FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Oversight of the Enterprises' Management of High-Risk Seller/Servicers

Audit Report: AUD-2012-007 September 18, 2012

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AT A GLANCE

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Why FHFA-OIG Did This Audit

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) buy mortgages from lenders, such as banks, and primarily rely on servicing companies for post origination mortgage-related work, such as collecting payments. Further, it is common for the same company to sell and service the loans that Fannie Mae and Freddie Mac (collectively, the Enterprises) purchase.

The Enterprises monitor counterparties (e.g., sellers and/or servicers) that they have identified as representing a high-risk for concerns such as the counterparties' financial health. As of the third quarter of 2011, the Enterprises had placed more than 300 high-risk counterparties on watch lists and stopped doing business with more than 40 of them. In 2009, a large seller/servicer for Freddie Mac collapsed, which led the Enterprise to file a $1.8 billion claim against its bankruptcy estate. Since 2008, the Enterprises estimate that they incurred losses of up to $6.1 billion from failures at just four of their counterparties. The Enterprises estimate their remaining risk exposure to high-risk seller/servicers to be approximately $7.2 billion, based on these counterparties' mortgage portfolios totaling $955 billion.

The Federal Housing Finance Agency (FHFA or Agency), Office of Inspector General (FHFA-OIG) undertook this audit to assess how the Agency oversees the Enterprises' controls over their high-risk counterparties.

What FHFA-OIG Found

FHFA can strengthen the Enterprises' counterparty risk management by, among other things, publishing standards for the development of contingency plans related to failing or failed high-risk counterparties (i.e., step-by-step procedures explaining how to work through a large seller/servicer's failure). FHFA is required to help the Enterprises manage risk, including establishing prudential limits that restrict counterparty risk exposure. Contingency plans help to manage such risks because they identify actions to pursue when a counterparty's changing financial or other circumstances pose a financial threat to an Enterprise.

FHFA's 2012 draft examination manual provides guidance to Agency examiners concerning how to review contingency plans. FHFA has been field testing the draft manual and expecting that the Enterprises will develop contingency plans after learning that the Agency instructs its examiners to look for plans during examinations. However, although the Agency recently asked the Enterprises to develop such plans as part of FHFA's supervisory process, the Agency has not published guidance requiring them to do so or governing their contents. Accordingly, as of April 2012, the Enterprises had not developed comprehensive contingency plans for any of their more than 300 high-risk counterparties.

Counterparty contingency plans will not eliminate losses, but they can help reduce the Enterprises' risk exposure. Although FHFA-OIG saw examples of steps the Enterprises took to lower financial risk exposure associated with particular counterparties, Fannie Mae and Freddie Mac have no comprehensive strategy. Consequently, FHFA-OIG identified at least one instance in which an Enterprise increased its exposure and business volume with a counterparty after concerns were identified.

Contingency plans also can help prepare the Enterprises for unexpected collapses of counterparties that handle a concentrated, high-volume of their business. As of September 2011, 70% (or $3.1 trillion) of the Enterprises' mortgage portfolios were controlled by their top 10 single-family mortgage servicers. Although these counterparties may not be on watch lists, their high concentration of the Enterprises' business significantly increases the financial and operational consequences of their failure. Accordingly, the Enterprises can benefit from published FHFA guidance about when counterparties' volume and concentration of business raise their risk enough to warrant contingency plans.

What FHFA-OIG Recommends

In general, FHFA-OIG recommends that FHFA issue standards for the Enterprises to develop comprehensive contingency plans for high-risk and high-volume seller/servicers, and that the Agency finalize its examination guidance regarding contingency planning.

The Agency's management provided comments agreeing with the recommendations in this report.

TABLE OF CONTENTS

ABBREVIATIONS

Fannie Mae..... Federal National Mortgage Association

FHFA or Agency.....Federal Housing Finance Agency

FHFA-OIG.....Federal Housing Finance Agency, Office of Inspector General

Freddie Mac .....Federal Home Loan Mortgage Corporation

HERA.....Housing and Economic Recovery Act of 2008

MBS .....Mortgage-Backed Securities

TBW..... Taylor, Bean & Whitaker Mortgage Corp.

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

In accordance with the Housing and Economic Recovery Act of 2008 (HERA), which amended the Inspector General Act of 1978, FHFA-OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations.[1] FHFA-OIG is also authorized to recommend policies that promote economy and efficiency, and to prevent and detect fraud and abuse.

This audit report is in furtherance of FHFA-OIG's mission to promote the economy, efficiency, and effectiveness of FHFA's programs and operations, and, in accordance with FHFA-OIG's first strategic goal, it adds value by helping the Agency improve the Enterprises' economic health. Specifically, the report is intended to strengthen FHFA's oversight of how the Enterprises protect themselves from high-risk and high-volume counterparties that sell and/or service mortgage loans. Doing business with such counterparties increases the Enterprises' risk of financial loss, which in turn can lead to their need to draw more taxpayer support from the U.S. Department of the Treasury.[2] This report identifies ways that FHFA can protect the taxpayers' investment better by helping the Enterprises manage their risks better.

FHFA-OIG appreciates the cooperation of everyone who contributed to the audit, including officials at Fannie Mae, Freddie Mac, and FHFA. This audit was led by Heath Wolfe, Assistant Inspector General for Audits, who was assisted by Andrew W. Smith, Auditor-in-Charge.

Russell A. Rau
Deputy Inspector General for Audits

[1] HERA: Public Law No. 110-289; Inspector General Act of 1978: Public Law No. 95-452.

