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Federal Housing Finance Agency
Office of Inspector General

FHFA's Examinations Have Not Confirmed Compliance by One Enterprise with its Advisory Bulletins Regarding Risk Management of Nonbank Sellers and Servicers

Evaluation Report • EVL-2017-002 • December 21, 2016

FEDERAL HOUSING FINANCE AGENCY
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Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) carry out their statutory mission to provide stability and liquidity to the secondary mortgage market by, in large part, purchasing mortgage loans from banks and other lenders that originate them. The Enterprises did not originate and do not service the over $5 trillion in loans they hold or are exposed to in mortgage backed securites. Instead, the Enterprises rely upon third-parties for loan origination and servicing, according to standards and guidelines set by the Enterprises.

Since 2010, the role of nonbanks – non-depository firms unaffiliated with commercial banks – in selling and servicing single-family mortgages has increased dramatically. While nonbanks originated less than 10% of the mortgages purchased by the Enterprises in 2010, the nonbank share of mortgages purchased in 2015 increased to almost 50%. On the servicing side, the nonbank share of mortgages held by the Enterprises saw similar growth, increasing five-fold between 2010 and 2015 from 7% to almost 35%.

The increase in nonbank sellers and servicers has yielded increased risk. Between 2012 and 2016, both the Enterprises and their safety and soundness regulator, the Federal Housing Finance Agency (FHFA) have acknowledged several risk factors associated with nonbank seller/servicers, including the lack of a federal prudential regulator, potential liquidity and financial strength issues, and operational problems caused by rapid acquisitions of servicing portfolios and the higher costs associated with servicing delinquent loans.

In the 2016 OIG Audit and Evaluation Plan, we explained that we intended to focus our resources on four areas of significant risk facing FHFA. One of the four risk areas we identified was the risk from counterparties the Enterprises rely upon as part of their business operations to fulfill their mission. One of the largest counterparty risks to the Enterprises is the risk posed by nonbank seller/servicers because of their growing share of originations and servicing of mortgage loans acquired by the Enterprises. We said in the 2016 Audit and Evaluation Plan that in light of this risk, we intended to assess FHFA's oversight of Enterprise risk management of counterparties.

FHFA has issued three advisory bulletins setting forth its supervisory expectations for Enterprise oversight of mortgage sellers and servicers, whether depository institutions or nonbanks. In this evaluation, we assessed FHFA's efforts to determine whether the Enterprises' practices were in compliance with these advisory bulletins regarding risk management of nonbank sellers and servicers.

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We found that DER conducted supervisory activities to assess whether one Enterprise's practices comply with the supervisory expectations set forth in the three advisory bulletins, and that DER concluded that the Enterprise's [redacted]. We further found that DER examined the other Enterprise's compliance with only one of the advisory bulletins, and that DER concluded in 2014 that the Enterprise [redacted] DER conducted no supervisory activities to determine the other Enterprise's compliance with the other two advisory bulletins and, as a result, issued no findings or conclusions related to its compliance.

We also reviewed DER's supervisory plan for 2016 and found no targeted examinations that would position DER to reach conclusions regarding whether the second Enterprise's practices comply with the supervisory expectations set forth in these two advisory bulletins. Although DER is conducting limited ongoing monitoring of the Enterprise's risk management related to seller/servicers, these activities are not specific to nonbank seller/servicers and do not identify nonbank risk management as a focus area.

Based on these findings, we recommend that FHFA conduct examination activities necessary to determine whether the Enterprise's risk management of nonbank seller/servicers satisfies FHFA's supervisory expectations as expressed in its advisory bulletins. FHFA generally agreed with this recommendation. FHFA's response, however, does not commit the Agency to complete the specific actions described in our recommendation. Given the Agency's statement that it "generally agree[s]" with our recommendation, we will treat its response as an agreement to implement the recommendation as written.

This report was prepared by Gregg Schwind, Attorney Advisor, and Adrienne Freeman, Investigative Counsel. We appreciate the cooperation of FHFA staff and employees of Fannie Mae and Freddie Mac, as well as the assistance of all those who contributed to the preparation of this report.

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

Kyle D. Roberts
Deputy Inspector General for Evaluations

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ABBREVIATIONS

AB	Advisory Bulletin
DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FHFA or Agency	Federal Housing Finance Agency
GAO	U.S. Government Accountability Office
Ginnie Mae	Government National Mortgage Association
MRA	Matter Requiring Attention
MSR	Mortgage Servicing Right
OCC	Office of the Comptroller of the Currency
OIG	Federal Housing Finance Agency Office of Inspector General
ROE	Report of Examination
UPB	Unpaid Principal Balance

BACKGROUND

The Role of Mortgage Sellers and Servicers in the Enterprises' Operations

Established by Congress, Fannie Mae and Freddie Mac (collectively, the Enterprises) are tasked with the mission of providing stability and liquidity to the secondary market for residential mortgages. The Enterprises carry out this mission by purchasing single-family and multifamily mortgage loans from banks and other lenders that originate them. The Enterprises pool single-family loans into mortgage-backed securities, which in turn are sold to investors. The Enterprises guarantee the payment to investors of principal and interest on the underlying loans, and charge sellers a guarantee fee as compensation.

Mortgage Sellers and Servicers

The Enterprises do not originate or service the mortgage loans they acquire. These loans are originated by mortgage *sellers* that contractually agree to follow standards and guidelines established by the Enterprises.[1] Mortgage sellers deliver the loans to the Enterprises in exchange for a security or for cash.

Once a mortgage loan closes, mortgage *servicers* become the primary point of contact for borrowers. Servicers collect principal and interest payments, pay property taxes and insurance costs from escrow accounts, and monitor and report delinquencies. Servicers also engage in loss mitigation efforts – including loan modifications, repayment plans, forbearances, and short sales – in accordance with the Enterprises' guidelines and, if necessary, preserve properties and process foreclosures and bankruptcies. Servicers can acquire mortgage servicing rights (MSRs) by retaining them after originating the loan or through purchasing existing MSRs from other entities.

