Federal Housing Finance Agency
Office of Inspector General

Additional FHFA Oversight Can Improve the Real Estate Owned Pilot Program

Audit Report • AUD-2013-012 • September 27, 2013

Synopsis

September 27, 2013

Additional FHFA Oversight Can Improve the Real Estate Owned Pilot Program

Why OIG Did This Audit

The Federal Housing Finance Agency (FHFA or agency) currently serves as both regulator and conservator of the Federal National Mortgage Association (Fannie Mae or enterprise) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the enterprises), with a responsibility to preserve and conserve their assets. The enterprises support the nation's housing finance system by acquiring mortgages in the secondary mortgage market, which gives lenders the liquidity to make additional loans. The enterprises can either retain mortgages they purchase or securitize them by pooling them into mortgage-backed securities (MBS) that are then sold to investors. Typically, when borrowers default on these mortgages and efforts to cure the defaults are unsuccessful, the mortgages are foreclosed on. Through foreclosure, properties that secure the defaulted mortgages can be acquired by the enterprises as real estate owned (REO) properties.

The enterprises' REO inventory levels increased dramatically in the years following the financial crisis. In accordance with its broad conservatorship objective to minimize costs and maximize net present value of REO, FHFA initiated a pilot program in 2012 to assist with REO disposition efforts. The REO Pilot Program was the first, and to date only, transaction to be conducted under a broader FHFA initiative to develop and implement an improved REO disposition program. For the pilot transaction, about 2,500 single-family Fannie Mae REO properties, many with tenants, were consolidated into pools in eight geographic areas and offered to prequalified investors for sale.

The objective of this performance audit was to assess FHFA's oversight of Fannie Mae's policies, procedures, and practices with respect to the selection and administration of investors participating in the REO Pilot Program.

What OIG Found

FHFA established a sound process for reviewing, scoring, and recommending investors to qualify as bidders under the REO Pilot Program. However, Fannie Mae's bidder qualification contractor did not fully comply with important provisions of the established process. Specifically, the contractor did not properly score the risk attributes for 12 of 47 potential investors, 6 of whom were determined to be eligible to bid even though they did not meet prescribed bidder qualification scoring criteria. Moreover, certain areas of the application and scoring criteria require clarification if used for similar programs in the future.

Additionally, Fannie Mae did not always follow its contractor's scores and recommendations. For example, the enterprise, with FHFA's concurrence, permitted two potential investors to bid on mortgage pools even though both

Synopsis

September 27, 2013

were scored by the contractor as high risk and not recommended to bid. Further, FHFA did not independently verify the work performed by Fannie Mae's bidder qualification contractor, and, thus, the instances of noncompliance were not discovered by the agency.

In addition, FHFA has not clarified several goals that are applicable to the REO Pilot Program. Specifically, FHFA has not clarified how the goals and objectives of the pilot program will be achieved, or how the agency intends to monitor and assess the performance of the pilot or any other future initiatives under the overall REO disposition program. In particular, FHFA has not prepared a program plan to guide its REO disposition-related initiatives. Such planning is important to provide the oversight needed to ensure proper disposition of Fannie Mae's extensive REO inventory.

What OIG Recommends

FHFA should: (1) establish verification controls to ensure enterprise contractors are performing in accordance with agreed criteria and that any proposed waivers to the criteria are documented and submitted for FHFA review and approval; (2) clarify guidance regarding bidder submission of financial statements and explanation of adverse financial events as part of the bidder qualification process; and (3) issue formal guidance for the REO disposition program, including the REO Pilot Program, requiring a program plan with clearly defined goals and objectives, a program monitoring and oversight mechanism, criteria to measure and evaluate program success, and the means to assess alternative REO disposition strategies.

FHFA generally agreed with OIG's recommendations and will implement corrective action if transactions beyond the initial REO Pilot Program are pursued.

TABLE OF CONTENTS .....

ABBREVIATIONS 6

PREFACE 7

CONTEXT 8

REO 8

FHFA's REO Initiative 8

First Transaction of the REO Initiative: the REO Pilot Program 10

Bidder Qualification Process for the REO Pilot Program 11

Potential Bidder Experience 12

Transaction Type's Impact on the Qualification Process 12

Winning Bidders 13

LLC Structure 14

FINDINGS 16

1. The Process for Reviewing, Scoring, and Recommending Investors for the REO Pilot Program Was Not as Rigorous as Intended 16

Bidder Application Scoring Process 16

Prescribed Risk Scoring Process Not Followed in Some Cases 16

FHFA Did Not Independently Verify Applications or Scoring 18

Inconsistent Scoring Increases Risks 19

Two Unqualified Investors Subsequently Determined Eligible to Bid 19

Impact of Noncompliance with Bidder Criteria 20

Scoring Process for Qualifying Pilot Program Investors Could Affect Future REO Disposition Initiatives 20

Summary 21

2. FHFA's Goals and Objectives for Overseeing the REO Disposition Program, Including the REO Pilot, Can Be Strengthened and Improved 21

Goals and Objectives for REO Disposition Have Evolved 21

Need for an REO Disposition Program Plan 22

REO Disposition Will Remain an FHFA Priority 24
FHFA Previously Recommended Fannie Mae Establish a Governing Process for Pilot Programs 24
Oversight and Monitoring of Pilot Program 25
Summary 25
CONCLUSIONS 27
RECOMMENDATIONS 27
OBJECTIVE, SCOPE, AND METHODOLOGY 28
APPENDIX A 30
FHFA's Comments on OIG's Findings and Recommendations 30
APPENDIX B 33
OIG's Response to FHFA's Comments 33
APPENDIX C 35
Summary of FHFA's Comments on the Recommendations 35
APPENDIX D 36
2012 YTD REO Inventory Inflow and Outflow 36
APPENDIX E 37
REO Pilot Program Timeline of Events 37
ADDITIONAL INFORMATION AND COPIES 38

ABBREVIATIONS

Fannie Mae or enterprise	Federal National Mortgage Association
FDIC	Federal Deposit Insurance Corporation
FHFA or agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
HUD	Department of Housing and Urban Development
IAWG	Interagency Working Group
LLC	Limited Liability Company
MBS	Mortgage-Backed Securities
OIG	Federal Housing Finance Agency Office of Inspector General
REIT	Real Estate Investment Trust
REO	Real Estate Owned
RFI	Request for Information
Treasury	U.S. Department of the Treasury

PREFACE

The Housing and Economic Recovery Act of 2008 established the FHFA Office of Inspector General (OIG). OIG is authorized to conduct audits, evaluations, investigations, and other law enforcement activities pertaining to FHFA's programs and operations. As a result of OIG's work, OIG may recommend policies that promote economy and efficiency in administering FHFA's programs and operations, or that prevent and detect fraud and abuse in them.

Given the risks associated with the enterprises' REO management, this audit report is part of OIG's proactive audit and evaluation strategy to assess the agency's related oversight and conservatorship efforts. One aspect of this strategy focuses on REO to determine whether the agency and the enterprises manage REO to maximize financial recoveries and minimize foreclosures' negative effects on communities.

This report furthers OIG's REO work by assessing the process and controls governing FHFA's and Fannie Mae's implementation and monitoring of the REO Pilot Program. OIG found that the process for reviewing, scoring, and recommending selection of investors for participation in the REO Pilot Program was not as rigorous as intended. Additionally, FHFA's oversight of the program can be improved. This report's recommendations (along with those in prior reports) can increase FHFA's assurance that the enterprises are operating safely and soundly, and that their assets are being preserved and conserved.

OIG appreciates the cooperation of everyone who contributed to this audit, including officials at Fannie Mae and FHFA. This audit was led by Kevin Carson, Audit Director, who was assisted by Damon Jackson, Auditor-in-Charge, and Rachael Young, 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.fhfaoig.gov.

Russell A. Rau
Deputy Inspector General for Audits

CONTEXT

REO

FHFA currently serves as both regulator and conservator of the enterprises. As regulator, the agency's mission is to ensure that the enterprises operate in a safe and sound manner. As conservator, the agency seeks to conserve and preserve enterprise assets.