[2] Several other FHFA-OIG audits and evaluations also demonstrate the benefit of FHFA proactively supervising the Enterprises' risk management. These include FHFA-OIG's separate assessments of the Agency's oversight of Enterprise activities related to loan repurchase settlements, mortgage servicing contractors, and single-family underwriting standards. See FHFA-OIG, *Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America* (EVL-2011-006; September 27, 2011); FHFA-OIG, *FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors* (AUD-2012-001; March 7, 2012); and FHFA-OIG, *FHFA's Oversight of Fannie Mae's Single-Family Underwriting Standards* (AUD-2012-003; March 22, 2012).

BACKGROUND

The Enterprises support the secondary mortgage market by purchasing residential mortgage loans from lenders. They may hold these mortgages as their own investments or bundle them into mortgage-backed securities (MBS)—typically with guarantees covering principal and interest payments—for sale to other investors. MBS issued or guaranteed by government agencies (e.g., the Government National Mortgage Association) or government-sponsored enterprises, such as the Enterprises, are referred to as "agency MBS." In 2011, the agency MBS market of $5.5 trillion was more than four times larger than the non-agency MBS market.

Selling and Servicing Loans for the Enterprises

The Enterprises' mortgage-related business is considerable. The Enterprises owned or guaranteed $4.6 trillion of the nation's estimated $10.3 trillion in outstanding single-family mortgages as of September 30, 2011. In other words, the Enterprises own or guarantee almost half of all mortgages on homes in the United States.

The same lenders that sell these mortgages to the Enterprises frequently also service the loans for them. Servicing includes much of the day-to-day work involved with mortgages, such as:

- Collecting payments from borrowers;
- Maintaining escrow accounts for property taxes and insurance; and
- Handling mortgage modifications, defaults, and foreclosures.

In 2011, the Enterprises worked with over 2,000 servicers.

Doing such a large volume of business with multiple counterparties poses risks to the Enterprises when their success depends on the counterparties' stability.[3] Indeed, as demonstrated by the recent housing crisis, counterparties can fail rapidly in response to adverse market conditions.

Enterprises' Counterparty Risks

Since 2007, the Enterprises have suspended or terminated business with more than 40 seller/servicers on their high-risk watch lists. Although such suspensions and terminations are designed to protect the Enterprises from one or more specific risks and to stop the creation of additional exposure, they can leave them vulnerable to a variety of other financial risks, including:

[3] For the purposes of this report, "counterparty" refers to an entity that sells mortgages to and/or services mortgages for the Enterprises. In general, the term "counterparty" can also refer to other entities that have contractual relations with the Enterprises, such as mortgage insurance companies, asset managers, real estate brokers, etc.

- Loss of guarantees on counterparties' work. Counterparties commit (i.e., they make representations and warranties when they sell loans to the Enterprises) to follow Enterprise requirements for underwriting mortgage loans. If they do not comply, the Enterprises can have them repurchase the loan(s) they sold to the Enterprises for up to full face value or terminate their servicing rights. However, if a counterparty sold the Enterprises mortgage loans that did not meet standards (e.g., borrowers lack the necessary income to pay their mortgages), the Enterprises could lose the full or partial loan amounts if borrowers default following the counterparty's failure.
- Increased tax and insurance payments. If a servicer fails and its portfolio cannot be transferred quickly, an Enterprise may have delayed access to the tax and insurance escrow accounts, potentially resulting in late fees for not making timely payments for the underlying properties' insurance and tax obligations as the servicer normally would have done.
- Legal fees and associated costs.
    - Counterparty bankruptcy cases can be complex and take years to complete. The Enterprises need specialized legal representation to make, negotiate, and settle claims in competition with other entities seeking to recover funds from the counterparty (e.g., mortgage payments and escrow accounts held at the time of the failure/bankruptcy filing).
    - In addition, there is risk inherent in moving mortgages to other servicers, including expenses incident to the transfer of servicing responsibilities from the failed servicer (e.g., costs associated with the physical movement of loan files from one servicer to another).

The volume of business an Enterprise does with a given counterparty can magnify such risks. Due to consolidation in the mortgage industry and mortgage lenders that went out of business during the housing crisis, the Enterprises' loan purchasing business has concentrated among fewer large mortgage lenders.[4] For example, as of September 2011, the Enterprises' top 10 seller/servicers were responsible for 70% of their mortgage portfolios.

In their recent financial filings, the Enterprises acknowledged that they face significant risks from the sudden collapse of large counterparties. Freddie Mac noted that it would have "operational and capacity challenges . . . transferring a large servicing portfolio" to a new servicer in the event one or more of its largest seller/servicers collapsed.[5] Similarly, Fannie Mae warned that "failure by a significant seller/servicer counterparty, or a number of seller/servicers,

[4] *Federal National Mortgage Association SEC 10K for FY 2011*, p.52.

[5] *Federal Home Loan Mortgage Corporation SEC 10K for FY 2011*, p. 133.

to fulfill repurchase obligations to us could result in a significant increase in our credit losses and have a material adverse effect on our results of operations and financial condition."[6]

To address such risks, the Enterprises screen counterparties before working with them, require them to guarantee that they will follow rules for selling/servicing mortgage loans, and monitor their ongoing performance, financial condition, and compliance.

Enterprises' Controls over Counterparty Risks

Before agreeing to do business with seller/servicers, the Enterprises assess their financial strength and operational capabilities, and ensure they meet eligibility requirements. For example, the Enterprises may take precautionary steps such as requiring seller/servicers to meet minimum financial capacity standards. They also conduct operational reviews of their single-family mortgage seller/servicers and use this information to determine the terms of their business with them (e.g., setting limits on financial transactions).

