

**FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL**

**FHFA's Oversight of Fannie Mae's
Default-Related Legal Services**



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FEDERAL HOUSING FINANCE AGENCY OFFICE OF INSPECTOR GENERAL

AT A GLANCE

FHFA's Oversight of Fannie Mae's Default-Related Legal Services

Why FHFA-OIG Did This Audit

In 1997, the Federal National Mortgage Association (Fannie Mae or Enterprise) established its Retained Attorney Network (RAN) to acquire default-related legal services associated with foreclosure, bankruptcy, loss mitigation, eviction, and Real Estate Owned (REO) closings. In August 2010, news reports alleged that RAN attorneys had engaged in inappropriate foreclosure practices such as routinely filing false documents in court proceedings and "robo-signing."

The Housing and Economic Recovery Act of 2008 (HERA) established the Federal Housing Finance Agency (FHFA or Agency) as supervisor and regulator of the Enterprises: Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac). On September 6, 2008, FHFA placed the Enterprises into conservatorships out of concern that their deteriorating financial conditions threatened the stability of the financial markets. As the conservator, FHFA is responsible for preserving and conserving each Enterprise's assets and restoring them to a sound financial condition in order to support the nation's housing finance markets. FHFA commenced a special review of Fannie Mae's RAN in late 2010 to determine whether the program met safety and soundness standards, to evaluate the design and implementation of the RAN, and to identify vulnerabilities in its control structure. To date, FHFA has not released the results of its review.

On February 25, 2011, Representative Elijah E. Cummings requested that the FHFA Office of Inspector General (FHFA-OIG) examine "widespread allegations of abuse by ... law firms hired to process foreclosures as part of" the RAN, and Fannie Mae's and FHFA's efforts "to investigate these allegations and implement corrective action." Pursuant to the request, FHFA-OIG performed an audit to assess FHFA's oversight of Fannie Mae's default-related legal services performed by law firms within the RAN.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA: (1) review the circumstances surrounding FHFA's not identifying the RAN foreclosure abuses at an earlier stage and develop potential enhancements to its capacity to identify new and emerging risks; (2) develop and implement comprehensive examination guidance and procedures together with supervisory plans for default-related legal services; and (3) develop and implement policies and procedures to address poor performance by default-related legal services vendors that have contractual relationships with both of the Enterprises.

In response to FHFA-OIG's recommendations, FHFA provided written comments dated September 29, 2011. The Agency agreed with the recommendations. The complete text of the written comments can be found in Appendix A of this report.

What FHFA-OIG Found

FHFA can strengthen its oversight of default-related legal services. FHFA recognized the importance of its oversight of the Enterprises' default-related legal services and gradually accumulated information on the attorney network programs of Fannie Mae and Freddie Mac. However, FHFA did not schedule comprehensive examination coverage of foreclosure issues, including allegations of abuse by RAN law firms until after news stories about alleged abuses surfaced in August 2010. FHFA had not previously considered risks associated with foreclosure processing to be significant. Instead, FHFA focused its examination resources on assessing high risk areas such as the Enterprises' management of credit risk.

Also, there were indicators prior to August 2010 that could have led FHFA to identify the heightened risk posed by foreclosure processing within Fannie Mae's RAN. These indicators included significant increases in foreclosures, which accompanied the deterioration of the housing market; consumer complaints alleging improper foreclosures; contemporaneous media reports about foreclosure abuses by Fannie Mae's law firms; and public court filings in Florida and elsewhere highlighting such abuses. Although FHFA's management has yet to publish the results of its special review of Fannie Mae's RAN, the examiners' preliminary findings confirm that at least one of these indicators – deteriorating industry conditions – should have provided adequate warning of the increased risk associated with default-related legal services. Importantly, FHFA has a number of corrective actions planned in response to the special review.

FHFA needs to develop procedures to identify and assess new or heightened risks, as it simultaneously addresses historic risks with which it is familiar. FHFA had neither an ongoing risk-based supervisory plan detailing examination and continuous supervision of default-related legal services, nor finalized examination guidance and procedures for use in performing targeted examinations and supervision of such services. Consequently, FHFA has limited assurance that foreclosure processing abuses will be prevented and detected through its supervisory activities.

Additionally, FHFA has not developed formal policies to address poor performance by law firms that have relationships – either directly through contract or through its loan servicers – with both of the Enterprises. FHFA-OIG identified instances where Freddie Mac terminated for poor performance law firms that processed foreclosures on its behalf, but Fannie Mae continued to use the firms. FHFA did not specifically review such terminations and, therefore, lacks assurance that law firms with histories of performance deficiencies do not jeopardize the safety and soundness of the Enterprises.

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ABBREVIATIONS

DCP.....	Designated Counsel Program
Fannie Mae.....	Federal National Mortgage Association
FHFA	Federal Housing Finance Agency
FHFA-OIG.....	Federal Housing Finance Agency Office of Inspector General
FHLBanks.....	Federal Home Loan Banks
Freddie Mac	Federal Home Loan Mortgage Corporation
GSE.....	Government-Sponsored Enterprise
HERA.....	Housing and Economic Recovery Act of 2008
MBS	Mortgage-Backed Securities
NSO.....	National Servicing Organization
RAN	Retained Attorney Network
REO.....	Real Estate Owned

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Federal Housing Finance Agency

Office of Inspector General

Washington, DC

PREFACE

FHFA-OIG was established by HERA,¹ which amended the Inspector General Act of 1978.² FHFA-OIG is authorized to conduct audits, investigations, and other activities of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them. This is one in a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities to promote economy, effectiveness, and efficiency in the administration of FHFA's programs.

The objective of this performance audit was to assess FHFA's oversight of Fannie Mae's default-related legal services performed by law firms within the RAN. Specifically, FHFA-OIG reviewed FHFA's: (1) written policies and procedures for its oversight of Fannie Mae's RAN; (2) oversight of Fannie Mae's internal controls over its RAN; and (3) supervisory actions taken concerning the RAN.

The audit found that FHFA recognizes the importance of its oversight of Fannie Mae's default-related legal services performed by law firms within the RAN, but it needs to improve its capacity to identify new and emerging areas of risk. Additionally, FHFA does not have a continuous supervision plan or detailed examination guidance to govern its oversight of the RAN, and it had not accomplished any targeted examinations of the RAN until it initiated a special review in late 2010. FHFA also has not established a formal process and the requisite policies to address concerns associated with law firms that have relationships with both Fannie Mae and Freddie Mac to ensure that information is shared across both Enterprises.

FHFA-OIG believes that the recommendations contained in this report will help the Agency achieve more economical, effective, and efficient operations. FHFA-OIG appreciates the assistance of all those who contributed to the audit.

¹ Public Law No. 110-289.

² Public Law No. 95-452.

This audit was led by Jennifer Fain, Audit Director, who was assisted by Jacob Kennedy, Auditor-in-Charge.

This report will be distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaig.gov.