The enterprises support the nation's housing finance system by buying and selling mortgages in the secondary mortgage market. The enterprises either retain or securitize the mortgages they purchase by pooling them into MBS, which are then sold to investors. Typically, when borrowers default on these mortgages and efforts to cure the defaults are unsuccessful, the mortgages are foreclosed on. Through foreclosure, properties that secure the defaulted mortgages are acquired by the enterprises as REO.

The enterprises suffer losses when inadequately collateralized mortgages go into default and the enterprises either own the loans or guarantee them as part of an MBS transaction. Inadequate collateral means that the value of the property securing a mortgage is less than the unpaid principal balance of the mortgage. This can occur as a result of, among other factors, significant market declines or poor underwriting of the loan.

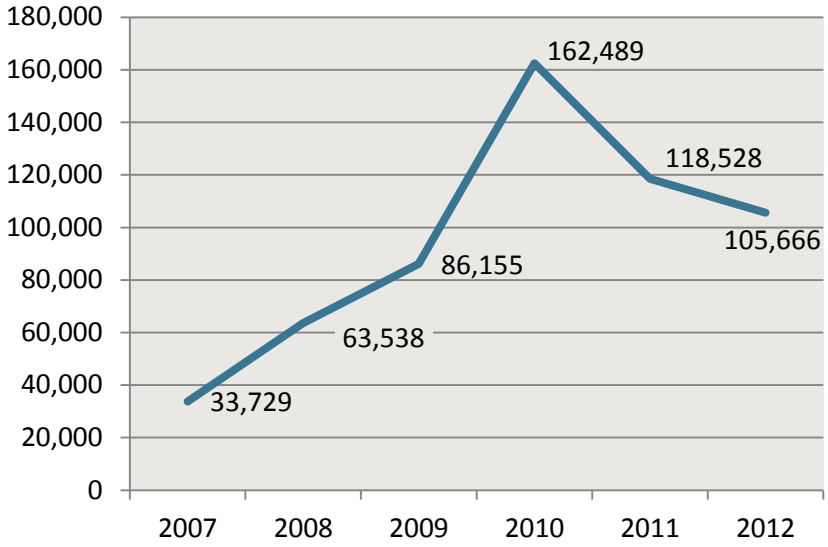
The enterprises attempt to minimize these losses by taking ownership (through foreclosure and other means) of the properties securing the defaulted mortgages, and then marketing and selling them through local real estate professionals. The primary objectives in selling foreclosed properties are to (1) minimize the severity of loss by maximizing sales prices and (2) stabilize neighborhoods by preventing unoccupied homes from depressing home values in surrounding areas. Other disposition methods used by the enterprises include selling homes to cities, municipalities, and other public entities, and selling properties in bulk or through public auctions. Appendix D provides a breakdown of methods used by Fannie Mae for REO disposition.

FHFA's REO Initiative

The enterprises' REO inventory levels increased dramatically in the years following the financial crisis, and they have remained at elevated levels. Figure 1 provides details regarding Fannie Mae's REO inventory levels from 2007 through 2012, when the REO Pilot Program began.

In accordance with its broad conservatorship objective to preserve and conserve enterprise assets, including through minimizing costs and maximizing net present value of REO, FHFA initiated a program to assist with REO disposition efforts. In August 2011, FHFA, in consultation with the Department of the Treasury (Treasury) and the Department of Housing and Urban Development (HUD), launched the REO Initiative by issuing a request for information (RFI) designed to solicit public input on options for selling single-family REO properties held by Fannie Mae, Freddie Mac, and the Federal Housing Administration. In addition to helping with the current and future disposition of REO, the purposes of the RFI were to solicit ideas to improve loss recoveries compared to individual retail REO sales, help stabilize neighborhoods and local home values, and expand the supply of rental housing where feasible and appropriate.

FIGURE 1. FANNIE MAE END OF YEAR REO INVENTORY 2007–2012[1]



Consistent with these purposes, the RFI solicited ideas for the pooling for sale or rent of single-family REO properties in specified geographic areas in a way that would maximize their economic value. The RFI also sought to gather information about whether a third-party, joint venture, or some other structure would be more effective at addressing local economic and real estate conditions and managing REO than individual sales overseen by Fannie Mae and Freddie Mac.

In response to the RFI, FHFA received more than 4,000 comments from a variety of market participants, stakeholders, community groups, and industry observers with specific suggestions for improving market conditions in the disposition of REO properties. The respondents offered a range of transaction principles, guidelines, structures, and strategies. Some respondents supported many of the asset disposition strategies and structures used by the Federal Deposit Insurance Corporation (FDIC) for failed savings institutions, including

[1] Sources: *Fannie Mae 2012 Annual Report (10-K)*, available at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2012/10k_2012.pdf; and *Fannie Mae 2009 Annual Report (10-K)*, available at http://www.fanniemae.com/resources/file/ir/pdf/proxy-statements/form10k_022610.pdf.

joint venture partnerships, outright sales, and auctions. Other respondents recommended that FHFA adopt approaches similar to Treasury's Public-Private Investment Partnership program, and still others proposed the use of real estate investment trust (REIT) structures. Most respondents suggested disposition strategies that involved renting properties for a period of time.

After the comment period closed, FHFA convened an Interagency Working Group (IAWG) to help design the REO Initiative. The IAWG was comprised of representatives from federal agencies with significant interests in the state of the housing market—FHFA, HUD, FDIC, the Federal Reserve, and Treasury—and the enterprises. The IAWG met regularly to develop a broad strategy based on ideas submitted through the RFI process and continuing research.

Based in part on the foregoing processes, FHFA issued a press release on February 1, 2012, announcing the first, and to date only, program under the REO Initiative. This pilot program would allow interested investors to prequalify to bid on transactions in an initial pilot phase as well as subsequent phases. The initial pilot would allow qualified investors to purchase pools of foreclosed properties from Fannie Mae—conditioned on the requirement that the investors offer the properties purchased for rent for a specified number of years. FHFA stated that interested investors could begin to prequalify for the transaction by demonstrating their financial capability and operational expertise to manage properties in communities hit hard by the housing downturn.

First Transaction of the REO Initiative: the REO Pilot Program

On February 27, 2012, FHFA publicly announced the first pilot program under the REO Initiative. The pilot targeted several of the hardest-hit metropolitan areas. On this same date, the FHFA acting director (with Treasury approval) [2] authorized the president and chief executive officer of Fannie Mae to execute the REO Pilot Program, which was publicly described as the REO-to-Rental Pilot Program.[3]

As part of the initial REO Pilot Program, a prequalified bidder would make a $250,000 deposit, sign a confidentiality agreement, and could then gain access to confidential Fannie Mae data regarding the transaction and available properties. As part of the program, approximately 2,500 single-family Fannie Mae REO properties configured in eight geographic pools were offered for sale. Most of the properties had tenants in residence and were located in areas that were greatly affected by the housing downturn, exhibited a strong

[2] Treasury approval is required for a transfer of assets in accordance with Section 5.4 of the Senior Preferred Stock Purchase Agreement between Fannie Mae and Treasury.

[3] OIG refers to the REO-to-Rental Pilot Program as the REO Pilot Program throughout the report. The pilot program was the first transaction in FHFA's initiative to develop and implement an improved REO disposition program at Fannie Mae.

demand for rental housing, and contained a significant number of Fannie Mae REO properties. Figure 2 contains details by each geographic area regarding the number and type of REO properties contained in each of the eight pools.