In addition, both Enterprises have guides that outline counterparties' responsibilities.[7] For example, the Enterprises require sellers to ensure that the mortgages they originate comply with underwriting requirements, which set standards for borrowers' eligibility (e.g., credit score thresholds) and collateral sufficiency. Counterparties represent and warrant their compliance with these Enterprise guidelines. If the Enterprises suffer a loss on a loan and discover that the seller significantly deviated from its representations and warranties, they can recoup their losses.

Further, although the Enterprises generally do not conduct compliance reviews on loans before purchase, they review samples of loans after purchase to ensure adherence to Enterprise requirements. The Enterprises also have fraud programs that review cases of suspected fraud, identify fraud risk, and work to remediate fraud and recoup losses.

Despite such precautions, doing business with counterparties poses risks. For example, a servicer's financial condition may deteriorate to the point of bankruptcy if market conditions change. The Enterprises protect themselves from such risk by establishing counterparty limits and identifying and monitoring high-risk counterparties.

Fannie Mae's and Freddie Mac's High-Risk Counterparty Watch Lists

As summarized below, the Enterprises have independently developed systems to identify high-risk counterparties and add them to watch lists to monitor their performance. In total, as of

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[6] *Federal National Mortgage Association SEC 10K for FY 2011*, p. 66.

[7] *Fannie Mae 2012 Single-Family Selling Guide*; *Fannie Mae Single-Family 2011 Servicing Guide*; and *Freddie Mac Single-Family Seller/Servicer Guide*.

September 2011, the Enterprises had identified more than 300 high-risk seller/servicers with an estimated risk exposure of $7.2 billion.

Freddie Mac's Watch List

Freddie Mac's Counterparty Credit Risk Management Group conducts a three-phase review to identify seller/servicers to add to the Enterprise's watch list. The review procedure includes analyzing financial and operational information.

The group reports the results of its reviews and recommends remediation plans as appropriate to a special committee that reviews them. These plans can include terminating the Enterprise's business relations with the counterparty, increasing the collateral required from it, etc. After the committee determines the appropriate remediation plan, Freddie Mac's watch list is updated accordingly.

Fannie Mae's Watch Lists

Fannie Mae has two watch lists: (1) an Enterprise risk management list for all its high-risk counterparties across all of its business units including single- and multi-family housing, and (2) a high-risk lender list specifically for high-risk single-family seller/servicers.

Fannie Mae's Counterparty Risk Monitoring Unit can add a counterparty to the lists when it determines that a seller/servicer has a deficiency or the potential to breach its contract. For example, the unit may add a counterparty to a watch list for problems including financial and operational concerns.

Next, the unit prepares a fact sheet, also known as an "Action Plan," detailing any issues and recommended sanctions or remedial actions, and then sends it to Fannie Mae's Counterparty Analysis and Single-Family Underwriting and Pricing teams, which may add information and recommendations. If a seller/servicer does not resolve the problems identified in the Action Plan, the Enterprise can fine it, suspend it, or terminate business with it.

The Enterprises take ad hoc, remedial actions in response to specific deficiencies they identify with high-risk counterparties on their watch lists. For example, one Enterprise found that one of its seller/servicer's loan portfolios was underperforming. The counterparty was at risk of going out of business and threatened to encumber Fannie Mae with costs associated with finding a new company to take over servicing the Enterprise's loan portfolio. Therefore, Fannie Mae took remedial steps such as reducing the Enterprise's credit exposure to the counterparty and requiring additional collateral. Ultimately, the seller/servicer did not fail and continues to work with Fannie Mae. These specific remedial actions, however, do not always prevent the Enterprises from suffering losses from their work with high-risk counterparties.

Additionally, employing ad hoc risk reduction tools to remediate specific deficiencies differs from systemically incorporating the tools into a formalized, comprehensive plan that accounts for various adverse economic scenarios. For example, the Enterprises have each identified a particular large seller/servicer as high-risk on their respective watch lists; the seller/servicer represents an estimated risk exposure of $3.5 billion and is responsible for servicing thousands of mortgages for the Enterprises. Although the Enterprises have taken steps to protect themselves from the immediate risks they have identified, they have not prepared a systematic plan to respond to more disastrous potential eventualities, such as the seller/servicer's failure to meet its contractual obligations to the Enterprises. Alternatively, contingency planning could pre-establish a systematic process to manage the transfer of thousands of mortgages on short notice from one servicer to another.

Contingency Plan Overview

Generally, contingency plans are risk management mechanisms designed to guide organizations to respond effectively if a particular event occurs or fails to occur. In the context of a counterparty's financial deterioration or failure, a contingency plan is a step-by-step protocol governing how to work through the risk that the counterparty may be unable to satisfy its contractual obligations. Contingency plans may not prevent losses in the event of a counterparty's failure, but they may reduce risk exposure.

In spite of the obvious advantages of contingency plans and the fact that the Agency has identified seller/servicer failures as a high risk, FHFA has not required the Enterprises to prepare contingency plans to avoid or mitigate the consequences of counterparty deterioration or failure. The Enterprises should have contingency plans in place to provide provisional processes in case of counterparty failure. Such plans should be developed based on each Enterprise's assessment of the risks posed by its counterparties, which could include individual plans or group plans for counterparties based upon size or risk tier. The objective of the plans should be to restore operations quickly and seamlessly with approved counterparties, proactively anticipating alternative courses of action while minimizing the impact of counterparty failure.