Russell A. Rau
Deputy Inspector General for Audits

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BACKGROUND

FHFA and Fannie Mae

HERA established FHFA as supervisor and regulator of the housing government-sponsored enterprises (GSEs): Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks. FHFA's mission is to provide effective supervision and regulation over the GSEs to support their housing finance and affordable housing goals and to provide for a stable and liquid mortgage market. Targeted examinations and continuous supervision of GSE operations are means to accomplish FHFA's mission.

As a GSE chartered by Congress, Fannie Mae's mission is to provide liquidity, stability, and affordability to the U.S. housing and mortgage markets. Fannie Mae accomplishes this mission by supporting the secondary mortgage market. It purchases from loan sellers residential mortgages that meet its underwriting criteria, and loan sellers can use the sales proceeds to originate additional mortgages. Fannie Mae may hold these mortgages in its portfolio or may package them into mortgage-backed securities (MBS) that are, in turn, sold to investors. In exchange for a fee, Fannie Mae guarantees that investors will receive timely payment of principal and interest on the MBS. With respect to the loans that it holds in its portfolio, Fannie Mae contracts with loan servicers to collect mortgage payments, segregate tax and insurance escrows, forward to Fannie Mae principal and interest payments, pay obligations from escrows, and handle foreclosure actions.

Targeted Examinations
are in-depth focused assessments of a specific risk or risk management system.

Continuous Supervision
is a wide range of ongoing activities designed to monitor and analyze an Enterprise's overall business profile, including any trends or associated emerging risks.

On September 6, 2008, FHFA placed the Enterprises into conservatorships after finding that their deteriorating financial conditions threatened the stability of the financial markets.³ The FHFA Director stated that the conservatorships were designed to stabilize the Enterprises by preserving and conserving their assets with the objective of returning them to normal business operations. As conservator, FHFA is responsible for the overall management of the Enterprises.

³ Among FHFA's statutory authorities is the ability of the Director to appoint the Agency as "...conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity." 12 U.S.C. § 4617(a)(1) and (2).

Retained Attorney Network

In 1997, Fannie Mae established the RAN to perform default-related legal services associated with foreclosure, bankruptcy, loss mitigation, eviction, and REO closings and entered into engagement letters with the RAN firms.⁴

Fannie Mae does not manage individual law firms as they litigate foreclosure proceedings; instead, the servicers of Fannie Mae mortgages are responsible for managing the RAN law firms. In all cases where a servicer refers Fannie Mae foreclosures to a law firm, the servicer is responsible for monitoring all aspects of the performance of the attorney to whom it makes a referral.⁵

According to Fannie Mae, the RAN permits it to control costs through negotiated rates with the law firms and gives it the ability to direct law firms to take consistent actions while monitoring and controlling timelines and efficiency.

In August 2008, Fannie Mae announced that it was enhancing its network and was expanding the RAN model to 140 law firms covering 31 jurisdictions. The intent of the enhanced network was to "...foster a more disciplined, end-to-end approach to default management; facilitate more effective management of fees, costs, quality, and reporting to Fannie Mae; and facilitate enhanced loss mitigation efforts by network attorneys." To achieve these objectives, Fannie Mae required that loan servicers refer foreclosures and bankruptcy cases only to attorneys included in the RAN. Prior to this enhancement, servicers selected and managed foreclosure law firms of their choice, which Fannie Mae asserted limited its ability to oversee the process and manage its costs. Fannie Mae has expanded the RAN model to 191 firms within 45 states.⁶

Historically FHFA did not consider the RAN to be a high-risk area and did not focus its examination and monitoring efforts on it. FHFA's practice was and is to focus on high-risk areas

⁴ An engagement letter is a contract between Fannie Mae and a RAN law firm requiring the "...firm's non-exclusive representation of Fannie Mae and provision of services in foreclosure, bankruptcy, loss mitigation, eviction, related litigation, and REO closing proceedings in the firm's [respective] state(s)...." Law firms in the RAN may also have other clients.

⁵ Fannie Mae's Servicing Guide, Section 104.01 (p. 281).

⁶ According to Fannie Mae's Servicing Guide, Section 104.03:

For jurisdictions that are not included on the Retained Attorney List, Fannie Mae will continue to rely upon servicers to select and retain qualified attorneys (or trustees) of their choice to handle Fannie Mae foreclosure and bankruptcy matters in accordance with Fannie Mae's standard guidelines. When the servicer retains its own attorney (or trustee) to handle foreclosure proceedings, Fannie Mae requires the servicer to retain competent, diligent, local legal counsel (or trustees) who are highly experienced in conducting foreclosures. Foreclosure services must be performed by qualified and experienced attorneys (or trustees) in accordance with applicable law and professional standards of conduct.

such as credit risk,⁷ which has caused billions of dollars of losses for the Enterprises in recent years. High-risk areas were a critical concern for FHFA after its establishment and the creation of the conservatorships. Further, FHFA officials explained that during the relevant time frame, the Office of Credit Risk (OCR)⁸ focused its limited resources on evaluating loan modification and loss mitigation proposals from the Enterprises and scaled back scheduled examinations. FHFA officials viewed foreclosures, including addressing foreclosure abuse,⁹ as primarily the responsibility of servicers.¹⁰

Distressed Mortgage Environment

When FHFA placed Fannie Mae into conservatorship in September 2008, Fannie Mae's credit book of business was \$3.1 trillion, or approximately 26% of the total U.S. residential mortgage debt outstanding.¹¹ According to Fannie Mae's loan price index, home prices declined approximately 9% by the end of 2008, the greatest decline since the home price index's inception in 1975. Home prices continued to fall through 2010.

As home prices declined, serious delinquencies rose, as illustrated in Figure 1 below, rising from 400,000 homes at the end of 2008 to nearly 1,000,000 at the end of 2009.¹²

⁷ Credit Risk arises from an obligor's failure to meet a term of any financial contract with the Enterprise or other failure to fulfill a financial commitment.

⁸ Although unrelated to the impending foreclosure and documentation issues that were publicized in August 2010, the Agency's OCR was tasked with the responsibility of analyzing the attorney networks as early as May 2010. According to FHFA officials, other than responding to Congressional inquiries, the credit risk team did not conduct any special reviews of the attorney networks at that time.