FIGURE 2. REO INITIATIVE, PROPERTY DATA FOR FIRST PILOT TRANSACTION[4]

Sub-Portfolio	Property Count	% by Property Count	Term Lease Unit Count	Month-to-Month Lease Unit Count	Vacant Unit Count	Total Units	% by Total Units
Atlanta, GA	572	23.0	426	121	58	605	21.2
Chicago, IL	99	4.0	75	11	34	120	4.2
Florida-Central and Northeast	190	7.6	133	50	14	197	6.9
Florida-Southeast	418	16.8	166	222	52	440	15.4
Florida-West Coast	167	6.7	118	44	37	199	7.0
Las Vegas, NV	219	8.8	176	33	36	245	8.6
Los Angeles / Riverside, CA	484	19.4	349	164	150	663	23.2
Phoenix, AZ	341	13.7	248	89	48	385	13.5
Total	2,490	100.0	1,691	734	429	2,854	100.0

Property Type	Property Count	% by Property Count	Term Lease Unit Count	Month-to-Month Lease Unit Count	Vacant Unit Count	Total Units	% by Total Units
Single Family	1,743	70.0	1,172	435	136	1,743	61.1
Condo	527	21.2	310	159	58	527	18.5
Manufactured Housing	7	0.3	6	0	1	7	0.2
Co-op	1	0.0	0	1	0	1	0.0
Duplex (2 units)	118	4.7	102	54	80	236	8.3
Triplex (3 units)	36	1.4	35	28	45	108	3.8
4-Plex (4 units)	58	2.3	66	57	109	232	8.1
Total	2,490	100.0	1,691	734	429	2,854	100.0

Bidder Qualification Process for the REO Pilot Program

To determine bidder eligibility, Fannie Mae primarily used the FDIC's model for structured sales of assets; in addition, it engaged an experienced contractor to oversee the bidder qualification and evaluation process. The contractor developed a process for qualifying potential bidders that encompassed establishing minimum qualifications for entities interested in acting as investors, asset managers, or property management infrastructure firms. The bidder qualification process was designed to be rigorous and included significant information and documentation requirements for each of the applicants and their business partners. The process was purposely designed to allow only investors with sufficient capital and operational expertise to participate in a transaction.

[4] Source: *Fannie Mae SFR REO 2012-1 Transaction Portfolio*, available at http://homepath-activedt.netdna-ssl.com/content/pdf/FNMASFRREO2012-1SummaryofAssets.pdf.

Potential Bidder Experience

Fannie Mae required all entities interested in qualifying as bidders to complete and submit a bidder qualification application along with associated supporting documentation. The applications were reviewed and scored by Fannie Mae's bidder qualification contractor based on scoring criteria developed by the IAWG (e.g., FHFA, FDIC, and Fannie Mae) and the contractor. The scoring criteria were divided into five major sections covering the potential bidder's (1) financial background, (2) funding, (3) asset management, (4) property management infrastructure, and (5) portfolio management plan. The scoring criteria contained specific review components for each of these five sections:

- Financial background (e.g., credit rating, continuing net loss, going concern issues, or experience in real estate and mortgage finance)
- Funding (e.g., third-party support or reasonable timeframe to secure funding)
- Asset management (e.g., experience in managing real estate rental units)
- Property management infrastructure (e.g., staffing, adequate systems, or planning)
- Portfolio management (e.g., management, marketing, disposition strategies, or community relations activities)

Sections were scored either satisfactory or unsatisfactory. Depending on the number of satisfactory scores, the investor was given a rating of low, medium, or high risk. With some exceptions, if all five sections were satisfactory, the investor was rated low risk; if one of the five sections was rated unsatisfactory, the investor was rated medium risk; and if two or more sections were unsatisfactory, the investor was rated high risk.

Additionally, the IAWG emphasized a potential bidder's relations with the community as part of the bidder qualification scoring process. Community relations were evaluated in three of the five sections of the application. If community relations were determined to be unsatisfactory in the portfolio management section and either the asset management or property management sections, then the bidder was scored high risk and not recommended to bid.

Transaction Type's Impact on the Qualification Process

Potential bidders also were qualified depending on the type of bid they wanted to submit, either sole ownership or joint venture transaction, and according to the desired geographic pools of the REO properties.

Under a sole ownership transaction, a winning bidder would own 100% of the economic interest in the assets. In contrast, under a joint venture transaction, the winning bidder would

be the managing member of a joint venture with Fannie Mae. The respective ownership interests would depend on the type of joint venture. For example, in a pro-rata joint venture, the winning bidder would be entitled to 50% of the distributions to the equity holders for the life of the joint venture. However, in a modified cash flow joint venture, the winning bidder would be entitled to receive 10% of the distributions to the equity holders until the occurrence of either the:

- Initial shift threshold event,[5] after which the managing member interest would be entitled to receive 50% of the distributions to equity, or
- Secondary shift (return) threshold event,[6] after which the managing member interest would be entitled to receive 30% of the distributions to equity.

A total of 73 potential bidders submitted applications to be considered as qualified bidders for the REO Pilot Program. In May 2012, of the 73 applications submitted, 42 bidders were determined qualified to bid on the pilot transaction by the bidder qualification contractor and Fannie Mae, with FHFA approval.

Winning Bidders

On June 25, 2012, 6 of the 42 qualified bidders submitted best and final offers for REO pools. Of the six, three bidders (i.e., Pacifica Companies LLC, Cogsville Group LLC, and Colony Capital LLC) were awarded a total of seven of the eight pools. Fannie Mae and FHFA decided not to award the eighth pool, which was comprised of 541 properties in Atlanta, because the bids received did not exceed the value Fannie Mae estimated that it could achieve through its REO retail sales channel. As a result, plans were made for the Atlanta properties to be sold through either Fannie Mae's retail process or through future structured sale transactions. Figure 3 below provides further details on the winning bidders, the pools of properties acquired, and the dollar value of each transaction.

[5] Initial shift threshold event: the amount paid by the managing member to acquire its interest in the newly created limited liability company (LLC), multiplied by four.

[6] Secondary shift (return) threshold event: if certain yield and cash flow thresholds are achieved by the managing member, then the equity interest from the LLC will shift again from 50% to 30% equity distributions for the managing member.

FIGURE 3. WINNING BIDDERS OF THE REO PILOT PROGRAM[7]

Geographic Pools	Winning Investor	Transaction Closing Date	No. of Properties	Recent Third Party Value ($ Millions)	Purchase Price ($ Millions)	Transaction Value ($ Millions)
Atlanta, GA	N/A–This pool did not transact					
Chicago, IL	Cogsville	9/27/2012	94	13.7	2.1	11.8
Florida – Central & Northeast	Pacifica	9/6/2012	699	81.5	12.3	78.1
Florida – Southeast						
Florida – West Coast						
Las Vegas, NV	Colony	11/1/2012	970	156.8	34.1	176.0
Los Angeles / Riverside, CA						
Phoenix, AZ						

Appendix E shows the timeline of events related to the REO Pilot Program from the release of the RFI through the award and closing of the three transactions.

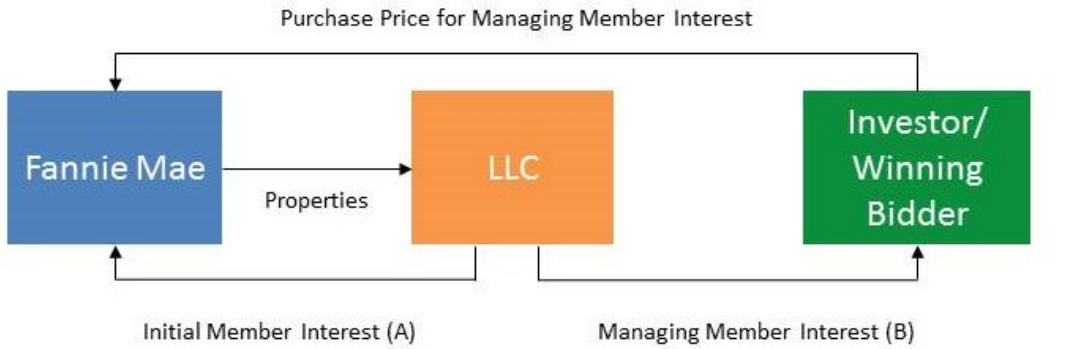
LLC Structure

Each of the three winning investors submitted bids utilizing the modified cash flow joint venture structure, in which the investor proposed to partner with Fannie Mae and jointly enter into a newly created limited liability company (LLC) in which the winning investor serves as the managing member.

