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Introduction

This Federal Housing Finance Agency (FHFA) module for Default Legal Services is designed as a resource and reference for all FHFA examiners. It contains information and procedures intended for the examination of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), collectively referred to as the Enterprises. The module may be used in conjunction with examinations of the Enterprise’s oversight of single-family seller/servicers or third-party relationships. The module contains a workprogram with a broad range of worksteps within five categories, and examiners should identify and perform those worksteps most relevant to reach conclusions given the scope of the examination.

The module provides supplemental guidance to assist FHFA examiners in understanding the risk issues, developing the examination scope, and selecting examination procedures specifically related to legal services provided for default management, foreclosure proceedings, and real estate owned (REO) management (default legal services). It provides procedures applicable to third-party default legal services providers managed by mortgage servicers for Enterprise loans and directly contracted default legal services providers. It also provides examiners with an examination resource for determining whether an Enterprise has a risk management framework that ensures that default legal services are performed in a manner consistent with servicing requirements and in accordance with applicable law.

Default legal services may include foreclosure, loss mitigation (i.e., deeds-in-lieu of foreclosure), bankruptcy, and related litigation, in connection with single-family mortgage loans owned or securitized by an Enterprise. Post-foreclosure default legal services may involve managing the eviction process, obtaining clear title to properties, and managing the closing process for the resale of REO.

Mortgage servicers are responsible for contracting directly with pre-foreclosure default legal services providers to handle default management and foreclosure activities. An Enterprise engages default legal services providers directly to handle post-foreclosure legal activities. With regard to the former, an Enterprise’s servicing guide prescribes the obligations of the mortgage servicers when retaining default legal services providers, including criteria for selection; engagement; contracting; training; law firm management and oversight; performance and compliance management; reporting; and terminations and suspensions. The objective of safety and soundness examination activity is to evaluate the adequacy of an Enterprise’s oversight of mortgage servicers who engage default legal services providers, and an Enterprise’s oversight of default legal services providers directly engaged by the Enterprise.

Examiners should consult the Managing Seller-Servicer Relationships module, the Single Family REO Management module, and the Third-party Relationship Management module for additional information.
Default Legal Services

Background

The Enterprises manage defaulted loans and foreclosure proceedings in two ways. First, they require their mortgage servicers to have programs that provide for the engagement of qualified legal counsel and monitoring of third-party default legal services providers. The mortgage servicer is responsible for managing the law firm in accordance with applicable law, the servicing guidelines set by the Enterprises, and, where applicable, pooling and servicing agreements (PSAs). The mortgage servicer is contractually bound to manage the law firm according to the terms of the servicing guidelines or PSAs. The Enterprises manage the counterparty risk associated with mortgage servicers; in turn, the servicers manage the day-to-day activities of third-party default legal services providers.

Second, the Enterprises may directly engage default legal services providers to address matters that arise after the foreclosure process has been completed (e.g., evictions, title work, and closing transactions). This situation is necessary because the loan that had been secured by the property is extinguished through the foreclosure process, and the mortgage servicer is no longer servicing the loan.

Default Legal Services Risks

Given their national presence, the Enterprises require legal representation in the fifty states as well as other U.S. jurisdictions (e.g., Guam, Puerto Rico). Local management of foreclosures is important because foreclosure proceedings are generally governed by state and local law. In addition, individual courts may have the authority to impose supplemental procedural requirements with which the parties to foreclosure proceedings must comply.

Incidents of improper attorney conduct in foreclosure matters (e.g., robo-signing) expose vulnerabilities in the default management and foreclosure process. A default legal services provider’s failure to prudently manage operational risks may lead to substandard practices and actions that fail to meet professional legal practice standards and court rules. For example, filing improperly executed legal documents with the court may result in significant delays in the foreclosure process, excess legal expenses, and reputational harm to the borrowers, the default legal services provider, individual attorneys, the mortgage servicer, and the impacted Enterprise. Chronic problems may lead to the financial collapse of the default legal services provider and the need to transfer the Enterprise’s files between default legal services providers. These risks may in turn result in operational, reputational, and credit risk for an Enterprise.