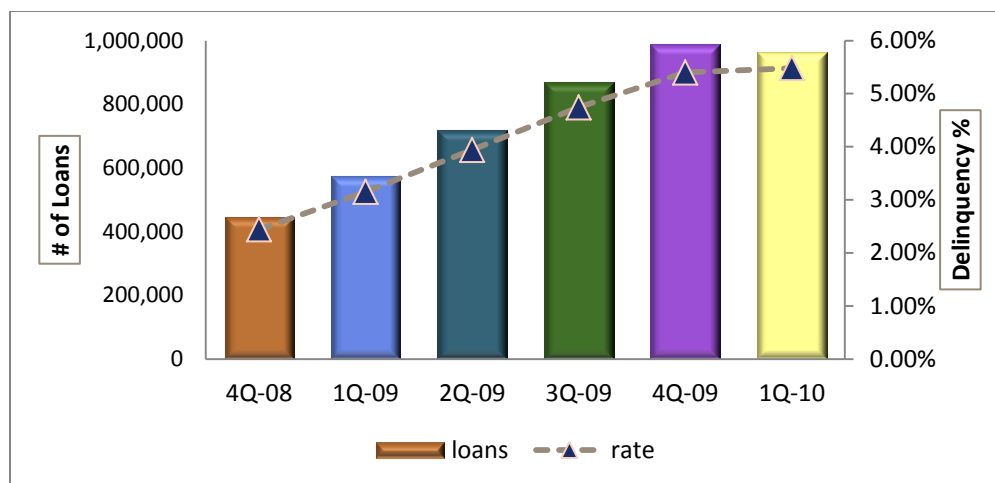
⁹ For purposes of this report, "foreclosure abuse" relates to allegations against certain law firms who performed default-related services on behalf of or for Fannie Mae, either directly or through contract with servicers who service Fannie Mae loans. Examples of abusive practices include: (1) creating and filing incomplete and improper documents; (2) fraudulent affidavits; (3) improper notarizations; and (4) use of "robo-signing" to process foreclosure documents. "Robo-signing" refers to habitually signing documents without the requisite knowledge of the underlying facts.

¹⁰ Although foreclosures are the responsibilities of the servicers and law firms, the Agency has statutory responsibility for the safety and soundness of the Enterprises, and this includes compliance with the legal requirements and liability risks associated with foreclosures.

¹¹ This figure includes mortgage assets held in Fannie Mae's investment portfolio, Fannie Mae MBS held by third parties, and credit enhancements provided on mortgage assets.

¹² Fannie Mae classifies single-family loans that are three months or more past due or in the foreclosure process as seriously delinquent.

Figure 1: Seriously Delinquent Single-Family Loans



Source: FHFA “1Q10 SF Risk Assessment” Analysis Memorandum, May 7, 2010

As of the first quarter of 2011, approximately 400,000 additional loans were seriously delinquent.¹³

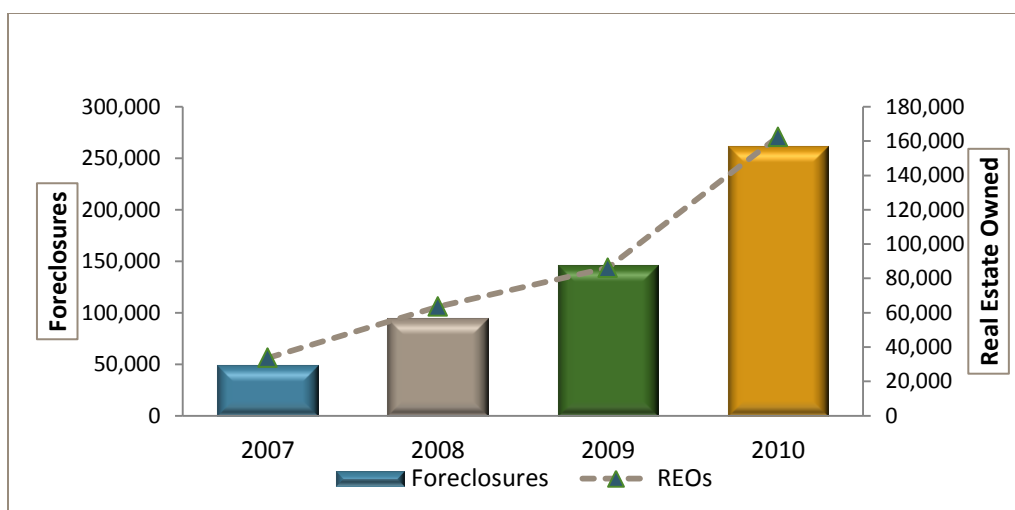
Rising delinquencies led to substantial increases in foreclosures. Between 2007 and 2010, the volume of Fannie Mae foreclosures increased to historic levels. Fannie Mae foreclosures more than doubled from 2007 to 2008, and increased by more than 50% the following year.¹⁴ Fannie Mae foreclosed on 262,078 properties in 2010, an 80% increase from 2009 and a 433% increase from 2007. The unpaid principal balance on the 2010 foreclosures totaled over \$47 billion.

Additionally, Fannie Mae’s sale of foreclosed properties did not keep pace with the rapid foreclosure increases, and its inventory of REO grew. In 2007, Fannie Mae’s REO portfolio consisted of 33,729 properties, which then rapidly increased in succeeding years through 2010 to 162,489 properties. That 381% increase over three years is illustrated in Figure 2 showing foreclosures and REO inventory.

¹³ According to an FHFA official, Fannie Mae had referred 700,000 loans to foreclosure in 2010.

¹⁴ Total properties acquired through foreclosure between 2007 and 2009: 49,121; 94,652; and 145,617, respectively.

Figure 2: Single-Family Foreclosure and REO Properties



Source: Fannie Mae Securities and Exchange Commission 10K Filings for 2008 and 2010

Allegations and Evidence of Foreclosure Abuses (2005 - Present)

As the volume of home foreclosures rose, Fannie Mae, Freddie Mac, FHFA, and FHFA's predecessor agency, the Office of Federal Housing Enterprise Oversight (OFHEO), were in a position to learn of foreclosure abuses through direct reports and the news media¹⁵ and to understand their impact on the law firms' relationships with the Enterprises.

The Enterprises Are Required to Disclose Operational Risk

Prior to FHFA's establishment, OFHEO required the Enterprises to develop operational risk management programs.¹⁶ As envisioned by OFHEO, the Enterprises' operational risk management programs would feed data to its examiners who, in turn, would use the data to identify the level of – and trends in – operational risk at the Enterprises. FHFA's definition of

¹⁵ The media reports referenced herein are not offered for the accuracy or truth of their content. Rather, they illustrate that information about foreclosure abuses was publicly available at times relevant to this audit.

¹⁶ "These requirements [to collect operational event data and report it to OFHEO] are consistent with the safety and soundness responsibilities of OFHEO under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992." Letter to Richard F. Syron from Director, OFHEO, dated August 10, 2007.

On September 23, 2008, OFHEO/FHFA reiterated the Enterprises' requirements to develop operation risk programs and report information to OHFEO/FHFA and issued its *Enterprise Guidance on Operational Risk Management* (Guidance). The Guidance notes that "the effective management of operational risk is required to support Enterprise safety and soundness." Enterprise Guidance on Operational Risk Management (PG-08-002) at pp. 1-4. The Guidance formally requires the Enterprises to develop and implement operational risk programs.

operational risk is broad and applies to the full range of the Enterprises' business activities. Operational risk is defined as, "...exposure to loss resulting from inadequate or failed internal processes, people, and systems, or from external events (including legal events)."¹⁷

Fannie Mae recognizes that foreclosure abuse is an operational risk. As it noted in its 2010 Securities and Exchange Commission 10-K filing, "the failure of our servicers or a law firm to apply prudent and effective process controls and to comply with legal and other requirements in the foreclosure process poses operational, reputational and legal risks for us."¹⁸ Yet, there is little evidence that Fannie Mae disclosed allegations of foreclosure abuse to its regulator.

