Federal Housing Finance Agency
Office of Inspector General

FHFA Oversight of Fannie Mae's Reimbursement Process for Pre-Foreclosure Property Inspections

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OFFICE OF INSPECTOR GENERAL
Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

January 15, 2014

TO: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation

FROM: Russell A. Rau, Deputy Inspector General for Audits

SUBJECT: FHFA Oversight of Fannie Mae's Reimbursement Process for Pre-Foreclosure Property Inspections (AUD-2014-005)

Summary

The Federal Housing Finance Agency (FHFA) serves as the federal regulator of the Federal National Mortgage Association (Fannie Mae or Enterprise) with broad responsibilities for the Enterprise's safety and soundness. Additionally, since September 2008, FHFA has acted as conservator for Fannie Mae, with management authority to preserve and conserve the assets of the Enterprise. In both of these roles, FHFA has taken action to mitigate losses associated with delinquent single-family residential mortgages purchased by Fannie Mae. As of December 31, 2012, the Enterprise had more than 570,000 mortgages that were more than 90 days past due and had credit losses of over $14 billion for 2012 because of foreclosures and alternative actions to address delinquencies. Treasury has provided considerable financial support to Fannie Mae while it has been in conservatorship. Enterprise losses can reduce payments made to Treasury as a condition to the financial support provided.

When a borrower is delinquent on mortgage payments, Fannie Mae and its servicers use property inspections, referred to as pre-foreclosure property inspections, to help protect the interest in the property securing the mortgage from physical conditions that may result in additional credit loss.[1] The Fannie Mae *Single Family 2012 Servicing Guide* (*Servicing Guide*) requires servicers to perform a monthly inspection on all properties where borrowers have become delinquent on

[1] Mortgage servicers typically collect and deliver principal and interest payments, administer escrow accounts, monitor and report delinquencies, perform default prevention activities, evaluate transfers of ownership interests, respond to requests for partial releases of security, and handle proceeds from casualty and condemnation losses.

their mortgage loan.[2] However, Fannie Mae limits the total amount per loan that servicers are reimbursed for pre-foreclosure property inspections.

The objective of this audit was to assess FHFA's oversight of Fannie Mae's reimbursement to its servicers for pre-foreclosure property inspection claims.

Overall, OIG concluded that additional FHFA oversight is needed regarding pre-foreclosure property inspection claims. Specifically, Fannie Mae's process for paying servicer property inspection claims has significant control deficiencies. Further, Fannie Mae does not have system controls to automatically approve, curtail, or reject claims based on Fannie Mae's established reimbursement limits. As a result, Fannie Mae approved inspection claims incorrectly by using processing procedures for other types of reimbursements. These deficiencies caused the Enterprise to overpay servicers by approximately $5 million in 2011 and 2012 for pre-foreclosure property inspection claims in excess of established reimbursement limits.

OIG recommends that FHFA direct Fannie Mae to: (1) obtain a refund from servicers for overpayments of property inspection claims; (2) implement system controls to reject property inspection claims over established tolerance limits; and (3) issue guidance to all servicers concerning requirements to adhere to reimbursement limits for property inspection claims. OIG also recommends that FHFA assess the need for additional examination coverage of Fannie Mae's pre-foreclosure property inspection reimbursement process. FHFA is taking action that is generally responsive to the recommendations except for obtaining refunds for overpayments of property inspection claims.

Background

In performing duties incident to the servicing of delinquent mortgage loans, servicers should take action necessary to protect Fannie Mae's interest in the property securing the loan as authorized by servicing guidance and the terms of the mortgage loan. Among other duties, this includes periodically inspecting property to ensure that: (1) its physical condition is satisfactory; (2) no apparent hazardous conditions affect occupants or others; and (3) no apparent violations of applicable law might result in its seizure or forfeiture.

On April 28, 2011, FHFA announced a Servicing Alignment Initiative (SAI) directed at Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac, together the Enterprises) to align their respective guidelines for servicing delinquent mortgages that they either own or guarantee. The SAI required the Enterprises to align servicing requirements in four key areas, including: (1) borrower contact, (2) delinquency management practices, (3) loan modifications,

[2] Fannie Mae, "Part III: General Servicing Functions – Chapter 3, Property Inspections," *Fannie Mae Single Family 2012 Servicing Guide* (March 14, 2012). Accessed December 23, 2013, at https://www.fanniemae.com/content/guide/svc031412.pdf.

and (4) foreclosure timelines. Included in the delinquency management practices section, the directive required the Enterprises to align standards for property inspections.[3]

In response, the Enterprises changed their existing standards for conducting pre-foreclosure property inspections on delinquent loans to align the following:

1. **Ordering Inspections**. The servicer must generally order the first property inspection no later than the 45th day of delinquency and complete the property inspection no later than the 60th day of delinquency.
2. **Subsequent Inspections**. The servicer must generally continue to obtain property inspections every 30 days as long as the mortgage loan remains 45 days or more delinquent.
3. **Bankruptcy**. Inspections are not required for loans under a bankruptcy plan.
4. **Interior Inspections**. An interior property inspection must be performed after confirmation that a property has been abandoned and within 30 days of a foreclosure sale.

The Fannie Mae *Servicing Guide* is consistent with these standards and requires servicers to perform monthly property inspections on all properties when borrowers have become delinquent on their mortgage loans. The guide requires that once a loan becomes 30 days delinquent, the servicer must order a property inspection by the 45th day of delinquency. The initial inspection must be performed by the 60th day. After the initial inspection, the guide requires that a subsequent inspection of the property be performed every 30 days.

When the decision is made to start foreclosure, Fannie Mae requires the servicer to schedule its property inspections in a way that will ensure that the final comprehensive property inspection is completed within 30 days of the foreclosure sale.

