REDACTED

DER Provided Effective Oversight of the Enterprises' Nonbank Seller/Servicers Risk Management But Needs to Develop Policies and Procedures for Two Supervisory Activities

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Executive Summary

Mortgage sellers and servicers pose counterparty risk to Fannie Mae and Freddie Mac (together, the Enterprises) operations (e.g., the risk of loss to an Enterprise should sellers or servicers not meet their contractual obligations). Sellers originate single-family mortgage loans and sell them to an Enterprise, which either holds them in its portfolio or guarantees and securitizes them as mortgage-backed securities. Servicers process payments (e.g., collect principal and interest, taxes, and insurance payments) and perform necessary loan administration functions for mortgages. Sellers and servicers may be either depository institutions (i.e., banks, thrifts, credit unions) or non-depository institutions (i.e., nonbanks such as direct-to-consumer mortgage lenders). An entity may act as both a seller and a servicer for an Enterprise. We refer to sellers and servicers, collectively, as seller/servicers throughout this report.

The Federal Housing Finance Agency's (FHFA) mission 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 has communicated its supervisory expectations for managing risks related to seller/servicers (including nonbank seller/servicers) to the Enterprises in certain advisory bulletins (ABs) and issued directives to the Enterprises on seller/servicers' financial eligibility requirements. FHFA exercises its supervision authority of the Enterprises through the Division of Enterprise Regulation (DER).

FHFA has identified elevated risks associated with the Enterprises' relationship with nonbank seller/servicers. In its 2023 DER Supervisory Priorities, FHFA identified the oversight of nonbank seller/servicers as a top supervision priority and noted that the Enterprises are exposed to increased risk from nonbank seller/servicers because they (1) are not subject to a federal prudential regulator, (2) face a higher liquidity risk, and (3) represent a higher share of loans originated and serviced.

We conducted this audit to determine whether DER's oversight was effective for ensuring the Enterprises managed nonbank seller/servicers' risks. The scope of this audit covered DER's supervision of the Enterprises' management of nonbank seller/servicers' risks during calendar years 2020, 2021, 2022, and through August 31 of 2023.

We found that DER's examination teams conducted effective oversight to ensure that the Enterprises managed nonbank seller/servicers' risks. Specifically, these DER teams (a) used examination guidance that was consistent with the applicable advisory bulletins and seller/servicers' financial

eligibility requirements to design examination procedures to assess the Enterprises' management of nonbank seller/servicers' risks, (b) prepared Enterprise risk assessments that identified risks presented by nonbank seller/servicers, (c) conducted supervisory examination activities that responded to identified risks and provided coverage of the Enterprises' significant risk management processes for nonbank seller/servicers, and (d) conducted a limited number of reviews of nonbank seller/servicers that assessed performance of these entities. In addition, DER's Nonbank Seller Servicer Risk Monitoring Branch (NBSS branch) prepared analysis products that supported DER's oversight of nonbank seller/servicers.

We also found that DER has not developed policies and procedures for reviews of nonbank seller/servicers or policies and procedures that govern the work of DER's NBSS branch risk monitoring and analysis. The lack of policies and procedures increases the risk that (1) DER examiners might not consistently or effectively plan and perform reviews of nonbank seller/servicers and (2) FHFA officials might rely on inaccurate nonbank seller/servicer risk monitoring and analysis products.

DER officials told us that DER's framework for reviews of nonbank seller/servicers continues to mature, and DER is currently developing an Operating Procedures Bulletin (OPB) for reviews of nonbank seller/servicers with an expected completion date of June 30, 2024. Similarly, a DER official told us that DER has not yet developed policies and procedures for the NBSS branch because it was established in April 2021, and the office has not yet matured. Some of its analysis products have been produced only a few times.

We made two recommendations in this report. In a written management response, FHFA agreed with our recommendations.

This report was prepared by Jim Lisle, Audit Director; April Ellison, Audit Manager; Mike Rivera, Auditor-in-Charge; and Kobe Wilson, Auditor; with assistance from Abdil Salah, 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 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, and www.oversight.gov.

James Hodge, Deputy Inspector General for Audits /s/

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ABBREVIATIONS

AB	Advisory Bulletin
DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
FHFA	Federal Housing Finance Agency
GAO	U.S. Government Accountability Office
Green Book	*Standards for Internal Control in the Federal Government*
MRA	Matter Requiring Attention
NBSS branch	Nonbank Seller Servicer Risk Monitoring Branch
OIG	Federal Housing Finance Agency Office of Inspector General
OPB	Operating Procedures Bulletin

BACKGROUND ....