Most sellers of loans to the Enterprises are also mortgage servicers, and vice versa. Of the top 50 mortgage sellers to the Enterprises in 2015, 49 were also servicers of loans held by the Enterprises; of the top 50 servicers of Enterprise-held loans in 2015, 47 also originated mortgage loans.

Mortgage sellers and servicers can be depository institutions or nonbank entities.[2] Depository institutions include commercial banks, credit unions, and thrifts, and they typically have a

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[1] Mortgage sellers are subject to contractual representation and warranty obligations that permit the Enterprises to, among other things, demand the repurchase of a loan if the loan does not meet the Enterprises' underwriting and eligibility guidelines.

[2] For purposes of this report, we adopt the definitions of "bank" and "nonbank" used by the Government Accountability Office (GAO) in its April 2016 report on nonbank mortgage servicers. "Banks" are defined as

variety of business lines, including customer deposits, loan and other credit products (e.g., mortgage loans, auto loans, and lines of credit) and credit cards. Depository institutions are subject to federal supervision from the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), or the Board of Governors of the Federal Reserve System (Federal Reserve) for safety and soundness. By operation of rules promulgated by the OCC and Federal Reserve, large depository institutions are subject to capital requirements adopted by the Basel Committee on Banking Supervision (Basel III).

Nonbank mortgage seller/servicers generally specialize in originating and/or servicing real-estate mortgage loans. Nonbank seller/servicers are not subject to the same federal oversight and capital requirements as depository institutions. Although states are required to regulate non-depository institutions, that regulation typically focuses on consumer protection.

Growth of Nonbank Seller/Servicers

In the aftermath of the 2008 financial crisis, banks have stepped away from mortgage lending and nonbanks have stepped in to fill the gap. Since 2010, there has been a marked increase in loans sold to the Enterprises by nonbank sellers and a corresponding decrease in loans sold by depository institutions. In 2010, only 10.6% of Fannie Mae's single-family mortgage loans (measured by acquisition unpaid principal balance, or UPB) were purchased from nonbank sellers; by 2015 that number had grown to 51.5%. Over the same period, the share of Freddie Mac loans purchased from nonbanks increased from 6.7% to 43.1%.[3]

There has also been significant growth in the market share of nonbank servicers since 2010.[4] The share of Fannie Mae-held loans serviced by nonbank servicers rose from 8.5% (measured

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bank holding companies, financial holding companies, savings and loan holding companies, insured depository institutions, and credit unions, including any subsidiaries or affiliates of these types of institutions; "nonbanks" are entities that are not banks. *See* GAO, *Nonbank Mortgage Servicers: Existing Regulatory Oversight Could Be Strengthened*, at 1, note 1 (Apr. 14, 2016) (GAO-16-278) (online at www.gao.gov/assets/680/675747.pdf).

[3] The Fannie Mae nonbank share for 2010 is based on the top 50 single-family loan sellers in 2010. The 2015 nonbank share for Fannie Mae, and both nonbank share figures for Freddie Mac, are based on all loan purchases by each Enterprise during those years.

[4] The GAO Report published earlier this year contains additional statistics in trends related to nonbank servicers. *See* GAO, *Nonbank Mortgage Servicers: Existing Regulatory Oversight Could Be Strengthened*, at 8-16, *supra* note 2. In addition, a recent report by the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) noted the increased role of nonbank servicers in Treasury's Home Affordable Modification Program (HAMP). *See* SIGTARP, *Quarterly Report to Congress*, at 63-76 (Apr. 27, 2016) (online at www.sigtarp.gov/Quarterly%20Reports/April_27_2016_Report_to_Congress.pdf). SIGTARP found that nonbanks service a greater share of mortgages (56%) in HAMP than banks (44%) and that the nonbank share is increasing. Observing that a number of nonbank servicers have engaged in practices that harm homeowners, and that some servicers have been subject to law enforcement actions for failing to follow HAMP rules, SIGTARP concluded that there is an increased need for regulatory oversight.

by servicing UPB) in 2010 to 38.2% in 2015; at Freddie Mac, the nonbank servicing share increased from 5.0% to 27.0%.[5]

The largest nonbank servicers – and the servicers who have experienced by far the greatest growth since 2012 – are called "special" or "specialty" servicers because they specialize in servicing delinquent loans. Between 2010 and 2013, the Enterprises transferred large numbers of seriously delinquent loans[6] to these servicers. As of year-end 2015, nonbank servicers serviced 76.0% of Fannie Mae's seriously delinquent loan portfolio, and 44.6% of Freddie Mac's seriously delinquent portfolio. Two nonbank servicers together serviced over half of Fannie Mae's seriously delinquent loans in 2015, and Freddie Mac's top two nonbank servicers of seriously delinquent loans serviced just under 25% of the Enterprise's seriously delinquent portfolio in 2015.

Seriously delinquent loans also comprise a larger share of the mortgage loan portfolios of nonbanks compared to banks. For example, of the combined Enterprise servicing portfolios of the Enterprises' three largest bank servicers – [redacted] – less than 1% was seriously delinquent. In contrast, approximately 20% of the servicing portfolio of one large nonbank servicer for one Enterprise – [redacted] – and approximately 5% of the servicing portfolios of three large nonbanks for both Enterprises – [redacted] – were seriously delinquent at year-end 2015.

Freddie Mac has also disclosed the significant role of nonbank specialty servicers in servicing subprime, Alt-A, and option ARM loans backing single-family private label mortgage securities held in its portfolio.[7] Subprime, Alt-A, and option ARM are high-risk components of Freddie Mac's mortgage-related securities. At year-end 2014, one nonbank servicer was responsible for servicing 43% of Freddie Mac's investments in these securities.

