

Federal Housing Finance Agency
Office of Inspector General



**FHFA Oversight of Fannie Mae's
Remediation Plan to Refund
Contributions to Borrowers for the
Short Sale of Properties**



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

A handwritten signature in blue ink, appearing to read "Russell A. Rau".

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

SUBJECT: FHFA Oversight of Fannie Mae's Remediation Plan to Refund Contributions to Borrowers for the Short Sale of Properties

Background

The Federal National Mortgage Association (Fannie Mae or Enterprise) is a federally chartered corporation that was placed in conservatorship by the Federal Housing Finance Agency (FHFA or Agency) in September 2008 due largely to losses on residential mortgage loans from defaults. While in conservatorship, FHFA has the decision-making authority in addition to its responsibilities as a regulator for the Enterprise. Short sales, also known as preforeclosure sales, are a part of Fannie Mae's foreclosure alternative strategy that can minimize the severity of losses it incurs as a result of loan defaults. In a short sale, the borrower sells the residence for less than the balance remaining on the loan and uses the proceeds to help satisfy the mortgage obligation. The proceeds received from a short sale are less than the amount of debt secured by liens against the property, which most often results in a loss to the Enterprise. In certain short sale transactions, depending on the borrower's financial condition, the borrower may be required to make a contribution toward the short sale, which in turn reduces the Enterprise's loss on the sale.

Through their Seller/Servicer Guides, Fannie Mae and Freddie Mac provide guidance on a large number of matters, including delinquency management and default prevention. Servicers are required to comply with the guidance through their contractual agreements with the Enterprises. The Enterprises have quality control processes that are designed to identify and address servicer noncompliance and the contracts include remedial tools, such as financial penalties. Pursuant to its delinquency management and default prevention guidance, Fannie Mae expects servicers to identify borrowers who are having difficulty making mortgage payments due to a financial hardship and offer appropriate workout options, such as a short sale. Fannie Mae also depends on its servicers to evaluate borrowers for contributions unless they are required to request approval from Fannie Mae for the contribution amount. Furthermore, Fannie Mae relies on its servicers to collect borrower contributions with the net proceeds from the short sale closing.

Before Fannie Mae clarified the requirements for borrower contributions, there was little guidance for servicers to follow with respect to requesting contributions and collecting them. On August 22, 2012, Fannie Mae issued Servicing Guide Announcement SVC-2012-19 that introduced new requirements to simplify and streamline the short sale process.¹ This announcement provided specific guidance for evaluating a borrower for a contribution and reminded servicers that they must not request cash contributions and/or promissory notes where applicable law prohibited borrower contributions; however, it did not state that borrower contributions were prohibited in California.

Although Fannie Mae issued guidance to its servicers informing them of the requirements for evaluating borrower contributions, Fannie Mae and its servicers did not always have the option to collect them. On September 30, 2010, the state of California enacted a law which went into effect on January 1, 2011, that prohibited a deficiency judgment for any note where the property sold for less than the indebtedness.² According to Fannie Mae, the language of this new law was unclear and did not expressly prohibit borrower contributions in short sale transactions.

On July 11, 2011, the state of California amended Section 580e on an emergency basis to provide clarity in connection with borrower contributions on short sale transactions. The amendment, which went into effect four days later on July 15, clarified the law to include an express prohibition against any type of borrower contribution in connection with a short sale. Specifically, Section 580e subsection (b) forbids “A holder of a note” from requiring the borrower “to pay any additional compensation, aside from the proceeds of the sale, in exchange for the written consent to the sale.”

Fannie Mae and its servicers were also prohibited from collecting contributions for short sales completed through Fannie Mae’s Home Affordable Foreclosure Alternatives (HAFA) Program that went into effect on August 1, 2010.³ Fannie Mae’s HAFA Program was discontinued with the implementation of the Standard Short Sale Program on November 1, 2012, which was created as part of FHFA’s Servicing Alignment Initiative (SAI).⁴

¹ Servicing Guide Announcement SVC-2012-19 is entitled, “Standard Short Sale/HAFA II and Deed-in-Lieu of Foreclosure Requirements.”