The Role of Seller/Servicers

Mortgage seller/servicers pose counterparty risk to the Enterprises' operations. Sellers originate mortgage loans and sell them to an Enterprise. An Enterprise holds these single-family mortgages in its portfolio or guarantees and securitizes them as mortgage-backed securities. Servicers process payments (e.g., collect principal and interest, taxes, and insurance payments) and perform the necessary loan administration functions for these mortgages.[1] An entity may act as both a seller and a servicer for an Enterprise. Seller/servicers may be either depository institutions (i.e., banks) or non-depository institutions (i.e., nonbanks). Bank seller/servicers include commercial banks, credit unions, and thrifts. Banks offer a variety of financial products to consumers, including deposit products, loan products such as mortgage and auto loans, and credit card products. In contrast, nonbank seller/servicers are companies that generally specialize in originating or servicing mortgage loans and do not offer consumer deposits. Nonbank seller/servicers include direct-to-consumer mortgage lenders and wholesale lenders.

Seller/servicers conduct activities in accordance with the contracts that establish their relationships with the Enterprises. These contracts impose certain obligations on the seller/servicers. For example, sellers may be required to repurchase mortgage loans that do not meet the Enterprises' underwriting and quality standards, and servicers must advance principal, interest, taxes, and insurance payments due regardless of whether the borrower is making mortgage payments. The Enterprises incur counterparty risk in relationships with seller/servicers (e.g., the risk that a seller/servicer fails because its cash flow is insufficient to satisfy its contractual obligations to the Enterprises).

Nonbank Seller/Servicers Present Elevated Risk

FHFA has identified elevated risks in the Enterprises' relationship with nonbank seller/servicers. In FHFA's 2023 DER Supervisory Priorities, FHFA identified the oversight of nonbank seller/servicers as a top priority and identified the following risks:

- *Lack of Regulatory Oversight* – While banks are subject to prudential federal regulation oversight by a member of the Federal Financial Institutions Examination

[1] Loan administration functions may include sending borrowers monthly account statements and tax documents, responding to customer service inquiries, maintaining escrow accounts for property taxes and hazard insurance, and forwarding monthly mortgage payments to the loan owners. In the event that borrowers become delinquent on their loan payments, servicers may initiate a range of actions, from offering a workout option to allow the borrower to stay in the home to initiating foreclosure proceedings.

Council, nonbank seller/servicers lack a federal prudential regulator. FHFA does not have express statutory authority to supervise nonbank seller/servicers.[2] Nonbank seller/servicers are regulated by the Consumer Financial Protection Bureau with respect to consumer protection, but their financial and operational conditions are most closely monitored by the Enterprises to whom they deliver most of their business.

- *Liquidity Risk* – Nonbank seller/servicers have unique liquidity risks relative to their bank counterparts because nonbank seller/servicers generally lack access to the same funding sources as banks, such as the Federal Reserve's lending facilities, Federal Home Loan Bank advances, and liquidity from other product lines, such as consumer deposits. Instead, nonbanks tend to rely on shorter-term funding sources such as warehouse lines of credit and repurchase agreements that are more vulnerable to being reduced or canceled, particularly during periods of economic stress.

- *Increasing Share of Originations and Loans Serviced* – Nonbank seller/servicers have comprised a steadily increasing share of the agency origination market since 2013, representing 72 and 69 percent of Fannie Mae and Freddie Mac loan deliveries, respectively, for the nine months ended September 2022.[3] In the third quarter of 2022, eight of the top-ten Enterprise servicers were nonbank seller/servicers.[4]

FHFA Has Communicated Supervisory Expectations for the Enterprises' Management of Seller/Servicers' Risks (Including Nonbank Seller/Servicers' Risks)

FHFA Advisory Bulletins

FHFA has communicated to the Enterprises its supervisory expectations for managing risks related to seller/servicers (including nonbank seller/servicers) in the following advisory bulletins (ABs):

- **AB 2013-01, *Contingency Planning for High-Risk or High-Volume Counterparties*** – Provides guidance for establishing a risk management framework

[2] In FHFA's 2022 Report to Congress, FHFA noted that it concurred with the Government Accountability Office's (GAO) recommendation that Congress provide FHFA authority to examine third parties (including nonbank seller/servicers) that do business with the Enterprises similar to the authorities conferred upon the federal banking agencies through a provision in the Bank Service Company Act. *See* GAO, *Nonbank Mortgage Servicers: Existing Regulatory Oversight Could Be Strengthened* (March 2016) (GAO-16-278).