In effect, each winning investor purchased a managing member interest in the equity cash flows of newly created LLCs, which would hold the properties transferred to the LLC by Fannie Mae. Fannie Mae also retained interests in the equity cash flows of the LLCs. Each investor, as managing member of the LLC, is responsible for managing the operations of the LLC. Fannie Mae is initially entitled to receive 90% of the LLCs' cash flows (and the investors to receive 10%) until the shift thresholds are reached. Once a shift threshold is met, Fannie Mae and the investor are each entitled to 50% of the cash flow. If the negotiated yield and cash flow thresholds are met by the investor, the shift ratio subsequently changes to 70% for Fannie Mae and 30% to the investor. Figure 4 further details the structure for the modified cash flow joint ventures.

[7] Sources: FHFA News Release, September 10, 2012, "*FHFA Announces First Winning Bidder in REO Pilot Initiative,*" available at http://www.fhfa.gov/webfiles/24273/REOInvestor91012.pdf; FHFA News Release, October 2, 2012, "*FHFA Announces Winning Investor in Chicago REO Pilot Initiative,*" available at http://www.fhfa.gov/webfiles/24561/REOInvestorsChicago100212.pdf; and FHFA News Release, November 1, 2012, "*FHFA Statement on REO Pilot Transactions,*" available at http://www.fhfa.gov/webfiles/24609/REOColony.pdf.

FIGURE 4. MODIFIED CASH FLOW JOINT VENTURE STRUCTURE[8]



(A) 90% shifts to 50% at Shift Threshold, and to 70% if certain yield and cashflow thresholds are achieved by Investor
(B) 10% shifts to 50% at Shift Threshold, and to 30% if certain yield and cashflow thresholds are achieved by Investor

[8] Source: OIG analysis based on Fannie Mae SFR REO 2012-1 Transaction Summary for Each Winning Investor. See, http://homepath-activedt.netdna-ssl.com/content/pdf/structuredsales/SFR_2012-1_Florida/SFR_2012-1_Florida_Transaction_Details_9-6-12.pdf; http://homepath-activedt.netdna-ssl.com/content/pdf/structuredsales/SFR_2012-1_Chicago/SFR_2012-1_Chicago_Transaction_Summary_9-27-12.pdf; and http://homepath-activedt.netdna-ssl.com/content/pdf/structuredsales/SFR_2012-1_USWest/SFR_2012-1_US_West_Transaction_Summary_11-01-12.pdf.

FINDINGS .....

1. The Process for Reviewing, Scoring, and Recommending Investors for the REO Pilot Program Was Not as Rigorous as Intended

Overall, FHFA established a sound process for reviewing, scoring, and recommending investors to qualify as bidders under the REO Pilot Program. However, Fannie Mae's bidder qualification contractor did not fully comply with important provisions of the established process. Specifically, the contractor did not properly score risk for a number of investors, some of whom were determined to be eligible to bid even though they did not meet prescribed bidder qualification scoring criteria. In addition, two investors that had been scored by the contractor as high risk and not recommended to bid based on the established process were subsequently determined by Fannie Mae, with FHFA concurrence, to be eligible to bid. Looking forward, FHFA oversight can be strengthened to ensure compliance with the established process for future transactions, if any.

Bidder Application Scoring Process

Seventy-three interested investors initially submitted applications to be considered as qualified bidders. Under the established process, each investor's application was reviewed and scored by Fannie Mae's bidder qualification contractor. Each application was scored either satisfactory or unsatisfactory for each of the five major sections evaluated. Based on the scoring for each section, the application was assigned an overall rating of low, medium, or high risk. The bidder qualification contractor was supposed to recommend only those investors rated as low or medium risk as qualified bidders. Once qualified, a bidder was then able to submit bids on the various pools of REO properties to be offered under the pilot program.

After the initial application submission, 13 of the original 73 interested investors withdrew their applications and thus were not scored by the bidder qualification contractor. Of the remaining 60 applications, 13 were determined to be incomplete and not scored. Of the remaining 47 investor applications reviewed and scored, 9 bidders were rated low risk, 31 as medium risk, and 7 as high risk.

Prescribed Risk Scoring Process Not Followed in Some Cases

Fannie Mae's bidder qualification contractor incorrectly scored 12 of the 47 investor applications. This improper scoring resulted in understated risk ratings for 7 of those investors' applications. Specific details concerning the 12 applications are as follows:

- Seven investors were assigned overall risk ratings that were understated based on the erroneous scoring performed by the bidder qualification contractor. Six of the seven investors were rated by the contractor as medium risk, but should have been rated high risk and thus not considered as qualified to submit bids. Two of these six investors—that should have been rated as high risk—actually submitted bids for the pilot program and were considered in the selection process, although they were not ultimately awarded any of the pools.
- Five additional investors were also scored incorrectly. However, the exceptions noted with the scoring did not affect their overall risk rating.

Figure 5 provides summary details regarding the results of OIG's analysis of the scoring of investor applications.

FIGURE 5. SCORING OF INVESTOR QUALIFICATION APPLICATIONS[9]

Bidder Score Given by Fannie Mae Contractor	No. of Applications	Correctly Scored	Incorrectly Scored
Low	9	8	1
Medium	31	23	8
High	7	4	3
Total Applications Scored	47	35	12

Bidder Score Given by Fannie Mae Contractor	No. of Bidders with Incorrect Score that Resulted in an *Unchanged* Risk Score	No. of Bidders with Incorrect Score that Resulted in a *Changed* Risk Score
Low	0	1
Medium	2	6
High	3	0
Total Applications Scored	5	7

Bidder Score Given by Fannie Mae Contractor	Resultant Risk Score	
	Medium	High
Low	1	0
Medium	0	6
High	N/A	N/A
Total Applications Scored	1	6

[9] Based on OIG analysis.

Overall, for the 12 bidders that were scored incorrectly, OIG found 22 instances of noncompliance with the approved scoring criteria. Specifically, the following areas were not scored by the bidder qualification contractor in accordance with the approved scoring criteria:

- Third-party documentation of funding, such as bank statements, was not provided in two instances. Nevertheless, the funding section was still scored satisfactory.
- Community relations component within the portfolio management plan section was incorrectly scored as satisfactory in three instances. For example, investors did not describe forward-looking community awareness initiatives, as required by the scoring criteria, or were incomplete in detailing their plans.
- Limited real estate experience based on the scoring criteria was scored satisfactory in thirteen instances.
- Asset managers and key management personnel were not identified in one instance; however, the component was scored satisfactory.
- Bidders required 30 and 45 days to secure funding when the approved scoring criteria required the availability of funds within 10 days or less in two instances; however, this component was scored satisfactory.
- Funding availability was incorrectly stated by the investor in one instance. Specifically, funds stated as available were in fact removed from an account prior to the end of the reporting period. Fannie Mae's contractor did not amend the amount of available funds based on this information.

OIG also noted two areas of the application and scoring criteria that could use clarification if used for similar programs in the future. First, although investors were required to submit financial statements or acceptable alternative documentation to the qualification contractor, a definition of what was considered acceptable alternative documentation was not provided. Second, if the income statements contained any adverse data, such as continuing net losses, scoring criteria stated that the adverse data must be explained in the notes to the financial statements. However, the scoring criteria did not describe what factors should be considered in deciding whether an investor with a record of net losses should be scored satisfactory or how other adverse data should be addressed. Additionally, the criteria did not establish documentation submission requirements to address adverse data such as capital and liquidity plans.

FHFA Did Not Independently Verify Applications or Scoring

This erroneous scoring might have been identified earlier had FHFA performed independent verification of the bidder qualification contractor's work. FHFA approved the scoring matrix used by the contractor to score the applicants. In addition, the bidder qualification contractor

and Fannie Mae briefed FHFA on the scoring results and made recommendations concerning which applicants should qualify to bid. Fannie Mae also represented to FHFA that the pool of qualified bidders was selected in accordance with the approved scoring criteria and process. However, FHFA accepted Fannie Mae's and the contractor's assertions and recommendations without verifying either the veracity of the information in investor applications or the performance of the bidder qualification contractor.