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[5] As has been noted in industry literature, nonbank companies are not new to the mortgage industry. According to the Urban Institute, nonbanks serviced approximately 30% of the industry from 2002 to 2007. *See* Urban Institute, *Nonbank Servicer Regulation, New Capital and Liquidity Requirements Don't Offer Enough Loss Protection*, at 2 (Feb. 2016) (online at www.urban.org/sites/default/files/alfresco/publication-pdfs/2000633-Nonbank-Servicer-Regulation-New-Capital-and-Liquidity-Requirements-Don't-Offer-Enough-Loss-Protection.pdf).

[6] The Enterprises define seriously delinquent loans as loans that are 90 or more days delinquent.

[7] These loan products and their presence in Freddie Mac non-agency securities are explained in Freddie Mac's 2014 Annual Report. *See* Freddie Mac, *2014 Annual Report (Form 10-K)*, at 35, 80, 104-105 (online at www.freddiemac.com/investors/er/pdf/10k_021915.pdf).

Risks Associated with Nonbank Mortgage Seller/Servicers

In a 2014 evaluation, we outlined a number of the risks created by the rising volume of nonbank sellers.[8] We reported that some sellers, particularly nonbank mortgage companies, may lack the financial capacity to honor their repurchase obligations. We explained that depository institutions, which had been the most significant mortgage originators and sellers to the Enterprises, are generally well-capitalized, benefit from broad access to funding, and maintain diverse business lines. In contrast, we reported that some nonbank sellers had relatively limited financial capacity and were not subject to federal safety and soundness oversight. We cautioned that the Enterprises could incur financial losses on mortgages purchased from nonbanks if the Enterprises subsequently determined that the mortgages had not met established Enterprise underwriting standards.

FHFA has regularly acknowledged, in its annual Performance and Accountability Reports and Reports to Congress, that the Enterprises have significant risk exposure to nonbank seller/servicers. Between 2012 and 2016, FHFA highlighted several dimensions of the risks associated with nonbank seller/servicers that distinguish these entities from depository institution seller/servicers:

- **Lack of Regulatory Oversight.** Nonbank seller/servicers are not subject to the federal prudential regulatory oversight to which federally insured depository institutions are subject.[9] Prudential standards applicable to banks require formal stress testing and capital ratios intended to protect customer deposits; nonbanks do not have similar standards.[10] In its 2015 Annual Report, the Financial Stability Oversight

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[8] OIG, *Recent Trends in the Enterprises' Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies* (July 17, 2014) (EVL-2014-010) (online at www.fhfaoig.gov/Content/Files/EVL-2014-010_0.pdf).

[9] *See* FHFA, *2015 Performance and Accountability Report*, at 28 (Nov. 16, 2015) (online at www.fhfa.gov/AboutUs/Reports/Pages/Performance-and-Accountability-Report-2015.aspx). OIG has previously observed the risk caused by the unequal regulatory framework and oversight for nonbank seller/servicers compared to banks. *See* OIG, *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages*, at 2 (July 1, 2014) (AUD-2014-014) (online at www.fhfaoig.gov/Content/Files/AUD-2014-014.pdf).

[10] GAO observed in its April 2016 report that nonbank servicers are subject to oversight from the Consumer Financial Protection Bureau (CFPB), and to oversight and requirements imposed by many states. *See* GAO, *Nonbank Mortgage Servicers: Existing Regulatory Oversight Could be Strengthened*, at 32-37, *supra* note 2. In addition, FHFA has an indirect oversight role through its guidance to the Enterprises, approval authority over large MSR transfers, and, in certain circumstances, its ability to examine a seller/servicer. *Id.* at 38, 45-46.

Council observed that the absence of capital and liquidity standards could inhibit the ability of nonbank servicers to withstand an economic downturn.[11]

- **Liquidity Risk.** FHFA has recognized that liquidity risk is more pronounced for nonbank servicers. All servicers need to maintain sufficient liquidity because they are responsible for advancing principal, interest, property taxes, and insurance if a borrower is delinquent or defaults on a loan. In contrast to bank-affiliated seller/servicers, nonbank seller/servicers have lower levels of capital and generally rely on lines of credit and short-term funding. Nonbanks also lack access to customer deposits and to funding through the Federal Reserve in times of need.

- **Higher Cost of Servicing Delinquent Loans.** As discussed above, some nonbank servicers specialize in servicing delinquent loans and, compared to banks, a larger portion of the loans they service are delinquent. Delinquent loans are more costly to service compared to performing loans because they require intervention by servicer personnel. A recent estimate based on Mortgage Bankers Association data is that the average cost of servicing a non-performing loan is over 13 times that of servicing a performing loan.

- **Rapid Growth of Nonbank Seller/Servicers.** FHFA has said that transfers of large mortgage servicing portfolios from banks to rapidly growing nonbank companies create a new level and type of risk to the Enterprises.[12] Three of the Enterprises' top nonbank servicers at least doubled in size between June 2012 and June 2013. FHFA has noted that the unprecedented growth of nonbank seller/servicers potentially exposes the Enterprises to an elevated level of operational risk in the event that one of these firms is unable to fulfill its contractual obligations to an Enterprise.[13] For borrowers, rapid growth creates a risk of insufficient infrastructure to service the loans and, as a result, accounting, payment processing, and loss mitigation errors.

- **Need to Locate Replacement Servicers if a Servicer Fails.** The Enterprises have contractual rights that permit them to require the transfer of servicing portfolios under

[11] The Council is chaired by the Secretary of the Treasury, and its voting members include the FHFA Director, the heads of the federal banking regulators, the Chairman of the Securities and Exchange Commission, and the Chairperson of the Commodities and Futures Exchange Commission. The Council was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act and is charged with, among other things, identifying risks to the financial stability of the United States that could arise from large, interconnected bank holding companies and nonbank financial companies.