Ordering Property Inspections

A consequence of the volume of delinquent mortgage loans is demand for property preservation services, including property inspections. Most servicers hire property preservation companies to conduct these inspections. In turn, these companies often hire subcontractors to conduct the actual inspections. Figure 1 provides a chronology of the typical property inspection ordering process.

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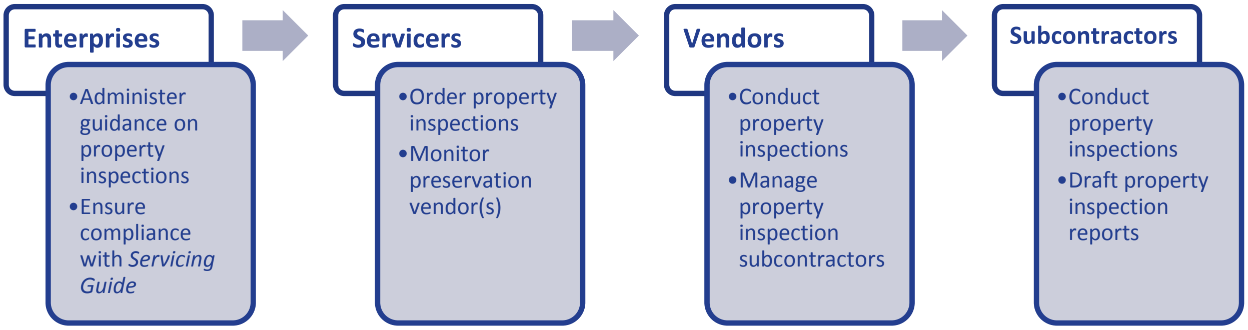
[3] FHFA, "Frequently Asked Questions – Servicing Alignment Initiative," *Fannie Mae and Freddie Mac to Align Guidelines for Servicing Delinquent Mortgages*." Accessed December 23, 2013, at http://www.fhfa.gov/webfiles/21191/faqs42811final.pdf.

Figure 1. Chronology of the Process to Order a Property Inspection



Source: OIG Analysis

FHFA's Actions Related to Property Inspections

Before 2013, FHFA had not examined the Enterprises' controls over pre-foreclosure property inspections or issued related guidance to the Enterprises. However, in 2013, FHFA examined servicer and real estate owned expense claim reimbursements. The examination's scope included an evaluation of the following:

- Policies, procedures, and standards used to manage reimbursements;
- Data analytics, tools, and controls used to monitor external vendors and payees;
- Operational reports used for performance oversight; and
- Previous internal audit concerns and remediation progress.

In a September 2013 conclusion letter, FHFA examiners noted that Fannie Mae should improve its oversight of and controls over its reimbursement process for servicer expenses (such as property inspections) to avoid potential losses. Further, FHFA noted that additional oversight of contractors providing claims reimbursement services to Fannie Mae was needed to manage financial and reputational risk. FHFA examiners recommended actions to address these matters.

Separate from FHFA's oversight of pre-foreclosure property inspections, the OIG noted issues with pre-foreclosure property inspections before 2013. OIG issued a report in November 2012 to FHFA related to a previous investigation of a property preservation company that created fraudulent property inspection reports.[4] According to FHFA officials, the Agency informally shared the information contained in the OIG report with its internal examiners and staff at the Enterprises.

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[4] OIG Systemic Implication Report, *Enterprise Oversight of Property Preservation Inspections*, SIR-2013-0002 (November 26, 2012). Accessed December 23, 2013, at http://fhfaoig.gov/Content/Files/SIR%20FINAL%20Enterprise%20Oversight%20of%20Property%20Preservation_0.pdf.

Fannie Mae Oversight and Quality Control

The scope of Fannie Mae's oversight of its servicers' property inspection controls is limited to determining whether inspections were ordered appropriately. The Enterprise conducts Servicer Quality Reviews to ensure servicers comply with requirements outlined in its *Servicing Guide*. These requirements include ensuring servicers order property inspections when mortgage loans become delinquent. After ordering inspections, Fannie Mae relies on servicers to ensure controls are in place to minimize the risk of inconsistent, inaccurate, and incomplete property inspections and reports, and to ensure inspections are used for their intended purposes.

Fannie Mae reimbursed servicers approximately $61 million in 2011 and 2012 for property inspection expenses on delinquent loans. Generally, to obtain reimbursement for these expenses, servicers access Fannie Mae's Asset Management Network and electronically submit a Cash Disbursement Request (Form 571).[5]

Form 571 comprises 13 broad, billable categories, including one for property inspections. Each Form 571 submitted by a servicer to Fannie Mae is referred to as a claim. Claim complexity and submission timing vary. Generally, servicers submit their claims near the end of borrowers' delinquency periods or immediately after loans' foreclosure dates. Thus, it is possible for servicers to incur expenses and make payments for years before they ask for reimbursement from Fannie Mae.

Claim Processing

Fannie Mae processes all property inspection reimbursement claims submitted either on Form 571 or via the Lender Processing Services (LPS) Invoice Management (IM) System. Before 2011, Fannie Mae internally reviewed claims that required processing. In 2011, however, Fannie Mae decided to outsource this task to a claims contractor. By July 2011, the contractor was processing the majority of claims—a practice that continued through the audit period.

Fannie Mae has information systems and prescribes specific servicer claim review procedures that contractor analysts are required to use when reviewing each claim. The procedures are intended to ensure Fannie Mae only reimburses servicers for claims that comply with its *Servicing Guide*. After reviewing each line item on the claim, the analyst: (1) approves reimbursement of the claim in full, (2) curtails the claim, or (3) rejects it.[6] Fannie Mae receives the analyst's decision and distributes the approved amount of money to the servicer.