Among other regulators, the practice of developing counterparty contingency plans is generally considered a best practice. For example, the *Interagency Supervisory Guidance on Counterparty Credit Risk Management* (June 2011) is a joint guide issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision. The guide is intended to help banking organizations establish their counterparty risk management practices and includes criteria for counterparty failure contingency plans. The guide refers to such contingency plans as "close out plans" and recommends that at a minimum organizations should:

- Develop a sequence of critical task and decision-making responsibilities needed to execute a counterparty close-out;
- Test a hypothetical close-out simulation for a complex counterparty at least once every two years;
- Develop standards for the speed and accuracy with which the organization can compile comprehensive counterparty exposure data and net cash outflows within four hours of the failure; and
- Periodically review documentation related to counterparty terminations and confirm that current agreements specify the definition of events of default and the termination methodology that will be used.

Accordingly, contingency plans should be comprehensive and include all critical processes addressing how counterparty risk will be managed and operations continued if a counterparty fails. Beyond these basic requirements, a plan should include quantitative assessment, event management, monitoring, and testing, as follows:

- Contingency plans should quantify the impact a counterparty failure is expected to have on the Enterprise. The plan can identify events that would have a significant effect on the Enterprise, assess the level and nature of impact on the Enterprise, and identify alternative, qualified counterparties that may be used during the contingency period. As part of the plan, the Enterprise would have to assess its other counterparties' ability to accept that new business, especially if it were a large volume of activity.
- Contingency plans should also include an event management process outlining procedures during the contingency period. Contingency actions may include curtailing existing or new activities with the failed counterparty or transferring that business to other qualified counterparties. The contingency plan also should discuss circumstances that will trigger action (including, but not limited to, rating downgrades), limits on the potential future exposure, and the impact of collateral requirements. Further, management information systems should be able to supply quick and accurate information on exposures to support the plan. In addition, the contingency plan should identify authorized individuals and their responsibilities for executing the procedures.
- The contingency plan should include a monitoring component so the Enterprise is ready for a potential counterparty failure. Monitoring emerging events and other risks related to the Enterprise's counterparties not only positions the Enterprise to work proactively to minimize its counterparty exposure, but such information also enables the Enterprise to update its contingency plan(s) as appropriate based on new or changing market conditions.

- Plans should be tested periodically. Testing allows the Enterprise to assess the contingency plan's reliability during the contingency period. Such testing would include mimicking a crisis to test communications, coordination, and decision-making. In addition, the Enterprise should periodically evaluate whether other qualified counterparties could accept new business from a failed counterparty, especially if it were a large volume of activity.

Enterprise Losses from Counterparty Failures

Despite steps to identify, monitor, and mitigate the impact of potential failures of high-risk counterparties, the Enterprises have suffered significant losses and/or have accumulated significant future exposure from seller/servicers on their watch lists. In some cases, these counterparty failures were due to fraud and in others were due to risky business models. For example, Fannie Mae estimates losses and future exposure resulting from the failure of three selected counterparties to be approximately $4.35 billion.[8]

Freddie Mac's interaction with one seller/servicer, Taylor, Bean & Whitaker Mortgage Corp. (TBW), illustrates the risks associated with the failure of a high-risk or high-volume counterparty. FHFA's review of Freddie Mac's business with TBW found that TBW was undercapitalized, underperforming, and carried too much debt.[9] The Enterprise placed the counterparty on its high-risk watch list in December 2007.[10] Nonetheless, as shown in Figure 1 below, Freddie Mac increased its volume of business with TBW from over $43 billion to approximately $52 billion at the end of 2008 and its corresponding risk exposure increased from almost $64 million to about $244 million at the end of 2008.[11] In August 2009, when the Federal Bureau of Investigation executed a search warrant at TBW's headquarters as part of a criminal fraud investigation, total business volume stood at approximately $49 billion and total exposure was around $702 million.

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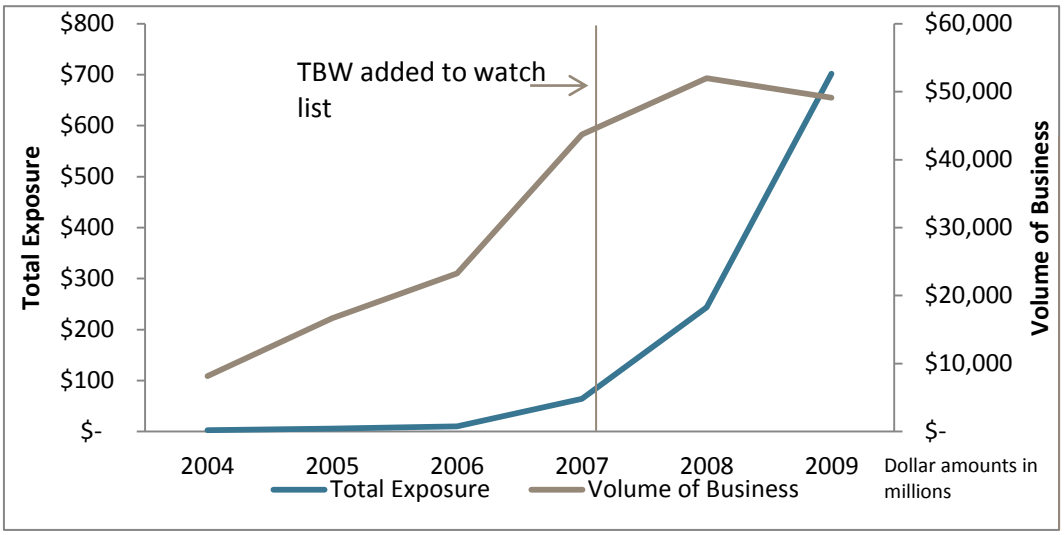
[8] The figure does not cover all of Fannie Mae's losses from all high-risk seller/servicers, but instead reflects information that was readily available from the Enterprise.