[12] FHFA, *2012 Report to Congress*, at 19 (June 13, 2013) (online at www.fhfa.gov/AboutUs/Reports/Pages/FHFA-2012-Annual-Report-to-Congress.aspx).

[13] FHFA, *2013 Report to Congress*, at 9 and 12 (June 13, 2014) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2013_Report_to_Congress.pdf).

certain conditions, including a servicer's failure to meet net worth or performance requirements. FHFA has warned that in the event of a large nonbank servicer failure, it could be extremely difficult to transfer large servicing books in a timely manner to other servicers with the financial and operational capacity to absorb them.

- **Low Financial Strength of Nonbanks.** FHFA has stated that nonbank seller/servicers may lack the financial strength of depository institutions that have traditionally been the Enterprises' primary seller/servicer counterparties. Nonbanks carry higher credit risk because, unlike large traditional banks, nonbanks have lower levels of capital and a more limited ability to raise capital and obtain funding.

The Enterprises have disclosed the risks posed by nonbank seller/servicers in their annual SEC filings over the past several years.[14] The growth in market share by nonbanks is an industry trend that has been recognized by others as altering the risk landscape within the industry.[15] In September 2014, the president of the Government National Mortgage Association, a major guarantor of mortgage-backed securities, summarized the shift in the allocation of risk and attendant implications in these terms:

> For a government guarantor, a counterparty landscape dominated by enormous banking institutions with substantial resources, diverse lines of business and deep access to low-cost funding is an appealing proposition. Each step away from this state represents a meaningful increase in the possibility of loss to Ginnie Mae. . . . While the advantage in capital and funding sources in particular dramatically favors the risk profile of the banks, the stringent regimen of prudential regulation that undergirds their activities presents an additional advantage. When the MSR portfolio is heavily concentrated in the hands of such regulated institutions, as it had been, Ginnie

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[14] Fannie Mae reported in its 2013 Annual Report (Form 10-K) that it was acquiring an increasing portion of its mortgages from nonbank sellers and that a larger portion of its servicing was being performed by nonbanks. Fannie Mae stated that these institutions "may not have the same financial strength, liquidity or operational capacity as our larger depository financial institution counterparties," potentially affecting their ability to satisfy their repurchase or compensatory fee obligations or to service mortgage loans. Fannie Mae disclosed similar risks in its 2014 and 2015 Annual Reports. Freddie Mac made similar statements in its annual 10-K filings for 2014 and 2015, noting its increasing exposure to nonbank institutions as it acquired more loans directly from nonbanks and relied upon nonbanks to service a growing share of single-family loans, and in particular, troubled loans.

[15] *See generally*, Mortgage Bankers Association and PricewaterhouseCoopers, *The Changing Dynamics of the Mortgage Servicing Landscape* (June 2015) (online at www.pwc.com/us/en/consumer-finance/publications/assets/pwc-mortgage-servicing-landscape-dynamics.pdf). The authors of a March 2015 study observed that nonbanks gained significant market share at the expense of large banks and that loans originated by nonbanks are generally riskier than those originated by banking institutions. *See* Stephen Oliner, Edward Pinto and Brian Marein, AEI's International Center on Housing Risk, *Study shows seismic shift in lending away from large banks to nonbank s continued in February* (Mar. 30, 2015) (online at www.housingrisk.org).

> Mae can consider itself to have outsourced a significant portion of its risk management to banking regulators with a vast experience in attending to the "safety and soundness" of these institutions. As the allocation among various actors shifts in favor of nonbanks, no equivalent entity is playing a similar role to that of banking regulators.

FHFA has issued three advisory bulletins setting forth its supervisory expectations for Enterprise oversight of mortgage sellers and servicers, whether depository institutions or nonbanks. In this evaluation, we assessed FHFA's efforts to determine whether the Enterprises are in compliance with these advisory bulletins regarding risk management of nonbank sellers and servicers.

FACTS AND ANALYSIS……………………………………………………

FHFA has repeatedly emphasized the need for effective management of the Enterprises' relationships with nonbanks. In its 2013 Report to Congress, FHFA referred to the need for "rigorous standards" for managing third-party relationships, particularly in light of the operational risk associated with nonbank, specialty servicers. In its most recent Performance and Accountability Report, FHFA reported that the Enterprises continue to have "significant risk exposure" to nonbank seller/servicers, and that FHFA supervision of Enterprise nonbank risk management was an "oversight priority."

Consistent with its public statements on the need for supervisory standards and oversight, FHFA has issued three advisory bulletins that communicate its supervisory expectations with regard to Enterprise oversight of seller/servicers.[16] The Agency subsequently emphasized in its 2014 Report to Congress that "implementing effective management programs to meet expectations articulated in FHFA Advisory Bulletins for all matters related to counterparty risk management should be a priority."[17] These three advisory bulletins are:

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[16] In this evaluation we look at actions taken by FHFA as supervisor of the Enterprises to determine compliance with advisory bulletins regarding risk management of nonbank seller/servicers. Although FHFA in its role as conservator has also taken actions affecting Enterprise relationships with nonbank sellers and servicers, such as directing the Enterprises in 2015 to implement operational and financial eligibility requirements for all single-family sellers and servicers, those actions are beyond the scope of this evaluation. We recognize that FHFA, in its role as supervisor, has undertaken examinations of the Enterprises relating to nonbank sellers and/or servicers; this work is also outside the scope of this report.