Inconsistent Scoring Increases Risks

In discussions with Fannie Mae and its bidder qualification contractor, both repeatedly explained that the criteria for scoring applications was meant to be as flexible as possible in order to encourage and increase participation from multiple bidders. The scoring criteria were intended to serve as a guideline for scoring in a consistent manner across multiple bidder applications. However, not scoring bidders in accordance with the established scoring criteria can have the opposite effect by reducing consistency across multiple bidders and creating an unlevel playing field. For example, there are potential problems associated with strictly enforcing scoring criteria for some, but not all, bidders. This creates a scenario in which compliant bidders are potentially at a competitive disadvantage compared to noncompliant bidders if the latter group is not excluded. Also, there were no clear provisions in the guidance for how to assess and address the increased risk posed by bidders that did not meet the scoring criteria.

Two Unqualified Investors Subsequently Determined Eligible to Bid

Despite having in place criteria prohibiting the acceptance of bids from investors scored as high risk, Fannie Mae, with FHFA concurrence, qualified two investors to bid on REO pools after these investors had been scored by the bidder qualification contractor as high risk. FHFA relied exclusively on Fannie Mae's determination regarding the investors' eligibility to bid and approved these two high risk investors to submit bids without independent verification.

The two high risk bidders that Fannie Mae subsequently determined as qualified to bid were found by the bidder qualification contractor to be unlike the other five high risk bidders. The bidder qualification contractor identified factors that could offset risks identified.[10] FHFA did not review these potential offsetting factors to determine if they did in fact mitigate the risk associated with these investors.

By allowing these two investors to bid when both received overall high risk ratings, the established eligibility process was not followed and the undue risk of selecting a potentially

[10] The two bidders recommended to bid were scored high risk due to their negative credit outlook. The other five high risk bidders that were not allowed to bid were determined to be high risk based on unsatisfactory responses in other areas of the scoring criteria.

unqualified bidder was introduced into the scoring process. Although neither of these high risk investors subsequently submitted bids, both were afforded the opportunity to do so for the initial pilot program pools and also could be considered to be qualified to participate in future sales.

Impact of Noncompliance with Bidder Criteria

FHFA established prescriptive bidder qualification requirements and processes for the pilot program as key controls to ensure investors had the requisite financial capability, experience, and expertise to successfully perform REO-related responsibilities. A senior FHFA official stated in congressional testimony that the pilot program's "rigorous application process is intended to narrow the pool of eligible bidders to those who have financial and operational expertise, but also the mission-oriented commitment to ensure that this program brings capital to markets in need in a way that stabilizes communities."[11]

In addition, a Treasury official testified that in order to ensure that the pilot program stabilizes communities, the program must attract responsible property owners who will sustain the repair and restoration of the hardest hit communities.[12] This official noted that one control built into the pilot program is the strict investor qualification requirements. Among these requirements is assessing an investor's ability to provide tenants with housing counseling services and to provide credit bureaus with documentation related to a tenant's timely payment of rent so that those individuals hard hit by the financial crisis can rebuild their credit scores more quickly. The official added that only those investors that meet the high standards built into the qualification process would be permitted to bid on the enterprises' portfolios.

A key process control regarding investor qualification as a bidder is verifying the financial condition and amount of funding stated as available in the application package. The lack of FHFA verification in these areas could result in the selection of an investor who is unable to fund the bid price or financially support its REO-related operations.

Scoring Process for Qualifying Pilot Program Investors Could Affect Future REO Disposition Initiatives

FHFA contracted for a program advisor to compile feedback from participants involved in the pilot program and to provide advice to FHFA for possible similar transactions in the future. One suggestion for future transactions was that FHFA should evaluate whether bidders that qualified for this transaction should be exempted from having to participate in future

[11] Statement of FHFA Senior Associate Director for Housing and Regulatory Policy before the House Subcommittee on Capital Markets and Government Sponsored Enterprises on May 7, 2012.

[12] Statement of Treasury Counselor to the Secretary for Housing Finance Policy before the House Subcommittee on Capital Markets and Government Sponsored Enterprises on May 7, 2012.

qualification processes. If FHFA follows this recommendation and automatically qualifies REO Pilot Program bidders, bidders that were incorrectly qualified for the pilot would be eligible to bid on similar transactions in the future.

Summary

FHFA intended the bidder application process to be thorough in order to control the quality of investors involved in the REO Pilot Program. However, because FHFA and Fannie Mae did not ensure adherence to the agreed method of scoring, the scoring process was actually not as rigorous as intended. As a result, several investors were qualified as bidders in spite of their not meeting established scoring criteria, thus potentially jeopardizing the success of the REO Pilot Program. As FHFA further develops its REO Disposition Program discussed in its FY 2013–2017 Strategic Plan, it is important that it establish oversight controls to ensure that the bidders are in fact meeting the requirements set forth in program guidance. Additionally, FHFA needs to clarify how to address the absence of bidder financial statements, particularly regarding the financial condition of and availability of funding for prospective bidders and the explanation of adverse financial information. Doing so will help ensure that a comprehensive qualification process is in place.

2. FHFA's Goals and Objectives for Overseeing the REO Disposition Program, Including the REO Pilot, Can Be Strengthened and Improved

FHFA has stated a number of goals and objectives intended to address key risks associated with management of the enterprises' current and forecasted REO inventory. Although each of these goals and objectives is potentially significant, FHFA has not clarified the specific goals that are applicable to the REO Pilot Program as compared to future REO disposition initiatives, how the goals and objectives will be achieved, or how the agency intends to monitor and assess the performance of both the pilot and any future initiatives against established goals and objectives. In particular, FHFA has not prepared a program plan—to guide its improvement initiatives as part of its overall REO disposition program—that addresses these areas or responds to its stated intent to improve REO disposition activities.

Goals and Objectives for REO Disposition Have Evolved

FHFA's goals and objectives related to REO disposition have evolved over time. When FHFA first announced its efforts to improve REO asset disposition in August 2011, the agency stated its objectives were to achieve the following:

1. Reduce the REO portfolios of the enterprises in a cost-effective manner;

2. Reduce average loan loss severities to the enterprises relative to individual distressed property sales;

3. Address property repair and rehabilitation needs;

4. Respond to economic and real estate conditions in specific geographies;

5. Assist in neighborhood and home price stabilization efforts; and

6. Suggest analytic approaches to determine the appropriate disposition strategy for individual properties, whether sale, rental, or, in certain instances, demolition.

In February 2012, the FHFA acting director, with Treasury concurrence, directed Fannie Mae to execute the REO Pilot Program in accordance with the following goals and objectives:

1. Reduce taxpayer losses,

2. Stabilize neighborhoods and home values,

3. Shift to more private management of properties, and

4. Reduce the supply of REO properties in the marketplace.

In May 2012, an FHFA senior official conveyed the following goals for the REO pilot program during congressional testimony:

1. Gauge investor appetite for a new asset-class—scattered site single family rental housing—as measured by the price that investors are willing to pay for a traditionally high-value commodity that has been hampered by oversupply;

2. Determine whether the disposition of properties in bulk, as opposed to one-by-one, presents an opportunity for well-capitalized investors to partner with regional and local property management companies and other community-based organizations to create appropriate economies of scale, yet provides civic-minded approaches that can stabilize and improve market conditions; and

3. Assess whether the model can be efficiently replicated to make it a worthwhile addition to the standard retail and small-bulk sales strategies in place at the enterprises and other financial institutions with large inventories of properties to sell.

When program goals and objectives are unclear or shifting, it is progressively difficult to assess whether the program is worthwhile and should be continued.

Need for an REO Disposition Program Plan

Although the REO Pilot Program was authorized with specific—albeit shifting—objectives, FHFA did not prepare accompanying guidance, such as a program plan, to guide either the

initial REO Pilot Program or the planning and execution of any future REO property disposition initiatives. In addition, there is no plan in place for monitoring and overseeing the agency's REO disposition program or initiatives. The following examples illustrate why the various goals and objectives stated for the REO Pilot Program need to be clarified relative to future REO disposition initiatives. In turn, such clarification can mitigate risks associated with achieving the goals and objectives by laying out the actions to be taken and the means to provide oversight and monitoring.