² This law, Section 580e of the California Code of Civil Procedure, provides that a deficiency judgment shall not be rendered for any note secured by a first lien where the property is sold for less than the amount of the indebtedness with the written consent of the mortgagee, if certain conditions are satisfied. CAL. CIV. PROC. § 580e(a)(1).

³ Section 610.02.01 of Fannie Mae’s 2012 Servicing Guide prohibits borrower contributions for HAFA short sales. The guide states that “Cash contributions or promissory notes are not permitted under HAFA; therefore, if a servicer or mortgage insurer determines that a borrower has an ability to contribute meaningfully to reducing the potential loss on the mortgage loan, the borrower is not eligible for HAFA and may only obtain a preforeclosure sale or deed-in-lieu under the requirements of other Fannie Mae preforeclosure sale or deed-in-lieu alternatives.” See Fannie Mae Single Family 2012 Servicing Guide Part VII, § 610.02.01.

⁴ The SAI establishes consistent policies and processes for the servicing of delinquent loans owned or guaranteed by Fannie Mae and Freddie Mac (the Enterprises).

Finding: FHFA Should Oversee Fannie Mae's Remediation Plan to Refund Contributions to Borrowers for the Short Sale of Properties

Through its review of closed short sale transactions in a recently completed audit on short sale borrower eligibility,⁵ OIG found that Fannie Mae and its servicers may have improperly collected borrower contributions for short sales of properties on two fronts—in the state of California and under the HAFA Program, which was available in all states. The collection of these borrower contributions prompted Fannie Mae to initiate a remediation plan to return up to \$3,173,249 to borrowers who may have been impacted from the short sale of properties located in California and up to \$53,000 for HAFA short sales.

As of July 15, 2011, the state of California expressly prohibited the holder of a note from requiring the borrower to pay any additional compensation in exchange for the written consent to a sale other than the sale's proceeds. This would include the collection of borrower contributions as a condition of a short sale. Nonetheless, based on a review of short sale data provided by Fannie Mae, it appeared that Fannie Mae's servicers collected borrower contributions for 124 short sales completed during 2012 that would be contrary to the amended California law. Upon identifying this issue, OIG followed up with Fannie Mae to identify all short sales of California properties where borrower contributions were collected since the law became effective on January 1, 2011.

As reflected in Figure 1, Fannie Mae provided the OIG with data showing that 1,222 borrower contributions may have been improperly collected for the short sale of California properties closed between January 1, 2011 and June 30, 2013. The contributions were either cash or promissory notes executed by borrowers to pay the contribution over time. However, Fannie Mae has advised that there are significant data accuracy issues and has identified a number of short sales where the data reported to Fannie Mae by its servicers erroneously reflects the collection of a borrower contribution. Therefore, the total number and amount of borrower contributions improperly collected may be substantially less than the data supplied by Fannie Mae.

⁵ See OIG, *Fannie Mae's Controls Over Short Sale Eligibility Determinations Should be Strengthened*, AUD-2014-003 (November 20, 2013), available at <http://www.fhfaig.gov/Content/Files/AUD-2014-003.pdf>.

FIGURE 1. Borrower Contributions for California Short Sales

Contribution Type	No. of Contributions	Total Amount Collected
Cash – Delegated ⁶	900	\$1,903,880
Cash – Non-delegated	288	\$897,311
Promissory Note ⁷	34	\$372,058
Total Contributions for Properties Located in California	1,222	\$3,173,249