[17] In its technical comments to our report, FHFA objected to the use of the term "compliance" with respect to Enterprise actions relating to FHFA's advisory bulletins on the grounds that such bulletins do not have the power of a law or regulation. FHFA's objection is at odds with its own practice: it regularly directs the entities it regulates to comply with its supervisory guidance. For example, FHFA's Prudential Management and

Advisory Bulletin 2013-01 – *Contingency Planning for High-Risk or High-Volume Counterparties*. The supervisory guidance in AB 2013-01 directs the Enterprises (and Federal Home Loan Banks) to establish criteria for identifying high-risk or high-volume counterparties based on internal limits, including ranges and tolerances. According to AB 2013-01, the Enterprises should have: (1) written contingency plans for high-risk and high-volume counterparties, including plans for individual counterparties or groups of related counterparties; and (2) policies that limit concentrations of credit risk and establish exposure limits to individual counterparties and groups of related counterparties, in accordance with FHFA's prudential management and operations standards.

Advisory Bulletin 2014-06 – *Mortgage Servicing Transfers*. Recognizing that nonbanks have increased their purchases of MSRs and servicing of mortgage loans, AB 2014-06 sets forth FHFA's supervisory expectation that each Enterprise scrutinize proposed MSR transfers in light of financial, operational, and legal risk factors; approve an MSR transfer only if it is consistent with sound business practice, aligned with the Enterprise's board-approved risk appetite, and in compliance with regulatory and conservator requirements; and monitor the transfer after approval.

Advisory Bulletin 2014-07 – *Oversight of Single-Family Seller/Servicer Relationships*. In AB 2014-07, FHFA states that each Enterprise should establish a framework and policy for seller/servicer oversight.[18] Each Enterprise should evaluate financial, operational, legal, compliance, and reputation risks associated with single-family seller/servicers, take appropriate action to mitigate those risks or reduce the Enterprise's exposure, and conduct risk-based ongoing monitoring of seller/servicers. Although AB 2014-07 does not require an Enterprise's assessment of a nonbank to be different from its assessment of a depository institution, it observes that "[i]ndividual seller/servicers may present unique risks due to their organizational structure and complexity; operational and technological capabilities and capacity; experience; access to financial resources, both funding and capital; and scope of regulatory oversight." AB 2014-07 also states that an Enterprise's policy for the scope and

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Operations Standards (PMOS) direct that each regulated entity "should comply with all applicable laws, regulations, and supervisory guidance (e.g., advisory bulletins)," (12 C.F.R. Part 1236, Appendix (Standards 1-10)) and FHFA's Examination Manual explains that a purpose of ongoing monitoring of an Enterprise is "to determine the Enterprise's compliance with supervisory guidance" and other agency direction. FHFA, *Examination Manual*, at 21 (Dec. 2013). Our use of the term "compliance" with respect to an advisory bulletin mirrors FHFA's use of that term.

[18] In our 2014 audit report, *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages*, OIG found that FHFA had not established a process or framework for managing the risks presented by nonbank servicers specializing in servicing delinquent loans. In response to the OIG report, FHFA committed to issue guidance setting forth expectations for how the Enterprises manage risks associated with the servicing of troubled loans, including by nonbank servicers. FHFA also committed to issue guidance describing supervisory expectations for the Enterprises' risk management of MSR transfers. AB 2014-06 and 2014-07 reflect those supervisory expectations.

frequency of monitoring "should be commensurate with the risk associated" with particular seller/servicers.

DER Identified Risks Posed by Nonbank Seller/Servicers in its Risk Assessments

Like other federal financial regulators, FHFA maintains that it uses a risk-based approach to carry out its supervisory activities. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises. DER has assigned a core team of examiners to plan and conduct supervisory activities for each Enterprise, led by an examiner-in-charge.

FHFA stresses in the *Examination Manual* the critical role of risk assessments in planning supervisory activities to focus supervisory attention on high-risk matters and in developing an annual supervisory strategy that addresses FHFA's supervisory concerns. According to the *Examination Manual*, the goal of a risk assessment is to present "a comprehensive view of the Enterprise." A risk assessment should include a number of elements, such as a description of the types of risk (credit, market, liquidity, reputational, operational, model, and legal) and their level (high, moderate, or low) and direction (increasing, stable, or decreasing).[19] FHFA directs that a risk assessment should be prepared semi-annually and reflect an updated view of risk based upon supervisory activities conducted in the first half of the year and any other changes in risk caused by the external environment.[20] The examiners-in-charge prepare separate risk assessments for each Enterprise.

In its recent Reports to Congress, FHFA has highlighted the shift from federally-regulated banks (and their affiliates) to less regulated seller/servicers with limited access to capital. FHFA has advised that its monitoring of specialty servicers and counterparty credit risk is warranted because of nonbank growth and concerns that such servicers may not have the capacity to handle large increases in servicing volumes. FHFA publicly reported that five nonbank servicers serviced 60 percent of the seriously delinquent mortgage loans held by one Enterprise.[21] Risk assessments for both Enterprises for the 2014, 2015, and 2016 supervisory

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[19] For a thorough discussion of the critical importance of risk assessments to DER's supervisory activities, see OIG, *Utility of FHFA's Semi-Annual Risk Assessments Would Be Enhanced Through Adoption of Clear Standards and Defined Measures of Risk Levels* (Jan. 4, 2016) (EVL-2016-001) (online at www.fhfaoig.gov/Content/Files/EVL-2016-001.pdf); OIG, *FHFA's Supervisory Planning Process for the Enterprises: Roughly Half of FHFA's 2014 and 2015 High-Priority Planned Targeted Examinations Did Not Trace to Risk Assessments and Most High-Priority Planned Examinations Were Not Completed* (Sept. 30, 2016) (AUD-2016-005) (online at https://origin.www.fhfaoig.gov/Content/Files/AUD-2016-005.pdf).

[20] In May 2016, FHFA issued updated guidance to DER staff setting forth required procedures and documentation for the preparation of Enterprise risk assessments.

[21] *See* FHFA, *2015 Report to Congress*, at 18 (June 15, 2016) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2015_Report-to-Congress.pdf).

cycles mirror FHFA's public statements on the shift from bank to nonbank for loan origination and servicing, and the increased risks created by this shift. Read collectively, the risk assessments discuss, in greater detail, the risks associated with the rise of nonbank seller/servicers, which FHFA views as the same for both Enterprises.