Servicer Responsibilities Related to Pre-Foreclosure Default Legal Services Providers

The Enterprises moved to a system where mortgage servicers select default legal services providers that meet certain minimum, uniform criteria established by the Servicing Alignment Initiative (SAI). Since August 2013, mortgage servicers are responsible for the selection, retention, and management of default legal services providers to handle all pre-foreclosure Enterprise default-related legal matters in all jurisdictions in which the mortgage servicers have, or anticipate having, delinquent Enterprise mortgage loans. Servicers are liable to the
Enterprises for any delays or losses resulting from default legal services provider deficiencies. Servicers must also reimburse the Enterprises for any losses suffered because a default legal services provider did not meet its obligations.

The standards for default legal services are set forth in each Enterprise’s single-family servicing guide. The following provides a general summary of applicable provisions of the servicing guide.

**Selection and Retention of a Default Legal Services Provider**

The mortgage servicer is responsible for conducting due diligence to determine whether the default legal services provider satisfies the minimum requirements outlined in each Enterprise’s servicing guide. These requirements generally relate to licensing and location, staffing and experience, operations, and ethics and professional standards. Once the mortgage servicer determines that the default legal services provider meets the minimum standards, the mortgage servicer refers the default legal services provider to the Enterprise who must issue a non-objection in order for the default legal services provider to handle default-related legal work for Enterprise-owned loans. In addition to the contract between the mortgage servicer and the default legal services provider, an Enterprise will enter into a limited retention agreement with the default legal services provider that will recognize and reflect a joint attorney-client relationship between the default legal services provider, the Enterprise, and the mortgage servicer. Finally, the mortgage servicer must ensure that the default legal services provider completes an Enterprise’s new firm training prior to referring default legal matters to an approved default legal services provider.

**Default Legal Services Provider Management and Oversight**

The mortgage servicer must develop and have in place policies and procedures to monitor the performance of default legal services providers handling Enterprise default legal matters. Specifically, the mortgage servicer must have policies and procedures reasonably designed to ensure that default legal services providers handling Enterprise matters are in compliance with the limited retention agreement; the applicable provisions of the servicing guide, including the minimum requirements; and applicable federal, state, and local law. In addition, the mortgage servicer is responsible for ongoing training of default legal services providers and providing an Enterprise with reports related to default legal services provider performance as detailed in the servicing guides.

**Escalation of Issues and Suspension or Termination**

The servicing guides provide guidelines on the escalation of issues, as well as the suspension or termination of the default legal services provider or transfer of legal matters to another default legal services provider. When a mortgage servicer becomes aware of issues that might warrant a suspension of the default legal services provider, transfer of matters to another default legal services provider, or termination of the default legal services provider, the servicing guides set
forth policy for notifying the Enterprise; conducting due diligence; and implementing the suspension, termination, or matters transfer.

Risk Management

In order to manage the counterparty risk associated with mortgage servicers and directly contracted default legal services providers, the Enterprises should have the ability to identify, measure, monitor, and control the risks involved. In addition, the Enterprises should document these elements of risk management. The Enterprises have contractual agreements with default legal services providers that provide the Enterprises with important rights and remedies in the event of a failure to perform in accordance with the terms of the agreement. The Enterprises should have a well-designed and executed risk management framework that enables them to identify indicators that a third party is failing to perform at an adequate level, and to take action to protect its interests when appropriate.

Single-Family Seller/Servicer Risk Management

Default legal services providers engaged by a servicer are included as part of the Enterprise’s oversight of single-family seller/servicers. As discussed in the Managing Seller-Servicer Relationships module and FHFA’s Advisory Bulletin 2014-07 Oversight of Single-Family Seller/Service Relationships, each Enterprise is expected to have a risk management framework for the oversight of its single-family seller/servicers. As part of that framework, an Enterprise should evaluate the mortgage servicer’s management and oversight of third-party service providers, including default legal services providers, as part of the selection of the mortgage servicer as well as through ongoing monitoring procedures. The Enterprise’s risk management framework should require an evaluation of the effectiveness of a mortgage servicer’s policies and procedures for the management and oversight of its default legal services providers and the mortgage servicer’s compliance with servicing guide requirements related to default legal services providers.