[9] "Undercapitalized" is used generally to refer to a counterparty's insufficient self-funding or equity to support its operations.

[10] TBW had worked with both Enterprises, but, in January 2000, a Fannie Mae executive discovered that TBW had sold the same loans to more than one entity including Fannie Mae. In April 2002, Fannie Mae ended its relationship with TBW due to possible fraud, but it did not report the termination to law enforcement or outside the Enterprise. FHFA's predecessor agency, the Office of Federal Housing Enterprise Oversight, was aware of the termination, but not its basis. Accordingly, Freddie Mac continued to conduct business with TBW without intervention. See additional information in FHFA-OIG, *Audit of the Federal Housing Finance Agency's Consumer Complaints Process* (AUD-2011-001, June 21, 2011).

[11] Risk exposure is influenced by a number of factors, only one of which is volume (servicing portfolio). The 2007-2008 housing crisis caused a steep drop in home prices and increased losses on defaulted mortgages, which resulted in a more dramatic increase in Freddie Mac's risk exposure.

Figure 1: Freddie Mac's Rising Volume of Business and Risk Exposure with TBW[12] (Year-End Data)



Source: FHFA-OIG's analysis of Freddie Mac's Data.

In July 2009, Freddie Mac required TBW to post collateral, a measure that could mitigate losses from a counterparty that poses risk. However, TBW collapsed shortly thereafter. On August 4, 2009, TBW's business with Freddie Mac was terminated and, in June 2010, Freddie Mac filed a claim for $1.8 billion in TBW's bankruptcy proceeding.[13]

Contingency planning may have reduced Freddie Mac's losses. For example, Freddie Mac could have implemented a contingency plan that outlined procedures to monitor and curtail TBW's existing or new activities when it learned that TBW's financial condition was deteriorating. As discussed below, FHFA recognizes that contingency planning can reduce the Enterprises' counterparty risk exposure (i.e., the Agency recently asked the Enterprises for contingency plans as part of its supervisory process, see below at p. 19), but FHFA has not published written policy guidance for the Enterprises requiring such contingency plans or describing what should be included in them.

[12] The decreased servicing portfolio for 2009 represents a partial year of purchases due to Freddie Mac suspending business with TBW, but the Enterprise estimated its rising risk exposure through the end of the year based on its projection of repurchases.

[13] According to publicly available information, Freddie Mac filed a claim in the amount of approximately $1.8 billion on or about June 14, 2010. For additional information, see p. 4 of 9 at http://www.scribd.com/doc/58862183/Docket-3237-TBW-Freddie-Mac-Settlement-Agreement, accessed on August 22, 2012.

FHFA's Oversight of Enterprises' Counterparty Risk

Under HERA, FHFA is responsible for establishing standards for systems to identify concentrated financial risk and to set limits on the Enterprises' risk exposure.[14]

In part, FHFA fulfills these responsibilities by providing guidance for its Division of Enterprise Regulation to examine, among other things, the Enterprises' contingency plans for counterparties.[15] FHFA's 2009 supervision manual directed its examiners to consider the Enterprises' use of contingency plans to mitigate counterparty risks and to protect acquisition activities (e.g., buying mortgages).[16] FHFA's Division of Supervision Policy and Support (previously the Division of Examination Programs & Support) further developed Agency examination procedures in a February 2012 draft examination manual, which is currently being field tested.[17] The new draft manual provides guidance for Agency examiners to review the Enterprises' contingency plans for detailed risk management procedures to reduce risks in the event of a seller/servicer's collapse.

According to FHFA's draft examination manual, it is a prudent practice to develop plans for reducing counterparty risk that is viewed as being too high (e.g., when the counterparty's credit rating drops below a predetermined threshold). FHFA also believes that contingency plans should be risk-based and provide a variety of actions to consider relative to adverse changes in a counterparty's financial condition. For instance, a contingency plan can describe what actions will be taken to reduce exposure to a counterparty's deteriorating financial condition (e.g., transferring assets to other counterparties or specifying a timeline to reduce exposure). FHFA's draft manual prescribes that contingency plans should correspond to weaknesses disclosed by stress testing counterparties.[18] The manual also states that contingency plans should include increasing supervision, limiting further advances (i.e., loans), restricting portfolio growth, and devising exit strategies. FHFA's Examiner-in-Charge for Fannie Mae described a contingency

[14] 12 U.S.C. § 4513b(9).

[15] The contingency plans discussed here differ from the "resolution plans" required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. According to the Act, financial institutions, including insured depository institutions with assets over $50 billion, are required to have resolution plans for winding down if they fail or go bankrupt. Also, the resolution plans are designed to protect creditors and depositors from collapses by regulated financial entities. In contrast, contingency plans as defined by FHFA in its *Draft Examination Manual, Credit Risk Management* (February 2012) focus on protecting the Enterprises from the financial deterioration of their counterparties.

[16] FHFA Division of Enterprise Regulation, *Supervision Reference and Procedure Manual* (June 2009), p. 9.

[17] FHFA, *Draft Examination Manual, Credit Risk Management* (February 2012).

[18] Stress testing is a risk management tool through which an organization analyzes various adverse financial, structural, or economic scenarios to determine how they would affect the business.

plan's goal: "[it] should identify the credit and operational risks stemming from a seller/servicer failure, and establish responsibility and procedures to contain and mitigate risks."