Fannie Mae completed an analysis of the California law on March 28, 2011. Fannie Mae determined that it would not collect borrower contributions in connection with non-delegated cases involving the short sale of properties located in California, despite the lack of clarity in the law before it was amended in July 2011. Nonetheless, Fannie Mae did not issue any guidance to its servicers regarding its decision to cease requesting borrower contributions for short sales of California properties or to require them to adopt a consistent practice. Instead, it relied on its servicers to comply with all federal, state, and local laws per its Servicing Guide and make their own legal determinations.⁸ In addition, Fannie Mae did not enhance its own controls to identify short sales in California with borrower contributions and monitor servicer compliance with the California law prohibiting collection of such contributions until May 2013.⁹

Consequently, the controls in place at Fannie Mae did not prevent the potential inappropriate collection of borrower contributions contrary to California law until they were enhanced toward the end of May 2013. Fannie Mae’s servicers collected borrower contributions on its behalf for the short sale of properties located in California after the law went into effect on January 1, 2011, and, to a lesser extent, continued to collect them after the law was clarified and expressly prohibited any type of borrower contribution as of July 15, 2011. Such cash contributions should be potentially returned to the borrowers. Further, as previously discussed, Fannie Mae’s servicers inappropriately executed promissory notes on its behalf for the collection of contributions from

⁶ Fannie Mae has two categories of servicers, non-delegated and delegated. Non-delegated servicers have no authority to make short sale decisions on behalf of Fannie Mae. Their role is limited to collecting short sale information and forwarding the information to Fannie Mae for consideration. Delegated servicers have been granted authority to make short sale determinations and complete short sales on behalf of Fannie Mae subject to certain limitations in Fannie Mae’s Servicing Guide.

⁷ Cash contributions were also paid by the borrowers for six of these short sales.

⁸ See Fannie Mae Single Family 2012 Servicing Guide Part I, § 307.

⁹ At the end of May 2013, Fannie Mae implemented a daily exception report to identify all short sales where contributions were received in connection with the short sale of properties located in California. Fannie Mae has also implemented a secondary control to review the Settlement Statement (HUD 1) for properties sold short in California to identify whether a borrower contribution was received. The HUD 1 is a form used by a settlement or closing agent itemizing all charges imposed on a borrower and seller in a real estate transaction. Additionally, Fannie Mae’s short sale letters to California borrowers will be updated with language that indicates borrower contributions are prohibited.

borrowers in California that should be discontinued and assessed for repayment of amounts received.

In addition, based on a review of short sales data provided by Fannie Mae, it appeared that Fannie Mae's servicers improperly collected borrower contributions totaling \$53,000 for 18 short sales under Fannie Mae's HAFA Program, which has since been discontinued.¹⁰ Based on data provided by its servicers, Fannie Mae approved 6 of these short sales and its servicers approved 12. Fannie Mae's Servicing Guide specifically prohibited borrower contributions for HAFA short sales.

Based on OIG's work, Fannie Mae was made aware that borrower contributions collected for properties located in the state of California may be contrary to California law and that borrower contributions collected for HAFA short sales are in violation of HAFA Program requirements. In response, Fannie Mae acknowledged the importance of the issue and developed a Remediation Plan that was finalized during October 2013 to notify its servicers to refund the borrowers the amount of any improper contributions for the short sale of properties located in California that were closed on or after January 1, 2011. A remediation plan is also in place for the HAFA short sales where borrower contributions were collected.

Pursuant to its remediation plan, Fannie Mae sent a list of loans to each of its servicers that collected borrower contributions. The servicers have been requested to research the amount of the actual contributions collected and respond to Fannie Mae by December 31, 2013, identifying the loans that would require a servicer refund for any improper borrower contribution. Upon validation of each contribution, Fannie Mae will refund the amount of the contributions to its servicers. Fannie Mae further explained that the decision to pursue refunds rests with each servicer that reviews the identified cases where improper borrower contributions may have been collected. If the servicer validates that a contribution was not collected or if the servicer has a reasonable basis to support the contribution, a borrower refund may not be required by Fannie Mae. The servicers would also presumably decide whether they believe there was a reasonable basis to collect contributions made while the California law was unclear. As a result, the current remediation plan may not provide for consistent treatment of borrowers by servicers even if borrower circumstances are similar. For example, two large servicers have already taken the legal position that refunds are not warranted for contributions collected prior to July 15, 2011, the effective date of the amended California law. Fannie Mae has received eight requests for the reimbursement of borrower contributions and is evaluating whether refunds should be paid to the borrowers.