During 2011 and 2012, Fannie Mae's claims contractor processed over 750,000 property inspection reimbursement claims.

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[5] During the audit period, Fannie Mae began to transition from using Form 571 to requiring servicers to submit reimbursement requests via the Lender Processing Services (LPS) Invoice Management (IM) System.

[6] By curtailing a claim, Fannie Mae reimburses a servicer less than it requests. If a servicer believes its claim was unjustly curtailed or denied, it can contact Fannie Mae for an explanation. Additionally, the servicer can repeatedly resubmit a curtailed or denied claim.

Information Systems

Fannie Mae and its contractor use various information systems in support of the claim process. These systems, among others, include:

1. **Distressed Asset Reporting and Tracking System**. Displays all servicer delinquency action and reason codes submitted on all seriously delinquent loans.
2. **Lender Processing Services (LPS) Invoice Management (IM) System**. Allows servicers to handle invoices and expense reimbursements in one, web-based application.[7]

Fannie Mae's 571 Servicer Processing Guide

Fannie Mae's *571 Servicer Processing Guide* provides instructions to its claims contractor for analyzing and processing reimbursement requests by servicers. The guide provides instructions for claiming reimbursement for the various expenses incurred by servicers on single-family mortgages in default before the property goes into foreclosure (i.e., pre-foreclosure claims).

The guide consists of several sections with instructions for processing claims such as "Pre-foreclosure," "Loss Mitigation," and "REO Servicer." Several sections provide explicit guidance for processing pre-foreclosure property inspection claims. These sections also outline tolerance limits for servicers requesting reimbursement for accrued property inspection expenses.[8] According to the guide, the maximum amount Fannie Mae reimburses servicers depends on the servicer's name[9] and the type of mortgage loan[10] in default. Figure 2 illustrates Fannie Mae's *571 Servicer Processing Guide* and several related sections.

[7] Servicers are able to link directly from their invoices to create expense request claim forms and submit them to Fannie Mae for approval. The servicer and Fannie Mae have direct access to invoices that tie into claims, and supporting documents can be attached directly to the line item.

[8] In this report, tolerance limits refer to the amount Fannie Mae is willing to reimburse servicers for property inspection claims.

[9] Fannie Mae's *571 Servicer Processing Guide* lists servicers by name along with the amount the Enterprise is willing to pay them for property inspection claims.

[10] Fannie Mae's *571 Servicer Processing Guide* prescribes procedures and tolerance limits for various types of mortgage loans, such as those in second-lien position (i.e., loans that have a lien position subordinate to the first-lien mortgage loan).

Figure 2. Fannie Mae *571 Servicer Processing Guide* and Sections

Source: OIG Analysis

The "Pre-foreclosure Reimbursement" section of the guide provides instructions for analyzing and processing reimbursement requests related to the default of single-family mortgages for expenses incurred before the property goes into foreclosure. Specifically, the guide provides a table outlining the amount Fannie Mae is willing to reimburse servicers for performing property inspections required in connection with a delinquent mortgage or an acquired property.

The "Reverse Mortgage" section provides instructions for processing claims associated with reverse mortgages when servicers incur expenses during their delinquency and foreclosure-processing period.[11] Fannie Mae processes two types of reverse mortgages: home equity conversion mortgages (HECM) and home keeper mortgages (HKM). The HECM is a Federal Housing Administration (FHA)-insured reverse mortgage, and the HKM is a Fannie Mae reverse mortgage product.

Objective

The overall audit objective was to assess FHFA's oversight of the Enterprises' controls over pre-foreclosure property inspections that are performed on properties with delinquent mortgages. The results of the audit related to the overall audit objective will be addressed in a separate report. While performing audit work related to the overall objective, however, OIG identified potential control issues related to servicers' claims for reimbursement of pre-foreclosure property inspection expenses. Therefore, the objective related to this report was to assess FHFA's oversight of Fannie Mae's reimbursement to its servicers for pre-foreclosure property inspection claims.

[11] Through reverse mortgages, owners regularly receive money for their property that is added to their total mortgage loan (e.g., instead of making a monthly $1,000 mortgage payment that lowers the mortgage, the owner receives $1,000 that increases it).

Finding

Fannie Mae Overpaid Servicers for Pre-Foreclosure Property Inspections

Fannie Mae's process for reimbursing servicers for pre-foreclosure property inspection claims did not prevent payments in excess of applicable tolerance limits. Specifically, processors were able to: (a) override system edit flags and approve claims that exceeded established limits, and (b) approve claims incorrectly using processing procedures for other types of reimbursements with higher limits. As a result, the Enterprise overpaid servicers approximately $5 million in property inspection disbursements.

Fannie Mae's 571 Servicer Processing Guide Includes Established Tolerance Limits for Property Inspections

To receive reimbursement for property inspection expenses, servicers submit either a Form 571 or a request through the LPS IM System.[12] Fannie Mae's supplemental *571 Servicer Processing Guide* allows servicer reimbursements for property inspection expenses up to established tolerance limits.[13]

The reimbursement tolerance limits for property inspection claims were:

- $200 over the life of the mortgage loan for 16 designated servicers;[14]
- $15 per inspection (per month) for Seterus, Inc.;[15] and
- $60 over the life of the mortgage loan for all other servicers.[16]

Property inspection claims for reverse mortgages have similar tolerance limits that cap these reimbursements to either $60 or $200 over the life of the loan. Figure 3 further details the prescribed tolerance limits for reimbursement of property inspection claims submitted by servicers.

[12] During the audit period, Fannie Mae was transitioning from using the Form 571 to using the LPS IM System. Servicers used both methods during the audit period to submit reimbursement requests.