Although FHFA recognizes the importance of contingency planning as part of a strategy to identify and mitigate counterparty risk exposure, the Agency has not published written policies requiring the Enterprises to develop and maintain such plans or explaining what should be in them. As discussed in the finding that follows, FHFA-OIG encourages the Agency to fully realize the benefits to be derived from contingency planning by promptly publishing guidance requiring the Enterprises to develop and maintain plans for FHFA's review under its examination policies.

FINDING

FHFA Can Better Supervise the Enterprises' Risk Management of High-Risk Counterparties by Issuing Standards for Contingency Plans

FHFA can help strengthen the Enterprises' risk management by establishing standards for developing contingency plans for dealing with high-risk and high-volume counterparties. (Such plans could be individual or grouped according to counterparty size or risk tier.) In the absence of such guidance, the Enterprises have not developed contingency plans for the more than 300 counterparties on their high-risk watch lists, nor have they developed contingency plans for their largest seller/servicers.[19]

HERA requires that FHFA establish standards for each regulated entity to manage credit and counterparty risk.[20] These standards include systems to identify concentrated financial risk and to set prudential limits restricting the Enterprises' risk exposure. FHFA has taken some positive steps toward meeting this requirement by providing guidance for its examiners to review contingency plans.

However, although FHFA asked for contingency plans as part of its supervisory process (see below at p. 19), the Agency has not published written policy guidance for the Enterprises requiring contingency plans or governing what should be included in them. Instead, FHFA has been field testing draft examination procedures, hoping that the Enterprises will voluntarily conform their procedures to the Agency's internal examination instructions.

Consequently, the Enterprises have not developed contingency plans. Documents provided by the Enterprises in response to FHFA-OIG requests for contingency plans illustrate how the Enterprises have not met the standards outlined in the *Interagency Supervisory Guidance on Counterparty Credit Risk Management*.

- Fannie Mae initially advised that its "Action Plans" for high-risk seller/servicers are contingency plans. FHFA-OIG notes that, although these action plans list remedial actions taken by Fannie Mae or the counterparty in response to specific deficiencies, they do not lay out in advance comprehensive procedures for reducing the Enterprise's risk exposure relative to the counterparty's financial condition or other deficiencies that fail to improve. In response to another FHFA-OIG request for contingency plans, Fannie Mae conceded that its management has informally discussed contingency planning but does not formally establish contingency plans.

[19] As stated above, the Enterprises' top 10 servicers are responsible for 70% of their mortgage portfolios.

[20] 12 U.S.C. § 4513b(9).

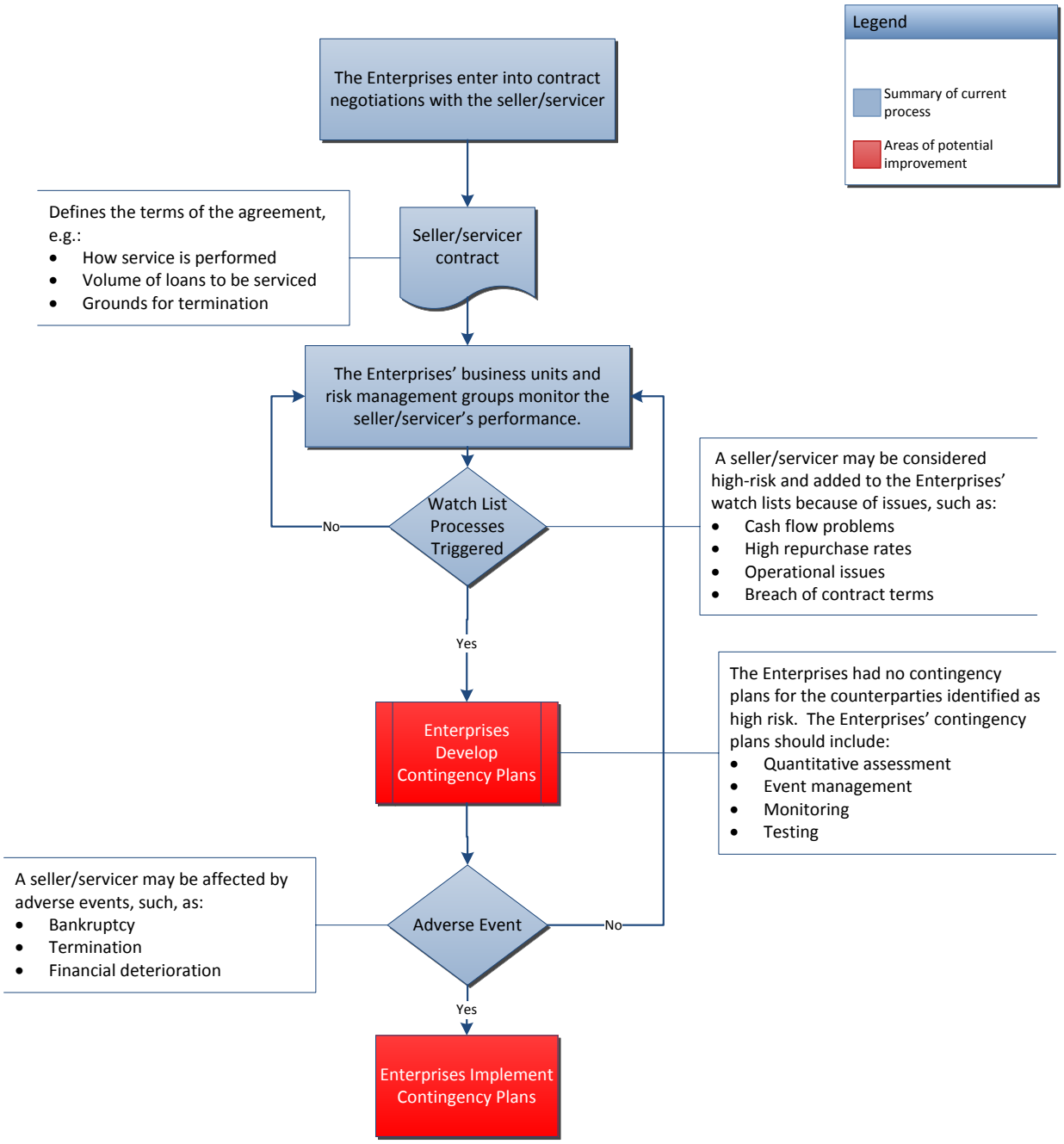
- In response to FHFA-OIG's request for contingency plans, Freddie Mac provided various documents related to screening counterparties (e.g., credit applications), monitoring them (e.g., financial reviews), and remediating specific risks (e.g., requiring more collateral). Although these actions may help mitigate Freddie Mac's counterparty risk, the Enterprise's tools and actions do not constitute an overall contingency plan as outlined by the *Interagency Supervisory Guidance on Counterparty Credit Risk Management* because they do not lay out a comprehensive plan of action to limit risk exposure in case of deteriorating financial conditions or failure.[21]