2006 Report to Fannie Mae of Foreclosure Abuses in Florida

In December of 2003, a Fannie Mae shareholder began alerting Fannie Mae to foreclosure abuse allegations, and in 2005 Fannie Mae hired an outside law firm to investigate a variety of allegations regarding purported foreclosure processing abuses. In May 2006, the law firm issued a report of investigation in which it found that:

[F]oreclosure attorneys in Florida are routinely filing false pleadings and affidavits.... The practice could be occurring elsewhere. It is axiomatic that the practice is improper and should be stopped. Fannie Mae has not authorized this unlawful conduct.

Further, the report observed that Fannie Mae did not take steps to ensure the quality of its foreclosure attorneys' conduct, the legal positions taken in the attorneys' pleadings, or the manner in which the attorneys processed foreclosures on the Enterprise's behalf.

FHFA-OIG could not establish whether Fannie Mae complied with its obligation to notify OFHEO of the 2006 report of foreclosure abuses. Fannie Mae officials claim that they informed an OFHEO senior official of the report during a telephone conversation in 2006, but they have no record of the communication. The OFHEO official, who now works for FHFA, has no records or recollection of the conversation.

¹⁷ Enterprise Guidance on Operational Risk Management (PG-008-002), September 23, 2008.

¹⁸ Fannie Mae's 10-K Report as of December 31, 2010, www.fanniemae.com/ir/pdf/earn-ings/2010/10k_2010.pdf, p. 62.

2008 News Reports

In 2008, allegations began to circulate about “foreclosure mills” managing defaulted loans for the Enterprises. For example, a March 30, 2008, New York Times article, *Foreclosure Machine Thrives on Woes*, reported on complaints involving law firms filing improper or duplicative foreclosure and bankruptcy pleadings and levying inappropriate fees upon borrowers. Further, the article revealed that several courts had imposed significant financial sanctions against the abusive firms and – in some cases – their clients, which included Fannie Mae. In particular, the article stated that:

In 2006 ... [a] federal bankruptcy judge overseeing a matter involving ... a borrower in Lodi, N.J., issued a \$125,000 sanction against the Shapiro & Diaz firm, which is a part of the Shapiro Attorneys Network. The judge found that Shapiro & Diaz had filed 250 motions seeking permission to seize homes using pre-signed certifications of default executed by an employee who had not worked at the firm for more than a year.

Butler & Hosch, a law firm in Orlando, Fla., that is employed by Fannie Mae, has also been the subject of penalties. Last year, a judge sanctioned the firm \$33,500 for filing 67 faulty motions to remove borrowers from their homes.

Barrett Burke in Texas has come under intense scrutiny by bankruptcy judges. Overseeing a case last year[, a bankruptcy judge] examined the firm’s conduct in eight other foreclosure cases and found problems in all of them. In five of the matters, documents show, the firm used inaccurate information about defaults or failed to attach proper documentation when it moved to seize borrowers’ homes. [The Judge] imposed \$75,000 in sanctions against Barrett Burke for a pattern of errors in the [one] case.

Consumer Complaints Received by FHFA in 2009

At least as early as August 2009, FHFA received consumer complaints concerning purportedly inappropriate foreclosure practices involving Fannie Mae loans. FHFA-OIG identified 35 such complaints that FHFA received and referred to Fannie Mae between August 2009 and October 2010. FHFA-OIG previously found that FHFA did not assess overall trends related to consumer complaints.¹⁹

¹⁹ See FHFA-OIG, *Report on the Audit of the Federal Housing Finance Agency’s Consumer Complaints Process* (AUD-2011-001, dated June 21, 2011), available for inspection at www.fhfaig.gov/Content/Files/AUD-2011-001.pdf, which found that FHFA did not adequately record, evaluate or follow up on consumer complaints. Additionally, FHFA did not have a consolidated system for receiving complaints, maintaining them, processing

FHFA Staff Informed of Foreclosure Problems in Florida in June 2010

In June 2010, FHFA's Office of Conservatorship Operations performed a two-day field visit to Florida to gain a better understanding of foreclosure processing, among other things. FHFA staff met with 17 representatives from the mortgage industry, legal community, and federal and state government, including a local circuit court judge whom the FHFA General Counsel had repeatedly suggested should be contacted. The resulting report to FHFA's Acting Director, dated June 9, 2011, noted that servicers, attorneys, and other supporting personnel were overloaded with the volume of foreclosures, the average timeline for foreclosures had increased from 150 to 400 days, documentation problems were evident, and law firms (referred to as "foreclosure mills") were not devoting the time necessary to their cases due to Fannie Mae's flat fee structure and volume-based processing model. As a result of the visit, FHFA staff developed a listing of actionable items for FHFA, including:

- Incorporating foreclosure checklists into the Enterprises' attorney network processes to ensure that attorneys are prepared in legal proceedings;
- Revising the Enterprises' compensation model for attorneys to incentivize speed and effectiveness and penalize poor performance; and
- Engaging the Enterprises on servicer (and law firm) problems such as:
 - lost/mishandled documents;
 - inadequate responsiveness to borrowers; and
 - delays in the foreclosure process, including foreclosure sale cancellations and poor preparation for foreclosure hearings.

FHFA-OIG has found no evidence that action was taken on any of these items except as noted below.

Shortly after the Florida visit, FHFA notified senior Fannie Mae officials about the results of the visit, including that: "attorneys are increasingly unprepared when they enter the courtroom (e.g., they don't have the note, don't know if the borrower has been offered HAMP [a loan modification], service has been cancelled, etc.) which cause foreclosure sale cancellations and ultimately lengthens timelines." FHFA did not ask Fannie Mae for a response to the information provided concerning the results of the Florida visit.

them, or tracking their resolution by the Enterprises. Therefore, additional complaints beyond the 35 could have been received by FHFA.

August 2010 Article Reporting on Enterprise Foreclosure Abuses

In August 2010, a widely circulated news article reported that Fannie Mae and Freddie Mac had failed to oversee their networks of law firms that process foreclosures on their behalf. Specifically, the article alleged that some of those firms – including RAN firms – had filed forged documents (e.g., affidavits and mortgage assignments) in judicial foreclosure proceedings.²⁰ Thereafter, many other print and electronic media reports described similar behavior by law firms representing Fannie Mae and Freddie Mac.

Federal and state regulators and law enforcement officials subsequently initiated probes into whether banks and foreclosure law firms improperly seized homes using fraudulent or incomplete paperwork. For example, in August 2010, the Florida Attorney General announced that his office had launched investigations into allegations of unfair and deceptive foreclosure practices involving three Florida law firms. The three law firms were part of Fannie Mae's RAN and included the Law Offices of David J. Stern, P.A. (the Stern Law Firm).

Responses to Allegations of Foreclosure Abuse

FHFA's Efforts to Address Allegations of Abuse

In November 2010, FHFA initiated concurrent special reviews of Fannie Mae's RAN and Freddie Mac's Designated Counsel Program (DCP) risk management practices. The primary objective of these reviews was to determine whether the attorney network programs met safety and soundness standards. The reviews evaluated the design and execution of the existing frameworks, identified vulnerabilities in the control structure, and assessed the recent enhancements to the frameworks adopted in 2010.