Directly-Contracted Default Legal Services Provider Risk Management

Default legal services providers engaged directly by an Enterprise are included in the Enterprise’s third-party risk management program. The Third-party Relationship Management module discusses guidelines for conducting due diligence reviews on third parties, negotiating contracts with third parties, and performing ongoing monitoring of third-party relationships. The Enterprise should have policies and procedures regarding eligibility standards, contract requirements, performance measures, oversight and monitoring procedures, reporting, and termination and suspension specific to default legal services providers engaged directly by an Enterprise. The Enterprise should also have processes to make a reasonable assessment of whether its default legal services providers comply with applicable federal, state, and local law. See the Third-party Relationship Management module for further information.
Regulatory Environment

The primary laws, regulations, and references of FHFA pertaining to default legal services are listed below. Other resources that may be helpful to examiners are also listed. While not identified here, certain consumer protection laws and regulations direct the requirements and actions of default legal services providers.

Rules and Regulations Relevant to Default Legal Services:

- FHFA, Suspended Counterparty Program (12 CFR Part 1227)

FHFA Examination Resources Relevant to Default Legal Services:

- AB 2017-01: Classifications of Adverse Examination Findings (3/14/2017)
- AB-2014-02: Operational Risk Management (2/18/2014)
- AB-2012-03: FHFA Examination Rating System (12/19/2012)

Non-FHFA Examination Resources Relevant to Default Legal Services:

- Fannie Mae’s Single Family Servicing Guide, as may be amended. Available at https://www.fanniemae.com/content/guide/servicing/index.html.
Examination Workprogram

The workprogram for the examination of Default Legal Services is detailed below. Examiners are expected to develop procedures that satisfy the specific objectives of the examination activity. The procedures should support the examination workprogram and, when executed, provide sufficient evidence to support a conclusion regarding the objective. Examiners should not exclusively rely upon representations made by management or work performed by other internal or external parties to support conclusions regarding an examination objective.

Examination procedures should include testing designed to confirm that policies, processes, controls, or models operate as intended. This may be achieved through transaction testing or other testing methods. In limited circumstances, examiners may determine that testing cannot be reasonably conducted. Examples of such circumstances include cases where there is insufficient data, a program or product is too new to test, or when testing cannot be scaled to a manageable level. In these instances, examiners are expected to document in the examination procedures, with the examination manager’s approval, the rationale for not conducting testing.

An examiner may leverage testing performed by internal and external parties, such as internal or external audit functions, if (i) the testing used to support the examiner’s conclusions is clearly applicable in the scope of the examination activity, and (ii) the examiner has assessed the methodology and results of any testing that is used to support the examiner’s conclusions.

NOTE: Text in italics referenced in a workstep represents illustrative guidance that serves as suggestions for specific inquiry.

1. Scope of Examination Work Performed

1) Review workpapers from the most recent examination when the scope included a review of default legal services.

2) Assess the status or review the remediation progress based on management’s commitments of any outstanding examination findings (e.g., Matters Requiring Attention, Violations, or Recommendations) pertaining to default legal services.

3) Review internal audit or quality assurance reports for outstanding issues relating to default legal services.

4) Review for and address any applicable portions of FHFA-issued Advisory Bulletins or other examination guidance (Supervisory Directives or Examiner Practices Bulletins).
5) Access the DOC Status Tracking and Reporting (DOC STAR) system to determine whether decisions (e.g., Directives, Orders) by the Conservator impact the scope of examination work.

6) Review meeting minutes of the board of directors and relevant board and management committees for any issues related to an Enterprise’s or mortgage servicer’s oversight and management of default legal services providers.

7) Review publicly available information regarding default legal services providers.

8) Evaluate any significant changes in policy that have been implemented since the last examination or are being considered that may affect an Enterprise’s risk profile related to an Enterprise’s or a mortgage servicer’s oversight of default legal services providers.