[3] FHFA reported this in its 2023 DER Supervisory Priorities (November 29, 2022) based on information obtained from a nonprofit research organization.

[4] FHFA reported this in its 2023 DER Supervisory Priorities (November 29, 2022) based on information obtained from a mortgage industry publication.

that identifies and monitors counterparties (including certain nonbank seller/servicers) and develops contingency plans for high-risk or high-volume counterparties.

- **AB 2014-06, *Mortgage Servicing Transfers*** – Communicates risk management practices in conjunction with the sale and transfer of mortgage servicing rights or the transfer of the operational responsibilities of servicing mortgage loans owned or guaranteed by the Enterprises.[5]

- **AB 2014-07, *Oversight of Single-Family Seller/Servicer Relationships* and AB 2018-08, *Oversight of Third-Party Provider Relationships*** – Provide guidance for effectively managing general third-party and specific seller/servicers' risks. These advisory bulletins contain processes that include, but are not limited to: (1) establishing a risk management framework in policies and procedures that assesses, monitors, and manages risks; (2) performing due diligence when selecting seller/servicers; and (3) conducting risk-based ongoing monitoring to evaluate changes in seller/servicers' risks.[6]

- **AB 2023-01, *Valuation of Mortgage Servicing Rights for Managing Counterparty Credit Risk*** – Communicates supervisory expectations for the Enterprises to establish and implement risk management processes, policies, and procedures for monitoring and valuing seller/servicers' mortgage servicing rights.

FHFA Directives on Seller/Servicers' Financial Eligibility Requirements

In 2015, FHFA directed the Enterprises to strengthen their counterparty standards and issue new financial eligibility requirements for single-family mortgage seller/servicers with a focus on nonbank seller/servicers. These eligibility requirements became effective on December 31, 2015, and established minimum levels of capital and liquidity to be maintained by seller/servicers.[7] FHFA noted that the Enterprises used the financial eligibility requirements to monitor and manage risk exposures to nonbank seller/servicers while largely relying on banking regulators' prudential capital and liquidity standards as financial requirements for bank counterparties. In 2022, FHFA directed the Enterprises to enhance the

[5] The Enterprise compensates seller/servicers for their loan servicing activities. Mortgage servicing rights are the rights to receive future cash flows from servicing mortgage loans, which seller/servicers typically record as an asset for financial accounting purposes.

[6] Ongoing monitoring includes review of various items related to the oversight of nonbank seller/servicers such as: delivery and performance records; results of operational reviews performed by the Enterprises; and reviews of seller/servicer compliance with Enterprise Seller/Servicer guides (including financial eligibility requirements) and other contractual terms.

[7] The 2015 requirements set a minimum capital ratio (tangible net worth/ total assets) that is generally 6 percent and a minimum liquidity of 3.5 basis points or 0.035 percent of the unpaid principal balance of the loans serviced by the seller/servicer for the Enterprises and the Government National Mortgage Association.

2015 minimum financial eligibility requirements, including increasing the liquidity requirements and establishing supplemental requirements applicable to large nonbank seller/servicers.[8]

DER Performed Supervisory Activities to Address Nonbank Seller/Servicers' Risks

DER's Office of Fannie Mae Examinations and Office of Freddie Mac Examinations conduct an annual examination of each Enterprise, which includes targeted examinations focusing on discrete business or functional areas, programs, products, models, processes, or internal controls. Examination guidance, including FHFA's Enterprise Examination Manual, FHFA's Examination Practices Bulletin on sampling, and DER's OPBs, govern the planning and performance of supervisory activities. DER's OPB, Supervisory Planning, requires DER to perform an annual risk assessment, which documents DER's view of risk and identifies potential areas of supervisory focus for inclusion on Supervision Plans.

DER examiners use the following examination modules and workprograms when designing examination procedures to assess the Enterprises' management of seller/servicers' risks (including nonbanks): (1) the Counterparty Credit Risk Management, (2) the Oversight of Third-Party Provider Relationships, (3) the Credit Risk Management, and (4) the Single-Family Credit Risk Management.[9]

As a result of examinations, DER may issue adverse findings to the Enterprises with the most severe findings categorized as Matters Requiring Attention (MRAs) and the least severe findings identified as Recommendations.[10] DER's OPB, Adverse Examination Findings, governs processes and documentation standards that DER staff follow for issuing, monitoring, and closing adverse examination findings.