FHFA is currently reviewing Fannie Mae's remediation plan to ensure that borrowers are protected and made whole due to inappropriate borrower contributions. Additionally, FHFA will determine if similar conditions exist at the Federal Home Loan Mortgage Corporation (Freddie Mac) that uses most of the same servicers as Fannie Mae and similarly is handling defaulted loans in California. Like Fannie Mae, Freddie Mac is regulated by FHFA and was placed into

¹⁰ Fannie Mae informed the OIG that it collected borrower contributions for 16 of the 18 HAFA short sales and that the difference between the data provided to the OIG and actual collections was the result of data input errors.

conservatorship by the Agency in September 2008. FHFA's timely review of Fannie Mae's remediation plan will help ensure the consistent treatment of borrowers by Fannie Mae and its servicers.

Recommendations

OIG recommends that FHFA:

1. Review Fannie Mae's remediation plan to ensure that the plan provides for the return of borrower contributions to borrowers in a consistent manner by Fannie Mae and its servicers, and issue guidance as deemed appropriate regarding the execution of the remediation plan.
2. Oversee the execution of Fannie Mae's remediation plan to ensure that a good faith effort is made to promptly refund inappropriately collected borrower contributions to borrowers.
3. Examine Freddie Mac's controls over the collection of borrower contributions for the short sales of properties located in California and issue guidance to strengthen controls as deemed appropriate based on the results of the examination.

Objective, Scope, and Methodology

The objective of this overall performance audit was to assess FHFA's oversight of Fannie Mae's controls over borrower eligibility requirements applicable to its short sale program.¹¹ During the performance of fieldwork, OIG identified that in certain instances borrower contributions were collected on short sales of properties located in California, a state with a law that expressly prohibits this practice. Accordingly, OIG is separately reporting on Fannie Mae's collection of borrower contributions with an emphasis on those collected in the state of California.

OIG conducted its fieldwork at FHFA's headquarters in Washington, D.C., and Fannie Mae's corporate offices in Washington, D.C. and Dallas, TX.

In order to accomplish its objective, OIG:

- Reviewed FHFA's guidance to the Enterprises related to the short sales program;
- Reviewed Fannie Mae's policies and procedures related to the short sales process;
- Interviewed FHFA and Fannie Mae officials to further OIG's understanding of the short sale process;

¹¹ See footnote 5, *supra*.

- Reviewed and analyzed Fannie Mae short sales completed in 2012 and additional borrower contribution information for short sales closed from January 1, 2011 through May 31, 2013; and
- Interviewed seven Fannie Mae servicers concerning the short sale process.

OIG conducted fieldwork for this performance audit from January 2013 through October 2013 in accordance with Generally Accepted Government Auditing Standards. Those standards require that OIG plan and perform audits 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 finding and conclusions included herein, based on the audit objective.

OIG appreciates the cooperation of everyone who contributed to this audit, including officials at FHFA and Fannie Mae. This audit was led by Laura Benton, Audit Director, and Scott H. Smith, Audit Manager, who were assisted by Cairo Carr, Auditor-in-Charge, and Mendy Breitkopf, Auditor. This audit report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on OIG's website, www.fhfa.ig.gov.