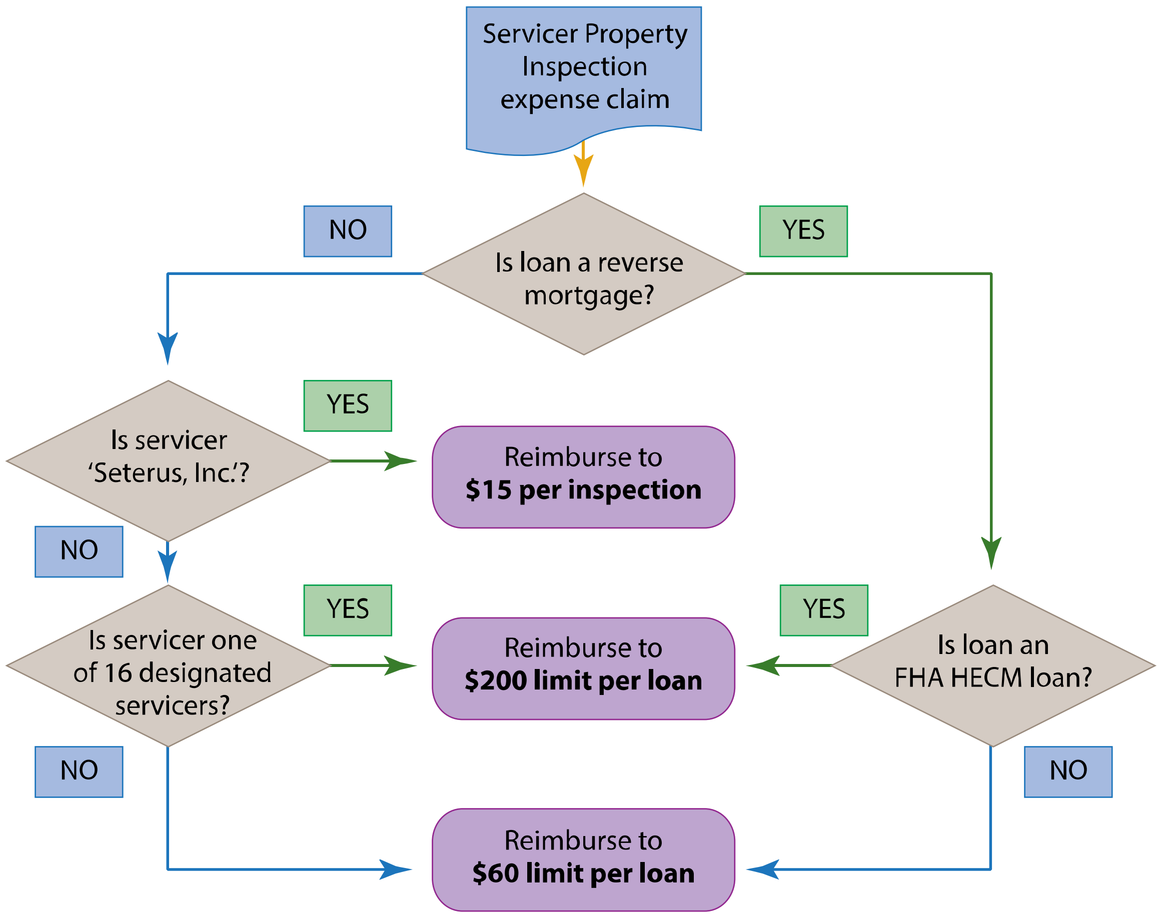
[13] Source: Fannie Mae's *571 Servicer Processing Guide*, sec. 571 "Pre-foreclosure."

[14] Fannie Mae's 571 servicer processing guides identify 16 servicers that are allowed to exceed the $60 tolerance limit.

[15] Seterus, Inc. was the only high-touch servicer the guide identified through 2012 under the $15 per inspection criteria. Fannie Mae added Greentree during 2013. High-touch servicers provide enhanced servicing that includes closer and more frequent contact between a delinquent borrower and the servicer.

[16] The processing guide permits servicers to submit claims up to $60 for property inspections of HKM loans and $200 for HECM loans. According to the guide, HECM claims processed up to $200 do not require a voucher from the Department of Housing and Urban Development (HUD)—also known as a HUD voucher.

Figure 3. Fannie Mae Servicer Reimbursement Tolerance Limits for Pre-Foreclosure Property Inspections



Source: OIG Analysis

Fannie Mae Reimbursed Servicers' Property Inspection Claims at Amounts in Excess of the Established Tolerance Limits Detailed in the 571 Servicer Processing Guide

Fannie Mae did not consistently follow established procedures for reimbursing servicers for property inspection expenses accrued on delinquent mortgage loans. OIG identified numerous instances where Fannie Mae approved servicers' claims for pre-foreclosure property inspection expenses in excess of Fannie Mae's property inspection tolerance limits. For example, one servicer submitted a claim for a total of $3,847 in property inspections on one loan. According to the *571 Servicer Processing Guide*, this servicer was limited to $200 for property inspections over the life of the loan. As a result, the servicer received an overpayment of $3,647 for this particular loan, or over 1,800% in excess of the limit.

In another instance, a servicer submitted a claim for $1,469 for property inspections on one loan. This servicer was entitled to no more than $60 in total for property inspections over the life of the loan as specified in the *571 Servicer Processing Guide*. The overpayment of $1,409 represented over 2,300% in excess of the limit.

There were numerous other examples similar to these with respect to overpayments made on Fannie Mae loans. While not significant on an individual mortgage loan basis, when taken in the aggregate, there were approximately $5 million in overpayments to Fannie Mae servicers for property inspection reimbursement claims in excess of the limits specified in the *571 Servicer Processing Guide* during 2011 and 2012.