Targeted Examinations and Remediation of Adverse Findings

During the audit scope, DER conducted 21 targeted examinations activities that focused, in whole or in part, on the Enterprises management of nonbank seller/servicers' risks.[11] There

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[8] The supplemental requirements became effective beginning September 30, 2023 (outside the audit scope), with some requirements becoming effective December 31, 2023, and March 31, 2024. Supplemental requirements specify that large nonbank seller/servicers submit annual capital and liquidity plans describing how they intend to manage capital and liquidity.

[9] Examination Manual modules and workprograms contain procedures that DER examiners are expected to consider and perform, as appropriate, when planning and conducting supervisory activities of the Enterprises.

[10] AB 2017-01, *Classifications of Adverse Examination Findings*, establishes the classifications of adverse findings at the Enterprises.

[11] As of August 31, 2023, an additional targeted examination addressing nonbank seller/servicers' risks was in progress.

were [redacted] MRAs (i.e., [redacted] already open at the beginning of the audit scope period and [redacted] issued during the audit scope period) related to nonbank seller/servicers' risks. As of the end of our audit, [redacted] MRAs remained open.

Reviews of Nonbank Seller/Servicers

During the audit scope, DER completed three reviews of nonbank seller/servicers relating to loans that the nonbank sold to or serviced for the Enterprises, and one review was in progress. These reviews included an on-site inspection, examination, audit, and review of records relating to the operations, policies, procedures, controls, and documentation of the nonbank seller/servicer. Because FHFA does not have express authority in its regulator role to supervise Enterprise third parties, such as nonbank seller/servicers, these reviews were performed using its conservatorship authority.[12]

Nonbank Seller/Servicer Risk Monitoring and Analysis

DER's NBSS branch prepares risk monitoring and analysis products related to nonbank seller/servicers. The NBSS branch obtains nonbank seller/servicer data from various sources, analyzes the data to monitor nonbank seller/servicers' loan profiles and financial conditions, and communicates the results of its analysis to various FHFA stakeholders.

FACTS AND ANALYSIS ....

DER Conducted Effective Oversight of the Enterprises' Management of Nonbank Seller/Servicers' Risks

We found that DER conducted effective oversight to ensure that the Enterprises managed nonbank seller/servicers' risks. Specifically, we noted that DER did the following during the scope of this audit:

- Used Enterprise Examination Manual modules and workprograms that were consistent with the applicable advisory bulletins and financial eligibility requirements to design examination procedures for reviewing and evaluating the Enterprises' management of nonbank seller/servicers' risks.

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[12] *See* 12 U.S.C. 4617(b)(2) (FHFA as conservator succeeds by operation of law to all rights, titles, powers, and privileges of the regulated entity, to the regulated entity's books, records, and assets, and has the power to operate and conduct all business of the regulated entity). Since the Enterprises' contract with nonbank seller/servicers and seller/servicing guide requirements permits the Enterprises to inspect a nonbank seller/servicers' books or records related to mortgages sold or serviced, FHFA's conservator authority also allows FHFA to perform such inspections.

- Prepared risk assessments for the Enterprises' examination cycles that identified risks presented by nonbank seller/servicers.

- Conducted 21 targeted examinations that responded to identified nonbank seller/servicers' risks. These examination procedures provided coverage of each of the Enterprises' nonbank seller/servicers' risk management processes.[13] Specifically, DER:

    - Assessed the Enterprises' (1) risk management frameworks, (2) processes for the identification and monitoring of high-risk and high-volume counterparties, (3) ongoing monitoring processes, (4) monitoring of seller/servicers' capital and liquidity requirements, and (5) valuation of mortgage servicing.

    - Prepared examination workpapers that supported DER examiners' supervisory conclusions and complied with requirements in DER's OPB, Targeted Examinations, for all four targeted examinations in our sample.[14]

    - Issued [redacted] MRAs to strengthen the Enterprises' risk management processes related to seller/servicers (including nonbank seller/servicers), such as improving [redacted] DER also assessed the Enterprises' remediation of MRAs. Further, DER examiners assessed the Enterprises' remediation plans and documented remediation progress as required by OPB, Adverse Examination Findings, for all [redacted] MRAs in our sample.