Attachments: Attachment A: FHFA's Comments
Attachment B: OIG's Response to FHFA's Comments
Attachment C: Summary of Management's Comments on the Recommendations

Attachment A

FHFA's Comments



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 Oversight of Fannie Mae's Remediation Plan to Refund Contributions to Borrowers for the Short Sale of Properties (Audit Assignment AUD-2012-015)

DATE: January 9, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations resulting from the Audit Report: FHFA Oversight of Fannie Mae's Remediation Plan to Refund Contributions to Borrowers for the Short Sale of Properties (Audit Assignment AUD-2012-015). The Audit Report discusses an OIG finding that suggests Fannie Mae and its servicers collected up to \$2.8 million potentially contrary to California state law during 2011, 2012 and 2013. The report makes three recommendations regarding actions that FHFA should carry out in resolving legal issues with these borrower contributions.

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

FHFA recognizes the GSE's obligations to protect their interests¹. However, it remains unclear whether or not actions occurred that run contrary to California law as noted by the FHFA-OIG. The interpretation of California law, in the first instance, is not the responsibility of FHFA, Fannie Mae, or Freddie Mac. That responsibility rests with other federal and state regulatory agencies and is explicitly noted as a responsibility in the representations and warranties between seller/servicers and the Enterprises.

¹ Regarding compliance with law requirements in Fannie Mae and Freddie Mac guides it should be noted that (i) responsibility for remaining current with all legal requirements, state and federal, resides with the servicers who are compensated for this pursuant to contracts; (ii) the increased number of state enactments since 2008 have complicated consumer law compliance and routinely legislative enactments require regulatory interpretation and may be subject to court reviews that impact determination of legal requirements; (iii) compliance with a state law is undertaken with consideration of whether such law conflicts with a federal law, in which case federal law will control, and in conservatorship, states may not interfere with conservator directed policies of the Enterprises; (iv) the representation and warranty and other tools of the Enterprises are there to address problems that will invariably arise in administering complex and broad mortgage programs; and, (v) FHFA has responsibilities to oversee the conduct of the Enterprises in these matters.

Notwithstanding the uncertainties noted here, Fannie Mae is addressing concerns about the treatment of borrowers in several ways, including initiating a remediation plan and instructing servicers, who have the primary responsibility for executing short sales with borrowers, to identify and refund borrower contributions incorrectly collected under Fannie Mae and Freddie Mac's policies. The Enterprises have these types of processes in place when they become aware of noncompliance with Fannie Mae and Freddie Mac's contractual selling and servicing guide. FHFA is monitoring Fannie Mae's remediation plan through our normal supervisory process.

As the report acknowledges, the activity in question arose largely because the California law that went into effect in January 2011 was unclear and confusing. Recognizing this, the California legislature subsequently amended the law through emergency legislation. As Fannie Mae's servicers work through the potential universe of inappropriately collected borrower contributions, the dollar amount of refunds due will likely be considerably less than the \$2.8 million identified in the report.

Recommendation 1: **OIG recommends that FHFA review Fannie Mae's remediation plan to ensure that the plan provides for the return of borrower contributions to borrowers in a consistent manner by Fannie Mae and its servicers, and issue guidance as deemed appropriate regarding the execution of the remediation plan.**

Recommendation 2: **OIG recommends that FHFA oversee the execution of Fannie Mae's remediation plan to ensure that a good faith effort is made to promptly refund inappropriately collected borrower contributions to the subject borrowers.**

Management Response to Recommendations 1 and 2: FHFA agrees with these recommendations. FHFA has been monitoring Fannie Mae's execution of its remediation plan as part of our normal supervisory activities. FHFA is responsible for ensuring that the representation and warranty framework model under which the Enterprises operate clearly provides that seller/servicers bear the legal responsibility for knowing that they are fulfilling their contractual obligations in full compliance with all applicable laws. FHFA will continue to monitor Fannie Mae's execution of the remediation plan, but does not believe that additional guidance is warranted at this time. FHFA will provide OIG a report by June 15, 2014 regarding the progress made by Fannie Mae in executing its remediation plan.