The Agency concluded its review in January 2011, and Agency examiners documented their findings in a memorandum and verbally briefed Fannie Mae about the findings. Among other things, the examiners concluded that Fannie Mae could have reacted to foreclosure deficiencies sooner because, "deteriorating industry conditions over the past several years should have provided adequate warning to the GSEs to review policies, processes, and controls of other vendors and counterparties including law firms."²¹

²⁰ *Fannie and Freddie's Foreclosure Barons*, Mother Jones, August 4, 2010.

²¹ The Agency communicates its special review findings to the Enterprises through a "conclusion letter." This letter includes the findings from the review, a "supervisory rating" based on the remediation effort necessary to address the identified weaknesses, and recommendations – called "Matters Requiring Attention."

FHFA examiners also found that Fannie Mae's existing control structure for RAN did not meet safety and soundness standards in a number of areas:

- Fannie Mae had not performed a formal cost-benefit analysis to determine if the RAN is cost effective (i.e., if the documented benefits of the program outweighed its inherent risks, such as the legal risk that Fannie Mae could be held liable for the actions of the RAN participants).
- Prior to the media reports that followed the magazine article in August 2010, Fannie Mae had inadequate controls in place to prevent or detect foreclosure abuses such as false assignment affidavits. Since then, it has developed controls to prevent or detect foreclosure documentation issues among the RAN law firms, but these controls are yet to be fully implemented.
- Fannie Mae had not developed adequate procedures for the RAN, such as procedures for (1) determining whether a law firm should be added to or removed from the RAN, (2) conducting oversight of RAN participants by its National Servicing Organization (NSO), (3) performing onsite visits to law firms by Fannie Mae's internal legal department, and (4) defining steps that oversight employees must take if they uncover an issue such as improper preparation and/or notarization of documents used in foreclosure proceedings.
- Fannie Mae had not developed comprehensive training manuals for the law firms participating in RAN.
- Fannie Mae's ongoing monitoring of law firms was inadequate. After law firms completed their applications and were accepted into the RAN, their reporting and Fannie Mae's monitoring of them was less than satisfactory. If a law firm self-reported no issues as it processed cases, then Fannie Mae presumed the firm was doing a good job.

Although the Agency briefed Fannie Mae management and FHFA-OIG on the results of its special review, a final report has not been published or released to the Enterprise. FHFA is still deliberating on the best course of action concerning Fannie Mae's RAN.²²

²² During the same time frame as FHFA's special review, the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation conducted a review of foreclosure practices, which focused on 14 federally-regulated mortgage servicers. The resulting report, *Interagency Review of Foreclosure Policies and Practices*, issued in April 2011, identified inadequate monitoring and controls to oversee foreclosure activities conducted on behalf of servicers by external law firms or other third-party vendors and disclosed enforcement actions taken. See www.occ.treas.gov/news-issuances/news-

Fannie Mae's Efforts to Address Allegations of Abuse

Fannie Mae has also initiated multiple efforts to address foreclosure abuse issues. These efforts include: (1) audits and reviews of RAN law firms; (2) questionnaires to the RAN law firms; and (3) RAN compliance oversight enhancements.

1. Audits and Reviews of RAN Law Firms: Beginning in early 2010, Fannie Mae initiated certain loss mitigation activities associated with its default-related legal services. According to the Enterprise, it hired a third-party vendor to perform audits of law firms in the RAN, and the audits focused on compliance with engagement letters. The audits included review of fees and costs charged; the accuracy of the language used in foreclosure pleadings to describe the standing of the servicer; and compliance with state foreclosure processes.

Fannie Mae also retained a law firm to develop a legal compliance checklist and work with Fannie Mae's attorneys to conduct litigation reviews at the largest RAN firms in Florida.²³ The law firm's objective was to perform foreclosure and litigation loan file reviews at several RAN law firms. Another law firm was retained to conduct a review of the foreclosure and consumer bankruptcy processes in the United States. The objective of this review was to identify legal risks in the foreclosure and consumer bankruptcy processes and to identify which of those risks were the most serious for Fannie Mae.

Through June 30, 2011, contractors retained by Fannie Mae have conducted 49 onsite reviews of law firms. FHFA-OIG selected and reviewed the contractor's reports for four RAN law firms.²⁴ The contractors documented their work in various reports and memorandums to Fannie Mae. FHFA-OIG assessed whether the audits and reviews provided Fannie Mae with information about the deficiencies or operational weaknesses that may have contributed to improper preparation and notarization of documents used in foreclosure proceedings. FHFA-OIG determined that the reports reviewed missed the opportunity to confirm and provide a better understanding of the allegations of foreclosure abuses. Instead, the audits and reviews were narrowly focused on areas such as attorney fees and engagement letter issues (e.g., data protection controls), rather than on more substantive qualitative issues regarding foreclosure processing in compliance with applicable laws and regulations. As a result, FHFA-OIG

releases/2011/nr-occ-2011-47a.pdf. The interagency review identified safety and soundness weaknesses in the oversight of vendors of default-related legal services. Although the federal banking regulators proceeded with enforcement actions against servicers months ago, FHFA has not yet finalized its special review and related actions.

²³ The litigation reviews were subsequently expanded to encompass law firms located in New York, New Jersey, Michigan, Pennsylvania, and Ohio.

²⁴ The selection was based on the law firm's caseload size, alleged issues, and auditor's judgment.

concluded the audits and reviews did not lend themselves to identifying critical operational issues including risks associated with improper foreclosures.

2. Questionnaires to RAN Law Firms: In late 2010, after assessing the allegations of foreclosure abuse by the Stern Law Firm in Florida, as discussed above, Fannie Mae emailed questionnaires to all RAN law firms asking them to report if they had issues similar to the Stern Law Firm. Specifically, the questionnaire asked the law firms to determine whether: (1) their policies, procedures, and processes are adequate to ensure that the documents prepared and executed in connection with foreclosure proceedings are in compliance with applicable law; and (2) their employees and/or third parties responsible for preparing and executing such documents followed and continue to follow its policies, procedures, and processes. Most of the RAN firms acknowledged receipt of the questionnaire and/or provided confirmation that their policies and procedures are in compliance. Several law firms, however, disclosed foreclosure process issues, and Fannie Mae stated that it worked with these law firms to understand their issues and to develop plans of remediation. Additionally, Fannie Mae has dedicated staff to monitor the progress in remediating these issues.

3. RAN Compliance Oversight Enhancements: In early 2011, Fannie Mae's internal auditors initiated their own review of the RAN. The internal audit was primarily focused on the effectiveness of Fannie Mae's oversight of its servicers. According to Fannie Mae officials, the internal audit findings were similar to the findings of FHFA's special review examiners. The internal audit team communicated its findings to Fannie Mae's NSO, which is tasked with all oversight of the RAN. Officials from NSO stated that they began addressing the internal audit's findings and recommendations, including: assigning ownership of the RAN and designing a staffing plan; creating a risk-based process for on-site reviews; developing a firm performance and compliance monitoring plan; and assessing policies and procedures governing default-related legal services.