Processing Errors Caused Fannie Mae to Overpay Servicers

Fannie Mae and its contractor approved over 750,000 property inspection reimbursement claims through the Enterprise's IM system during 2011 and 2012. OIG detected two types of processing errors that caused approval of property inspection reimbursement claims in excess of established tolerance limits. Specifically, processors were:

- Overriding system edit flags and approving property inspection claims that exceeded established tolerance limits; and
- Approving property inspection claims in excess of tolerance limits by using procedures established for loss mitigation claims.

Processors Are Able to Override System Edit Flags

Fannie Mae did not implement controls in the IM system to prevent processors from approving property inspection reimbursement claims over established tolerance limits. For example, each time a servicer submits a claim requesting reimbursement for property inspections related to a particular loan, the IM system flags the transaction as requiring review by a processor. The processor must then review each flagged transaction to determine whether the servicer has previously submitted property inspection reimbursement claims for the same loan. Once the processor identifies all applicable transactions related to the particular loan under review, the processor must then calculate the total allowable amount for property inspection reimbursement. Subsequently, the processor compares the aggregate amount to the established property inspection tolerance limit for the type of servicer as described in the *571 Servicer Processing Guide* to determine the total reimbursement allowed. As a result, the primary control over determining whether the requested reimbursement is within the established tolerance limits is the processor reviewing the reimbursement claim.

Although Fannie Mae's IM system generates an edit flag for each transaction related to a property inspection claim, processors are able to override the edit flag and approve claims for any amount. According to Fannie Mae personnel, the edit flag simply instructs the processor to review property inspection transactions before approving a claim. Fannie Mae's IM system does not have additional controls to avoid erroneous payments, such as a control that can compare claims to tolerance limits.

Processors Approve Property Inspection Claims Using Incorrect Procedures

The servicing fee that Fannie Mae pays a servicer is intended to compensate the servicer for standard activities associated with servicing mortgage loans such as collection and distribution of payments. The servicing fee is not intended to encompass additional work that the servicer performs at Fannie Mae's request such as pre-foreclosure property inspections and certain loss mitigation activities for which Fannie Mae separately compensates the servicer. Fannie Mae describes pre-foreclosure property inspection expenses as costs associated with a servicer inspecting a property from the time a mortgage loan becomes delinquent until 30 days before the delinquent mortgage goes into foreclosure. Fannie Mae has established specific limits on these expenses. In comparison, Fannie Mae engages in loss mitigation activities with troubled borrowers to avoid foreclosure. These activities include pre-foreclosure sales, loan modifications, repayment plans, and forbearance arrangements. Loss mitigation expenses are generally associated with these activities and can include reimbursement for payments of attorney fees, property taxes, and hazard insurance. They do not include pre-foreclosure property inspections and are subject to limits based on the estimated cost to liquidate the property through foreclosure.

Fannie Mae's IM system combined pre-foreclosure property inspection claims and loss mitigation claims. In the absence of the claims being separately identified, processors erroneously classified and approved some pre-foreclosure property inspection claims as expenses incurred in connection with loss mitigation. Figure 4 provides examples of inspection claims Fannie Mae paid as loss mitigation expenses, thus exceeding the loan's established tolerance limit for payments for pre-foreclosure property inspections.

Figure 4. Property Inspection Claims Processed as Loss Mitigation

Loan	Tolerance Limit	Claim Amount	Overpayment
1.	$60	$1,469	$1,409
2.	$60	$636	$576
3.	$200	$1,191	$991
4.	$200	$1,090	$890
5.	$200	$1,065	$865
6.	$200	$1,050	$850
7.	$200	$990	$790
8.	$200	$970	$770

Source: OIG Analysis

Because of FHFA's examination coverage and this audit, Fannie Mae advised OIG that it is working with its claims contractor to address errors in payment of pre-foreclosure inspection claims. In addition, Fannie Mae issued guidance to its contractor discontinuing the loss mitigation section of the *571 Servicer Processing Guide*.[17] Therefore, pre-foreclosure property inspections may no longer be categorized as loss mitigation claims. However, the Enterprise did not contact appropriate servicers to seek a refund for improper payments of inspection claims that were due to processing errors nor did FHFA require them to do so.

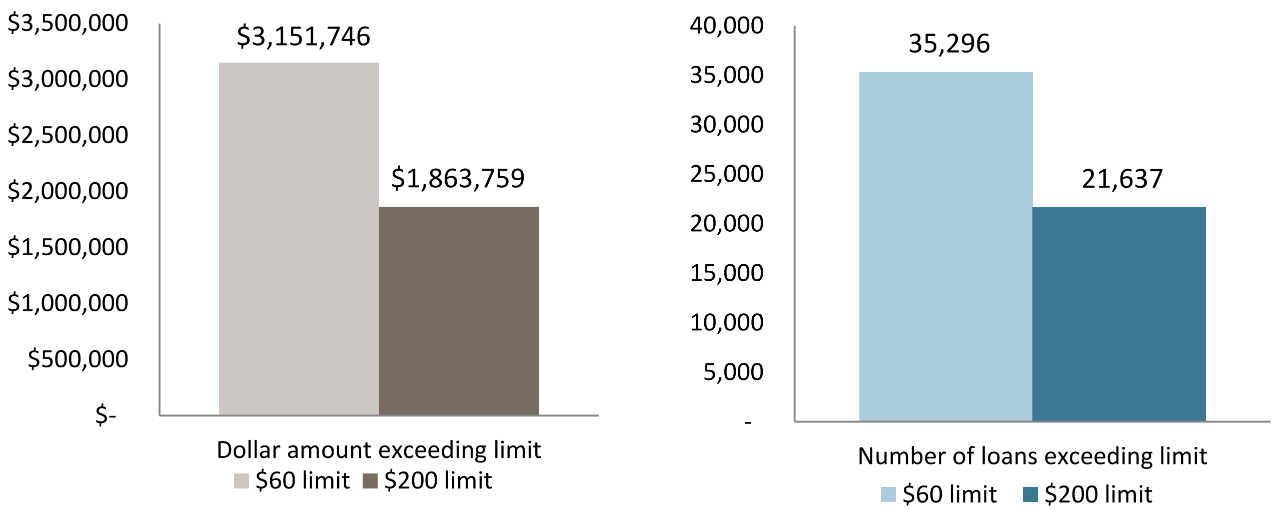
[17] Fannie Mae issued communication to its contractor with guidelines on a new procedure regarding the processing of loss mitigation claims. Source: *Svcr. Communication Amended Procedure Processing of Loss Mitigation Claims,* dated 4.18.13.