- Completed three reviews of nonbank seller/servicers that assessed the performance of these entities, including the nonbank seller/servicer's (1) risk management framework, (2) underwriting and quality control processes to ensure loans adhered to the Enterprises' selling guides, and (3) adequacy of liquidity and funding sources. One review was in progress as of the end of our audit scope period.

- Prepared 14 risk monitoring and analysis products that supported DER's oversight of nonbank seller/servicers.

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[13] DER performed examination procedures to assess most Enterprises' risk management processes identified in AB 2013-01, AB 2014-07, AB 2018-08, and AB 2023-01, including those related to the Enterprises' financial eligibility requirements. DER did not perform examination procedures within our audit scope period to assess the Enterprises' risk management processes related to conducting due diligence when approving new seller/servicers and processes related to AB 2014-06, *Mortgage Servicing Transfers*. However, we did not consider these exceptions because DER provided an appropriate risk-based rationale for these decisions.

[14] For details of the sample selection, see the Objective, Scope, and Methodology section of this report.

DER Has Not Developed Policies and Procedures for Reviews of Nonbank Seller/Servicers

While DER's examination workpapers supported examiners' supervisory conclusions for the two reviews of nonbank seller/servicers in our sample, we found that DER has not yet developed policies and procedures to govern the processes for performing reviews of nonbank seller/servicers.

Reviews of nonbank seller/servicers are focused on the operations, policies, procedures, controls, and documentation of the nonbank seller/servicers rather than the Enterprises' risk management processes with respect to these seller/servicers. However, because DER does not have express supervisory authority over nonbank seller/servicers, these reviews are conducted under FHFA's conservatorship authority. A DER official told us that, as a result, specifics of the reviews (i.e., planning and scope) and follow-up on issues identified may be different from a targeted examination at the Enterprises, and that the existing Targeted Examination OPB does not apply. DER initiated its first review of a nonbank seller/servicer in October 2021.[15] DER officials told us that DER's framework for reviews of nonbank seller/servicers continues to mature and they are currently developing an OPB for these reviews with an expected completion date of June 30, 2024.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (Green Book) states that management should design control activities to achieve objectives and implement control activities through policies. Management may further define policies through day-to-day procedures.[16]

Without policies and procedures for reviews of nonbank seller/servicers, there is an increased risk that DER examiners might not consistently or effectively plan and perform these reviews. For example, DER examiners might not meet management's expectations for: (1) selecting nonbank seller/servicers for review based on risk; (2) planning and performing examination procedures that address key risk areas; (3) documenting examination procedures to support examiner conclusions; (4) communicating results to the Enterprises and nonbank seller/servicers; and (5) facilitating correction of significant observations identified.

[15] DER identified increasing levels of counterparty risk related to nonbank seller/servicers in its calendar year 2020 risk assessments. Consequently, DER designated nonbank seller/servicers as a priority in its 2021 DER Supervisory Strategy and Priorities. A review of a nonbank seller/servicer was included in DER's 2021 Examination Plan.

[16] See GAO-14-704G (September 2014) for Principle 10 (Design Control Activities) and Principle 12 (Implement Control Activities).

DER's NBSS Branch Has Not Developed Policies and Procedures for Conducting Risk Monitoring and Analysis of Nonbank Seller/Servicers

The NBSS branch's risk monitoring and analysis products include (1) presentations to the FHFA Director regarding counterparty risks, (2) a database of nonbank seller/servicers' financial and performance metrics, (3) watchlist reports that identify nonbank seller/servicers' heightened risks to the Enterprises, (4) nonbank seller/servicers' acquisition trend reports, (5) detailed financial analysis reports of nonbank seller/servicers selected for review, and (6) ad hoc analysis reports.

We sampled 6 of 14 NBSS branch analysis products and found that DER has not developed written policies and procedures to govern the NBSS branch's processes to ensure that it produces accurate risk monitoring and analysis products using quality information. A DER official stated that DER has not yet developed policies and procedures for the NBSS branch because it was established in April 2021, and the office has not yet matured. Some of its analysis products have been produced only a few times.

As noted above, GAO's Green Book states that management should design control activities to achieve objectives and implement control activities through policies. Management may further define policies through day-to-day procedures. The Green Book also notes that management should use quality information to achieve the entity's objectives.[17]

Without documenting processes and internal control in policies and procedures, the NBSS branch may not produce accurate risk monitoring and analysis products using quality information as intended. For example, NBSS branch staff might not consistently or effectively review the integrity of source data used in the analysis product or the accuracy of analysis product calculations. This increases the risk that FHFA officials might rely on inaccurate nonbank seller/servicer risk monitoring and analysis products.