Current Status of RAN Oversight

FHFA's Oversight

FHFA recently underwent an organizational restructuring. According to FHFA's Acting Director, "...the new structure will enhance our capability to meet our critical mission, provide greater career opportunities for our staff, and make us more efficient and consistent in our regulatory activities." Specifically, the core examination teams on-site at each Enterprise will be responsible for all Enterprise issues, including RAN oversight. Other Agency groups, like the credit risk and operational risk teams, will support the core examination teams. Additionally, the

Agency is drafting new examination policies and procedures, which are expected to be completed by the end of 2012, and these policies will address default-related service vendors.

The Agency also has directed Fannie Mae to recoup some of the costs and fees on its foreclosed loan portfolio as well as address foreclosure-related deficiencies. For example, in 2010, the Agency directed Fannie Mae to impose compensatory fees against the servicers for violating foreclosure timeline limits.

Fannie Mae's Oversight

Fannie Mae stated that it enhanced its oversight activities in 2010 by expanding its legal department and NSO.²⁵ The legal department added 6 staffers (3 full-time attorneys, a contract attorney, a paralegal, and a business analyst) to oversee the network, and NSO increased its staff size from 6 to 28.

In June 2011, NSO also developed a staffing analysis in response to Fannie Mae's internal audit report. A critical element of the staffing plan is an analysis of how NSO will incorporate key drivers when assessing the need to adjust staffing levels for RAN governance purposes. These key drivers include, but are not limited to, anticipated volumes (i.e., foreclosures, serious delinquencies), trending of non-routine litigation issues, additional RAN governance program requirements, and new internal audit or FHFA requirements.

At the direction of FHFA, Fannie Mae began imposing compensatory fees against certain servicers in 2010.²⁶ Compensatory fees are a remedy used by Fannie Mae against the servicers for "breach of servicing obligations."²⁷ Although Fannie Mae does not impose compensatory fees directly against law firms, the firms have compensated Fannie Mae for errors, such as failing to bid the proper amount at a foreclosure sale and failing to provide notice to subordinate lien holders in connection with the foreclosure process. Moreover, the law firms indemnify Fannie Mae against losses or damages incurred as a result of their negligence or failure to perform their obligations in accordance with the terms of the engagement letters. Finally,

²⁵ Fannie Mae's NSO manages the Enterprise's loss mitigation activities through its relationship with mortgage servicers who are tasked with servicing Fannie Mae's single-family guarantee book of business.

²⁶ According to Fannie Mae, compensatory fees were not imposed on the servicers prior to 2010.

²⁷ According to Fannie Mae's Lender Letter LL-2010-11 dated October 1, 2010:

If Fannie Mae believes that the servicer is failing to comply with Fannie Mae's servicing requirements, Fannie Mae may pursue a variety of remedies, either to correct a specific problem or to improve the servicer's overall performance. One possible remedy is the imposition of a compensatory fee to compensate Fannie Mae for damages and to emphasize the importance Fannie Mae places on a particular aspect of the servicer's performance.

concerning law firms terminated from the RAN, Fannie Mae is currently pursuing recovery for losses caused by the errors and omissions of those firms handling Fannie Mae's foreclosures.

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FINDINGS

FHFA-OIG finds that:

1. Various Indicators Could Have Led FHFA to Identify and Address the Heightened Risk Posed by Foreclosure Abuses Prior to Late 2010

FHFA did not begin to act on foreclosure abuse issues involving Fannie Mae's RAN until mid-2010. Prior to that time, FHFA had not considered risks associated with foreclosure processing to be significant, and, instead, had focused its limited examination resources on assessing high risk areas such as the Enterprises' management of credit risk.

FHFA-OIG believes that there were multiple indicators of foreclosure abuse risk prior to 2010 that could have led FHFA to identify and act earlier on the issue. Moreover, FHFA Supervisory Handbook 2.1 requires "Managers [to] develop work plans that are dynamic documents, reviewed and updated as necessary based on Enterprise business profiles, risk assessments, and external factors such as industry, economic, legislative, and regulatory developments." These foreclosure abuse indicators included, among other things, the deteriorating financial conditions that led to the conservatorship (i.e., the increasing number and dollar value of mortgage defaults and REO in the Enterprises' portfolios), consumer complaints alleging improper foreclosures, contemporaneous media reports about foreclosure abuses by Fannie Mae's law firms, and public court filings in Florida and elsewhere alleging such abuses.

Notwithstanding these indicators, FHFA did not begin to implement a risk-based supervisory plan of targeted examinations and monitoring activities associated with the Enterprises' default-related legal services until media reports began to circulate widely in August 2010, at which time FHFA concluded that reports of improper foreclosure activities reached a critical level that supported further action. Prior to August 2010, FHFA stated it was gradually accumulating information on the attorney network programs of Fannie Mae and Freddie Mac but did not formally assess the risks the networks may have posed to their safety and soundness.

Among the indicators was the deteriorating condition of the housing market. Although dramatically increasing mortgage delinquencies and resulting foreclosures prompted FHFA to take the extraordinary measure of placing the Enterprises into conservatorships,²⁸ it did not cause

²⁸ The purpose of appointing the conservator is to preserve and conserve Fannie Mae's assets and property and to put it in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in the Enterprise, enhance its capacity to fulfill its mission, and mitigate the systemic risk that has contributed directly to the instability in the current market. As conservator, FHFA may take any necessary action to restore the firms to a sound and solvent condition. The conservator controls and directs the operations of the Enterprises. The

the Agency to focus supervisory strategies on the foreclosure process. Yet, as part of its special review of the Enterprises' default-related legal services, FHFA examiners concluded that deteriorating industry conditions over the past several years should have prompted the Enterprises to review their policies, processes, and controls over their default-related legal services vendors. Moreover, the foreclosure spikes that contributed to the conservatorships in September 2008 continued to rise, further heightening the risk of loss. As discussed earlier (see Figures 1 and 2), from 2008 through 2010, the number of Fannie Mae properties in foreclosure and in its REO portfolio increased substantially.

As the foreclosures increased and REO accumulated, news reports began to circulate about "foreclosure mills."²⁹ News coverage of law firm deficiencies in filing foreclosures (including firms working on behalf of Fannie Mae and Freddie Mac) became especially prominent beginning in August 2010. Numerous news articles were written about "robo-signing," which involves employees signing mortgage related documents at record speeds without verifying their accuracy; foreclosure mills that file incomplete and inaccurate documents, fraudulent affidavits, and improper notarizations; and the concealment of known mistakes from courts, attorneys, and clients. Additionally, in late 2010, several of the largest servicers imposed a foreclosure filing moratorium.

FHFA-OIG finds that these indicators could have led FHFA to identify the emerging risk before the rise in media attention in August 2010. Based on the foregoing, FHFA needs to develop procedures to identify and assess new or heightened risks, as it simultaneously addresses historic risks with which it is familiar. In the absence of such action, FHFA has limited assurance that foreclosure processing abuses will be prevented and detected through its supervisory activities.

conservator may take over the assets of, operate the Enterprises with all the powers of the shareholders, the directors, and the officers of them, and conduct all of their business.