Conclusion

Pre-foreclosure claim processing errors resulted in Fannie Mae overpaying its servicers at an overall rate of 8% for property inspection claims in excess of established tolerance limits.[18] Of the $61 million paid to servicers for property reimbursement claims in 2011 and 2012, OIG identified transactions in which Fannie Mae overpaid servicers more than $5 million.

Figure 5 provides an illustration of the total overpayments and related number of loans impacted.

Figure 5. 2011-2012 Total Overpayments and Related Mortgage Loans



Source: OIG calculations using Fannie Mae's: (1) *571 Servicer Processing Guide*, and (2) 2011 and 2012 total disbursements.[19]

OIG concluded that collection of the $5 million in overpayments would result in funds put to better use.[20] Fannie Mae has been in conservatorship since 2008 and Treasury has provided considerable financial support to the Enterprise, totaling over $117 billion as of December 31, 2012. Under the provisions governing this financial support, Treasury receives payments based generally on the Enterprise's net income, which would be increased by Fannie Mae's collection of the overpayments.

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[18] This percentage is the total improper payments divided by total amount reimbursed to servicers during 2011 and 2012.

[19] OIG calculated the overpayment by: (a) adjusting Fannie Mae's total disbursements for 2011 and 2012 to exclude duplicate payments, (b) identifying and segregating disbursements from the 16 designated servicers, (c) applying the $200 limit to all reverse mortgages (i.e., FHA-insured and Fannie Mae reverse mortgages), (d) comparing the total disbursement issued for each loan number to the established tolerance limit (i.e., $60 or $200), and (e) identifying all disbursements that exceed these tolerance limits as overpayments.

[20] Funds put to better use are reported by the OIG in its *Semiannual Report to Congress.* Recommendations that funds be put to better use tell agency management that taking action to implement the recommendations would result in more efficient or effective use of funds. Such actions could include reducing outlays, deobligating funds, and avoiding unnecessary expenditures.

Additionally, given the OIG's Systemic Implication Report dated November 2012 and the results of this audit, FHFA needs to timely assess the need for additional examination coverage regarding pre-foreclosure property inspections to ensure this control is operating as intended and determine if additional guidance is needed.

Recommendations

OIG recommends that FHFA direct Fannie Mae to:

1. Obtain a refund from servicers for improperly reimbursed property inspection claims, resulting in estimated funds put to better use of $5,015,505;

2. Implement controls in the IM system to reject pre-foreclosure property inspection claims over established tolerance limits; and

3. Submit guidance to all servicers that reminds them of requirements to adhere to reimbursement tolerance limits for pre-foreclosure property inspection claims.

Additionally, OIG recommends that FHFA:

4. Assess the need for examination coverage related to reimbursement of pre-foreclosure property inspection claims.

Scope and Methodology

In order to accomplish its objective, OIG:

- Surveyed servicers for information pertaining to property inspections conducted during 2011 and 2012;
- Interviewed FHFA officials and reviewed guidance related to findings resulting from examinations;
- Interviewed Enterprise officials and reviewed Enterprise property inspection reimbursement and monitoring processes, procedures, servicing guidance, and internal reports;
- Analyzed the Enterprise's property inspection reimbursement and quality control data;
- Interviewed selected servicer officials and reviewed property inspection reports, quality control reports, vendor contracts, procedures, and other documents pertinent to their property inspection oversight and controls; and
- Analyzed the servicers' quality control procedures and files associated with property inspections.

OIG conducted its fieldwork at FHFA's offices in Washington, DC, and Fannie Mae's corporate offices in Washington, DC. The scope of the audit was January 2011 through December 2012, and was expanded as necessary to obtain data that are more current for reporting purposes.

OIG assessed the reliability of data received for this audit as determined necessary by corroborating the information with publicly available reports and with other source data.

OIG assessed the internal controls related to the audit objective. Specifically, OIG evaluated the following control standards that were significant to the audit objective: control activities, information and communication, and monitoring. Based on the work completed on this performance audit, OIG considers its finding regarding processing pre-foreclosure property inspection claims to be significant in the context of the audit objective. Importantly, a recent OIG investigation found that between 2009 and 2012 a property preservation company hired to perform inspections of properties in the pre-foreclosure process created fraudulent inspection reports and received over $12 million for inspections not performed. Interviews were conducted in the course of this audit to consider the risk of fraud as it relates to the audit objective.

OIG performed fieldwork for this audit from May 2013 through November 2013 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 the findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on the audit objective.