FINDINGS ....

- DER has not developed policies and procedures for conducting reviews of nonbank seller/servicers.
- DER's NBSS branch has not developed policies and procedures for conducting risk monitoring and analysis of nonbank seller/servicers.

[17] See GAO-14-704G (September 2014) for Principle 10 (Design Control Activities), Principle 12 (Implement Control Activities), and Principle 13 (Use Quality Information).

CONCLUSIONS ....

DER's examination teams conducted effective oversight to ensure that the Enterprises managed nonbank seller/servicers' risks. Specifically, these DER teams (a) used examination guidance that was consistent with the applicable advisory bulletins and seller/servicers' financial eligibility requirements to design examination procedures to assess the Enterprises' management of nonbank seller/servicers' risks, (b) prepared Enterprise risk assessments that identified risks presented by nonbank seller/servicers, (c) conducted supervisory examination activities that responded to identified risks and provided coverage of the Enterprises' significant risk management processes for nonbank seller/servicers, and (d) conducted a limited number of reviews of nonbank seller/servicers that assessed performance of these entities. In addition, DER's NBSS branch prepared analysis products that supported DER's oversight of nonbank seller/servicers. We also found that DER has not developed policies and procedures for reviews of nonbank seller/servicers or policies and procedures that govern the work of DER's NBSS branch risk monitoring and analysis. The lack of policies and procedures increases the risk that (1) DER examiners might not consistently or effectively plan and perform reviews of nonbank seller/servicers and (2) FHFA officials might rely on inaccurate nonbank seller/servicer risk monitoring and analysis products.

RECOMMENDATIONS ....

We recommend the Deputy Director, DER ensures that:

1. DER develops and implements written policies and procedures for conducting reviews of nonbank seller/servicers, to include but not limited to, procedures, internal controls, and documentation requirements.

2. DER's NBSS branch develops and implements written policies and procedures to guide the risk monitoring and analysis process, to include but not limited to, procedures and internal controls.

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

We provided FHFA management an opportunity to respond to a draft of this audit report. FHFA management provided technical comments on the draft report and those comments were considered in finalizing this report. FHFA management also provided a written response, which is included as an Appendix to this report. In its management response, FHFA agreed with our recommendations and included the following planned corrective actions:

1. DER will develop internal supervisory guidance to formalize processes and expectations for targeted reviews of Enterprise oversight of third parties, including nonbank seller/servicers, should circumstances warrant such a review, by June 30, 2024.

2. DER will issue appropriate internal guidance regarding the execution and documentation of non-examination activities pursuant to the supervision plans, which will include DER's NBSS branch, by November 30, 2024.

We consider FHFA's planned corrective actions responsive to our recommendations.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

Our audit objective was to determine whether DER's oversight was effective for ensuring the Enterprises managed nonbank seller/servicers' risks. The scope of this audit covered DER's supervision of the Enterprises' management of nonbank seller/servicers' risks during calendar years 2020, 2021, 2022, and 2023 as of August 31.

To accomplish our objective, we performed the following procedures.

- Reviewed Government Accountability Office's *Standards for Internal Control in the Federal Government* (GAO-14-704G; September 2014) and determined that the risk assessment, control activities, and information and communication components of internal control were significant to this objective, and focused on the underlying principles that management should: (1) identify, analyze, and respond to risks related to achieving the defined objectives; (2) design and implement control activities through policies; and (3) use and communicate quality information to achieve its objectives.

- Assessed the following FHFA advisory bulletins and determined the extent to which they described FHFA's supervisory expectations for the Enterprises' management nonbank seller/servicers' risks:

    - FHFA, AB 2013-01, *Contingency Planning for High-Risk or High-Volume Counterparties* (April 1, 2013)

    - FHFA, AB 2014-06, *Mortgage Servicing Transfers* (June 11, 2014)

    - FHFA, AB 2014-07, *Oversight of Single-Family Seller/Servicer Relationships* (December 1, 2014)

    - FHFA, AB 2018-08, *Oversight of Third-Party Provider Relationships* (September 28, 2018)

    - FHFA, AB 2023-01, *Valuation of Mortgage Servicing Rights for Managing Counterparty Credit Risk* (January 12, 2023)

- Assessed the FHFA Enterprise Examination Manual to determine the extent to which examination modules and workprograms were consistent with the advisory bulletins related to the Enterprises' management nonbank seller/servicers' risks.