- One stated goal is to reduce the REO portfolios of the enterprises. However, under the current REO Pilot Program, Fannie Mae is still reporting the covered assets in the REO Pilot Program on its financial statements as the transactions do not meet sales accounting criteria. The bulk sale transactions in the program are based on an eight-year horizon to dispose completely of REO properties, with property sales restricted until the third anniversary following the closing date of the governing agreement. Therefore, the contribution of bulk REO sales with rental provisions to any near-term reductions in the REO portfolios requires clarification.
- Several goals refer to stabilizing neighborhoods through REO sales programs. However, Fannie Mae has noted that utilizing its retail sales channel rather than disposing of REO properties in bulk sales produces the most favorable execution strategy to help stabilize neighborhood home values. Specifically, Fannie Mae believes that selling to owner-occupants is a more effective means to stabilize neighborhoods. Approximately two-thirds of Fannie Mae's REO properties are sold to owner-occupants. In addition, retail sales to owner-occupants often occur within 60 days of the property being placed for sale and at close to market value—both of which contribute to neighborhood stabilization. Therefore, the benefits of how bulk REO sales help stabilize neighborhoods need further clarification.
- Several stated goals refer to reducing losses on REO property disposition. However, Fannie Mae has indicated that the REO Pilot Program represents 1% of their annual REO sales (roughly 200,000 properties). Further, in the current REO Pilot Program, Fannie Mae is responsible for most of the losses since it retains a 90% owner interest in the underlying assets. Fannie Mae sold a 10% interest in the transactions to each of the three bidders who are responsible for asset and property management functions. The bidders are compensated for these services through the rental income received on the properties with any resulting losses borne largely by the enterprise. Therefore, the approach to achieving a significant reduction in losses on REO property disposition should be further clarified.

REO Disposition Will Remain an FHFA Priority

REO disposition beyond the pilot program is seen as an agency priority, which further necessitates that a detailed program plan be prepared. For example, disposition of REO is addressed in FHFA's FY 2013–2017 Strategic Plan. Specifically, the plan states that FHFA will:

> *Develop and implement an improved real estate owned (REO) disposition program for the Enterprises.* FHFA will work with HUD and Treasury to consider new approaches to disposing of enterprise- and FHA-owned REO properties. Approaches will be tailored to the needs and economic conditions of local communities to bring greater stability to local housing markets.

FHFA Previously Recommended Fannie Mae Establish a Governing Process for Pilot Programs

In March 2012, FHFA identified the lack of an enterprise-level plan for pilot programs as a "Matter Requiring Attention" during an agency examination of Fannie Mae. FHFA examiners recommended that Fannie Mae establish a governing process for pilot programs. This process was defined as including goals and objectives, monitoring and tracking controls, and criteria for determining if pilot programs should be continued.

In the context of REO, Fannie Mae responded that the pilot program utilizes current policies and procedures already in place in its business unit as guidance. However, Fannie Mae stated that it would finalize a process for establishing, approving, documenting, and tracking REO pilot programs. Fannie Mae agreed to draft and finalize a policy and/or procedure to be used for future pilot projects; the enterprise completed this action in June 2012. The policy included the definition of a pilot program and requirements for pilot approval. Additionally, the policy requires that pilots include goals and objectives; requirements for monitoring, tracking, and reporting progress; and a timeframe for the pilot to be reviewed for termination, extension, or conversion to a permanent program. Fannie Mae's guidance is generic for any future REO pilot program but does not address the current REO Pilot Program.

Moreover, Fannie Mae officials informed us that the enterprise has not implemented any pilot projects with the exception of the REO Pilot Program, which it considered to be an FHFA initiative with objectives and performance measures set by the agency rather than the enterprise. In fact, Fannie Mae described its role in the pilot program as limited to operational execution of the program and providing the properties to be included, with all program activities under the direction and approval of FHFA. Accordingly, in order to fully complete FHFA's recommended action, the enterprise needs a better understanding of FHFA's current goals, objectives, and other expectations for the current pilot program as well as future REO

disposition initiatives. Such goals, objectives, and expectations should be documented in a comprehensive program plan prepared by FHFA. This program plan in turn could be used by the enterprises to formalize their programs if it is decided to move forward with additional REO disposition approaches, such as using bulk sales rather than retail sales in some cases.

Oversight and Monitoring of Pilot Program

The Compliance and Governance Working Group of the IAWG reviewed and discussed two levels of governance and compliance—one related to FHFA's responsibilities at the program level and the other related to enterprise responsibilities at the transaction level. In addition, this group reviewed compliance and reporting requirements in the event financing was provided as part of an REO Initiative transaction.

- Program Governance and Compliance—The working group proposed that program level governance and compliance requirements apply to all properties and transactions involved in the REO Initiative. It included uniform requirements and reporting for all submissions to FHFA and monitoring by FHFA regardless of who the transaction participants might be.
- Transactional Governance and Compliance—The working group proposed that transactional governance and compliance would apply to each specific transaction and would be a part of contracts between the parties to any transaction. Transaction compliance could be uniform or it could vary across different transactions.

This guidance is helpful in planning needed controls in future REO disposition activities.

Finally, Standards for Internal Control in the Federal Government promulgated by the Comptroller General of the United States identify control activities, such as establishment and review of performance measures, and monitoring of established controls in the course of normal operations. To achieve these standards, FHFA can more clearly document how it intends to achieve its control objectives for the REO disposition initiatives discussed in the agency's Strategic Plan.

Summary

FHFA has not clarified the goals and objectives for the REO pilot program or future REO disposition activities as the program has evolved. Also, neither FHFA nor Fannie Mae took action to develop a detailed program plan for the REO Pilot Program or other REO disposition initiatives that may comprise the agency's REO disposition program. Without clear direction from FHFA in the form of a program plan documenting goals and objectives and an oversight and governance structure for the REO Pilot Program and future REO disposition program activities, measuring the program's effectiveness and, ultimately, its success is impeded. For example, absent oversight of the REO Pilot Program, FHFA cannot

ensure that Fannie Mae and winning bidders comply with bulk sale transaction terms. This is critical due to the nature of the contract financing structure, asset management strategy, property sale restrictions, property management provisions, and reporting requirements. Also, although planned 2013 examination coverage is important to ensuring the safety and soundness of Fannie Mae, it does not necessarily constitute the program level monitoring and oversight needed to ensure proper disposition of the current REO inventory of over 96,000 properties at Fannie Mae and additional REO properties that may result from the almost 500,000 seriously delinquent single-family loans in Fannie Mae's portfolio.

It is critical for FHFA to be diligent in overseeing and monitoring Fannie Mae and its winning bidders to ensure the completeness of receipts from rentals and sales, contractor compliance with applicable rental and housing regulations, REO vendor expenses and reimbursements, and investigation of renter complaints against investors and contractors. As conservator, FHFA has a responsibility to help ensure enterprise REO disposition is consistent with conservatorship goals and can do so through clarifying and better documenting its goals and objectives for the REO Pilot Program. Some of these issues were highlighted in FHFA's most recent targeted examinations of the enterprises' REO vendor management.

The need for effective goals and objectives as well as sufficient oversight is further compounded by the scope and length of the pilot program. For example, Fannie Mae estimated higher sales proceeds with the current REO Pilot Program—potential REO cash flow of $308 million versus $293 million for the retail disposition of the slightly over 2,300 REO properties in the REO Pilot Program—or a credit loss savings of $15 million over the eight-year disposition schedule. Although this is a considerable benefit, achieving this outcome depends on the coordinated action of multiple parties including FHFA, Fannie Mae, and the three joint ventures. The REO Pilot Program's bulk sales estimated future value is based on rental rates and property sales that are not assured and will require considerable asset and property management skills to achieve. Comparatively, REO retail sales may not incur the same holding costs associated with maintaining the rental properties over extended periods. Therefore, clear program guidance and comprehensive performance measurement and monitoring are essential and can form key components of an overall FHFA program plan.

CONCLUSIONS

FHFA established a sound process for reviewing, scoring, and recommending investors to qualify as bidders under the REO Pilot Program. However, Fannie Mae's bidder qualification contractor did not fully comply with important provisions of the established process. FHFA also needs to address how to handle the absence of prospective bidder financial statements and their submission of adverse financial information such as repeated losses.

