DER did not identify risks associated with the new framework as a specific focus for the 2016 examination cycle and did not perform any new framework-related supervisory activities during the examination cycle.

This audit follows on that work. In this audit, we assessed whether DER completed the planned procedures and sufficiently supported its conclusions for that 2015 targeted examination.

FACTS AND ANALYSIS

Required Documents Were Prepared and Approved for the 2015 Loan Quality Center Targeted Examination

As discussed above, DER performed a targeted examination of the LQC at Fannie Mae during the 2015 examination cycle. According to the targeted examination documents, the objective of the targeted examination was “to assess the [REDACTED] employed by the [REDACTED] business unit.” The scope statement in these documents specified that the examination would focus on [REDACTED] with Fannie Mae’s [REDACTED] operations. In addition, the examination was to

⁵ See OIG, *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* (Sept. 22, 2017) (AUD-2017-008) (online at <https://www.fhfaoig.gov/Content/Files/AUD-2017-008>).

include a review of the [REDACTED] that were needed to implement the [REDACTED] with a particular focus on Fannie Mae's [REDACTED]

Required targeted examination documents – the Request Letter, Procedures Document, Meeting Notes, Analysis Memorandum, and Conclusion Letter – were completed, reviewed, and approved by the appropriate DER officials in accordance with the requirements of 2013-DER-OPB-04. Additionally, our review of the Conclusion Letter showed that DER’s conclusion that “FHFA did not identify [REDACTED] [REDACTED] was consistent with conclusions detailed in the Analysis Memorandum. DER performed its required quality control review of the targeted examination’s workpapers prior to issuance of the Conclusion Letter. No exceptions to DER examination standards and FHFA guidance for document preparation and management were identified in this audit. As we reported in our September 2017 audit, the results of this targeted examination were included in the Report of Examination for the 2015 examination cycle before being subject to a required independent quality control review.”⁶

Workpapers Supported DER’s Conclusions Regarding the [REDACTED] for This Targeted Examination

The Procedures Document for this targeted examination was constructed using a combination of work steps selected from FHFA’s *Single-Family Mortgage Underwriting and Acquisition* (Field Test version) examination module and work steps developed by the examiners. The Procedures Document also included a work step for a transaction test, as required in the examination module.⁷

In the Analysis Memorandum, DER concluded that:

- Fannie Mae’s [REDACTED] Fannie Mae standards and requirements,
- Fannie Mae has [REDACTED]
- [REDACTED]

⁶ For a detailed discussion about this shortcoming, see OIG, *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* (Sept. 22, 2017) (AUD-2017-008) (online at <https://www.fhfoig.gov/Content/Files/AUD-2017-008>).

⁷ The workprogram that accompanies the *Single-Family Mortgage Underwriting and Acquisitions* examination module (Field Test version) states that: “Transaction testing...is mandatory and must evidence sufficient work steps to support the findings and conclusions from this examination module.”

• [REDACTED]

The documentation supporting these conclusions included notes documenting meetings with and presentations by Fannie Mae management describing quality control processes and systems, copies of Fannie Mae’s LQC policies and procedures, copies of LQC governance and management reports, descriptions of DER’s testing of repurchase requests, internal audit reports related to this topic, and analyses. DER examiners also performed a transaction test to determine whether [REDACTED] to Fannie Mae [REDACTED]

Rationale for Reduced Transaction Testing Was Not Documented in Accordance with DER’s Guidance on Sampling Practices

As our audit found, DER examiners performed transaction testing designed to determine whether [REDACTED]

[REDACTED] Based on that testing, DER concluded that [REDACTED] the files reviewed [REDACTED] to perform a review to determine [REDACTED] with [Fannie Mae] [REDACTED]

According to the Analysis Memorandum, examiners obtained [REDACTED] and [REDACTED] was reviewed by the [REDACTED] for certain criteria. However, in the Procedures Document, DER documented that it [REDACTED]

[REDACTED] When questioned about this discrepancy, a DER official explained that the examiners determined that the review [REDACTED] constituted a significant representation of the entire population. EPB 2014-01 states, “Examiners may expand or reduce sampling activities as appropriate based on the sampling results and the need to support examination conclusions and findings; however, the examiner should include in the examination workpapers the reasons for expanding or reducing sampling activities.” This explanation was not documented in the supporting workpapers, as directed by EPB 2014-01.

FINDING

DER’s EPB 2014-01 directs that examiners include in the examination workpapers the reasons for expanding or reducing sampling activities. For this targeted examination, we found that DER [REDACTED] from Fannie Mae to conduct a transaction test.

Ultimately, the examiners [REDACTED] because they felt that the tested [REDACTED] were representative of the entire population. This rationale for reducing the sampling activity was not documented in the targeted examination workpapers, as directed by EPB 2014-01. As a result, the workpapers did not provide a third party with a clear understanding of the examination work performed.