- Reviewed the following FHFA Examination Practices Bulletin and DER OPBs to identify requirements for DER's supervision of the Enterprises' management of nonbank seller/servicers' risks:
  - FHFA Examination Practices Bulletin, Sampling Practices in Examinations, (February 2014)
  - DER OPB, Enterprise Supervisory Risk Assessments (June 17, 2019; updated February 24, 2020)
  - DER OPB, Risk Assessments (April 29, 2022)
  - DER OPB, Examination Planning Process (April 1, 2019; updated February 24, 2020)
  - DER OPB, Supervisory Planning – Pilot Program for 2021 (September 3, 2021)
  - DER OPB, Supervisory Planning (November 18, 2022)
  - DER OPB, Examination Processes and Documentation: Targeted Examinations (September 27, 2018; updated February 11, 2020)
  - DER OPB, Targeted Examination Processes and Documentation (February 24, 2020)
  - DER OPB, Targeted Examinations (December 31, 2020; updated August 29, 2022)
  - DER OPB, Independent Quality Control Process (January 23, 2018; updated February 24, 2020)
  - DER OPB, Quality Control Program (March 2, 2023)
  - DER OPB, Examination Processes and Documentation: Issuance of Adverse Examination Findings and Assessment of MRA Remediation (October 31, 2018)
  - DER OPB, Issuance of Adverse Examination Findings and Assessment of MRA Remediation Examination Processes and Documentation (February 24, 2020)
  - DER OPB, Remediation (December 31, 2020)
  - DER OPB, Adverse Examination Findings: Issuing, Monitoring, and Closing (January 4, 2022)

- DER OPB, Adverse Examination Findings (November 25, 2022; effective January 1, 2023)

- Reviewed prior OIG and GAO reports to identify findings and recommendations related to nonbank seller/servicers to determine their impact, if any, on our audit:

  - OIG, *FHFA's Examinations Have Not Confirmed Compliance by One Enterprise with its Advisory Bulletins Regarding Risk Management of Nonbank Sellers and Servicers* (December 21, 2016) (EVL-2017-002)

  - OIG, *FHFA's Division of Enterprise Regulation Did Not Follow or Train to its Procedures for Information Sharing of Enterprise Counterparty Performance Issues* (September 28, 2021) (AUD-2021-014)

  - OIG, *FHFA Actions to Manage Enterprise Risks from Nonbank Servicers Specializing in Troubled Mortgages* (July 1, 2014) (AUD-2014-014)

  - GAO, *Nonbank Mortgage Servicers – Existing Regulatory Oversight Could Be Strengthened* (March 2016) (GAO-16-278)

  - GAO, *Housing Finance – Prolonged Conservatorships of Fannie Mae and Freddie Mac Prompt Need for Reform* (January 2019) (GAO-19-239)

- Interviewed DER personnel to understand DER's processes for conducting oversight of the Enterprises' management of nonbank seller/servicers' risks. Obtained written responses from DER personnel to address questions and observations related to audit testing procedures. DER personnel included Associate Directors, a Principal Program Analyst, and examination and NBSS staff responsible for conducting oversight of the Enterprises' management of nonbank seller/servicers' risks.

- Reviewed supervisory planning activities (i.e., risk assessments, supervisory priorities, supervisory strategies, and examination plans) for calendar years 2020 through 2023 examination cycles to determine whether DER documented an assessment of nonbank seller/servicers' risks in accordance with DER OPBs.

- Analyzed the work performed in DER supervisory activities that focused, in whole or in part, on the Enterprises management of nonbank seller/servicers' risks. We assessed whether these examination procedures addressed the nonbank seller/servicers' risks identified in DER risk assessments and provided effective coverage of the Enterprises' significant nonbank seller/servicers' risk management processes.

- Selected samples of supervisory activities within the audit scope for testing DER's compliance with examination guidance, including FHFA's Examination Practices Bulletin on sampling, and DER's OPBs governing the planning and performance of supervisory activities as follows:

  - Selected a judgmental sample of 4 targeted examinations (19 percent) from a population of 21 targeted examinations related to nonbank seller/servicers' risks and 2 reviews (67 percent) from a population of 3 reviews of nonbank seller/servicers. Collectively, our samples covered 25 percent of relevant supervisory activities (6 of 24 total targeted examinations and reviews of nonbank seller/servicers). We selected these samples to gain coverage of 2 targeted examinations and 1 review performed by each of DER's Office of Fannie Mae Examinations and Office of Freddie Mac Examinations. We selected these samples for the purpose of avoiding bias and not for the purpose of projecting results across the population of supervisory activities.