Attachments:

Appendix A: FHFA's Comments on OIG's Findings and Recommendations
Appendix B: OIG's Response to FHFA's Comments
Appendix C: Summary of FHFA's Comments on the Recommendations

APPENDIX A

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

TO: Russell A. Rau, Deputy Inspector General for Audits

FROM: Jon D. Greenlee, Deputy Director, Division of Enterprise Regulation

SUBJECT: Audit Report: FHFA's Oversight of Fannie Mae's Reimbursement Process for Pre-Foreclosure Property Inspections (Audit Assignment: AUD-2013-002)

DATE: December 17, 2013

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses to the recommendations resulting from the Audit Report: FHFA's Oversight of Fannie Mae's Reimbursement Process for Pre-Foreclosure Property Inspections (Audit Assignment: AUD-2013-002). As stated in the report, the purpose of the audit was to assess FHFA's oversight of Fannie Mae's reimbursement to its servicers for pre-foreclosure property inspection claims.

This memorandum: (1) identifies management's agreement and/or disagreement with the recommendations; and (2) identifies the actions that FHFA will take to address the recommendations.

Background

The timeframe for this audit was 2011 and 2012, and the scope focused solely on the dollar reimbursement by Fannie Mae for pre-foreclosure property inspections carried out by servicers on Fannie Mae's behalf. Specifically, the audit reviewed whether servicers were reimbursed by Fannie Mae's reimbursement contractor in excess of the $60 and $200 dollar benchmarks[1] contained in the Fannie Mae's reimbursement processing guide. The report estimated that approximately 9.5% of claims for property inspections processed in 2011 and 2012 exceeded these dollar benchmarks, equaling a total "overpayment" of approximately $5 million over the two-year period. It is important to note that the $60 and $200 benchmarks are used for risk management purposes and, when exceeded, trigger additional management review and evaluation. Therefore, the mere fact that the benchmarks were exceeded does not necessarily mean that a property inspector was inappropriately overpaid for which restitution should be made as suggested by the FHFA-OIG report. Given the importance of preserving the value of Fannie Mae collateral with delinquent loans, FHFA believes that exceeding these processing cost

[1] The tolerance levels measured by OIG were $60 total cost for property inspections over the life of a mortgage loan for most servicers and $200 total cost for property inspections over the life of a mortgage loan for 16 selected servicers.

benchmarks could in fact be prudent and appropriate in individual cases, such as initiating property preservation efforts.

Since the timeframe of the FHFA-OIG's audit, FHFA completed examination work on Fannie Mae's servicer reimbursement process, and the Enterprises' internal audit function also has completed audit reviews. To the extent exceptions or deficiencies were noted, Fannie Mae's responses and remediation plans are closely tracked through already established processes. For example, Fannie Mae has increased staffing in this area since the timeframe of the FHFA –OIG audit and continues to enhance existing processes.

In 2013, FHFA responded to similar findings outlined in a prior FHFA-OIG OIG audits that focused on improving the efficiency and accuracy of servicer reimbursement, and more broadly on improving the management of Seller/Servicers by both Enterprises. As noted in that response, FHFA has devoted examination resources to monitoring Fannie Mae's vendor management and servicer reimbursement processes. This will continue into 2014.

Recommendation 1: OIG recommends that FHFA direct Fannie Mae to obtain a refund from servicers for improperly reimbursed property inspection claims, resulting in estimated funds put to better use of $5,015,505.

Management Response: FHFA disagrees with this recommendation. FHFA does not agree that property inspection claims in excess of the $60 and $200 benchmarks were necessarily improper since they are primarily used for risk management purposes. Further, FHFA believes that initiation of reimbursement for these claims could provide an adverse incentive to the effective management of Fannie Mae's pre-foreclosure portfolio. In situations where Fannie Mae does discover an overpayment or inaccurate expense claim payment through its quality control efforts, FHFA agrees that Fannie Mae should pursue the return of these funds.

Recommendation 2: OIG recommends that FHFA direct Fannie Mae to implement controls in the IM system to reject pre-foreclosure property inspection claims over established tolerance limits.

Management Response: FHFA disagrees with the recommendation. FHFA does not believe that internal tolerance benchmarks should necessarily function as rigid limits resulting necessarily in the rejection of claims. In fact, doing so may result in less than fully effective risk management. Fannie Mae is enhancing its 'red flag' business rules process to improve internal controls and associated management reports. These new controls should assist in further identifying inaccurate or unreasonable transactions. FHFA continues to support an administrative process at both Enterprises which encourages the prudent expenditure of funds for the preservation of Enterprise assets, reimbursed through a process with appropriate review and controls.

Recommendation 3: OIG recommends that FHFA direct Fannie Mae to submit guidance to all servicers that reminds them of requirements to adhere to reimbursement tolerance limits for pre-foreclosure property inspection claims.

Management Response: FHFA disagrees with the recommendation. FHFA believes that both Enterprises should continue to provide benchmarks for reimbursement, and require documentation for legitimate claims in excess of benchmarks. It is also important to note that Fannie Mae recently updated its guidance in relation to property inspections through policy release SVC-2013-22.

Recommendation 4: OIG recommends that FHFA assess the need for examination coverage related to reimbursement of pre-foreclosure property inspection claims.

Management Response: FHFA agrees with this recommendation, and has already started and completed reviews of this area prior to receiving the FHFA-OIG report. As with all key risks, FHFA continually assesses the need for examination coverage of all aspects affecting the safety and soundness of the Enterprises, and conducts a focused assessment annually to prepare a detailed examination plan for both Enterprises. By January 31, 2014, we will forward a copy of FHFA's Supervisory Strategy and examination plans to OIG which reflects that assessment.