For example, the risk assessments mirror FHFA's public statements that: significant transfers of mortgage servicing from banks to non-depository institutions over the past few years have increased the profile of nonbank servicers;[22] nonbank servicers "pose a significant and growing risk due to serious operational and regulatory issues,"[23] including whether they have sufficient financial and operational capacity to absorb transfers of large servicing books in the event of a servicer failure;[24] and increased concentrations with a few large nonbank servicers created increasing risk.[25]

The 2015 risk assessments for both Enterprises, which provided the foundation for DER's 2016 supervisory plans, continued DER's focus on risks associated with nonbank seller/servicers. FHFA examiners noted that continuing MSR transfer transactions resulted in an increased concentration of nonbank servicers. Operational risk, which is inherent in the management of seller/servicer relationships, is heightened because nonbank servicers lack a federal prudential regulator to ensure that they have adequate liquidity, compliance management systems, vendor oversight, and continuity planning. Given that the regulatory environment for nonbanks servicers is evolving, increased regulation may result in increased servicing and compliance costs. Increased servicing costs could call into the question the ability of nonbank servicers to sustain their low cost servicing model and meet their contractual servicing obligations.

DER's Supervisory Activities Have Not Confirmed Compliance by One Enterprise with FHFA's Advisory Bulletins Pertaining to Risk Management of Nonbank Seller/Servicers

Based on the analysis in its risk assessments, DER is to prepare an annual supervisory strategy and supervisory plan that identifies and schedules the specific supervisory activities it intends to conduct during the year. These supervisory activities include targeted examinations and ongoing monitoring. DER examiners are tasked with developing an annual supervisory

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[22] FHFA, *2013 Report to Congress*, at iv (June 13, 2014) (online at www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2013_Report_to_Congress.pdf).

[23] FHFA, *2014 Report to Congress*, at 16 (June 15, 2015) (online at www.fhfa.gov/AboutUs/Reports/Pages/Annual-Report-to-Congress-2014.aspx).

[24] *Id.*

[25] *Id.* "Counterparty risk remains high at Freddie Mac due to…concentrations in a few large bank and nonbank servicers, and significant operational and regulatory issues."

plan, revised at mid-year, for each Enterprise. Each supervisory plan sets forth the planned supervisory activities for the year.

The purpose of ongoing monitoring is to analyze real-time information and to use these analyses to identify Enterprise practices and changes in an Enterprise's risk profile that may warrant supervisory attention. Ongoing monitoring is also "used to determine the status of the Enterprise's compliance with supervisory guidance, MRAs [Matters Requiring Attention], and conservatorship directives." Targeted examinations complement ongoing monitoring by enabling examiners to conduct "a deep or comprehensive assessment" of the areas found to be of high importance or risk.

DER examiners may identify supervisory concerns or deficiencies occurring at an Enterprise as a result of targeted examinations or ongoing monitoring. According to FHFA, only the most serious supervisory deficiencies are categorized as MRAs.[26] DER has issued most MRAs to the Enterprises as a result of targeted examinations.

In light of FHFA's supervisory guidance regarding Enterprise management of seller/servicers and DER's identification of nonbank seller/servicers as a significant risk in the risk assessments, we assessed whether DER has examined Enterprise compliance with these advisory bulletins with respect to their management of nonbank seller/servicer risks.

DER Has Concluded, Based on the Information Learned During its Examinations, that the Practices of One Enterprise Comply with Supervisory Expectations in its Three Advisory Bulletins

Our review of DER's supervisory plans and examination documentation found that DER conducted supervisory activities to assess the compliance by one Enterprise with the three advisory bulletins, and concluded that [redacted]. For AB 2013-01, DER conducted ongoing monitoring in 2014 and 2015 of seller/servicer contingency planning by that Enterprise and [redacted].

For AB 2014-06 and AB 2014-07, DER conducted a targeted examination in 2015 of management of nonbank seller/servicer risks by that Enterprise and reviewed, among other things, its compliance with FHFA's supervisory expectations for MSR transfers and oversight of single-family seller/servicer relationships. DER concluded that [redacted]

[26] According to FHFA, MRAs are the most serious supervisory matters and include non-compliance with laws or regulations that result or may result in significant risk of financial loss or damage to the regulated entity; repeat deficiencies that have escalated due to insufficient action or attention; unsafe or unsound practices; and matters that have resulted, or are likely to result, in an unsafe or unsound condition. MRAs also include breakdowns in risk management, significant control weaknesses, or inappropriate risk-taking.

[redacted] and that [redacted].

DER's 2016 examination activities for the same Enterprise include ongoing monitoring to continue to assess its continuing compliance with relevant advisory bulletins. The scope of this monitoring includes: (1) how that Enterprise manages [redacted] pursuant to AB 2014-07; and (2) its [redacted] pursuant to AB 2013-01.

DER Has Examined Whether the Second Enterprise's Practices Comply with Only One of the Three Relevant Advisory Bulletins

In the June 2015 submission of its 2014 Report to Congress, FHFA advised that "it is critical that [redacted] continue to monitor counterparty credit risk, particularly given the risk arising from non-depository seller/servicers and mortgage insurers" and that "[i]mplementing effective management programs to meet expectations articulated in FHFA Advisory Bulletins for all matters related to counterparty risk management should be a priority." FHFA's representations to Congress underscored the critical importance of Enterprise implementation of its supervisory guidance set forth in the three advisory bulletins issued in 2013 and 2014.

We found that DER conducted a targeted examination of the counterparty credit risk management by the other Enterprise in 2014 and concluded that [redacted]. DER [redacted] In August 2016, DER [redacted] after determining that the Enterprise [redacted].