CONCLUSION.....

We found that DER performed its planned procedures and prepared the required examination documents for the 2015 targeted examination entitled Single-Family Loan Quality Center. The conclusions that DER presented in the Conclusion Letter for this targeted examination were consistent with those detailed in the targeted examination workpapers. Further, the targeted examination workpapers sufficiently supported DER’s conclusions regarding the [REDACTED]. We found, however, that DER examiners did not document the reason(s) that the sample size was reduced for a transaction test of [REDACTED], as directed by FHFA guidance.

In a companion audit issued today on DER’s execution of a new framework-related targeted examination of Freddie Mac, we found the examination workpapers were not sufficiently documented because they did not reference certain work that was relied upon to support DER’s conclusions on that targeted examination.⁸ In that audit report, we recommended that FHFA reinforce, in examiner training, the need to prepare workpapers for targeted examinations with sufficient detail and clarity to provide a third party with a clear understanding of the examination work performed; the examination findings, conclusions, and ratings reached; and any implications of the findings, conclusions, and ratings. We are not making a recommendation for this audit because we only found a lapse in examiner adherence to FHFA and DER workpaper directives for a single procedure that did not inhibit a third party’s ability to understand the conclusions reached for the targeted examination that was the scope of this audit. We counsel that the sufficiency of examination workpapers—to provide a third-party with a clear understanding of the examination work performed, the examination findings, conclusions, and ratings reached, and any implications of the findings, conclusions, and ratings—is a matter needing continued and continual DER examiner and management attention.

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, which we incorporated as appropriate. In its management response, which is included in the Appendix to this report, FHFA acknowledged our report.

⁸ See OIG, *FHFA Completed its Planned Procedures for a 2016 Representation and Warranty Framework Targeted Examination at Freddie Mac, but the Supporting Workpapers Did Not Sufficiently Document the Examination Work* (March 13, 2018) (AUD-2018-006) (online at www.fhfa.ig.gov/reports/auditsandevaluations).

OBJECTIVE, SCOPE, AND METHODOLOGY

We conducted this audit to assess whether DER completed the planned procedures and sufficiently supported its conclusions for the 2015 targeted examination entitled Single-Family Loan Quality Center.

To accomplish our objective, we reviewed the *FHFA Examination Manual* (December 2013) and the related examination module, *Single-Family Mortgage Underwriting and Acquisitions*; as well as guidance issued by FHFA and DER related to conduct of and supervisory products for targeted examinations. In addition, we reviewed Fannie Mae Selling Guides and Lender Letters related to the new framework.

Specifically, for Fannie Mae, we:

- Reviewed DER’s documentation for the 2015 Single-Family Loan Quality Center targeted examination, including the Procedures Document, Request Letter, Meeting Notes, Analysis Memorandum, Conclusion Letter, and supporting workpapers to see that the required documents were completed and approved in accordance with FHFA and DER guidance, and supported the conclusions reached for the targeted examination.
- Interviewed DER personnel to gain an understanding of the supervisory activities planned and performed to supervise Fannie Mae’s implementation of the new framework.
- Reviewed DER’s supervisory work products to determine the extent of planned and future examinations as it pertains to the automated systems under review in the audit.
- Reviewed the following Fannie Mae Selling Guide Announcements:
 - SEL-2012-08, *New Lender Selling Representations and Warranties Framework* (September 11, 2012)
 - SEL-2014-05, *Lender Selling Representations and Warranties Framework Updates* (May 12, 2014)
 - SEL-2014-16, *Selling Guide Updates* (December 16, 2014)
 - SEL-2015-11, *Selling Representations and Warranties Framework – Origination Defects and Remedies* (October 7, 2015)

- SEL-2016-01, *Selling Representations and Warranties Framework – Independent Dispute Resolution* (February 2, 2016)

We conducted this performance audit from September 2017 through March 2018 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.

APPENDIX: FHFA MANAGEMENT RESPONSE.....



Federal Housing Finance Agency

MEMORANDUM

TO: Marla A. Freedman, Deputy Inspector General for Audits

FROM: Nina A. Nichols, Deputy Director, Division of Enterprise Regulation (DER)^{NAN}

SUBJECT: Draft OIG Report: *FHFA Completed Its Planned Procedures for a 2015 Representation and Warranty Framework Targeted Examination at Fannie Mae, But Did Not Document a Change to Planned Testing*

DATE: March 5, 2018

We are in receipt of the Federal Housing Finance Agency Office of Inspector General's (OIG) draft report referenced above. The audit assessed whether DER completed the planned procedures and sufficiently supported its conclusions for a 2015 representation and warranty framework-related targeted examination.

We are pleased the audit found that DER performed its planned procedures, prepared the required examination documents, and supported examiner conclusions in the targeted examination workpapers. Please feel free to contact me with any questions.

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

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