- In March 2012, Fannie Mae's Agency Examiner-in-Charge agreed with FHFA-OIG's conclusion that "Fannie Mae does not have a contingency plan to manage the risk of a failed seller/servicer institution." The same was true for a Freddie Mac examiner who told FHFA-OIG that "Freddie [Mac] does not have a document that lays out their plan in a comprehensive manner."

As indicated by these examples, the Enterprises' processes to manage their exposure to seller/servicers they have identified as high risk do not yield contingency plans that prescribe procedures to follow (e.g., an exit strategy) in response to potential risks (e.g., bankruptcy or termination). Figure 2 on the next page illustrates how a more comprehensive counterparty risk management process with prescribed future actions could further FHFA's goal of preserving and conserving the Enterprises' assets. The red boxes represent where FHFA contingency plan standards could help limit the Enterprises' financial exposure to high-risk counterparties.

[21] FHFA, *Draft Examination Manual, Credit Risk Management* (February 2012).

Figure 2: The Enterprises' Counterparty Risk Management Process



Source: FHFA-OIG analysis of Enterprise counterparty risk management procedures.

As a result of FHFA-OIG's audit, FHFA's Examiners-in-Charge asked the Enterprises to develop servicer contingency failure plans as part of the Agency's supervisory process. With respect to Fannie Mae, the Agency examiner also asked that the plan be a written document that the Enterprise can reference, execute, test, and account for in the event of a servicer's sudden and unexpected failure. This request is noteworthy; but, the Agency has not published written policy guidance for the Enterprises regarding what should be included in such contingency plans or formally requiring their creation. FHFA should follow through by issuing contingency plan standards that require both Enterprises to develop plans for both high-risk and concentrated, high-volume counterparties as defined by the Agency.

CONCLUSION

As of September 2011, high-risk counterparties managed mortgage portfolios of $955 billion and exposed the Enterprises to an estimated $7.2 billion in potential financial losses. In addition, the Enterprises' 10 largest servicers were responsible for handling $3.1 trillion in outstanding mortgages. As shown by the more than 40 seller/servicers that the Enterprises have suspended or terminated since 2007, and by the Enterprises' estimates of up to $6.1 billion in losses following the failure of just 4 high-risk seller/servicers, the Enterprises face significant risks from their counterparties.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

1. Issue standards, by regulation or guidelines, for the Enterprises to develop comprehensive contingency plans for their high-risk and high-volume seller/servicers (individually or by group). At a minimum, these standards should include quantitative assessment, event management (e.g. curtailing business with or transferring business from a seller/servicer or specifying reasonable timeframes for reducing risks), monitoring, and testing elements.
2. Finalize FHFA's February 2012 draft examination manual to include elements related to contingency planning.

OBJECTIVE, SCOPE, AND METHODOLOGY

This performance audit's objective was to assess FHFA's oversight of the Enterprises' management of counterparty risk related to high-risk seller/servicers. Although FHFA-OIG focused on FHFA's supervision of the Enterprises, FHFA-OIG also performed a limited review of the Enterprises' management of high-risk counterparties.

The audit scope was from August 1, 2009, through September 30, 2011, and was expanded as necessary. FHFA-OIG performed field work from October 2011 through April 2012 at FHFA's offices in Washington, DC; Fannie Mae's headquarters in Washington, DC; and Freddie Mac's headquarters in McLean, VA.

To achieve its objective, FHFA-OIG:

- Interviewed FHFA and Enterprise officials about their oversight of high-risk counterparties;
- Assessed FHFA's 2009, 2010, and 2011 quarterly risk assessment processes for counterparty risk;
- Reviewed FHFA's 2008, 2009, and 2010 examination reports on the Enterprises, focusing on counterparty risk;
- Evaluated the Enterprises' 2009 and 2012 policies and procedures for managing high-risk counterparties; and
- Sampled the Enterprises' respective high-risk counterparty watch lists (2007–2012) to review their procedures for monitoring, reporting, and mitigating risk exposure.

FHFA-OIG also assessed the internal controls related to the audit's objective. Internal controls are an integral component of an organization's management. They provide reasonable assurance of: (1) effective and efficient operations; (2) reliable financial reporting; and (3) compliance with applicable laws and regulations. Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives, and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance. Based on the work completed in this performance audit, FHFA-OIG considers weaknesses in FHFA's oversight of the Enterprises' management of counterparty risk related to high-risk seller/servicers to be significant in the context of the audit's objective.