APPENDIX B

OIG's Response to FHFA's Comments

On December 17, 2013, FHFA provided comments to a draft of this report. FHFA agreed with Recommendation 4 and identified responsive corrective actions. FHFA disagreed with Recommendations 1, 2, and 3. OIG has attached FHFA's full response as Appendix A and considered it where appropriate in finalizing this report. Appendix C provides a summary of the agency's response to OIG's recommendations and the status of any agreed-upon corrective actions remaining open. In summary, although disagreeing with Recommendations 2 and 3, FHFA's actions are sufficient to resolve those recommendations. FHFA's management decision not to pursue reimbursement of overpayments closes Recommendation 1.

With respect to Recommendation 4, FHFA management agreed to continue assessing the need for examination coverage of all aspects affecting the safety and soundness of the Enterprises. Importantly, FHFA has conducted a recent examination of Fannie Mae's claims reimbursement process. By January 31, 2014, FHFA plans to forward a copy of FHFA's Supervisory Strategy and examination plans for future coverage to OIG, which reflects its assessment and consideration of risk in examination activities. OIG considers FHFA's response to Recommendation 4 to be sufficient to resolve the recommendation, which will remain open until OIG receives and reviews the Agency's examination strategy and plans.

Regarding Recommendations 1, 2, and 3, FHFA cited Fannie Mae's issuance of Servicing Guide Announcement SVC-2013-22 (October 30, 2013) that updated property inspection reimbursements and requirements. Effective January 1, 2014, SVC-2013-22 eliminates the $60 and $200 tolerance limits over the life of a loan in Fannie Mae's *571 Servicer Processing Guide*, stating that:

> Fannie Mae will reimburse servicers a maximum of $15 per exterior property inspection and a maximum of $20 per interior property inspection.

Thus, going forward, the tolerance limits are no longer in effect, which provides important context for the following discussion of responses to Recommendations 1, 2, and 3. Also, FHFA pointed out that its recent examination coverage contributed to Fannie Mae's actions to strengthen payment controls through issuance of SVC-2013-22.

In response to Recommendation 1, FHFA stated that it is "important to note that the $60 and $200 benchmarks are used for risk management purposes and, when exceeded, trigger additional management review and evaluation." However, OIG found that Fannie Mae's actual claim process in effect during 2011 and 2012, as well as language in the Enterprise's *571 Servicer Processing Guide*, instructs processors to curtail (i.e., disallow and send back to the servicer) claimed amounts above tolerance with a note stating: "Paid Property Inspection Fees to Tolerance." Further, Fannie Mae did not provide evidence that alternative processing procedures exist for processors to refer claims that exceed tolerance to an approving official. Finally, servicers contacted by OIG acknowledged their responsibility to adhere to these tolerance limits. In fact, several servicers incurred additional property inspection expenses that were not reimbursed due to the existence of tolerance limits.

With the tolerance limits being eliminated, the risk of future payments in excess of those limits is mitigated. FHFA has stated that Fannie Mae, through its quality control efforts, should pursue return of funds in cases of overpayment of expense claims. Thus, the remaining issue regarding Recommendation 1 is pursuit of past overpayments. Based on a meeting with FHFA on December 18, 2013, FHFA again stated its management decision not to pursue recovery of the estimated $5 million in overpayments because some of the excess costs may have been associated with effective risk management of the pre-foreclosure portfolio. This decision closes the recommendation and will be reported in OIG's next semiannual report to Congress.

With respect to Recommendation 2, while FHFA disagreed with the recommendation, the Agency stated that Fannie Mae is enhancing its "red flag" business rules process to improve internal controls. These new controls are intended to assist in identifying inaccurate and unreasonable transactions. Further, in a meeting with OIG on December 18, 2013, FHFA stated that these controls should help ensure consistency in implementing the provisions for the new property inspection reimbursement guidance under SVC-2013-22. While OIG continues to believe that Fannie Mae's IM system should have controls built into it related to property inspection reimbursement, Fannie Mae's actions may be sufficient to resolve the recommendation. Therefore, OIG considers the planned actions potentially responsive to the recommendation and requests that FHFA provide supporting information by June 30, 2014, demonstrating that the new "red flag" business rules establish controls to help ensure compliance with the property inspection provisions of SVC-2013-22. Relatedly, OIG encourages FHFA to assess whether controls are needed to authorize payment of additional pre-foreclosure inspection expenses above the SVC-2013-22 limits in order to provide effective portfolio management as discussed in its response to Recommendation 1.

Regarding Recommendation 3, although FHFA disagreed with OIG's recommendation, OIG considers Fannie Mae's change to pre-foreclosure inspection policy through issuance of SVC-2013-22 to be responsive to the recommendation as it provides guidance to servicers regarding limits for reimbursement of property inspection claims. Accordingly, this action is sufficient to close the recommendation.

APPENDIX C

Summary of FHFA's Comments on the Recommendations

This table presents the management responses to the recommendations in 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.	FHFA provided a management decision disagreeing with Fannie Mae's pursuit of overpayments for pre-foreclosure property inspections and the related monetary benefits.		$5,015,505	Yes	Closed
2.	FHFA will ensure Fannie Mae implements internal controls to help ensure consistency in implementing the provisions for the new property inspection reimbursement guidance under SVC-2013-22.	06/30/2014	$0	Yes	Open
3.	Fannie Mae issued a new pre-foreclosure inspection policy through its SVC-2013-22 that provides guidance to servicers regarding limits for reimbursement of property inspection claims.		$0	Yes	Closed
4.	FHFA will forward a copy of FHFA's Supervisory Strategy and examination plans to OIG reflecting risk-based consideration of examination coverage regarding inspection payments.	01/31/2014	$0	Yes	Open
Total			$5,015,505		

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, and 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 OIG monetary benefits, a different amount, or no amount ($0). Monetary benefits are considered resolved as long as management provides an amount.

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

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