Our review of DER's supervisory plans for this second Enterprise and examination documentation found no evidence that DER conducted supervisory activities in 2014 or 2015 to determine its compliance with the other two advisory bulletins (AB 2014-06 and AB 2014-07) with respect to its management of nonbank seller/servicer risks. We identified no conclusion letters in which DER addressed whether that Enterprise was in compliance with these two advisory bulletins. We recognize that DER generally conducted ongoing monitoring of counterparty credit risk and third-party risk management in 2015. This monitoring included attending meetings with Enterprise management, reviewing documents, and providing high-level feedback. We found no evidence that DER issued any findings or conclusions related to compliance by the second Enterprise with these two advisory bulletins.

Like other federal financial regulators, FHFA directs that results, conclusions, findings, and supervisory concerns from supervisory activities completed during the annual supervisory cycle are to be summarized in a written Report of Examination (ROE), which is to be issued to the board of directors of each regulated entity. Because DER had not [redacted] from its supervisory activities respecting compliance by the second Enterprise with AB 2014-06 and AB 2014-07 during 2015, [redacted] to report in its 2015 ROE. Instead, DER included [redacted]

[redacted]

DER's Planned Examination Activities in 2016

We reviewed DER supervisory work planned for 2016 to identify activities that may address compliance by this second Enterprise with AB 2014-06 and AB 2014-07 and address their application to the management of risks from nonbank seller/servicers. As discussed, FHFA has repeatedly recognized the risks associated with nonbank seller/servicers, described them in internal risk assessments for 2015 and in the June 2015 Report to Congress, and in particular has underscored the critical priority for this Enterprise to implement "effective management programs to meet expectations articulated in FHFA advisory bulletins for all matters related to counterparty risk management." As of March 2016, when DER issued its 2015 ROE, management for this Enterprise had concluded that its practices did not meet the guidance in AB 2014-07.

Based on our review of DER's supervisory plan for 2016, we found no targeted examinations planned for 2016 that would position DER to reach conclusions about compliance by this Enterprise with these two advisory bulletins. From our review, it appears that DER is conducting two relevant ongoing monitoring activities: one focuses on counterparty credit risk management by this Enterprise; the other focuses on the Enterprise's development of a third-party risk management framework. These planned ongoing monitoring activities include several types of counterparties. They are not specific to nonbank seller/servicers and do not identify nonbank risk management as a focus area.

With respect to DER's monitoring of this Enterprise's counterparty credit risk management, although DER examiners are to assess the level of compliance with supervisory guidance, the [redacted] does not identify AB 2014-07 or describe any supervisory activities that will examine whether the Enterprise has [redacted]. DER examiners are completing this monitoring work primarily by calling into meetings and participating in conference calls.

With respect to DER's ongoing monitoring of this Enterprise's third-party risk management framework, the procedures document for this activity identifies AB 2014-07 as one of several sources of guidance DER considered when developing the procedures. According to this document, DER will conduct a gap assessment of the Enterprise's third-party risk management relative to FHFA's third-party risk management standards. The planning document states that DER plans to review the results of its gap assessment, the results of its sampling/testing, and meetings with Enterprise management to determine whether there are any supervisory concerns.[27] The planning document also states that any supervisory concerns will be communicated to management. The examination procedures do not mention or otherwise identify [redacted]; nor do the procedures explain how examiners will monitor [redacted] The lead examiner stated to OIG that examiners will not opine on the Enterprise's compliance with AB 2014-07 as part of the ongoing monitoring activity.

Our review of DER's supervisory plan for 2016 identified no supervisory activity planned to assess the Enterprise's compliance with AB 2014-06, transfers of mortgage servicing rights.[28]

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[27] OIG recently published a report describing DER's poor track record completing targeted examinations of Fannie Mae. *See* OIG, *FHFA's Targeted Examinations of Fannie Mae: Less Than Half of the Targeted Examinations Planned for 2012 Through 2015 Were Completed and No Examinations Planned for 2015 Were Completed Before the Report of Examination Issued* (Sept. 30, 2016) (AUD-2016-006) (online at www.fhfaoig.gov/Content/Files/AUD-2016-006.pdf).

[28] In its technical comments to this report, FHFA asserted that DER "recently completed a review of the Enterprise's controls in this area." OIG reviewed the applicable examination workpapers and found that the scope of that work was relatively narrow and the bulk of the field work occurred in 2011—well prior to FHFA's issuance of supervisory expectations on MSR transfers in the form of AB 2014-06. FHFA did not assert that it has reached the overall conclusion that Fannie Mae's practices comply with the Agency's supervisory expectations.

FINDING ....

FHFA has warned of the Enterprises' significant risk exposure to nonbanks and is aware of shortcomings in [redacted] practices but has not confirmed that [redacted] practices comply with FHFA's advisory bulletins pertaining to risk management of nonbank seller/servicers.

Since 2012, FHFA has repeatedly recognized in its annual Performance and Accountability Reports, Reports to Congress, risk assessments, and supervisory guidance that the Enterprises have significant risk exposure to nonbank seller/servicers. In its most recent Performance and Accountability Report, FHFA reported that the Enterprises continue to have "significant risk exposure" to nonbank seller/servicers, and that FHFA supervision of Enterprise nonbank risk management was an "oversight priority." Similarly, in its most recent Report to Congress, FHFA pointed out that Fannie Mae has seen a shift in servicing to nonbanks and that nonbanks serviced 60 percent of the Enterprise's delinquent single-family mortgages as of year-end 2015.

Consistent with its public statements on the risks posed by nonbank seller/servicers and the need for supervisory standards, FHFA has issued three advisory bulletins – AB 2013-01, 2014-06, and 2014-07 – establishing its supervisory expectations with regard to Enterprise oversight of seller/servicers. FHFA emphasized in its 2014 Report to Congress that "implementing effective management programs to meet expectations articulated in FHFA Advisory Bulletins for all matters related to counterparty risk management should be a priority."