9) Review internal management reports, watch lists, internal risk ratings and classification analyses, scorecards, and operational incidents that address an Enterprise’s or mortgage servicer’s oversight and management of default legal services providers.

10) Review complaints against authorized default legal services providers and pending litigation (if any).

11) Review external audit reports and any external consultant reports relating to default legal services providers to determine trends and emerging exposures.

12) Review instances where one Enterprise permits a servicer-selected default legal services provider and the other Enterprise does not.

13) Review Enterprise notifications to FHFA of rejection and termination of servicer-selected default legal services providers.

Summarize the work performed in the Default Legal Services workprogram. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

2. Description of Risks

Examiners should develop an understanding of existing default legal services risks at the Enterprise. This information may be obtained through a review of current and historic Enterprise risk assessments or other risk-related reports.

1) Assess whether the Enterprise is exposed to risk either through a mortgage servicer’s use of default legal services providers or when the Enterprise directly engages default legal services
providers.

2) Assess whether the Enterprise has an effective process to select, monitor, and resolve problems related to default legal services providers directly engaged by the Enterprise.

3) Assess whether the Enterprise has an effective process to oversee, monitor, and address weaknesses in a mortgage servicer’s engagement of default legal services providers.

4) Consider the adequacy of the board of directors’ and management’s level and quality of support, in their respective roles, of the Enterprise’s overall management of third-party risks.

5) Assess whether the Enterprise has processes to monitor publicly available information for adverse events involving an approved default legal services provider. Assess to what extent the Enterprise incorporates this information into its ongoing monitoring activities.

6) Assess the adequacy of the Enterprise’s contingency plans associated with default legal services providers.

3. Risk Management

Risk Identification Process

1) Based on work steps performed under Description of Risks, consider the adequacy of the Enterprise’s risk identification process with respect to default legal services and impacted business activities. (Has the Enterprise appropriately identified significant areas of potential risk resulting from the related processes? Is risk exposure managed and monitored on an ongoing basis?)

2) Determine if the Enterprise has appropriately identified, monitored, and managed the risk issues related to default legal services.

Organizational Structure

1) Identify key personnel and their primary responsibilities and technical expertise to determine if resources are effectively deployed to manage risks related to default legal services. (Does management possess the experience and required skills for their particular position?)

2) As appropriate, evaluate the segregation of duties and cross-training of personnel to determine if resources are sufficient to manage default legal services risk. (Does staff have appropriate training and experience to carry out their responsibilities within the Enterprise?)
3) Evaluate coordination among departments that cover such risk and determine whether procedures are coordinated in an efficient and effective manner.

**Policy and Procedure Development**

1) Evaluate the Enterprise’s policies, procedures, and practices for reviewing mortgage servicer compliance with servicing guide requirements and rules and regulations pertaining to default legal services. *(Have there been instances where these policies or processes have not been applied consistently? Have Enterprise personnel identified such instances? Have they taken appropriate corrective action? If inconsistent application of policies and processes did occur, did the Enterprise identify and document an appropriate reason for the inconsistency?)*

2) Evaluate the Enterprise’s policies, procedures, and practices for addressing non-compliance and weaknesses identified through monitoring of mortgage servicer performance measures, default legal services provider performance measures, results of reviews of mortgage servicer compliance with servicing guide requirements, compliance audits, or other sources of information.

3) Evaluate the Enterprise’s policies, procedures, and practices for overseeing and managing default legal services providers directly engaged by the Enterprise through all stages of the relationship’s life cycle. *(Have there been instances where these policies or processes have not been applied consistently? Have Enterprise personnel identified such instances? Have they taken appropriate corrective action? If inconsistent application of policies and processes did occur, did the Enterprise identify and document an appropriate reason for the inconsistency?)*

4) Evaluate the Enterprise’s policies, procedures, and practices for determining whether default legal services providers directly engaged by the Enterprise comply with applicable rules and regulations.

5) Determine if the Enterprise has procedures to conduct adequate due diligence and ongoing monitoring to verify whether a default legal services provider it has directly engaged has publicly known outstanding regulatory or legal issues.