FHFA-OIG conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for FHFA-OIG's finding

and conclusion based on the audit objective. FHFA-OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusion included herein, based on the audit objective.

APPENDIX A:

FHFA's Comments on the Finding and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Russell Rau, Deputy Inspector General for Audits

FROM: Jon Greenlee, Deputy Director, Division of Enterprise Regulation
Fred Graham, Acting Deputy Director, Division of Supervisory Policy and Support

SUBJECT: FHFA Response to *FHFA's Oversight of the Enterprises' Management of High Risk Seller/Servicers* (Assignment No. AUD-2011-015)

DATE: August 27, 2012

This is a response to your memo of July 31, 2012, which transmitted FHFA-OIG's draft report containing findings and recommendations from your recent audit of FHFA's oversight of Fannie Mae and Freddie Mac's (the Enterprises') management of high risk seller-servicers. We appreciate the opportunity to provide feedback on your report. FHFA agrees this is a critical area for ongoing supervisory attention, and our view of the risk has been a driver for supervisory action. We believe we have taken an important step in addressing key counterparty risk by requesting contingency plans through the supervisory process. Moreover, FHFA agrees with FHFA-OIG's recommendations to issue and finalize guidance to the Enterprises and FHFA examination staff regarding contingency plans. While we believe that the risk mitigation objectives stated by FHFA-OIG in the report were largely achieved through effective use of the supervisory process and by draft policy documents utilized by FHFA examination staff, we agree that the supervision program could be enhanced by written guidance articulating FHFA's supervisory expectations for risk management of counterparty exposures. Below are the Agency responses to FHFA-OIG's two recommendations.

Recommendation 1: FHFA-OIG recommends that FHFA's Deputy Directors of Examination Programs & Support (which develops examination guidance) and Enterprise Regulation (which conducts examinations) coordinate to:

1. Issue standards, by regulation or guidelines, for the Enterprises to develop contingency plans for their high-risk or high-volume seller/servicers (individually or by group). At a minimum, these standards should include quantitative assessment, event management (e.g., curtailing business with or transferring business from a seller/servicer or specifying reasonable timeframes for reducing risks), monitoring, and testing elements.

Agency Response: Agree.

Standards relating to contingency plans for high-risk and high-volume counterparties have been incorporated in FHFA's draft examination manual, which is now in the process of being field-tested by FHFA examiners, and they are reflected in communications by the examiners-in-charge to the Enterprises that included direction to create contingency plans to mitigate risks. As noted in the report, the examiners-in-charge for both Fannie Mae and Freddie Mac requested contingency plans from the Enterprises in the course of ongoing 2012 supervisory activity. The examiners specified certain particular components of acceptable contingency plans for the Enterprises, but the communications did not reference published Agency policy.

The Division of Supervisory Policy and Support (which will take on responsibilities of DEPS) - Office of Examination Policy and Programs is currently working to develop guidance specifically targeted to the Enterprises.[1] It is anticipated that the substantive points will incorporate what is currently included in the draft examination manual, for example, quantitative analysis of risk exposure and ongoing monitoring of counterparties' condition and ability to fulfill contractual obligations to the Enterprises. The target completion date for an Advisory Bulletin covering contingency planning for high risk seller/servicers is the first quarter 2013.

Recommendation 2: Finalize FHFA's February 2012, draft examination manual to include elements related to contingency planning.

Agency Response: Agree.

OEPP is currently working to finalize the draft examination manual that is now being tested by the examination teams. The manual's section on counterparty risk management includes a number of specific requirements relating to the timing, content and implementation of contingency plans, which have informed supervisory work and communications to date. The section of the draft manual addressing supervisory expectations for contingency plans is expected to be finalized by the first quarter of 2013.

[1] Division and section names may be modified in the upcoming realignment of FHFA Supervision, but the Office of Examination Policy and Programs will retain responsibility for issuance of supervisory policy guidance and examiner guidance.

APPENDIX B:

FHFA-OIG's Response to FHFA's Comments

On August 27, 2012, FHFA provided comments to a draft of this report agreeing with both recommendations and identifying FHFA actions to address them. FHFA-OIG considers the actions sufficient to resolve the recommendations, which will remain open until FHFA-OIG determines that agreed-upon corrective actions are completed and responsive to the recommendations. FHFA-OIG has attached the Agency's full response (see Appendix A), which was considered in finalizing this report. Appendix C provides a summary of management's comments on the recommendations and the status of agreed-to corrective actions.

APPENDIX C:

Summary of Management's Comments on the Recommendations

This table presents the management response to the recommendations in FHFA-OIG's report and the status of the recommendations as of when the report was issued.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved: Yes or No[a]	Open or Closed[b]
1.	Issue standards, by regulation or guidelines, for the Enterprises to develop comprehensive contingency plans for their high-risk or high-volume seller/servicers (individually or by group). At a minimum, these standards should include quantitative assessment, event management (e.g. curtailing business with or transferring business from a seller/servicer or specifying reasonable timeframes for reducing risks), monitoring, and testing elements.	3/31/2013	$0	Yes	**Open**
2.	Finalize FHFA's February 2012 draft examination manual to include elements related to contingency planning.	3/31/2013	$0	Yes	**Open**
Total			**$0**		

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to the FHFA-OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

[b] Once FHFA-OIG determines that agreed-upon corrective actions have been completed and are responsive, the recommendations can be closed.

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