²⁹ A widely circulated Mother Jones article from August 2010, *Fannie and Freddie's Foreclosure Barons*, was just one of many newspaper articles that highlighted foreclosure abuses such as "robo-signing." Earlier stories on the topic also circulated. For example, and as discussed above, a March 30, 2008, New York Times report, *Foreclosure Machine Thrives on Woes*, noted complaints of law firms filing improper or duplicative foreclosure and bankruptcy pleadings and levying inappropriate fees upon borrowers.

2. FHFA's Supervisory Planning and Guidance Do Not Adequately Address Default-Related Legal Services

To date, FHFA has neither an ongoing risk-based supervisory plan detailing examination and continuous supervision of default related legal services, nor finalized examination guidance and procedures for use in performing targeted examinations and monitoring of such services.

As a Federal agency, FHFA is subject to internal control standards that help it meet its responsibilities and minimize risk associated with its programs and operations. For example, the Government Accountability Office's *Standards for Internal Control in the Federal Government* defines control activities as the policies, procedures, techniques, and mechanisms that help ensure an agency's objectives are met.³⁰ Further, as specified in the Office of Management and Budget's Circular A-123, it is management's responsibility to develop and maintain effective internal controls.³¹ Thus, as agencies develop and execute strategies for implementing or reengineering agency programs and operations, they should design management structures that help ensure accountability for results, such as approved guidance and procedures specific to performing targeted examinations and continuous monitoring of default-related legal services.

FHFA's examination guidance and procedures – *Supervisory Guide* and *Supervision Handbook* – are general in nature and not specific to operational risk areas, such as default-related legal services. Although the Agency's *Supervision Reference and Procedures Manual* includes more detail concerning review procedures related to operational risk, these procedures do not address specific third-party vendor risks, such as risks associated with default-related legal services performed by law firms.

Additionally, the Agency has not finalized the manual for use by its examiners. Rather, the manual has been in "beta testing"³² for over two years. FHFA has stated that the manual is authorized for use by examiners, and during the "beta testing" the examiners have been using the manual to conduct examinations, including the special review of the RAN. Nonetheless, FHFA would benefit from completion of supervisory plans and finalization of examination guidance for default-related legal services that collectively provide management's direction governing the supervisory process.

³⁰ GAO/AIMD-00-21.3.1 (11/99), p. 11.

³¹ OMB Circular A-123 (June 21, 1995), § 2.

³² Beta testing is the last stage of product testing and normally involves using the product in real-world circumstances.

3. FHFA Does Not Have a Formal Process for the Enterprises to Share Information About Problem Law Firms

FHFA does not have a formal process to address performance problems associated with law firms that have relationships – either directly through contract or through its loan servicers – with both of the Enterprises. Specifically, FHFA does not have a policy requiring the Enterprises to notify the Agency when they terminate a third-party vendor, such as a law firm, for poor or inappropriate performance. The Agency also does not have a process to apprise an Enterprise when it learns that a particular law firm has been terminated by the other Enterprise. Although the Enterprises appear to have notified each other of vendor terminations in the past, such notifications appear to have been done on an *ad hoc* basis. FHFA also has not developed and implemented a policy that requires Enterprises to evaluate the performance of a vendor when they learn that the other Enterprise terminated the firm.

Fannie Mae has terminated six law firms from its RAN since 2008, but FHFA does not have a formal policy or practice to apprise either Enterprise of the other Enterprise's termination actions. Moreover, Freddie Mac has terminated law firms for poor performance, and Fannie Mae has retained the firms. Indeed, Freddie Mac terminated one law firm that processed over 43% of Fannie Mae's loan foreclosures in Florida. Freddie Mac voluntarily notified Fannie Mae of its reasons for terminating the firm, which included foreclosure processing abuses, but Fannie Mae decided to retain the law firm's services. Fannie Mae determined that the cost of transferring its files from the firm to a replacement vendor would be substantial. Additionally, Fannie Mae claimed it would work closely with the firm to mitigate its deficiencies.³³ In another example, Freddie Mac terminated a law firm in Maryland,³⁴ and, again, Fannie Mae decided to retain its services. Fannie Mae asserted that it reviewed the allegations and did not find the same type of deficiencies in its review of the firm.

FHFA needs to address concerns (e.g., poor and inappropriate performance) associated with third-party vendors, such as law firms, that do business with both Enterprises. Failure to do so leaves the Enterprises vulnerable to problems or abuses identified by the other Enterprise. Further, FHFA's prompt action will help mitigate the reputational risks associated with the allegations of improper foreclosure practices.

³³ Fannie Mae estimates it will incur significant costs when it terminates law firms in its RAN for breach of contract. These costs include costs incurred to investigate the actions of the firm, external third-party fees, internal operating costs, and file transfer fees (i.e., fees paid to the replacement RAN firm to physically acquire the foreclosure files). For example, when Fannie Mae terminated the Stern Law Firm, it estimated it would incur approximately \$5.5 million in total costs. The costs include \$4.6 million in file transfer fees (this estimate represents \$200 per transfer for approximately 23,000 loan files). Fannie Mae estimated all other associated costs at approximately \$900,000.

³⁴ Again, its reasons included foreclosure processing abuses.

CONCLUSION

FHFA can strengthen its oversight of default-related legal services. FHFA recognized the importance of its oversight of the Enterprises' default-related legal services and gradually accumulated information on the attorney network programs of Fannie Mae and Freddie Mac. However, FHFA did not schedule comprehensive examination coverage of foreclosure issues, including allegations of abuse by specific law firms that performed default-related legal services for Fannie Mae until after news accounts of abuses surfaced in August 2010. FHFA historically considered the RAN to be an area of comparatively low risk, but several key indicators could have led the Agency to recognize its increasing risk. For example, rising default and foreclosure rate trends reflect increased operational risks, and the consequential allegations of foreclosure abuses represent reputational risks for the Enterprises. Had the Agency more fully explored and considered these indicators, it could have elevated default-related legal services as an area of concern worthy of increased supervisory attention. Indeed, FHFA might have been able to take earlier action to strengthen controls over Fannie Mae's law firms involved in the foreclosure process. Even if these indicators had not precipitated a program of examinations of Fannie Mae's default-related legal services, at the very least they should have prompted the Agency to enhance its risk assessment and monitoring activities.

The Agency's special review of the RAN framework is a positive step and the Agency should continue with undertaking such reviews. FHFA-OIG contends, however, that the Agency should have paid closer attention to the highly dynamic housing foreclosure environment between 2008 and 2010 and, in the future, should become more proactive in its oversight of the RAN in particular and the foreclosure process in general. The Agency needs to apply a proactive approach going forward to identify and assess new and emerging risks and to develop detailed guidance on conducting targeted examinations of the Enterprises' operational risks associated with their vendors. This guidance should incorporate continuous supervision, special reviews, and targeted examinations and address crossover issues that affect both of the Enterprises and their relationships with third-party vendors.