**Risk Metrics**

1) Evaluate any risk metrics established related to default legal services providers’ performance *(i.e., achievement of milestones, adherence to timelines, delays, successful completion of default legal matters). *(Do the metrics consider significant aspects of potential risk to the Enterprise? Are the metrics appropriately updated?)*

2) Determine if risk metrics are consistent with sound risk management practices.
Default Legal Services

Reporting

1) Determine if reporting is comprehensive and supports appropriate monitoring of risks resulting from third parties providing default legal services.

2) Evaluate the adequacy of regularly produced management reports for inclusion of weaknesses or concerns related to default legal services providers, if appropriate. (*Are instances of non-compliance with servicing guide requirements tracked? Are issues that may result in reputational risk reported?*)

Internal/External Audit

1) For internal audits completed in the default legal services area since the previous examination, consult with the Office of the Chief Accountant (OCA) regarding any findings about the adequacy of the scope and testing performed by internal audit.

2) If there are no prior findings, select internal audits related to default legal services and determine whether or not the scope of the audit work was adequate and assess the adequacy of workpapers to support findings. (*Does the scope include an assessment of internal policies and procedures? Does the scope include testing compliance with policies? Does the scope include an evaluation of internal controls and testing of operational processes? Do the workpapers include a clear trail to conclusions? Do the workpapers identify areas for further review?*)

3) Coordinate with OCA to determine whether or not external audit performed work for default legal services risk management and whether or not OCA performed an evaluation of the adequacy of the scope and testing completed by external audit.

Information Technology

1) Identify and assess the automated and manual systems and applicable controls for supporting management of default legal services. (*Are authorities and responsibilities clearly defined? Are delegations current? Do information systems provide the information needed to make informed and timely decisions? Are authorized change processes followed as data is acquired from sub-systems?*)

2) Determine if the Enterprise has processes to backup and restore automated and manual systems supporting management of default legal services.

3) Determine if the Enterprise has developed a quality assurance framework for systems used by servicers and default legal services providers to submit data relating to default legal services activities. (*Have appropriate steps been taken to address concerns identified by management?*)
Compliance

1) Evaluate if the Enterprise has appropriately complied with pertinent regulations and adhered to regulatory guidance. *(With regard to Standard 8: Overall Risk Management Processes and Standard 9: Management of Credit and Counterparty Risk Management of 12 CFR Part 1236 Prudential Management and Operations Standards (PMOS), has the board and management appropriately identified risks associated with the managing of third parties by providing the Enterprise’s counterparties with policies and standards? Has the Enterprise’s board and management taken action to mitigate the risks? What was the underlying cause for any violation or non-adherence? Has the Enterprise strengthened internal controls to prevent recurrence?)*

2) Determine whether the efforts of the board, or a board committee, and management are appropriate to confirm adherence to policies and procedures related to the Enterprise’s default legal services-related processes. *(Have the board and management taken appropriate steps to address instances of non-adherence?)*

3) Determine whether the Enterprise’s oversight of mortgage servicer’s efforts to determine compliance with default and foreclosure-related regulations are appropriate.

4) Determine compliance with Conservatorship decisions related to default legal services.

4. Testing

Servicers Engagement of Pre-Foreclosure Default Legal Services Providers

1) Evaluate a sample of Enterprise reviews of a mortgage servicer’s oversight and monitoring of pre-foreclosure default legal services providers. Consider the following:

a) Determine if the Enterprise reviews the mortgage servicer’s policies and procedures required by the servicing guide.

b) Determine if the Enterprise is confirming that the mortgage servicer is appropriately evaluating a default legal services provider’s eligibility and adherence to servicing guide minimum requirements.

c) Determine whether the Enterprise is confirming that the mortgage servicer is complying with servicing guide requirements pertaining to providing training to the default legal services provider.

d) Determine whether the Enterprise is confirming that the mortgage servicer is complying with servicing guide requirements that pertain to initiating an investigation and
suspension and/or terminating a default legal services provider, suspending a default legal services provider’s active cases or referrals, or transferring a default legal services provider’s files.

e) Determine whether the Enterprise is confirming that the mortgage servicer is adhering to servicing guide requirements pertaining to reporting.

f) Determine whether the Enterprise is confirming that the mortgage servicer is adequately evaluating default legal services provider’s financial condition, performance, and compliance with the limited retention agreement, applicable provisions of the servicing guide, and applicable law.