DER conducted ongoing monitoring and a nonbank-focused targeted examination to assess [redacted] compliance with the three advisory bulletins, and concluded that [redacted]. Going forward, DER's 2016 supervisory plan for [redacted] lists ongoing monitoring to assess [redacted].

In contrast, DER conducted a targeted examination of [redacted] practices with respect to one of the three advisory bulletins, and concluded that the Enterprise was [redacted] with the guidance. DER has not issued conclusions on whether [redacted] practices comply with the other two advisory bulletins. DER noted in its 2015 Report of Examination of [redacted] that management found [redacted] for [redacted] to meet the guidance contained in AB 2014-07. However, because these findings were made by [redacted] compliance. Notwithstanding [redacted]

[redacted], FHFA did not [redacted] to address the Enterprise's [redacted].

DER is not scheduled to conduct targeted examinations in 2016 that would position DER to reach conclusions with respect to [redacted] compliance with the two advisory bulletins. DER's ongoing monitoring of [redacted] seller/servicer risk management is not specific to nonbank seller/servicers, does not identify nonbank risk management as a focus area, and is not intended to determine whether the Enterprise's practices comply with the relevant advisory bulletins.

CONCLUSION

As the safety and soundness regulator for the Enterprises, FHFA asserts that it uses a risk-based approach to plan and execute its supervisory activities. Since 2010, both Enterprises have seen significant and rapid growth in the presence of nonbank institutions in the origination and servicing of mortgage loans the Enterprises acquire and hold.

This trend and its ramifications have not gone unnoticed. FHFA has repeatedly acknowledged, in its public reports and its internal risk assessments of the Enterprises, that the Enterprises have significant risk exposure to nonbank seller/servicers. Consistent with these statements, FHFA has issued three advisory bulletins that communicate its supervisory expectations, and has emphasized that meeting these expectations should be an Enterprise priority.

Although DER examined whether [redacted] is in compliance with the three advisory bulletins, it has examined [redacted] compliance with only one of the bulletins. It has not examined compliance with the other two advisory bulletins [redacted] FHFA's supervisory guidance. Identifying and communicating supervisory expectations does not meet the goal of safety and soundness if an Enterprise fails to meet those expectations. Absent sufficient examination work, FHFA does not have assurance that the Enterprises have met its expectations and are exercising sufficient risk management with respect to nonbank seller/servicers.

RECOMMENDATION

OIG recommends that FHFA:

In 2017, or as expeditiously as possible, complete the examination activities necessary to determine whether [redacted] risk management of nonbank seller/servicers meets FHFA's supervisory expectations as set forth in its supervisory guidance. These activities should include an independent assessment of the [redacted].

FHFA COMMENTS AND OIG RESPONSE....................................

We provided FHFA an opportunity to respond to a draft report of this evaluation. FHFA provided technical comments on the draft report, which we incorporated as appropriate. In its management response, which is reprinted in its entirety in the Appendix, FHFA "generally agree[s]" with OIG's recommendation. FHFA's response, however, does not commit the Agency to complete the specific actions described in our recommendation. Their response does not describe any change in their current practice despite the report's findings and conclusion. Given the Agency's statement that it "generally agrees" with our recommendation, we will treat its response as an agreement to implement the recommendation as written.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

We conducted this evaluation to outline nonbank seller/servicer risks identified by FHFA and to assess FHFA's examination efforts to determine whether the Enterprises' practices were in compliance with three advisory bulletins related to Enterprise risk management of nonbank seller/servicers.

To achieve these objectives, we conducted an entrance conference with FHFA and met with FHFA personnel involved in examination activities that focused on risks associated with nonbank seller/servicers. We also reviewed publicly available documents, industry literature, internal DER documents, and non-public information provided by FHFA which included official minutes and materials of the boards of directors from both Enterprises. We also requested and received nonbank seller/servicer data from the Enterprises. We followed up with specific requests for documents from DER related to recent and ongoing examination activities.

This evaluation was conducted under the authority of the Inspector General Act and in accordance with the *Council of the Inspectors General on Integrity and Efficiency's Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform an evaluation based upon evidence sufficient to provide a reasonable basis to support its findings and recommendations. We believe that the finding and recommendation discussed in this report meet those standards.

The fieldwork for this report was completed between May and October 2016. The review period for DER examination activities included this evaluation was between January 1, 2014, and June 1, 2016.

Federal Housing Finance Agency

MEMORANDUM

TO: Kyle D. Roberts, Deputy Inspector General for Evaluations

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

SUBJECT: Draft OIG Report: *FHFA's Examinations Have Not Confirmed Compliance by One Enterprise with its Advisory Bulletins Regarding Risk Management of Nonbank Sellers and Servicers*

DATE: December 19, 2016

This Memorandum transmits the management response of the Federal Housing Finance Agency (FHFA) to the FHFA OIG draft report referenced above (Report).

We agree that effective third-party risk management is important to the safety and soundness of the Enterprises. As noted in the Report, FHFA Advisory Bulletins issued in 2013 and 2014 articulate supervisory expectations for managing counterparty risk exposures, including, but not limited to, nonbank seller/servicer risks. DER's evaluation of the Enterprises' management of risks associated with nonbank seller/servicers has been included in FHFA's risk-based supervision both before and after issuance of the Advisory Bulletins referenced in the Report. The totality of DER's examination work with respect to nonbank seller/servicers affords FHFA considerable knowledge of the Enterprises' management of nonbank seller/servicer risks.

By January 31, 2017, DER will finalize risk-based examination plans for 2017 that include review of each Enterprise's management of risks associated with mortgage servicing transfers and with single-family seller/servicer operations. Consistent with FHFA's customary approach, the examination plans will incorporate standards set forth in FHFA's

Advisory Bulletins, and examination activities will be conducted within planned timeframes. In light of this, we generally agree with the Report's recommendation.

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

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