Additionally, FHFA has stated a number of goals and objectives in connection with REO but has not clarified the specific goals that are applicable to the REO Pilot Program as compared to future REO disposition initiatives, how the goals and objectives will be achieved, or how the agency intends to monitor and assess the performance of both the pilot and any future initiatives against established goals and objectives. In particular, FHFA has not prepared a program plan to guide its REO disposition-related initiatives that addresses these areas or responds to its stated intent to improve the REO disposition program. Such planning is important to provide the oversight needed to ensure proper disposition of Fannie Mae's current and future REO inventory.

RECOMMENDATIONS

OIG recommends that FHFA:

1. Establish verification controls to ensure enterprise contractors are performing in accordance with agreed criteria and that any proposed waivers to the criteria are documented and submitted for FHFA review and approval.

2. Clarify guidance regarding submission of financial statements and explanation of adverse financial events as part of the bidder qualification process.

3. Issue formal guidance for the REO disposition program, including the REO Pilot Program, requiring a program plan with clearly defined goals and objectives, a program monitoring and oversight mechanism, criteria to measure and evaluate program success, and the means to assess alternative REO disposition strategies.

OBJECTIVE, SCOPE, AND METHODOLOGY .....

The objective of this performance audit was to assess FHFA's oversight of Fannie Mae's policies, procedures, and practices with respect to the selection and administration of investors participating in the REO Pilot Program.

OIG performed fieldwork for this audit from November 2012 through July 2013. OIG conducted this audit in Washington, D.C., at FHFA's and Fannie Mae's respective offices. OIG interviewed personnel of FHFA, Fannie Mae, Fannie Mae's third-party contractors, and federal financial regulators.

The scope of OIG's audit related to an assessment of the extent of FHFA's oversight of Fannie Mae's REO Pilot Program. OIG relied on computer-processed and hardcopy data from FHFA, Fannie Mae, Fannie Mae's third-party contractors, and FHFA's third-party contractor.

To achieve the audit objective, OIG:

- Interviewed FHFA management and Fannie Mae corporate and business unit personnel to obtain an understanding of the goals and objectives of the REO Pilot Program;
- Interviewed FHFA staff to understand and corroborate oversight, supervision, and guidance regarding the REO Pilot Program; and
- Obtained an understanding of the criteria used in the bidder qualification process and reviewed the selection process conducted by Fannie Mae's third-party contractor.

OIG also assessed the internal controls related to the audit objective. 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, OIG considers deficiencies in FHFA's oversight of Fannie Mae's policies, procedures, and practices with respect to the selection and administration of

investors participating in the REO Pilot Program to be significant in the context of the audit's objective.

OIG conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that OIG plan audits and obtain sufficient, appropriate evidence to provide a reasonable basis for audit findings and conclusions based on the audit objective. OIG believes that the evidence obtained provides a reasonable basis for the findings and conclusions included herein, based on OIG's audit objective.

APPENDIX A .....

FHFA's Comments on OIG's Findings and Recommendations

Federal Housing Finance Agency

MEMORANDUM

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

FROM: Sandra Thompson, Deputy Director, Division of Housing, Mission, & Goals

SUBJECT: Audit Report: Additional FHFA Oversight Can Improve the Real Estate Owned Pilot Program (AUD-2012-016)

DATE: September 12, 2013

This memorandum serves as the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the aforementioned audit report. We appreciate the opportunity to respond.

FHFA management agrees that the strategies and procedures associated with any subsequent REO structured bulk sale program require refinement based on the lessons learned from the initial REO bulk structured sale. Refinements would serve to enhance the program terms, including the bidder qualification scoring methodology, and would serve as the foundation for formalizing a program plan including strategies and success measures.

Scoring Methodology

The REO pilot was designed in coordination with an Interagency Working Group (IAWG) consisting of representatives from several Federal Agencies, Fannie Mae, and Freddie Mac. The design of the program reflected a commitment from the federal government to balance competing interests of both industry and the public. Industry aimed to invest in single-family properties, while the public interests centered on the collective needs of local communities. These competing interests resulted in a set of broad and flexible criteria, which required interested parties (or applicants) to submit extensive information as part of their application to make certain each potential bidder had the financial ability and property management experience to operate a single-family rental program. The application and scoring methodology were designed to encourage both established and newly formed consortia of various types to participate.

Audit report findings focus on the design of the bidder qualification scoring methodology, rather than the execution of the methodology. The FHFA OIG observations are based on a set of definitions for the scoring criteria that differ from that developed by the IAWG. This discrepancy in interpretation is understandable, given the overall design of the pilot, which the IAWG envisioned and embraced as the formation of different types of partnerships to manage rental REO assets.

FHFA recognizes the relative ease of evaluating a program with well defined, narrowly limited criteria. However, the REO pilot did not use this approach because the types of partnerships were unknown prior to the development of the pilot program.

The IAWG established a multi-layered review process to ensure consistency in the application of the criteria. An independent vendor was selected to review and score the bidder applications. This vendor was selected based on their extensive demonstrated experience as an industry leader in applying scoring methodologies for similar types of transactions for a large number of agencies and private corporations. FHFA management contends that the scoring methodology was reasonably designed, applied, and executed in a consistent manner across all bidders which provided a fair and uniform process of evaluation and scoring.

Pilot Objectives

The final program design reflects the IAWG's interest and desire to permit flexibility and encourage different types of firms to participate including partnerships among large institutional investors, local property management firms, and community based service providers or entities. The Audit Report comments seem to confuse the objectives and scope differences between the overall REO disposition strategies of the Enterprises and the REO pilot program.

Unlike the broad goals of the overall REO disposition platform, the objectives of the REO pilot program were narrowly defined and outlined clearly within FHFA management's May 7, 2012 testimony. The Audit Report indicates that these program objectives were unclear and suggests some of the broader goals of overall REO disposition were not achieved. However the pilot was always intended to complement and supplement Fannie Mae's existing REO sales. The above referenced testimony highlights this position. At its core, the REO pilot program was intended to provide the federal government with an opportunity to encourage the investment of private capital in single family homes to absorb the excess supply of single family foreclosed properties adversely impacting a number of communities across the country.

FHFA OIG recommends that FHFA:

1. Establish verification controls to ensure enterprise contractors are performing in accordance with agreed criteria and that any proposed waivers to the criteria are documented and submitted for FHFA review and approval.

   Management Response: The Interagency Working Group (IAWG) designed the pilot to incorporate flexibility into the qualification process. The vendor hired to execute this methodology ensured consistent application across all bidders. If a decision is made to utilize a similar transaction, we will establish appropriate controls to ensure contractors are performing in accordance with agreed criteria.

2. Clarify guidance regarding submission of financial statements and explanation of adverse financial events as part of the bidder qualification process.

   Management Response: FHFA agrees that, based on lessons learned from this transaction, additional guidance would be provided to bidders as to what would be considered an acceptable financial statement and bidder explanation as part of any future structured bulk sale transaction.

3. Issue formal guidance for the REO disposition program, including the REO Pilot Program, requiring a program plan with clearly defined goals and objectives, a program monitoring and oversight mechanism, criteria to measure and evaluate program success, and the means to assess alternative REO disposition strategies.

   Management Response: FHFA management has not decided to formalize an REO Pilot Program; however, if a decision is made to utilize a similar transaction, we will issue formal guidance. The Enterprises, under their delegations, will continue to execute a range of asset disposition options which minimize taxpayer loss and contribute to further community stabilization efforts across the country.

Thank you for allowing FHFA the opportunity to respond.

APPENDIX B.....

OIG's Response to FHFA's Comments

On September 12, 2013, FHFA provided comments to a draft of this report. FHFA agreed with Recommendations 1, 2, and 3 and identified corrective actions to be taken to the extent there are any subsequent REO disposition transactions similar to the REO Pilot Program. 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 agreed-upon corrective actions.

Overall, FHFA management agreed that strategies and procedures associated with any subsequent REO structured bulk sale program require refinement based on the lessons learned from the initial REO bulk sale, referred to in this report as the REO Pilot Program. FHFA stated that these refinements would serve to enhance the bulk sale program terms, including the bidder qualification scoring methodology, and would serve as the foundation for formalizing a program plan including strategies and success measures.