2) Determine whether the Enterprise is confirming that the mortgage servicer adequately evaluates a pre-foreclosure default legal services provider’s compliance with applicable law, regulation, and professional practice in the following areas:

a) Document execution;
b) Document notarization;
c) Lost note affidavits;
d) Whistleblower mechanisms; and
e) Foreclosure documentation.

3) Determine whether the Enterprise is confirming that the mortgage servicer is evaluating whether a pre-foreclosure default legal services provider accepts matters that pose a conflict of interest that may be adverse to the Enterprise and to financial institutions.

4) Review a sample of contract agreements between the Enterprise and the default legal services provider to determine if they consider the following topics:

1) Scope of the arrangement;
2) Performance measures or benchmarks;
3) Responsibilities for providing and receiving information;
4) Cost and compensation;
5) Confidentiality and security;
6) Default and termination; and
7) Customer complaints.

5) Select a sample of recently terminated pre-foreclosure default legal services providers and determine why the mortgage servicer terminated the relationship and whether the cause for the termination was appropriate, documented, and consistent with the policies and procedures of the Enterprise.
6) Review reports from mortgage servicers that provide performance measures (i.e., achievement of milestones, adherence to timelines, delays, successful completion of default legal matters) for pre-foreclosure default legal services providers for Enterprise loans and identify indications that reflect substandard default legal services provider performance.

7) Review documentation of instances in which the Enterprise objected to the engagement of a pre-foreclosure default legal services provider the mortgage servicer certified as qualified under the Enterprise’s eligibility criteria.

Enterprise Engagement of Post-Foreclosure Default Legal Services Providers

1) Select a sample of Enterprise reviews of default legal services providers providing legal services in conjunction with the management of REO. Determine whether the reviews adequately evaluate the default legal services provider’s financial condition, quality of service, risk management practices and applicable controls, and compliance with Enterprise requirements.

2) Determine how default legal services providers are evaluated in the Enterprise’s third-party risk management framework.

General Oversight of Default Legal Services Providers

1) Review the results of the last internal audit, examination, or consultant review conducted on the Enterprise’s policies and procedures for oversight of default legal services providers. (Are there significant findings that need to be addressed? If so, how has management responded? If only certain categories of third parties were reviewed [e.g., foreclosure attorneys], were reviews performed or planned to provide adequate coverage over the most critical/significant default legal services provider reliance? If not, how does the Enterprise understand and mitigate the risk of the critical/significant default legal services provider reliance?)

5. Conclusions

1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff as it relates to the Enterprise’s management of default legal services. Develop a memorandum describing the risks to the Enterprise resulting from the risks related to default legal services and the Enterprise’s management of those risks. The memorandum should describe the basis of conclusions reached and summarize the analysis completed. Within the memorandum, discuss the types of risk the Enterprise is exposed to (e.g., market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak).
memorandum must be prepared irrespective of whether the examiner’s assessment is positive or negative.

2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the Enterprise’s response to previous examination findings and concerns.

3) Draft a conclusions letter. Findings should identify the most significant risks to the Enterprise and the potential impacts to the Enterprise resulting from the concerns identified. Significant findings should describe a specific end result that will resolve the issue. Communicate preliminary conclusions and findings, if applicable, to the EIC. Discuss conclusions and findings, if applicable, with Enterprise personnel to confirm the analysis and findings are free of factual errors.

4) Develop a list of follow-up items to evaluate during the next examination. In addition to findings developed in the steps above (if any), include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the Enterprise is in the process of addressing, but require follow-up work to confirm actions are completed appropriately. In addition, potential concerns should include anticipated changes to the Enterprise practices or anticipated external changes that could affect the Enterprise’s future oversight of default legal services practices.