  - Selected a random sample of [redacted] MRAs (25 percent) from a population of [redacted] MRAs (excluded [redacted] MRAs from the initial population of [redacted] because they were issued in 2023 and we determined that not enough time had passed as of August 31, 2023). We selected the sample to assess DER's efforts to monitor the Enterprises' remediation. We used a random number generator to select our sample for the purpose of avoiding bias and not for the purpose of projecting results across the population of MRAs.

  - Selected a judgmental sample of 6 NBSS branch analysis products (43 percent) from a population of 14 products. Since the NBSS branch had only recently been established, we selected the most recent product from each of the six different NBSS product types. We selected our sample for the purpose of avoiding bias and not for the purpose of projecting results across the population of NBSS branch products.

  - Since information systems were not significant to our audit objective, we did not rely on system generated reports to identify or validate our populations. We identified the populations of supervisory activities through a review of DER examination plans and MRA remediation files. To gain comfort that the populations were complete, we compared them to individual records in FHFA's document repository (Information Management System) or DER Remediation Tracking System and confirmed the populations of supervisory activities with DER officials.

We conducted this performance audit from September 2023 to March 2024 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 our 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............................

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Federal Housing Finance Agency

MEMORANDUM

TO: James Hodge, Deputy Inspector General for Audits, Office of Inspector General

FROM: Christopher Bosland, Acting Deputy Director, Division of Enterprise Regulation

CHRISTO PHER BOSLAND Digitally signed by CHRISTOPHER BOSLAND Date: 2024.03.20 17:32:04 -04'00'

SUBJECT: Draft Audit Report: *DER Provided Effective Oversight of the Enterprises' Nonbank Seller/Servicers Risk Management But Needs to Develop Policies and Procedures for Two Supervisory Activities*

DATE: March 20, 2024

Thank you for the opportunity to respond to the above-referenced Office of Inspector General (OIG) draft report (Report). The objective of the OIG audit was to determine whether DER's oversight was effective for ensuring the Enterprises managed nonbank seller/servicers' risks. The scope of the audit covered DER's supervision of the Enterprises' management of nonbank seller/servicers' risks during calendar years 2020-2022, and 2023 through August 31.

We are pleased that the Report found that DER's examination teams conducted effective oversight to ensure that the Enterprises managed nonbank seller/servicers' risk, and that DER's Nonbank Seller Servicer Risk Monitoring (NBSS) branch prepared analyses that supported DER's oversight of nonbank seller/servicers. The Report also noted areas for improvement, and makes two recommendations, with which we agree.

Recommendation 1: *DER develops and implements written policies and procedures for conducting reviews of nonbank seller/servicers, to include but not limited to, procedures, internal controls, and documentation requirements.*

Management Response: FHFA agrees with the recommendation. As noted in the Report, FHFA only recently began conducting these targeted reviews under its conservatorship powers on a limited basis, and the Agency continues to refine and improve its processes based on experience. DER is currently developing internal supervisory guidance to formalize processes and expectations for any such targeted reviews of Enterprise oversight of third parties, including nonbank seller/servicers, should circumstances warrant such a review. DER will issue this guidance by June 30, 2024.

The Government Accountability Office has recommended that Congress provide FHFA authority to examine third parties that do business with FHFA's regulated entities similar to the authority conferred upon the federal banking agencies through the Bank Service Company Act. Were Congress to grant FHFA such authority, giving FHFA tailored parity with other federal financial regulators, the Agency would be in a better position to achieve its statutory duties to ensure the safe and sound operations of the Enterprises and the Federal Home Loan Banks. The Financial Stability Oversight Council made a similar recommendation in its *2023 Annual Report*, as it has for the past several years.

Recommendation 2: *DER's NBSS branch develops and implements written policies and procedures to guide the risk monitoring and analysis process, to include but not limited to, procedures and internal controls.*

Management Response: FHFA agrees with the recommendation. By November 30, 2024, DER will issue appropriate internal guidance regarding the execution and documentation of non-examination activities pursuant to the supervision plans, which will include DER's NBSS branch.

We appreciate the professionalism and courtesy of the OIG staff who conducted this audit and thank you for your work to help improve DER's supervision program.

If you have any questions related to our response, please do not hesitate to contact Eric Wilson.

cc: John Major
Eric Wilson

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