OIG considers FHFA's responses to Recommendations 1 and 2 to be sufficient to resolve the recommendations. Because any corrective actions are contingent on utilizing a future REO disposition transaction similar to the REO Pilot Program, the recommendations are considered to be closed upon issuance of this final report.

With respect to Recommendation 3, the agency agreed to issue formal guidance including a program plan and success measures if a decision is made to pursue additional transactions under an REO structured bulk sale program. Although such action is notable, an important aspect of this recommendation is defining the means to assess alternative REO disposition strategies in order to support decisions concerning disposition transactions that should be pursued. The need exists to define the means to perform these assessments before decisions are actually made regarding future REO transactions. Consequently, OIG considers Recommendation 3 to be resolved given the agency's commitment to formalize a program plan but requests that, within 30 days of issuance of this report, FHFA provide clarification regarding agency actions to develop a means to assess alternative REO disposition strategies.

Additionally, FHFA indicated in its response that OIG's finding related to the scoring methodology was actually directed to the design of the bidder qualification scoring methodology rather than the execution of that methodology. OIG assessed both the design and execution of the scoring methodology including the scoring criteria used. For example, the bidder qualification scoring criteria for funding requires the bidder to provide supporting documentation. Specifically, the criteria stated that third party documentation (e.g., bank

statements, etc.) must be provided to support the availability of the funds identified in the bidder's application. This third party documentation of funding was required so that when bids were received, the bid amount for the potentially winning bidder could be compared to the funding documentation provided by the bidder to ensure the bidder has the financial capability to perform in accordance with the resulting contract. In this case, OIG reviewed both the methodology and criteria for determining funding availability and the execution of these controls through review of bidder information received and the use of that information in the scoring process.

FHFA also asserted in its response that the OIG audit report seems to confuse the objectives and scope of the overall REO disposition strategies of the enterprises and the REO Pilot Program. Finding 2 identifies how the objectives of various REO-related activities have evolved over time and the importance of FHFA defining its expectations in this critical area in order to avoid any confusion regarding future REO disposition initiatives. Therefore, the intent of Recommendation 3 is for FHFA to clarify the goals and objectives of FHFA's overall REO disposition program as well as the program monitoring and oversight mechanisms and criteria to measure and evaluate program success. Such action will help distinguish the roles and responsibilities of the agency and the enterprises and result in FHFA's disposition program driving the REO disposition strategies of the enterprises as it did with regard to the REO Pilot Program.

APPENDIX C.....

Summary of FHFA's Comments on the Recommendations

This table presents the management 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	Resolved[a] Yes or No	Open or Closed[b]
1	If a decision is made to utilize a similar transaction, FHFA will establish appropriate controls to ensure contractors are performing in accordance with agreed criteria.	N/A	$0	Yes	Closed
2	FHFA agrees that, based on lessons learned from this transaction, additional guidance would be provided to bidders as to what would be considered an acceptable financial statement and bidder explanation as part of any future structured bulk sale transaction.	N/A	$0	Yes	Closed
3	FHFA management has not decided to formalize an REO Pilot Program; however, if a decision is made to utilize a similar transaction, FHFA will issue formal guidance. Refinements to program terms, including bidder qualification, would serve as the foundation for a program plan including strategies and success measures. Clarification is requested within 30 days regarding agency actions to develop a means to assess alternative REO disposition strategies.	N/A	$0	Yes	Open

[a] Resolved means: (1) Management concurs with the recommendation, and the planned, ongoing, or completed corrective action is consistent with the recommendation; (2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation; or (3) Management agrees to the 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.

APPENDIX D .....

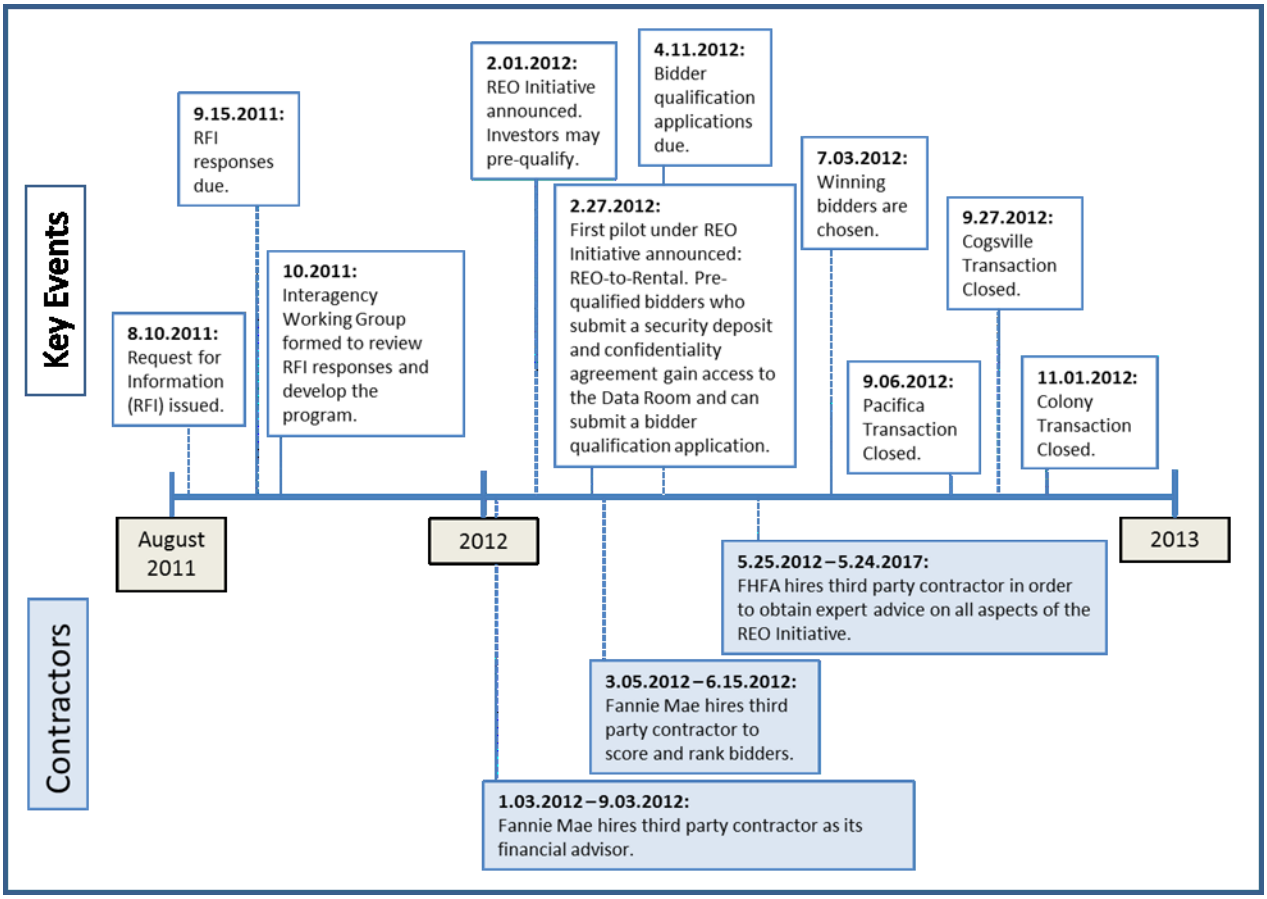
2012 YTD REO Inventory Inflow and Outflow[13]

1 Inflow references property occupancy at the time of marketability not at date of acquisition
2 Sales YTD as of 10/31/12

[13] Source: Fannie Mae, "FHFA REO Pilot Lessons Learned," December 4, 2012.

APPENDIX E

REO Pilot Program Timeline of Events[14]



[14] Source: OIG Analysis.

ADDITIONAL INFORMATION AND COPIES.....

For additional copies of this report:

- Call: 202–730–0880
- Fax: 202–318–0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1–800–793–7724
- Fax: 202–318–0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

  FHFA Office of Inspector General
  Attn: Office of Investigation – Hotline
  400 Seventh Street, S.W.
  Washington, DC 20024