FHFA would have greater assurance that foreclosure processing abuses will be prevented and detected by strengthening controls in its supervisory processes.

RECOMMENDATIONS

FHFA-OIG recommends that FHFA:

1. Review the circumstances surrounding FHFA not identifying the foreclosure abuses at an earlier stage and develop potential enhancements to its capacity to identify new and emerging risks.
2. Develop and implement comprehensive examination guidance and procedures together with supervisory plans for default-related legal services.
3. Develop and implement policies and procedures to address poor performance by default-related legal services vendors that have contractual relationships with both of the Enterprises.

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OBJECTIVE, SCOPE AND METHODOLOGY

The objective of this performance audit was to assess the extent of FHFA's oversight of Fannie Mae's default-related services performed by law firms within the RAN. Specifically, FHFA-OIG sought to review FHFA's: (1) written policies and procedures for its oversight of Fannie Mae's RAN; (2) oversight of Fannie Mae's internal controls over its RAN; and (3) supervisory actions taken concerning the RAN.³⁵

FHFA-OIG performed its fieldwork for this audit from April 2011 through July 2011. FHFA-OIG conducted this audit at FHFA's three offices located in Washington, D.C., and Fannie Mae's office in Washington, D.C. FHFA-OIG interviewed FHFA and Fannie Mae personnel. To achieve its objective, FHFA-OIG relied on computer-processed and hard copy data from FHFA and Fannie Mae. This included data contained in the xWorks document repository and the Agency's MS Outlook email account. FHFA-OIG assessed the validity of the computerized and hard copy data and found it to be generally accurate, but could not conclude on its completeness.

FHFA-OIG assessed the internal controls related to its audit objectives. Internal controls are an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- 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 on this performance audit, FHFA-OIG considers deficiencies related to FHFA's oversight of Fannie Mae's default-related legal services performed by law firms within the RAN to be significant within the context of the audit objective.

FHFA-OIG conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that audits be planned and performed

³⁵ The audit was not intended or designed to assess the effectiveness of Fannie Mae's oversight of the RAN.

to obtain sufficient, appropriate evidence to provide a reasonable basis for FHFA-OIG's findings and conclusions based on the audit objective. FHFA-OIG believes that the evidence obtained provides a reasonable basis for the finding and conclusions included herein, based on the audit objectives.

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APPENDIX A

FHFA's Comments on Findings and Recommendations



Federal Housing Finance Agency

MEMORANDUM

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

FROM: Christopher H. Dickerson, Acting Deputy Director for Enterprise Regulation *Chig H. D.*

SUBJECT: OIG Assignment No. AUD-2011-003—FHFA's Oversight of Fannie Mae's Default-Related Legal Services

DATE: September 29, 2011

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses to the recommendations from the audit referenced above. As stated in report, the purpose of the audit was to assess FHFA's oversight of Fannie Mae's default-related legal services performed by law firms within the company's retained attorney network (RAN), including a review of FHFA's (1) written policies and procedures for its oversight of Fannie Mae's RAN; (2) oversight of Fannie Mae's internal controls over the RAN; and (3) supervisory actions taken concerning the RAN.

FHFA staff previously provided to the OIG a detailed set of technical comments. Those comments pertained to a number of factual and other issues that are separate from FHFA's formal response to the OIG's specific recommendations. For the benefit of readers, FHFA notes that it does not have direct supervisory authority over providers of default-related legal services. The matters at hand concern FHFA's oversight of Fannie Mae and how Fannie Mae manages counterparty risk in its contractual relationships with legal service providers.

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

Recommendation 1: "Review the circumstances surrounding FHFA's not identifying abuses at an earlier stage, and develop potential enhancements to its capacity to identify new and emerging risks."

Management Response: FHFA agrees that identifying new and emerging risks is a constant challenge for financial regulators, including FHFA. The agency will continue to review its existing supervisory practices, including off-site monitoring activities, and determine whether there are useful enhancements to consider and implement. Any such changes will be implemented by September 29, 2012.

Recommendation 2: “Develop and implement comprehensive guidance and procedures together with supervisory plans for default-related legal services.”

Management Response: FHFA has a supervision reference and procedures manual for Third Party Relationship Management that governs default-related legal services. We believe that the manual meets existing regulatory standards, but we agree to review the manual and consider the OIG’s recommendation to add detailed provisions to it that pertain to default-related legal services. Further, FHFA’s supervisory plans will be revised by September 29, 2012 to reflect the final actions taken to address weaknesses that FHFA identified in the RAN.

Recommendation 3: “Develop and implement policies and procedures to address poor performance by default-related legal services vendors and that have contractual relationships with both of the Enterprises.”

Management Response: FHFA agrees with the recommendation. As OIG notes in the report, FHFA is concluding its examination activity in this area and will ensure that appropriate steps are taken by September 29, 2012 to remediate Enterprise deficiencies in the management of risks associated with default-related legal services vendors. Like examination reports of other regulators, FHFA examination reports are not public documents. They are appropriately summarized and reported in FHFA’s Annual Report to Congress.

APPENDIX B

FHFA-OIG's Response to FHFA's Comments

On September 29, 2011, FHFA provided comments to a draft of this report agreeing with all three recommendations and identifying FHFA actions to address each recommendation. 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. See Appendix C of this report for a summary of management's comments on the recommendations.

With regard to FHFA's response to Recommendation 3, FHFA stated that it is concluding its examination activity and will ensure that appropriate steps are taken by September 29, 2012, to remediate Enterprise deficiencies in the management of risks associated with default-related legal services vendors. While this action is positive, FHFA should address poor performance by these counterparties that have relationships with both of the Enterprises as part of its remedial efforts in accordance with the agreed-to recommendation.

FHFA noted that it does not have direct supervisory authority over providers of default-related legal services and that the matters at issue concern FHFA's oversight of Fannie Mae and how Fannie Mae manages counterparty risk in its contractual relationships with legal service providers. FHFA-OIG agrees with these points and further notes that FHFA, as conservator for Fannie Mae, has the powers of the management, Board of Directors and shareholders of the Enterprise.

FHFA's response referred to prior comments provided to FHFA-OIG that were considered in finalizing this report.

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 the date of report issuance.

<i>Rec. No.</i>	<i>Corrective Action: Taken or Planned</i>	<i>Expected Completion Date</i>	<i>Monetary Benefits</i>	<i>Resolved:^a Yes or No</i>	<i>Open or Closed^b</i>
1.	FHFA will review its existing supervisory practices, including off-site monitoring activities, and determine whether there are useful enhancements to consider and implement concerning assessments of emerging risks.	09/29/2012	\$0	Yes	Open
2.	FHFA will review its supervision reference and procedures manual and add detailed provisions to it that pertain to default-related legal services. Further, FHFA's supervisory plans will be revised to reflect the final actions taken to address weaknesses in the RAN.	09/29/2012	\$0	Yes	Open
3.	FHFA will ensure that appropriate steps are taken to remediate Enterprise deficiencies in the management of risks associated with default-related legal services vendors.	09/29/2012	\$0	Yes	Open

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 FHFA-OIG monetary benefits, a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

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

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