Recommendation 3: **OIG recommends that FHFA examine Freddie Mac's controls over the collection of borrower contributions for the short sales of properties located in California and issue guidance to strengthen its controls as deemed appropriate based on the results of the examination.**

Management Response: FHFA agrees that Freddie Mac's servicers operating in California may face the same operational issues as do Fannie Mae's and has already notified the Enterprise about this matter. FHFA will monitor the results of Freddie Mac's review into the matter and will follow-up on any identified deficiencies or exceptions through its normal supervisory process. FHFA will provide the FHFA-OIG an update on the results by April 15, 2014.

Attachment B

OIG's Response to FHFA's Comments

On January 9, 2014, FHFA provided comments to a draft of this report. Although FHFA stated it agreed with OIG's three recommendations, the Agency's actions are not fully responsive and the recommendations are unresolved. In particular, FHFA actions provide limited confidence that borrowers will be treated consistently in decisions concerning refunds of their contributions to short sales.

Although FHFA stated it agrees with Recommendations 1 and 2, its comments suggest otherwise. While OIG recommended that FHFA provide guidance and oversight for the return of borrower contributions, FHFA stated it would monitor execution of Fannie Mae's remediation plan. FHFA's reliance on Fannie Mae's representation and warranty framework model will not provide for the return of borrower contributions in a consistent manner as OIG recommended. Under this framework, each servicer will independently interpret the California law and decide whether to return contributions to impacted borrowers. In particular, the servicers would decide whether contributions made prior to amendments to California law would be refunded. Therefore, different servicers could come to varying conclusions about refunding contributions even if borrower circumstances are similar. Fannie Mae's remediation plan provides for reimbursement of all borrower contributions refunded by the servicers. Therefore, the servicers will not experience a loss for refunding borrower contributions. However, this action by the Enterprise alone will not be sufficient to cause servicers to refund contributions in a consistent manner. For example, two large servicers have already taken the legal position that refunds are not warranted for contributions collected before amendments to California law went into effect. The OIG considers it necessary for FHFA and Fannie Mae to actively engage in oversight of this effort including issuing appropriate guidance to ensure that borrowers receive consistent treatment by servicers concerning refund of borrower contributions.

FHFA stated it agrees with Recommendation 3 and has already notified Freddie Mac that servicers operating in California may face the same operational issues as Fannie Mae's servicers. FHFA also plans to review Freddie Mac's oversight of servicers' collection of borrower contributions for the short sale of properties located in California and will provide OIG an update on the results by April 15, 2014. OIG views FHFA's actions as positive steps. However, just as with Fannie Mae's approach, OIG is concerned that servicers will come to varying conclusions about refunding contributions and not provide consistent treatment to borrowers in similar circumstances without guidance and oversight from FHFA and Freddie Mac.

OIG requests that FHFA reconsider its position on these three recommendations and provide additional comments within 30 days of the issuance of this report. 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 corrective actions.

OIG also noted that in footnote 1 of FHFA's response, the Agency provided various comments regarding compliance with federal and state law, including the relationship between state law and conservator directed policies of the Enterprises.

Attachment C

Summary of Management's Comments on the Recommendations

This table presents management's response 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 (\$ Millions)	Resolved: Yes or No^a	Open or Closed^b
1.	FHFA agrees with this recommendation. Nonetheless, FHFA proposes to allow Fannie Mae to rely on its representation and warranty framework, which does not necessarily provide for the return of borrower contributions in a consistent manner. Further, FHFA is not planning on issuing additional guidance on this matter.	06/15/2014	\$0	No	Open
2.	FHFA agrees with this recommendation. See response to Recommendation 1.	06/15/2014	\$0	No	Open
3.	FHFA agrees with this recommendation. FHFA has informed Freddie Mac of this matter and will review the Enterprise's current oversight of servicers' collection of borrower contributions for the short sale of properties located in California and follow-up any identified deficiencies through its normal supervisory process. FHFA will provide OIG an update on the results by April 15, 2014. OIG is concerned that without proper oversight and guidance by FHFA and Freddie Mac, there may be inconsistent treatment of borrowers and untimely refunding of improperly collected contributions.	04/15/2014	\$0	No	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 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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